US tax developments

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THE US LANDSCAPE UNDERWENT SIGNIFICANT DEVELOPMENTS IN THE PAST YEAR (2013/14), INCLUDING US COMPANIES ENTERING INTO INVERSION TRANSACTIONS, DEVELOPMENTS RELATING TO BEPS, FOREIGN TAX CREDIT AND SECTION 956 CHANGES, AS WELL AS NEW GUIDANCE RELATING TO COMPETENT AUTHORITY AND ADVANCE PRICING AGREEMENTS, AND DEVELOPMENTS RELATING TO SECTION 367(D) AND THE DEFINITION OF INTANGIBLES. IN THE ARTICLE TO FOLLOW WE PROVIDE A BROAD OVERVIEW OF THESE DEVELOPMENTS.

Inversions

US companies recently have been entering into inversion transactions due to the US corporate tax rules. The US has the highest corporate tax rate in the world and is one of the last countries to use a worldwide system of taxation. In the global economy, US companies must be able to compete with foreign companies. It is difficult for US companies to compete when they are mired in a corporate tax system that dates back to World War II at a time when their foreign competitors operate in more modern, 21st century tax systems.

Even Congress has acknowledged this problem. In its "reasons for change" in enacting the § 7874 anti-inversion rule 10-years ago, the House stated: "corporate inversion transactions are a symptom of larger problems with our current uncompetitive system for taxing US-based global businesses and are also indicative of the unfair advantages that our laws convey to foreign ownership."

The Obama Administration's 2015 Budget contained an anti-inversion proposal. Senate Finance Committee Chair Ron Wyden (D-Ore.) announced in a Wall Street Journal op-ed on May 8, 2014 that he was putting companies on notice that anti-inversion legislation would be effective for transactions completed after the date of his op-ed.

Two very similar anti-inversion bills were introduced in Congress (S. 2360 and H.R. 4679) with retroactive May 9, 2014 effective dates. Under the bills, the § 7874 80%

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historic ownership inversion threshold would be reduced to 50%. Consequently, if the historic shareholders of the former domestic corporation own more than 50% of the stock (by vote or value) of the foreign-incorporated entity; the foreign-incorporated entity is considered a US corporation for US tax purposes. The 50% threshold would prevent US companies from being able to invert to a foreign country by engaging in an acquisition transaction with an equal or smaller size foreign company.

Importantly, the bills would also drop the threshold to 0% if, after the acquisition, the management and control of the foreign acquirer's worldwide group (its expanded affiliated group) is primarily in the US and the group has significant US business activities. A foreign acquiring company could become subject to these rules in a cash acquisition where no target shareholders become shareholders in the foreign acquiring corporation.

Retroactive regulations would define management and control. However, the bills state that management and control is treated as occurring, directly or indirectly, primarily within the US if substantially all of the executive officers and senior management of the group who exercise day-to-day responsibility for making strategic, operating and financial decisions are based or primarily located in the US. If passed, the management and control provision could result in companies moving management and executive positions outside the US.

The bills state that an expanded affiliated group has significant US business activities if at least 25% of its (1) employees by headcount, (2) employees by compensation, (3) tangible assets, or (4) income is in the US. The secretary can decrease this percentage by regulations.

Under these bills a previously inverted company would never be able to acquire a US company. Even other foreign companies with significant foreign operations would risk being subject to these rules if they acquired a US business and have significant US business activities and management in the US.

Republicans have criticised the proposed anti-inversion changes and have expressed opposition to any immediate anti-inversion legislation. They believe the source of the problem should be addressed and that the corporate tax laws should be brought into the 21st century. Senate Finance Committee member Orin Hatch (R-Utah) stated that nothing will fully stop inversions short of a tax code overhaul that lowers the corporate rate to a level more in line with other industrialised nations.

One possibility that some Senators have discussed involves preventing earnings stripping following an inversion. Nothing has yet been introduced along these lines, however.

BEPS

According to the OECD BEPS discussion drafts, "special measures, either within or beyond the arm's length principle, may be required with respect to intangible assets, risk and over-capitalisation" to address purported flaws in the current transfer pricing system. The OECD is considering circumstances in which related-party contracts can or should be ignored under a "special measure." The concept of a "special measure" involves subjectivity and vagueness which obscure the arm's length standard.

US tax officials have expressed misgivings that the OECD's efforts deviate to this extent from the arm's length standard. Robert Stack, deputy assistant secretary for international tax affairs with the US Treasury and the US delegate to the OECD, recently stated that the US wants a thorough discussion paper on the arm's length principle that deals with how to price hard-to-value intangibles. Stack has also voiced the view that tax administrators seeking bilateral solutions to tax issues is preferable to a BEPS project resulting in vague principles.

Mike Danilack, the recently departed LB&I Deputy Commissioner (International) and Sam Maruca, formerly the LB&I Director of Transfer Pricing, also have voiced concerns that some US treaty partners may see BEPS as an invitation to "snatch away" the US's tax base, and that transfer pricing controversies will become more common and competent authorities worldwide will be under increased pressure to resolve them.

Interestingly, however, while the US supports the arm's length standard internationally, domestically the IRS itself has sought to undermine the arm's length standard in some recent transfer pricing disputes. In *Altera v. Commissioner*, the IRS is arguing that it can write regulations that deviate from the § 482 arm's length standard. An IRS victory in *Altera* could undermine the US's efforts to preserve the arm's-length standard in BEPS discussions.

Regarding the BEPS treaty discussion draft, Stack stated that there are concerns about the US's LOB provisions, such as discretionary relief and the approach to benefits. While the US does not like the "main purpose" (GAAR) approach, other countries assert that the US can deny treaty benefits to taxpayers under its statutory and case law. Stack also said the US likely would not join a multilateral tax treaty that has a main purpose test. The Senate rejected "main purpose" language during its consideration of treaties with Italy and Slovenia in 1999.

The US wants to prevent country-by-country reporting from being used as a basis for formulary apportionment (in lieu of the arm's length standard). Stack stated that the OECD's draft country-by-country reporting standards call for too much information from multinationals. The Tax Executives Institute expressed similar concerns in written comments.

In addition, a concern was expressed during a recent US Senate hearing that BEPS could be used by other countries to increase taxes on US taxpayers. A US Treasury official and an OECD official were urged by Senator Hatch (R-Utah) not to rush into accepting a "bad deal" just for sake of reaching an agreement.

The BEPS Action Plan addresses digital economy issues including character and source of income. US officials have said the digital economy discussion draft creates winners and losers and that the US is often the loser. Multilateral agreement on digital economy issues might not be possible.

The US already has tax law holding that the source of income is the situs of the income-producing activity in the case of radio advertising income (*Piedras Negras Broadcasting*). US officials have reported that the BEPS digital economy report will not propose a new tax regime. The committee concluded that the world is digital, the economy is digital, and you really can't hive off the digital economy from the rest of the economy as a basis for setting up some kind of fundamental new tax regime.

Foreign tax credit developments

Notice 2014-44, provides guidance relating to certain dispositions of assets following a § 901(m) covered asset acquisition ("CAA").

Section 901(m)(3)(B) provides that if there is a disposition of any relevant foreign asset ("RFA") before the end of the cost recovery period, the remaining portion of that RFA's basis is allocated entirely to the year of the disposition. The IRS expressed a concern that taxpayers take the position that the deemed liquidation that results from a check-the-box election constitutes a disposition of RFAs for purposes this rule. As a result, taxpayers claim that all of the basis difference with respect to the RFA is allocated to the final tax year of foreign target that occurs by reason of the deemed liquidation, and that no basis difference with respect to the RFAs is allocated to any later tax year.

To address this situation, the IRS and Treasury intend to issue regulations that limit the definition of a disposition to include only events that result in gain or loss recognition with respect to RFAs for purposes of US income tax, foreign income tax, or both. Under this definition, the tax-free deemed liquidation of foreign company, for example, is not a disposition.

The new regulations would also provide a new definition of the "disposition amount." The disposition amount is the portion of the basis difference in the RFAs that is taken into account in the year of the disposition. If a disposition is fully taxable for both US and foreign purposes, the disposition amount is the full unallocated basis difference. If a disposition is only partly taxable for either US or foreign purposes, there would continue to be a basis disparity and the unallocated basis difference is taken into account only to the extent the basis disparity for US and

foreign tax purposes is reduced. In general, the future regulations will apply to dispositions occurring on or after July 21, 2014.

Section 956 Developments

A recent IRS legal memorandum (ILM) 201420017 (December 27, 2013) held that a loan made by a controlled entity that is disregarded for US federal income tax purposes ("DE"), to a controlled foreign corporation ("CFC"), and then to their US parent company ("USP"), can be treated as being made directly from the disregarded entity to USP.

The ILM addresses a USP that owns a number of CFCs. Some of the CFCs are partners in a foreign partnership, which in turn owns DE that operates a cash pooling/related-party finance business. DE loaned funds to one of the CFCs, which in turn made a loan to USP. The subpart F income inclusion under § 956 would have been substantially greater had DE loaned directly to USP. This is because the earnings and profits of the CFC were limited.

The ILM holds that the anti-abuse rule can apply to treat DE as having made the loan directly to USP. The ILM states that the substantially lower inclusion reported by USP and the close proximity in time between the loans, are strong evidence that one of the principal purposes of funding that CFC was to avoid § 956.

Competent authority

In Notice 2013-78, the IRS proposed new guidance on US competent authority ("CA") which: clarify that CA issues may arise as a result of taxpayer-initiated positions; make clear that the offices of the US CA are available for informal consultations, including regarding the steps necessary to achieve greater certainty that a foreign tax will qualify as a compulsory payment; recognise that a mutual agreement case may arise where the US CA notifies a foreign CA on a US-initiated case raising CA issues; provide new procedures for invoking the accelerated CA process without consent of the IRS's examination team; provide the US CA can start a CA proceeding even without the taxpayer's request; permit taxpayer requests to make a joint presentation to the two CAs; specify that the Simultaneous Appeals Procedure ("SAP") is the only procedure for obtaining IRS Appeals and CA review of the same issue; provide that the CA will not accept a request for assistance if the taxpayer has entered into a prior resolution with the IRS's exam team unless the US CA agreed in writing to the prior resolution. Some of these changes would be material if adopted.

The IRS reported that from October 1, 2012 through December 31, 2013, 159 CA cases involving MAP requests concerning the allocation and attribution of business profits, were resolved. These cases arose from 40 US, and 119 foreign, initiated adjustments. Full relief was granted in 130. In eight cases (seven foreign-initiated), only partial relief was granted, and in seven cases (all foreign-initiated) no relief was granted. In 14 matters, the taxpayer withdrew its request. Thus, over 80% of CA cases were resolved favorably for the taxpayer. The average processing time for cases was 26 months, which seems in accord with previous years.

There were 102 cases arising under all other treaty articles, including requests for discretionary determinations under treaty limitations on benefits provisions, were resolved. Fifty-three were US-initiated and 49 were foreign-initiated matters.

Advance pricing agreements

Notice 2013-79 proposed new guidance on advance pricing agreements ("APAs"). Importantly, the new guidance: explain potential interactions between requests for APA and requests for CA assistance; state that the IRS Advance Pricing and Mutual Agreement office may condition its acceptance of an APA request upon a taxpayer's agreeing to roll back the terms of the proposed APA; clarify that a complete APA request will be a factor in determining whether the taxpayer has met the documentation requirements for purposes of the accuracy-related penalty on underpayments; restate and revise the treatment of and

procedures regarding repatriation payments for bilateral or multilateral APAs and unilateral APAs; and provide that a taxpayer may seek permission to submit an abbreviated APA request in cases involving renewals of current APAs if the relevant factors of the current APA are substantially the same as those in the proposed renewal APA years.

While substantially improved in many respects, the new APA procedure takes an audit-like approach that significantly undermines the benefits of an APA for both taxpayers and the government in a process that was, in the past, more collaborative.

There were 145 APAs were executed in 2013 and 111 applications (down from 126 in 2012) were received. The termination of Eaton's APAs may have had an impact on the number of applications received in 2013. Two of Eaton's APAs were unilaterally cancelled by the IRS.

The median completion time for an APA decreased seven months to 32.7 months, and the median time to complete a new bilateral APA is 38.8 months. Inbound APAs involving foreign parent companies and US subsidiaries accounted for 55% of the APAs, with the majority of bilateral APAs involving Japan (53%), Canada (19%) and the UK (8%).

Section 367(d) and the Definition of Intangibles

The IRS has taken the position that goodwill, going concern value and workforce in place can be taxed to the US company under § 367(d). Section 367(d) provides that if a US person "transfers any intangible property (within the meaning of Section 936(h)(3)(B)) to a foreign corporation in an exchange described in Section 351 or 361," the US person is treated as transferring intangible property in exchange for contingent payments that must be commensurate with the income attributable to the intangible. However, the § 367(d) regulations themselves specifically exempt foreign goodwill and going concern value. Furthermore, the intangibles that are covered under § 367(d) are defined by reference to § 936(h) and the § 936(h) rules do not include goodwill, going concern value and workforce in place.

This issue is in litigation in a number of Tax Court cases involving so-called § 936 conversions (outbound reorganisations), the IRS asserts large transfer pricing adjustments (in some, US$1bn or more), and, as an alternative argument, asserts that certain intangibles were transferred subject to § 367(d), namely goodwill, going concern and workforce in place.

The Obama 2015 Budget once again proposed a change in the definition of intangible property under § 936(h) that applies for purposes of § 367 and § 482. For the first time, the proposal states "the proposal would *provide* that the definition of intangible property…" (instead of using the word "clarify").

The proposed intangibles definition change would also include "any *other* item owned or controlled by a taxpayer that is not a tangible or financial asset and that has substantial value independent of the services of any individual." This could seriously expand the definition of "intangibles."

Since the proposed change would apply for purposes of § 482 as well as § 936, numerous questions would arise in the context of many everyday intercompany transactions, such as the sale of goods.

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