International Tax Update

NCACPA

Morrisville, NC

June 4, 2009

Henry A. Paula, Principal

Reznick Group - Charlotte

Reznick Group

ACCOUNTING • TAX • BUSINESS ADVISORY

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

To Cover Today

- Major Developments: January through May 2009
- Outbound US international tax, particularly President's indicative proposals for US Multinational Corporations (MNCs) and reporting of offshore income
- Inbound US international tax
- Assumes some level of familiarity with international taxation concepts

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

President's Proposals for International Tax Reform

Summary

- **Except for foreign income & reporting provisions, generally intended to be effective for years beginning after 12-31-2010, if adopted by Congress**
- **Estimated to raise $210 billion in revenues over 10 years**
- **Revenues raised intended to offset large part of Administration proposal to make Research & Development credit permanent**
- **Closes what some call "loopholes" for deferring or eliminating US tax on foreign earnings, example – "check the box foreign tax nothings", alleged foreign tax credit abuse, tightening enforcement of tax laws on offshore investments**

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

President's Proposals for International Tax Reform

- **Check the Box "foreign tax nothings"**
  - Foreign eligible entity would be disregarded if the single member owner and the eligible entity were not both organized in the same country – example, eligible entity subsidiaries of a low tax rate country holding company that are currently disregarded under the check the box rules (thus permitting the interest and royalty payments received by the Holding from the subsidiaries to avoid Sub-part F income inclusion) would be regarded for US income tax purposes causing the interest and dividends to be taxed currently as Sub-part F income.
  - Rule not intended to apply to "first-tier" eligible entities (i.e., those owned by the US person) unless formed for tax avoidance purposes

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

President's Proposals for International Tax Reform

- **Matching of foreign-related US deductions with presumed future foreign income**
  - Defer US deduction of expenses (other than R&D) related to foreign earnings and investments until the related income is recognized for US income tax purposes
  - Administration apparently believes that the current US deduction and related tax savings for early stage losses of foreign business investments, which would be no different for domestic investments, is contrary to public policy of keeping jobs in the US
  - Deferred deductions would be carried forward until the related foreign income becomes US taxable but no mention as to when it would become deductible if the foreign investment never generates a profit

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

President's Proposals for International Tax Reform

- **Eliminate "cross-crediting" of foreign taxes under Section 902 (deemed paid credit)**
  - Currently US multinationals (MNCs) can shift income to low rate jurisdictions without triggering US tax (e.g., via the check the box structures referred to earlier) while incurring higher rate taxes, possibly higher than the US effective tax rates, in other subsidiaries' countries in which they must operate
  - To assure sufficient foreign source income and US creditability of the higher rate taxes when the higher taxed foreign earnings must be brought back, the MNCs will frequently trigger the deemed or actual repatriation of the low-taxed earnings thus bringing the effective foreign rate on the total income down below the US rate and permit full creditability – all legally and within the current rules
  - Proposal would consolidate the total foreign source taxable incomes and losses for of all the foreign subsidiaries to determine if there would be sufficient profits in the year to take the Section 902 deemed dividend

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

President's Proposals for International Tax Reform

- **Eliminate improper splitting of foreign taxes from its foreign source income**
  - Currently, through structuring techniques, the splitting of the foreign taxes from its foreign source income can take place so that the possibility of crediting those foreign taxes is enhanced in the current year or the carryover period
  - Administration simply says it would provide a matching rule to prevent this. No further details on the matching and under what circumstances the splitting would be inappropriate

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

President's Proposals for International Tax Reform

- **Clarification that "Dual Capacity" taxpayers' foreign taxes would only be creditable if the foreign country also generally imposed an income tax or tax in lieu of an income tax**
  - In general, Dual Capacity taxpayers are those whose "tax" levy by a foreign country covers both a tax as well as a payment for an economic benefit, the economic benefit portion being non-creditable under US tax law
  - Seems aimed at the oil and gas companies that operate in countries where there is not generally imposed an income tax except, on those companies extracting oil and gas. The tax is imposed upon the extraction or related to the extraction activity thus, in effect, being a payment being extracting the oil. So, in effect, the US Treasury is directly paying for part of the oil, irrespective of its lack of consumption
  - Change is proposed to provide creditability of those foreign "taxes" only if the country makes substantial application of the tax on the business income of the country's non-dual taxpayers and its nationals and residents.

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

President's Proposals for International Tax Reform

- **Repeal "gain within boot" limitation for foreign reorganizations to prevent repatriation foreign E&P with minimal US tax**
  - Currently, a US "seller" of a foreign corporation can "sell" stock in a foreign target in exchange for stock and property not permitted to be received tax-deferred under Section 356 ("boot") and the gain recognized for tax will be the lesser of the boot or the gain realized ("gain within boot" limitation), irrespective of the fact that the foreign corporation may have significant previously non-taxed E&P – something that is against the US principle that a foreign subsidiary's E&P should be taxed in the US upon, in effect, being repatriated
  - The proposal would eliminate the "gain within boot" limitation for certain foreign reorganizations where the acquirer is foreign and exchange would have the effect of a dividend distribution

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

President's Proposals for International Tax Reform

- **Limit income shifting abroad via intangible property migrations**
  - Currently, when US corporations transfer intangible property to foreign jurisdictions, often to low tax rate jurisdictions to accumulate the related income in such low-rate jurisdictions and defer tax using check the box planning. Section 367(d) generally would impute a royalty to the transferor commensurate with the income from the property, if the transferor does not calculate and report this own its own. IRS can also invoked Section 482 to accomplish the same.
  - However, it is neither clear how to value the different pieces of intangible properties that may be transferred or what intangible property was contemplated by Congress
  - The proposal would:
    - Clarify that intangibles include workforce in place, goodwill and going concern value,
    - Would permit IRS to value in the aggregate multiple properties transferred if more reliable,
    - Call for valuing the property at its highest and best use

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

President's Proposals for International Tax Reform

- **Limit "earnings stripping" by expatriated entities (tax years after 2010)**
  - Administration officials strongly suspect that expatriated entities are stripping earnings out of the US via related party interest deductions paid to foreign entities. In general, these are companies that have purposely established their top level company (the ultimate parent company) outside the US, particularly before the Section 7874 tax on "inversions" e.g., Ingersoll Rand, Tyco.
  - In general, the proposal would be to tighten up the anti-earnings stripping rules (Section 163(j)) for these US groups such as by eliminating the 1.5 to 1.0 debt-equity safe harbor, changing the adjusted taxable income rule, and limiting the excess interest carryover to 10 years.
  - An expatriated entity would be defined with reference to Section 7874's definition.
  - **NOTE** – New Form 8926 applies for 2008 returns to report Section 163(j) interest for **non-US owned** companies in the US

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

President's Proposals for International Tax Reform

- **Repeal of 80-20 companies (effective after 2010)**
  - In general, 80-20 companies are US companies with 80% or more of their income (for a 3 year testing period) from foreign sources and constituting active business income
  - No US withholding tax applies to interest or dividends paid by these companies
  - Administration believes that these companies can be manipulated (e.g., US tax base eroded with deductible interest without earnings stripping and withholding tax) and proposes total repeal

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

President's Proposals for International Tax Reform

- **Prevent avoidance of US withholding tax via equity swaps (after 2010)**
  - Currently, instead of investing in US equities that would suffer withholding taxes upon payment of dividends, foreigners often invest in equity swaps (also referred to as notional principal contracts) which basically offer the same economic benefits and risks but the income of which is foreign source so no US withholding tax applies.
  - Proposal is to treat the income from the equity swaps in accordance to the source of the underlying equity and apply withholding tax rules, subject to altering by treaty and revoke Notice 97-66
  - Exceptions would apply

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

President's Proposals for International Tax Reform

Combating Income Under-Reporting Via Use of Offshore Accounts

- **Fourteen different proposals divided as follow:**
  - Proposals to strengthen Qualified (and Nonqualified) Intermediary (QI) program wherein foreign financial institutions assist in reporting and withholding US income tax on monies flowing thru them from US and foreign persons
  - Proposals to strengthen and increase Foreign Bank Account Reporting procedures, penalties and information on foreign financial accounts and money transfers, generally:
    - Report on tax returns greater detail on foreign financial accounts
    - Report on 1040 transfers of property to and from abroad
    - Require 3rd parties to report money/property transfers and establishment of new entities
    - "Negative presumptions", doubling accuracy penalties and extending the stature of limitations
  - Generally applicable for tax years beginning after December 31st of the year of adoption

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

US Outbound International Taxation

- **Final, Temp. & Prop. Contract Manufacturing Regs. (12/08)**
  - Address manufacturing exception to foreign base company sales income (FBCSI, a type of Subpart F income)
  - Address “branch rule” which is intended to prevent getting around the FBCSI by using a branch instead of a Controlled Foreign Corporation (CFC) so that the inter-branch sale would be a disregarded transaction
  - Apply to tax years of CFCs beginning after June 30, 2009
  - Applicable to almost any US group with foreign trade and related party transactions

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

US Outbound International Taxation

- **New Cost-Sharing Agreements (CSAs) Temp. Regs. (12/08)**
  - Regs. address criteria that CSAs and “platform contributions transactions” should meet in order for them to meet Section 482’s Commensurate with Income Standard (CSW)
  - Introduce three new methods for CSAs:
    - Income method
    - Acquisition price method
    - Capitalization method
  - Also retain the comparable uncontrolled transaction (CUT) and revised residual profit split RPS) methods
  - Apply only to CSAs meeting standards in the regs (1.482-7T)
  - Other intangibles transactions to be analyzed under 1.482-4
  - Temp. CSA regs. replace those from 1995 in 1.482-7

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

US Outbound International Taxation

- **Subpart F "partnership blocker" - IRS transaction of interest**
  - Notice 2009-7 designates as transactions of interest transactions and structures where taxpayer interposes a US partnership in a CFC structure to turn off Subpart F income
  - IRS officials consider the turn off of Subpart F position aggressive solely on its surface but do not name it a "listed transaction" and are interested in the "business purpose" of the partnership under the particular circumstances and comparison to other judicial standards that may be relevant (e.g., sham, substance over form)

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

US Outbound International Taxation

- **IRS: Foreign Tax Credit "generators" are Tier 1-type issues**
  - Highly structured transactions where assets are "parked" in a jurisdiction and structure primarily to generate foreign source income to utilize foreign tax credits (FTCs)
  - IRS has issued temporary and proposed regulations to address the generators
  - IRS has previously denied on various grounds including debt/equity, substance over form, lack of business or economic purpose
  - Tier 1 designation brings IRS national attention and consistency

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

US Outbound International Taxation

- **IRS: Practitioners have duty to inform taxpayers of FBAR**
  - Deputy Director of IRS Office of Professional Responsibility allegedly believes that practitioners have a duty to inform taxpayers of FBAR under Circular 230
  - Practitioners cannot, as part of their professional responsibility, ignore questions the requirements raise

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

US Outbound International Taxation

- **IRS: FAQs on Voluntary Disclosure of Offshore Accounts**
  - Issued May 6, 2009
  - For previously undisclosed foreign accounts and foreign entities
  - Example of penalty on underreported interest income would work
  - Contrasts result with voluntary disclosure compliance versus getting caught
    - Drastic difference in total due IRS given assumptions in example
    - $368,000 plus interest versus $2,306,000 **NOT** including potential fraud penalty and other failure to file informational returns penalties, civil penalties and criminal charges

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

US Inbound International Taxation

- **IRS letter on filing of Form 8833 re: treaty-based positions:-**
  - Only taxpayers in certain situations must disclose treaty-based return positions. For individuals, generally, only dual resident individuals claiming US non-residency under a treaty have to file 8833
  - IRS cannot deny a treaty benefit because Form 8833 is not attached to the return or it is attached to the wrong return

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

US Inbound International Taxation

- **IRS issues fact sheet on TO DOs for departing aliens**
  - Issued May 2009
  - Provides who should file Form 2063, US Departing Alien Income Tax Statement, to obtain a tax clearance (“sailing or departure permit”) for leaving the US
  - Also, when Form 1040C, US Departing Alien Income Tax Return, will be required to obtain a sailing permit
  - Cross-references to Publication 519 and Form 8854 and related potential “Expatriation Tax”

Reznick Group
ACCOUNTING • TAX • BUSINESS ADVISORY

Henry A. Paula, CPA
704.295.9356
henry.paula@reznickgroup.com

Mr. Paula has over 30 years experience, including significant experience working with US and non-US multinationals in mergers and acquisitions, complex capital structures, multistate and multinational tax planning and accounting for income taxes (FAS 109 and FIN 48). His recent clients have ranged from closely-held companies in their early stages to several large SEC-registrant audit and non-audit clients with operations in practically every state and over 50 countries.

Mr. Paula recently retired as a partner from PricewaterhouseCoopers (PwC) to join Reznick Group in the fall of 2008 as a tax principal. Mr. Paula served clients in industries ranging from real estate to, more recently, the software, telecom equipment, pharmaceutical services, biotechnology and industrial products industries. He has significant experience in cross-border acquisitions, divestitures and financing structures and transfer pricing and intellectual property migrations.

Mr. Paula served three years as a Managing Director in the Corporate Finance Group of a major US bank's capital markets group and before that he also served as the US Desk Tax Partner in Paris France for another Big Four firm. Mr. Paula has frequently taught courses in international taxation, general corporate taxation, taxation of mergers and acquisitions, and FAS 109/FIN 48. He has also revised several publications such as Taxation of Foreign Investment in US Real Estate, US Citizens Abroad and Foreign National in the US.

Reznick Group

ACCOUNTING • TAX • BUSINESS ADVISORY