Federal Tax Advisory

ALSTON + BIRD LLP

OCTOBER 1, 2009

Insights Into Recent Regulatory, Judicial and Legislative Developments

Atlanta
Charlotte
Dallas
Los Angeles
New York
Research Triangle
Silicon Valley
Ventura County
Washington, D.C.

Check the Box Proposal Raises Hackles

The Obama administration has proposed to eliminate "check the box" elections for lower-tier foreign subsidiaries. According to the White House, the purpose of the reform is to raise revenue ($87 billion) by forcing U.S. taxpayers to repatriate foreign business income otherwise eligible for deferral. Skeptics have serious doubts about the revenue estimate and the administration's statements about its rationale.

Taxing Worldwide Income: The Balancing Act

In the United States, domestic taxpayers are subject to tax on their worldwide incomes. As a result, two sets of rules are essential to avoid over-taxation of domestic businesses: The first is a system of foreign tax credits; the second is a set of rules to permit the deferral of U.S. tax on foreign income when it is earned by a controlled foreign corporation.

Early on, the U.S. tax system recognized that taxpayers could take advantage of overbroad deferral rules to defer recognition of taxable income simply by contributing income-generating assets to controlled foreign corporations. Accordingly, subpart F was enacted to limit the deferral of certain categories of income, such as interest income, earned outside the United States by foreign corporations controlled by United States shareholders (CFCs).

Specifics of the Proposal

The Obama administration's proposal would change the business entity classification rules to treat a lower-tier foreign eligible entity with a single owner as a corporation unless it is organized in the same country as its single owner. According to the administration's press release, the proposal generally would not apply to a first-tier foreign eligible entity wholly owned by a U.S. person except in cases of U.S. tax avoidance, however that might be defined.

According to the "Green Book," the purpose of the proposal is to prevent taxpayers from shifting the earnings of a foreign disregarded entity owned by a centralized holding company to low-tax jurisdictions without a current income inclusion under subpart F.

The White House press release characterized the proposal as "Eliminating Loopholes for 'Disappearing' Offshore Subsidiaries" and said:

> Traditionally, U.S. companies have been required to report certain income shifted from one foreign subsidiary to another as passive income subject to U.S. tax. But over the past decade, so-called "check-the-box" rules have allowed companies to make their foreign subsidiaries "disappear" for tax purposes—permitting them to legally shift income to tax havens and make the taxes they owe the United States disappear as well.

Example

The proposal describes a simple example under current law in which a U.S. parent decides to invest $10 million in building a new factory in Germany. Instead of creating and investing directly in a German subsidiary, however, the U.S. parent creates three new corporations. First, the U.S. parent creates a Cayman Islands holding company ("Cayman Holding"). Cayman Holding, in turn, creates both a German subsidiary to own the factory ("German Sub") and a Cayman Islands subsidiary to make a loan to German Sub ("Cayman Sub"). Because interest on the loan is deductible to German Sub and income to Cayman Sub, the loan will serve to shift income from higher-tax Germany to the no-tax Cayman Islands.

Ordinarily, under the subpart F rules, the interest income would count as passive income for the U.S. parent, and would be subject to current U.S. tax. The subpart F inclusion, however, can legally be avoided simply by electing to treat both Cayman Sub and German Sub as branches of Cayman Holding so that the loan, from one branch of Cayman Holding to another, is disregarded for U.S. tax purposes. In the administration's language, the check the box rules allow the taxpayer to make both Cayman Sub and German Sub, and the income shifted by the loan, "disappear" for U.S. tax purposes.

The Treasury Department's estimate of the revenue potential of the proposal is so large ($87 billion over 10 years) that it suggests that the proposal will somehow have a significant impact on existing structures for overseas investments by U.S. companies. The manner in which it would affect existing investments is unclear.

Predictably, the estimated revenue potential of the proposal is disputed. Critics point out, quite rightly it would seem, that some transactions in which check the box rules could reduce foreign taxes simply would not occur in the future.

Jack Cummings
Editor

The Atlantic Building
950 F Street, NW
Washington, DC 20004-1404
202.756.3300
Fax: 202.756.3333

www.alston.com

To the extent the current check the box rules for lower-tier foreign entities are being used, or misused, to avoid tax, the natural effect of reversing that incentive would be an increase in the amount of income taxes paid to foreign governments—but that would simply create the potential for additional foreign tax credits. The press release does not connect the dots to offer a justification for its estimate of large additional revenues to the United States.

Analysis of the Proposal

The curious aspect of the "loophole" addressed by the reform proposal is that the tax being "avoided" in the example is not U.S. tax but German tax. The loan, disregarded for U.S. purposes, is simply shifting income from higher-tax Germany to the no-tax Cayman Islands.

However, just as it is an underlying principle of the U.S. tax system that active foreign business income is not taxed twice, it has also been a basic principle that the income is taxed once. The income is first taxed by the foreign jurisdiction when earned, placing the U.S.-owned subsidiary on a level playing field with foreign-owned businesses. The earnings of the U.S.-owned subsidiary are also eventually subject to tax at higher U.S. rates, but not until the earnings are paid to the U.S. parent, and even then, of course, the foreign tax credit rules are designed to protect the earnings from being taxed twice.

The principle that income is taxed once is violated if the earnings are not subject to current taxation in any jurisdiction.

The ability of the United States to continue to adhere to that basic principle has been undermined by the rapid growth in multinational operations of more and more U.S. taxpayers and the predictable response of some jurisdictions, such as the "tax havens" disparaged in the administration's press release, to attract greater amounts of business investments and to foster domestic employment opportunities by offering low tax rates to investors.

The underlying tax policy question of why the United States ought to care if the foreign income of a foreign subsidiary is taxed at a low rate, or even a zero percent rate, remains unaddressed. The simplest explanation is most likely the best. If foreign rates are too low by U.S. standards, but deferral opportunities remain, the foreign jurisdictions will attract an undue amount of investment by U.S. companies, at least in the view of the administration, which is explicitly in favor of stimulating investment and domestic employment opportunities, but not so much as to champion reduced corporate income tax rates.

The press release states, "It is clear that this loophole, while legal, has become a reason to shift billions of dollars in investments from the U.S. to other countries." Again, trying to brake the inevitable slide of domestic assets and business abroad appears to be the true aim of the proposal, rather than domestic revenue raising.

The sizeable revenue estimate would seem to indicate a belief that the taxpayer in this example will leave the loan in place and subject Cayman Sub's passive income to current U.S. tax. If that is the thinking, it is naïve. While check the box elections offer convenience and certainty, there is no assurance that taxpayers would not strive to achieve similar results by other means, including, for example, the introduction of partnerships into the structure.

Competitiveness: That Was Then, This Is Now

The Tax Relief Extension Reconciliation Act of 2005 amended the Code to provide that passive income such as interest received by one CFC from a related CFC is not treated as foreign personal holding company income, to the extent attributable or properly allocable to non-subpart-F income of the payor. Initially, the provision was effective for taxable years beginning after 2005 and before 2009, but was extended for one year by the Emergency Economic Stabilization Act of 2008. The Obama administration's proposals would extend this look-through provision for another year, through 2010, along with other expiring provisions that have routinely been extended.

Unlike the routine extensions, however, the look-through provision is directly at odds with the administration's specific proposal for subsequent taxable years. Presumably, the administration's view is that the competitiveness rationale cited for its enactment is adequate to extend the provision through 2010, but is outweighed by other considerations applicable in 2011 and subsequent taxable years.

Another factor to consider is whether the proposal would simply cause more U.S. businesses to locate in jurisdictions offering lower tax rates. Although the anti-inversion rules are a significant obstacle to relocating existing businesses, new companies can choose their domicile, and would be derelict not to consider a low-tax jurisdiction.

Conclusion

In any event, the tax policy arguments about competitiveness that are typically raised by multinational businesses ultimately depend on economic data that are difficult to obtain and even more difficult to interpret. From a layman's perspective, they quickly devolve to a contest that can only be resolved by political forces. In this instance, if domestic businesses conclude that greater financial benefits are attached to investments in jurisdictions with low tax rates, only political forces can change the equation to direct their intentions to investing in U.S. domestic operations, if even they can.

For additional information, call Terry Greene at 404.881.7493.

All regular monthly and "Special Alert" issues of the *Federal Tax Advisory* can be viewed on our Web site at **www.alston.com** under Resources or contact us at **taxgroup@alston.com**.

Federal Tax Group

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481

Edward Tanenbaum
Co-Chair
212.210.9425

John F. Baron
704.444.1434

Henry J. Birnkrant
202.756.3319

Robert T. Cole
202.756.3306

Philip C. Cook
404.881.7491

James E. Croker, Jr.
202.756.3309

Jasper L. Cummings, Jr.
919.862.2302

Tim L. Fallaw
404.881.7836

Terence J. Greene
404.881.7493

Brian D. Harvel
404.881.4491

Michelle M. Henkel
404.881.7633

L. Andrew Immerman
404.881.7532

Brian E. Lebowitz
202.756.3394

Clay A. Littlefield
704.444.1440

Vivek Patel
404.881.7686

Timothy J. Peaden
404.881.7475

Jennifer Siegel
202.756.3310

Matthew A. Stevens
202.756.3553

Gerald V. Thomas II
404.881.4716

Charles W. Wheeler
202.756.3308

ALSTON & BIRD LLP