General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals

International Tax Proposals

Department of the Treasury
March 2014

REFORM U.S. INTERNATIONAL TAX SYSTEM **42**
Defer Deduction of Interest Expense Related to Deferred Income of Foreign Subsidiaries *42*
Determine the Foreign Tax Credit on a Pooling Basis *44*
Tax Currently Excess Returns Associated with Transfers of Intangibles Offshore *45*
Limit Shifting of Income Through Intangible Property Transfers *47*
Disallow the Deduction for Excess Non-Taxed Reinsurance Premiums Paid to Affiliates *48*
Restrict Deductions for Excessive Interest of Members of Financial Reporting Groups. *49*
Modify Tax Rules for Dual Capacity Taxpayers *51*
Tax Gain from the Sale of a Partnership Interest on Look-Through Basis *53*
Prevent Use of Leveraged Distributions from Related Corporations to Avoid Dividend Treatment *55*
Extend Section 338(h)(16) to Certain Asset Acquisitions *56*
Remove Foreign Taxes From a Section 902 Corporation's Foreign Tax Pool When Earnings Are Eliminated *57*
Create a New Category of Subpart F Income for Transactions Involving Digital Goods or Services *58*
Prevent Avoidance of Foreign Base Company Sales Income through Manufacturing Services Arrangements *60*
Restrict the Use of Hybrid Arrangements That Create Stateless Income *61*
Limit the Application of Exceptions Under Subpart F for Certain Transactions That Use Reverse Hybrids to Create Stateless Income *62*
Limit the Ability of Domestic Entities to Expatriate *64*

REFORM TREATMENT OF FINANCIAL AND INSURANCE INDUSTRY INSTITUTIONS AND PRODUCTS **66**
Require that Derivative Contracts be Marked to Market with Resulting Gain or Loss Treated as Ordinary *66*
Modify Rules that Apply to Sales of Life Insurance Contracts *69*
Modify Proration Rules for Life Insurance Company General and Separate Accounts .. *71*
Expand Pro Rata Interest Expense Disallowance for Corporate-Owned Life Insurance *73*

ELIMINATE FOSSIL FUEL PREFERENCES **75**
Eliminate Oil and Natural Gas Preferences 75
Repeal Enhanced Oil Recovery (EOR) Credit *75*
Repeal Credit for Oil and Natural Gas Produced from Marginal Wells *76*
Repeal Expensing of Intangible Drilling Costs *77*
Repeal Deduction for Tertiary Injectants *79*
Repeal Exception to Passive Loss Limitation for Working Interests in Oil and Natural Gas Properties *80*
Repeal Percentage Depletion for Oil and Natural Gas Wells *81*
Repeal Domestic Manufacturing Deduction for Oil and Natural Gas Production *83*
Increase Geological and Geophysical Amortization Period for Independent Producers to Seven Years *84*
Eliminate Coal Preferences 85
Repeal Expensing of Exploration and Development Costs *85*
Repeal Percentage Depletion for Hard Mineral Fossil Fuels *87*

REFORM U.S. INTERNATIONAL TAX SYSTEM

DEFER DEDUCTION OF INTEREST EXPENSE RELATED TO DEFERRED INCOME OF FOREIGN SUBSIDIARIES

Current Law

Taxpayers generally may deduct ordinary and necessary expenses paid or incurred in carrying on any trade or business. The Internal Revenue Code and the regulations thereunder contain detailed rules regarding allocation and apportionment of expenses for computing taxable income from sources within and without the United States. Under current rules, a U.S. person that incurs interest expense properly allocable and apportioned to foreign-source income may deduct those expenses even if the expenses exceed the taxpayer's gross foreign-source income or if the taxpayer earns no foreign-source income. For example, a U.S. person that incurs debt to acquire stock of a foreign corporation is generally permitted to deduct currently the interest expense from the acquisition indebtedness even if no income is derived currently from such stock. Current law includes provisions that may require a U.S. person to recapture as U.S.-source income the amount by which foreign-source expenses exceed foreign-source income for a taxable year. However, if in a taxable year the U.S. person earns sufficient foreign-source income of the same statutory grouping in which the stock of the foreign corporation is classified, expenses, such as interest expense, properly allocated and apportioned to the stock of the foreign corporation may not be subject to recapture in a subsequent taxable year.

Reasons for Change

The ability to deduct expenses from overseas investments while deferring U.S. tax on the income from the investment may cause U.S. businesses to shift their investments and jobs overseas, harming the domestic economy.

Proposal

The proposal would defer the deduction of interest expense that is properly allocated and apportioned to stock of a foreign corporation that exceeds an amount proportionate to the taxpayer's pro rata share of income from such subsidiaries that is currently subject to U.S. tax. Under the proposal, foreign-source income earned by a taxpayer through a branch would be considered currently subject to U.S. tax; thus, the proposal would not apply to interest expense properly allocated and apportioned to such income. Other directly earned foreign source income (for example, royalty income) would be similarly treated.

For purposes of the proposal, the amount of a taxpayer's interest expense that is properly allocated and apportioned to stock of a foreign corporation would generally be determined under the principles of current Treasury regulations. The Treasury Department, however, will continue to revise existing Treasury regulations and propose such other statutory changes as necessary to prevent inappropriate decreases in the amount of interest expense that is allocated and apportioned to foreign-source income.

Interest expense that is deferred under the proposal would be deductible in a subsequent tax year to the extent that the amount of interest expense allocated and apportioned to stock of foreign subsidiaries in such subsequent year is less than the annual limitation for that year. Treasury regulations may modify the manner in which a taxpayer can deduct previously deferred interest expenses in certain cases.

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

DETERMINE THE FOREIGN TAX CREDIT ON A POOLING BASIS

Current Law

Section 901 provides that, subject to certain limitations, a taxpayer may choose to claim a credit against its U.S. income tax liability for income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or any possession of the United States. Under section 902, a domestic corporation is deemed to have paid the foreign taxes paid by certain foreign subsidiaries from which it receives a dividend (the deemed paid foreign tax credit). The foreign tax credit is limited to an amount equal to the pre-credit U.S. tax on the taxpayer's foreign-source income. This foreign tax credit limitation is applied separately to foreign-source income in each of the separate categories described in section 904(d)(1), i.e., the passive category and general category.

Reasons for Change

The purpose of the foreign tax credit is to mitigate the potential for double taxation when U.S. taxpayers are subject to foreign taxes on their foreign-source income. The reduction to two foreign tax credit limitation categories, for passive category income and general category income under the American Jobs Creation Act of 2004, enhanced U.S. taxpayers' ability to reduce the residual U.S. tax on foreign-source income through "cross-crediting."

Proposal

The proposal would require a U.S. taxpayer to determine its deemed paid foreign tax credit on a consolidated basis taking into account 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 (including lower tier subsidiaries described in section 902(b)). The deemed paid foreign tax credit for a taxable year would be limited to an amount proportionate to the taxpayer's pro rata share of the consolidated earnings and profits of the foreign subsidiaries repatriated to the U.S. taxpayer in that taxable year that are currently subject to U.S. tax. Foreign taxes deferred under this proposal in prior years would be creditable in a subsequent taxable year to the extent that the amount of deemed paid foreign taxes in the current year are less than the annual limitation for that year. The Secretary would be granted authority to issue any Treasury regulations necessary to carry out the purposes of the proposal.

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

TAX CURRENTLY EXCESS RETURNS ASSOCIATED WITH TRANSFERS OF INTANGIBLES OFFSHORE

Current Law

Section 482 authorizes the Secretary to distribute, apportion, or allocate gross income, deductions, credits, and other allowances between or among two or more organizations, trades, or businesses under common ownership or control whenever "necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses." The regulations under section 482 provide that the standard to be applied is that of unrelated persons dealing at arm's length. In the case of transfers of intangible assets, section 482 further provides that the income with respect to the transaction must be commensurate with the income attributable to the transferred intangible assets.

In general, the subpart F rules (sections 951-964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation (CFC) to include currently in income for U.S. tax purposes their pro rata share of certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is actually distributed to the shareholders. 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 corporation's voting stock.

Subpart F income consists of foreign base company income, insurance income, and certain income relating to international boycotts and other proscribed activities. Foreign base company income consists of foreign personal holding company income (which includes passive income such as dividends, interest, rents, royalties, and annuities) and other categories of income from business operations, including foreign base company sales income, foreign base company services income, and foreign base company oil-related income.

A foreign tax credit is generally available for foreign income taxes paid by a CFC to the extent that the CFC's income is taxed to a U.S. shareholder under subpart F, subject to the limitations set forth in section 904.

Reasons for Change

The potential tax savings from transactions between related parties, especially with regard to transfers of intangible assets to low-taxed affiliates, puts significant pressure on the enforcement and effective application of transfer pricing rules. There is evidence indicating that income shifting through transfers of intangibles to low-taxed affiliates has resulted in a significant erosion of the U.S. tax base. Expanding subpart F to include excess income from intangibles transferred to low-taxed affiliates will reduce the incentive for taxpayers to engage in these transactions.

Proposal

The proposal would provide that if a U.S. person transfers (directly or indirectly) an intangible asset from the United States to a related CFC (a "covered intangible"), then certain excess income from transactions connected with or benefitting from the covered intangible would be treated as subpart F income if the income is subject to a low foreign effective tax rate. In the case of an effective tax rate of 10 percent or less, the proposal would treat all excess income as subpart F income, and would then phase out ratably for effective tax rates of 10 to 15 percent. For this purpose, excess intangible income would be defined as the excess of gross income from transactions connected with or benefitting from such covered intangible over the costs (excluding interest and taxes) properly allocated and apportioned to this income increased by a percentage mark-up. For purposes of this proposal, the transfer of an intangible asset includes by sale, lease, license, or through any shared risk or development agreement (including any cost sharing arrangement)). This subpart F income will be a separate category of income for purposes of determining the taxpayer's foreign tax credit limitation under section 904.

The proposal would be effective for transactions in taxable years beginning after December 31, 2014.

LIMIT SHIFTING OF INCOME THROUGH INTANGIBLE PROPERTY TRANSFERS

Current Law

The Secretary may distribute, apportion, or allocate gross income, deductions, credits, and other allowances between or among two or more organizations, trades, or businesses under common ownership or control whenever "necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses" (section 482). In the case of transfers of intangible property (as defined in section 936(h)(3)(B)), section 482 also provides that the income with respect to the transaction must be commensurate with the income attributable to the transferred intangible property. Further, under section 367(d), if a U.S. person transfers intangible property (as defined in section 936(h)(3)(B)) to a foreign corporation in a transaction that would otherwise be tax-free under section 351 or section 361, the U.S. person is treated as (i) having sold such property in exchange for payments which are contingent upon the productivity, use, or disposition of the property, and (ii) receiving amounts which reasonably reflect the amounts which would have been received annually in the form of such payments over the useful life of the property, or, in the case of a disposition following such transfer, at the time of the disposition. The amounts taken into account shall be commensurate with the income attributable to the intangible. Finally, under the regulations issued pursuant to section 367(e)(2), if a U.S. subsidiary corporation transfers intangible property (as defined in section 936(h)(3)(B)) to a foreign parent corporation in an otherwise tax-free liquidation described in section 332, the U.S. subsidiary must recognize gain upon the distribution of such property.

Reasons for Change

Controversy often arises concerning the value of intangible property transferred between related persons and the scope of the intangible property subject to sections 482 and 367. This lack of clarity may result in the inappropriate avoidance of U.S. tax and misuse of the rules applicable to transfers of intangible property to foreign persons.

Proposal

The proposal would provide that the definition of intangible property under section 936(h)(3)(B) (and therefore for purposes of sections 367 and 482) also includes workforce in place, goodwill, and going concern value, and any other item owned or controlled by a taxpayer that is not a tangible or financial asset and that has substantial value independent of the services of any individual. The proposal also would clarify that where multiple intangible properties are transferred, or where intangible property is transferred with other property or services, the Commissioner may value the properties or services on an aggregate basis where that achieves a more reliable result. In addition, the proposal would clarify that the Commissioner may value intangible property taking into consideration the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken.

The proposal would be effective for taxable years beginning after December 31, 2014. No inference is intended regarding the scope of intangible property included in section 936(h)(3)(B) under current law.

DISALLOW THE DEDUCTION FOR EXCESS NON-TAXED REINSURANCE PREMIUMS PAID TO AFFILIATES

Current Law

Insurance companies are generally allowed a deduction for premiums paid for reinsurance. If the reinsurance transaction results in a transfer of reserves and reserve assets to the reinsurer, potential tax liability for earnings on those assets is generally shifted to the reinsurer as well. While insurance income of a controlled foreign corporation is generally subject to current U.S. taxation, insurance income of a foreign-owned foreign company that is not engaged in a trade or business in the United States is not subject to U.S. income tax. Reinsurance policies issued by foreign reinsurers with respect to U.S. risks are generally subject to an excise tax equal to one percent of the premiums paid, unless waived by treaty.

Reasons for Change

Reinsurance transactions with affiliates that are not subject to U.S. federal income tax on insurance income can result in substantial U.S. tax advantages over similar transactions with entities that are subject to tax in the United States. The excise tax on reinsurance policies issued by foreign reinsurers is not always sufficient to offset this tax advantage. These tax advantages create an inappropriate incentive for foreign-owned domestic insurance companies to reinsure U.S. risks with foreign affiliates.

Proposal

The proposal would (1) deny an insurance company a deduction for premiums and other amounts paid to affiliated foreign companies with respect to reinsurance of property and casualty risks to the extent that the foreign reinsurer (or its parent company) is not subject to U.S. income tax with respect to the premiums received; and (2) would exclude from the insurance company's income (in the same proportion in which the premium deduction was denied) any return premiums, ceding commissions, reinsurance recovered, or other amounts received with respect to reinsurance policies for which a premium deduction is wholly or partially denied.

A foreign corporation that is paid a premium from an affiliate that would otherwise be denied a deduction under this proposal would be permitted to elect to treat those premiums and the associated investment income as income effectively connected with the conduct of a trade or business in the United States and attributable to a permanent establishment for tax treaty purposes. For foreign tax credit purposes, reinsurance income treated as effectively connected under this rule would be treated as foreign source income and would be placed into a separate category within section 904.

The provision would be effective for policies issued in taxable years beginning after December 31, 2014.

RESTRICT DEDUCTIONS FOR EXCESSIVE INTEREST OF MEMBERS OF FINANCIAL REPORTING GROUPS

Current Law

Business interest payments generally are deductible from taxable income while dividend payments are not deductible. An exception to this general rule is section 163(j), which denies U.S. tax deductions for interest paid by a corporation to a related party when (1) the corporation's debt-equity ratio exceeds 1.5, and (2) net interest expense exceeds 50 percent of the corporation's adjusted taxable income (computed by adding back net interest expense, depreciation, amortization, depletion, and any net operating loss deduction, and any deduction for domestic production activities under section 199). Disallowed interest expense may be carried forward indefinitely for deduction in a subsequent year. In addition, the corporation's excess limitation for a tax year (*i.e.*, the amount by which 50 percent of adjusted taxable income exceeds net interest expense) may be carried forward to the three subsequent tax years.

Reasons for Change

The fungibility of money makes it easy to adjust the mix of debt and equity in a controlled entity, making the use of debt one of the simplest techniques available to multinational groups for shifting profits to lower tax jurisdictions. Although section 163(j) places a cap on the amount of interest expense a corporation can deduct relative to its U.S. earnings, section 163(j) does not consider the leverage of a multinational group's U.S. operations relative to the leverage of the group's worldwide operations. Therefore, under current law, multinational groups are able to inappropriately reduce their U.S. tax on income earned from U.S. operations by over-leveraging their U.S. operations relative to those located in lower tax jurisdictions. The Administration has included a separate proposal, *Defer Deduction of Interest Expense Related to Deferred Income*, in the Administration's Fiscal Year 2015 Revenue Proposals, to address this concern for U.S.-parented groups by denying current deductions for interest expense that is properly allocated and apportioned based on fungibility principles to the deferred foreign earnings of non-U.S. members of the group. Nonetheless, opportunities remain for foreign-parented multinationals to disproportionately leverage the operations of a U.S. subgroup.

Proposal

The proposal generally would apply to an entity that is a member of a group that prepares consolidated financial statements ("financial reporting group") in accordance with U.S. Generally Accepted Accounting Principles ("GAAP"), International Financial Reporting Standards ("IFRS"), or other method authorized by the Secretary of the Treasury under regulations. Under the proposal, a member's U.S. interest expense deduction generally would be limited to the member's interest income plus the member's proportionate share of the financial reporting group's net interest expense computed under U.S. income tax principles. A member's proportionate share of the financial reporting group's net interest expense would be determined based on the member's proportionate share of the group's earnings (computed by adding back net interest expense, taxes, depreciation, and amortization) reflected in the group's financial statements. If a member fails to substantiate the member's proportionate share of the group's net interest expense, or a member so elects, the member's interest deduction would be limited to 10 percent of the member's adjusted taxable income (as defined under section 163(j)). Regardless of whether a taxpayer computes the interest limitation under the proportionate share approach or using the ten-percent alternative, disallowed interest would be carried forward indefinitely and any excess limitation for a tax year would be carried forward to the three subsequent tax years. A member of a financial reporting group that is subject to the proposal would be exempt from the application of section 163(j).

U.S. subgroups would be treated as a single member of a financial reporting group for purposes of applying the proposal. For this purpose, a U.S. subgroup is defined as any U.S. entity that is not owned directly or indirectly by another U.S. entity, and all members (domestic or foreign) that are owned directly or indirectly by such entity. If a U.S. member of a U.S. subgroup owns stock of one or more foreign corporations, this proposal would apply before the Administration's proposal that defers the deduction of interest expense allocable to deferred foreign earnings. The U.S. subgroup's interest expense that remains currently deductible after the application of this proposal would then be subject to deferral to the extent such remaining U.S. interest expense is allocable to deferred foreign earnings.

The proposal would not apply to financial services entities, and such entities would be excluded from the financial reporting group for purposes of applying the proposal to other members of the financial reporting group. The proposal also would not apply to financial reporting groups that would otherwise report less than $5 million of net interest expense, in the aggregate, on one or more U.S. income tax returns for a taxable year. Entities that are exempt from this proposal would remain subject to section 163(j).

The Secretary would be granted authority to issue any Treasury regulations necessary to carry out the purposes of the proposal, including coordinating the application of the proposal with other interest deductibility rules, defining financial services entities, permitting financial reporting groups to compute the group's non-U.S. net interest expense without making certain adjustments required under U.S. income tax principles, and providing for the treatment of pass-through entities. In addition, if a financial reporting group does not prepare financial statements under U.S. GAAP or IFRS, it is expected that regulations generally would allow the use of financial statements prepared under other countries' generally accepted accounting principles in appropriate circumstances.

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

MODIFY TAX RULES FOR DUAL CAPACITY TAXPAYERS

Current Law

Section 901 provides that, subject to certain limitations, a taxpayer may choose to claim a credit against its U.S. income tax liability for income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or any possession of the United States.

To be a creditable tax, a foreign levy must be substantially equivalent to an income tax under United States tax principles, regardless of the label attached to the levy under law. Under current Treasury regulations, a foreign levy is a tax if it is a compulsory payment under the authority of a foreign government to levy taxes and is not compensation for a specific economic benefit provided by the foreign country. Taxpayers that are subject to a foreign levy and that also receive a specific economic benefit from the levying country (dual capacity taxpayers) may not credit the portion of the foreign levy paid for the specific economic benefit. The current Treasury regulations provide that, if a foreign country has a generally-imposed income tax, the dual capacity taxpayer may treat as a creditable tax the portion of the levy that application of the generally imposed income tax would yield (provided that the levy otherwise constitutes an income tax or an in lieu of tax). The balance of the levy is treated as compensation for the specific economic benefit. If the foreign country does not generally impose an income tax, the portion of the payment that does not exceed the applicable federal tax rate applied to net income is treated as a creditable tax. A foreign tax is treated as generally imposed even if it applies only to persons who are not residents or nationals of that country.

There is no separate section 904 foreign tax credit limitation category for oil and gas income. However, under section 907, the amount of creditable foreign taxes imposed on foreign oil and gas income is limited in any year to the applicable U.S. tax on that income.

Reasons for Change

The purpose of the foreign tax credit is to mitigate double taxation of income by the United States and a foreign country. When a payment is made to a foreign country in exchange for a specific economic benefit, there is no double taxation. Current law recognizes the distinction between a payment of creditable taxes and a payment in exchange for a specific economic benefit but fails to achieve the appropriate split between the two when a single payment is made in a case where, for example, a foreign country imposes a levy only on oil and gas income, or imposes a higher levy on oil and gas income as compared to other income.

Proposal

The proposal would allow a dual capacity taxpayer to treat as a creditable tax the portion of a foreign levy that does not exceed the foreign levy that the taxpayer would pay if it were not a dual-capacity taxpayer. The proposal would replace the current regulatory provisions, including the safe harbor, that apply to determine the amount of a foreign levy paid by a dual-capacity taxpayer that qualifies as a creditable tax. The proposal also would convert the special foreign tax credit limitation rules of section 907 into a separate category within section 904 for foreign oil and gas income. The aspect of the proposal that would determine the amount of a foreign levy paid by a dual-capacity taxpayer that qualifies as a creditable tax would yield to United States treaty obligations to the extent that they explicitly allow a credit for taxes paid or accrued on certain oil or gas income.

The aspect of the proposal that would determine the amount of a foreign levy paid by a dual-capacity taxpayer that qualifies as a creditable tax would be effective for amounts that, if such amounts were an amount of tax paid or accrued, would be considered paid or accrued in taxable years beginning after December 31, 2014. The aspect of the proposal that would convert the special foreign tax credit limitation rules of section 907 into a separate category within section 904 would be effective for taxable years beginning after December 31, 2014.

TAX GAIN FROM THE SALE OF A PARTNERSHIP INTEREST ON LOOK-THROUGH BASIS

Current Law

In general, the sale or exchange of a partnership interest is treated as the sale or exchange of a capital asset. Capital gains of a nonresident alien individual or foreign corporation generally are subject to federal income tax only if the gains are or are treated as income that is effectively connected with the conduct of a trade or business in the United States (Effectively Connected Income (ECI)). Section 875(1) provides that a nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged. Revenue Ruling 91-32 holds that gain or loss of a nonresident alien individual or foreign corporation from the sale or exchange of a partnership interest is effectively connected with the conduct of a trade or business in the United States to the extent of the partner's distributive share of unrealized gain or loss of the partnership that is attributable to property used or held for use in the partnership's trade or business within the United States (ECI property). A partnership may elect under section 754 to adjust the basis of its assets upon the transfer of an interest in the partnership to reflect the transferee partner's basis in the partnership interest.

Reasons for Change

Nonresident alien individuals and foreign corporations may take a position contrary to the holding of Revenue Ruling 91-32, arguing that gain from the sale of a partnership interest is not subject to federal income taxation because no Internal Revenue Code (Code) provision explicitly provides that gain from the sale or exchange of a partnership interest by a nonresident alien individual or foreign corporation is treated as ECI. If the partnership has in effect an election under section 754, the partnership's basis in its assets is also increased, thereby preventing that gain from being taxed in the future.

Proposal

The proposal would provide that gain or loss from the sale or exchange of a partnership interest is effectively connected with the conduct of a trade or business in the United States to the extent attributable to the transferor partner's distributive share of the partnership's unrealized gain or loss that is attributable to ECI property. The Secretary would be granted authority to specify the extent to which a distribution from the partnership is treated as a sale or exchange of an interest in the partnership and to coordinate the new provision with the nonrecognition provisions of the Code.

In addition, the transferee of a partnership interest would be required to withhold 10 percent of the amount realized on the sale or exchange of a partnership interest unless the transferor certified that the transferor was not a nonresident alien individual or foreign corporation. If a transferor provided a certificate from the Internal Revenue Service that established that the transferor's federal income tax liability with respect to the transfer was less than 10 percent of the amount realized, the transferee would withhold such lesser amount. If the transferee failed to withhold the correct amount, the partnership would be liable for the amount of underwithholding, and would satisfy the withholding obligation by withholding on future distributions that otherwise would have gone to the transferee partner.

The proposal would be effective for sales or exchanges after December 31, 2014.

PREVENT USE OF LEVERAGED DISTRIBUTIONS FROM RELATED CORPORATIONS TO AVOID DIVIDEND TREATMENT

Current Law

Section 301 provides rules for characterizing a distribution of property by a corporation to a shareholder. The amount of the distribution is first treated as a dividend to the extent of the distributing corporation's applicable earnings and profits. To the extent the amount of the distribution exceeds the distributing corporation's applicable earnings and profits, the excess amount is treated as a reduction in the shareholder's adjusted tax basis in the stock of the distributing corporation, and then any remaining excess is treated by the shareholder as gain from the sale or exchange of property. For these purposes, a corporation generally calculates its earnings and profits on a stand-alone basis, with special rules for consolidated groups.

Reasons for Change

Under current law, the earnings and profits of a foreign corporation can be repatriated without being characterized as a dividend by having such corporation fund a distribution from a second, related foreign corporation that does not have earnings and profits, but in which the distributee shareholder has sufficient tax basis to characterize the distribution (in whole or substantial part) as a return of stock basis under the ordering rules of section 301. Similarly, the earnings and profits of a domestic corporation also can be distributed in such a manner to a shareholder that has sufficient tax basis.

Proposal

The proposal would provide that to the extent a corporation (the "funding corporation") funds a second, related corporation (the "distributing corporation") with a principal purpose of avoiding dividend treatment on distributions to a U.S. shareholder, the U.S. shareholder's basis in the stock of the distributing corporation will not be taken into account for the purpose of determining the treatment of the distribution under section 301. For this purpose, the funding corporation and the distributing corporation are related if they are members of a controlled group within the meaning of section 1563(a), but replacing the reference to "at least 80 percent" with "more than 50 percent." Funding transactions to which the proposal would apply include capital contributions, loans, or distributions to the distributing corporation, whether the funding transaction occurs before or after the distribution.

The proposal would be effective for distributions made after December 31, 2014.

EXTEND SECTION 338(h)(16) TO CERTAIN ASSET ACQUISITIONS

Current Law

A corporation that makes a qualified stock purchase of a target corporation is permitted to elect under section 338 (section 338 election) to treat the stock acquisition as an asset acquisition, thereby stepping up the tax basis of the target corporation's assets. For this purpose, a qualified stock purchase is any transaction or series of transactions in which the purchasing corporation acquires 80 percent of the stock of the target corporation. Section 338(h)(16) provides that (subject to certain exceptions) the deemed asset sale resulting from a section 338 election is not treated as occurring for purposes of determining the source or character of any item for purpose of applying the foreign tax credit rules to the seller. Instead, for these purposes, the gain is generally treated by the seller as gain from the sale of the stock. Thus, section 338(h)(16) prevents a seller from increasing allowable foreign tax credits as a result of a section 338 election.

Section 901(m) denies a credit for certain foreign taxes paid or accrued after a covered asset acquisition (CAA). A CAA includes a section 338 election made with respect to a qualified stock purchase as well as other transactions that are treated as asset acquisitions for U.S. tax purposes but the acquisition of an interest in an entity for foreign tax purposes.

Reasons for Change

Section 338(h)(16) applies to a qualified stock purchase for which a section 338 election is made, but it does not apply to the other types of CAAs subject to the credit disallowance rules under section 901(m). These other types of CAAs present the same foreign tax credit concerns as those addressed by section 338(h)(16) in the case of a qualified stock purchase for which a section 338 election is made.

Proposal

The proposal would extend the application of section 338(h)(16) to any CAA, within the meaning of section 901(m). The Secretary would be granted authority to issue any Treasury regulations necessary to carry out the purposes of the proposal.

The proposal would apply to CAAs occurring after December 31, 2014.

REMOVE FOREIGN TAXES FROM A SECTION 902 CORPORATION'S FOREIGN TAX POOL WHEN EARNINGS ARE ELIMINATED

Current Law

Sections 902 and 960 provide that a domestic corporation owning at least 10 percent of the voting stock of a foreign corporation is allowed a credit for foreign taxes paid by a foreign corporation if the domestic corporation receives a dividend distribution from the foreign corporation or an income inclusion under subpart F that is treated as a dividend for purposes of section 902. Regulations under section 367(b) provide rules for the allocation of earnings and profits and foreign taxes of a foreign corporation in transactions described in section 381.

Certain transactions result in a reduction, allocation, or elimination of a corporation's earnings and profits other than by reason of a dividend or by reason of section 381 (generally providing that earnings and profits and other tax attributes of a target corporation carry over to an acquiring corporation in a tax-free restructuring transaction). For example, if a corporation redeems a portion of its stock and the redemption is treated as a sale or exchange, there is a reduction in the earnings and profits (if any) of the redeeming corporation (see section 312(n)(7)). As another example, certain section 355 distributions can result in the reduction of the distributing corporation's earnings and profits (see section 312(h) and the regulations thereunder).

Reasons for Change

The reduction, allocation, or elimination of a corporation's earnings and profits in a transaction without a corresponding reduction in the corporation's associated foreign taxes paid would result in a corporate shareholder of the corporation claiming an indirect credit under section 902 for foreign taxes paid with respect to earnings that will no longer fund a dividend distribution for U.S. tax purposes.

Proposal

The proposal would reduce the amount of foreign taxes paid by a foreign corporation in the event a transaction results in the reduction, allocation, or elimination of a foreign corporation's earnings and profits other than a reduction by reason of a dividend or a section 381 transaction. The amount of foreign taxes that would be reduced in such a transaction would equal the amount of foreign taxes associated with such earnings and profits.

The proposal would be effective for transactions occurring after December 31, 2014. No inference is intended regarding the determination of the amount of foreign taxes deemed paid under current law.

CREATE A NEW CATEGORY OF SUBPART F INCOME FOR TRANSACTIONS INVOLVING DIGITAL GOODS OR SERVICES

Current Law

Internal Revenue Code (Code) sections 952 and 954 describe certain categories of income that, when earned by a controlled foreign corporation (CFC), are currently included in the income of United States shareholders of that CFC as subpart F income under Code section 951. These categories include "foreign base company income", which includes foreign personal holding company income, foreign base company sales income, and foreign base company services income. Foreign personal holding company income generally includes rents and royalties other than those derived in the active conduct of a trade or business and received from a person other than a related person. Foreign base company sales income generally includes income earned in connection with a purchase and subsequent sale of personal property where such property is purchased from (or on behalf of), or sold to (or on behalf of), a related person, provided the property is manufactured outside of the CFC's country of organization and sold for use or consumption outside that country. Foreign base company services income generally includes income earned in connection with the performance of certain services performed outside of the CFC's country of organization for or on behalf of a related person. All these categories of subpart F income are intended to ensure that tax is not deferred on income that is not generated by an active trade or business of the CFC.

Digital transactions involving copyrighted articles can take the form of leases, sales, or services. For example, a transaction involving a transfer of a computer program (i.e., a copyrighted article) could be characterized as a sale or lease of the computer program, depending on the facts and circumstances concerning the benefits and burdens of ownership with respect to the computer program. A computer program hosted on a server also might be used in a transaction characterized as the provision of a service to a user who accesses the server from a remote location.

Reasons for Change

The existing categories of subpart F income do not adequately address mobile income earned from providing digital goods and services. By choosing different forms for substantially similar transactions involving digital goods and services (leases, sales, or services), taxpayers may be able to avoid the application of the existing subpart F rules. In this regard, the subpart F rules, which are generally intended to require current U.S. taxation of passive and highly mobile income, have not kept pace with advances in technology. This shortcoming enables CFCs to shift income related to digital goods and services to low-tax jurisdictions, in many cases eroding the U.S. tax base. For example, a CFC may be able to conduct business with remotely-located customers through the "cloud" using intangible property acquired from a related party and without conducting any substantial business activities of its own.

Proposal

The proposal would create a new category of subpart F income, foreign base company digital income, which generally would include income of a CFC from the lease or sale of a digital copyrighted article or from the provision of a digital service, in cases where the CFC uses intangible property developed by a related party (including property developed pursuant to a cost sharing arrangement) to produce the income and the CFC does not, through its own employees, make a substantial contribution to the development of the property or services that give rise to the income. An exception would apply where the CFC earns income directly from customers located in the CFC's country of incorporation that use or consume the digital copyrighted article or digital service in such country.

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

PREVENT AVOIDANCE OF FOREIGN BASE COMPANY SALES INCOME THROUGH MANUFACTURING SERVICES ARRANGEMENTS

Current Law

Section 954 describes certain categories of foreign base company income that, when earned by a controlled foreign corporation (CFC), are currently included in the income of United States shareholders of that CFC as subpart F income under section 951. One category of foreign base company income, foreign base company sales income, generally includes income earned in connection with a purchase and subsequent sale of personal property where such property is purchased from (or on behalf of), or sold to (or on behalf of), a related person, provided the property is manufactured outside of the CFC's country of organization and sold for use or consumption outside that country. Another category of foreign base company income, foreign base company services income, generally includes income earned in connection with the performance of certain services outside of the CFC's country of organization where such services are performed for or on behalf of a related person.

Reasons for Change

In order for the foreign base company sales income rules of subpart F to apply, a CFC generally must engage in both a purchase and subsequent sale of personal property where such property is either purchased from, or sold to, a related person. Under current law, taxpayers take the position that a CFC can avoid foreign base company sales income by structuring the related party transaction by which the CFC obtains the property that the CFC sells to customers as the provision of a manufacturing service to the CFC rather than as a purchase of the property by the CFC. In some cases, taxpayers take this position with respect to property produced in the United States on behalf of a related CFC. The policy concerns that underlie the foreign base company sales income rules, including concerns about U.S. base erosion, apply with respect to income earned by a CFC from the sale of property produced by a related party, regardless of whether the CFC is characterized as obtaining the property through a purchase transaction or through a manufacturing service.

Proposal

The proposal would expand the category of foreign base company sales income to include income of a CFC from the sale of property manufactured on behalf of the CFC by a related person. The existing exceptions to foreign base company sales income would continue to apply.

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

RESTRICT THE USE OF HYBRID ARRANGEMENTS THAT CREATE STATELESS INCOME

Current Law

Subject to certain exceptions and limitations, interest and royalty payments made or incurred in carrying on a trade or business are generally deductible under current law without regard to the tax treatment of such payments in other jurisdictions.

Reasons for Change

There has been a proliferation of tax avoidance techniques involving a variety of cross-border hybrid arrangements, such as hybrid entities, hybrid instruments, and hybrid transfers (such as a sales-repurchase or "repo" transaction, in which the parties take inconsistent positions in respect of the ownership of the same property). Such arrangements enable taxpayers to claim deductions in the United States without corresponding inclusions in the payee's tax jurisdiction, resulting in income that is not subject to tax in any jurisdiction ("stateless income"). Taxpayers may also use arrangements involving hybrid entities to claim multiple deductions for the same payment in different jurisdictions.

Proposal

The proposal would deny deductions for interest and royalty payments made to related parties under certain circumstances involving hybrid arrangements. For example, the proposal would deny a deduction in the United States when a taxpayer makes an interest or royalty payment to a related party, and either (i) as a result of the hybrid arrangement, there is no corresponding inclusion to the recipient in the foreign jurisdiction or (ii) the hybrid arrangement would permit the taxpayer to claim an additional deduction for the same payment in another jurisdiction.

The Secretary would be granted authority to issue any Treasury regulations necessary to carry out the purposes of this proposal, including regulations that would (1) deny deductions from certain conduit arrangements that involve a hybrid arrangement between at least two of the parties to the arrangement; (2) deny interest or royalty deductions arising from certain hybrid arrangements involving unrelated parties in appropriate circumstances, such as structured transactions; and (3) deny all or a portion of a deduction claimed with respect to an interest or royalty payment that, as a result of the hybrid arrangement, is subject to inclusion in the recipient's jurisdiction pursuant to a preferential regime that has the effect of reducing the generally applicable statutory rate by at least 25 percent.

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

LIMIT THE APPLICATION OF EXCEPTIONS UNDER SUBPART F FOR CERTAIN TRANSACTIONS THAT USE REVERSE HYBRIDS TO CREATE STATELESS INCOME

Current Law

In general, U.S. multinational companies do not pay current U.S. tax on the profits earned by their foreign subsidiaries (referred to as controlled foreign corporations, or CFCs). Under current law, the rules of subpart F (sections 951-964) provide a limited exception to this general rule, by requiring certain U.S. shareholders of CFCs to include in their income on a current basis certain narrowly defined categories of income of the CFC (referred to as "subpart F income"), regardless of whether the income is distributed to the shareholders. Subpart F income includes passive items of income such as dividends, interest, rents and royalties.

There is an exception from subpart F income for certain dividend and interest income received from a related corporation created or organized and operating in the same country as the CFC receiving the income (the same-country exception in section 954(c)(3)). In addition, the same-country exception provides that certain rents and royalties received from a related corporation for the use of property within the country under the laws of which the CFC receiving the income is created or organized are not included in subpart F income. There also was a temporary provision (section 954(c)(6))that provided another exception to subpart F income (the look-through exception) for certain dividends, interest, rents and royalties received from a related CFC to the extent such income is attributable or properly allocable to income of the related CFC that is neither subpart F income nor income effectively connected with the conduct of a trade or business within the United States. The look-through exception expired on December 31, 2013.

Reasons for Change

There has been a proliferation of tax avoidance techniques involving a variety of cross-border hybrid arrangements. In one such arrangement, a U.S. person holds an interest in a reverse hybrid, which is an entity that is a corporation for U.S. tax purposes but is a fiscally transparent entity (such as a partnership) or a branch under the laws of a foreign jurisdiction. Because the U.S. treats the reverse hybrid as a corporation, income earned by the reverse hybrid generally will not be subject to current U.S. tax. Moreover, even if the reverse hybrid is treated as a CFC, interest and royalty income earned by the reverse hybrid from certain foreign related persons (which otherwise would qualify as subpart F income) may nonetheless not be subject to current U.S. taxation as a result of either section 954(c)(3) or section 954(c)(6). Payments to the reverse hybrid, however, generally are also not subject to tax in the foreign jurisdiction in which it is established or organized, because the foreign jurisdiction views the reverse hybrid as a fiscally transparent entity and therefore treats that entity's income as derived by its owners, including its U.S. owners. As a result of this hybrid treatment, income earned by the reverse hybrid generally would not be subject to tax currently in either the United States or the foreign jurisdiction.

Proposal

The proposal would provide that sections 954(c)(3) and 954(c)(6) do not apply to payments made to a foreign reverse hybrid held directly by a U.S. owner when such amounts are treated as deductible payments received from foreign related persons.

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

LIMIT THE ABILITY OF DOMESTIC ENTITIES TO EXPATRIATE

Current Law

Section 7874 applies to certain transactions (known as "inversion transactions") in which a U.S. corporation (an expatriated entity) is replaced by a foreign corporation ("foreign acquiring corporation") as the parent company of a worldwide affiliated group of companies. Section 7874 generally provides that certain adverse tax consequences apply if (i) substantially all of the assets of a domestic corporation are acquired by a foreign acquiring corporation; (ii) the historical owners of the domestic corporation retain a sufficient ownership interest in the foreign acquiring corporation (i.e., at least 60 percent); and (iii) the foreign acquiring corporation, together with the affiliated group that includes the foreign acquiring corporation, does not conduct substantial business activities in the country in which it is created or organized. Similar provisions apply if a foreign acquiring corporation acquires substantially all of the properties constituting a trade or business of a domestic partnership.

The resulting U.S. tax consequences depend on the level of shareholder continuity. If the continuing ownership of historical shareholders of the domestic corporation in the foreign acquiring corporation is 80 percent or more (by vote or value), the new foreign parent corporation is treated as a domestic corporation for all U.S. tax purposes (the "80-percent test"). If the continuing shareholder ownership is at least 60 percent but less than 80 percent, the foreign status of the acquiring corporation is respected but certain other adverse tax consequences apply, including the inability to use tax attributes to reduce certain corporate-level income or gain ("inversion gain") recognized by the expatriated entity (the "60-percent test").

Reasons for Change

In order to reduce their U.S. taxes, domestic entities have with greater frequency been combining with smaller foreign entities such that the level of continued ownership of the historical shareholders of the domestic entity is less than 80 percent (although above the 60-percent threshold). As a result of the combination, the domestic entity and the foreign entity often will be subsidiaries of a newly formed foreign parent company located in a tax favorable jurisdiction. Domestic entities engaging in these transactions often emphasize that the U.S. tax liability of the multinational group is expected to be substantially reduced as a result of the transaction with only minimal changes to its operations. Inversion transactions raise significant policy concerns because they facilitate the erosion of the U.S. tax base through deductible payments by the remaining U.S. members of the multinational group to the non-U.S. members and through aggressive transfer pricing for transactions between such U.S. and non-U.S. members. The resulting group's U.S. taxes also may be reduced because foreign subsidiaries may no longer qualify as controlled foreign corporations, thus permitting the group to avoid U.S. taxation on passive and other highly mobile income that it earns abroad and that would otherwise be currently included in the U.S. tax base under subpart F of the Code.

Existing adverse tax consequences of 60-percent inversion transactions have not prevented inversion transactions with continuity between 60 and 80 percent from occurring. There is no policy reason to permit a domestic entity to engage in an inversion transaction when its owners retain a controlling interest in the resulting entity, only minimal operational changes are expected, and there is significant potential for substantial erosion of the U.S. tax base. Furthermore, if as a result of a cross-border business combination the shareholders of the domestic entity do not maintain control of the resulting multinational group, the transaction should still be considered an inversion transaction if the affiliated group that includes the foreign acquiring corporation has substantial business activities in the United States and the foreign acquiring corporation is primarily managed and controlled in the United States.

Proposal

To limit the ability of domestic entities to expatriate, the proposal would broaden the definition of an inversion transaction by reducing the 80-percent test to a greater than 50-percent test, and eliminating the 60-percent test. The proposal would also add a special rule whereby, regardless of the level of shareholder continuity, an inversion transaction will occur if the affiliated group that includes the foreign corporation has substantial business activities in the United States and the foreign corporation is primarily managed and controlled in the United States. Finally, the proposal would amend section 7874 to provide that an inversion transaction can occur if there is an acquisition either of substantially all of the assets of a domestic partnership (regardless of whether such assets constitute a trade or business) or of substantially all of the assets of a trade or business of a domestic partnership.

The proposal would be effective for transactions that are completed after December 31, 2014.