International Tax Developments TEI

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Agenda

- Legislative Update
- Potential repeal of boot within gain rule
- Covered asset acquisitions – Section 338 elections are not dead
- Fragmented basis
- LB&I Directive on Assertion of Economic Substance Doctrine and Penalty (LB&I-4-0711-015)
- Dual consolidated loss – IRS GLAM
- Treaty Update – Hungary, Switzerland, and Luxembourg
- Section 1441 withholding & reporting

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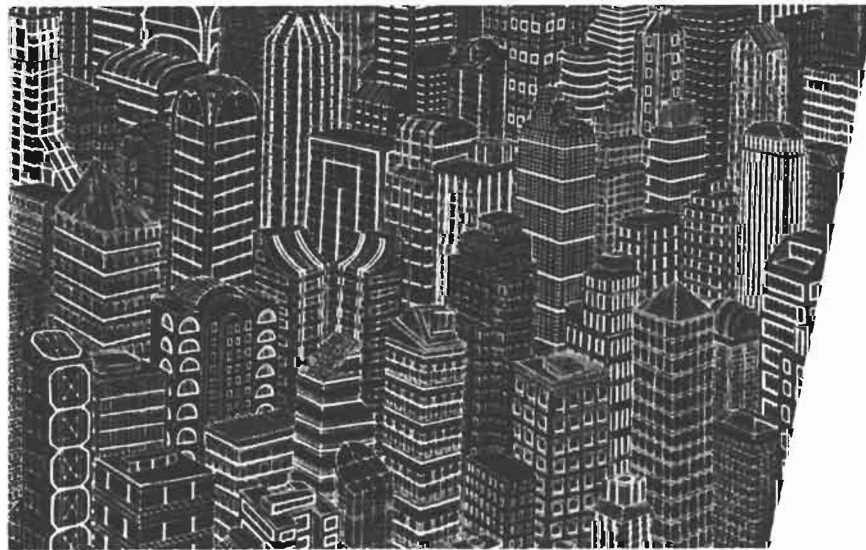
Legislative Update



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Section 1441 compliance is a Tier I issue

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Repatriation

- New JCT staff revenue estimates for temporary repatriation holiday proposals have recently been made public.
  - Over the 10-year budget window, the JCT staff concluded that a 70% elective temporary dividends received deduction ("DRD") for repatriated earnings would lose $41.7 billion, while an 85% elective temporary DRD would lose $78.7 billion. The new estimates represent significant increases from prior published estimates of such proposals.
- The most recent legislative proposal on repatriation, introduced in the House of Representatives on May 11, 2011 by Representative Brady (R-TX) and five co-sponsors, would allow an elective 85% DRD for either 2011 or 2012, which would yield a maximum tax rate of 5.25 percent.
  - The reduced rate would apply only to earnings above what the company brings back on average and there would not be any restrictions on how the money could be used.
  - However, any company that reduces its average employment level in the United States in the two-year period beginning with the month of the first distribution under the repatriation holiday would be subject to a gross income inclusion of $25,000 per employee reduced as a penalty for the reduction.

International Tax Reform
House Ways and Means Committee Hearings

- On May 12, 2011, four CFOs from major US multinationals (UTC, Caterpillar, Zimmer, and Kimberly-Clark) testified in favor of a lower US corporate tax rate and a switch to a territorial tax system.
  - When asked which tax expenditures they would be willing to give up in exchange for a reduced rate, each of the witnesses indicated that any tax expenditure "could be on the table," given a low enough rate.
    - If all tax expenditures were eliminated, the witnesses agreed that they would expect a tax rate in the mid-20s.
  - The witnesses encouraged a focus on the international tax system choices made by US trading partners.
  - The witnesses further agreed that they would not favor a stand-alone repatriation holiday (outside of the context of comprehensive tax reform) to allow companies to bring foreign earnings back to the United States at a reduced tax rate.
    - Some of the witnesses testified that a repatriation holiday could be a distraction from the goal of comprehensive international tax reform.

International Tax Reform
House Ways and Means Committee Hearings

- In a follow-up international tax reform hearing on May 24, 2011, the Committee heard testimony from experts on the tax systems of four countries with territorial or exemption systems (Germany, Japan, the Netherlands, and the UK).
  - The witnesses provided written testimony describing the details of their countries' territorial systems.
  - The witnesses said the international tax systems in their countries were adopted out of a desire to make their domestic companies more competitive with foreign-based companies.
    - Although the witnesses generally were disinclined to suggest what the United States *should* do with its international tax system, some opined that the United States would likely benefit from a move to a territorial system.
  - Committee members opposed to a territorial system voiced their concerns about income shifting and transfer pricing pressure associated with a territorial system; they also tried to draw a link between a territorial system with a low rate and the presence of a VAT.

International Tax Reform
House Ways and Means Committee Hearings

- Among the witnesses at the May 24 hearing were Ernst & Young partners Frank Schoon and Jörg Menger.
  - Mr. Schoon described the participation exemption regime in the Netherlands (where corporate tax rates have been lowered significantly over the past 30 years) as well as the "innovation box" regime that allows earnings from intellectual property to be taxed at an effective rate as low as 5%.
  - Mr. Menger described the German tax system, which employs a dividend exemption mechanism under which 95% of dividends received by a corporation are exempted. The taxable portion of the dividend serves as a proxy for expense disallowance rules, which were the source of controversy under prior law.
  - Schoon and Menger said that the Netherlands and Germany made capital import neutrality and competitiveness priorities in designing their tax systems.

S. 1346 / H.R. 2669
The Stop Tax Haven Abuse Act

- The Stop Tax Haven Abuse Act was introduced in the Senate on 14 July 2011 by Senator Levin (D-MI), along with five co-sponsors, and in the House of Representatives on 27 July 2011 by Representative Doggett (D-TX), along with 53 co-sponsors.
  - Similar to S. 506 and H.R. 1265, bills with the same name introduced by Senator Levin, Representative Doggett, and others in 2009.
  - Does not include the proposal included in the 2009 bill that would have established a list of "offshore secrecy jurisdictions."
  - Repeats provisions from the 2009 bill that are intended to "crack down" on tax shelters.

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S. 1346 / H.R. 2669
The Stop Tax Haven Abuse Act

- Some highlights of the bill include:
  - Managed and controlled test for treatment as a domestic corporation
    - Language of proposal is the same as 2009 language
  - Rules that would require SEC reporting of company financial information on a country-by-country basis
  - Provision that would treat funds deposited in a U.S. bank account by or on behalf of a CFC as a constructive distribution to its U.S. shareholder for purposes of subpart F
  - Rules that would treat outbound credit default swap payments as U.S. source income subject to withholding tax
  - Modifications to specific rules within the FATCA provisions
  - Provisions authorizing special measures against foreign jurisdictions, financial institutions, and others that impede U.S. tax enforcement

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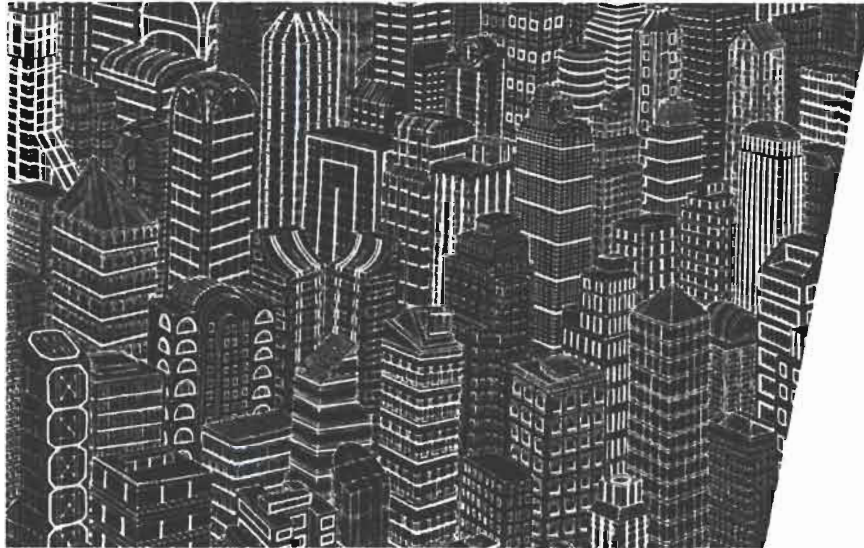
Potential Repeal of Boot-within-gain Limitation



Repeal of boot within gain limitation

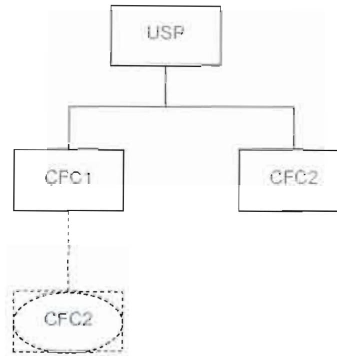
Overview

- Proposal to repeal the boot-within-gain limitation in the case of any reorganization
  - Included among the Obama Administration's FY 2012 Budget proposals and in bills introduced in both chambers of Congress.
    - Introduced in the House by Representative Doggett (D-TX) (H.R. 62) and in the Senate by Senator Rockefeller (D-WV) (S. 1373).
  - Would amend section 356(a)(2) to treat all boot as a dividend in any reorganization in which the US shareholder's exchange has the effect of the distribution of a dividend.
    - A determination as to whether boot has the effect of a dividend is made under the rules of section 302.
  - Adds a rule that sources any dividend in the case of a reorganization under section 368(a)(1)(D) under the rules of section 304(b)(2).
    - Regulatory authority is also granted to include other reorganizations within this provision.

Repeal of boot within gain limitation
Illustrative example

Facts:

- USP owns all stock of CFC1 and CFC2.
- CFC 1 has low taxed E&P and current excess cash.
- CFC2 has high-taxed E&P and a built-in-gain.
- Pursuant to an integrated plan, CFC1 purchases all stock of CFC2 from USP for cash and stock and a CTB election is made to treat CFC2 as a disregarded entity for US federal income tax purposes. The cash consideration is equal to the amount of the built-in gain in the CFC2 stock.



Consequences:

- Rev. Rul. 2004-83 treats transaction as a section 368(a)(1)(D) reorganization.
- Cash received by USP is dividend to extent the E&P of CFC1 and then to the extent of the E&P of CFC2.

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Covered Asset Transaction – Section 338 Elections Are Not Dead

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Covered asset acquisitions
Overview

- General provision
  - Foreign tax credits are disallowed for a portion of foreign income tax attributable to income from foreign assets acquired in a "covered asset acquisition"
- "Covered asset acquisitions" are:
  - Qualified stock purchases to which section 338(a) applies
  - Transactions which are treated as acquisitions of assets for US tax purposes and as acquisitions of stock (or are disregarded) for foreign tax purposes
  - Acquisitions of partnership interests (where the partnership has a section 754 election in effect)
  - Any other similar transaction
- Disqualified portion equals:

$$\frac{\text{Aggregate basis differences allocable to such taxable year with respect to all relevant foreign assets}}{\text{Income on which the foreign income tax is determined}}$$

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Covered asset acquisitions
Overview

- "Basis difference" means, with respect to any relevant foreign asset:
  - The excess of (1) the adjusted basis of such asset immediately after the covered asset acquisition, over (2) the adjusted basis of such asset immediately before the covered asset acquisition
    - US tax basis
    - Allocate basis difference to a taxable year using the applicable cost recovery method under US tax rules
- "Relevant foreign asset" means, with respect to any covered asset acquisition, an asset only if any income, deduction, gain, or loss attributable to such asset is taken into account in determining foreign income tax in the relevant jurisdiction
- Disallowed foreign taxes still allowed as a deduction for E&P purposes
  - Amortization related to a covered asset acquisition also still allowed as a deduction for E&P purposes

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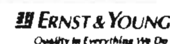


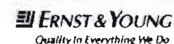
Covered asset acquisitions
Overview

- Effective date
  - Generally applies to covered asset acquisitions after 31 December 2010
- Grandfather rule
  - Provision does not apply to any covered asset acquisition involving unrelated parties if such acquisition is:
    - Made pursuant to a written agreement which was binding on 1 January 2011, and at all times thereafter
    - Described in a ruling request submitted to the IRS on or before 29 July 2010

      Or
    - Described on or before 1 January 2011 in a public announcement or in an SEC filing

Covered asset acquisitions
Overview

- Regulatory authority:
  - Necessary or appropriate to carry out the purposes of this provision
  - May list exemptions
- JCT explanation anticipates that regulations will be issued:
  - Identifying those circumstances in which, for purposes of determining the adjusted basis of such assets immediately before the covered asset acquisition, it may be acceptable to utilize the basis of such asset under the law of the relevant jurisdiction or another reasonable method;
  - Clarifying, in a covered asset acquisition that involves either (1) both US assets and relevant foreign assets, or (2) assets in multiple relevant jurisdictions, the manner in which any relevant foreign asset (such as intangible assets that may relate to more than one jurisdiction) will be allocated between those jurisdictions; and
  - Clarifying the extent to which income is considered attributable to a relevant foreign asset, as well as the treatment of an asset that ceases to be taken into account in determining the foreign income tax in the relevant jurisdiction by some mechanism other than a disposition



Covered asset acquisitions
Issues

- Computation on transaction-by-transaction basis or aggregate?
  - Aggregate built-in gain transactions and built-in loss transactions or is zero aggregate basis difference applied to each transaction?
- All covered asset acquisitions of future foreign target companies will be relevant
  - Future due diligence item
- Later transaction that reconciles local country and US basis doesn't impact computation related to covered asset acquisition
  - Even if local country transaction completed as part of planned series of transactions related to the covered asset acquisition?

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Section 338(g) Elections – Example of Covered Asset Acquisition Rules

- Step-up in basis:

	FMV	Section 197 Depreciation
Equipment (5 yrs)	50.00	10.00
Goodwill (15 yrs)	150.00	10.00
Total	200.00	20.00

- Local country tax:

  100 income * 35% tax rate = $35 tax

- Disqualified Tax:

US Depreciation	20.00
Income	100.00
Percentage	20%
Taxes	35.00
Disqualified portion	7.00

- US Tax Calculation:

	No Sec. 197 Current Rules	Sec. 197 Current Rules	Sec. 197 Proposed Rules
Income	100.00	100.00	100.00
Depreciation		(20.00)	(20.00)
Income	100.00	80.00	80.00
Tax	(35.00)	(35.00)	(35.00)
E&P	65.00	45.00	45.00
Distribution	65.00	45.00	45.00
Gross-up	35.00	35.00	35.00
Disqualified portion			(7.00)
Taxable dividend	100.00	80.00	73.00
Tax rate	35%	35%	35%
Tax	35.00	28.00	25.55
Foreign tax credit	(35.00)	(35.00)	(28.00)
Tax due / (excess cr)	-	(7.00)	(2.45)

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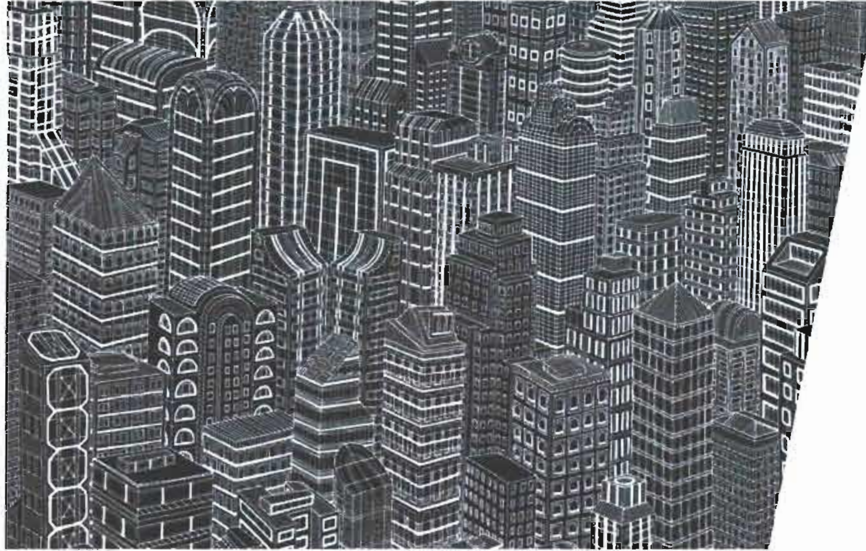
Fragmented Basis



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Section 301 distributions of property

- Section 301 – distributions of "property"
  - "Property" is defined as money, securities, and any other property, other than stock in the distributing corporation
  - Stock dividends are subject to section 305:
    - Taxable under section 305(b); or
    - Excludable under section 305(a)
- Section 301(b) – amount of the distribution
  - Amount of money received
  - Plus: FMV of other property received
  - Less: amount of any liabilities assumed by the shareholder

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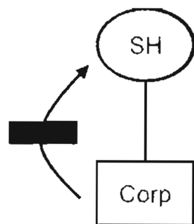
Treatment of a distribution of property



- Section 301(c)(1): a distribution is a <u>dividend</u> to the extent of the corporation's earnings and profits
- Section 301(c)(2): the portion of a distribution that is not a dividend is a tax-free <u>return of basis</u> (but not below zero)
- Section 301(c)(3): any amount in excess of basis is treated as gain from the sale or exchange of stock and generally <u>capital gain</u> if the shareholder holds the stock as a capital asset

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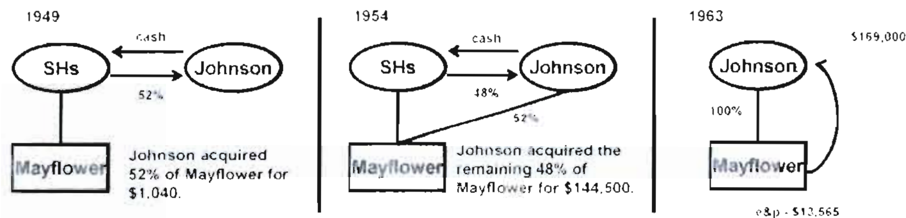
Johnson v. United States

435 F.2d 1257 (4th Cir. 1971)



- As a result of the two purchases, Johnson had an aggregate basis of $145 540 in his Mayflower stock In 1963 Mayflower made a $169 000 distribution to Johnson, only $13,565 of which was a dividend
- Johnson argued that he recognized no capital gain under section 301(c)(3) on the distribution, since under section 301(c)(2) the sum disbursed did not exceed the total amount paid by Johnson for the stock Johnson combined the cost of the two acquisitions
- The Service argued that each acquisition must be apportioned its part of the distribution, individually Therefore there should be allotted to each the proportion of the distribution that the number of shares in that block bears to the number of shares outstanding
- Held Johnson recognized capital gain under section 301(c)(3) since the distribution should be deemed to be made pro rata on each share

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Proposed Regulations (REG-143686-07)
Section 301 distributions – Prop. Reg. §1.301-2

- Share-by-share approach. A section 301 distribution is treated as received on a pro rata, share-by-share basis with respect to the class of stock upon which the distribution is made. *See Johnson v. United States*, 435 F.2d 1257 (4th Cir. 1971).
- Gain possible on some blocks and not others. To the extent that a distribution is not a dividend, basis recovery under section 301(c)(2) is made on a share-by-share basis on each share in the class upon which the distribution is made. Therefore, a shareholder with multiple blocks of stock may have section 301(c)(3) gain on some blocks but not others.

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Example from Proposed Regulations

- Example: A has two blocks of stock in Corporation X: 25 shares were acquired on Date 1 for $25 (Block 1) and 75 were acquired on Date 2 for $175 (Block 2). On December 31, when X has E&P of $100, it makes a $3 distribution on each share of common stock. A is treated as receiving $75 of the distribution on Block 1 and $225 on Block 2. On Block 1, A has a $25 dividend under section 301(c)(1), a $25 return of capital under section 301(c)(2) and a $25 gain under section 301(c)(3). On Block 2, A has a $75 dividend under section 301(c)(1), a $150 a return of capital under section 301(c)(2) and will have a remaining basis of $25 in the shares of block 2.

	% FMV of total stock	Total distribution	Distribution on block	E&P for block (Dividend)	Distribution in excess of E&P	Basis	301(c)(3) gain	Residual basis
Block 1	25%	$300	$75	$25	$50	$25	$25	$0
Block 2	75%		$225	$75	$150	$175	$0	$25

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LB&I Directive on Assertion of Economic Substance Doctrine and Penalty (LB&I-4-0711-015)

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Section 7701(o)

- Economic substance doctrine ("ESD") codified March 2010 in new section 7701(o)
- Under section 7701(o)(1), a transaction is treated as having economic substance only if
  - (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
  - (2) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.
- ESD means the common law doctrine under which tax benefits with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose. Section 7701(o)(5)(A)

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Penalties

- Section 6662(b)(6) imposes a new 20% penalty on any underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance or failing to meet the requirement of any similar rule of law
  - The penalty is increased to 40% if the relevant facts affecting the tax treatment of any portion of the transaction are not adequately disclosed
  - This is a "strict liability" penalty, meaning that once it has been determined, by the Service or by a Court, that there has been an underpayment attributable to a violation of the economic substance rule or any similar rule, there is no exception for reasonable cause or good faith under §6664

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LMSB 20-0910-024 (September 14, 2010)

- LMSB 20-0910-024 ("2010 Directive") required that, before proposing to apply the new penalty, an examiner had to seek and obtain the approval of the appropriate Director of Field Operations ("DFO")
- LB&I-4-0711-015 complements the 2010 Directive by providing specific guidelines

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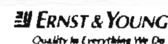
LB&I-4-0711-015 (July 15, 2011)

- Directive for examiners to use in determining whether and when to seek high-level review in asserting the codified economic substance doctrine and its associated strict liability penalty
  - Until further guidance is issued, the penalties are limited to ESD and may not be imposed due to the application of any "similar rule of law" or judicial doctrine
- Mandates a four-step inquiry before asking an IRS DFO to assert the penalty
- The four-step procedure provides a framework for examiners to carefully consider the elements of the transaction and narrows the potential breadth of the ESD

Four Step Inquiry

- As a first inquiry, an examiner should evaluate whether the circumstances in the case are those under which application of the economic substance doctrine to a transaction is likely not appropriate
- Second, an examiner should evaluate whether the circumstances in the case are those under which application of the doctrine to the transaction may be appropriate



Four Step Inquiry

3. Third, if an examiner determines that the application of the doctrine may be appropriate, the guidance provides a series of inquiries an examiner must make before seeking approval to apply the doctrine
4. Fourth, if an examiner and his or her manager and territory manager determine that application of the economic substance doctrine is merited, guidance is provided on how to request approval of the appropriate DFO

- Note: Generally, in applying the directive, when a transaction involves a series of interconnected steps with a common objective, the term "transaction" refers to all of the steps taken together. However, in certain circumstances, the agency said it may be appropriate to apply this guidance separately to one or more steps that are included within a series of arguably interconnected steps

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ESD likely not appropriate

- Transaction is not promoted/developed/administered by tax department or outside advisors
- Transaction is not highly structured
- Transaction contains no unnecessary steps
- Transaction that generates targeted tax incentives is, in form and substance, consistent with Congressional intent in providing the incentives
- Transaction is at arm's length with unrelated third parties
- Transaction creates a meaningful economic change on a present value basis (pre-tax)
- Taxpayer's potential for gain or loss is not artificially limited
- Transaction does not accelerate a loss or duplicate a deduction
- Transaction does not generate a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset)
- Taxpayer does not hold offsetting positions that largely reduce or eliminate the economic risk of the transaction
- Transaction does not involve a tax-indifferent counterparty that recognizes substantial income
- Transaction does not result in the separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years
- Transaction has credible business purpose apart from federal tax benefits
- Transaction has meaningful potential for profit apart from tax benefits
- Transaction has significant risk of loss
- Tax benefit is not artificially generated by the transaction
- Transaction is not pre-packaged
- Transaction is not outside the taxpayer's ordinary business operations.

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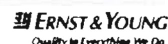
Safe Harbors

It is also not likely appropriate to apply ESD if the transaction being considered is related to the following circumstances:

- choice between debt or equity;
- a U.S. person's choice between a domestic or foreign entity to make an investment;
- the choice to enter into corporate organization or reorganization transactions under subchapter C; or
- the choice to utilize a related-party entity in a transaction, provided section 482 and other applicable standards re satisfied.

ESD may be appropriate

- Transaction is promoted/developed/administered by tax department or outside advisors
- Transaction is highly structured
- Transaction includes unnecessary steps
- Transaction is not at arm's length with unrelated third parties
- Transaction creates no meaningful economic change on a present value basis (pre-tax)
- Taxpayer's potential for gain or loss is artificially limited
- Transaction accelerates a loss or duplicates a deduction
- Transaction generates a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset)
- Taxpayer holds offsetting positions that largely reduce or eliminate the economic risk of the transaction
- Transaction involves a tax-indifferent counterparty that recognizes substantial income
- Transaction results in separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years
- Transaction has no credible business purpose apart from federal tax benefits
- Transaction has no meaningful potential for profit apart from tax benefits
- Transaction has no significant risk of loss
- Tax benefit is artificially generated by the transaction
- Transaction is pre-packaged
- Transaction is outside the taxpayer's ordinary business operations.



Step 3: Additional considerations during case development

1. Is the transaction a statutory or regulatory election?
2. Is the transaction subject to a detailed statutory or regulatory scheme?
3. Does precedent exist (judicial or administrative) that either rejects the application of the ESD, to the type of transaction or a substantially similar transaction or upholds the transaction and makes no reference to ESD when considering the transaction?
4. Does the transaction involve tax credits (energy credits, etc.) that are designed by Congress to encourage certain transactions?
5. Does another judicial doctrine (step transaction, etc.) more appropriately address the noncompliance being examined? If so ESD should not be applied.
6. Does recharacterizing the transaction more appropriately address the noncompliance that is being examined? If so, recharacterization trumps ESD.
7. In considering all of the arguments available to challenge a claimed tax result, is ESD among the strongest arguments available?

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Step 4: DFO Approval

- Examiner in consultation with manager and territory manager should describe in writing how the analysis described in the guidance above was completed
- DFO should review written material and consult with Counsel prior to making a decision.
- Taxpayer should be provided an opportunity to explain their position, either in person or in writing at the DFO's discretion
- Once DFO has made a final decision, it should be conveyed to the examiner in writing

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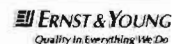

Dual Consolidated Losses – IRS GLAM AM2011-002

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Dual Consolidated Losses – IRS GLAM AM-2011-002

- IRS issued Generic Legal Advice Memorandum ("GLAM") August 5, 2011 that outlines how separate return limitation year ("SRLY") rules apply to DCL attributable to foreign separate unit
- Applies "cumulative register" concept of the Reg. Sec. 1.1502-21 Regulations
- GLAM provides that, under certain circumstances, DCL of separate unit may be used in computation of domestic parent's CTI, even if domestic parent does not make DCL domestic use election

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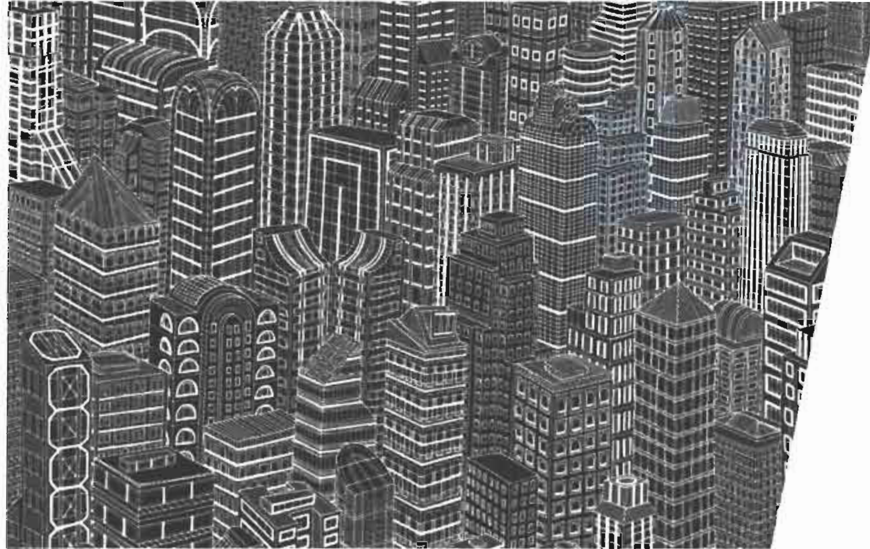
Treaty Update



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Treaty Hearing on 26 July 2011

New Treaty with Hungary; Swiss and Luxembourg Protocols

- The Senate Foreign Relations Committee on 26 July voted and approved the new US-Hungary Treaty, as well as the Switzerland and Luxembourg Protocols out of committee.
  - The new Hungarian treaty replaces the existing US-Hungary Convention, which lacks a limitation on benefits provision.
  - The protocols to the Swiss and Luxembourg treaties expand the exchange of information provisions in the existing treaties.
    - Other provisions in the Swiss Protocol establish new rules for mandatory and binding arbitration and extend treaty benefits to individual retirement accounts.
  - It is expected that the treaty and protocols will be sent on to the full Senate as soon as possible for its vote to provide its consent to the agreements.

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Section 1441 compliance is a Tier I issue

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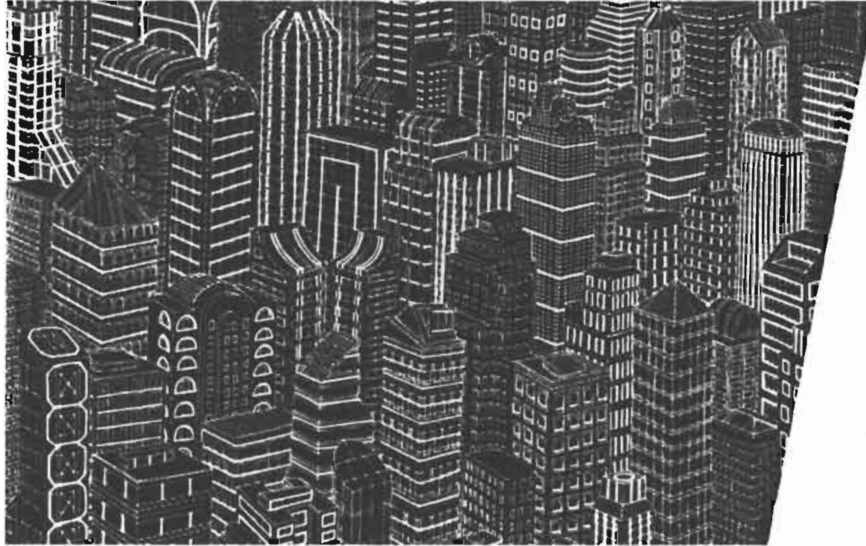
Section 1441 withholding & reporting



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Section 1441 Withholding & Reporting - Overview

- Section 1441 withholding & reporting
  - Basic rules of nonresident alien (NRA) withholding
  - §1441: Tier 1 issue
  - Four step process
  - Exceptions
  - Final notes

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Basic rules of NRA withholding

- NRA withholding is required when:
  - A person who is a withholding agent;
  - Has control, receipt, custody, disposal of income;
  - Makes a payment;
  - Of an amount subject to NRA withholding (US source FDAP); and
  - The payment is to a foreign person.
- NRA withholding rate is 30%;
  - May be reduced under a provision of the Internal Revenue Code or an income tax treaty.
    - Any reduction of the 30% withholding tax is dependent on proper documentation being provided to the withholding agent.

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The IRS' ground rules

- 30% NRA withholding is generally required on US source "fixed or determinable income" paid to foreign persons (entities and individuals)
- There are no exempt recipients for NRA withholding and reporting purposes. All foreign persons are subject to these rules.
- We MUST treat payments of "fixed or determinable income" as US source where we don't know whether a payment is US or foreign source
- A payor is responsible for any withholding tax it should have withheld but did not, ***plus*** penalties and interest

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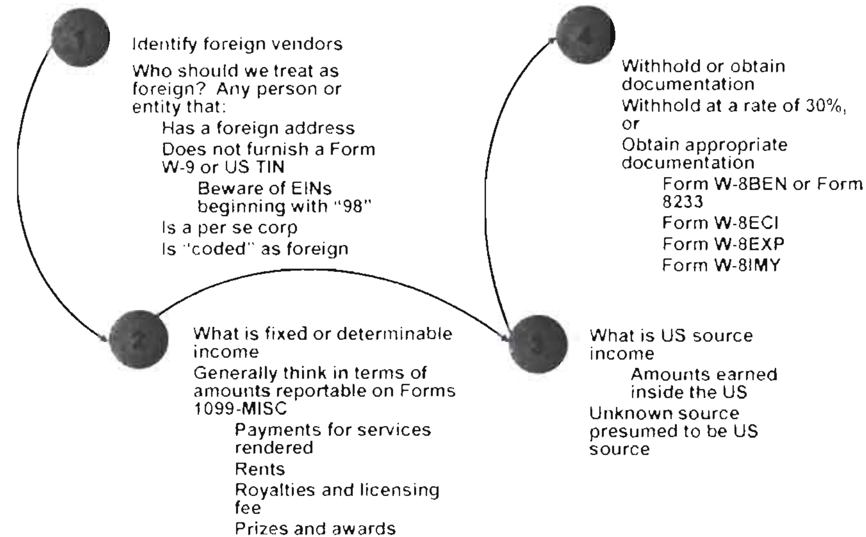

Multi-national company (MNC) sample IDR included in IRM

- Any Forms 1042 and 1042-S filed
- Operation manuals and written procedures pertaining to the company's NRA withholding and reporting process
- Procedures to determine whether a payment is:
  - Made to a foreign person
  - FDAP income
  - US source
- List of departments that make:
  - Payments to foreign vendors
  - Payments to foreign related parties
  - Payments of pension benefits to foreign persons
  - Payments of interest and dividends to foreign persons

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Step Four
Withhold unless an exception applies

Exceptions

- Foreign source income
- "[G]ains derived from the sale of property" (Reg. Sec. 1.1441-2(b)(2)(i))
- Proper claim for treaty rate reduction benefits
  - Made on a Form W-8BEN or 8233, generally ***requires a US TIN***
  - Result may be either 0% withholding, or
  - A reduced rate of withholding
  - (Note: No withholding does not mean no reporting)
- Income effectively connected with the conduct of a US trade or business
  - Made on a Form W-8ECI, requires a US TIN
  - Result is 0% withholding
  - (Note: No withholding does not mean no reporting and no taxation)

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MNCs CAN "cure" before an audit

- Identify foreign vendors
- Identify FDAP income
  - Typically requires review of invoices to determine nature of payment
  - Use general ledger accounts when appropriate
- Identify US source income
  - Typically requires contacting personnel who engaged the vendor or approved the payment
  - For intercompany payments, look to §482 allocations
- Solicit retroactive Forms W-8 and 8233 claiming treaty benefits or effectively connected income

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