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Obama Administration Proposes Broad International Tax Reforms

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by Joy S. MacIntyre, Marjorie S. Elkin, Joseph Savitsky

On May 4, 2009, the Obama Administration released a statement reaffirming its campaign trail promise to toughen U.S. international tax rules in a number of respects that could have a dramatic impact on multinational corporations and other U.S. taxpayers with cross-border activities. The Administration's previously released outline of its fiscal year 2010 budget had projected $210 billion in additional revenues over the next decade by increasing international enforcement, reforming deferral, and "other tax reform policies."

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The May 4 statement follows months of speculation and provides greater insight into some of the Administration's proposed international tax revenue raisers. Many of the details remain uncertain and presumably will be fleshed out in the actual budget proposal, expected to be released this week, and through the legislative process. Nevertheless, while it appears the Administration's current proposals will stop short of an outright repeal of the ability to defer U.S. tax on foreign profits, the current proposals include a number of reforms that could materially impact U.S. taxpayers with international operations or investments, particularly those taxpayers that have relied heavily on "check-the-box" planning in structuring their worldwide operations.

The international tax proposals previewed in the Administration's May 4 statement include the following:

- **Defer Deductions.** Deductions for interest and other expenses relating to foreign operations would be deferred until the earnings from those foreign operations were repatriated. An exception would permit current deductions for research and experimentation expenses.

  The Administration's May 4 release is light on details, but indicates that its proposal might be similar to a provision proposed by House Ways and Means Chair Charles B. Rangel (D-NY) in 2007 as part of H.R. 3970, the *Tax Reduction and Reform Act of 2007* (the "Rangel Bill"). The Rangel Bill provides for the deferral of a U.S. corporation's deductions allocable to income generated by controlled foreign corporations ("CFCs") until the associated income is repatriated and included in income for U.S. federal income tax purposes. Deductions allocated under the provision to CFCs and foreign branches would only be allowed on a current basis in proportion to the group's foreign source income currently included in U.S. income. Deferred deductions would be carried over to future taxable years.

- **Limit "Check-the-Box" Regime.** In a move described as targeting a "range of tax-avoidance techniques," the Administration proposes to mandate U.S. corporate taxation of certain overseas subsidiaries established by U.S. businesses. The statement indicates that one technique of concern involves the payment of interest by one disregarded entity to another disregarded entity, both wholly-owned by the same U.S. person, giving rise to a deductible expense in the disregarded entity's home taxing jurisdiction but no recognizable interest income to the U.S. owner.

This proposal, which is projected to be the largest revenue raiser of the group at a total of $86.5 billion over a decade, is certain to be the subject of extensive lobbying efforts by corporate taxpayers in a wide range of industries. Since the adoption of the "check-the-box" entity classification elections over a decade ago, the election has become a standard part of the worldwide structure of multinational businesses. Depending on the details of this proposal, for some industries the impact of this change in law might be little different from an outright repeal of the ability to defer tax on foreign earnings until they are repatriated.

- **Reform Foreign Tax Credits.** The Administration proposes to close loopholes through which it believes some U.S. businesses are artificially inflating or accelerating the use of foreign tax credits to offset U.S. tax. Although no details are provided, the Administration expresses its intent to ensure that the foreign tax credit is based on the taxes actually paid by the taxpayer on its foreign earnings and that the foreign tax credit is not allowed for foreign taxes paid on income not subject to U.S. tax.

Here again, although the details remain to be revealed, the proposal might be similar to a provision earlier proposed as part of the Rangel Bill. The Rangel Bill provides that aggregate foreign taxes paid or accrued by a U.S. taxpayer and its CFC subsidiaries would be allowed as credits on a current basis in proportion to the total amount of the worldwide group's foreign source income that is currently included in U.S. income. The remaining credits would be deferred until the deferred income is repatriated. Thus, under the Rangel Bill proposal, U.S. corporations would continue to be able to defer foreign source income, subject to the restrictions of subpart F, but would no longer be able to maximize foreign tax credits and the benefit of deferral of low-taxed foreign income by selectively repatriating high-taxed foreign income while continuing to defer low-taxed foreign income.

- **Increase Disclosure, Withholding and Enforcement Measures to Limit Abuses.** The Administration proposes a number of measures to combat perceived abuses that may allow evasion of taxes through overseas accounts. Thus, the proposals would require U.S. financial institutions to withhold 20% to 30% of their U.S. payments to individuals who use financial institutions that have not signed an agreement with the IRS to participate in the "qualified intermediary" (or "QI") program and require investors to "demonstrate that they're obeying the law" to obtain a refund; give Treasury authority to issue regulations requiring that a financial institution may be a QI only if all commonly–controlled financial institutions are also QIs; and create certain evidentiary presumptions regarding the filing of FBAR forms (the "Foreign Bank and Financial Account Report" for foreign accounts over $10,000) for accounts held at a non-QI, thus making it easier for the IRS to demand information and pursue cases. These changes would presumably increase participation in the QI program. The Administration would also tighten various reporting requirements, and require QIs to report information on their U.S. customers to the same extent that U.S. financial intermediaries must. The proposal states that U.S. customers at QIs would no longer be allowed to "hide behind foreign entities," and proposes enhanced reporting requirements for both U.S. investors and financial institutions. The Administration would also increase penalties when a taxpayer fails to make a required disclosure of foreign financial accounts, extend the statute of limitations on international tax enforcement and provide the IRS with funds to hire new employees devoted to international enforcement. While the proposal includes general language referring to the "Abuse of Tax Havens by Individuals," the more specific language of the May 4 release suggests that the Administration's proposals may not be limited to countries traditionally thought of as tax havens, and in some instances may not be limited to individuals.

The above proposals would generally become effective beginning in 2011. The Administration proposes to use a portion of the additional revenues expected to be generated by the above proposals to make permanent the research and experimentation tax credit. That credit has previously been subject to only temporary extensions and is currently set to expire at the end of 2009.

The Administration's May 4 statement provides little detail about the mechanics and scope of its proposals, and it appears that additional international tax reforms (expected to account for approximately $12 billion of revenue) will be unveiled only when the full budget proposal is released. Notably, while it appears a number of the Administration's proposals may be modeled on earlier proposals by Chairman Rangel, the Administration does not appear to have adopted the Rangel Bill's approach of an offsetting reduction in the corporate tax rate. The proposals as ultimately detailed by the Administration might well be altered through the legislative process to include a corporate tax rate reduction, or in other respects. The current proposals have received early support from a number of Congressional leaders, several of whom also have recently proposed legislation to toughen various international tax rules.[1] Other lawmakers, including some Democrats, have reacted more cautiously, and it is not possible to predict the form in which the above or similar proposals might eventually be enacted, if at all. Morrison & Foerster's Federal Tax Group will continue to monitor this evolving area.

Footnotes

[1] See "Stop Tax Haven Abuse Act: An Attempt to Close Down Dividend 'Washing' has New Life with a New Congress and New Administration; if Enacted Would have Broader Implications," March, 2009, and "Stop Tax Haven Abuse Act – Tax Provisions of Interest to Private Funds and Fund Managers," March, 2009.