AMERICANS FOR TAX REFORM FOUNDATION

ANALYSIS OF PROPOSED CHANGES TO THE U.S. INTERNATIONAL TAX SYSTEM

FEBRUARY 2010

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The President's Fiscal Year 2010 budget called for hundreds of billions of dollars in higher tax for Americans doing business abroad. Americans for Tax Reform Foundation created this informative document which analyzes each proposed change in the 2010 Budget. This will be updated once further information from the 2011 Budget will be released.

- OVERVIEW OF REFORMS
- REFORM BUSINESS ENTITY CLASSIFICATION RULES FOR FOREIGN ENTITIES
- DEFER DEDUCTION OF EXPENSES
- DETERMINE THE FTC ON A POOLING BASIS
- PERCENT SPLITTING OF FOREIGN INCOME AND FOREIGN TAXES
- LIMIT SHIFTING OF INCOME THROUGH INTANGIBLE PROPERTY TRANSFERS
- LIMIT EARNINGS STIRIPPING BY EXPATRIATED ENTITIES
- PREVENT REPATRIATION OF EARNINGS IN CERTAIN CROSS BORDER REORGANIZATIONS
- REPEAL 80/20 COMPANY RULES
- PREVENT THE AVOIDANCE OF DIVIDEND WITHHOLDING TAXES
- MODIFY TAX RULES FOR DUAL CAPACITY TAXPAYERS
- COMBAT UNDER-REPORTING OF INCOME

Analysis of Administration Proposals to "Reform" the International Tax System
2010 Americans for Tax Reform Foundation

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Analysis of Administration Proposals to "Reform the U.S. International Tax System"

With the current global financial downturn, now more than ever it is critical that we ensure American employers can compete in the world market.

Currently, American businesses are struggling under a crippling tax regime unparalleled anywhere else in the world. The United States has the highest federal corporate tax rate in the world, at a staggering 35 percent. This is almost 15 percent higher than the OECD average, and *more than double* the rate of high-growth economies like Switzerland and Ireland.

More insidiously, the U.S. is one of only a handful of countries to violate principles of national sovereignty and to tax *worldwide* income, forcing American businesses overseas to pay tax *twice.* Only the relatively low-taxing Korea, Mexico, Ireland and Poland continue to place such a burden on business. This system was recently abandoned as unworkable, unfair and harmful by the U.K., Canada and Japan. What this means is that our businesses overseas are forced to pay up to *twice* as much as their foreign competition. Not only is this grossly unfair, it means less profit for Americans employers, less money flowing into the U.S., and fewer jobs back at home.

Now the Obama Administration wants to make this even worse. Yet while the whole world is moving to a tax system based on *territoriality* (taxing income only once in the country it is earned) so their businesses can stay competitive, the Obama Administration wants us to do the exact opposite. They have proposed 11 tax hikes on American businesses overseas. While the technical details of these proposals are still missing, one thing is clear: rather than helping Americans, the Obama Administration has proposed a staggering $200 billion of tax hikes on American companies trying to compete in the world market.

At the end of the day, companies don't pay these double taxes – people do. If enacted, these changes will hurt all American families, through lower wages and higher prices at the store. For every worker employed by a U.S. subsidiary in a foreign country, 2.3 Americans are employed in the U.S. And these jobs are in very serious jeopardy if the Administration gets its way. If these changes are enacted, ultimately, businesses will be unable to cope with the burden of excessive taxation. They will shut their doors here, and move overseas. Workers will lose their jobs, economic growth will plummet, and living standards for all families will fall.

In order to restart the American economy, we need to urgently slash (or better yet, abolish) the unfair double tax on foreign earnings. We already have a successful model by which this can be done. In 2004, the Invest America act slashed the double tax on foreign earnings to 5.25 percent for 2005. A staggering $312 billion was brought back to the U.S. because of this, resulting in nearly $18 billion in new corporate income tax revenue. The Joint Committee on Taxation predicted that less than $3 billion in new revenue would be generated during the repatriation year—a six-fold difference. There are billions of dollars in foreign held revenue that could be injected to the U.S. economy *today* if this double tax is lifted. The Obama Administration's proposals do the exact opposite.

Starting on November 18th, Americans for Tax Reform Foundation will be publishing a semi-weekly International Tax Series, explaining each of the 11 proposals, and what they will do to American families if passed into law.

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Reform Business Entity Classification Rules For Foreign Entities

Current Law

Businesses are classified under "check the box" regulations. Foreign business with a single owner can *choose* to be treated either as a corporation, or as a "disregarded entity". In the case of a disregarded entity, the income of the entity is treated as the income of the owner, and revenue 'flows through' the entity to the owner, where it is taxed as income.

Proposed Change

The Obama budget abolishes 'check the box' and forces all foreign entities to be treated as corporations.

ATR Analysis

This proposal would completely abolish flow-through. As such, it would lead to significantly higher foreign taxes paid, and an increased burden on investment. It also removes flexibility and choice in corporate structure and financial planning, and denies persons the right to structure their finances as suits their needs.

Furthermore, this proposal may also lead to "double double" taxation: firstly, taxation on dividends paid and again as after tax corporate profits, and then double taxation by the country where a entity is located and also by the U.S. government.

This is a blatant tax-hike disguised in language of reform. If the Administration was serious about reforming international tax law, it would focus on abolishing our complex, burdensome and economically damaging system of 'worldwide taxation', and replace it with 'territorial taxation' – as is done in almost every other country. The current perverse system forces corporations into such arrangements to remain competitive. Punishing them with such changes will force many to close their doors, leading to lower long term revenue and job loses here at home. It is essential to address the root problem, and not continue with blatant tax grabs such as this.

10-year Revenue Estimate:

U.S Department of Treasury: $86.5 billion
Joint Committee on Taxation: $31.6 billion

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Americans For Tax Reform Foundation
Analysis of Administration Proposals to "Reform the U.S. International Tax System"
Defer Deduction of Expenses, Except R&E Expenses, Related to Deferred Income

Current Law

Taxpayers are able to deduct ordinary and necessary expenses incurred in carrying on business, both inside and outside the United States.

Proposed Change

This proposal will 'defer' deductions for all non research & development expenses, so that they cannot be claimed until the profits are 'repatriated' to the U.S.

ATR Analysis

The current tax-deduction rules stimulate investment and encourage economic growth. By forcing a 'deferral', and effectively forbidding taxpayers to deduct their expenses, the time-value of this money falls, and businesses will *lose* a significant percentage of allowable deductions.

For instance: Assuming a conservative inflation rate of 3-4% annually, deferral for only five years would wipe 20% off the value of the deduction. This does not even account for the problems attributed to the fact that the money could be better spent on opportunities presently – particularly in the current financial economic downturn when generating investment is critical.

For many taxpayers, this 'deferral' may mean they will *never* realize the deductions they are legally entitled to: **Deduction delayed is deduction denied.**

This proposal will burden business and hurt investment. It will cut company revenue, and lead to downsizing back at home, meaning slower economic growth and job losses at home.

10-year Revenue Estimate:

U.S. Department of Treasury: 60.1 billion
Joint Committee on Taxation: 51.5 billion

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Reform Foreign Tax Credit: Determine the Foreign Tax Credit on a Pooling Basis

Current Law

Under present law, foreign sourced income is taxed according to two separate categories: general and passive. While it differs slightly country by country, 'passive' income is income from capital gains, dividends, investments and so forth. 'General' income is all other income. General income is taxed at a considerably higher rate than passive income. Furthermore, the foreign tax credit is based on the tax rate paid in the actual country you are paying tax.

Proposed Change

Under the proposal, a U.S. taxpayer would determine its deemed paid foreign tax credit on an aggregated basis of all foreign taxes and earnings and profits of all foreign subsidiaries.

ATR Analysis

By aggregating the foreign tax credit across countries, subsidiaries in high tax countries will be substantially disadvantaged with an effective 'cap' being placed on their Federal Tax Credit rate – notably *below* what they would be entitled to.

It is notable that the Administration did not even provide a justification for this change. This is no more than a blatant grab for cash.

10-year Revenue Estimate:

U.S. Department of Treasury: 24.5 billion
Joint Committee on Taxation: 45.5 billion

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Prevent Splitting Of Foreign Income And Foreign Taxes

Current Law

In some situations involving hybrid arrangements, it is possible for a taxpayer to 'split' creditable foreign taxes from associated foreign income. As such, a tax credit could be allowed for foreign taxes on income not subject to U.S. federal income tax.

Proposed Change

This proposal would adopt a 'matching' rule to prevent the separation of creditable foreign taxes from the associated foreign income.

ATR Analysis

Superficially, this change makes sense. After all, why should a tax credit be given out for income not subject to tax? However, this change is *only* necessary *because* we have the most convoluted foreign tax system in the world.

As a principle of national sovereignty, a country should only govern what happens in its borders. And that means should only tax what occurs inside its borders. Yet we are one of only 5 countries that tax worldwide income. This means that we tax revenue made in other countries – even if they have *already* paid taxes there. The rest of the world has a territorial tax system – you only pay taxes for activity that happens inside your country.

What this system means is that U.S businesses are forced to pay taxes *twice*. Firstly, to the country where they do business, and then *again* to the U.S. taxman. To make matters worse, U.S. corporate taxes are the highest in the world! This means U.S companies are at a serious disadvantage to their foreign competitors who do not have this burden. In order to stay in business, many companies have created hybrid arrangements to ease the burden of big government. This is the only way they have been able to keep their doors open, and to continue helping the U.S economy.

This rule change does address one minor problem. But in doing so, it makes the whole situation worse.

If we want a flexible, fair and transparent corporate tax system, we must abandon this failed method of worldwide taxation, and follow the rest of the world in adopting a territoriality based system.

10-year Revenue Estimate:

U.S. Department of Treasury: $18.5 billion
Joint Committee on Taxation: $10.2 billion

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Analysis of Administration Proposals to "Reform the U.S. International Tax System"
Limit Shifting of Income Through Intangible Property Transfers

Current Law

Currently, if a U.S. taxpayer owns a company, they can give property they own to that company as a tax-free transaction. This applies not only to physical property, but also 'intangible' property, (for instance, intellectual property). It is up to the taxpayer to determine the monetary value of this property (which can later be challenged by the IRS)

Proposed Change

This proposal would a)issue specific definitions of intangible assets b)give the IRS power to value intangible property on an aggregate basis c)would set a 'highest and best use' value on the transfer.

ATR Analysis

While couched in the language of 'clarification', this is little more than a blatant power-grab by the IRS. Ultimately, this change will make the IRS the appraiser of intangible property in a business. It will give the IRS power to assign value, and *tell* a business what things are worth. If a business wants to challenge this, it will have to formally challenge the IRS. It will give the IRS power to 'aggregate' properties when it gives them a better result, force businesses to value property at its highest level, and would impose its own definitions on inter-business transfers.

If this was really about 'clarification', it would be revenue neutral. It is not. This is a clear grab for cash.

10-year Revenue Estimate:

U.S. Department of Treasury: $2.9billion
Joint Committee on Taxation: $1.0billion

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Analysis of Administration Proposals to "Reform the U.S. International Tax System"
Limit Earnings Stripping By Expatriated Entities

Current Law

Under current law, a debt-to equity 'safe harbor' provision (of up to 50%) exists to protect companies. This is a provision that reduces or eliminates a company's liability and protects them from IRS action, provided they act in good faith. If you stay within the 'safe harbor', you will not be pursued by the IRS. Furthermore, disallowed interest expenses may be carried forward for deductions in subsequent years, and the corporations' excess limitation for a tax year may also be carried forward to the three subsequent years.

The 'safe harbor' provision has two parts. Firstly, you must have a debt to equity ratio of less than 1.5 to 1. Secondly, you must have a net interest expense less than 50% of adjusted taxable income. If you are not within the safe harbor, the IRS assumes you are trying to shift income, and will deny deductions for interest. This has the effect of limiting the interest that can be deducted by a company.

Proposed Change

This proposal would eliminate the debt-to equity safe harbor, and would reduce the 50% adjusted taxable income threshold to 25%. The carryforward for 'disallowed interest' would be limited to 10 years, and the carryforward of excess limitation would be eliminated. This would significantly further limit the interest that can be deducted by a company.

ATRF Analysis

If enacted, this proposal would have two effects on top of raising the overall tax burden on businesses: 1)it would put the IRS in a position of determining how much debt/equity a company can hold, and 2)would interfere in the relationship between a stockholder and a company.

The effect of this would be to significantly punish debt-financing as opposed to share-financing, and in doing so significantly interferes with a business's ability to choose how to finance projects. This also significantly limits the ability of a company to pay interest to the owner/stockholders.

If passed, this would significantly interfere with fundamental business decisions made by a company.

10-year Revenue Estimate:

U.S. Department of Treasury: $1.2 billion
Joint Committee on Taxation: $1.25 billion

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Analysis of Administration Proposals to "Reform the U.S. International Tax System"

Prevent Repatriation Of Earnings In Certain Cross-border Reorganizations

Current Law

Under current law, American companies who sell goods and services overseas (with overseas subsidiaries) can reorganize themselves tax-free. If however they cash out on this, then some U.S. tax must be paid.

Proposed Change

This will impose an additional layer of taxation on the reorganization of U.S. companies' overseas operations.

ATR Analysis

This proposal is couched in complicated jargon and arcane tax-terms to hide a very simple fact: this is an unjustified, unfair, and unjust grab for cash by the IRS.

If passed, it will lead to the farcical situation of quadruple taxation. 1)The income used to purchase shares is already *after tax* 2)The subsidiary pays a foreign tax 3)the company pays US taxes 4)Now they will pay an additional tax on reorganization. This is just another burden on US companies selling goods and services overseas that they cannot afford.

10-year Revenue Estimate:

U.S. Department of Treasury: $297 million
Joint Committee on Taxation: $410 million

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Repeal 80/20 Company Rules

Current Law

Under current law, if at least 80% of a corporation's gross income during a 3 year period is foreign-source and attributable to the active conduct of a foreign trade or business, a foreign person does not have to pay withholding tax on its dividends or interest.

Proposed Change

This proposal would repeal the "80/20" provision.

ATR Analysis

This would vastly increase the scope of the IRS's power to 'withhold' a taxpayer's money and would extend withholding to foreign taxpayers who receive almost all their income from foreign activities.

Withholding leads to greater compliance costs for taxpayers, significantly greater burdens in recovery of taxes, depreciation of financial value of capital over time due to inflation, lost interest opportunities, and would also limit the flexibility of a taxpayer in spending his money at the appropriate time.

The only justification for this proposal is taken from Star Trek's First Ferengi Rule of Acquisition: "once you have their money, never give it back".

10-year Revenue Estimate:

U.S. Department of Treasury: $1.2 billion
Joint Committee on Taxation: $850 million

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Americans For Tax Reform Foundation
Analysis of Administration Proposals to "Reform the U.S. International Tax System"
Prevent the Avoidance of Dividend Withholding Taxes

Current Law

Foreign investors who hold stock in U.S. domestic corporations are generally subject to 30% withholding tax on dividends. Equity swaps, where a set of future cash flows are agreed to be exchanged between two parties at a future date, are generally treated as foreign-source payments that are not subject to U.S. withholding tax.

Furthermore, under IRS Notice 97-66, the problem of 'cascading withholding tax' is limited.

Proposed Change

Any income earned by foreign persons with respect to equity swaps referencing U.S. equities would be treated as U.S. source to the extent the income is attributable to dividends paid by a domestic corporation. Furthermore, the Treasury plans to revoke Notice 97-66, and replace it with "guidance"

ATRF Analysis

This proposal will allow the IRS to withhold tax, not just for actual income, but also on theoretical future non-realized income. It is a basic principle of sound tax policy that income should only be taxed when it is accumulated. If enacted, this will tax you for income you only *might* earn.

What's next – taxing you for the job you might get?

10-year Revenue Estimate:

U.S. Department of Treasury: $1.4 billion
Joint Committee on Taxation: $1.2 billion

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Modify the Tax Rules for Dual Capacity Taxpayers

Current Law

Under current law, a taxpayer may claim a credit against its U.S. tax liability for taxes paid to a foreign country. Taxpayers that are subject to a foreign levy and that also receive a specific benefit from the levying country are known as dual capacity taxpayers. In some cases, these taxpayer are entitled to claim this credit for a foreign levy, which is substantially equivalent to an income tax, even if it is not called as such. Currently we can claim a foreign tax credit for taxes paid in all countries.

Proposed Change

This proposal will mean dual capacity taxpayers can only treat a foreign levy (that would otherwise qualify as an income tax) as a creditable tax only if the foreign country imposes an income tax.

ATRF Analysis

This proposed change uses complex jargon for a very simple reason: it is a nonsensical grab for cash by the IRS with no underpinning logic whatsoever. Rationality would dictate that if there is a foreign levy equivalent to an income tax, then it should be treated as an income tax – irrespective of whether such a tax exists or not.

The end result of this change will be twofold. Firstly, it will place yet another tax on American employers seeking to trade abroad. Secondly, it will make it harder for US companies to do business in countries with no income tax, particularly developing countries. It will clearly put on the record that the U.S. only wants to do business in developed countries.

10-year Revenue Estimate:

U.S. Department of Treasury: $4.5 billion
Joint Committee on Taxation: $7.2 billion

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Combat Under-Reporting of Income Through Use of Accounts and Entities in Offshore Jurisdictions

Current Law

Under current law, foreign financial institutions can elect to become 'qualified intermediaries' – which mean they have entered into a withholding agreement with the IRS. Qualified Intermediaries (QI) can be treated as a payee to the extent they assume withholding responsibility.

Proposed Change

Under this proposal no foreign financial institution would qualify as a QI unless it identifies all of its account holders who are U.S. persons, and would be required to report all payments received to the IRS.

ATR Analysis

This is an Orwellian, Big Brother proposal to force foreign financial institutions to divulge private information to the IRS. It will allow the IRS to interfere in almost every financial transaction overseas.

Furthermore, by allowing the IRS to publish the list of Qualified Intermediaries, it intends to create a "whitelist" of foreign financial institutions, and create a stigma on those banks which value the privacy of their clients.

If the Administration is worried about people investing money overseas, there is a much simpler solution: make investing in the United States more attractive by reducing rates and simplifying our draconian tax law.

10-year Revenue Estimate:

U.S. Department of Treasury: $8.7 billion
Joint Committee on Taxation: $8.8 billion

Americans for Tax Reform Foundation (ATRF) is a 501(c)3 educational foundation that performs research and analysis in order to educate taxpayers on the true causes and effects of legislation and regulatory affairs. ATRF's efforts inform debate, initiate conversation, and emphasize the importance of fundamental tax reform and spending restraint. In turn, Americans for Tax Reform (ATR), a 501(c)4 nonprofit advocacy organization, uses this research and analysis to track initiatives.

Every day, ATR evaluates and weighs in on legislation that would negatively affect taxpayers and communicates those policy positions to all legislators through phone calls, letters, personal visits, emails, blog posts, and earned media. Additionally, ATR and ATRF have formed five special project lines to highlight and advocate free market solutions to challenges in the areas of property rights (Property Rights Alliance), shareholder advocacy (American Shareholders Association), telecommunications and network ownership (Media Freedom Project), workers' rights (Alliance for Worker Freedom), and transparency and government spending reduction (Center for Fiscal Accountability).

ATRF highlights the effects of tax policy and educates policymakers, analysts, center-right coalition members, the media, and other opinion-shapers about fundamental tax reform and the increasing burden on individuals and small businesses. ATRF does this by researching, producing and publicizing publications like the *Cost of Government Day*, the *International Property Rights Index*, and the *Index of Worker Freedom*.

The Cost of Government Day (COGD) is the date of the calendar year, counting from January 1, on which the average American has earned enough in cumulative gross income to pay for his or her share of government spending (total federal, state, and local) ***plus*** the cost of regulation. The International Property Rights Index (IPRI) is an international comparative study that aims to quantify the strength of property rights – both physical and intellectual – and to rank countries accordingly. The Index of Worker Freedom (IWF) serves as a national report card for labor issues. It is a state-by-state comparative study that measures the level of worker freedom by analyzing policy as well as quantitative state data.

ATRF also hosts an annual networking conference, the Pacific Rim Policy Exchange which provides a unique, centralized, high-quality forum for the open exchange of free-market ideas between policy advocates on both sides of the Pacific Ocean.

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