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Client Alert

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INTERNATIONAL TAX REGIME TARGETED IN LATEST REVENUE PROPOSAL

On Monday, May 11, 2009, the Obama Administration (the “Administration”) revealed details about its proposed changes to the United States’ international tax regime. The Administration’s “General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals,” includes detail regarding proposed revisions to the treatment of deductions attributable to deferred foreign income, the check-the-box regime, the qualified intermediary regime, the foreign tax credit rules, the earning stripping rules for expatriated entities, the transfer pricing rules, and the withholding rules for payments made pursuant to equity swaps, among a range of other proposals (the “Proposal”).

Technical detail is lacking for certain of the proposals, making it difficult to assess precisely what impact they may have. These proposed changes generally would be effective for tax years ending after December 31, 2010.

Business Entity Classification Rules for Foreign Entities

Under the so called “check the box” Treasury regulations, an eligible foreign business entity with a single owner generally may elect to be treated as a corporation or as an entity disregarded as separate from its owner (a “disregarded entity”). The use by U.S. taxpayers of foreign disregarded entities under a corporate holding company organized in a low-tax jurisdiction can facilitate shifting offshore earnings to low-taxed jurisdictions without a corresponding income inclusion to the U.S. taxpayer under subpart F of the Internal Revenue Code (the “Code”). For certain multi-national businesses, a fairly common structure has been to establish a holding company (e.g., in the Cayman Islands) to own disregarded entities in multiple foreign countries in which the group conducts its business. Such a structure permits earnings to be redeployed among the non-U.S. businesses without triggering U.S. taxes.

The Proposal, if enacted, would require that a foreign eligible entity with a single owner (other than a first-tier foreign entity wholly owned by a U.S. taxpayer) be treated as a corporation by default unless both the foreign eligible entity and its owner are organized under the laws of the same foreign

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jurisdiction. Since the Proposal includes no grandfathering provision, it appears existing cross-border disregarded entities that are subject to the Proposal would be automatically deemed to convert into corporations in a manner consistent with current Treasury regulations and relevant tax principles. Presumably, deemed asset transfers resulting from such a conversion would potentially be eligible for non-recognition under various provisions in the Code if the requirements of such provisions are met. Depending on the circumstances of the taxpayer, however, such a deemed transfer could have a variety of tax consequences.

Defer Deduction of Expenses Related to Deferred Income

Under current law, a U.S. person that incurs expenses properly allocable and apportioned to foreign-source income may currently deduct those expenses (although the allocation affects the limitations applicable to foreign tax credits), even if the expenses exceed the taxpayer's gross foreign-source income or if the taxpayer earns no foreign-source income. The Proposal would require taxpayers to defer deducting expenses (other than research and experimentation expenses) that are properly allocated and apportioned to foreign-source income to the extent such income is not currently subject to U.S. federal income tax. Deferred expenses for a particular year would be carried forward to subsequent years, combined with foreign-source expenses in such subsequent year, and become deductible only to the extent that the taxpayer's foreign-source income is subject to U.S. federal income tax.

Reform Foreign Tax Credit

The Proposal includes two changes with respect to the foreign tax credit. First, a U.S. taxpayer would determine its deemed paid foreign tax credit on a consolidated basis based on all of the foreign taxes paid and all foreign earnings and profits, including taxes and earnings of certain lower-tier foreign subsidiaries, to the extent of foreign earnings repatriated to the U.S. in that year. Second, a foreign tax credit would no longer be allowed for foreign taxes paid on income that is not subject to U.S. federal income tax.

Limit Shifting of Income through Intangible Property Transfers

Code section 482 provides that in the case of any transfer (or license) of intangible property, the income with respect to such transfer or license must "be commensurate with the income attributable to the intangible property." Further, under Code section 367(d), if a U.S. person transfers intangible property to a foreign corporation in certain non-recognition transactions, the U.S. person is treated as selling the intangible property for a series of contingent payments that relate to the income arising from the use or sale of that property. Under current law, it can be unclear what property will be treated as intangible property subject to Code sections 482 and 367(d). The Administration proposes to clarify the definition of intangible property for purposes of these Code provisions to include workforce in place, goodwill and going concern value. The Proposal would also "clarify" that in a transfer of multiple intangible properties, the IRS may value the intangible properties on an aggregate basis where such a valuation achieves a more reliable result. The Proposal would further clarify that intangible property must be valued based on its "highest and best use," as it would in an arm's-length transaction.

Limit Earnings Stripping by Expatriated Entities

The so called "earning stripping" rules in Code section 163(j) currently limit the ability of a corporation to deduct certain interest paid to related parties if the corporation fails a debt-to-equity safe harbor (the debt to equity ratio exceeds 1.5 to 1) and has net interest expense in excess of 50 percent of adjusted taxable income. Currently, disallowed interest expense may be carried forward indefinitely for deduction in a subsequent year, and the corporation's excess limitation for a tax year (i.e., the amount by which 50 percent of adjusted taxable income exceeds net interest expense) may be carried forward to the three subsequent tax years.

The Proposal, if enacted, would revise Code section 163(j) to tighten the limitation on the deductibility of interest paid by an expatriated entity to related persons. The debt-to-equity safe harbor would be eliminated, and the 50 percent adjusted taxable income threshold would be reduced to 25 percent, except with respect to interest paid to unrelated parties that is subject to

Code section 163(j) because the debt is guaranteed by a related party. The carryforward for disallowed interest would be limited to ten years and the carryforward of excess limitation would be eliminated.

The Proposal, in its current form, would apply only to expatriated entities, but the Administration is studying whether to revise the earning stripping rules more generally. In addition, the Proposal would require companies to determine for the first time whether they expatriated after July 10, 1989 and prior to 2004.

Prevent Repatriation of Earnings in Certain Cross-Border Reorganizations

Current law limits the amount of gain that an exchanging shareholder recognizes in an otherwise tax-free reorganization to the lesser of boot received or gain realized on the exchange (commonly referred to as the “boot within gain” limitation). Further, in certain scenarios, all or part of the gain recognized by the exchanging shareholder may be treated as a dividend, as determined under Code section 356(a)(2), and the remainder of the gain (if any) is treated as gain from the exchange of property. These rules may allow U.S. shareholders with high tax basis in their stock of a target foreign corporation to effectively repatriate the foreign corporation’s earnings at a low U.S. federal income tax rate, even when most or all of the consideration received is “boot” and the corporation has earnings and profits that equal or exceed the amount of boot distributed. The Proposal would repeal the “boot within gain” limitation in reorganizations where the acquiring corporation is foreign and the exchange would give rise to a dividend under Code section 356(a)(2).

Repeal 80/20 Company Rules

Under current law, dividends and interest paid by a domestic corporation generally are U.S.-source income to the recipient and are subject to gross basis withholding tax if paid to a foreign person. This withholding tax does not apply to distributions by certain domestic corporations (“80/20 companies”), at least 80 percent of whose gross income during a three-year testing period is foreign-source and attributable to the active conduct of a foreign trade or business. The Proposal would repeal this exception from dividend withholding for 80/20 companies.

Prevent the Avoidance of Dividend Withholding Taxes

Foreign investors holding stock in domestic corporations generally are subject to 30 percent U.S. withholding tax on dividends paid with respect to that stock unless an applicable U.S. income tax treaty reduces or eliminates the withholding tax rate. The Administration is concerned that foreign investors may enter into equity swaps referencing U.S. equities and avoid withholding tax on underlying dividend payments since payments made to a foreign investor with respect to such a swap generally are treated as foreign-source payments that are not subject to U.S. withholding tax.

Under the Proposal, income earned by foreign persons with respect to equity swaps referencing U.S. equities would be treated as U.S. source to the extent that the income is attributable to (or calculated by reference to) dividends paid by a domestic corporation. An exemption from the proposed rule would apply to equity swaps with all the following characteristics:

- the terms of the equity swap do not require the foreign person to post more than 20 percent of the value of the underlying stock as collateral;
- the terms of the equity swap do not include any provision addressing the hedge position of the counterparty to the transaction;
- the underlying stock is publicly traded and the notional amount of the swap represents less than 5 percent of the total public float of that class of stock and less than 20 percent of the 30-day average daily trading volume;
- the foreign person does not sell the stock to the counterparty at the inception of the contract, or buy the stock from the counterparty at the termination of the contract;
- the prices of the equity that are used to measure the parties’ entitlements or obligations are based on an objectively observable price; and
- the swap has a term of at least 90 days.

In addition, to address the avoidance of U.S. withholding tax through the use of securities lending transactions, the Treasury Department plans to revoke Notice 97-66 (which modified the operation of the regulations on the taxation of substitute dividend payments in cross-border securities lending transactions to limit “cascading” withholding) and issue guidance. Require Withholding on Payments made through Nonqualified Intermediaries.

Require Withholding on Payments made through Nonqualified Intermediaries

In general, payments of U.S. source fixed or determinable annual or periodical gains, profits, or income (“FDAP income”) to nonresident alien individuals and foreign entities are subject to withholding tax at a rate of 30 percent unless statutory provisions or an applicable U.S. income tax treaty reduces the withholding tax. Similarly, brokers are required to apply backup withholding tax at a rate of 28 percent to certain payments made to U.S. non-exempt recipients if the recipient fails to certify that it is not subject to backup withholding or if the recipient fails to provide a taxpayer identification number.

Under the Proposal, any withholding agent making a payment of FDAP income to a nonqualified intermediary would be required to withhold tax at a rate of 30 percent. Moreover, a broker would be required to withhold tax at a rate of 20 percent on payments made to a nonqualified intermediary unless the nonqualified intermediary is eligible to claim the benefits of a U.S. income tax treaty that includes a satisfactory “exchange of information” program.

In the case of gross basis withholding tax and backup withholding, the Treasury would be granted authority to identify exceptions, including exceptions for payments collected by nonqualified intermediaries for foreign government, central bank, foreign pension fund, foreign insurance company, and other similar investors that, in the opinion of Treasury, present a low risk of tax evasion. Foreign persons subject to over-withholding as a result of the Proposal would be permitted to apply for a refund of any excess tax withheld. In the case of payments made by a broker, a nonqualified intermediary would also be eligible to claim a refund on behalf of its direct account holders for any taxable year in which such intermediary identified all of its direct account holders that are U.S. persons and reported all reportable payments received on behalf of U.S. account holders.

This proposal would be effective for payments made after December 31 of the year of enactment.

Require Withholding on FDAP Payments made to Certain Foreign Entities

As noted above, payments of FDAP income to nonresident alien individuals and foreign entities are subject to withholding tax at a rate of 30 percent unless a statutory provision or applicable treaty reduces the withholding tax rate. The Administration has noted its concern that non-U.S. persons that are not entitled to an exemption from, or a reduction in, the 30 percent gross basis withholding tax often arrange to receive payments through entities, acting as conduits, that appear to qualify for an exemption or a reduced withholding rate.

The Proposal, if enacted, would require withholding agents to withhold a 30 percent gross basis withholding tax on payments of FDAP income to foreign entities unless the foreign entities provide documentation identifying their beneficial owners. Exceptions to the documentation requirements would be provided for payments made to publicly traded companies and their subsidiaries, foreign governments, and pension funds. The Treasury would also receive regulatory authority to provide other exceptions for payments to entities engaged in the active conduct of a trade or business in their country of residence, charities, widely-held investment vehicles, entities that enter into an agreement with the IRS to collect documentation for all owners and report all U.S. non-exempt owners to the IRS, and for any other payment that the Treasury concludes presents a low risk of tax evasion.

Extend Statute of Limitations for Certain Reportable Cross-Border Transactions and Foreign Entities

Certain taxpayers are required to file information returns with respect to certain foreign transfers, foreign entities, and foreign-owned entities. Code section 6501(c)(8) grants the IRS three years from the due date of such returns to assess taxes, interest and penalties related to those returns. If an assessment is not made within the required time period, liabilities generally

cannot be assessed or collected. The Administration has expressed concern that the three-year statute of limitation does not provide the IRS sufficient time to determine a taxpayer's liability.

The Proposal, if enacted, would extend the statute of limitations under Code section 6501(c)(8) to six years from the date the return is furnished to the IRS. The Proposal would also broaden the scope of Code section 6501(c)(8) to include information returns filed by passive foreign investment companies treated as "qualifying electing funds," the proposed tax return disclosure of Foreign Bank Account Report information, and information returns proposed to be required of U.S. individuals with respect to certain transfers of money or property to, and receipts from, certain foreign bank, brokerage, or other financial accounts. Additionally, the extended statute of limitations would also apply to taxpayers who fail to furnish information or maintain records with respect to related-party transactions under Code section 6038A (requiring certain foreign-owned U.S. corporations to file information returns with respect to related-party transactions).

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