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. 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. U.S. tax on Subpart F income would be reduced by deemed-paid foreign tax credits as under the current rules.

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.

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), its 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
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. 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. 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-tax Subpart F inclusions).

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”).


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).


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