Washington Tax Legislative Update: Weathering the Gathering Storm

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Weathering The Gathering Storm

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Outline – Topics to be covered

A. 2009 Legislation

1. American Recovery and Reinvestment Act

2. Health Care – Is there any oxygen left in DC and when will it ever end?

3. Estate Tax – Short term patch versus long term fix

4. Additional economic recovery items
   (i) New extenders (e.g., homebuyer’s credit; bonus depreciation)
   (ii) NOL carrybacks
   (iii) Relief for victims of financial fraud

5. Traditional extenders (R&E credit, active finance exception, cfc look-through, etc.)
   (i) No need for AMT patch
   (ii) Possible pay-fors

B. Beyond 2009 – Potential schizophrenia and the perfect storm

1. Need for additional stimulus versus deficit reduction
   (i) When will offsets be needed?

2. Expiration of 2001 and 2003 tax cuts (e.g., reductions to individual marginal tax rates, marriage penalty relief, the additional child tax credit, and reduced tax rates on dividends and capital gains.)

3. Possibility of Tax Reform
   (i) Chairman Rangel – “Mother of All Tax Reform” bill
   (ii) Presidential buy-in? – Volcker Tax Reform panel
   (iii) President’s budget – international reforms
   (iv) Possible impediments to tax reform
Summary of Corporate Tax Reform Proposals

Tax relief measures

The bill has two business tax relief proposals that cost, in the aggregate, $385 billion over 10 years:

1. **Corporate rate reduction** ([§3001 of the bill and §11 of the Code]): Would reduce the corporate tax rate from 35% to 30.5%. Effective for tax years beginning after December 31, 2008. Ten-year cost is $364 billion.
   
a. Creates disparity between top individual rate and top corporate rate, which could lead to certain sheltering techniques.

2. **Permanent extension of small business expensing** ([§3401 of the bill and §179 of the Code]): Permanent extension of small business expensing, including eligibility of computer software (current law expires in 2010). Effective for tax years beginning after date of enactment and for software placed in service after date of enactment. Ten-year cost is $21 billion.

Extenders

The bill provides for a one-year extension of 17 business provisions that expired at the end of 2007 at a 10-year cost of $15.2 billion. These provisions include the research credit ($9 billion), new markets tax credit ($1.3 billion), and 15-year cost recovery for certain leasehold improvements and restaurant property ($3.5 billion).

Offsets

The cost of these tax relief measures and business extenders would be offset by 14 proposals that raise, in the aggregate, approximately $414 billion over 10 years. The significant proposals are as follows:

1. **Repeal domestic manufacturing and production incentive** ([§3101 of the bill and §199 of the Code]): Would repeal §199 of the Code, which provides a 9% deduction for certain income derived from domestic manufacturing and production activities. Effective for tax years beginning after December 31, 2008. Ten-year savings is $115 billion.
   
a. The bill effectively replaces a 3% effective rate cut targeted at domestic production and applicable to both corporations and pass-
through entities, with a 4.5% across the board rate cut solely for corporate taxpayers.

b. Businesses organized as pass-through entities would not benefit from the corporate rate reduction and would be faced with significant tax increases to the extent they are currently eligible for §199 benefits.

2. **Defer deductions allocable to deferred foreign income** [§3201 of the bill, and new §975 of the Code]: Otherwise deductible US expenses that are allocable to deferred foreign income would be deferred and deducted when the “related” foreign income is repatriated (or deemed repatriated under §956). The proposed rules are applied before §§901-908. Effective for tax years beginning after December 31, 2007. Ten-year savings is $106 billion (in combination with foreign tax credit proposal, discussed below).

a. **Deduction for current year expenses**: “Foreign-related deductions” (“FRD”) incurred in the U.S. are “taken into account” only to the extent allocable to “currently-taxed foreign income” (“CTFI”). It appears the mechanics of the computation would be as follows:

i. First, treat all CFCs as one CFC (a consolidated CFC approach) and assume all deferred foreign income (i.e., [current year] earnings and profits of CFCs minus actual dividends and deemed dividends) (“DFI”) is includable under subpart F;

   (1) CTFI is all foreign source income (determined without regard to taxable distributions paid out of prior years’ DFI), reduced by direct foreign taxes.

   (2) §78 gross-up does not apply in determining CTFI or DFI.

ii. Second, compute the amount of FRD allocable to total foreign income (CTFI plus DFI) [presumably under §861 regulations];

iii. Third, compute amount of allowable FRD by multiplying FRD by a fraction, the numerator of which is CTFI and the denominator of which is CTFI plus DFI.

iv. The amount of FRD allocated to DFI is deferred to a later year and those deferred deductions become “previously deferred deductions” (“PDD”) in subsequent years.

b. **Deduction for deferred expenses**: PDD are “taken into account” when “previously deferred foreign income” (the accumulated DFI for all prior tax years, determined at the beginning of the year, less “repatriated foreign income” (“RFI”) for all prior years) (“PDFI”) is repatriated in future years.

i. Amount of deductible PDD is the amount allocated to RFI (taxable distributions out of PDFI).
ii. Computed by multiplying accumulated PDD by a fraction, the numerator of which is RFI and the denominator of which is PDFI.

iii. Deductions related to RFI are allocated to foreign source income, and are not again included in FRD.

c. Considerations

i. “taken into account” presumably means deductions being allowed or allowable.

ii. Consolidated CFC approach:

1. CFC’s with current year deficits would appear to offset current year E&P of other CFCs.

2. Intercompany transactions: It is unclear whether proposal requires simple addition of current year E&P, or whether intercompany transaction rules would be in place.

iii. Availability of deferred deductions:

1. As a consequence of the consolidated CFC approach, distributions would constitute RFI in any particular year only to the extent aggregate distributions from all CFCs exceed aggregate current year E&P of all CFCs, even if a distribution from a particular CFC exceeded that CFC’s current year E&P.

2. Thus, in order to access any portion of deferred deductions from prior years, a US multinational would have to first repatriate an amount equal to the current year E&P of all its foreign subsidiaries, although it does not appear that all the current year E&P of each individual CFC needs to be repatriated. For example, assume CFC1 has $600 of current year E&P and $2,000 of accumulated E&P, and CFC2 has $400 of current year E&P and $1,000 of accumulated E&P. Under the consolidated CFC approach, the aggregate current year E&P is $1,000. If CFC1 makes a taxable distribution of $1,500 and CFC2 makes no distribution, it appears that RFI would equal $500, even though none of CFC2’s current year E&P was distributed, and $900 of CFC1’s prior year E&P was distributed.

3. Phantom deductions? Unclear what happens if DFI is a loss, producing an allowance fraction greater than 1. Would this be treated as a deemed repatriation, so that a portion of PDD could be taken?
iv. Impact on FTC limitation:

(1) Year deductions are deferred: in theory, such deductions would have otherwise been allocated to US source income, so FTC limitation should not be significantly affected. However, it is difficult to make a general conclusion without performing specific calculations.

(2) Year previously deferred deductions are deducted: in theory, these deductions would have otherwise been allocated to US source income (in a previous year), so should have a downward effect on FTC limitation.

v. Interest expense:

(1) Allocation method: Chairman Rangel also proposes to repeal the worldwide interest allocation rules enacted in AJCA 2004. This would generally increase the amount of interest expense allocated to foreign income.

(2) Assumed subpart F inclusion: Under the proposal, all current year earnings and profits are assumed to be subpart F. It is unclear how that assumption would affect the foreign asset ratio for allocating interest expense. If the E&P was actually subpart F, the resulting §961 basis adjustment would not be included in the asset representing the CFC stock, but the amount of the subpart F would be included in the E&P basis adjustment in the year of the inclusion. In subsequent years, the subpart F would become previously taxed income, and would not be included in stock basis. See Treas. Reg. §1.861-12T(c) and 1.902-1(a)(9). Thus, only current year subpart F and accumulated untaxed E&P are included in the CFC stock basis. It appears a similar result would occur under the proposal.

vi. R & D expense: Under Treas. Reg. §1.861-17, taxpayers can elect one of two methods: sales method or gross income method. If the assumed subpart F inclusion is taken into account, it would produce a relatively more unfavorable result under the gross income method, but the sales method should be unaffected.

vii. FAS 109 implications

(1) Deferred tax assets: deferred deductions would presumably be characterized as deferred tax assets.

(2) Valuation allowance: Whether the deferred tax asset is subject to a valuation allowance would seem to depend on demonstrating those deductions would be utilized from future repatriations of post-enactment earnings.
APB 23: Assumptions about repatriations needed to utilize the deferred deductions could impact a company's APB 23 analysis, potentially resulting in a deferred tax liability for the residual U.S. tax on post-enactment earnings. In such a case, the financial accounting effective tax rate would approximate the U.S. statutory rate (30.5% under the proposal).

In cases where the deferred tax liability for unremitted earnings substantially exceeds the deferred tax asset for deferred deductions, taxpayers may instead opt for a valuation allowance on the deferred tax asset (or adopt expense shifting strategies) rather than alter repatriation plans.

3. **Compute foreign tax credits on an overall basis** [§3201 of the bill and new §976 of the Code]: Foreign tax credits would be determined based on the average overall foreign effective tax rate for the year, using the same consolidated CFC approach used in the deduction deferral proposal. All rules would be applied before §§901-908 and be applied separately for each foreign tax credit limitation basket under §904(d)(1). Effective for tax years beginning after December 31, 2007.

a. **Current year foreign taxes available**: the amount “taken into account as foreign income taxes” in any year is equal to total foreign income taxes for the year (“TFT”) multiplied by a fraction, the numerator of which is CTFI and the denominator of which is CTFI plus DFI for the year.

   i. “taken into account” presumably means available for credit.

   ii. TFT means aggregate foreign income taxes paid or accrued during the year (not including carrybacks and carryovers), plus the increase in deemed paid taxes under §§902 and 960, computed by treating all CFCs as one CFC and assuming all [current year] earnings and profits were includible in taxable income under subpart F.

   iii. The amount of TFT not “taken into account” under the general rule is deferred, becoming “previously deferred foreign income taxes” (“PDFT”).

b. **Prior year foreign taxes available**: A portion of PDFT becomes available for credit when the taxpayer has RFI. The portion available equals PDFT multiplied by a fraction, the numerator of which is RFI and the denominator of which is PDFI.

   i. Presumably, RFI has the same meaning as in proposed §975 (i.e., taxable distributions out of PDFI).
ii. PDFT equals the aggregate amount of TFT not taken into account for all prior years (determined at the beginning of the year), reduced by amounts previously taken into account under this rule.

c. Considerations

i. Impact on FTC planning: The proposal takes a "forced blending" approach to foreign tax credits and eliminates FTC planning considerations from dividend decisions by eliminating the ability of taxpayers to choose high-tax or low-tax dividends.

(1) Taxpayers in an excess limitation position who prefer a dividend from a high-tax jurisdiction will have a watered down deemed paid credit.

(2) Taxpayers in an excess credit position who prefer a dividend from a low-tax jurisdiction will have a spiked deemed paid credit.

ii. Proposal appears to be based, in part, on the theory that CFCs are "fungible." The following proposals would be consistent with that theory:

(1) Make permanent CFC lookthrough rule in §954(c)(6);

(2) Repeal foreign base company sales and services income categories of Subpart F (at least to the extent of foreign to foreign transactions).

iii. Averaging of direct and indirect foreign taxes:

(1) Repatriating foreign taxes without repatriating foreign income? Current year foreign taxes paid by CFCs are included in TFT. Where a taxpayer has other foreign source income (e.g., royalties, foreign branches, §863(b) income), US tax on that income could be offset with foreign taxes paid by CFCs even in the absence of CFC dividends.

(2) Watering down direct foreign taxes: Since all foreign taxes are pro-rated over all foreign income, including DFI, only a portion of direct foreign taxes (e.g., withholding tax, foreign branch taxes) is available for credit in the year the tax is incurred and the associated income subject to US tax. Any of the remainder would not be available for credit until the taxpayer receives taxable distributions from CFCs (in excess of aggregate CFC current year E&P). This would seem to encourage minimizing foreign withholding tax and incorporating high-tax foreign branches.

(3) Section 78: Once foreign taxes available for credit is determined based on the forced blending approach, it is
unclear how the amount of deemed paid taxes included in that amount would be computed in order to apply §78. For example, if TFT consists of direct and indirect taxes, but only a portion of the total is available for credit, some ordering rule or method of allocating the allowable amount between direct and indirect credits will be necessary.

iv. E&P and tax pools:

(1) Consolidated CFC E&P and tax pools: It appears that all post-enactment years would be included in a pool of previously deferred earnings and previously deferred taxes for purposes of the proposed rules. One could imagine the proposal taking an annual layering approach. Under a layering approach, FDI and PDFT would be maintained in annual layers, and RFI would, along with associated taxes, be deemed to first come out of the layers on a LIFO basis, similar to pre-1987 foreign tax credit rules.

➢ It does not appear that pre-enactment pools, on a consolidated basis, are aggregated with post-enactment DFI and PDFT. It is unclear how distributions out of pre-enactment E&P and taxes would be handled under the proposal.

(2) Maintenance of E&P and tax pools: Would need to continue to be done on a separate CFC basis in order to make other relevant determinations, such as subpart F (current year E&P limitation, high-tax and de minimis exceptions), and character of distributions.

➢ It is unclear how the proposed foreign tax credit rules would interact with the separate company tax and E&P pools for purposes of determining the amount of distributions and associated taxes that come out of individual CFC pools. Under the theory that CFCs are fungible, distributions (and taxes) would come out of each CFC first in proportion to current year E&P and distributions constituting RFI would be in proportion to PDFI. It is unclear how distributions out of pre-enactment E&P and taxes would be handled under such an approach.

v. Current year DFI loss: It is unclear what the result would be if DFI is a loss in a particular year. The allowance fraction would then be greater than 1, which would produce allowable foreign tax credits.
in excess of the year's TFT. Would taxpayers be permitted to claim a credit for some portion of PDFT?

4. **Currency conversion rules for determining foreign taxes and earnings and profits** (§3202 of the bill, and §986 of the Code): Earnings and profits would be required to be translated into dollars at the average exchange rate for the year earned by the CFC, rather than the spot rate on the date of distribution (or year-end spot rate for subpart F inclusions) under current law. Ten-year savings is $2 million.
   a. **Distributions of PTI**: exchange gain or loss based on the difference between average rate in year when previously taxed and spot rate on distribution date.
   b. **Considerations**:
      i. Appears to create exchange gain or loss on actual distributions of non-PTI E&P. Does not change the amount of income, but changes the character of a portion of the dividend.
      ii. Appears to change the reference point for calculating exchange gain or loss on distributions of PTI from §956 inclusions. Instead of comparing spot rate on date of distribution with year-end rate of the year of the inclusion, such rate will be compared with the average rate of the year the subpart F was earned (similar to §951(a)(1)(A) inclusions).

5. **Repeal worldwide interest allocation** (enacted in 2004) (§3203 of the bill, and §864(f) of the Code): The proposal would repeal the provision in the AJCA that allows interest expense to be allocated on a worldwide basis (i.e., interest expense of foreign affiliates would have been included in any allocation among all affiliates) for foreign tax credit limitation purposes, rather than on a water's-edge basis as under current law. The AJCA provision would also have allowed an election for an expanded financial institution group to apply interest allocation rules separately from the rest of the affiliated group. Effective for tax years beginning after December 31, 2008. Ten-year savings is $26 billion.
   a. The effective date of the election to use worldwide interest allocation enacted in AJCA originally was delayed for five years (tax years beginning after 2008) for revenue reasons.
   b. 3-year additional delay (until after 2011) was included in House TAA bill, H.R. 3920, in October 2007.
      i. Reason for change in Committee report - "the Committee believes that it is appropriate to delay implementation of the worldwide interest allocation rules."
      ii. Minority views - opposed the delay because it would cause continued potential for double taxation and make American companies less competitive.

c. 8-year additional delay (until after 2016) included in House AMT and extenders bill, H.R. 3996, in October 2007.

d. 1-year additional delay (until after 2009) and apply 22% limitation on first year included in H.R. 3221, Housing Rescue and Foreclosure Prevention Act of 2008, which passed the House in May 2008. (raises $3.2 billion).

i. Bush Administration opposed the delay in a Statement of Administration Policy on House Amendments to Senate Amendment to H.R. 3221.

e. 10-year additional delay (until after 2018) included in H.R. 6049, the Energy and Tax Extenders Act of 2008 (raises $30 billion).

f. 10-year additional delay (until after 2018) and a 3-year exception for banks with at least 97% of their assets constituting U.S. assets included in Baucus proposed amendment to H.R. 6049 (raises $29.6 billion).

g. In theory, repeal is inconsistent with the worldwide approach taken in the deduction deferral and overall foreign tax credit proposals.

6. Limitation on treaty benefits [§3204 of the bill, and new §894(d) of the Code]: Reduced treaty withholding rate would not apply to any “deductible related party payment” unless a reduced treaty withholding rate would apply if the payment were made directly to the foreign payee’s foreign parent corporation. Effective for payments made after date of enactment. This proposal is included in H.R. 6275, the Alternative Minimum Tax Relief Act of 2008. Ten-year savings is $6 billion.

a. “deductible related party payment” means any deductible payment made, directly or indirectly, to a person that is in the same “foreign controlled group of entities” as the person making the payment. For this purpose, “foreign controlled group of entities” means generally a §1563 controlled group, except based on 50% control (rather than 80%) and the foreign parent corporation is the common parent of the controlled group.

b. This proposal is similar to an offset used in the House farm bill in 2007. Under the farm bill provision, the withholding tax would have been the higher of the rate on the payment to the direct recipient, or the rate that would apply if the payment were made directly to the ultimate parent. By contrast, this proposal only applies if a hypothetical payment directly to the foreign parent of the actual payee would not have been eligible for a reduced withholding rate (even if that reduced treaty rate would be higher than the rate being applied to the actual payment).
c. This modification is not expected to change Senate opposition to the proposal, because it still results in disregarding treaties, even those with robust limitation on benefits articles and could result in retaliation by treaty partners.

d. Because of the change from the farm bill proposal, this proposal would only impact foreign multinationals based in countries with no U.S. tax treaty.

7. **Repeal last-in-first out ("LIFO") and lower of cost or market ("LCM") inventory accounting methods [§§3301 and 3302 of the bill and §§471, 472, 473 and 474 of the Code]:** Taxpayers would no longer be allowed to use the last-in-first-out method of inventory accounting (which is only permitted under current law if the method is also used for financial accounting purposes) and would no longer be allowed to mark inventories down to reflect market value. Effective for tax years beginning after date of enactment. Ten-year savings is $114 billion.

a. **LIFO method repeal:**

   i. The proposal would require LIFO reserves to be taken into account ratably over a period of 8 years beginning in the first taxable year that starts after the date of enactment.

   ii. Allowing the use of LIFO was intended to match current income with current costs and defer income attributable to any inflationary gain.

   iii. International Financial Reporting Standards ("IFRS") do not permit the use of LIFO. Thus, if the U.S. moves to adopt IFRS (as has been discussed), it is unclear whether the use of LIFO would still be permitted for accounting purposes, and thus for tax purposes.

b. **LCM method repeal:**

   i. The proposal would require taxpayers to take any resulting §481 adjustment into income ratably over the eight-year period beginning in the first taxable year that starts after the date of enactment.

   ii. The LCM method is consistent with the accounting principle of conservatism, but may be inconsistent with our tax system's general concept of realization.

   iii. This proposal seems to eliminate the subnormal goods method as well, which currently allows taxpayers to write-down the cost of goods that have been damaged or otherwise not salable at normal market prices.

8. **Special rule for service providers on accrual method of accounting not applicable to C corporations [§3303 of the bill and §448(d)(5) of the Code]:** A C-corporation with gross receipts of $5 million or less would no
longer be allowed to reduce its income from the performance of services by amounts which it deems will not be collected based on experience. Effective for tax years beginning after the date of enactment. Ten-year savings is $225 million.

a. The proposal would require taxpayers to take any resulting §481 adjustment into income ratably over the eight-year period beginning in the first taxable year that starts after the date of enactment.

b. Similar to LCM repeal (discussed above), this proposal would eliminate a current law exception to the realization principle.

9. **Increase §197 intangible amortization period from 15-years to 20-years** [§3402 of the bill and §197 of the Code]: Would effectively modify the amortization rate for purchased goodwill and other intangibles from 6.7% per year to 5% per year. Effective for property acquired after the date of enactment. Ten-year savings is $21 billion.

a. May impact desirability of certain mergers and acquisitions.

10. **Codification of economic substance doctrine and other penalty provisions** [§§3501 and 3502 of the bill and §§7701, 6662 and 6664 of the Code]: Would codify a conjunctive test for courts to apply the economic substance doctrine, impose a strict-liability penalty on underpayments attributable to transactions that lack economic substance (as defined), and make broader changes to underpayment penalty standards applicable to tax shelters and large corporations. Ten-year savings is $3.8 billion.

a. **Codification of ESD**: if ESD is relevant to a transaction, would require courts to apply the conjunctive test; that is, ESD is satisfied only if (i) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position; and (ii) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction. Effective for transactions entered into after date of enactment.

i. Determination of relevance: made in the same manner as if ESD not codified. Other common law doctrines are not affected.

- Basic business transactions not affected: Committee report language in Senate (S. 2242, S. Rep. No. 110-206)) and JCT technical explanation of a bill containing the House proposal (H.R. 4351, JCX-113-07) clarified that codifying economic substance “is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages.”
Illustrative examples of such transactions include (i) the choice between debt and equity financing; (ii) the choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (iii) the choice to enter into a tax-free corporate reorganization; and (iv) the choice to utilize a related party in a transaction where the arm’s length standard of section 482 is met. This list is illustrative, and not exclusive.

ii. Profit potential test: If taxpayer relies on profit potential to satisfy ESD, then present value of reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits. Transaction costs and foreign taxes are treated as expenses in determining profit potential.

► Senate comparison: Under Senate version, foreign taxes only treated as expenses to the extent provided in regulations (although legislative history says courts are not precluded from treating foreign taxes as expenses in the absence of regulations).

iii. State and local tax benefits – would only be a valid business purpose if it is not related to a Federal tax effect.

► Senate comparison: Senate version would disqualify non-Federal tax benefits (including state and local tax benefits) if there are similarities in the law and Federal tax benefits are greater or substantially coextensive.

iv. Financial accounting benefits: not a valid business purpose “if such transaction results in a Federal income tax benefit.”

► Senate comparison: Under the Senate version, financial accounting benefits are not a valid business purpose if they arise from a reduction of Federal taxes.

v. Exception for personal transactions: Statutory ESD only applies to transactions with respect to a trade or business or for the production of income.

vi. Regulatory authority: regulations to carry out purposes of the provision, including exemptions.

b. Underpayment penalty

i. 40% penalty for transactions lacking ESD.

► Senate comparison: Senate version would impose a 30% penalty for undisclosed transactions, similar to the penalty for undisclosed listed transactions.
The Senate version would also require the IRS to nationally coordinate, through the Chief Counsel’s office, when the penalty is asserted and when it is compromised. As a protective measure, taxpayers would be permitted to make their case to the IRS at the national level before the penalty is asserted.

ii. Reduction for disclosure: Penalty would be reduced to 20% if adequately disclosed. Amended returns not to be taken into account for purposes of adequate disclosure if filed after IRS contacts taxpayer about an examination of the return.

iii. Penalty base: Penalty would be in §6662, which applies penalties to underpayments of tax.

(1) Thus, ESD understatement is not segregated from the rest of the return. No penalty to the extent the understatement is offset by other tax return items.

(2) Other tax return items would include:

- Current year deductions, losses and credits claimed on originally filed return;
- Current year items claimed on an amended return (even if filed after notification of IRS exam);
- Losses, deductions or credits carried forward to the year of the ESD transaction;
- But NOT losses, deductions or credits carried back to the year of the ESD transaction. See Treas. Reg. §1.6664-2(f).

iv. Strict liability: No reasonable cause exception for any portion of an underpayment attributable to an ESD transaction.

v. Erroneous refund penalty: A provision was added to this proposal in H.R. 4351, the AMT Relief Act of 2007 which would treat amounts attributable to an ESD transaction as having no reasonable basis for purposes of erroneous refund penalty in §6676.
c. Deficiency interest: Would not deny a deduction for deficiency interest on underpayments attributable to transactions that lack economic substance.

> Senate comparison: Senate version would deny a deduction for deficiency interest on understatements attributable to transactions that lack economic substance.

d. Broader underpayment penalty changes (unrelated to ESD)

i. Eliminates reasonable cause exception in §6664 for any underpayment attributable to tax shelters (defined in §6662(d)(2)(C)) and for underpayments of “specified large corporations” (gross receipts for the taxable year exceed $100 million).

(1) Thus, no defense for relying on a tax opinion.

ii. General change to §6662 definition of an understatement – understatements reduced for specified large corporations only if taxpayer had reasonable belief that tax treatment was more likely than not correct.

(1) Under current law, reduction applies if there is substantial authority or reasonable basis (in the case of disclosure). §6662(d)(2)(B).

(2) Does not apply to any item attributable to a tax shelter (as defined in §6662(d)(2)(C)).

(3) Does not apply to underpayments due to lack of economic substance.

(4) Difference between this proposal and a reasonable cause exception with a more likely than not requirement is that under this approach, taxpayers would not be able to rely on a tax opinion to avoid the penalty. See Treas. Reg. §§1.6662-4(g)(4)(ii)(B) and 1.6664-4(c) (reasonable cause exists where a taxpayer relies in good faith on a more likely than not tax opinion).

iii. Senate comparison – none of these broader penalty changes are contained in the Senate version.

11. Reduce dividends received deduction [§3601 of the bill and §§243, 244, 245, 246, 246A of the Code]: The deduction for dividends received from domestic corporations which are not members of the same affiliated group would generally be reduced by 10 percentage points. Ten-year savings is $4.6 billion.

a. Bill summary says this is a corollary to corporate tax rate reductions, generally maintaining the current level of corporate tax integration
with respect to corporations that are not more than 80% owned. Rate reduction is effectively a 12.9% reduction (4.5/35).

b. DRD would change from 70% to 60% for dividends received from domestic corporations owned less than 20% -- effectively a 14% reduction (10/70).

c. DRD would change from 80% to 70% for dividends received from 20% owned domestic corporations -- effectively a 12.5% reduction (10/80).

12. **Recognition of ordinary income on sale or exercise of stock option in S-corporation with an Employee Stock Ownership Plan ("ESOP")**
   [§3701 of the bill and new §409B of the Code]: Upon exercise or sale of an option to purchase stock of an S-corporation, the option holder would be required to include as ordinary income a proportionate share of the S-corporation's net income that was allocated to an ESOP during the taxpayer's holding period. Effective for options granted after date of enactment. Ten-year savings is $606 million.
   
   a. Tax on the income included under this proposal would be increased by interest computed at the underpayment rate.
   
   b. This proposal is intended to prevent taxable investors from benefiting from appreciation in the value of an S-corporation during the period that the S-corporation's income is untaxed because it is allocated to an ESOP.

13. **Terminate Interest Charge-Domestic International Sales Corporation ("IC-DISC") provisions** [§3702 of the bill and §992 of the Code]: Provisions effectively allowing U.S. exporters to defer tax (subject to an interest charge) on a portion of their income from export sales would be repealed for any taxable year beginning after 2007. Ten-year savings is $881 million.

   a. Any deemed or actual distribution upon termination would not be qualified dividend income under §1(h)(11)(B).

   b. Existing IC-DISC elections would be terminated effective for the first tax year beginning after the last tax year that began in 2007.

   c. This proposal appears to have originated from a proposed, but not enacted, technical correction that would have denied the reduced rate of tax for qualified dividend income with respect to dividends from an IC-DISC.

14. **Modify rules for certain tax-free spin-offs** [§3703 of the bill and §361 of the Code]: Distributions of a controlled corporation's securities and non-qualified preferred stock in a divisive reorganization would be treated as boot and taxable to the parent corporation to the extent the value of the securities and preferred stock exceeds its basis in the controlled
corporation. Effective for distributions after the date of enactment. Ten-year savings is $235 million.

a. According to the bill summary, this proposal is intended to treat “distributions of debt securities in a tax-free spin-off transaction in the same manner as distributions of cash or other property.”

b. The proposal may affect non-abusive transactions where only a proportionate amount of debt is borne by the controlled corporation.

c. The proposal creates a significant distinction in the treatment of common stock and securities.

d. Under the proposal, no transition relief would be provided. Transition relief has typically been provided to exclude transactions for which an SEC filing has been made or IRS ruling requested when changes affecting corporate reorganizations have been made.
Obama Administration FY2010 Budget Proposals to Reform the U.S. international tax system

1. **Reform business entity classification rules for foreign entities**: Would overturn entity classification regulations with respect to certain cross-border single-owner entities by eliminating the election to treat a foreign eligible entity as a disregarded entity unless the single owner is treated as a corporation and is organized in the same jurisdiction. The proposal would not apply to first-tier foreign entities wholly owned by a United States person, except in cases of U.S. tax avoidance. Effective for taxable years beginning after December 31, 2010. *Ten-year revenue gain is $86.509 billion.*

   **JCT score:** $31.053B. **Revised Treasury score:** $36.459B.

   a. **Foreign base erosion**: The explanation of the proposal suggests a concern that the ability to use foreign disregarded entities “may permit the migration of earnings to low-taxed jurisdictions without a current income inclusion” under Subpart F.

      i. The example contained in the Administration’s press release was that of a German disregarded entity making an interest payment to a Caymans disregarded entity, enabling the reduction of German tax through an interest deduction with no corresponding tax liability on the Caymans interest income.

         ➤ This example is similar to an example contained in Notice 98-11, which faced significant opposition from taxpayers and some members of Congress. Ultimately, proposed regulations were issued that would be effective only for payments made in tax years beginning 5 years after being finalized. The delayed effective date was provided “to give Congress the opportunity to consider in greater depth the issues raised by hybrid transactions.”

         ➤ Under section 954(c)(6) (“CFC lookthrough”), the Caymans interest income in this example would not be Subpart F income even if the proposal applied to treat both entities as CFCs. The Administration proposes to extend CFC lookthrough through calendar year 2010. It is assumed that the Administration would allow this provision to expire, at least with respect to deductible payments.

   ii. Like Notices 98-11 and 95-35 and Prop. Treas. Reg. §1.954-9, the proposal appears to be aimed at foreign tax base erosion through deductible payments that would otherwise constitute foreign personal holding
company income (in the absence of CFC lookthrough). The proposal, however, would go further and would impact (i) deductible cross-border payments that do not involve a significant tax rate disparity between the payor and payee; (ii) non-deductible cross-border dividends; and (iii) certain sales income from supply chain structures that currently does not run afoul of the tax rate disparity test under the branch rule of section 954(d)(2) and therefore is not treated as foreign base company sales income.

b. First-tier and “same country” exceptions: The scope of these exceptions (e.g. whether they extend to multiple tiers of disregarded entities) and of the “U.S. tax avoidance” exception to the first-tier exception is unclear. According to the JCT analysis, the first-tier exception appears to be intended to accommodate foreign holding company structures designed to avoid foreign dividend withholding tax.

c. Conversion to corporation: The tax treatment of incorporating a disregarded entity would be consistent with current rules. Thus, the single member would be deemed to contribute all the assets and liabilities of the entity to the corporation in exchange for stock. For entities with that are not eligible for the first-tier exception, potentially applicable rules would include section 367(a) & (d) (tax on the transfer of inventory and intangibles; branch loss recapture), section 1503(d) (triggering of dual consolidated losses), section 904(f)(3) (overall foreign loss recapture), section 987 (foreign currency gains or losses), sections 351(b), 357(c) or 304 (as a result of debt or other boot that springs into existence). JCT notes that “[t]hese costs may warrant the consideration of additional transitional relief.”

d. Prior proposals:

i. JCT staff proposed a similar measure in January 2005. That proposal would require corporate classification for any organization organized under foreign law as a separate entity. A similar proposal was included in a bill introduced by Sen. Voinovich (S.3162, 110th Cong.). JCT estimated its proposal would raise $1.2 billion over ten years, which is quite different from the Administration’s and JCT estimates of this proposal.

ii. The American Bar Association Tax Force on International Tax Reform proposed a similar measure in 2006. The ABA proposal would require any foreign business entity subject to an entity level income tax in its country of residence to be treated as a corporation for U.S. tax purposes.

e. Other issues:

i. It is unclear whether the Administration’s proposal could be avoided by using foreign partnership elections or domestic disregarded entities. Note that under the JCT and Voinovich proposals, Treasury would have regulatory authority to apply the rule to: (i) a foreign entity with more than one owner; and (ii) a domestic business entity with a CFC owner.
ii. Presumably, the proposal would not affect true branches. Thus, taxpayers would be forced to have their CFCs establish true branches, rather than entities with limited liability, in other jurisdictions to avoid Subpart F in some circumstances.

iii. Under section 902(b)(2), foreign taxes of controlled foreign corporations below the sixth tier, and foreign taxes of non-CFCs below the third tier, are not eligible for deemed paid foreign tax credits. Eliminating disregarded entities will create additional tiers in chains of foreign corporations, causing the loss of foreign tax credits, and perhaps a planning opportunity to move low-tax subsidiaries to lower-tiers to avoid having those earnings included in the foreign tax credit pooling proposal.

iv. The proposal would appear to prevent individual taxpayers operating through partnerships or S-corporations from claiming foreign tax credits, since only C-corporations are allowed an indirect foreign tax credit under section 902. JCT has raised the question of whether current law permits inappropriate results.

v. JCT has described ways in which the proposal could be avoided, including (i) organizing a DRE in the same country as its owner, but have it be a tax resident in another jurisdiction; (ii) using domestic LLC that is a tax resident in a foreign jurisdiction; and (iii) using a foreign eligible entity with a nominal second owner. JCT has suggested ways to prevent such techniques, including (i) requiring lower-tier single-member domestic eligible entities and foreign eligible entities to be treated as corporations for U.S. tax purposes if they are subject to residence-based taxation in a country other than the one in which they are organized; (ii) provide regulatory authority to treat multi-member foreign eligible entities as corporations if a principal purpose of adding the additional members was to avoid the application of the proposal.

vi. JCT has pointed out that, because of the first-tier exception, the proposal may not address certain types of hybrid entity structures designed to separate foreign taxes from related foreign income (such as the structure in the Guardian Industries case).

2. **Defer deduction of expenses, except R&E expenses, related to deferred income:** Would defer otherwise deductible U.S. expenses (other than research and experimentation expenses) properly allocated and apportioned to deferred foreign-source income. Allocation and apportionment of expenses would be determined under current Treasury regulations. The amount of deferred deductions would be carried forward to subsequent years and combined with foreign-source expenses of such year before applying the proposal to such year. Effective for taxable years beginning after December 31, 2010. **Ten-year revenue gain is $60,050 billion. JCT score: $51,525B. Revised Treasury score: $52,909B.**
a. **Exception for research expenses:** According to the Administration, research expenses would not be subject to the rule “because of the positive spillover impacts of those investments on the U.S. economy.”

   i. **Similar to Bush Administration Reform Panel Proposal:** Proposed a dividend exemption system with expense allocation rules similar to those under the proposal (except deductions would be disallowed, rather than deferred). Research expenses would not be subject to such rules, on the theory that the research expenses relate to income that is not exempt (royalties).

   ii. **JCT Analysis:**

   (1) To the extent research expenses are excluded under the proposal for reasons similar those stated by the Bush Reform Panel, JCT questions those reasons on two grounds: (i) taxable royalty income may be inappropriately low because of aggressive transfer pricing practices; and (ii) taxable royalty income is largely sheltered from U.S. tax through the use of excess foreign tax credits on highly taxed dividend income.

   (2) While excluding research expenses may avoid undermining the policy of a permanent research credit, it also “may undermine the proposal’s policy objective of reducing the tax incentive for U.S. businesses to shift income overseas.” This is because, according to JCT, substantial income shifting results from the migration of intangible property developed in the United States.

   (3) JCT suggests balancing these policy objectives by including research expenses in the expense deferral rules, but modifying the rules in a way that would allocate less expense to deferred foreign income through an increased “exclusive apportionment” to where the research is performed (currently 25% or 50%, depending on method under Treas. Reg. §1.861-17).

b. **Interest expense:** Under current Treasury regulations, interest expense is allocated under the asset method. The only asset that produces deferred foreign-foreign source income is CFC stock basis. The proposal would create a new statutory grouping of income – deferred foreign income. Some issues in determining the amount of interest expense subject to deferral and allocated to CFC stock basis that would then be allocated to deferred foreign income include:

   i. Would worldwide interest allocation rules be permitted to take effect as scheduled in 2011? JCT notes that if the current waters edge rules are to remain in effect, the proposal “may overcorrect” for the “problems” at which the proposal is aimed (mismatching of income and deduction,
making foreign investment more attractive than domestic investment and enhancing tax advantage of debt over equity financing).

ii. Would interest expense on debt that is on-loaned to foreign subsidiaries be subject to deferral (see CFC netting rule in Treas. Reg. §1.861-10(e), which provides computational rules for determining how much interest expense to allocate to interest income from CFCs)?

iii. Would the amount of stock basis attributable to pre-2011 earnings be treated differently than post-2010 earnings?

iv. Would previously taxed income included in CFC stock basis attract deferred interest expense?

v. Would the amount allocated to CFC stock basis be further split between currently taxable CFC income (taxable distributions or deemed distributions) and deferred CFC income?

vi. How would CFC stock basis other than earnings and profits be classified?

c. **Other expenses:** Presumably, any deduction (other than research and experimentation) that would be allocated or apportioned to foreign subsidiary earnings, if those earnings were distributed as a dividend, under current rules used to determine the foreign tax credit limitation would be subject to the proposal. In addition to interest expense (discussed above), other specific deductions addressed by the current regulations include the following:

i. **Stewardship:** Under Treas. Reg. §1.861-8T(e)(4)(ii), stewardship expenses are generally allocated to dividends from the subsidiaries with respect to which the stewardship was performed. Expenses that are charged out to foreign subsidiaries are allocated to the associated fee income under Treas. Reg. §1.861-8T(e)(4)(i), and would not appear to be subject to deferral.

ii. **Supportive functions:** Under Treas. Reg. §161-8T(b)(3), deductions which are supportive in nature (overhead, general and administrative) are allocated either with other related deductions, or on a reasonable basis, such as using a gross income ratio.

iii. **Legal and accounting fees and expenses:** Under Treas. Reg. §1.861-8(e)(5), legal and accounting fees are allocated either to specific income to which they relate, or to all of the taxpayer's gross income (using a gross income ratio).

iv. **State and local income taxes:** Under Treas. Reg. §1.861-8(e)(6), state and local taxes are allocated to the gross income with respect to which such taxes are imposed. Deduction deferral should only arise to the extent any states currently tax deferred income [CA??].
v. **Gross income ratio:** Presumably, any rules requiring the use of a gross income ratio (e.g., supportive functions, legal and accounting fees) would be applied by including deferred CFC income in the gross income ratio.

vi. **Branch expenses:** Presumably, branch expenses would be directly allocated to branch gross income and not subject to deferral.

d. **Deduction for deferred expenses:**

i. Under a similar proposal by Chairman Rangel, deferred deductions would be taken into account only when aggregate distributions from all CFCs exceed aggregate current year E&P of all CFCs; and then only in proportion to the amount of such excess relative to cumulative previously deferred earnings.

ii. The Administration's proposal appears to take a different approach, by carrying over deferred deductions to subsequent years and including them in the amount of expenses subject to the new rule.

(1) With respect to interest expense, which would be allocated using an asset method, this approach appears to be less restrictive than the Rangel bill approach, assuming similar deferral ratios from year to year.

➢ Example: In each of years 1 and 2, taxpayer USP has $100 of interest expense and a deferral ratio of 40%. Under the Rangel bill approach, in year 1 and year 2, USP's deferred interest expense would be $40, resulting in cumulative allowable deduction of $120. Under the Administration's approach, the result would be the same for year 1, but in year 2, the prior year's deferred deduction of $40 would be added to the actual expense of $100, producing a deferred deduction of $56 and an allowable deduction of $84, resulting in cumulative allowable deduction of $144.

(2) With respect to other expenses allocated on a gross income basis, whether this approach is less restrictive than the Rangel bill approach depends on whether the deferral ratio takes into account previously deferred CFC income. If not, previously deferred deductions could be triggered by repatriating a higher percentage of aggregate current year CFC earnings than in previous years. If previously deferred income is taken into account, then, similar to the Rangel bill, previously deferred deductions would only be available to the extent repatriations exceed aggregate current year CFC earnings.

➢ Example: In each of years 1 and 2, USP has $100 of SG&A expenses, no domestic source income and $100 of CFC
income, of which $40 is repatriated in year 1 and $50 is repatriated in year 2. In year 1, USP’s deferral ratio is 60%, producing deferred deductions of $60, which are carried forward to year 2. In year 2, USP’s deferral ratio is 50% if computed on an annual basis, producing deferred deductions of $80 and allowable deductions of $80, resulting in a cumulative allowable deduction of $120. However, if year 1 deferred income is included in the deferral ratio for year 2, the deferral ratio would be 68.75%, producing deferred deductions of $110 and allowable deductions of $50, resulting in cumulative allowable deductions of $90. The latter result would be consistent with the Rangel approach.

(3) Companies with overall foreign losses will be faced with the decision of whether to indefinitely forego deductions or to pay double-tax on their repatriated earnings due to the inability to claim any foreign tax credits.

e. JCT Policy analysis

i. By increasing the effective tax rate on foreign operations of U.S. firms, the proposal creates an added incentive to conduct such operations through non-U.S. firms (located in jurisdictions with territorial systems). If the incentive were strong enough, ultimately, the only significant business operations carried on by U.S. firms (and thus within the U.S. tax base) would be U.S. business operations (creating a de facto territorial system). These effects could be exacerbated if the proposal is enacted in combination with the foreign tax credit pooling proposal.

ii. On the other hand, non-tax reasons may dominate the tax consequences, and the concerns of business migration may be more appropriately a criticism of the “malleability of corporate residence based on the U.S. place of incorporation rule.”

f. JCT technical issues

i. Unclear treatment of expenses that are definitely related and allocable entirely to a class of gross income that is subject to current U.S. tax (e.g., branch expenses). Policy suggests no deferral because no matching issue.

ii. Unclear how allocation computation would work for taxpayers with both currently taxed foreign source income (e.g., §863(b) sales, royalties) and deferred foreign income. First allocate to all foreign source income and then make a “sub-apportionment” among different classes of foreign source income? Alternatively, group all expenses together, and then pro-rate between currently taxed and deferred foreign income (like Rangel)? Latter
approach administratively easier, but less accurate application of matching principle.

iii. Unclear how deferred foreign income is computed. How to treat related party transactions (aggregate or eliminate?), treatment of deficits (disregard or aggregate with positive earnings of other CFCs?)

iv. The need for currency translation rules for determining non-Previously taxed foreign earnings.

v. Whether the earnings of entities below the 6th tier (and thus not included in the §902 qualified group) are excluded from the computation of deferred foreign income.

vi. Additional reporting requirements/taxpayer burdens related to 10/50 earnings and tax pools.

g. **FAS 109 implications**

i. Deferred tax assets: deferred deductions would presumably be characterized as deferred tax assets.

ii. Valuation allowance: Whether the deferred tax asset is subject to a valuation allowance would seem to depend on demonstrating those deductions would be utilized from future repatriations of foreign earnings.

iii. APB 23: Assumptions about repatriations needed to utilize the deferred deductions could impact a company's APB 23 analysis, potentially resulting in a deferred tax liability for residual U.S. tax on foreign earnings. In cases where the deferred tax liability for unremitted foreign earnings substantially exceeds the deferred tax asset for deferred deductions, taxpayers may instead opt for a valuation allowance on the deferred tax asset (or adopt expense shifting strategies) rather than alter repatriation plans.

3. **Reform foreign tax credit**: Determine the foreign tax credit on a pooling basis:

Would require indirect foreign tax credits to be determined based on aggregate earnings and profits and tax pools of all foreign subsidiaries with respect to which the U.S. taxpayer can claim a deemed-paid foreign tax credit under section 902. Effective for taxable years beginning after December 31, 2010. *Ten-year revenue gain is $24.492 billion. JCT score: $45.552B.*

a. **Earnings and tax pools:**

i. Under a similar proposal by Chairman Rangel, post-enactment foreign source income (including deferred CFC earnings and other non-CFC income, such as interest, royalties, and export sales income) and all foreign taxes (including direct credits, such as withholding taxes and branch taxes) would be aggregated on an annual basis to determine the blended foreign tax credit.
ii. The Administration's proposal appears to take into account only earnings and taxes of CFCs and 10/50 companies and would not create new post-2010 pools – the proposal would be applied by aggregating accumulated earnings and tax pools, including pre-2011 pools.

(1) By pooling only foreign subsidiary earnings and taxes, the Administration's proposal would not allow foreign source non-dividend income to carry any foreign tax credits (other than withholding tax) and would not subject direct foreign tax credits to blending.

(2) By including pre-2011 pools, the Administration's proposal would penalize taxpayers for historical low-tax deferred foreign earnings, producing what may be a much lower blended foreign tax credit than what the Rangel proposal would produce.

(3) JCT notes that this creates an incentive to earn high-taxed income through a branch rather than a subsidiary, which, over time, will reduce further the foreign effective tax rate on deferred earnings and increase the U.S. tax on repatriation, creating a disincentive to repatriation. JCT notes that the Rangel alternative (parity between income earned through branches and subsidiaries) would avoid this problem, but create other technical and policy issues, such as the treatment of withholding taxes on previously deferred income and the ability to accelerate credits for taxes paid by CFCs to the extent allocated to other currently taxed foreign income.

iii. Presumably CFC deficits would be included in the aggregate earnings pool. JCT analysis identifies this as an area requiring clarification, along with treatment of related party transactions (eliminate or aggregate).

iv. Presumably, deemed dividends under Subpart F would carry foreign tax credits on a pooled basis. However, it is unclear whether the high-tax exception would be applied on a pooled or separate CFC basis. If on a pooled basis, then it would seem that most Subpart F income would be ineligible for the exception.

v. Presumably, separate company earnings and profits pools would still be relevant for other purposes, such as characterizing a distribution under section 301 or applying the earnings limitation and de-minimis exception under Subpart F.

b. Interaction with check-the-box proposal:

i. While the check-the-box proposal results in forced separation of foreign subsidiaries for Subpart F purposes, the foreign tax credit proposal results in forced combination of foreign subsidiaries.
ii. Under the Administration's check-the-box proposal, taxpayers would no longer be able to avoid Subpart F on foreign-to-foreign interest or royalty payments. The resulting Subpart F income would presumably carry a blended foreign tax credit (rather than the likely lower foreign tax credit that would result if only the taxes paid by the recipient CFC were considered). However, interest or royalties received directly by the U.S. taxpayer would not carry any credits (other than any applicable withholding tax). Thus, in effect, these proposals may encourage placing financing activities and intangible property in a low-tax jurisdiction rather than in the United States.

iii. To avoid diluting foreign tax credits on dividends from high-tax foreign subsidiaries, taxpayers who regularly repatriate may consider electing disregarded entity treatment, so that the high-tax subsidiary is treated as a branch (assuming this would not be considered to be a case of "U.S. tax avoidance").

c. **ICT technical and administrative issues**

   i. Need to develop rules for allocating earnings and tax pools proportionally among multiple shareholders, including rules to account for varying proportionate interests resulting from acquisitions and dispositions. This would result in shareholder level accounts to which annual earnings and taxes would be allocated.

   ii. Need to provide rules for determining combined earnings and tax pools, ordering rules for determining the extent to which an earnings deficit in one limitation category should reduce positive earnings in another category for the same entity or other entities.

   iii. Unclear whether the amount and separate limitation character of dividends and subpart F inclusions should be determined by reference to blended earnings pool or on a separate entity basis.

   iv. Need rules to integrate proposal with §905(c) (regarding foreign tax redeterminations).

   v. Currency translation rules for determining amounts included in blended pools of earnings and taxes.

   vi. Treatment of earnings and taxes in entities below the 6th tier that are not included in the §902 qualified group.

   vii. Interaction between the rules for determining taxable distributions under §§301 and 302 (requiring earnings on an entity basis) and the aggregate approach under the proposal.

   viii. Whether the available foreign tax credit is determined on a single credit carryforward calculation or on the basis of an annual calculation with
respect to current earnings and then with respect to unrepatriated earnings (like the Rangel approach).

ix. Increased reporting requirements/taxpayer burdens with respect to 10/50 companies.

d. JCT transition issues

i. Pre-enactment earnings included in pools. Simpler, but would need complex rules for merging earnings and tax pools of foreign subsidiaries with U.S. shareholders who acquired shares on different dates.

ii. Alternatively, adopt pre and post pool approach, similar to 1986 Act. Would need a dividend ordering rule.

e. JCT treaty issues

i. U.S. treaties generally require the U.S. to allow a 10% corporate owner of a treaty partner corporation an indirect foreign tax credit with respect to dividends from the other corporation. Under the pooling proposal, the available foreign tax credit would not entirely correspond to foreign taxes paid to the treaty partner with respect to the earnings distributed, but would take into account earnings and taxes from subsidiaries in other jurisdictions. An argument could be made that the pooling proposal would violate U.S. treaty obligations.

ii. Unless specific treaty override provision, any legislation would be expected to take precedence over a treaty under the “last-in-time” principle.

iii. Double tax relief obligations in treaties, however, prohibit the U.S. from amending internal foreign tax credit laws in ways that are inconsistent with the general principle of the treaty provisions (which, according the model treaty technical explanation is the “allowance of a credit”). Thus the question is whether the proposal would be viewed as consistent with the general principle of allowing a credit.

(1) Could be viewed as consistent, in that it does not deny a foreign tax credit. Instead, it alters the timing of when the taxes are creditable. In effect, high taxes are deferred and low taxes are accelerated. It is “somewhat similar” to the limitations of section 904, which are expressly contemplated by U.S. tax treaties.

(2) On the other hand, the proposal would function differently from the §904 limitation, which restricts the ability to credit one country’s tax against U.S. tax on other income. The proposal, in contrast, would limit the amount of foreign tax that could be credited against U.S. tax on the same income on which the foreign tax was paid.
4. **Reform foreign tax credit: Prevent splitting of foreign income and foreign taxes:**

   a. **Scope:** The scope of this proposal is unclear. It undoubtedly is aimed at structures used to accelerate the use of foreign tax credits before the underlying foreign income is subject to U.S. tax, such as the structure at issue in the *Guardian Industries* case, which involved a first-tier disregarded entity that paid foreign tax on a CFC subsidiary’s earnings, which were deferred. In 2006, the IRS and Treasury proposed regulations under section 901 intended to address these situations where a taxpayer claims direct foreign tax credits even though the underlying income is not currently subject to U.S. tax. This proposal could be viewed as simply codifying those proposed regulations. However, the proposal could also be read to deny foreign tax credits for taxes on income that is never income under U.S. tax principles (base differences) or is income at a later time (timing differences). The JCT analysis of the proposal, however, does not suggest this broader application.

   b. **Prior proposal:** The Bush Administration had proposed granting Treasury regulatory authority to address foreign tax credit transactions involving inappropriate separation of foreign taxes from related foreign income. The Senate passed this proposal in 2004 and 2005. That proposal was intended to address splitting transactions and structures and not base or timing differences.

5. **Limit shifting of income through intangible property transfers:** Would “clarify” that (i) the definition of intangible property for purposes of sections 367(d) and 482 includes workforce in place, goodwill, and going concern value; (ii) the IRS may value intangible properties on an aggregate basis; and (iii) intangible property must be valued at its highest and best use. *Ten year revenue gain is $2.924 billion. JCT score: $1.039B. Revised Treasury Score: $1.009B.*

   a. **Foreign goodwill:** Under Treas. Reg. §1.367(d)-1T(b), foreign goodwill and going concern value are excluded from the definition of intangible property subject to section 367(d). The IRS has taken the position that this exception is narrow, and does not apply to the extent other intangible assets, such as workforce in place, are identifiable. The proposal would codify the IRS’s position, but would not appear to overturn the regulatory exception for foreign goodwill and going concern value, according to the JCT description.

   b. **Interaction with check-the-box proposal:** To the extent the first-tier exception to the check-the-box proposal does not apply, then the incorporation of a foreign disregarded entity would entail an outbound transfer of intangibles under section 367(d).