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Client Alert

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Cross-Border Financial Transactions in Camp and 2015 Budget Proposals

Both Representative Camp, Republican Ways and Means Committee Chair, and President Obama have recently released far reaching proposed changes to the U.S. taxation of cross-border financial transactions.

After several months of hearings on comprehensive tax reform, on February 26, 2014, Representative Camp released a proposal referred to as the Tax Reform Act of 2014. On March 4, President Obama released his Budget Proposals for 2015. The following is a summary of certain proposed changes related to cross-border financial transactions in Rep. Camp's proposal and the 2015 Budget. We have also prepared summaries of other provisions relevant to other topical areas - please check our website for those. Although neither the Tax Reform Act of 2014 nor the Budget Proposals has been formally introduced as a bill, and the prospects for passage of either are uncertain at this point, given the significant nature of the proposed reforms, we will monitor their progress and provide updates as warranted.

Earnings Stripping Rules

Under current law, a U.S. corporation generally may deduct interest payments, including payments to a related party. However, if the taxpayer's debt-to-equity ratio exceeds 1.5 to 1, interest payments to certain related parties that are not subject to U.S. tax (e.g., foreign corporations) are disallowed to the extent the taxpayer has "excess interest expense," – i.e., net interest expense (interest expense less interest income) in excess of 50% of the taxpayer's adjusted taxable income (defined as taxable income without regard to deductions for net interest expense, net operating losses, certain cost recovery, and domestic production activities). Any disallowed interest deductions may be carried forward indefinitely, while any "excess limitation" (the excess of 50 percent of the corporation's adjusted taxable income over the corporation's net interest expense) may be carried forward three years.

Under the Camp proposals, the threshold for excess interest expense would be reduced to 40% of adjusted taxable income. In addition, corporations would no longer be permitted to carry forward any excess limitation.

Under the Budget Proposal, a member of a financial reporting group's U.S. interest expense deduction generally would be limited to the member's interest income plus the member's proportionate share of the financial reporting group's net interest expense computed under U.S. income tax principles. A member's proportionate share of the financial reporting group's net interest expense would be determined based on the member's proportionate share of the group's earnings (computed by adding back net interest expense, taxes, depreciation, and amortization) reflected in the group's financial statements. If a member fails to substantiate the member's proportionate share of the group's net interest expense, or a member so elects, the member's interest deduction would be limited to 10% of the member's adjusted taxable income (as defined under the current earnings stripping rules). Regardless of whether a taxpayer computes the interest limitation under the proportionate share approach or using the 10% alternative, disallowed interest would be carried forward indefinitely and any excess limitation for a tax year would be carried forward to the three subsequent tax years. A member of a financial reporting group that is subject to the proposal would be exempt from the application of the current earnings stripping rules. U.S. subgroups would be treated as a single member of a financial reporting group for purposes of applying the proposal.

The Budget Proposal would not apply to financial services entities, and such entities would be excluded from the financial reporting group for purposes of applying the proposal to other members of the financial reporting group.

Limiting U.S. Group Interest Expense on Excess U.S. Group Debt

Under current law, corporations generally may deduct all of their interest expense even if the debt was acquired to capitalize foreign subsidiaries. Expense allocation rules,

however, may require the interest expense to be allocated against foreign source income, which may limit the amount of foreign tax credits the U.S. parent may utilize.

Under the Camp proposal, the deductible net interest expense of a U.S. parent of one or more foreign subsidiaries would be reduced by the lesser of the amounts by which (1) net interest expense on the amount of indebtedness of the U.S. parent (including other members of the U.S. consolidated group) exceeds what such net interest expense would be if such U.S. parent's leverage ratio were 110% of the group's worldwide ratio and (2) net interest expense exceeds 40% of the adjusted taxable income of the U.S. parent. Any disallowed interest expense could be carried forward to a subsequent tax year.

Deduction of Interest Expense Related to Deferred Income of Foreign Subsidiaries

Under current rules, a U.S. person that incurs interest expense properly allocable and apportioned to foreign-source income may deduct those expenses even if the expenses exceed the taxpayer's gross foreign-source income or if the taxpayer earns no foreign-source income.

Under the Budget Proposals, the deduction of interest expense that is properly allocated and apportioned to stock of a foreign corporation that exceeds an amount proportionate to the taxpayer's pro rata share of income from such stock that is currently subject to U.S. tax would be deferred.

Foreign-source income earned by a taxpayer through a branch is subject to U.S. tax under existing law; thus, the proposal would not apply to interest expense properly allocated and apportioned to such income. Other directly earned foreign source income (for example, royalty income) would be similarly treated, falling outside the proposal. For purposes of the proposal, the amount of a taxpayer's interest expense that is properly allocated and apportioned to stock would generally be determined under the principles of current Treasury regulations.

Limitation on Treaty Benefits Among Related Parties

Under current law, certain payments of fixed or determinable, annual or periodical (FDAP) income – such as interest, dividends, rents, and annuities – to foreign recipients are subject to a statutory 30% withholding tax. Income tax treaties between the United States and other countries, however, often reduce or eliminate this withholding tax for payments from one treaty country to residents of the other treaty country.

Under the Camp proposal, if a payment of FDAP income is deductible in the United States and the payment is made by an entity that is controlled by a foreign parent to another entity in a tax treaty jurisdiction that is controlled by the same foreign parent, then the statutory 30-percent withholding tax on such income would not be reduced by any treaty unless the withholding tax would be reduced by a treaty if the payment were made directly to the foreign parent.

Foreign Dividend Exclusion Instead of FTC

Under current law, U.S. citizens, resident individuals, and domestic corporations generally are taxed on all income, whether earned in the United States or abroad. Foreign income earned by a foreign subsidiary of a U.S. corporation generally is not subject to U.S. tax until the income is distributed as a dividend to the U.S. corporation. To mitigate the double taxation on earnings of the foreign corporation, the United States allows a credit for foreign income taxes paid. The foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign income. When foreign tax credits are insufficient to offset the U.S. tax liability on the repatriated earnings, the additional U.S. tax the U.S. corporation must pay is referred to as the "U.S. residual tax." A U.S. taxpayer may elect to deduct foreign income taxes paid rather than claim the credit.

Under the Camp proposal, the current-law system of taxing U.S. corporations on the foreign earnings of their foreign subsidiaries when these earnings are distributed would be replaced with a dividend-exemption system. Under the exemption system, 95% of dividends paid by a foreign corporation to a U.S. corporate shareholder that owns 10% or more of the foreign corporation would be exempt from U.S. taxation. No foreign tax credit or deduction would be allowed for any foreign taxes (including withholding taxes) paid or accrued with respect to any exempt dividend. The basis of the stock of the foreign corporation would be reduced by the amount of any exempt dividend, but only for purposes of determining the amount of a loss (and not gain) on any sale or exchange of the foreign subsidiary stock. This approach, when combined with the overall reduction in the US corporate tax rate that is also being proposed by Camp, may provide an attractive incentive to repatriate excess earnings to the US to be invested here at rates that are more competitive with foreign income tax rates.

To transition to the new system, "earnings and profits" ("E&P") of 10% or more owned foreign corporations from pre-2015 that had not previously been subject to U.S. tax generally would be included in the income of the U.S. shareholder, and taxed at a special rate (generally 3.5%, but 8.75% for E&P consisting of liquid assets). Taxpayers could elect to pay the resulting tax over 8 years.

Related Party Look-Thru Made Payment

Under current law, a U.S. parent of a foreign subsidiary generally is subject to current U.S. tax on dividends, interest, royalties, rents, and other types of passive income earned by the foreign subsidiary, regardless of whether the foreign subsidiary distributes such income to the U.S. parent. However, for tax years of foreign subsidiaries beginning before 2014, and tax years of U.S. shareholders in which or with which such tax years of the foreign subsidiary end, a special “look-through” rule provided that passive income received by one foreign subsidiary from a related foreign subsidiary generally was not includible in the taxable income of the U.S. parent, provided such income was not subject to current U.S. tax or effectively connected with a U.S. trade or business.

Under the Camp proposal, the look-through rule would be made permanent.

Active Finance Exception Reinstated

Under current law, a U.S. parent of a foreign subsidiary generally is subject to current U.S. tax under subpart F on dividends, interest, royalties, rents, and other types of passive income (collectively “foreign personal holding company income”) earned by the foreign subsidiary, regardless of whether the foreign subsidiary distributes such income to the U.S. parent. However, for tax years of foreign subsidiaries beginning before 2014, and tax years of U.S. shareholders in which or with which such tax years of the foreign subsidiary end, there was a temporary exception for such income if it was derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (“active financing income”).

The Camp proposal would extend the active financing income exception for five years, for active financing income that is subject to a foreign effective tax rate of 12.5 percent or higher. Active financing income that is subject to a lower foreign tax rate would not be exempt, but would be subject to a reduced U.S. tax rate of 12.5 percent, before the application of foreign tax credits.

For More Information

For more information, please contact Paul Carman (312.845.3443), Colman Burke (415.278.9033), or Melanie Gnazzo (415.278.9020).

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