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President Obama's Foreign Tax Proposals: An Impact on Shipping? By Marc Orlofsky, J.D., MSPC Certified Public Accountants and Advisors

This note considers the impact of President Obama's foreign tax proposals on the international marine industry.

Foreign Tax Proposals:

The good news here is that international shipping companies can essentially sail through these proposals unscathed. Sections 883 and 887 are not directly impacted by any of the proposals. To understand the potential impact of the Obama foreign tax proposals, we need to divide the universe of foreign shipping corporations subject to section 883 into two groups: those owned by non-US persons (and without ownership in other US entities) and those that are majority owned by a US parent or US shareholders, collectively referred to as controlled foreign corporations or CFCs, and subject to special rules.

Foreign owned shipping companies

Foreign owned shipping corporations are the ones that we commonly see in our practice. Such shipping companies will be totally shielded from the impact of the Obama proposals, except for the potential of increased IRS scrutiny that all foreign filers will face due to a proposed increase in international tax enforcement. One Obama proposal is to hire 800 new international employees. This initiative is in addition to the existing IRS program that has increased international audits. However, foreign owned foreign corporations that properly claim section 883, treaty benefits or the 4% tax of section 887 for international shipping income have nothing to fear, other than the potential nuisance and cost of additional IRS correspondence or audits.

CFC Shipping companies with US parent corporation

With respect to CFC's owned by US parent corporations, as already noted, there is no proposed change in their exclusion claims under section 883, or the 4% tax under section 887. However, in limited situations, if the CFC shipping company or its US parent engages in certain tax structuring transactions, then it is possible that some of the Obama proposals may impact the group. This is in addition to the increased risk of international tax audits due to the increase in auditors under the Obama proposal or pursuant to the existing IRS program of increased international audits. The key Obama proposals with potential application to CFC's are analyzed below.

Limitation on foreign source losses except for R&D

One Obama proposal that has attracted a great deal of attention concerns the situation where a US parent incurs substantial current deductions allocable to its CFC, such as for interest and

other business deductions, even though it does not receive equal current foreign source income. Under current law, a US parent may generate current US tax savings on such foreign source losses. The Obama proposal will defer such foreign losses until there is offsetting foreign source income. However, the proposal provides an exception that allows foreign source loss for research and development expenses allocable to the CFC. This provision will be of consequence for those US corporations that are actively involved in the development of the CFC's business, or where the US parent has substantial acquisition indebtedness incident to the purchase of the CFC. The application of this provision to the shipping industry would probably be minimal, unless there was such acquisition debt that generated a foreign source loss.

Foreign tax credit limitations

Three of the Obama proposals relate to perceived abuses with respect to the computation of current foreign tax credits by US parent corporations with respect to their foreign subsidiaries. None are likely to be of much relevance to the shipping companies unless they are part of a US parent group that engaged in the targeted activities. One proposal is designed to limit the U.S. parent's ability to maximize its use of deemed foreign tax credits when subsidiaries are subject to differing foreign tax percentages on their foreign source income. Current law allows a US parent to "cross credit" its deemed foreign taxes paid by various subsidiaries which means applying a higher percentage foreign tax credit against foreign source income from a lower taxed jurisdiction. Another esoteric foreign tax issue arises with respect to "hybrid" arrangements that again do not directly impact foreign shipping companies. Briefly, if a US parent corporation owns a foreign entity that is disregarded for US tax purposes, but recognized for foreign law purposes, the foreign entity is a "hybrid", and the assets of the hybrid are viewed as owned by the US parent. In a 2007 court decision, a hybrid foreign entity owned other foreign corporations (that were not disregarded), and a consolidated foreign return was filed. Under foreign law the tax was imposed on the hybrid foreign corporation, or in other words on the US parent. The court held the US parent was allowed to claim the foreign tax credit, even though there was no current US taxation on the foreign source income of the foreign subsidiaries. Similar issues may arise in connection with "hybrid" instruments between related parties. The Obama proposal would prevent the separation of the tax credit and the foreign source income. Unless a shipping CFC was part of a group that sailed in such choppy waters, this proposal would not create any headwinds. Finally, under a third Obama proposal, US oil and gas companies treated as dual capacity taxpayers (taxable in US and foreign country) would not be able to claim a US foreign tax credit for certain foreign oil or gas exactions unless the foreign county imposed an income tax on business income of nationals or residents of that country. Obviously, this is not relevant to shipping companies.

Transfers of intangibles

Transfers of intangibles between US and related foreign corporations are subject to special arm's length rules in section 482 and generate US taxation for such "outbound" transfers under section 367(d). In order to maximize the US tax on such transactions, an Obama foreign tax proposal will clarify or redefine "intangibles" subject to taxation so as to include good will, going concern, and workforce in place. In addition, such intangibles may be valued on an aggregate basis at its highest and best uses. This proposal is unlikely to impact foreign shipping companies unless there has been a transfer of intangibles from the US parent.

Avoiding Subpart F with a disregarded entity

Section 883 is only available to a foreign *corporation* that is exempt from local foreign income taxation on its shipping income. Thus, disregarding the corporate existence of the CFC shipping company would not accomplish any tax savings. However, suppose the shipping CFC owned two foreign subsidiaries: one in Germany that operated a factory and another in a tax haven. If the tax haven subsidiary lent money to the German subsidiary, the interest payment could save German tax, and the interest income would normally be taxed to the US parent as Subpart F passive income from the tax haven subsidiary. If the two subsidiaries were disregarded for US tax purposes (but still regarded for foreign law purposes), the lending transaction would be

disregarded for US tax purposes, and Subpart F income would be eliminated, even though German taxes could still be saved because of the interest payment. A key Obama proposal would preclude the "check the box election" in such a case. Therefore the subsidiaries would remain corporations for US tax purposes, and Subpart F passive interest income would flow through to the US parent. Although not discussed in the Obama explanations set forth in the "Greenbook", this proposal would also presumably ban a related technique sanctioned by the US Tax Court in its 2004 decision in *Dover Corp. v. Commissioner*. In that case, by checking the box before the sale of stock in a foreign subsidiary by its foreign parent, the transaction was viewed as a sale of assets not subject to Subpart F income pass through to the US parent, whereas a sale of stock would have generated Subpart F income. However, as noted this provision does not directly impact shipping companies, unless they or their US parent was engaged in such deep-sea diving tactics.

Miscellaneous

There are some additional foreign tax proposals that are interesting but not even indirectly relevant and are not discussed here. They include proposals to limit interest deductible by expatriated US companies, maximize tax in cross border reorganizations where "boot" is present, repeal the 80/20 company rules for domestic companies paying interest or dividends to foreign persons, and increase compliance and enforcement of US and certain foreign investors in offshore accounts. Further study will be required to see if the latter provision has any impact on investors in a foreign shipping company.

Conclusion

This review of the key Obama foreign tax proposals demonstrates that foreign shipping companies are not directly impacted by these proposals, and the section 883 exclusion and the 4% tax in section 887 remain untouched.

(About the Author: Marc S. Orlofsky holds his JD, and is currently employed by MSPC, NYC. He was formerly a law clerk in the US Tax Court, a Research Fellow at Yale Law School, Assistant Professor of Tax Law at Hofstra Law School, a tax associate at Proskauer Rose, a partner in a small New York City law firm, and a solo tax practitioner. Marc is a member of ABA and NYS tax committees.)

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