U.S. INTERNATIONAL TAX REFORM

U.S. House Ways and Means “Territorial” Proposal

The international tax reform process continues. House Ways and Means Chairman Dave Camp (R-MI) released his draft of a territorial tax proposal to replace the existing international provisions of the Code. The technical terminology would be that a “participation exemption” is provided for distributions from foreign affiliates, so that only 5% of the income would be subject to U.S. tax. There would also be a reduction in the maximum U.S. corporate tax from 35% to 25%.

There has been near universal agreement that the extant provisions of the Code need to be discarded in favor of a regime that will (1) maximize U.S. economic growth, (2) make U.S.-based MNEs competitive in the global marketplace, and (3) protect the U.S. tax base to facilitate a corporate tax rate reduction. Below summarizes the proposal and in the future we will address likely effective tax rate (ETR) planning strategies under the proposal and comment on U.S. tax base protection, which obviously needs significant additional focus as the legislative process continues.

Ways and Means Proposal

The terms of the proposal are basically straightforward, though they would obviously have a dramatic impact on each of the issues noted above. Below are the major points in the proposal:

> (1.) *Foreign dividend (participation) exemption.* In the case of E&P occurring after 31 December 2012, any distribution from a foreign subsidiary to a U.S. shareholder would be entitled to a 95% exemption, meaning that 5% of the distribution would be subject to U.S. tax. The foreign entity stock must have a holding period of at least one year.
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> (2.) *Foreign branch = CFC.* Foreign branches would be treated as CFCs, eligible for the participation exemption on branch distributions.
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> (3.) *10/50 foreign corporations.* U.S. shareholders of foreign corporations that own more than 10% but less than 50% may elect to treat the entity as a CFC.

(4.) *Foreign tax credit.* The foreign tax credit would not be allowed with respect to any portion of the distribution qualifying for the participation exemption, including the 5% portion subject to tax.

(5.) *Reduction in maximum tax rate.* The maximum corporate tax rate would be reduced from 35% to 25%.

(6.) *Transition for pre-January 1, 2013, E&P.* Pre-existing E&P would be deemed repatriated over an eight-year period at an effective U.S. tax rate of 5.25% (85% exclusion and pre-reform 35% tax rate applied; the remaining 15% times 35% = 5.25%), providing a slight incentive to actually distribute the income.

(7.) *Base broadening.* The proposal anticipates that the “base” of the income tax, subject to the reduced 25% rate, would be broadened, though details are not provided. Inevitably, this would include limiting or eliminating deductions or credits currently included in the Code.

(8.) *Subpart F and foreign tax credit coordination.* There are provisions to facilitate coordination of the existing Subpart F and foreign tax credit provisions with the new regime.

(9.) *Tax base defense.* Under the territorial system, sourcing of income becomes critical. U.S.-source income is subject to regular, but reduced U.S. tax, while foreign-source income is not taxed in the U.S. (other than the 5% on dividends or repatriation). As a future “Feature” will discuss, ETR planning will focus on the sourcing of income as well as foreign tax minimization. An important element of ETR planning will be to maximize foreign-source income, hence reducing the U.S. tax base.

The proposal contains the following potential means of protecting the U.S. tax base, as well as a request for additional proposals:

(1.) An expanded thin cap mechanism to strengthen **Code Sec. 163** where a U.S. corporation is deemed to have excess domestic interest.

(2.) Prevention of outbound migration of intangibles with potential options:

- Excess foreign intangible income from transferred intangibles (an Obama Administration proposal) is treated as Subpart F income (which would require even more extensive transfer pricing-type analysis to ascertain the presence of such “excess”).

- Low-taxed foreign-source income is treated as Subpart F income if is neither active income nor taxed locally at a rate higher than 10%. A home-country exemption would be provided (like the current “same country” Subpart F provisions) if (1) the income arises from an active trade or business; (2) there is an actual office or other fixed place of business; and (3) the activities must serve the local market.
- A “patent box” approach (under consideration in the U.K.), which would provide a 40% exclusion of income from foreign exploitation of intangibles, as well as a 15% tax rate on royalties paid relating to such exploitation.

(3.) The proposal requests comment and suggestion for other means of addressing tax base defense. A future “Feature” will comment on these.

The Ways and Means proposal would leave intact most of the extant international tax provisions, since the CFC, foreign tax credit, and related rules could be applied in a variety of circumstances. In other words, complexity would continue in this field.

In the future we will address likely transitional planning considerations for outbound and inbound MNEs, followed by some thoughts about an effective tax base defense mechanism.

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