Obama Administration Proposes a 19-Percent Minimum Tax on Foreign Earnings

The Obama Administration's 2016 Budget proposes a radical change to the taxation of foreign business operations of U.S. based corporations.[1] The proposal would impose a 19-percent minimum tax on earnings derived outside the United States. This new regime would apply in addition to most of the other international tax rules. The Administration also proposes to reduce the general corporate tax rate from 35 percent to 28 percent.

Under the proposal, Subpart F would apply before the minimum tax. Income of a CFC that falls within the definition of Subpart F income would be included in the gross income of the U.S. corporate shareholders and subject to the full 28-percent tax rate. The 2016 Budget proposes to expand the definition of Subpart F income to include certain digital income and income from certain contract manufacturing arrangements.[2] U.S. tax on Subpart F income would be reduced by deemed-paid foreign tax credits as under the current rules.[3]

The remaining earnings of a CFC less an allowance for corporate equity ("ACE") would be included in the income of its U.S. shareholders and subject to a 19-percent minimum tax. The ACE reduction is intended to exempt from the minimum tax a risk-free return on equity invested in active assets. Active assets generally include assets that do not generate foreign personal holding company income.[4]

The 19-percent tax rate is reduced by 85 percent of the foreign effective tax rate associated with the earnings that are subject to the minimum tax (but not below zero). For example, if a foreign country taxes the earnings at a 20-percent rate, the minimum tax would be two percent [19% - (20% x .85)]. If instead the foreign country imposes a 25-percent tax rate, there would be no U.S. tax (25% x .85 exceeds 19%). The foreign taxes are not a credit, but just a component of the minimum tax calculation (*i.e.*, there would be no excess credits).

The minimum tax is computed on a per-country basis. Accordingly, foreign income and taxes, as well as the ACE, must be allocated to specific countries.

A CFC's country will be based on tax residence determined under foreign law. Thus, a CFC incorporated in Country X but tax resident in Country Y under the laws of both Country X and Country Y will have its earnings and taxes assigned to Country Y. If a CFC is not subject to foreign tax anywhere (*e.g.*, a reverse hybrid), it earnings will be subject to the full 19-percent minimum tax.

Earnings of a CFC may be allocated to multiple countries if its earnings are subject to tax in different countries. If the same earnings are subject to tax in more than one



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country, the earnings and taxes will be assigned to the highest-tax country, including the taxes paid to both countries.

Generally the foreign earnings taken into account would be computed under U.S. principles, but special rules would address hybrid arrangements. The relevant earnings assigned to a country would include disregarded payments deductible in another foreign country. While dividends received from related corporations generally would be ignored, the earnings assigned to a low-tax country would be increased for a dividend payment from a high-tax country that is treated as deductible in the high-tax country. In addition, no deduction would be recognized for a payment from a low-tax country to a high-tax country that would be treated as a dividend eligible for a participation exemption in the high-tax country.

The foreign effective tax rate would be computed on an aggregate basis with respect to all foreign earnings and the associated taxes assigned to a country for the prior five years. 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.

Like Subpart F, the minimum tax would apply regardless of whether earnings are repatriated to the United States. All foreign earnings could be repatriated without further U.S. taxation.[5] In addition, the proposal would repeal the Subpart F rules that include in the income of U.S. shareholders earnings invested in U.S. property.

Foreign-source royalty and interest payments received by U.S. corporations would be subject to the full 28-percent tax rate.[6] U.S. tax could be reduced with foreign taxes as under current rules. Under the new system, however, there would be no excess foreign taxes to reduce U.S. tax on such income because dividends received from high-tax CFCs would be exempt from tax, and the Subpart F high-tax exception would become mandatory (preventing high-taxed Subpart F inclusions).[7]

The concepts of the minimum tax regime would also apply to gain on the sale of stock in a CFC. Such gain would not be subject to tax to the extent it reflects undistributed earnings (which generally would have already been subject to U.S. taxation). In addition, U.S. tax would be imposed on the remaining gain at a rate that would be applied to the future earnings of the CFC's assets, *i.e.*, 19 percent for non-Subpart F earnings and 28 percent for Subpart F earnings.

The minimum tax also would apply to branches, which would be treated as CFCs for this purpose. Intangibles used by a branch would result in a deemed royalty to the U.S. owner subject to the 28-percent tax rate.

Interest expense generally would continue to be deductible. Interest expense incurred by a U.S. corporation that is allocated and apportioned to foreign earnings on which the minimum tax is paid would be deductible at the residual minimum tax rate applicable to those earnings (*e.g.*, two percent in the above example with a 20-percent foreign tax rate). No deduction would be permitted for interest expense allocated and apportioned to foreign earnings for which no U.S. income tax is paid.

The new minimum tax regime is creative and would contain a number of rules addressing issues the Administration has expressed concern with. The rules treat disregarded entities owned by CFCs as separate corporations, address hybrid arrangements and eliminate cross-crediting of foreign tax credits. Nevertheless, this regime would significantly increase the complexity of the international tax rules. It also would subject U.S. companies with foreign operations to a materially higher tax rate than under existing law and to a greater tax burden than foreign-based multinationals, which generally are not subject to tax on foreign earnings, and thereby weaken the competitive position of U.S.-based corporations in the global economy.

ENDNOTES

1 Department of the Treasury, General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals (2015), at pp. 19-22 (hereinafter the "Greenbook").

2 *See* Lowell D. Yoder, *Proposed Foreign Base Company Digital Income*, 44 Tax Mgmt. Int'l J. 251, April 10, 2015; Lowell D. Yoder, *President's Budget Would Apply Subpart F to Toll Manufacturing Arrangements*, 43 Tax Mgmt. Int'l J. 496, August 8, 2014.

3 Code Sec. 960.

4 Code Sec. 954(c). The determination of whether an asset is active would be made without regard to the look-through rule of Code Sec. 954(c)(6) and any election to disregard an entity as separate from its owner.

5 Previously untaxed foreign earnings would be subject to a 14-percent tax (less 40 percent of the foreign tax credits associated with the earnings).

6 The 2016 FY Budget carries over prior proposals to expand the definition of intangible property for purposes of Code Sec. 367(d) (deemed contingent-payment sale upon transfer of Code Sec. 936(h)(3)(B) intangibles to a foreign corporation) and Code Sec. 482 ("commensurate with income" pricing required for sales or licenses of Code Sec. 936(h)(3)(B) intangibles). *See* Lowell D. Yoder, *Obama Administration's FY 2012 Budget: International Tax Proposals*, Int'l Tax J., May-June 2011, at 3; Lowell D. Yoder and Elizabeth Lewis, *Properly Valuing Intangibles Transferred to Foreign Subsidiaries*, 143 Tax Notes 470, April 28, 2014.

7 *See* Code Sec. 954(b)(4); Reg. §1.954-1(d).

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