United States Senate Committee on Finance

The International Tax
Bipartisan Tax Working Group Report

July 2015
# TABLE OF CONTENTS

Foreword by the co-chairs........................................................................................................5

I. Reasons for Action.............................................................................................................7
   A. Inversions / Foreign Acquisitions...............................................................................7
   B. OECD’s Base Erosion and Profit Shifting Project......................................................8

II. International Principles of Taxation...........................................................................10
   A. General Overview......................................................................................................10
   B. International Principles as Applied in the U.S. System............................................13

III. Present Law..................................................................................................................15
   A. Principles Common to Inbound and Outbound Taxation.......................................15
      1. Transfer Pricing......................................................................................................15
      2. Entity Classification..............................................................................................16
      3. Source of Income Rules........................................................................................17
      4. Corporate Residence.............................................................................................21
   B. U.S. Tax Rules Applicable to Nonresident Aliens and Foreign Corporations
      (Inbound)....................................................................................................................24
      1. Gross-basis taxation of U.S.-source income..........................................................24
      2. Net-basis taxation of U.S.-source income..............................................................28
      3. Special Rules..........................................................................................................32
   C. U.S. Tax Rules Applicable to Foreign Activities of U.S. Persons (Outbound).........35
      1. In General...............................................................................................................35
      2. Anti-deferral regimes.............................................................................................35
      3. Foreign tax credit....................................................................................................41
      4. Special rules..........................................................................................................43
D. U.S. tax rules applicable to the U.S. territories

1. Background

2. In General

3. Income Taxation of Individuals

4. Income Taxation of Corporations

5. Estate and Gift Taxation

6. Payroll Taxes

7. Excise Taxes

8. Tax Incentives

9. Tax Treaties

IV. Prior International Tax Reform Efforts

A. The Tax Reform Act of 2014 (“TRA14”)

1. Ninety-five percent dividend received deduction

2. Foreign base company intangible income

3. Denial of deduction for interest expense of U.S. shareholders which are members of worldwide affiliated groups with excess domestic indebtedness

4. Modifications to section 163(j), limitation on deduction for interest on certain indebtedness

5. Deemed repatriation of deferred foreign income

B. President’s FY 2016 Budget Proposal

1. Impose a 19-percent Minimum Tax on Foreign Income

2. Interest allocation

3. Impose a 14-percent One-Time Tax on Previously Untaxed Foreign Income

V. Bipartisan Framework for International Tax Reform
A. Ending the lock-out effect........................................................................................72
B. Patent Box Regime..................................................................................................73
C. Base Erosion.............................................................................................................76
D. Interest Expense Limitations................................................................................77
E. Deemed Repatriation..............................................................................................78

VI. Miscellaneous Issues..........................................................................................78
   A. CFC Look-Through..............................................................................................78
   B. Active Financing Exception................................................................................79
   C. Foreign Investment in Real Property Tax Act.....................................................79
   D. Foreign Affiliate Reinsurance............................................................................80
   E. Territories............................................................................................................80
   F. Overseas Americans.........................................................................................80
FOREWORD BY THE CO-CHAIRS

Over the past few months, the working group has examined every aspect of the international tax code in an attempt to find ways to fix a system that is clearly broken. Our current system of international taxation was put into place during the Kennedy Administration and reflects the realities of a different era. By standing still, the United States has fallen behind other countries that have adopted modern international tax rules to help their companies and workers compete in the global marketplace.

As the Business Roundtable pointed out in their submission to the working group, “[n]ew technologies, emerging economies, and falling trade barriers have significantly increased global cross-border investment and trade over this period, while increasing economic competition.” And the numbers bear this out. In 1982, U.S. multinational companies earned only about 23 percent of their income from outside the United States. In 2012, 54 percent of the income of U.S. multinational companies was earned outside the United States.

When U.S. businesses can compete and win in this growing global market, the real winners are U.S. workers. A 2009 study on the domestic effects of the foreign activities of U.S. companies found that every 100 jobs added abroad by U.S. multinational companies resulted in an average increase of 124 jobs added in the United States.1 A March 2015 report by Ernst & Young found that for each dollar of additional wages paid in U.S. foreign affiliates, U.S. wages increased by $1.84.2 Further, the report found that each dollar of foreign investment by U.S. multinational companies led to $3.50 of additional investment here at home.3

Unfortunately, as the importance of success in foreign markets has grown, the United States has become less competitive abroad because of its worldwide system of international taxation. In 1989, only 10 OECD member countries had territorial tax systems and just two of the G-7 countries had such a system.4 Today, 28 OECD countries and every other G-7 country has adopted some form of territorial system5 - and all of these countries have lower corporate tax rates than the United States. This means that no matter what jurisdiction a U.S. multinational company is competing in, it is competing at a disadvantage. The National Association of Manufacturers may have said it best in their submission: “[i]f American companies cannot

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3 Id.

4 See Alliance for Competitive Taxation, Comments Submitted to the Senate Committee on Finance International Tax Working Group 7 (2015).

5 Id.
compete abroad, where 95 percent of the world’s consumers are located, the U.S. economy suffers from the loss of both foreign markets and domestic jobs that support foreign operations.”

Like any major tax reform, fixing the international tax code won’t be easy, but it will be essential if we want U.S. businesses and their workers to be able to compete and win in an increasingly global economy. While we are still working with the staff of the Joint Committee on Taxation on the specifics of an international tax reform proposal, we believe that the framework below represents what a bipartisan proposal should look like. While not within the jurisdiction of the international working group, there is no doubt that the policies below work best with a substantial corporate tax rate reduction and broader tax reform for all businesses.

We would like to thank the members of the International Tax Reform Working Group: Senator Pat Roberts (R-KS), Senator Sherrod Brown (D-OH), Senator Michael Enzi (R-WY), Senator Tom Carper (D-DE), Senator John Cornyn (R-TX), and Senator Mark Warner (D-VA); as well as their staffs and the professional staff of Chairman Orrin Hatch (R-UT) and Ranking Member Ron Wyden (D-OR). Their participation and engagement is a large part of what made the working group process successful; however, it should be noted their participation does not imply agreement with all of the details of the framework outlined below. We would also especially like to thank Tom Barthold and his staff at the Joint Committee on Taxation for their countless hours spent with Senators and staff discussing the technical details involved in various international tax reform measures, and for their assistance in the preparation of this report. Finally, we would like to thank the stakeholders who took the time to be engaged in the process. Their continued participation and input will be vital in moving this process forward.

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I. REASONS FOR ACTION

A. Inversions / Foreign Acquisitions

Unfortunately, the negative consequences of our current tax code have played out in the headlines over the last two years. From 2013 through September 2014, at least a dozen companies pursued tax inversions, transactions which move a company’s corporate tax home outside of the United States.\(^7\) Last September, the Treasury Department issued anti-inversion regulations to combat the problem. Although the regulations have had an impact, staving off additional inversions, it’s clear that the fundamental problem cannot be fixed without reform of our tax system.

For example, take the saga of Salix Pharmaceuticals. Salix is a North Carolina-based pharmaceutical company. Last fall, Salix attempted to buy an Irish subsidiary of Cosmo Pharmaceuticals and invert to Ireland. As a result of Treasury’s regulations, Salix called off the deal due to “more uncertainty regarding the potential benefits”\(^8\) that Salix hoped to achieve through the transaction. Instead of being the end of the story, the collapsed deal sparked a bidding war for Salix. All but one of the bidders for Salix were foreign headquartered companies, and the one that was based in the United States, Mylan Inc., has subsequently inverted to the Netherlands. In the end, Valeant Pharmaceuticals, a former U.S. company which inverted to Canada in 2010, won the bidding.\(^9\) In April, Valeant announced that it would lay off 258 Salix workers in Raleigh - approximately one third of its workforce.\(^10\)

The story illustrates the simple fact that today’s U.S. tax code makes U.S. companies more valuable in the hands of foreign acquirers - and it’s a trend that appears to be growing. According to the Wall Street Journal, “[f]oreign takeovers of U.S. companies have surged lately, hitting $275 billion last year, according to data provider Dealogic. That is double the 2013 amount and far outpaces the increase in overall global mergers and acquisitions, which rose 30 percent in dollar volume.”\(^11\) And this isn’t to say that foreign investment in the United States is


\(^11\) Supra note 7.
Several recent studies show that tax reform in the United States is the answer. One suggests that if the United States converted from a worldwide to a hybrid territorial-like system of international taxation, that the number of cross-border deals where the United States company is the acquirer would increase by seventeen percent. In Ernst and Young’s recent cross-border mergers and acquisitions (M&A) study, they estimate that a 25 percent corporate tax rate would have kept 1,300 companies from leaving the United States through acquisition or inversion over the last ten years.

B. OECD’s Base Erosion and Profit Shifting (BEPS) Project

Almost every U.S. multinational company and trade group that met with the working group has expressed serious concerns about the impact the BEPS Project will have and, in fact, is already having on their business decisions, the U.S. corporate tax base. and our economy as a whole.

For background, at the request of the G20 finance ministers, the OECD has undertaken work to develop an Action Plan on Base Erosion and Profit Shifting (i.e., the BEPS Project). This project is intended to develop policy and administrative recommendations in fifteen discreet action areas in an effort to harmonize international tax rules between jurisdictions and combat tax avoidance by multinational companies. The project is operating on a rapid timeline, with recommendations to be finalized by the end of 2015. An outline of BEPS Action Items and timeline is below:

<table>
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<tr>
<th>OECD'S BEPS Action Plan</th>
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<tbody>
<tr>
<td><strong>September 2014</strong></td>
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<tr>
<td>Action 1</td>
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<td>Action 2</td>
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13 *Supra* note 2.
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<th>Action 13</th>
<th>Interim report regarding rules for transfer pricing in relation to country-by-country documentation requirements</th>
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<td>Action 15</td>
<td>Final report on the development of a multilateral, as opposed to a bilateral, mechanism to implement BEPS measures, particularly with regard to treaty modification</td>
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**September 2015**

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<th>Action 3</th>
<th>Recommendations regarding the design of domestic rules to strengthen Controlled Foreign Companies (CFC) Rules</th>
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<tr>
<td>Action 4</td>
<td>Recommendations regarding the design of domestic rules to limit base erosion via interest deductions and other financial payments</td>
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<td>Action 5</td>
<td>Strategy to expand participation to non-OECD members to counter harmful tax practices more effectively</td>
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<td>Action 7</td>
<td>Tax treaty measures to prevent the artificial avoidance of permanent establishment status</td>
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<td>Actions 9 and 10</td>
<td>Changes to the transfer pricing rules in relation to risks and capital, and other high-risk transactions</td>
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<td>Action 11</td>
<td>Recommendations regarding data on BEPS to be collected and methodologies to analyze them</td>
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<td>Action 12</td>
<td>Recommendations regarding the design of domestic rules to require taxpayers to disclose their aggressive tax planning arrangements</td>
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<td>Action 14</td>
<td>Tax treaty measures to make dispute resolution mechanisms more effective</td>
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**December 2015**

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<th>Action 4</th>
<th>Changes to the transfer pricing rules to limit base erosion via interest deductions and other financial payments</th>
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<td>Action 5</td>
<td>Revision of existing criteria to counter harmful tax practices more effectively</td>
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<td>Action 15</td>
<td>The development of a multilateral instrument</td>
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<tr>
<td>Action 14</td>
<td>Tax treaty measures to make dispute resolution mechanisms more effective</td>
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Pressure for action developed over the past few years, primarily in the European Union, where alleged gaming of the differences in tax rates among member nations received significant media scrutiny and became a political issue. In 2012, the Public Accounts Committee of the British House of Commons called upon Amazon, Google and Starbucks to explain their companies’ U.K. tax strategies. The European Commission has undertaken formal state aid investigations of Ireland, Luxembourg and The Netherlands—largely focused on tax treatment of U.S. multinational companies. Additionally, German Chancellor Angela Merkel urged action to crack down on profit shifting in a speech at the OECD in February 2014; French President Francois Hollande has called for some form of global tax harmonization to combat stateless income; and many countries have increased audit scrutiny on multinational companies in an effort to combat tax avoidance—notably, with Italy going so far as to raid the Italian headquarters of multiple U.S. companies, including Facebook and Apple, in recent years.

Additionally, although coordination amongst taxing jurisdictions is one goal of the BEPS project, some participating countries have already begun to take unilateral actions before the
project is complete. In addition to investigations and audits such as those listed above, statutory changes are already going into effect. Approximately thirty unilateral measures were introduced in 2014, including guidance and legislation or proposed legislation on hybrid mismatches, interest deductibility and controlled foreign corporation rules, among others.\textsuperscript{14}

The United Kingdom plans to enact a new nexus requirement for participation in its patent box in line with the OECD’s new requirements for acceptable preferential tax regimes for intangible property. In addition, the U.K. enacted a new "diverted profits tax" that went into effect April 1, 2015. Under the diverted profits tax, a 25 percent tax will be imposed on profits considered to be artificially shifted out of the United Kingdom. This is intended to curtail the ability of a company to book sales associated with mobile income within the country through lower-tax jurisdictions. Similar efforts are being taken by other countries around the globe, including Australia, which has put forth a number of proposals consistent with BEPS efforts in its 2015-2016 federal budget; and Spain, France and Mexico have all recently implemented stricter interest deductibility limits.

Even if the United States does not accede to the BEPS recommendations, U.S. multinational companies will still be impacted. U.S. companies will be subject to base erosion rules in effect in other countries; and, in fact, are the intended targets of many of the new rules going into effect. The U.K. diverted profits tax is often referred to as the “Google Tax” and the Australian proposal as the “Netflix Tax.”

As former Chairman Camp recently stated, “the bottom line is that change is coming-- if not here at home, then it is certainly coming from overseas.” If policymakers fail to implement new rules in a timely fashion to combat overseas action, BEPS-related and unilateral actions around the globe will undoubtedly result in far more taxes paid into foreign coffers by U.S. multinational companies, with a corresponding revenue and job loss here in the United States.

\section*{II. INTERNATIONAL PRINCIPLES OF TAXATION}

\subsection*{A. General Overview}

A number of commonly accepted principles have developed to minimize the extent to which conflicts arise between countries as a result of extraterritorial or overlapping exercise of authority. International law generally recognizes the right of each sovereign nation to prescribe rules to regulate conduct with a sufficient nexus to the sovereign nation. The nexus may be between conduct and the territory of the nation or it may be between a person (whether natural or juridical) and the status of that person in the view of the sovereign nation.\textsuperscript{15} Normative limitations based on the reasonableness of such regulatory action have developed. In addition, most legal systems respect limits on the extent to which extraterritorial measures can be given

\textsuperscript{14} Pricewaterhouse Coopers (April 2014). The Forces and Tensions Shaping BEPS. \textit{PwC TaxTalk Monthly.}

effect. The broad acceptance of such norms extends to cross-border trade and economic dealings.

These two broad bases of jurisdiction, i.e., territoriality and nationality of the person whose conduct is regulated, have been refined and, in varying combinations, form the bases of most systems of income taxation. Exercise of taxing authority based on a person’s status as a national, resident, or domiciliary of a jurisdiction reaches worldwide activities of such persons and is the broadest assertion of taxing authority. A more limited exercise of taxation occurs when taxation is imposed only to the extent that activities occur, or property is located, in the territory of the taxing jurisdiction. If a person conducts business or owns property in a jurisdiction, or if a transaction occurs in whole or in part in a jurisdiction, the resulting limited basis of taxation is a territorial application.

Regardless of which basis of taxation is used by a jurisdiction, the identification of its tax base depends upon establishing rules for determining whether the income falls within its authority to tax. The source of income and its related expenses are governed by source rules that specify the treatment of income derived from a broad range of activities. Those rules sometimes turn on residency, leading to another set of rules that determine how to identify which persons have sufficient contact with a jurisdiction to be considered resident. For individuals, the test may depend solely upon nationality, or a physical presence test, or some combination. For all other persons, determining residency may require more complex consideration of the level of activities within a jurisdiction. Such rules generally reflect a policy decision about the requisite level of activity within a geographic location that warrants assertion of taxing jurisdiction.

Mechanisms to eliminate double taxation were developed to address those situations in which the source and residency determinations of the respective jurisdictions result in duplicative assertion of taxing authority, as well as to permit limited mutual administrative assistance between jurisdictions. For example, asymmetry between different standards adopted in two countries for determining residency of persons, source of income, or other basis for taxation may result in income that is subject to taxation in both jurisdictions. When the rules of two or more countries overlap, potential double taxation is usually mitigated by operation of bilateral tax treaties or by legislative measures permitting credit for taxes paid to another jurisdiction.

In addition to bilateral treaties, countries work with multilateral organizations to develop common principles for adoption by its members and to identify emerging issues and possible solutions. As mentioned above, the Organization for Economic and Cooperation and Development (“OECD”), in response to concerns raised by the G20 about base erosion and profit shifting and the desire to provide an internationally coordinated approach to such concerns, is conducting an ongoing project, which began with the release of a report on February 12, 2013,

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16 Although U.S. courts extend comity to foreign judgments in some instances, they are not required to recognize or assist in enforcement of foreign judgments for collection of taxes, consistent with the common law “revenue rule” in *Holman v. Johnson*, 1 Cowp. 341, 98 Eng. Rep. 1120 (K.B.1775). American Law Institute, *Restatement (Third) of Foreign Relations Law of the United States*, sec. 483, (1987). To the extent that the revenue rule is abrogated, it is done so in bilateral treaties, to ensure reciprocity.
Addressing Base Erosion and Profit Shifting.¹⁷ That report presents an overview of data and global business models, identifies the issues under study and provides timeframes in which it is issuing reports and delivering recommendations to the G20. The European Union and several of its member states have introduced proposals or enacted laws that deny tax benefits in arrangements in which companies might otherwise derive low-tax or zero-tax cross-border income.

B. International Principles as Applied in the U.S. System

The United States has adopted a Code\(^{18}\) that combines the worldwide taxation of all U.S. persons (U.S. citizens or resident aliens and domestic corporations)\(^{19}\) on all income, whether derived in the United States or abroad, with territorial-based taxation of U.S.-source income of nonresident aliens and foreign entities, and limited deferral for foreign income earned by subsidiaries of U.S. companies. Under this system (sometimes described as the U.S. hybrid system), the application of the Code differs depending on whether the income arises from outbound investment or inbound investment. Outbound investment refers to the foreign activities of U.S. persons, while inbound investment is investment by foreign persons in U.S. assets or activities.

With respect to outbound activities, income earned directly by a U.S. person, including as a result of a domestic corporation’s conduct of a foreign business itself (by means of direct sales, licensing or branch operations in the foreign jurisdiction), or through a pass-through entity such as a partnership, is taxed on a current basis. However, active foreign business income earned by a domestic parent corporation indirectly through a foreign corporate subsidiary generally is not subject to U.S. tax until the income is distributed to the domestic corporation. This result is circumscribed by the anti-deferral regimes of the Code, described below.

By contrast, nonresident aliens and foreign corporations are generally subject to U.S. tax only on income that has a sufficient connection with the United States. 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 (either by gross-basis withholding or on a net basis through tax return filing).

Category-by-category rules determine whether income has a U.S. source or a foreign source. For example, compensation for personal services generally is sourced based on where the services are performed, dividends and interest are, with limited exceptions, sourced based on the residence of the taxpayer making the payments, and royalties for the use of property generally are sourced based on where the property is used. These and other source rules are described in more detail below.

To mitigate double taxation of foreign-source income, the United States allows a credit for foreign income taxes paid. 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, the source of income remains a critical factor to the extent that it determines the amount of credit available for foreign taxes paid. In addition to the statutory relief afforded by the credit, the network of

\(^{18}\) Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”).

\(^{19}\) Sec. 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).
bilateral treaties to which the United States is a party provides a system for elimination of
double-taxation and ensuring reciprocal treatment of taxpayers from treaty countries.

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. The expense allocation rules
apply to a domestic corporation principally for determining the corporation’s foreign tax credit
limitation. This limitation is computed by reference to the corporation’s U.S. tax liability on its
taxable foreign-source income in each of two principal limitation categories, commonly referred
to as the “general basket” and the “passive basket.” Consequently, the expense allocation rules
primarily affect taxpayers that may not be able to fully use their foreign tax credits because of
the foreign tax credit limitation.

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 or aggressive intercompany pricing practices with respect to intangible property.
III. PRESENT LAW

A. Principles Common to Inbound and Outbound Taxation

Although the U.S. tax rules differ depending on whether the activity in question is inbound (United States activities of nonresident aliens and foreign corporations) or outbound (foreign activities of U.S. persons), there are certain concepts that apply to both inbound and outbound investment. Such areas include the transfer pricing rules, entity classification, the rules for determination of source, and whether a corporation is foreign or domestic.

1. 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.\(^{20}\) Similarly, the domestic laws of most U.S. trading partners include rules to limit income shifting through transfer pricing.\(^{21}\) 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\(^{22}\) 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.\(^{23}\) 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

\(^{20}\) 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.


\(^{22}\) 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.”

\(^{23}\) 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.
of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)),
the income with respect to such transfer or license shall be commensurate with the income
attributable to the intangible.” By requiring inclusion in income of amounts commensurate with
the income attributable to the intangible, Congress was responding to concerns regarding the
effectiveness of the arm’s-length standard with respect to intangible property—including, in
particular, high-profit-potential intangibles.24

2. Entity classification

A business entity is generally eligible to choose how it is classified for Federal tax law
purposes, under the “check-the-box” regulations adopted in 1997.25 Those regulations simplified
the entity classification process for both taxpayers and the Internal Revenue Service (“IRS”), by
making the entity classification of unincorporated entities explicitly elective in most instances.26
Whether an entity is eligible and the breadth of its choices depends upon whether it is a “per se
corporation” and the number of beneficial owners.

Certain entities are treated as per se corporations for which an election is not permitted.
Generally, these are domestic entities formed under a State corporation statute. A number of
specific types of foreign business entities are identified in the regulations as per se corporations.
These entities are generally corporations that are not closely held and the shares of which can be
traded on a securities exchange.27

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

The regulations also provide explicitly that a single-member unincorporated entity may
elect either to be treated as a corporation or to be disregarded (treated as not separate from its


25 Treas. Reg. sec. 301.7701-1, et seq.

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

27 For domestic entities, the State corporation statute must describe the entity as a corporation, joint-stock
company, or in similar terms. The regulations also treat insurance companies, organizations that conduct certain
banking activities, organizations wholly owned by a State, and organizations that are taxable as corporations under
other Code provisions as per se corporations.
owner). A disregarded entity owned by an individual is treated in the same manner as a sole proprietorship. In the case of an entity owned by a corporation or partnership, the disregarded entity is treated in the same manner as a branch or division. The default treatment for an eligible single-member domestic entity is as a disregarded entity. For an eligible single-member foreign entity, the default treatment depends upon whether the single-member entity has limited liability. If it does, the foreign entity is treated as a corporation; otherwise, its default treatment is that of a disregarded entity.

The regulations extended elective classification to foreign, as well as domestic, entities on the basis that the complexities and resources devoted to classification of domestic unincorporated business entities were mirrored in the foreign context. As a result, it is possible for an entity that operates across countries to elect into a hybrid status. “Hybrid entities” refers to entities that are treated as flow-through or disregarded entities for U.S. tax purposes but as corporations for foreign tax purposes; for “reverse hybrid entities,” the opposite is true. The existence of hybrid and reverse hybrid entities can affect whether the taxpayer can use foreign tax credits attributable to deferred foreign-source income or income that is not taxable in the United States, as well as whether income is currently includible under subpart F.

3. 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 location of the assets that generate the income. If a payor or recipient is an entity that is eligible to elect its classification for Federal tax purposes, its choice of whether to be recognized as legally separate from its owner in another jurisdiction can affect the determination of the source of the income and other tax attributes, if the hybrid entity is disregarded in one jurisdiction, but recognized in the other. To the extent that the source of income is not specified by statute, the Treasury Secretary may promulgate regulations that explain the appropriate treatment. However, many items of income are not explicitly addressed by either the Code or Treasury regulations, sometimes resulting in non-taxation of the income. On several occasions, courts have determined the source of such items by applying the rule for the type of income to which the disputed income is most closely analogous, based on all facts and circumstances.²⁸

Interest

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


²⁹ Sec. 861(a)(1); Treas. Reg. sec. 1.861-2(a)(1).
partnerships and certain other amounts paid by foreign branches of domestic financial institutions.\textsuperscript{30} Interest paid by the U.S. branch of a foreign corporation is also treated as U.S.-source income.\textsuperscript{31}

**Dividends**

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

**Rents and royalties**

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

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

**Income from sales of personal property**

Subject to significant exceptions, income from the sale of personal property is sourced on the basis of the residence of the seller.\textsuperscript{36} For this purpose, special definitions of the terms “U.S. resident” and “nonresident” are provided. A nonresident is defined as any person who is not a U.S. resident,\textsuperscript{37} while the term “U.S. resident” comprises any juridical entity which is a U.S.

\textsuperscript{30} Secs. 861(a)(1) and 862(a)(1). For purposes of certain reporting and withholding obligations the source rule in section 861(a)(1)(B) does not apply to interest paid by the foreign branch of a domestic financial institution. This results in the payment being treated as a withholdable payment. Sec. 1473(1)(C).

\textsuperscript{31} Sec. 884(f)(1).

\textsuperscript{32} Secs. 861(a)(2), 862(a)(2).

\textsuperscript{33} Sec. 861(a)(2)(B).

\textsuperscript{34} Sec. 861(a)(4).

\textsuperscript{35} Ibid.

\textsuperscript{36} Sec. 865(a).

\textsuperscript{37} Sec. 865(g)(1)(B).
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. As a result, nonresident includes any foreign corporation.

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. 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. Income from the sale of inventory property that a taxpayer produces (in whole or in part) in the United States and sells outside the United States, or that 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.

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

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38 Sec. 865(g)(1)(A).
39 Sec. 865(g).
40 Secs. 865(b), 861(a)(6), 862(a)(6); Treas. Reg. sec. 1.861-7(c).
41 Sec. 865(e)(2).
42 Sec. 863(b). A taxpayer may elect one of three methods for allocating and apportioning income as U.S.-or foreign-source: (1) 50-50 method under which 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 under which, 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 under which, with advance permission, the taxpayer may use books of account to detail the allocation of receipts and expenditures between production and sales activities. Treas. Reg. sec. 1.863-3(b), (c). If production activity occurs only within the United States, or only within foreign countries, then all income is sourced to where the production activity occurs; when production activities occur in both the United States and one or more foreign countries, the income attributable to production activities must be split between U.S. and foreign sources. Treas. Reg. sec. 1.863-3(c)(1). The sales activity is generally sourced based on where title to the property passes. Treas. Reg. secs. 1.863-3(c)(2), 1.861-7(c).
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.\textsuperscript{44} 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.\textsuperscript{45}

**Personal services income**

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

**Insurance income**

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

**Transportation income**

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

**Income from space or ocean activities or international communications**

In the case of a foreign person, generally no income from a space or ocean activity or from international communications is treated as U.S.-source income.\textsuperscript{50} With respect to the latter, an exception is provided if the foreign person maintains an office or other fixed place of business in the United States, in which case the international communications income attributable to such

\textsuperscript{44} Sec. 865(c).

\textsuperscript{45} Sec. 865(d).

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

\textsuperscript{47} Treas. Reg. sec. 1.861-4(b).

\textsuperscript{48} Sec. 861(a)(7).

\textsuperscript{49} Sec. 863(c).

\textsuperscript{50} Sec. 863(d).
fixed place of business is treated as U.S.-source income.\textsuperscript{51} For U.S. persons, all income from space or ocean activities and 50 percent of international communications is treated as U.S.-source income.

\textbf{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.\textsuperscript{52} This includes payments that are made indirectly for the provision of a guarantee. For example, U.S.-source income under this rule includes a guarantee fee paid by a foreign bank to a foreign corporation for the foreign corporation’s guarantee of indebtedness owed to the bank by the foreign corporation’s domestic subsidiary, where the cost of the guarantee fee is passed on to the domestic subsidiary through, for instance, additional interest charged on the indebtedness. In this situation, the domestic subsidiary has paid the guarantee fee as an economic matter through higher interest costs, and the additional interest payments made by the subsidiary are treated as indirect payments of the guarantee fee and, therefore, as U.S.-source.

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

\textbf{4. Corporate residence}

The U.S. tax treatment of a multinational corporate group depends significantly on whether the parent corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the laws of the United States or of any State.\textsuperscript{53} All other corporations (that is, those incorporated under the laws of foreign countries) are treated as foreign.\textsuperscript{54} Only domestic corporations are subject to U.S. tax on a worldwide basis. Foreign corporations are taxed only on income that has a sufficient connection with the United States. Thus, place of incorporation determines whether a corporation is treated

\textsuperscript{51} Sec. 863(e).

\textsuperscript{52} Sec. 861(a)(9). This provision effects a legislative override of the opinion in \textit{Container Corp. v. Commissioner}, 134 T.C. 122 (February 17, 2010), aff’d 2011 WL1664358, 107 A.F.T.R.2d 2011-1831 (5th Cir. May 2, 2011), in which 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.

\textsuperscript{53} Sec. 7701(a)(4).

\textsuperscript{54} Sec. 7701(a)(5).
as domestic or foreign for purposes of U.S. tax law, irrespective of substantive factors that might be thought to bear on a corporation’s residence, considerations such as the location of the corporation’s management activities, employees, business assets, operations, or revenue sources; the exchange or exchanges on which the corporation’s stock is traded; or the country or countries of residence of the corporation’s owners.

The ability of a domestic corporation to expatriate and thus avoid taxation on its worldwide income was curtailed by the anti-inversion rules enacted as part of the American Jobs Creation Act of 2004 ("AJCA"). Among other things, the general anti-inversion rules (the “toll charge rules”) provide that during the 10-year period following the inversion transaction corporate-level gain recognized in connection with the inversion generally may not be offset by tax attributes such as net operating losses or foreign tax credits. These sanctions generally apply to a transaction in which, pursuant to a plan or a series of related transactions: (1) a domestic corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after March 4, 2003; (2) the former shareholders of the domestic corporation hold (by reason of the stock they had held in the domestic corporation) at least 60 percent but less than 80 percent (by vote or value) of the stock of the foreign-incorporated entity after the transaction (this stock often being referred to as “stock held by reason of”); and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (that is, the “expanded affiliated group”), does not have substantial business activities in the entity’s country of incorporation, compared to the total worldwide business activities of the expanded affiliated group.

If a transaction otherwise satisfies the requirements for applicability of the anti-inversion rules and the former shareholders of the domestic corporation hold (by reason of the stock they had held in the domestic corporation) at least 80 percent (by vote or value) of the stock of the foreign-incorporated entity after the transaction, the anti-inversion rules entirely deny the tax

55 Prior to AJCA, shareholders of the re-domiciled parent company who were U.S. persons generally would be subject to U.S. tax on the appreciation in the value of their stock of the U.S. company unless a number of conditions were satisfied, including that U.S. persons who were shareholders of the U.S. company received 50 percent or less of the total voting power and total value of the stock of the new foreign parent company in the transaction. See section 367(a)(1); Treas. Reg. sec. 1.367(a)-3(c)(1). The IRS promulgated these greater-than-50-percent rules after becoming aware of tax-motivated inversion transactions, including the publicly traded Helen of Troy cosmetic company’s re-domiciliation in Bermuda. See Notice 94-46, 1994-1 C.B. 356 (April 18, 1994); T.D. 8638 (December 26, 1995). Shareholder taxation under section 367 as a result of inversion transactions remains largely the same after enactment of AJCA.

If an inversion transaction was effectuated by means of an asset acquisition, corporate-level gain generally would have been recognized under section 367(a).

For a fuller description of the possible tax consequences of a reincorporation transaction before AJCA, see Joint Committee on Taxation, Background and Description of Present-Law Rules and Proposals Relating to Corporate Inversion Transactions (JCX-52-02), June 5, 2002, p. 4.

56 Section 7874(a). AJCA also imposes an excise tax on certain stock compensation of some executives of companies that undertake inversion transactions. Section 4985.
benefits of the inversion transaction by deeming the new foreign parent to be a domestic corporation for all Federal tax purposes.\textsuperscript{57}

Similar rules apply if a foreign corporation acquires substantially all of the properties constituting a trade or business of a domestic partnership.\textsuperscript{58}

The Treasury Department has promulgated detailed guidance under section 7874, including the recent IRS and Treasury Department notice intended to address avoidance of section 7874 and to restrict or eliminate certain tax benefits facilitated by inversion transactions.\textsuperscript{59}

\textsuperscript{57} Sec. 7874(b).

\textsuperscript{58} Sec. 7874(a)(2)(B)(i).

\textsuperscript{59} Notice 2014-52, 2014 I.R.B. LEXIS 576 (Sept. 22, 2014). Among other things, the notice describes regulations that the Treasury Department and IRS intend to issue (1) addressing some taxpayer planning to keep the percentage of the new foreign parent company stock that is held by former owners of the inverted domestic parent company (by reason of owning stock of the domestic parent) below the 80 or 60 percent threshold; (2) restricting the tax-free post-inversion use of untaxed foreign subsidiary earnings to make loans to or stock purchases from certain foreign affiliates, and (3) preventing taxpayers from avoiding U.S. taxation of pre-inversion earnings of foreign subsidiaries by engaging in post-inversion transactions that would end the controlled foreign corporation status of those subsidiaries.
B. U.S. Tax Rules Applicable to Nonresident Aliens and Foreign Corporations (Inbound)

Nonresident aliens and foreign corporations are generally subject to U.S. tax only on income that has sufficient connection with the United States. 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.61

1. Gross-basis taxation of U.S.-source income

Non-business income received by foreign persons from U.S. sources is generally subject to tax on a gross basis at a rate of 30 percent, which is collected by withholding at the source of the payment. As explained below, the categories of income subject to the 30-percent tax and the categories for which withholding is required are generally coextensive, with the result that determining the withholding tax liability determines the substantive liability.

The income of non-resident aliens or foreign corporations that is subject to tax at a rate of 30-percent includes FDAP income that is not effectively connected with the conduct of a U.S. trade or business.62 The items enumerated in defining FDAP income are illustrative; the common characteristic of types of FDAP income is that taxes with respect to the income may be readily computed and collected at the source, in contrast to the administrative difficulty involved in determining the seller’s basis and resulting gain from sales of property.63 The words “annual or periodical” are “merely generally descriptive” of the payments that could be within the

60 E.g., the portfolio interest exception in section 871(h) (discussed below).

61 The United States has set forth its negotiating position on withholding rates and other provisions in the United States Model Income Tax Convention of November 15, 2006 (the “U.S. Model Treaty”). Because each treaty reflects considerations unique to the relationship between the two treaty countries, treaty withholding tax rates on each category of income are not uniform across treaties.

62 Secs. 871(a), 881. If the FDAP income is also ECI, it is taxed on a net basis, at graduated rates.

63 Commissioner v. Wodehouse, 337 U.S. 369, 388-89 (1949). After reviewing legislative history of the Revenue Act of 1936, the Supreme Court noted that Congress expressly intended to limit taxes on nonresident aliens to taxes that could be readily collectible, i.e., subject to withholding, in response to “a theoretical system impractical of administration in a great number of cases. H.R. Rep. No. 2475, 74th Cong., 2d Sess. 9-10 (1936).” In doing so, the Court rejected P.G. Wodehouse’s arguments that an advance royalty payment was not within the purview of the statutory definition of FDAP income.
purview of the statute and do not preclude application of the withholding tax to one-time, lump sum payments to nonresident aliens.\textsuperscript{64}

**Types of FDAP income**

FDAP income encompasses a broad range of types of gross income, but has limited application to gains on sales of property, including market discount on bonds and option premiums.\textsuperscript{65} Capital gains received by nonresident aliens present in the United States for fewer than 183 days are generally treated as foreign source and are thus not subject to U.S. tax, unless the gains are effectively connected with a U.S. trade or business; capital gains received by nonresident aliens present in the United States for 183 days or more\textsuperscript{66} that are treated as U.S.-source are subject to gross-basis taxation. In contrast, U.S-source gains from the sale or exchange of intangibles are subject to tax, and subject to withholding if they are contingent upon productivity of the property sold and are not effectively connected with a U.S. trade or business.\textsuperscript{67}

Interest on bank deposits may qualify for exemption on two grounds, depending on where the underlying principal is held on deposit. Interest paid with respect to deposits with domestic banks and savings and loan associations, and certain amounts held by insurance companies, are U.S. source but are not subject to the U.S. withholding tax when paid to a foreign person, unless the interest is effectively connected with a U.S. trade or business of the recipient.\textsuperscript{68} Interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not treated as U.S.-source income and is thus exempt from U.S. withholding tax (regardless of whether the recipient is a U.S. or foreign person).\textsuperscript{69} Similarly, interest and original issue discount on certain short-term obligations is also exempt from U.S. withholding tax when paid to

\textsuperscript{64} Commissioner v. Wodehouse, 337 U.S. 369, 393 (1949).

\textsuperscript{65} Although technically insurance premiums paid to a foreign insurer or reinsurer are FDAP income, they are exempt from withholding under Treas. Reg. sec. 1.1441-2(a)(7) if the insurance contract is subject to the excise tax under section 4371. Treas. Reg. sec. 1.1441-2(b)(1)(i), -2(b)(2).

\textsuperscript{66} For purposes of this rule, whether a person is considered a resident in the United States is determined by application of the rules under section 7701(b).

\textsuperscript{67} Sec. 871(a)(2). In addition, certain capital gains from sales of U.S. real property interests are subject to tax as effectively connected income (or in some instances as dividend income) under the Foreign Investment in Real Property Tax Act of 1980, discussed \textit{infra} at part II.B.3.

\textsuperscript{68} Secs. 871(a)(1)(D), 881(a)(4).

\textsuperscript{69} Secs. 871(i)(2)(A), 881(d); Treas. Reg. sec. 1.1441-1(b)(4)(ii).

\textsuperscript{70} Sec. 861(a)(1)(B); Treas. Reg. sec. 1.1441-1(b)(4)(iii).
a foreign person. Additionally, there is generally no information reporting required with respect to payments of such amounts.

Although FDAP income includes U.S.-source portfolio interest, such interest is specifically exempt from the 30 percent withholding tax. Portfolio interest is any interest (including original issue discount) that is paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person. For obligations issued before March 19, 2012, portfolio interest also includes interest paid on an obligation that is not in registered form, provided that the obligation is shown to be targeted to foreign investors under the conditions sufficient to establish deductibility of the payment of such interest. Portfolio interest, however, does not include interest received by a 10-percent shareholder, certain contingent interest, or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.

**Imposition of gross-basis tax and reporting by U.S. withholding agents**

The 30-percent tax on FDAP income is generally collected by means of withholding. Withholding on FDAP payments to foreign payees is required unless the withholding agent, 

71 Secs. 871(g)(1)(B), 881(a)(3); Treas. Reg. sec. 1.1441-1(b)(4)(iv).
72 Treas. Reg. sec. 1.1461-1(c)(2)(ii)(A), (B). Regulations require a bank to report interest if the recipient is a nonresident alien who resides in a country with which the United States has a satisfactory exchange of information program under a bilateral agreement and the deposit is maintained at an office in the United States. Treas. Reg. secs. 1.6049-4(b)(5) and 1.6049-8. The IRS has published a list of the 84 countries whose residents are subject to the reporting requirements, and a list of countries with respect to which the reported information will be automatically exchanged naming 18 countries. Rev. Proc. 2014-64, I.R. B. 2014-53 (December 29, 2014), available at http://www.irs.gov/pub/irs-irbs/irb14-53.pdf.
73 Sec. 871(h)(2).
74 Sec. 163(f)(2)(B). The exception to the registration requirements for foreign targeted securities was repealed in 2010, effective for obligations issued two years after enactment, thus narrowing the portfolio interest exemption for obligations issued after March 18, 2012. See Hiring Incentives to Restore Employment Law of 2010, Pub. L. No. 111-147, sec. 502(b).
75 Sec. 871(h)(3).
76 Sec. 871(h)(4).
77 Sec. 881(c)(3)(C).
78 Sec. 881(c)(3)(A).
79 Secs. 1441, 1442.
80 Withholding agent is defined broadly to include any U.S. or foreign person that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. Treas. Reg. sec. 1.1441-7(a).
i.e., the person making the payment to the foreign person receiving the income, can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.\textsuperscript{81} The principal statutory exemptions from the 30-percent withholding tax apply to interest on bank deposits, and portfolio interest, described above.\textsuperscript{82}

In many instances, the income subject to withholding is the only income of the foreign recipient that is subject to any U.S. tax. No U.S. Federal income tax return from the foreign recipient is required with respect to the income from which tax was withheld, if the recipient has no ECI income and the withholding is sufficient to satisfy the recipient’s liability. Accordingly, although the 30-percent gross-basis tax is a withholding tax, it is also generally the final tax liability of the foreign recipient.

A withholding agent that makes payments of U.S.-source amounts to a foreign person is required to report and pay over any amounts of U.S. tax withheld. The reports are due to be filed with the IRS by March 15 of the calendar year following the year in which the payment is made. Two types of reports are required: (1) a summary of the total U.S.-source income paid and withholding tax withheld on foreign persons for the year and (2) a report to both the IRS and the foreign person of that person’s U.S.-source income that is subject to reporting.\textsuperscript{83} The nonresident withholding rules apply broadly to any financial institution or other payor, including foreign financial institutions.\textsuperscript{84}

To the extent that the withholding agent deducts and withholds an amount, the withheld tax is credited to the recipient of the income.\textsuperscript{85} If the agent withholds more than is required, and results in an overpayment of tax, the excess may be refunded to the recipient of the income upon filing of a timely claim for refund.

**Excise tax on foreign reinsurance premiums**

An excise tax applies to premiums paid to foreign insurers and reinsurers covering U.S. risks.\textsuperscript{86} The excise tax is imposed on a gross basis at the rate of one percent on reinsurance and life insurance premiums, and at the rate of four percent on property and casualty insurance

\begin{footnotes}
\footnotetext[81]{Secs. 871, 881, 1441, 1442; Treas. Reg. sec. 1.1441-1(b).}
\footnotetext[82]{A reduced rate of withholding of 14 percent applies to certain scholarships and fellowships paid to individuals temporarily present in the United States. Sec. 1441(b). In addition to statutory exemptions, the 30-percent withholding tax with respect to interest, dividends or royalties may be reduced or eliminated by a tax treaty between the United States and the country in which the recipient of income otherwise subject to withholding is resident.}
\footnotetext[83]{Treas. Reg. sec. 1.1461-1(b), (c).}
\footnotetext[84]{See Treas. Reg. sec. 1.1441-7(a) (definition of withholding agent includes foreign persons).}
\footnotetext[85]{Sec. 1462.}
\footnotetext[86]{Secs. 4371-4374.}
\end{footnotes}
premiums. The excise tax does not apply to premiums that are effectively connected with the conduct of a U.S. trade or business or that are exempted from the excise tax under an applicable income tax treaty. The excise tax paid by one party cannot be credited if, for example, the risk is reinsured with a second party in a transaction that is also subject to the excise tax.

Many U.S. tax treaties provide an exemption from the excise tax, including the treaties with Germany, Japan, Switzerland, and the United Kingdom.\(^{87}\) To prevent persons from inappropriately obtaining the benefits of exemption from the excise tax, the treaties generally include an anti-conduit rule. The most common anti-conduit rule provides that the treaty exemption applies to the excise tax only to the extent that the risks covered by the premiums are not reinsured with a person not entitled to the benefits of the treaty (or any other treaty that provides exemption from the excise tax).\(^{88}\)

2. Net-basis taxation of U.S.-source income

The United States taxes on a net basis the income of foreign persons that is “effectively connected” with the conduct of a trade or business in the United States.\(^{89}\) Any gross income derived by the foreign person that is not effectively connected with the person’s U.S. business is not taken into account in determining the rates of U.S. tax applicable to the person’s income from the business.\(^{90}\)

**U.S. trade or business**

The question whether a foreign person is engaged in a U.S. trade or business is factual and has generated much case law. Basic issues include whether the activity constitutes business rather than investing, whether sufficient activities in connection with the business are conducted in the United States, and whether the relationship between the foreign person and persons performing functions in the United States in respect of the business is sufficient to attribute those functions to the foreign person. Partners in a partnership and beneficiaries of an estate or trust

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

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

89 Secs. 871(b), 882.

90 Secs. 871(b)(2), 882(a)(2).
are treated as engaged in the conduct of a trade or business within the United States if the
partnership, estate, or trust is so engaged.\textsuperscript{91}

The trade or business rules differ from one activity to another. The term “trade or
business within the United States” expressly includes the performance of personal services
within the United States.\textsuperscript{92} If, however, a nonresident alien individual performs personal services
for a foreign employer, and the individual’s total compensation for the services and period in the
United States are minimal ($3,000 or less in total compensation and 90 days or fewer of physical
presence in a year), the individual is not considered to be engaged in a U.S. trade or business.\textsuperscript{93}
Detailed rules govern whether trading in stocks or securities or commodities constitutes the
conduct of a U.S. trade or business.\textsuperscript{94} A foreign person who trades in stock or securities or
commodities in the United States through an independent agent generally is not treated as
engaged in a U.S. trade or business if the foreign person does not have an office or other fixed
place of business in the United States through which trades are carried out. A foreign person
who trades stock or securities or commodities for the person’s own account also generally is not
considered to be engaged in a U.S. business so long as the foreign person is not a dealer in stock
or securities or commodities.

For eligible foreign persons, U.S. bilateral income tax treaties restrict the application of
net-basis U.S. taxation. Under each treaty, the United States is permitted to tax business profits
only to the extent those profits are attributable to a U.S. permanent establishment of the foreign
person. The threshold level of activities that constitute a permanent establishment is generally
higher than the threshold level of activities that constitute a U.S. trade or business. For example,
a permanent establishment typically requires the maintenance of a fixed place of business over a
significant period of time.

\textbf{Effectively connected income}

A foreign person that is engaged in the conduct of a trade or business within the United
States is subject to U.S. net-basis taxation on the income that is “effectively connected” with the
business. Specific statutory rules govern whether income is ECI.\textsuperscript{95}

In the case of U.S.-source capital gain and U.S.-source income of a type that would be
subject to gross basis U.S. taxation, the factors taken into account in determining whether the
income is ECI include whether the income is derived from assets used in or held for use in the
conduct of the U.S. trade or business and whether the activities of the trade or business were a

\textsuperscript{91} Sec. 875.

\textsuperscript{92} Sec. 864(b).

\textsuperscript{93} Sec. 864(b)(1).

\textsuperscript{94} Sec. 864(b)(2).

\textsuperscript{95} Sec. 864(c).
material factor in the realization of the amount (the “asset use” and “business activities” tests). Under the asset use and business activities tests, due regard is given to whether the income, gain, or asset was accounted for through the U.S. trade or business. All other U.S.-source income is treated as ECI.

A foreign person who is engaged in a U.S. trade or business may have limited categories of foreign-source income that are considered to be ECI. Foreign-source income not included in one of these categories generally is exempt from U.S. tax.

A foreign person’s foreign-source income generally is considered to be ECI only if the person has an office or other fixed place of business within the United States to which the income is attributable and the income is in one of the following categories: (1) rents or royalties for the use of patents, copyrights, secret processes or formulas, good will, trade-marks, trade brands, franchises, or other like intangible properties derived in the active conduct of the trade or business; (2) interest or dividends derived in the active conduct of a banking, financing, or similar business within the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account; or (3) income derived from the sale or exchange (outside the United States), through the U.S. office or fixed place of business, of inventory or property held by the foreign person primarily for sale to customers in the ordinary course of the trade or business, unless the sale or exchange is for use, consumption, or disposition outside the United States and an office or other fixed place of business of the foreign person in a foreign country participated materially in the sale or exchange. Foreign-source dividends, interest, and royalties are not treated as ECI if the items are paid by a foreign corporation more than 50 percent (by vote) of which is owned directly, indirectly, or constructively by the recipient of the income.

In determining whether a foreign person has a U.S. office or other fixed place of business, the office or other fixed place of business of an agent generally is disregarded. The place of business of an agent other than an independent agent acting in the ordinary course of business is not disregarded, however, if the agent either has the authority (regularly exercised) to negotiate and conclude contracts in the name of the foreign person or has a stock of merchandise from which he regularly fills orders on behalf of the foreign person. If a foreign person has a U.S. office or fixed place of business, income, gain, deduction, or loss is not considered attributable to the office unless the office was a material factor in the production of the income,

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96 Sec. 864(c)(2).
97 Sec. 864(c)(3).
98 This income is subject to net-basis U.S. taxation after allowance of a credit for any foreign income tax imposed on the income. Sec. 906.
99 Sec. 864(c)(4)(B).
100 Sec. 864(c)(4)(D)(i).
101 Sec. 864(c)(5)(A).
gain, deduction, or loss and the office regularly carries on activities of the type from which the income, gain, deduction, or loss was derived.\textsuperscript{102}

Special rules apply in determining the ECI of an insurance company. The foreign-source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code is treated as ECI if the income is attributable to its United States business.\textsuperscript{103}

Income, gain, deduction, or loss for a particular year generally is not treated as ECI if the foreign person is not engaged in a U.S. trade or business in that year.\textsuperscript{104} If, however, income or gain taken into account for a taxable year is attributable to the sale or exchange of property, the performance of services, or any other transaction that occurred in a prior taxable year, the determination whether the income or gain is taxable on a net basis is made as if the income were taken into account in the earlier year and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the later taxable year.\textsuperscript{105} If any property ceases to be used or held for use in connection with the conduct of a U.S. trade or business and the property is disposed of within 10 years after the cessation, the determination whether any income or gain attributable to the disposition of the property is taxable on a net basis is made as if the disposition occurred immediately before the property ceased to be used or held for use in connection with the conduct of a U.S. trade or business and without regard to the requirement that the taxpayer be engaged in a U.S. business during the taxable year for which the income or gain is taken into account.\textsuperscript{106}

\textbf{Allowance of deductions}

Taxable ECI is computed by taking into account deductions associated with gross ECI. For this purpose, the apportionment and allocation of deductions is addressed in detailed regulations. The regulations applicable to deductions other than interest expense set forth general guidelines for allocating deductions among classes of income and apportioning deductions between ECI and non-ECI. In some circumstances, deductions may be allocated on the basis of units sold, gross sales or receipts, costs of goods sold, profits contributed, expenses incurred, assets used, salaries paid, space used, time spent, or gross income received. More specific guidelines are provided for the allocation and apportionment of research and experimental expenditures, legal and accounting fees, income taxes, losses on dispositions of property, and net operating losses. Detailed regulations under section 861 address the allocation and apportionment of interest deductions. In general, interest is allocated and apportioned based on assets rather than income.

\begin{itemize}
\item \textsuperscript{102} Sec. 864(c)(5)(B).
\item \textsuperscript{103} Sec. 864(c)(4)(C).
\item \textsuperscript{104} Sec. 864(c)(1)(B).
\item \textsuperscript{105} Sec. 864(c)(6).
\item \textsuperscript{106} Sec. 864(c)(7).
\end{itemize}
3. Special rules

FIRPTA

The Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")\(^{107}\) generally treats a foreign person’s gain or loss from the disposition of a U.S. real property interest ("USRPI") as ECI and, therefore, as taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain. A foreign person subject to tax on this income is required to file a U.S. tax return under the normal rules relating to receipt of ECI.\(^{108}\) In the case of a foreign corporation, the gain from the disposition of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

The payor of income that FIRPTA treats as ECI ("FIRPTA income") is generally required to withhold U.S. tax from the payment. Withholding is generally 10 percent of the sales price, in the case of a direct sale by the foreign person of a USRPI, and 35 percent of the amount of a distribution to a foreign person of proceeds attributable to such sales from an entity such as a partnership, real estate investment trust ("REIT") or regulated investment company ("RIC").\(^{109}\) The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person’s total ECI and deductions (if any) for the taxable year.

Branch profits taxes

A domestic corporation owned by foreign persons is subject to U.S. income tax on its net income. The earnings of the domestic corporation are subject to a second tax, this time at the shareholder level, when dividends are paid. As described previously, when the shareholders are foreign, the second-level tax is imposed at a flat rate and collected by withholding. Unless the portfolio interest exemption or another exemption applies, interest payments made by a domestic corporation to foreign creditors are likewise subject to U.S. withholding tax. To approximate these second-level withholding taxes imposed on payments made by domestic subsidiaries to their foreign parent corporations, the United States taxes a foreign corporation that is engaged in a U.S. trade or business through a U.S. branch on amounts of U.S. earnings and profits that are shifted out of, or amounts of interest that are deducted by, the U.S. branch of the foreign corporation. These branch taxes may be reduced or eliminated under an applicable income tax treaty.\(^{110}\)

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\(^{107}\) Pub. L. No. 96-499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. See secs. 897, 1445, 6039C, 6652(f).

\(^{108}\) Sec. 897(a). In addition, section 6039C authorizes regulations that would require a return reporting foreign direct investments in U.S. real property interests. No such regulations have been issued, however.

\(^{109}\) Sec. 1445 and Treasury regulations thereunder. The Treasury Department is authorized to issue regulations that reduce the 35-percent withholding on distributions to 20-percent withholding during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 20 percent.

\(^{110}\) See Treas. Reg. sec. 1.884-1(g), -5.
Under the branch profits tax, the United States imposes a tax of 30 percent on a foreign corporation’s “dividend equivalent amount.”\textsuperscript{111} The dividend equivalent amount generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its ECI as adjusted for increases or decreases in U.S. net equity.\textsuperscript{112} Limited categories of earnings and profits attributable to a foreign corporation’s ECI are excluded in calculating the dividend equivalent amount.\textsuperscript{113}

In arriving at the dividend equivalent amount, a branch’s effectively connected earnings and profits are adjusted to reflect changes in a branch’s U.S. net equity (that is, the excess of the branch’s assets over its liabilities, taking into account only amounts treated as connected with its U.S. trade or business).\textsuperscript{114} The first adjustment reduces the dividend equivalent amount to the extent the branch’s earnings are reinvested in trade or business assets in the United States (or reduce U.S. trade or business liabilities). The second adjustment increases the dividend equivalent amount to the extent prior reinvested earnings are considered remitted to the home office of the foreign corporation.

Interest paid by a U.S. trade or business of a foreign corporation generally is treated as if paid by a domestic corporation and therefore is subject to U.S. 30-percent withholding tax (if the interest is paid to a foreign person and a Code or treaty exemption or reduction would not be available if the interest were actually paid by a domestic corporation).\textsuperscript{115} Certain “excess interest” of a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation to a foreign parent and, therefore, is subject to U.S. 30-percent withholding tax.\textsuperscript{116} For this purpose, excess interest is the excess of the interest expense of the foreign corporation apportioned to the U.S. trade or business over the amount of interest paid by the trade or business.

**Earnings stripping**

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

\textsuperscript{111} Sec. 884(a).

\textsuperscript{112} Sec. 884(b).

\textsuperscript{113} See sec. 884(d)(2) (excluding, for example, earnings and profits attributable to gain from the sale of U.S. real property interests described in section 897 (discussed below)).

\textsuperscript{114} Sec. 884(b).

\textsuperscript{115} Sec. 884(f)(1)(A).

\textsuperscript{116} Sec. 884(f)(1)(B).
a taxable year is generally disallowed to the extent of the payor’s excess interest expense.\textsuperscript{117} Disqualified interest includes interest paid or accrued to related parties when no Federal income tax is imposed with respect to such interest;\textsuperscript{118} 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.

\textsuperscript{117} Sec. 163(j).

\textsuperscript{118} 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).
C. U.S. Tax Rules Applicable to Foreign Activities of U.S. Persons (Outbound)

1. In general

U.S. citizens, resident individuals, and domestic corporations generally are taxed on all income, whether derived in the United States or abroad. 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 to the domestic parent corporation. Until that repatriation, the U.S. tax on the income generally is deferred. U.S. shareholders of foreign corporations are taxed by the U.S. when the foreign corporation distributes its earnings or when a U.S. shareholder sells it stock at a gain. Thus, the U.S. tax on foreign earnings of foreign corporations is “deferred” until distributed to a U.S. shareholder or a U.S. shareholder recognizes gain on its stock.

However, certain anti-deferral regimes may cause the domestic shareholder of a foreign corporation to be taxed on a current basis in the United States on certain categories of passive or highly mobile income earned by the foreign corporation, regardless of whether the income has been distributed to the domestic shareholder. The main anti-deferral regimes in this context are the controlled foreign corporation (“CFC”) rules of subpart F and the passive foreign investment company (“PFIC”) rules which are discussed below. A 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 a U.S. person, repatriated from a foreign corporation, or included in the domestic shareholder’s income under one of the anti-deferral regimes.

2. Anti-deferral regimes

Subpart F

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

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119 Secs. 951-964.
120 Secs. 1291-1298.
121 Secs. 901, 902, 960, 1293(f).
122 Secs. 951(b), 957, 958.
123 Sec. 951(a).
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,\textsuperscript{124} insurance income,\textsuperscript{125} and certain income relating to international boycotts and other violations of public policy.\textsuperscript{126}

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.\textsuperscript{127}

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

In the case of insurance, a temporary exception from foreign personal holding company income applies for certain income of a qualifying insurance company with respect to risks located within the CFC’s country of creation or organization. Temporary exceptions from insurance income and from foreign personal holding company income also apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met. In the case of a life insurance or annuity contract, reserves for such contracts are determined under rules specific to the temporary exceptions. Present law also permits a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process or in published guidance, to establish that the reserve of a life insurance company for life insurance and annuity contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining

\textsuperscript{124} Sec. 954.

\textsuperscript{125} Sec. 953.

\textsuperscript{126} Sec. 952(a)(3)-(5).

\textsuperscript{127} Sec. 954.
foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for Federal income tax purposes.

Special rules apply under subpart F with respect to related person insurance income.\(^{128}\) Enacted in 1986, these rules address the concern that “the related person insurance income of many offshore ‘captive’ insurance companies avoided current taxation under the subpart F rules of prior law because, for example, the company’s U.S. ownership was relatively dispersed.”\(^{129}\) For purposes of these rules, the U.S. ownership threshold for CFC status is reduced to 25 percent or more. Any U.S. person who owns or is considered to own any stock in a CFC, whatever the degree of ownership, is treated as a U.S. shareholder of such corporation for purposes of this 25-percent U.S. ownership threshold and exposed to current tax on the corporation’s related person insurance income. Related person insurance income is defined for this purpose to mean any insurance income attributable to a policy of insurance or reinsurance with respect to which the primary insured is either a U.S. shareholder (within the meaning of the provision) in the foreign corporation receiving the income or a person related to such a shareholder.

**Investments in U.S. property**

The 10-percent U.S. shareholders of a CFC also are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation’s untaxed earnings invested in certain items of U.S. property.\(^{130}\) 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.\(^{131}\) 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.\(^{132}\) 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 provision colloquially referred to as the “CFC look-through” rule and applicable for taxable years beginning after 2005 and before 2015, excludes from foreign personal holding company income dividends, interest, rents, and royalties received or accrued by one CFC from a related CFC (with relation based on control) to the extent attributable or properly allocable to

\(^{128}\) Sec. 953(c).


\(^{130}\) Secs. 951(a)(1)(B), 956.

\(^{131}\) Sec. 956(c)(1).

\(^{132}\) Sec. 956(c)(2).
non-subpart-F income of the payor.\textsuperscript{133} The exclusion has been extended most recently to apply for taxable years of the foreign corporation beginning before 2015.\textsuperscript{134}

There is also an exclusion from subpart F income for certain income of a CFC that is derived in the active conduct of banking or financing business (“active financing income”).\textsuperscript{135} The exception from subpart F for active financing income now applies to taxable years of foreign corporations starting before January 1, 2015 (and to taxable years of 10-percent U.S. shareholders with or within which those corporate taxable years end). With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the active financing exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit (“QBU”) of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country’s tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met.

In the case of a securities dealer, the temporary exception from foreign personal holding company income applies to certain income. The income covered by the exception is any interest or dividend (or certain equivalent amounts) from any transaction, including a hedging transaction or a transaction consisting of a deposit of collateral or margin, entered into in the ordinary course of the dealer’s trade or business as a dealer in securities within the meaning of section 475. In the case of a QBU of the dealer, the income is required to be attributable to activities of the QBU in the country of incorporation, or to a QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity. A coordination rule provides that this exception generally takes precedence over the exception for income of a banking, financing or similar business, in the case of a securities dealer.

Income is treated as active financing income only if, among other requirements, it is derived by a CFC or by a qualified business unit of that CFC. 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.\textsuperscript{136} 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

\textsuperscript{133} Sec. 954(c)(6).


\textsuperscript{136} Sec. 954(h)(3)(E).
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 organized.137 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).138

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.139 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 when such earnings are ultimately distributed.140 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.141

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.142 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

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137 Sec. 954(c)(3).
138 Sec. 954(b)(4).
139 Sec. 959(a)(1).
140 Sec. 959(a)(2).
141 Sec. 959(c).
142 Sec. 961(a).
distributions that the 10-percent U.S. shareholder receives from the CFC that are excluded from its income as previously taxed under subpart F.\textsuperscript{143}

**Passive foreign investment companies**

The Tax Reform Act of 1986\textsuperscript{144} established the PFIC anti-deferral regime. A PFIC is generally 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.\textsuperscript{145} Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a PFIC, regardless of their percentage ownership in the company. One set of rules applies to PFICs that are qualified electing funds, under which electing U.S. shareholders currently include in gross income their respective shares of the company’s earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.\textsuperscript{146} 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.\textsuperscript{147} 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.”\textsuperscript{148}

**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\textsuperscript{149} and the personal holding company rules.

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.

\textsuperscript{143} Sec. 961(b).
\textsuperscript{144} Pub. L. No. 99-514.
\textsuperscript{145} Sec. 1297.
\textsuperscript{146} Secs. 1293-1295.
\textsuperscript{147} Sec. 1291.
\textsuperscript{148} Sec. 1296.
\textsuperscript{149} Secs. 531-537.
3. 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.\textsuperscript{150}

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.\textsuperscript{151} 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.\textsuperscript{152}

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.\textsuperscript{153} However, subject to certain exceptions, deductions for interest expense and research and experimental expenses are apportioned based on taxpayer ratios.\textsuperscript{154} 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.\textsuperscript{155}

\begin{itemize}
  \item \textsuperscript{150} Secs. 901, 902, 960, 1291(g).
  \item \textsuperscript{151} Secs. 901, 904.
  \item \textsuperscript{152} Sec. 904(c).
  \item \textsuperscript{153} Treas. Reg. sec. 1.861-8(b), Temp. Treas. Reg. sec. 1.861-8T(c).
  \item \textsuperscript{154} Temp. Treas. Reg. sec. 1.861-9T, Treas. Reg. sec. 1.861-17.
  \item \textsuperscript{155} Sec. 864(e)(1), (6); Temp. Treas. Reg. sec. 1.861-14T(e)(2).
\end{itemize}
The term “affiliated group” is determined generally by reference to the rules for determining whether corporations are eligible to file consolidated returns.\textsuperscript{156} These rules exclude foreign corporations from an affiliated group.\textsuperscript{157} AJCA modified the interest expense allocation rules for taxable years beginning after December 31, 2008.\textsuperscript{158} The effective date of the modified rules has been delayed to January 1, 2021.\textsuperscript{159} 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.\textsuperscript{160} 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

\textsuperscript{156} Secs. 864(e)(5), 1504.

\textsuperscript{157} Sec. 1504(b)(3).

\textsuperscript{158} AJCA sec. 401.

\textsuperscript{159} The most recent delay in these rules was enacted in the Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, sec. 551(a).

\textsuperscript{160} 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).
other payments were made.\textsuperscript{161} 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.\textsuperscript{162}

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.\textsuperscript{163}

4. Special rules

**Temporary dividends-received deduction for repatriated foreign earnings**

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

The temporary deduction was subject to a number of general limitations. First, it applied only to cash repatriations generally in excess of the taxpayer’s average repatriation level calculated for a three-year base period preceding the year of the deduction. Second, the amount of dividends eligible for the deduction was generally limited to the amount of earnings shown as permanently invested outside the United States on the taxpayer’s recent audited financial statements. Third, to qualify for the deduction, dividends were required to be invested in the United States according to a domestic reinvestment plan approved by the taxpayer’s senior management and board of directors.\textsuperscript{164}

No foreign tax credit (or deduction) was allowed for foreign taxes attributable to the deductible portion of any dividend.\textsuperscript{165} 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

\textsuperscript{161} Sec. 904(d)(3). The subpart F rules applicable to CFCs and their 10-percent U.S. shareholders are described below.

\textsuperscript{162} Sec. 904(d)(4).

\textsuperscript{163} Sec. 909.

\textsuperscript{164} 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.

\textsuperscript{165} Sec. 965(d)(1).
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). Deductions were disallowed for expenses that were directly allocable to the deductible portion of any dividend.

**U.S. citizens living abroad: the foreign earned income exclusion**

A U.S. citizen who earns income in a foreign country also may be taxed on that income by the foreign country. As a practical matter, the United States generally cedes the primary right to tax a U.S. citizen’s foreign source income to the foreign country in which the income is derived. This concession is effected by the allowance of a credit against the U.S. income tax imposed on foreign-source income for foreign taxes paid on that income. As described previously, the amount of the credit for foreign income tax paid on foreign-source income generally is limited to the amount of U.S. tax otherwise owed on that income. Accordingly, if the amount of foreign tax paid on foreign-source income is less than the amount of U.S. tax owed on that income, a foreign tax credit generally is allowed in an amount not exceeding the amount of the foreign tax, and a residual U.S. tax liability remains.

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. This exclusion applies regardless of whether any foreign tax is paid on the foreign earned income or housing costs. To qualify for these exclusions, an individual (a “qualified individual”) must have his or her tax home in a foreign country and must be either (1) a U.S. citizen who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire taxable year, or (2) a U.S. citizen or resident present in a foreign country or countries for at least 330 full days in any 12-consecutive-month period.

The maximum amount of foreign earned income that an individual may exclude in 2013 is $97,600. The maximum amount of foreign housing costs that an individual may exclude in

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166 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).

167 Sec. 965(d)(2).

168 In a provision referred to as the “saving clause,” the United States reserves the right to tax its citizens as citizens under bilateral income tax treaties.

169 Sec. 911.

170 Generally, only U.S. citizens may qualify under the bona fide residence test. A U.S. resident alien who is a citizen of a country with which the United States has a tax treaty may, however, qualify for the section 911 exclusions under the bona fide residence test by application of a nondiscrimination provision of the treaty.

2013 is, in the absence of Treasury adjustment for geographic differences in housing costs, $13,664. The combined foreign earned income exclusion and housing cost exclusion may not exceed the taxpayer’s total foreign earned income for the taxable year. The taxpayer’s foreign tax credit is reduced by the amount of the credit that is attributable to excluded income.

172 Sec. 911(c)(1), (2). The Treasury Secretary has authority to issue guidance making geographic cost-based adjustments. Sec. 911(c)(2)(B). The Secretary has exercised this authority annually. The most recent guidance, Notice 2013-31, 2013 I.R.B. LEXIS 253 (May 1, 2013), includes adjustments for many locations. Under these adjustments, the maximum housing cost exclusion for any geographic area is $101,484 for expenses for housing in Tokyo, Japan.
D. U.S. tax rules applicable to the U.S. territories

1. Background

The United States has 13 territories under the jurisdiction of the Department of the Interior. Three of the territories, Navassa Island, Puerto Rico, and the U.S. Virgin Islands, are in the Caribbean Sea. Ten territories—American Samoa, Baker Island, Guam, Howland Island, Jarvis Island, Johnston Atoll, Kingman Reef, Midway Atoll, the Northern Mariana Islands, and Wake Atoll—are in the Pacific Ocean. Two territories, the Northern Mariana Islands (also referred to as “Northern Marianas”) and Puerto Rico, are commonwealths. Commonwealth status typically involves a legal relationship with the United States that is embodied in a written mutual agreement. Territories that do not have commonwealth status generally have less developed legal relationships with the United States. Their governments are generally constituted by U.S. Federal statutes referred to as organic acts.

The summary below describes U.S. Federal tax rules and issues related to the five territories that have significant populations: American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands. American Samoa became a U.S. territory by deed of cession from the local chiefs of the largest island in 1900. It has no organic act for the establishment of its government, but it adopted its own constitution in 1967. Guam became a territory in 1898, and its organic act was enacted in 1950. For the Northern Mariana Islands a covenant to establish political union with the United States signed in 1975 and came into full effect in 1986. Puerto Rico became a territory in 1898 and a commonwealth in 1952. The United States purchased the U.S. Virgin Islands from Denmark in 1917, and the Virgin Islands’ current organic act was enacted in 1954. The five territories are represented in the U.S. Congress by non-voting delegates (in the case of Puerto Rico, a non-voting resident commissioner) in the House of Representatives. Residents of Guam, the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands are generally U.S. citizens. American Samoa residents, by contrast, are generally nationals but not citizens.

Following common current and historical tax law usage, the summary below uses the term “possessions” interchangeably with “territories.”

2. In General

While U.S. statutory laws apply to the U.S. possessions, and natives of U.S. possessions are U.S. citizens or nationals, for tax purposes the Code generally treats the U.S. possessions as foreign countries. When the Code uses the term in a geographical sense, the “United States” includes only the 50 States and the District of Columbia.\(^{174}\)

\(^{173}\) The source of information about the territories included in this paragraph and the paragraph that follows is the website of the Office of Insular Affairs of the Department of the Interior: http://www.doi.gov/oia/index.html.

\(^{174}\) Sec. 7701(a)(9).
The meaning of the term possession is not uniform throughout the Code, and is not among the defined terms in section 7701. For purposes of assessment and collection of Federal taxes, the possessions are generally treated the same as the States, except as provided in the Revised Organic Act of the Virgin Islands and the Organic Act of Guam with respect to certain taxes covered over to the treasuries of the U.S. Virgin Islands and Guam.\textsuperscript{175} Taxes imposed by the Code in any possession are collected under the direction of the Secretary. Taxes with respect to any individual to whom section 931 or 932(c) applies are covered into the Treasury of the specific possession of which the individual is a bona fide resident.\textsuperscript{176}

Income derived from U.S. possessions is ordinarily treated as foreign-source income. Entities organized in U.S. possessions are generally treated as foreign persons. Of the various trust territories and possessions of the United States, only those with local taxing authorities that have entered into a tax coordination agreement with the United States, that is, American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands, are provided special treatment in the Code and are the focus of this pamphlet.\textsuperscript{177}

Three of the possessions employ a “mirror system” of taxation. In Guam,\textsuperscript{178} the Commonwealth of Northern Mariana Islands\textsuperscript{179} and the U.S. Virgin Islands,\textsuperscript{180} the United States Federal income tax laws are in effect (or “mirrored”) as the local territorial income tax. Proceeds of the mirror codes are generally paid to the treasuries of the possessions. Not all of the Code is mirrored; generally, only the income tax provisions of the Code are mirrored.\textsuperscript{181} In the tax

\textsuperscript{175} Sec. 7651.
\textsuperscript{176} Sec. 7654.
\textsuperscript{177} See Rev. Proc. 2006-23, 2007-1 C.B. 900. In addition to these five jurisdictions, other territories may be considered possessions of the United States for political purposes but are not generally accorded special status under the Code or by Treasury. But see, e.g., section 274(h)(3)(A) (defines “North American area” to include the United States, its possessions and the Trust Territory of the Pacific Islands, as well as Canada and Mexico) and Rev. Rul. 2011-26, 2011-1 C.B. 803 (explains the current status of the entities that were part of the Trust Territory when 274(h) was enacted, and rules that “possessions” includes, in addition to the five discussed in this pamphlet, Baker Island, Howland Island, Jarvis Island, Johnston Island, Kingman Reef, the Midway Islands, Palmyra Atoll, Wake Island, and any other United States islands, cays, and reefs that are not part of the fifty states or the District of Columbia).


\textsuperscript{181} For example, 48USC 1421i(d) specified that for Guam, the mirrored sections include most of subtitle A (income tax), chapters 24 and 25 (withholding tax), and subtitle F (administrative) as applicable to the income tax.
The Tax Reform Act of 1986 (the “1986 Act”) granted authority to Guam, the Commonwealth of Northern Mariana Islands and American Samoa to cease use of the mirror system, and authorized the U.S. Virgin Islands to impose local taxes at variance from the rates in the Code as mirrored. It repealed the relevant rules that provide coordination between the Federal statutes and the statutes as mirrored in Guam, American Samoa and the Northern Mariana Islands and amended the coordination rules for the U.S. Virgin Islands. The changes are not yet in effect for Guam or the Northern Mariana Islands, because the effective date is contingent upon the existence of an implementation agreement, and the contingency has not been met.183

3. Income Taxation of Individuals

The United States generally imposes income tax on the worldwide income of U.S. citizens and residents. Thus, all income earned by a U.S. citizen or resident, whether from sources inside or outside the United States, is taxable whether or not the individual lives within the United States. All U.S. citizens and residents whose gross income for a taxable year is not less than the sum of the personal exemption amount and the basic standard deduction are required to file an annual U.S. individual income tax return.

The taxable income of a U.S. citizen or resident is equal to the taxpayer’s total worldwide income less certain exclusions, exemptions, and deductions. A foreign tax credit, with limitations, may be claimed for foreign income taxes paid or accrued, or, alternatively, foreign taxes may be treated as a deduction. Income taxes paid in a U.S. possession are generally creditable taxes for these purposes.

Generally, special U.S. income tax rules apply with respect to U.S. persons who are bona fide residents of U.S. possessions and who have possession source income or income effectively

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182 Gumataotao v. Director of Revenue and Taxation of Guam, 236 F.3d 1077, 1080 (9th Cir. 2001) (“Only those provisions of the I.R.C. that are “manifestly inapplicable or incompatible with the intent of [the Income Tax Section do not apply to Guam taxpayers.”); 48 U.S.C. § 1421h(d); see Sayre & Co. v. Riddell, 395 F.2d 407, 410 (9th Cir. 1968) (en banc) (“Sayre”) (G.T.I.T. “mirrors” the I.R.C., except where “manifestly inapplicable or incompatible”).

183 The special effective date for the revision of section 931 and repeal of section 935 is provided in section 1277(b) of the 1986 Act, stating “The amendments made by this subtitle shall apply with respect to Guam, American Samoa, or the Northern Mariana Islands (and to residents thereof and corporations created or organized therein) only if (and so long as) an implementing agreement under section 1271 is in effect between the United States and such possession.” Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1277(a), (b), 100 Stat. 2085, 2600 (1986).
connected with the conduct of a trade or business within a possession.\textsuperscript{184} The term bona fide resident means a person who meets a two-part test with respect to American Samoa, Guam, the U.S. Virgin Islands, Puerto Rico, or the Northern Mariana Islands as the case may be, for the taxable year. First, an individual must be present in the U.S. possession for at least 183 days in the taxable year.\textsuperscript{185} Second, an individual must (1) not have a tax home outside such possession during the taxable year and (2) not have a closer connection to the United States or a foreign country during such year.

Individual residents living in U.S. possessions generally are subject to either a single- or double-filing system with respect to their income. Individual residents subject to section 931 or 933 (that is, bona-fide residents of American Samoa and Puerto Rico) operate under a double-filing system. Under a double-filing system, income that is not exempt from U.S. tax under section 931 or 933, and meets certain filing thresholds, must be reported to the United States on a U.S. return. Thus, an individual operating under a double-filing system that has income from sources outside the U.S. possession where the individual is resident (e.g., a Puerto Rico individual with non-Puerto Rico-source income) must file a tax return in the United States and in the U.S. possession where the individual is a bona-fide resident if such income is subject to reporting. Income reported on a U.S. return by a bona-fide resident of a U.S. possession is generally subject to the same U.S. tax treatment that applies to individuals resident in the United States.

In contrast, individual residents subject to section 932(c) or 935 (that is, bona fide residents of the U.S. Virgin Islands, as well as the Northern Mariana Islands and Guam\textsuperscript{186}) generally operate under a single-filing system. Under a single-filing system, income is only reported in one jurisdiction, based on bona-fide residency. Thus, an individual operating under a single-filing system generally does not have to file a tax return with the United States. In a single-filing system, income is often allocated between the U.S. possession and the United States through a cover over\textsuperscript{187} mechanism.

As a general rule, the principles for determining whether income is U.S. source are applicable for purposes of determining whether income is possession source. In addition, the

\textsuperscript{184} For more detail about these special rules, see generally, Joel D. Kuntz and Robert J. Peroni, \textit{U.S. International Taxation}, “U.S. Taxation Relating to Possessions” (Warren Gorman and Lamont-RIA, 2005), Part D.

\textsuperscript{185} Sec. 937(a). Treasury regulations provide guidance related to meeting the presence test, including exceptions for certain extended absences from the possession. Treas. Reg. sec. 1.937-1.

\textsuperscript{186} The repeal of section 935 is not yet effective for Guam or the Northern Marianas, due to failure to meet the condition in the special effective date provided in section 1277(b) of the 1986 Act, which states, “The amendments made by this subtitle shall apply with respect to Guam, American Samoa, or the Northern Mariana Islands (and to residents thereof and corporations created or organized therein) only if (and so long as) an implementing agreement under section 1271 is in effect between the United States and such possession.” Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1277(a), (b), 100 Stat. 2085, 2600 (1986).

\textsuperscript{187} Cover over refers to the collection of certain taxes and fees by the U.S. Treasury and subsequent payment of such taxes and fees to the governments of the territories as specified.
principles for determining whether income is effectively connected with the conduct of a U.S. trade or business are applicable for purposes of determining whether income is effectively connected to the conduct of a possession trade or business. However, except as provided in regulations, any income treated as U.S. source income or as effectively connected with the conduct of a U.S. trade or business is not treated as income from within any possession or as effectively connected with a trade or business within any such possession.\textsuperscript{188}

For purposes of the foreign earned income exclusion, the U.S. possessions are not treated as foreign countries. Thus, residents of U.S. possessions do not qualify for the foreign earned income or housing exclusion under section 911 of the Code because they are not considered resident abroad.\textsuperscript{189}

U.S. citizens who relinquish their citizenship and U.S. residents who terminate their long-term residency may be subject to special tax rules intended to limit any tax benefits from expatriation. Certain persons expatriating before June 17, 2008 are subject to an alternative tax regime for a period of 10 years if they meet certain income and net-worth thresholds or they fail to comply with certain U.S. Federal tax obligations.\textsuperscript{190} Certain persons expatriating after June 16, 2008, are treated as if all property was sold on the day before their expatriation date for its fair market value.\textsuperscript{191} U.S. citizens and lawful permanent residents who leave the United States and establish residency in one of the possessions are generally not considered to have either relinquished their U.S. citizenship or terminated their U.S. residency; however, the special source rules may apply to U.S. citizens and residents that leave the United States and establish residency in American Samoa, the Northern Mariana Islands, or Guam during the 10-year period beginning when the person first becomes a resident.\textsuperscript{192}

4. Income Taxation of Corporations

\textbf{U.S. corporations}

U.S. corporations are subject to U.S. income tax on their worldwide income, whether derived in the United States or abroad. 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 corporation. Until such repatriation, the U.S. tax on such income is generally deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United

\textsuperscript{188} Sec. 937(b).

\textsuperscript{189} Treas. Reg. secs. 1.911-2(g),(h).

\textsuperscript{190} Sec. 877.

\textsuperscript{191} Sec. 877A.

\textsuperscript{192} See section 1277(e) of the 1986 Act. Under this special source rule, gains from dispositions of certain property held by a U.S. person prior to becoming a resident in American Samoa, the Northern Mariana Islands, or Guam are treated as income from sources within the United States for all purposes of the Code.
States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F\textsuperscript{193} and the passive foreign investment company rules.\textsuperscript{194} A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether earned directly by the domestic corporation, repatriated as a dividend, or included under one of the anti-deferral regimes, subject to certain limitations.

**Foreign corporations**

Foreign corporations with U.S. source income are generally subject to U.S. tax on a net basis at graduated rates on income effectively connected to a U.S. trade or business. U.S.-source passive income paid to a foreign corporation is generally taxed on a gross basis at a withholding rate of 30 percent. Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. persons that hold stock in such corporation. However, several sets of anti-deferral rules impose current U.S. tax on certain income earned by a U.S. person through a foreign corporation.

Corporations formed in the U.S. possessions are generally treated as foreign corporations for U.S. tax purposes. Thus, the foreign status of entities formed in a U.S. possession means that the shareholders of such entities may be subject to U.S. anti deferral regimes, such as the controlled foreign corporation regime (subpart F), and the shareholders of such entities may have to pay current U.S. tax on their foreign source income.

However, notwithstanding the general rule that companies organized in a U.S. possession are treated as foreign corporations, certain qualifying corporations are deemed not to be foreign corporations for purposes of withholding taxes on passive income. Corporations organized in American Samoa, Guam, the U.S. Virgin Islands, or the Northern Mariana Islands are not subject to withholding tax on payments from corporations organized in the United States, provided that certain local ownership and activity requirements are met.\textsuperscript{195} In turn, each of those possessions have adopted local internal revenue codes that provide a zero rate of withholding tax on payments made by corporations organized in such possession to corporations organized in the United States. Thus, certain corporations organized in American Samoa, Guam, the U.S. Virgin Islands, or the Northern Mariana Islands can receive dividend payments from a U.S. subsidiary at a zero rate of withholding.

\textsuperscript{193} Secs. 951-964.

\textsuperscript{194} Secs. 1291-1298.

\textsuperscript{195} Sec. 881(b).
5. Estate and Gift Taxation

U.S. citizens and residents

U.S. citizens and residents are subject to estate tax on the transfer of their worldwide estate at the time of death. The taxable estate is equal to the decedent’s worldwide gross estate, less allowable deductions (including the marital deduction). Certain credits are allowed, including the unified credit, which directly reduce the amount of the estate tax.  

U.S. citizens and residents are subject to gift tax on transfers of property by gift made directly or indirectly, in trust or otherwise. Thus, the gift tax applies to transfers of property, regardless of where such property is situated. The amount of a taxable gift is determined by the fair market value of the property on the date of the gift. An annual exclusion (adjusted periodically for inflation) applies to gifts given in a calendar year.  

A U.S. citizen residing in a U.S. possession is treated as a citizen for estate and gift tax purposes unless he acquired U.S. citizenship solely by reason of birth or residence within the possession.  

Nonresident aliens

The estate of a nonresident alien generally is taxed at the same estate tax rates applicable to U.S. citizens, but the taxable estate includes only property situated within the United States that is owned by the decedent at death (and certain property transferred during life subject to reserved interests or powers). This estate generally includes the value at death of all real and personal tangible property situated in the United States and certain intangible property, such as stock of a domestic corporation, considered to be situated in the United States. The estate of a nonresident alien is allowed a unified credit of $13,000 and under treaty may instead be allowed a pro rata portion of the generally applicable unified credit.  

Nonresident alien individuals are subject to gift tax with respect to certain transfers by gift of U.S.-situated property under the same tax rate schedule applicable to U.S. citizens. The unified credit amount is the tax computed on the applicable exclusion amount or $5.25 million for 2013 (indexed for inflation). The maximum estate tax rate is 40 percent.  

Sec. 2503(b). The annual gift tax exclusion amount for 2013 is $14,000.  

An applicable exclusion amount applies for computing the gift tax on lifetime transfers ($5.25 million for 2013), and the maximum gift tax rate is 40 percent.  

Secs. 2208 (estate tax) and 2501(b) (gift tax).  

For these purposes the United States means the 50 States and the District of Columbia.  

Sec. 2102(b). This credit essentially acts to shelter the first $60,000 of the taxable estate from Federal estate tax.
tax applies only where the value of the transfer exceeds the annual exclusion amount.\textsuperscript{202} Such property includes real estate and tangible property located within the United States. Nonresident aliens generally are not subject to U.S. gift tax on the transfer of intangibles, such as stock or securities, regardless of where such property is situated.

A U.S. citizen residing in a possession is treated as a nonresident alien for estate and gift tax purposes if the individual’s U.S. citizenship was acquired solely by reason of birth or residence within the possession.\textsuperscript{203} Estates of decedents who are treated as nonresident aliens for purposes of this rule are allowed a credit against the estate tax equal to the greater of $13,000 or that proportion of $46,800 which the value the decedent’s gross estate situated in the United States bears to the value of the entire gross estate wherever situated.\textsuperscript{204}

6. Payroll Taxes

Employees and employers in the United States are subject to payroll taxes for the Federal Insurance Contributions Act (“FICA”) that fund Social Security and certain Medicare benefits, Federal unemployment insurance payroll tax (“FUTA”), and the withholding tax for Federal income tax.\textsuperscript{205} FICA imposes tax on employers based on the amount of wages paid to an employee during the year. The tax imposed is composed of two parts: (1) the old age, survivors, and disability insurance (“OASDI”) tax as a percentage of covered wages; and (2) the Medicare hospital insurance (“HI”) tax amount, also a percentage of covered wages. In addition to the tax on employers, each employee is subject to FICA taxes equal to the amount of tax imposed on the employer. The employee level tax generally must be withheld and remitted to the Federal government by the employer. Certain categories of services and employment are often exempt from FICA, including foreign agricultural workers with appropriate visas.

Similar FICA payroll tax obligations generally apply to persons in any of the U.S. possessions.\textsuperscript{206} In contrast, employees and employers in the possessions are generally not subject to the withholding at source for Federal income tax, although they are subject to withholding for local taxes.\textsuperscript{207} These payroll obligations of the employers are generally applicable to Federal agencies with personnel in the possession. Finally, only Puerto Rico and

\textsuperscript{202} The annual exclusion amount is $14,000 for 2013 (indexed for inflation).

\textsuperscript{203} Sec. 2209 (estate tax) and 2501(c) (gift tax).

\textsuperscript{204} Sec. 2102(b)(2).

\textsuperscript{205} Secs. 3121(a) and 3402(a).

\textsuperscript{206} Internal Revenue Service, \textit{Federal Tax Guide for Employers in the U.S. Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands} (Publication 80 Circular SS), 2012.

\textsuperscript{207} Under section 3401(a)(8), most wages paid to U.S. persons for services performed in one of the possessions are excluded if the payments are subject to withholding by the possession, or, in the case of Puerto Rico, the payee is a bona fide resident of the possession for the full year.
the U.S. Virgin Islands are within the scope of the FUTA obligations.\textsuperscript{208} Wages paid to persons employed in Puerto Rico or the U.S. Virgin Islands are subject to FUTA on wages for each calendar year paid by a covered employer to each employee. Federal unemployment insurance payroll taxes are used to fund programs maintained by the local jurisdictions for the benefit of unemployed workers. Employers in such jurisdictions with programs approved by the Federal government may qualify for a credit of 5.4 percentage points against the 6.0 percent tax rate, making the minimum, net Federal unemployment tax rate 0.6 percent.\textsuperscript{209}

7. Excise Taxes

U.S. excise taxes generally do not apply within the U.S. possessions. However, U.S. excise taxes equal to the taxes on domestically produced articles are imposed on articles of manufacture brought into the United States from Puerto Rico and the Virgin Islands and withdrawn for consumption or sale.\textsuperscript{210} These taxes are generally covered over to the respective treasuries. Articles imported from the United States into Puerto Rico, the Virgin Islands, Guam, and American Samoa are generally exempt from U.S. excise tax; however articles imported from the United States into Puerto Rico and the Virgin Islands are subject to a local excise tax equal to the tax imposed under the revenue laws of the United States.\textsuperscript{211} Provisions related to the allowance of drawback\textsuperscript{212} on excise tax on articles exported from the Unites States are extended to like articles when shipped from the United States to Puerto Rico, the Virgin Islands, Guam, or American Samoa.\textsuperscript{213}

8. Tax Incentives

The Code contains other provisions that provide incentives for certain activities. Some of the provisions expand the incentives provided for State and local jurisdictions to the U.S. possessions while others are specifically targeted at certain activities within a specific U.S. possession. Examples of State and local incentives that apply to U.S. possessions include the

\textsuperscript{208} Section 3306(j) provides that for purposes of the FUTA tax, the term State includes both Puerto Rico and the Virgin Islands.

\textsuperscript{209} While the gross FUTA tax rate was 6.2 percent (until July 2011), the net rate was 0.8 percent. The credit is not available to employers who are delinquent in repaying a Federal loan.

\textsuperscript{210} Sec. 7652.

\textsuperscript{211} Sec. 7653.

\textsuperscript{212} A drawback is a refund of certain duties, taxes and fees paid by the importer of record and granted to a drawback claimant upon the exportation, or destruction of eligible articles upon which the duties, taxes and fees have been paid. The purpose of drawback is to place U.S. exporters on equal footing with foreign competitors by refunding most of the duties, taxes and fees paid on imports used in domestic manufacturing intended for export.

\textsuperscript{213} Sec. 7653(c).
exclusion of interest on State and local bonds, the credit for research and experimentation, and the low-income housing credit. Other incentives are described in the discussion of the individual possessions below.

9. Tax Treaties

In addition to the U.S. and foreign statutory rules for the taxation of foreign income of U.S. persons and U.S. income of foreign persons, bilateral income tax treaties limit the amount of income tax that may be imposed by one treaty partner on residents of the other treaty partner. For example, treaties often reduce or eliminate withholding taxes imposed by a treaty country on certain types of income, such as dividends, interest, and royalties paid to residents of the other treaty country. Treaties also include provisions governing the creditability of taxes imposed by the treaty country in which income is earned in computing the amount of tax owed to the other country by its residents with respect to that income.

There are no bilateral tax treaties between any of the possessions and any foreign country. In addition, U.S. treaties typically do not include the possessions in the definition of United States for treaty purposes. However, for purposes of identifying the scope of exchange of information agreements, the possessions are included. Treaties further provide procedures under which inconsistent positions taken by the treaty countries on a single item of income or deduction may be mutually resolved by the two countries. To the extent that inconsistent positions are taken by the Internal Revenue Service and the taxing authority of one of the possessions, relief from double taxation may be available by negotiation between the two taxing agencies. Each of the U.S. possessions has an agreement (variously styled as coordination, exchange of information, or implementation agreements) that permits entry into a memorandum of understanding to resolve such conflicts. The process for seeking such relief is similar to that available under competent authority procedures.

214 Sec. 103. Section 103(c)(2) defines State to include any possession of the United States.

215 Sec. 41. The credit is generally not available to foreign research; however, section 41(d)(4)(F) defines foreign research to be research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States.

216 Sec. 42. Section 42(h)(8)(B) defines State to include a possession of the United States.


IV. PRIOR INTERNATIONAL REFORM EFFORTS

A. The Tax Reform Act of 2014 (“TRA14”)

1. Ninety-five percent dividend received deduction

In general

TRA14 establishes a participation exemption system for foreign income. This exemption is effectuated by means of a 95-percent deduction for the foreign-source portion of dividends received from certain foreign corporations (“specified 10-percent owned foreign corporations”) by domestic corporations that are 10-percent U.S. shareholders of those foreign corporations. As under the exemption systems of some other countries, five percent of an otherwise deductible dividend from a foreign corporation remains taxable. This taxation is intended to be a substitute for the disallowance of deductions for expenses incurred to generate exempt foreign income.

A specified 10-percent owned foreign corporation is any foreign corporation if any domestic corporation owns directly, or indirectly through a chain of ownership described under section 958(a), 10 percent or more of the voting stock of that foreign corporation.

Foreign-source portion of a dividend

The 95-percent exemption is available only for foreign income, not for U.S-source income. Some specified 10-percent owned foreign corporations, however, may have U.S-source income. Consequently, the 95-percent dividends-received deduction is available only for the foreign-source portion of a dividend.

The foreign-source portion of a dividend from a specified 10-percent owned foreign corporation for which the 95-percent deduction is allowed represents the portion of the dividend that relates to the foreign corporation’s post-1986 undistributed foreign earnings. The foreign-source portion of any dividend is, therefore, the amount that bears the same ratio to the dividend as the foreign corporation’s post-1986 undistributed foreign earnings bears to the corporation’s total post-1986 undistributed earnings. This rule complements the present law section 245 rule allowing a deduction for the U.S-source portion of a dividend received from a qualified 10-percent owned foreign corporation. The U.S-source portion of any dividend for which a deduction is allowed under section 245 is the amount that bears the same ratio to the dividend as the dividend-paying corporation’s post-1986 undistributed U.S. earnings bears to the corporation’s total post-1986 undistributed earnings. For this purpose, a corporation’s post-1986 undistributed U.S. earnings are, in general, undistributed earnings attributable to (a) the

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219 The term “participation exemption,” commonly used in describing similar systems in other countries, refers to the exemption granted to a domestic corporation for earnings of a foreign corporation by virtue of the present corporation’s participation in the ownership of the subsidiary.

220 Undistributed foreign earnings include both foreign income on which a U.S. taxpayer may be taxed under subpart F and other foreign income on which no U.S. taxpayer is taxed before receipt of the dividend.
corporation’s income that is effectively connected with the conduct of a trade or business within the United States, or (b) any dividend received (directly or through a wholly owned foreign corporation) from an 80-percent-owned (by vote or value) domestic corporation.\(^{221}\)

Under the proposal, a CFC’s post-1986 undistributed foreign earnings are, in general terms, the portion of post-1986 undistributed earnings that is not attributable to post-1986 undistributed U.S. earnings.

The term post-1986 undistributed earnings means the amount of the earnings and profits of the specified 10-percent owned foreign corporation (computed in accordance with sections 964(a) and 986) accumulated in taxable years beginning after December 31, 1986 as of the close of the taxable year of the foreign corporation in which the dividend is distributed and without diminution by reason of dividends distributed during that year.

Rules similar to the rules just described apply when a dividend is paid out of earnings of a specified 10-percent owned foreign corporation accumulated in taxable years beginning before January 1, 1987. As a consequence, the participation exemption system is available for both post-1986 and pre-1987 foreign earnings. An ordering rule provides that dividends are treated as paid out of post-1986 undistributed earnings to the extent of those earnings.

As a result of the coordination with the present law section 245 dividends received deduction for dividends received from certain 10-percent owned foreign corporations, the proposal provides the 95-percent dividends-received deduction for a dividend received by a United States shareholder from a specified 10-percent owned foreign corporation 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 proposal is intended to provide an exemption from U.S. corporate tax when a domestic corporation receives a dividend from an eligible foreign corporation attributable to the corporation’s foreign-source income.

**Foreign tax credit disallowance; foreign tax credit limitation**

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 dividends-received deduction is allowed. A deduction for any foreign tax paid or accrued in respect of a deductible dividend also is denied. This 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 (on, for example, 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

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\(^{221}\) Section 3650 of the discussion draft, described previously, modifies the definition of a domestic corporation for purposes of the definition of post-1986 undistributed U.S. earnings so that dividends derived from RICs and REITs are ineligible for the section 245 dividends received deduction.
imposed on dividends for which the 95-percent deduction is permitted. The proposal’s foreign tax credit rules are described in more detail below.

For purposes of computing its section 904(a) foreign tax credit limitation, a domestic corporation that is a United States shareholder of a specified 10-percent owned foreign corporation must compute its foreign-source taxable income by disregarding the foreign-source portion of any dividend received from that foreign corporation and any deductions properly allocable to that foreign-source portion.

**Six-month holding period requirement**

A domestic corporation is allowed the 95-percent deduction for a dividend it receives on stock of a specified 10-percent owned foreign corporation only if the domestic corporation satisfies a six-month 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 stock that is held by the domestic corporation for 180 days or less during the 361-day period beginning on the date that is 180 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 stock to the extent the domestic corporation that owns the share is under an obligation (under a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

These holding period requirements parallel the section 246(c)(1) requirements for the dividends-received deductions available under present law sections 243, 244, and 245. The proposal also incorporates some, but not all, of the other present law section 246(c) holding-period-related rules (including, for example, the section 246(c)(4) rule under which holding periods are reduced in a manner provided in Treasury regulations for any period during which the taxpayer has diminished its risk of loss in respect of stock on which a dividend is paid).

The 180-out-of-361-days test described above is satisfied only if the specified 10-percent owned foreign corporation is a specified 10-percent owned foreign corporation at all times during the period and the domestic corporation is a United States shareholder of the foreign corporation at all times during the period.

**Foreign branches**

TRA14 does not change the general rules related to the taxation of foreign branches of domestic corporations. However, TRA14 does provide a new income recognition rule when a domestic corporation transfers a foreign branch to its specified 10-percent owned foreign corporation and coordinates those new rules with the present law branch loss recapture rules.

**Conforming amendments and other changes**

The proposal includes a number of changes that coordinate the new dividends-received deduction rules with existing Code provisions or that conform existing Code provisions to the new dividends-received deduction rules. Certain changes are described below.
Like the present law dividends-received deduction rules of sections 243, 244, and 245, the proposal’s 95-percent dividends-received deduction is not available for any dividend from a corporation that is exempt from taxation under section 501 or 521.

In conformity with the present law dividends-received deduction rules, deductible dividends under the proposal 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 section 243, 244, or 245. The proposal extends this rule to stock on which a dividend eligible for the 95-percent dividends-received deduction is paid.

2. Foreign base company intangible income

In general

TRA14 addresses erosion of the U.S. tax base through shifting intangible income by creating a new category of subpart F income for intangible income derived by CFCs and providing a phased deduction for a domestic corporation for income from its foreign exploitation of intangibles. As a result, the proposal both increases the U.S. taxation of income derived from intangibles owned or licensed by a CFC and decreases the U.S. tax on the income of a U.S. corporation from its use of intangibles in foreign markets. When fully phased in, the deduction from the gross income of the domestic corporation results in a reduced tax rate of 15 percent for income from the foreign exploitation of intangible property.

Foreign base company intangible income

The proposal adds a new category of subpart F income, foreign base company intangible income. Foreign base company intangible income is the excess of the corporation’s adjusted gross income over 10 percent of the corporation’s qualified business asset investment. This amount is reduced by the applicable percentage of the corporation’s foreign personal holding company income, foreign base company sales income, foreign base company services income, and foreign base company oil related income. The applicable percentage is the excess of the corporation’s adjusted gross income over 10 percent of the corporation’s qualified business asset investment divided by the total adjusted gross income of the corporation. Adjusted gross income means the gross income of the corporation reduced by commodities gross income.

A corporation’s qualified business asset investment is the aggregate of the corporation’s adjusted bases in specified tangible property. A corporation’s aggregate basis in specified tangible property is determined as of the close of any taxable year after any adjustments made for the taxable year. Specified tangible property is any tangible property unless the property is used in the production of commodities gross income. The specified tangible property is property used in a trade or business of the corporation, and is of a type with respect to which a deduction is allowable under section 168. The basis of any property is determined in accordance with the
new rules provided elsewhere in the discussion draft, and without regard to any provisions enacted after the enactment of these rules. The proposal includes authority for the Secretary to issue guidance appropriate to prevent the avoidance of the application of the tangible property rules, including guidance providing for the treatment of property if the property is transferred or held temporarily or if avoiding the purpose of the proposal is a factor in the transfer or holding of property.

To illustrate, suppose a CFC in the business of manufacturing and selling widgets has an aggregate basis in specified tangible property of $300, and adjusted gross income of $50 which includes $10 of foreign personal holding company income. The amount of the CFC’s adjusted gross income in excess of 10 percent of its basis in property is $20 [$50 - $30]. The applicable percentage of 40 percent [$20 / $50] multiplied by the $10 of foreign personal holding company income is $4. The CFC’s foreign base company intangible income is $16.

Foreign base company intangible income is only subpart F income under the proposal to the extent that the income is subject to a foreign effective tax rate lower than the effective U.S. tax rate imposed after taking into account the deduction for foreign intangible income discussed below.

**Commodities gross income**

Commodities gross income is excluded from the computation of foreign base company intangible income. A CFC’s commodities gross income is the gross income derived from the sale, disposition, production or extraction of any commodity. Additionally, specified tangible property does not include property used in the production of commodities gross income. If a property is used for the production of both commodities gross income and other income, the property is treated under the proposal as specified tangible property in the same proportion as the adjusted gross income produced with respect to the property bears to the total gross income produced with respect to the property.

For purposes of the TRA14, a commodity is any commodity described in section 475(e)(2)(A).

**Deduction for foreign intangible income**

TRA14 allows a domestic corporation a deduction equal to the applicable percentage of the lesser of (1) the sum of the domestic corporation’s foreign percentage of its net intangible income and the domestic corporation’s share of a CFC’s foreign base company intangible income multiplied by the CFC’s foreign percentage, and (2) the taxable income of the domestic corporation.

The applicable percentage phases in over time in accordance with the phase-in of the lower domestic corporate tax rate introduced in TRA14. The applicable percentage is 55 percent for 2015, 52 percent for 2016, 48 percent for 2017, 44 percent for 2018, and 40 percent for 2019 and thereafter.

The domestic corporation’s intangible income is computed in the same manner as the foreign base company intangible income of a CFC. Intangible income of the domestic
corporation is equal to the adjusted gross income in excess of 10 percent of the corporation’s qualified business asset investment. Adjusted gross income and qualified business asset investment are defined the same for the domestic corporation as they are for the CFC. Net intangible income is the excess of the intangible income over deductions property allocable to that income.

Only foreign intangible income is eligible for the deduction. Foreign intangible income is computed by multiplying the foreign percentage by the domestic corporation’s net intangible income and multiplying the CFC’s foreign percentage by the domestic corporation’s share of the CFC’s foreign base company intangible income.

A corporation’s foreign percentage is the ratio of the foreign-derived adjusted gross income over the corporation’s total adjusted gross income for the taxable year. Under the proposal, foreign-derived adjusted gross income is gross income derived in connection with property which is sold for use, consumption, or disposition outside the United States, or services provided with respect to persons or property located outside the United States. The location of title passage is not determinative of where property is sold for use, consumption, or disposition. For example, the gross income from a foreign military sale where title is transferred first to the U.S. government for on-sale to a foreign purchaser for use, consumption, or disposition outside the United States qualifies as foreign-derived adjusted gross income.

Property is not treated as sold for use, consumption, or disposition outside the United States if the taxpayer knew, or had reason to know, that the property would ultimately be sold for use, consumption, or disposition in the United States. Property sold to a related party will not be treated as sold for use, consumption, or disposition outside the United States unless the property is ultimately sold by a related party for use, consumption, or disposition outside the United States, or if the property is resold to an unrelated party outside the United States and no related party knew or had reason to know that the property would ultimately be sold for use, consumption, or disposition in the United States. Similar rules apply with respect to services. A related party for these purposes means any member of an affiliated group defined in section 1504(a) determined by using “more than 50 percent” in place of “at least 80 percent” and by including insurance companies and foreign corporations. Any person (other than a corporation) is treated as a member of the group if the person is controlled by members of the group, or controls any member of the group. Control for these purposes is determined under the rules of section 954(d)(3).

3. Denial of deduction for interest expense of U.S. shareholders which are members of worldwide affiliated groups with excess domestic indebtedness

TRA14 addresses base erosion that results from excessive and disproportionate borrowing in the United States by limiting the deductibility of net interest expense of a U.S. corporation that is a U.S. shareholder with respect to any CFC if both the CFC and U.S. corporation are part of a worldwide affiliated group. A portion of otherwise deductible interest is disallowed if the U.S. group fails to meet both a relative leverage test and a percentage of

\[ \text{Net interest for the purposes is defined in section 163(j)(6)(B) as the excess of interest paid or accrued over the interest includible in gross income for the taxable year.} \]
adjusted taxable income test. The lesser of the two amounts determined under these tests is the amount by which deductible interest is reduced. The proposal does not apply to a wholly domestic group.

A worldwide affiliated group is one or more chains of corporations, connected through stock ownership with a common parent that would qualify as an affiliated group under section 1504, with two differences. First, the ownership threshold of section 1504(a)(2) is applied using 50 percent rather than 80 percent. Second, the restriction on inclusion of a foreign corporation under section 1504(b)(3) is disregarded for purposes of identifying the worldwide affiliated group.

In the relative leverage test, all U.S. members of the worldwide affiliated group are treated as one member in order to determine whether the group has excess domestic indebtedness as a result of a debt-to-equity differential. Excess domestic indebtedness is the amount by which the total indebtedness of the U.S. members exceeds 110 percent of the debt those members would hold if their aggregate debt-to-equity ratio were proportionate to the ratio of debt-to-equity in the worldwide group. The percentage of aggregate domestic debt represented by excess domestic indebtedness is the debt-to-equity differential by which net interest expense is multiplied to determine the amount of interest that would be disallowed under the relative leverage test. Intragroup debt and equity interests are disregarded for purposes of this computation.

The percentage of adjusted taxable income test computes the amount by which the net interest expense of a U.S. shareholder exceeds 40 percent of adjusted taxable income. The proposal requires that the U.S. shareholder first compute adjusted taxable income as defined in section 163(j)(6)(A), that is, taxable income increased by deductible losses, interest, depreciation and amortization, qualified production expenses and as prescribed under regulations. The net interest expense is the amount of interest paid or accrued in the taxable year in excess of the amount of interest includible in gross income for the same taxable year, as defined in section 163(j)(6)(B).

Several changes to section 163(j) conform its operation to the new subsection. Interest disallowed under either this rule or under section 163(j) may be carried forward to subsequent taxable years. The amount by which corporate net interest expense may exceed the adjusted taxable income of the corporation (plus any excess limitation carryforward from years beginning before January 1, 2015) is reduced to 40 percent from 50 percent. Excess limitation for years beginning after January 1, 2015 is not available to be carried forward. Finally, the amount of interest disallowed under section 163(j) is reduced to the extent that a disallowance of deduction is required by this proposal.

The Secretary is provided regulatory authority to provide anti-avoidance rules and the treatment of partnership indebtedness, allocation of partnership debt, interest, or distributive shares.
4. Modifications to section 163(j), limitation on deduction for interest on certain indebtedness

TRA14 modifies the limitation on the deduction for interest expense under section 163(j). Under TRA14, excess interest expense is the excess of the corporation’s net interest expense over 40 percent (changed from present law 50 percent) of the adjusted taxable income of the corporation. Additionally, under TRA14, excess limitation from taxable years beginning after December 31, 2014 may not be carried forward.

5. Deemed repatriation of deferred foreign income

In general

TRA14 generally requires that, for the last taxable year beginning before the participation exemption takes effect, any 10-percent U.S. shareholder of a CFC or other 10-percent owned foreign corporation must include in income its pro rata share of the undistributed, non-previously-taxed post-1986 foreign earnings of the corporation. Up to 90 percent of the amount so included in income is deductible by the U.S. shareholder, depending on whether the deferred earnings are in cash or other assets. The deduction results in a reduced rate of tax with respect to income from the required inclusion of pre-effective date earnings. A corresponding portion of the credit for foreign taxes is disallowed, thus limiting the credit to the taxable portion of the included income. In determining the increase in a 10-percent U.S. shareholder’s U.S. tax liability as a result of the mandatory inclusion, the Code is applied as in effect before enactment of the discussion draft. For example, the corporate tax rate remains unchanged and the separate foreign tax credit limitation rules of present law section 904 apply. The increased tax liability generally may be paid over an eight-year period. An amount equivalent to the taxes collected under this proposal is appropriated to the Highway Trust Fund.

Subpart F

The mechanism for the mandatory inclusion of pre-effective date foreign earnings is subpart F. TRA14 provides that in the last taxable year of a specified foreign corporation that ends before January 1, 2015, which is that foreign corporation’s last taxable year before the participation exemption system begins, the subpart F income of the foreign corporation is increased by the accumulated deferred foreign income of the corporation determined as of the close of that taxable year. In contrast to the participation exemption deduction available only to domestic corporations that are U.S. shareholders under subpart F, the transition rule applies to all U.S. shareholders223 of a specified foreign corporation, which includes any foreign corporation in which a U.S. person owns ten percent of the voting stock. Consistent with the general operation of subpart F, each 10-percent U.S. shareholder of a specified foreign corporation must include in

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223 Sec. 951(b), which defines United States shareholder as any U.S. person that owns 10 percent or more of the voting classes of stock of a foreign corporation.
income its pro rata share of the foreign corporation’s subpart F income attributable to its accumulated deferred foreign income.\(^{224}\)

A 10-percent U.S. shareholder of a specified foreign corporation is allowed a deduction in an amount determined by reference to the portion of deferred earnings and profits that are held in cash or liquid assets. The noncash portion is eligible for a deduction of 90 percent; the U.S. shareholder aggregate foreign cash position is eligible for a deduction of 75 percent.

**Accumulated deferred foreign income**

A specified foreign corporation’s accumulated deferred foreign income that must be taken into account as subpart F income is the portion of the foreign corporation’s post-1986 undistributed earnings that is not attributable to (1) income that is effectively connected with the conduct of a trade or business in the United States and subject to U.S. income tax, (2) subpart F income (determined without regard to the mandatory inclusion rule) of a CFC that is included in the gross income of a 10-percent U.S. shareholder of the CFC and with respect to which the CFC has not made distributions that are excludable from gross income under section 959, (3) or, for PFICs, an amount that would be treated as an excess distribution or attributable to an unreversed inclusion. Undistributed earnings are the earnings and profits of the foreign corporation (computed in accordance with sections 964(a) and 986) as of the close of the corporation’s last taxable year that ends before January 1, 2015.

The income inclusion required of a U.S. shareholder under this transition rule is reduced by the portion of aggregate foreign earnings and profits deficit allocated to that person by reason of that person’s interest in one or more E&P deficit foreign corporations. An E&P deficit foreign corporation is defined as any specified foreign corporation owned by the U.S. shareholder as of February 26, 2014 and which also has a deficit in post-1986 earnings and profits as of that date. The U.S. shareholder aggregates its pro rata share in the foreign E&P deficits of each such company and allocates it among the deferred foreign income corporations in which the shareholder is a U.S. shareholder. The aggregate foreign E&P deficit allocable to a specified foreign corporation is in same ratio as the U.S. shareholder’s pro rata share of post-1986 deferred income in that corporation bears to the U.S. shareholder’s pro rata share of accumulated post-1986 deferred foreign income from all deferred income companies of such shareholder.

To illustrate, assume that a U.S. corporation is a U.S. shareholder with respect to each of four specified foreign corporations, two of which are E&P deficit foreign corporations, and that the foreign companies have the following accumulated post-1986 deferred foreign income or foreign E&P deficits as of February 26, 2014:

**Table 8–Example**

\(^{224}\) For purposes of taking into account its subpart F income under this rule, a noncontrolled 10/50 corporation is treated as a CFC.
Specified Foreign Corp. | Percentage Owned | Foreign profit/deficit | Pro Rata Share |
--- | --- | --- | --- |
A | 60 | (1,000) | (600) |
B | 10 | (200) | (20) |
C | 70 | 2,000 | 1,400 |
D | 100 | 1,000 | 1,000 |

The aggregate foreign E & P deficit of the U. S. shareholder is (620), and the aggregate share of accumulated post-1986 deferred foreign income is 2400. Thus, the portion allocable to Corporation C is $362, that is, $620 x 1400/2400. The remainder of the aggregate foreign E&P deficit is allocable to Corporation D.

Specific regulatory authority is granted to permit reductions of accumulated deferred earnings and profits where appropriate to effect the intent of the drafters that U.S. persons not incur tax with respect to earnings and profits of a controlled foreign corporation allocable to stock owned by persons other than United States shareholders as deferred foreign income.

**Foreign tax credit**

Like present law section 965, the proposal disallows a foreign tax credit for the portion of foreign taxes paid with respect to the pre-effective-date undistributed CFC earnings inclusion. The proposal also denies a deduction for any foreign tax for which a credit is disallowed. A 10-percent U.S. shareholder’s income is not increased under section 78 by the amount of tax for which a foreign tax credit is not allowed.

The required inclusion of deferred foreign income under this provision is disregarded for purposes of determining the amount of income from foreign sources that a U.S. shareholder has for purposes of the recapture rules applicable to overall foreign losses.

**Installment payments**

A 10-percent U.S. shareholder may elect to pay the net tax liability resulting from the mandatory inclusion of pre-effective-date undistributed CFC earnings in eight installments, in the following amounts: installments one through five in an amount equal to eight percent of the net tax liability; a sixth installment of 15 percent of the net tax liability; the seventh is 20 percent and the eighth, 25 percent. The net tax liability that may be paid in installments is the excess of the 10-percent U.S. shareholder’s net income tax for the taxable year in which the pre-effective-date undistributed CFC earnings are included in income over the taxpayer’s net income tax for that year determined without regard to the inclusion. Net income tax means net income tax as defined for purposes of the general business credit, but reduced by the amount of that credit.

An election to pay tax in installments must be made by the due date for the tax return for the taxable year in which the pre-effective-date undistributed CFC earnings are included in income. The Treasury Secretary has authority to prescribe the manner of making the election. The first installment must be paid on the due date (determined without regard to extensions) for the tax return for the taxable year of the income inclusion. Succeeding installments must be paid annually no later than the due dates (without extensions) for the income tax return of each
succeeding year. If a deficiency is later determined with respect to the net tax liability, the additional tax due may be prorated among all installment payments in most circumstances. The portions of the deficiency prorated to an installment for which the due date is past must be paid upon notice and demand. The portion prorated to any remaining installment is payable with the timely payment of that installment payment, unless the deficiency is attributable to negligence, intentional disregard of rules or regulations, or fraud with intent to evade tax, in which case the entire deficiency is payable upon notice and demand.

The timely payment of an installment does not incur interest. If a deficiency is determined that is attributable to an understatement of the net tax liability due under this proposal, the deficiency is payable with underpayment interest for the period beginning on the date on which the net tax liability would have been due, without regard to an election to pay in installments, and ending with the payment of the deficiency. Furthermore, any amount of deficiency prorated to a remaining installment also bears interest on the deficiency, but not on the original installment amount.

TRA14 also includes an acceleration rule. If (1) there is a failure to pay timely any required installment, (2) there is a liquidation or sale of substantially all of the 10-percent U.S. shareholder’s assets (including in a bankruptcy case), (3) the 10-percent U.S. shareholder ceases business, or (4) another similar circumstance arises, the unpaid portion of all remaining installments is due on the date of the event (or, in a title 11 or similar case, the day before the petition is filed).

Special rule for S corporations

A special rule permits deferral of the transition net tax liability for shareholders of a 10-percent U.S. shareholder that is a flow-through entity known as an S corporation. Any shareholder of the S corporation may elect to defer his portion of the net tax liability at transition to the participation exemption system until the shareholder’s taxable year in which a triggering event occurs. If an election to defer tax is made, the S corporation and the electing shareholder are jointly and severally liable for any net tax liability and related interest or penalties. The election to defer the tax is due not later than the due date for the return of the S corporation for its last taxable year that begins before January 1, 2015.

Three types of events may trigger an end to deferral of the net tax liability. The first type of triggering event is a change in the status of the corporation as an S corporation. The second category includes liquidation, sale of substantially all corporate assets, termination of the company or end of business, or similar event, including reorganization in bankruptcy. The third type of triggering event is a transfer of shares of stock in the S corporation by the electing taxpayer, whether by sale, death or otherwise, unless the transferee of the stock agrees with the Secretary to be liable for net tax liability in the same manner as the transferor. Partial transfers

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225 Section 1361 defines an S corporation as a domestic small business corporation that has an election in effect for status as an S corporation, with fewer than 100 shareholders, none of whom are nonresident aliens, and all of whom are individuals, estates, trusts or certain exempt organizations.
trigger the end of deferral only with respect to the portion of tax properly allocable to the portion of stock sold.

If a shareholder of an S corporation has elected deferral under the special rule for S corporation shareholders and a triggering event occurs, that shareholder may be eligible to elect to pay the net tax liability in installments, subject to rules similar to those generally applicable absent deferral. Whether or not a shareholder may elect to pay in installments depends upon the type of event that triggered the end of deferral. If the triggering event is liquidation, sale of substantially all corporate assets, termination of the company or end of business, or similar event, installment payments are not available. Instead, the entire net tax liability is due upon notice and demand. The installment election is due with the timely return for the year in which the triggering event occurs. The first installment payment is required by the due date of the same return, determined without regard to extensions of time to file.

If an election to defer payment of the net tax liability is in effect for a shareholder, the period within which the IRS may collect such liability does not begin before the date of an event that triggers the end of the deferral.

**Highway Trust Fund**

TRA14 requires that income tax payments relating to the net tax liability for deemed repatriation of pre-effective date foreign earnings will be transferred to the Highway Trust Fund. The Highway Trust Fund, established in 1956, is divided into two accounts, a Highway Account and a Mass Transit Account, each of which is the funding source for specific programs. The Highway Trust Fund is currently funded by taxes on motor fuels (gasoline, kerosene, diesel fuel, and certain alternative fuels), a tax on heavy vehicle tires, a retail sales tax on certain trucks, trailers and tractors, and an annual use tax for heavy highway vehicles. Of the receipts received in the Treasury as a result of the deemed repatriation provision (and not otherwise appropriated), an amount equivalent to twenty percent will be transferred to the Mass Transit Account, the balance transferred to the Highway Account.

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226 Sec. 9503(e)(1).
B. President’s FY 2016 Budget Proposal

1. Impose a 19-Percent Minimum Tax on Foreign Income

Minimum tax

The Administration proposes to significantly change the taxation of foreign earnings of domestic C corporations and their CFCs by imposing a minimum tax on earnings from a CFC, branch, or from the performance of services abroad. Under the proposal, the foreign earnings of a CFC or branch or from the performance of services are subject to current U.S. taxation at a rate (not below zero) of 19 percent less 85 percent of the per-country foreign effective tax rate (the “residual minimum tax rate”).

Under the proposal, the minimum tax for a particular country is computed by multiplying the applicable residual minimum tax rate by the minimum tax base for that country. A U.S. corporation's tentative minimum tax base with respect to a country for a taxable year is the total amount of foreign earnings for the taxable year assigned to that country for purposes of determining the effective tax rate for the country.

Under the proposal, the minimum tax is computed country-by-country on the tax base assigned to the country. The tax base is the tentative minimum tax base reduced by an allowance for corporate equity. The ACE allowance provides a risk-free return on equity invested in active assets. Under the proposal active assets generally include assets that do not generate foreign personal holding company income (determined without regard to both the look-through rule of section 954(c)(6) and any election to disregard an entity as separate from its owner). Thus, the ACE allowance is intended to exempt from the minimum tax a return on the actual activities undertaken in a foreign country.

The foreign effective tax rate under the proposal is computed on an aggregate basis determined over a 60-month period ending on the date the domestic corporation's current taxable year ends, or in the case of a CFC, that ends on the date on which the CFC's current taxable year ends. For purposes of computing the foreign effective tax rate, the foreign taxes taken into account are those taxes that, absent the proposal, would be eligible to be claimed as a foreign tax credit during the 60-month period. The foreign earnings taken into account for the 60-month period are determined using U.S. tax principles, but would include disregarded payments deductible elsewhere, such as disregarded intra-CFC interest or royalties, and would exclude dividends from related parties. These rules would be further subject to rules applicable to hybrid arrangements discussed below.

The Administration's proposal includes rules for assigning foreign earnings and taxes to a foreign country. The basic rule assigns earnings and taxes to the country based on the tax residence determined under foreign law. The Administration provides some examples. In the first example, a CFC is incorporated in Country X, but is a tax resident of Country Y under both the Country X and Country Y place of management tests for tax residence. In this example, the CFC's earnings and associated foreign taxes are assigned to Country Y for purposes of computing the foreign effective tax rate and the minimum tax. The Administration's second example follows the first, but instead of a place of management test, Country Y uses the place of
incorporation test. Country X sees the CFC as a tax resident of Country Y, but Country Y sees the CFC as a tax resident of Country X. Here the CFC is not subject to foreign tax anywhere and the CFC's earnings are subject to the full 19 percent minimum tax under the proposal.

The proposal provides that where the same earnings of a CFC are subject to tax in multiple countries, the earnings and all of the foreign taxes associated with those earnings are assigned to the highest-tax country. For example, if a CFC incorporated in high-tax Country Z has a permanent establishment in low-tax Country Q and both Country Z and Country Q tax the earnings of the permanent establishment, the earnings and both the Country Z and Country Q taxes associated with those earnings are assigned to Country Z.

In assigning earnings to countries under the proposal, both for purposes of determining the foreign effective tax rate as well as for determining the tentative minimum tax base for a particular year, rules are implemented to restrict the use of hybrid arrangements to shift earnings from a low-tax country to a high-tax country for U.S. tax purposes without triggering tax in the high-tax country. For example, no deduction is recognized for a payment from a low-tax country to a high-tax country that is treated as a dividend eligible for a participation exemption in the high-tax country. In addition, the earnings assigned to a low-tax country are increased for a dividend payment from a high-tax country that is treated as deductible in the high-tax country.

The Administration’s minimum tax is imposed on current foreign earnings regardless of whether those earnings are repatriated to the United States. All foreign earnings could be repatriated without further U.S. tax. Thus, under the proposal, U.S. tax is imposed on a CFC’s earnings either immediately (either under present law subpart F rules or the minimum tax proposal) or not at all (if the income is subject to sufficient foreign tax or is exempt pursuant to the ACE allowance).

Additionally, rules regarding CFC investments in United States property and previously taxed earnings would be repealed for United States shareholders that are U.S. corporations.

The proposal retains present law subpart F rules. Subpart F generally continues to require a United States shareholder of a CFC to include in its gross income on a current basis, at the full U.S. tax rate (with foreign tax credits available with respect to current year foreign taxes available as provided under present law), the shareholder's share of the CFC’s subpart F income, but the subpart F high-tax exception is made mandatory under the proposal for United States shareholders that are U.S. corporations.

Under the proposal, no U.S. tax is imposed on the sale by a United States shareholder of stock of a CFC to the extent any gain reflects the undistributed earnings of the CFC. These undistributed earnings would generally have already been subject to tax under the subpart F rules, the minimum tax, or the 14-percent one-time tax. Additionally, the proposal taxes any stock gain attributable to unrealized gain in the CFC’s assets in the same manner as would apply to the future earnings from the CFC’s assets. Accordingly, stock gain is subject to the minimum

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227 See the discussion of the Administration’s proposal to Impose a 14-Percent One-Time Tax on Previously Untaxed Income described in Part II.G. of this document.
tax or to tax at the full U.S. rate to the extent that the gain reflects unrealized appreciation in assets that would generate earnings subject to the minimum tax or subpart F, respectively.

2. Interest allocation

The Administration’s proposal modifies present-law rules for allocating interest expense incurred by the U.S. parent in support of its foreign operations. Additionally, the election to allocate worldwide interest is accelerated. As under present law, interest expense of the U.S. group would first be allocated between U.S.-source and foreign-source income. However, the amount of interest expense allocated to foreign-source income under these rules then would be further allocated between the three broad categories of foreign-source income on a pro rata basis, based on assets. Broadly, these foreign-source income categories include income that is subject to taxation at the full U.S. statutory tax rate, income that is entirely exempt from U.S. taxation, and income that is taxed at a variety of different tax rates under the minimum tax system.

Interest allocated and apportioned to foreign-source income subject to the minimum tax would be deductible only at the applicable minimum tax rate, while no deduction would be permitted for interest expense allocated and apportioned to foreign-source income on which no U.S. tax is paid.

The first category is for income that is taxed at the full U.S. statutory tax rate, and includes foreign-source royalty and interest income received directly by the U.S. group as well as foreign-source income that is generated through the subpart F mechanism, such as the various types of foreign base company income under present law. Under the proposal, this category of foreign-source income that is subject to tax at full U.S. rates would still be eligible for offset by foreign tax credits, though only with respect to current year foreign taxes. Accordingly, the interest allocated to this category would operate to compute the foreign tax credit limitation, but would remain fully deductible. The inclusion of branch income in the determination of the minimum tax base means that the deductibility of interest expense used to support branch operations is more limited than under present law, where those expenses are fully deductible as branch income is subject to the lower minimum tax under the proposal.

The second category is for income that is not at all taxed, and includes foreign subsidiary earnings that were already subject to a local tax at a rate equal or exceeding 22.35 percent, thus yielding zero residual U.S. minimum tax. In addition, any foreign subsidiary earnings that are exempt from U.S. taxation based on the allowance for corporate equity would also be included in this category of foreign-source income that is not subject to further U.S. taxation. This would necessarily require that an interest allocation be made to the income exempt under the allowance for corporate equity on a per-country basis, as described below, in order to determine the interest expense disallowance with respect to earnings up to the allowance for corporate equity, which is exempt from the U.S. minimum tax, and therefore subject to interest expense disallowance.

The third category of foreign-source income includes income that is earned by foreign subsidiaries and which is subject to the 19-percent minimum tax based on a residual tax rate on a per-country basis. Interest allocated to this category would only be deductible at the rate at which the residual minimum tax was applied. This would necessarily require that interest expense allocated to foreign earnings that are subject to the minimum tax be further allocated within this category to each country, in order to compute the interest expense disallowance on a
per-country basis. Moreover, once the per-country interest allocation is determined, the interest must be further allocated within each country to earnings up to the allowance for corporate equity, which, as mentioned, results in complete disallowance of interest expense, and to the remainder of the earnings within the country, which results in partial expense disallowance.

3. **Impose a 14-Percent One-Time Tax on Previously Untaxed Foreign Income**

The Administration’s proposal imposes a one-time tax of 14 percent on earnings and profits of CFCs accumulated before January 1, 2016. The proposal allows a credit for the foreign taxes associated with the deferred earnings, multiplied by the ratio of the one-time tax rate (14 percent) to the maximum U.S. corporate tax rate in 2015 (35 percent), or 40 percent. The one-time tax is payable ratably over five years. The proposal is contingent upon enactment of the related proposal for a minimum tax.

Revenues from the proposal are intended to pay for a surface transportation reauthorization proposal and any shortfalls between revenue and surface transportation spending under present law for fiscal year 2016.\(^{228}\)

The Administration presents the 14 percent tax on deferred income as a transition rule to be enacted together with its proposed 19-percent minimum tax, rather than a proposal to be considered in the absence of comprehensive reform of U.S. rules on international taxation.

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V. BIPARTISAN FRAMEWORK FOR INTERNATIONAL TAX REFORM

A. Ending the lock-out effect

One crucial rationale for enacting reforms to the international tax system utilized by the United States is to end the “lock-out effect.” As a result of our worldwide system of international taxation—combined with the high U.S. corporate tax rate and the option to defer those earnings overseas—U.S. multinational companies have a powerful incentive to make foreign, rather than domestic investments. The ability to defer payment of residual U.S. tax liability on the returns to the foreign investments may make those foreign investments more attractive on an after-tax basis, even if they yield the same pre-tax return as a domestic investment. Publicly traded firms have the additional incentive to declare in filings to the S.E.C. that they are reinvesting foreign earnings overseas rather than repatriate them to the United States.

To eliminate the lock-out effect, a number of bipartisan panels, economists and experts in international taxation have recommended adoption of an international tax system that greatly diminishes the tax consequences for repatriation of overseas earnings, such as a dividend exemption or hybrid territorial-type system, paired with appropriate base erosion measures. Varying versions of this reform have been included in proposals made by the President’s FY 2016 budget, TRA14, the President’s Advisory Panel on Federal Tax Reform (2005), the co-chairs of the Simpson-Bowles Commission (the National Commission on Fiscal Responsibility and Reform, 2010), the President’s Export Council (2010), the President’s Council of Advisors on Science and Technology (2011), and many members of the President’s Council on Jobs and Competitiveness.

As mentioned above, 28 of the 34 current OECD member countries, as well as every G-7 country except the United States, have some type of hybrid territorial system of taxation that exempts from taxation most active earnings that are repatriated in the form of a dividend from foreign subsidiaries. As shown in the chart below, of the 28 OECD countries with territorial tax systems, 20 countries exempt 100 percent of foreign subsidiary dividends, one country (Norway) exempts 97 percent of foreign subsidiary dividends, and seven countries exempt 95 percent of foreign subsidiary dividends.

While most OECD nations do not require their multinationals to allocate costs that are deemed to relate to foreign earnings, the countries that allow less than a 100 percent dividend exemption generally cite the three or five percent inclusion as a proxy for expense allocation. This system trades the complexity of allocation for the complexity of the anti-abuse rules. In order to move the U.S. international tax system in a direction that keeps the U.S. economy globally competitive with their foreign rivals, the co-chairs believe that it is imperative to adopt a dividend exemption regime in conjunction with robust and appropriate base erosion rules.
Two areas present unique challenges under a dividend exemption system: the tax treatment of branches and S corporations.

While the co-chairs are not yet issuing any formal recommendation regarding the treatment of branches, Congress faces two broad options: either 1) treat branches similar to controlled foreign corporations (CFCs) by allowing branch earnings to qualify for exemption treatment, or 2) subject branch earnings to immediate U.S. tax as under current law. If branches are to be treated as CFCs and have their earnings qualify for the exemption, consideration should be given to enactment of an appropriate one-time transition tax for the branches electing to be eligible for the dividend exemption. Under such a proposed transition tax, all of the assets used in the foreign branch’s active conduct of a trade or business, including intangible assets, would be treated as if such assets had been transferred to a CFC in a taxable transaction under Code section 367 and taxed at rates comparable to any accompanying deemed repatriation proposal.

The working group has received comments regarding the tax treatment of S corporations. While the co-chairs are not yet issuing any formal recommendation, we believe that careful consideration of the appropriate tax treatment of S corporations is warranted. TRA14 made S corporation earnings ineligible for that proposal’s dividend exemption system. Other options might take a different approach, such as deferring tax on S corporation foreign earnings until distributed to shareholders and extending the exemption system (and any transition tax) to S corporations.

### B. Patent Box Regime

Throughout the working group process, the co-chairs consistently heard from a wide range of U.S. companies regarding their concerns about the impact of the OECD Base Erosion and Profits Shifting (BEPS) project and unilateral actions already being undertaken in certain countries (discussed above), with a particular emphasis on the impact of reforms to existing innovation box regimes.
For background, an innovation box provides a substantially discounted tax rate on certain forms of intangible business income. These discounted rates have the potential to be effective in encouraging the movement of ownership of intellectual property (IP) offshore. Concurrent with the increase in these discounted rate regimes around the globe, the United States will continue to experience an increase in the migration of intellectual property out of the country.

The form of property covered as well as the discount provided varies country to country. Below is a summary of existing innovation box regimes.

<table>
<thead>
<tr>
<th>Country</th>
<th>Standard Corp. Rate in 2015</th>
<th>Patent Box Rate in 2015</th>
<th>Fully Phased-In Patent Box Rate</th>
<th>Qualified IP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>33.99%</td>
<td>6.8%</td>
<td>6.8%</td>
<td>Qualifying Patents</td>
</tr>
<tr>
<td>Cypress</td>
<td>12.5%</td>
<td>2.5%</td>
<td>2.5%</td>
<td>Patents, copy-marks, trademarks, designs and models</td>
</tr>
<tr>
<td>France</td>
<td>38.0%</td>
<td>15.0%</td>
<td>15.0%</td>
<td>Patent granted in France, UK or European Patent Office</td>
</tr>
<tr>
<td>Hungary</td>
<td>19.0%</td>
<td>9.5%</td>
<td>9.5%</td>
<td>Patents, know-how, trademarks, business names, business secrets and copyrights</td>
</tr>
<tr>
<td>Ireland (proposed)</td>
<td>12.5%</td>
<td>n.a.</td>
<td>5.0% to 6.25%</td>
<td>Patents and property functionally equivalent to patents</td>
</tr>
<tr>
<td>Italy</td>
<td>27.5%</td>
<td>19.25%</td>
<td>13.75%</td>
<td>Patents and property functionally equivalent to patents</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>29.22%</td>
<td>5.84%</td>
<td>5.84%</td>
<td>Patents, trademarks, designs, domain names, models and software copyrights</td>
</tr>
<tr>
<td>Malta</td>
<td>35.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>Patented IP and qualifying copyrights</td>
</tr>
<tr>
<td>Netherlands</td>
<td>25.0%</td>
<td>5.0%</td>
<td>5.0%</td>
<td>Worldwide patents and IP arising from R&amp;D activities for which the taxpayer has obtained declaration from the Dutch government (trademarks, non-technical design rights and literary copyrights are not included)</td>
</tr>
<tr>
<td>Spain</td>
<td>28.0%</td>
<td>11.2%</td>
<td>10.0%</td>
<td>Patents, drawings or models, plans, secret formulas or procedures and rights on information related to industrial, commercial, or scientific experiments</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>20.0%</td>
<td>12.0%</td>
<td>10.0%</td>
<td>Patents granted by the United Kingdom or European Patent Office (excludes trademarks and</td>
</tr>
</tbody>
</table>
As mentioned in the discussion of the BEPS project above, Action 5 in the BEPS Action Plan considers reforms to counter harmful tax practices. Of note, consensus regarding a “substantial activity” requirement for preferential IP regimes (i.e., innovation boxes) has been reached, with details still being finalized and expected by July of this year. Specifically, under the proposed BEPS modified nexus approach, businesses will be permitted to participate in existing innovation box regimes only to the extent they can show that business activities -- such as research and development (R&D) -- which give rise to IP income, were substantially performed in the country where the discounted rate is being received. This approach is consistent with new rules already scheduled to go into effect on the U.K. patent box in 2021.

The co-chairs agree that the anticipated impact of the new nexus requirements on innovation box regimes will have a significant detrimental impact on the creation and maintenance of intellectual property in the United States, as well as on the associated domestic manufacturing sector, jobs, and revenue base. Excerpts from several working group submissions regarding the anticipated impact of inaction by U.S. policymakers to combat OECD efforts are below:

- “The creation and commercialization of R&D in the United States is directly tied to highly-skilled jobs with good wages and benefits. An Innovation Box would level the playing field with our foreign counterparts that have already reduced rated and tax incentives, and encourage companies to invest in innovation, manufacturing and retain ownership of the resulting, valuable IP in the United States.”
  - National Association of Manufacturers\textsuperscript{229}

- “...the United States needs to take specific steps to address developments overseas that, if left unanswered, will result in significant U.S. job and revenue loss. Other countries are aggressively seeking to attract IP creation and commercialization through the introduction of broad IP regimes....In addition, the OECD Base Erosion and Profits Shifting (BEPS) project will likely require a stronger "nexus" between economic activity and location of IP income in order to take advantage of these incentives. Because companies like ours are facing increased pressures from stakeholders to take advantage of these incentives, many will decide to locate IP ownership and a higher proportion of IP development functions overseas to establish the requisite "nexus" to claim such benefits....This will cause U.S. tax revenues to shrink as the U. S. tax base attributable to IP decreases and credits for foreign taxes paid on IP developed and owned overseas increase.”
  - Motion Picture Association of America\textsuperscript{230}

\textsuperscript{229} Supra note 6.

\textsuperscript{230} Motion Picture Association of America, Inc. Submission to the International Tax Reform Working Group 4 (2015).
• "Once decisions are made to shift existing and/or locate new R&D jobs and investment overseas, they will be difficult to reverse. As a result, the United States could lose (or not gain) significant high-paying jobs as well as the revenue base associated with the IP. This loss would be felt on a long-term or permanent basis, making it more difficult in the future to achieve revenue neutral reform."
  - Silicon Valley Tax Directors Group\textsuperscript{231}

• "...creating an American ‘Innovation Box’ now would relieve significant market pressure on companies such as ours to retain and invest resources in the United States. Creating an American ‘innovation box’ now would be a good down payment on comprehensive tax reform...."
  - McGraw Hill Financial\textsuperscript{232}

The co-chairs agree that we must take legislative action soon to combat the efforts of other countries to attract highly mobile U.S. corporate income through the implementation of our own innovation box regime that encourages the development and ownership of IP in the United States, along with associated domestic manufacturing. They continue to work to determine appropriate eligibility criteria for covered IP, a nexus standard that incentivizes U.S. research, manufacturing, and production, as well as a mechanism for the domestication of currently offshore IP.

### C. Base Erosion

The adoption of a territorial-type international tax system could, on its own and without appropriate safeguards, exacerbate the incentive for multinational companies to erode the US tax base to tax haven jurisdictions. This is because income could be shifted to haven jurisdictions and repatriated to the United States with minimal tax consequences.

As mentioned above, both TRA14 and the President’s FY 2016 Budget impose a minimum level of tax on a subset of earnings by CFCs. During the working group process, feedback was received from former Ways and Means Committee staff and Treasury Department officials on why they structured their proposals in the manner that they did, and from a wide variety of stakeholders on how those proposals would affect different businesses and sectors of the economy.

The co-chairs are continuing to consider different options around the scope and design of this new proposal, or other targeted base erosion measures. Should there be a minimum tax, we believe that the type of income subject to a minimum level of tax and the rate applied to such income should meet the twin goals of preventing base erosion while ensuring that U.S. multinational companies are more competitive vis-à-vis their overseas rivals.


The co-chairs are committed to designing base-erosion proposals that protect the US tax base and address the proliferation of tax havens, while not undermining the ability of American companies to compete abroad. This means creating clear, manageable standards that take into account the fact that losses can cause low effective tax rates in particular years and designing rules that dissuade companies from shifting money to tax haven jurisdictions.

D. Interest Expense Limitations

As described above, current law provides certain rules and limitations associated with interest expense on intra-group and third party financing of domestic companies operating abroad (i.e., subpart F and foreign tax credit limitation) and on intra-group financing of foreign companies operating in the U.S. (i.e., section 163(j) deduction limitation). In 1989, Congress deemed 163(j) to be necessary as the fungibility of capital assets provides a readily-available means for multinational companies to strip profits using intra-group debt beyond what a third-party lender would lend to a similarly situated borrower.

Of note, experts agree that jurisdictions where the statutory tax rate is relatively high are at the greatest risk of suffering from this form of tax arbitrage. With that said, this is a tax strategy employed in jurisdictions around the world, which is why the OECD BEPS Project has included it as Action 4 in their action plan. The BEPS discussion draft released at the end of last year laid out a number of options to make existing limitations more restrictive, including group proportionality as well as fixed-ratio tests.

The working group received input from both domestic and foreign multinational companies expressing the legitimate business purposes for which intra-group debt is necessary and the detrimental impact on capital investment that may occur if limits are inappropriately set. The working group also examined the common practice of significant leveraging of U.S. subsidiaries soon after corporate inversions occur.

The co-chairs agree that it is important to design measures that discourage excessive leverage for both domestic companies operating globally and foreign companies operating in the U.S. to simply reduce their tax bills. They acknowledge concerns raised through the working group process and by experts in the field regarding the administrability of the President's proposed proportionality test and regarding TRA14, which, similar to current law, arguably doesn't provide sufficient limits in light of international norms and unilateral actions of other countries. As a result, the co-chairs will continue working to determine the appropriate net limitation necessary to allow for legitimate intra-group lending while at the same time stopping disproportionate leveraging to avoid U.S. taxation and gaming of interest expense limits in place. They are also committed to designing rules that keep inbound and outbound companies on a level playing field. Finally, the co-chairs will continue to examine the appropriate use of excess limitation and carryforward rules for disallowed interest expense; as well as whether additional limits should be placed on domestic companies that choose to invert.
E. Deemed Repatriation

Under current law, U.S. multinational companies pay no U.S. tax on most active profits earned by foreign subsidiaries until those profits are repatriated into the U.S. (i.e. sent back to the U.S. parent company as dividend payments). When this income is repatriated, the U.S. parent can offset its U.S. tax on those foreign earnings with a foreign tax credit for any foreign taxes paid with respect to those earnings. According to a recent Bloomberg News analysis of securities filings of U.S. multinational companies, approximately $2.1 trillion dollars of deferred income has been accumulated offshore untaxed by the U.S., increasing at an average of eight percent yearly. As discussed above, the significant amount of deferred overseas earnings shows the twin faults of our current system: an incentive to shift money to low or no tax jurisdictions and a disincentive to bring the money back home to reinvest in jobs and wages.

To account for this untaxed, deferred income in the transition to a new international tax system, both the President's budget proposal as well as Chairman Camp's tax reform proposal would impose a one-time transition toll charge at a rate significantly lower than the statutory corporate rate. Chairman Camp’s draft provides a bifurcated rate structure with a lower tax rate on “non-cash” holdings to account for the fact that many companies have reinvested a significant part of their foreign earnings in hard, brick-and-mortar assets. In addition, both proposals allow the toll charge to be paid ratably over a number of years, provide a tax credit for foreign taxes paid and specify that certain associated one-time revenues will be used for investment in transportation infrastructure.

The co-chairs have agreed to the framework contemplated by Chairman Camp and President Obama. They continue work to design a toll charge with the appropriate discounted rate, foreign tax credit treatment and ratable transition. Additionally, they continue to examine whether a multi-tiered rate structure is appropriate to account for income already permanently reinvested overseas.

VI. MICELLANEOUS ISSUES

A. CFC Look-Through

As stated above, absent extension of the CFC look-through exception payments attributable to active foreign earnings by a CFC to a related CFC would be treated as foreign personal holding company income subject to subpart F. As expressed through the National Association of Manufacturer’s submission to the working group, these payments represent an important source of funding for U.S. manufacturers actively operating globally. This provision provides companies the ability to move cash between foreign related parties without triggering an immediate U.S. tax. Opponents of the provision argue that its effect within the current system of worldwide taxation and deferral results in the ability of multinational corporations to strip their

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global earnings out of foreign jurisdictions, resulting in “stateless income” that is never taxed in any jurisdiction.

The co-chairs contemplate that if the new international tax regime would retain the subpart F foreign personal holding company income rules in order to prevent passive investment type income from qualifying for exemption from U.S. tax, then exceptions from subpart F for CFC look-through treatment will likely continue to be a necessary, permanent part of the tax code.

B. Active Financing Exception

As said in SIFMA’s submission to the working group, the active financing exception (AFE) reflects “Congress’s recognition that: (i) the business conducted by financial services companies can be just as active as the businesses conducted by manufacturing, pharmaceutical or high-tech companies, but (ii) the principles used to distinguish active from passive income in the context of non-financial businesses don’t work for financial services businesses.” 234 The co-chairs contemplate that if the new exemption regime would largely retain the subpart F foreign personal holding company income rules in order to prevent passive investment type income from qualifying for exemption from U.S. tax, then exceptions from subpart F for active financing income will likely continue to be a necessary, permanent part of the tax code.

The co-chairs are also considering several proposed modifications to the current AFE rules submitted by stakeholders. These proposals include modifying the rules regarding related party reinsurance contracts that currently treat premiums paid between affiliates as subpart F income unless the reinsurance relates to home country risks and allowing more realistic assessment of insurance company reserves.

C. Foreign Investment in Real Property Tax Act

FIRPTA imposes U.S. tax on gain realized by a foreign investor on the disposition of a U.S. real property interest, including commercial real estate and infrastructure assets. A U.S. real property interest generally includes stock in a U.S. corporation where the majority of the corporation’s assets are U.S. real property (unless the corporation is publicly-traded and the shareholder owns 5 percent or less of the relevant shares of stock). In contrast, foreign investors in U.S. corporations that hold assets other than U.S. real property are not subject to any tax on disposition of their stock in such corporations. As a result of this disparity in treatment, foreign long-term capital is discouraged from flowing into much needed infrastructure investments.

The co-chairs agree the reforms included in the bipartisan Real Estate Investment and Jobs Act of 2015 (H.R. 2128) should be included in any international tax reform package. Specifically, reforms should:

- Increase the ownership stake that a foreign investor can take in a U.S. publicly traded REIT without triggering FIRPTA liability by increasing the FIRPTA exemption for portfolio investors in a U.S. publicly traded REIT from 5 percent to 10 percent; and

• Improve tax parity and put foreign pension funds on a level playing field with domestic pension funds by exempting foreign pension funds from FIRPTA.

D. Foreign Affiliate Reinsurance

As mentioned above, under current law, insurance companies generally may deduct premiums paid for reinsurance. While insurance income of a CFC owned by a U.S. insurance company generally is subject to current U.S. taxation, insurance income of a foreign-owned company that is not engaged in a U.S. trade or business generally is not subject to U.S. tax. Thus, according to the Administration, “Reinsurance transactions with affiliates that are not subject to U.S. Federal income tax on insurance income can result in substantial U.S. tax advantages over similar transactions with entities that are subject to tax in the United States . . . . These tax advantages create an inappropriate incentive for foreign-owned domestic insurance companies to reinsure U.S. risks with foreign affiliates.” To address this advantage, both TRA14 and the President’s FY ’16 budget placed limits on the deductibility of reinsurance premiums paid to non-taxed foreign affiliates.

Foreign-owned US insurance firms argue that foreign affiliate reinsurance is a vital tool for inter-company transfers of risk, and that proposals like TRA14 and the Administration’s would all but eliminate the offshore affiliate reinsurance market, favor domestic companies over foreign companies, cause higher prices and reduced availability of insurance for US homeowners and businesses, be a potential treaty violation, and disproportionately affect certain states and lines of business. Domestically-owned insurance firms argue that the proposed rule puts US and foreign insurance carriers on the same footing – making the rule non-discriminatory and treaty compliant. They also contend it would have no effect on market capacity because in affiliate reinsurance scenarios does not add capacity, as the risk remains in the same overall enterprise, and would have little effect on short-tailed lines of business such as catastrophe coverage in coastal markets.

The co-chairs will continue to consider both sides’ arguments moving forward.

E. Territories

The working group requested and received a briefing for its staff with regard to tax reform issues that focus primarily on Puerto Rico and the other U.S. possessions. While this report does not include any specific recommendations with respect to those issues, the co-chairs acknowledge that federal tax policy has traditionally recognized the unique relationship of Puerto Rico to the United States, as well as the important role manufacturing plays in the Puerto Rican economy. Such issues, as well as the economic impact of existing laws in Puerto Rico regarding the taxation of capital gains and dividends, will warrant specific consideration and further review when the committee moves forward with international tax reform.

F. Overseas Americans

According to working group submissions, there are currently 7.6 million American citizens living outside of the United States. Of the 347 submissions made to the international working
group, nearly three-quarters dealt with the international taxation of individuals, mainly focusing on citizenship-based taxation, the Foreign Account Tax Compliance Act (FATCA), and the Report of Foreign Bank and Financial Accounts (FBAR).

While the co-chairs were not able to produce a comprehensive plan to overhaul the taxation of individual Americans living overseas within the time-constraints placed on the working group, the co-chairs urge the Chairman and Ranking Member to carefully consider the concerns articulated in the submissions moving forward.