

**Obama proposals in light of
the Joint Committee Report on
International Tax Reform**

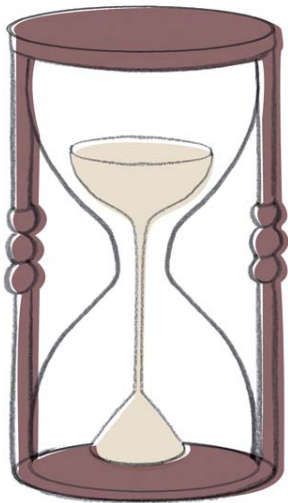
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Today's agenda



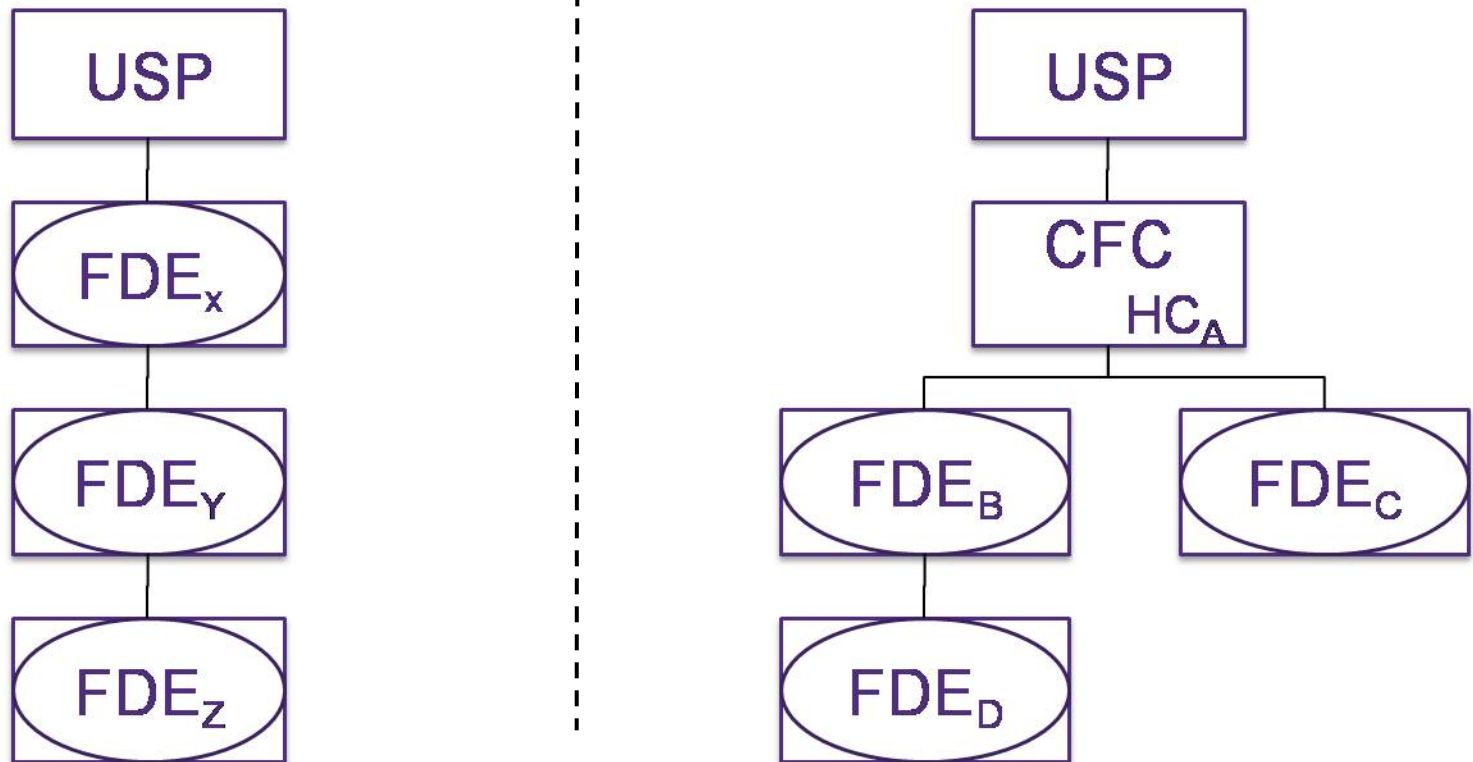
- **Reform of the check-the-box rules**
- **Deferral of deductions**
- **Reform of the foreign tax credit**
- **Modification of the "boot-within-the-gain" rule of Section 356(a)(1)**
- **Treatment of intangible property**

Reforming the Check-the-Box Rules

- Under the proposal, a foreign eligible entity may be treated as a disregarded entity only if the single owner of the foreign eligible entity is created or 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.
 - Therefore, a foreign eligible entity with a single owner that is organized or created in a country other than that of its single owner would be treated as a corporation for federal tax purposes.
 - The proposal would generally not apply to a first-tier foreign eligible entity wholly owned by a United States person, except in cases of U.S. tax avoidance.
- The tax treatment of the conversion to a corporation of a foreign eligible entity treated as a disregarded entity would be consistent with current Treasury regulations and relevant tax principles.
- The proposal would be effective for taxable years beginning after December 31, 2010.
- Additionally, Section 954(c)(6) (the “CFC look-through rule”) is scheduled to expire.
 - A separate proposal would extend this provision through December 31, 2010 (but not beyond).

Observations and Issues

Some typical structures that could be impacted if proposal passed



Observations and Issues

- Some potential US tax consequences of a conversion of a foreign disregarded entity (FDE) to a corporation under the proposal (one or more of the following consequences below may apply depending on the particular structure, type of transaction (outbound, foreign-to-foreign) and the particular facts):
 - Recognition of income under sections 351(b), 357(c), and 304 as a result of debt or other boot that springs into existence
 - Potential trigger gain recognition on transfers of assets under section 367(a)
 - If outbound foreign stock transfer, may be required to enter into GRA to avoid gain recognition
 - Potential application of section 367(d)
 - Branch terminations
 - DCL, Branch Loss, OFL Recapture

Observations and Issues

- Section 987 exchange gain/loss
- Some post-conversion issues:
 - Previously disregarded intercompany transactions may now trigger subpart F income
 - Foreign-to-foreign royalties/interest/dividends between related CFCs (as opposed to transactions between a CFC and its FDEs or between FDEs of a single CFC)
 - Section 954(c)(6) likely will not be extended to period proposal would take effect (Administration has proposed extending section 954(c)(6) through 2010 but not beyond)
 - Need to evaluate structure for purposes of determining potential Subpart F implications (e.g., does new structure result in foreign base company sales income?)
 - Potential impact on contract manufacturing structures

Observations and Issues

- JCT explanation assumes that stacked foreign FDEs owned by a U.S. person will not be treated as a single, first-tier entity (page 114)
- JCT report acknowledges proposal may be detrimental to some FDEs' U.S. shareholders not eligible for deemed paid credits under section 902.
 - Could have detrimental impact for certain structures from a foreign tax credit perspective (e.g., S corporations that conduct business through a chain of FDEs)
 - JCT report suggests that this result arguably is appropriate under general distinction between direct and indirect foreign tax credits
- The Administration's proposal provides for no transition relief

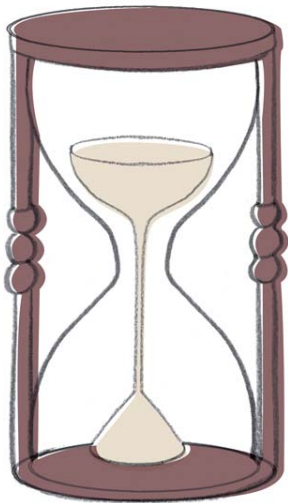
Observations and Issues

- Some observations/issues with FDEs and the CTB proposal cited by the JCT report include:
 - FDEs can encourage indefinite deferral of U.S. tax on foreign income through continued foreign reinvestment of foreign earnings
 - FDEs can affect timing and utilization of foreign tax credits under certain circumstances by facilitating the separation of relatively high-taxed and low-taxed foreign source income and can be used to maximize a taxpayer's foreign tax credit
 - FDEs can be used to circumvent Subpart F (e.g., check-and-sell transactions to avoid Subpart F income)

Observations and Issues

- Some observations/issues with FDEs and the CTB proposal cited by the JCT report include:
 - There may be structures that would undermine the proposal
 - Use of second-tier foreign eligible entities where they are created or organized in the jurisdiction of its single owner but subject to residence based taxation in another country because it is managed and controlled or has its principal place of business in that other country
 - Use of a nominal owner such that the foreign eligible entity is not a disregarded entity (i.e., a partnership for U.S. federal tax purposes)
 - Need guidance on what is “U.S. tax avoidance” as it relates to a first-tier foreign eligible entity wholly owned by a U.S. person.
 - Is foreign base erosion through the use of disregarded indebtedness U.S. tax avoidance?
 - Possible administrative and fairness considerations because of effective date of proposal and absence of any transitional rule

Today's agenda



- Reform of the check-the-box rules
- **Deferral of deductions**
- **Reform of the foreign tax credit**
- **Modification of the "boot-within-the-gain" rule of Section 356(a)(1)**
- **Treatment of intangible property**

Deferring Deductions

- The proposal would defer a deduction for expenses (other than research and experimentation expenditures) of a U.S. person that are properly allocated and apportioned to foreign-source income to the extent the foreign-source income associated with the expenses is not currently subject to U.S. tax.
 - The amount of expenses properly allocated and apportioned to foreign-source income generally would be determined under current Treasury regulations.
 - The amount of deferred expenses for a particular year would be carried forward to subsequent years and combined with the foreign-source expenses of the U.S. person for such year before determining the impact of the proposal in such year.
- The proposal would be effective for taxable years beginning after December 31, 2010.

Observations and Issues

- Some possible implications of proposal on U.S. multinationals:
 - Increased after-tax cost of capital
 - Increased after-tax cost of supportive, general and administrative expenses.
 - Movement of debt offshore
 - Increased importance on properly allocating and apportioning expenses
 - Less competitive in global marketplace compared to foreign multinationals (especially when other international tax reform proposals are considered, such as the check-the-box reform and foreign tax credit reform)

Observations and Issues

- JCT observations relating to proposal:
 - Income from 10/50 companies included in analysis
 - By more closely matching the timing of expense deductions with income inclusion, proposal may reduce the incentive under present law for a U.S. multinational corporation to derive income through foreign subsidiaries in low-tax jurisdictions
 - Because proposal does not apply to research and experimentation expenses, the proposal may have little effect on existing incentives to shift certain intangibles-related income offshore and may treat U.S. firms in certain industries differently from U.S. firms in other industries.

Observations and Issues

- JCT observations relating to proposal:
 - Significant impact on interest expense, stewardship or supportive expenses and general and administrative expenses
 - Proposal would have a disproportionate effect on U.S.-based multinationals that have relatively high degrees of U.S. borrowing to fund offshore operations, most notably firms in the financial sector
 - Proposal may over-correct for income and expense matching concerns, unless the worldwide allocation rules (section 865(f)) for interest expense are permitted to take effect as scheduled in 2011
 - Proposal silent regarding section 865(f) (However, the postponement of section 865(f) has been included in a number of proposals, including HR 3200)
 - Proposal (in conjunction with other proposals) could encourage inversions of U.S. multinationals or encourage new foreign businesses to be foreign headed (a foreign company as the first-tier company)

Observations and Issues

- JCT observations relating to proposal :
 - Technical and Administrative Issues
 - Proposal not clear on the treatment of expenses that are directly related and allocable to a class of gross income that is subject to current taxation
 - Application of present law allocation and apportionment principles in determining the amount of deductions that are potentially deferred

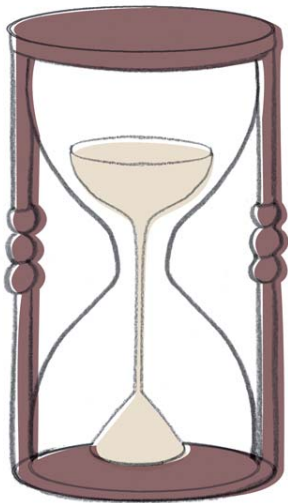
Observations and Issues

- JCT observations relating to proposal :
 - Technical and Administrative Issues
 - Manner in which foreign-source income on which U.S. tax is deferred should be computed
 - Unclear whether non-previously taxed earnings of CFCs and 10/50 companies would be determined on a consolidated basis, with elimination of the effects of intercompany transactions, or as the sum of separately-computed company results
 - Additional issues relating to treatment of transactions between two foreign subsidiaries for purposes of determining the earnings of each that are includible as foreign subsidiary income not currently subject to tax, and (2) the treatment of deficits, including whether the earnings deficit of one foreign subsidiary should offset the positive earnings of other foreign subsidiaries.

Observations and Issues

- JCT observations relating to proposal :
 - Technical and Administrative Issues
 - Currency translation rules for determining the non-previously taxed CFC and 10/50 corporation earnings on which U.S. tax is deferred
 - Whether the earnings of entities below the sixth-tier that are not included in the section 902 qualified group should be excluded from the computation of foreign-source income on which U.S. tax is deferred
 - Tax reporting and administrative issues

Today's agenda

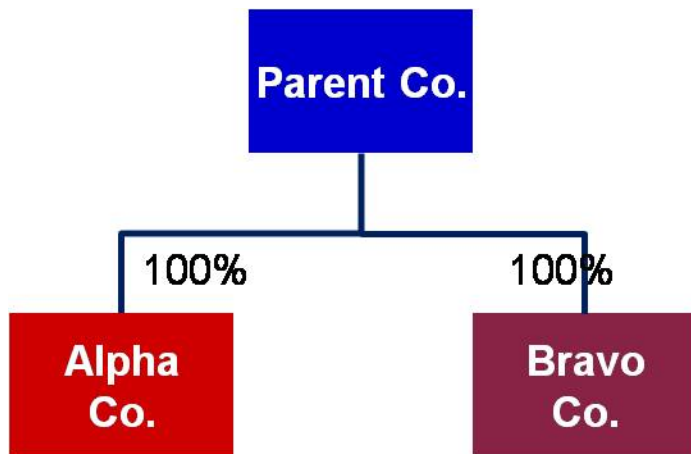


- Reform of the check-the-box rules
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- **Reform of the foreign tax credit**
- **Modification of the "boot-within-the-gain" rule of Section 356(a)(1)**
- **Treatment of intangible property**

Reforming the Foreign Tax Credit

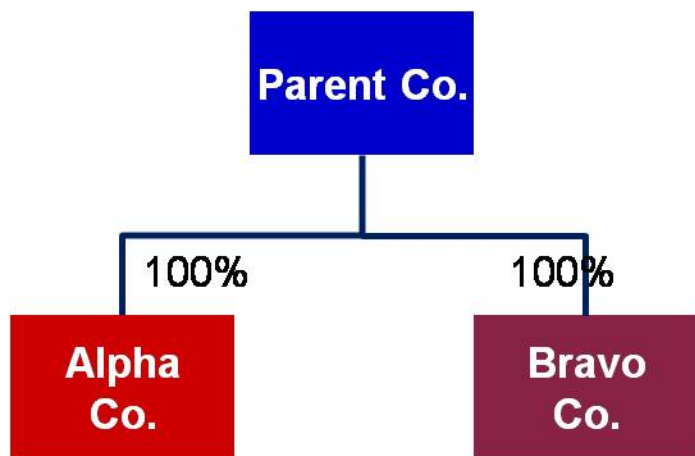
- Under the proposal, a U.S. taxpayer would determine its deemed paid foreign tax credit on a consolidated basis by determining the aggregate foreign taxes and earnings and profits of all of the foreign subsidiaries with respect to which the U.S. taxpayer can claim a deemed paid foreign tax credit (including lower tier subsidiaries described in section 902(b)).
 - The deemed paid foreign tax credit for a taxable year would be determined based on the amount of the consolidated earnings and profits of the foreign subsidiaries repatriated to the U.S. taxpayer in that taxable year.
- Additionally, another proposal addressing the foreign tax credit would adopt a matching rule to prevent the separation of creditable foreign taxes from the associated foreign income.
- The proposals would be effective for taxable years beginning after December 31, 2010.

Reforming the Foreign Tax Credit



- Parent Co. owns 100 percent of the shares of each Alpha Co. and Bravo Co., CFCs organized in Alphaland and Bravoland.
- Alpha Co. has pre-tax earnings of \$1,000 in the general limitation category, pays foreign tax of \$125 (at a 12.5 percent tax rate), and has net earnings after taxes of \$875.
- Bravo Co has pre-tax earnings of \$1,000 in the general limitation category, but pays foreign taxes of \$410 (at a 41 percent tax rate) and has net earnings after taxes of \$590.
- The aggregate amount of net earnings and profits of Alpha Co. and Bravo Co. is \$1,465 ($\$875 + \590), and the aggregate amount of foreign taxes paid is \$535 ($\$125 + \410).

Reforming the Foreign Tax Credit



- If Alpha Co. distributes \$500 to Parent Co. as a dividend, the amount of foreign taxes that Parent Co. would be deemed to have paid under the proposal with respect to the distributed earnings is \$183 (or $\$535 \times (\$500/\$1,465)$).
- Similarly, if Bravo Co. distributes \$500 to Parent Co. as a dividend, the amount of foreign taxes that Parent Co. would be deemed to have paid with respect to the distributed earnings is \$183 (or $\$535 \times (\$500/\$1,465)$).
- Absent other factors, Parent Co. would be indifferent as to whether the \$500 is remitted from Alpha Co. or Bravo Co., leaving Parent Co. to decide the source of the dividend based on business needs, rather than U.S. tax considerations.
 - Compare result under current law in which dividend from Bravo Co. would bring greater deemed paid credits under section 902 than a dividend from Alpha Co. (and more section 78 gross up)

Observations and Issues

- Some observations/issues raised by JCT report:
 - By determining the amount of deemed paid taxes on an aggregate or blended basis under section 902, the proposal would require that foreign taxes imposed at high rates be used to offset potential U.S. tax liability on lower-taxed foreign earnings, without regard to the timing or source of any particular distribution of foreign earnings.
 - Accelerates credits for low-taxed subsidiaries but delays credits for high taxed subsidiaries
 - Proposal would revise the rules of section 902 so that a U.S. corporation would determine the amount of foreign taxes that it is deemed to have paid under section 902 with respect to dividends received from a foreign corporation (and, correspondingly, under section 960 with respect to subpart F income inclusions) on an aggregate, rather than corporation-by-corporation, basis.

Observations and Issues

- Some observations/issues raised by JCT report:
- Applies for purposes of sections 902 and 960 (no changes to direct credits under section 901) and includes 10/50 companies
- Proposal may not eliminate opportunities for foreign tax credit planning.
 - Remove high-taxed foreign earnings from the blending regime (e.g., by converting foreign subsidiaries located in high-tax jurisdictions into branches or partnerships, so that foreign taxes associated with those earnings would be considered directly paid taxes under section 901 rather than deemed paid under section 902)
 - Remove low-taxed earnings from the blending regime (e.g., by placing low-taxed subsidiaries below the sixth-tier foreign corporations described in section 902(b)(2))
- Parity between branch and subsidiary operations that results from the interaction of Sections 78, 901 and 902 is delinked
- Several technical and administrative issues:
 - Need rules for allocating subsidiary earnings and foreign taxes proportionally among multiple shareholders (direct and indirect), including in situations where shareholders' proportionate interests change as a result of acquisitions, dispositions, dilutions, mergers and other corporate events

Observations and Issues

- Several technical and administrative issues:
 - Manner in which the pools of foreign subsidiary earnings would be determined: whether on a consolidated basis, with elimination of the effects of intercompany transactions, or as the sum of separately-computed company results .
 - Treatment of transactions between foreign subsidiaries for purposes of determining the earnings of each that are includible in the section 902 aggregate earnings amount
 - Treatment of deficits
 - Ordering rules for determining the extent to which an E&P deficit in one limitation category should reduce positive E&P in another limitation category of the same entity or other entities
 - whether the amount and separate limitation character of dividends and subpart F inclusions should be determined by reference to the aggregate blended E&P pool or on a separate-entity basis
 - Foreign tax redeterminations under section 905(c) and currency translation issues

Observations and Issues

- Several technical and administrative issues:
 - Treatment of earnings and taxes in entities below the sixth-tier that are not included in the section 902 qualified group
 - Interaction between the rules for determining the taxable distribution under sections 301 and 302, for which purpose E&P must be determined on an entity-by-entity basis, and the aggregate E&P pool approach mandated by the proposal for determining the available foreign tax credit
 - Whether the available foreign tax credit (before application of the section 904 limitation) is determined on the basis of a single, carryforward calculation or under the approach taken in H.R. 3970, which provides for an annual calculation with respect to current earnings and a second calculation with respect to unrepatriated earnings

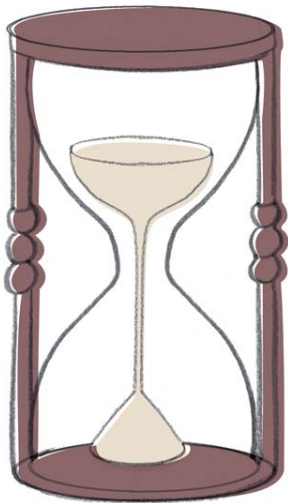
Observations and Issues

- Several technical and administrative issues:
 - Tax reporting requirements will increase under the proposal
 - Transition considerations (the proposal does not provide for a transition rule)
 - Absent a transition rule, all foreign taxes and all earnings of foreign subsidiaries, including amounts attributable to periods prior to the enactment of the proposal, would be subject to the blending rule.
 - Treaty considerations
 - The U.S. must allow an indirect credit for “the taxes” paid to the treaty partner on the accumulated profits out of which “the” dividend is paid

Observations and Issues

- Proposal adding matching rule to prevent the separation of creditable foreign taxes from the associated foreign income designed to address *Guardian Industries* case and certain reverse hybrid type structures
 - Foreign tax credits are appropriate only in cases in which the foreign income to which they relate is currently subject to U.S. tax
 - Discusses issues related to 2006 proposed regulations designed to address such splitters

Today's agenda



- Reform of the check-the-box rules
- Deferral of deductions
- Reform of the foreign tax credit
- **Modification of the "boot-within-the-gain" rule of Section 356(a)(1)**
- **Treatment of intangible property**

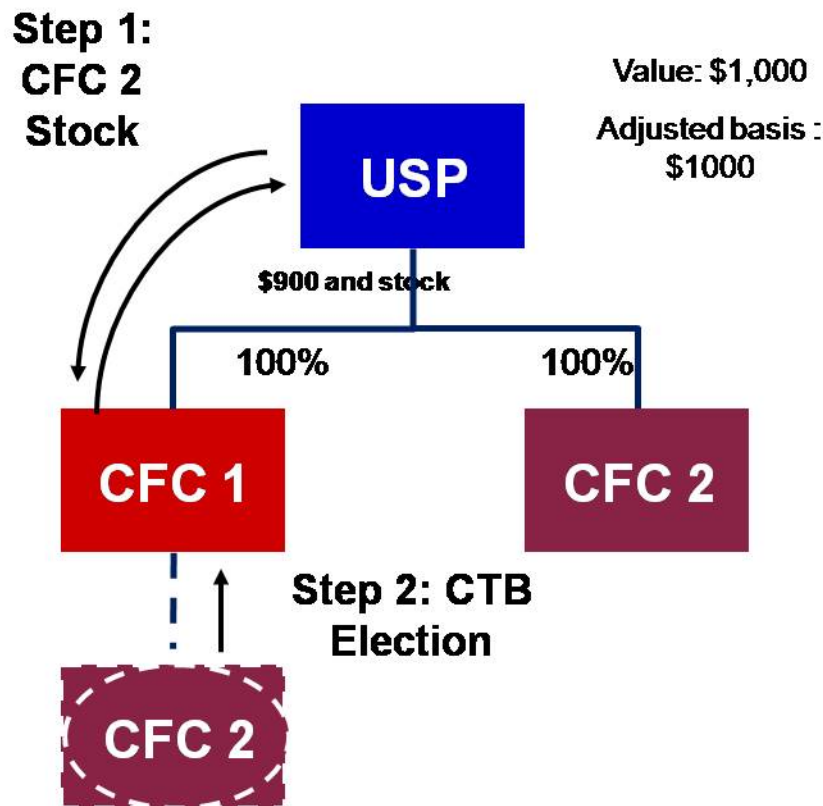
Modifying the “Boot-within-the Gain” Rule

- **Modifying the “boot-within-the gain” rule of section 356** - The Administration’s proposal would repeal the boot-within-gain limitation of current law 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 section 356(a)(2).
- The proposal would be effective for taxable years beginning after December 31, 2010.

Modifying the “Boot-within-the-Gain” Rule

- IRS and Treasury have previously suggested modifying this rule in the preamble to REG-209006-89:
 - *“the IRS and Treasury Department are analyzing whether it is appropriate for the gain limitation rule of section 356(a)(1) to apply in an acquisitive asset reorganization involving a foreign acquiring corporation, considering that a policy of section 367(b) is “to protect against tax avoidance in transfers to foreign corporations and upon the repatriation of previously untaxed foreign earnings.” H.R. Rep. No. 94-658 (1975). Comments are requested in this regard, including whether the application of any such guidance should be limited to cases where section 356(a)(2) would otherwise apply to the shareholder's receipt of non-qualifying property.”*

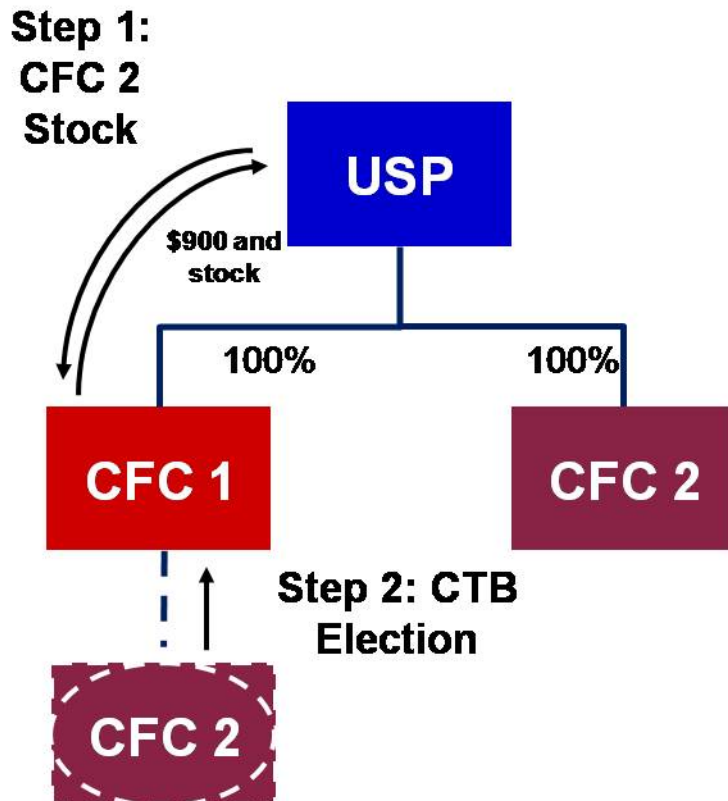
Cash "D" Reorganization (Current Law)



- CFC1 and CFC2 are pre-existing, operating foreign subsidiaries of USP and CFC2 has only common stock outstanding.

- Step 1: CFC 1 purchases all of the stock of CFC 2 from USP for cash (\$900) and CFC1 stock. USP's basis in its CFC 2 stock is \$1000 (no gain in transaction).

Cash "D" Reorganization (Current Law)

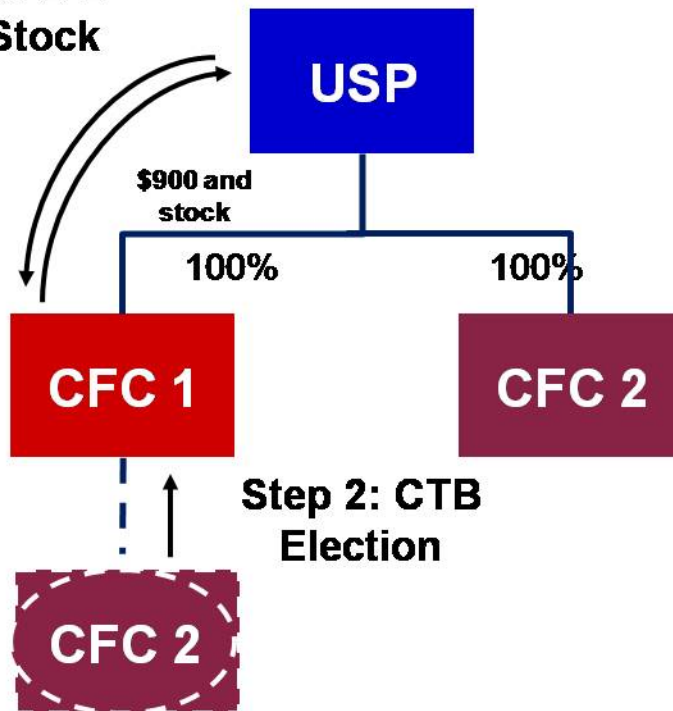


- **Step 2:** As part of the overall plan, CTB Election subsequently made to treat CFC 2 as a disregarded entity of CFC 1 such that the CFC1's acquisition of the CFC2 stock followed by CFC2's subsequent deemed liquidation into CFC1 is treated as a reorganization under Section 368(a)(1)(D).

See Rev. Ruls. 67-274, 70-240, 2001-46, and 2004-83 and Reg. 1.368-2T(l). See also *J.E. Davant v. Commr.*, 366 F.2d 874 (5th Cir. 1966), *cert. denied* 386 U.S. 1022 (1967).

Cash "D" Reorganization (Current Law)

Step 1:
CFC 2
Stock



- USP asserts no gain/income inclusion under Section 356(a)(1) and (2).

Observations and Issues

- Some JCT report observations:
 - JCT report discussed various comments from the tax community relating to boot-within-the gain rule.
 - Some commentators have questioned whether this type of transaction is a repatriation of earnings.
 - Proposal is overly broad.
 - The boot-within the gain limitation could equally apply to a transaction in which the selling shareholder is a CFC. In such a situation, cash would be moving from one foreign corporation to another and not result in an actual repatriation of cash back to the United States such that there may be no intent to repatriate non-previously taxed earnings.

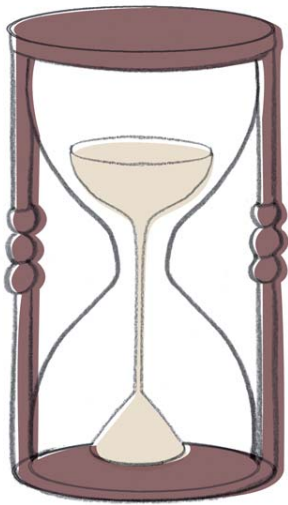
Observations and Issues

- Some JCT report observations:
 - Proposal is under-inclusive.
 - In contrast with the Killer B guidance, the proposal does not address domestic-to-domestic reorganizations with a foreign shareholder where there may be the potential for withholding tax avoidance.
 - Under such circumstances, the amount of boot recharacterized as a dividend and subject to withholding tax will continue to be limited under the boot-within-gain rule.

Observations and Issues

- JCT report observations:
 - Manner in which the boot will be taxed to the extent it is not subject to the boot-within-gain limitation.
 - Presumably section 356(a)(2) would still apply but would treat the entire amount of boot as a dividend to the extent of accumulated E&P.
 - Need clarification on source of the accumulated E&P from which the deemed dividend is generated under section 356(a)(2).
 - The repeal of the boot-within-gain limitation may have other unintended consequences that may be used affirmatively by taxpayers for planning purposes.

Today's agenda



- Reform of the check-the-box rules
- Deferral of deductions
- Reform of the foreign tax credit
- Modification of the "boot-within-the-gain" rule of Section 356(a)(1)
- **Treatment of intangible property**

Providing Guidance Relating to the Treatment of Intangible Property

- The proposal would clarify the definition of intangible property for purposes of sections 367(d) and 482 to include workforce in place, goodwill and going concern value.
- The proposal would also clarify that in a transfer of multiple intangible properties, the Commissioner may value the intangible properties on an aggregate basis where that achieves a more reliable result.
- The proposal would also clarify that intangible property must be valued at its highest and best use, as it would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.
- The proposal would be effective for taxable years beginning after December 31, 2010.

Providing Guidance Relating to the Treatment of Intangible Property

- Questions relating to Proposal:
 - Is this really a clarification?
 - Will the carve out for foreign goodwill and going concern in Treas. Reg. 1.367(d)-1T(b) be retained?

Observations and Issues

- Some JCT Observations:
 - The proposal, if enacted, would establish that the compensable proportion of the value inherent in many outbound transfers of intangibles would be larger under the proposal than the amount believed by many to be compensable under present law.
 - It is possible that other proposals included in the Administration's budget -- in particular those relating to the deferral of expense deductions, foreign tax credit blending, and the treatment of single member foreign entities -- will sufficiently reduce the benefits of deferral that incentives for inappropriate income shifting will decline.
 - However, JCT states that these other proposals would have uneven effects.

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