



## US Crackdown on Offshore Tax Abuse

President Obama's 2010 budget proposes further changes to US international tax rules to curb offshore tax planning that, in some cases, do not require the very public process of congressional approval. The proposals are a road map for potential changes of major import to both companies with cross-border operations and US individuals, including US citizens who live abroad but remain subject to US tax on worldwide income. Since taking office, President Obama has launched a number of initiatives designed to stop the use of offshore accounts or foreign entities by US persons to avoid the payment of US taxes. The recent budget proposals continue the trend; at least some of them are likely to be implemented and will further the tax system's complexity.

- **Check-the-box rules.** A significant proposal restricts the check-the-box rules for some foreign entities. For US federal tax purposes, any foreign entity that is not a per se corporation (listed in regulations and including a Canadian federal or provincial corporation) may check the box to elect US federal tax classification as a disregarded entity, a partnership, or a corporation. The change proposes that a foreign eligible entity with a single owner can elect disregarded entity status only if it and its owner were created under the law of the same country; otherwise, the entity is treated as a corporation for US federal tax purposes.

Exceptions apply, such as that for a first-tier foreign eligible entity wholly owned by a US person (and not deemed to have been created for US tax avoidance). The administration's goal is to require corporation-status treatment for some foreign eligible entities, and thus there is no impact on a foreign eligible entity that checked the box to be classified as a corporation. The proposal is much narrower than some anticipated. Unlike most of the budget proposals, however, the change does not require congressional approval to become law because the check-the-box rules are regulatory and not legislative. The check-the-box proposal could conceivably be implemented at any time and catch unawares many companies with cross-border structures that use the check-the-box rules.

- **Earnings-stripping limitations.** The earnings-stripping rules are designed to limit the amount of a corporation's US tax deductions for expenses (especially interest) on a debt obligation to a related party if the debtor's debt-to-equity ratio is more than 1.5:1 and the related party pays reduced or no US income tax on the interest's receipt (such as interest on a debt owing from a USco to a Canco). A related party's guarantee of debt owing to an unrelated party may also trigger the rules if the debt-to-equity ratio test is met. Currently, affected interest cannot exceed 50 percent of the corporation's adjusted taxable income (generally adjusted upward for net

interest expense, depreciation, and amortization), but a disallowed expense may be carried forward indefinitely.

Several proposals in Congress in recent years sought to broaden the earnings-stripping rules—for example, by reducing the adjusted taxable income limitation to 35 percent and by not allowing carryforwards. The new proposal is narrower than expected and applies only to certain expatriated entities. As defined (in Code section 7874), an expatriated entity is generally one into which a US parent company inverts and its top-tier position is thus assumed by a foreign parent as a result of the acquisition by the US parent's former shareholders of at least 60 percent of the foreign corporation's shares at the time it acquires the US parent. The inversion rules commence to apply to an expatriated entity at a 60-percent-plus inversion threshold, but are different for an 80 percent or more inversion. Cross-border mergers and acquisitions of US companies by foreign entities often trigger the expatriation entity rules, to the dismay and surprise of participants and tax planners.

The proposals limit the deductibility of the relevant interest only on related-party debt to 25 percent of an expatriated entity's adjusted taxable income. The carryforward for disallowed interest is also limited to 10 years. However, the proposals do not apply if a foreign parent is treated as a domestic corporation for US tax purposes because it undertook an 80 percent or greater inversion, presumably because it remains taxable on its worldwide income. One curious aspect of the proposal requires that section 7874, enacted in 2004, be read as if it applied to tax years beginning after July 10, 1989 when determining whether the proposal applies.

- **Foreign financial accounts and trusts.** A significant number of the budget initiatives are designed to combat US taxpayer abuses of offshore accounts and foreign trusts, and many enhance reporting requirements for foreign intermediaries that make payments to US citizens or US entities. These proposals are in large part aimed at compelling foreign financial institutions to report to the IRS the identity of and other information about their US account holders. The proposals are not surprising in light of the aggressive measures already taken by the administration against companies such as UBS and other financial institutions that refused to cooperate with US government demands for information about the accounts of US persons.

Taxpayers who have interests in foreign financial accounts or foreign trusts are also exposed to newly proposed initiatives, such as a significantly increased penalty on the understatement of income in an offshore account and a new minimum \$10,000 penalty for failure to make proper foreign trust reporting. The proposals also increase the limitation period from three to six years in some cases—for example, for certain information returns and tax return disclosures by taxpayers with foreign activities.

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