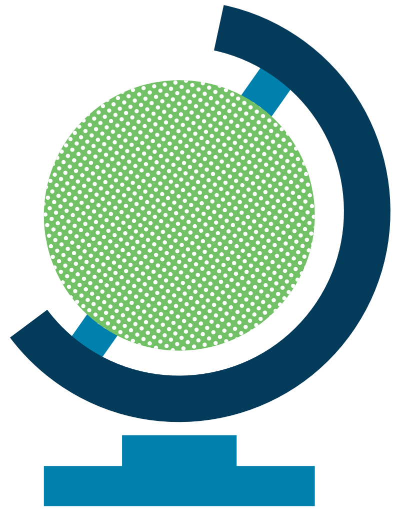

INTERNATIONAL TIDBIT:

New Territory for U.S. Tax System

UHY's 2012 Fall Tax Forum was held on November 8, just two days after the election. While much of the focus was on the Fiscal Cliff and the scheduled expiration of tax cuts, the discussion of international tax zeroed in on various proposals to shift the U.S. from a worldwide to a territorial system of taxation.

Among others, the House Ways and Means Committee circulated a proposal last year containing some specific suggestions and eliciting comments. The Fiscal Commission Report issued in 2010 also suggested consideration of a switch to a territorial tax system. The President's proposals, including those made in the course of the campaign, would keep the current worldwide system but reduce the maximum corporate tax rate to 28% (25% for active manufacturing). From these, we offer some FAQs on how a territorial system could work.

WHAT TYPE OF SYSTEM DOES THE U.S. HAVE NOW?

The U.S. has a worldwide system of taxation. U.S. corporations are taxable on their worldwide income with a credit available for corporate income taxes paid in other countries, whether by partnerships and foreign branches, or by subsidiaries owned at least 10% by a U.S. corporation. Coupled with this is the privilege of deferral, meaning that U.S. shareholders of foreign corporations may defer income and tax until such time as dividends are received from those corporations. However, that privilege does not apply to certain types of income earned by a controlled foreign corporation ("CFC"), such as passive income and income from sales involving related parties.

HOW WOULD THE PROPOSED TERRITORIAL SYSTEM OPERATE DIFFERENTLY FROM THE CURRENT WORLDWIDE SYSTEM?

A territorial system is based on the premise that tax should be paid where economic activity is based. In a "pure" territorial system, this would mean that a U.S. corporation would be taxed on income from its economic activities in the U.S. Its foreign subsidiaries would still be subject to tax in the country or countries where they operate but the U.S. parent would not be taxable on their income. When dividends are paid to the U.S. parent, these dividends would be exempt from tax using what is termed a "participation exemption." Typically, this involves requiring a certain minimum participation or percentage share ownership in a foreign subsidiary in order for dividends from it to be exempt from tax. In some cases a portion of the dividend remains taxable, as in the approach taken in the Ways and Means Committee's proposal, where 95% of the dividend income from a CFC would be exempt from U.S. tax but 5% would be taxable. That 5% would be treated as U.S. source income, meaning that no foreign tax credits from the foreign subsidiary could be used to offset U.S. corporate income tax. Similar rules would apply to foreign partnerships while foreign branches would be treated as wholly-owned corporations for these purposes. Gains from the sale of CFCs would also be eligible for the participation exemption.

IT SOUNDS LIKE THE TERRITORIAL SYSTEM MIGHT STILL ENCOURAGE COMPANIES TO BUILD UP EARNINGS OFFSHORE?

The proposals include something similar to the "general anti-abuse rule" that many of our trading partners have. Like our current Subpart F provisions, passive income of CFCs would continue to be subject to tax currently as if dividends had been paid to U.S. shareholders, but this income would not be eligible for any participation exemption. Some of the proposals also include an end to deferral of income earned by CFCs in low-tax jurisdictions and from the exploitation of intangible property. This reflects concerns that U.S.-based technology companies develop valuable intangible property in the U.S. and then transfer it offshore for exploitation in low-tax jurisdictions where earnings build up outside the U.S. tax net. Whether a territorial tax system will encourage U.S. corporations with active business earnings to repatriate those funds has been the subject of much speculation, particularly if the U.S. corporate tax rates are not reduced to a level closer to the OECD average of 25.1%. Part of the answer may depend on the transition rules adopted as part of the shift from a worldwide to a territorial system of taxation.

HOW WOULD A TERRITORIAL SYSTEM IMPACT INDIVIDUALS WHO MAY OWN SHARES OF A FOREIGN CORPORATION DIRECTLY OR THROUGH A FLOW-THROUGH TAX STRUCTURE INVOLVING AN S CORPORATION, PARTNERSHIP OR LIMITED LIABILITY COMPANY?

The participation exemption described above would only be available to U.S. corporations that are shareholders in CFCs. Presumably, the current worldwide system of taxation would still apply to individuals. This could be a disadvantage for U.S. individuals who receive dividends from foreign corporations or who might have a capital gain from the sale of shares of a CFC with a portion of that gain recharacterized as ordinary income (dividend) under IRC §1248. The provisions covering "qualified dividend income" from foreign corporations resident in certain countries with which the U.S. has a double taxation treaty, and which satisfy other conditions, are scheduled to expire on December 31, 2012. If these provisions are not extended, a dividend that would have been eligible for the preferential tax rate of 15% would be taxed at ordinary income rates, scheduled to increase to 39.6% if tax cuts expire. Therefore, even though a switch to a territorial tax system would not change the way individuals are taxed on dividends from foreign corporations, other changes in tax rules could have a profound impact on the effective tax rate attributable to income from those investments.