Proposed reform of the US business entity classification rules in the US

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In May, 2009, the President of the US issued his revenue proposals for the fiscal year 2010 ('2010 Proposals'). This article addresses one of the more critical ones: reform of the business entity classification rules (commonly referred to as 'check-the-box' rules or 'CTB').

Background

As a general rule, the income earned by a controlled foreign corporation ('CFC') in an active trade or business is not taxable in the US parent's hands until repatriated to the US. One would be hard pressed to find an issue with the policy of taxing pure passive income (i.e., income from portfolio investments) on a current basis but Subpart F went beyond the pure passive aspect. This is due, in part, to the outdated 50-year old principles underlying Subpart F. Today, the global economic environment is borderless.

With the exception of Brazil, the US stands alone in holding onto the policy of corporate worldwide taxation. There is no doubt that, when this policy is combined with the 2010 Proposals, the results will not be an increase in 'US job creation', an objective of the Obama Administration.

Reform of the CTB

In 1997, the CTB rules were introduced (under a Democrat Administration) to facilitate simplicity (minimised litigation prevalent under the so-called 'Kintner' regulations) and promote growth. Until the recent financial crisis occurred (which had nothing to do with these rules), the US experienced exponential growth.

The change being proposed by the Administration is as follows: "…a foreign eligible entity with a single owner that is organized or created in a country other than that of its single owner would be treated as a corporation for federal tax purposes." For example, if a CFC incorporated in Switzerland is the sole owner of a Netherlands BV ('BV') which is treated as a disregarded entity for US tax purposes, the BV would be treated as a CFC.

We will examine four major aspects with respect to the CTB rules: (i) financing; (ii) manufacturing and sales; (iii) dispositions; and (iv) foreign tax credits.

Financing

Currently, under Subpart F, where a CFC requires funding for its operations and such funding (in the form of debt) is received from another related CFC, the interest (ignoring the same country exception) paid by the borrower is treated as Subpart F income in the US-parent's hands. This provision is illogical in today's environment and utilising the entity classification rules to mitigate this should not be viewed as a 'loophole'.

The countries in which the foreign entities reside and operate will, invariably, have thin capitalisation rules, transfer pricing rules, and a withholding tax on interest. If it makes economic sense to redeploy cash where it is needed, why is the US impeding the competitiveness of its own enterprises?

The US has to look no further than its neighbour to the north, Canada, to see the higher burden a US enterprise faces. If a Canadian foreign affiliate finances another foreign affiliate and the borrower is engaged in an active trade or business (among other conditions), the interest received by the lender is characterised as active business income and not taxed in the Canadian parent's hands on a current basis. In addition, a dividend paid from the foreign 'financing' entity is not taxed in Canada.

Manufacturing and sales

While the entity classification rules may be seen as a 'loophole' by some, at times, some taxpayers found themselves caught in the manufacturing and sales branch rules of Subpart F. These rules are antiquated, create complexities (evidence the new contract manufacturing regulations) and, most importantly, impede competitiveness. The following example illustrates the impediment which can occur.

USCo manufactures and sells Product A worldwide. Competitor X is in Country X and it, too, manufactures and sells Product A worldwide. Further assume that the costs of production, shipping, etc., and selling prices are similar for USCo and Competitor X. Both USCo and Competitor X have been long-time competitors and both have manufacturing facilities outside of their respective countries.

Country X has a territorial taxation system vis-à-vis Competitor X's foreign operations while USCo has to contend and deal with the Subpart F rules.

Competitor X realises it can create a competitive advantage if it establishes a manufacturing operation in Country Y with a sales office in Country Z. The advantage which Company X wishes to exploit is expanding its market share by being closer to a new large market while exploiting USCo's vulnerable tax position arising from USCo's exposure to the outdated Subpart F rules. Nevertheless, USCo has no choice but to counteract.

Country Y's general tax rate for manufacturers is 15 percent while Country Z imposes a general tax rate of 10 percent. Assume the following: the unit price of Product A is $100 and there are costs of $50 ($40 for manufacturing and $10 for selling).

By the US potentially taxing all of USCo's income, in order to maintain the same net had the income not been taxed in the US, USCo needs to increase its selling price by approximately 40 percent while Competitor X can continue to sell at $100. Is this good policy? This will not create nor return jobs to the US.

Dispositions

Currently, if the stock of a CFC is sold, the gain is taxable in the US. However, all or a portion of the gain can be taxed as a dividend if the CFC has sufficient earnings and profits. On the other hand, a sale of assets used in an active trade or business by the CFC does not, as a general rule, create immediate taxation in the US. Thus, the importance of the role the CTB rules play.

At first blush, the immediate reaction is "that's why the CTB rules are a loophole and should be closed". However, this is misguided. Invariably, the foreign entity which is treated as a disregarded entity has certain contracts. These contracts cannot be assigned to another party where assets are sold. Thus, the value of purchasing only the underlying assets of the foreign entity, in the eyes of the purchaser, diminishes. As such, the stock of the foreign entity is sold while the sale is viewed as a sale of assets for US tax purposes. This is an economic win-win situation for both parties. Thus, why does the US view this result as a form of abuse or loophole? In many other countries, the gain on the sale of the stock of the foreign subsidiary is not even taxable in the ultimate parent's hands.

Foreign tax credits

A foreign tax credit is granted to the US parent for both the withholding tax on the distribution (dividend), if any, and the underlying taxes paid by the CFC in its home country. However, there is a limit on the number of tiers of CFCs from which foreign tax credits can be utilised (the limit is six).

For example, if there is one chain of seven CFCs, the taxes paid by the seventh CFC are not creditable in the US. As a result, double taxation arises. This was mitigated by using the CTB rules. The proposed changes in the rules may lead to significant double taxation since many groups could have more than six tiers.

For more information about the issues discussed in the above publication, or about US taxation in general, you can contact Marc Schwartz (marc.schwartz@corptax.org)