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Joint Committee on Taxation (JCT) Analyzes the Obama Administration's International Tax Proposals

On September 14, 2009, the Joint Committee on Taxation ("JCT") released a 255 page pamphlet (the "Pamphlet") that describes and analyzes the international tax proposals contained in President Obama's 2010 budget proposal. (The "Administration's International Tax Proposals")

The JCT is a Committee of the U.S. Congress. The JCT is composed of ten Members of Congress, five from the Senate Finance Committee and five from the House Ways and Means Committee. The responsibilities of the JCT include, among other things, the study, review and providing of recommendations related to pending tax proposals.

The Administration's Tax Proposals would have a significant impact on U.S multinational corporations in the pharmaceutical industry, including, among other things, the timing of deductibility of certain foreign related expenses; the ability to elect the U.S. tax status of foreign entities to facilitate international tax planning; and flexibility in foreign tax credit planning so as to tax optimize the cost of foreign dividend repatriation.

Summarized below are comments from the JCT which are contained in the Pamphlet and which relate to several of the more significant Administration's International Tax Proposals.

1. Deferral of Deductions Allocable to Unremitted Foreign Earnings

Under this proposal, "foreign related deductions" would be allowed only to the extent that expenses and losses are properly allocable and apportionable to currently taxed foreign source income (the " Expense Deferral Proposal"). Any such deductions properly allocable or apportionable to foreign income that is not currently taxed would be deferred, except for research and experimentation expenses ("R&D Expenses").

The JCT acknowledges that the impact of the Expense Deferral Proposal on US investment and wages is uncertain. The Pamphlet indicates:

> "Because, however, empirical research has not produced definite conclusions about the effect of foreign direct investment on U.S. labor productivity, wages, and aggregate national income, the (Expense Deferral Proposal) effects on these features of the U.S. economy are uncertain. "

As indicated above, the Expense Deferral Proposal would exclude R&D Expenses. In this connection, the JCT comments that the Proposal can be viewed as consistent with the Administration's budget proposal to make the R&D tax credit permanent. The R&D tax credit provides an incentive for conducting research activities in the United States, and excluding research costs from the scope of the Proposal could be viewed as necessary to avoid undermining this policy. On the other hand, the JCT indicates that exclusion of R&D Expenses could be viewed as undermining the Proposal's policy objective of reducing the tax incentive for US businesses to move income offshore. The JCT remains troubled by the likelihood that the Expense Deferral Proposal may treat U.S. firms in certain industries differently than in other industries.

Regarding the impact of deferral of deductions related to interest expense allocated against foreign source income, the JCT indicates that the Expense Deferral Proposal could have a disproportionate effect on U.S. based multinationals that have relatively high degrees of U.S.

borrowings to fund offshore operations, in particular unless the worldwide allocation rules for interest expense are permitted to take effect in 2011.

The JCT acknowledges that the Expense Deferral Proposal could cause U.S. multinationals to lose global market share. The Pamphlet indicates that:

> "To the extent the proposal increases the effective U.S. tax rate on foreign Investment by U.S. firms, firms with U.S. and overseas operations will have an added incentive to conduct their overseas operations not through
> foreign subsidiaries of U.S. resident firms but instead through firms that are owned by foreign persons. If this incentive were strong it would be possible that after some number of years, the only significant business operations carried out through U.S. headed firms would be U.S. business operations"

The JCT does not discuss the effect of the deferral of deductions for general and administrative expenses on the incentive to relocate those activities to offshore service centers, to the potential detriment of U.S. jobs.

The Pamphlet suggests that expenses related to foreign income that is being recognized for U.S. tax purposes, i.e., such as foreign branch and section 863(b) ("foreign title transfer") income could be excluded from the Expense Deferral Proposal. However, the JCT also states that it would be simpler (though technically less accurate) to pool all such expenses with other foreign related expenses in order to order to determine the amount that would be deferred.

2. Foreign Disregarded Entities Scaled Back

This proposal would revise the "check the box" entity classification rules to disallow disregarded entity treatment for certain entities organized under foreign law (the "Foreign DE Limitation Proposal") . In general, entities organized under foreign law would not be eligible for disregarded treatment with exceptions for (1) disregarded entities owned directly by controlled foreign corporations organized under the laws of the same jurisdiction as the disregarded entity, and (2) foreign disregarded entities owned directly by U.S. entities, "except in cases of U.S. tax avoidance…"

The JCT notes the use of disregarded entities to reduce foreign tax and observes that "these techniques arguably may also make foreign investment of foreign earnings significantly more attractive than repatriation and reinvestment of these earnings in the United States, thus exacerbating the investment distortion already inherent in the deferral regime that some may view as detrimental."

Further, the JCT identifies several exceptions which are not covered by the Foreign DE Limitation Proposal. Since entities which are created or organized in the same country as their shareholder are not covered, effective tax planning could potentially be achieved by utilizing a shareholder which is organized in the same country as the disregarded entity, but is resident in a different country, because it is managed and controlled or has its principal place of business in the other country.

In addition, since the Foreign DE Limitation Proposal would not apply to domestic eligible entities such as single member LLCs, taxpayers may attempt to engage in check the box planning through a domestic LLC treated as a tax resident in a foreign jurisdiction under a managed-and-controlled test or through a domestic LLC that is organized under the laws of a foreign country.

Additionally, since the Foreign DE Limitation Proposal applies only to single- member foreign eligible entities, in the absence of anti-abuse rules, a foreign eligible entity with a nominal second owner could be used to achieve similar results as under current law.

The JCT comments that a narrowing of the Proposal's exceptions may be warranted taking into account the possibilities for avoidance which continue to exist.

The JCT notes that the prohibition on disregarded entity treatment for foreign entities held directly by the U.S. requires clarification.

Further, the JCT also points out that the consequences of deemed incorporation will apply to foreign disregarded entities at the effective date of the legislation, including branch recapture, dual consolidated loss recapture, section 987 termination, section 304 deemed dividends, section 357(c) liability assumptions, and section 367(d) deemed royalty for the value of workforce-in-place and possibly goodwill, if the Administration's proposal on that issue is also enacted. The JCT acknowledges that this treatment raises "administrative and fairness" considerations, and that some form of transition relief might be appropriate.

3. Foreign Tax Credit Changes

Determining the Section 902 Foreign Tax Credit on a Blended Basis

This proposal would effectively treat all of a company's foreign subsidiaries as a single subsidiary for purposes of computing deemed paid foreign tax credits (the "Aggregation of E&P and FTC Proposal"). The JCT explains that, under the Aggregation of E&P and FTC Proposal," a U.S. company would be required to aggregate its proportionate share of the foreign taxes and earnings of all eligible foreign subsidiaries. This is in contrast to current law where dividend and deemed dividends and associated foreign tax credits are generally calculated on an entity by entity basis. The Proposal would inhibit a U.S. based multinational group's ability to selectively cross-credit high and low taxed foreign earnings.

The JCT acknowledges that the Aggregation of E&P and FTC Proposal applies only to section 902 "deemed paid credits," so that U.S. companies could plan around this Proposal through structuring that converts section 902 credits into section 901 direct foreign tax credits (i.e., by using foreign branches rather than subsidiaries in high taxed countries). In this connection, the JCT suggests that the 2007 Rangel Bill (which contained a similar proposal, but which also included section 901 credits) may be preferable because it thwarts such planning.

In addition, the JCT acknowledges that the Aggregation of E&P and FTC Proposal may have such a significantly negative impact on foreign tax credit planning that potential costs could offset the incentive to repatriate cash resulting from the Expense Deferral Proposal, resulting in a more permanent deferral of foreign earnings.

The JCT assumes that pre-effective date earnings would be included in the blended pool, because the Administration's proposal does not state otherwise. The JCT acknowledges that this approach is simpler in some ways than a phased in approach, but notes that it will still require some complex accounting for changes of shareholders and mergers and acquisition activity over time.

Further, the Pamphlet notes that high tax countries having a tax treaty with the United States could object that the Aggregation of E&P and FTC Proposal does not allow for full prevention of double taxation, because it does not permit a full offset for the country's own taxes.

The JCT believes that "10-50" companies, i.e., generally, non-controlled foreign companies in which the U.S. corporate investor holds at least 10%, but not more than 50% of the stock, would be included in this proposal.

Matching Foreign Tax Credits to Foreign Income

This proposal addresses situations where a U.S. taxpayer claims credits foreign taxes paid on income that is not treated as currently earned by the taxpayer under U.S. principles. Specifically, the Administration intends to adopt a "matching rule to prevent the separation of credits of creditable foreign taxes from the associated income (the "Credit and Income Matching Proposal").

It has been unclear whether the Credit and Income Matching Proposal would provide specific rules, grant the Treasury the authority to issue new regulations, or a combination of these approaches. The JCT acknowledges this question but does not answer it.

For specific rules, the new legislation may adopt the "technical taxpayer" regulations proposed under section 901 in August, 2006 to deal with foreign consolidated groups and reverse hybrids, among other issues. The JCT discusses the proposed regulations and the possibility of finalizing them or, alternatively, codifying them if it is thought that Treasury lacks the authority to finalize them.

4. Broader Application of Sections 367(d) and 482 to Intangible Property Transfers

This proposal seeks to prevent what it considers inappropriate shifting of income outside the United States by "clarifying" the definition of intangible property for purposes of section 367(d) and 482 to include workforce-in-place, goodwill and going concern value (the "IP Proposal").

The IP Proposal would also authorize the IRS to apply a valuation policy for intangible property transfers that would (1) value multiple intangible properties transferred together on an aggregate basis (where that achieves what the Administration considers a "more reliable result") and (2) value intangible property at what the IRS considers its "highest and best use."

The JCT notes that the IP Proposal is aimed primarily at resolving (in the IRS's favor) disputes that have arisen on examination, and it further anticipates that the section 367(d) exception for foreign goodwill and going concern value would likely continue to operate.

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