Legislative Update – Where Is It Going and What Does it Mean?
Agenda

Reform Approaches

Territorial Proposal

FY2013 Budget and Greenbook

Corporate Tax Reform Whitepaper

Same Country Exception Refresher in a Post §954(c)(6) World
Reform Approaches
Fundamental reform approaches

Domestic
- Lower Corporate Rate
- Territoriality
- Repatriation

International
- Base Broadeners
- Subpart F
- Mandatory Repatriation

- §199
- LIFO
- Depreciation
- Oil & Gas
- Certain Insurance items
- Carried interest
- Interest deductibility

- Expand Subpart F based on foreign tax rate
- Focus on IP
- Repatriation of prior year earnings taxed at 5.25%, 10.5%?

- 100% DRD
- 95% DRD
- Transition tax: elective or mandatory, or grandfather old E&P
- Deduction limits?

- 28%
- 25%
Territorial Proposal
Camp tax reform discussion draft

On October 26, 2011, Chairman Dave Camp (R-Mich.) of the Ways and Means Committee (the “Committee”) released a discussion draft of the Tax Reform Act of 2011, a bill that would reduce the top corporate rate to 25% and dramatically rewrite the rules for taxing the foreign income of U.S. multinationals (the “discussion draft”)

• The discussion draft was accompanied by a technical explanation of its provisions

• The discussion draft reserves space for additional tax reform proposals related to individuals and to corporate tax generally, including presumably provisions that expand the business tax base

• No revenue estimate was released along with the discussion draft
<table>
<thead>
<tr>
<th>Proposal</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>95% DRD</td>
<td>• Generally provides U.S. corporate shareholders a 95% DRD for foreign source dividends received from CFCs</td>
</tr>
<tr>
<td></td>
<td>• Foreign branches and electing 10/50 companies deemed CFCs</td>
</tr>
<tr>
<td></td>
<td>• Generally, 1.25% U.S. rate on qualifying dividends</td>
</tr>
<tr>
<td></td>
<td>• (Stock gains also 95% exempt in certain cases)</td>
</tr>
<tr>
<td>FTC</td>
<td>• §§902 and 909 repealed</td>
</tr>
<tr>
<td></td>
<td>• §960 retained in modified form (single §904 basket; modified deductions)</td>
</tr>
<tr>
<td>Subpart F</td>
<td>• Retains and expands existing rules.</td>
</tr>
<tr>
<td></td>
<td>• §§956, 959 and 961 repealed</td>
</tr>
<tr>
<td></td>
<td>• Repatriated subpart F income generally subject to 26.25% U.S. rate</td>
</tr>
<tr>
<td>Interest Deductions</td>
<td>• Corporate U.S. shareholders of a WW affiliated group must reduce interest deductions by the lesser of haircuts imposed by either: (i) relative leverage test or (ii) percentage-of-adjusted-taxable-income test.</td>
</tr>
<tr>
<td>Transition</td>
<td>• Accumulated deferred income treated as subpart F income of CFCs and 10/50s last TY of CFCs &amp; 10/50s ending before 2013</td>
</tr>
<tr>
<td></td>
<td>• 85% DRD, but remaining 15% can be sheltered by NOLs/excess FTCs</td>
</tr>
</tbody>
</table>
FY2013 Budget and Greenbook
FY2013 Budget and Treasury Greenbook

- On February 13, 2012, the Obama Administration released its FY2013 Budget

- Same day the Treasury Department released the General Explanations of the Administration’s Fiscal Year 2013 Revenue Proposals (the “Greenbook”)

- Contains all the international tax proposals from the FY2012 Budget (“carryover proposals”)

- Includes four new international tax proposals

- Includes extenders for §§954(c)(6) (CFC look-through) and 954(h) (active financing exception) through December 31, 2013
## FY2013/2012 budget comparison (in billions)

<table>
<thead>
<tr>
<th>Carryover Proposals</th>
<th>FY2013</th>
<th>FY2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defer interest deductions</td>
<td>37.3</td>
<td>37.7</td>
</tr>
<tr>
<td>Super pooling</td>
<td>60.8</td>
<td>51.4</td>
</tr>
<tr>
<td>“Excess Returns” with transfers of intangibles</td>
<td>23.0</td>
<td>20.8</td>
</tr>
<tr>
<td>Redefine intangible property for §§367(d) and 482</td>
<td>1.6</td>
<td>1.7</td>
</tr>
<tr>
<td>Modify dual capacity taxpayer rules</td>
<td>2.4</td>
<td>2.6</td>
</tr>
<tr>
<td>Disallow certain reinsurance premiums paid to affiliates</td>
<td>4.4</td>
<td>4.2</td>
</tr>
<tr>
<td>Limit earning stripping by expatriated entities</td>
<td>10.7</td>
<td>10.8</td>
</tr>
<tr>
<td>Repeal Boot-within-Gain**</td>
<td>0.9</td>
<td>0.8</td>
</tr>
<tr>
<td><strong>Carryover proposals total</strong></td>
<td><strong>141.1</strong></td>
<td><strong>130.0</strong></td>
</tr>
</tbody>
</table>

** Not listed as an international tax reform item
## FY2013/2012 budget comparison (in billions)

<table>
<thead>
<tr>
<th>New Proposals</th>
<th>FY2013</th>
<th>FY2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax gain from sale of partnership interest on look-through basis</td>
<td>2.6</td>
<td>N/A</td>
</tr>
<tr>
<td>Prevent use of leveraged distributions from related foreign corporations to avoid dividend treatment</td>
<td>3.3</td>
<td>N/A</td>
</tr>
<tr>
<td>Extend §338(h)(16) to certain asset acquisitions</td>
<td>1.0</td>
<td>N/A</td>
</tr>
<tr>
<td>Remove foreign taxes from §902 corporation’s foreign tax pool when earnings are eliminated</td>
<td>0.4</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>New proposals total</strong></td>
<td>7.3</td>
<td>0.0</td>
</tr>
<tr>
<td><strong>Total for all international proposals</strong></td>
<td>148.4</td>
<td>130.0</td>
</tr>
</tbody>
</table>
## New proposals

<table>
<thead>
<tr>
<th>New Proposal</th>
<th>Description</th>
</tr>
</thead>
</table>
| **Tax Gain from the Sale of Partnership Interest on Look-through Basis** | • Codify Rev. Rul. 91-32 and impose FIRPTA-type withholding  
• Transferee subject to withhold 10% of amount realized (certification exceptions)  
• Failure to withhold causes partnership to be subject to withholding on future distributions to transferee partner  
• Effective for sales or exchanges after December 31, 2012 |
| **Prevent Use of Leveraged Distributions from Related Foreign Corporations to Avoid Dividend Treatment** | Prevents leveraged return of basis transactions by not taking into account the U.S. shareholder’s basis in the foreign distribution corporation if:  
• A foreign corporation funds (“funding corporation”) a related foreign corporation (“foreign distributing corporation”) and  
• There is a principal purpose to avoid dividend treatment on a distribution by the foreign distributing corporation  
• Effective for distributions after December 31, 2012 |
## New proposals (cont’d)

<table>
<thead>
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</table>
| **Extended §338(h)(16) to Certain Asset Acquisitions** | • Extends the application of §338(h)(16) to any covered asset acquisition (“CAA”) under §901(m)  
• Effective for CAAs occurring after December 31, 2012 |
| **Remove Foreign Taxes from §902 Corporation’s Tax Pool When Earning Eliminated** | • In the event of a transaction that results in the elimination of a foreign corporation’s E&P by reason of a dividend, deemed dividend, or §381 transition, the foreign corporations tax pool would be reduced equal to the foreign taxes associated with the eliminated E&P from the transaction  
• Examples include §312(n)(7) and certain §355 distributions via §312(h)  
• Effective for transactions occurring after December 31, 2012 |
Administration’s Business Tax Reform Whitepaper
## Business Tax Reform Whitepaper

<table>
<thead>
<tr>
<th>Item</th>
<th>Description</th>
</tr>
</thead>
</table>
| **Top Corporate Rate** | - 28%  
- 25% ETR for domestic manufacturing (10.7% §199; higher for advanced manufacturing)                                                     |
| **Base Broadeners**  | **Targeted offsets:**  
- Repeal LIFO  
- Repeal tax preferences for fossil fuels  
- Tighten §264 rules for corporate-owned life insurance; enact other unspecified revenue-raising proposals (presumably from FY2013 budget package) aimed at insurance companies and products  
- Tax carried interest income as ordinary  
- Increase depreciation recovery period for corporate-owned aircraft  
**Broad-based proposals**  
- Move current depreciation schedules toward straight line  
- Reduce deductibility of interest  
- Increase parity in tax treatment of large corporate and large noncorporate entities |
### Business Tax Reform Whitepaper (cont’d)

<table>
<thead>
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</table>
| **New Incentives** | • Reform existing §199 deduction and increase it to 10.7% (from 9%)  
• Make R&D credit permanent; increase simplified credit to 17%  
• Make tax credit for production of renewable electricity permanent and refundable  
• Make bonus depreciation permanent for small businesses (100% expensing of qualified expenses up to $1 million); increase threshold for small businesses to use cash method of accounting to $10 million in gross assets (from $5 million) |
| **International Proposals** | • Retain worldwide system and significantly limit deferral  
• Establish minimum tax – rate unspecified – for offshore income earned by U.S. subsidiaries; allow FTC for applicable income taxes paid to host country  
• Eliminate deduction for expenses related to moving operations offshore; provide 20% credit for expenses related to returning operations to the United States  
• Tax CFC earnings attributable to IP purchased from or jointly developed with a domestic affiliate  
• Defer interest deductions attributed to deferred CFC earnings until the earnings are repatriated |
Overview of Same Country Exception
Same Country Exception—General Requirements

• Excludes from foreign personal holding company income ("FPHCI") certain dividend, interest, rents and royalties that a CFC receives from a related person.

• Related Person is defined under IRC § 954(d)(3)
  – Includes a corporation that controls the CFC, is controlled by the CFC, or that is controlled by the same persons as the CFC.
  – Control means either: ownership of more than 50% of either the total voting power of all classes of stock entitled to vote, or the total value of stock of a corporation.
  – Rules “similar to” those of IRC § 958 apply.
## Same Country Exception—General Requirements

<table>
<thead>
<tr>
<th>Income</th>
<th>Requirements</th>
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<tbody>
<tr>
<td><strong>Interest</strong></td>
<td>• Interest received from related corporation “created or organized” under the laws of the same foreign corporation as recipient</td>
</tr>
<tr>
<td></td>
<td>• Payor meets substantial assets test</td>
</tr>
<tr>
<td></td>
<td>• Interest cannot reduce payor’s “subpart F income” or create (or increase) deficit that reduces subpart F income of payor or related CFC</td>
</tr>
<tr>
<td><strong>Dividends</strong></td>
<td>• Dividend received from related corporation “created or organized” under the laws of the same foreign corporation as recipient</td>
</tr>
<tr>
<td></td>
<td>• Payor meets substantial assets test (1) at time dividend paid (Code) and (2) at time earnings earned (Regulation)</td>
</tr>
<tr>
<td></td>
<td>• Payor and payee were in same chain when earnings earned</td>
</tr>
<tr>
<td><strong>Rents &amp; Royalties</strong></td>
<td>• Rents or royalties received from related corporation for the use of, or the privilege of using, property in the foreign country under which the recipient CFC is “created or organized”</td>
</tr>
</tbody>
</table>
“Created or Organized”
“Created or Organized”

• The CFC that earns the dividend/interest/rent/royalty income must be "created or organized under the laws of" the relevant foreign country.

• In the case of dividends and interest, the payor must also be "created or organized under the laws of" that jurisdiction.

• There is no requirement that the CFC be **taxable** in that country.
  - Strictly a place of “creation or organization” test.

• What does it mean to be "created or organized" in a particular country?
  - Reverse hybrid partnerships
  - Dual resident companies
Does Not Reduce Adjusted Gross Foreign Base Company Income
Same Country Exception—Not Available if Payor’s Adjusted Gross Foreign Base Company Income Reduced

- FC1 uses a majority of its assets in an active Country X trade or business
- FC1 pays deductible interest to FC2 that reduces Adjusted Gross Foreign Base Company Income (“AG FBCI”) as defined in Treas. Reg. §1.954-1(a)(3)
- Per Treas. Reg. §1.954-2(b)(4)(ii)(B)(1), FC2’s interest income is not eligible for the same country exception
Reduction in AG FBCI – High Tax Exception

- FC1 uses a majority of its assets in an active Country X trade or business
- FC1’s only income is $1,000,000 of Foreign Base Company Sales Income, which is subject to a foreign effective tax rate of 32% (as computed under Treas. Reg. §1.954-1(d))
- FC1 pays $25,000 interest to FC2

Is FC2’s interest income eligible for the same country exception?

No, not eligible. High tax exception is applied in computing Adjusted Net Foreign Base Company Income in Treas. Reg. §1.954-1(a)(5). All of FC1’s income is AG FBCI and thus the interest expense reduced AG FBCI
Substantial Asset Test
Substantial Assets Test

• Payor has more than 50% of its assets used in a trade or business and the assets are located in such country (Reg. §1.954-2(b)(4))
  – Average is computed based on assets held at the end of each quarter of the taxable year
  – Asset values are assumed to equal tax basis unless there is affirmative evidence otherwise
  – All assets counted in denominator—loan generally “bad” asset b/c not business asset
    ➢ For example, receivables are only trade or business property if: dealer property, inventory or arise from the sale of goods or rendition of services in the ordinary course
  – Characterization of intangibles—based upon where expenses incurred
  – Look-through for stock, but only if subsidiary incorporated in same country
    ➢ The value of stock is the actual FMV, but the characterization is look-through
• FC2 has an active trade or business in Country X where it is created.

• FC2 lent surplus cash to FC3 and earns income eligible for same country exception

• FC3 also has an active trade or business in Country X, and pays interest to FC2

• However, because less than 50% of FC2’s assets are used in its Country X business, none of the interest it pays to FC1 qualifies for same country exception
Substantial Assets—Stock

- FC3 has an active business in Country X as well as an active business in Country Y
- FC3 stock, FMV $1,600, is treated as $800 used in a trade or business in Country X because 50% of the assets in FC3 are used in a trade or business in Country X
- Note that if FC3 were organized in Country Y, none of the stock would be treated as used in a Country X business
- See Reg. §1.954-2(b)(4)(x)
Dividends
Same Country Exception—Dividends

• Dividends have the same requirements as for interest
  – Payor and CFC are related persons
  – Payor has substantial assets used in a trade or business in such country
  – Payor and CFC are created or organized under the laws of the same country

• Dividends have two additional requirements:
  – Dividend must be attributable to earnings (i) that accumulated while the CFC held the stock of the payor either directly or indirectly (through a chain of ownership) and (ii) the substantial assets test was met when the earnings were earned.

  ➢ Statute requires test to be met when dividend is paid, but regulation also requires test to be met when earnings earned (Reg. §1.954-2(b)(4)(ii))
Same Chain—Dividend Example 1

- FC3 earned E&P when held directly by USCo
- USCo contributes FC3 to FC1, which contributes FC3 to FC2
- FC3 pays a dividend to FC2
- Assume that all CFCs always met the substantial assets test
- Dividend not eligible for same country because E&P was not earned when E&P was in the chain
IRC § 304 treats cash as a dividend to FCX1 first from FCX3, then from FCX2.

Assume all three CFCs meet the substantial assets test.

The portion of the dividend from FCX3 cannot meet the stock ownership requirement of the Same Country Exception.

The portion of the dividend from FCX2 should meet this requirement.
Rents and Royalties
Same Country Exception—Rents & Royalties

• Rent and Royalty
  – Payor and CFC are related persons
  – CFC receives rent or royalty for the right to use property in its country of creation or organization.
  – Rent or royalty deduction cannot reduce the Subpart F income of payor.

• NOTE: Relaxed requirements on payor:
  – No substantial assets test
  – No requirement relating to the Payor of the rent or royalty (could even be a US corporation)
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