



The Obama administration's international tax proposals

U.S. PRIVATE EQUITY CONSIDERATIONS

The international tax provisions in the Obama administration's budget proposal would, if enacted, raise \$210bn in revenue and represent significant changes in U.S. tax policy. The changes include increased reporting of tax haven income, deferred deductions for expenses related to foreign income, enhanced limitations on foreign tax credits and elimination of strategies that use disregarded entities to avoid subpart F income.¹ This outline briefly describes only the proposals likely to be most relevant to U.S. private equity investors.²

Prospects of enactment

Since the U.S. does not have a parliamentary system of government, it is quite possible that the administration's international tax proposals will not be enacted. Whether the proposals are enacted this year probably depends more on the need for revenue to fund the administration's health care reform and other initiatives than it does on tax policy. Important tax policy posts at the Treasury remain unfilled and important members of the Congressional finance committees who generally support many of the proposals have indicated that they would prefer to address international tax reform more comprehensively later. Even if not enacted this year, some of the proposals almost certainly will appear again.³

If enacted as proposed, most of the substantive international tax provisions in the administration's budget would not become effective until 2011. The procedural and enforcement provisions to tighten withholding and information reporting generally are proposed to take effect in 2010.

¹ Legislation to implement tax proposals in the Obama administration's budget has not yet been introduced. This summary relies on brief descriptions in the U.S. Treasury Department's General Explanation of the Administration's Fiscal Year 2010 Revenue Proposals (May 11, 2009), which can be found at www.treas.gov/offices/tax-policy/library/grnbk09.pdf.

² This outline highlights only the substantive proposals in the administration's press release. It does not describe procedural proposals aimed largely at individual taxpayers' unreported income from offshore accounts. It also does not describe other tax measure already introduced in the U.S. Congress (such as Senator Levin's Stop Tax Haven Abuse bill (S. 506) or Representative Levin's proposals to tax income from carried interests of service partners as ordinary income (H.R. 1935)).

³ Similar proposals were introduced in the previous U.S. Congress, see S. 681, 110th Cong. (2007) (Sen. Levin, Coleman and Obama); H.R. 3970, 110th Cong. (2007) (Rep. Rangel), and in the current Congress, see S. 506, 111th Cong. (2009) (Sen. Levin, Whitehouse, McCaskill and Nelson).

Check-the-box foreign subsidiaries

Administration proposal

- The administration wants to stop U.S. multinational companies from electing to disregard foreign subsidiaries so that they can shift income from high-tax to low-tax jurisdictions without U.S. tax consequences.
- Loans between disregarded entities are disregarded transactions, so finance subsidiaries in low-tax jurisdictions have no interest income for U.S. purposes when they make loans to subsidiaries in high-tax jurisdictions.
- The administration also would repeal a look-through rule that treats dividend, interest and royalty payments between related controlled companies as active income rather than passive income currently taxable to U.S. 10 per cent shareholders under the anti-deferral rules in subpart F.

Consequences

- The proposals would hit multi-tiered holding company structures used to avoid foreign withholding tax on repatriated profits and to push down acquisition debt into operating subsidiaries (which rely on disregarding intermediate entities to avoid generating earnings from intra-group interest payments).
- U.S. private equity investors holding less than 10 per cent of a foreign company's shares (directly or indirectly through a fund) generally would not have additional current income (unless the company is a

PFIC and the investors have made QEF elections). However, dividends and individuals' exit gains are more likely to be taxed at higher ordinary income rates (unless they are qualified dividend income entitled to the same rate as capital gains) because the recognition of previously disregarded payments could cause portfolio companies to have higher earnings and profits.

- U.S. investors holding at least 10 per cent of the shares of a controlled foreign corporation (directly or indirectly through a fund) likely would have additional current income (under subpart F).⁴
- The use of check-the-box elections to ameliorate PFIC concerns in groups with significant real estate, intangible assets or financial services businesses also would be limited or entirely prevented.

Expenses related to foreign investment

Administration proposal

- The administration would defer U.S. deductions for the expenses of earning foreign income (other than research and development expenses) until the taxpayer pays U.S. tax on the income.
- The amount of U.S. interest expense related to foreign investments would probably be determined by allocating interest based on the relative tax basis or value of the taxpayer's U.S. and foreign assets. The interest related to foreign investments that do not produce currently taxable earnings would be deferred.

Consequences

- Since acquisition debt is typically pushed down into portfolio companies, the proposal generally should not affect U.S. private equity investors' interest expense deductions.
- Deductions for other expenses related to foreign investments would be deferred until U.S. investors repatriate income or recognize gain.

Foreign tax credits

Administration proposal

- The administration proposes (i) to pool a corporate group's worldwide foreign tax credits to prevent taxpayers from repatriating only high-taxed earnings and (ii) to deny credits until the U.S. taxpayer takes account of the foreign income on which the tax was imposed.
- The first proposal might foreshadow a major change in U.S. law. The second proposal appears to advance changes mooted in proposed Treasury regulations on foreign consolidated groups.

Consequences

- The administration's first proposal would affect U.S. taxpayers claiming foreign tax credits for taxes paid by a foreign company. It would affect few U.S. private equity investors because only a U.S. taxpayer holding at least 10 per cent of a foreign company's shares can claim credits for tax paid by the company (as distinguished from credits for tax withheld from distributions to the U.S. taxpayer).
- The other proposals are also likely to affect few U.S. private equity investors because private equity funds typically have not done (or had the opportunity to do) significant foreign consolidated group tax credit planning.

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⁴ The affected investors are likely to be U.S. sponsors of private label funds that hold significant investment interests in their own funds or U.S. funds that do not hold foreign companies through alternative investment vehicles.