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Breaking Developments in Tax Law

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Obama's Tax Proposals Target U.S. Persons and U.S. Businesses with Foreign Activities

Every U.S. individual and business engaged in foreign activities should take note of President Obama's recent tax proposals. On May 4, 2009, President Obama released information on a plan to raise \$210 billion over a ten-year period by curbing the use of offshore tax havens and encouraging U.S. businesses to create jobs in the United States. The President's plan affects tax deferral rules, the foreign tax credit, entity classification and information reporting requirements of U.S. persons with foreign activities. The plan also targets U.S. persons holding funds outside the United States.

I. Changing U.S. Tax Deferral Rules

Under current U.S. tax rules, a U.S. company with a foreign subsidiary does not pay U.S. tax on most of the foreign subsidiary's income until the income is distributed to the U.S. company. While the foreign income remains offshore, U.S. tax is deferred but the U.S. company can deduct related expenses, including deductions for interest payments, on a current basis.

The President's plan would defer deductions properly allocable to foreign source income until the foreign subsidiary repatriates the foreign income to the U.S. and the foreign income is subject to U.S. tax. Under such revised deferral rules, the U.S. parent company may lose tax benefits associated with the foreign subsidiary and would have less of an incentive to reinvest earnings in foreign business activities. The proposal would be effective for taxable years beginning after December 31, 2010.

II. Limiting the Foreign Tax Credit

U.S. taxpayers are allowed a foreign tax credit for foreign taxes paid on income derived in a foreign country. The foreign tax credit relieves U.S. taxpayers of double taxation, *i.e.*, being taxed on the foreign income by a foreign country and again by the U.S.

Currently, a U.S. taxpayer claims the foreign tax credit by calculating U.S. tax liability on total worldwide income (foreign and domestic), and offsets with creditable foreign taxes the U.S. tax liability associated with foreign income. The statutory formula for the foreign tax credit ensures that the amount of the credit which may be taken in any one year is proportional to the U.S. tax liability imposed on foreign taxable income. The existing limitation formula averages the tax rates of all the foreign countries and then allows a full credit for foreign taxes if the average foreign tax rate does not exceed the U.S. tax rate.

In certain situations involving the use of hybrid tax entities, a U.S. company can claim a foreign

tax credit separate from the associated foreign income. To prohibit a U.S. company from doing so, the President's plan would require matching the tax credit allowed with respect to each foreign tax to the associated foreign income. The President's plan also would require a U.S. parent company to aggregate the foreign taxes and earnings and profits of all foreign subsidiaries to which the U.S. company can claim a deemed paid foreign tax credit. The foreign tax credit for the year would be determined based on the aggregate earnings and profits repatriated back to the U.S. and subject to U.S. tax. These proposals would be effective for taxable years beginning after December 31, 2010.

III. Restricting the "Check-the-Box" Classification for Foreign Subsidiaries

Under the "check-the-box" rules, a U.S. company can classify certain foreign entities as pass-through entities for federal tax purposes. The use of these entity classification rules can result in the avoidance of current U.S. tax on certain earnings. Frequently, U.S. companies use multiple foreign subsidiaries to conduct international businesses. One foreign subsidiary of a U.S. company might make a loan to a second foreign subsidiary located in a low-tax jurisdiction. The interest income the lending foreign subsidiary pays is taxed at a low-tax rate, and the borrowing foreign subsidiary can deduct the interest payment it receives as an expense. Because the foreign subsidiaries are pass-through entities not subject to U.S. tax under the "check-the-box" rules, the interest income is not subject to U.S. tax.

Under the President's plan, a foreign subsidiary may be treated as a disregarded entity only if the foreign subsidiary is wholly owned by a U.S. person or organized in the jurisdiction of its single foreign owner. Otherwise, the foreign subsidiary would be treated as a separate corporation for U.S. tax purposes and its earnings would result in U.S. tax obligations to the U.S. shareholder.

IV. Targeting the Use of Offshore Tax Havens

The IRS continues to target U.S. persons with money in offshore accounts on which U.S. tax has not been paid. Media reports indicate the IRS is investigating U.S. persons holding Swiss UBS accounts and offering voluntary disclosure of undeclared bank accounts in exchange for a waiver from criminal tax prosecution.

In addition, the U.S. Treasury revised Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* ("FBAR") to expand the list of persons obligated to file the FBAR and required more detailed reporting of information concerning foreign financial accounts (see Tax Law Hot Sheet titled "Expanded Scope of Requirement to Report Foreign Bank and Financial Accounts").

Congress is also examining the use of offshore tax havens as reflected in Senator Carl Levin's proposed legislation titled the Stop Tax Haven Abuse Act (Senate Bill 506) introduced on March 2, 2009 (see Tax Law Hot Sheet titled "Proposed Federal Tax Legislation Would Alter U.S. Taxation of Foreign Entities").

The President's plan supplements efforts to target offshore accounts used to avoid U.S. taxes.

A. Enhanced Information Reporting

The Qualified Intermediary ("QI") program seeks to ensure that appropriate U.S. withholding is imposed on foreign persons. The proposed rules would require foreign financial institutions to withhold and report on foreign income and accounts of U.S. and foreign persons. Foreign financial institutions would be required to enter into agreements with the IRS to share information about their U.S. customers. Currently, the IRS has the burden to show that an account holder of a QI is a U.S. person if the account holder attests to being a non-U.S. person.

The President's plan would require QIs to identify all account holders that are U.S. persons and file IRS Form 1099 with respect to payments to U.S. account holders, including income from foreign sources. Any withholding agent making a payment to a nonqualified intermediary would be required to withhold 30 percent. Withholding agents paying gross proceeds from the sale of any security to a non-qualified intermediary not located in an income tax treaty jurisdiction would be required to withhold 20 percent. To get a refund of the amount withheld, account holders would be required to disclose their identities and demonstrate compliance with U.S. tax laws.

B. Increased Penalties and Stricter Penalty Standards

The President's plan would double certain penalties for failing to make the required disclosure of foreign financial accounts.

For any foreign bank, brokerage or other financial account held by a U.S. person at a non-qualified intermediary, the IRS would apply a rebuttable presumption that the account has enough funds to require filing the FBAR. Failure to file the FBAR would be considered intentional if an account at a nonqualified intermediary has a balance greater than \$200,000 at any point during the calendar year. For an intentional violation of the FBAR, the current penalty is the greater of \$100,000 or 50 percent of the balance in the account at the time of the violation. There is no maximum penalty limit for an intentional violation of the FBAR.

C. Broader IRS Enforcement

The President's plan would presume that financial institutions not registered under the QI program are facilitating tax evasion and would shift the burden in a tax proceeding to the financial institutions and account holders to prove they are not sheltering income from U.S. taxes. Also, the IRS would have six years (instead of the current three years) after the U.S. person submits required information to assert tax deficiencies attributable to international tax positions.

The IRS would be authorized to issue regulations requiring that a financial institution be recognized as a QI only if all commonly-controlled financial institutions are also QIs. The purpose is to prohibit a QI from using a controlled nonqualified intermediary to hide the foreign accounts of U.S. persons.

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