INTERNATIONAL TAX PROPOSALS IN THE OBAMA ADMINISTRATION'S BUDGET: AN OVERVIEW FOR NON-US COMPANIES

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The international tax provisions in the Obama Administration's first budget, if enacted, will represent significant changes in US tax policy. Because the proposed changes are the current US tax developments most interesting to a Canadian audience, this paper focuses on them to the exclusion of other developments that I discussed at the International Tax Seminar.

The budget proposals affecting the tax burden on US multinational companies have received a great deal of attention, but other important proposals directly affect non-US companies with US investments, US investors, or US customers. This summary highlights selected provisions in the Administration's budget from a practical perspective with an emphasis on those most likely to interest non-US companies.[1]

HIGHLIGHTS

Key international tax provisions in the Obama Administration's budget proposals will

- restrict US companies' deferral of US tax on their non-US subsidiaries' active business income;
- defer US deductions for interest and other expenses allocable to deferred non-US income;
- prevent US companies from selectively repatriating high-taxed income (that carries foreign tax credits sufficient to pay the US tax);
- impose tax on the expatriation of goodwill, assembled workforce, and other soft intangibles;

[1] Legislation to implement tax proposals in the Obama Administration's budget has not yet been introduced. This overview therefore relies on the summary descriptions in the US Treasury Department's *General Explanation of the Administration's Fiscal Year 2010 Revenue Proposals*, May 11, 2009.

- reduce the threshold for denying deductions for interest paid by an inverted US company to a related non-US company;
- repeal the US withholding tax exemption for dividends paid by US companies that receive substantially all of their income from active foreign businesses (called 80/20 companies);
- limit the foreign tax credits available to US oil and gas companies;
- impose withholding tax on certain dividend equivalent payments;
- require qualified intermediaries to report to US tax authorities payments to US persons and the acquisition or formation of a non-US entity on behalf of a US person; and
- impose withholding tax on many payments, such as those made through non-qualified intermediaries or those made to non-US entities that do not disclose their beneficial owners.

PROSPECTS FOR ENACTMENT

Because the United States does not have a parliamentary system of government, it is quite possible that the Administration's international tax proposals will not be enacted. Whether the proposals are enacted this year probably depends more on the need for revenue to fund the Administration's health-care reform and other initiatives than it does on tax policy. Important tax policy posts at the Treasury remain unfilled, and important members of the congressional finance committees who generally support many of the proposals have indicated that they would prefer to address international tax reform more comprehensively later. Even if not enacted this year, some of the proposals almost certainly will appear again.[2]

If enacted as proposed, most of the substantive international tax provisions in the Administration's budget will not become effective until 2011. The procedural and enforcement provisions to tighten withholding and information reporting generally are proposed to take effect in 2010.

PROPOSALS

Restrict Deferral of US Tax on Non-US Active Business Income

US companies generally do not pay tax on the active business income of their non-US subsidiaries until it is repatriated to the United States. US companies must pay tax currently, however, on their share of a controlled foreign corporation's passive income or its income from certain related-party sales and services. A temporary exception to the controlled corporation rules (in subpart F of the US tax code[3]) treats

[2] Similar proposals were introduced in the previous US Congress: see S. 681, 110th Cong. (2007) (Sen. Levin, Coleman, and Obama); HR 3970, 110th Cong. (2007) (Rep. Rangel). In the current Congress, see S. 506, 111th Cong. (2009) (Sen. Levin, Whitehouse, McCaskill, and Nelson).

[3] Internal Revenue Code of 1986, as amended (herein referred to as "the IRC").

interest received from a related controlled company engaged in active business as active business income.[4] US multinational companies use that exception when they form finance subsidiaries in low-tax countries to make loans to controlled affiliates in high-tax countries. It allows them to shift earnings from the high-tax to the low-tax jurisdiction without incurring US tax. For many years, US companies have achieved a similar result by electing under the US tax entity characterization rules (the so-called check-the-box rules) to disregard the finance subsidiary and the controlled affiliate, which causes the loan between them also to be disregarded.

The Administration's budget contains a proposal aimed at this type of tax planning that has potentially more sweeping consequences. The budget proposes to prevent companies formed outside their parent company's home country from electing to be disregarded for US tax purposes. There would be an exception for a US company's first-tier foreign subsidiaries (because the US company would pay US tax currently on their income if they were disregarded). The budget also seems to contemplate that, after a one-year extension to 2011, when other international tax changes take effect, the temporary exception to the controlled foreign corporation rules for interest received from a related company will expire.

These changes will significantly increase the tax burden on the non-US business income of many US multinational groups. They will turn US international tax policy in a new direction completely contrary to the direction currently being proposed in the United Kingdom, Japan, and Canada. The Administration apparently seeks to curtail deferral because it believes that the relatively lower tax burden on non-US business income has encouraged US companies to shift activity and employment outside the United States.[5] US multinationals believe the changes will hamper their competition with companies resident in countries that have territorial tax systems or more favourable controlled foreign corporation rules. Enacting the reforms proposed in countries with which the United States has major trading relationships will increase the competitive disadvantage.

Defer US Deductions for Expenses of Deferred Non-US Income

US companies generally can take current deductions for interest and other expenses associated with an investment in non-US companies, even though they generally have no taxable income from the investment until they receive dividends or sell the investment.

The budget proposes to defer US deductions for all expenses allocable to non-US income (other than research and experimentation expenses) until the income becomes subject to US tax. Treasury regulations currently allocate expenses to non-

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[4] The exception, which covers interest, dividends, and rents and royalties and resembles the interaffiliate payment exception in the Canadian foreign affiliate rules, is found in IRC section 954(c)(6); cf. IRC section 954(c)(3) (similar rule for items from same-country affiliates).

[5] The Clinton Administration tried unsuccessfully to achieve the same policy result through an administrative interpretation of the controlled foreign corporation rules. See IRS Notice 98-35, 1998-2 CB 34; IRS Notice 98-11, 1998-1 CB 433.

US income to compute a US taxpayer's foreign tax credit limitations, and the budget proposes to use those regulations to determine the non-deductible amount.

The expense deferral proposal will substantially reduce the interest deductions available to many US companies. The Administration believes that is appropriate because current deductions for expenses associated with income deferred (sometimes indefinitely) have effectively subsidized US corporate investment outside the United States. This proposal obviously presents US multinationals with another disadvantage against competitors in countries with more favourable rules, such as territorial systems where interest deductions are allowed in exchange for a 5 percent reduction in the participation exemption for foreign dividends.

Prevent Selective Repatriation of High-Taxed Income

A US company receiving a dividend from a non-US company in which it owns a 10 percent interest can claim foreign tax credits for non-US taxes paid on the underlying income. The tax paid on the underlying income depends on the effective tax burden borne by the company paying the dividend as determined under US tax principles. Through tax planning, US companies can reduce the effective tax rate on some non-US affiliates and increase the effective tax rate on others. Hybrid arrangements also can shift non-US tax liability to an entity other than the one that earned the income for US tax purposes. Selective distributions from the high-taxed companies can repatriate earnings without additional US tax or with excess foreign tax credits that can offset the US tax on other non-US income that bore non-US tax at less than the US rate.

The budget proposal will require US taxpayers to determine the non-US tax paid on income underlying dividends on a consolidated or pooled basis. The effective non-US tax rate on all underlying non-US earnings will be the average rate imposed on the earnings of all non-US companies in which the taxpayer owns a 10 percent interest. The budget also proposes to require US taxpayers to match non-US tax to the income on which the tax was imposed. The proposal presumably contemplates departure from the current rule that assigns tax to the person legally responsible for paying it. These changes aim to prevent selective repatriation of high-taxed income. The pooling proposal differs substantially from approaches taken in other countries with foreign tax credit systems that have sometimes attacked blending. The matching proposal, on the other hand, may prove to be more consistent with international norms.

Impose Tax on the Expatriation of Soft Intangibles

Over decades, the United States has developed rules to prevent US companies from completely expatriating valuable intangibles. Those rules generally require anyone transferring intangibles to a related person annually to recognize an amount no less than a deemed royalty for use of the intangibles that is commensurate with the income they produce.[6] The rules are controversial both domestically and inter-

[6] See IRC sections 367(d) and 482.

nationally, and some disputes centre on the scope of the intangible property to which the rules apply.

The budget will clarify that so-called soft intangibles such as goodwill, going-concern value, and assembled workforce are covered by the current rules that require ongoing payments commensurate with income. It will also allow US tax authorities to value related intangibles as a unit. The proposals are styled as clarifications so that they do not compromise the tax authorities' position that current rules already achieve these results. Broader US legislation, of course, can only increase the potential for international disputes about whether non-US transferees of intangibles can deduct in their home countries amounts equal to the royalties imputed to the US transferors.

Reduce the Threshold for Denying Interest Deductions to Inverted US Companies

The United States uses earnings-stripping rules to address concerns elsewhere addressed with thin capitalization rules. The earnings-stripping rules prevent a US company with a debt-to-equity ratio greater than 1.5 to 1 from deducting net interest expense greater than 50 percent of adjusted taxable income (essentially EBITDA, or earnings before interest, taxes, depreciation, and amortization).[7] Some members of Congress have contended over the years that the rules do not adequately prevent foreign-controlled corporate groups from eroding their US tax base. The rules were particularly strained when some US companies expatriated through inversion transactions in which a non-US subsidiary became the parent of the group formerly headed by the US parent company. The former US parent company typically relied heavily on interest payments to non-US affiliates to reduce the group's US tax base. In a 2007 study ordered by Congress, the US Treasury reported strong evidence of earnings stripping by inverted companies, but it reached less definite conclusions about earnings stripping by other foreign-controlled US companies.[8]

The Administration proposes to apply the earnings-stripping rules to all inverted companies, whether or not their debt-to-equity ratio exceeds 1.5 to 1. The Administration also proposes to reduce the threshold at which earnings-stripping rules apply to the interest they pay to related parties from 50 percent to 25 percent of adjusted taxable income. The 50 percent threshold will continue to apply to interest paid to unrelated parties even if related parties guarantee it. Disallowed interest can no longer be carried forward indefinitely, but only for 10 years. The Administration will continue to study earnings stripping by foreign-controlled US companies using information gleaned from enhanced reporting requirements.

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7 IRC section 163(j).

8 US Treasury Department, *Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Tax Treaties* (November 2007), at 25-27.

Repeal the Dividend Withholding Tax Exemption for 80/20 Companies

Dividends paid by US companies that receive at least 80 percent of their income from active foreign business, either directly or through controlled subsidiaries, enjoy a withholding tax exemption. The exemption applies to the portion of the dividend equal to the portion of the company's income derived from active foreign business during the last three years.[9] By timing the receipt of dividends from selected subsidiaries, a US holding company with significant investments not in active foreign business can qualify the dividends it pays for exemption. The exemption particularly benefits non-US shareholders otherwise subject to basic 30 percent dividend withholding tax, whether because their home country has no tax treaty with the United States or because they do not qualify for treaty benefits.

The budget proposes to repeal the dividend withholding tax exemption for 80/20 companies because it can be manipulated. More targeted measures likely were not proposed because the Administration does not expect a constituency to resist full repeal.

Limit the Foreign Tax Credits Available to US Oil and Gas Companies

US companies cannot claim US foreign tax credits for foreign levies to the extent that they receive economic benefits in exchange for the levies. As a practical matter, this limitation for so-called dual capacity taxpayers primarily affects mining companies and oil and gas companies. Current US regulations determine the creditable amount of a foreign levy on extraction by reference to the tax that would have been assessed under the foreign country's generally imposed income tax system. If the country has no generally imposed income tax, the creditable amount is limited to the US tax imposed on the relevant net income.[10]

The Administration's budget will not allow any US foreign tax credit for a foreign levy on a dual capacity taxpayer unless the country that makes the levy has a generally imposed income tax. A foreign income tax will not generally be imposed unless it applies to the business income of the country's own residents. The proposal could significantly increase the overall tax burden on oil and gas income from some important oil-producing countries.

Impose Withholding Tax on Certain Dividend Equivalent Payments

Dividends paid by US corporations are subject to 30 percent US withholding tax unless the shareholder can claim treaty relief. Treaties typically reduce the withholding rate on portfolio dividends only to 15 percent. Dividend substitute payments made to a securities lender are subject to withholding as dividends except

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[9] IRC sections 871(i)(2)(D) and 881(d).

[10] Treas. reg. sections 1.901-2A and 1.901-3.

when the securities borrower (often a resident of the same country as the lender) is subject to dividend withholding at the same rate as the securities lender.[11] Dividend equivalent payments made under an equity swap, however, can be exempt from US withholding tax. Swap payments take their source from the recipient's residence, so they are treated as foreign-source income even if the underlying index is a US-source dividend.[12]

The withholding tax benefit gives portfolio investors an incentive to swap physical positions into synthetic long positions or to lend shares over dividend date to a borrower in their home country. The counterparties or securities borrowers can hedge themselves with US persons who receive the underlying dividend free of withholding. Financial institutions also use equity derivatives to provide investors with synthetic brokerage accounts. In recent years, US tax authorities have audited equity derivative arrangements aggressively, particularly where they believe the short party effectively has acted as an agent or conduit for the long party.[13]

The Administration proposes to treat dividend equivalent payments under equity swaps as US-source income subject to withholding. At the same time, the Administration announced that it will use its administrative authority to revoke the withholding exception for dividend substitute payments to securities lenders in the same country as the borrower. Those are significant changes, but they come with an important exception. The source rule will not apply to 90-day swaps on publicly traded shares as long as (among other things) the contracts are not substantially prepaid, reference less than 5 percent of the public float and less than 20 percent of the average daily volume, and relate to no physical share trades between the parties. Because parties to equity derivatives trades typically have observed similar conditions, the budget proposal may have limited practical consequences.

Require Additional Reporting by Qualified Intermediaries

Non-US financial institutions acting as qualified intermediaries can certify the US withholding tax rate applicable to the US investment income they collect for their undisclosed account holders. To become a qualified intermediary, a financial institution must make a withholding agreement with the US tax authorities. Withholding tax agreements require the intermediary to maintain records subject to audit, but the intermediary need not file information returns with US tax authorities. Qualified intermediaries determine the appropriate withholding rate based on certifications they receive from account holders. Non-US companies controlled by US persons can certify that they are not US account holders.[14]

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11 See IRS Notice 97-66, 1997-2 CB 328.

12 Treas. reg. section 1.863-7.

13 See generally US Senate Permanent Subcommittee on Investigations, *Dividend Tax Abuse* (September 11, 2008).

14 See generally US Congress Joint Committee on Taxation, *Tax Compliance and Enforcement Issues with Respect to Offshore Accounts and Entities* (March 30, 2009).

Congressional hearings earlier this year about tax evasion by US persons heightened concern over abuses of the qualified intermediary system. Testimony indicated that US persons have used non-US shell companies to open accounts with qualified intermediaries through which they receive unreported income. Evidence of foreign bank complicity has poisoned (fairly or not) political attitudes toward the offshore activities of all US taxpayers and has prompted several proposals from the Administration.

Three proposals are particularly important. The first will require qualified intermediaries to report to US tax authorities all payments received for US account holders. The second will require qualified intermediaries to report all accounts opened for US persons or their controlled entities as well as all transfers of more than $10,000. The third will require qualified intermediaries to report the acquisition or formation of a non-US entity on behalf of a US person. The US Treasury will have authority to require qualified intermediaries to determine the beneficial owners of non-US entities and to report ownership by US persons. Because virtually all major non-US financial institutions currently are qualified intermediaries, these measures, if enacted, will have direct and immediate consequences outside the United States.

Impose Withholding Tax on Payment to Insufficiently Trusted Persons

Non-qualified intermediaries cannot claim US withholding tax reductions or exemptions unless they disclose the account holder to the US withholding agent, who generally must report the payment to US tax authorities. In determining how much US tax to withhold, US withholding agents generally can rely on account holder certifications received through a non-qualified intermediary. A non-US company can certify that it is not a US person even if US persons control it.

The Administration's budget includes proposals that, by dramatically increasing the tax burden on investment through many non-qualified intermediaries, effectively will force non-US persons investing in US assets to use only trusted intermediaries. One proposal will require 30 percent withholding from income paid to non-qualified intermediaries. Proceeds from asset sales generally are exempt from US withholding tax, but another proposal will impose a 20 percent withholding tax on proceeds paid to a non-qualified intermediary in a country with which the United States does not have a tax treaty providing for adequate exchange of information. Both proposals contemplate an exception for payments to accounts of trusted taxpayers. Trusted taxpayers might include foreign governments, central banks, pension funds, and insurance companies. Other taxpayers will have to claim a refund of any excess tax withheld. Another proposal will require 30 percent withholding from income paid to any foreign entity that has not identified its beneficial owners. Here the exception for trusted taxpayers might expand to include publicly traded companies and their subsidiaries, companies engaged in active business, charities, and widely held investment entities.