

## A Note From the Editor-in-Chief

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### Obama Administration's International Tax Proposals

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The Obama Administration has proposed a number of amendments to the international tax rules.<sup>1</sup> If enacted, these proposals would substantially increase the U.S. tax burden on U.S. multinationals.

The Administration would significantly limit the classification of foreign entities as disregarded. Current law provides that most foreign entities with one owner-member may, by election, be classified as disregarded from their owners for U.S. tax purposes. Accordingly, such entities are treated in the same manner as a division or a branch of the owner.<sup>2</sup>

Under the Obama Administration's proposals, foreign entities with one foreign owner generally would be classified as corporations for U.S. tax purposes. This would result in more foreign active earnings becoming subject to current U.S. taxation under subpart F. For example, interest income received by a disregarded Irish FinCo on a loan to a disregarded German OpCo, where both entities are owned by the same foreign corporation, would no longer be disregarded, but subject to subpart F (this could be avoided by funding German OpCo with equity, but that would increase foreign taxes).<sup>3</sup> In addition, subpart F would apply to gain from the sale of stock by a CFC in a disregarded entity (this could be avoided by selling the entity's assets, but such transaction would be subject to foreign taxation). An exception would be provided for entities the owner of which is organized under the laws of the same country,<sup>4</sup> and the proposal would not apply to foreign entities owned directly by a U.S. person, except in cases of U.S. tax avoidance.<sup>5</sup>

The Administration also proposes to deny a current deduction for certain U.S. expenses (e.g., interest expense) that are allocated to deferred foreign earnings as determined under current Treasury regulations (i.e., Code Sec. 861), and it is not expected that interest expense will be allocated on a worldwide basis. The amount of expenses deferred would be deductible in the year when the associated deferred foreign income is repatriated to the United States. The effect of such a rule might be indefinite deferral of the expenses where the U.S. taxpayer would pay significant incremental U.S. taxes upon repatriation of foreign earnings. Research and experimentation expenditures would not be subject to this deferral rule.

The proposals would modify the foreign tax credit rules in two respects. First, it would adopt a "matching rule" preventing the separation of foreign taxes from the associated foreign income. This change apparently would reverse *Guardian Industries*, which held that a U.S. person is entitled to claim a direct foreign tax credit for foreign taxes on income that is earned by a separate lower-tier foreign subsidiary where such U.S. person is legally liable for the taxes (through a disregarded entity) under the foreign country's consolidated group rules. The provision also likely would not allow direct foreign tax credits to be claimed by U.S. owners of an entity treated as a partnership for foreign purposes but as a corporation for U.S. tax purposes, where the



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owners are liable under foreign law for the taxes (see Rev. Rul. 72-197<sup>6</sup>). Instead, the foreign taxes would be treated as paid by the entities earning the income for U.S. tax purposes.<sup>7</sup>

A more dramatic foreign tax credit proposal would require a U.S. taxpayer to calculate its deemed paid foreign tax credits on a consolidated basis by determining the aggregate foreign taxes and earnings and profits of all of the foreign subsidiaries to which the U.S. taxpayer can claim a deemed paid foreign tax credit. For example, where deferred foreign earnings on a consolidated basis bear an effective tax rate of 15 percent, a dividend from a Japanese subsidiary subject to a 40-percent effective tax rate would bring back credits at the 15-percent effective tax rate.<sup>8</sup> This rule is intended to prevent accessing high taxed earnings in a CFC to reduce the residual U.S. tax on low-taxed foreign source income (e.g., royalties received from foreign subsidiaries). Direct foreign taxes paid by a foreign branch or foreign disregarded entity of the U.S. group apparently would not be subject to this rule.

Another proposal would “clarify” the definition of intangible property for purposes of Code Sec. 367(d) (deemed “royalty” upon transfer of Code Sec. 936(h)(3)(B) intangibles to a foreign corporation) and Code Sec. 482 (commensurate with income pricing required for transfers of Code Sec. 936(h)(3)(B) intangibles). Under the proposal, Code Sec. 936(h)(3)(B) intangible property would include workforce in place, goodwill, and going concern value. In addition, the proposal would “clarify” that with transfers of multiple intangible properties the Commissioner may value the intangible properties on an aggregate basis, and that intangible property must be valued at its highest and best use. These have been areas of

controversy between the IRS and taxpayers, and the new provision may result in more intangibles being subject to the deemed royalty rules of Code Sec. 367(d) and the commensurate with income transfer pricing rule, as well as generally increase the value of intangibles subject to these rules. There is no indication whether foreign goodwill would continue to qualify for an exception to Code Sec. 367(d).

A proposal would repeal the rule that limits the amount of income with respect to a cross-border reorganization with boot to the amount of the gain. For example, a foreign subsidiary may acquire another foreign subsidiary from a U.S. affiliate for cash, and then liquidate the target, in a transaction that qualifies as a “Cash D” reorganization.<sup>9</sup> If the U.S. affiliate has a high basis in the stock of the target, little U.S. tax should be paid. This “boot-within-gain” limitation would be repealed in the case of any reorganization in which the acquiring corporation is foreign and the shareholder’s exchange has the effect of the distribution of a dividend, as determined under Code Sec. 356(a)(2). It appears that this proposal would subject to tax the amount of boot that is treated as a dividend.<sup>10</sup>

Finally, the 80/20 company rules would be repealed. Those rules provide that dividends and interest paid by a domestic corporation are not subject to withholding taxes if at least 80 percent of the corporation’s gross income during a three-year testing period is foreign source and attributable to the active conduct of a foreign trade or business (look-through rules to foreign subsidiaries apply for purposes of the active business test). If repealed, for example, withholding taxes would be imposed on interest payments to a foreign subsidiary in a non-treaty country made by a U.S. company that holds foreign subsidiaries.

## ENDNOTES

<sup>1</sup> White House Press Release, *Leveling the Playing Field*, available at [www.whitehouse.gov/the\\_press\\_office/](http://www.whitehouse.gov/the_press_office/); see also U.S. Treasury Department, General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals, May 15, 2009, available at <http://search.treas.gov/>.

<sup>2</sup> Reg. §301.7701-2(c)(2)(i).

<sup>3</sup> *But see* Code Sec. 954(c)(6) (provides temporary look-through exception, which the Obama Administration would extend to December, 31, 2010).

<sup>4</sup> *Cf.*, Code Sec. 954(c)(3).

<sup>5</sup> The Joint Committee staff and Treasury have in the past also proposed to limit disregarded status for foreign entities. See Lowell D. Yoder, *JCT Recommends Classifying Foreign Disregarded Entities as CFCs: A Time Warped Idea*, J. TAX’N GLOBAL TRANS., Spring 2005, at 3.

<sup>6</sup> 1972-1 CB 215 (Jan. 1, 1972).

<sup>7</sup> *Cf.*, Proposed Reg. §1.901-2(f) (2006).

<sup>8</sup> Absent a special rule, this proposal would also result in a significant (and inappropriate)

erosion of the availability of the subpart F high tax exception, which is determined on the basis of taxes deemed paid with respect to the subpart F income. See Reg. §1.954-1(d)(3).

<sup>9</sup> Lowell D. Yoder, *CFC Purchases Stock in a Related CFC: Code Sec. 304 vs. D Reorganization Treatment*, INT’L TAX J., Mar.–Apr. 2008, at 3.

<sup>10</sup> See REG-209006-89, 73 FR 49278 (Aug. 20, 2008), at D, 2 of Explanation.

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