SUBPART F

Overview

• U.S.-based multinationals that conduct business abroad through foreign subsidiaries are subject to U.S. tax on their worldwide earnings, but the United States generally permits deferral of U.S. tax on active foreign business income until the earnings are distributed to the U.S. parent (i.e., repatriated to the U.S.). For this reason, the U.S. system is often described as a “worldwide” system with “deferral.” In the meantime, the multinational pays the applicable foreign taxes to the countries in which the foreign income is earned.

• To avoid taxing repatriated earnings twice (i.e., foreign tax and U.S. tax), the United States provides a credit to the extent a company pays foreign taxes on its earnings. The foreign tax credit (“FTC”) reduces the company’s U.S. tax, but it still owes U.S. tax on the difference between the foreign and the U.S. tax rates.

Specifics

• Foreign earned business income that is entitled to deferral of U.S. tax until repatriated includes most income from active business operations and income that has a close link to a foreign subsidiary’s country of incorporation. (See below under “Subpart F” for a description of income sources that are not entitled to deferral.)

  o These foreign business earnings are generally subject to immediate tax in the foreign countries in which they are earned.

  o When the foreign business earnings are repatriated to a U.S. parent company, the United States taxes the earnings again, but provides a credit for foreign taxes paid on the earnings to mitigate double taxation. However, the credit is subject to complex limitations that often result in a significant second layer of tax on the repatriated earnings.

• “Subpart F” describes the part of the Internal Revenue Code that contains rules that operate as an exception to the deferral rule. The subpart F rules impose immediate U.S. tax on certain kinds of income earned by the foreign subsidiaries of U.S. parent companies, again subject to a limited foreign tax credit:

  o Passive subpart F income includes dividends, interest, rents and royalties.

    • There are exceptions to the exceptions, e.g., interest earned in an active financing business is not subject to immediate U.S. tax.

  o Active subpart F income includes certain sales or services income received by a foreign subsidiary with insufficient connection to the relevant business operations or customer markets.
Another exception provides that foreign income subject to an effective foreign tax rate equal to at least 90% of the U.S. rate is generally not considered subpart F.

Examples

Bank Account Interest

- A U.S. company owns a foreign subsidiary that has accumulated cash that it holds in its bank account for future use. Absent a special rule, the interest income earned on the accumulated cash will be subject to immediate U.S. taxation under subpart F as passive income.

Note: One such special rule is the “look-through” rule, which will be covered in a later draft.

Sales Income

- A U.S. company owns a foreign subsidiary incorporated in a European country (e.g., Germany) which has employees carrying out marketing and sales functions. The foreign subsidiary purchases product manufactured by its foreign affiliates and resells the products in countries throughout Europe. The foreign subsidiary, which is profitable, operates in Germany where it is subject to an effective tax rate of 30%, which is less than 90% of the current U.S. statutory tax rate of 35%.

Under the subpart F rules, the U.S. company will be subject to immediate U.S. tax on the foreign subsidiary’s income because the sales income is earned by a subsidiary that is incorporated in a country other than the countries in which the products are manufactured or sold for use.

Foreign Tax Credit Calculation

<table>
<thead>
<tr>
<th>Step One: Income is earned offshore</th>
<th>Step Two: Cash earned in foreign market is transferred to the U.S.</th>
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</thead>
<tbody>
<tr>
<td>Foreign Tax Impact (assume 20% foreign tax rate)</td>
<td>United States Tax Impact (35% tax rate)</td>
</tr>
<tr>
<td>○ Foreign Subsidiary sells product internationally, earning $100</td>
<td>○ Foreign Subsidiary repatriates cash of $100</td>
</tr>
<tr>
<td>• Income $100</td>
<td>▪ Taxable income (grossed up) $100</td>
</tr>
<tr>
<td>• Local tax @ 20% $20</td>
<td>▪ Tax @ 35% 35</td>
</tr>
<tr>
<td>• Net income 80</td>
<td>▪ Foreign tax credit $20</td>
</tr>
<tr>
<td></td>
<td>▪ Incremental U.S. Tax 15</td>
</tr>
</tbody>
</table>
Observations

- The appropriate scope of the subpart F rules has been much debated since their enactment in 1962. More recently, much of the debate has centered around arguments that the scope of the rules should be (1) expanded to further limit benefits for U.S companies that conduct operations and earn profits in countries with lower tax rates, or (2) reduced to better reflect the manner in which international business operations are generally conducted in today's global marketplace. That debate is likely to continue.