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Client Alert

Administration's Fiscal Year 2011 Budget Reflects Significant Changes to Previous International Tax Proposals

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On February 1, 2010, the Obama Administration (the "Administration") issued general explanations of its Fiscal Year 2011 revenue proposals. Although many of this year's international tax reform proposals have been carried over essentially unchanged from the Administration's 2010 budget,[1] there are a few notable exceptions. If enacted, the proposals described below would be effective for tax years beginning after December 31, 2010.

No Check-the-Box Repeal. Most significantly, the Administration has dropped its prior proposal to severely curtail the use of entity classification elections for foreign entities. Given the critical role such "check-the-box" elections play in U.S. international tax planning, the Administration's decision to drop this proposal will be welcomed by multinational businesses and other taxpayers with foreign investments or activities.

Narrowed Expense Deferral Rule. The Administration's prior proposal to defer all of a U.S. person's deductions (except for research and experimentation expenses) allocable to its deferred foreign source income has been modified so that it will apply only to interest expense deductions. Although narrower, the current proposal may still have a significant impact on many taxpayers for whom interest expense deductions constitute a large percentage of deductions allocable to foreign source income.

Tax Excessive Returns from Intangibles Transferred Offshore. Presumably as a more narrowly focused replacement for the former proposal to essentially repeal the "check-the-box" rules, a new proposal targets transfers of intangibles from the United States to a related controlled foreign corporation that is subject to a "low foreign effective tax rate." Under the proposal, which invokes transfer pricing principles as authority, if the circumstances evidence "excessive income shifting," an amount equal to the "excessive return" will be treated as Subpart F income in a separate foreign tax credit limitation basket. The proposal does not elaborate on what constitutes a "low foreign effective tax rate," "excessive income shifting," or "excessive return."

Excess Nontaxed Reinsurance Premiums Paid to Affiliates. The Administration also added a proposal to deny a U.S. insurance company deductions for certain reinsurance premiums paid to foreign affiliated reinsurers with respect to U.S. risks insured by the insurance company or its U.S. affiliates. Specifically, a deduction would be denied to the extent that (i) the foreign reinsurers (or their parent companies) are not subject to U.S. income tax with respect to premiums received, and (ii) the amount of reinsurance premiums (net of ceding commissions) paid to the foreign reinsurers exceeds 50 percent of the total direct insurance premiums received by the U.S. insurance company and its U.S. affiliates for a line of business. If a deduction for a reinsurance premium would be denied under this provision, a foreign insurer may elect to treat such premium (and the associated investment income) as effectively connected income subject to U.S. income tax.

[1] See our prior client alert, "Administration Issues General Explanation of its Fiscal Year 2010 Revenue Proposals, Including International Provisions" (http://www.mofo.com/pubs/xpqPublicationDetail.aspx?xpST=PubDetail&pub=7962).