TECHNICAL EXPLANATION OF THE SENATE COMMITTEE ON FINANCE CHAIRMAN'S STAFF DISCUSSION DRAFT OF PROVISIONS TO REFORM INTERNATIONAL BUSINESS TAXATION

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November 19, 2013
JCX-15-13

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of the Senate Committee on Finance Chairman's staff discussion draft (MCG13834, MCG13835, and MCG13836) of provisions to reform international business taxation. This document is prepared at the request of Senate Committee on Finance Chairman Max Baucus.

[1] This document may be cited as follows: Joint Committee on Taxation, Technical Explanation of the Senate Committee on Finance Chairman's Staff Discussion Draft of Provisions to Reform International Business Taxation (JCX-15-13), November 19, 2013.

I. PRESENT LAW

Overview of the U.S. international tax system

Present law combines the worldwide taxation of all U.S. persons[2] on all income, whether derived in the United States or abroad, with limited deferral for foreign income earned by foreign subsidiaries of U.S. companies, and provides territorial-based taxation of U.S.-source income of nonresident aliens and foreign entities. This combination is sometimes described as the U.S. hybrid system. Under this system, the application of the Code to outbound investment (the foreign activities of U.S. persons) differs somewhat from its rules applicable to inbound investment (foreign persons with investment in U.S. assets or activities).

The worldwide scope of present law generally requires U.S. citizens, resident individuals, and domestic corporations to be taxed on all income, whether derived in the United States or abroad.[3] Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax only when the income is distributed as a dividend to the domestic parent corporation. Until that repatriation, the U.S. tax on the income generally is deferred. However, certain U.S. anti-deferral regimes may cause the domestic parent corporation to be taxed currently in the United States on certain categories of passive or highly mobile income earned by its foreign corporate subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[4] and the passive foreign investment company rules.[5] Taxation of income earned from foreign operations may differ depending upon the classification of the foreign entity conducting the foreign operations.

To mitigate double taxation of foreign-source income, the United States allows a credit for foreign income taxes paid.[6] The foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether the income is earned directly by the domestic corporation, repatriated as an actual dividend, or included in the domestic parent corporation's income under one of the anti-deferral regimes.[7] Therefore, even though U.S.

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[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code"). Section 7701(a)(30) defines U.S. person to include all U.S. citizens and residents as well as domestic entities such as partnerships, corporations, estates, and certain trusts. Whether a noncitizen is a resident is determined under rules in section 7701(b).

[3] A U.S. citizen or resident living abroad may be eligible to exclude from U.S. taxable income certain foreign earned income and foreign housing costs under section 911. For a description of this exclusion, see *Present Law and Issues in U.S. Taxation of Cross-Border Income* (JCX-42-11), September 6, 2011, p. 52.

[4] Secs. 951-964.

[5] Secs. 1291-1298.

[6] In lieu of the foreign tax credit, foreign income, war profits, and excess profits taxes may instead be claimed as deductions under section 164(a)(3).

[7] Secs. 901, 902, 960, 1291(g).

citizens, resident individuals, and domestic corporations are subject to U.S. tax on all their income, both U.S. and foreign source, source of income remains a critical factor to the extent that it determines the amount of credit available for foreign taxes paid. Foreign income taxes eligible for a credit include such taxes paid directly by a U.S. person and taxes paid by foreign corporations to the extent such corporations have substantial U.S. ownership. In addition to the statutory relief afforded by the credit, the U.S. network of bilateral income tax treaties provides a system for removing double taxation and ensuring reciprocal treatment of taxpayers from treaty countries.

Category-by-category rules determine whether income has a U.S. source or a foreign source. Additionally, present law provides detailed rules for the allocation of deductible expenses between U.S.-source income and foreign-source income. These rules do not, however, affect the timing of the expense deduction. A domestic corporation generally is allowed a current deduction for its expenses (such as interest and administrative expenses) that support income that is derived through foreign subsidiaries and on which U.S. tax is deferred. Instead, the expense allocation rules apply to a domestic corporation principally for determining the corporation's foreign tax credit limitation.

Taxation of nonresident aliens and foreign corporations

Nonresident aliens and foreign corporations are generally subject to U.S. tax only on their U.S.-source income. Thus, the source and type of income received by a foreign person generally determines whether there is any U.S. income tax liability and the mechanism by which it is taxed. The U.S. tax rules for U.S. activities of foreign taxpayers apply differently to two broad types of income: U.S.-source income that is "fixed or determinable annual or periodical gains, profits, and income" ("FDAP income") or income that is "effectively connected with the conduct of a trade or business within the United States" ("ECI"). FDAP income generally is subject to a 30-percent gross-basis withholding tax, while ECI is generally subject to the same U.S. tax rules that apply to business income derived by U.S. persons. That is, deductions are permitted in determining taxable ECI, which is then taxed at the same rates applicable to U.S. persons. Much FDAP income and similar income is, however, exempt from withholding tax or is subject to a reduced rate of tax under the Code or a bilateral income tax treaty.[8]

FDAP income includes U.S.-source portfolio interest, which means any interest (including original issue discount) that is paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person.[9] For obligations issued before March 19, 2012, portfolio interest also includes interest paid on an obligation that is not in registered form, provided that the obligation is shown to be targeted to foreign investors under the conditions sufficient to establish deductibility of the payment of such interest.[10] Portfolio interest, however,

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[8] E.g., the portfolio interest exception at sec. 871(h) (discussed below).

[9] Sec. 871(h)(2).

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

does not include interest received by a 10-percent shareholder,[11] certain contingent interest,[12] interest received by a controlled foreign corporation from a related person,[13] or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.[14]

U.S. tax law includes rules intended to prevent reduction of the U.S. tax base, whether through excessive borrowing in the United States,[15] migration of the tax residence of domestic corporations from the United States to foreign jurisdictions through corporate inversion transactions,[16] or aggressive intercompany pricing practices,[17] particularly with respect to intangible property.

The Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")[18] generally treats a foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") as ECI and, therefore, as taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain. A foreign person subject to tax on this income is required to file a U.S. tax return under the normal rules relating to receipt of ECI.[19] In the case of a foreign corporation, the gain from the disposition of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

The payor of amounts that FIRPTA treats as ECI ("FIRPTA income") is generally required to withhold U.S. tax from the payment. Withholding is generally 10 percent of the sales price, in the case of a direct sale by the foreign person of a USRPI, and 35 percent of the amount of a distribution to a foreign person of proceeds attributable to such sales from an entity such as a

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

[11] Sec. 871(h)(3).

[12] Sec. 871(h)(4).

[13] Sec. 881(c)(3)(C).

[14] Sec. 881(c)(3)(A).

[15] Sec. 163(j).

[16] See sec. 7874. For a description of provisions designed to curtail inversion transactions, see Joint Committee on Taxation, *Present Law and Issues in U.S. Taxation of Cross-Border Income* (JCX-42-11), September 6, 2011, p. 50.

[17] Sec. 482.

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

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

partnership, real estate investment trust ("REIT") or regulated investment company ("RIC").[20] The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's total ECI and deductions (if any) for the taxable year.

With regard to insurance, an excise tax applies to premiums paid to foreign insurers and reinsurers covering U.S. risks.[21] The excise tax is imposed on a gross basis at the rate of one percent on reinsurance and life insurance premiums, and at the rate of four percent on property and casualty insurance premiums. The excise tax does not apply to premiums that are effectively connected with the conduct of a U.S. trade or business or that are exempted from the excise tax under an applicable income tax treaty. The excise tax paid by one party cannot be credited if, for example, the risk is reinsured with a second party in a transaction that is also subject to the excise tax.

Certain U.S. tax treaties provide an exemption from the excise tax, including the treaties with Germany, Switzerland, and the United Kingdom.[22] To prevent persons from inappropriately obtaining the benefits of exemption from the excise tax, the treaties generally include an anti-conduit rule. The most common anti-conduit rule provides that the treaty exemption applies to the excise tax only to the extent that the risks covered by the premiums are not reinsured with a person not entitled to the benefits of the treaty (or any other treaty that provides exemption from the excise tax).[23]

<u>Entity classification</u>

Many business entities are generally eligible to choose how they are classified for Federal tax purposes under the "check-the-box" regulations adopted in 1997.[24] Those regulations simplified the entity classification process for both taxpayers and the IRS by making the entity

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

[21] Secs. 4371-4374.

[22] Generally, when a foreign person qualifies for benefits under such a treaty, the United States is not permitted to collect the insurance premiums excise tax from that person.

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

[24] Treas. Reg. sec. 301.7701-1, *et seq*.

classification of unincorporated entities explicitly elective in most instances.[25] Whether an entity is eligible and its choices in classification depend upon whether it is a "per se corporation" and the number of beneficial owners.

Certain entities are treated as "per se corporations" for which an election is not permitted. Generally, these are domestic entities formed under a State corporation statute. A number of specific types of foreign business entities are identified in the regulations as per se corporations. These entities are generally corporations that are not closely held and the shares of which can be traded on a securities exchange.[26]

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

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

Because domestic and foreign eligible entities can elect entity classification and due to differences between U.S. and foreign law, it is possible for an entity that operates cross-border to elect into a hybrid status. "Hybrid entities" refers to entities that are treated as flow-through or disregarded entities for U.S. tax purposes but as corporations for foreign tax purposes; for "reverse hybrid entities," the opposite is true. The existence of hybrid and reverse hybrid entities can affect whether the taxpayer can use foreign tax credits attributable to deferred foreign-source

[25] The check-the-box regulations replaced Treas. Reg. sec. 301.7701-2, as in effect prior to 1997, under which the classification of unincorporated entities for Federal tax purposes was determined on the basis of a four characteristics indicative of status as a corporation: continuity of life, centralization of management, limited liability, and free transferability of interests. An entity that possessed three or more of these characteristics was treated as a corporation; if it possessed two or fewer, then it was treated as a partnership. Thus, to achieve characterization as a partnership under this system, taxpayers needed to arrange the governing instruments of an entity in such a way as to eliminate two of these corporate characteristics. The advent and proliferation of limited liability companies ("LLCs") under State laws allowed business owners to create customized entities that possessed a critical common feature—limited liability for investors—as well as other corporate characteristics the owners found desirable. As a consequence, classification was effectively elective for well-advised taxpayers.

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

income or income that is not taxable in the United States, as well as whether income is currently includible under subpart F.

Source of income rules

The rules for determining the source of certain types of income are specified in the Code and described briefly below. Various factors determine the source of income for U.S. tax purposes, including the status or nationality of the payor, the status or nationality of the recipient, the location of the recipient's activities that generate the income, and the situs of the assets that generate the income. If a payor or recipient is an entity that is eligible to elect its classification for federal tax purposes, its choice of whether to be recognized as legally separate from its owner in another jurisdiction can affect the determination of the source of the income and other tax attributes (for example, if the hybrid entity is disregarded in one jurisdiction, but recognized in the other).[27] To the extent that the source of income is not specified by statute, the Treasury Secretary may promulgate regulations that explain the appropriate treatment. However, many items of income are not explicitly addressed by either the Code or Treasury regulations. On several occasions, courts have determined the source of such items by applying the rule for the type of income to which the disputed income is most closely analogous, based on all facts and circumstances.[28]

Interest

Interest is derived from U.S. sources if it is paid by the United States or any agency or instrumentality thereof, a State or any political subdivision thereof, or the District of Columbia. Interest is also from U.S. sources if it is paid by a resident or a domestic corporation on a bond, note, or other interest-bearing obligation.[29] Special rules apply to treat as foreign source certain amounts paid on deposits with foreign commercial banking branches of U.S. corporations or partnerships and certain other amounts paid by foreign branches of domestic financial institutions.[30] Interest paid by the U.S. branch of a foreign corporation is also treated as U.S.-source income.[31]

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[27] See Treas. Reg. secs. 301.7701-1 through 301.7701-3.

[28] See, *e.g.*, *Hunt v. Commissioner*, 90 T.C. 1289 (1988).

[29] Sec. 861(a)(1); Treas. Reg. sec. 1.861-2(a)(1).

[30] Sec. 861(a)(1) and 862(a)(1). For purposes of certain reporting and withholding obligations, the source rule in section 861(a)(1)(B) does not apply to interest paid by the foreign branch of a domestic financial institution, resulting in treating the payment as a withholdable payment. Sec. 1473(1)(C).

[31] Sec. 884(f)(1).

Dividends

Dividend income is generally sourced by reference to the payor's place of incorporation.[32] Thus, dividends paid by a domestic corporation are generally treated as entirely U.S.-source income. Similarly, dividends paid by a foreign corporation are generally treated as entirely foreign-source income. Under a special rule, dividends from certain foreign corporations that conduct U.S. businesses are treated in part as U.S.-source income.[33]

Rents and royalties

Rental income is sourced by reference to the location or place of use of the leased property.[34] The nationality or the country of residence of the lessor or lessee does not affect the source of rental income. Rental income from property located or used in the United States (or from any interest in such property) is U.S.-source income, regardless of whether the property is real or personal, intangible or tangible.

Royalties are sourced in the place of use of (or the place of privilege to use) the property for which the royalties are paid.[35] This source rule applies to royalties for the use of either tangible or intangible property, including patents, copyrights, secret processes, formulas, goodwill, trademarks, trade names, and franchises.

Income from sales of personal property

Subject to significant exceptions, income from the sale of personal property is sourced on the basis of the residence of the seller.[36] For this purpose, special definitions of the terms "U.S. resident" and "nonresident" are provided. A nonresident is defined as any person who is not a U.S. resident,[37] while the term "U.S. resident" means any juridical entity which is a U.S. person, all U.S. citizens, as well as any individual who is a U.S. resident without a tax home in a foreign country or a nonresident alien with a tax home in the United States.[38] As a result, nonresident includes any foreign corporation.[39]

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[32] Secs. 861(a)(2), 862(a)(2).

[33] Sec. 861(a)(2)(B).

[34] Sec. 861(a)(4).

[35] *Ibid.*

[36] Sec. 865(a).

[37] Sec. 865(g)(1)(B).

[38] Sec. 865(g)(1)(A).

[39] Sec. 865(g).

Several special rules apply. For example, income from the sale of inventory property is generally sourced to the place of sale, which is determined by where title to the property passes.[40] However, if the sale is by a nonresident and is attributable to an office or other fixed place of business in the United States, income from the sale is treated as U.S.-source income without regard to the place of sale, unless the property is sold for use, disposition, or consumption outside the United States and a foreign office materially participates in the sale.[41] Income from the sale of inventory property which a taxpayer produces (in whole or in part) in the United States and sells outside the United States, or which a taxpayer produces (in whole or in part) outside the United States and sells in the United States is treated as partly U.S. source and partly foreign source.[42]

In determining the source of gain or loss from the sale or exchange of an interest in a partnership, the IRS applies the asset-use test and business activities test at the partnership level to determine whether there is a U.S. business and, if so, the extent to which income derived is effectively connected with that U.S. business. To the extent that there is unrealized gain attributable to partnership assets that are effectively connected with the U.S. business, the foreign person's gain or loss from the sale or exchange of a partnership interest is effectively connected gain or loss to the extent of the partner's distributive share of such unrealized gain or loss. Similarly, to the extent that the partner's distributive share of unrealized gain is attributable to a permanent establishment of the partnership under an applicable treaty provision, it may be subject to U.S. tax under a treaty.[43]

Gain on the sale of depreciable property is divided between U.S. source and foreign source in the same ratio that the depreciation was previously deductible for U.S. tax purposes.[44] Payments received on sales of intangible property are sourced in the same manner as royalties to

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[40] Secs. 865(b), 861(a)(6), 862(a)(6); Treas. Reg. sec. 1.861-7(c).

[41] Sec. 865(e)(2).

[42] Sec. 863(b). A taxpayer may elect one of three methods for allocating and apportioning income as U.S. or foreign source: (1) 50-50 method. 50 percent of the income from the sale of inventory property in such a situation is attributable to the production activities and 50 percent to the sales activities, with the income sourced based on the location of those activities; (2) IFP method. In certain circumstances an independent factory price ("IFP") may be established by the taxpayer to determine income from production activities; (3) Books and records method. With advance permission, the taxpayer may use books of account to detail the allocation of receipts and expenditures between production and sales activities. Treas. Reg. sec. 1.863-3(b), (c). If production activity occurs only within the United States, or only within foreign countries, then all income is sourced to where the production activity occurs; when production activities occur in both the United States and one or more foreign countries, the income attributable to production activities must be split between U.S. and foreign sources. Treas. Reg. sec. 1.863-3(c)(1). The sales activity is generally sourced based on where title to the property passes. Treas. Reg. secs. 1.863-3(c)(2), 1.861-7(c).

[43] Rev. Rul. 91-32, 1991-1 C.B. 107.

[44] Sec. 865(c).

the extent the payments are contingent on the productivity, use, or disposition of the intangible property.[45]

Personal services income

Compensation for labor or personal services is generally sourced to the place-of-performance. Thus, compensation for labor or personal services performed in the United States generally is treated as U.S.-source income, subject to an exception for amounts that meet certain de minimis criteria.[46] Compensation for services performed both within and without the United States is allocated between U.S. and foreign source.[47]

Insurance income

Underwriting income from issuing insurance or annuity contracts generally is treated as U.S.-source income if the contract involves property in, liability arising out of an activity in, or the lives or health of residents of, the United States.[48]

Transportation income

Generally, income from furnishing transportation that begins and ends in the United States is U.S.-source income.[49] Fifty percent of other income attributable to transportation that begins or ends in the United States is treated as U.S.-source income.

Income from space or ocean activities or international communications

In the case of a foreign person, generally no income from a space or ocean activity is treated as U.S.-source income.[50] The same holds true for international communications income unless the foreign person maintains an office or other fixed place of business in the United States, in which case the income attributable to such fixed place of business is treated as U.S.-source income.[51]

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[45] Sec. 865(d).

[46] Sec. 861(a)(3). Gross income of a nonresident alien individual, who is present in the United States as a member of the regular crew of a foreign vessel, from the performance of personal services in connection with the international operation of a ship is generally treated as foreign-source income.

[47] Treas. Reg. sec. 1.861-4(b).

[48] Sec. 861(a)(7).

[49] Sec. 863(c).

[50] Sec. 863(d).

[51] Sec. 863(e).

Amounts received with respect to guarantees of indebtedness

Amounts received, directly or indirectly, from a noncorporate resident or from a domestic corporation for the provision of a guarantee of indebtedness of such person are income from U.S. sources.[52] This includes payments that are made indirectly for the provision of a guarantee. For example, U.S.-source income under this rule includes a guarantee fee paid by a foreign bank to a foreign corporation for the foreign corporation's guarantee of indebtedness owed to the bank by the foreign corporation's domestic subsidiary, where the cost of the guarantee fee is passed on to the domestic subsidiary through, for instance, additional interest charged on the indebtedness. In this situation, the domestic subsidiary has paid the guarantee fee as an economic matter through higher interest costs, and the additional interest payments made by the subsidiary are treated as indirect payments of the guarantee fee and, therefore, as U.S. source.

Such U.S.-source income also includes amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of indebtedness of that foreign person if the payments received are connected with income of such person that is effectively connected with the conduct of a U.S. trade or business. Amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of that person's debt are treated as foreign-source income if they are not from sources within the United States under section 861(a)(9).

Subpart F

Generally

Subpart F,[53] applicable to controlled foreign corporations ("CFCs") and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A CFC generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).[54] Under the subpart F rules, the United States generally taxes the 10-percent U.S. shareholders of a CFC on their pro rata shares of certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is distributed to the

[52] Sec. 861(a)(9). This provision effects a legislative override of the opinion in *Container Corp. v. Commissioner*, 134 T.C. No. 5 (February 17, 2010), *aff'd* 2011 WL1664358, 107 A.F.T.R.2d 2011-1831 (5th Cir. May 2, 2011). The Tax Court held that fees paid by a domestic corporation to its foreign parent with respect to guarantees issued by the parent for the debts of the domestic corporation were more closely analogous to compensation for services than to interest, and determined that the source of the fees should be determined by reference to the residence of the foreign parent-guarantor. As a result, the income was treated as income from foreign sources.

[53] Secs. 951-964.

[54] Secs. 951(b), 957, 958.

shareholders.[55] In effect, the United States treats the 10-percent U.S. shareholders of a CFC as having received a current distribution of the corporation's subpart F income.

With exceptions described below, subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,[56] insurance income,[57] and certain income relating to international boycotts and other violations of public policy.[58]

Foreign base company income consists of foreign personal holding company income, which includes passive income such as dividends, interest, rents, and royalties, and a number of categories of income from business operations, including foreign base company sales income, foreign base company services income, and foreign base company oil-related income.[59]

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income.[60]

In the case of insurance, a temporary exception from foreign personal holding company income applies for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization. Temporary exceptions from insurance income and from foreign personal holding company income also apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met. In the case of a life insurance or annuity contract, reserves for such contracts are determined under rules specific to the temporary exceptions. Present law also permits a

[55] Sec. 951(a).

[56] Sec. 954.

[57] Sec. 953.

[58] Sec. 952(a)(3)-(5).

[59] Sec. 954. The American Jobs Creation Act of 2004, Pub. L. No. 108-357, eliminated the category of foreign base company shipping income.

[60] Prop. Treas. Reg. sec. 1.953-1(a).

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

Special rules apply under subpart F with respect to related person insurance income.[61] Enacted in 1986, these rules address the concern that "the related person insurance income" of many offshore "captive insurance companies avoided current taxation under the subpart F rules of prior law because, for example, the company's U.S. ownership was relatively dispersed."[62] For purposes of these rules, the U.S. ownership threshold for controlled foreign corporation status is reduced to 25 percent or more. Any U.S. person who owns or is considered to own any stock in a controlled foreign corporation, whatever the degree of ownership, is treated as a U.S. shareholder of such corporation for purposes of this 25-percent U.S. ownership threshold and exposed to current tax on the corporation's related person insurance income. Related person insurance income is defined for this purpose to mean any insurance income attributable to a policy of insurance or reinsurance with respect to which the primary insured is either a U.S. shareholder (within the meaning of the provision) in the foreign corporation receiving the income or a person related to such a shareholder.

Investments in U.S. property

The 10-percent U.S. shareholders of a CFC also are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's untaxed earnings invested in certain items of U.S. property.[63] This U.S. property generally includes tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets, such as patents and copyrights, acquired or developed by the CFC for use in the United States.[64] There are specific exceptions to the general definition of U.S. property, including for bank deposits, certain export property, and certain trade or business obligations.[65] The inclusion rule for investment of earnings in U.S. property is intended to prevent taxpayers from avoiding U.S. tax on dividend repatriations by repatriating CFC earnings through non-dividend payments, such as loans to U.S. persons.

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[61] Sec. 953(c).

[62] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87, May 4, 1987, p. 968.

[63] Secs. 951(a)(1)(B), 956.

[64] Sec. 956(c)(1).

[65] Sec. 956(c)(2).

Subpart F exceptions

A temporary provision enacted in 2006 (colloquially referred to as the "CFC look-through" rule) excludes from foreign personal holding company income dividends, interest, rents, and royalties received or accrued by one CFC from a related CFC (with relation based on control) to the extent attributable or properly allocable to non-subpart-F income of the payor.[66] The exclusion originally applied for taxable years beginning after 2005 and before 2009 and has been extended most recently to apply for taxable years of the foreign corporation beginning before 2014.[67]

Under a provision enacted in 1997 and originally applicable only for one taxable year,[68] there is an exclusion from subpart F income for certain income of a CFC that is derived in the active conduct of a banking or financing business ("active financing income").[69] Congress has extended the application of section 954(h) several times, most recently in 2013.[70] The exception from subpart F for active financing income now applies to taxable years of foreign corporations starting before January 1, 2014 (and to taxable years of 10-percent U.S. shareholders with or within which those corporate taxable years end). With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the active financing exception. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit ("QBU") of a CFC from transactions with customers is eligible for the exception if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions provided that certain requirements are met.

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

[66] Sec. 954(c)(6).

[67] Sec. 954(c)(6)(C). American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, sec. 323(a).

[68] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1175.

[69] Sec. 954(h).

[70] American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, sec. 322(b); Pub. L. No. 111-312, sec. 750(a) (2010); Pub. L. No. 110-343, div. C, sec. 303(b) (2008); Pub. L. No. 109-222, sec. 103(a)(2) (2006); Pub. L. No. 107-147, sec. 614 (2002); Pub. L. No. 106-170, sec. 503 (1999); Pub. L. No. 105-277 (1998).

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

The American Jobs Creation Act of 2004 ("AJCA")[71] expanded the scope of the active financing income exclusion from subpart F. Income is treated as active financing income (and was so treated before AJCA) only if, among other requirements, it is derived by a CFC or by a QBU of that CFC. After the enactment of AJCA, certain activities conducted by persons related to the CFC or its QBUs are treated as conducted directly by the CFC or QBU.[72] An activity qualifies under this rule if the activity is performed by employees of the related person and if the related person is an eligible CFC, the home country of which is the same as the home country of the related CFC or QBU; the activity is performed in the home country of the related person; and the related person receives arm's-length compensation that is treated as earned in the home country. Income from an activity qualifying under this rule is excepted from subpart F income so long as the other active financing requirements are satisfied.

Other exclusions from foreign personal holding company income include exceptions for dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized and for rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is organized.[73] These exclusions do not apply to the extent the payments reduce the subpart F income of the payor. There is an exception from foreign base company income and insurance income for any item of income received by a CFC if the taxpayer establishes that the income was subject to an effective foreign income tax rate greater than 90 percent of the maximum U.S. corporate income tax rate (that is, more than 90 percent of 35 percent, or 31.5 percent).[74]

Exclusion of previously taxed earnings and profits

A 10-percent U.S. shareholder of a CFC may exclude from its income actual distributions of earnings and profits from the CFC that were previously included in the 10-percent U.S. shareholder's income under subpart F.[75] Earnings giving rise to an income inclusion (under section 956) resulting from investments in U.S. property may also be excluded from the 10-percent U.S. shareholder's income upon distribution.[76] Ordering rules provide that

[71] Pub. L. No. 108-357.

[72] AJCA sec. 416; Code sec. 954(h)(3)(E).

[73] Sec. 954(c)(3).

[74] Sec. 954(b)(4).

[75] Sec. 959(a)(1).

[76] Sec. 959(a)(2).

distributions from a CFC are treated as coming first out of earnings and profits of the CFC that have been previously taxed under subpart F, then out of other earnings and profits.[77]

Basis adjustments

In general, a 10-percent U.S. shareholder of a CFC receives a basis increase with respect to its stock in the CFC equal to the amount of the CFC's earnings that are included in the 10-percent U.S. shareholder's income under subpart F.[78] Similarly, a 10-percent U.S. shareholder of a CFC generally reduces its basis in the CFC's stock in an amount equal to any distributions that the 10-percent U.S. shareholder receives from the CFC that are excluded from its income as previously taxed under subpart F.[79] Similar rules apply to adjust an upper-tier CFC's basis in a lower-tier CFC to account for subpart F inclusions and distributions from the lower-tier CFC.[80]

Passive foreign investment companies

The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies ("PFICs"). A PFIC generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.[81] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a PFIC, regardless of their percentage ownership in the company. One set of rules applies to PFICs that are "qualified electing funds," under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.[82] A second set of rules applies to PFICs that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.[83] A third set of rules applies to PFIC stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the

[77] Sec. 959(c).

[78] Sec. 961(a).

[79] Sec. 961(b).

[80] Sec. 961(c).

[81] Sec. 1297.

[82] Secs. 1293-1295.

[83] Sec. 1291.

taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."[84]

Other anti-deferral rules

The subpart F and PFIC rules are not the only anti-deferral regimes. Other rules that impose current U.S. taxation on income earned through corporations include the accumulated earnings tax rules[85] and the personal holding company rules.[86]

Rules for coordination among the anti-deferral regimes are provided to prevent U.S. persons from being subject to U.S. tax on the same item of income under multiple regimes. For example, a corporation generally is not treated as a PFIC with respect to a particular shareholder if the corporation is also a CFC and the shareholder is a 10-percent U.S. shareholder. Thus, subpart F is allowed to trump the PFIC rules.

Foreign tax credit

Subject to certain limitations, U.S. citizens, resident individuals, and domestic corporations are allowed to claim a credit for foreign income taxes they pay. A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a "deemed-paid" credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed as a dividend or is included in the domestic corporation's income under the anti-deferral rules.[87]

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles). This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income.[88] The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous year or carry forward the excess taxes to one of the succeeding 10 years.[89]

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[84] Sec. 1296.

[85] Secs. 531-537.

[86] Secs. 541-547. The accumulated earnings tax rules and the personal holding company rules apply in respect of both U.S.-source and foreign-source income.

[87] Secs. 901, 902, 960, 1295(f).

[88] Secs. 901, 904.

[89] Sec. 904(c).

The computation of the foreign tax credit limitation requires a taxpayer to determine the amount of its taxable income from foreign sources in each limitation category (described below) by allocating and apportioning deductions between U.S.-source gross income, on the one hand, and foreign-source gross income in each limitation category, on the other. In general, deductions are allocated and apportioned to the gross income to which the deductions factually relate.[90] However, subject to certain exceptions, deductions for interest expense and research and experimental expenses are apportioned based on taxpayer ratios.[91] In the case of interest expense, this ratio is the ratio of the corporation's foreign or domestic (as applicable) assets to its worldwide assets. In the case of research and experimental expenses, the apportionment ratio is based on either sales or gross income. All members of an affiliated group of corporations generally are treated as a single corporation for purposes of determining the apportionment ratios.[92]

The term "affiliated group" is determined generally by reference to the rules for determining whether corporations are eligible to file consolidated returns.[93] These rules exclude foreign corporations from an affiliated group.[94] AJCA modified the interest expense allocation rules for taxable years beginning after December 31, 2008.[95] The effective date of the modified rules has been delayed to January 1, 2021.[96] The new rules permit a U.S. affiliated group to apportion the interest expense of the members of the U.S. affiliated group on a worldwide-group basis (that is, as if all domestic and foreign affiliates are a single corporation). A result of this rule is that interest expense of foreign members of a U.S. affiliated group is taken into account in determining whether a portion of the interest expense of the domestic members of the group must be allocated to foreign-source income. An allocation to foreign-source income generally is required only if, in broad terms, the domestic members of the group are more highly leveraged than is the entire worldwide group. The new rules are generally expected to reduce the amount of the U.S. group's interest expense that is allocated to foreign-source income.

The foreign tax credit limitation is applied separately to "passive category income" and to "general category income."[97] Passive category income includes passive income, such as

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[90] Treas. Reg. sec. 1.861-8(b), Temp. Treas. Reg. sec. 1.861-8T(c).

[91] Temp. Treas. Reg. sec. 1.861-9T, Treas. Reg. sec. 1.861-17.

[92] Sec. 864(e)(1), (6); Temp. Treas. Reg. sec. 1.861-14T(e)(2).

[93] Secs. 864(e)(5), 1504.

[94] Sec. 1504(b)(3).

[95] AJCA, sec. 401.

[96] Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, sec. 551(a).

[97] Sec. 904(d). AJCA generally reduced the number of income categories from nine to two, effective for tax years beginning in 2006. Before AJCA, the foreign tax credit limitation was applied separately to the following categories of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled section 902 foreign corporations (also known as "10/50 companies"), (6) certain dividends from a domestic international sales corporation or former domestic

portfolio interest and dividend income, and certain specified types of income. General category income includes all other income. Passive income is treated as general category income if it is earned by a qualifying financial services entity. Passive income is also treated as general category income if it is highly taxed (that is, if the foreign tax rate exceeds the highest rate of tax specified in section 1 or 11, as applicable). Dividends (and subpart F inclusions), interest, rents, and royalties received by a 10-percent U.S. shareholder from a CFC are assigned to a separate limitation category by reference to the category of income out of which the dividends or other payments were made.[98] Dividends received by a 10-percent corporate shareholder of a foreign corporation that is not a CFC are also categorized on a look-through basis.[99]

In addition to the foreign tax credit limitation just described, a taxpayer's ability to claim a foreign tax credit may be further limited by a matching rule that prevents the separation of creditable foreign taxes from the associated foreign income. Under this rule, a foreign tax generally is not taken into account for U.S. tax purposes, and thus no foreign tax credit is available with respect to that foreign tax, until the taxable year in which the related income is taken into account for U.S. tax purposes.[100]

Transfer pricing

A basic U.S. tax principle applicable in dividing profits from transactions between related taxpayers is that the amount of profit allocated to each related taxpayer must be measured by reference to the amount of profit that a similarly situated taxpayer would realize if the transaction was with an unrelated party. The transfer pricing rules of section 482 and the accompanying Treasury regulations are intended to preserve the U.S. tax base by ensuring that taxpayers do not shift income properly attributable to the United States to a related foreign company through pricing that does not reflect an arm's-length result.[101] Similarly, the domestic laws of most U.S. trading partners include rules to limit income shifting through transfer pricing. The arm's-length standard is difficult to administer in situations in which no unrelated party market prices exist for transactions between related parties. When a foreign person with U.S. activities has transactions with related U.S. taxpayers, the amount of income attributable to U.S. activities is determined in

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international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called "general basket" income). A number of other provisions of the Code, including several enacted in 2010 as part of Pub. L. No. 111-226, create additional separate categories in specific circumstances or limit the availability of the foreign tax credit in other ways. See, e.g., secs. 865(h), 901(j), 904(d)(6), 904(h)(10).

[98] Sec. 904(d)(3). The subpart F rules applicable to CFCs and their 10-percent U.S. shareholders are described below.

[99] Sec. 904(d)(4).

[100] Sec. 909.

[101] For a detailed description of the U.S. transfer pricing rules, see Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010, pp. 18-50.

part by the same transfer pricing rules of section 482 that apply when U.S. persons with foreign activities transact with related foreign taxpayers.

Section 482 authorizes the Secretary of the Treasury to allocate income, deductions, credits, or allowances among related business entities[102] when necessary to clearly reflect income or otherwise prevent tax avoidance, and comprehensive Treasury regulations under that section adopt the arm's-length standard as the method for determining whether allocations are appropriate.[103] The regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been unrelated parties dealing at arm's length. For income from intangible property, section 482 provides "In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." By requiring inclusion in income of amounts commensurate with the income attributable to the intangible, Congress was responding to concerns regarding the effectiveness of the arm's-length standard with respect to intangible property—including, in particular, high-profit-potential intangibles.[104]

Other special rules

Dual consolidated loss rules

Under the rules applicable to corporations filing consolidated returns, a dual consolidated loss ("DCL") is any net operating loss of a domestic corporation if the corporation is subject to an income tax of a foreign country without regard to whether such income is from sources in or outside of such foreign country, or if the corporation is subject to such a tax on a residence basis (a "dual resident corporation").[105] The DCL rules are intended to prevent an entity from using a loss to offset income of a domestic affiliate in the United States while using the same loss to offset income of a foreign affiliate which is not subject to U.S. tax. A DCL generally cannot be used to reduce the taxable income of any member of the corporation's affiliated group. Losses of a separate unit of a domestic corporation (a foreign branch or an interest in a hybrid entity owned by the corporation) are subject to this limitation in the same manner as if the unit were a wholly owned subsidiary of such corporation. An exemption is available under Treasury regulations in the case of DCLs for which a domestic use election (that is, an election to use the loss only for domestic, and not foreign, tax purposes) has been made.[106] Recapture is required,

[102] The term "related" as used herein refers to relationships described in section 482, which refers to "two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests."

[103] Section 1059A buttresses section 482 by limiting the extent to which costs used to determine custom valuation can also be used to determine basis in property imported from a related party. A taxpayer that imports property from a related party may not assign a value to the property for cost purposes that exceeds its customs value.

[104] Committee Report accompanying H.R. 3838, The Tax Reform Act of 1986, H.R. Rep. No. 99-426, December 7, 1985, p. 423.

[105] Sec. 1503(d).

[106] Treas. Reg. sec. 1.1503(d)-6(d).

however, upon the occurrence of certain triggering events, including the conversion of a separate unit to a foreign corporation and the transfer of 50 percent or more of the assets of a separate unit within a twelve-month period.[107]

Temporary dividends received deduction for repatriated foreign earnings

AJCA section 421 added to the Code section 965, a temporary provision intended to encourage U.S. multinational companies to repatriate foreign earnings. Under section 965, for one taxable year certain dividends received by a U.S. corporation from its CFCs were eligible for an 85-percent dividends received deduction. At the taxpayer's election, this deduction was available for dividends received either during the taxpayer's first taxable year beginning on or after October 22, 2004, or during the taxpayer's last taxable year beginning before such date.

The temporary deduction was subject to a number of general limitations. First, it applied only to cash repatriations generally in excess of the taxpayer's average repatriation level calculated for a three-year base period preceding the year of the deduction. Second, the amount of dividends eligible for the deduction was generally limited to the amount of earnings shown as permanently invested outside the United States on the taxpayer's recent audited financial statements. Third, to qualify for the deduction, dividends were required to be invested in the United States according to a domestic reinvestment plan approved by the taxpayer's senior management and board of directors.[108]

No foreign tax credit (or deduction) was allowed for foreign taxes attributable to the deductible portion of any dividend.[109] For this purpose, the taxpayer was permitted to specifically identify which dividends were treated as carrying the deduction and which dividends were not. In other words, the taxpayer was allowed to choose which of its dividends were treated as meeting the base-period repatriation level (and thus carry foreign tax credits, to the extent otherwise allowable), and which of its dividends were treated as part of the excess eligible for the deduction (and thus subject to proportional disallowance of any associated foreign tax credits).[110] Deductions were disallowed for expenses that were directly allocable to the deductible portion of any dividend.[111]

[107] See Treas. Reg. sec. 1.1503(d)-6(e)(1).

[108] Section 965(b)(4). The plan was required to provide for the reinvestment of the repatriated dividends in the United States, including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, and the financial stabilization of the corporation for the purposes of job retention or creation.

[109] Sec. 965(d)(1).

[110] Accordingly, taxpayers generally were expected to pay regular dividends out of high-taxed CFC earnings (thereby generating deemed-paid credits available to offset foreign-source income) and section 965 dividends out of low-taxed CFC earnings (thereby availing themselves of the 85-percent deduction).

[111] Sec. 965(d)(2).

Earnings stripping

A domestic corporation may reduce the U.S. tax on the income derived from its operations through the payment of deductible amounts such as interest, rents, royalties, premiums, and management service fees to foreign affiliates that are not subject to U.S. tax on the receipt of such payments.[112] Generating excessively large U.S. tax deductions in this manner is known as "earnings stripping."

Although the term "earnings stripping" may be broadly applied to excessive deductions for interest, rents, royalties, premiums, management fees, and similar types of payments in the circumstances described above, more commonly it refers only to excessive interest deductions. In general, earnings stripping provides a net tax benefit only to the extent the foreign recipient of the interest income is subject to a lower amount of foreign tax on such income than the net value of the U.S. tax deduction applicable to the interest, i.e., the amount of U.S. deduction times the applicable U.S. tax rate, less the U.S. withholding tax. That may be the case if the country of the interest recipient provides a low general corporate tax rate, a territorial system with respect to interest, or reduced taxes on financing structures.

Taxpayers are limited in their ability to reduce the U.S. tax on the income derived from their U.S. operations through certain earnings stripping transactions involving interest payments. If the payor's debt-to-equity ratio exceeds 1.5 to 1 (a debt-to-equity ratio of 1.5 to 1 or less is considered a "safe harbor"), a deduction for "disqualified interest" paid or accrued by the payor in a taxable year is generally disallowed to the extent of the payor's "excess interest expense."[113] Disqualified interest includes interest paid or accrued to related parties when no Federal income tax is imposed with respect to such interest;[114] to unrelated parties in certain instances in which a related party guarantees the debt ("guaranteed debt"); or to a REIT by a taxable REIT subsidiary of that REIT. Excess interest expense is the amount by which the payor's "net interest expense" (that is, the excess of interest paid or accrued over interest income) exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion). Interest amounts disallowed under these rules can be carried forward indefinitely and are allowed as a deduction to the extent of excess limitation in a subsequent tax year. In addition, any excess limitation (that is, the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

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[112] In general, for U.S.-controlled corporations, this type of tax planning is greatly limited by the anti-deferral rules of subpart F.

[113] Sec. 163(j).

[114] If a tax treaty reduces the rate of tax on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed under the treaty, bears to the rate of tax imposed without regard to the treaty. Sec. 163(j)(5)(B).

Corporate dividends received deduction

A corporation is generally allowed to deduct a portion of the dividends it receives from another corporation. The deductible amount is a percentage of the dividends received. The percentage depends on the level of ownership that the corporate shareholder has in the corporation paying the dividend. The dividends received deduction is 70 percent of the dividend if the recipient owns less than 20 percent of the stock of the payor corporation, 80 percent if the recipient owns at least 20 percent but less than 80 percent of the stock of the payor corporation, and 100 percent if the recipient owns 80 percent or more of the stock of the payor corporation.[115]

REITs and RICs are U.S. domestic corporations that qualify and elect to be taxed under a special tax regime that allows them (unlike other corporations) to deduct dividend distributions to shareholders. REITs and RICs are restricted to certain types of assets and income, and generally must distribute 90 percent of their income annually (except for net capital gains).[116] REITs generally must invest in real estate related assets. RICs generally must invest in stocks and securities.

Dividends from REITs are not eligible for the corporate dividends received deduction.[117] Dividends from RICs are eligible only to the extent attributable to dividends received by the RIC from certain other corporations, and are treated as dividends from a corporation that is not 20-percent owned.[118]

Dividends received from a foreign corporation are not generally eligible for the dividends received deduction. However, section 245 provides that if a U.S. corporation is a 10-percent shareholder of a foreign corporation, the U.S. corporation is generally entitled to a dividends received deduction for the portion of dividends received that are attributable to the post-1986 undistributed U.S. earnings of the foreign corporation. The post-1986 undistributed U.S. earnings are measured by reference to earnings of the foreign corporation effectively connected with the conduct of a trade or business within the United States, or received by the foreign corporation from an 80-percent owned U.S. corporation.[119] A 2013 IRS Chief counsel advice memorandum advised that dividends received by a 10-percent U.S. corporate shareholder from a foreign corporation controlled by the shareholder are not eligible for the dividends received

[115] Sec. 243.

[116] Secs. 856- 860.

[117] Sec. 243(d)(3). Treasury regulations provide that a dividends received deduction under sections 243, 244, or 245 is not available for any dividend received from a REIT.

[118] Secs. 243(d)(2) and 854(b)(1)(A) and (C).

[119] Sec. 245.

deduction where the dividends were attributable to interest income of an 80-percent owned RIC.[120]

[120] IRS CCA 201320014. The situation addressed in the memorandum involved a controlled foreign corporation that had terminated its "CFC" status before year end, through a transfer of stock to a partnership. The advice was internal IRS advice to the Large Business and International Division. Such advice is not to be relied upon or cited as precedent by taxpayers, but may offer some indication of administrative practice.

II. REFORM OF TAXATION OF INCOME EARNED BY CONTROLLED FOREIGN CORPORATIONS

General Provisions

OPTION Y

A. Participation Exemption System for Taxation of Foreign Income

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

Explanation of Provision

In general

Option Y of the discussion draft establishes a dividend exemption system for foreign business income. This exemption is effectuated by means of a 100-percent deduction for the foreign-source portion of dividends received from CFCs by domestic corporations that are 10-percent U.S. shareholders of those CFCs.[121]

The dividends received deduction is available only if a one-year holding period requirement, described below, is satisfied.

The discussion draft retains but significantly modifies subpart F of the Code. Consequently, although the foreign-source portion of a dividend generally is 100-percent deductible when received by a 10-percent U.S. shareholder from a CFC, the 10-percent U.S. shareholder remains taxable in the United States on a current basis under the discussion draft on its pro rata share of certain items of passive, low-taxed, U.S.-related, or insurance income of the CFC. The modified subpart F rules are intended to ensure that the dividend exemption applies only to income from the conduct of an active foreign business and to limit shifting of income from the United States to low-tax foreign countries. The discussion draft's modifications to subpart F are described in more detail below.

The discussion draft generally denies a foreign tax credit (or deduction) for foreign taxes imposed on income that is exempt from U.S. taxation under the dividend exemption system. The discussion draft's foreign tax credit rules are described in more detail below.

Foreign-source portion of a dividend

The dividend exemption system is intended to apply only to foreign business income and not to U.S-source income. Some CFCs, however, may have U.S.-source income. Consequently, the 100-percent dividends received deduction is available only for the foreign-source portion of a dividend.

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[121] United States shareholder has the meaning given in section 951(b).

The foreign-source portion of a dividend for which the 100-percent deduction is allowed represents the portion of the dividend that relates to the CFC's undistributed foreign earnings. The foreign-source portion of any dividend is, therefore, the amount that bears the same ratio to the dividend as the CFC's undistributed foreign earnings bears to the CFC's undistributed earnings.

Under the provision, a CFC's undistributed foreign earnings are undistributed earnings that are attributable to neither income effectively connected with the conduct of a U.S. trade or business and subject to U.S. income tax nor any dividend received directly or indirectly from a U.S. corporation (including, for example, a corporation taxable under subchapter C of the Code, a RIC, or a REIT). Undistributed earnings are the earnings and profits of the foreign corporation (computed in accordance with sections 964(a) and 986) as of the close of the CFC's taxable year in which the dividend is distributed, without diminution for dividend distributions during that taxable year.

The foreign-source portion rules complement the present law section 245 rule allowing a deduction for the U.S.-source portion of a dividend received from a qualified 10-percent owned foreign corporation. The U.S.-source portion of any dividend for which a deduction is allowed under section 245 is (as modified by the provision) the amount that bears the same ratio to the dividend as the dividend-paying corporation's undistributed U.S. earnings bears to the corporation's undistributed earnings. For this purpose, a corporation's undistributed U.S. earnings are, in general, undistributed earnings attributable to the corporation's income that is effectively connected with the conduct of a trade or business within the United States.[122]

In broad terms, present law section 245 is intended to prevent a second imposition of U.S. corporate tax when a domestic corporation receives a dividend from a foreign corporation attributable to the foreign corporation's U.S.-source effectively connected income, whereas the new section 245A is intended to provide an exemption from U.S. corporate tax when a domestic corporation receives a dividend from a CFC attributable to the CFC's non-subpart-F foreign-source business income.

One-year holding period requirement

A domestic corporation is allowed the 100-percent deduction for a dividend it receives on stock of a CFC only if the domestic corporation satisfies a one-year holding period requirement for the stock on which the dividend is paid. No deduction is allowed for any dividend on any share of CFC stock that is held by the domestic corporation for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the dividend is paid. A deduction also is not permitted for any dividend on any share of CFC stock to the extent the domestic corporation that owns the share is under an obligation (under a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

These holding period requirements parallel the section 246(c)(1) requirements for the dividends received deductions available under present law sections 243, 244, and 245. The

[122] Section 245(a)(5)(A).

discussion draft also incorporates the other present law section 246(c) holding-period-related rules (including, for example, the section 246(c)(4) rule under which holding periods are reduced in a manner provided in Treasury regulations for any period during which the taxpayer has diminished its risk of loss with respect to stock on which a dividend is paid).

The 365-out-of-731-days test described above is satisfied only if the CFC is a CFC at all times during the period and the domestic corporation is a 10-percent U.S. shareholder of the CFC at all times during the period.

Special rules for hybrid dividends

Hybrid dividends are not eligible for the 100-percent dividends received deduction under the provision. A hybrid dividend is a payment that is treated as a dividend for purposes of the Code but for which the CFC making the payment receives a deduction (or similar tax benefit) under the laws of any country with respect to which the CFC is a resident for purposes of the country's income tax laws.

The discussion draft provides special subpart F rules for the treatment of hybrid dividends paid by one CFC to a related CFC, and it provides special foreign tax credit and deduction disallowance rules for foreign taxes related to hybrid dividends. Those rules are described below.

Application to tiered CFC structures

The dividends received deduction is available only for 10-percent corporate U.S. shareholders of CFCs. Other provisions of the discussion draft generally excludes from subpart F income dividends – other than hybrid dividends – paid by one CFC to a related CFC. The CFC-to-CFC dividend rules are described below.

10/50 companies

The discussion draft allows the 100-percent dividends received deduction for dividends received by 10-percent corporate U.S. shareholders of CFCs but does not allow the deduction for dividends received by 10-percent corporate U.S. shareholders of noncontrolled section 902 corporations (so-called "10/50 companies").[123]

The discussion draft repeals the section 902 indirect credit for foreign taxes deemed paid by 10-percent corporate U.S. shareholders of 10/50 companies by reason of dividends received from those 10/50 companies. The foreign tax credit rules under the discussion draft's dividend exemption system are described in more detail below.

[123] A noncontrolled section 902 corporation is, in general, a foreign corporation that is at least 10 percent owned by one or more domestic corporations but which is not a CFC because it is not more than 50 percent owned by five or fewer 10-percent U.S. shareholders. See section 904(d)(2)(E)(i). Under present law a 10-percent domestic corporate shareholder of a noncontrolled section 902 corporation is allowed a section 902 deemed-paid credit in respect of foreign taxes paid by the noncontrolled section 902 corporation but, by definition, is not subject to the subpart F rules in respect of its ownership of that corporation.

Foreign branches

The provision generally does not change the present law taxation of foreign branches of U.S. corporations. Consequently, U.S. corporations remain taxable by the United States on their foreign branch income.

Conforming amendments and other changes

The provision includes a number of changes that coordinate the new dividends received deduction rules with existing Code provisions or that conform existing Code provisions to the new dividends received deduction rules. Certain changes are described below.

Like the present law dividends received deduction rules of sections 243, 244, and 245, the provision's 100-percent dividends received deduction is not available for any dividend from a corporation that is exempt from taxation under section 501 or 521.

In conformity with the present law dividends received deduction rules, dividends that qualify for the dividends received deduction under the provision and the stock on which deductible dividends are paid are treated as 100-percent tax-exempt income and 100-percent tax-exempt assets, respectively, for purposes of allocating and apportioning deductible expenses.

The discussion draft also disallows interest expense attributable to exempt CFC income. These interest disallowance rules, new section 265A of the Code, are described below.

Present law section 1059 generally requires that a corporation that receives an extraordinary dividend in respect of stock that the corporation has not held for more than two years before the dividend announcement date must reduce its basis in the stock by the amount of the dividends received deduction available under section 243, 244, or 245. The provision extends this rule to stock on which a dividend eligible for the 100-percent dividends received deduction is paid.

Effective Date

The provision applies to taxable years of foreign corporations beginning after December 31, 2014 and to taxable years of 10-percent corporate U.S. shareholders with or within which those taxable years of foreign corporations end.

2. Application of dividends received deduction to certain sales and exchanges of stock (sec. 2 of the Option Y discussion draft and secs. 964 and 1248 of the Code)

Explanation of Provision

In general

The provision provides that when a domestic corporation sells or exchanges stock in a foreign corporation that it has held for one year or more, any amount received from the sale or exchange that is treated as a dividend under section 1248 is treated as a dividend for purposes of the discussion draft's 100-percent dividends received deduction. Accordingly, if a 10-percent

U.S. corporate shareholder of a CFC sells its CFC stock at a gain, and the corporation has held the stock for at least one year, the corporation is allowed the dividends received deduction for any portion of the gain that section 1248 treats as a dividend.

Losses disallowed

The provision disallows a domestic corporation's deduction for any loss from the sale or exchange of foreign corporation stock if the domestic corporation satisfies the section 1248(a)(2) ownership requirement.[124]

Lower-tier sales

The provision provides that if one CFC sells or exchanges stock of another CFC and the loss disallowance provision just described would have applied had the selling CFC been a United States shareholder, then the earnings and profits of the selling CFC are not reduced by reason of any loss from the sale or exchange.

Effective Date

The provision is generally effective for sales or exchanges after December 31, 2014. The provision does not, however, apply to any sale or exchange of foreign corporation stock if the sale or exchange is before the beginning of the foreign corporation's first taxable year beginning after December 31, 2014.

[124] Section 1248(a)(2) requires that the selling shareholder has owned (within the meaning of section 958(a)) or has been considered as owning (under section 958(b)) 10 percent or more of the total combined voting power of all classes of the foreign corporation's voting stock at any time during the five-year period ending on the date of the sale or exchange at a time when the foreign corporation was a CFC.

B. Reform of Subpart F Inclusion

1. Inclusion of United States related income in subpart F income (sec. 3 of the Option Y discussion draft and secs. 952(a) and 955 of the Code)

Explanation of Provision

The provision adds United States related income as a new category of subpart F income. For purposes of the provision, the United States related income of any CFC is the sum of the CFC's imported property income and its United States services income. United States related income does not include income of a CFC that is (1) insurance income, (2) foreign personal holding company income, (3) international boycott income, (4) illegal bribes, etc., or (4) income derived from countries to which section 901(j) applies.

Imported property income under the provision is income derived in connection with (1) manufacturing, producing, growing, or extracting imported property, (2) the sale, exchange, or other disposition of imported property, or (3) the lease, rental, or licensing of imported property.

Imported property is property that is imported into the United States by the CFC or a related person.[125] It also includes any property sold, exchanged, or otherwise disposed of by the CFC or a related person to any person if, when the property was sold, exchanged, or otherwise disposed of, it was reasonable to expect that the property would be imported into the United States or would be used in the manufacture or production of, or as a component part in, other property which would be imported into the United States.

If property is ultimately imported into the United States and all sales, exchanges, or dispositions of the property (or property used in the manufacture of, or as a component part in the property), before the sale for use, consumption, or disposition in the United States are between related persons, the CFC is deemed to have had a reasonable expectation that the property would be imported into the United States.

To illustrate the intended scope of this provision, assume a domestic corporation has two related subsidiaries, CFC1 and CFC2, which are involved in the process of producing and selling widgets. Assume that CFC1 makes molds used in the production of widgets and sells such molds to CFC2. Assume further that CFC2 uses the molds to manufacture widgets that it subsequently sells for use in the United States. Although CFC1 operates entirely outside the United States, and sells to a foreign party, its income from the sales of the molds to CFC2 is imported property income. CFC1 is presumed to know that the property will be used in the manufacture or production of, or as a component part in, a widget to be used, consumed, or disposed of in the United States.

Imported property does not include any property which, before substantial use in the United States, is sold, leased, rented, or licensed by the CFC or a related person for use, consumption, or disposition outside the United States, or is used by the CFC or a related person

[125] A related person for purposes of this provision means a related person as defined in section 954(b).

as a component in other property which is sold, leased, rented, or licensed for use outside the United States.

Imported means bringing of property into the United States for consumption or use within the United States. It includes any grant of the right to use intangible property, tangible property, or real property in the United States.

United States services income is income derived in connection with services (including insurance, reinsurance, annuity contracts, banking, financing, or a similar business) provided with respect to persons or property located in the United States (or, in the case of insurance or reinsurance services, with respect to United States risks). It does not include imported property income.

Effective Date

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

2. Low-taxed income treated as subpart F income (sec. 4 of the Option Y discussion draft and secs. 952 and 956 of the Code)

Explanation of Provision

The provision repeals present law section 956 and adds low-taxed income as a new category of subpart F income. Low-taxed income is any item of income, other than certain other subpart F categories of income,[126] if the effective rate of foreign income tax on such item of income is less than [80] percent of the maximum U.S. corporate tax rate. Dividends (other than hybrid dividends) received or accrued from another CFC which is a member of the same expanded affiliated group are excluded from subpart F income.[127]

The effective foreign tax rate on any item of income is computed using U.S. tax principles (including net operating loss carryforward (not carryback) rules under section 172) and taking into account only taxes and other deductions related to the tested item of income. It is anticipated that rules similar to those in Treasury regulations section 1.904-6 will be used to relate taxes and other deductions to income. Accordingly, the numerator in computing the effective tax rate is the amount of a foreign income tax determined for U.S. tax purposes imposed on an item of income and the denominator is the amount of taxable income for U.S. tax purposes. It is anticipated that regulations will allow the effective tax rate test to be applied by aggregating the items of income and deduction (determined for U.S. tax purposes) arising from

[126] Low-taxed income does not include insurance income (as defined under section 953), foreign personal holding income (as determined under section 954), United States related income (as defined in section 955), certain income subject to the international boycott factor, illegal bribes, kickback, etc. included in subpart F, and income derived from any foreign country during any period to which section 901(j) applies to such foreign country.

[127] See section 7 of the Option Y discussion draft for the exclusion of CFC dividends.

activities giving rise to a foreign tax base and the related foreign income taxes (determined for U.S. tax purposes).

Additionally, under the provision, a U.S. shareholder of a CFC is allowed a deduction of [20] percent of the amount included in gross income attributable to low-taxed income. The inclusion of a CFC's low-taxed income in combination with this deduction has the effect of imposing a minimum worldwide tax rate on income earned by a CFC.

A U.S. shareholder is allowed a full tax credit with respect to the subpart F income inclusion attributable to low-taxed income. This ensures that the U.S. shareholder pays a consistent amount of worldwide tax equal to [80] percent of the maximum Federal corporate income tax rate if the foreign effective tax rate is less than [80] percent of such maximum rate.

To illustrate (using the present law statutory corporate tax rate of 35 percent), assume a domestic corporation (DC) owns 100 percent of a CFC. Assume the CFC earns $100 of foreign income and pays $15 in foreign income taxes related to its business in country Y. The CFC's income is not otherwise subpart F income. The CFC's effective tax rate is 15 percent, or 43 percent of the present law 35-percent U.S. corporate tax rate. This amount is less than 80 percent of the maximum U.S. corporate tax rate and $100 ($85 plus the $15 section 78 gross up) is included in DCs income. Additionally, DC is allowed a $20 deduction against the low-taxed income inclusion, and a full $15 foreign tax credit. DC has $28 of U.S. tentative tax ($80 x 35 percent), and pays $13 of U.S. residual tax (after $15 foreign tax credit) resulting in worldwide tax of $28 on $100 of income, a tax rate of 28 percent (80 percent of the highest U.S. corporate tax rate) on the CFC's foreign income.

<u>Effective Date</u>

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

3. Repeal of foreign base company sales, services, and oil related income; modification to foreign personal holding company income (sec. 5 of the Option Y discussion draft and secs. 543 and 954 of the Code)

<u>Explanation of Provision</u>

Under the provision, foreign personal holding company income (as modified by the provision) is included in subpart F income. The inclusion of other foreign base company income (foreign base company sales income, foreign base company services income, and foreign base company oil related income) in subpart F is repealed. The rule exempting de minimis amounts from foreign personal holding company income and insurance income is repealed. The rule deeming all income of a CFC to be insurance income or foreign personal holding company income if the sum of such income exceeds 70-percent of such CFC's gross income is repealed. The exception from foreign personal holding company income and insurance income of items of income subject to high foreign taxes is repealed.

An item of income excluded from foreign personal holding company income may be included in another category of subpart F income, for example United States related income (as defined in section 955) or low-taxed income (as defined in section 956).

For the purposes of PFICs, the term passive income means any income which would be foreign personal holding company income were such PFIC a CFC.

Modifications to foreign personal holding company income

Under the provision, the foreign currency gains business needs exception is modified to provide that foreign currency gains and losses from borrowing transactions of the CFC are taken into account in the foreign currency gains inclusion. No inference is intended regarding the application of current law to nonfunctional currency borrowing transactions.

The provision repeals the exception for export financing interest derived in the conduct of a banking business.

The provision broadens and makes permanent the exception for regular dealers in property that gives rise to dividends, interest, rents, royalties, and annuities, and other categories of property. Under the provision, dividends, interest, rents, royalties, and annuities (and certain equivalent amounts) from any transaction (including hedging transactions and transactions involving physical settlement) entered into in the ordinary course of the CFC's trade or business as a dealer are not taken into account in computing foreign personal holding company income. The provision supersedes the separate temporary rule relating to dividends and interest (and certain equivalent amounts) received by dealers in securities.

The provision does not extend the temporary "CFC look-thru" rules of current law section 954(c)(6) for determining the character of dividends, interest, rents, and royalties paid by a related CFC. The provision modifies the same-country exception for dividends, interest, rents, and royalties. Under the provision, in general, dividends and interest received by a CFC from a related corporation which are both subject to tax under the laws of the same foreign country and rents and royalties received by a CFC from a related corporation for the use of property within the country under the laws of which the CFC is subject to tax are excluded from foreign personal holding company income. The exclusion does not apply to the extent the payment reduces the subpart F income of the payor or another CFC, or to the extent that dividends are attributable to earnings and profits accumulated during a period during which the person receiving the dividend did not own the stock.

The provision modifies the rule for sales of partnership interests where a CFC directly owns 25-percent or more of the capital or profits interest in such partnership. The provision treats the portion of the gain or loss on the sale of such interest which bears the same ratio as such CFC's distributional share of subpart F income over the three taxable years preceding the sale bears to such CFC's distributional share of gross income over the same period as gain or loss from the sale of an interest in a trust, partnership, or REMIC.

Active financing exception

Foreign personal holding company income does not include qualified banking or financing income of an eligible CFC or qualified insurance income of a qualifying insurance company. These exceptions do not apply for purposes of determining low-taxed income treated as subpart F income, discussed above. Under the provision, the active financing exception is made permanent.

Banking, financing, and similar businesses

Under the provision, a CFC is eligible if it is either a regulated financial institution or if 80 percent of its gross income is derived from the active and regular conduct of a lending, finance, or financial services business from transactions with customers located outside the United States who are not related persons. The provision codifies a list of activities, conducting the business of any of which constitutes a lending, finance, or financial services business.

A regulated financial institution is an institution that is engaged in the active conduct of a banking business and licensed to do business as a bank in the United States, or is an institution that is licensed as a bank in, and subject to the regulatory supervision of, a jurisdiction whose central bank (or equivalent) is a member of the Basel Committee on Banking Supervision, and is wholly owned by a domestic bank or depository institution holding company as defined under the Federal Deposit Insurance Act. The Secretary may issue regulations to expand the definition of regulated financial institution.

In connection with the modification to the foreign personal holding company rules as applied to securities brokers and dealers, discussed above, the provision repeals the application of the active financing exception to registered securities brokers and dealers. The provision repeals the coordination rule for when a CFC is subject to the exceptions for both active financing and dealers in securities.

The provision repeals the CFC-wide eligibility determination if a CFC has one or more qualified business units (QBUs). Under the provision, rules for determining eligibility and the amount of qualified banking or financing income are applied separately to the CFC and to each unit in the same manner as if such unit were a CFC. If, on a separate basis, a QBU is treated as an eligible CFC, then any qualified banking or financing income of such unit is treated as qualified banking or financing income of such CFC. In computing the qualified banking or financing income of a QBU, only items of income, deduction, gain, or loss and activities properly allocable or attributable to such QBU are taken into account.

The provision repeals the limitation that treats no income of a CFC (or QBU) as qualified banking or financing income unless more than 30-percent of such CFC's (or QBU's) gross income is derived directly from the active and regular conduct of a lending or finance business from transactions with unrelated customers and which are located within the CFC's (or QBU's) home country.

The provision makes several modifications to the definition of qualified banking or financing income. In the case of regulated financial institutions, income derived from customers includes income derived from reserves that are required to be held pursuant to banking regulations, deposits placed with the central bank in the corporation's home country, and investments in debt instruments issued by the home country.

Under the provision, activities of the employees of a related person are treated as conducted directly by an eligible CFC if the related person is subject to tax in its home country, such home country is the same home country as the eligible CFC's, the activity is performed in such home country, the related person is compensated on an arm's-length basis for such performance, and such compensation is treated as earned by such related person in its home country for purposes of the home country's tax laws. It is not necessary for the related person to be a CFC.

For purposes of the active financing exception, home country with respect to a CFC is revised to mean the country under the laws of which the CFC is subject to tax on the basis of residence. The home country of a QBU is the country where such unit maintains its principal office. With respect to a customer who is a natural person, such customer is considered to be located in the country where he is physically present when entering into the transaction. With respect to a customer who is not a natural person, such customer is considered to be located in the country from which the customer enters into the transaction.

Insurance business

The provision retains the present-law definition of qualified insurance income for purposes of the exception from foreign personal holding company income in the case of qualified insurance income of a qualifying insurance company, although the definition of a qualifying insurance company is modified. The definition of a qualifying insurance company under the provision is described below with related modifications to the definition of exempt insurance income under section 953(e).

Personal holding company income not to include certain dividends

Under the provision, if a domestic corporation is a United States shareholder of a CFC, then dividends received by such domestic corporation from such CFC are not included in the personal holding company income (as defined in section 543) of such domestic corporation.

Effective Date

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

4. Modification to exempt insurance income (sec. 6 of the Option Y discussion draft and sec. 953(e) of the Code)

Explanation of Provision

The provision modifies several definitions used in calculating exempt insurance income under section 953(e).

The provision revises the definition of a qualifying insurance company to better address current international insurance market practices and to better address abuse. The provision retains certain present-law rules defining requirements applicable to a qualifying insurance company. Thus, the provision retains the requirement that a qualifying insurance company be subject to home country regulation. The provision retains the requirement that a qualifying insurance company derive more than 50 percent of aggregate net written premiums from contracts not involving related persons; however, the provision does not retain the present-law requirement that it derive more than 50 percent of aggregate net written premiums from contracts covering home country risks. The provision retains the requirement that a qualifying insurance company be engaged in the insurance business and that it would be subject to tax under subchapter L if it were a domestic corporation.

The provision adds two new requirements for qualifying insurance company status. The discussion draft requires that more than 50 percent of the CFC's gross receipts for a taxable year consist of premiums for insurance or reinsurance in connection with property, liability, or the lives or health of individuals, that are treated as earned by such CFC in its home country for purposes of tax laws in the home country of the CFC. In addition, the provision requires that the CFC's applicable insurance liabilities constitute more than 35 percent of the CFC's total assets as reported on the company's applicable financial statement for the year with or within which the taxable year ends. Insurance liabilities are defined as loss and loss adjustment expenses, unearned premiums, and reserves (other than catastrophe, deficiency, equalization, or similar reserves) for life and health insurance risks and life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks (not to exceed the amount of such reserve that is required to be reported to the home country insurance regulatory body).

The CFC's applicable financial statement for this purpose means the statement for financial reporting purposes that is made on the basis of generally accepted accounting principles or, (if not made on the basis of generally accepted accounting principles) is made on the basis of international financial reporting standards. If a CFC does not make such a financial statement, then the applicable financial statement is the annual statement required to be filed with the home country insurance regulatory body, except as otherwise provided by the Secretary.

The percentage tests generally are applied on a CFC-by-CFC basis (or branch-by-branch basis); however, regulatory authority is provided to determine circumstances (if any) under which it is appropriate and consistent with the purposes of the provision to apply the percentages by treating all CFCs filing a consolidated tax return, including a home country consolidated tax return, as one CFC. Further regulatory authority is provided with respect to the application of the 50-percent premiums test and the 35-percent insurance liabilities test in the case of a startup or runoff company. In the absence of guidance, it is intended that rules apply for this purpose that are similar to those applicable under section 815, providing generally that in the case of a startup or runoff company, a company without adequate premiums for two successive taxable years cannot be treated as an insurance company.

The provision modifies the definition of exempt contract. It repeals the home country risk prong of the 30-percent net written premium requirement for a qualifying insurance company (or qualifying insurance company branch) to treat any contract as an exempt contract. The provision retains the requirement for an exempt contract that the qualifying insurance company or branch derive more than 30 percent of its net written premiums from exempt contracts (determined without regard to this rule) with respect to which no policyholder, insurance, annuitant, or beneficiary is a related person. In addition, the substantial activity requirement is expanded to require that any CFC insurance contract, and not just a contract covering cross-border risks, is an exempt contract only if the CFC conducts substantial activities with respect to the contract and that substantially all of the activities necessary to give rise to the income generated by the contract are performed by the CFC in its home country. For this purpose, an activity is considered directly conducted by a qualifying insurance company in its home country if the activity is performed in such home country by the employees of a related person and (1) the related person is subject to tax in the home country of the qualifying insurance company, (2) the related person is compensated at arm's length for the activities of its employees, and (3) such compensation is treated as earned in such home country for purposes of the home country's income tax laws.

The rule for determining whether an insurance contract was issued by a CFC or QBU where such contract is regulated as a life insurance or annuity contract by the CFC's or unit's home country and no policyholder, insured, annuitant, or beneficiary with respect to the contract is a United States person is narrowed to apply only to CFCs and QBUs that are qualifying insurance company branches.

Effective Date

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

5. Exclusion of dividends from related CFCs (sec. 7 of the Option Y discussion draft and sec. 952 of the Code)

Explanation of Provision

Under the provision, the subpart F income of a CFC does not include any dividend received or accrued from another CFC which is a member of the same expanded affiliated group. The provision does not apply to any hybrid dividend (as defined in section 245A(d)(3)).

Effective Date

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

6. Other conforming modifications to definition of subpart F income (sec. 8 of the Option Y discussion draft and secs. 951 and 952 of the Code)

Explanation of Provision

Deductions to be taken into account

Consistent with the present law principle that subpart F income is net income, this provision allows CFCs to reduce their foreign personal holding company income, U.S. related income, and low-taxed income by taking into account deductions (including taxes) properly allocable to such income. Except to the extent provided in regulations prescribed by the Treasury Secretary, any interest which is paid or accrued by the CFC to a U.S. shareholder (or any CFC related to such shareholder) is allocated first to foreign personal holding income which is passive income of such CFC, as is the case under present law.[128]

Modifications to earnings and profits limitation

A CFC's subpart F income in any taxable year is limited to its earnings and profits for that year, less qualified deficits. A qualified deficit is defined as any deficit in earnings and profits incurred by a CFC for any prior taxable year which began after December 31, 1986, to the extent that such deficit is attributable to the same qualified activity as the activity giving rise to the income being offset, and has not already been accounted for as a qualified deficit.

This provision redefines qualified activity as any activity giving rise to: (1) U.S. related income; (2) low-taxed income; (3) foreign personal holding company income or qualified insurance income earned by a qualified insurance company; and (4) foreign personal holding company income earned by a qualified financial institution.

Conforming amendments

This provision also includes conforming amendments that, among other things, coordinate the calculation of a U.S. shareholder's gross income with the repeal of rules concerning the withdrawal of previously excluded subpart F income that was invested in foreign base company shipping operations.[129]

Effective Date

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

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[128] The definition of passive income is discussed in section 11 of the Option Y discussion draft.

[129] Sec. 955.

OPTION Z

1. Modifications to definition of subpart F income: active foreign market income (secs. 1(a), 1(b), 1(f) and 1(g) of Option Z discussion draft and secs. 951 through 959 of the Code)

Explanation of Provision

Option Z of the discussion draft generally imposes current tax on U.S. shareholders of CFCs in respect of that shareholder's pro rata share of all CFC income, while retaining the structure of subpart F. It repeals the existing definitions of subpart F income, insurance income, foreign base company income, shipping, and investment in US property. A new definition of subpart F income is provided that introduces the concepts of modified active income, modified non-active income, and active foreign market income.

Subpart F income defined

Under the new definition, subpart F income is the sum of modified active income and modified nonactive income. The former is [60] percent of active foreign market income; modified nonactive income is the net income of a CFC determined without regard to active foreign market income. Each component of subpart F income is reduced by expenses properly allocable to items of income taken into account in the determination of such component as well as certain losses, as explained below. The effect of the new definition is to eliminate deferral of income by a CFC and to provide a partial exemption from U.S. tax for active foreign market income. As in present law, subpart F income does not include income effectively connected with a U.S. trade or business, unless such income was exempted from taxation under a tax treaty.

Both active foreign market losses and qualified losses in the current year may reduce active foreign market income in computing modified active income. Only qualified losses are available to reduce modified non-active income, but not below zero. Qualified losses are the amounts by which allocable expenses exceed gross income of a CFC computed without regard to active foreign market income. For taxable years beginning after December 31, 2014, qualified losses from non-active foreign market operations in a taxable year are carried forward and reduce non-active foreign market income in future years. Such a loss is measured as the amount by which a shareholder's pro rata share of deductions attributable to subpart F income exceeds subpart F income, determined without regard to active foreign market income, and thus do not include active foreign market losses. Similarly, for post-December 31, 2014 taxable years, active foreign market losses are carried forward to reduce active foreign market income in future years. Ordering rules apply with respect to the use of qualified losses from more than one taxable year to ensure that qualified losses are used first to offset non-active income, then to reduce active foreign market income. Similarly active foreign market income is first reduced by carry forwards of active foreign market losses and then by carry forwards of qualified losses.

Active foreign market income

Active foreign market income is income attributable to economically significant activities of a qualified trade or business derived in connection with property sold or exchanged for use outside the United States or services performed outside the United States with respect to persons or property located outside the United States. Economically significant activities must be performed outside the United States by officers or employees of the controlled foreign corporation and must make a substantial contribution to the production of income. Active foreign market income does not include passive income, generally, but income that would otherwise be characterized as passive income may nevertheless be active foreign market income, and thus eligible for the deduction, if the item of income satisfies the exceptions for active banking, finance, or insurance income, or is certain rent and royalty income, as explained below.

Similarly, the discussion draft provides rules for determining the extent to which sales of CFC stock or interests in partnerships are taken into account in determining active foreign market income. With respect to sales of partnership interests, gains or losses are generally taken into account only if a CFC is a 25-percent owner, i.e., holds 25 percent or more of the capital or profits interest in a partnership. For purposes of determining if it is a 25-percent owner of a partnership, the CFC is treated as directly owning its proportionate share of capital or profits in any partnership that it owns indirectly through ownership in another corporation or partnership. For purposes of this section, direct ownership also includes ownership determined by application of the constructive ownership rules.

The rules for determining whether or not income is active foreign market income specify that the determination of whether or not income is active foreign market income is on an item-by-item basis. A trade or business is a qualified trade or business if it consists of manufacturing, producing, growing, or extracting property, or providing services, outside of the United States. It also may include a trade or business that consists of making substantial contributions through the activities of the officers or employees of the CFC to the qualified trade or business of another person. Thus, active foreign market income broadly includes cross-border income, but generally excludes income attributable to U.S. market sales or services.

Related persons and special rules

In determining active foreign market income, a special rule generally excludes any income derived from any transactions if it was reasonable for a CFC or related person to anticipate that the property would be used, consumed, or disposed of in the United States or would be incorporated into another item that would be used, consumed, or disposed of in the United States. For purposes of this rule, related persons include any person that controls or is controlled by the CFC, or is controlled by common owners that control the CFC. A person controls an entity if it controls 50 percent of the vote in a corporation or 50 percent of the value of beneficial interests for partnerships, trusts, or estates. A presumption that ultimate use in the United States was contemplated exists if all sales of property in a series of transactions are among related persons. A single sale to an unrelated person does not create a presumption that there was no reasonable expectation of such use.

To illustrate the intended scope of the related party rules and the concept of a qualified trade or business, assume there is a domestic corporation with two related subsidiaries, CFC1 and CFC2, which are involved in the process of producing and selling widgets. Assume that CFC1 makes molds used in the production of widgets and sells such molds to CFC2. Assume further that CFC2 uses the molds to manufacture widgets that it subsequently sells for use in the United States. Although CFC1 operates entirely outside the United States, and sells to a foreign party, its income from the sales of the molds to CFC2 does not qualify as active foreign market income, because it is presumed to know that the property will be used in the manufacture or production of, or as a component part in, a widget to be used, consumed, or disposed of in the United States. Sales of the mold by CFC1 to an unrelated foreign party may produce active foreign market income, depending upon the facts and circumstances.

Determination of previously taxed income

The provision coordinates rules governing amounts required to be included by the U.S. shareholder of the CFC with rules for determining the extent to which distributed amounts are treated as having been previously taxed. With respect to determining the latter, all subpart F income is considered to have been previously taxed. A special ordering rule provides that distributions of earnings and profits are considered to be made first from the deductible portion of the deemed repatriation under section 965, and next from the amount of active foreign market income that was deducted in determining subpart F income, before applying the general ordering rules for distributions. The general ordering rules require that a distribution be considered made from previously taxed income even if the CFC otherwise has an overall deficit in earnings and profits under section 312 or if such distribution would create such an overall deficit. In so providing, the ordering rules override the administrative position reflected in Revenue Ruling 86-131[130] that the earnings and profits reflected in the categories under section 959(c) must equal the CFC's total earnings.

Anti-loss importation rules inapplicable

The anti-loss importation rules are amended to provide that a CFC is considered to be subject to tax, except to the extent provided under regulations.

Effective Date

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

2. Modifications to definition of subpart F income: passive income (sec. 1(a) in the Option Z discussion draft and sec. 954 of the Code)

Explanation of Provision

Passive income

Passive income is excluded from the definition of active foreign market income. In addition, the discussion draft's passive income definition also provides the definition of passive income for the purposes of the passive foreign investment company rules of section 1291 et seq., subject to certain limited exceptions. Similar to foreign personal holding company income under present law, passive income includes dividends, interest, rents, royalties, and annuities, the

[130] Rev. Rul. 86-131, 1986-2 C.B. 135, 1986.

excess of gains over losses from the sale or exchange of certain property, the excess of gains over losses from transactions in commodities, the excess of foreign currency gains over foreign currency losses, certain interest and dividend equivalent payments, net income from notional principal contracts, and amounts received under a personal services contract or from the sale or other disposition of such contract.

Passive income is also subject to exclusions similar to the exclusions to foreign personal holding company income under present law. Rents and royalties received from an unrelated party and derived in the active conduct of a trade or business are excluded.

Under the provision, the foreign currency gains business needs exception is modified to provide that foreign currency gains and losses from borrowing transactions of the CFC are taken into account in the foreign currency gains inclusion. No inference is intended regarding the application of current law to nonfunctional currency borrowing transactions.

The provision broadens the exception for regular dealers in property that gives rise to dividends, interest, rents, royalties, and annuities, and other categories of property. Under the provision, any item of income, gain, deduction, or loss (including dividends, interest, rents, royalties, annuities, and certain equivalent amounts) from any transaction entered into in the ordinary course of the CFC's trade or business as a dealer is not taken into account in computing passive income. The provision supersedes the separate temporary rule relating to dividends and interest (and certain equivalent amounts) received by dealers in securities.

Dividends, interest, rents, and royalties received or accrued from a related CFC are not subject to a "CFC look-thru" rule for the purposes of computing passive income. In addition, the provision repeals the same-country exception for dividends, interest, rents, and royalties. Distributions from one CFC to another CFC would be exempt from tax under the section 959 previously taxed income rules, as modified in the discussion draft.

The provision modifies the rule for sales of partnership interests where a CFC directly owns 25-percent or more of the capital or profits interest in such partnership. The provision excludes from the definition of passive income the portion of the gain or loss on the sale of such interest which bears the same ratio as such CFC's distributional share of active foreign market income and non-active foreign market income (other than passive income) over the three taxable years preceding the sale bears to such CFC's distributional share of gross income over the same period. The excluded portion is characterized as active foreign market income and non-active foreign market income under the rules for characterizing gain or loss from the sale or exchange of certain equity interests (discussed above).

Passive income is not subject to a de minimis exception, a full inclusion rule for CFCs with passive income in excess of 70-percent of gross income, or an exclusion of items of income subject to high foreign taxes. Export financing interest derived in the conduct of a banking business is not exempt from passive income.

Active financing exception

The active financing exception exempts certain income from passive income. An item of income eligible for the active financing exception is active foreign market income under section 953. Under the provision, the active financing exception is permanent.

Banking, financing, and similar businesses

Similar to the rules for present law foreign personal holding company income, passive income does not include qualified banking or financing income of an eligible CFC.

Under the provision, a CFC is eligible if it is either a regulated financial institution or if 80 percent of its gross income is derived from the active and regular conduct of a lending, finance, or financial services business from transactions with customers located outside the United States who are not related persons. The provision codifies a list of activities, conducting the business of any of which constitutes a lending, finance, or financial services business.

A regulated financial institution is an institution that is engaged in the active conduct of a banking business and licensed to do business as a bank in the United States, or is an institution that is licensed as a bank in, and subject to the regulatory supervision of, a jurisdiction whose central bank (or equivalent) is a member of the Basel Committee on Banking Supervision, and is wholly owned by a domestic bank or depository institution holding company as defined under the Federal Deposit Insurance Act. The Secretary may issue regulations to expand the definition of regulated financial institution.

In connection with the modification of the passive income rules as applied to securities brokers and dealers, discussed above, the provision repeals the application of the active financing exception to registered securities brokers and dealers. The provision repeals the coordination rule for when a CFC is subject to the exceptions for both active financing and dealers in securities.

The provision repeals the CFC-wide eligibility determination if a CFC has one or more qualified business units (QBUs). Under the provision, rules for determining eligibility and the amount of qualified banking or financing income are applied separately to the CFC and to each unit in the same manner as if such unit were a CFC. If, on a separate basis, a QBU is treated as an eligible CFC, then any qualified banking or financing income of such unit is treated as qualified banking or financing income of such CFC. In computing the qualified banking or financing income of a QBU, only items of income, deduction, gain, or loss and activities properly allocable or attributable to such QBU are taken into account.

The provision repeals the limitation that treats no income of a CFC (or QBU) as qualified banking or financing income unless more than 30-percent of such CFC's (or QBU's) gross income is derived directly from the active and regular conduct of a lending or finance business from transactions with unrelated customers and which are located within the CFC's (or QBU's) home country.

The provision makes several modifications to the definition of qualified banking or financing income. In the case of regulated financial institutions, income derived from customers includes income derived from reserves that are required to be held pursuant to banking regulations, deposits placed with the central bank in the corporation's home country, and investments in debt instruments issued by the home country.

Under the provision, activities of the employees of a related person are treated as conducted directly by an eligible CFC if the related person is subject to tax in its home country, such home country is the same home country as the eligible CFC's, the activity is performed in such home country, the related person is compensated on an arm's-length basis for such performance, and such compensation is treated as earned by such related person in its home country for the purpose of the home country's tax laws. It is not necessary for the related person to be a CFC.

For the purposes of the active financing exception, home country with respect to a CFC means the country under the laws of which the CFC is subject to tax on the basis of residence. The home country of a QBU is the country where such unit maintains its principal office. With respect to a customer who is a natural person, such customer is considered to be located in the country where he is physically present when entering into the transaction. With respect to a customer who is not a natural person, such customer is considered to be located in the country from which the customer enters into the transaction.

Insurance business

The provision retains the present-law definition of qualified insurance income for purposes of the exception from foreign personal holding company income in the case of qualified insurance income of a qualifying insurance company, although the definition of a qualifying insurance company is modified. The definition of a qualifying insurance company under the provision is described below with related modifications to the definition of exempt insurance income under new section 955(c).

Effective Date

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

3. Modifications to definition of subpart F income: insurance income (sec. 1(a) in the Option Z discussion draft and secs. 955 and 956 of the Code)

Explanation of Provision

Insurance income

Insurance income of a controlled foreign corporation

Under the provision, insurance income is a gross income concept, but is otherwise unchanged from present law section 953(a) and (b). Deductions taken into account under present law section 953(b)(4) are, under the provision, taken into account under section 952(e) (described above). Insurance income of a CFC is not active foreign market income.

Captive insurance companies

Under the provision, treatment of captive insurance companies is the same as under present law sections 953(c) and (d). Related person insurance income of a captive insurance company is not active foreign market income.

Active financing exception

Similar to present law, insurance income does not include exempt insurance income. Exempt insurance income is active foreign market income. Under the provision, rules regarding exempt insurance income are permanent.

The provision revises the definition of a qualifying insurance company to better address current international insurance market practices and to better address abuse. The provision retains certain present-law rules defining requirements applicable to a qualifying insurance company. Thus, the provision retains the requirement that a qualifying insurance company be subject to home country regulation. The provision retains the requirement that a qualifying insurance company derive more than 50 percent of aggregate net written premiums from contracts not involving related persons; however, the provision does not retain the present-law requirement that it derive more than 50 percent of aggregate net written premiums from contracts covering home country risks. The provision retains the requirement that a qualifying insurance company be engaged in the insurance business and that it would be subject to tax under subchapter L if it were a domestic corporation.

The provision adds two new requirements for qualifying insurance company status. The discussion draft requires that more than 50 percent of the CFC's gross receipts for a taxable year consist of premiums for insurance or reinsurance in connection with property, liability, or the lives or health of individuals, that are treated as earned by such CFC in its home country for purposes of the tax laws in the CFC's home country. In addition, the provision requires that the CFC's applicable insurance liabilities constitute more than 35 percent of the CFC's total assets as reported on the company's applicable financial statement for the year with or within which the taxable year ends. Insurance liabilities are defined as loss and loss adjustment expenses, unearned premiums, and reserves (other than catastrophe, deficiency, equalization, or similar reserves) for life and health insurance risks and life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks (not to exceed the amount of such reserve that is required to be reported to the home country insurance regulatory body).

The CFC's applicable financial statement for this purpose means the statement for financial reporting purposes that is made on the basis of generally accepted accounting principles or, (if not made on the basis of generally accepted accounting principles) is made on the basis of international financial reporting standards. If a CFC does not make such a financial statement, then the applicable financial statement is the annual statement required to be filed with the home country insurance regulatory body, except as otherwise provided by the Secretary.

The percentage tests generally are applied on a CFC-by-CFC basis (or branch-by-branch basis); however, regulatory authority is provided to determine circumstances (if any) in which it is appropriate and consistent with the purposes of the provision to apply the percentages by treating all CFCs filing a consolidated tax return, including a home country consolidated tax return, as one CFC. Further regulatory authority is provided with respect to the application of the 50-percent premiums test and the 35-percent insurance liabilities test in the case of a startup or runoff company. In the absence of guidance, it is intended that rules apply for this purpose that are similar to those applicable under section 815, providing generally that in the case of a startup or runoff company, a company without adequate premiums for two successive taxable years cannot be treated as an insurance company.

The provision modifies the definition of exempt contract. The provision repeals the home country risk prong of the 30-percent net written premium requirement for a qualifying insurance company (or qualifying insurance company branch) to treat any contract as an exempt contract. The provision retains the requirement for an exempt contract that the qualifying insurance company or branch derive more than 30 percent of its net written premiums from exempt contracts (determined without regard to this rule) with respect to which no policyholder, insured, annuitant, or beneficiary is a related person. In addition, the substantial activity requirement is expanded to require that any CFC insurance contract, and not just a contract covering cross-border risks, is an exempt contract only if the CFC conducts substantial activities with respect to the contract and that substantially all of the activities necessary to give rise to the income generated by the contract are performed by the CFC in its home country. For this purpose, an activity is considered directly conducted by a qualifying insurance company in its home country if the activity is performed in such home country by the employees of a related person and (1) the related person is subject to tax in the home country of the qualifying insurance company, (2) the related person is compensated at arm's length for the activities of its employees, and (3) such compensation is treated as earned in such home country for purposes of the home country's income tax laws.

The rule for determining whether an insurance contract was issued by a CFC or QBU where such contract is regulated as a life insurance or annuity contract by the CFC's or unit's home country and no policyholder, insured, annuitant, or beneficiary with respect to the contract is a United States person is narrowed to apply only to CFCs and QBUs that are qualifying insurance company branches.

Effective Date

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

4. Gains and losses from the sale of CFC stock and repeal of ordinary income treatment for gains from the sale of certain foreign corporations (sec. 1(c) and (d) of the Option Z discussion draft and new secs. 1203 and 1213 of the Code)

Explanation of Provision

The provision repeals the present law section 1248 rules that treat certain gains recognized by U.S. persons on the sale or exchange of stock of a CFC as dividends to the extent of the undistributed, non-previously-taxed earnings of the CFC attributable to that stock.

The provision replaces section 1248 with a rule excluding from the gross income of a 10-percent U.S. shareholder of a CFC a portion (the "applicable portion") of any gain from the sale or exchange of stock of the CFC.

The applicable portion for which an exclusion from gross income is allowed is, in broad terms, the portion of the CFC's historical earnings that has been excluded from subpart F income by reason of the preferential treatment of modified active income. More specifically, the applicable portion of gain from the sale or exchange of stock of a CFC is the ratio of (1) the selling shareholder's pro rata share (determined under section 951(a)(2)) of the excludable portion of the CFC's aggregate subpart F income for the applicable period, to (2) the selling shareholder's pro rata share of the CFC's aggregate subpart F income for the applicable period, plus the selling shareholder's pro rata share of the excludable portion of the CFC's aggregate subpart F income for that period.

The excludable portion of the CFC's subpart F income is the [40] percent of modified active income (described previously) not taken into account in computing subpart F income.

For any sale or exchange of CFC stock, the applicable period is the three-taxable-year period immediately preceding the taxable year of the sale or exchange, or, if shorter, the selling shareholder's holding period in the stock. In no event does the applicable period include any portion of any taxable year beginning before January 1, 2015.

The provision also includes a rule for the treatment of losses from the sale of CFC stock. If a United States shareholder has a loss from the sale or exchange of stock in a CFC, the loss is reduced, not below zero, by an amount equal to the shareholder's pro rata share (determined under section 951(a)(2)) of the excludable portion (described immediately above) of the aggregate subpart F income of the CFC during the shareholder's entire holding period in the stock. Accordingly, a United States shareholder's losses on a sale of CFC stock are reduced to the extent of the shareholder's cumulative exclusion from income for the CFC's modified active income (described previously).

Effective Date

The provision is effective for sales or exchanges after December 31, 2014.

Foreign Tax Credit Limitations

OPTION Y

1. Reform of foreign tax credit limitation (sec. 11 of the Option Y discussion draft and sec. 904(d) of the Code)

Explanation of Provision

Option Y modifies the foreign tax credit limitation categories. Under the provision, the foreign tax credit limitation is applied separately for six separate categories of income: (1) passive income; (2) subpart F income attributable to United States related income (as defined in amended section 955); (3) subpart F income attributable to low-taxed income (as defined in amended section 956); (4) foreign branch income, (5) subpart F income attributable to insurance income (as defined in section 953), and (6) all other income.

This provision relies on the new subpart F provisions to categorize CFC subpart F income for foreign tax credit purposes. By definition within the subpart F provisions, CFC subpart F income is either passive income (if it is attributable to foreign personal holding company income), United States related income, insurance income, or low-taxed income. Look-thru rules apply to subpart F income inclusions to characterize such inclusions based on the CFC's income to which it is attributable. Passive income earned by a branch is included in the passive income category and not as branch income under this provision.

Passive income is income received or accrued which is of a kind which would be foreign personal holding company income as defined in amended section 954(a) and subpart F income attributable to foreign personal holding company income. Passive income does not include high-taxed income. In determining whether income is passive income, the special rule for certain income from loans of a CFC applies only in the case of income of a CFC. The passive income category does not include income that would be active financing income or active insurance income if earned by a CFC, as these income types are not of a kind which would be foreign personal holding company income under amended section 954(a).

High-taxed income is any income which would be passive income if the sum of (1) the foreign taxes paid or accrued by the taxpayer with respect to such income, and (2) the foreign income taxes deemed paid by the taxpayer under the amended section 960 exceeds the highest individual or corporate tax rate (whichever applies) multiplied by the amount of the income (including the section 78 gross-up where applicable). For these purposes, foreign income taxes include income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States.

Under the provision, foreign branch income includes the business profits of the taxpayer which are attributable to one or more QBUs in one or more foreign countries. In a treaty country, the business profits are determined in accordance with the terms of the treaty. In non-treaty countries, the business profits are determined under rules established by the Secretary. It is anticipated that such rules will determine branch business profits in a manner similar to the manner established under the U.S. model income tax treaty.

Tax imposed under the law of a foreign country or possession of the United States on an amount which is not income under United States tax principles (a so-called "base difference") is treated as imposed on income included in the "all other income" category.

Taxes carried from any taxable year beginning before January 1, 2015, to any taxable year beginning on or after that date are treated as attributable to passive category income if they were attributable to passive category income under rules in effect for tax years beginning in 2014, and as other category income if they were attributable to general category income under rules in effect for tax years beginning in 2013. The Secretary is given authority to provide for the allocation of any carryback of taxes with respect to income from a taxable year beginning on or after January 1, 2015, to a taxable year beginning before that date for purposes of allocating the income among the separate categories in effect for the year to which the taxes are carried.

If without regard to any treaty obligation of the United States, any item of income is treated as U.S.-source income, but is treated under a treaty as foreign-source income, and the taxpayer chooses the benefits of the treaty, the foreign tax credit limitation is applied separately with respect to such item.

Under the provision, the Secretary is granted authority necessary or appropriate to carry out the purposes of this provision.

Effective Date

The provision is applicable to taxable years of foreign corporations beginning after December 31, 2014.

2. Denial of credit and deduction for foreign taxes with respect to income not treated as subpart F income (sec. 12 of the Option Y discussion draft and sec. 901 of the Code)

Explanation of Provision

The provision disallows a foreign tax credit for taxes paid with respect to CFC income which is not treated as subpart F income or for taxes paid with respect to any dividend eligible for the deduction under new section 245A.

The intent of this provision coupled with the provision amending section 960 is to allow a foreign tax credit or deduction only for foreign income taxes paid or accrued with respect to the income of a CFC which is subject to tax under the provisions of subpart F. A foreign tax credit or deduction for direct taxes and deemed-paid taxes paid or accrued with respect to CFC income is thus limited to only those taxes properly attributable to CFC subpart F income.

Further, this provision disallows direct credits for income earned by a CFC. To illustrate, assume a domestic corporation (DC) owns 100 percent of reverse-hybrid entity (CFC1) (a corporation for U.S. tax purposes, but a pass-through for foreign tax purposes). Assume further that CFC1 owns 100 percent of CFC2 and CFC3, and that CFC1 files a group return in the foreign jurisdiction. Assume further that all of the income earned by CFC1, CFC2, and CFC3 is not subpart F income under Option Y. Although DC is viewed by the foreign jurisdiction as the taxpayer, the taxes paid relate to the income of CFC1, CFC2, and CFC3 that, under the new tax regime, is exempt from U.S. tax. These taxes are not allowable as credits in the United States. No credit for taxes paid by DC that are attributable to the CFC1 group income is allowed except to the extent the taxes are attributable to subpart F income of CFC1, CFC2, or CFC3.

Effective Date

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

OPTION Z

1. Modification of foreign tax credit limitation (sec. 11 of the Option Z discussion draft and sec. 904(d) of the Code)

Explanation of Provision

Option Z modifies the foreign tax credit category limitations. Under the provision, the foreign tax credit limitation is applied separately for three separate categories of income: (1) subpart F income from active foreign market income; (2) passive income; and (3) all other income.

Active foreign market category income is income described in the amended section 953.[131]

Passive income includes income U.S. taxpayer passive income which is income of a kind that would be passive income as defined in the amended section 954(a),[132] and subpart F income to the extent such income is attributable to passive income. For purposes of this provision, passive income does not include any high-taxed income. In determining whether income is passive income, the special rule for certain income from loans of a CFC applies only in the case of income of a CFC.

Tax imposed under the law of a foreign country or possession of the United States on an amount which is not income under United States tax principles (a so-called "base difference") is treated as imposed on income included in the "all other income" category.

High-taxed income

High-taxed income is any income that would be passive category income if the sum of (1) the foreign income taxes paid or accrued by the taxpayer with respect to such income, and (2) the foreign income taxes deemed paid by the taxpayer under the amended section 960 exceeds the highest individual or corporate tax rate (whichever applies) multiplied by the amount of the income (including the section 78 gross-up where applicable). For these purposes, foreign income taxes include income, war profits, or excess profits tax imposed by any foreign country or possession of the United States.

Financial services income

Financial services income, other than financial services income that is active foreign market income, is included in the "all other income" category in the case of a member of a financial services group and any other person which is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. A financial services group is any

[131] See section 1 of the Option Z discussion draft for a description of active foreign market income.

[132] See section 1 of the Option Z discussion draft for a description of passive income.

affiliated group[133] which is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. To determine whether a group is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, only the income of members of the group that are either U.S. corporations or CFCs at least 80 percent owned, directly or indirectly, by U.S. corporations.

Financial services income is income received or accrued by a person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, and which is passive income or which is the following: (1) derived in the active conduct of a banking, financing, or similar business; (2) derived from the investment by an insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business; or (3) would be insurance income as defined in section 955(a).

Items resourced under treaties

If income would be treated as derived from sources in the United States, but is treated as foreign source by the taxpayer in accordance with a treaty provision, the foreign tax credit limitation applies separately with respect to such income.

Transition rules for pre-2015 carryforwards

Taxes carried from any taxable year beginning before January 1, 2015, to taxable years on or after such date are treated as attributable to passive income if they were treated as passive income under the rules in effect for taxable years beginning in 2014, and as income in the other category if they were treated as general category income under the rules in effect for taxable years beginning in 2014.

The Secretary may provide for the allocation of any carryback of taxes with respect to income from a taxable year beginning on or after January 1, 2015, to a taxable year beginning before such date, among the separate categories of income in effect for the taxable year to which the taxes are carried.

Effective Date

The provision is applicable to taxable years beginning after December 31, 2014.

[133] Affiliated group is defined as in section 1504(a) without regard to paragraphs (2) and (3) of section 1504(b).

2. Denial of credit and deduction for foreign taxes with respect to excluded subpart F income (sec. 12 of the Option Z discussion draft and sec. 901 of the Code)

Explanation of Provision

The provision disallows a foreign tax credit for taxes paid with respect to the excludable portion of subpart F income. The provision turns off the section 78 gross-up with respect to taxes not allowable as a credit under this provision.

For purposes of this provision, the excludable portion of subpart F income is the [40] percent portion of active foreign market income which is not taken into account in computing subpart F income.

The intent of this provision coupled with the provision amending section 960 is to allow a foreign tax credit or deduction only for foreign income taxes paid or accrued with respect to the taxable portion of CFC income.

Effective Date

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

Expense Disallowance

OPTION Y

1. Disallowance of deduction for interest expense allocable to exempt income of a controlled foreign corporation (sec. 21 of the Option Y discussion draft and new sec. 265A of the Code)

Explanation of Provision

In general

Option Y disallows a deduction for a portion of the interest expense of a corporate United States (10 percent) shareholder of a CFC. In broad terms the portion of the interest expense for which a deduction is disallowed represents the interest that is apportioned to income of a CFC that is exempt from taxation by the United States (because it is not subpart F income or effectively connected income).

Disallowance computation

The provision denies a deduction for the disallowed portion of any allocable CFC interest. For any allocable CFC interest in connection with a CFC, the disallowed portion is the percentage of the allocable CFC interest equal to the ratio of (1) the amount by which the CFC's earnings and profits for the applicable taxable year exceeds the sum of the CFC's subpart F income in that year (reduced, under regulations provided by the Secretary, to take into account the deduction allowed under new section 200 (described previously)) and the CFC's net effectively connected income (that is, after taking into account properly allocable deductions, including taxes) in that year, to (2) the CFC's earnings and profits in the applicable taxable year. The numerator described in (1) above represents the earnings and profits of the CFC that are exempt from U.S. taxation.

In this calculation, earnings and profits are computed in the same manner as in section 952(c) except that earnings are reduced by dividends received by the CFC from another CFC if the dividends are not taken into account in computing the subpart F income of the recipient CFC by reason of the exclusion for CFC-to-CFC dividends allowed by new section 952(e) (described previously).

Allocable CFC interest potentially subject to disallowance is interest expense paid or accrued during the taxable year by a 10-percent corporate U.S. shareholder of a CFC that is apportioned under the principles of present law sections 861(b) and 864(e) or (f) (as applicable), and the accompanying regulations, to income of the CFC. In applying the interest allocation rules for purposes of the disallowance computation, the CFC stock in not considered an exempt asset under section 864(e)(3).

The applicable taxable year is, with respect to a CFC, the taxable year of the CFC that ends with or within the taxable year of the U.S. 10-percent corporate shareholder for which the interest disallowance amount is being computed.

Rule for affiliated groups

If a 10-percent corporate U.S. shareholder of a CFC is a member of a group all the members of which are treated as a single corporation under section 864(e) or (f) (as applicable), all domestic corporations that are members of the group are treated as a single corporation for purposes of the interest disallowance rule. Just as interest is apportioned to foreign-source income on a group basis under present law section 864(e) and (f), so the disallowance amount is also computed group-wide.

Ordering rule

Except as otherwise provided by regulations, the discussion draft's interest disallowance rule applies before any other provision of Chapter 1 of the income tax rules of the Code that limits the deductibility of any allocable CFC interest.

Basket-by-basket disallowance

The interest expense disallowance rule is applied separately with respect to the separate foreign tax credit limitation categories of amended section 904(d)(1) (described previously). Accordingly, taxable income in each foreign tax credit limitation category is computed by taking into account the amount of the interest expense deduction disallowance properly apportioned to that category.

Regulatory authority

The provision directs the Treasury Secretary to prescribe any regulations necessary to carry out the purposes of the interest disallowance rules, including regulations that provide (1) for the sharing of information between shareholders if necessary to carry out the provision, (2) for directly associating interest expense disallowed under the provision with income of a controlled foreign corporation and for coordinating the provision with other Code rules limiting the deductibility of interest or other expenses, and (3) for the proper application of the provision with respect to the taxpayer's share of net operating losses or deficits in earnings and profits of a CFC.

Effective Date

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

OPTION Z

1. Disallowance of deduction for expenses allocable to exempt income of a controlled foreign corporation (sec. 21 of the Option Z discussion draft and new sec. 265A of the Code)

Explanation of Provision

In general

Option Z disallows a deduction for a portion of the interest expense of a 10-percent U.S. shareholder of a CFC. In broad terms the portion of the interest expense for which a deduction is disallowed represents the interest that is apportioned to income of a CFC that is exempt from taxation by the United States (because it is the excludable portion of the CFC's active foreign market income).

The provision also disallows a deduction for expenses of a United States shareholder that are definitely allocable as a factual matter to the [40] percent of the modified active income not taken into account in computing subpart F income.

Interest disallowance computation

The provision denies a deduction for the disallowed portion of any allocable CFC interest. For any allocable CFC interest in connection with a CFC, the disallowed portion is [40] percent of the amount that bears the same ratio to the amount of the allocable CFC interest as (1) the CFC's modified active income (described previously) for the applicable taxable year bears to (2) the CFC's earnings and profits in the applicable taxable year. The [40]-percent disallowance for interest allocated to a CFC's modified active income corresponds to the [40]-percent exclusion from U.S. taxation for a 10-percent U.S. shareholder's pro rata share of a CFC's modified active income.

In this calculation current earnings and profits are the earnings and profits of the CFC for the applicable tax year without diminution for distributions made during the year. Earnings and profits of a CFC are determined without regard to paragraphs (4), (5), and (6) of section 312(n), except to the extent that application of this rule would increase earnings and profits by an amount that was previously distributed by the CFC.

Allocable CFC interest potentially subject to disallowance is interest expense paid or accrued during the taxable year by a United States shareholder of a CFC that is apportioned under the principles of present law sections 861(b) and 864(e) or (f) (as applicable), and the accompanying regulations, to income of the CFC.

The applicable tax year is, with respect to a CFC, the taxable year of the CFC that ends with or within the taxable year of the United States shareholder for which the interest disallowance amount is being computed.

Rule for affiliated groups

If a United States shareholder of a CFC is a domestic corporation that is a member of a group all the members of which are treated as a single corporation under section 864(e) or (f) (as applicable), all domestic corporations that are members of the group are treated as a single corporation for purposes of the interest disallowance rule. Just as interest is apportioned to foreign-source income on a group basis under present law section 864(e) and (f), so the disallowance amount is also computed group-wide.

Ordering rule

Except as otherwise provided by regulations, the discussion draft's interest disallowance rule applies before any other provision of Chapter 1 of the Code that limits the deductibility of any allocable CFC interest.

Basket-by-basket disallowance

The interest expense disallowance rule is applied separately with respect to the separate foreign tax credit limitation categories of amended section 904(d)(1) (described previously). Accordingly, taxable income in each foreign tax credit limitation category is computed by taking into account the amount of the interest expense deduction disallowance properly apportioned to that category.

Regulatory authority

The provision directs the Treasury Secretary to prescribe any regulations necessary to carry out the purposes of the interest disallowance rules, including regulations that provide (1) for the sharing of information between shareholders if necessary to carry out the provision, (2) for directly associating interest or other expenses disallowed under the provision with income of a CFC and for coordinating the provision with other rules of the Code limiting the deductibility of interest or other expenses, and (3) for the proper application of the provision with respect to the taxpayer's share of net operating losses of a CFC.

Effective Date

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

PROVISIONS COMMON TO OPTIONS Y AND Z

Other Provisions Relating to Subpart F

A. Previously Deferred Foreign Income

1. Treatment of previously deferred foreign income (sec. 31 of the Common Provisions discussion draft and sec. 965 of the Code)

Explanation of Provision

In general

Regardless of which reform option for taxation of foreign income of CFCs is adopted, a transition rule for taxation of previously deferred foreign income is included. The provision requires that a domestic corporation that is a U.S. shareholder of a CFC include its pro rata share of the accumulated deferred foreign income in gross income. A deduction of an applicable percentage of the mandatory inclusion is permitted, resulting in a 20 percent effective tax rate. A foreign tax credit is available only for taxes paid with respect of the taxable portion of the included income. The increase in the U.S. tax liability of the U.S. shareholder as a result of the mandatory inclusion is generally payable in installments over a period of up to eight years.

Determination of the taxable portion of previously deferred foreign income

The mechanism for the mandatory inclusion of pre-effective date foreign earnings is subpart F. As of the close of the last taxable year of a CFC that ends before January 1, 2015 (which is that foreign corporation's last taxable year before the revised subpart F regime takes effect), the subpart F income of the foreign corporation is increased by the accumulated deferred foreign income of the corporation. Consistent with the general operation of subpart F, each corporate U.S. shareholder of a CFC must include in income its pro rata share of the foreign corporation's subpart F income attributable to its accumulated deferred foreign income. It is expected that the Secretary will issue regulations addressing the application of this provision to domestic partnerships, domestic trusts, and domestic estates that have domestic corporations as partners or beneficiaries.

For purposes of the transition rule, accumulated deferred foreign income is defined as the portion of the foreign corporation's undistributed earnings that exceeds undistributed U.S. earnings. Undistributed earnings are the earnings and profits of the foreign corporation described in section 959(c)(3) as of the close of the corporation's last taxable year that ends before January 1, 2015, without taking into account distributions made during such taxable year. Undistributed U.S. earnings are those undistributed earnings, determined without regard to the mandatory inclusion of this transition rule, that are attributable to income that is either effectively connected with the conduct of a trade or business in the United States and subject to U.S. income tax or to dividends from a foreign controlled domestic corporation, including dividends received from a RIC or REIT. The treatment of current year distributions is determined after the application of the mandatory inclusion, in accordance with a special ordering rule for determining previously taxed income under section 959, discussed below.

The deduction from the mandatory inclusion of earnings and profits is determined by an applicable percentage. This formulaic approach is necessary to maintain a 20 percent rate of tax for all U.S. shareholders in the event that differences between taxable years of U.S. shareholders and CFCs result in some domestic corporations having inclusions in 2014, while others have an inclusion in 2015 and the relevant corporate income tax rates differ. The applicable percentage is a fraction, the numerator of which is the difference between the highest rate of Federal income tax in effect for the taxable year of the U.S. shareholder and 20 percent. The denominator is such Federal income tax rate. The applicable percentage is multiplied by the mandatory inclusion of earnings and profits to compute the deduction available.

No credit is allowed for taxes attributable to the applicable percentage of previously deferred foreign income that is deducted from gross income. The provision also denies a deduction for any foreign tax for which a credit is disallowed. The income of the U.S. shareholder is not increased under section 78 by the amount of tax for which a foreign tax credit is not allowed.

Special ordering rule for distributions

A new ordering rule for distributions out of previously taxed income is added to section 959. Under the new rule, distributions are made first out of the deductible portion of the subpart F inclusion for previously deferred foreign income. Absent this rule distributions would be considered made only partly out of this deductible portion and partly out of other previously taxed subpart F earnings (to the extent of those other previously taxed earnings). Because no foreign tax credits are allowed for foreign taxes related to the deductible portion of this subpart F income, absent this rule, additional foreign taxes imposed on previously taxed income that is distributed to a U.S. shareholder would be partly allowed and disallowed. To address the complexity and administrability concerns this raises, the provision first sources distributions out of earnings attributable to the deductible portion of the subpart F inclusion for previously deferred foreign income. This has the effect of accelerating the distribution of historical earnings with a corresponding disallowance of credits for foreign taxes imposed on such earnings.

To illustrate, assume $100 of a CFC's previously deferred foreign income is included in a domestic corporate shareholder's income under subpart F and the deductible portion is $43. Further assume that the CFC distributes $50 of previously taxed income (related to both the deductible portion of previously deferred foreign income and other previously taxed income) subject to a foreign withholding tax. Under the provision, $43 of the distribution is allocated to the deductible portion of the section 965 subpart F inclusion and no foreign tax credit is available for the withholding taxes allocable to this portion. A foreign tax credit is available for withholding taxes with respect to the $7 portion of the distribution.

Installment payments

A U.S. shareholder may elect to pay the net tax liability resulting from the mandatory inclusion of pre-effective-date undistributed CFC earnings in up to eight equal installments. An election to pay tax in installments must be made by the due date of the tax return for the taxable year in which the pre-effective-date undistributed CFC earnings are included in income. The Secretary has authority to prescribe the manner of making the election.

The first installment must be paid on the due date (determined without regard to extensions) of the tax return for the taxable year of the income inclusion. Succeeding installments must be paid annually no later than the due dates (without extensions) for the tax returns for each succeeding taxable year until all installments are satisfied. If a deficiency is later determined with respect to the net tax liability, the additional tax due may be prorated among all installment payments. With regard to any installment for which the last day for timely payment has passed, the prorated deficiency is due upon notice and demand, with interest for the period from the due date of the first installment until payment is made. If the deficiency is attributable to negligence, intentional disregard of rules or regulations, or fraud with intent to evade tax, proration of the deficiency is not permitted, and is due upon notice and demand.

The net tax liability that may be paid in installments is the excess of the U.S. shareholder's net income tax for the taxable year in which the pre-effective-date undistributed CFC earnings are included in income over the taxpayer's net income tax for that year determined without regard to the inclusion. Net income tax means net income tax as defined for purposes of the general business credit, but reduced by the amount of that credit.

The provision also includes an acceleration rule. If (1) there is a failure to pay timely any required installment, (2) there is a liquidation or sale of substantially all of the U.S. shareholder's assets (including in a bankruptcy case), (3) the U.S. shareholder ceases business, or (4) another similar circumstance arises, the unpaid portion of all remaining installments is due on the date of the event (or, in a title 11 or similar case, the day before the petition is filed).

Finally, if an election is made to defer payment as described above, the period of limitations for assessment and collection of the net tax liability shall not expire before the due date of final installment payment.

Effective Date

The provisions of section 965 apply generally to taxable years of foreign corporations beginning after December 31, 2013, and for taxable years of U.S. shareholders in which or within which such taxable years of foreign corporations end, except that the conforming amendments to the definition of undistributed U.S. earnings are effective for taxable years of foreign corporations beginning after December 31, 2014, and for taxable years of U.S. shareholders in which or within which such taxable years of foreign corporations end.

B. Other Provisions

1. Elimination of 30-day requirement (sec. 36 of the Common Provisions discussion draft and sec. 951(a) of the Code)

Explanation of Provision

With respect to foreign corporations, the present law rules of subpart F apply to those foreign corporations that are CFCs for an uninterrupted period of 30 days during any taxable year. This provision eliminates the 30-day requirement, thereby broadening the scope of subpart F so that its rules apply to foreign corporations that are CFCs at any point during the taxable year.

Effective Date

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

2. Modification of definition of United States shareholder (sec. 37 of the Common Provisions discussion draft and sec. 951(b) of the Code)

Explanation of Provision

This provision expands the definition of U.S. shareholder under subpart F to include any U.S. person who owns 10 percent or more of the total value of shares of all classes of stock of a foreign corporation.

Effective Date

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

II. REFORM OF FOREIGN TAX CREDIT PROVISIONS

1. Repeal of section 902 indirect foreign tax credits; foreign tax credit related to subpart F income (sec. 41 of the Common Provisions discussion draft and secs. 78, 902 and 960 of the Code)

Explanation of Provision

The provision repeals the section 902 deemed-paid credit with respect to dividends received by a domestic corporation which owns 10-percent or more of the voting stock of a foreign corporation.

A deemed-paid credit is provided to a domestic corporation with respect to any income inclusion under subpart F. The deemed-paid credit is limited to the amount of foreign income taxes properly attributable to the subpart F inclusion. Tax imposed on income that is not subpart F income is not considered attributable to subpart F income. For foreign tax credit limitation purposes, these provisions apply separately with respect to each category of income. Under present law, the deemed-paid credit computation rules are based on pools of current-year and historic earnings and profits and taxes. This provision replaces these rules with a computation of deemed-paid credits based solely on current-year subpart F inclusions and the attributable taxes.

Additionally, if a distribution from a CFC is excluded from gross income under the previously taxed income rules, a deemed-paid credit amount is allowed to the extent the foreign income taxes are properly attributable to the amount excluded and were not deemed paid by the domestic corporation for any prior taxable year. Amendments to section 901 in Option Y and Option Z, discussed above, deny credits for taxes attributable to amounts excluded from the income of a U.S. shareholder under those provisions.

Accordingly, under both Option Y and Option Z, subpart F inclusions and subsequent distributions of previously-taxed income under section 959 are the only means for U.S. persons to credit foreign income taxes paid by controlled foreign corporations. Further, the current law provision providing a foreign tax credit for taxes paid by certain non-CFCs (so called "10/50 companies") is repealed.

Foreign income taxes under the provision include income, war profits, or excess profits taxes paid or accrued by the CFC to any foreign country or possession of the United States.

The Secretary is granted authority under the provision to provide regulations as necessary and appropriate to carry out the purposes of this provision, including providing rules for the application of the provision to domestic partnerships with partners that are domestic corporations. It is anticipated that the Secretary would provide rules for allocating taxes that are similar to the rules currently in place for purposes of determining the allocation of taxes to specific foreign tax credit baskets.[134] Under such rules taxes are not attributable to an item of subpart F income if the base upon which the tax was imposed does not include the item of

[134] See Treas. Reg. 1.904-6(a).

subpart F income. For example, if foreign law exempts capital gains from its income tax base, no deemed-paid credit results from the subpart F inclusion of capital gains.

The gross-up provision under section 78 is retained for deemed-paid taxes under the provision, but is amended to treat the section 78 inclusion as a subpart F inclusion. For purposes of the foreign tax credit limitation, the inclusion is deemed to be attributable to the same category of income as the income giving rise to the deemed-paid taxes.

In addition to the rules described in this section, the provision makes several conforming amendments to various other sections of the Code reflecting the repeal of section 902 and the modification of section 960.

Effective Date

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

2. Repeal of rule suspending foreign taxes and credit until related income is taken into account (sec. 42 of the Common Provisions discussion draft and secs. 909 and 901(m)(1)(B) of the Code)

Explanation of Provision

The provision repeals the section 909 “anti-splitter” rule. Additionally, the provision makes a conforming amendment to the covered asset acquisition provision, deleting the reference to section 909.

The new deemed-paid credit rules in section 960, discussed in the preceding section, limit a taxpayer’s deemed-paid credit to the amount of tax that is attributable to income included in subpart F. This has the effect of preventing a taxpayer from taking into account CFC taxes before the taxable year in which the related CFC income is included in the taxpayer’s income under subpart F. In addition, amendments to section 901 in Option Y and Option Z, discussed above, prevent taxpayers from crediting directly imposed taxes relating to exempt income.

Effective Date

The provision is applicable to foreign taxes paid or accrued in taxable years beginning after December 31, 2014.

III. ENTITY CLASSIFICATION REFORMS

1. Certain entities owned by controlled foreign corporations treated as corporations (sec. 51 of the Common Provisions discussion draft and sec. 7701 and new sec. 7705 of the Code)

Explanation of Provision

The provision treats as a corporation any business entity that would otherwise be eligible under the entity classification rules of section 7701 to elect its taxable status if it is wholly owned either by a single controlled foreign corporation or by two or more members of an expanded affiliated group, one of which is a controlled foreign corporation. The business entity thus treated as a corporation may be a domestic or foreign entity. The rule is not applicable to entities wholly owned by one or more domestic entities, for whom the basic elective regime of the entity classification rules remains in effect.

An expanded affiliated group is defined as in section 7874(c), which defines the term as a group of corporations that are connected to a common parent in a manner that would satisfy the consolidated return rules, with two exceptions. First, foreign corporations are includible in the expanded affiliated group, unlike the consolidated return rules. Second, the threshold for determining the requisite voting and value test is lowered to 50 percent from 80 percent.

The effect of the provision is to limit a number of techniques that have been used to circumvent subpart F, or to otherwise alter the application of the foreign tax credit rules, the transfer pricing rules, and other international tax provisions. As a consequence, a wide range of transactions that are currently not fiscally recognized for Federal tax purposes will no longer be transparent, and hybrid entities will be CFCs. Together with the sunset of the look-through rule of section 954(c)(6), the provision thus reduces opportunities for the avoidance of subpart F, the manipulation of the foreign tax credit limitation and other tax motivated transactions that may erode the U.S. tax base.

The provision may change the treatment of both disregarded and certain flow-through entities. For example, under present law, a sale of stock of an operating company by a CFC may give rise to subpart F income, but if an election to disregard the operating company is in effect, the transaction may be treated as a sale of operating assets thus avoiding realization of subpart F income.[135] Under the provision, the election is not permitted. Similarly, entities that elected partnership status may be treated as corporations if the partners include a CFC and all other partners are members of the expanded affiliated group. For example, if a U.S. parent and an unrelated third party each own 50 percent of a CFC, which in turn owns 50 percent of a U.S. limited partnership with a domestic subsidiary of the U.S. parent owning the other 50 percent, the partnership will be treated as a domestic corporation. If the partnership were instead a foreign entity, owned by the same expanded affiliated group, the provision would treat it as a CFC.

[135] See, e.g., *Dover Corp. v. Commissioner*, 122 T.C. 324 (2004).

Effective Date

The provision is generally effective for taxable years of business entities beginning after December 31, 2014, and taxable years of shareholders of, or holders of other ownership interests in, such foreign business entities with or within which such taxable years of such business entities end. An existing business entity not taxable as a corporation under the Code in its most recent taxable year beginning on or before December 31, 2014, but taxable as a corporation under this provision for the first taxable year beginning after that date is treated as having elected to change its status to a corporation as of the beginning of that first taxable year, resulting in the deemed transfers applicable to elective changes of entity status under present law and the tax consequences that flow from such transfers.[136]

[136] Treas. Reg. sec. 301.7701-3(g) describes the deemed transfers that occur.

IV. REFORM OF RULES FOR PASSIVE FOREIGN INVESTMENT COMPANIES

1. Treatment of non-marketable stock (sec. 61 of the Common Provisions discussion draft and sec. 1291 of the Code)

Explanation of Provision

In general

The provision repeals the present law rules that impose an interest charge when a U.S. person who owns stock of a PFIC receives an excess distribution in respect of that stock.

The provision also repeals the rules relating to elective annual taxation in respect of qualified elective funds in sections 1293, 1294, and 1295.

In place of the excess distribution and qualified electing fund rules, the provision requires a U.S. person who owns non-publicly-traded PFIC stock to include in income annually a deemed return on the PFIC stock equal to the Federal short-term rate plus five percent.

Income inclusion

Under the provision, if a United States person owns non-publicly-traded stock in a PFIC, the person must include in gross income each year the person's interest accrual amount with respect to the stock.

The interest accrual amount with respect to PFIC stock in any taxable year is the stock owner's adjusted basis in the stock at the beginning of the year (or, if the taxpayer acquires stock during the year, the adjusted basis at the time of acquisition) multiplied by the sum of five percentage points plus the monthly Federal short-term rate determined under section 1274(d) for the first month ending during that year. In the case of PFIC stock held indirectly, it is anticipated that, subject to regulations promulgated by the Secretary, the interest accrual amount would be computed by reference to the basis in the asset (for example, an interest in a foreign partnership or stock in another foreign corporation) that is directly held by the United States person and gives rise to the indirect ownership of the PFIC stock. In addition, except as provided in regulations promulgated by the Secretary, it is anticipated that there will be just one interest accrual amount inclusion arising from an upper-tier PFIC's direct or indirect ownership of lower-tier PFICs.

If a taxpayer owns PFIC stock for part but not all of a taxable year, the interest accrual amount with respect to that stock is prorated to a percentage equal to the proportion of the year during which the taxpayer owns the stock. In particular, the interest accrual amount had the taxpayer owned the stock for less than the entire taxable year is multiplied by the ratio of the number of days in the year when the taxpayer owns the stock to the number of days in the year.

Any interest accrual amount is treated as interest for purposes of the Code.

Distributions related to previously taxed amounts

If a U.S. person who owns PFIC stock receives one or more distributions in respect of the stock during a taxable year, the aggregate amount of the distributions otherwise included in the person's gross income is reduced by the excess of the aggregate amounts that the person includes or has included in gross income with respect to the PFIC stock for the taxable year and all preceding taxable years over the aggregate reductions under this provision in the amounts includible in the person's gross income for all preceding taxable years.

Basis adjustments

If a U.S. person who owns PFIC stock includes in gross income an interest accrual amount with respect to that stock, that person's basis in the stock is increased by the amount included.

A person's basis in PFIC stock is reduced by the amount of any distributions with respect to the PFIC stock that are excluded from the person's gross income under the rules described above.

Losses

If a U.S. person recognizes a loss from the disposition of PFIC stock, the portion of the loss that does not exceed the aggregate net basis increases under the rules just described (basis increases for interest accrual amounts and basis decreases for distributions related to previously taxed amounts) is treated as an ordinary loss.

Exceptions to interest accrual

The interest accrual regime just described does not apply to PFIC stock ownership for any taxable year if the stock has been held for less than one year and is disposed of on or before the due date for the income tax return for the taxable year in which the stock was acquired (without regard to any extension of time for filing the return).

Regulations

The provision directs the Treasury Secretary to issue any regulations necessary or appropriate to carry out the purposes of the provision, including regulations relating to the inclusion of income from and basis adjustments with respect to PFIC stock owned indirectly by the taxpayer and regulations to prevent the avoidance of the purposes of the provision.

Effective Date

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

2. Treatment of marketable stock (sec. 62 of the Common Provisions discussion draft and sec. 1296 of the Code)

The provision modifies in two respects the present law mark-to-market rules applicable to marketable stock of a PFIC.

Under present law a U.S. person who owns marketable PFIC stock may elect the mark-to-market regime in lieu of the present law section 1291 interest charge rules. The provision makes the mark-to-market regime mandatory in all circumstances in which a U.S. person owns PFIC stock that is marketable.

The provision also modifies the definition of marketable stock. Except to the extent that regulations provide otherwise, marketable stock under the provision includes, in addition to stock covered by the unmodified portion of the present law definition, stock (1) in any foreign corporation that is subject to governmental regulation comparable to Federal regulation of regulated investment companies (mutual funds), and (2) that is redeemable or otherwise disposable at its net asset value or at any other price determined under an independent valuation method fixed at the time of purchase.

Effective Date

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

3. Other reforms (sec. 63 of the Common Provisions discussion draft and sec. 1297 of the Code)

The provision repeals the present law asset test for determining whether a foreign corporation is a PFIC, and it reduces the income test threshold for status as a PFIC from 75 to 60 percent. Accordingly, under the provision a foreign corporation is a PFIC if 60 percent or more of its gross income for the taxable year is passive income (under the modified rules for passive income described elsewhere in this document).

Consistent with the repeal of the asset test for status as a PFIC, the provision modifies the present law look-through rule in the case of 25-percent owned foreign corporations by eliminating the rule that, for purposes of determining PFIC status, treats a 25-percent foreign corporate owner of another corporation as owning its proportionate share of the assets of that other corporation. The provision also adds to the look-through provision a rule providing that, except to the extent provided in regulations, for purposes of determining PFIC status, a foreign corporation that owns at least 25 percent of the stock of another corporation is treated as if it conducted the trade or business activities of that other corporation.

For example, assume a foreign corporation (FC1) wholly-owns two foreign subsidiaries (FC2 and FC3). FC2 owns a rental real estate portfolio. FC3 employs people who manage and market FC2's real estate portfolio. For purposes of testing whether FC1 is a PFIC, FC1 takes into account the income and trade or business activities of both FC2 and FC3. Accordingly, the active management and marketing activities undertaken by FC3 with respect to FC2's rental real property are taken into account in determining whether FC2's rental income is passive income.

Effective Date

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

4. Mark to market of stock for which no election under section 1295 or 1296 in effect for last taxable year beginning before 2014 (sec. 64 of the Common Provisions discussion draft and sec. 1298 of the Code)

In general

The provision requires any U.S. person who holds certain PFIC stock ("covered stock") on the last day of the person's taxable year beginning in 2014 to treat the PFIC stock as sold for its fair market value on that day.

The provision adjusts the amount of any gain or loss subsequently realized from covered stock to reflect the amount of any gain or loss on the stock from the deemed sale.

Covered stock

Covered stock subject to the deemed sale rule is any stock of a PFIC unless there was a section 1295 qualified electing fund election or section 1296 mark-to-market election in effect for the taxable year in which the deemed sale would take place.

Installment payment election

A taxpayer may elect to pay the tax liability ("net tax liability") related to the deemed sale just described in up to eight equal annual installments, with the first installment due on the due date for filing a tax return (determined without regard to any extension of time for filing) for the tax year in which the deemed sale takes place. The taxpayer likewise must pay each subsequent installment by the due date for filing a tax return (determined without regard to any extension of time for filing) for the year to which the installment payment relates.

The net tax liability of an electing taxpayer is the excess of the taxpayer's net income tax for the taxable year over the taxpayer's net income tax for that year determined without regard to the deemed sale rule described above. Net income tax for this purpose has the same meaning as net income tax under the present law section 38 general business credit reduced by the amount of the section 38 credit allowed to the taxpayer.

Certain events accelerate the dates for paying the unpaid portion of all remaining installments. These events include a taxpayer's failure to pay any installment by the due date; a liquidation or sale of substantially all the taxpayer's assets, including in bankruptcy; a cessation of the taxpayer's business; and any similar circumstance. If any of these events occurs, the unpaid portion of all remaining installments must be paid on the date of the event (or, in the case of a bankruptcy, on the day before the bankruptcy petition is filed).

If the IRS assesses a deficiency in relation to the net tax liability of a taxpayer who has elected to pay in installments, the deficiency is added proportionately to each installment and must be paid at the same time as and as part of that installment. The part of a deficiency that is added to an installment the due date for payment of which has passed must be paid on notice and demand from the Treasury Secretary. If a deficiency is due to negligence, to intentional disregard of the rules and regulations, or to fraud with intent to evade tax, a deficiency may not be prorated among the installments and instead must be paid in the manner applicable to deficiencies generally.

A taxpayer who elects to pay the net tax liability in installments is not required to pay interest on unpaid portions of the net tax liability if the taxpayer pays installments when they are due. If, however, a deficiency is assessed in respect of the net tax liability, interest on the deficiency accrues from the last date for payment of tax for the taxable year in which the net tax liability arose, and any interest with respect to a deficiency that is assigned to an installment the due date for payment of which has passed must be paid upon notice and demand from the Secretary. Similar rules apply if the taxpayer amends its return in a manner that increases its net tax liability.

A taxpayer must make an installment payment election no later than the due date for the tax return for the taxpayer's last taxable year beginning in 2014.

Effective Date

The provision is effective for a U.S. person's last taxable year beginning in 2014.

V. REFORM OF SOURCING RULES

1. Acceleration of election to allocate interest, etc., on a worldwide basis (sec. 71 of the Common Provisions discussion draft and sec. 864(f) of the Code)

Explanation of Provision

The provision accelerates the effective date of worldwide interest allocation rules to apply to taxable years beginning after December 31, 2014, rather than to taxable years beginning after December 31, 2020.

Effective Date

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

2. Repeal of fair market value of interest expense apportionment (sec. 72 of the Common Provisions discussion draft and sec. 864(e) of the Code)

Explanation of Provision

The provision prohibits members of a U.S. affiliated group from allocating interest expense on the basis of the fair market value of assets for purposes of section 864(e). Instead, the members must allocate interest expense based on the adjusted tax basis of assets.

Effective Date

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

3. Reform of title passage rules for inventory property (sec. 73 of the Common Provisions discussion draft and sec. 865 of the Code)

Explanation of Provision

Under this provision, income from the sale of inventory property is sourced wholly within the United States when a taxpayer's office or fixed place of business within the United States is a material factor in the sale. For example, if a taxpayer's sales agent in a foreign jurisdiction relies on the taxpayer's U.S. warehouse to store and prepare goods for sale in a foreign jurisdiction, the sale is sourced within the United States even if title passage occurs elsewhere. This provision does not apply to sales that generate gain, profits, or income that may be taxed by a foreign government, and are not permitted to be taxed by the United States, under an income tax treaty.

Effective Date

This provision is effective for taxable years beginning after December 31, 2014.

4. Certain asset acquisitions disregarded in determining source and character of income for foreign tax credit purposes (sec. 74 of the Common Provisions discussion draft and sec. 901(m) of the Code)

Explanation of Provision

The provision amends the covered acquisition rules in section 901(m) to add a rule similar to section 338(h)(16) providing that covered asset acquisitions other than section 338 elections are not taken into account for purposes of determining the source or character of income for purposes of computing the foreign tax credit.

Effective Date

The provision is applicable to acquisitions occurring in taxable years beginning after December 31, 2014.

VI. PROVISIONS TO PREVENT BASE EROSION

1. Limitations on income shifting through intangible property transfers (sec. 81 of the Common Provisions discussion draft and secs. 367 and 482 of the Code)

Explanation of Provision

The provision addresses recurring definitional and methodological issues that have arisen in controversies[137] in transfers of intangible property for purposes of sections 367(d) and 482, both of which use the statutory definition of intangible property in section 936(h)(3)(B). The provision revises that definition and the authority to require certain valuation methods. It does not modify the basic approach of the existing transfer pricing rules with regard to income from intangible property.

The definition of intangible property in section 936(h)(3)(B) is amended to specify that workforce in place, goodwill and going concern value are intangible property. The residual category of "any similar item" is defined to be any other item the value of which is not attributable to tangible property or the services of an individual. Finally, the flush language at the end of that subparagraph is removed, to make clear that the source or amount of value is not relevant to whether property that is one of the specified types of intangible property is within the scope of the definition.

The provision also clarifies the authority of the Commissioner to specify the method to be used to determine the value of intangible property, both with respect to outbound restructurings of U.S. operations and to intercompany pricing allocations.[138] First, in the case of transfers of multiple intangible properties in one or more related transactions, valuation of such intangible property on an aggregate basis is explicitly permitted if the Commissioner determines that an aggregate basis achieves a more reliable result than an asset-by-asset approach. The provision is consistent with the position that the additional value that results from the interrelation of intangible assets can be properly attributed to the underlying intangible assets in the aggregate, where doing so yields a more reliable result. This approach is also consistent with Tax Court decisions in cases outside of the section 482 context, where collections of multiple, related

[137] *Veritas v. Commissioner,* 133 T.C. No. 14 (December 10, 2009), non-acq., IRB 2010-49 (December 6, 2010).

[138] Sections 367(d) and 482.

intangible assets were viewed by the Tax Court in the aggregate.[139] Finally, it conforms with the position taken in the recently issued cost-sharing regulations.[140]

The provision also codifies the realistic alternative principle with respect to intangible property. The realistic alternative principle is predicated on the notion that a taxpayer will only enter into a particular transaction if none of its realistic alternatives is economically preferable to the transaction under consideration. As a result, the existing regulations provide the IRS with the ability to determine an arm's-length price by reference to a transaction (such as the owner of intangible property using it to make a product itself) that is different from the transaction that was actually completed (such as the owner of that same intangible property licensing the manufacturing rights and then buying the product from the licensee).

Effective Date

The provision applies to transfers in taxable years beginning after December 31, 2014, but no inference is intended with respect to application of section 936(h)(3)(B) or the authority of the Secretary to provide by regulation for such application on or before the date of enactment

2. Prevent avoidance of U.S. tax through reinsurance with nontaxed affiliates (sec. 82 of the Common Provisions discussion draft and new sec. 849 of the Code)

Explanation of Provision

General rule of nondeduction and noninclusion

Under the provision, an insurance company is not allowed a deduction for nontaxed reinsurance premiums paid.[141] In addition, its income is determined by not taking into account (so no deduction is allowed for) any additional amount paid with respect to the reinsurance for which the nontaxed reinsurance premium is paid to the extent the additional amount is properly allocable to the premium. Finally, the insurance company's income is determined by not taking

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[139] See, *e.g.*, *Kraft Foods Co. v. Commissioner*, 21 T.C. 513 (1954) (thirty-one related patents must be valued as a group and the useful life for depreciation should be based on the average of the patents' useful lives); *Standard Conveyor Co. v. Commissioner*, 25 B.T.A. 281, p. 283 (1932) ("[I]t is evident that it is impossible to value these seven patents separately. Their value, as in the case of many groups of patents representing improvements on the prior art, appears largely to consist of their combination."); *Massey-Ferguson, Inc. v. Commissioner,* 59 T.C. 220 (1972) (taxpayer who abandoned a distribution network of contracts with separate distributorships was entitled to an abandonment loss for the entire network in the taxable year during which the last of the contracts was terminated because that was the year in which the entire intangible value was lost).

[140] See Treas. Reg. sec. 1.482-7(g)(2)(iv) (if multiple transactions in connection with a cost-sharing arrangement involve platform, operating and other contributions of resources, capabilities or rights that are reasonably anticipated to be interrelated, then determination of the arm's-length charge for platform contribution transactions and other transactions on an aggregate basis may provide the most reliable measure of an arm's-length result).

[141] A nontaxed reinsurance premium is any reinsurance premium paid directly or indirectly to an affiliated corporation with respect to certain contracts, to the extent that the income attributable to the premium is not subject to Federal income tax, as described below.

into account any return premium, ceding commission, reinsurance recovered or other amount received by the insurance company with respect to the reinsurance for which the nontaxed reinsurance premium is paid to the extent the item is properly allocable to the premium. Thus, these items of income (to the extent they arise with respect to reinsurance for which nontaxed reinsurance premiums were paid) generally are excluded from the insurance company's income. The provision applies in the case of reinsurance of risks other than life insurance, annuity, or noncancellable accident and health insurance risks.

The exclusion for the return premium, ceding commission, reinsurance recovered, or other amount received is allowed to the same extent that no deduction was allowed for the reinsurance premium paid (and for additional amounts paid by the insurance company with respect to the reinsurance with respect to which the premium was paid). The exclusion does not apply to any greater extent.

For example, if the amount of the reinsurance premium (and any additional amount) totaling 100 for which a deduction is not allowed is 80, then 80 percent of the total amount of the return premium, ceding commission, reinsurance recovered, and other amount received is excluded. Thus, if the total amount of the return premium, ceding commission, reinsurance recovered, and other amount received is 200, then 80 percent, or 160, may be excluded, and the balance is included in the company's income. It is intended that the Treasury Secretary provide prompt guidance as to the method of allocation among items of income, and in the absence of guidance, a pro rata allocation is the appropriate method (i.e., the same percentage of each item is excluded (80 percent of each item in the above example)).

Application to insurance companies

The provision applies to an insurance company for purposes of determining its taxable income under section 831 or its life insurance company taxable income under section 801 (to the extent the company pays reinsurance premiums with respect to risks other than life insurance, annuity, or noncancellable accident and health insurance risks). Thus, for example, a property and casualty insurance company subject to tax in the United States is subject to the provision with respect to reinsurance of risks other than life insurance, annuity, or noncancellable accident and health insurance risks. A life insurance company subject to tax in the United States is subject to the provision only with respect to reinsurance of risks other than life insurance, annuity, or noncancellable accident and health insurance risks. The fact that a company has no U.S. income tax liability for the taxable year (for example, due to losses) does not cause the company not to be considered as subject to the provision.

Nontaxed reinsurance premiums

A nontaxed reinsurance premium is any reinsurance premium paid directly or indirectly to an affiliated corporation with respect to certain contracts, to the extent that the income attributable to the premium is not subject to Federal income tax. Nontaxed reinsurance premiums do not include premiums for reinsurance with respect to any life insurance, annuity, or noncancellable accident and health insurance contract (including a life insurance or annuity contract combined with noncancellable accident and health insurance).[142] Thus, the risks to which the provision applies are property and casualty insurance risks, not life insurance risks. For purposes of the provision, the income is not subject to U.S. income tax if it is neither included in the income of the affiliated corporation, nor included in income by a United States shareholder under section 951 pursuant to the rules of subpart F.

The excise tax under section 4371 is disregarded for purposes of determining whether income attributable to the premium is subject to U.S. income taxation. Thus, for example, a foreign insurer or reinsurer that issues policies, premiums on which are subject to the excise tax under section 4371, and that is not subject to U.S. income tax as an insurance company, is not considered an affiliated corporation the income of which is subject to U.S. income taxation for purposes of this provision.

As a further example, assume that a controlled foreign corporation with a 15-percent minority interest held by persons that are not 10-percent U.S. shareholders receives a reinsurance premium. The 10-percent U.S. shareholders are subject to current U.S. income taxation on their shares of income attributable to the reinsurance premium, but the holders of the 15-percent minority interest are not. Assume further that the corporation is not subject to U.S. corporate income tax. Under these circumstances, 15 percent of the income attributable to the premium is not subject to U.S. income tax for purposes of the provision.

Affiliated corporation

For purposes of the provision, a corporation is treated as affiliated with an insurance company if both corporations would be treated as members of the same controlled group of corporations under section 1563(a), but applying a standard of at least 50 percent (rather than at least 80 percent) of total vote or value of shares. Foreign corporations and life insurance companies are not excluded, and no attribution of stock ownership through a tax-exempt employee's trust described in section 401(a) is made, for purposes of this determination.

Election to treat specified reinsurance income as effectively connected

The bill provides an election for an affiliated foreign reinsurer that is a specified affiliated corporation to be subject to U.S. tax on premiums and net investment income that is specified reinsurance income. This election is intended to provide another option to ensure that these foreign affiliates are not treated less favorably than U.S. reinsurers. Under the election, the deduction disallowance for reinsurance premiums and additional amounts with respect to such reinsurance does not apply, and the exclusion for return premiums, ceding commissions, reinsurance recovered, or other amounts received with respect to such reinsurance does not apply.

[142] Thus, premiums for reinsurance with respect to contracts, reserves for which constitute life insurance reserves for purposes of determining whether a company is a life insurance company, are not nontaxed reinsurance premiums. See section 816(a), (b), (c), (e), (f), and (h).

Effects of election

The election provides that an affiliated corporation treats specified reinsurance income (which is intended to include both premium income and net investment income) as effectively connected with the conduct of a trade or business in the United States and, for purposes of any treaty between the United States and any foreign country, as income attributable to a permanent establishment in the United States. The effect of the election is that the deduction otherwise disallowed for nontaxed reinsurance is not disallowed, because the premiums are subject to U.S. income taxation under the election. In addition, the excise tax under section 4371 with respect to reinsurance does not apply to the premiums treated as effectively connected with the conduct of a trade or business in the United States by reason of the election.

Specified reinsurance income is subject to tax under subchapter L of the Code to the same extent and in the same manner as if such income were the income of a domestic insurance company.

Foreign tax credit treatment

For purposes of the foreign tax credit, the provision provides that specified reinsurance income treated as effectively connected under the election is treated as foreign source income and is placed in a separate category for purposes of the section 904 limitation on the foreign tax credit, and sections 902, 907, and 960 are applied separately with respect to each item of such income. Treasury Department guidance may permit aggregation of related items of specified reinsurance income for purposes of the separate category under the section 904 limitation and sections 902, 907, and 960, provided such aggregation is consistent with the purpose of the provision.

Specified reinsurance income

Specified reinsurance income for this purpose means all income of a specified affiliated corporation that is attributable to reinsurance to which the provision would apply but for the election.

It is intended that under the provision, specified reinsurance income include with respect to any taxable year, not only (1) all reinsurance premiums (and additional amounts) for which (but for this election) a deduction would be disallowed under the provision and that are received by an electing specified affiliated corporation during the taxable year directly or indirectly, but also (2) the net investment income (within the meaning of section 842(b)) for the taxable year allocable to reinsurance premiums (and additional amounts) with respect to which an election applies (whether for the current or a prior taxable year). As under present law, for purposes of this election, deductions are allowed only if and to the extent that they are connected with the income that is treated under this election as effectively connected with the conduct of a trade or business within the United States. The Treasury Department is directed to strictly ensure that, for purposes of determining net investment income, only those deductible items are allowed that are directly allocable to gross investment income that is allocable to premiums (and other amounts that would otherwise be nondeductible to the paying insurance company) taxed as specified reinsurance income under the election.

Specified affiliated corporation

A specified affiliated corporation means any affiliated corporation (within the meaning of the provision) that is a foreign corporation. The corporation must also meet any other requirements imposed by the Treasury Secretary to ensure that tax on specified reinsurance income is properly determined and paid.

The election may be revoked only with the consent of the Secretary.

Regulatory authority

The provision grants regulatory authority to carry out or to prevent the avoidance of the purposes of this provision. In particular, the Treasury Department is directed to identify, and prevent avoidance of the provision through, transactions that are alternatives to traditional reinsurance, through fronting transactions, conduit and reciprocal transactions, and through any economically equivalent transactions. The Treasury is directed to publish guidance relating to prevention of avoidance of the purposes of the provision as promptly as possible, and is directed to make such guidance effective at a time consonant with the statutory effective date.

Effective Date

The provision is effective for taxable years beginning after December 31, 2013.

3. Treatment of gain or loss of foreign persons from sale or exchange of interests in partnerships engaged in trade or business within the United States (sec. 83 of the Common Provisions discussion draft and secs. 864 and 875 of the Code)

Explanation of Provision

If a foreign person sells or exchanges a partnership interest, the resulting gain or loss is effectively connected to a U.S. trade or business to the extent that the transferor is considered to be engaged in a U.S. trade or business by reason of its membership in the partnership. To measure the portion of gain or loss that is ECI to the foreign partner, the provision deems all partnership assets to be sold at fair market value on the same date as the actual sale or exchange. The amount of gain or loss that is ECI to the foreign person is in the same proportion as the ECI portion of his distributive share of proceeds of the deemed sale of all partnership assets. The provision is not intended to change the treatment of dispositions of U.S. real property interests. Thus, amounts that are considered to be received from the sale or exchange of a U.S. real property interests within the meaning of section 897 is not taken into account in determining the ECI portion of the foreign partner.

Special rules for withholding with respect to sales of partnership interests are provided to ensure that the tax incurred by the transferring partner is satisfied. The transferor is subject to withholding in the amount of ten percent of the amount realized on the disposition of a partnership interest, unless the transferor establishes that he is not a foreign person. The transferor may establish that he is not subject to withholding under this provision by providing an affidavit, under penalty of perjury, attesting that the transferor is neither a nonresident alien nor a foreign entity, and provide the U.S. taxpayer identification number of the transferor. Such affidavit cannot be relied upon if the transferee knows or has reason to know that the affidavit is false.

The Secretary may prescribe a reduced amount to be withheld, upon request of either the transferor or transferee, if the Secretary determines that to do so would not jeopardize collection of the tax imposed on the gain realized.

If the transferee fails to withhold as required, the partnership is required to deduct and withhold from distributions that would otherwise be made to the transferee partner. The amounts withheld by the partnership are equal to the amount that the transferee partner failed to withhold, plus interest.

Specific regulatory authority is granted both as to the substantive and procedural aspects of the provision. With respect to determining whether income is ECI, the Secretary is granted authority to address by regulation the appropriate application of nonrecognition provisions of the Code, whether distributions from a partnership to a partner should be treated as a sale or exchange of a partnership interest, treatment of contributions to partnerships, and the treatment of sales of by a partnership of interests in other partnerships. Procedural issues that may be addressed by regulation include the determination of reduced withholding amounts and the time and manner of providing an affidavit for exemption from withholding.

Effective Date

The provision is effective for sales and exchanges after December 31, 2014.

4. Interest on corporate debt obligations not treated as portfolio interest (sec. 84 of the Common Provisions discussion draft and secs. 871(h) and 881(c) of the Code)

Explanation of Provision

This provision imposes the 30-percent gross-basis withholding tax on payments, including interest income, arising from corporate obligations held by nonresident aliens and foreign corporations, who are otherwise exempt from the withholding tax under present law. However, this provision is not intended to override any bilateral treaty agreements that reduce or eliminate U.S.-withholding tax on interest payments. Because the provision does not override treaties, the effect is that the portfolio interest exemption in respect of interest on corporate debt is available only to residents of other countries when U.S. residents are eligible for similar exemptions under U.S. income tax treaties with those countries.

Effective Date

The provision applies to obligations issued more than one year after the date of enactment.

5. Denial of deductions for related party payments arising in a base erosion arrangement (sec. 85 of the Common Provisions discussion draft and new sec. 267A of the Code)

<u>Explanation of Provision</u>

The provision disallows deductions for any related party payment arising in connection with a base erosion arrangement. For purposes of this provision, a related party payment is any payment made by a domestic corporation (or a foreign corporation subject to tax on income effectively connected with the conduct of a trade or business in the United States) to a related party, but does not include any payment to the extent that the payment gives rise to a subpart F income inclusion to a U.S. shareholder.

A related party is a person who either controls or is controlled by the paying domestic corporation, or is controlled by the same person or persons which control the paying corporation. For purposes of the provision, control is ownership, directly or indirectly, more than 50 percent of the total voting power of all classes of stock entitled to vote, or of the total value of the stock. In the case of a partnership, trust, or estate, control means ownership, directly or indirectly, of more than 50 percent (by value) of the beneficial interests in the partnership, trust, or estate.

A base erosion arrangement is any transaction or series of transactions, or other arrangement, that reduces the amount of foreign income tax paid or accrued and that involves a (1) hybrid transaction or instrument, (2) a hybrid entity, (3) an exemption arrangement, or (4) a conduit financing arrangement.

A hybrid transaction or instrument is an instrument, transaction, or series of transactions that the issuer treats as debt for purposes of any relevant income tax and that the holder treats as other than debt (including as an acquisition of property) for purposes of any relevant income tax. For example, assume a foreign multinational corporation (Foreign Parent) located in country X has a U.S. subsidiary (U.S. Sub). In order to fund U.S. Sub's operations, Foreign Parent sets up a financing company (FinCo) in country Y. Foreign Parent capitalizes FinCo with cash and receives a hybrid instrument that is characterized as debt for country Y purposes, but as equity for country X purposes. FinCo then lends cash to U.S. Sub. The provision would deny U.S. Sub an interest deduction for its interest payments on the debt owed to FinCo if the use of the hybrid instrument in the financing structure has the effect of reducing either country X or country Y tax on income generated by the financing structure.

Alternatively, under the same facts as above, assume U.S. Sub wholly-owns all of the common and preferred stock issued by a U.S. operating company (U.S. OpCo). U.S. Sub sells the U.S. OpCo preferred stock to Foreign Parent and simultaneously enters into an agreement to buy the stock back from Foreign Parent at an agreed price. For U.S. tax purposes, the sale and repurchase transaction is treated as a secured financing (that is, Foreign Parent lends funds to U.S. Sub and holds the U.S. OpCo stock as security on the loan). For country X purposes, Foreign Parent is treated as the owner of the U.S. OpCo stock until it is transferred pursuant to the repurchase agreement. Because Foreign Parent holds U.S. OpCo equity for country X purposes and holds U.S. Sub debt for U.S. tax purposes, the transaction is a hybrid instrument or transaction. The provision will deny interest deductions for U.S. tax purposes for U.S. OpCo's payments on the preferred stock if the financing structure has the effect of reducing country X tax as compared with the country X that would arise tax if Foreign Parent were treated as holding debt for country X tax purposes.

A hybrid entity is any entity treated as fiscally transparent for purposes of any relevant income tax if the entity is not treated as fiscally transparent for purposes of any other relevant income tax. For example, using the same facts as above, assume Foreign Parent and a country X subsidiary form a financing company (FinCo) in the United States that is treated as a partnership for country X purposes and as a domestic corporation for U.S. tax purposes. FinCo borrows from a third-party lender and onlends funds to U.S. Sub. FinCo's interest payments to the third party lender give rise to deductions for both U.S. and country X tax purposes. Because FinCo is a hybrid entity, U.S. Sub will be denied an interest deduction for its interest payment on the debt owed to FinCo if FinCo's status as a hybrid entity has the effect of reducing the country X tax as compared with the Country X tax that would arise if FinCo were treated as a corporation for country X tax purposes.

An exemption arrangement is any provision of foreign income tax law that has the effect of reducing the generally applicable statutory rate of foreign income tax by 30 percent or more. An exemption arrangement does not include any foreign income tax law that requires economically significant expenditures in order to obtain the benefit provided.

A conduit financing arrangement is an arrangement under which one party (the "financing entity") advances money or property, or grants the right to use property, to another entity (the "financed entity") indirectly through the involvement of one or more other entities (the "intermediate entities") if there are financing transactions linking the financing entity, the financed entity, and the intermediate entities, and the financing entity, the financed entity, and any intermediate entity are related parties. A financing transaction is any transaction involving debt, a lease or license, or any other transaction in which a person makes an advance of money, property, or rights to use property to a person obligated to repay or return a substantial portion of the money or other property advanced.

Income tax includes any war profits or excess profits tax. Relevant income tax is any income tax to which an entity is subject by reason of its residence or taxable presence in a jurisdiction.

The Secretary has authority to provide regulations necessary to carry out the purposes of this section including providing rules for determining the generally applicable statutory rate and requirements for record keeping and information reporting.

Effective Date

The provision is applicable to taxable years beginning after December 31, 2014.

VII. OTHER PROVISIONS

1. Termination of special rules for domestic international sales corporations (sec. 91 of the Common Provisions discussion draft and secs. 991 through 997, and new sec. 998, of the Code)

Explanation of Provision

The provision repeals the special Code rules for domestic international sales corporations.

In particular, the provision terminates any corporate election to be treated as a DISC that is in effect for the corporation's last taxable year beginning in 2014. The termination is effective for the corporation's immediately succeeding taxable year (and all years thereafter). The provision also prohibits any new corporate election to be treated as a DISC for any taxable year beginning after December 31, 2014.

As a result of the provision's termination of existing corporate DISC elections and its prohibition of new DISC elections, the special rules that apply to DISCs and DISC shareholders will no longer have effect. In particular, corporations will no longer be permitted the exemption from corporate level tax allowed under the DISC rules, and individual shareholders of corporations for which DISC elections are terminated will be subject to shareholder-level taxation in respect of the earnings of the corporations in which they are shareholders under all the normal rules for shareholder-level taxation of corporate earnings.

The provision includes a transition rule for shareholders of corporations the DISC elections of which are terminated. Under this transition rule, a shareholder of a corporation whose DISC election is terminated is deemed to have received, in the first taxable year for which the termination is effective, a distribution to which the section 995(b)(2) deemed distribution rules apply. The provision provides that this deemed distribution – and any actual distribution after termination of the DISC election to the extent paid out of the corporation's accumulated DISC income – is not qualified dividend income under section 1(h)(11)(B). Consequently, an individual DISC shareholder is not eligible for the preferential tax rate allowed under section 1(h)(11) for this deemed distribution or any such actual distribution.

Effective Date

The provision is effective for taxable years beginning after 2014.

2. Repeal of dual consolidated loss rules (sec. 92 of the Common Provisions discussion draft, and sec. 1503(d) of the Code)

Explanation of Provision

Under the provision, the statutory limitation on the use of losses within a consolidated group where one of the members is subject to foreign income tax is repealed.

Effective Date

The provision is effective for net operating losses for taxable years beginning after December 31, 2014.

3. Modifications to tax on foreign investments in United States real property interests (sec. 93 of the Common Provisions discussion draft and secs. 897 and 1445 of the Code)

Explanation of Provision

Modification to the rule that excepts certain stock from the definition of a USRPI

The provision would modify the rule that stock of a corporation is not a USRPI on disposition if, as of the time of disposition, such corporation does not own any U.S. real property interests, and all of the U.S. real property interests held by such corporation at any time during the five-year period ending with the date of disposition (or the period after June 18, 1980, during which the interest was held, if shorter), were disposed of in transactions in which the full amount of gain (if any) was recognized.

Under the provision, that rule would not apply to any interest in a corporation that is or was taxable as a REIT or RIC under subchapter M during the relevant time period, or that is a successor to a corporation taxable under subchapter M in which the taxpayer held an interest at any time during the five year period ending with the date of disposition of the interest in the successor. Thus, for example, no portion of recognized gain of such entity (or a predecessor) during the five-year period ending on the date of disposition can have been deductible to the corporation, or taxed to the corporation with such tax eligible to be refunded to nontaxable shareholders, under subchapter M.

Increase in percentage of public stock ownership for REITs

For corporations that are REITs, the provision increases from five percent to 10 percent the percentage ownership of a class of stock regularly traded on an established securities market that a foreign shareholder may have during the five years prior to disposition of stock, in order for the stock to not be treated as a USRPI upon sale.[143]

A conforming amendment is made to the constructive ownership rules for this purpose, substituting “10 percent” for “50 percent” in the case of sections 318(a)(2)(C) and 318(a)(3)(C).

Distributions from REITs and certain RICs to certain public shareholders

The provision increases from five percent to 10 percent the ownership threshold for certain publicly traded qualified investment entity[144] stock below which a foreign shareholder

[143] Sec. 897(c)(3).

[144] A qualified investment entity for this purpose is any REIT, and any RIC that is a U.S. real property holding corporation, or that would be one if certain REIT ownership interests were counted as USRPI's. Sec. 897(h).

can qualify for an exemption from FIRPTA tax on certain distributions from the qualified investment entity[145].

Distributions treated as a sale of exchange of stock

The provision generally overrides Notice 2007-55. Under the provision, a distribution by a REIT or a RIC that is a qualified investment entity is not subject to tax under section 897(h) if the distribution is treated as a sale or exchange under sections 301(c) (applicable to distributions for which the distributing corporation has insufficient earnings and profits to treat the distribution as a dividend), 302 (applicable to distributions in redemption of shareholder stock where the shareholder experiences sufficient reduction in his interest that the transaction is treated as a sale of stock), or 331 (applicable to distributions in liquidation, in which the shareholder receives a liquidating distribution in exchange for the surrender of all the shareholder's stock).

Definition of domestically controlled entity

In order to address uncertainty in the determination of indirect ownership, the provision applies the attribution rules of section 318 for purposes of determining whether a REIT or a RIC that is a qualified investment entity is domestically controlled. Among other things, those rules impose family attribution and also treat stock owned by a corporation as owned by persons with a 50 percent or greater interest in the corporation.

Exception for interests held by foreign pension funds

The provision exempts from the rules of section 897 any U.S. real property interest held by a qualified foreign pension fund or by a foreign entity wholly-owned by a qualified foreign pension fund. A qualified foreign pension fund means any trust, corporation, or other organization or arrangement (A) which is created or organized outside of the United States, (B) which is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for services rendered, (C) which does not have a single participant or beneficiary with a right to more than five percent of its assets, (D) which is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates, and (E) with respect to which, under the laws of the country in which it is established or operates, (i) contributions to such organization arrangement that would otherwise be subject to tax under such laws are deductible or excluded from the gross income of such organization or arrangement, or (ii) taxation of any investment income of such organization or arrangement is deferred or such income is taxed at a reduced rate.

The provision also makes conforming changes to section 1445 to eliminate withholding on sales by qualified foreign pension funds (and their wholly-owned foreign subsidiaries) of USRPIs.

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[145] Sec. 897(h)(1).

The Secretary of the Treasury may provide such regulations as are necessary to carry out the purposes of the provision.

Effective Date

The provision generally applies to dispositions of USRPI's after the date of enactment.

The provision providing exceptions to the FIRPTA character of distributions by a REIT or RIC attributable to gain from the sale of U.S. real property interests applies to any distribution by a REIT or RIC on or after the date of enactment which is treated as a deduction for a taxable year of such REIT or RIC ending after such date.

4. Dividends from foreign corporations attributable to dividends from RICs and REITs not deductible as U.S.-source dividends (sec. 94 of the Common Provisions discussion draft and sec. 245 of the Code)

Explanation of Provision

The provision excludes RICs and REITs from the category of domestic corporations whose dividends to a foreign corporation are treated as U.S. source, for purposes of the 10-percent qualified shareholder dividends received deduction under section 245.

Effective Date

The provision is effective for dividends received from a RIC or REIT on or after the date of enactment. No inference is intended as to present law.