## **ENTITY CLASSIFICATION WORKING GROUP**

August 25, 2009

## TALKING POINTS—WHY THE OBAMA ADMINISTRATION'S "CHECK-THE-BOX" PROPOSAL IS THE WRONG PROPOSAL AT THE WRONG TIME

President Obama's budget includes a proposal to reverse regulations that simplified the entity classification rules (rules which are referred to as "check-the-box" because of the action required on the IRS form used to elect the classification of eligible business entities for Federal income tax purposes). The Clinton Administration created the check-the-box regulatory structure to simplify outmoded rules for classifying business operations. Basically, the Obama Administration's budget proposal would exclude many American companies with foreign subsidiaries from using this elective regime that now applies consistently in both the domestic and the foreign context. At the same time, the Administration has proposed two other major changes to the manner in which the United States taxes the active foreign business earnings of U.S. companies – the combined effect of these three proposals would be to dramatically curtail the application of the long-standing deferral rules to U.S.-based companies that derive active business earnings through foreign subsidiaries.

- ➤ <u>Use of Check-the-box is Not an Abuse:</u> Typically, U.S. companies may have tens or hundreds of subsidiaries doing business around the world, and some of those businesses may be established as subsidiaries of other subsidiaries.
  - Frequently, it makes sense to simplify this structure by classifying these foreign subsidiaries as branches similar to the tax treatment of pass-through entities as allowed by foreign and U.S. law.
  - Prior to the issuance of the check-the-box regulations, U.S. tax law required the application of a series of subjective tests in order to classify legal entities as subsidiary corporations or as branches.
  - Treatment as a branch whether under the current check-the-box rules or under the subjective tests of prior law means that the income of the entity is treated as if it were earned directly by the entity's owner; such income doesn't "disappear," as the Administration suggests, but rather is reported directly by the U.S. or foreign entity that owns the branch.
  - The ability to obtain this flow through treatment for tax purposes is by no means "abusive;" the result of the check-the-box rules is simplification, certainty, and the elimination of noncompetitive tax penalties for U.S. businesses operating in foreign markets.

## **➤** Here's What Check-the-box Achieves:

- Simplification and certainty—
  - The check-the-box regulations turned what was a subjective determination into an objective and relatively simple exercise that allows U.S. companies to greatly simplify their operating structures both in the United States and in

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- foreign countries, while eliminating the need for IRS resources devoted to entity classification determinations.
- Prior law's reliance on State or foreign law to determine the classification of a business entity created uncertainty that could be mitigated only by incurring the administrative burden and cost of obtaining an IRS ruling.
- The Internal Revenue Service benefits from check-the-box as well because it reduces the need to issue rulings or conduct audits relating to the entity classification question and reduces the number of controversies with taxpayers.
- Efficiencies in business operations and restructurings The check-the-box rules have developed into an important tool that allows global business operations to facilitate the movement of goods and services across borders, the reinvestment of profits where most needed to grow an investment, and the restructuring of business operations, without triggering a U.S. tax penalty.
- Foreign tax reduction The use of check-the-box to accomplish a mode of operating that reduces foreign tax liability improves the competitiveness of American businesses vis-à-vis foreign multinationals that are able to achieve the same results under the tax systems of their home countries.
- The Administration's Proposal Requires More Study. The Administration's proposal presents numerous issues for business operating structures that were put in place during the 12 years since the regulations came into effect, including:
  - A host of transition costs when U.S. companies are forced to unravel business structures that have made them more competitive in global markets;
  - The imposition of unanticipated new taxes on existing transactions of U.S. taxpayers that detrimentally relied on current law in structuring their operations outside the United States; and
  - Going forward, the imposition of a U.S. tax penalty on American companies conducting business and moving funds in the global economy, a penalty not suffered by foreign-based companies.
- Congress should delay consideration of all three of the Administration's major international tax proposals until it turns its attention to comprehensive tax reform legislation. Like the President's other anti-deferral proposals, the proposal to exclude most foreign subsidiaries from the check-the-box rules would increase the tax burden on American companies operating overseas and reduce their flexibility and competitiveness in the global marketplace.
  - The check-the-box regulations and other provisions targeted by the Administration are part-and-parcel of the current law rules that enable domestic corporations to compete against foreign-based companies that operate under very different international tax systems in their home countries and do not face the obstacles created by the U.S. international tax regime.
  - The goal of preserving the competitiveness of American companies relative to foreign corporations with which they compete would be ill-served by a piecemeal approach to international tax changes.