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International Business: Federal Tax Planning Update

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WEDNESDAY, JANUARY 5, 2011

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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International Business: Federal Tax Planning Update Webinar

Jan. 5, 2011

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Today's Program

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[Layla Aksakal]
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[David Forst]
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[Brent Lipschultz]
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Layla Aksakal, Miller & Chevalier

CORPORATE TAXPAYER ISSUES: FOREIGN TAX CREDIT UPDATE

Agenda For This Section

- New Sect. 909: Rules to prevent splitting of foreign tax credits from related income
- New Sect. 960(c): Limitation on foreign tax credits on Sect. 956 inclusions
- P.L. 111-226, enacted Aug. 10, 2010

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Sect. 909 Purposes

- New legislation is intended to "prevent the separation of creditable foreign taxes from the associated foreign income."
  - For example, Guardian Industries, reverse hybrid and hybrid instrument structures

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Sect. 909 Overview

- Direct credit (Sect. 901)
  - In the event of a "**foreign tax credit splitting event**," Sect. 909 suspends the use of FTCs until "**related income**" is taken into account by the taxpayer.

- Indirect credit (sections 902 or 960)
  - In the event of an FTC-splitting event, foreign tax is not taken into account until related income is taken into account by a Sect. 902 corporation or domestic corporate shareholder, for purposes of:
    - Sections 902 or 960 (indirect credit), or
    - Determining E&P under Sect. 964(a)

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Sect. 909 Definitions

- "**Related income**" is the income or E&P to which an FTC relates.

- "**FTC splitting event**" occurs when related income is taken into account by a "**covered person**."
  - **"Covered person"** is, with respect to the payor of the foreign tax:
    - Entity in which payor holds, directly or indirectly, 10% ownership interest
    - Person that holds, directly or indirectly, 10% ownership interest in the payor
    - Related person under sections 267(b) or 707(b)
    - Any other person specified in regulations

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Sect. 909 Effective Dates

- Effective for foreign taxes paid or accrued in years after 12/31/2010
- But, possible retroactive application to certain foreign taxes ("pre-2011 taxes") paid or accrued by a Sect. 902 corporation in a tax year beginning on or before 12/31/2010 ("pre-2011 years"), for purposes of applying sections 902 or 960 in tax years beginning after 12/31/2010 ("post-2010 years")
  - Sect. 909 does not apply to taxes deemed paid by U.S. shareholder on or before last day of Sect. 902 corporation's last Pre-2011 year
    - Fiscal year corporations may still be able to pull up taxes
  - Also not applicable to taxes paid in years beginning before 1/1/1997

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Sect. 909 Foreign Tax Credit-Splitting Events

- Notice 2010-92 identified exclusive list of FTC-splitting events for pre-2011 years:
  - Reverse hybrid structures
  - Foreign consolidated groups (Guardian Industries)
  - Hybrid instruments
  - Group relief (arising from disregarded debt instruments)

- Notice and government statements suggest that list is expected to grow (*i.e.*, new transactions will be covered) for post-2010 years.

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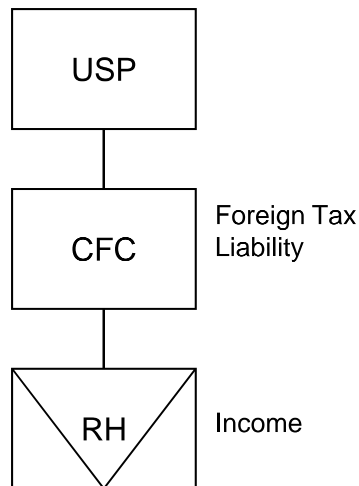
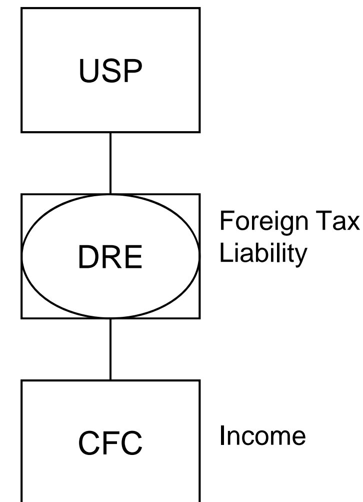
Sect. 909
Reverse Hybrid And Foreign Consolidated Group Structures

Reverse Hybrid



- Foreign tax liability is incurred by one person (CFC), but the income that gives rise to the foreign tax is earned by a related person (RH)
- 2006 Proposed Regulations (§1.901-2(f))

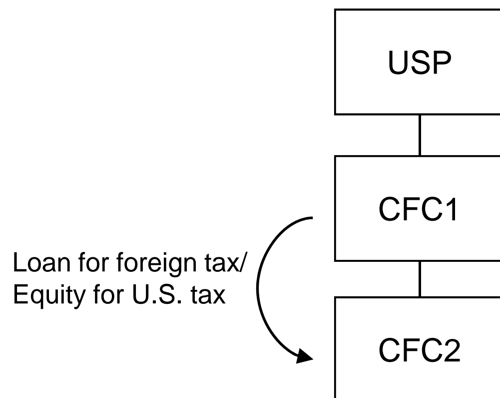
Foreign Consolidated Group



- DRE is legally liable for foreign taxes paid on income of CFC
- Compare to Guardian Industries, 65 Fed. Cl. 50 (2003)
- 2006 Proposed Regulations (§ 1.901-2(f))

Sect. 909
Hybrid Instruments

U.S. Equity HI



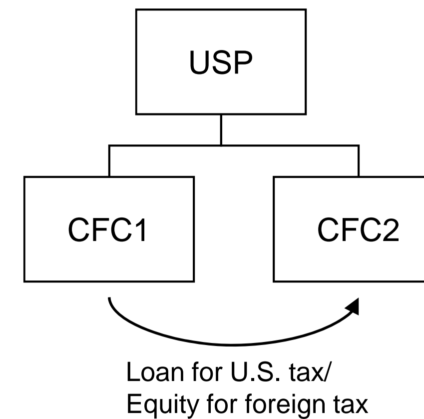
Foreign Law:

- CFC1 accrues interest income, pays foreign tax
- CFC2 accrues (but does not pay) interest expense

U.S. Law:

- CFC1 has no E&P because no "dividends" are paid but CFC1 has paid foreign tax

U.S. Debt HI



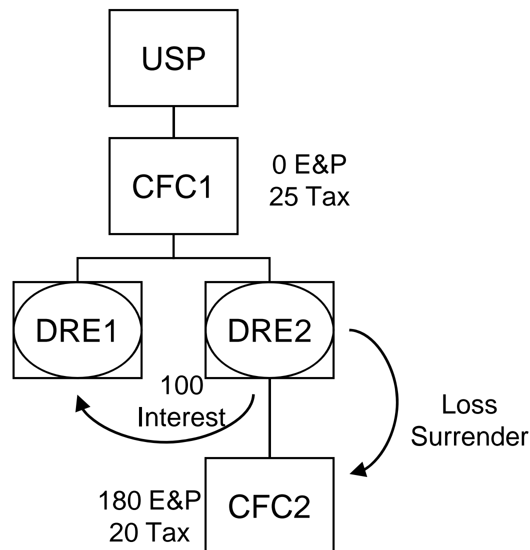
Foreign Law:

- CFC2 pays foreign tax on its income, without any deduction for "interest" on hybrid instrument

U.S. Law:

- CFC2's E&P is reduced by interest on hybrid instrument

Sect. 909
Group Relief: Disregarded Debt Instruments



- Foreign law
  - DRE1 has interest income
  - DRE2 has interest expense (loss)
  - DRE2 loss reduces tax liability of CFC2
- U.S. law
  - DRE1-DRE2 loan is disregarded
  - CFC1 has no income (E&P) but has paid foreign tax (on income of DRE1)
  - In this example, DRE2's loss appears "artificial" from a U.S. perspective, but what are hallmarks of an artificial loss?

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Sect. 909: Other FTC-Splitting Events?

- Notice 2010-92 solicits comments on:
  - Covered asset acquisitions [Sect. 901(m)]
  - Mid-year incorporation of a DRE or hybrid partnership
  - Transfer pricing adjustments
  - Other group relief structures
  - Sale and repurchase agreements
  - Foreign anti-deferral regimes
  - Foreign consolidated groups in which members have losses

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Sect. 909: Related Income Issues

- Rules for associating foreign taxes with related income?
- Ordering rules for dividends out of E&P comprising both related income and other income?
  - Notice 2010-92 provides related-income-out-first election for pre-2011 taxes
- Effect on related income of losses and deficits in E&P
- Rules for assigning taxes and related income to separate categories

Sect. 960(c)
Limitation On FTCs On Sect. 956 Inclusions

- Under prior law, income inclusion from Sect. 956 investment in U.S. property was treated as a direct dividend from CFC to U.S. shareholder.
  - Rule allowed E&P from high-taxed, lower-tier CFC to “hopscotch” over chain, without dilution of E&P pool that would occur if dividend were distributed up the chain.

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Sect. 960(c)
Limitation On FTCs On Sect. 956 Inclusions (Cont.)

- New Sect. 960(c) prevents affirmative use of hopscotch rule to increase FTCs.
- Taxes deemed paid on a Sect. 956 inclusion are the lesser of:
  - Deemed paid taxes under hopscotch rule
  - Deemed paid taxes that would be included if CFC had paid a dividend up the chain to the U.S. shareholder
- Effective date: U.S. property acquired after 12/31/10
- Note: Sect. 960 hopscotch continues to be the rule for other subpart F inclusions.

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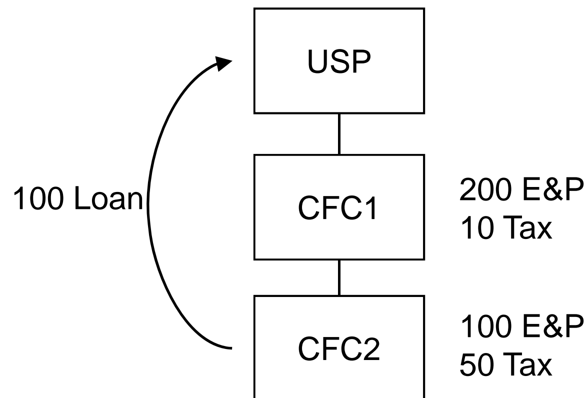
Sect. 960(c)
Limitation On FTCs On Sect. 956 Inclusions (Cont.)



- USP has Sect. 956 inclusion of $100 arising from investment in U.S. property by CFC2.
- Under hopscotch rule, deemed paid tax would be $50 [$100 dividend x ($50 tax /$100 E&P)].
- Dividend up the chain produces deemed paid tax of $20 [$100 dividend x ($60 tax/$300 E&P)].
- FTC is limited to $20 under Sect. 960(c).

Peter Daub, Baker & McKenzie

CORPORATE TAXPAYER ISSUES: COVERED ASSET ACQUISITIONS AND CODIFICATION OF ECONOMIC SUBSTANCE DOCTRINE

DENIAL OF FOREIGN TAX
CREDITS DUE TO COVERED
ASSET ACQUISITIONS

Covered Asset Acquisitions

- Essentially attempts to unwind the foreign tax credit results that would otherwise result from certain transactions that generally produce a basis step-up for U.S. tax purposes, but not for foreign tax purposes

- Applies to “covered asset acquisitions” that occur after Dec. 31, 2010
  - Transition rule exempts certain post-Dec. 31, 2010 covered asset acquisitions that had reached designated milestones before Jan. 1, 2011.

Covered Asset Acquisitions (Cont.)

- “Disqualified portion” of any foreign income tax paid or accrued in connection with a “covered asset acquisition” is permanently disallowed, for foreign tax credit purposes.
  - Not disallowed for deduction purposes

- Covered asset acquisitions:
  - Sect. 338 qualified stock purchases
  - Foreign stock transfers treated as asset transfers for U.S. tax purposes (e.g., sale of shares of a foreign disregarded entity)
  - Acquisition of partnership interest with Sect. 754 basis step-up election

Covered Asset Acquisitions (Cont.)

- “Disqualified portion” of a foreign income tax for a taxable year is the ratio of:
  - Aggregate basis difference allocable to the year for all relevant foreign assets, compared with
  - Foreign taxable income upon which the foreign tax is based
- “Basis difference” is the excess of:
  - U.S. tax basis of a relevant foreign asset immediately after a covered asset acquisition, over
  - U.S. tax basis of the asset immediately before the acquisition

- Basis difference is allocated to a particular taxable year based on cost recovery method under U.S. tax law, and is accelerated upon disposition of the asset.

Covered Asset Acquisitions (Cont.)

- Example: Sect. 338 qualified stock purchase
  - USP acquires foreign target (FT) and makes a Sect. 338(g) election
  - Aggregate basis difference of $200
    - Asset A: $150 basis difference and 15-year recovery period → $10 annually
    - Asset B: $50 basis difference and 5-year recovery period → $10 annually

Covered Asset Acquisitions (Cont.)

- Example: Sect. 338 qualified stock purchase
  - Year 1: FT earns $100 and pays $25 of tax.
    - Disqualified portion of foreign tax = $5
      - ($10 + $10) / $100 x $25 = $5
  - Year 2: FT earns $100 and pays $25 of tax.
    - Disqualified portion of foreign tax = $5
      - ($10 + $10) / $100 x $25 = $5
  - Year 3: FT earns $140, incl. income from disposition of Asset B and pays $35 of tax.
    - Disqualified portion of foreign tax = $10
    - ($10 + $30) / $140 * $35 = $10

Covered Asset Acquisitions (Cont.)

- Effectively disallows any credit for the portion of the CFC's foreign income tax for a particular year that is attributable to foreign taxable income that was offset in computing E&P for U.S. tax purposes by amortization or depreciation deductions attributable to U.S. tax basis created in a covered asset acquisition
- Aimed at perceived inappropriate result of a CFC having a higher ETR for U.S. tax purposes because of deductions reducing E&P but not reducing foreign taxable income

Covered Asset Acquisitions (Cont.)

- Overly broad, because rule applies even if there is a foreign tax basis step-up, and thus no U.S.-foreign step-up disparity
  - Example: Foreign tax regime with push-down of purchase price paid for stock to the company's inside assets
  - Regulatory relief may be forthcoming

Interpretive Questions

- What happens when a 338(g) election has been made in connection with the sale of stock and the stock is resold?
- How is the amount of the disallowance computed when a covered asset acquisition is made with respect to a foreign holding company that owns disregarded entities operating in different jurisdictions?
- Relationship with double-taxation articles of income tax treaties

Covered Asset Acquisitions

- Sect. 338(g) election for a foreign target may still make sense in circumstances in which benefits (reduction of E&P, elimination of unfavorable U.S. tax attributes) outweigh detriment of disallowed FTCs, depending on a number of factors:
  - Amount of depreciation resulting from basis step-up
  - Deductibility of foreign taxes
    - Amount of leverage introduced upon acquisition
  - Foreign income tax rate
  - Uncertainty regarding target's U.S. tax attributes

- Sale of shares of disregarded foreign company may still make sense in circumstances in which subpart F benefit outweighs the FTC detriment.

CODIFICATION OF THE
ECONOMIC SUBSTANCE
DOCTRINE

Overview

- Economic substance doctrine codified by Sect. 1409 of the Health Care and Education Reconciliation Act of 2010

- Adopts the conjunctive analysis of the economic substance doctrine. §7701(o)

- Imposes a strict liability penalty for transactions that lack economic substance. §6662(b)(6)

Elements Of Sect. 7701(o)

- A three-part test for application to a transaction, or series of transactions:
  - Is the economic substance doctrine “relevant” to the transaction?
  - Does the transaction change in a meaningful way, apart from any U.S. federal income tax effects, the taxpayer’s economic position?
  - Does the taxpayer have a substantial purpose, apart from U.S. federal income tax effects, for entering into such transaction?

Elements Of Sect. 7701(o) (Cont.)

- When does the economic substance doctrine apply?
  - The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if the doctrine had not been codified.
    - Reliance on prior common law
    - Facts and circumstance analysis

Elements Of Sect. 7701(o) (Cont.)

– Economic substance doctrine is not intended to alter the tax treatment of “certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages.” H.R. Rep. 111-443 at 296

Elements Of Sect. 7701(o) (Cont.)

- When does the economic substance doctrine apply? (Cont.)
  - House report provides a non-exclusive list of examples of “basic business transactions”:
    - The choice between capitalizing a business enterprise with debt or equity
    - A U.S. person’s choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment
    - The choice to enter into a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C
    - The choice to utilize a related-party entity in a transaction, provided that the arm’s length standard of Sect. 482 and other applicable concepts are satisfied

Elements Of Sect. 7701(o) (Cont.)

- What is a “transaction”?
  - A transaction includes a “series of transactions.”
  - House report provides that the codified economic substance doctrine does not alter the court’s ability to aggregate, disaggregate or otherwise recharacterize a transaction when applying the doctrine.
  - Note that the effective date is tied to when the “transaction” was entered.

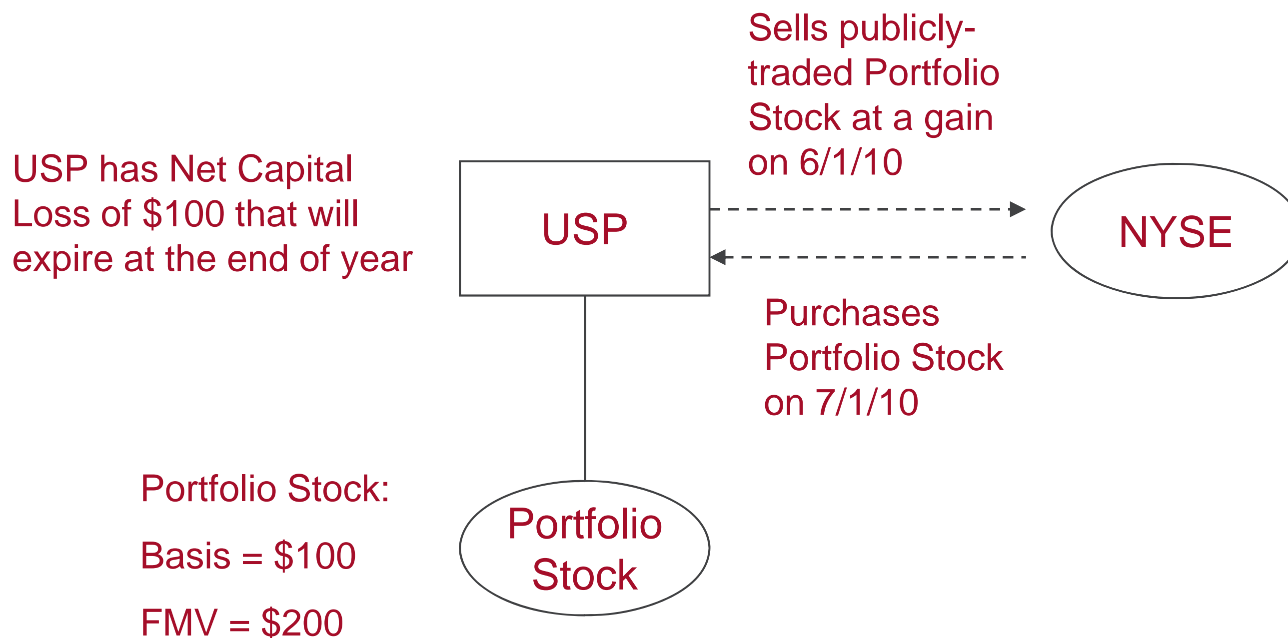
Penalty Provisions

- Penalty amounts
  - Sect. 6662(b)(6) imposes a 20% penalty for any underpayment attributable to disallowance of benefit by reason of failing to meet economic substance doctrine or “any similar rule of law.”
  - Penalty is increased to 40% if transaction is not disclosed.
    - Amended returns or supplements to disclose transaction must occur prior to first contact by the IRS regarding examination of the return (or such earlier date as is specified by the IRS).

Penalty Provisions (Cont.)

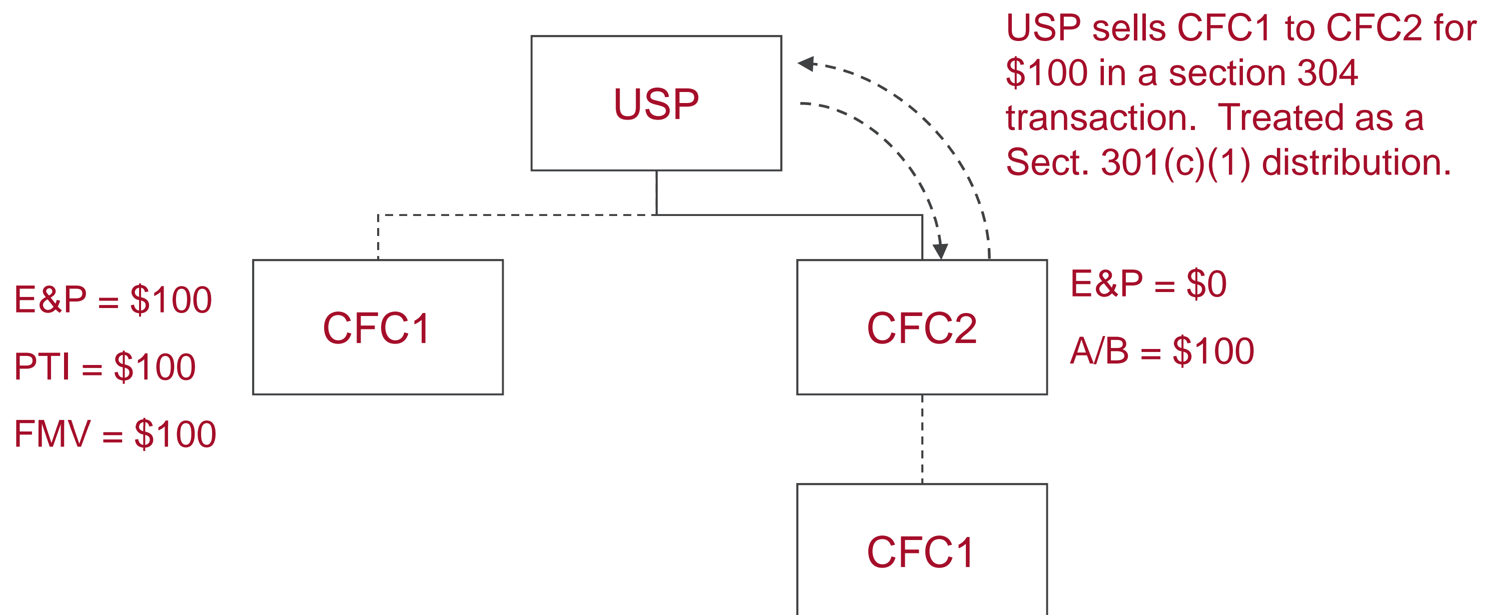
- When does the penalty apply?
  - Disallowance must be because transaction lacked economic substance
  - Penalty can apply to any transaction that does not have economic substance or “any similar rule of law.”
    - Intended to capture other doctrines whose application entails similar factors and analysis as the economic substance doctrine.
    - *E.g.*, sham transaction doctrine
  - Strict liability: No reasonable cause exception

Sale Of Gain Asset



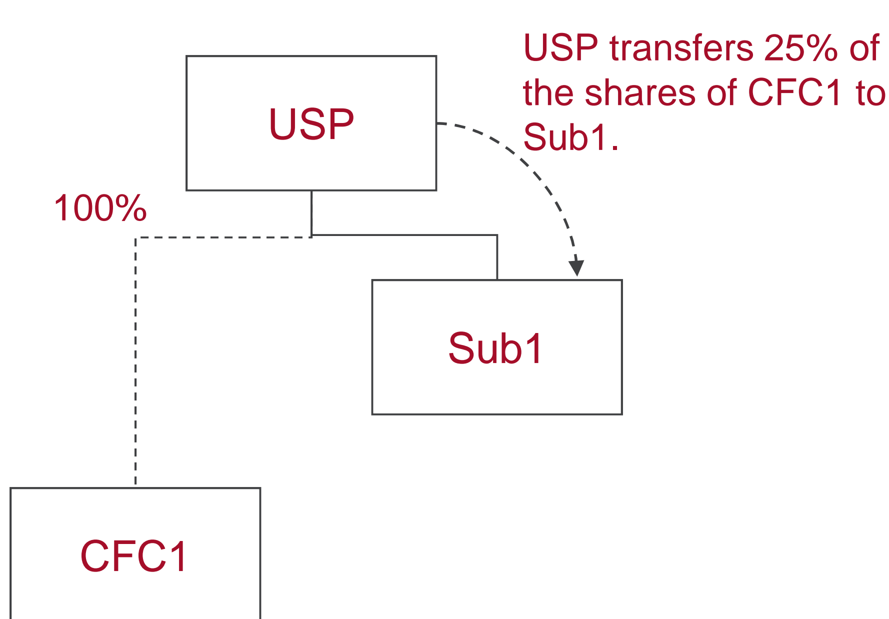
Question: Is the economic substance doctrine “relevant” to sale and subsequent repurchase of the portfolio stock? Is the sale required to have economic substance?

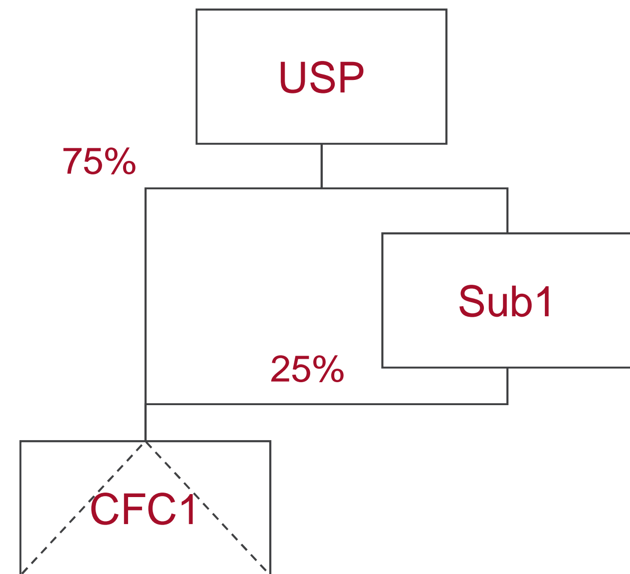
Sect. 304 Transaction



Question: Is the sale of CFC1 to CFC2 required to have economic substance? Does USP need a non-tax purpose for the sale?

Sect. 331 Liquidation





CFC1 liquidates in a Sect. 331 taxable transaction and converts to a partnership

Question: Is the transfer of 25% of CFC1 to Sub1 required to have economic substance because the requirements for a Sect. 331/332 liquidation are provided in the Code?

Other Transactions

How or does Sect. 7701(o) apply to:

– *Dover*-style check-and-sell transactions
– Contributions for Sect. 351(g) NQPS
– Corporate organizations or reorganizations
– Affirmative uses of Sect. 956
– Creation of partnership outside basis
– Foreign-to-foreign cash “D” reorganizations
– Debt push-downs

David Forst, Fenwick & West

CORPORATE TAXPAYER ISSUES: UTP, FTCS AND SECT. 482

Uncertain Tax Positions

- In Announcement 2010-9, the IRS stated that it plans to begin requesting information about uncertain tax positions. The IRS released a final version of the schedule and instructions on Sept. 24, 2010.
- Reporting is required for a corporation's federal income tax positions for which the corporation or a related party has recorded a reserve in an audited financial statement. Reporting also is required for tax positions taken by the corporation in a return for which a reserve has not been recorded by the corporation or a related party based on an expectation to litigate. The IRS eliminated the proposed requirement to report tax positions for which no reserve is created due to IRS administrative practice.

Uncertain Tax Positions (Cont.)

- The proposed schedule required that the maximum tax adjustment be disclosed, but this requirement was dropped in the final schedule. Rather, a corporation must rank all reported tax positions, including transfer pricing and valuation, based on the amount of the reserve. Interest and penalties must be taken into account in the rankings. The corporation also must designate those positions for which the reserve exceeds 10% of the aggregate amount of the reserves for all positions taken.

- The IRS eliminated the proposed requirement that taxpayers must disclose the rationale and nature of the uncertainty. Instead, the taxpayer must describe the relevant facts affecting the tax treatment of the position and information that reasonably can be expected to appraise the IRS of the identity of the tax position and the nature of the issue.

Uncertain Tax Positions (Cont.)

- The IRS stated that it will not consider taxpayers to have waived privilege for otherwise privileged documents that they disclosed to their financial advisors. However, waiver will be treated as occurring if taxpayers have taken action that otherwise waives a privilege, or a request for tax accrual workpapers is made under otherwise applicable IRS procedures because of unusual circumstances or because listed transactions are involved. Therefore, the exception might be broader than the rule.

FTC Issues: Notice 2010-65

- Notice 2010-65 provides an exception to §901(1), which disallows a FTC for withholding tax on non-dividend income or gain with respect to property if generally (1) the recipient of the item has not held the property for more than 15 days, or (2) the recipient is under an obligation to make related payments with respect to positions in substantially similar or related property.

- Notice 2010-65, expands on Notice 2005-90, which provides an exception to the application of §901(l)(1)(B) for certain back-to-back computer program licensing arrangements.

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FTC Issues: Notice 2010-65 (Cont.)

- The regulations will provide that:
  - §901(l)(1)(B) will not apply to disallow a credit for foreign gross-basis withholding taxes (which otherwise meet the legal requirements to be treated as creditable taxes) imposed on income or gain with respect to back-to-back licensing arrangements involving certain intellectual property or copyrighted articles entered into in the ordinary course of business; and
  - §901(l)(1)(A) will not apply to disallow a credit for foreign gross-basis withholding taxes (which otherwise meet the legal requirements to be treated as creditable taxes) imposed on income or gain with respect to retail distribution arrangements for certain copyrighted articles entered into in the ordinary course of business.

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FTC Issues: *PPL Corporation*

- *PPL Corporation v. Commissioner*, 135 T.C. No. 15 (2010), addressed the creditability of the U.K. windfall imposed on British utilities. The court held the tax was creditable under §901.

- The Service argued that the windfall tax did not have the predominant character of an income tax in the U.S. sense.

- The Service stated that the regulations "neither require nor permit inquiry into the purpose underlying the enactment of a foreign tax or the history of a foreign taxing statute."

FTC Issues: *PPL Corporation* (Cont.)

- The taxpayer argued that, given the historical development, design, and actual operation of the windfall tax, it constitutes a creditable tax on excess profits. The taxpayer argued that the court may consider extrinsic evidence of the purpose and effect of the tax as applied to the windfall tax companies. In support of its position, the taxpayer cited *Exxon Corp. v. Commissioner*, 113 T.C. 338 (1999) and *Phillips Petroleum Co. v. Commissioner*, 104 T.C. 256 (1995).

FTC Issues: *Procter & Gamble*

- *Procter & Gamble Co. v. U.S.*, ___ F. Supp ___ (SD Ohio 2010), denied foreign tax credits to the taxpayer on the grounds that it did not exhaust its administrative remedies in seeking to reduce the tax.

- P&G had a Singapore subsidiary that did business in Japan. The Singapore subsidiary managed both Japanese and Korean operations. It had no physical location or employees in Korea and used a contract manufacturer there. The Singapore subsidiary sold the products to Korean distributors or end-users.

FTC Issues: *Procter & Gamble* (Cont.)

- The Singapore subsidiary paid royalties to the U.S. parent company and withheld 10% Japanese tax under the old U.S.-Japan Income Tax Treaty.

- The Korean tax determined that a portion of the royalties paid by the Singapore subsidiary to the U.S. parent were Korean-source income and therefore subject to Korean withholding tax, since they were attributable to Korean sales.

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FTC Issues: *Procter & Gamble* (Cont.)

- The taxpayer obtained advice of Korean tax counsel, who stated that the taxes were properly assessed by the Korean authorities and that a challenge to the assessment was unlikely to be successful. The taxpayer and its Singapore subsidiary therefore determined that there was no reasonable basis to appeal the assessment of the Korean tax or to invoke procedures under the U.S.-Korean tax treaty. Further, the taxpayer and its Singapore subsidiary did not seek a redetermination of the source of the royalty income under Japanese law or commence U.S.-Japan competent authority proceedings.

FTC Issues: *Procter & Gamble* (Cont.)

- The court held that the taxpayer may only credit the Korean withholding tax amounts that exceeded the credits claimed in respect of Japanese withholding tax on the same income. It stated that the taxpayer was not precluded from claiming FTCs for taxes paid to more than one country on the same income, but held that the taxpayer had failed to exhaust all administrative and practical remedies including invocation of competent authority procedures to reduce the Japanese tax liability. The court also noted that the taxpayer did not seek advice from Japanese tax counsel.

FTC Issues: *PPL Corporation*

- The court agreed with the taxpayer, stating that its position was consistent with case law preceding the issuance of 1983 regulations and in particular with two of the cases cited in the preamble to those regulations, including *Inland Steel Co. v. U.S.*, 677 F.2d 72 (1982). Cases that have applied the 1983 regulations' predominant character standard are consistent with *Inland Steel*. The court then applied the predominant character standard to the windfall tax.

Sect. 482 Issues: *Xilinx*

- The Ninth Circuit affirmed the Tax Court in the *Xilinx* case, which involved use of employee stock options in a cost-sharing arrangement.
- The Tax Court held that the IRS regulations in effect at the time did not require the sharing of any amounts related to ESOs, since parties operating at arm's length did not and would not share such amounts.
- The court stated that the purpose of the Sect. 482 regulations is parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions, and that the cost sharing regulations should be interpreted consistently with this purpose. It also looked to the U.S-Ireland Income Tax Treaty, which incorporates the arm's length standard and was negotiated by the Treasury Department (which also wrote the Sect. 482 regulations).

Sect. 482 Issues: *Xilinx* (Cont.)

- A concurring opinion expressed trouble over the Service agreeing with the result, but not the reasoning, of an earlier opinion that favored the Service but subsequently was withdrawn. It also stated that "it is an open question whether these flaws have been addressed in the new regulations Treasury issued after the tax years at issue in this case."
- The IRS subsequently issued an AOD, acquiescing in result only.
- Note that the preamble to the final Service regulations declines to further elaborate on stock-based compensation issues, stating that stock-based compensation will be addressed in a future guidance project.

Sect. 482 Issues: *Veritas*

- *Veritas Software Corporation, Symantec Corporation (its successor-in-interest) v. Commissioner*, 133 T.C. No. 14 (2009) addressed the amount of a cost sharing buy-in payment between a U.S. parent and its Irish subsidiary. The amount of the buy-in was $166 million. The Service initially used an income method in arguing that payment should have been $2.5 billion.

- The court held the Service's §482 adjustments were arbitrary, capricious and unreasonable. It held that Veritas' comparable uncontrolled transaction method, with certain adjustments, was the best method to determine the requisite buy-in payment.

Sect. 482 Issues: *Veritas* (Cont.)

- Important to the Court's decision was that in the industry, products with state-of-the-art function lost value quickly, and Veritas' products had finite lifecycles (an average of four years). In this regard, it stated that the Service incorrectly valued short-lived intangibles as if they had a perpetual useful life.

- The Court concluded as follows: "Veritas Ireland prospered, not because Veritas simply spun off a portion of an established business and transferred valuable intangibles, but because Veritas Ireland employed aggressive salesmanship and savvy marketing, successfully developed the EMEA and APJ markets, and co-developed new products that performed well in those markets. For the foregoing reasons, we conclude that respondent's allocations set forth in the amendment to amended answer and at trial are arbitrary, capricious, and unreasonable."

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INTERNATIONAL PRIVATE CLIENT ISSUES

Tax Relief, Unemployment Insurance Reauthorization And Job Creation Act Of 2010

- Extension for two years of the current individual income tax rates
- Extension of the current tax rates on capital gains and dividends
- Act extends the personal exemption phase out and the itemized deduction limitation phase-out
- Alternative minimum tax (AMT) patch for two years
- Provision of temporary employee payroll tax cut
- Provision of temporary changes in wealth transfer taxes
  - Unification of the gift and estate tax with maximum tax rate of 35% for two years
  - $5 million exemption per person, with portability for U.S. citizens and domiciliaries

Tax Relief, Unemployment Insurance Reauthorization And Job Creation Act Of 2010 (Cont.)

- $5 million exemption per person, with portability for U.S. citizens and domiciliaries (Cont.)
  - Act did not change the $60,000 exemption for non-resident aliens.
  - Act extended the ability for foreigners to invest in a domestic mutual fund without significant estate tax exposure, if the fund holds foreign investments.
  - Planning for U.S. estate tax is an important element of global transfers.

Foreign Earned Income Exclusion And IRS Attention

- Introduction to Sect. 911 exclusion and impact on international assignment programs
  - $92,900 exclusion in 2011
  - Housing exclusion for 2010: Sydney Australia, and Tel Aviv, Israel added (Notice 2010-27)
  - Beneficial to claim foreign tax credit in high-taxing jurisdictions
- IRS has lost more than $90 million paying erroneous claims, according to Treasury Inspector General, due to overstating or not qualifying for deduction, and not meeting physical presence test.
- 2010 Case: *Savory v. Comm.*, TC Summ. Op. 2010-150
  - Flight attendant entitled to FEI exclusion for income earned in foreign country was eligible for exclusion and not income earned in international air space.

2010 Observations, Trends On International Assignment Programs

- Average cost of sending employee on international assignment is 3 to 4 times U.S. compensation on average, due to high foreign tax rates.
  - UK has highest tax increase in Western Europe; benchmark average tax rate is 29%.
  - Compensation packages include foreign service bonuses, mobility premiums, housing differentials, COLAs, relocation costs, tax reimbursements, educational expenses, other expenses.
  - Tax equalization most common in 2010 for assignment packages, with social insurance and local government taxes included in hypothetical tax computations. Companies split on decision to treat equity compensation as personal income and not equalized. Most companies offer standard tax preparation and tax briefing services, with a trend in providing population financial planning.

2010 Observations, Trends On International Assignment Programs (Cont.)

- Trend in sending employees abroad for particular projects not based on duration (short-term vs. long term assignments)
- High attrition rates in repatriated assignee population
- Program managers need to be focused on recent U.S. legislation (*see slide on FATCA*).
- Be aware that there are significant tax implications for executives obtaining green cards and who may leave the U.S. in the future.
  - IRC Sect. 877A (Notice 2009-85)
- Foreign institutions may close banking relationships to U.S. persons (*cf.* Bank Leumi)

2010 Treaty Developments Affecting Private Clients

- Case law: Filipino teacher's salary from teaching in the U.S. is not exempt from U.S. taxation under the U.S. – Philippines Income Tax Treaty.
  - *Abiog v. Comm*, TC Summ. Op. 2010-66.
- Income tax treaty developments in 2010
  - Malta treaty enters into force (effect of 1/1/2011) and reduced source-country withholding, comprehensive LOB provision, exchange of information provision
  - New income tax treaty between U.S. and Hungary (prior to treaty, had relaxed LOB provisions)
  - New income tax treaty with Chile (would be only second with South American country) reduced in-source-country withholding and rules to enhance mobility of labor by coordinating tax aspects of pensions. Represents a departure from the 2006 US Model Income Tax Convention
  - New Zealand-U.S. income tax treaty protocol ratified (elimination of source country-taxation of direct dividends and certain interest paid to banks and financial enterprises, reduction of cross-border payments of royalties, and modernized LOB and exchange of information provisions)

2010 Treaty Developments Affecting Private Clients (Cont.)

- Tax information exchange agreement signed with Panama; similar agreements reached with Gibraltar and Luxembourg in 2009
- Application of exchange-of-information agreement in today's world
  - IRS fight with U.S. businessman over disclosure of information exchanged under Australia and UK treaties
- Canada revenue refund claim opportunities in light of *TD Securities (USA) LLC v. Queen*
- The U.S. foreign tax credibility of the new UK remittance tax has yet to be officially determined and is on the IRS 2010-2011 guidance plan.

International Gift And Estate Tax Developments In 2010

- The payment of gift tax by a non-resident alien within three years of death is not considered property deemed situated in the U.S. and does not increase a gross estate. ILM 2010-20-009
- Conflict of law rules required an NRA to include U.S. stock in a gross estate as separate property and not community property. *Estate of Charania v. Shulman*, 105 AFTR 2d 2010-988
- Guidance under IRC Sect. 2801 regarding tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates is in IRS 2010-2011 business plan.
- IRS rules on entity classification of Liechtenstein Anstalts and Stiftungs (*see AM 2009-012, 10/16/09*)

Update On FBAR, Voluntary Disclosures, IRS Enforcement

- IRS proposed regulations have not been finalized, but comment period has ended.
- Filing requirements
  - U.S. person
    - Includes single-member LLCs
    - Includes certain foreign persons; Announcement 2010-16 not yet extended
  - Signature authority also reportable
    - Old FBARs are due under Notice 2010-23 by June 30, 2011.
  - Mutual funds, foreign hedge funds, etc.
  - June 30, 2011 due date

Update On FBAR, Voluntary Disclosures, IRS Enforcement (Cont.)

- FBAR penalty developments
  - *U.S. v. Williams*, 106 AFTR 2d 2010-6150 (DC VA, 9/1/10)
    - Government failed to show willfulness for civil penalty
    - Failure to check the “no “ on Schedule B is not enough
  - *U.S. v. Simon*, 106AFTR 2d 2010-6739 (DC IN, 10/8/10)
    - Filing FBAR by extended due date in Notice 2010-23 does not prevent a conviction for criminal failure to file prior to notice.

Voluntary Disclosure Update

- 3,000 voluntary disclosures were received by U.S. after 2009 program closed.
- IRS is considering another voluntary disclosure program for those who come forward after October 2009, with higher penalties.
- Statutory civil FBAR penalties
  - Up to $10,000 per non-willful violation
  - For willful violations, up to greater of $100,000 or 50% of the account balance at time of violation (with each year of non-filing being another violation)
  - Consider IRS penalty mitigation guidelines; see IRM 4.26.16.4.6.2

Voluntary Disclosure Update (Cont.)

- Foreign mutual fund issues focus of IRS
  - Internal Revenue Code rules (ordinary income tax rates apply, plus interest charge relating back to original purchase date)
  - Mark-to-market election or QEF election available under Code
  - VCP participants are permitted to apply a modified mark-to-market regime.
    - More favorable than MTM rules of the Code
    - Gains taxed at 20% rate, with some losses allowed
    - Simplified and reduced interest rate structure
  - FATCA rules require disclosure in 2011. FBAR filings apply.

IRS Enforcement, 2010

- UBS chapter is closed. IRS withdraws John Doe summons, but the UBS agreement is a template for requests from other institutions with no presence in U.S.
- HSBC customers have also been targeted in 2010.
- Asia and Middle East financial institutions are focus.
- International joint audits have begun; Australia is first partner.
- Transfer pricing remains an important area, with a new IRS transfer pricing practice staffed with expert examiners and economists.

IRS Enforcement, 2010 (Cont.)

- New LMSB global high-wealth industry group
  - Objective is to provide a holistic review of a web of business entities controlled by a high-wealth individual, to understand the economics and to assess tax compliance.
  - Includes: Trusts, private foundations, flow-through entities, REITS, privately held companies and partnerships.
  - Group consists of pass-through specialists, international examiners, appraisers, and technical advisors with industry expertise.
- IRS realigned LMSB Division in 2010, renaming it the Large Business and International Division.
  - – Dedicated 875 employees to international unit, headed by Michael Danilack
- Treasury Inspector General for Tax Administration noted improvements were needed in the processing of NRA income tax returns, with more than $2.3 million of questionable refunds.

Hire Act And FATCA

- Ernst & Young recent Webcast survey indicated that 41% of companies are not ready to comply with new FATCA, and 33% will need to make significant efforts to prepare for the 2013 effective date.

- The Hiring Incentives to Restore Employment Act of 2010 (Hire, P.L., 111-147, 3/18/2010) added Chap. 4 to the Internal Revenue Code (sections 1471 through 1474).
  - Rules were effective for payments made after 2012. Supplemental withholding tax regime is to enforce new reporting requirements on specified foreign accounts owned by specified U.S. persons or by U.S.-owned foreign entities.

HIRE Act And FATCA (Cont.)

- Rules do not change the manner in which foreign persons are taxed in the U.S., but uses a "stick" of a withholding tax to force foreign entities to provide reporting that the IRS has no other legal means of obtaining.
- Perceived abuse under the existing withholding rules through misleading certification
- Even where IRS receives full compliance with these new reporting requirements, old withholding tax regime continues to apply.
- IRS guidance released in 2010 (Notice 2010-60); comments requested.
- Basic provision: For payments made after Dec. 12, 2012, a withholding agent must deduct and withhold a tax equal to 30% of any "withholdable payment" made to a "non-financial foreign entity" if the beneficial owner of the payment is a non-financial foreign entity that does not meet specified requirements. Withholding is not required if the payee or the beneficial owner of the payment provides the withholding agent either a certification that the foreign entity does not have a substantial U.S. owner, or provides the withholding agent with the name, address and TIN of each substantial U.S. owner.

HIRE Act And FATCA (Cont.)

- Definitions
  - A withholdable payment
    - Non-effectively connected U.S.-source FDAP income (which includes interest and dividends but not gains on sales of property)
    - Gross proceeds from the sale of property that produces interest and dividends
      - » Observation: This is a major difference from pre-FATCA law, under which gross proceeds and even capital gains were not subject to withholding.
    - Interest on deposits with foreign branches of a domestic commercial bank

HIRE Act And FATCA (Cont.)

- Definitions (Cont.):
  - Foreign financial institution
    - Accepts deposits in the ordinary course of banking or similar business
    - Holds financial assets for the account of others as a substantial portion of its business
    - Is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting or trading in securities, partnership interests, commodities or any interest in such securities, partnership interests or commodities
      - » Includes a mutual fund, fund of funds, ETF, hedge fund, PE funds, VC funds and other managed funds, commodity pools and any other investment vehicles
      - » Notice 2010-60: IRS guidance will provide that such activities of an entity will be determined based on all relevant facts and circumstances.

HIRE Act And FATCA (Cont.)

- Definitions (Cont.):
  - IRS had authority to exclude certain entities from reporting requirements and intends to issue regulations to provide that a foreign entity that otherwise satisfies definition of "financial institution" solely because it is primarily engaged in investing, etc. will not be treated as a financial institution if it falls within following groups:
    - Foreign holding company of a subsidiary primarily engaged in a trade or business other than that of a financial institution
    - Foreign start-up entity that is investing capital into assets with the intent to operate a non-financial institution, but is not yet in operation. Exclusion for first 24 months after organization
    - Foreign entity in process of liquidation, with intent to continue or recommence operations as a non-financial institution
    - Foreign entity that primarily engages in financing and hedging transactions with members of an expanded affiliated group that are not foreign financial institutions and that does not provide such services to non-affiliates
    - Entities whose business consists solely of issuing insurance or reinsurance contracts without a cash value
    - IRS intends to issue regulations exempting certain foreign pension funds.

HIRE Act And FATCA (Cont.)

- What obligations does a foreign financial institution have under an agreement with the IRS?
  - Obtain information regarding each account holder maintained by institution, to determine which accounts are U.S. accounts
  - Comply with verification and due diligence procedures
  - Report annually for any U.S. account and any substantial owner of a U.S.-owned foreign entity
  - Deduct and withhold 30% from certain pass-through payments made to “recalcitrant account holders” or certain other foreign financial institutions
  - Comply with IRS information requirements
  - Attempt to obtain a waiver where foreign law would prevent reporting of information and if a waiver is not obtained, close the account
  - IRS is considering how to coordinate this agreement with others, such as foreign withholding partnership and trust agreements and qualified intermediary agreements, but for now all are independent obligations of the taxpayer.

HIRE Act And FATCA (Cont.)

- A U.S. account is:
  - Financial account that is held by one or more specified U.S. persons or a U.S.-owned foreign entity (with an exception in situations where all accounts with the financial institution held by a natural person do not exceed $50,000)
    - "Specified U.S. person" is any U.S. person other than a publicly traded company on an established securities market or members of an expanded affiliated group, a specified exempt entity or a government body.
    - "U.S.-owned foreign entity" is a foreign entity with one or more substantial U.S. owners (applying a "more than 10% ownership of stock by vote or value test" to a corporation, a more than 10% capital or profits interest in case of partnership, a 10% interest in income or principal of a trust, or any interest in a grantor trust).

Other FATCA Provisions

- Disclosure of foreign assets on U.S. individual tax returns
  - Applies if aggregate value of all specified foreign assets (SFA) exceeds $50,000
    - » SFA includes any financial account maintained by a foreign financial institution,and other assets not maintained by a foreign financial institution, such as stock or securities issued by a non-U.S. person, any financial instrument or contract where the counterparty is a non-U.S. person, or any investment in a foreign legal entity.
  - Minimum $10,000 penalty applies to non-compliance, with an additional $10,000 per 30-day period after issuance of an IRS notice, capped at $50,000.
  - Supplements FBAR, and application is much broader than current FBAR definitions
  - IRS released draft Form 8938

Other FATCA Provisions (Cont.)

- 40% penalty is imposed on any amount of understatement of tax attributable to undisclosed financial assets, effective for tax years beginning after 2010
- Expansion of the statute of limitations for omission of gross income which is derived from a reportable foreign asset is extended to six years, if such income is in excess of $5,000.
- U.S. shareholders of PFICs must file Form 8621 even if they receive no taxable distributions or other payments with respect to such shareholdings, effective for taxable years after March 18, 2010.

Other FATCA Provisions (Cont.)

- Application to foreign trusts
  - FATCA clarifies that a foreign trust will be treated as having a US beneficiary if:
    - A U.S. person is a current, future or contingent beneficiary.
    - Any person has discretion to determine the beneficiaries of the trust, unless the terms of the trust specifically identify the class of beneficiaries, and none of those beneficiaries are U.S. persons.
    - A presumption that a foreign trust to which a U.S. person has transferred property will be treated as a U.S. beneficiary, unless the transferor proves to the satisfaction of Treasury that under the terms of the trust, no part of the trust's income or principal may be paid or accumulated during the tax year to or for the benefit of a U.S. person; and, if the trust were terminated during the taxable year, no part of its income or principal could be paid to or for the benefit of a U.S. person

Other FATCA Provisions (Cont.)

- Any uncompensated use of foreign trust property (e.g., real estate or personal use property) by a U.S. grantor, U.S. beneficiary or any U.S. person related to such grantor or beneficiary is treated as a distribution to the grantor or beneficiary equal to the fair market value of the use of such property. The use or loan of property will not be treated as a distribution, to the extent that the U.S. person repays any loan at market value or makes a payment equal to the FMV of the use of property within a reasonable time period.
  - » Observation: A distribution may require the filing of a Form 3520. Prior to the effective date of the new law, rent-free use of real estate by a trust beneficiary did not constitute a distribution that would carry out current or accumulated distributable net income. If a foreign trust has accumulated UNI, the deemed distribution could be subject to the throwback rules with an interest charge. The fair market value of the use of property could be a contentious issue. Thus, consider having property in a trust that would not generate distributable net income.

Other FATCA Provisions (Cont.)

– Other FACTA provisions: Withholding on dividend-equivalent payments
  - Payments are substitute dividend payments if made pursuant to a securities lending transaction, or sale or repo transaction; or any payment made pursuant to a notional principal contract that is contingent upon or determined with reference to any U.S.-source dividend.
  - Practitioners question whether , in the case where an index or fixed basked is treated, as a single security, a perfect match must be maintained in a swap for withholding to be required.
  - IRS anticipates final regulations being released prior to entire statute becoming effective on 3/18/12.

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