

Measuring the impact of key international tax proposals: The importance of modeling

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This article first appeared in the November/December 2009 edition of the *Journal of Corporate Taxation*.

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The Obama Administration's 2010 budget proposes fundamental changes in the taxation of U.S.-based multinationals (and the earnings of their foreign subsidiaries) effective for tax years beginning after 2010.¹ Under U.S. federal income tax law principles, U.S. companies can generally defer paying U.S. tax on their foreign subsidiaries' earnings until those earnings are remitted back to the United States. This "deferral" of foreign earnings has long been limited by laws aimed at specific perceived abuses (including Subpart F for controlled foreign corporations, or CFCs), but recently it has come under broader attack. The budget proposals would effectively reduce the scope of deferral, increasing taxes on U.S. companies conducting foreign operations through foreign subsidiaries.

Many U.S. companies' global business operations would be affected most by three key proposals, two of which echo legislation proposed in 2007 by Chairman Charles Rangel (D-NY) of the House Ways and Means Committee:²

1. Deferring foreign-related deductions until the related foreign earnings are taxed in the United States
2. Blending foreign tax credit rates for the deemed-paid credit under [Section 902](#)

The third proposal would curtail application of the "check-the-box" rules by limiting the use of single-member foreign disregarded entities (DEs).

¹ See U.S. Dept. of Treasury, "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals" (May 2009).

² See H.R. 3970, "Tax Reduction and Reform Act of 2007," section 3201.

More specifically, the proposals would require the following:

- “Foreign-related deductions” would be allowed only to the extent that expenses (other than R&D) and losses are allocable or apportionable to currently taxed foreign income. The largest categories of foreign-related expenses likely to be deferred in some degree would be interest and stewardship/headquarters costs. Deferred expenses would be carried forward to subsequent years and would be combined with foreign-source expenses for that year before applying the proposal in that year.
- Deemed-paid foreign tax credits under [Section 902](#) would be limited to no more than the average rate of total foreign tax actually paid on total foreign earnings by the company’s foreign subsidiaries (presumably earned after the effective date), eliminating the ability to manage high- and low-tax foreign income pools separately.
- In general, foreign DEs would be treated as separate corporations for U.S. tax purposes, except for foreign DEs owned directly by (1) companies (e.g., CFCs) incorporated in the same country, or (2) U.S. entities (except in cases of “U.S. tax avoidance”). This proposal would cause many U.S. companies to have current Subpart F income tax inclusions.

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The political future of these proposals is still uncertain, as they raise some fundamental issues of U.S. tax policy, including competitiveness in the global economy. However, in a political climate where revenue needs are expanding, companies should consider the effects of these proposals on their operations. Modeling is an important tool to assist companies in assessing the potential impact of these proposals on their global business operations and financial results. These impacts will be significant for most companies with substantial deferred earnings from foreign subsidiaries. Because the proposals depart from long-standing U.S. tax conventions, evaluating that impact will likely require a careful and thorough quantitative analysis.

Modeling the potential impact of the proposals—general considerations

Each proposal will affect a different part of a company's tax calculations: Check-the-box limitations will primarily affect Subpart F inclusions; deferral of deductions will affect U.S. taxable income calculations; and foreign tax credit pooling will affect [Section 902](#) computations (including dividends gross up). A company's modeling should address all three proposals, recognizing that the proposals may affect one another. For example, deferred expenses may increase the foreign tax credit limitation. This, in turn, may increase incentives for a company to trigger excess foreign tax credits before the effective date of the legislation).

Treating foreign DEs as corporations for U.S. federal income tax purposes could result in Subpart F income arising from intercompany transactions among CFCs, particularly if Congress does not extend the "CFC look-through" rules ([Section 954\(c\)\(6\)](#)). Companies will need to evaluate transactions among their foreign DEs (and between foreign DEs and their CFC owners), which are generally disregarded under current U.S. federal income tax law, and model out the impact of those transactions being suddenly "regarded" for U.S. tax purposes. Many companies will prefer to unwind loans and other transactions with DEs before the proposed legislation becomes effective. In addition, the termination of CFC-owned DEs that constitute a qualified business unit could affect a company's immediate tax liability or foreign exchange pools under [Section 987](#).

Any modeling of the foreign DE proposal will need to take account of the [Section 902](#) pooling proposal, which would limit [Section 960](#) foreign tax credits accompanying the Subpart F inclusions. In addition, Subpart F modeling will need to recognize that certain foreign income currently meeting the high-tax exception of [Section 954\(b\)\(4\)](#) may not qualify after 2010 under the [Section 902](#) pooling proposal.

“Deferral group” vs. “repatriation group”

The foreign tax credit pooling proposal increases the tax cost of repatriating relatively high-taxed earnings from foreign subsidiaries, while the deduction deferral proposal reduces the tax cost of repatriation. Thus, the combination of the deduction deferral and foreign tax credit pooling proposals will ultimately result in companies having to decide which is more important to them: continued deferral (the “deferral group” of companies) or repatriation of foreign earnings (the “repatriation group” of companies). Deferral would allow companies to maintain low-taxed pools of foreign earnings at the cost of deferred deductions, while repatriation would allow companies to bring cash back to the United States and benefit from all foreign-related deductions, at the cost of lower deemed-paid foreign tax credits.

Most companies will already have a good sense of which approach is likely to be more important to them, based on recent history and current projections. For instance, companies that anticipate having generally high-taxed foreign tax credit pools or large net operating losses may find it advantageous to choose repatriation. Companies with significant low-taxed foreign earnings and relatively little interest expense may choose to continue to defer.

For companies that may be uncertain, modeling will be helpful in clarifying the situation. For example, in 2011, Company A anticipates its foreign subsidiaries will have pre-tax earnings of \$100 million and an effective tax rate of 20%. Under the foreign tax credit pooling proposal, Company A would need to pay additional U.S. “top-up” tax of \$15 million to bring those earnings back to the United States. If Company A also has \$50 million of U.S. expenses, of which 40% (\$20 million) is allocable to foreign-source income, then if it deferred all of its foreign earnings, the deferral of deduction proposal would disallow the \$20 million of deductions, at a cost of \$7 million. If choosing solely on the basis of these tax costs, Company A would choose deferral.

Some companies in the deferral group may conclude that it is important to accelerate the payment of foreign dividends before the effective date of the foreign tax credit pooling proposal.

For companies in the deferral group, modeling may begin with a projection of foreign earnings and profits (E&P) (and related foreign income taxes) over the next five to ten years. Even companies in the deferral group will likely need to repatriate some earnings of foreign subsidiaries in years after the effective date (including potentially increased Subpart F income under the check-the-box proposal), which should be projected in the modeling over that period. Then, U.S. expenses (particularly interest and headquarters costs) should be projected out over the same period, allowing the company to see what percentage of expenses may be disallowed.

Some companies in the deferral group may conclude that it is important to accelerate the payment of foreign dividends before the effective date of the foreign tax credit pooling proposal. To determine whether such action would be advisable, companies should make a present-value analysis that models out their needs for repatriated cash in the United States over the next five to ten years, comparing current available foreign earnings and taxes against anticipated available foreign earnings and blended [Section 902](#) credits. To complete this analysis, companies will need to know their relevant foreign subsidiaries' E&P and foreign tax pools through December 2010.

For example, Company B has \$300 million in deferred foreign earnings and profits that were taxed at 30% and anticipates a need for \$300 million cash to be remitted back to the United States over several years—\$100 million in each of 2013, 2015, and 2017—with an overall blended tax rate of 20% expected for its foreign earnings in those years. The modeling would first analyze the cost of the additional U.S. tax if the \$300 million were fully repatriated before foreign tax credit pooling (say, in 2010).

The model would next estimate the impact of repatriating in three tranches of \$100 million in 2013, 2015, and 2017, respectively, looking at (1) the amount of deductions allowable for 2013, 2015, and 2017 if earnings were repatriated in each year, (2) the additional U.S. tax to be paid in each year due to [Section 902](#) blending, and (3) the present value of the additional tax less the allowable deductions. Ignoring APB23 implications, if the incremental cost of bringing the cash back in 2010 is \$21 million, and the incremental cost of bringing the cash back in 2013, 2015, and 2017 is, say, \$40 million (\$56 million less \$16 million from allowable deductions), the present value calculation may favor accelerated repatriation.

Companies that choose to repatriate foreign earnings before the foreign tax credit pooling provisions become effective should model out their foreign tax credit limitation amounts over five to ten years, evaluating the possible usage of foreign tax credit carryforwards generated prior to the effective date. Some companies in the repatriation group may not need accelerated repatriation but will need to model out anticipated blended foreign tax rates and foreign tax credit limitation over a similar period.

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Conclusion

Modeling can help companies understand the potential impact of the Administration's key international tax proposals. Once the modeling has been completed, a company can consider how its tax liability could change—both on a short-term (cash) basis and a longer-term (effective tax rate) basis—as well as the potential impact on earnings, cash flow and treasury needs, capital structuring, and any operational changes or restructuring of business operations that might be appropriate. The time to begin modeling is now, to allow for careful consideration of the potential impact and an opportunity to consider potential remedial actions.

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