



Tax Policy Conference

Tax Reform: Status, Needs and Realities

Chairman Camp's Proposal – Territorial, 25%
and More



Introductions

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Agenda

1. International Tax Framework
2. Camp Proposal – Generally
3. Camp Proposal – Base Erosion Alternatives



International Tax Framework

International Tax Framework

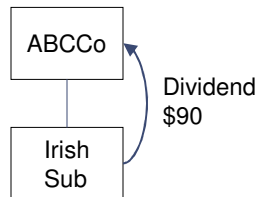
- U.S. corporations taxed on worldwide income
 - Most OECD countries have a territorial tax system
- Double taxation mitigated via foreign tax credit (“FTC”)
- Income of a foreign corporation owned by a U.S. person can be deferred until earnings repatriated

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5

International Tax Framework - Example

Facts: ABCCo owns Irish Sub which earns \$100.
Irish sub pays a dividend of \$90 to ABCCo



If ABCCo in the US (Worldwide Tax System)	
PBT - IrishCo	\$ 100
Irish tax rate	10%
Irish taxes paid	\$ 10
Dividend - ABCCo	\$ 90
US gross-up for foreign taxes paid	\$ 10
Taxable income	\$ 100
US tax rate	35%
Preliminary US tax due	\$ 35
Less: foreign tax credit	\$ (10)
Net US income tax	\$ 25
Total taxes paid	\$ 35
Effective tax rate	35%

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6



Controlled Foreign Corporations (“CFCs”)

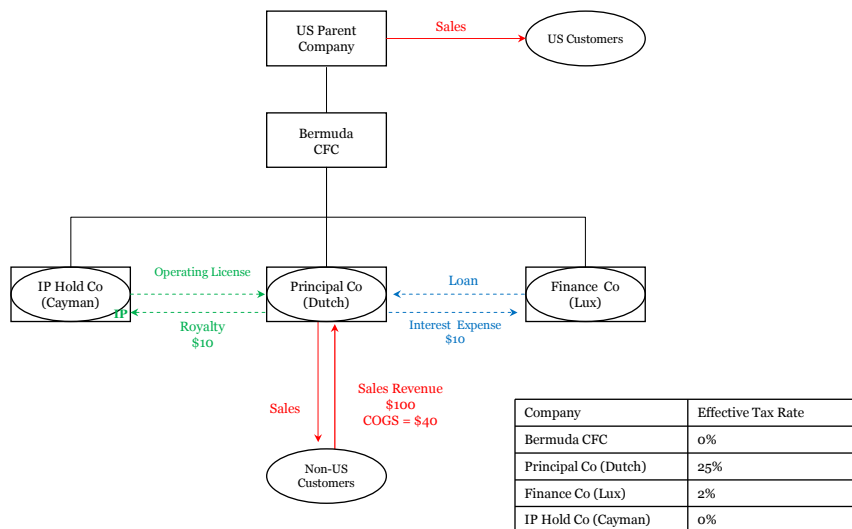
- A foreign corporation is a CFC if **U.S. shareholders** own, either directly, indirectly, or constructively, **more than 50 percent** of the foreign corporation's total voting power or value
 - A U.S. shareholder is any **U.S. person** that owns **10% or more** of the voting power of a foreign corporation
- Earnings of a CFC subject to anti-deferral regime under Subpart F



Subpart F - Generally

- Subpart F taxes certain unrepatriated earnings of CFC currently
- Categories of Subpart F Income
 - Foreign Personal Holding Company Income (“FPHCI”)
 - Generally passive type income (interest, rents, royalties, etc)
 - Foreign Base Company Sales Income (“FBCSI”)
 - Generally requires the CFC to purchase from, or sell to, a related party
 - Foreign Base Company Services Income (“FBCSvI”)
 - Generally requires the performance of services on behalf of a related party where such services are performed outside the CFC's country of incorporation

US International Structure – Example



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9

US Multinational International Structure

	Bermuda CFC	IP Hold Co (Cayman)	Finance Co (Lux)	Principal Co (Dutch)
Sales	100	0	0	100
COGS	(40)			(40)
Gross Revenue	60	0	0	60
SG&A	(30)	0	0	(30)
Royalty	0	10	0	(10)
Interest	0	0	10	(10)
Net Income	30	10	10	10
Tax Rate	9%	0%	2%	25%
Tax	\$2.7	\$0	\$2	\$2.5

- As a result of the “check-the-box” elections, IP Hold Co (Cayman), Principal Co (Dutch), and Finance Co (Lux) are treated as branches of Bermuda CFC. Generally, transactions between branches of the same CFC are disregarded for U.S. federal income tax purposes.
- The transactions occurring between the branches of the Bermuda CFC (e.g., Principal Co (Dutch) paying interest and royalties to Finance Co and IP Hold Co) are disregarded and generally do not give rise to subpart F income (note that the branch rule of section 954(d)(2) may cause the Bermuda CFC to have subpart F income. A discussion of the branch rule is beyond the scope of this presentation).

February 3, 2012

10



Camp Proposal



Background – Issues with Current Framework

- High Statutory Corporate Tax Rate (35%)
- Worldwide System - Competitiveness
- Deferral – Incentive to Keep Cash Offshore
- Deferral – Differences between Industries, Taxpayers
- FTC Issues – OFL's, Double Taxation

Background – Camp Proposal

- 1 of 3 tax reform components
- Competitiveness (25% tax rate)
- Revenue neutral (assuming 25% rate) – domestic “pay fors”?
- The provisions would be effective for tax years beginning after 2012

Dividend Received Deduction

- 95% DRD for dividends from FS income of a CFC to a U.S. corporate shareholder that owns 10% or more of CFC stock (holding period rules apply)
- No FTCs are allowed for dividends that qualify for the DRD.
- Capital gain on CFC shares is 95% exempt if no more than 30% of CFC assets generate FPHCI over 3-year period (otherwise, 1248 applies)
 - Losses are disallowed on shares that would qualify for the 95% DRD if sold at a gain; other losses remain as under current law.



Portfolio Investment Regime

- Dividends that do not qualify for the 95% DRD taxed as portfolio dividends (sec. 901 but no sec. 902 FTC)
- Examples of dividends taxed under the portfolio dividend regime are dividends received by:
 - Less than 10% shareholders.
 - 10% or more shareholders in:
 - 10/50 companies that are not treated as CFCs.
 - CFCs and 10/50 companies that do not meet the one-year holding period.



Controlled Foreign Corporation Treatment

- Elect to treat 10% owned non-CFCs (“10-50 companies”) as CFCs on the first tax return in which the 10/50 company is subject to the new law.
 - Election effective for all of taxpayer's 10-50 companies
 - Absent election, 10/50 companies are treated as portfolio investment (i.e., no sec. 902 credit).
- First-tier foreign branches (including check-the-box branches) are treated as CFCs for all purposes.

Subpart F Income

- No change to subpart F income categories (other than anti-base erosion options).
 - active finance exception and look thru?
- Subpart F taxed under present rules (960/901)
- Inter-CFC dividends not subpart F if eligible for 95% DRD if paid up chain to U.S. shareholder.
- Repeal of section 956 and section 959 (PTI).
 - PTI dividends eligible for 95% DRD, would be taxed at a 1.25% rate (5% of 25%).

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17

Transition Rules

- All non-PTI E&P of 10% owned foreign corps of the last tax year of such corps ending before 1/1/2013 would be included as subpart F income (including 10% individual shareholders).
 - Allows for an 85% DRD taxed at 35%. (ETR 5.25%).
 - Disallows 85% of FTCs related to this subpart F inclusion.
 - Applies present law FTC rules.
 - Excess FTC carryovers, if available, would offset the subpart F inclusion.

February 3, 2012

18



Transition Rules

- Tax may be paid over eight years with an interest charge.
 - All transition tax is due by 2021 (end of 10-year budget period).
- Future repatriation of pre-enactment E&P would be taxable but generally eligible for the 95% DRD.
 - Tax is imposed regardless of whether the E&P is held in cash.
- Pre-enactment FTC carryforwards would be preserved and usable as under present law.

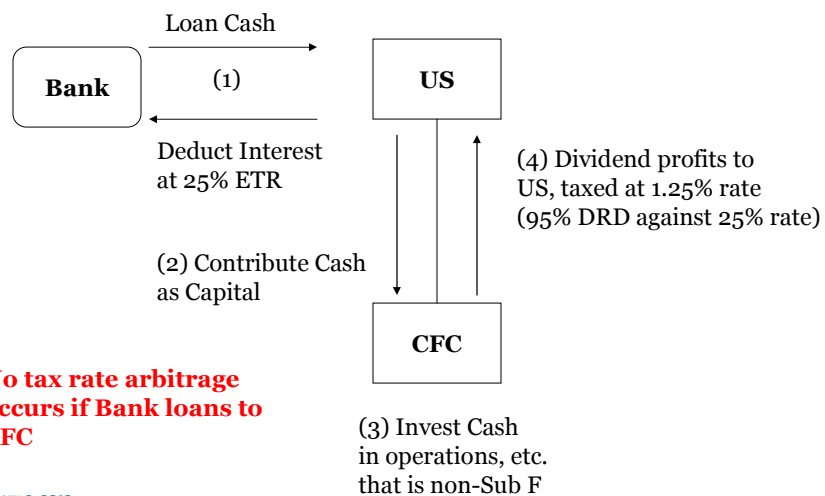


Camp Proposal Base Erosion Alternatives

Need for Thin Capitalization Rules

- Thin cap rules are needed in a participation exemption system, otherwise would leverage US company to:
 - (i) Create US deductions, and
 - (ii) Use cash to finance tax-exempt foreign earnings.

Possible Abuse: 25% Deduction and 1.25% Inclusion



Proposed Thin Capitalization Rules

- Apply where have a US – CFC relationship (i.e., an arrangement where the US company would otherwise be able to earn exempt foreign income).
- Interest is disallowed if US group fails to meet both the (i) relative leverage test and (ii) percentage of adjusted taxable income test. The lesser of these amounts is the amount by which US deductible interest is reduced.
- **Relative Leverage Test:** Fail test if have a greater debt percentage in the US members than the average debt percentage for the WW group.
- **Percentage of Adjusted Taxable Income Test:** Fail test if (per §163(j)) debt:equity ratio is greater than 1.5 to 1.

Need for Base Erosion Rules in Exemption System

- Because US income will be taxed at 25% and foreign income is effectively exempt, US MNCs have an incentive to shift income to foreign jurisdictions
- Primary concern is with respect to low-tax IP income.
- Goes back to 1962 legislative history of Subpart F that Subpart F should generally encompass all types of ‘readily moveable income’.
- 50 years ago, companies did not have the same value of IP, nor did tax planners engage in the same sophisticated IP planning that exists now, so use of low-tax IP income was not identified as a category of Subpart F.
- The base erosion alternatives create new categories of subpart F income
 - So, existing structures may ‘work’ under current law, but might create Subpart F income under new proposals.

Three Alternative Base Erosion Options Proposed

- 1) Obama's excess returns proposal (but no need for a separate FTC basket).
- 2) Subpart F treatment of CFC income taxed at an ETR of less than 10% (determined country-by-country); same-country exception for active income.
- 3) "Carrot and stick" option.

Base Erosion Option I - Obama Excess Returns

- Creates a new category of subpart F income called "foreign base company excess intangible income" (FBCEII).
- FBCEII to the extent of the "**excess return**" of a CFC's gross income from:
 - The sale, lease, license, or other disposition of property in which a "**covered intangible**" is used (directly or indirectly), and
 - Services related to the covered intangible or in connection in which the covered intangible is used (directly or indirectly).
- Two basic requirements: high profit margin + intangible originated from related US person
- The "**excess return**" threshold is a **50 percent markup** over the CFC's directly allocable costs. Interest and taxes are specifically excluded from such costs.
- "**Covered intangible**" includes any Section **936(h)(3)(B) intangible** if such intangible is sold, leased, licensed, or otherwise **transferred to a CFC by a related U.S. person**. Additionally, an intangible subject to any shared risk or development agreement (including a **cost-sharing agreement**) between the CFC and any related person would be covered.

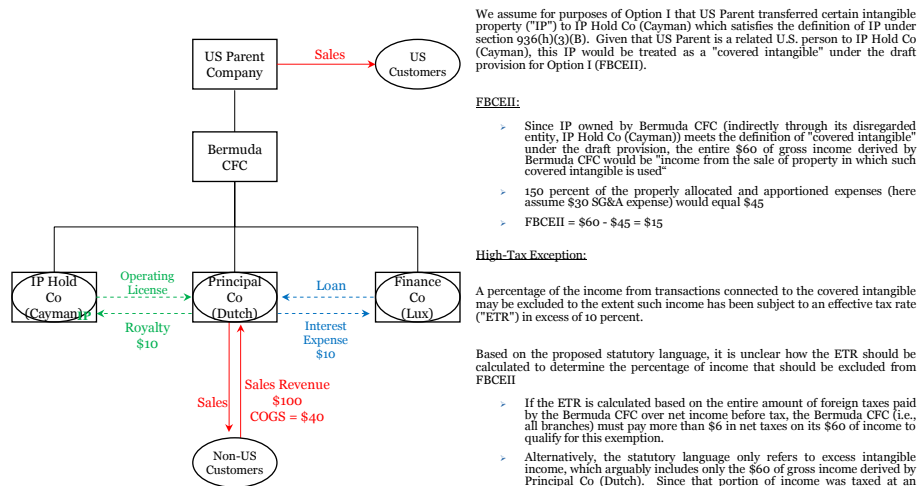
Base Erosion Option I - Obama Excess Returns

- Sliding Scale High-Tax Exception
 - **All** of the CFC's excess intangible income would be FBCEII if subject to an effective tax rate of **10 percent** or lower;
 - **None** of the CFC's excess intangible income would be FBCEII if subject to an effective tax rate of **15 percent** or higher; and
 - An applicable percentage of the CFC's excess intangible income would be FBCEII if subject to an **effective tax rate between 10 and 15 percent** (e.g., a 12 percent effective rate would result in a 60 percent FBCEII inclusion).
- Same-Country Exception
 - FBCEII excludes income from the sale, lease, license, or other disposition of property in which a covered intangible is used, if the property is sold, leased, licensed, or otherwise disposed for use or consumption in the CFC's country of incorporation
 - FBCEII excludes services income if the services are performed in the CFC's country of incorporation.

February 3, 2012

27

Base Erosion Option I – Example



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28

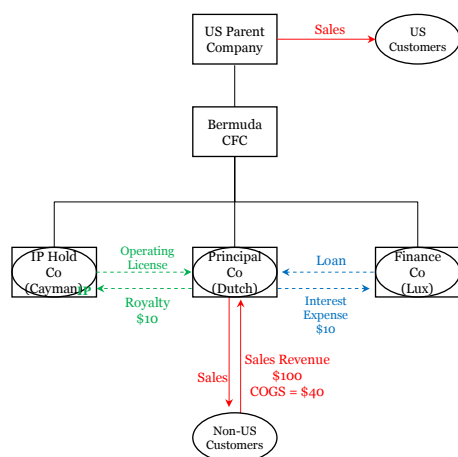
Base Erosion Option II – Low Taxed CFC Income

- Treats the gross income (including active) of a CFC is Subpart F if taxed at an effective rate of 10% or less
 - Test each country in which a CFC operates separately
- **Same Country Exception – Income not Subpart F if:**
 1. Income derived in the conduct of a trade or business of the CFC in the country in which the CFC is created or organized;
 2. The CFC has an office, etc. in country of incorporation; and
 3. Income is from (a) property sold for use or consumption in that country, or (b) services provided with respect to persons or property located in such country.

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29

Base Erosion Option II – Example



We assume for purposes of Option II that IP Hold Co (Cayman), Finance Co (Lux), and Principal Co (Dutch) each conduct a trade or business within the country in which each entity is created or organized.

Since IP Hold Co (Cayman), Finance Co (Lux) and Principal Co (Dutch) are all treated as disregarded entities of Bermuda CFC, Bermuda CFC is considered as conducting a trade or businesses in the Cayman Islands, Luxembourg, and the Netherlands.

Low-Taxed Income:

Income earned by Bermuda CFC is includible in subpart F income if the income is:

- Derived from the conduct of an active trade or business outside the home country of the CFC ("home country exception"); or
- Is subject to an effective tax rate (ETR) of less than 10 percent (Bermuda CFC must aggregate its income in each jurisdiction and determine the ETR for each jurisdiction: Cayman, Luxembourg, and the Netherlands).

Both Cayman Islands and Luxembourg impose an ETR that is less than 10 percent.

- As a result, \$20 of income derived by Bermuda CFC (\$10 from the Cayman Islands and \$10 from Luxembourg) shall be included as subpart F income.
- Because the Netherlands imposes an ETR of 25 percent, none of the income allocated to the Dutch Principal Co should generate subpart F under Option II.

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30

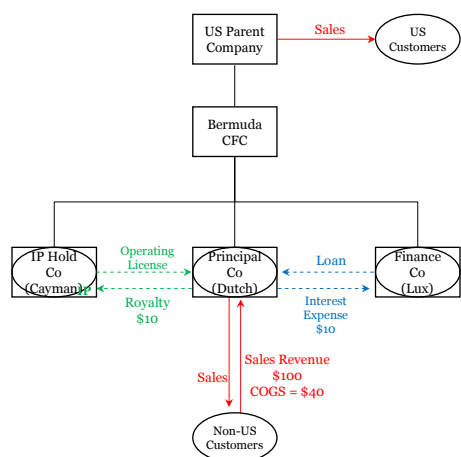
Base Erosion Option III – Carrot & Stick

- **Stick:** New category of Sub F income, “foreign base company intangible income” (FBCII)
 - Includes “intangible income” of a CFC, unless subject to a tax rate of 13.5% (90% of 60% of 25%)
 - Intangible income is gross income from goods and services attributable to §936(h)(3)(B) intangibles
- **Carrot:** US Corporation may deduct [40%] of the “foreign intangible income” earned (i) directly (e.g., exports, or foreign-source royalties), or (ii) indirectly through a CFC to the extent attributable to foreign intangible income
 - Foreign intangible income is intangible income derived from (i) property sold for use, consumption or disposition outside the US, and (ii) services on such property outside the US.

February 3, 2012

31

Base Erosion Option III – Example



FBCII:

Income earned by Bermuda CFC is includable in subpart F income as FBCII if the Bermuda CFC derived intangible income, which is defined as gross income from the sale of property in which intangible property is used directly or indirectly, to the extent that such gross income is properly attributable to such intangible property.

- We assume for purposes of Option III that \$25 is the amount of gross income of the Bermuda CFC that is properly attributable to intangible property.
- Option III provides a corresponding deduction equal to 40% of the lesser of FBCII or foreign intangible income (which in this scenario is the same amount, \$25). The 40% deduction will result in a \$10 deduction.
- $FBCII = \$25 - \$10 = \$15$

High-Tax Exception:

Intangible income of the CFC is exempt from Subpart F if it has been taxed in a foreign jurisdiction at a rate greater than 13.5 percent ($60\% * 25\% * 90\%$).

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32



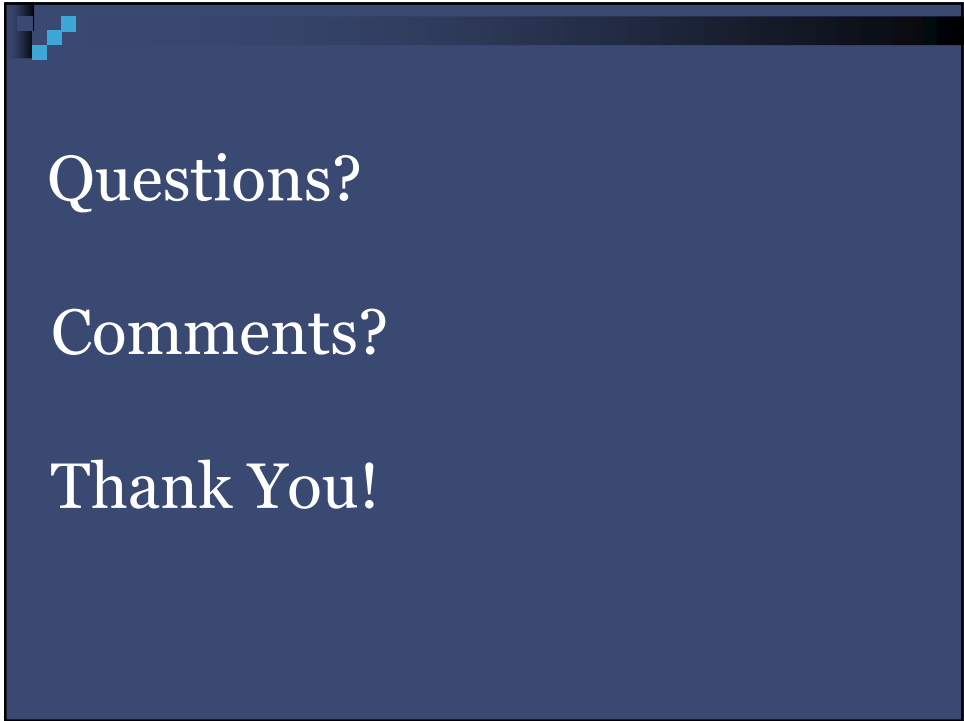
Repeal of the Following Superfluous Provisions

- Deemed-paid foreign tax credits
- Multiple foreign tax credit baskets
- §909 – Suspension of foreign tax credits until related income is taken into account
- §956 - Investments in U.S. property
- §959 – Previously taxed income



Items Not Addressed in Discussion Draft

- ODLs , OFLs or DCLs.
- Tax treaty implications.
- Cross-border reorganizations.



Questions?

Comments?

Thank You!