

May 2009

Title:
Obama Administration Outlines Proposals to Reform International Tax Provisions and to Strengthen Enforcement of Offshore Tax Disclosures

Subject:
Significant United States International Tax Changes Proposed

Affecting:
All taxpayers with international business operations and investments

Proposed Date:
2011

Details:

On May 11, 2009, the Treasury Department released *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* ("Green Book"), a document which provides a description of the Obama Administration's budget proposals affecting revenues. In a May 4, 2009, news release President Obama had announced, and the United States Treasury Department had outlined, a sweeping tax reform proposal that would, if enacted, affect almost all United States taxpayers conducting international activities and/or having international investments. These provisions are explained in further detail in the Green Book. A significant portion of the anticipated tax revenue resulting from the reforms (estimated at more than \$210 billion between 2011 and 2019) is proposed to provide an offset for any potential revenue losses from making the research credit permanent.

Set forth below is a summary of the proposed changes affecting the international taxation arena (unless otherwise stated, the below proposals would be effective for taxable years beginning after December 31, 2010):

- f Continuation Of Certain Expiring Provisions Through Calendar Year 2010.** Certain expiring provisions, including the subpart F "active financing" and "look-through" exceptions, would be extended an additional year through December 31, 2010 (currently, these rules are set to expire December 31, 2009).

As a Member Firm of BDO Alliance, MillerMusmar CPAs serves multinational clients by leveraging a global network of 1,095 offices in 110 countries. BDO Alliance is a worldwide network of public accounting firms. Each BDO Member Firm is an independent legal entity in its own country.

For more information, please contact:

Joey Musmar
MillerMusmar CPAs
1861 Wiehle Ave, Suite 125
Reston, VA 20190
703.437.8877 Ext. 117
Joeym@millermusmar.com

Continued on next page

INTERNATIONAL TAX ALERT

- f Reforming The Entity Classification (“Check-The-Box”) Rules.** If a foreign eligible entity is owned by a single owner, it will be treated as disregarded *only if* that single owner and its foreign eligible entity are both organized in the same foreign country. If a single member foreign eligible entity is created or organized outside its owner’s home country, the disregarded entity would instead be treated as a foreign corporation for federal tax purposes. This rule is not intended to affect elections by a first-tier foreign eligible entity, *i.e.*, owned directly by the United States person, unless it was formed for tax avoidance purposes. This proposal would constitute a significant change under the rules for international tax planning that have been available for most United States taxpayers since 1997. The change in classification from a disregarded entity to a corporation would be subject to any existing tax provisions that otherwise apply to a corporate conversion transaction. The proposal makes no reference to foreign eligible entities with multiple owners.
- f Prevention Of Foreign Tax Credit Abuse.** Rather than continue the application of the foreign tax credit limitation separately to foreign-source income in each of the separate categories under section 904(d), the proposal would determine the deemed paid foreign tax credit for a taxable year based on the amount of the consolidated earnings and profits of the foreign subsidiaries repatriated to the United States taxpayer in that particular taxable year. Thus, the aggregate foreign taxes and earnings and profits of all the foreign subsidiaries on a consolidated basis would determine the deemed paid foreign tax credit.
- f Matching Rule.** In addition to the change to the deemed paid credit, a matching rule has been proposed to prevent the separation of creditable foreign taxes from the associated foreign-source income.
- f Modification Of The Tax Rules For Dual Capacity Taxpayers.** The proposal would change the foreign tax credit with respect to dual capacity taxpayers (taxpayers that are subject to a foreign levy and also receive a specific economic benefit from the levying country) so that a foreign levy that otherwise qualifies as an income tax or in-lieu-of tax would only be creditable if the foreign country generally imposes an income tax. Because there is no separate section 904 foreign tax credit category under current law for foreign oil and gas income, the proposal would convert the special foreign tax credit limitation rules of section 907 into a separate category within section 904 for foreign oil and gas income.
- f Restrict Or Defer Certain Deductions.** These changes would apply to deductions (other than research and experimentation expenditures) such as interest expense and other expenses that are properly allocated and apportioned to foreign-source income to the extent the foreign-source income associated with the expenses is not currently subject to United States tax.

Continued on next page

To ensure compliance with Treasury Department regulations, we wish to inform you that any tax advice that may be contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or applicable state or local tax law provisions or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

Material discussed in this tax alert is meant to provide general information and should not be acted on without professional advice tailored to your firm’s individual needs.

INTERNATIONAL TAX ALERT

- f Limit Shifting Of Income Through Intangible Property.** The definition of intangible property for purposes of section 367(d) (transfers to a foreign corporation) and section 482 (allocation of income and deductions among taxpayers) would be amended to include certain intangibles such as workforce in place, goodwill, and going concern value to prevent the inappropriate shifting of income outside the United States.
- f Tightening Of Earnings Stripping Limitation As Related To Expatriated Entities.** Current law limits the deductibility of certain interest paid by a corporation to related foreign persons. Such limitation applies when a corporation's debt-to-equity ratio is greater than 1.5 to 1 and the net interest expense is in excess of 50 percent of the adjusted taxable income. The proposed rule will eliminate the debt-to-equity safe harbor provisions and reduce the net interest expense percentage to 25 percent of adjusted taxable income with respect to disqualified interest paid to expatriated entities other than interest paid to unrelated parties on debt that is subject to related-party guarantee.
- f Prevention Of Repatriation Of Earnings In Certain Cross-Border Reorganizations.** Current law allows foreign earnings not previously taxed in the United States to be repatriated to United States shareholders with minimal United States tax consequences in some instances because of the "boot-within-gain" limitation under section 356(a)(1). The repeal of the boot-within-gain limitation has been proposed for reorganizations in which the acquiring corporation is foreign and the shareholder's exchange has the effect of the distribution of a dividend, as determined under section 356(a)(2). This provision appears to affect certain "all-cash" or "all-boot" D reorganizations where the acquirer is foreign.
- f Repeal 80/20 Company Rules.** Under current law, section 861(c) provides that if at least 80 percent of a domestic corporation's gross income during a three-year testing period is foreign-source and attributable to the active conduct of a foreign trade or business (a so-called "80/20" company), a limited exception applies to prevent dividends and interest paid by such corporation from being treated as United States source income and thus subject to gross basis withholding tax if paid to a foreign person. The 80/20 provision would be repealed under the proposal.
- f Treat Income Earned By Foreign Persons With Respect To Equity Swaps As United States Source To The Extent That Income Is Attributable To Dividends Paid By A Domestic Corporation (Subject To Certain Exceptions).** Current law provides that income from notional principal contracts is generally sourced to the residence of the investor, resulting in substitute dividend payments made to a foreign investor with respect to an equity swap referencing United States equities being treated as foreign-source and thereby not subject to United States withholding tax. The proposal would repeal Notice 99-66 and re-source such income to the United States, to the extent that the income is attributable to dividends paid by a domestic corporation. The proposal would be effective for taxable years beginning after December 31 of the year of enactment.
- f Increase In Penalties For Failure To Report Overseas Investments Or Financial Accounts.** This will be accomplished by extending the statute of limitations to six years after the taxpayer provides the required information.

INTERNATIONAL TAX ALERT

f Qualified Intermediary (“Qi”) Provisions: Reforms to be enacted will strengthen the enforcement of tax laws by expanding the requirements of the QI program. Separately, the Administration plans to provide additional resources (including 800 new IRS personnel) for the enforcement of the international tax rules. Some key proposals relating to QIs and non-QIs are:

- Prohibiting the qualification of a foreign financial institution as a QI unless it identifies all of its account holders that are United States persons.
- Requirement that all payments of fixed, determinable, annual, and periodic income to a nonqualified intermediary are to be treated as a payment to an unknown foreign person and thus subject to 30-percent withholding tax. A refund mechanism for over-withholding would be permitted for foreign persons.
- Requirement that tax at a rate of 20 percent is to be withheld on the gross proceeds from the sale of any security of a type that would be reported to a United States non-exempt payee, when paid to a nonqualified intermediary located in a jurisdiction with which the United States does not have a comprehensive income tax treaty.

These proposals would be effective for payments made after December 31 of the year of enactment.

f Other Proposed Changes Include:

- Require United States individuals to report any transfer of money or property (in excess of \$10,000) made to, or received from, any foreign bank, brokerage, or other financial account by the individual, or by any entity in which the individual owns more than 50 percent.
- Require individual taxpayers who are required to file an annual reporting of a foreign bank account report (Form TD F 90-22.1 or “FBAR”) to also disclose certain information on a schedule as part of the individual’s income tax return.
- Require third-party information reporting regarding the transfer of assets to foreign financial accounts and the establishment of foreign financial accounts.
- Require third-party information reporting regarding the establishment of offshore entities.
- Rebuttable evidentiary presumption with respect to foreign accounts for which an FBAR has not been filed.
- Rebuttable evidentiary presumption with respect to failure to file an FBAR for accounts with nonqualified intermediaries.
- Double the accuracy-related penalties on understatements involving undisclosed foreign accounts (the proposed penalty would be 40 percent when the understatement arises from a transaction involving a foreign account that the taxpayer failed to disclose properly under the proposed requirement that taxpayers disclose FBAR-related information on their income tax returns).
- Improve and increase the foreign trust reporting penalty by increasing the initial penalty to the greater of \$10,000 or 35 percent of the gross reportable amount.

Continued on next page

INTERNATIONAL TAX ALERT**Observations:**

Any proposals will require passage by both houses of Congress before they are enacted into law. The legislative process may take significant time as the proposed changes affect many current Internal Revenue Code provisions, and members of Congress may not support the precise proposals made by the Administration. Thus, the timing of approval of any legislation (in the form of the Treasury proposal or any other form) and signature by the President cannot be known.

The proposed reforms did not state any specific changes to or repeal of, the controlled foreign corporation ("CFC") rules including subpart F (except for the one-year extension of certain subpart F temporary provisions). However, the proposed changes to the check-the-box rules may create situations where taxpayers may in fact be subject to the application of the subpart F rules in 2011 and thereafter. Many taxpayers had previously avoided creating subpart F exposure by affirmatively using check-the-box tax planning in their offshore structures. No transition rules were provided to allow taxpayers to restructure their operations without triggering a number of adverse consequences related to any change in the United States tax status of the foreign subsidiaries. Currently a decision to uncheck the box by taxpayers may trigger significant tax consequences including sections 351, 367, 904, 987, and 1503. The sweeping nature of the provisions and the proposed effective date (taxable years beginning after December 31, 2010) provide a relatively short window of opportunity for taxpayers to take into account the impact of the provisions and to implement any planning needed to work within the new rules.

The repeal or major reform of the check-the-box rules may have a significant impact on S corporations and partnerships (including limited liability companies ("LLCs") classified as partnerships), which are ultimately owned by United States individuals and are taxed on the individual owners' income tax returns. A full repeal would likely result in increased double taxation of foreign income (once in the foreign jurisdiction and again in the United States) as individual taxpayers in the United States are not given the ability to avail themselves of the indirect tax credit mechanism for any foreign corporate tax paid by a foreign subsidiary. Historically, corporations taxed as C corporations have been provided the ability to claim local foreign taxes as a foreign tax credit as an indirect credit under section 902. This disparity may increase the effective tax rate on the income of S corporations or partnerships (including LLCs taxed as partnerships) currently conducting business outside the United States through the use of the check-the-box rules.

The tracking of deferred deductions in addition to the change in the deemed paid (indirect) foreign tax credit will require additional recordkeeping and tracking by taxpayers to determine their foreign tax credits and limitation amounts available for future taxable years.