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Tax Provisions Compel U.S. Multinationals to Review Existing Business Structures

Recently enacted law makes significant changes to the U.S. foreign tax credit regime.

On August 10, 2010, President Obama signed legislation[1] that includes international tax provisions that may make it more difficult for some U.S. companies to repatriate earnings of foreign subsidiaries to the United States while maintaining their existing effective tax rate. The effective dates for the legislation may leave open the opportunity for some companies to take action before year-end to mitigate the near-term impact of the enacted rules.[2]

Companies will need to quickly evaluate these new rules to ascertain whether immediate remedial action would be appropriate. Without regard to the outcome of that evaluation, U.S.-based companies should discuss cash repatriation to the United States, assess the implications to offshore organization structures, and plan appropriate adjustments. These inquiries and activities may involve strategic business decisions that will require active oversight and consideration by corporate boards and executives. For example, the new law may change the criteria used to select where certain offshore functions should be located and how sourcing and shared service operations should be structured.

Business executives and boards might also use these changes as the occasion to ask whether they are receiving the information they need to adequately oversee tax risk, risk appetite models,[3] and the potential impact of the legislation on business strategies. The new tax provisions are potentially broad-reaching, and the consequences will be difficult to assess without appropriate data aggregation and reporting, oversight, and assessment processes.

Five Key Questions Business Leaders Should Be Asking:

1. Do we have substantial foreign earnings?
2. Have we determined the tax and financial impact of the changes on our current business structures?
3. Are we reexamining global supply chain or shared services strategies with a new tax provision lens?
4. Are we reviewing our current legal entity structure in light of the foreign tax credit changes?
5. Have we evaluated how this legislation, or previously enacted tax changes, will affect our decision-making process with respect to business expansion, acquisitions, and dispositions?

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[1] Public Law No: 111-226.

[2] Generally, the effective date of these provisions is taxable years beginning after August 10, 2010, taxable years beginning after December 31, 2010, or transactions after December 31, 2010.

[3] For more information on the appetite for risk, see What's Your Company's Risk Culture?, Farrell, John Michael and Hoon, Angela, directorship.com, April 15, 2009.

International Provisions Further the Government Agenda to Reform Tax Compliance

The foreign tax credit is designed to relieve taxpayers from being taxed on the same income by multiple countries or "double taxation". The changes to the foreign tax credit rules enacted this week stem from Congressional concern that U.S. multinationals are using the foreign tax credit regime to reduce U.S. tax in situations that do not give rise to double taxation.

Overview of Key Provisions Impacting the Foreign Tax Credit Regime

A number of the recently enacted international tax provisions tighten the rules on foreign tax credits that multinational companies can claim. The newly enacted law affecting foreign tax credit utilization (and, thus, the ability to repatriate cash to the United States tax efficiently) includes provisions that:

- Suspend use of foreign tax credits in situations in which foreign income remains offshore but related taxes are currently available as foreign tax credits to offset a U.S. taxpayer's other foreign source income
- Deny foreign tax credits with respect to income deemed not subject to U.S. tax by reason of certain asset acquisitions ("covered asset acquisitions" [4]). The new rules would disallow foreign tax credits attributable to additional depreciation or amortization deductions that are taken for U.S. tax purposes but not for foreign tax purposes
- Apply additional foreign tax credit limits to income items of certain foreign corporations and foreign branches of a U.S. taxpayer that are resourced under an income tax treaty
- Modify the affiliation rules for purposes of allocating interest expense between U.S. source income and foreign source income[5]

The law also includes three other provisions not specific to the U.S. foreign tax credit regime. One of the provisions, effective for tax years beginning after December 31, 2010, generally terminates the special sourcing rules for interest and dividends received from U.S. companies that generate most of their income from an active foreign business, with the result that the income will be subject to U.S. withholding tax.

A second provision, effective for acquisitions after August 10, 2010, would police a multistep transaction in which a

[4] An example of a covered asset acquisition includes a transaction treated as a stock sale under foreign law but as an asset sale under U.S. tax law.

[5] As a general rule, the foreign tax credit is limited to the U.S. companies' U.S. tax liability on its foreign source "taxable income" (as determined under U.S. tax principles). Interest expense allocation to foreign source income results in reduced foreign source taxable income; thus, creating a decreased amount of foreign tax credit that can offset the U.S. tax on offshore earnings repatriated (or deemed repatriated) to the United States

U.S. corporation (USCo) "sandwiched" between a foreign parent (FP) and foreign subsidiary (FSub) corporation would move FSub out-from-under USCo without incurring any U.S. tax cost.

The third provision provides some good news for U.S. companies. Specifically, it is a technical correction to a recently enacted law that extended indefinitely the statute of limitations for tax assessments where a U.S. company fails to comply with certain information reporting requirements related to its offshore activities.[6] The technical correction provides that, if the failure to furnish the required information was due to reasonable cause and not willful neglect, the extension of the statute of limitation only applies to the item(s) related to the compliance failure.

Considerations for Responding in the Near and Longer Term

Careful consideration of the business and financial consequences of the new law are necessary to understand and mitigate the impact of these provisions.

Selected Implications to Repatriating Cash Sources: For many U.S. multinationals, the changes to the foreign tax credit regime will result in a higher U.S. tax rate on amounts repatriated (or deemed repatriated) to the United States. U.S. companies with significant foreign investments and/or operations might consider their current and anticipated cash sources to determine the impact of the changes on their effective tax rate. Companies may also reexamine their models for non-U.S. product distribution, foreign portable income, and non-U.S. operating structures – including sourcing and shared service arrangements.

Looking at Legal Entity Structures and Operating Location Decisions through a New Tax Lens: In the nearterm, companies should assess whether the legal entity structure and the location of operating, sourcing, or shared services facilities continue to create anticipated business value. In particular, if foreign tax credits are significant criteria in deciding in which countries to operate, companies should carefully review the new

Tax Legislation Puts a Premium on Tax Planning

Seventy percent of executives polled by KPMG recently indicated concern that the uncertainty created by frequent regulatory changes was significantly affecting their long-term business planning. The recent tax legislation, when examined in the context of other policy changes, will add to this uncertainty and put a premium on those companies that are quickly able to move tax planning to the top of their agenda.

Gauging the Impact of Regulatory Reform, KPMG LLP, March 2010

6 The Hiring Incentives to Restore Employment (HIRE) Act modified Internal Revenue Code 6501(c)(8) to extend the statute of limitations for taxpayers who fail to provide information about certain transactions or foreign assets. Returns with this missing information could be held open for up to three years.

provisions. Further, companies may find that the existing legal entity structures are adding to the complexity of the analysis and may need to be simplified.

Possible Financial Reporting Implications: Companies will also need to consider the financial reporting ramifications of this new tax legislation, such as the determination of annual effective tax rates used for interim reporting, measurement of deferred tax assets and liabilities, evaluation of valuation allowances on deferred tax assets, appropriateness of assertions that earnings of foreign subsidiaries and joint ventures will be indefinitely reinvested overseas when applying the exception to recording deferred tax liabilities on those earnings, etc. The impact of changes in tax laws on current and deferred tax assets and liabilities at the August 10, 2010 enactment date of the legislation is recorded in the period that includes the enactment date (the quarter ended September 30, 2010 for calendar-year companies).

Mounting Uncertainty Drives the Need to Accelerate the Review of Business Structures and Risk Planning

The pace and complexity of new legislation and regulation is driving companies to reassess their processes for analyzing the composite impact of these changes. Companies are building competitive advantage by recalibrating and honing capabilities to assess quickly and respond to change. As tax reform continues to move forward, leading companies will put a renewed focus on assessing business structures and tax risk.