

AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

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► **SUBJECT**
**OBAMA ADMINISTRATION
OUTLINES NEW PROPOSALS TO
REFORM INTERNATIONAL TAX
PROVISIONS AND TO
STRENGTHEN ENFORCEMENT
OF OFFSHORE TAX
DISCLOSURES**

► **SUMMARY**
Significant United States International Tax Changes Proposed

► **AFFECTING**
All taxpayers with international business operations and investments

► **PROPOSED DATE**
Taxable years beginning after December 31, 2010 (unless indicated otherwise)

► **DETAILS**
On February 1, 2010, the Treasury Department released *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals* ("Green Book"), a document which provides a description of the Obama Administration's budget proposals affecting revenues.

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Set forth below is a summary of the proposed changes affecting the international taxation arena (unless otherwise stated, the proposals would be effective for taxable years beginning after December 31, 2010):

- **Removal of 2010 Proposal to Reform Check-the-Box Entity Classification Rules.** The 2011 proposal does not include the check-the-box proposals included in the 2010 Green Book released by Treasury in May 2009. This omission may alleviate many concerns and potential adverse United States tax consequences regarding a reform or partial repeal of the check-the-box rules.
- **Extension of Certain Expiring Provisions through Calendar Year 2011.** Certain expiring provisions, including the subpart F “active financing” and “look-through” exceptions, would be extended for an additional two years through December 31, 2011 (these rules expired December 31, 2009).
- **Defer Interest Deductions.** These changes would apply to interest deductions 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 United States taxation.
- **Prevention of Foreign Tax Credit Abuse.** Rather than apply the foreign tax credit limitation separately to foreign-source income in each of the separate categories under section 904(d), the proposal would determine the deemed paid foreign tax credit for a taxable year based on the amount of the consolidated earnings and profits of the foreign subsidiaries repatriated to the United States taxpayer in that particular taxable year. Thus, the aggregate foreign taxes and earnings and profits of all the foreign subsidiaries on a consolidated basis would determine the deemed paid foreign tax credit.
- **Matching Rule.** In addition to the change to the deemed paid credit, a matching rule has been proposed to prevent the separation of creditable foreign taxes from the associated foreign-source income.
- **Modification of the Tax Rules for Dual-Capacity Taxpayers.** The proposal would allow the taxpayer to treat as a creditable tax the portion of a foreign levy that does not exceed the foreign levy that the taxpayer would pay if it had not been a dual-capacity taxpayer. The proposal would replace the current regulatory provisions, including the safe harbor, that apply to determine the amount of a foreign levy paid by a dual-capacity taxpayer that qualifies as a creditable tax. The proposal would also convert the special foreign tax credit limitation rules of section 907 into a separate category within section 904 for foreign oil and gas income. The proposal would yield to United States treaty obligations to the extent they would allow a credit for taxes paid or accrued on certain oil and gas income.
- **Tax Currently Excess Returns Associated with Transfers of Intangibles Offshore.** Transfers by a United States person of intangibles from the United States to a related controlled foreign corporation that is subject to a low effective tax rate, in circumstances that evidence excessive income-shifting, is treated as subpart F income in a separate foreign tax credit limitation basket for the amount of the excessive return.
- **Limit Shifting of Income through Intangible Property.** The definition of intangible property for purposes of section 367(d) (transfers to a foreign corporation) and section 482 (allocation of income and deductions among taxpayers) would be amended to include certain intangibles such as workforce in place, goodwill, and going concern value to prevent the inappropriate shifting of income outside the United States. The proposal also would clarify that, when multiple intangible properties are transferred, the Commissioner may value the intangible properties on an aggregate basis where that achieves a more reliable result. In addition, the proposal would clarify that the Commissioner may value intangible property taking into consideration the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken.
- **Tightening of Earnings Stripping Limitation as Related to Expatriated Entities.** Current law limits the deductibility of certain interest paid by a corporation to related foreign persons. Such limitation applies when a corporation’s debt-to-equity ratio is greater than 1.5 to 1 and the net interest expense is in excess of 50 percent of the adjusted taxable income. The proposed rule will eliminate the debt-to-equity safe harbor provisions and

reduce the net interest expense percentage to 25 percent of adjusted taxable income with respect to disqualified interest paid to expatriated entities other than interest paid to unrelated parties on debt that is subject to a related-party guarantee.

- **Prevention of Repatriation of Earnings in Certain Cross-Border Reorganizations.** Current law allows foreign earnings not previously taxed in the United States to be repatriated to United States shareholders with minimal United States tax consequences, in some instances because of the “boot-within-gain” limitation under section 356(a)(1). The repeal of the boot-within-gain limitation has been proposed for reorganizations 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). This provision appears to affect certain “all-cash” or “all-boot” D reorganizations.
- **Repeal 80/20 Company Rules.** Under current law, section 861(c) provides that if at least 80 percent of a domestic 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 (a so-called “80/20” company), a limited exception applies to prevent dividends and interest paid by such corporation from being treated as United States source income and thus subject to gross basis withholding tax if paid to a foreign person. The 80/20 provision would be repealed under the proposal.
- **Prevent the Avoidance of Dividend Withholding Taxes.** Income earned by foreign persons with respect to equity swaps that reference United States equities would be treated as United States-source to the extent that the income is attributable to (or calculated by reference to) dividends paid by a domestic corporation. An exception to this source rule would apply to swaps that are unlikely to reflect avoidance of United States gross-basis taxation. The proposal would (1) ensure that economically equivalent transactions are subject to similar tax treatment, and (2) prevent avoidance of dividend withholding taxes by reforming the existing rules applicable to substitute dividends in a securities loan or a sale-repurchase transaction, while minimizing instances of over-withholding. The Treasury Department would be given regulatory authority to provide additional exceptions to implement the purpose of these rules.

Provisions related to combating under-reporting of income of accounts and entities in offshore jurisdictions include (and have various effective dates discussed within each provision in the Green Book):

- Require increased reporting on certain foreign accounts;
- Require increased reporting with respect to certain recipients of FDAP (fixed or determinable annual or periodical) income or gross proceeds;
- Repeal certain foreign exceptions to registered bond requirements;
- Require disclosure of foreign financial assets to be filed with tax return;
- Impose penalties for underpayments attributable to undisclosed foreign financial assets;
- Extend statute of limitations for significant omission of income attributable to foreign financial assets;
- Require reporting of certain transfers of assets to or from foreign financial accounts;
- Require third-party information reporting regarding the transfer of assets to or from foreign financial accounts and the establishment of foreign financial accounts;
- Permit the Service to require electronic filing by financial institutions of certain withholding tax returns;
- Establish presumption of United States beneficiary in case of transfers to foreign trusts by a United States person;
- Treat certain uncompensated uses of foreign trust property as a distribution to United States grantor; and
- Improve foreign trust reporting penalty.

► OBSERVATIONS

Any proposals will require passage by both houses of Congress before they are enacted into law. The legislative process may take significant time as the proposed changes affect many current Internal Revenue Code provisions, and members of Congress may not support the precise proposals made by the Administration. Thus, the timing of approval of any legislation (in the form of the Treasury proposal or any other form) and signature by the President should be closely monitored.

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