

ENTITY CLASSIFICATION WORKING GROUP

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THE OBAMA ADMINISTRATION'S "CHECK-THE-BOX" PROPOSAL

President Obama's budget includes a proposal to reverse regulations that simplified the rules for classifying business entities for Federal income tax purposes. The regulatory classification rules are referred to as "check-the-box" because of the action required on the IRS form that is used to elect the classification of eligible business entities. The White House has described the current rules as "loopholes" that "have allowed companies to make their foreign subsidiaries disappear for tax purposes – permitting them to legally shift income to tax havens and avoid paying taxes on their foreign profits in the United States or abroad."

The reality is the Clinton Administration created the check-the-box regulatory structure in order to simplify outdated rules for classifying business operations.

It is also important to note that "checked entities" do not "disappear" from the sight of the Internal Revenue Service because their activities must continue to be reported on information returns. Moreover, the earnings of these entities are reported on the tax returns of their owners.

The Obama budget proposal would exclude many American companies with foreign subsidiaries from using the elective entity classification treatment 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.

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

- ***Simplification and certainty***–
 - The check-the-box regulations turned what was a subjective determination into an objective and relatively simple exercise that

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allows U.S. companies to greatly simplify their operating structures both in the United States and in 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 as well because the check-the-box regulations reduce the number of controversies with taxpayers, as well as the need to issue rulings or conduct audits relating to the entity classification question.
 - ***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.
 - U.S. companies utilize the rules to redeploy their earnings outside the United States as business needs dictate, from businesses in one country to start-up or other operations in another country.
 - ***Foreign tax reduction*** – The use of check-the-box to accomplish a mode of operating that reduces foreign tax liability in high-tax jurisdictions 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.
- **Congress Should Delay Consideration of All Three of the Administration's Major International Tax Proposals Until it Turns to Comprehensive Tax Reform.**
- Like the President's other anti-deferral proposals, the proposal to exclude foreign subsidiaries from the check-the-box regime would increase the tax burden on American companies operating overseas and would reduce their flexibility and competitiveness in the global marketplace.
 - Check-the-box is an integral part 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 that do not face the obstacles created by the U.S. international tax regime.
 - Essentially, the current regulations permit a corporate parent to elect to treat a subsidiary as if it were a flow through entity. This rule applies to both domestic and non-U.S. subsidiaries.

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- To take a simple example of the operational efficiencies this elective treatment achieves, an American company can satisfy foreign law rules that require operation as a local corporation, and at the same time avoid triggering unwarranted U.S. tax costs.
 - Forcing U.S.-based companies to operate in corporate form rather than providing the flexibility to operate as flow-through entities imposes a barrier to the efficient flow of capital and the efficient structuring of operations – namely additional U.S. taxation – which foreign-based companies do not face.
 - The goal of preserving the competitiveness of American companies relative to foreign corporations with which they compete would be ill-served by a piece-meal approach to international tax changes.
- **The Clinton Treasury that Issued the Current Regulations Clearly Contemplated their Use in the International Context.**
- As described in the Preamble that accompanied publication of the regulations:

Treasury and the IRS believe that it is appropriate to replace the increasingly formalistic rules under the current regulations with a much simpler approach that generally is elective. To further simplify this area, the proposed regulations provide similar rules for organizations that have a single owner..... With respect to foreign organizations ... the distinctions are similarly formalistic, [a]ccordingly, the simplified system provided under the proposed regulations extends to foreign organizations as well....¹

In light of the increased flexibility under an elective regime for the creation of organizations classified as partnerships, the Treasury Department and the IRS will continue to monitor carefully the uses of partnerships in the international context and will issue appropriate substantive guidance when partnerships are used to achieve results that are inconsistent with the policies and rules of particular Code provisions or of U.S. tax treaties.

- **The Application of Check-the-box Should Not be Changed until Congress Can Undertake a Comprehensive Update to Subpart F that Takes into Account Contemporary Global Business Practices.**

¹ See Preamble to the proposed regulations relating to “Simplification of Entity Classification Rules, 61 FR 21989 (May 13, 1996).

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- Subpart F was created in 1962 when U.S. businesses expanded “one country at a time.” Much of current law still bears the imprint of this 1962 legacy.
 - The rules of Subpart F are ill-equipped for the current global business environment, and can often constrain U.S. corporations from deploying their business capital in the most efficient manner.
 - The world has changed dramatically in the last 47 years – globalization requires companies that operate around the world to rationalize their manufacturing, distribution, financing, IT & management infrastructures across multiple countries, essentially operating one business across numerous jurisdictional boundaries.
 - The check-the-box rules equip U.S. companies with a planning tool that allows them to operate in an efficient and economically viable manner by mitigating some of the outmoded and anti-competitive aspects of Subpart F.
- **Additional Study is Needed to Determine Whether there are Transactions that Should be Curtailed, and if such Transactions are Identified, to Develop a Measured Response.**
- As noted in the preamble to the proposed check-the-box regulations, the Clinton Treasury advocated the approach of “careful monitoring” and then issuing “appropriate substantive guidance” if it determined that the rules are being used to achieve results that are “inconsistent with the policies and rules of particular Code provisions or of U.S. tax treaties.
 - The current Administration has itself determined the need for exceptions that were not included in earlier versions of this proposal,² and therefore have proposed to continue application of the current regulations in circumstances involving entities in the same country and certain entities directly owned by U.S. companies.
 - The Clinton-era regulations were a “gloss” on the pre-existing body of law that was established by Federal court cases calling for highly subjective factual determinations.
 - Thus, the proposal would simply reverse the Administrative simplification achieved by the current regulations, while complicating non-abusive restructuring, financing, and other business transactions that are now accomplished with relative ease.

² A proposal that excluded foreign subsidiary corporations from the “check the box” rules was included in “Options to Improve Tax compliance and Reform Tax Expenditures,” published in 2005 by the staff of the Joint Committee on Taxation, and in a Senate bill (S. 3162) introduced by Senator Voinovich in 2008.

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- Also, the Administration's proposal presents numerous issues for transactions that were consummated 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.

- **It is Also Important to Understand the Connection Between Check-the-Box and Subpart F Look-Through.**
 - In 2006, Congress passed the Subpart F look-through-rule to permit interest, dividends, rents, and royalties to be paid out of the active business earnings of subsidiaries in one country to subsidiaries in another without triggering current U.S. tax, as if the payor subsidiaries were flow-through activities of the subsidiaries in the other countries.
 - The Subpart F look-through rule is an expiring provision. The Administration's budget would extend the rule for only one more year, through 2010.
 - Although the look-through rule is a substitute for the check-the-box regime in many cases, in other cases it facilitates the redeployment of capital or other business planning when use of the check-the-box regime is not possible. Moreover, until the look-through rule is made permanent, it will not provide the certainty and simplification – for both taxpayers and the IRS – that is available through the check-the-box rules.