International Tax Developments:
Keeping up with critical changes in policy

Panel discussion
Panel Members

- Steve Towers (Deloitte) (moderator)
- Robert Lider (JP Morgan Chase)
- Lim Lee Ching (Sony)
- Liza Zheng (Procter & Gamble)
- Michael Velten (Deloitte)

Note: The comments made by Robert Lider, Lim Lee Ching and Lisa Zheng reflect their personal views and are not necessarily the views of their organizations.
Discussion Topics

• “Permanent Establishment” definition
  – Draft amendments to the OECD Commentary on Art. 5
  – Recent cases

• US Outbound taxation reform
  – President Obama’s proposals
  – Camp proposals

• Intangibles and Risk
  – OECD’s Intangibles project
  – UN Transfer Pricing Manual

• Base Erosion and Profit Shifting (BEPS)
  – OECD’s BEPS initiative
“Permanent Establishment” definition
### Proposed changes to OECD Commentary: 2012 Draft

<table>
<thead>
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<th>Topics covered:</th>
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<tbody>
<tr>
<td>Can a farm be a permanent establishment (PE)?</td>
<td>Does a development property constitute a PE?</td>
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<td><strong>Meaning of “at the disposal of”</strong></td>
<td>Do “goods or merchandise” cover digital products or data?</td>
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<td>Can the premises of a (converted) local entity constitute a permanent establishment?</td>
<td>Carrying on various activities listed alternatively in subparagraphs 4 a) and b)</td>
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<tr>
<td>Home office as a PE</td>
<td>Negotiation of import contracts as an activity of a preparatory or auxiliary nature</td>
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<td>Shops on ships operated in international traffic</td>
<td>Fragmentation of activities</td>
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<td>Time requirement for the existence of a permanent establishment</td>
<td><strong>Meaning of “to conclude contracts in the name of the enterprise”</strong></td>
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<tr>
<td>Presence of foreign enterprise’s personnel in the host country</td>
<td>Is paragraph 5 restricted to situations where sales are concluded?</td>
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<td>Main contractor who subcontracts all aspects of a contract</td>
<td><strong>Does paragraph 6 apply only to agents who do not conclude contracts in the name of?</strong></td>
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<td>Application of paragraph 3 to joint venture and partnership activities</td>
<td><strong>Assumption of entrepreneurial risk as a factor indicating independence</strong></td>
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<td>Meaning of “place of management”</td>
<td><strong>Activities of fund managers</strong></td>
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<td>Additional work on a construction site</td>
<td><strong>Clarification of paragraph 8 of the Commentary on Article 5</strong></td>
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<tr>
<td>Must the activities referred to in paragraph 4 be of a preparatory or auxiliary nature?</td>
<td><strong>Activities of insurance agents</strong></td>
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<td>Relationship between delivery and the sale of goods in subparagraph 4 a)</td>
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What does “at the disposal” mean? (under 2012 Draft)

Principles

- **Effective power to use** the location
- **Extent of the presence** of the enterprise at that location
- **Activities that the enterprise performs** at the location

Examples (additional)

<table>
<thead>
<tr>
<th>No.</th>
<th>Nature of example</th>
<th>“At the disposal” of enterprise?</th>
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<tbody>
<tr>
<td>A</td>
<td>Enterprise has <em>exclusive legal right</em> to use location which is <em>used only for carrying on that enterprise’s</em> own business activities</td>
<td>Yes</td>
</tr>
<tr>
<td>B</td>
<td>Enterprise is <em>allowed to use</em> a specific location that <em>belongs to another enterprise</em> (or that is used by a number of enterprises) and <em>performs its business activities</em> at that location on a <em>continuous</em> basis during an <em>extended period</em> of time</td>
<td>Yes</td>
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What does “at the disposal” mean? (under 2012 Draft) (cont’d)

<table>
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<th>No.</th>
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<th>“At the disposal” of enterprise?</th>
</tr>
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<tr>
<td>C</td>
<td>Enterprise's presence at a location is so <em>intermittent or incidental</em> that the location cannot be considered a place of business of the enterprise (e.g., where employees of an enterprise have <em>access</em> to the premises of associated enterprises which they <em>often visit</em> but <em>without</em> working in these premises for <em>an extended period of time</em>)</td>
<td>No</td>
</tr>
<tr>
<td>D</td>
<td>Enterprise <em>does not have a right to be present at a location and, in fact, does not use that location itself</em>. For example, it cannot be considered that a plant that is owned and used exclusively by a <em>supplier</em> or <em>contract-manufacturer</em> is at the disposal of an enterprise that will receive the goods produced at that plant merely because all these goods will be used in the business of the enterprise</td>
<td>No</td>
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Recent cases

Supporting “orthodox” view

• **Boston Scientific** (Italy) : “stripped” supply chain (physical goods)
• **eBay** (India) : on-line auction platform
• **Right Florists** (India) : advertising fees paid to Google Ireland and Yahoo U.S.

Challenging “orthodox” view

• **Roche** (Spain) : “stripped” supply chain (physical goods)
• **Dell** (Spain) : “stripped” supply chain (physical goods) / website
Unresolved technical issues (selected)

- Secondment of employees: in what circumstances will an Art. 5(1) PE or Art. 5(3)(b) PE arise?
- Toll manufacturing / warehousing services:
  - Art. 5(4): exceptions
  - Art. 5(1): “at the disposal” condition
- VAT registration: will an Art. 5 PE be created?
- Contract-concluding agency PE:
  - “Binding” condition in Art. 5(5): legally or commercially “binding”? 
- Circumstances in which a PE can be created by actions of a non-contract concluding dependent agent:
  - Relationship between Art. 5(5) & 5(6)
  - Art. 5(1): “a fixed place of business through which the business of an enterprise is wholly or partly carried on”
“Permanent Establishment” definition

• Unresolved technical issues
• Significant PE issues and challenges in Asia
• Management of PE risks
• Practical guidelines?
US Outbound taxation reform
US Outbound taxation reform

- President Obama’s proposals for changing the US outbound international tax rules
- Camp proposals for US outbound international tax
- Likelihood that any of these proposals will be implemented
Intangibles and Risk
OECD’s Intangibles project

**Key dates**

**Nov. 2011**  Public consultation on the OECD’s intangibles project

**6 June 2012**  Discussion draft on revisions to Chapter VI of the OECD’s Transfer Pricing Guidelines (“TPG”) released for public comments

**23 Nov. 2012**  OECD organized a meeting with the commentators on the Discussion Draft

• OECD is due to issue revised draft Chapter VI in 2013
Draft Chapter VI : Meaning of “intangibles”

• Legal and accounting meanings not used

• Thus, wider than “intellectual property” which is legally recognised and protected

• Instead, the OECD uses the phrase:

  “something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities”

• Inclusions (examples) : patents, know-how and trade secrets, trademarks, trade names, brands, licences and similar limited rights in intangibles, goodwill and ongoing concern

• Exclusions (examples) : group synergies, market specific characteristics, assembled workforce
Draft Chapter VI : “Intangible related returns”

• To refer to the connection between an intangible and a company, the OECD does not use the term, “economic ownership”. Instead, it uses the term, “intangible related returns” (IRR) – ie is the company entitled to IRR in regard to an intangible?

• To determine whether a company is entitled to IRR in regard to an intangible, you consider these factors:

  i. Legal ownership

  ii. Economic substance – ie which party has contributed the following in regard to the development, enhancement, maintenance and protection of the intangible:

    – Control of functions and risks
    – Use of assets
    – Costs incurred

  iii. Whether services rendered by related parties (ie services in connection with the development, enhancement, maintenance and protection of the intangible) have been compensated on an arm’s length basis
Draft Chapter VI : “Intangible related returns” (cont’d)

• Legal ownership and / or incurring of costs, without more : no qualification for IRR

• Critical requirement for IRR is “control of functions and risk”
UN Transfer Pricing Manual

- UN Practical Manual on Transfer Pricing for Developing Countries was drafted by the UN’s sub-committee on Transfer Pricing – Practical Issues, and adopted by the UN in October 2012
- 24 current and past members of the sub-committee contributed to the writing, of whom 14 were drawn from the OECD or OECD member countries, and 10 were drawn from non-OECD member countries
- Over 300 pages
- Based on the arm’s length standard which is reflected in Article 9 of the UN Model treaty
  - No views given on other possible pricing standards (e.g., formulary apportionment)
  - Consistency with the OECD TPG has been sought
Contents of the Manual

- Foreword
- Chapter 1: Introduction
- Chapter 2: The Business Environment
- Chapter 3: The Legal Environment
- Chapter 4: Building Capability
- Chapter 5: Comparability
- Chapter 6: Methods
- Chapter 7: Documentation
- Chapter 8: Audits
- Chapter 9: Dispute Resolution
- Chapter 10: Country practices
  - Preamble, Brazil, China, India, South Africa
- Appendix I: Comparability examples
- Appendix II: Documentation

Key chapters: Chapter 5 and Chapter 10
Location Specific Advantages (LSAs) : Chapter 5

• Net location savings + Other location-specific benefits = LSAs

• Net location savings =

  Location savings  ———  Location dis-savings

  [Examples :
  - Labour costs
  - Raw material costs
  - Transportation cost
  - Rent
  - Training cost
  - Subsidies
  - Incentives (including tax incentives)
  - Infrastructure costs

  [Examples :
  - Low productivity
  - Power supply reliability
  - Poor quality control
  - Poor infrastructure]
Location Specific Advantages (LSAs) : Chapter 5 (cont’d)

• Other location-specific benefits:
  – Highly specialised skilled manpower and knowledge
  – Proximity to growing local / regional market
  – Large customer base with increased spending capacity
  – Advanced infrastructure (eg information / communication networks, distribution system)
  – Market premium

• The incremental profit, if any, derived from the exploitation of LSAs is called “location rent”

• Two key issues with location rent:
  1. Do LSAs lead to location rents?
  2. If location rents exist, what impact should they have on the application of the arm’s length principle?
Intangibles and Risk

• “Intangible related returns” : application to a distributor in regard to marketing intangibles which it does not legally own
  – LG Electronics case (India)

• Location specific advantages : India and China

• Control of risk : recent Indian circular regarding contract R&D

• Proposed treatment of intangibles in US outbound tax reform
Base Erosion and Profit Shifting (BEPS)
Introduction

• Context
  – Global financial crisis
  – Fiscal crisis in many countries (individual income taxes and consumption taxes raised)
  – Corporate social responsibility
  – Naming and shaming

• Perceived problems
  – Very low effective tax rates of MNCs, including double non-taxation
  – Uneven playing field
  – Investment decisions distorted, harming economic growth
  – Risk to general voluntary compliance

• Where will the BEPS initiative end up?
## Base Erosion and Profit Shifting (BEPS)
### June to October 2012

<table>
<thead>
<tr>
<th>Period</th>
<th>OECD</th>
<th>UN</th>
<th>G20</th>
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<tr>
<td>June to September 2012</td>
<td>Discussion Draft: <em>Revision of the Special Considerations for Intangibles</em> …</td>
<td>The <strong>OECD base erosion and profit shifting project</strong> is looking at whether and why MNEs taxable profits are being allocated to locations different from those where the actual business activity takes place.</td>
<td>“We reiterate the need to prevent base erosion and profit shifting and we will follow with attention the ongoing work of the OECD in this area.”</td>
</tr>
<tr>
<td>October 2012</td>
<td>• Adopted: <em>Practical Manual on Transfer Pricing for Developing Countries</em></td>
<td>• Manual includes India and China position: existing application of current transfer pricing rules does not leave an adequate level of taxable profits in developing countries</td>
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## Base Erosion and Profit Shifting (BEPS)
Since November 2012

**November 2012 to January 2013**

**OECD**
- The OECD base erosion and profit shifting project …

**G20**
- “We welcome the work that the OECD is undertaking into the problem of base erosion and profit shifting and look forward to a report about progress of the work at our next meeting.”
- “We welcome the OECD report on addressing base erosion and profit shifting and acknowledge that an important part of fiscal sustainability is securing our revenue bases. We are determined to develop measures to address base erosion and profit shifting, take necessary collective actions ….”

**Countries (including BRICS)**
- **UK**: Google, Amazon, and Starbucks structures questioned in Parliament.
- **Germany and UK**: called on G20 to back the OECD’s work on BEPS. “Britain and Germany back the OECD – BEPS (tax base erosion and profit shifting) initiative of the OECD ….”
- **BRICS**: We commit to prevent the base erosion and profit shifting through cooperation amongst ourselves and with other countries.
- **Australia**: “Governments are constantly moving to close the loopholes and rorts that enterprises exploit to shift profits, but there are other countries whose tax arrangements are so concessional that they are simply havens for the world’s serial tax avoiders and aggressive tax minimizers.”

**February 2013**

**OECD**
- Report issued: Addressing Base Erosion and Profit Shifting
The OECD’s BEPS work plan

- **June 2013: OECD Committee on Fiscal Affairs Meeting** to discuss and approve plan
- **July 2013: G20 Meeting** to consider and endorse plan
- **Comprehensive action plan (actions, deadlines, resources, methodology...)**
  - Measures that governments can agree on
  - If treaty changes required, solutions for quick implementation to be examined and proposed (officially sanctioned and coordinated “treaty override”?)
  - Improvements to eliminate double taxation to be kept in mind, e.g., increased efficiency of mutual agreement procedures and arbitration provisions
## Action plan specifically to address pressure points identified by OECD

<table>
<thead>
<tr>
<th>Source countries’ jurisdiction to tax</th>
<th>Transfer pricing</th>
<th>Intra-group financial transactions</th>
<th>Hybrids</th>
<th>Anti-avoidance measures</th>
<th>Harmful regimes</th>
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<tr>
<td>• Updated solutions to the issues related to jurisdiction to tax, in particular in the areas of digital goods and services. May include revision of treaty provisions</td>
<td>• Improvements or clarifications to address specific areas where the current rules produce undesirable results from a policy perspective, in particular intangibles</td>
<td>• Rules on the treatment of intra-group financial transactions, e.g., deductibility of payments and the application of withholding taxes</td>
<td>• Instruments to put an end or neutralise the effects of hybrid mismatch arrangements and arbitrage</td>
<td>• More effective anti-avoidance measures, as a complement to the previous items, including general anti-avoidance rules, controlled foreign companies rules, limitation of benefits rules and other anti-treaty abuse provisions</td>
<td>• Solutions to counter harmful regimes more effectively, taking into account also factors such as transparency and substance</td>
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Will the BRICS countries accept it?

- The G20 (Chair in 2013: Russia) includes all of the BRICS countries
- BRICS countries well represented on all relevant OECD bodies
- BRICS countries emphasized their commitment to prevent base erosion and profit shifting
- BRICS countries support OECD plan and process, but have reserved their respective positions in relation to the outcome

"We commit to prevent the base erosion and profit shifting through cooperation amongst ourselves and with other countries."

"[We agree to] contribute to development of International Standards on International Taxation and Transfer Pricing taking into account the aspirations of developing countries in general and BRICS Countries in particular."

Communiqué of BRICS Heads of Revenue Meeting issued in New Delhi on 18 January, 2013

"China...has unique economic and geographic factors...using some practical solutions that are sensitive to unique economic and geographic factors for companies operating in China...such as location savings, market premium, and alternative methods of analysis..."

UN TP Manual: Chapter 10.2 China Country Practices

"...‘location savings’...should be one of the major aspects to be considered...Most of these R&D centres in India were actually found to be engaged in creation of unique intangibles."

UN TP Manual: Chapter 10.3 Emerging Transfer Pricing Challenges in India
Base Erosion and Profit Shifting (BEPS)

- Public and political focus on tax planning by multinationals
- Approach to BEPS
- “Source countries’ jurisdiction to tax” : what will happen?
- “Transfer pricing” : what will happen?
Q & A
Appendix : Proposed U.S. Corporate Tax Reform
Proposed U.S. Corporate Tax Reform

Robert Lider
Executive Director and
Regional Tax Counsel for Treasury and Securities Services
JPMorgan Chase
The Political Landscape for Potential U.S. Corporate Tax Reform

• **Reduction of the U.S. Corporate Effective Tax Rate:**
  
  – One issue on which Republicans and Democrats agree is the need to reduce the corporate tax rate. The top rate of 35%, when combined with the average state and local levies of 4.1%, produces an effective corporate tax rate of 39.1%.

  – This is the highest corporate tax rate amongst advanced economies. It’s 11% higher than the weighted statutory rate in OECD countries (27.89%) and almost 7% higher than the G-7 countries’ weighted statutory rate.

• **Base Broadening Measures:**
  
  – There is also general agreement among Republicans and Democrats to achieve corporate tax rate reduction through the adoption of “base broadening measures that would limit or repeal deductions, exclusions, credits or preferences in the current tax code.”
The Political Landscape for Potential U.S. Corporate Tax Reform (Cont’d)

• Reform of the U.S. International Tax System
  – Finally, both Republicans and Democrats agree that there should be significant tax reform of the U.S. international tax system

• Is U.S. Corporate Tax Reform Achievable?:
  – The crux of the issue is the political divide between Republicans and Democrats on the guiding principles and objectives of U.S corporate tax reform.

• Republicans’ Approach to U.S. Tax Reform: Guiding Principles and Objectives:
  – Tax reform must be revenue neutral.
  – The top corporate tax rate should be reduced from 35% to 25%.
  – Base broadening measures (i.e., anti-base erosion) should be adopted to fund the corporate tax rate cut.
Republicans’ Approach to U.S. International Tax Reform: Guiding Principles and Objectives

- **Reduce the current worldwide tax system with a territorial based tax system**
  - The rationale here is to strengthen the competitiveness of the U.S. tax companies in the global market place. The U.S. remains the only large developed country with a worldwide tax system. All other G-7 countries and 28 of 34 OECD countries use territorial tax systems in which all or portion of foreign dividends are exempt from domestic taxation.
  - There is recognition that the current U.S. international tax system “imposes a substantial tax barrier to repatriation of foreign earnings back for use in the U.S. economy. Currently U.S. MNCs have over $1.4 trillion in un-taxed foreign earnings that they are reluctant to repatriate because of the 35% tax rate on those deferred foreign earnings.
  - House Ways and Means Committee Chairman Dave Camp (R – Michigan) released a draft legislative proposal on 10/11/11 detailing tax reform proposals to the U.S. international tax system.

- Democrats’ Approach to U.S. Tax Reform: Guiding Principals and Objectives:
  - Senate Finance Committee Chairman Max Baucus (D - Montana) has yet to introduce a detailed legislative proposal for U.S. tax reform.
  - However, the Obama Administration has released two important documents in which it sets forth its guiding principles and objectives for U.S. tax reform.

- “President’s Framework for Business Tax Reform” (a joint report by the White House and the Treasury Department, released February, 2012).

- Five proposed elements of business tax reform are set forth:
  - First, eliminate dozens of business tax loopholes and subsidies, broaden the tax base and cut the corporate tax rate to spur growth in the U.S.
  - Elimination of corporate loopholes include: “last in first out (LIFO) accounting, which is viewed as artificially lowering the corporate tax rate; oil and gas preferences (expensing of intangible drilling costs and percentage depletion for oil and gas wells).
Democrats’ Approach to U.S. Tax Reform: Obama Administration’s and U.S. Treasury’s Proposed Tax Reform Plan (Cont’d)

• Reform treatment of insurance industry and products: Here, the perceived tax shelter abuse under current rules that allow companies to invest in life insurance for their officers, directors, or employees and benefit from the inside build up (gains on the investments) that are tax-deferred or never taxed while financing the investment through debt that allows corporations to take interest deductions.

• Tax carried interest as ordinary income. This is the so-called hedge fund manager tax abuse that allows them to pay tax at a 15% rate on labor income.

• Eliminate special depreciation rules for purchases of corporate aircraft.

• Address accelerated depreciation schedules as these are viewed as a less effective way to increase investment and job creation than reducing tax rates.

• Reduce the bias towards debt financing by reducing the deductibility of interest deductions. This also could finance lower corporate tax rates.
Democrats’ Approach to U.S. Tax Reform: Obama Administration’s and U.S. Treasury’s Proposed Tax Reform Plan (Cont’d)

• Second, strengthen American manufacturing and innovation:
  – Effectively cut the corporate tax rate on manufacturing income to 25% and to even a lower rate for advanced manufacturing activities by reforming the domestic production activities deduction (e.g., expand the deduction to 10.7%).
  – Expand, simplify and make permanent the R&D tax credit. The new R&D tax credit would be simplified and increased to 17%.
  – Extend, consolidate and enhance key tax incentives to encourage investment in clean energy. A permanent tax credit for the production of renewable energy would be provided. This tax credit would promote the development of clean renewable energy technologies such as wind and solar.
Democrats’ Approach to U.S. Tax Reform: Obama Administration’s and U.S. Treasury’s Proposed Tax Reform Plan (Cont’d)

• Third, strengthen the international tax system to encourage domestic investment – Background:

  - Under current deferral rules, many U.S. companies reinvest, rather than repatriate and pay U.S. tax on foreign earnings. Even though the U.S. has adopted a worldwide tax system, “opportunities for deferral can effectively make [the U.S. tax system] closer to a territorial system because U.S. taxes may never be paid on foreign income.

  - Deferral encourages U.S. companies to reduce overall taxes paid by shifting profits to low-tax jurisdictions, either by moving operations or jobs there or by relying on accounting methods or transfer pricing to shift profits there. This contributes to inefficient over investment abroad and under investment in the U.S. It also erodes the U.S. tax base.

  - The Obama administration rejects a pure territorial tax system as it would further erode the U.S. tax base as well as provide even greater incentives to locate operations abroad or use accounting methods to shift profits out of the U.S.
Democrats’ Approach to International Tax Reform: The Obama Administration’s and U.S. Treasury’s Proposals

• Proposed Framework to protect the U.S. tax base and strengthen the international tax system:
  – Require companies to pay a minimum tax on overseas profits. Foreign income deferred in a low tax jurisdiction would be subject to immediate U.S. tax up to the minimum tax rate with a foreign tax credit allowed on income taxes paid to the host country.
  – Remove the tax deductions for moving production overseas and provide incentives for bringing production back to the U.S. (e.g., a 20% income tax credit).
  – Reduce incentives to shift income and assets overseas. Here, the target is the transfer of intangibles to low tax countries. Excess profits associated with such transfer would be taxed currently. New international tax rules would also require the deduction for interest expense attributable to overseas investment be delayed until the related income is taxed in the U.S.
Democrats’ Approach to International Tax Reform: The Obama Administration’s and U.S. Treasury’s Tax Reform Plan

• **Fourth, simplify and cut taxes for U.S. small business:**
  • Tax reform should make take filing simpler for small business and entrepreneurs. Tax code complexity would be reduced by the following tax reforms:
    • Allow small businesses to expense up to $1 million in qualified investments.
    • Allow cash accounting in businesses with up to $10 million in gross receipts. This would be easier for small business than accrual accounting, which requires business to immediately recognize their future cash receipts and costs for income tax purposes.
    • Double the deduction for start-up costs for entrepreneurs from $5000 to $10,000 as well as simplifying accounting for small business.

• **Fifth, restore fiscal responsibility:**
  • Business tax reform should be fully paid for and be more fiscally responsible. Temporary business tax provisions that are continually extended and deficit financed would either be eliminated or if continued and made permanent such as the R&D credit, would be fully paid for within business tax reform.
Obama Administration’s Tax Reform Proposals in its FY 2014 Budget

• On April 10, 2013, the Obama administration transmitted to U.S. Congress its spending and revenue recommendations for the 2014 fiscal year, beginning October 1, 2013.

• The FY 2014 Budget proposes a revenue neutral framework containing five elements similar to those proposed in the joint report issued by the White House and the Treasury Department:
  – First, eliminate loopholes and subsidies, broaden the base and cut the corporate tax rates:
  – Second, strengthen domestic manufacturing and innovation;
  – Third, strengthen the international tax system;
  – Fourth, Simplify and cut taxes for small business, and
  – Fifth, restore fiscal responsibility.
Obama Administration’s Tax Reform Proposals in its FY 2014 Budget (Cont’d)

• Eliminate loopholes and subsides include those previously mentioned in the White House and Treasury Department report, including fossil fuel (oil and gas and coal) preference items.

• Domestic manufacturing and innovation is strengthen by adding a tax credit against income equal to 20% of eligible expenses paid or incurred in connection with insourcing a U.S. trade or business (or line of business) conducted outside the U.S. Conversely, if a U.S. trade or business (or line of business) is moved outside the U.S., expenses for such move would be disallowed. For the tax credit or expense disallowance to apply, there must be an impact on U.S. jobs. The R&D credit would be permanently extended as well as those for renewal electricity production (wind and solar).

• The international tax system is strengthened by the inclusion of anti-deferral provisions similar to those proposed in the White House and Treasury Department report, as follows:
Obama Administration’s Tax Reform Proposals in its FY 2014 Budget (Cont’d)

• Defer the deduction of interest expense properly allocated and apportioned to the stock of a foreign subsidiary to the extent that it exceeds an amount proportionate to the taxpayers pro rata share of subsidiary income that is currently subject to U.S. tax.
  – This provision would impact U.S. companies with a significant debt load and/or allocation of interest expense to foreign subsidiary stock. The Obama administration is in effect saying, repatriate your deferred foreign source earnings or otherwise lose the current tax benefit of your interest expense allocation.

• Determine FTCs on a pooling basis. U.S. companies would determine its section 902 deemed paid FTC on a consolidated basis taking into account the aggregate foreign taxes and e&p of all foreign subsidiaries from which the U.S. corporation may claim deemed paid FTCs. Under this proposal section 902 FTCs would be limited in a tax year to an amount proportionate to taxpayer’s consolidated e&p repatriated to the U.S. taxpayer and currently subject to U.S. tax.
  – This provision attacks tax planning where a U.S. corporation chooses to repatriate foreign subsidiary earnings from high – tax countries and deferring active foreign earnings in low – tax countries.
Obama Administration’s Tax Reform Proposals in its FY 2014 Budget (Cont’d)

• Other proposed international tax provisions in the Obama administration’s FY 2014 budget:
  
  – Tax currently excess returns associated with transfers of intangibles offshore. This proposal creates a new separate category of subpart F income determining the FTC limitation under section 904 by requiring a U.S. corporation to currently include in income “excess intangible income from the transfer of a U.S. intangible asset to a related CFC if income is subject to a low effective foreign tax rate (10% or less, with a ratable phase out for effective foreign tax rates between 10% and 15%). Excess intangible income is defined as excess of gross income from transactions connected with intangible assets over costs (including interest and taxes) allocated and apportioned to this income increased by a percentage mark-up.

  – Limit shifting of income through intangible property transfers. This proposal would clarify the definition of intangible property for purposes of sections 367(d) and 482 to include work-force-in-place, goodwill and going concern value. It would also allow the IRS to aggregate values of transferred intangibles versus item-by-item valuations and to provide a more realistic alternative transfer pricing approach.
Obama Administration’s Tax Reform Proposals in its FY 2014 Budget (Cont’d)

• Disallow the deduction for a non-taxed reinsurance premiums paid to affiliates. This is a deduction deferral mechanism and not a disallowance mechanism. At issue is the ability of a U.S. corporation to claim a deduction for reinsurance premiums paid to affiliates while associated ceding commissions and/or reinsurance income is excluded.

• Exempt foreign pension funds from the application of FIRPTA. The objective here is to encourage foreign investment in U.S. infrastructure by exemption from U.S. tax on gain from the disposition of U.S. real property investments.

• Provide for reciprocal reporting of information in connection with implementation of FATCA. This provision addresses information exchange under reciprocal Intergovernmental Agreements (“IGAs”) which, under Model 1, requires the U.S. financial institutions to exchange information it collects on non-resident (NRA) accounts. The concern here for U.S. financial institutions is looking through entities considered beneficial owners under U.S. tax principles (e.g., corporations and complex trusts) in order to identify and report on underlying owners that are resident in countries that have entered into an IGA with U.S. Treasury. Look through is limited to U.S. entities only: i.e., an account maintained by a non-U.S. corporation at a U.S. financial institution. Reporting would only be at the corporate level (the foreign IGA country where the corporation was organized).
Obama Administration’s Tax Reform Proposals in its FY 2014 Budget (Cont’d)

- Limit earnings stripping by expatriated entities. Under this proposal, section 163(j) would be revised by tightening the limitation on the deductibility of interest paid by an expatriated entity to related persons.
- Modify the tax rule for dual capacity taxpayers. These rules generally apply to oil and gas producers but they can also apply to other businesses; e.g., a corporation loaning money to a foreign government or contractor.
- Prevent use of leverage distributions from related foreign corporations to avoid dividend treatment.
- Extend section 338(h)(16) to certain asset acquisitions.
- Reserve foreign taxes from a section 902 corporation’s foreign tax pool when earnings are eliminated.

Other Changes:
- Repeal of LIFO accounting.
- Repeal of LOCOM accounting.
- Repeal gain limitation for dividends received in reorganization exchanges. This eliminates the boot within gain limitation under section 356(a)(1) if the exchange has the effect of a dividend distribution.
Obama Administration’s Financial Products Tax Reform Proposals in its FY 2014 Budget

- **Obama Administration’s Proposed Revisions to the Tax Treatment of Financial Products:**
  - Require derivative contracts to be marked to market with resulting gain or loss treated as ordinary income in the last day of the taxpayer’s taxable year.
    - Objective here is to eliminate the current disparate treatment of derivatives (forwards, notional principal contracts), contractual agreements such as convertible debt, contingent debt, structured notes and securities lending transactions that are themselves derivatives or contain embedded derivatives. Current tax rules allow financial institutions to construct instruments to achieve different desired tax results in terms of the timing and character of income. Sections 1256 and 1092 would be eliminated.
    - Mark to market accounting won’t be required for transactions qualifying as a business hedging transaction (that is, derivative contracts entered into in the taxpayer’s trade or business primarily to manage risk of price change, including changes to interest notes, currency fluctuations, or credit worthiness.)
Republican International Tax Reform Proposals: Chairman Camp’s Proposed Participation Exemption (Territorial) Plan

- The following are the key elements of the Camp international tax reform plan:
  - Tax rate – the top corporate tax rate would be reduced from 35% to 25%.
  - Participation Exemption (i.e., dividend exemption): a 95% dividends-received deduction would be adopted for foreign-source dividends paid by controlled foreign corporations out of the CFC’s un-previously taxed e&p; i.e., non-subpart F income.
  - Tax treatment of the 5% taxable portion of the foreign-source dividends: the 5% taxable portion of a CFC’s previously un-taxed foreign-source dividends would be subject to an effective tax rate of 1.5%.
  - Subpart F is largely retained. Consequently, although the foreign-source portion of a dividend generally is 95% deductible when received by a 10% U.S. shareholder from a CFC, the 10% U.S. shareholder remains taxable in the U.S. on a current basis on passive income or highly mobile income of a CFC. Retention of subpart F is intended to ensure that the participation exemption applies only to income from the conduct of an active foreign business.
  - Tax treatment of U.S. incurred expenses: no longer would there be a tax regime for the allocation and apportionment of U.S. incurred expenses to foreign exempt earnings.
  - Tax treatment of a CFC’s disposition of stock: a 95% deduction would also apply for gains on disposition of stock in certain active CFCs (and no deductions for losses).
Republican International Tax Reform Proposals: Chairman Camp’s Proposed Participation Exemption (Territorial) Plan (Cont’d)

• **Transition Rules:**
  - Before the new territorial tax regime is implemented, a 5.25% mandatory tax will be imposed on pre-effective date earnings. This tax would be spread over a period of up to eight years, with interest.
  - Actual distribution of these earnings would be subject to the additional 1.5% tax rate after applying the 95% foreign dividends-received deduction.
  - Existing CFC rules would be extended that would treat foreign branches of U.S. parent companies as CFCs as well as foreign corporations that are not CFCs but have 10% U.S. corporate shareholders (the so-called 10 to 50 corporations) as CFCs under certain circumstances. Similar rules would also apply to partnerships.

• **Subpart F Provisions:** The basic statutory framework for subpart F would be retained, except for the following provisions:
  - The current inclusion rule for investments in U.S. property would be repealed;
  - The income exclusion for previously taxed income (“PTI”) would be repealed as these amounts would be eligible for the 95% deduction.
Republican International Tax Reform Proposals: Chairman Camp’s Proposed Participation Exemption (Territorial) Plan (Cont’d)

• Base Erosion Rules:
  • Thin cap rules would limit deductibility of interest expense if a U.S. company that is a member of a worldwide group fails a two-part test.

  • Three proposed options on the tax treatment of intangibles:
    – Excess income from the transfer of intangible property could be treated as subpart F income;
    – There would be a new category of subpart F income from low-tax cross-border income, and finally
    – A tax would be imposed on all of a CFC’s foreign intangibles income as subpart F income subject to a 15% rate.
Republican International Tax Reform Proposals: Chairman Camp’s Proposed Participation Exemption (Territorial) Plan (Cont’d)

• Closer Look at Chairman Camp’s Proposed Participation Exemption Plan:
  • A 95% deduction for foreign-source dividends received from CFCs by a U.S. domestic company that is a 10% shareholder of the CFCs.
    − The key to understanding how the proposed foreign tax rules apply is to distinguish between a CFC’s deferred (active) foreign-source income and its subpart F income (passive) that is taxed currently;
    − The 95% dividends received deduction applies only to a CFC’s foreign-source portion of dividend income that is paid out of previously deferred e&p. Accordingly, only 5% of a CFC’s deferred income that gives rise to the dividends to a U.S. 10% shareholder remains taxable at a 1.5% tax rate.
    − No FTC or deduction is allowed for any foreign taxes (including withholding taxes) paid or accrued with respect to any dividend from the 95% dividends received deduction is allowed.
    − The 95% dividends received deduction would not apply to a CFC’s subpart F income. Instead, the subpart F income regime is retained and 100% of a CFC’s subpart F income is taxable but a FTC 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 (e.g., income from foreign sales). FTCs are generally available as well for foreign withholding tax imposed on payments such as royalties and interest.
Republican International Tax Reform Proposals : Chairman Camp’s Proposed Participation Exemption (Territorial) Plan (Cont’d)

• Foreign source portion of a dividend: the participation exemption system is intended to apply only to foreign-source business income and not to a CFC’s U.S.-source income. The participation exemption coordinates with section 245, which allows a deduction for the U.S.-source portion of a dividend received by a 10% U.S. shareholder from a CFC. Thus the 95% dividends-received deduction applies to a dividend received by a 10% U.S. shareholder from a CFC only to the extent the dividend is not deductible under section 245.

• Tiered CFCs: Dividends paid by one CFC to another CFC are exempt from U.S. tax to the extent the dividends would qualify for the 95% dividends-received deduction if paid directly to a 10% U.S. shareholder.

• 10/50 Corporations (noncontrolled 902 corporations): a U.S. domestic corporation may elect on a group wide basis to treat its ownership of all 10/50 corporations in which it is a 10% shareholder as ownership of CFCs. In effect the domestic corporation is treated for all purposes as a 10% U.S. shareholder of each of these deemed CFCs. Consequently:
  – Dividends received from non-controlled 10/50 corporations are eligible for the 95% dividends-received deduction.
Republican International Tax Reform Proposals: Chairman Camp’s Proposed Participation Exemption (Territorial) Plan (Cont’d)

• 10/50 Corporations (cont.):
  – Subpart F applies to a domestic corporations making the CFC election in the same manner as it would apply if non-controlled 10/50 corporations were actual CFCs.
  – FTCs are allowed under modified deemed –paid credit rules for foreign tax imposed on income included under subpart F.
  – If the election to treat a non-controlled 10/50 corporation as a CFC is not made, the 95% dividends-received deduction is not available and no deemed paid FTC is allowed for foreign taxes paid by the non-controlled 10/50 corporation.

• Foreign Branches: The participation exemption treats any foreign branch of a domestic corporation as a CFC for all purposes of the code. Consequently:
  – The 95% dividends-received deduction is available for payments treated as dividends from a foreign branch to its domestic parent.
  – The full range of rules applicable to inter-company transactions (e.g., section 482 and cross-border section 367) would apply to transactions between a foreign branch and its domestic parent.
  – The only FTCs in respect of foreign tax imposed on a foreign branch are the credits that are available in respect of foreign tax imposed on CFCs (e.g., foreign tax on income included under subpart F).
Republican International Tax Reform Proposals: Chairman Camp’s Proposed Participation Exemption (Territorial) Plan (Cont’d)

• Transition Rule: Treatment of Deferred (non-PTI) Foreign-Source Income:
  – Before the participation exemption takes effect, a 10% U.S. shareholder of a CFC or noncontrolled 10/50 corporation must include in its income its pro rata share of the undistributed, non-previously taxed foreign earnings (non-PTI) of the CFC or noncontrolled 10/50 corporation (regardless of whether the aforementioned election was made to treat it as a CFC).
  – This non-PTI will be taxed at a rate of 5.25%.
  – Actual distributions of these same earnings would be subject to tax at an additional 1.25% tax rate.
  – The mandatory 5.25% tax on pre-effective date non-PTI earnings can be paid over a period up to eight years, with interest.
  – Note – Remember the Homeland Investment Act of 2004 (“HIA”) and the 5.25% preferential tax rate that was applied to un-taxed foreign-source CFC earnings that were repatriated to the U.S. The major difference is that repatriation under HIA was voluntary. Under Camp’s proposed transition rule, repatriation by a CFC of pre-effective date non-PTI is mandatory.
Republican International Tax Reform Proposals: Chairman Camp’s Proposed Participation Exemption (Territorial) Plan (Cont’d)

- Transition Rule: Treatment of Deferred (non-PTI) Foreign-Source Income (cont.):
  - Then (HIA 2004) and now, many major U.S. corporations have been lobbying for a preferential tax rate that would apply to the repatriation of un-taxed foreign earnings. It is estimated that U.S. corporations currently have in excess of $1.4 trillion of un-taxed earnings in their CFCs.
  - Unlike HIA, no mention is made in Camp’s transition rule that the mandatory repatriation of pre-effective date and un-taxed foreign earnings would spur U.S. job growth, build new domestic plants and equipment and fund investment in research and development. These were the enunciated objectives of HIA in 2004. Yet studies completed years after HIA revealed that 92% of those foreign earnings repatriated to the U.S. were used to benefit company shareholders in the form of increased dividends and share re-purchase programs (despite the fact that HIA specifically prohibited using repatriated earnings for such purposes).
  - For companies that have planned to repatriate a significant portion of their un-taxed foreign earnings if a preferential tax rate were to apply, the Camp transition proposal is welcome.
Republican International Tax Reform Proposals: Chairman Camp’s Proposed Participation Exemption (Territorial) Plan (Cont’d)

• Transition Rule: Treatment of Un-Taxed (non-PTI) Foreign-Source Income (cont.):
  – However, many corporations have elected APB 23 and have captured a U.S. GAAP benefit on tax deferred earnings. The one-time mandatory repatriation of pre-effective date un-taxed foreign-source earnings could adversely affect these companies’ plans to permanently retain tax deferred foreign earnings overseas.

• Modifications Related to the Foreign Tax Credit System
  – Deemed-paid foreign tax credits under section 902 (indirect taxes) are repealed for actual dividends received by a 10% U.S. shareholder of a foreign corporation (but remember what replaces the deemed-paid credit is the 95% dividends-received deduction).
  – Deemed-paid foreign tax credits are also denied for taxes paid by a non-controlled 10/50 corporation regardless of whether or not an election is made to treat such corporations as a CFC.
  – The foreign tax credit limitation applied by allocating only direct allocable deductions to foreign-source income.
Republican International Tax Reform Proposals: Chairman Camp’s Proposed Participation Exemption (Territorial) Plan (Cont’d)

• Modifications Related to the Foreign Tax Credit System
  – Direct allocable deductions include such items as salaries of sales personnel, supplies, shipping expenses. These are deductions that are directly incurred in connection with activities that produce related foreign-source income.
  – No longer deductible are indirect allocable expenses such as stewardship expenses, general and administrative expenses, and interest expenses not considered directly allocable.

• The separate foreign tax credit baskets are eliminated. Replacing them will be a single foreign tax credit limitation that will apply to all foreign-source income. Separate basket category rules (e.g., passive, HWTI, etc.) are also eliminated. Instead, a single foreign tax credit limitation applies to all foreign-source income.
Republican International Tax Reform Proposals: Chairman Camp’s Proposed Participation Exemption (Territorial) Plan (Cont’d)

• Rules Related to Passive Income Rules:
  
  - Termination of current year inclusion based on investments in U.S. property. This repeals the requirement that a U.S. shareholder must include in income the amount of deferred earnings that are invested in U.S. property. The participation exemption of 95% for CFC e&p, regardless of whether such earnings are invested in U.S. property or abroad, eliminates the need for the existing rules under section 956.
  
  - Repeal of Exclusions of previously taxed earnings and profits (sections 959 and 961); This provision eliminates the rules providing for the exclusion from income of a 10% U.S. shareholder of a CFC of distributions from the CFC’s e&p that were previously included in the 10% U.S. shareholder’s income under subpart F. Consequently, all distributions by a CFC to a 10% U.S. shareholder out of e&p, including amounts previously included in the 10% U.S. shareholder’s income under subpart F, are taxed as dividends potentially eligible for the 95% dividend’s received deduction.
Republican International Tax Reform Proposals: Chairman Camp’s Proposed Participation Exemption (Territorial) Plan (Cont’d)

- Rules Related to Passive Income (cont):
  - Repeal of exclusions of previously taxed e&p (sections 959 and 961, cont): This provision also eliminates the rules requiring adjustments to the 10% U.S. shareholder’s basis in the stock of the CFC when the 10% U.S. shareholder has an income inclusion under subpart F or when the 10% U.S. shareholder receives a distribution from the CFC of e&P that were previously taxed under subpart F.
Republican International Tax Reform Proposals: Chairman Camp’s Proposed Participation Exemption (Territorial) Plan (Cont’d)

- **Prevention of Base Erosion:** The targets here are highly mobile income otherwise known as intangible property and excessive borrowing by a U.S. member of a worldwide group.

- Three proposed options to change the taxation of income from intangible assets:
  - Option A: the subpart F income option – This option is coincidentally raised by the Obama administration in budget recommendations for fiscal years 2011 and 2012. Income attributable to the use or exploitation of intangibles that hasn’t been subject to a specified minimum tax in any jurisdiction is included in U.S. income to the extent that such income exceeds 150% of costs attributable to such income.
  - This option covers the transfer of intangibles by a U.S. corporation to its CFC. Certain excess income paid in respect of the intangible is treated as a new category of subpart F income, called foreign base company excess intangible income.
Republican International Tax Reform Proposals: Chairman Camp’s Proposed Participation Exemption (Territorial) Plan (Cont’d)

- **Prevention of Base Erosion, Option A (cont.):**
  - Subpart F applies if three elements exist: (1) an intangible is transferred by a U.S. company to a CFC (called a covered intangible); (2) there is excess income from transactions connected with or benefiting from a covered intangible, and (3) a low foreign effective tax rate of 10% or less applies.
    - The definition of a covered intangible is very broad (e.g., patent, invention formula, process, design, pattern, know-how, copyright, literary, musical, or artistic composition, trademark, trade name, brand name, method, program, system, procedure, campaign, survey study, forecast, estimate, customer list, or technical data OR any similar item which has substantial value independent of the services of the individual.
    - Excess intangible income is the amount of gross income from transactions connected with or benefiting from the transferred intangible property that exceeds 150% of the costs (excluding interest and taxes) that are properly allocated and apportioned to the income, including R&D costs that are properly allocable to the line of business in which such income is earned.
Republican International Tax Reform Proposals: Chairman Camp’s Proposed Participation Exemption (Territorial) Plan (Cont’d)

**Prevention of Base Erosion, Option A (cont.):**

- **Option B: Treat low-taxed cross-border foreign income as subpart F income**
  - Here, income earned by a CFC that is neither derived from the conduct of an active trade or business in the CFC’s home country (the home country exception) nor subject to an effective rate of foreign tax of at least 10% is includible in subpart F income as low-taxed cross-border income.
  - To qualify for the home country exception and thus avoid inclusion of low-taxed cross-border income as subpart F income, a CFC must satisfy three tests: (1) the income must be in connection with the CFC’s active conduct of a trade or business within the country in which the CFC is organized; (2) the CFC must maintain an office or fixed place of business within each country, and (3) the income must be derived from activities that service the local market of the home country either through transactions with respect to property located in that country or by performing services with respect to persons or property located in that country.
Republican International Tax Reform Proposals: Chairman Camp’s Proposed Participation Exemption (Territorial) Plan (Cont’d)

- Prevention of Base Erosion (cont.):
  - Option C: This option also creates a new category of subpart F income for worldwide derived by a CFC from intangibles and provides a deduction for a domestic corporation of 40% of its income from foreign exploitation of intangibles. This provision therefore increases U.S. taxation of income 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.
    - The 40% deduction from the gross income of the domestic corporation results in a reduced tax rate of 15% for the income from foreign exploitation of intangible property. The base on which the deduction is computed is the sum of all foreign intangible income earned directly by the domestic corporation and, in the case of a corporation which is a U.S. shareholder, the lesser of foreign base company intangible income, or the foreign intangible income of a CFC.
Chairman Camp’s Proposed Revisions to the Tax Treatment of Financial Products

- Chairman Camp’s proposals provide a uniform tax treatment of financial derivatives by requiring all derivative positions to be marked to market at the end of each tax year and to be taxed as ordinary income or loss.
  - Straddles (i.e., offsetting financial positions) that include at least one derivative position would be marked to market with ordinary income or loss treatment.
  - Specifically exempted from mark to market treatment are hedges used by corporations to mitigate the risk of price, currency, and interest rate changes in their business operations.
  - The effective date would be for derivatives entered into on or after December 31, 2013.
  - These proposals would simplify business hedging tax rules by permitting taxpayers to identify transactions as a hedge for financial accounting purpose

- Other financial product tax reform proposals include:
  - Elimination of “phantom “ tax resulting from debt restructurings by generally providing that the issue price of the modified date instrument cannot be less than the issue price of the debt instrument prior to the modification. The floor on the issue price of the modified debt instrument would be reduced by any amount of actual principal that is forgiven which would result in cancellation of indebtedness income to the borrower in the amount of principal that is forgiven.
Chairman Camp’s Proposed Revisions to the Tax Treatment of Financial Products (Cont’d)

• Other financial product tax reform proposals:
  – Increase the accuracy of determining gain and losses on sales of securities: This proposal would require taxpayers who sell a portion of their holdings in substantially identical securities to determine their taxable gain or loss based on the taxpayer’s average basis in the securities, including both securities sold and retained by the taxpayer.
  – Prevent the harvesting of tax losses on securities: This proposal closes the loophole in the current “wash sales” rules by expanding the scope of the rules to include acquisition of replacement securities by certain closely related parties (e.g., family members, controlled or controlling entities and certain qualified compensation, retirement, health and education plan accounts.)
The Political Landscape for Potential U.S. Corporate Tax Reform

• Is corporate tax reform achievable given the differences between Republicans and Democrats on their guiding principles and objectives?
• Can Republicans and Democrats overcome their different approaches to tax reform and compromise on tax reform legislation that is acceptable to both parties?