Preparing for International Tax Reform

The Wall Street Journal recently ran an article entitled Business Fends Off Tax Hit: Obama Administration Shelves Plan to Change How U.S. Treats Overseas Profits. The article describes the international tax reform proposals advanced by the Administration in May 2009, which would materially increase the U.S. taxes of U.S. multinationals. It discusses how a large number of U.S. multinationals joined coalitions and took their case to Washington. They argued that the proposals would put U.S. companies at a competitive disadvantage with foreign companies and ultimately result in fewer U.S. jobs. The article suggests that the Administration understands this, and has retreated from pushing its international tax proposals. An editorial published in the Journal the same week described this supposed development as an example of the use of lobbying to protect the public good.

These reports of the death of the Administration’s international tax proposals may have been premature. International tax reform may not be in the offering this year, but it is not going away. The Administration immediately responded to the WSJ article, stating that the Administration remained committed to its international tax reform proposals to end “unfair loopholes” and tax breaks for international corporations. Furthermore, a recent Joint Committee on Taxation pamphlet describing the Administration’s proposals discussed numerous additional international tax reform ideas that address perceived problems with the current rules, and the Presidential tax reform task force headed by Paul Volcker is expected to present a range of options in a report due in early December. Therefore, it is likely that international tax reform will be on Congress’ agenda next year.

U.S. multinationals should determine the effect on their international structures of the possible changes to the international tax rules that are being discussed, including a quantitative analysis of the additional U.S. tax burden. They should continue making the case to the Administration and to their Congressional representatives of the detrimental impact of the reform proposals, as well as develop alternative proposals.

A U.S. multinational also should consider proactively restructuring certain foreign operations to avoid material costs resulting under the proposed new rules. One proposal of particular concern would generally prevent single-member foreign entities from being disregarded as separate from their owners, instead classifying such entities as corporations. This would have an immediate tax impact of “incorporating”
branches and an ongoing impact of causing transactions involving disregarded entities (DEs) to become regarded. Under the Administration’s proposal, exceptions would be provided for entities organized under the laws of the same foreign country as their owners and, except in cases of U.S. tax avoidance (whatever that means), for first-tier entities owned directly by a U.S. person. The Joint Committee pamphlet has called these exceptions into question, thus raising the possibility that this proposal could actually be made harsher in some respects when it next appears.6

The reclassification of DEs as corporations could result in immediate U.S. tax costs. As discussed in a prior article, a disregarded loan to a DE will “spring” into existence and can result in taxable gain.7 Liabilities assumed by a newly classified CFC can result in taxable boot or a deemed dividend under Code Sec. 304 where the DE owns stock in a subsidiary. Loans made by a DE can result in a loan receivable with a zero basis, and subsequent income upon repayment of the loan. The gain triggered can be subpart F income. If the classification rules apply to a DE with a U.S. owner, various branch loss recapture rules can result in taxable income. Furthermore, currency related gain under Code Sec. 987 can be triggered upon the deemed incorporation of a branch. Therefore, proactively restructuring liabilities and addressing loss branches may be important to avoid material tax costs upon the reclassification of DEs as CFCs. The Administration does not mention these results as an intended consequence under the new proposals. The Joint Committee pamphlet includes a discussion of these effects of the proposal and suggests that these conversion costs may warrant additional transition relief.8

The proposals to classify DEs as CFCs could result in subpart F sales income under Code Sec. 954(d). For example, an Irish principal may purchase products from an unrelated contract manufacturer and sell the products to a U.K. entity that is disregarded for U.S. tax purposes, which sells the products to U.K. customers. The Irish principal’s income under current law is not Subpart F income because it does not purchase products from, nor sell products to, a related person. If the U.K. DE becomes a CFC, the Irish principal’s income would become subpart F income because it is considered as selling products to a related person, unless an exception applies. Steps should be considered to ensure that the Irish principal’s income qualifies for the manufacturing exception, which applies when the principal “substantially contributes” to the manufacture of the products sold. Accordingly, if the exception applies, the current tax rate imposed on the principal’s income would be the tax rate in the principal’s country, which generally would be the same rate paid by foreign competitors on income from similar operations.

The proposed classification rules may also cause services income derived by U.S. multinationals to become subpart F income under Code Sec. 954(e). Generally, income from services provided to an unrelated person is not subpart F income. Many multinationals centralize important aspects of their service functions and multiple related entities may be involved in providing specific services to a particular customer, which can result in related party transactions and subpart F income. The subpart F rules enacted in the early 1960s are arcane and did not envision today’s globally integrated services organizations. On the other hand, the disregarded entity classification rules have effectively updated the rules, by allowing centralization of service functions without creating related person transactions. Service-providing DEs becoming CFCs would likely create numerous related party transactions and result in a material amount of subpart F services income. Hence, a U.S. multinational would become subject to greater tax cost than its foreign competitors with similar operations, unless it restructured into a less business-efficient structure to avoid current U.S. taxation. The IRS and the Treasury recently addressed the out-of-date nature of the rules in issuing Notice 2007-13, which eliminated certain subpart F issues arising from related CFCs providing assistance to each other in servicing unrelated customers.

Alternatively, a company might consider maintaining something resembling the status quo from a U.S. tax perspective by converting its DEs into actual branches. This would eliminate the related person transactions. Operating through branches, however, could increase the risks of paying more taxes in higher tax foreign countries. Nevertheless, this may be a desired course of action because the tax rates in most countries are lower than the additional U.S. tax costs on subpart F income.

The ability to use excess foreign tax credits on high taxed earnings may be limited under future legislation. U.S. multinationals might consider repatriating high taxed earnings before any legislation is enacted in order to avoid the loss of the excess credits. The use of excess taxes on certain active income to reduce U.S. taxes on other foreign source active income is well within the purview of current law. Such practice was effectively sanctioned with the legislative changes in
2004, which replaced the multiple foreign tax credit limitation categories of Code Sec. 904(d) with two foreign tax credit baskets (passive and active).

It may be advisable to restructure foreign entities before new international tax rules become effective. There is generally much more flexibility in reorganizing entities, transactions and loans when an election can be made to disregard a particular foreign entity.

ENDNOTES

5 Joint Committee on Taxation, Description of Revenue Provisions Contained in the President’s Fiscal Year 2010 Budget Proposal; Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment (JCS-4-09), Sept. 2009 (the “Joint Committee pamphlet”).
6 See Joint Committee pamphlet, at 111–13.
8 See Joint Committee pamphlet, at 115.