

OBAMA ADMINISTRATION PROPOSES INTERNATIONAL TAX REFORM

May 5, 2009

To Our Clients and Friends:

On May 4, 2009, the Obama Administration issued a press release outlining the President's initial international tax reform proposals. According to the press release, the proposals are designed to end perceived incentives under existing law to locate jobs outside the U.S. The press release states that further proposals will be unveiled in the Administration's full budget later in May.

The press release outlines the proposals in broad conceptual terms. At this point, no legislative language is available. Some business groups have expressed concern over the effect of the proposals on U.S. competitiveness, and the proposals are likely to be the subject of substantial debate over the coming months. The proposals generally have an effective date in 2011. Contrary to earlier speculation, the proposals do not eliminate the ability of U.S. companies to defer U.S. taxation of foreign earnings. The key proposals are as follows:

Eliminate elective classification for certain foreign corporations

Under current law, it is possible for U.S. multinationals to reduce their non-U.S. tax burden through deductible intercompany charges (*e.g.*, interest and royalties) between their foreign subsidiaries, without causing the U.S. parent to include income currently under the controlled foreign corporation ("CFC") regime. This is facilitated by the elective system of classifying foreign corporations (the "check-the-box" system) pursuant to which wholly-owned foreign corporations generally can elect to be disregarded. The Administration proposes to change the check-the-box system such that "certain corporations" cannot elect to be disregarded. In this way, intercompany charges will generally be taxable in the U.S. under the CFC regime. It is unclear whether the restrictions on the check-the-box system will be narrowly focused on companies that use intercompany charges to reduce foreign taxes or whether the check-the-box system will be broadly reformed. The Administration believes that this proposal will raise \$86.5 billion between 2011 and 2019.

Defer deductions associated with foreign investment

Under current law, U.S. taxpayers are generally entitled to deduct expenses incurred in the U.S., such as interest, even though the earnings of their non-U.S. subsidiaries are generally not taxed in the U.S. until repatriation. The Administration believes that deductions, to the extent

associated with foreign investment, should be deferred until foreign earnings are repatriated. The Administration's proposal makes an exception for the deduction of research and experimentation expenses. A similar measure was proposed in 2007 by Congressman Charles Rangel. The Administration believes that this proposal will raise \$60.1 billion between 2011 and 2019.

Limit utilization of foreign tax credits

Under current law, U.S. corporations generally are entitled to a U.S. foreign tax credit for foreign income taxes imposed on their 10% or greater owned subsidiaries. The credit can be claimed when the subsidiaries make, or are deemed to make, distributions to the U.S. U.S. corporations generally manage actual and deemed distributions from high- and low-taxed pools of foreign earnings to optimize foreign tax credit utilization. The Administration proposes to restrict the ability to optimize foreign tax credit utilization by determining creditable foreign taxes based on the amount of total foreign tax the taxpayer actually pays on its total foreign earnings, regardless of which earnings are currently taxed in the U.S. This proposal also appears to be drawn from measures introduced in 2007 by Congressman Charles Rangel.

The Administration also proposes to limit the ability of taxpayers to claim a foreign tax credit on income that is not subject to U.S. tax. It is not clear how this limitation will fit into existing foreign tax credit limitations that are also designed to prevent this outcome.

The Administration's proposals are expected to raise \$43 billion between 2011 and 2019.

Make the research and experimentation credit permanent

Under current law, taxpayers may receive a credit equal to 20% of their qualified research expenses above a base amount. The credit has never been permanent but rather has been extended 13 times in the past. It is set to expire at the end of 2009 unless renewed. The Administration proposes to make the credit permanent to provide certainty to taxpayers engaged in long-term planning and foster the creation of American jobs. The Administration believes this proposal will cost \$74.5 billion over 10 years.

Deter U.S. taxpayers from underreporting income earned offshore

Presumably in response to widely publicized reports of individuals evading U.S. tax through offshore accounts, the Administration proposes to enhance information reporting by financial institutions, increase withholding taxes on income earned through offshore accounts, strengthen the rules applicable to qualified intermediaries, increase penalties on taxpayers who underreport offshore income and lengthen the statute of limitations for assessing tax on offshore income. This proposal is expected to raise \$8.7 billion over 10 years.

Please feel free to contact us with any questions.

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