Tax Technologies, Inc.

Tax Training Newsletter **December, 2009**

This newsletter is from JD Choi of Tax Technologies, Inc. (TTI) to tax professionals whose interests include improving tax management processes.

Inside this issue: How will your company deal with the new international tax provisions?

On May 4, 2009, the Obama Administration announced new international tax proposals that include 1) reform of deferral rules by virtual elimination of check-the-box (CTB) entities; 2) deferral of expense deductions relating to foreign investment; 3) creation of super-pools for earnings and profits (E&P) and tax for computing deemed paid credits; 4) disallowance of foreign tax credit for income not subject to U.S. taxation; and 5) disallowance of separation between E&P and taxes.

This newsletter explores the implications of the first three revenue raising proposals listed above ($171.1 billion of additional revenue over 10 years) that will have a widespread impact on many companies. Additionally, this newsletter identifies potential calculation and administrative issues associated with these changes as well as explains how your company can measure the impact of each of the proposals.

TTI will host a conference on January 7, 2010 to explore how planning calculations can be performed quickly to measure the effect of each of the three revenue raising proposals. The conference will be held in our New York Training Center (336 West 37th Street, New York, NY). Seating is limited to 30. Please visit www.taxtechnologies.com to register for the conference or send an e-mail to choi@taxtechnologies.com. (Note: This conference will not be broadcasted on WebEx due to intellectual property concerns.)

Register for the Tax Technologies, Inc. New International Tax Provisions Conference.

Analysis of the Three Major Proposals and Proposed Action Items

1. Elimination of CTB Entities

Under the current proposal, most CTB entities will be converted to separate legal entities for taxable years beginning after December 31, 2010. Exceptions to this rule apply to a CTB entity that is in the same country as its owner, and to a CTB entity of a U.S. corporation. This proposal is expected to raise $86.5 billion of tax revenue over 10 years. The elimination of the CTB entity structure will cause the following changes:

- Removal of consolidated adjustments to eliminate intracompany transactions may result in an increase in subpart F income and higher effective tax rates on general limitation non-subpart F income and lower effective tax rate on subpart F income inclusion.

The current CTB structure allows intracompany transactions to be eliminated as part of the legal entity consolidation process, as the E&P is computed on a legal entity basis. Removal of such eliminations will increase both income and expenses between the CTB entity and its legal entity parent. This intracompany elimination adjustment is the mechanism that allowed potential subpart F income to disappear. For example, interest income of a CTB entity is eliminated by offsetting interest expense of another CTB entity if both the payor and recipient CTB entities are owned by a common parent. Thus, removal of intracompany elimination adjustments will create additional income for the recipient company while creating corresponding additional expense for the payor company. Additional income by the recipient is likely to be sourced to Foreign Personal Holding Company Income (FPHCI). Because the recipient company has no corresponding expense, this will increase the subpart F income inclusion amount of the recipient company.

Also, because there will be no blending of taxes between the payor company and recipient company, the payor company is likely to have a higher effective tax rate as the deduction is on the books of a high-tax jurisdiction to get a higher tax rate benefit. Seeing that the payor company is most likely to have general limitation income, it may push the effective rates up for the general limitation income basket, which may not be desirable for many corporations with excess credit in that basket. On the other hand, while the recipient company is most likely be in a low tax jurisdiction, the increased subpart F income will carry a low rate of deemed paid credit (most likely in the passive basket). This may be a very undesirable result for most corporations.

- Change in sourcing of income and apportionment of expense may produce more subpart F income even without intracompany transactions.

  Overall subpart F income may increase even in situations where there were no intracompany payments. This can happen when there is a change in expense apportionment base. Suppose one CTB company has foreign base company sales income that was reduced by the expense of another company within the same legal entity group prior to the conversion of CTB entities to separate Controlled Foreign Corporations (CFCs). Under the old rule, the expense apportionment based on legal entity gross income may have been acceptable based on the facts and circumstances of the legal entity group's business practice. Using the legal entity based expense apportionment method, the expense of a member company can offset the subpart F income of the CTB entity that has foreign base company income as long as both companies were in the same legal entity group.

  Under the new proposal, the expense of one company cannot reduce the income of another company as they will be in two separate legal entities. Thus, the original CTB company that had foreign base company sales income can no longer reduce its subpart F income inclusion amount by the expense of the other company. As a result, even in the absence of intracompany transactions, the subpart F income inclusion will increase.

Again, since the trading company that produced the foreign base company income is most likely to be in a low tax rate jurisdiction, it may create subpart F income (foreign base company sales income) with low deemed paid credit while raising the effective tax rate for the company that had deductions.

- Creation of an E&P pool at the former CTB entity will add additional administrative burden to the annual tax liability calculation process and impact the effective tax rate on future U.S. shareholder income inclusions.

  Under the proposal to apportion interest expense based on worldwide assets and to defer expenses attributable to unrepatriated earnings, it will become necessary to calculate the earnings and profits of all foreign subsidiaries annually. Conversion of the CTB entities to separate legal entities for U.S. tax purposes will increase the number of entities for which detailed E&P and tax pools have to be maintained separately. This will increase the administrative burden for companies that have a significant amount of CTB entities.

  Whether the new rule will require the creation of E&P and tax pools for unremitted earnings based on the CTB entity's entire history, or only prospectively from the year of conversion to corporate entity, is not clear at this point. That outcome can make a significant difference in terms of the effective tax rate on deemed paid credit for all U.S. shareholder income inclusions going forward.

- Altered dividend and Sec. 956 inclusions may require companies to examine E&P composition and loan arrangements.

  Because the E&P of the legal entity parent that pays dividends in the pre-conversion period may no longer include the E&P of the former CTB entities, it will alter the composition of E&P and tax pools for determining the amount of dividends and deemed paid credits.

  In addition, the section 956 inclusion based on applicable earnings will also be impacted as the E&P and Previously Taxed Income (PTI) composition will significantly change. If the loan to the U.S. was from the former CTB entity, it may lower the inclusion amount due to the increase in subpart F income (assuming the CTB entity has increased subpart F income inclusion). If the loan is with the legal entity parent, it may increase the inclusion amount with a higher effective tax rate (assuming that the legal entity parent has general limitation income with a higher tax rate). Thus, the details of loan arrangements between the U.S. parent and foreign subsidiaries (including CTB entities) should be examined before the new rule takes effect to avoid an undesirable outcome.

Action to be taken by corporations: Companies should examine the current organizational structure of their foreign subsidiaries and perform impact studies under the alternative scenarios. It will necessitate a significant level of quantitative analysis based on changes in entity characterization, intracompany adjustments, sourcing, and subpart F income, dividend, and Sec. 956 inclusion amounts. It will also

require the examination of E&P and tax pools, both pre- and post-conversion, as well as intercompany debt arrangements.

2. Deferral of Expense Deductions Relating to Foreign Investment

The current proposal seeks to remove the benefit of deductions on U.S. tax returns that are associated with the earnings that are eligible for deferral. The deduction is suspended until the corresponding foreign earnings are repatriated and subject to U.S. tax. Research and Development (R&D) expense is not subject to this matching deferral rule.

This proposal will have a significant impact on the amount of interest expense deduction, whether favorable or unfavorable. This provision is expected to raise $60.1 billion of tax revenue over 10 years. However, it may be extremely difficult to enact into law as it may not be possible to properly administer the rules as proposed.

- The foreign exchange rate fluctuation causes tax liability to be unpredictable for taxpayers.

  The proposal requires the amount of expense apportionable to foreign earnings be deferred until the corresponding earnings are repatriated, thereby postponing tax benefits. The most significant impact will be from interest expense for most U.S. corporations.

  The deferred portion of interest expense is determined by apportioning the total interest expense between the U.S. and the foreign source based on asset composition (U.S. versus foreign assets). This calculation of the asset base for the interest apportionment will cause a considerable level of unpredictability (especially if a worldwide asset approach is adopted), and it may cause companies practical problems for provision reporting purposes.

  The interest expense for most companies is apportioned based on assets using the tax-book method (except for a small number of companies that are using the fair-market-value method). Under this method, affiliated group assets are categorized between U.S. source and foreign source assets, and the interest expense is apportioned pro-rata. The new proposal requires the interest expense apportioned to foreign assets to be further allocated between repatriated earnings and unrepatriated earnings. The amount of interest expense attributable to unrepatriated earnings will be disallowed until it is repatriated.

  Foreign source assets include assets used in foreign countries (foreign branch assets or assets in foreign partnership) or the assets that produce (or are expected to produce) foreign source income on the books of U.S. corporations. It also includes the earnings and profits of 10 percent or more owned foreign subsidiaries.

  Because most foreign branch assets and partnership assets are maintained in a functional currency that is not the U.S. dollar (USD), fluctuation in foreign exchange rates can significantly impact the amount of interest expense that is attributable to foreign assets. Likewise, the exchange rate can significantly impact the translation of foreign E&P that must be included in the foreign asset amount, which in turn is a factor in determining the amount of deferred

interest deduction. This issue will become even more amplified once worldwide asset apportionment is adopted.

Seeing that the exchange rate is a factor that cannot be controlled by the taxpayer, this proposal will create a significant level of uncertainty when forecasting the tax liability of U.S. corporations operating in many countries. TTI has tracked the relative strength of 11 currencies selected in comparison to that of the USD since 1998. (See Figure 1 in section 3 of this newsletter.) There has been significant fluctuation in the foreign exchange rate. I think the level of fluctuation (as much as 30 percent in one year) will create uneasiness for most tax executives who manage the tax liability of their companies. It will be extremely difficult to calculate taxable income at year-end provision time due to the uncertainty introduced by this proposal as well as possibly create a condition that forces companies to produce an incorrect effective tax rate on their financial reports as both the calculation of tax basis assets and E&P are difficult and time consuming for most multinational corporations.

- Increase in taxable income and increase in foreign tax credit limitations may allow more foreign tax credits to be utilized.

  Obviously, if deductions are deferred, the taxable income of U.S. companies will increase and the corresponding U.S. tax liability will increase. On the other hand, from the foreign tax credit limitations perspective, removal of the expense that would have reduced foreign source income will increase the foreign source income portion of the foreign tax credit limitation calculation. As the increase in worldwide income for the same amount does nothing for the foreign tax credit limitation, the increase in foreign source income will increase the foreign tax credit limitation, and allow companies to use *more* foreign tax credits. Companies that have maintained E&P and tax pools properly may take advantage of this condition by triggering repatriations from high tax E&P pools.

- The reduction of overall foreign loss (OFL).

  Generally, an OFL is created because expense and the corresponding income in a taxable year do not match; for example, interest expense is deducted on the U.S. corporate return while there is no corresponding foreign source income. This proposal will reduce the possibility of creating an OFL as it will defer the deduction of the expense until the corresponding income recognition. The problem, however, is that as most companies take the position of permanently reinvesting earnings in foreign countries, the deferred deduction may also be suspended indefinitely. This will have significant impact on financial reporting (higher effective tax rates) for multinational corporations.

Action to be taken by corporations: The simplest way to measure the impact of this proposal is 1) to examine the total amount of expense apportioned and allocated to foreign source categories, and 2) to further divide the foreign source expense between the expense attributable to repatriated foreign earnings and un-repatriated foreign earnings. Also, companies need to take into account the foreign exchange rate fluctuation in computing the asset base for interest expense apportionment as it will have

a significant impact on the amount of any deferred interest deduction, which will in turn have a direct impact on taxable income.

3. Creation of Super-Pools of E&P and Tax for Determining Deemed Paid Credits

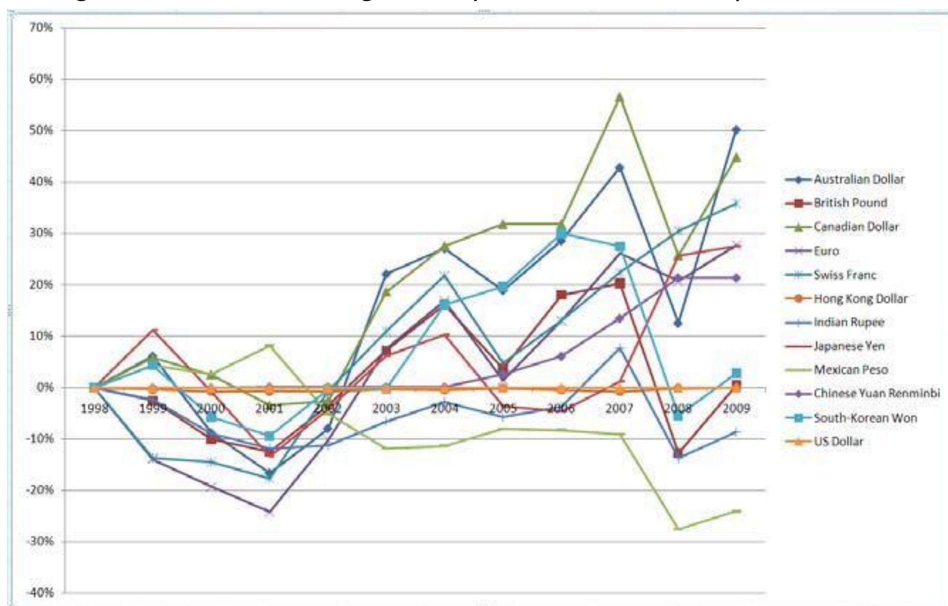
Under this proposal, a U.S. corporation would determine its deemed paid foreign tax credit on a consolidated basis by determining the aggregate foreign taxes and E&P of all of the foreign subsidiaries on which the U.S. corporation can claim a deemed paid foreign tax credit (including lower tier subsidiaries described in Sec. 902(b)). This proposal is expected to raise $24.5 billion of tax revenue over 10 years.

As proposed, dividends will come from a specific entity's E&P while the deemed paid credit will be calculated based on the super-pools of E&P and tax.

- Effect of foreign exchange rates on deemed paid credit may render the foreign tax credit calculation unpredictable.

  If the deemed paid credit is calculated from the super-pools of E&P and tax, all distributions from foreign subsidiaries will have exactly the same effective tax rate. The only way the effective tax rate will change is based on changes in foreign currency exchange rates. This is because E&P is maintained in functional currency while the tax pools are maintained in USDs. Upon distribution, all different functional currency E&Ps must be converted into USDs for the purpose of computing deemed paid credits.

  The following chart shows foreign exchange rate fluctuations since 1998. The chart is based on the year-end rate of 11 currencies, using the USD as the base currency. As shown, the foreign exchange rate has fluctuated significantly over the last twelve years.



(Figure 1, Foreign exchange rate is based on Oanda.com)

Because the exchange rate fluctuates differently for different currencies, the impact of the exchange rate on the effective tax rate becomes extremely difficult to predict. The impact is proportional to the amount of E&P in each of the currencies. For example, if the U.S. parent has substantial E&P in Australia, the effective tax rate on any distribution in 2009 (in comparison to 2008) will fall significantly. On the other hand, if a company has substantial E&P in China or Japan, the effective tax rate on the distribution will not change significantly between 2008 and 2009.

This dependency on exchange rate in computation of deemed paid credit will make it very difficult for the companies that are involved in repatriation planning.

- Use of the high-tax-exception may be restricted.

  The current proposal is silent on whether the super-pool will be used to compute deemed paid credit on actual dividend distribution only or in all cases of deemed paid credit calculations, such as for subpart F income and Section 956 inclusion. If the proposal is applicable to subpart F income, use of the high-tax-exception may also be significantly altered under the super-pool method. As the effective tax rate will be controlled by the foreign exchange rate rather than by the amount of tax paid in any particular foreign subsidiary, companies may not be able to elect the benefit of the high tax exception for any of their subpart F income in a given year if the super-pool effective tax rate becomes lower that 31.5 percent (based on the current U.S. tax rate of 35%). Given that the USD has lost its value in recent years, and that most countries have lower statutory tax rates than the U.S., it is conceivable that the majority of companies will not be able to use the high tax exception to defer subpart F income inclusion.

  The same mechanism can also create significant problems for the U.S. Treasury. If the foreign exchange rate trend reverses (for example, if the USD gains strength against foreign currencies), the effective tax rate on the super-pools may rise higher than 31.5 percent for the majority of U.S. corporations. If the majority of corporations elect the high tax exception, reduction on U.S. tax revenue could be very significant in a given year.

Action to be taken by corporations: Although the foreign exchange rate may not be controlled, companies should perform a sensitivity analysis based on the current composition of E&P and tax pools. The companies that have neglected to maintain E&P and tax pools based on the assumption of permanent reinvestment will find it very difficult to comply with the super-pool approach.

Unless there is absolutely no subpart F income inclusion, dividends paid to the U.S. parent or Section 956 inclusion (which is extremely unlikely for any company under the new proposed structure), companies will find themselves incapable of computing the correct deemed paid credit, resulting in inaccurate U.S. tax return filings.

Conclusion

Because of the current focus on the health care debate, tax legislation may get delayed. However, it is clear that the U.S. Government will attempt to raise tax revenue or expedite the collection of revenue

given the current economic conditions. Unlike the previous administration's attempt to expedite foreign earnings repatriation with tax incentives and simple and temporary changes to the rules, the current administration appears to be focused on raising tax revenue by changing the fundamental structure of the rules governing foreign earnings. In particular, the focus is on perceived abuses in deferring repatriation of foreign earnings, and in the use of the foreign tax credit mechanism.

For companies that have completed tax returns for foreign subsidiaries diligently in the past, the overall proposal may not be a big issue as they should have good E&P and tax pools (along with other tax attributes) available to quantify the impact of each of the different proposals. However, for those companies that have not been able to maintain E&P and tax pools properly, they will find it difficult to provide proper analysis to their decision makers, and will find it hard to comply with the new compliance requirements. Further, the impact on financial reporting will have to be measured as the proposals introduced a substantial level of uncertainty and complexity in computing the effective tax rate. Because most of the proposed rule will take effect for the 2011 tax year, companies should prepare for the change in 2010. There is not much time.

As stated in the beginning of this newsletter, Tax Technologies, Inc. is planning to have a conference in New York City on January 7, 2010. During this conference, we will show you how to measure the impact of the CTB reversal, the impact of deferred deductions and of super-pooling. Please let us know if you are interested in attending the conference.

About Tax Technologies, Inc.

Tax Technologies, Inc. produces industry leading corporate income tax compliance and provision software as well as related services. Please visit http://www.taxtechnologies.com and learn more about our software solutions and services.

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Regards,

JD Choi
CEO, Tax Technologies, Inc.
(201)387-9451