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Tax Legislation

Capitol Tax Partners LLP Comparison Of International Tax Reform Proposals in Camp Discussion Drafts

House Ways and Means Committee Chairman Dave Camp (R-Mich.) Oct. 26, 2011, released the Tax Reform Act of 2011 as an initial tax reform discussion draft (the "2011 Discussion Draft"); as part of a broader tax reform effort to be developed, the 2011 Discussion Draft generally would have reformed the U.S. international tax system to move away from deferral and toward exemption, while addressing concerns about corporate tax base erosion primarily by subjecting more foreign income to immediate U.S. tax under Subpart F.

Over the next two-plus years, stakeholders provided feedback to members and staff. International tax reform was the subject of full committee hearings, with a particular focus on base erosion, and the 2011 Discussion Draft itself was the subject of a hearing by the Select Revenue Measures subcommittee. International tax was also one of the 11 bipartisan Tax Reform Working Groups that provided a process for Ways and Means Committee members to focus on specific aspects of tax reform and another avenue for stakeholders to submit comments.

Camp Feb. 26 unveiled the Tax Reform Act of 2014 as a comprehensive tax reform discussion draft (the "2014 Discussion Draft"). The 2014 Discussion Draft generally incorporated the international tax reform framework of the 2011 Discussion Draft, but with several significant modifications and additional proposals. The following table is intended to provide an overview of these modifications and additions.

Capitol Tax Partners LLP is Washington's largest independent consulting firm specializing in tax legislative and regulatory matters. Capitol Tax Partners consists of Lindsay Hooper, Jon Talisman, Joe Mikrut, Rick Grafmeyer, Mac McKenney, Lawrence Willcox, Chris Javens, Melissa Mueller, Patrick Heck and Katie Stimmel, all of whom have served either in senior positions with the legislative or executive branches of government or both, or in the news media covering Capitol Hill.

The firm's principals have more than 100 years of combined bipartisan experience working with the congressional tax-writing committees, the U.S. Treasury Department and the Internal Revenue Service.

Corporate International Tax Reform: Comparison of Camp Discussion Drafts
Part 1 of 6

Feature	Camp October 2011 Discussion Draft (10/26/11)	Camp February 2014 Discussion Draft (2/26/14)

Context	The Discussion Draft includes international tax reform, (generally effective for tax years beginning after December 31, 2012), as one of four titles and is intended to be a revenue-neutral part of comprehensive tax reform generally including:
	• Corporate rate reduction to 25%;
	• Other unspecified business tax reforms (i.e. base broadeners to offset rate reduction);
	• Individual tax reform; and
	• Other reforms.
		Generally same as the October 2011 draft, with the following modifications:
		• Generally effective for tax years beginning after December 31, 2014.
		• Corporate rate reduction to 25% is phased-in ratably over five years (2015–2019);
		• Other business tax reforms are specified;
		  ◦ Corporate rate cut, repeal of corporate AMT, and other business tax reforms estimated to raise net revenue of approximately $452 billion.*
		  ◦ Measures related to US activities of foreign persons estimated to raise approximately $20 billion (included in business tax reforms).
		• Participation exemption system and related outbound reforms estimated to raise net revenue of approximately $68 billion;
		  ◦ A portion of the transition tax revenue ($126 billion) is appropriated to the highway trust fund, but the full amount of the revenue ($170 billion) is taken into account to make the entire bill roughly revenue neutral over 10 years.
		• Individual rate cuts, repeal of individual AMT, and other individual tax reforms estimated to lose net revenue of approximately $588 billion; and
		• Other reforms related to tax-exempt entities (estimated to raise net revenue of approximately $8 billion), tax administration and compliance (estimated to raise revenue of approximately $5 billion) and excise taxes (estimated to raise net revenue of approximately $58 billion).

* All revenue estimates are for a 10-year period (2014 – 2023). See JCX 20-14, Estimated Revenue Effects of the "Tax Reform Act of 2014" (Feb. 26, 2014).

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Corporate International Tax Reform: Comparison of Camp Discussion Drafts

Part 2 of 6

Feature	Camp October 2011 Discussion Draft (10/26/11)	Camp February 2014 Discussion Draft (2/26/14)
Basic structure	Replace worldwide deferral and FTC system with: **Participation exemption**: Generally provides for a [95]% exemption for dividends received by domestic corporations from CFCs. **Current taxation**: Subpart F maintained and expanded to include either low-taxed or intangible income, possibly at a lower rate. **Thin capitalization**: Deduction for net interest expense disallowed to the extent attributable to excess domestic leverage. **Transition**: All pre-effective undistributed earnings taxed at [5.25]% reduced by pro-rated FTCs.	Generally same as the October 2011 draft, with the following modifications: **Participation exemption**: Generally provides for a 95% exemption for dividends received by domestic corporations from 10-percent owned foreign corporations. Estimated net revenue loss is approximately $212 billion. **Current taxation**: Subpart F maintained, modified, and expanded to include low-taxed intangible income, defined by reference to a formula based on depreciable tangible asset basis. Estimated net revenue gain is approximately $116 billion (including thin capitalization rules). • **US market income**: Subject to US tax at the full corporate rate (reduced by foreign tax credits). • **Foreign market income**: Subject to US tax at a reduced effective rate (15%) (reduced by foreign tax credits) via foreign intangible income deduction, which also applies to directly earned foreign market income such as export sales income. **Transition**: All post-1986 pre-effective date undistributed earnings taxed at one of two rates (reduced by pro-rated FTCs) – (i) 8.75% (earnings represented by cash, cash equivalents or other short-term assets); or (ii) 3.5% (all other earnings). Estimated net revenue gain is approximately $170 billion. **Inbound reforms**: Five measures added to increase US tax on US activities of foreign taxpayers, including (i) prevent avoidance of tax through certain related party reinsurance arrangements; (ii) tax certain cruise ship income; (iii) modify insurance exception to PFIC rules; (iv) tighten earnings stripping rules; and (v) override reduced withholding tax rates under treaties with respect to certain deductible payments. Estimated net revenue gain is approximately $20 billion.
Participation exemption	Generally • [95]% DRD applies to all distributions out of undistributed non-ECI CFC earnings. Thus 5% of all CFC dividends are subject to U.S. tax (including dividends out of pre-effective date earnings subject to transition tax and previously taxed subpart F income (PTI)). • One-year holding period requirement. **10/50 companies**: Elective CFC treatment applies to all 10/50 companies (universal election). **Foreign branches**: Mandatory CFC treatment of foreign branches (including what would otherwise be disregarded entities) of domestic corporations. **Tiered dividends**: CFC-to-CFC dividends excluded from subpart F. **CFC stock sales**: Gain on sale of certain CFC stock 95% exempt; no losses.	Generally same as the October 2011 draft, with the following modifications: • Applies to the foreign source portion of dividends paid out of non-ECI and non-PTI earnings of 10-percent owned foreign corporations. Thus, 5% of dividends from all CFCs and 10/50 companies generally are subject to US tax. • PTI rules are retained, so dividends paid out of previously taxed subpart F income (including pre-effective date earnings subject to transition tax) are excluded in full. • 956 rules are retained, but inclusions are not eligible for the participation exemption. • Six-month holding period requirement. **10/50 companies**: Eligible for exemption, but not subject to subpart F. **Foreign branches**: Present law treatment is retained – no CFC treatment permitted. Special rules to recapture branch losses with respect to branch-to-CFC conversions. **Tiered dividends**: CFC-to-CFC dividends excluded from subpart F under CFC lookthrough (made permanent without modification). **CFC stock sales**: Present law section 1248 rules would apply to determine amount eligible for exemption (accumulated earnings and profits).

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Corporate International Tax Reform: Comparison of Camp Discussion Drafts

Feature	Camp October 2011 Discussion Draft (10/26/11)	Camp February 2014 Discussion Draft (2/26/14)

Subpart F: Current law categories	Generally, no changes proposed.
	• Intention to revisit subpart F reform after determining proper structure of exemption system and "base erosion" provisions.
	• AFE and CFC lookthrough are not extended but would be analyzed as part of subpart F reform.
	• **Section 956 repealed**: Backstop to protect tax on 5% of CFC earnings not considered necessary.
	• **Section 959 repealed**: Thus, because there would be no PTI, [5]% of subpart F income subject to tax again upon distribution.
		Foreign personal holding company income (FPHCI):
		• CFC lookthrough made permanent.
		• AFE extended for five years (2014 – 2018) with respect to active financing income (AFE income) subject to a foreign effective tax rate of 12.5% or higher. AFE income subject to a foreign rate of less than 12.5% is treated as FPHCI, but is eligible for a 50% exclusion, resulting in a reduced effective rate of 12.5%, reduced by foreign tax credits.
		Foreign base company sales and services income: Rules retained, but (i) 100% exclusion provided for foreign base company sales income (FBCSI) if CFC is a qualified resident of a treaty country eligible for full benefits of the treaty; and (ii) 50% exclusion provided for any other FBCSI.
		Other rules:
		• High-tax exception changed to 100% of the applicable US tax rate (taking into account any exclusions) and made mandatory.
		• De minimis exception ($1 million) indexed for inflation.
		• Sections 956 and 959 retained. Note, however:
		  ◦ Section 956 inclusions do not qualify for the 95% DRD.
		  ◦ Undistributed PTI is taken into account in determining the "foreign source portion" of a non-PTI dividend (the fraction represented by the CFC's foreign source E&P divided by its total E&P).
		• Section 955 repealed (withdrawal of previously excluded subpart F income from investment in foreign base company shipping operations).

Subpart F: New categories	"Options to prevent base erosion." **Option A**: Excess returns from transferred intangibles to low-taxed CFC. • **Low-taxed**: Foreign effective tax rate of 10-15% or less, with a sliding scale applied within the range. • **Excess returns**: Gross income in excess of 150% of costs. • Exception for CFC's "home country" earnings. **Option B**: Low-taxed cross-border income • **Low-taxed**: Foreign effective tax rate of 10% or less. (determined on a country-by-country basis). • Not limited to IP income. • Exception for "home country" earnings–generally requires conduct of a trade or business through an office or fixed place of business and that customers be in home country. **Option C**: Foreign base company intangible income (FBCII); but taxed at reduced rate ([15]%) to the extent derived in connection with sales of property or performance of services in foreign markets (foreign intangible income). • **FBCII**: CFC's gross income attributable to intangible property (as defined in 936(h)(3)(B)); reduced by allocable expenses under 954(b)(5). • [40]% deduction for foreign intangible income (earned directly or indirectly through CFC as subpart F); expense allocation under general Subpart F rules. • High-tax exception would be applied by reference to [15]% (rather than 25%).	Generally adopts October 2011 draft's Option C, modified as follows: **FBCII**: Foreign base company intangible income is defined by the following formula (reduced by allocable expenses under 954(b)(5)) rather than by attributing income to IP defined in section 936: • The excess of a CFC's adjusted gross income (including other categories of subpart F income) over 10% of its aggregate adjusted basis in tangible property used in a trade or business ("adjusted" refers to the exclusion of income and property related to producing or extracting commodities); reduced by • A percentage of the CFC's other subpart F income (FPHCI, FBCSI, foreign base company services income, and foreign base company oil related income). The percentage is the excess amount determined above divided by total adjusted gross income. **Foreign intangible income deduction**: The amount of FBCII attributable to serving foreign markets is eligible for the deduction described below. **High-tax exception (mandatory)**: Only income subject to foreign tax at a rate less than 100% of the applicable US rate (phased-in corporate rate for US market income; 15% for foreign market income) treated as FBCII. **Interaction with other subpart F rules**: By operation of the above formula for determining FBCII, • CFC income that is excluded from subpart F under any other exception or exclusion (e.g., AFE, CFC lookthrough, FBCSI exclusion) would remain subject to the FBCII rules; and • CFC income that is subpart F under any of the other categories has the effect of increasing the amount of the CFC's FBCII by the amount that is not included in the FBCII excess return amount. • AFE Example: Under new rules (described above), AFE income taxed at a foreign rate of at least 12.5% is not FPHCI, but could be FBCII if taxed at a rate of less than 15%. Only 50% of AFE income that is subject to tax below 12.5% would be FPHCI. The excluded 50% could be FBCII and the included 50% would increase FBCII by the amount that is not included in the FBCII excess return amount.

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Corporate International Tax Reform: Comparison of Camp Discussion Drafts
Part 4 of 6

Feature	Camp October 2011 Discussion Draft (10/26/11)	Camp February 2014 Discussion Draft (2/26/14)
Foreign intangible income deduction (the "carrot" of Camp Option C)	**Foreign intangible income deduction**: [40]% deduction ([15]% ETR) for gross foreign intangible income (unreduced by expenses) of a domestic corporation. • Intangible income determined by attributing gross income to intangible property as defined in section 936(h)(3)(B). **Subpart F**: Deduction also applies to foreign intangible income of CFCs, which is taxed currently as subpart F under Option C. See above.	Generally same as October 2011 draft, with the following modifications: **Deduction base**: Deduction applies to the lesser of a domestic corporation's taxable income and the sum of its (i) net imputed intangible income; and (ii) share of any FBCII, which, in each case, is derived from serving foreign markets. • Imputed intangible income determined by formula (adjusted gross income in excess of 10% of adjusted depreciable basis in tangible property) rather than by attributing income to IP described in section 936. ◦ Adjusted gross income is gross income reduced by the corporation's commodities gross income (gross income derived from commodities produced or extracted by the corporation). • Foreign intangible income determined by applying the ratio of the domestic corporation's (or CFC's in the case of FBCII) foreign derived adjusted gross income to its total adjusted gross income. ◦ "Foreign-derived" means in connection with sales of property for use, consumption or disposition outside the United States or services provided with respect to persons or property outside the United States. ◦ Rules provided for making foreign-derived determinations. • Expense allocation required. Appears to require full domestic expense allocation, including interest expense. ◦ Rule limiting expense allocation to directly allocable expenses applies only for foreign tax credit limitation purposes, as described below. If interest expense is subject to allocation, there is apparent circularity between this allocation rule and the absolute leverage test of the thin capitalization rule described below. **Deduction percentage**: Phased-in deduction percentage correlates with corporate rate reduction phase-in, resulting in an effective tax rate approximating 15% in each year.
Deductions	No disallowance for deductions allocable to exempt income. The 5% "haircut" on the participation exemption is intended to be a proxy for expense disallowance. **Thin capitalization rules**: Disallow interest deductions of U.S. corporations to the extent determined by the application of two tests intended to identify excess domestic leverage. Disallowed amount lesser of: • Relative leverage test: Net interest expense multiplied by the "debt/equity differential percentage" which measures the relative excess of the U.S. debt/equity ratio over that of worldwide group; or ◦ Calculation determines the amount of US debt that would exist if the US group had the same debt/equity ratio as the worldwide group. Net interest attributable to the excess of the actual US debt over such amount would then be subject to disallowance. ◦ Worldwide affiliated group is determined by using a 50% (rather than 80%) ownership threshold. **Absolute leverage test**: The amount by which net interest expense exceeds a TBD percentage of adjusted taxable income (as defined in section 163(j)). • Disallowed interest can be carried forward indefinitely.	Generally same as October 2011 draft, with the following modifications to the thin capitalization rule (which disallows a deduction for net interest expense for the lesser of the amounts determined under a relative leverage test and an absolute leverage test). **Relative leverage test**: Debt/equity differential percentage determined by reference to 110% of what the US debt would be at the worldwide debt/equity ratio. • The amount produced under this test is the net interest expense attributable to the amount by which the US affiliated group's debt exceeds 110% of what the debt would be if the US affiliated group's debt/equity ratio was equal to that of the worldwide affiliated group. • Intragroup debt and equity are disregarded for purposes of applying the relative leverage test. **Absolute leverage test**: Applied with respect to 40% of adjusted taxable income. • The amount produced under this test is the net interest expense in excess of 40% of the US group's adjusted taxable income (as defined in section 163(j)) – taxable income before net interest, losses, depreciation, amortization, depletion, and the manufacturing deduction. • Correlative change to section 163(j) (changed from 50% to 40% of adjusted taxable income), described below.

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Corporate International Tax Reform: Comparison of Camp Discussion Drafts

Part 5 of 6

Feature	Camp October 2011 Discussion Draft (10/26/11)	Camp February 2014 Discussion Draft (2/26/14)

Foreign tax credits	**Actual dividends**: section 902 repealed
	• Exempt CFC dividends: Foreign taxes (direct and indirect) attributable to exempt dividends not creditable or deductible.
	  ◦ No section 78 gross-up;
	  ◦ Taxable portion of dividend (5%) is foreign source (generating FTC limitation).
	  ◦ Applies to electing shareholders of 10/50s.
	• Non-electing shareholders of 10/50s: Treated as portfolio investments—no indirect FTC (and no gross-up).
	Deemed dividends: section 960 modified
	• Indirect FTC generally determined under a current year "properly attributable" standard (replacing the multi-year pooling method) to prevent credits for taxes imposed on exempt income.
	• Indirect FTC associated with the deductible portion of the subpart F inclusion under Option C are fully creditable, resulting in a combined U.S. and foreign tax rate of 15%.
	• Section 909 (FTC splitters) repealed.
	FTC limitation
	• Baskets: single basket for all taxable foreign source income (e.g., subpart F, taxable 5% of CFC dividends, and other foreign source income earned directly by U.S. corporations.
	• Expense allocation: only directly allocable expenses taken into account; thus no interest or SG&A expense apportionment for purposes of FTC limitation.
	Carryovers and carrybacks: FTC carryforwards from pre-effective years survive in full and can be utilized against the single basket limitation. Treasury given authority to provide rules for FTC carrybacks to pre-effective years.
		Generally same as October 2011 draft, with the following modifications:
		Actual dividends from 10/50s: Eligible for the exemption; elective CFC treatment eliminated.
		Deemed dividends
		• Foreign taxes determined under a "properly attributable" standard, with regulatory authority expected to exclude any foreign taxes if the foreign tax base does not include the item of subpart F income at issue.
		• Indirect credits associated with the deductible portions of FBCII, FPHCI (low-taxed AFE income), and FBCSI are fully creditable (October 2011 draft only included deductible portion of FBCII under Option C).
		• Allow foreign tax credits for taxes imposed on previously included subpart F income when later distributed as PTI.
		• Section 909 (FTC splitters) retained.
		FTC limitation
		• **Baskets**: Two separate limitation baskets – mobile category income (includes passive income, FBCII and FBCSI) and general category income (all other foreign source income).
		• Repeal present law treatment of financial services category income as general category income.
		• Modify inventory sales source rule to source income based on location of production activities.
		• No changes to ODL or OFL rules (other than no OFL triggered on subpart F inclusion under transition tax).
		Carryovers: FTC carryovers from pre-effective date years survive in full and utilized in accordance with the new FTC limitation rules.

Treatment of pre-effective earnings (transition tax)	**Mandatory deemed repatriation**: In last pre-effective year, subpart F inclusion of all accumulated un-taxed earnings of each CFC and 10/50 company (regardless of election) and correlative deduction for [85]% of the inclusion (ETR of [5.25]%, reduced by pro-rated FTCs). • Does not appear to allow reduction in the taxable amount for any foreign corporation with an earnings and profits deficit. • No FTC and no section 78 gross-up for [85]% of the taxes associated with the earnings. • No restriction on use of NOLs or other credits or carryovers (including FTC carryovers). • Election to pay tax liability over eight years (with interest). • When actual distributions are made in post-effective date years, [5]% will be subject to tax (without FTCs) because PTI rules are repealed.	Generally the same as October 2011 draft, with the following modifications: **Applicable earnings**: Only post-1986 un-taxed earnings and profits are subject to the transition tax. **Bifurcated deduction**: 75% deduction for the portion of the deemed repatriated earnings and profits represented by cash, cash equivalents and certain short-term assets (ETR of 8.75%) and 90% for the remaining earnings and profits (ETR of 3.5%). Correlative reduction in FTCs and section 78 gross-up (ETRs reduced by pro-rated FTCs). **E&P deficits**: Proportionately allocated to each foreign corporation with positive earnings and profits. **Election to pay in eight annual installments**: No interest charge and payable 8% in each of years one through five, 15% in year six, 20% in year seven, and 25% in year eight. Subject to acceleration under certain circumstances (e.g., default), none of which involve making actual distributions in excess of the accumulated installment percentage. **PTI rules retained**: Actual distributions made in post-effective date years excluded in full under section 959.

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Corporate International Tax Reform: Comparison of Camp Discussion Drafts

Part 6 of 6

Feature	Camp October 2011 Discussion Draft (10/26/11)	Camp February 2014 Discussion Draft (2/26/14)
Treatment of pre-effective earnings (transition tax) Continued		**Overall foreign losses**: Deemed repatriation does not trigger OFL recapture; it is disregarded for purposes of applying OFL rules. **S-corporations**: Any shareholder of an S-corp. that is a US shareholder of a foreign corporation can elect to defer his portion of the transition tax until one of three types of "triggering events" occurs: (i) change in status as an S-corp.; (ii) liquidation, sale of substantially all corporate assets, termination of the company or end of business, or similar event, including reorganization in bankruptcy; and (iii) transfer of shares of stock in the S-corp. by an electing shareholder, unless the transferee agrees to be liable for the net tax liability in the same manner as the transferor.
Inbound reforms	None included.	The following measures related to US activities of foreign taxpayers are included in the February 2014 draft: **Related party reinsurance**: Deny a deduction for reinsurance premiums paid to a foreign related party that isn't subject to US tax on the premiums unless an election is made to treat the premium income as effectively connected income or the taxpayer demonstrates that the premiums were subject to tax in a foreign jurisdiction at a rate at least as high as the US corporate rate. If a deduction is denied, any return premium, ceding commission, reinsurance recovered or other amount received with respect to the reinsurance policy will not be taken into account. **Cruise ship income**: Tax effectively connected income derived from the operation of passenger cruise ships within US territorial waters without regard to whether the taxpayer's country of residence grants an equivalent exemption to US taxpayers (the present law section 883 exemption). Would also eliminate certain exceptions to the imposition of the 4% gross basis tax on US source transportation income of foreign taxpayers. **Insurance exception to PFIC rules**: Modify PFIC exception for insurance companies to apply only if certain requirements are satisfied. **Earnings stripping**: Lower the threshold for determining excess net interest expense from 50% to 40% of adjusted taxable income and eliminate the 3-year carryforward of excess limitation. Indefinite carryforward for excess interest would be retained. Correlates with absolute leverage test in outbound thin capitalization rules, described above. **Treaty override**: Deny otherwise applicable reduced treaty withholding tax rate (i.e., require 30% withholding) with respect to any deductible payment made to a foreign related party that is controlled by a common foreign parent that would not be eligible for a reduced treaty rate had the payment been made directly to the foreign parent.

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