President Obama’s Fiscal Year 2012 Revenue Proposals

Proposals Relating to International Taxation

SUMMARY
On February 14, 2011, the Obama Administration (the “Administration”) released the General Explanations of the Administration’s Fiscal Year 2012 Revenue Proposals (commonly known as the “Green Book”). Although the Green Book does not include proposed statutory language, the Green Book contains significant detail about the fiscal year 2012 revenue proposals. This memorandum discusses key aspects of the Green Book relating to international taxation that we anticipate may be of interest to our clients. Many of the proposals are similar to the Administration’s Fiscal Year 2011 Revenue Proposals (the “2011 Green Book”).¹ We are distributing separate memoranda addressing Green Book proposals relating to (1) domestic business taxation, and (2) individual, estate and gift taxation, both of which may be obtained by following the instructions at the end of this memorandum.

The Green Book’s international proposals fall into two groups: (1) the proposals to extend the subpart F “active financing” and “active insurance” income exceptions and the subpart F “look-through” rule for payments between related controlled foreign corporations to taxable years beginning in 2012 (all three of which are set to expire at the end of 2011); and (2) proposals that would make significant changes in existing law, each of which appeared in the same or similar form in the 2011 Green Book.

ANALYSIS
The Green Book proposals described below would generally become effective for taxable years beginning after December 31, 2011, and the Green Book estimates that these proposals (excluding the extensions described in Section 1 below) would raise more than $129 billion over the 10-year period 2012-2021. This estimate is approximately $42 billion higher than the estimate provided for the similar provisions in the 2011 Green Book.²
1. **Extend Subpart F “Active Financing”, “Active Insurance” and “Look-Through” Rules**

The Green Book would extend for another 12 months three temporary subpart F provisions that are set to expire at the end of 2011.

Since 1999, subpart F has included temporary exemptions from subpart F income for so-called “active financing” income (i.e., “qualified banking or financing income” derived by a CFC that is predominantly engaged in the active conduct of a banking, financing, or similar business, provided certain other conditions are met) and “active insurance” income (i.e., “qualified insurance income” of a “qualifying insurance company”). Since 2006, subpart F has also included a temporary related-party look-through rule (i.e., Code Section 954(c)(6)), under which dividends, interest, rents and royalties paid by a CFC to a related CFC are not treated as subpart F income, if the dividends, interest, rents and royalties are not attributable to subpart F income or effectively connected income of the payor CFC.

These three provisions have been extended several times, most recently in December 2010 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, which extended them to 2010 and 2011.

The Green Book would extend all three of these provisions another 12 months to taxable years of a foreign corporation beginning in 2012 and for taxable years of a U.S. Shareholder with or within which any such tax year of such foreign corporation ends.

2. **Defer Deduction of Interest Expense Related to Deferred Foreign Income**

Under current law, a U.S. person’s total interest expense is generally allocated and apportioned between the person’s U.S. assets and foreign assets, and the interest allocated to the foreign assets is treated as a foreign source expense. That foreign source interest expense may be currently deducted even if the foreign assets to which it was allocated did not currently generate any foreign income subject to U.S. tax.

The Green Book would defer the deduction of interest expense that is allocated and apportioned to “foreign-source income that is not currently subject to U.S. tax” (emphasis added). For this purpose, foreign-source income earned by a taxpayer through a branch would be considered currently subject to U.S. tax.

The Green Book provides that while current Treasury regulations would generally continue to govern the sourcing of interest expense, it is anticipated that the Treasury Department will “revise existing Treasury regulations and propose such other statutory changes as necessary to prevent inappropriate decreases in the amount of interest expense that is allocated and apportioned to foreign-source income.” Deferred interest expense would be deductible in a subsequent taxable year in proportion to the amount of previously deferred foreign-source income that becomes subject to U.S. tax in that later year, subject to Treasury regulations that may modify the manner in which such deferred interest expenses may be deducted.
3. Foreign Tax Credit Pooling

Under current law, a domestic corporation that owns 10% or more of the voting stock of a foreign corporation from which the domestic corporation receives a dividend may claim a deemed paid foreign tax credit for a portion of the income taxes paid to foreign jurisdictions by such foreign corporation.

The Green Book would require a domestic corporation to determine its deemed paid foreign tax credit by looking at the aggregate earnings and profits of all of the domestic corporation’s foreign subsidiaries. The domestic corporation’s deemed paid foreign tax credit would then be determined based on the aggregate earnings and profits repatriated to the United States in that year.

The 2011 Green Book contained an identical provision.

4. Provisions Relating to the Transfer of Intangible Property

The Green Book contains two provisions relating to transfers of intangible property by U.S. persons to foreign persons. Current law provides that if intangible property is transferred or licensed to a related person, the income recognized by the transferor must be “commensurate with the income” derived by the transferee from the intangible; similarly, if intangible property is transferred by a U.S. person to a foreign corporation in a nonrecognition transaction, the transfer is recharacterized as sales of such property in exchange for a series of contingent payments commensurate with the income derived by the transferee from the intangible. In addition, Code Section 482 authorizes the IRS Commissioner to “distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses.” According to the Green Book, the “potential tax savings from transactions between related parties, especially with regard to transfers of intangible assets to low-taxed affiliates, puts significant pressure on the enforcement and effective application of transfer pricing rules.”

This, together with frequent controversies about the scope of intangible property subject to the two “commensurate with income” rules, has led to “inappropriate avoidance of U.S. tax” and “significant erosion of the U.S. tax base.”

a. Excess Returns Associated with Transfers of Intangible Transfers

The first Green Book proposal would apply whenever a U.S. person transfers an intangible from the United States to a related controlled foreign corporation. The proposal would treat as subpart F income derived by that CFC any “excess intangible income” attributable to the intangible if such income is subject to a “low foreign effective tax rate.” Excess intangible income is defined as “the excess of gross income from transactions connected with or benefitting from” the intangible, over the costs (excluding interest and taxes) allocable to the income and increased by a percentage mark-up (emphasis added). A “transfer” to a CFC for this purpose includes transfers by license, lease, sale, or any shared risk or development
agreement (including any cost sharing arrangement). This subpart F income would be a separate category of income for foreign tax credit limitation purposes.

Although a similar provision was included in the 2011 Green Book, the current Green Book provides greater detail as to the definition of excess intangible income, the types of transfers to the CFC that would trigger the provision, and the effective date. The effective date proposed would apply the provision to any “transaction” by the CFC connected with or benefitting from the intangible occurring in taxable years beginning on or after January 1, 2012, even if the intangible “transfer” took place prior to 2012.

b. Limiting the Shifting of Income through Intangible Property Transfers

The second Green Book proposal would “clarify” that the definition of intangible property for purposes of Code Sections 367(d) and 482 includes “workforce in place, going concern value and goodwill,” meaning that transfers of such items would be subject to the two “commensurate with income” rules referred to above. The proposal would also clarify that (i) when multiple intangibles are transferred, the IRS Commissioner may value them on an aggregate basis if that achieves a more reliable result, and (ii) the IRS Commissioner may value intangible property “taking into consideration the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken.”

An identical proposal was in the 2011 Green Book.

5. Disallowance of Deduction for Non-Taxed Reinsurance Premiums Paid to Affiliates

Under current law, insurance companies are generally permitted to deduct premiums paid for reinsurance, including premiums paid to foreign affiliates. While subpart F limits the ability of domestic insurance companies to use reinsurance with foreign affiliates to avoid current U.S. taxation (because the foreign affiliate’s reinsurance premium income is subpart F income), foreign insurance companies with foreign parents are not subject to the subpart F regime. Current law does, however, impose a 1 percent excise tax on reinsurance premiums paid to foreign reinsurance companies with respect to U.S. risks. According to the Green Book, the Administration believes that this excise tax is not always sufficient to offset the tax advantage of reinsurance with foreign-owned foreign insurance company affiliates, and that this tax advantage “creates an inappropriate incentive for foreign-owned domestic insurance companies to reinsure U.S. risks with foreign affiliates.”

The Green Book proposal would deny an insurance company deductions for reinsurance premiums paid to an affiliated foreign reinsurance company to the extent that neither the foreign reinsurer nor its parent company is subject to U.S. income tax with respect to the premiums. The denial of the deduction would not apply if the foreign reinsurance company elected to treat the premium (and the associated investment income) as income effectively connected with a U.S. trade or business and attributable to a permanent
establishment for tax treaty purposes. If the election was made, the income would be foreign source and in a separate foreign tax credit limitation basket.

A similar proposal in the 2011 Green Book included an additional denial of deductions to the extent the amount of reinsurance premiums, net of ceding commissions, paid to foreign reinsurers exceeds 50% of the total direct insurance premiums received by the U.S. insurance company and its U.S. affiliates for a line of business. Additionally, legislation similar to this provision was introduced in the House during the Congressional sessions of 2009 and 2008.

The proposal would be effective for policies issued in taxable years beginning after December 31, 2011, and thus would apparently not apply to any policies issued before December 31, 2011.

6. Limit Earnings Stripping by Expatriated Entities

The “earnings stripping” rules of Code Section 163(j) currently limit the ability of a corporation to deduct interest paid to a related person who is not subject to U.S. tax on such interest. This limitation applies only if the corporation paying the interest (i) has a debt-to-equity ratio greater than 1.5-to-1 and (ii) has net interest expense in excess of 50% of adjusted taxable income (generally computed by adding back net interest expense, depreciation, amortization, depletion, any NOL deduction, and any Code Section 199 deductions). The interest expense disallowed may be carried forward indefinitely, and the corporation’s excess limitation for a tax year (the excess of 50% of adjusted taxable income, over the corporation’s net interest expense for the year) may be carried forward three years.

Code Section 7874 applies two alternative sets of special rules to so-called "expatriated" U.S. corporations and the related acquiring foreign corporations but generally applies only to expatriations taking place on or after March 4, 2003. Additionally, only if there was 80% or greater shareholder continuity in relation to the expatriation do the harsher set of Code Section 7874 rules apply (i.e., the acquiring foreign corporation is treated as a domestic corporation for all purposes of the Code).

The Green Book explains that, despite Code Sections 163(j) and 7874, a 2007 Treasury Department study found “strong evidence” of the use by expatriated entities of foreign related-party debt to reduce the U.S. tax on income earned from U.S. operations.

The Green Book proposal would apply to any “expatriated entity” (using the definition under Code Section 7874, as if it applied to taxable years beginning after July 10, 1989), other than an expatriated entity already treated as a domestic corporation pursuant to Code Section 7874. The proposal would tighten Code Section 163(j) for such entities by (i) eliminating the debt-to-equity safe harbor, (ii) reducing the 50% of adjusted taxable income threshold to 25%, (iii) limiting the carryforward of disallowed interest to ten years, and (iv) eliminating the excess limitation carryforward.

The 2011 Green Book contained an identical proposal.
7. Modify the Foreign Tax Credit Rules for Dual Capacity Taxpayers

Under current law, special foreign tax credit rules apply to taxpayers who pay a levy to a foreign jurisdiction and receive a specific economic benefit, such as the right to extract petroleum or other minerals in exchange for payment of the levy (such a taxpayer, a “dual capacity taxpayer”). When a foreign levy applies differently to dual capacity taxpayers as opposed to other taxpayers (other than as the result of a lower rate being applied to dual capacity taxpayers), such levy is treated as a creditable foreign income tax only to the extent established by the taxpayer to be a tax (i.e., not an amount paid in exchange for the specific economic benefit). A dual capacity taxpayer may meet this burden of establishing what portion of the levy is a tax under either: (1) the facts and circumstances test (i.e., the taxpayer must show based on the facts and circumstances that the amount was not paid as compensation for the specific economic benefit; or (2) the safe harbor test (a formula that derives the amount of the levy that may qualify as a tax).27

The Green Book explains that the current law “fails to achieve the appropriate split” that should exist “between a payment of creditable taxes and a payment in exchange for a specific economic benefit” in certain cases.28

The Green Book proposal would replace the current regulatory provisions and instead permit a dual-capacity taxpayer to treat as a creditable tax the portion of the foreign levy that does not exceed the foreign tax that would be due if the taxpayer were not a dual capacity taxpayer. The Green Book would also convert the Code Section 907 foreign tax credit limitation rules into a separate basket under Code Section 904 for foreign oil and gas income. The proposal would defer to U.S. treaty obligations that allow a credit for taxes paid or accrued on certain oil or gas income.

The Green Book is similar to a related provision in the 2011 Green Book.29
A further discussion of the 2011 Green Book can be found in the Sullivan & Cromwell LLP publication entitled “Presidential Fiscal Year 2011 Revenue Proposals – President Releases Fiscal Year 2011 Individual, Estate and Gift Taxation Proposals” (February 2, 2010), which may be obtained by following the instructions at the end of this publication.

It should be noted that during the interim, a handful of other significant foreign tax credits provisions were enacted, one of which (relating to “foreign tax credit splitter” arrangements) appeared in the 2011 Green Book. The enacted provisions are: new Code Section 901(m) (disallowing a portion of otherwise allowable foreign tax credits following a “covered asset acquisitions”); new Code Section 909 (deferring the creditability of foreign taxes paid in connection with a so-called “foreign tax credit splitter” arrangement, when the person liable for the foreign tax is not the person who recognizes the related income); new Code Section 960(c) (the so-called “anti-hopscotch rule,” limiting the amount of foreign taxes deemed paid in respect of any Code Section 956 inclusion to the amount of foreign taxes that would have been deemed paid if distributions were actually made, in cash, through the chain of foreign subsidiaries to the ultimate U.S. parent); and an amendment to Code Section 904(d) (creating a separate foreign tax credit basket for items re-sourced pursuant to a U.S. tax treaty). A further discussion of these provisions can be found in the Sullivan & Cromwell LLP publication entitled “Foreign Tax Provisions in Education Jobs and Medicaid Assistance Act – Congress Enacts Foreign Tax Revenue Raisers, Including New Limits on Foreign Tax Credits” (August 11, 2010), which may be obtained by following the instructions at the end of this publication.

“CFC” is used to refer generally to a foreign corporation more than 50%-owned (in terms of value or vote) by U.S. persons, who each own at least 10% of the foreign corporation’s voting shares (each, a “U.S. Shareholder”).

The Green Book does not elaborate on how the amount of foreign income “deferred” would be determined for this purpose or how the portion of total foreign source interest expense allocable to that deferred income, as opposed to currently taxed foreign source income, would be determined.

The Green Book’s revenue estimate of $37 billion for the 10-year period 2012-2021 is $12 billion higher than the 2011 Green Book’s 10-year period estimate for this proposal.

See generally Code Section 902. This foreign tax credit is subject to certain limitations. See generally Code Section 904.

The Green Book’s revenue estimate of $51 billion for the 10-year period 2012-2021 is $19 billion higher than the 2011 Green Book’s 10-year period estimate for this proposal.


The Green Book does not elaborate on how the “foreign effective tax rate” would be determined, including whether it would be determined using “net income” as determined under the foreign tax rules or under the U.S. tax rules.
ENDNOTES (continued)


20. The Green Book’s revenue estimate of $1 billion for the 10-year period 2012-2021 is $400 million higher than the 2011 Green Book’s 10-year period estimate for this proposal. Green Book, page 46.

22. The Green Book’s revenue estimate of $2.5 billion for the 10-year period 2012-2021 is $2 billion higher than the 2011 Green Book’s 10-year period estimate for this proposal. Green Book, page 46.


26. The Green Book’s revenue estimate of $4 billion for the 10-year period 2012-2021 is $600 million higher than the 2011 Green Book’s 10-year period estimate for this proposal. Treas. Regs. § 1.901-2A.


29. The Green Book’s revenue estimate of $10 billion for the 10-year period 2012-2021 is $2 billion higher than the 2011 Green Book’s 10-year period estimate for this proposal.
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