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"President Obama's Proposal Regarding U.S. Federal Income Tax Deferral and Enforcement against Tax Havens"

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On Monday, May 4, President Obama announced his proposal to make changes to the Internal Revenue Code of 1986, as amended, and Treasury regulations promulgated thereunder (the "Code") to:

- alter provisions of the Code applicable to U.S. federal income tax deferral by a U.S. company;
- limit the scope of provisions of the Code regarding use of foreign tax credits by a U.S. company;
- restrict disregarded entity classification of certain non-U.S. subsidiaries of a U.S. parent company;
- enhance enforcement of the Code with respect to jurisdictions deemed to be tax havens; and
- make permanent the research and experimentation tax credit.

U.S. Federal Income Tax Deferral

President Obama's proposal would limit the benefit of U.S. federal income tax deferral for a U.S. company by disallowing income tax deductions for the U.S. company for expenses of supporting its overseas investments until U.S. federal income tax is paid on earnings from the overseas investments. The only exception from this general prohibition is for research and experimentation expenses because of the positive spillover benefit of R&D on the U.S. economy.

Foreign Tax Credits

President Obama's proposal would limit the amount of foreign tax credits available for U.S. companies under the Code. First, a U.S. company's foreign tax credit would be determined based on the amount of total foreign tax the U.S. company actually pays on its total foreign earnings. Second, a U.S. company would not be permitted to claim a foreign tax credit for taxes paid on foreign income that would not be subject to U.S. federal income tax.

Subsidiaries as Disregarded Entities

President Obama's proposal would prevent tax haven subsidiaries from avoiding current U.S. tax through the use of the so-called "check the box" rules that permit a U.S. company to treat certain non-U.S. subsidiaries as branches of the U.S. company.

Qualified Intermediaries and Enhanced Reporting Requirements

President Obama's proposal would require any non-U.S. financial institution with U.S. clients to register with the IRS to become a "qualified intermediary" under the Code. Any non-U.S. financial institution with U.S. clients that fails to register as a qualified intermediary will be presumed to be assisting its U.S. clients in evading U.S. federal income tax and will trigger U.S. federal income tax withholding (20-30%) on payments by U.S. financial institutions to its U.S. clients.

Additionally, President Obama's proposal would impose the following restrictions on U.S. individuals investing overseas: tighten reporting on overseas investments, double the penalties for failure to report overseas investment (up to 40% of the amount of understatement), and extend the general statute of limitations for assessment to six years after the U.S. taxpayer submits required information.

Increased Enforcement

President Obama's proposal would increase the IRS' enforcement capability in addressing tax haven abuse by funding the hire of 800 new employees to work in this area.

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Research and Experimentation Tax Credit

The research and experimentation tax credit available to U.S. companies under the Code is set to expire on December 31, 2009. President Obama's proposal would make the research and experimentation tax credit permanent. The cost of this portion of President Obama's proposal would be paid for by the revenue-raising provisions of the proposal discussed above.

Disclosure

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