TECHNICAL EXPLANATION OF THE UNITED STATES JOB CREATION AND INTERNATIONAL TAX REFORM ACT OF 2012

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CONTENTS

PRESENT LAW

Overview of the U.S. international tax system

Present law combines the worldwide taxation of all U.S. persons[1] 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).

As stated above, U.S. citizens, resident individuals, and domestic corporations generally are taxed on all income, whether derived in the United States or abroad.[2] Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax 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[3] and the passive foreign investment company rules.[4]

To mitigate double taxation of foreign-source income, the United States allows a credit for foreign income taxes paid.[5] As a consequence, even though 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. 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

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[1] 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).

[2] 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.

[3] Secs. 951-964.

[4] Secs. 1291-1298.

[5] In lieu of the foreign tax credit, foreign income, war profits, and excess profits taxes are allowed as deductions under section 164(a)(3).

corporation's income under one of the anti-deferral regimes.[6] 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.

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.

U.S. tax law includes rules intended to prevent reduction of the U.S. tax base, whether through excessive borrowing in the United States, migration of the tax residence of domestic corporations from the United States to foreign jurisdictions through corporate inversion transactions,[7] or aggressive intercompany pricing practices, particularly with respect to intangible property.

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. 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,

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

[7] 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.

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.[8]

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.[9] 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.[10] Interest paid by the U.S. branch of a foreign corporation is also treated as U.S.-source income.[11]

Dividends

Dividend income is generally sourced by reference to the payor's place of incorporation.[12] 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.[13]

Rents and royalties

Rental income is sourced by reference to the location or place of use of the leased property.[14] 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.

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

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

[10] Sec. 861(a)(1) and 862(a)(1). For purposes of certain reporting and withholding obligations (discussed *infra*, in part II.B.2), 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).

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

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

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

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

Royalties are sourced in the place of use of (or the place of privilege to use) the property for which the royalties are paid.[15] 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.

<u>Income from sales of personal property</u>

Subject to significant exceptions, income from the sale of personal property is sourced on the basis of the residence of the seller.[16] 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,[17] while the term "U.S. resident" comprises 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.[18] As a result, nonresident includes any foreign corporation.[19]

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.[20] However, if the sale is by a nonresident and is attributable to an office or other fixed place of business in the United States, the sale is treated as U.S. source without regard to the place of sale, unless it is sold for use, disposition, or consumption outside the United States and a foreign office materially participates in the sale.[21] 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.[22]

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[15] *Ibid.*

[16] Sec. 865(a).

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

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

[19] Sec. 865(g).

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

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

[22] 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-

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.[23] Payments received on sales of intangible property are sourced in the same manner as royalties to the extent the payments are contingent on the productivity, use, or disposition of the intangible property.[24]

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.[25] Compensation for services performed both within and without the United States is allocated between U.S. and foreign source.[26]

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.[27]

Transportation income

Generally, income from furnishing transportation that begins and ends in the United States is U.S.-source income.[28] 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.[29] The same holds true for international communications income

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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).

[23] Sec. 865(c).

[24] Sec. 865(d).

[25] 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.

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

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

[28] Sec. 863(c).

[29] Sec. 863(d).

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.[30]

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.[31] 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,[32] applicable to controlled foreign corporations ("CFC") 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).[33] Under the subpart F rules, the United States generally taxes the 10-percent U.S.

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[30] Sec. 863(e).

[31] 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.

[32] Secs. 951-964.

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

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 shareholders.[34] 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,[35] insurance income,[36] and certain income relating to international boycotts and other violations of public policy.[37] 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.[38]

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.[39] 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.[40] 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.[41] 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.

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,

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[34] Sec. 951(a).

[35] Sec. 954.

[36] Sec. 953.

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

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

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

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

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

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.[42] 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 2012.[43]

Under a provision enacted in 1997 and originally applicable only for one taxable year,[44] 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").[45] Congress has extended the application of section 954(h) several times, most recently in 2010.[46] The exception from subpart F for active financing income now applies to taxable years of foreign corporations starting before January 1, 2012 (and to taxable years of 10-percent U.S. shareholders with or within which those corporate taxable years end).

The American Jobs Creation Act of 2004 ("AJCA")[47] 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 qualified business unit of that CFC. After the enactment of AJCA, certain activities conducted by persons related to the CFC or its qualified business unit are treated as conducted directly by the CFC or qualified business unit.[48] 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 qualified business unit; 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

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

[43] Sec. 954(c)(6)(C). Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, sec. 751(a).

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

[45] Sec. 954(h).

[46] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, sec. 750(a); 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).

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

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

organized.[49] 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).[50]

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.[51] Any 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.[52] Ordering rules provide that 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.[53]

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.[54] 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.[55]

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.[56] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders

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

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

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

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

[53] Sec. 959(c).

[54] Sec. 961(a).

[55] Sec. 961(b).

[56] Sec. 1297.

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.[57] 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.[58] 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 taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."[59]

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[60] and the personal holding company rules.[61] Until the enactment of AJCA, the Code included two other sets of anti-deferral rules, those applicable to foreign personal holding companies and those for foreign investment companies.[62] Because the overlap among the various anti-deferral regimes was seen as creating complexity, often with no ultimate tax consequences, AJCA repealed the foreign personal holding company and foreign investment company rules.[63]

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.

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[57] Secs. 1293-1295.

[58] Sec. 1291.

[59] Sec. 1296.

[60] Secs. 531-537.

[61] 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.

[62] Secs. 551-558, 1246-1247.

[63] AJCA, sec. 413.

Foreign tax credit

Subject to certain limitations, U.S. citizens, resident individuals, and domestic corporations are allowed to claim 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.[64]

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.[65] 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.[66]

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.[67] However, subject to certain exceptions, deductions for interest expense and research and experimental expenses are apportioned based on taxpayer ratios.[68] 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.[69]

The term "affiliated group" is determined generally by reference to the rules for determining whether corporations are eligible to file consolidated returns.[70] These rules exclude

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

[65] Secs. 901, 904.

[66] Sec. 904(c).

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

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

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

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

foreign corporations from an affiliated group.[71] AJCA modified the interest expense allocation rules for taxable years beginning after December 31, 2008.[72] The effective date of the modified rules has been delayed to January 1, 2021.[73] 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."[74] Passive category income includes passive income, such as 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 is determined to exceed the highest rate of tax specified in Code 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.[75] 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.[76]

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

[72] AJCA, sec. 401.

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

[74] 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 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).

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

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

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.[77]

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 in similar transactions with unrelated parties. 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.[78] 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 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[79] 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.[80] 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

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[77] Sec. 909.

[78] 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.

[79] 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."

[80] 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.

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.[81]

<u>Other special rules</u>

<u>Temporary dividends-received deduction for repatriated foreign earnings</u>

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.[82]

No foreign tax credit (or deduction) was allowed for foreign taxes attributable to the deductible portion of any dividend.[83] 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).[84] Deductions were disallowed for expenses that were directly allocable to the deductible portion of any dividend.[85]

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[81] H.R. Rep. No. 99-426, p. 423.

[82] 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.

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

[84] 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).

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

Earnings stripping

A domestic corporation may reduce the U.S. tax on the income derived from its U.S. 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.[86] 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 the generation of 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 the generation of excessive interest deductions. In general, earnings stripping provides a net tax benefit only to the extent that 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."[87] Disqualified interest includes interest paid or accrued to related parties when no Federal income tax is imposed with respect to such interest;[88] 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.

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

[87] Sec. 163(j).

[88] 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).

TITLE I.–PARTICIPATION EXEMPTION SYSTEM FOR TAXATION OF FOREIGN INCOME

1. Deduction for dividends received by domestic corporations from certain foreign corporations (sec. 101 of the bill and new sec. 245A of the Code)

Explanation of Provision

In general

The bill establishes a participation exemption system for foreign business income.[89] This exemption system is effectuated by means of a 95-percent deduction for the qualified foreign-source portion of dividends a domestic corporation receives from CFCs of which they are U.S. shareholders.[90] The deduction is available only if a one-year holding period requirement is satisfied and is unavailable for hybrid dividends, which are described below. As under the exemption systems of some other countries, five percent of a dividend from a CFC remains taxable. This taxation is intended to be a substitute for the disallowance of deductions for expenses incurred to generate exempt foreign income.

The bill retains subpart F of the Code with modifications.[91] Consequently, although the foreign-source portion of a dividend generally is 95-percent deductible when received by a U.S. shareholder from a CFC, the U.S. shareholder remains taxable in the United States on a current basis on its pro rata share of certain items of the CFC's income.

No foreign tax credit is allowed for any taxes (including withholding taxes) paid or accrued with respect to any dividend for which the 95-percent deduction is allowed. A deduction for any foreign tax paid or accrued in respect of a deductible dividend is also denied. Consequently, no section 78 gross-up is required for taxes disallowed under this provision. The foreign tax credit disallowance and deduction denial apply to foreign tax with respect to the entire amount of any deductible dividend even though a deduction is available for only 95 percent of the dividend. By contrast, a foreign tax credit is allowed for foreign tax imposed on income included under subpart F and for foreign tax paid directly by a domestic corporation on foreign-source income (such as income from foreign sales). Likewise, a foreign tax credit generally is available for foreign withholding tax imposed on payments such as royalties and interest. A foreign tax credit is not, however, available for foreign withholding tax imposed on dividends for which the 95-percent deduction is permitted. For purposes of applying the section

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[89] Throughout this document, "participation exemption" and "dividend exemption" are used interchangeably. The term "participation exemption" refers to the exemption granted to a domestic parent corporation for earnings of a foreign subsidiary by virtue of the parent corporation's participation in the ownership of the subsidiary.

[90] A U.S. shareholder has the meaning given in section 951(b), as modified by the rules for noncontrolled section 902 corporations described below.

[91] These modifications are part of Title II of the bill, described below.

904(a) foreign tax credit limitation, the non-deductible five-percent portion of a dividend is treated as U.S. source income.

The bill does not allow or require foreign branches of U.S. corporations to be treated as CFCs. Consequently, as under present law, income of a foreign branch of a U.S. corporation is taxable by the United States, losses of a foreign branch generally are deductible in the United States, and a credit against U.S. tax is available for foreign income taxes imposed on branch income.

The provision directs the Treasury Secretary to prescribe regulations that may be necessary or appropriate to carry out the 95-percent dividends-received deduction rules. These regulations may include, among other guidance, rules to prevent inappropriate loss or foreign tax credit planning, including through the use of branches.

Qualified foreign-source portion of dividends

The participation 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 95-percent deduction is available only for the qualified foreign-source portion of a dividend.

The foreign-source portion of a dividend that qualifies for the 95-percent deduction represents the portion of the dividend that relates to the CFC's post-2012 undistributed qualified foreign earnings. Specifically, the qualified foreign-source portion of any dividend is an amount which bears the same ratio to such dividend as the CFC's post-2012 undistributed qualified foreign earnings bears to its total post-2012 undistributed earnings. A CFC's post-2012 undistributed earnings are the earnings and profits[92] accumulated by the CFC in taxable years beginning after December 31, 2012, as of the close of the taxable year of the CFC, without diminution from dividends distributed during that taxable year.[93] A CFC's post-2012 undistributed qualified earnings are the portion of its post-2012 undistributed earnings that are not attributable to income effectively connected with the conduct of trade or business in the United States[94] or dividends received from a domestic corporation of which the CFC holds at least 80 percent of the stock (by vote or value).[95] Distributions are treated as first made out of a CFC's earnings and profits which are not post-2012 undistributed earnings, and then out of post-2012 undistributed earnings.

The restriction of the 95-percent dividends-received deduction to the foreign-source portion of a dividend complements the present law section 245 rule allowing a deduction for the

[92] The earnings and profits are computed in accordance with secs. 964(a) and 986.

[93] Earnings and profits accumulated in taxable years beginning after December 31, 2012, are referred to in this document as post-2012 earnings and profits.

[94] Sec. 245(a)(5)(A)

[95] Sec. 245(a)(5)(B)

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 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.[96] Under the provision, a CFC's post-2012 undistributed qualified foreign earnings are post-2012 undistributed earnings that are not U.S. earnings.

As a result of this coordination with section 245, the provision provides the 95-percent deduction for a dividend received by a U.S. shareholder from a CFC only to the extent the dividend is not deductible under present law section 245. More broadly, 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 provision in the bill 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 foreign-source income.

Noncontrolled section 902 corporations

Under the provision, a domestic corporation can elect to treat its ownership of a noncontrolled section 902 corporation[97] as a CFC for all purposes of the Code. A domestic corporation making such an election is treated as a U.S. shareholder of the noncontrolled section 902 corporation. A taxpayer must make an election with respect to a foreign corporation by the due date of the taxpayer's tax return for the first taxable year in which the foreign corporation is a noncontrolled section 902 corporation (or, if later, the first taxable year of the domestic corporation for which this provision is in effect). An election may be revoked only with the consent of the Treasury Secretary.

In cases in which the domestic corporation making such an election with respect to any noncontrolled section 902 corporation is a member of a controlled group of corporations, as defined in this provision,[98] then, except as otherwise provided by the Treasury Secretary, the election applies to all members of the group.

Special rules for hybrid dividends

Hybrid dividends are not eligible for the 95-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 the country in which the CFC was organized.

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[96] Sec. 245(a)(5)(A)

[97] A noncontrolled section 902 corporation has the meaning given in sec. 904(d)(2)(E)(i).

[98] The definition of a controlled group of corporations is similar to that contained in sec. 1563(a), except that "more than 50 percent" is substituted for "at least 80 percent" each place it appears.

Additionally, hybrid dividends of tiered CFCs are treated as subpart F income of the recipient CFC for the taxable year in which the dividend was received. This rule applies to hybrid dividends between CFCs with respect to which the same domestic corporation is a 10-percent shareholder. The 10-percent U.S. shareholder includes in gross income an amount equal to the shareholder's pro rata share (determined in the same manner as under section 951(a)(2)) of that subpart F income. No foreign tax credit or deduction is allowed for any taxes paid or accrued (or treated as paid or accrued) in respect of a hybrid dividend paid to a domestic corporation or in respect of a domestic corporation's subpart F inclusion as a result of a CFC-to-CFC dividend, and the section 78 gross-up does not apply to these taxes. Hybrid dividends are treated as U.S.-source income for purposes of applying the section 904(a) foreign tax credit limitation.

One-year holding period requirement

A domestic corporation is allowed the 95-percent deduction for a dividend it receives on stock of a CFC only if the domestic corporation satisfies a one-year holding period requirement in respect of the stock on which the dividend is paid. No deduction is allowed in respect of any dividend on any share of CFC stock that is held by a 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 share becomes ex-dividend with respect to the dividend. A deduction also is not permitted in respect of any dividend on any share of CFC stock to the extent that the domestic corporation owning 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 deduction available under present law sections 243, 244, and 245. The bill also incorporates 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 in respect of 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. In situations in which the domestic corporation elects to treat a noncontrolled section 902 corporation as a CFC, these requirements are treated as satisfied for any continuous period ending on the day before the election during which the noncontrolled section 902 corporation was a noncontrolled section 902 corporation with respect to the domestic corporation

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.

Like the present law dividends-received deduction rules of sections 243, 244, and 245, the provision's 95-percent dividends-received deduction is not available for any dividend from a corporation that is exempt from taxation under sections 501 or 521.

In conformity with the present law dividends-received deduction rules, deductible dividends under the provision and the stock on which deductible dividends are paid are treated as 95-percent tax-exempt income and 95-percent tax-exempt assets, respectively, for purposes of allocating and apportioning deductible expenses.

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 sections 243, 244, or 245. The provision extends this rule to stock on which a dividend eligible for the 95-percent dividends-received deduction is paid.

The provision provides that for purposes of subpart F, the term "United States shareholder" (that is, a U.S. person that owns at least 10 percent (by vote) of the foreign corporation) includes, with respect to a noncontrolled section 902 corporation, any domestic corporation that is treated as a 10-percent U.S. shareholder of that noncontrolled section 902 corporation as a result of an election described previously. The provision similarly provides that for purposes of subpart F, the term "controlled foreign corporation" includes any entity treated as a CFC as a result of the election.

Effective Date

The provision applies to taxable years of foreign corporations beginning after December 31, 2012, and to taxable years of U.S. shareholders in which or within which those taxable years of foreign corporations end.

2. Application of dividends-received deduction to certain sales and exchanges of stock (sec. 102 of the bill and secs. 964 and 1248 of the Code)

Explanation of Provision

The provision amends section 1248 so that when a domestic corporation recognizes a gain on the sale or exchange stock of a foreign corporation held for at least one year, any amount treated as a dividend under section 1248 is also treated as a dividend for purposes of applying the 95-percent dividends-received deduction rules. No deduction is allowed for any loss recognized by a domestic corporation from the sale or exchange of stock of a foreign corporation if (under section 1248(a)(2)) the domestic corporation owned at least 10 percent of the voting power of the foreign corporation at any time during the five years preceding the sale when the foreign corporation was a CFC.

The provision adds a new rule to 964(e) providing that when an upper-tier CFC sells or exchanges stock of a lower-tier CFC held for one year or more, and has gain from the sale that is treated as a dividend under section 964(e)(1), the qualified foreign-source portion of the deemed dividend[99] is treated as subpart F income of the upper-tier CFC; any 10-percent U.S. shareholder

[99] The qualified foreign-source portion of a dividend is defined in section 101 of the bill, described previously.

of that upper-tier CFC must include in gross income its pro rata share (under section 951(a)(2)) of that subpart F income; and the 95-percent dividends-received deduction is allowed to that 10-percent U.S. shareholder for the subpart F inclusion in the same manner as if that subpart F inclusion were a dividend received from the upper-tier CFC. No foreign tax credit is allowed with respect to this subpart F inclusion.

When an upper-tier CFC sells stock of a lower-tier CFC in a taxable year of the upper-tier CFC beginning after 2012, and the new section 964(e) rule described above would have applied to the sale if gain had been recognized, the earnings and profits of the upper-tier CFC are not reduced as a result of any loss from the sale or exchange.

Effective Date

The provision applies to taxable years of foreign corporations beginning after December 31, 2012, and to taxable years of domestic corporations with or within which those taxable years of foreign corporations end.

3. Deduction for foreign intangible income derived from trade or business within the United States (sec. 103 of the bill and new sec. 250 of the Code)

Explanation of Provision

This provision allows for a deduction equal to 50 percent of the qualified foreign intangible income of a domestic corporation. Qualified foreign intangible income means, with respect to any domestic corporation, foreign intangible income derived by the domestic corporation from the active conduct of a trade or business within the United States with respect to the intangible property giving rise to the income.

In identifying the property that gives rise to qualified foreign intangible income, the provision adopts the definition of intangible property used in determining the possession credit under section 936.[100] That definition enumerates specific types of property that are within the meaning of the statute, including any (1) patent, invention, formula, process, design, pattern, or know-how; (2) copyright, literary, musical, or artistic composition; (3) trademark, trade name, or brand name; (4) franchise, license, or contract; (5) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or (6) any similar item which has substantial value independent of the services of any individual.[101] The scope of property that may qualify as a "similar item" is not further defined in the statute.

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[100] In 1996, section 936 was amended to add subsection (j), which provides that the credit terminates subject to a 10-year transitional period for existing credit claimants.

[101] Sec. 936(h)(3)(B) incorporated by reference in sections 482 and 367(d). Treas. Reg. sec. 1.482-2A(d)(3)(j).

Foreign intangible income consists of any intangible income derived in connection with (1) property which is sold, leased, licensed, or otherwise disposed of for use, consumption or disposition outside the United States, or (2) services provided with respect to persons or property located outside the United States. Foreign intangible income does not include any amount treated as received by the domestic corporation under section 367(d)(2) with respect to any intangible property, any payment under a cost-sharing arrangement entered into under section 482, or any amount received from a CFC by a 10-percent U.S. shareholder of that CFC that is attributable or properly allocable to subpart F income or to effectively connected income subject to net-basis U.S. income tax. An amount otherwise not treated as subpart F is treated as such if the amount creates or increases a deficit that under section 952(c) may reduce the subpart F income of the payor or any other CFC.

To be considered qualified foreign intangible income, the domestic corporation must have derived the foreign intangible income from the active conduct of a U.S. trade or business with respect to the intangible property giving rise to the income. Foreign intangible income is considered derived from a domestic corporation's active conduct of a U.S. trade or business only if the domestic corporation developed, created, or produced in the United States the intangible property giving rise to the income or, in the case of acquired intangible property, added substantial value to it through the active conduct of the trade or business within the United States. Intangible income is gross income from the sale, lease, license, or other disposition of property in which intangible property is used directly or indirectly or from the provision of services in which intangible property is used directly or indirectly.

A domestic corporation's gross intangible income is reduced under Treasury regulations for deductions properly allocable to the income.

The Treasury Secretary is authorized to prescribe regulations necessary or appropriate to carry out the provision.

Effective Date

The provision applies to taxable years of domestic corporations beginning after December 31, 2012.

4. Treatment of deferred foreign income upon transition to participation exemption system of taxation (sec. 104 of the bill and sec. 965 of the Code)

Explanation of Provision

In general

A corporate 10-percent U.S. shareholder may elect a one-time 70-percent deduction for eligible amounts received from a CFC from pre-2013 earnings.[102] The eligible amounts include

[102] Unless otherwise stated, pre-2013 earnings refers to undistributed earnings and profits of the CFC, as of the close of the taxable year preceding the first taxable year of the CFC beginning after December 31, 2012, that were not previously subject to U.S. tax.

both cash repatriated in the form of dividends and amounts that a taxpayer elects to treat as subpart F income ("deemed repatriation"). The deduction is available only for the taxable year of the U.S. shareholder with or within which the first taxable year of the CFC beginning after December 31, 2012 ends. As a result of claiming the deduction, the taxpayer is not entitled to any credit or deduction for foreign taxes paid that would otherwise be available with respect to any portion of the dividends or deemed repatriations. In the absence of an election, foreign taxes paid with respect to pre-2013 earnings are creditable or deductible when the earnings are distributed, subject to relevant limitations. The 70-percent deduction election is not available for earnings of noncontrolled section 902 corporations that are treated as CFCs as a result of an election under new section 245A(b) (described previously). An election to apply any of the benefits of this provision (including the deduction, the deemed repatriation, and the installment payment method, described below) is due no later than the due date (including any extensions) of the return on which the deduction is claimed.

Eligible amount

The eligible amount with respect to which the deduction may be claimed comprises both cash dividends and deemed repatriations. It is the lesser of (1) the 10-percent U.S. shareholder's pro rata share of the pre-2013 earnings of the CFC as of the close of the taxable year immediately preceding the first taxable year beginning after December 31, 2012, or (2) the sum of cash dividends paid out of pre-2013 earnings plus any portion of the taxpayer's pro rata share of CFC's pre-2013 earnings that the taxpayer elects to deem to be subpart F income. It does not include amounts included as a dividend by reason of a section 78 gross-up for taxes paid with respect to subpart F income or dividends that are not subject to the election under this provision. An ordering rule for purposes of determining the eligible amount requires that cash dividends are treated as first paid from the pre-2013 earnings, to the extent thereof.

Treatment of foreign tax credits associated with eligible dividends

Neither a credit nor deduction is permitted for foreign taxes attributable to the eligible amounts with respect to which the 70-percent deduction is elected. Accordingly, no adjustment under section 78 is required with respect to those taxes. The nondeductible portion of the eligible amount for which the deduction is elected is treated as income from sources within the United States for purposes of applying the foreign tax credit limitation.

The benefits of the election are illustrated in the following examples. All examples assume that the CFC is wholly owned by the sole U.S. shareholder, has $1,500 pre-2013 earnings, and has paid $300 in foreign income taxes with respect to the accumulated earnings and profits.

- The U.S. shareholder receives an $800 dividend from the CFC and elects the benefits of this provision but does not elect a deemed repatriation with respect to the remaining pre-2013 earnings.
    a. The entire dividend of $800 is included in the eligible amount.
    b. A 70-percent deduction equal to $560 is available, and the balance of the dividend is taxed at 35 percent.

c. The foreign taxes related to the $800 distribution, $160, are neither available as a credit nor deductible for U.S. tax.

d. If the remaining $700 of earnings and profits are distributed in a subsequent year, the 70-percent deduction is not available, but foreign taxes of $140 attributable to the $700 are available for credit or deduction.

- If the U.S. shareholder receives an $800 distribution from the CFC and elects the benefits of this provision, the entire distribution of $800 is included in the eligible amount. Assume the taxpayer also elects to include as subpart F income an amount up to $700, the remaining portion of the CFC's pre-2013 earnings, for a total eligible amount of $1,500, with the following results:

  a. A 70-percent deduction of $1,050 is available, i.e., $560 for the cash distribution and $490 for the deemed repatriation.

  b. The foreign taxes attributable to the entire eligible amount equal $300, none of which is credited or deductible as a result of electing to claim the dividends-received deduction.

  c. Assuming that the nondeductible portion of the eligible amount, $450, is taxed at the highest rate of Federal income tax applicable to corporations, 35 percent, the U.S. shareholder incurs a U.S. tax of $157.50 on the distribution and deemed repatriation. The nondeductible 30 percent of the eligible amount is treated as income from U.S. sources for purposes of determining the foreign tax credit limitations applicable for the current year.

- Assume instead that the CFC distributes all of its pre-2013 earnings, $1500, and the U.S. shareholder does not elect the deduction under section 965:

  a. Present law rules apply to this distribution. The U.S. shareholder recognizes a dividend of $1500 and a section 78 gross up of $300, for total dividends of $1800.

  b. The U.S. shareholder incurs a U.S. tax liability of $630 [1800 x 35%], but

  c. The U.S. shareholder may credit the $300 foreign taxes paid with respect to that income to reduce the liability to $330.

<u>Election to pay by installment</u>

The tax attributable to the inclusion of deemed subpart F inclusions in the repatriation of earnings and profits may be paid in up to eight installments, at the election of the taxpayer. The installment payment election is required to be made at the same time as the election to claim the 70-percent deduction. Although the tax is determined and assessed with respect to the taxable year in which the deemed repatriation is elected, if installment payment is elected, the net tax liability is payable in equal installments. The net tax liability is the amount by which the net income tax (reduced by any credit allowed by section 38) exceeds the tax that would be due if it were determined without regard to the election to include deemed subpart F income. No installment election is available with respect to the portion of tax attributable to cash dividends. If the amount of the net tax liability is subsequently adjusted, resulting in a deficiency in tax, that deficiency will be assessed and prorated over all installments. The portion of the deficiency allocated to installments already paid will be due, with interest, upon notice and demand by the

Treasury Secretary. The portion of the deficiency allocated to installments not yet due will be added, with appropriate interest, to the installments.

The first installment payment is due on the due date for the income tax return on which the election is made, without regard to any extension of time for filing said return. Subsequent installment payments are due, with interest, on the due date for the income tax return for each succeeding taxable year, determined without extensions. An acceleration rule provides that the unpaid balance is due immediately upon the occurrence of any of several events, such as late payment that results in assessment of an addition to tax for failure to pay an installment; liquidation of the business; cessation of the business; sale of substantially all of the business assets, etc.

Effective Date

The provision is effective for taxable years of CFCs beginning after December 31, 2012 and to the taxable years of 10-percent U.S. shareholders with or within which such taxable years of the CFCs end.

TITLE II.–OTHER INTERNATIONAL TAX REFORMS

A. Modifications of Subpart F

1. Treatment of low-taxed foreign income as subpart F income (sec. 201 of the bill and sec. 952 of the Code)

Explanation of Provision

The bill adds a new category of subpart F income for low-taxed income. All gross income of a CFC is low-taxed income unless the 10-percent U.S. shareholder establishes that the income was subject to foreign tax at an effective rate that exceeds one-half of the maximum rate of income tax applicable to U.S. corporations for the relevant taxable period. For this purpose, the effective tax rate is determined under U.S. principles similar to those used for determining the high-tax exception of section 954(b)(4). Deductions properly allocable to the income in such country are taken into account in determining the amount of income. Income that was not subject to an effective rate of at least 17.5 percent (one-half of the current maximum U.S. corporate rate of 35 percent) may be excluded if it is qualified business income as described in the statute, other than intangible income within the meaning of new section 250(c).

The effective rate at which foreign income was taxed is determined by applying U.S. principles, on a country-by-country basis, for each country in which a CFC conducts any trade or business. Neither current losses nor losses carried to the taxable year are taken into account in determining the effective rate of tax imposed on income from a particular country.

After the effective tax rate is determined on a country-by-country basis, the amount of any low-taxed income from a particular country is reduced by the amount of income that constitutes qualified business income derived in that country. In order to be within the scope of the exception for qualified business income, the income of the CFC must be derived in a foreign country and attributable to the active conduct of a trade or business in that foreign country by the CFC, through its office or fixed place of business in such country and by its officers and employees who are physically located in the country. The activities performed by the employees and officers physically located in the country must be substantial and contribute significantly to the conduct of the business in that country, when viewed in relation to all functions required for the conduct of the trade or business to which the income is attributed. The CFC activities taken into account for purposes of determining whether the activities performed by employees and officers are substantial and contribute significantly to the conduct of the CFC's business include activities such as procuring supplies, manufacturing, distributing, and the sales and marketing of goods and services to persons located outside of the United States.

Examples

The following examples illustrate the application of the country-by-country computation of low-taxed subpart F income. For each example, assume that a CFC that has total income of $150 from its operations, of which $50 is qualified business income. The CFC has paid total foreign taxes of $20, or approximately 13 percent.

- Assume that all of the income was earned in a single country.

a. The qualified business income is taken into account for purposes of determining the effective rate of income tax at which the CFC is taxed. The tax paid by the CFC is less than half of the highest rate of tax applicable to a U.S. corporation under section 11(b). Thus, all $150 of the income of the CFC is potentially low-taxed income.

b. The amount of income potentially treated as low-taxed income is reduced by $50, the amount of qualified business income of the CFC.

c. Result: The CFC has $100 of low-taxed income includible under subpart F.

- Assume instead that the income is earned in two or more jurisdictions. Income is derived in Country A in the amount of $50, from investments and operations in Country A; the remainder is $50 investment income and $50 qualified business income derived in Country B. Thus, a country-by-country analysis is necessary, and reaches a different result.

  a. Country A has a statutory rate of income tax of 20 percent, and has imposed tax of $10, for an effective tax rate of 20 percent, which exceeds one-half of the highest rate imposed by section 11(b).

  b. Country B also has a statutory rate of 20 percent, but CFC was entitled to certain preferential rates based on its Country B activities, which reduced its total tax paid to $10 paid, for an effective tax rate of only 10 percent, less than one-half of the highest rate under section 11(b).

  c. CFC has $50 of subpart F low-taxed income, all from Country B, because it is entitled to reduce its low-taxed income by the amount of its qualified business income, $50, provided that none of it is from intangible income within the meaning of section 250(c)(3).

Although all of the income earned in a country is taken into account for purposes of determining whether any income is low-taxed income, the amount that is includible as subpart F low-taxed foreign income is reduced by the portion of income from that country that is qualified business income. That is again determined on a country-by-country basis; in this example, the activities in Country A need not be further examined because the income is not low-taxed income.

Effective Date

The provision applies to taxable years of CFCs that begin after December 31, 2012, and to taxable years of U.S. shareholders with or within which such taxable years of the CFCs end.

2. Permanent extension of look-thru rule for controlled foreign corporations (sec. 202 of the bill and sec. 954(c)(6) of the Code)

Explanation of Provision

From 2005 through 2011,[103] certain payments of dividends, interest, rents, and royalties that would otherwise be included in foreign personal holding company income were excepted if the payments were received from a related CFC and were properly attributable and allocable to income of the payor that was neither subpart F income nor treated as effectively connected to a U.S. trade or business. The bill revives the provision and makes it permanent.

Effective Date

The provision is effective for taxable years that begin after December 31, 2011, and to taxable years of U.S. shareholders with or within which such taxable years of the CFCs end.

3. Permanent extension of exceptions for active financing income (sec. 203 of the bill and secs. 953(e)(10), 954(h)(9) and 954(i) of the Code)

Explanation of Provision

Beginning with taxable years in 1998,[104] certain income derived (1) in the active conduct of a banking, financing, or similar business, (2) as a securities dealer, or (3) in the conduct of an insurance business (collectively known as active financing income) has been excepted from treatment as subpart F income. The exceptions expired at the end of 2011. Without the temporary exceptions, 10-percent U.S. shareholders are subject to U.S. tax currently on their pro rata shares of active financing income earned by the CFC, whether or not the income is distributed to shareholders.

Under the provision, the exception for active financing income is restored and made permanent.

Effective Date

With respect to CFCs, the provision is effective for taxable years that begin after December 31, 2011. For U.S. shareholders, the provision is effective for the taxable years during which taxable years of the CFCs end.

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[103] The provision was first enacted in the Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109-222) for taxable years beginning before January 1, 2009. It was twice extended: The Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (Div. C of Pub. L. No. 110-343) extended it for one year. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. No. 111-312), extended it through December 31, 2011.

[104] Taxpayer Relief Act of 1997, Pub. L. No. 105-34.

4. Foreign base company income not to include sales or services income (sec. 204 of the bill and sec. 954 of the Code)

Explanation of Provision

The provision narrows the anti-deferral rules in subpart F by removing certain foreign sales and services income from the categories of foreign base company income that are includible in the income of U.S. shareholders as subpart F income regardless of whether the income has been distributed as a dividend. The remaining category of income from business operations included in foreign base company income for certain oil-related income is not modified. As a result, in combination with the other provisions in this subtitle (permanent extension of the look-thru provision and active financing income exception in sections 202 and 203 respectively, and the active business exception (other than for intangible income) in the new category of subpart F income added by section 201), subpart F income is generally limited to passive income and low-taxed intangible income.

Effective Date

The provision is effective for taxable years of CFCs that begin after December 31, 2012 and to taxable years of U.S. shareholders with or within which such taxable years of the CFCs end.

B. Modifications Related to Foreign Tax Credit

1. Modification of application of sections 902 and 960 with respect to post-2012 earnings (sec. 211 of the bill and secs. 902 and 960 of the Code)

Explanation of Provision

The provision repeals the section 902 deemed-paid credit for any dividend or portion of any dividend paid by a foreign corporation to the extent paid out of the corporation's post-2012 earnings and profits (computed in accordance with sections 964(a) and 986). This rule disallows a deemed-paid credit in respect of dividends from foreign corporations regardless of whether the 95-percent dividends received deduction is available.

The section 902 deemed-paid credit remains available in respect of dividends paid out of earnings and profits accumulated in taxable years beginning before 2013. Any distribution in a taxable year beginning in 2013 or later is treated as made first out of earnings and profits accumulated in taxable years beginning before 2013. Consequently, the provision allows the section 902 deemed-paid credit to remain in effect for dividends received from a foreign corporation until the corporation's pre-2013 earnings and profits have been exhausted. In computing the amount of foreign income tax that a domestic corporation is deemed to have paid under section 902 in respect of dividends attributable to a foreign corporation's pre-2013 earnings, the term "post-1986 earnings" does not include the corporation's post-2012 earnings and profits.

The provision amends the deemed paid credit rules applicable to subpart F inclusions. If a domestic corporation has subpart F income with respect to any CFC in which the domestic corporation is a 10-percent U.S. shareholder, and the subpart F income is attributable to earnings and profits of the CFC (computed in accordance with sections 964(a) and 986) accumulated in taxable years beginning after December 31, 2012, the domestic corporation is deemed to have paid the portion of the CFC's foreign income tax that is properly attributable to the subpart F income. It is expected that the Treasury Secretary will prescribe regulations for determining the extent to which foreign income taxes paid or accrued by a CFC are considered properly attributable to subpart F income of a 10-percent shareholder of the CFC. Under the deemed-paid foreign tax credit rule for foreign income taxes attributable to subpart F income, the term "foreign income taxes" has the same meaning as under present law: any income, war profits, or excess profits taxes paid or accrued by a CFC to any foreign country or U.S. possession. As under present law, in-lieu-of income taxes under section 903, such as foreign withholding taxes, are considered foreign income taxes.

The provision directs the Treasury Secretary to provide regulations that are necessary or appropriate to carry out the provision.

Effective Date

The provision is effective on the date of enactment.

2. Separate foreign tax credit basket for foreign intangible income (sec. 212 of the bill and sec. 904 of the Code)

Explanation of Provision

The provision creates a new separate income category (basket) in the computation of the foreign tax credit limitation under section 904. The new limitation category is for foreign intangible income as defined in new Code section 250(c) (described above in the explanation of section 103 of the bill). The provision retains the present law separate limitation categories for passive and active income for income that is not included in the new category of foreign intangible income.

Effective Date

The provision applies to taxable years beginning after December 31, 2012.

In the case of any foreign tax carried over from a taxable year beginning before 2013 to any taxable year beginning in 2013 or later, any item of income to which the tax relates is considered to be in the separate limitation category (general category or passive category) in which that item would be described in the absence of the new limitation category for foreign intangible income.

In the case of a carryback of foreign tax related to an item of foreign intangible income from a taxable year beginning in 2013 or later to a taxable year beginning before 2013, the foreign tax is allocated to general category income.

3. Inventory property sales source rule exceptions not to apply for foreign tax credit limitation (sec. 213 of the bill and sec. 904 of the Code)

Explanation of Provision

The provision overrides certain inventory sales source rules for purposes of computing the foreign tax credit limitation. Amounts treated as foreign source by reason of the application of the special inventory sourcing rules of section 862(a)(6) and section 863(b)(2), and the regulations promulgated thereunder,[105] are treated as U.S.-source for purposes of computing the foreign tax credit limitation under the provision.

Section 862(a)(6), treats income from the sale outside the United States of inventory property purchased within the United States as foreign-source income. Under the provision, this income is treated as U.S.-source income for purposes of computing the foreign tax credit limitation.

[105] For more information regarding sourcing rules, see the discussion on source of income rules in the present law section of this document.

Section 863(b)(2) treats income from the sale of inventory property produced (in whole or in part) by a taxpayer in the United States and sold outside the United States, or produced (in whole or in part) outside the United States and sold in the United States, as partly U.S.-source and partly foreign-source income. Under the provision, income sourced outside the United States under these rules is treated as U.S.-source income for purposes of computing the foreign tax credit limitation.

Effective Date

The provision is applicable to taxable years beginning after December 31, 2012.

C. Other Provisions

1. Election to allocate interest on a worldwide basis (sec. 221 of the bill and sec. 864 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, 2012, rather than to taxable years beginning after December 31, 2020. The worldwide interest allocation 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 these rules 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. These rules are generally expected to reduce the amount of the U.S. group's interest expense that is allocated to foreign-source income.

Effective Date

The provision is effective for taxable years beginning after December 31, 2012.