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President Obama's International Tax Reform Proposals

On May 4, 2009, President Obama promised to crack down on U.S. companies, that ship jobs overseas and avoid U.S. taxes with offshore havens by proposing a "robust portfolio" of IRS international tax compliance initiatives that would raise USD 210 billion over a 10-year period. The administration is proposing fundamental changes to the tax regime governing U.S. multinational corporations; in addition, it aims to "curb tax havens and replace tax advantages for creating jobs overseas with incentives to create them here at home." The proposals created a sense of panic among some of the IT/ ITES companies in India. Among others there was a desire to understand how the proposed legislation would affect the IT and BPO industries in India.

It should be kept in mind that all U.S. tax legislation must be passed by both the House and the Senate and be signed into law by the President in order to take effect. Washington observers also believe that international tax reform is likely to be considered as part of a larger tax reform effort expected to take place over the next two years. Some have speculated that some international tax reform proposals might be used to fund current health care reform efforts that may be agreed on this summer. In that case, we could see further activity on international tax reform this summer.

The said reform proposes four main international tax prongs that would raise USD 198B, and would generally be effective starting 2011.

Eliminate loopholes in the "check-the-box" rules

The 1997 check the box regulations facilitate foreign tax planning by allowing foreign corporations with a single owner to elect to be disregarded for U.S. tax purposes. Check-the-box enhances the opportunity for U.S. Corporations to defer U.S. tax on foreign earnings by allowing them to shift income among foreign subsidiaries without triggering U.S. anti deferral (subpart F) rules. U.S. Corporations have relied on these rules in structuring their business operations for nearly 13 years. These rules allow a U.S. Corporation to move its capital between its foreign affiliates, in a manner that minimises foreign tax liabilities of the U.S. Corporation.

Under the Administration's proposal, a foreign corporation with a single owner may be treated as a disregarded entity only if the owner is created or organised under the law of the same foreign country, under which the foreign corporation is

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created or organised. Except in cases of U.S. tax avoidance, the proposal would generally not apply to a foreign corporation directly wholly owned by a U.S. person. The Administration's proposal is designed to prevent the use of foreign disregarded entities to mitigate earnings to low-taxed jurisdictions while deferring U.S. tax on those earnings (i.e., avoiding the subpart F rules).

India perspective:

As Indian multinational companies rarely employ such disregarded entities, there should be little or no impact of the Administration's proposed rules on Indian Companies.

Domestic expenses related to deferred foreign earnings disallowed

The proposal would defer deductions for expenses, other than those for research and experimentation expenses; incurred by a U.S. Corporation to the extent the deductions are allocable to unrepatriated foreign earnings. Under the proposed legislation, deductions would first be divided between U.S. and deferred and currently taxed foreign source income using current expense allocation rules. Deductions allocated to foreign source income would then be split between deferred and currently taxed foreign source income based on the relative amounts of each. Expenses allocated to deferred foreign source income would be carried forward and could be claimed in a later year as deferred income is repatriated. The Administration's proposal is intended to prevent U.S. taxpayers from taking current deductions on their U.S. tax returns for expenses supporting foreign investments while deferring U.S. tax on the earnings attributable to those investments.

The defer deduction proposal appears to be similar to a provision in the proposed Tax Reduction and Reform Act of 2007, H.R. 3970 (the "Rangel Bill"), with the exception that the Rangel Bill also applied to research and experimentation expenses, whereas the Administration's proposal excludes research and experimentation. There has been some recent informal discussion that the provision ultimately may apply only to interest expense.

India perspective:

- **Multinationals Operating in India through its own Indian Subsidiary:** Under the proposal, U.S. multinationals having operations in India (or an in any other non-U.S. jurisdiction) would have to defer deductions associated with deferred foreign profits until the deferred profits are repatriated.
- **U.S. Company outsourcing its IT, ITES, R&D to unrelated Indian Company:** Expenses paid by a U.S. company for outsourcing to India would have to be deferred under the proposed legislation to the extent that those expenses were allocable to deferred foreign source income. To the extent the

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services performed in India support operations that generate U.S. source income, the associated deductions would not be subject to the proposed deferral regime.

- **Indian multinationals operating in U.S. through its own U.S. subsidiary, and carries out marketing activities for its Indian parent:** The provision is unlikely to affect the computation of the U.S. subsidiary's taxable income because it typically will not have a foreign subsidiary with deferred earnings.
- **Indian multinationals operate in the U.S through their own U.S. operating subsidiary, which out sources part activities to the Indian parent:** The Administration's proposal is unlikely to affect the computation of the U.S. subsidiary's taxable income because it typically will not have a foreign subsidiary.

Prevent abuse of Foreign Tax Credit (FTC)

Under the current law, a U.S. Corporation may choose to repatriate its foreign earnings from high tax rate jurisdiction and blend it with earnings from a low tax rate jurisdiction in order to claim a foreign tax credit that shelters those low taxed earnings from U.S. tax.

- The Administration proposes three main changes to prevent the determination of the foreign tax credit.

  1. A U.S. taxpayer would compute its deemed paid foreign tax credit on a consolidated basis by determining the aggregate foreign taxes and E&P of all of the controlled foreign subsidiaries that are repatriated to U.S. This proposal is similar to the Rangel Bill proposal, that the credit would be determined, in effect, as if all controlled foreign subsidiaries of a taxpayer were one single entity. In addition, it also will prevent a U.S. taxpayer from maximising the credit by repatriating only high-taxed foreign income, while deferring the repatriation of active business earnings in other foreign subsidiaries to relatively, low foreign tax jurisdiction.
  2. A matching rule would prevent the inappropriate separation of creditable foreign taxes from the associated foreign income in certain cases such as those involving hybrid arrangements.
  3. The third proposed change would modify the foreign tax credit rules for "dual capacity" taxpayers (e.g., oil companies) to allow foreign levies to be a creditable tax only if the foreign country generally imposes an income tax.

  The Administration's proposal appears to represent the most fundamental change to the foreign tax credit since the reforms of 1986.

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Tax Havens by Individuals

The Administration's proposal includes:

- Changes to the qualified intermediary (QI) program (requiring QIs to identify U.S. account holders and report payments received on behalf of U.S. account holders) and required withholding on all FDAP payments to any non QI).
- Increase in reporting requirements for certain foreign accounts, the establishment of offshore entities, and reporting by certain payers of rental income.
- Extension of the statute of limitations from three to six years after a taxpayer furnishes the information required to be reported, relating to information returns transfers, foreign entities, and foreign-owned entities.

The Administration's proposal on tax haven for individuals are similar to other recent international tax proposal by Senator Max Baucus and some of the provisions contained in legislation proposal of Senator Carl Levin to oppose tax haven abuse. The proposal for tax havens is currently not limited to certain listed countries as provided in earlier provisions.

India perspective:

There will be no impact of the Administration's proposed rules on Indian Companies.

On Monday, 11 May, 2009, the Obama Administration released additional details regarding the proposals that were originally announced in a general press release on 4 May, 2009. The additional details are outlined in the Treasury Department's so-called "Green Book" on the President's budget, which announces almost USD 70 billion in new revenue raisers. These new revenue-raising provisions are in addition to the USD 198.3 billion of international tax increases described in the President's original (and more generally worded) press release on 4 May, 2009. In addition, there are additional proposals affecting business that had not been previously identified.

Limit shifting of income through intangible property transfers:

The Administration's proposal will limit the ability of U.S. multinationals to shift income outside the U.S. through intangible property transfers. The definition of intangible property for purposes of the special rules relating to transfers of intangibles by a U.S. person to a foreign corporation, and the allocation of income and deductions among taxpayers would be expanded to prevent inappropriate shifting of income outside the United States.

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Tighten earning-stripping rule for expatriated entities:

The earning stripping rules that limit the deductibility of interest paid to related persons subject to low or no U.S. tax on that interest would be tightened as they apply to expatriated entities.

Prevent repatriation of earnings and profits in certain cross-border reorganisations:

The Administration's proposal would repeal the boot-within-gain rule, which has been utilised to reduce the U.S. tax on earnings and profits of foreign subsidiaries repatriated to the U.S. in a cross-border reorganisation.

Repeal 80/20 rules:

The Administration's proposal will repeal the 80/20 company rules, whereby an 80/20 company effectively treats certain dividends and interest paid by the company as foreign source; if at least 80 percent of the company's gross income over three years is foreign source.

Change withholding on certain equity swap payments:

Foreign persons earning income with respect to equity swaps that reference U.S. equities would be treated having income arising from U.S. sources to the extent that the income is attributable to (or calculated by reference to) dividends paid by a domestic corporation.

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in.kpmg.com

KPMG in India

Mumbai
KPMG House
Kamala Mills Compound
448, Senapati Bapat Marg
Lower Parel
Mumbai 400 013
Telephone: +91 22 3989 6000
Fax : +91 22 3983 6000

Delhi
Building No.10, Tower B,
8th Floor, DLF Cyber City,
Phase – II Gurgaon 122002
Haryana
Tel +91 124 3074000
Fax +91 124 2549101

Bangalore
Solitare, 139/26, 3rd Floor
11-12/1 Inner Ring Road
Koramangala
Bangalore 560 071
Telephone: +91 80 3980 6000
Fax: +91 80 3980 6999

Chennai
No 10 Mahatama Gandhi Road
Nungambakkam, Chennai 600 018
Telephone +91 44 3914 4000
Fax : +91 44 3914 5999

Hyderabad
8-2-618/2 Reliance Humsafar,
4th Floor, Road No. 11,
Banjara Hills,
Hyderabad 500 034
Telephone: +91 40 6630 5000
Fax: +91 40 6630 5299

Kolkata
Infinity Benchmark, Plot No. G-1,
10th floor, Block - EP & GP,
Sector - V, Salt Lake City
Kolkata 700091
Tel: +91 33 44034066
Fax: +91 33 4403 4199

Pune
703, 7th Floor, Godrej Castlemaine,
Next to Ruby Hall Clinic,
Bund Garden Road, Pune 411 001
Telephone : +91 20 3058 5764 / 65
Fax: +91 20 2605 0409

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