A Note From the Editor-in-Chief

Obama Administration’s 2011 Budget: International Tax Proposals

The Obama Administration has proposed a number of amendments to the international tax rules in its fiscal year 2011 Budget. The proposals are essentially the same as those in the 2010 Budget, although with some modifications, one deletion and one significant addition.

One important development is the deletion of the 2010 Budget proposal to eliminate disregarded entity classification for foreign entities. Accordingly, most foreign entities with one owner-member may, by election, continue to be classified as disregarded from their owners for U.S. tax purposes, and treated in the same manner as a division of the owner. This permits payments and transactions involving disregarded foreign entities to be ignored for U.S. tax purposes, generally reducing the amount of active income of a controlled foreign corporation (CFC) that would otherwise be currently taxable to U.S. shareholders under subpart F.

The 2011 Budget also would extend the subpart F temporary look-through exception for two years. This rule generally permits payments out of active income of dividends, interest, rents and royalties between two related CFCs without application of subpart F.

The Administration proposes to deny a current deduction for interest expense allocated or apportioned to foreign earnings which are not subject to current U.S. taxation. The amount of interest allocated and apportioned to deferred foreign source income would be determined under current Treasury regulations issued pursuant to Code Sec. 861. The proposal would not apply to interest expense allocated to directly earned foreign source income, such as income derived through a foreign branch and royalty income. Interest expense of foreign subsidiaries would not be taken into account until 2018 (i.e., world-wide apportionment), which generally would cause a disproportionate amount of interest expense of the U.S. group to be allocated to deferred foreign income for several years. The amount of interest expense deferred would be deductible in the year in which the associated deferred foreign income is repatriated to the United States. The likely effect of such a rule could be indefinite deferral of the interest expense where the U.S. taxpayer would pay significant incremental U.S. taxes upon repatriation of foreign earnings. Unlike the 2010 proposal, no other expenses are subject to this rule, including general and administrative expenses.

Like the 2010 Budget, the 2011 Budget 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 owners are liable under foreign law for the taxes (see Rev. Rul. 72-197). Instead, the foreign taxes would be treated as paid by the entities earning the income for U.S. tax purposes.5

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 with respect 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. This rule would prevent accessing highly 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 provide that with respect to transfers of multiple intangible properties the Commissioner may value the intangible properties on an aggregate basis (taking into account additional value that results from the interrelationship of intangible assets), and may value intangible property taking into consideration the prices or profits that the U.S. parent could have realized by choosing a realistic alternative to the transactions undertaken. These have been areas of controversy between the IRS and taxpayers, and the new provision is intended to subject more intangibles 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 some indication that transfers to foreign subsidiaries of foreign goodwill and going concern value would continue to qualify for a regulatory exception to Code Sec. 367(d).

The Obama Administration apparently considers the transfer pricing rules as inadequate to address its concerns about shifting profits attributable to intangibles from U.S. companies to their low-taxed foreign subsidiaries, and has proposed a new category of subpart F income. Under the proposal, if a U.S. person transfers an intangible from the U.S. to a foreign subsidiary that is subject to a low foreign effective tax rate in circumstances that evidence excessive income shifting, then an amount equal to the excessive return would be treated as subpart F income in a separate foreign tax credit limitation basket. “Transfers” of intangibles apparently would include licenses and buy-in payments. Treasury officials have indicated that a 10-percent-or-less foreign effective tax rate may be considered as “low,” and returns of 30 percent or more on assets are potentially considered as “excessive.” There remain many unanswered questions concerning the details of how this provision would apply.

If this proposal were enacted, U.S. companies operating in tax structures with income subject to a low foreign tax rate could have a material portion of their income subject to current U.S. taxation. Nevertheless, this new rule may not apply to all low tax countries. For example, income derived by a foreign subsidiary operating in Ireland (12.5-percent tax rate) may avoid the U.S. 35-percent rate on excessive earnings resulting from intangibles.

ENDNOTES

1 See U.S. Treasury Department, General Explanations of the Administration’s Fiscal Year 2011 Revenue Proposals (Feb. 1, 2010).
2 Reg. §301.7701-2(c)(2)(i).
4 Code Sec. 954(c)(6). The exception for active financing income would also be extended for two years. Code Sec. 954(h).
6 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).

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