



## U.S. International Tax Alert

12 May 2009

### Treasury Department releases Greenbook

On May 11, 2009, the Treasury Department released the *General Explanations of the Administration's FY 2010 Revenue Proposals* (referred to below as the "Greenbook"), providing additional details with respect to, among other things, the international tax proposals announced by the President on May 4, 2009. In addition, the Greenbook describes seven international tax proposals that were *not* announced on May 4, 2009.

If enacted, these proposals represent a fundamental reform of longstanding international tax rules. Together, they raise \$209.8 billion over 10 years. Except as otherwise noted, all proposed changes would be effective for taxable years beginning after December 31, 2010.

#### Additional international tax proposals

##### Definition of "intangible property" for purpose of §§367(d) and 482

###### *Proposal*

The proposal would add "workforce in place," "goodwill" and "going concern value" to the items included in the definitions of "intangible property" for purposes of §§367(d) and 482.<sup>1</sup> The Greenbook describes these modifications as "clarifications" of existing law. In addition, the proposal would also "clarify" that, in a transfer of multiple intangible properties, the Internal Revenue Service (IRS) may value the intangible properties on an aggregate basis "where that achieves a more reliable result." Finally, the proposal would clarify that intangible property must be valued at its highest and best use, as it would change

#### Contacts

Tim Tuerff  
ttuerff@deloitte.com  
+1 (202) 378 5223

Gretchen Sierra  
gretchensierra@deloitte.com  
+1 (202) 220 2690

Harrison Cohen  
harrisoncohen@deloitte.com  
+1 (202) 378 5227

Michael Trujillo  
mtrujillo@deloitte.com  
+1 (202) 758 1288

<sup>1</sup> Section 367(d) generally recasts outbound transfers of "intangible property" (as defined in §936(h)(3)(B)) to a foreign corporation by a United States person in a §351 or §361 exchange as a sale of the property for a series of payments contingent on the productivity, use, or disposition of the property. Section 482 provides that the income with respect to any transfer or license of intangible property (as defined in §936(h)(3)(B)) shall be commensurate with the income attributable to the intangible.

hands between a willing buyer and a willing seller. The proposal is estimated to raise \$2.9 billion through 2019.

#### *Observations*

While this proposal may be consistent with some positions taken by the IRS in connection with §367(d) and cost sharing, it would be inaccurate to describe the proposal as a clarification with respect to *foreign* goodwill and going concern value, which have long been expressly excluded from the operation of §367(d).

### **Limit earnings stripping by expatriated entities**

#### *Proposal*

The proposal would make the limitation on interest deductions under §163(j) more restrictive in the case of expatriated entities.<sup>2</sup> First, the debt-to-equity safe harbor would be eliminated. Second, the 50 percent “adjusted taxable income” threshold would be reduced to 25 percent, except in the case of unrelated party debt guaranteed by a related party. The period for carrying forward disallowed deductions would be reduced to ten years, and the carryforward of “excess limitation” would be eliminated.

The proposal defines an “expatriated entity” under the rules of §7874 and the regulations thereunder as if §7874 were applicable for taxable years beginning after July 10, 1989 (i.e. the date of enactment of §163(j)). The proposal does not apply, however, if the “surrogate foreign corporation” is treated as a domestic corporation under §7874. The proposal is estimated to raise \$1.2 billion through 2019.

#### *Observations*

The proposal is identical to the §163(j) proposal in the Bush administration’s FY 2009 Budget.<sup>3</sup> The proposal raises compliance issues as applied to entities that expatriated (as described in §7874) in taxable years beginning after July 10, 1989, but prior to the effective date of §7874. Such entities would have to determine, for the first time in 2011, whether they expatriated up to 21 years ago, under a standard that was first set forth in the Internal Revenue Code in 2004. Companies potentially affected may have undergone significant restructurings since the transaction to be tested was completed, making application of the standard even more difficult.

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<sup>2</sup> Section 163(j) generally limits the deductibility of interest paid or accrued by a corporation. The amount of deduction disallowed is the lesser of “disqualified interest” (interest paid to a related person and not subject to U.S. tax, or paid on debt guaranteed by a related foreign or tax-exempt person) and “excess interest expense” (the excess of net interest expense over the sum of 50 percent of adjusted taxable income plus certain “excess limitation carryforwards”). The limitation generally applies only to a corporation that fails a debt-to-equity safe harbor of 1.5 to 1. Disallowed interest expense may be carried forward indefinitely. A corporation’s “excess limitation” for the year (the amount by which 50 percent of adjusted taxable income exceeds net interest expense) may be carried forward up to three years.

<sup>3</sup> See also §2001 of H.R. 2896 (the *American Jobs Creation Act of 2003*), as reported by the Ways and Means Committee, H.R. Rep. 108-393 (November 21, 2003).

## **Boot in acquisitive reorganizations by foreign corporations**

### *Proposal*

“Boot” (property other than certain stock or securities) received by an exchanging shareholder in certain corporate reorganizations is generally *not* taxable to the recipient to the extent that it *exceeds* the gain realized by the shareholder in the exchange. The proposal would remove this “boot within gain” limitation in situations where the acquiring corporation is foreign and the exchange “has the effect of the distribution of a dividend” within the meaning of §356(a)(2). The proposal is estimated to raise \$0.3 billion through 2019.

### *Observations*

The proposal is the latest in the Government’s effort to crack down on repatriation transactions.<sup>4</sup> It would change the treatment of, for example, “all-cash D” reorganizations where the exchanging shareholder has no built-in gain in the stock of the acquired corporation.

## **Repeal “80/20 company” rules**

### *Proposal*

This proposal would repeal the special rules for interest and dividends paid by a so-called “80/20 company” (i.e. a U.S. corporation 80 percent or more of the gross income of which, during a three-year testing period prior to the year of payment, was from active foreign business). Under present law, interest received from an 80/20 company is foreign source income, and at most 20 percent (and as little as none) of a dividend received by a foreign person from an 80/20 company is subject to 30-percent U.S. gross-basis tax. The proposal is estimated to raise \$1.2 billion through 2019.

### *Observations*

The proposal is a more draconian version of the Clinton Administration proposal in the FY 2001 Budget, and may affect both foreign tax credit utilization by U.S. taxpayers and U.S. taxation of foreign persons. While the 80/20 rules were significantly narrowed in 1986, they have been part of federal tax law since the 1920s.

## **Equity swaps**

### *Proposal*

Effective for payments made after December 31, 2010, income earned by foreign persons with respect to equity swaps that reference U.S. equities generally would be treated as arising from U.S. sources to the

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<sup>4</sup> See, e.g., T.D. 9400, 73 *Fed. Reg.* 30301 (May 27, 2008) (the so-called “Killer B regulations”).

extent that the income is attributable to (or calculated by reference to) dividends paid by a domestic corporation. The proposed source rule would not apply, however, to swaps with certain characteristics set forth in the proposal.<sup>5</sup> The Treasury Department would have authority to provide additional exceptions by regulation to implement the purpose of the rule.

In addition, the Greenbook indicates that, 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 taxation of certain payments on cross-border securities lending transactions), and issue guidance that “eliminates the benefits of such transactions but minimizes over-withholding.” The proposal is estimated to raise \$1.4 billion through 2019.

### *Observations*

This proposal is similar to one by Senator Carl Levin in the *Stop Tax Haven Abuse Act*, S. 506, §108 (introduced March 2, 2009). The proposal raises several issues. For example, it is unclear whether foreign parties to equity swaps will be taxed on the gross component of a typical total return swap arrangement (i.e. on the gross dividend or appreciation on the reference stock), or whether only the “net payment” under the swap contract would be treated as U.S. source income. Other questions are whether the proposal would allow for the “cascading” taxation of dividend equivalents, if so, whether it would limit the total withholding tax to 30 percent, and how it would interact with treaties.

## **Foreign tax credits for dual capacity taxpayers**

### *Proposal*

Additional restrictions would be placed on the creditability of foreign taxes paid by “dual capacity taxpayers.” (These are taxpayers that pay a levy to a foreign government and also receive a specific economic benefit from that government.) Under a regulatory safe harbor, if a foreign country does *not* generally impose an income tax, a dual capacity taxpayer is entitled to treat a levy by that country as a creditable tax to the extent of the product of the taxpayer’s net income and the applicable U.S. federal tax rate.

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<sup>5</sup> To be excluded, (1) the terms of the equity swap must not require the foreign person to post more than 20 percent of the value of the underlying stock as collateral; (2) the terms of the equity swap must not include any provision addressing the hedge position of the counterparty to the transaction; (3) the underlying stock must be publicly traded and the notional amount of the swap must represent 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; (4) the foreign person must 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; (5) the prices of the equity that are used to measure the parties’ entitlements or obligations must be based on an objectively observable price; and (6) the swap must have a term of at least 90 days.

Under the proposal, by contrast, a foreign tax generally would be considered creditable *only if* the foreign country generally imposes an income tax. A country would meet this requirement only if it imposes an income tax that applies to trade or business income from sources in the country, and the tax has substantial application to non-dual-capacity taxpayers and to persons who are nationals or residents of that country.

The proposal would convert the special foreign tax credit limitation rules of §907 into a separate basket for foreign oil and gas income. The proposal would not override a U.S. tax treaty that allows a credit for a foreign tax paid or accrued on certain oil or gas income. The proposal is estimated to raise \$4.5 billion through 2019.

#### *Observations*

The proposal appears substantially similar to proposals previously made but never enacted (e.g. S. 341, *Energy Fairness for America Act* (2007)).

### **Certain expiring provisions extended through 2010**

#### *Proposal*

Section 954(c)(6) (“the look-through exception”) and the active financing exception would be extended through December 31, 2010.

#### *Observations*

The Greenbook does not indicate that the Administration will propose an extension of these provisions beyond 2010, but within the 10-year budget window. Consequently, it is unclear whether §954(c)(6) and the active financing exception will be extended beyond 2010.

## **Additional information on proposals announced May 4, 2009**

### **Impose corporate status on certain foreign entities**

#### *Information provided in May 4 press release*

As part of the Administration’s proposals addressing the use of tax havens, it proposed to treat certain foreign hybrid entities as corporations for U.S. tax purposes (e.g. subpart F). However, it was unclear from the May 4 press release whether the proposal would only apply to single-member “disregarded” hybrid entities. The proposal is estimated to raise \$86.5 billion through 2019.

#### *Additional information in the Greenbook*

The proposal would generally treat a foreign eligible entity with a single owner as a corporation for U.S. tax purposes. The proposal would not

apply in two instances: (i) when the entity and the single member are created or organized in, or under the laws of, the same foreign country; and (ii) when the entity is a first-tier entity wholly owned by a U.S. person, except in the case of U.S. tax avoidance. The conversion from disregarded entity (DRE) classification to corporate status would be determined under current Treasury regulations and tax principles.

#### *Observations*

The Greenbook clarifies that the scope of the provision is limited to certain entities that are now eligible to be DREs. For example, the proposal does not apply to partnerships and does not affect the application of the check-the-box rules to “reverse hybrids.” It also only applies to certain single-member foreign business entities, and, in this respect, it differs from the 2005 proposal by the Joint Committee on Taxation, which applied to all foreign single member eligible entities.<sup>6</sup> Additional issues remain, however: for example, the intended scope of the term “U.S. tax avoidance” for this purpose; and the treatment of foreign eligible entities owned by an entity classified as a partnership, some or all of whose partners are U.S. persons.

#### **Deferral of certain U.S. income tax deductions**

##### *Information provided in May 4 press release*

This proposal would defer deductions, other than those for research and experimentation expenses, by U.S. persons to the extent they are allocable to unrepatriated foreign earnings. The proposal is estimated to raise \$60.1 billion through 2019.

##### *Additional information in the Greenbook*

The Greenbook provides additional detail regarding the treatment of deferred deductions. The amount of expenses properly allocated and apportioned to foreign source income generally would be determined under current Treasury regulations. Deferred deductions would be carried forward to the following year and treated essentially as current year expenses in that year for purposes of determining the allowed deductions.

#### *Observations*

The proposal differs in its treatment of deferred deductions from Chairman Rangel’s bill, H.R. 3970, the *Tax Reduction and Reform Act of 2007*. The Rangel bill provides that deferred deductions are put in a separate pool of deductions from current year deductions and they are generally allowed in subsequent years in the same ratio that deferred foreign earnings repatriated bear to total previously deferred earnings. In addition, the Greenbook does not contemplate the repeal of §864(f), and, consequently, it appears increasingly likely that the Administration intends for interest expense to be apportioned in accord with §864(f)

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<sup>6</sup> JCT, *Options to Improve Tax Compliance and Reform Tax Expenditures*, (JCS-02-05), at 182-185, January 27, 2005.

when it becomes effective in 2011. Such an approach perhaps may increase the possibilities that a U.S. taxpayer could, in some cases, minimize or eliminate the portion of its interest deduction deferred under the proposal. When considered together with the foreign tax credit proposals, the Greenbook further raises the possibility that the computation of the deferral could be affected by the presence of unreported earnings in noncontrolled §902 corporations (“10/50 corporations”).

### **Foreign tax credit proposals**

#### *Information provided in the May 4 press release*

First, a taxpayer’s foreign tax credit would be determined based on the amount of total foreign tax the taxpayer actually pays on its total foreign earnings; second, a foreign tax credit would no longer be allowed for foreign taxes paid on income not subject to U.S. tax. The proposal is estimated to raise \$43.0 billion through 2019.

#### *Additional information in the Greenbook*

##### 1. Calculation of taxes deemed paid with repatriations

The first proposal would revise the §902 and §960 deemed-paid tax rules so that a U.S. corporation would determine its deemed paid taxes on a consolidated basis by determining the aggregate foreign taxes and E&P of all of the “foreign subsidiaries” with respect to which the U.S. taxpayer can claim an indirect credit, and the amount of the consolidated E&P of the foreign subsidiaries repatriated to the U.S. taxpayer. This first part of the foreign tax credit proposal is estimated to raise \$24.5 billion.

#### *Observations*

Unlike the Rangel bill, the proposal makes clear that it does not apply to §901 credits and credit carryforwards (e.g. from pre-effective-date years). Also unlike the Rangel bill, there is no express exclusion of 10/50 corporations from the worldwide pooling computation. However, it is unclear whether the reference to “foreign subsidiaries” includes *all* 10/50 corporations or if it indicates that some threshold level of ownership is required. Finally, and also unlike the Rangel bill, there is no mention of a “second” pooling ratio applicable to taxes of foreign corporations that were paid or accrued in prior years but not deemed paid by the shareholder in such years.

##### 2. Matching of foreign income and taxes

The Greenbook states that it proposes to adopt “a matching rule to prevent the separation of creditable foreign taxes from the associated foreign income.” No further clarification is provided. This second part of the foreign tax credit proposal is estimated to raise \$18.5 billion.

## Observations

As worded in the Greenbook, this proposal could potentially have a much broader application than just *Guardian Industries*,<sup>7</sup> or just reverse hybrid structures, especially if adopted as a standalone provision separate from the other foreign tax credit proposal.

## Enforcement-related proposals

There are several proposals related to international tax enforcement that are geared towards tax havens and the international tax gap. These proposals include significant reform of the qualified intermediary (QI) program, increased withholding by financial institutions on U.S. source income paid to individuals who use non-QIs, extension of the statute of limitations to six years, and additional reporting and penalties related to overseas investments. These proposals are estimated to raise \$8.7 billion. The Greenbook provides substantially greater detail with respect to these proposals, which detail is, however, beyond the scope of this alert.

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<sup>7</sup> 477 F.3d 1368 (Fed. Cir. 2007).