



Public Policy Alert

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Proposed International Tax Reform the Most Significant in Decades

Changes to international tax law proposed by the administration in May 2009 would, if enacted by Congress, represent the most significant international tax reform in several decades, affecting the foreign operations of every U.S. company doing business abroad.

Some Questions for Business Leaders

As organizations evaluate tax planning opportunities to address the potential implications of these tax proposals, they might consider such questions as:

- Have we calculated the possible incremental tax costs presented by the new proposals?
- Do we have substantial foreign earnings? Companies with operations in low-tax jurisdictions may find the proposed reforms costly and burdensome.
- Will the company's tax burden, and consequently net income/EPS, be adversely affected by the elimination of the "check-the-box" rules?
- Are we considering any global supply chain structure changes? These changes should be evaluated in light of the proposed reform.
- Have we evaluated how the legislation could affect our decision-making process relating to potential business combination?

Under existing U.S. tax rules, companies may defer paying taxes at rates as high as 35 percent on most types of foreign profits so long as that money remains invested overseas. The administration proposals are intended to reduce incentives to invest overseas so that companies would be more likely to invest in the United States.

The potential consequences of these proposals include a significant increase in the financial accounting and cash effective tax rates of affected companies, accompanied by a corresponding reduction in net income and earnings per share.

A number of U.S. multinationals have indicated opposition to the proposals, alleging that they will make U.S. jobs more expensive.¹

The administration proposed as a part of the tax proposals in its FY2010 budget three changes in the taxation

of foreign income that would affect the deferral issue. None of these proposals, if enacted, is intended to be effective until 2011, but the changes would be fundamental in nature. Consequently, a significant amount of lead time and planning may be required to consider the impact and mitigate potential adverse effects. CFOs and board members have an opportunity now to evaluate various "what if?" scenarios under the three proposals:

Proposal #1: Deferral of U.S. deductions allocated to foreign-source income.

This proposal would require companies to defer deductions for U.S.-incurred expenses that support foreign investment until foreign earnings are repatriated. The proposal affects deductions for expenses that are allocated and apportioned to foreign source income ("foreign related deductions"), such as interest expense, general and administrative expenses (but not research and development expenses), employee compensation, and foreign branch expenses.

Business Implications: If this proposal is enacted, the foreign investments of U.S. taxpayers could potentially be affected in two ways. Deferral may become a less valuable tax planning option, which would reduce the incentive for outbound foreign investments. In

¹ Donmoyer, Ryan J. "Ballmer Says Tax Would Move Microsoft Jobs Offshore (Update3)," Bloomberg.com, June 3, 2009 16:12 EDT.



contrast, however, the change might help preserve overall tax benefits in foreign tax planning. As part of preenactment planning, controlled foreign corporations (CFCs) and foreign branches might consider accelerating deferred active income into tax periods before, and defer deductions until tax periods after, the effective date of the legislation.

Proposal #2: Reform of foreign tax credit (FTC) rules through pooling. This proposal would prevent U.S. taxpayers from selectively repatriating earnings that have been subject to high foreign taxes. A U.S. taxpayer would be required to determine the aggregate foreign taxes and earnings and profits (E&P) of its foreign subsidiaries. Its FTC for a particular year would be based on the amount of aggregated E&P that is repatriated in that year. In conjunction with the above, this

provision also specifically prevents separation of foreign tax and income (e.g., through use of hybrid entities) by adopting a “matching rule.”

Business Implications: The interaction of this proposal with existing U.S. foreign tax credit rules is unclear, making preenactment planning challenging at this time.

Proposal #3: Modification of the “check-the-box” rules. This proposal would require certain foreign entities that were previously ignored for tax purposes to be classified as corporations.

Business Implications: If this proposal is enacted, existing U.S. global organizational structures, particularly those relating to supply chains and intellectual property (IP), could require significant changes. For example, separation of IP expense from

associated business operations may no longer generate overall tax deferral. Consequently, IP ownership in low-tax jurisdictions may not be as beneficial as under existing law.

The debate over these proposals is likely to continue for some time, but they are the beginning of a robust debate over tax policy. White House Press Secretary Robert Gibbs termed the proposals “‘a down payment on longer-term tax reform’ that the administration already is considering.”² This debate will take place during a period of increasing and arguably unsustainable budget deficits, where the need for new sources of income is acute.

Regardless of timing or the final rules, the potential implications of these proposals on an affected company’s bottom line will likely prompt forward-looking company management and board members to focus on them today.

² McKinnon, John D. “President’s Tax Proposal Riles Business,” *The Wall Street Journal*, May 5, 2009, page A3.