

## Update Regarding Status of the Obama Administration's International Tax Proposals

October 22, 2009

On October 13, *The Wall Street Journal* reported that White House aides had confirmed that the Obama administration has shelved its plans to advance its international tax reform for 2009 as a result of heavy lobbying by the business community. The same report indicated that the administration might revisit the issue in 2010 as part of a broader tax reform effort. While this news produced an immediate collective sigh of relief from the business community and tax advisors, the collective view appears to be that any such relief is merely temporary, and that international issues will be revisited by the Obama administration and Congress in 2010 as they seek revenue to offset recent spending measures. This was confirmed by a White House spokeswoman shortly after the story first surfaced in *The Wall Street Journal*.

That same day, Reuters issued a news release quoting White House Deputy Press Secretary Jen Psaki as emphasizing that the Obama administration remains committed to pursuing changes to the international tax provisions. "While we have an open door to the ideas and concerns of business leaders, we remain as committed to reforming international corporate taxation to end unfair loopholes as we were the day the president announced the plan," Psaki stated.

### Background

The Obama administration (the administration) first made headlines with its international proposals in a press release on May 4.<sup>1</sup> That first announcement was followed by the May 11 release of the Treasury Department's "Green Book."<sup>2</sup> On September 14, the congressional Joint Committee on Taxation released "Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment," which contained the committee's description of the proposals and the current status of the relevant law, as well as an analysis of the revenue provisions related to the taxation of cross-border income and investments that were included in the administration's fiscal year 2010 budget proposal.

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<sup>1</sup> Unless otherwise indicated, all section references used herein refer to the Internal Revenue Code of 1986, as amended (the Code), and the regulations promulgated thereunder.

<sup>2</sup> Formally titled *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* Since the release of the Green Book, the administration's international proposals have been the focus of vocal criticism from the business community as well as intensive lobby efforts. The website [www.opensecrets.org](http://www.opensecrets.org), which is maintained by the Center for Responsive Politics, reports that nearly 100 multinational corporations and related associations identified lobbying efforts directed at the anti-deferral provisions, and 15 multinational corporations identifying lobbying efforts directed at the proposed changes to the entity classification rules.

## Important International Provisions

The following provisions are included in the administration's proposal under the heading "Reform U.S. International Tax System" in the Green Book, then further discussed in the Joint Committee on Taxation's analysis.<sup>3</sup> This outline does not contain a comprehensive discussion of all international-related provisions contained in the Administration's fiscal year 2010 budget proposal.

### Elimination of Disregarded Entity Elections for Most Foreign Entities

- The administration proposes to limit the ability of taxpayers to elect to cause certain foreign eligible business entities to be disregarded pursuant to the application of the so-called "check-the-box" provisions. Under the proposal, a foreign eligible entity (i.e., an entity not otherwise characterized as a per se corporation pursuant to Treas. Reg. section 301.7701-2) may be treated as a disregarded entity only if the single owner of the foreign eligible entity is created, organized in, or under the law of, the foreign country in, or under the law of, which the foreign eligible entity is created or organized. Thus, the proposal would apply a "same country" rule with respect to disregarded entity elections.
- The proposal provides that, except in cases of U.S. tax avoidance, the proposal generally would not apply to a first-tier foreign eligible entity that is owned by a single U.S. person.
- The proposed changes to the check-the-box rules will significantly alter the application of the anti-deferral provisions. Many of the standard planning tools, which also permit U.S.-based multinationals to effectively minimize their foreign tax liability, would be eliminated due to the change.
- The application of this proposal would have wide-ranging ancillary effects for taxpayers, which depending on the relevant facts of each structure could include:
  - Triggering of preexisting Gain Recognition Agreements (GRAs)
  - Triggering of taxable gain due to the triggering of boot gain and deemed dividends as a result of springing debt obligations
  - Triggering of taxable gain as a result of section 367(a), (b), and (d) and potential GRA implications associated with such transactions
  - Foreign currency issues under section 987
  - Dual Consolidated Loss implications
- Due to the wide range of potential tax implications, taxpayers will need to take immediate steps to restructure their operations if the proposal is implemented. Extending transition relief may be considered by Congress during the legislative process.
- Partnership structures may, in certain circumstances, provide structuring alternatives if the proposal is enacted. Such structures, however, have a host of issues under the Subpart F "Anti-Brown Group" regulations, section 987 and various other provisions.
- The proposal would be effective for taxable years beginning after December 31, 2010. Thus, the proposed change would allow a period of time for taxpayers to restructure their operations. However, note that the provision would not be limited to check-the-box

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<sup>3</sup> This summary does not address the various proposals that relate to foreign accounts and the reporting of such interests.

elections made after the effective date. Rather, it would apply to preexisting elections. Thus, there would be no grandfathering of preexisting structures.

### **Extend Subpart F Active Financing and Look-Through Exceptions**

- The administration proposes to extend the Active Financing Exception of section 954(h) and the Look-Through Exception to Foreign Personal Holding Company Income set forth at section 954(c)(6) to taxable years of foreign corporations beginning before January 1, 2011. Currently these proposals are scheduled to expire with respect to taxable years of foreign corporations beginning on or after January 1, 2010.

### **Defer Deductions of Expenses Related to Deferred Income**

- The administration proposes to defer deductions for expenses (such as interest expense) of a U.S. person that are properly allocated and apportioned to foreign source income to the extent such foreign source income associated with the expenses is not currently subject to U.S. taxation. The provision would not apply to research and experimentation expenses. Deferred expenses for a particular year would be carried forward to subsequent years and combined with foreign-source expenses of the U.S. person for such carry-over year.
- According to the administration, the ability of taxpayers to realize a U.S. deduction for expenses attributable to overseas investments while deferring U.S. tax on the income from such investments may encourage U.S. businesses to shift investments and jobs overseas. The proposal to defer the deduction of certain expenses related to tax-deferred foreign income is intended to eliminate or reduce the incentive for U.S.-based multinationals to shift income-producing activities offshore. As pointed out in the Joint Committee's analysis, there is no definitive empirical research to support the underlying hypothesis.
- This provision would disproportionately impact companies with large amounts of U.S.-based borrowing. Similarly, companies in overall foreign loss positions would be caught between the prospect of triggering double taxation from the repatriation of foreign earnings or the deferral of U.S. interest deductions under the proposal if such earnings are not repatriated.
- This proposal would be effective for taxable years beginning after December 31, 2010.

### **Foreign Tax Credit Pooling**

- The administration proposes to require U.S. taxpayers to determine their deemed paid foreign tax credits (FTCs) on a consolidated basis. This would be accomplished by requiring taxpayers to aggregate their creditable foreign taxes and E&P pools for all subsidiaries with respect to which the taxpayer is entitled to claim deemed paid foreign tax credits pursuant to the provisions of section 902.
- According to the administration, the 2004 Tax Act, which reduced the section 904 foreign tax credit limitation categories to passive income and general category income, increased the ability of taxpayers to "cross credit" between such categories. Such cross-crediting allows taxpayers to reduce the residual U.S. tax on foreign-source income.

- This proposal would effectively eliminate the technique of maintaining high-tax and low-tax chains of foreign subsidiaries for purposes of managing FTC planning.
- The proposal would be effective for taxable years beginning after December 31, 2010.

### **Foreign Tax Credit Splitting**

- The administration proposes to adopt a matching rule to prevent taxpayers from separating creditable foreign taxes from the underlying income that gives rise to such tax liability. This provision is intended to address “splitting” structures, such as that at issue in *Guardian Industries*.<sup>4</sup>
- It is interesting to note that the Green Book does not characterize this change as a “clarification,” which is not consistent with the IRS and Treasury’s characterization of proposed regulations that were issued pursuant to section 901 in August 4, 2006. Those regulations remain outstanding and would apply to years beginning after the final regulations are published in the Federal Register.
- The proposal would apply to taxable years beginning after December 31, 2010.

### **Expanding the “Intangible Property” Definition for Purposes of sections 367(d) and 482**

- The administration’s proposal indicates that the scope of “intangible property” as applied for purposes of sections 367(d) and 482 is “not entirely clear or consistent,” and that the lack of clarity and consistency may result in the inappropriate avoidance of U.S. tax and misuse of the rules applicable to transfers of intangible property to foreign parties. To remedy this issue, the administration proposes to clarify the definition of “intangible property” for purposes of sections 67(d) and 482 to include workforce in place, goodwill, and going concern value.<sup>5</sup>
- The administration has also proposed a change to the valuation rules as applied to sections 367(d) and 482. The proposed changes would also “clarify” that in a transfer of multiple intangible properties the IRS may value those properties on an aggregate basis where such an approach achieves a more reliable result.
- The administration proposes to clarify that intangible property must be valued based on its “highest and best use.” Such an approach, which appears to advocate a hypothetical use, as opposed to the actual use of intangible property for valuation purposes, is arguably contradictory to the “commensurate with income” standard of sections 367(d) and 482.
- This particular matter is a source of considerable controversy between the IRS and taxpayers currently, despite the fact that the administration’s proposal acknowledges a need for a legislative change. A number of ongoing field examinations and matters before IRS Appeals could produce one or more litigations on this issue in the near future.
- The proposal would be effective for taxable years beginning after December 31, 2010.

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<sup>4</sup> *Guardian Industries Corp. v. United States*, 477 F.3d 1368 (Fed. Cir. 2007).

<sup>5</sup> For a more detailed examination of this issue, please see [http://www.morganlewis.com/pubs/Tax\\_Sections367and482\\_LF\\_09oct09.pdf](http://www.morganlewis.com/pubs/Tax_Sections367and482_LF_09oct09.pdf).

## **Strengthening of Interest-Stripping Rules as Applied to Expatriated Entities**

- The administration proposes to make revisions to the interest stripping rules of section 163(j) to further tighten the limitations on deductibility of interest paid to expatriated entities by related persons. The current debt-to-equity safe harbor would be eliminated and the 50% adjusted taxable income threshold for the limitation would be reduced to 25% of adjusted taxable income with respect to “disqualified interest,” which is generally any interest other than interest paid to unrelated parties on debt that is subject to a related-party guarantee.
- The proposal notes that the 50% adjusted taxable income threshold would generally continue to apply on interest paid on guaranteed debt.
- The carryforward rules would provide that disallowed interest would be limited to 10 years and the carryforward of excess limitation would be eliminated.
- The proposal in its current form is limited in its application to “Expatriated Entities.” The proposal would define that term by reference to the anti-inversion rules of section 7874. Naturally the proposed change would not apply to foreign entities subject to the expatriated entity rules of section 7874, and thus characterized as a U.S. corporation for U.S. federal income tax purposes.
- The proposal would be effective for taxable years beginning after December 31, 2010.

## **Change to Boot Within Gain Rules for Cross-Border Transactions**

- The administration proposes to repeal the boot-within-gain limitation under section 356. Taxpayers have used this provision to effectuate tax-efficient repatriations of income from deferral platforms.
- Pursuant to section 356(a)(1), if pursuant to a reorganization an exchanging shareholder receives in exchange for its stock of the target corporation both stock of the acquiring entity as well as taxable “boot,” then the exchanging shareholder is required to recognize taxable gain equal to the lesser of the gain realized in the exchange or the amount of boot received (the “boot within gain” limitation).
- Taxpayers have utilized the boot-within-gain rule in cross-border reorganizations to repatriate previously untaxed E&P of foreign subsidiaries without triggering U.S. taxation. This is possible if the exchanging shareholder’s stock in the target has little or no built-in taxable gain at the time of the reorganization, in which case large sums of cash consideration can be distributed by the acquiring entity with little if any adverse U.S. tax results. The administration views such a result as inconsistent with the deferral provisions of the Code.
- A number of commentators on this provision have suggested it is unnecessarily broad, whereas others have suggested it is unduly narrow.
- The proposal would be effective for taxable years beginning after December 31, 2010.

## **Repeal of the 80/20 Sourcing Exceptions**

- The administration proposes to repeal the current 80/20 exceptions, which in certain circumstances cause dividends and interest paid by domestic corporations to be

characterized as foreign source income, in whole or in part, as opposed to U.S.-sourced. The 80/20 rules permit taxpayers to avoid the imposition of U.S. withholding taxes where the requirements of the rules are satisfied.

- The proposal would be effective for taxable years beginning after December 31, 2010.

### **Strengthening of the Dividend Withholding Tax Provisions**

- The Code would be modified to provide that income earned by foreign persons with respect to equity swaps that reference U.S. equities would be treated as U.S.-sourced income to the extent that the income is attributable to (or calculated by reference to) dividends paid by a domestic corporation. Certain exceptions would apply.
- The proposal would be effective for taxable years beginning after December 31, 2010.

### **Modify Dual-Capacity Taxpayer Rules Regarding the Creditability of Foreign Taxes**

- The administration proposes to further limit the ability of certain “dual-capacity” taxpayers to realize foreign tax credits for certain levies paid to foreign governments. The section 901 creditability rules provide that a foreign levy must be substantially equivalent to an income tax under U.S. tax principles in order to qualify for a foreign tax credit. A taxpayer that is subject to a foreign levy but also receives a specific economic benefit from the levying country (a “dual-capacity” taxpayer) may not credit the portion of the foreign levy paid in exchange for the specific economic benefit.
- The proposal would limit the ability of dual-capacity taxpayers to claim a foreign tax credit. Foreign levies that would otherwise qualify as income taxes or an in-lieu-of tax would be creditable only if the foreign country generally imposes an income tax. An income tax would be considered to be generally imposed only if the income tax applies to trade or business income from sources in such country and only if such income tax has substantial application to non-dual-capacity taxpayers and to persons who are nationals or residents of that country. These changes would override the current regulatory safe harbor that applies when a foreign country does not generally impose an income tax.
- Lastly, the administration’s proposal would convert the special FTC limitation rules of section 907 into a separate category under section 904 for foreign oil and gas income.
- The proposal contains an interesting deference to current U.S. treaty obligations, providing that such treaty provisions would control to the extent they expressly allow a credit for taxes paid or accrued on oil or gas income.
- The proposal would be effective for taxable years beginning after December 31, 2010.

### **Other Miscellaneous Provisions of Interest**

In addition to the international provisions, there are a number of other provisions that potentially impact international transactions.

#### **Codification of Economic Substance**

- **The administration proposes to codify the Economic Substance Doctrine.** To date the Economic Substance Doctrine has been Common Law. The proposal would codify the Economic Substance Doctrine such that a transaction would satisfy the test, and thus be

recognized for U.S. federal income tax purposes, if (1) it changes in a meaningful way (apart from federal tax effects) the taxpayer's economic position, and (2) the taxpayer has a substantial purpose (other than a federal tax purpose) for entering into the transaction. The provision would also provide that a transaction will not be treated as having economic substance solely by reason of a profit potential, unless the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the net federal tax benefits arising from the transaction.

- **New penalty provision.** In addition to codifying the Economic Substance Doctrine, the administration proposes to introduce a 30% penalty on any understatement of tax attributable to a transaction that lacks economic substance, reduced to 20% if there was adequate disclosure of the relevant facts on the taxpayer's return. These understatement penalties would be imposed in lieu of other accuracy-related penalties that might otherwise be applied with respect to the tax understatement. However, any understatement arising from lack of economic substance would be taken into account in determining whether there is a substantial understatement of income tax under current law.
- **IRS Discretion and Penalty Guidelines.** The proposal provides that the statute will delegate regulatory authority to the IRS. Further, the proposal states that the IRS could assert the penalty even if there has not been a court determination that the Economic Substance Doctrine was relevant. Once a penalty is asserted by the IRS, any abatement of the penalty would have to be proportionate to the abatement of the underlying tax liability. Interest deductions would be denied for any interest attributable to an understatement of tax arising from the application of the Economic Substance Doctrine.
- **The proposed codification of the Economic Substance Doctrine would apply to transactions entered into after the date of enactment.** The provision denying the deductibility of interest would be effective for taxable years ending after the date of enactment and with respect to transactions entered into after such date.

### **Withholding Tax Provisions**

- The administration's proposals include a number of provisions designed to strengthen the withholding tax provisions and information reporting rules as applied to foreign accounts, transfers of assets to foreign accounts, and the establishment of offshore entities and foreign trusts.

### **Statute of Limitations Extension**

- Section 6501(c)(8) currently provides for a three-year extension of the statute of limitations with respect to any tax relating to any event or period for which certain information returns are required with respect to certain foreign transfers, foreign entities, and foreign-owned entities. The administration proposes to extend section 6501(c)(8) to six years after the taxpayer furnishes the information that is required to be reported. The proposed changes would be effective for tax returns due to be filed after the date of enactment.

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