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Administration Issues General Explanation of its Fiscal Year 2010 Revenue Proposals, Including International Provisions

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On May 11, the Obama Administration (the "Administration") issued general explanations of its Fiscal Year 2010 revenue proposals, including a number of international tax reform proposals that could have a dramatic impact on multinational businesses and other taxpayers with foreign investments or activities. The proposals provide a more comprehensive look at international tax proposals that had previously been described, including proposals to impose significant constraints on the ability to defer U.S. tax on foreign earnings, tighten limitations on claiming foreign tax credits, and create a wide array of enhanced compliance measures. The Administration also introduced various new international tax proposals.

The following is a summary of the Administration's international tax proposals. Except as noted below, the proposed changes to the substantive tax rules would be effective for tax years beginning after December 31, 2010, while the effective dates for the various enhanced compliance measures generally depend upon the date of enactment.

Limit "Check-the-Box" Rules

Expressing concern that check-the-box elections have been used to migrate earnings to low-tax jurisdictions without a corresponding income inclusion to a U.S. taxpayer, the Administration proposes to mandate U.S. corporate taxation of certain overseas subsidiaries. Under the proposal, a foreign entity could only be treated as a disregarded entity for U.S. tax purposes if the foreign entity and its sole owner are both formed under the laws of the same jurisdiction. In other cases, a foreign entity with a single owner would be treated as a per se corporation for U.S. tax purposes, subject to a general exception for first-tier foreign entities that are wholly-owned by a U.S. person.

The proposal does not appear to address foreign entities having multiple owners. Those entities may therefore remain eligible to elect partnership status, perhaps preserving some structuring flexibility for multinational business operations.

Defer Deductions for Foreign-Related Expenses

Subject to an exception for research and experimentation expenses, the Administration's proposal provides for the deferral of a U.S. person's deductions allocable to its foreign source income until that income is repatriated and included in income for U.S. federal income tax purposes. Expenses would be allocated to foreign source income in accordance with existing Treasury regulations relating to expense allocation. Deductions allocated under the provision to foreign source income would only be allowed on a current basis in proportion to the group's foreign source income that is currently included in U.S. income. Deferred deductions would be carried over to future taxable years.

Tighten Foreign Tax Credit Limitations

The Administration's proposal provides for a new, consolidated approach to applying certain foreign tax credit limitations. Specifically, under the proposal, the aggregate foreign taxes paid or accrued by a U.S. taxpayer and its foreign 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 foreign income is repatriated. Thus, under the 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.

In addition, the Administration proposes to adopt a matching rule to prevent the separation of foreign tax credits from the associated foreign income in certain cases such as those involving hybrid entities. Although the proposal contains very general language, the language likely contemplates the use of structures that employ a reverse hybrid entity to generate foreign tax credits in an upper tier entity even though the actual tax payment underlying the credit is made by a lower tier entity that is treated as a corporation for U.S. tax purposes.

The Administration also proposes to tighten certain foreign tax credit rules applicable to foreign levies paid by persons who receive a specific economic benefit from the levying foreign country in exchange for their payment.

Revise Intangible Property Transfer Rules

The proposal aims to provide clarity and consistency in rules relating to intangible property transfers, in order to prevent taxpayers from shifting income attributable to intangible property to foreign tax jurisdictions.

Upon certain transfers (including licenses) of intangible property, Sections 482 and 367(d) of the Code can impose U.S. tax on the transferor well into the future, based upon a deemed receipt by the transferor of annual payments that are "commensurate with the income" generated by the intangible property over time. The proposal clarifies the definition of "intangible property" for purposes of Section 367(d) and Section 482 to include workforce in place, goodwill and going concern value. It also authorizes the Commissioner to value the transfer of multiple intangible properties on an aggregate basis if that achieves a more reliable result. Furthermore, it requires intangible property to be valued at its "highest and best use," as it would be exchanged between a willing buyer and seller having reasonable knowledge of relevant facts.

Expand Earnings Stripping Limitations for "Inverted" U.S. Corporations

The proposal expands the application of existing "earnings stripping" limitations on interest deductions in the case of interest paid by former U.S. parent corporations that have become subsidiaries of a new foreign parent by virtue of an "inversion" transaction. The new, stricter limitations would not apply to the "expatriated" U.S. corporation if its new foreign parent is taxable as a U.S. corporation under Section 7874 of the Code.

The proposals strengthen the earnings stripping limits imposed on the expatriated U.S. corporation, in three primary respects. First, the safe harbor for companies whose debt-to-equity ratio does not exceed 1.5 to 1 is eliminated. Second, the threshold for determining whether there is excess net interest expense is reduced by half. Last, excess interest expense that is not currently deductible can only be carried forward for 10 years (versus an indefinite carry forward under current law).

Prevent Repatriation of Earnings in Certain Cross-Border Reorganizations

The proposal includes a repeal of the "boot-within-gain" limitation on gain recognition for reorganizations where the acquiring corporation is foreign and the shareholder's exchange has the effect of a dividend. Generally, if a shareholder receives non-qualifying consideration ("boot") such as cash in exchange for its target stock in a reorganization, the shareholder recognizes gain equal to the smaller of the gain realized on the exchanged stock or the amount of boot. If the exchange has the effect of a dividend, all or part of gain is treated as a dividend to the extent of the shareholder's share of corporate earnings and profits.

When the acquiring corporation is foreign, this "boot-within-gain" limitation can enable U.S. shareholders to repatriate deferred earnings and profits of foreign subsidiaries with minimal U.S. taxation. For example, if a U.S. shareholder's target stock has little or no built-in gain, the shareholder recognizes minimal gain even if much of the consideration received is boot or the exchange has the effect of a dividend. Note that although this concern might be most pronounced in the case of a controlled foreign corporation and a reorganization among related parties, by its terms the proposal is not limited to that fact pattern.

Prevent the Avoidance of Dividend Withholding Taxes

In recent years Congress has investigated the use by financial institutions of equity swaps and stock lending transactions to enable their foreign clients to avoid U.S. withholding taxes on dividends paid with respect to U.S. securities. Although substitute dividend payments made under a stock lending agreement are sourced in the same manner as the dividends with respect to the underlying stock (and would therefore be U.S. source if made with respect to the stock of a U.S. corporation), transactions involving stock lending rely on IRS Notice 97-66 to avoid U.S. dividend withholding tax.[1] Transactions involving swaps rely on a Treasury regulation which provides that the source of any payments made pursuant to the swap is determined according to the country of residence of the recipient of the payment.

The proposal would combat the above described transaction in the following manner: With respect to securities lending transactions, the proposal contemplates the Treasury Department revoking IRS Notice 97-66 and issuing guidance that would address the concern involving a "cascading effect" of dividend withholding tax while closing the door to the unintended benefits described above. With respect to equity swaps, the proposal would cause any dividend equivalent amount with respect to a U.S. corporation paid under an equity swap contract to be U.S. source. As a result, such amounts would generally be subject to U.S. withholding tax to the extent paid to a foreign person.[2] However, an exception would apply to equity swaps that meet all of the following requirements:

- the terms of the equity swap do not require the foreign person [sic] to post more than 20% of the value of the underlying stock as collateral;
- the terms of the equity swap do not include any provision addressing the hedge position of the counterparty to the transaction;
- the underlying stock is publicly traded and the notional amount of the swap represents less than 5% of the total public float of that class of stock and less than 20% of the 30-day average daily trading volume;
- the foreign person does not sell the stock to the counterparty at the inception of the contract, or buy the stock from the counterparty at the termination of the contract;
- the prices of the equity that are used to measure the parties' entitlements or obligations are based on an objectively observable price; and
- the equity swap has a term of at least 90 days.

Extend Expiring Subpart F Exceptions

The Administration proposes to extend through December 31, 2010 the Subpart F "active financing" exception (treating as non-Subpart F income "qualified banking or finance income" of certain controlled foreign corporations engaged in an active finance business) and "look-through" exception (treating as non-Subpart F income certain dividends, interest, rents and royalties received by a controlled foreign corporation from a related controlled foreign corporation, to the extent attributable to non-Subpart F income of the payor). The exceptions would otherwise expire at the end of 2009. Unlike the other proposals discussed in this alert, this provision is not a revenue raiser.

Repeal 80/20 Company Rules

Under current law, dividends and interest paid by a U.S. corporation to a foreign payee may be exempt from U.S. withholding tax if at least 80% of the U.S. payor's gross income generated during a three-year test period is foreign source and attributable to the active conduct of a foreign trade or business. Citing a general concern that this "80/20 company" rule can be manipulated, the Administration proposes to repeal this exemption.

Enhance Foreign Account Information Reporting and Compliance Mechanisms

In light of recent high-profile cases showing possible widespread failure of U.S. taxpayers to report foreign financial accounts, the Administration has proposed increased information reporting requirements and enhanced compliance measures. The proposals include (i) requiring increased reporting by qualified intermediaries and withholding by nonqualified intermediaries, (ii) requiring U.S. individual taxpayers to report certain transfers involving foreign accounts and more completely disclose account identifying information in their income tax return, (iii) requiring certain third parties to report information about foreign accounts and foreign entities, and (iv) negative presumptions for certain filing failures, extended statute of limitations, and penalties. The goal for the enhanced reporting obligations apparently is to have overlapping and redundant sources of information so that if a taxpayer fails to report, an intermediary or withholding agent would still provide enough information to the IRS about the foreign account or entity.

Expand Reporting by Qualified Intermediaries

The Administration proposes to strengthen the withholding and reporting rules for "qualified intermediaries" ("QIs"), which are foreign financial institutions that contract with the IRS to assume certain documentation, reporting and withholding responsibilities. Among other things, additional reporting requirements would be imposed with respect to account holders that are U.S. persons. In addition, the Treasury Department would be authorized to issue regulations to implement the proposal, including reporting requirements that would apply if a U.S. person is the beneficial owner of an account holder which is a foreign entity and requirements with respect to foreign financial institutions that are commonly-controlled with a QI.

Expand Withholding Obligations of Nonqualified Intermediaries

To encourage use of the strengthened QI system and address a concern that persons not otherwise entitled to an exemption from, or reduction in, withholding tax may attempt to avoid U.S. tax by arranging to receive payments through foreign intermediaries that are not QIs, the Administration proposes that, subject to any exceptions provided by regulations, any withholding agent making a payment of "fixed and determinable annual and periodic income" to a non-QI would be required to withhold tax at a rate of 30%. Similarly, subject to any exceptions provided by regulations, a withholding agent would be required to withhold tax at a rate of 20% on gross proceeds from the sale of any security of a type that would be reported to a U.S. non-exempt payee, when paid by the withholding agent to a non-QI that is located in a jurisdiction with which the U.S. does not have a comprehensive income tax treaty that includes a satisfactory exchange of information program. Provisions would be included with respect to obtaining refunds of withheld amounts.

Expand Reporting by Individual U.S. Foreign Account Owners

Under the proposals, U.S. individual taxpayers would be required to report on their income tax return any transfer of money or property made to, or receipt of money or property from, any foreign bank, brokerage, or other financial account by the individual, or by any entity of which the individual owns, actually or constructively, more than 50% of the ownership interest. Note that the proposal does not apply to non-individual taxpayers, nor does it include U.S. taxpayers who only have signatory or other authority over the foreign account. Exclusions from this enhanced reporting exist for accounts held at QIs and situations in which the cumulative annual value of the transfers is less than $10,000. Note that so long as the aggregate annual account value is $10,000 or greater, the current reporting obligations (*i.e.*, filing the annual FBAR form and disclosure of certain information in the income tax return) still would apply. The proposal includes a special penalty (subject to a reasonable cause exception) for failure to report covered transfers equal to the lesser of $10,000 per reportable transfer or 10% of the cumulative amount or value of the unreported covered transfers.

A separate proposal would generally require the individual income tax return to reflect the more detailed foreign account information that is required to be reported on the FBAR. The FBAR filing requirement would remain in place and would not be affected by the proposal.

Require Intermediary Reporting of U.S.-Owned Foreign Accounts or Entities and Certain Transfers

The Administration has proposed to require any U.S. financial intermediary and any QI that opens a new foreign account, or transfers money or property with a value of more than $10,000 to or from a foreign account, on behalf of a U.S. person or entity beneficially more than 50% owned by a U.S. person to file an information return informing the IRS of the amounts transferred to the account and of basic account details. Exceptions to these reporting requirements include (i) accounts opened and amounts transferred to, from, or on behalf of, publicly traded companies and their subsidiaries, and (ii) accounts opened at and transfers made to and from QIs on behalf of a U.S. person or 50% owned entity.

The Administration also has proposed to require any U.S. person, or any QI, that forms or acquires a foreign entity on behalf of a U.S. individual or a 50% owned entity to provide the IRS with information regarding such formation or acquisition.

Enhance Penalties and Other Compliance Measures

To encourage compliance with these new and existing reporting obligations, the Administration has proposed a collection of measures.

The first set of measures is to establish the following negative presumptions:

- A rebuttable presumption that any foreign account for which an FBAR was not filed contains enough funds to *require* that an FBAR be filed. The presumption would not apply in criminal proceedings and would not apply to accounts held through QIs.

- A rebuttable presumption of willfulness in the case of a failure to file an FBAR with respect to any foreign account held with a non-QI which has a balance of greater than $200,000 at any point during the calendar year. The presumption would not apply in criminal proceedings and would not apply to accounts in which the person has signature or other authority by virtue of being an officer or employee of a corporation, but otherwise has no more than a de minimis financial interest in that corporation.

- An irrebuttable presumption that any payment of U.S.-source fixed or determinable annual or periodical income to a foreign entity is subject to 30% gross basis withholding, unless the foreign entity provides documentation regarding its beneficial owners. Exceptions would be provided for payments to publicly traded companies and their subsidiaries, foreign governments and pension funds, and may also be provided by Treasury regulation for payments to entities engaged in the active conduct of a trade or business in their country of residence, charities, widely-held investment vehicles, entities that enter into an agreement with the IRS to collect documentation for all owners and report all U.S. non-exempt owners to the IRS, and for any other payment that the Treasury Department concludes presents a low risk of tax evasion.

Another new compliance measure proposed by the Administration is to extend the statute of limitations for assessment of tax in cases of certain failures to file information returns regarding foreign entities and accounts, including the failure to comply with the newly proposed reporting requirements described above. The proposal would extend the statute of limitations from three to six years after the taxpayer furnishes the information required to be reported, and would broaden the reach of the six-year statute of limitations to include information returns filed by qualifying electing funds, the proposed tax return disclosure of FBAR information, the information returns proposed to be required of U.S. individuals with respect to certain transfers of money or property to and receipts from certain foreign accounts, and the related-party recordkeeping requirements of Section 6038A(a). The extension of the statute of limitations would apply to the entire income tax return as opposed to assessment of tax items relating only to the event or period for which the information returns are required.

Finally, the Administration has proposed to double, from 20 to 40%, the accuracy-related penalty imposed on (i) substantial understatements of income tax, (ii) understatements resulting from negligence or disregard of rules or regulations, or (iii) a reportable transaction understatement, in each case if the understatement arises from a transaction involving a foreign account for which the required FBAR-related information was not provided on the taxpayer's income tax returns. In a proposed change that is unrelated to FBAR reporting and represents a departure from general tax policy, the Administration also proposes to remove the reasonable cause exception to the penalty in the case of a reportable transaction understatement. The Administration has also proposed to enhance the penalties for failure to comply with certain information reporting requirements applicable to foreign trust transactions, in an effort to incentivize taxpayer cooperation with IRS information requests in that area.

Conclusion

If enacted, the proposals described above could radically alter the U.S. taxation of many multinational businesses and require many companies to restructure their worldwide operations. It remains to be seen, however, whether the above provisions, particularly those limiting deferral of foreign-source income, can be enacted in their current form without an offsetting corporate tax rate reduction or other measures to address concerns about maintaining the competitiveness of U.S. businesses. Morrison & Foerster LLP will continue to track developments in this area and will be ready to assist you in understanding and responding to any legislative changes.

Footnotes

[1] Notice 97-66, 1997-48 I.R.B. (1997). The notice addressed the concern expressed by practitioners with respect to a "cascading effect" of dividend withholding tax if the same U.S. securities are the subject of multiple stock lending transactions and therefore multiple substitute dividend payments.
[2] In March 2009, Senator Carl Levin (D-Michigan) and Representative Lloyd Doggett (D-Texas) introduced the Stop Tax Haven Abuse Act in the Senate and the House of Representatives, respectively, addressing the same issues. *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.