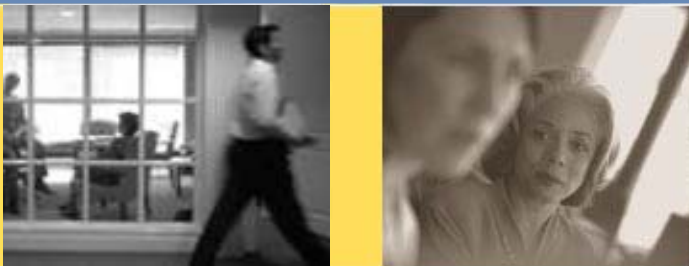


Selected U.S. Tax Developments

September 2010

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*Special acknowledgments to Amanda Pedvin Varma



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Overview

- Recent Legislative Developments
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Recent Tax Legislative Developments

Recent Tax Legislative Developments

- On September 8, President Obama announced new proposals to encourage business spending.
- Tax elements of his proposal included:
 - Making the R&D credit permanent (\$100 billion cost), and
 - Allowing companies to fully deduct qualified capital investments through the end of 2011 (\$30 billion).
- The proposal also included \$50 billion in additional infrastructure spending.
- White House Press Secretary Robert Gibbs has said the proposal may not be fully offset, but it is possible that more “loophole closers” could be used to pay for the tax provisions.

Recent Tax Legislative Developments

- Other potential tax-related Congressional action includes small business tax relief.
 - One version has already been passed by the House.
 - The House bill would create a small business lending fund and provide a temporary exclusion of 100% of gain on certain small business stock.
 - The House bill did not contain any international tax-related offsets.
 - On September 10, Senator Voinovich (R-OH) said he would support the Senate small business tax relief bill (the Small Business Jobs Act of 2010), which likely will allow the Senate to pass the bill the week of September 13.
 - The Senate version would provide a one-year extension of bonus depreciation, a temporary expansion of section 179 expensing, and an exclusion from capital gains rates for the sale of some small-business stock.
 - It would be paid for by repealing the *Container Corp.* decision, requiring persons receiving rental income to file information returns with the IRS, and a Roth retirement plan-related change.

Recent Tax Legislative Developments

- Other potential tax-related Congressional action includes:
 - Extenders
 - May not be fully offset
 - Carried interest may be used as partial offset
 - Estate tax
 - 2001/2003 tax cuts
 - President Obama continues to insist that rates should rise for households earning more than \$250,000, but there is speculation that President Obama would not veto a short-term extension of the tax cuts for all income earners.
 - House Minority Leader John Boehner has proposed extending all the tax cuts for two years but apparently is open to an extension for all but the highest earners.

What Revenue Raisers are Left?

- Several of President Obama's international tax-related Greenbook proposals
- Several of President Obama's business tax-related Greenbook proposals
- Other provisions
 - Bank tax

Status of Obama FY 2011 Greenbook International Tax-Related Proposals

Greenbook Proposal	Status
Defer Deduction of Interest Expense Related to Deferred Income	Not enacted Not proposed in legislation
Determine Foreign Tax Credit on Pooling Basis	Not enacted Not proposed in legislation
Prevent Splitting of Foreign Income and Foreign Taxes	Enacted in P.L. 111-226 ("Loophole Closers" Act)
Tax Currently Excess Returns Associated with Transfers of Intangibles Offshore	Not enacted Not proposed in legislation
Limit Shifting of Income Through Intangible Property Transfers	Not enacted Not proposed in legislation
Disallow the Deduction for Excess Nontaxed Reinsurance Premiums Paid to Affiliates	Not enacted Similar proposal introduced by Rep. Neal
Limit earnings stripping by expatriated entities	Not enacted Not proposed in legislation
Repeal 80/20 Company Rules	Enacted in P.L. 111-226 ("Loophole Closers" Act)
Prevent Avoidance of Dividend Withholding Taxes	Enacted in FATCA provisions of HIRE Act
Modify the Tax Rules for Dual Capacity Taxpayers	Not enacted Not proposed in legislation
Various Offshore Account-Related Proposals	Enacted in FATCA provisions of HIRE Act

Status of Obama FY 2011 Greenbook Business Tax-Related Proposals (Selected)

Greenbook Proposal	Status
Repeal Gain Limitation for Dividends Received in Reorganization Exchanges (i.e., "boot within gain" rule)	Not enacted Proposed in several extenders bills
Codified Economic Substance Doctrine	Enacted
Tax Carried (Profits) Interest as Ordinary Income	Not enacted Proposed in several extenders bills

Status of Other Selected Revenue Raisers

Greenbook Proposal	Status
Bank Tax	Not yet proposed
Doggett/Rangel "Treaty Shopping" Provision	Proposed in Small Business and Infrastructure Jobs Tax Act of 2010; Stop Tax Haven Abuse Act
Managed and Controlled Test for Corporate Residency	Proposed in Stop Tax Haven Abuse Act; International Tax Competitiveness Act of 2010
<i>Container Corp.</i> reversal	Proposed in Senate Small Business Act
Elimination of Royalties From Section 954(c) Look-Through Rule	Proposed in International Tax Competitiveness Act of 2010

Obama FY 2011 Greenbook Revenue-Raisers Not Yet Enacted (Selected)

Obama Tax Proposal: Defer Deduction of Interest Expense Related to Deferred Income

- Current law: U.S. businesses may deduct ordinary and necessary expenses paid or incurred in carrying on a trade or business
- Proposal: U.S. businesses must defer the deduction of interest expense properly allocated and apportioned to foreign-source income that is not currently subject to U.S. tax.

Obama Tax Proposal: Defer Deduction of Interest Expense Related to Deferred Income

- Proposal: U.S. businesses must defer the deduction of interest expense properly allocated and apportioned to foreign-source income that is not currently subject to U.S. tax.
 - Foreign-source income earned by a taxpayer through a branch would be considered currently subject to U.S. tax, so the proposal would not apply to interest expense properly allocated and apportioned to such income.
 - The amount of a taxpayer's interest expense that is properly allocated and apportioned to foreign-source income would generally be determined under current Treasury regulations, but the Treasury Department "will revise existing Treasury regulations and propose such other statutory changes as necessary to prevent inappropriate decreases in the amount of interest expense that is allocated and apportioned to foreign-source income."

Obama Tax Proposal: Defer Deduction of Interest Expense Related to Deferred Income

- Proposal: U.S. businesses must defer the deduction of interest expense properly allocated and apportioned to foreign-source income that is not currently subject to U.S. tax.
 - Deferred interest expense would be deductible in a subsequent tax year in proportion to the amount of the previously deferred foreign-source income that is subject to U.S. tax during that subsequent years Treasury regulations may modify the manner in which a taxpayer can deduct previously deferred interest expenses in certain cases.
 - The proposal is similar to a provision proposed by House Ways and Means Committee Chairman Rangel in Section 3201 of H.R. 3970 (2007). Chairman Rangel's provision, however, would apply to all foreign-related deductions.

Obama Tax Proposal: Foreign Tax Credit Reforms

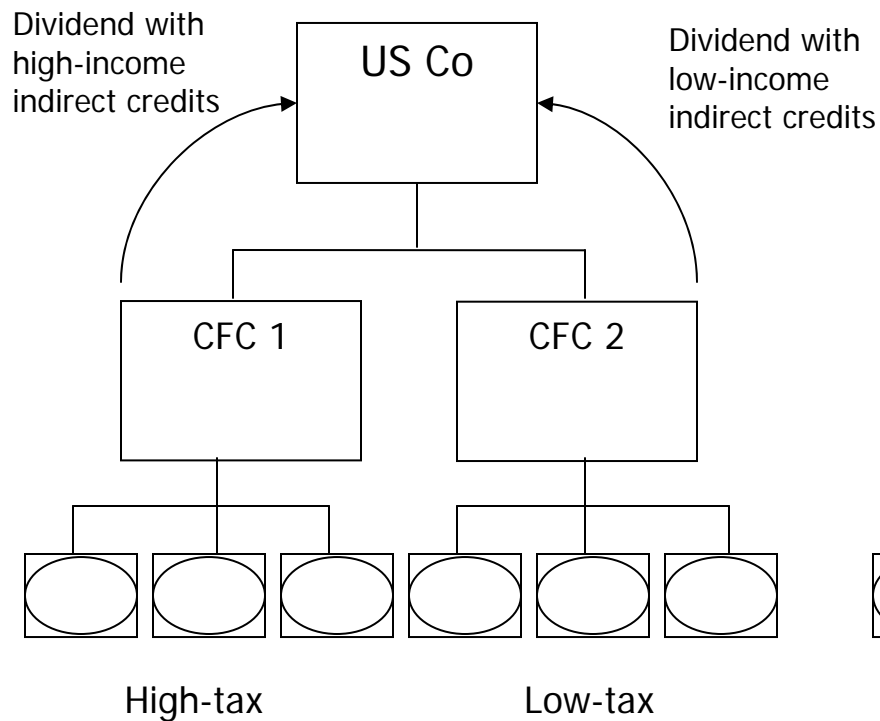
- Determine Foreign Tax Credit on Pooling Basis
 - Current Law: A domestic corporation is deemed to have paid the foreign taxes paid by certain foreign subsidiaries from which it receives a dividend.
 - Proposal: A U.S. taxpayer would determine its deemed paid foreign tax credit by determining the aggregate foreign taxes and earnings and profits of all the foreign subsidiaries with respect to which the U.S. taxpayer can claim a deemed paid foreign tax credit. The deemed paid foreign tax credit would be determined based on the amount of the consolidated earnings and profits of the foreign subsidiaries repatriated to the United States in that year.

Obama Tax Proposal: Foreign Tax Credit Reforms: Effect on Planning

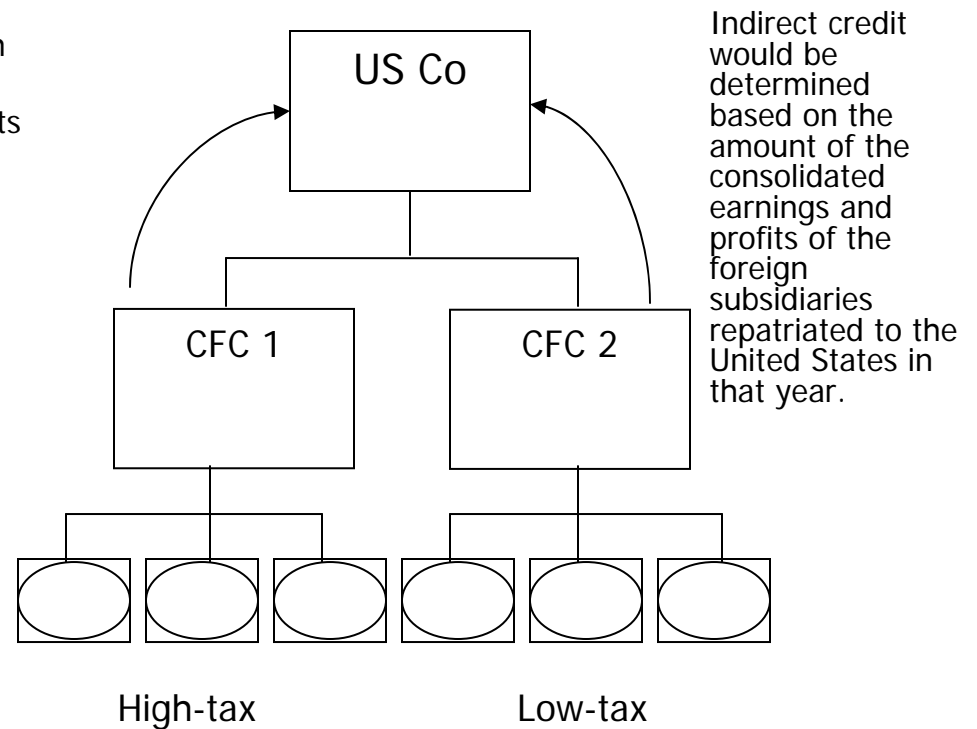
- “Cross-crediting”
 - Achieving the lowest overall U.S. tax rate, by using excess credits from taxes imposed by high-tax jurisdictions to offset U.S. tax on income repatriated from low-tax jurisdictions
- Selective repatriation
 - Repatriating amounts that carry high foreign tax credits while deferring inclusion of untaxed or low-taxed earnings, or repatriating high-taxed and low-taxed income so as to balance excess credits from the former with excess limitation from the latter

Obama Tax Proposal: Foreign Tax Credit Reforms: Effect on Planning

Current law:



Under Obama proposal:



Obama Tax Proposal: Tax Currently Excess Returns Associated with Transfers of Intangibles Offshore

- Current Law: In the case of transfers of intangible assets, section 482 provides that the income with respect to the transaction must be commensurate with the income attributable to the transferred intangible.
 - According to the Green Book, “[t]he potential tax savings from transactions between related parties, especially with regard to transfers of intangible assets to low-taxed affiliates, puts significant pressure on the enforcement and effective application of transfer pricing rules. There is evidence indicating that income shifting through transfers of intangibles to low-taxed affiliates has resulted in a significant erosion of the U.S. tax base.”

Obama Tax Proposal: Tax Currently Excess Returns Associated with Transfers of Intangibles Offshore

- Proposal: If a U.S. person transfers an intangible from the United States to a related CFC that is subject to a “low foreign effective tax rate in circumstances that evidence excessive income shifting,” then an amount equal to the “excessive return” would be treated as subpart F income (in a separate foreign tax credit limitation basket).
 - According to press reports, for purposes of conducting a revenue estimate of the proposal, the assumed “low foreign effective tax rate” was 10% and an “excessive return” was assumed to be a 30% rate of return on the relevant assets.
- Query:
 - To what extent is the proposal a repudiation of the arms'-length standard?
 - How does the proposal interact with the United States' treaty obligations?

Obama Tax Proposal: Limit Shifting of Income Through Intangible Property Transfers

- Current Law: Sections 482 and 367(d) reference section 936(h)(3)(B) for the definition of “intangible property.”
 - Section 936(h)(3)(B) provides:
 - The term “intangible property” means any—
 - patent, invention, formula, process, design, pattern, or know-how;
 - copyright, literary, musical, or artistic composition;
 - trademark, trade name, or brand name;
 - franchise, license, or contract;
 - method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
 - any similar item;
 - which has substantial value independent of the services of any individual.

Obama Tax Proposal: Limit Shifting of Income Through Intangible Property Transfers

- Proposal: Clarify the definition of intangible property to clearly include workforce in place, goodwill, and going concern value
 - The proposal would also clarify valuation issues:
 - In a transfer of multiple intangible properties, the IRS may value the intangibles on an aggregate basis where that achieves a more reliable result.
 - In valuing intangible property, the Commissioner may take into account the prices or profits that could have been realized by the taxpayer if it chose a realistic alternative to the controlled transaction (e.g., if the taxpayer itself exploited the intangible).
 - Treatment of foreign goodwill under current law and under the proposal?
- Question: How will a “clarification” affect the cases currently pending that involve the definition of intangible property?

Obama Tax Proposal: Disallow the Deduction for Excess Nontaxed Reinsurance Premiums Paid to Affiliates

- Current Law: Insurance companies generally are allowed a deduction for premiums paid for reinsurance.
 - Insurance income of a foreign-owned foreign company that is not engaged in a U.S. trade or business is not subject to U.S. income tax.
 - Reinsurance policies issued by foreign insurers with respect to U.S. risks generally are subject to an excise tax of 1% of the premiums paid unless waived by treaty.

Obama Tax Proposal: Disallow the Deduction for Excess Nontaxed Reinsurance Premiums Paid to Affiliates

- Proposal:
 - A U.S. insurance company would be denied a deduction for certain reinsurance premiums paid to affiliated foreign reinsurance companies with respect to U.S. risks insured by the insurance company or its U.S. affiliates.
 - The U.S. insurance company would not be allowed a deduction to the extent that (1) the foreign reinsurers (or their parent companies) are not subject to U.S. income tax with respect to premiums received and (2) the amount of reinsurance premiums (net of ceding commissions) paid to foreign reinsurers exceeds 50 percent of the total direct insurance premiums received by the U.S. insurance company and its U.S. affiliates for a line of business.
 - A foreign corporation that is paid a premium from an affiliate that would otherwise be denied a deduction under this provision may elect to treat those premiums and the associated investment income as income effectively connected with the conduct of a trade or business in the United States.

Obama Tax Proposal: Disallow the Deduction for Excess Nontaxed Reinsurance Premiums Paid to Affiliates

- The proposal's stated goal (to reduce U.S. tax advantages available to foreign-owned insurance companies) is the same as that of an earlier proposal by Representative Neal and a Senate Finance Committee Discussion Draft, but the Obama proposal is less far-reaching.
 - The Neal bill would deny a deduction based on an industry average for each line of business, while the Obama proposal would deny a deduction if the amount of reinsurance premiums paid to foreign reinsurers exceeds 50% of the total direct insurance premiums received for a line of business.

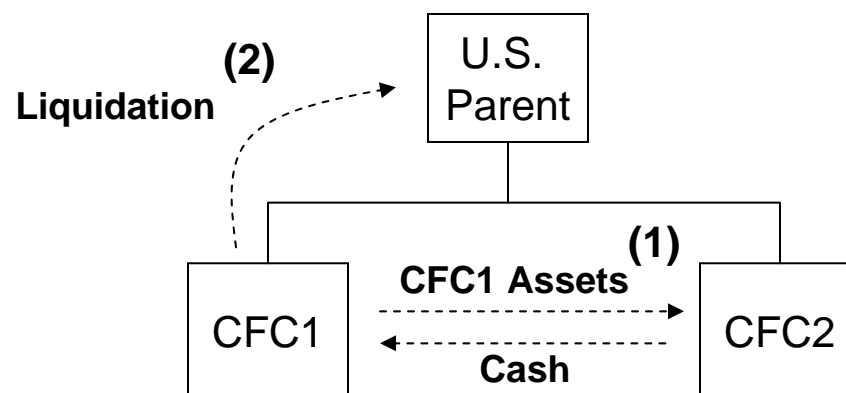
Obama Tax Proposal: Limit Earnings Stripping by Expatriated Entities

- Current Law: Section 163(j) limits the deductibility of interest paid by a corporation to a related person unless (1) the corporation's debt-to-equity ratio does not exceed 1.5 to 1, or (2) the corporation's net interest expense does not exceed 50% of adjusted taxable income.
- Proposal: With respect to expatriated entities only:
 - The debt-to-equity safe harbor would be eliminated; and
 - The 50% adjusted taxable income threshold would be reduced to 25%.
 - In the Administration's FY 2010 proposal, the 50% adjusted taxable income threshold would be reduced to 25% only for interest other than interest paid to unrelated parties that is subject to a related-party guarantee.

Repeal of Boot-Within-Gain Limitation

- Under current law, in general, gain or loss is not recognized with respect to exchanges of stock and securities in corporate reorganizations.
- Under section 356, a recipient of money or other property (“boot”) in a tax-free reorganization recognizes gain (if any) on the transaction in an amount not in excess of the sum of such money and the fair market value of such other property.
 - Under section 356(a)(2), if the exchange has the effect of the distribution of a dividend, then all or part of the gain recognized by the exchanging shareholder is treated as a dividend to the extent of the shareholder’s ratable share of the corporation’s E&P.
 - The remainder of the gain (if any) is treated as gain from the exchange of property.
- Accordingly, if a shareholder receives boot in connection with a corporate reorganization, the amount that the shareholder is required to recognize as income is limited to the amount of gain realized in the exchange (i.e., the boot-within-gain limitation).
 - This rule applies regardless of whether the property received would otherwise be considered to be a dividend for tax purposes.

Repeal of Boot-Within-Gain Limitation



Example of Perceived Abuse:

- In cross-border transactions, U.S. shareholders can utilize the boot-within-gain limitation to repatriate previously untaxed earnings and profits of foreign subsidiaries with minimal U.S. tax consequences.
- The above transaction should be treated as a valid "D" reorganization. *See* Treas. Reg. § 1.368-2(l).
 - If the U.S. Parent's stock in CFC1 has little or no built-in gain at the time of the exchange, the U.S. Parent will recognize minimal gain even if the exchange has the effect of the distribution of a dividend and/or the consideration received in the exchange is boot.
 - This is the result even if CFC2 has previously untaxed earnings and profits equal to or greater than the boot.

Repeal of Boot-Within-Gain Limitation

- The Greenbook proposal would repeal the boot-within-gain limitation in the case of any reorganization transaction (domestic or cross-border) if the exchange has the effect of the distribution of a dividend.
 - The amount of money or other property distributed would generally be treated as a dividend to the extent of the corporation's E&P.
- In the case of an acquisitive reorganization under section 368(a)(1)(D), or any other type of reorganization specified by the Secretary, the provision requires that the amount treated as a dividend include the E&P of each corporation that is a party to the reorganization, and that the amount of the dividend (and the source thereof) be determined under rules similar to those in sections 304(b)(2) and 304(b)(5).
- The provision also imposes a rule similar to the rule of section 312(n)(7) (adjustments to E&P) to the extent a distribution is treated as an exchange to which section 356(a)(1) applies.
- Subject to a transition rule, the provision would apply to exchanges after the date of the bill's enactment.
- The provision is estimated to raise \$510 million over 10 years.

Other Potential Revenue Raisers (Selected)

Financial Crisis Responsibility Fee (or “Bank Tax”)

- On January 14, 2010, President Obama announced that he would propose a “Financial Crisis Responsibility Fee” as part of his 2011 budget.
 - The “fee” (which is more accurately described as a tax because it would be collected by the IRS and proceeds would be contributed to the general fund) would equal .15% of a covered financial institution’s “covered liabilities.”
 - The amount of an institution’s covered liabilities would be determined by subtracting Tier 1 capital and FDIC-assessed deposits from the bank’s assets.
 - It has since been clarified that the Administration believes that assets should be risk-weighted for purposes of the tax calculation.
 - The tax would apply to insured depository institutions, bank holding companies, thrift holding companies, insurance or other companies that owned insured depository institutions, and securities broker-dealers.
 - Although the “Financial Crisis Responsibility Fee” is designed to offset the projected cost of the Troubled Assets Relief Program (“TARP”), financial institutions would be subject to the tax regardless of whether they were eligible for or took TARP or other government assistance.

Financial Crisis Responsibility Fee (or “Bank Tax”)

- The Senate Finance Committee held three hearings on the bank tax over the summer.
 - The hearings centered on the amount and nature of TARP losses, the Administration’s position on the bank tax, and industry opposition to the tax.
- The House Ways & Means Committee has considered the merits of an income-based (rather than asset-based) tax.
- No legislative proposal has actually emerged.

Global Action on Bank Taxes

- Global action on bank taxes appears unlikely at this point.
 - Prior efforts by some country governments (e.g., the UK) to encourage global action have waned
- The International Monetary Fund ("IMF") prepared a report for the G-20 describing "how the financial sector could make a fair and substantial contribution toward paying for any burden associated with government interventions to repair the banking system," but there appeared to be little global support for the IMF's two proposals (next slides).

IMF Proposed Taxes

- Financial Stability Contribution Tax
 - The IMF interim report suggests that a Financial Stability Contribution tax should be imposed on all financial institutions, stating that a broad perimeter “would recognize that all institutions benefit from the public good of enhanced financial stability.”
 - The tax could be imposed on a bank’s balance sheet, with exceptions for capital and insured liabilities.
 - The IMF suggests that the rate of the Financial Stability Contribution tax initially could be uniform to allow for easier implementation, but could later be risk-adjusted to reflect institutions’ contributions to systemic risk.

IMF Proposed Taxes

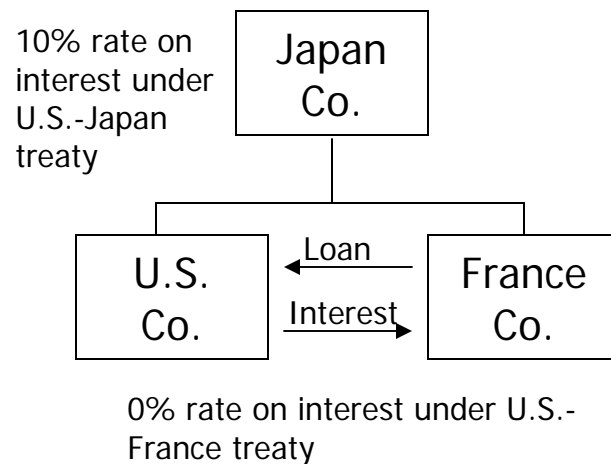
- Financial Activities Tax
 - Under the IMF's Financial Activities Tax proposal, financial institutions would be taxed on the sum of their profits and remuneration paid.
 - According to the IMF, a Financial Activities Tax "would approximate a tax on rents in the financial sector if the base included only high levels of remuneration and with the profit component also defined appropriately, to in effect exclude a normal return to capital."
 - The interim report does not suggest what would constitute a "high level of remuneration" or a "normal return to capital."

Doggett Anti-Treaty Shopping Bill: Rangel Version

- Rep. Doggett (D-TX) has championed a provision that would limit treaty benefits if a foreign-owned U.S. company makes a payment to a related corporation organized in a foreign country that the United States has a treaty with, but the U.S. company's foreign parent is not resident in a treaty country.
 - A prior version of Rep. Doggett's provision would have limited a reduction in withholding rates on payments made by a foreign-owned U.S. company to related foreign companies resident in a treaty country to the extent withholding would be reduced on a payment made from the U.S. company to its foreign parent.

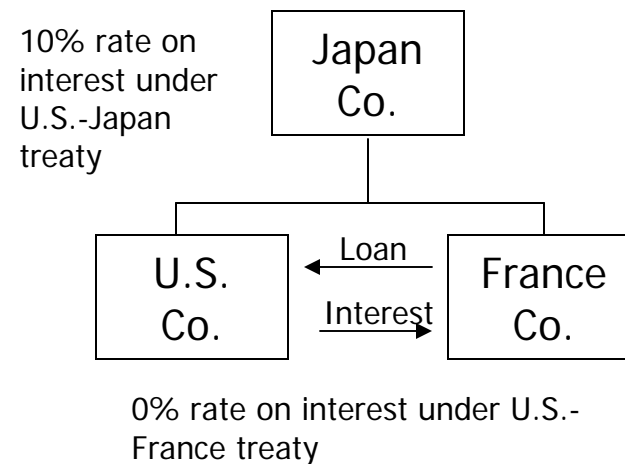
Doggett Anti-Treaty Shopping Bill: Treaty with Parent Company Country

Prior Version



The prior provision provided that the U.S.-Japan rate would apply because it is higher.

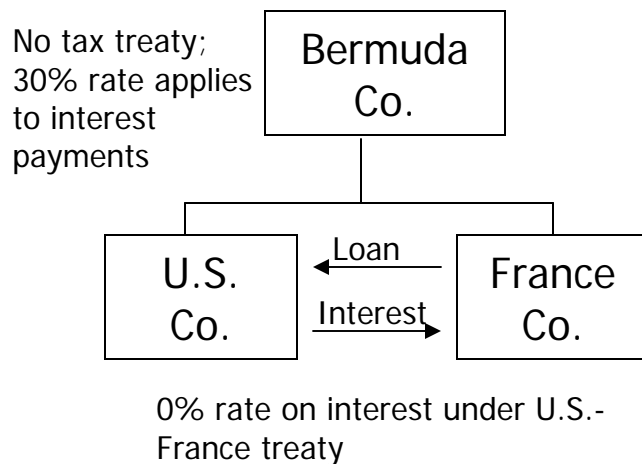
Current Version



The current version would allow for the reduction to 0% because the United States has a tax treaty with Japan.

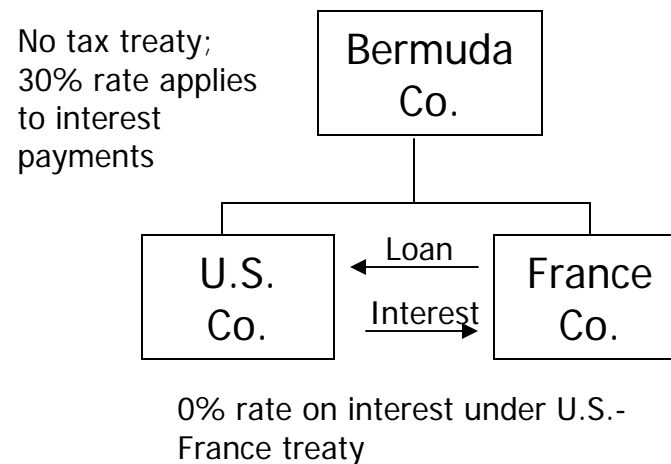
Doggett Anti-Treaty Shopping Bill: No Treaty with Parent Company Country

Prior Version



The prior provision provided that the 30% rate would apply because it is higher.

Current Version



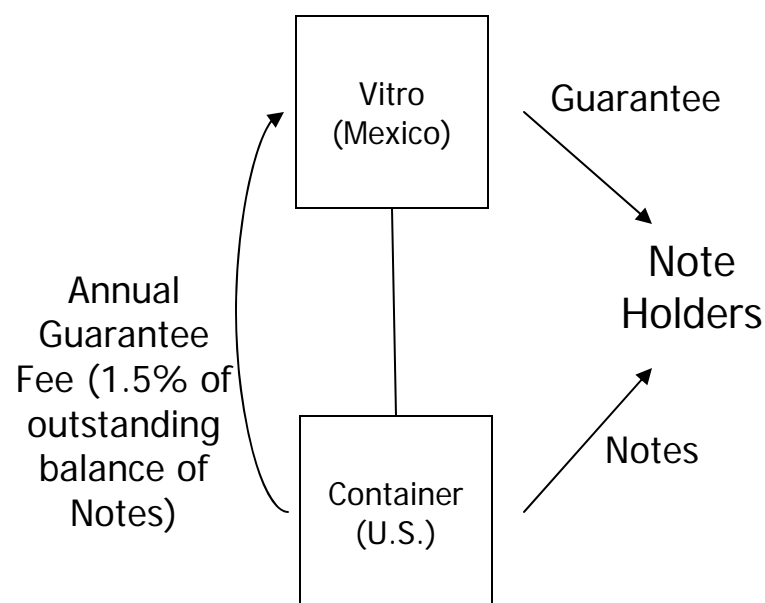
The current version also provides that the 30% rate would apply because the United States does not have a tax treaty with Bermuda.

“Managed and Controlled” Corporate Residency Test

- This provision has been included in Senator Levin’s “Stop Tax Haven Abuse Act” and in a Doggett international tax bill.
- Defines foreign corporations that are managed and controlled, directly or indirectly, primarily within the U.S. as domestic corporations for income tax purposes.
 - This definition applies to foreign corporations that (1) are publicly traded; or (2) have aggregate gross assets of \$50 million or more during the tax year or any preceding tax year.
- The management and control of a corporation shall be treated as occurring primarily within the U.S. if:
 - Substantially all of the executive officers and senior management who exercise day-to-day responsibility for making decisions involving strategic, financial, and operational policies of the corporation are located primarily in the U.S.; or
 - The assets of the corporation are being managed on behalf of investors and decisions about how to invest the assets are made in the U.S.
- The definition provides exceptions for:
 - Foreign corporations that are subsidiaries of active U.S. parent corporations; or
 - Foreign corporations that are granted a waiver by the Treasury Secretary because the corporation no longer meets and no longer expects to meet the criteria established by the definition.

Container Corp., 134 T.C. 5 (2010)

- Vitro, a Mexican corporation, guaranteed Notes issued by Container Corp., its U.S. subsidiary.
 - Container Corp. paid Vitro an annual guarantee fee equal to 1.5% of the outstanding balance of the Notes.
- Issue: What is the source of the guarantee fee paid to Vitro?



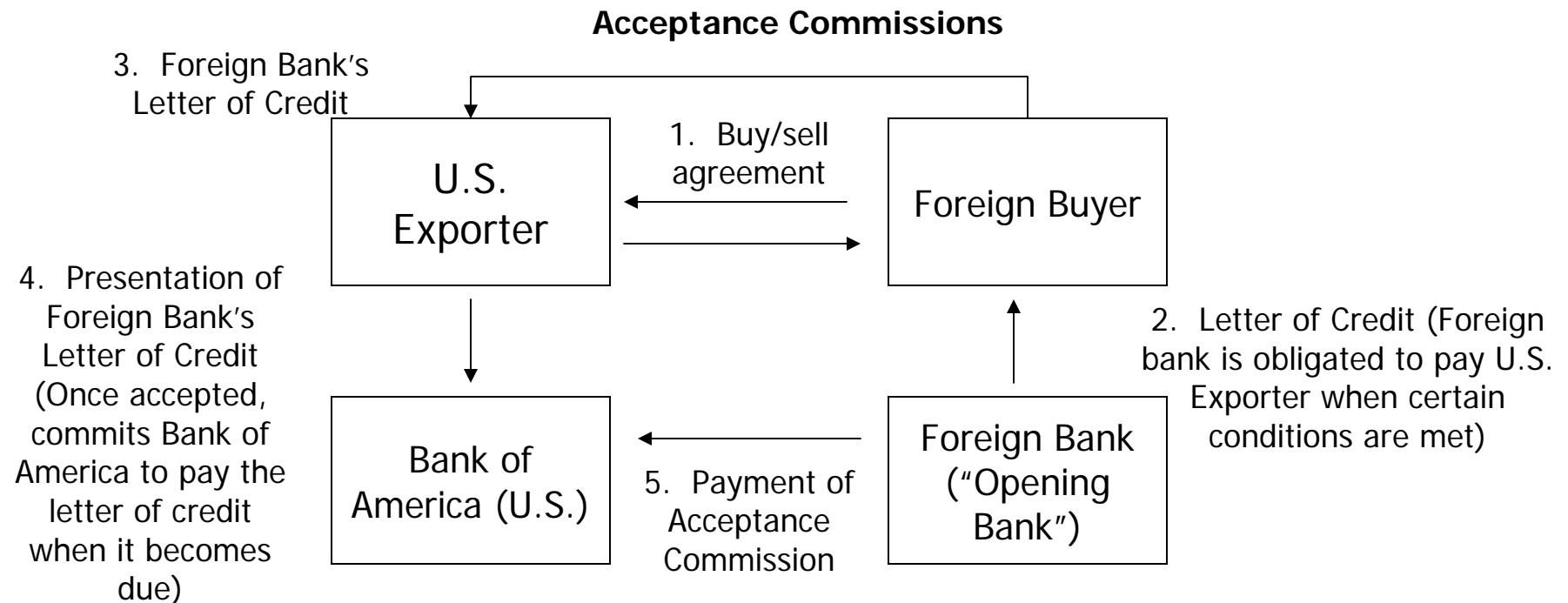
Container Corp., 134 T.C. 5 (2010)

- The parties agreed that the guarantee fee was FDAP, but disagreed on the source.
 - ❑ The IRS argued that the guarantee fee was interest or analogous to interest (and thus U.S. source) because the fee was essentially paid for using Vitro's credit.
 - ❑ Container Corp. argued that the guarantee fee was for services, or analogous to services (and thus foreign source).

Container Corp., 134 T.C. 5 (2010)

- The Tax Court determined that the guarantee fee was not itself interest or a payment for services, but determined that the guarantee fee was more analogous to a fee for the performance of a service.
 - The court determined that *Bank of America* (see next slides) was distinguishable:
 - The acceptance and confirmation commissions in *Bank of America* were paid by a foreign bank to Bank of America for its substitution of its own credit for that of the foreign bank.
 - Bank of America assumed an unqualified primary obligation, while Vitro was merely augmenting Container Corp.'s credit, and thus was taking on a secondary liability.
 - The court stated that “guarantees, like services, are produced by the [guarantor] and, as a result, like services, should be sourced to the location of the [guarantor].”
 - The court determined that the location of the business activity that generated the fee was Mexico because “Vitro was able to make this promise because it had sufficient Mexican assets—and its Mexican corporate management had a sufficient reputation for using those assets productively—to augment the” borrower’s credit.

Bank of America, 680 F.2d 142 (Ct. Cl. 1982)



Bank of America also received two other types of commissions: (1) **confirmation commissions**, which Bank of America received for confirming sight letters of credit and committing to pay when the seller met the bank's conditions, and (2) **negotiation commissions**, for which Bank of America determined whether the seller met the conditions of a confirmed letter of credit for the opening bank.

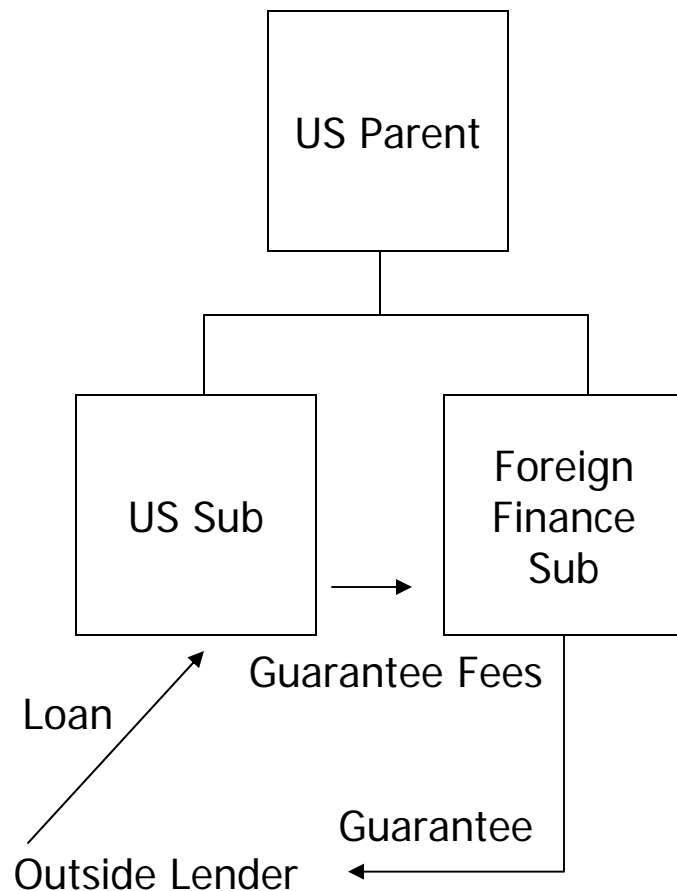
Bank of America, 680 F.2d 142 (Ct. Cl. 1982)

- The court sourced the acceptance and confirmation commissions by analogy to the interest sourcing rules.
 - The court determined that the most important feature of the acceptance transaction was the substitution of Bank of America's credit for that of the foreign bank. The court noted that Bank of America performed services as part of the acceptance process, but determined that those services were minor compared to the importance of Bank of America's substitution of its own credit.
 - Since the obligor was the foreign bank, and interest is sourced according to the location of the obligor, the guarantee payments were foreign source.
- In the case of negotiation commissions, however, the court determined that Bank of America was performing services in the United States and thus the commissions were sourced as services.

Questions Raised By *Container Corp.*

- In *Container Corp.*, Vitro was secondarily liable—Vitro was not required to pay unless or until the borrower defaulted.
 - Should this distinction determine the results?
 - Should *Container Corp.* be considered to be limited to these types of guarantees?
 - What if the guarantor is a co-obligor?
- Will Treasury and the IRS issue regulations providing a clear source rule? Will Congress overrule *Container Corp.* through legislation?
 - On March 5, Jeffrey Dorfman (IRS Office of Chief Counsel (International)) stated that the “IRS is extremely uncomfortable with the potential for abuse....The IRS doesn’t agree with that opinion. We’re deciding what to do.”
 - In the Preamble to T.D. 9278, 71 *Fed. Reg.* 44465-44519 (4 August 2006) (on treatment of services under section 482, allocation of income and deductions from intangibles, and apportionment of stewardship expense), the Treasury Department and IRS had stated that future regulations would cover the source of guarantee fees.
 - “The provision of a financial guarantee does not constitute a service for purposes of determining the source of the guarantee fees. See *Centel Communications, Inc. v. Commissioner*, 920 F.2d 1335 (7th Cir. 1990); *Bank of America v. United States*, 680 F.2d 142 (Ct. Cl. 1980). Nevertheless, some taxpayers have suggested that guarantees are services.... The Treasury Department and the IRS subsequently intend to issue transfer pricing guidance regarding financial guarantees....Such guidance will also include rules to determine the source of income from financial guarantees.”

Guarantee Planning After *Container Corp.*



- US Parent's Foreign Finance Subsidiary guarantees outside obligations of US Sub.
 - Guarantee fees to Foreign Finance Sub are deductible.

GE Canada: Background

- On December 4, 2009, the Tax Court of Canada issued its decision in *General Electric Capital Canada Inc. v. the Queen*, 2009 TCC 563, holding that the guarantee fee of 1% per annum of the principle amount of the guaranteed debt securities paid by GE Capital Canada Inc. ("GE Capital Canada") to its indirect parent, General Electric Capital Corporation ("GE Capital U.S."), was equal to or below an "arm's length" price, and thus deductible by GE Capital Canada.
- The amount of deductions at issue exceeded CAN \$136 million.
- The case addressed the conundrum of determining the proper reference point for arm's length guarantee fee.
 - Credit rating of subsidiary with *de facto* expectation of parent support even in absence of guarantee, or
 - Truly independent corporation with no parent in wings.
- The Tax Court of Canada took *de facto* expectation of support into account in valuing the guarantee.

GE Canada: Canadian Government Arguments

- The Canadian Minister of National Revenue argued that GE Capital Canada would have the same credit rating as its indirect parent GE Capital U.S. without a guarantee, because GE Capital U.S. had a strong incentive to provide financial support to GE Capital Canada, even if not contractually obligated to do so.
 - The Minister argued that, as a result, GE Capital Canada could have borrowed the same amount of money at the same interest rate without an explicit guarantee.
 - Because GE Capital Canada did not receive an economic benefit from the guarantee, the correct arm's length price was zero.
- Alternatively, the Minister argued that, even if the two companies' credit ratings would not be equalized due to their affiliation, the correct arm's length price should be determined by identifying the difference in interest rates that would be paid by entities with the respective credit ratings of GE Capital Canada and GE Capital U.S., then making adjustments to that spread to take into account the benefits that would flow to GE Capital U.S. under the guarantee arrangement.

GE Canada: Taxpayer Arguments

- GE Capital Canada argued that any “affiliation benefit” cannot be considered under the Canadian transfer pricing law because the law requires “that one situate the parties opposite each other to determine how they would have arranged their transaction if they had been dealing at arm’s length. All distortions that arise from the parties’ relationship must be eliminated to arrive at an arm’s length result.”
- Further, GE Capital Canada argued that, even under the Minister’s approach to calculating an arm’s length interest rate, the economic benefit enjoyed by GE Capital Canada due to the guarantee exceeded the 1% fee paid to GE Capital U.S.

GE Canada: Tax Court of Canada Decision

- The Tax Court of Canada, taking into account several expert opinions on the value of the guarantee, determined that GE Capital Canada would have a lower credit rating (BBB-/BB+) without explicit support from GE Capital U.S.
- The court determined that the interest cost savings based on the rating differential between BBB-/BB+ (GE Capital Canada's credit rating without explicit support) and AAA (GE Capital Canada's credit rating with explicit support) was approximately 1.83%.
- As a result, the court concluded that the 1% guarantee fee was equal to or below an arm's length price because GE Capital Canada "received a significant net economic benefit from the transaction."

GE Canada: Comments

- The Canadian government has announced that it will appeal the Tax Court of Canada's decision.

International Tax “Loophole Closers”

P.L. 111-226

International Tax “Loophole Closers”

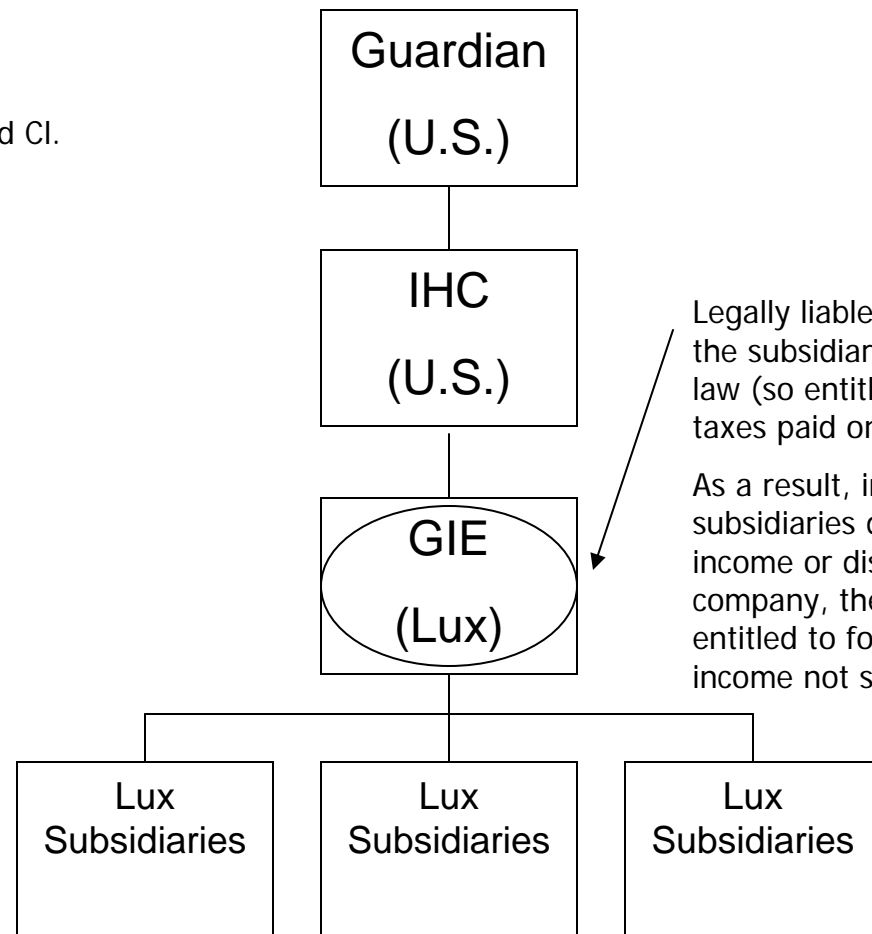
- P.L. 111-226 (officially the “_____ Act of _____”) contains several international tax-related revenue offsets:
 - ❑ Rules to Prevent Splitting of Foreign Tax Credits
 - ❑ Denial of Certain Foreign Tax Credits for Covered Asset Acquisitions
 - ❑ Separate Foreign Tax Credit Limitation for Certain Items Resourced Under Treaties
 - ❑ Limitation on Foreign Taxes Deemed Paid with Respect to Section 956 Inclusions
 - ❑ Special Rule with Respect to Certain Redemptions by Foreign Subsidiaries
 - ❑ Modification of Affiliation Rules for Purposes of Rules Allocating Interest Expense
 - ❑ Modification of 80/20 Rules
 - ❑ Limitation on Extension of Statute of Limitations for Failure to Report Certain Foreign Transfers

Rules to Prevent Splitting of Foreign Tax Credits

- Current law generally treats foreign taxes as being paid by the person on whom foreign law imposes legal liability (the “technical taxpayer” rule).
 - In some cases, the person who has legal liability for a foreign tax may be different than the person who realizes the underlying income under U.S. tax principles.
 - As a result, foreign taxes may be separated or “split” from the foreign income to which the taxes relate.
 - E.g., *Guardian Industries* structure in which a foreign consolidated rule treats the consolidated parent as the party solely responsible for the taxes of the group and the consolidated parent is thus the technical taxpayer.
 - Hybrid and reverse hybrid structures and hybrid instruments may also cause “splitting” of foreign income from taxes.

Rules to Prevent Splitting of Foreign Tax Credits: *Guardian Industries* Example

See Guardian Industries v. United States, 77 F.3d 1368 (Fed. Cir. 2007), *aff'g* 65 Fed Cl. 50 (2003).



Legally liable for the foreign taxes paid on the subsidiaries' income under Luxembourg law (so entitled to a foreign tax credit for taxes paid on the subsidiaries' income).

As a result, in this structure, if the operating subsidiaries do not generate subpart F income or distribute dividends to the holding company, the U.S. holding company is entitled to foreign tax credits on foreign income not subject to U.S. tax.

Rules to Prevent Splitting of Foreign Tax Credits: New Provision

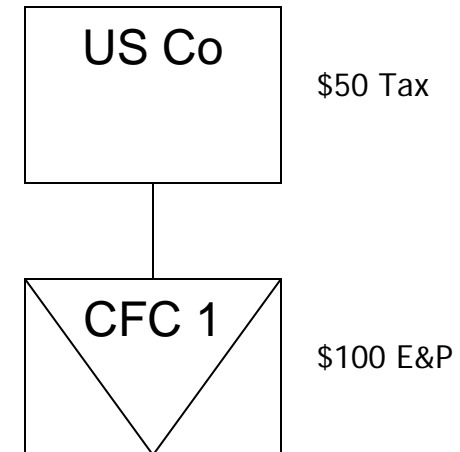
- The new law (new section 909) creates a matching rule to prevent the separation of creditable foreign taxes from the associated foreign income.
 - In general, where there is a “foreign tax credit splitting event” with respect to foreign income tax paid or accrued by the taxpayer, the foreign income tax is not taken into account for U.S. tax purposes before the taxable year in which the related income is taken into account by the taxpayer.
 - Rule also applies for indirect credits.

Rules to Prevent Splitting of Foreign Tax Credits: New Provision

- A “foreign tax credit splitting event” arises with respect to a foreign income tax if the related income is (or will be) taken into account for U.S. tax purposes by a “covered person.”
 - A “covered person” is:
 - Any entity in which the payor holds, directly or indirectly, at least a 10% ownership interest (determined by vote or value);
 - Any person that holds, directly or indirectly, at least a 10% ownership interest (by vote or value) in the payor;
 - Any person that bears a relationship to the payor described in section 267(b) or 707(b); and
 - Any other person specified by the Secretary.
- Effective Date: Applies to foreign income taxes paid or accrued after May 20, 2010.

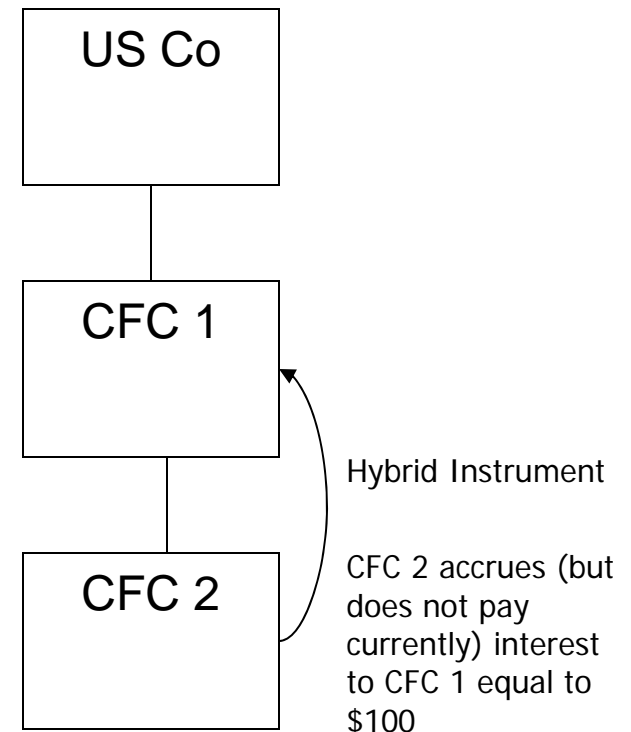
Rules to Prevent Splitting of Foreign Tax Credits: Example Under New Provision

- US Co, a domestic corporation, wholly owns CFC 1. CFC 1 is organized in Country A and is treated as a pass-through entity for Country A purposes. CFC 1 is treated as a corporation for U.S. tax purposes.
 - CFC 1 is engaged in an active business that generates \$100 of income.
 - Country A has a 30% tax rate.
- For Country A tax purposes, CFC's earnings pass to US Co. Under Country A law, US Co is treated as having paid \$30 of Country A tax.
- Under the old law, the United States views CFC 1 as having \$100 of E&P not subject to current U.S. tax and US Co as having \$30 of foreign taxes for which US Co may claim a direct foreign tax credit.
- Under the new law, the \$30 direct foreign tax credit is suspended until the related income is recognized for U.S. tax purposes.
 - CFC 1 must distribute its net income of \$100 to US Co to release the \$30 direct foreign tax credit.



Rules to Prevent Splitting of Foreign Tax Credits: Example Under New Provision

- US Co wholly owns CFC 1, a Country A corporation. CFC 1 wholly owns CFC 2, also a Country A corporation.
 - CFC 2 is engaged in an active business that generates \$100 of income.
- CFC 2 issues a hybrid instrument to CFC 1.
 - This instrument is equity for U.S. tax purposes.
 - The instrument is debt for Country A tax purposes.
- CFC 2 accrues (but does not pay currently) interest to CFC 1 equal to \$100.
 - CFC 2 has no income for Country A purposes.
 - CFC 1 has \$100 of income, which is subject to Country A tax at a 30% rate.
- For U.S. tax purposes, CFC 2 still has \$100 of E&P (the interest is ignored), while CFC 1 has paid \$30 of foreign taxes.
- Under the new matching rule, the “related income” with regard to the \$30 of foreign taxes paid by CFC 1 is the \$100 of E&P of CFC 2 and US Co will not be entitled to the \$30 foreign tax credit until it takes the related \$100 of income into account for U.S. tax purposes.



Other Situations Affected by Splitter Provision?

- Disregarded Payments
- Group Relief
- Liquidation of Person Who Pays or Accrues the Foreign Income Tax
- Transfer Pricing Adjustments?
- Contributions of Inventory Resulting in Shift of Deductions?
- Differences in the Timing of When Income is Taken into Account for U.S. and Foreign Tax Purposes?

Other Situations Affected by Splitter Provision? Potential for Guidance

- The statute grants authority to issue guidance necessary or appropriate to carry out the purposes of the provision.
 - According to the JCT Technical Explanation of the new law, “[s]uch guidance may include providing successor rules addressing circumstances such as where, with respect to a foreign tax credit splitting event, the person who pays or accrues the foreign income tax or any covered person is liquidated...It is anticipated that the Secretary may also provide guidance as to the proper application of the provision in cases involving disregarded payments, group relief, or other arrangements having a similar effect.”

Other Situations Affected by Splitter Provision? Potential for Guidance

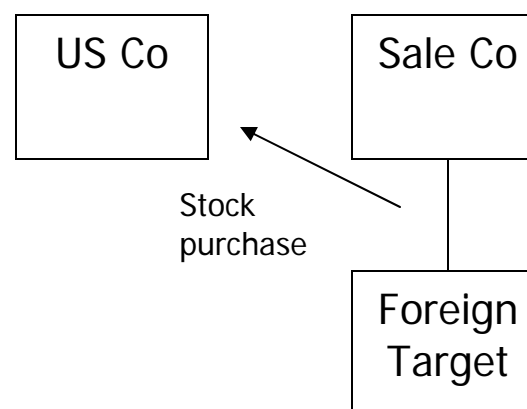
- The JCT Technical Explanation also states:
 - “For purposes of determining related income, the Secretary may provide rules on the treatment of losses, deficits in earnings and profits, and certain timing differences between U.S. and foreign law. Moreover, it is not intended that differences in the timing of when income is taken into account for U.S. and foreign tax purposes (e.g., as a result of differences in the U.S. and foreign tax accounting rules) should create a foreign tax credit splitting event in cases in which the same taxable person pays the foreign tax and takes into account the related income, but in different taxable period.”

Denial of Certain Foreign Tax Credits for Covered Asset Acquisitions

- The new rules are intended to prevent certain U.S. tax elections or transactions from resulting in the creation of additional asset basis eligible for cost recovery for U.S. tax purposes without a corresponding increase in the basis of such assets for foreign tax purposes.
 - Examples include a qualified stock purchase of a foreign corporation (or domestic corporation with foreign assets) for which a section 338 election is made; an acquisition of an interest in a partnership holding foreign assets for which a section 754 election is in effect; or certain other transactions involving a check-the-box election (see next slide).

Denial of Certain Foreign Tax Credits for Covered Asset Acquisitions: Example under Prior Law

- Example: US Co purchases the stock of Foreign Target, a foreign corporation. US Co makes a section 338(g) election to treat the stock purchase as an asset purchase for U.S. tax purposes.
- In this example, assume the excess of the purchase price of Foreign Target stock over the basis of Foreign Target's assets results in an aggregate basis difference of \$200. \$150 is attributable to goodwill with 15-year recovery and 50% is attributable to equipment with a 5-year recovery period.
- As a result, US Co has additional asset basis eligible for cost recovery for U.S. tax purposes (with no corresponding increase in the tax basis of such assets for foreign tax purposes).

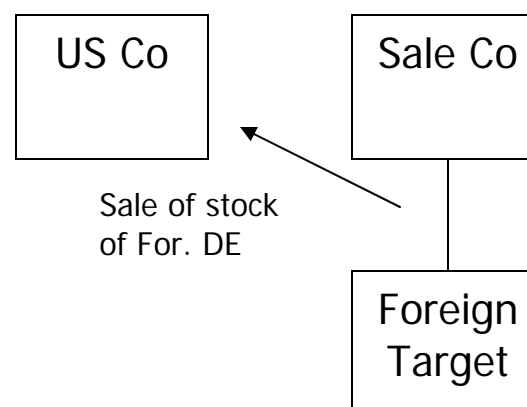


	Basis Difference	Cost Recovery of Additional AB
Asset A (Goodwill; 15-year recovery)	\$150	\$10
Asset B (equipment, 5-year recovery)	\$50	\$10

Denial of Certain Foreign Tax Credits for Covered Asset Acquisitions: Example under Prior Law

- The extra cost basis means that there is a difference in income as seen by the U.S. and the foreign country.
- Assume the foreign country has a 25% tax rate:

	U.S. Tax	Local Tax
Income	\$100	\$100
E&P Adjustment	(\$20)	\$0
Pre-Tax	\$80	\$100
Local Tax Rate		25%
Foreign Tax		\$25



	Basis Difference	Cost Recovery of Additional AB
Asset A (Goodwill; 15-year recovery)	\$150	\$10
Asset B (equipment, 5-year recovery)	\$50	\$10

Denial of Certain Foreign Tax Credits for Covered Asset Acquisitions: New Rule

- The provision (new section 901(m)) denies a foreign tax credit for the disqualified portion of any foreign income tax paid or accrued in connection with a covered asset acquisition.
 - A “covered asset acquisition” means:
 - A qualified stock purchase (i.e., transactions under section 338(g) and (h)(10);
 - Any transaction that is treated as the acquisition of assets for U.S. tax purposes and as the acquisition of stock (or is disregarded) for foreign income tax purposes;
 - Any acquisition in a partnership that has an election in effect under section 754;
 - Any similar transaction to the extent provided by Treasury.
 - The “disqualified portion” of any foreign income taxes paid or accrued with respect to a covered asset acquisition is:
 - The aggregate basis differences allocable to such taxable year with respect to all relevant foreign taxes, divided by
 - The income on which the foreign income tax is determined
 - The term “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.
 - A built-in loss in a relevant foreign asset is taken into account but cannot reduce the aggregate basis difference allocable to a taxable year below zero.

Denial of Certain Foreign Tax Credits for Covered Asset Acquisitions: New Rule

- Any foreign tax credit disallowed may be deductible.
- Treasury is given broad regulatory authority and may issue regulations or other guidance necessary to carry out the purpose of the provision, including:
 - An exemption for certain covered asset acquisitions, and
 - An exemption for relevant foreign assets with respect to which the basis difference is de minimis.

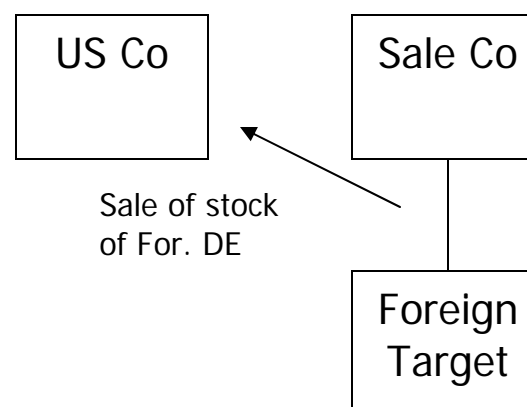
Denial of Certain Foreign Tax Credits for Covered Asset Acquisitions: New Rule Effective Date

- Provision is effective for covered asset acquisitions after December 31, 2010 but does not apply for covered asset acquisitions where transferor and transferee are not related (under section 267 and 707(b)) if the acquisition is
 - ❑ Made pursuant to a written agreement that was binding on January 1, 2011;
 - ❑ Described in a ruling request submitted to the IRS on or before July 29, 2010, or
 - ❑ Described in a public announcement or filing with the SEC on or before January 1, 2011.

Denial of Certain Foreign Tax Credits for Covered Asset Acquisitions: Example under New Law

	U.S. Tax	Local Tax
Income	\$100	\$100
E&P Adjustment	(\$20)	\$0
Pre-Tax	\$80	\$100
Local Tax Rate		25%
Foreign Tax		\$25

- “Disqualified portion of foreign income taxes paid” is aggregate basis differences / income on which foreign income tax is determined
 - = $\$20 / \$100 = 20\%$
- Of the \$25 that could be creditable, 20% (\$5) will be disallowed



	Basis Difference	Cost Recovery of Additional AB
Asset A (Goodwill; 15-year recovery)	\$150	\$10
Asset B (equipment, 5-year recovery)	\$50	\$10

Separate Foreign Tax Credit Limitation for Certain Items Resourced Under Treaties

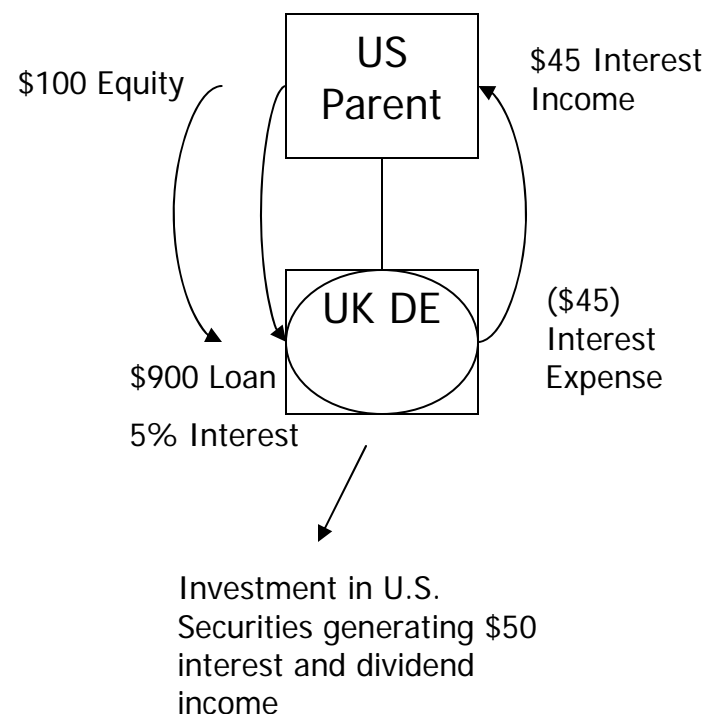
- Amounts derived from a foreign corporation (such as interest and dividends) generally are treated as foreign source income for U.S. foreign tax credit limitation purposes.
 - A special sourcing rule (section 904(h)) applies to amounts (such as interest and dividends) derived from a U.S.-owned foreign corporation that are attributable to U.S. source income of the foreign corporation—these amounts, which would otherwise be treated as foreign source, will be treated as U.S. source.
- A coordination rule applies in the case of an amount that would be treated as U.S. source income under the special sourcing rule but that is treated as foreign source under a tax treaty.
 - If:
 - Any amount derived from a U.S.-owned foreign corporation would be treated as U.S. source income under the special sourcing rule described above;
 - A U.S. treaty obligation would treat such income as arising from sources outside the United States; and
 - The taxpayer chooses the benefits of this coordination rule, then the amount will be treated as foreign source.
 - For foreign tax credit limitation purposes, however, a separate limitation applies to such amount and the associated foreign taxes.

Separate Foreign Tax Credit Limitation for Certain Items Resourced Under Treaties

- The bill adds a new section 904(d)(6) to extend the coordination rule to branches and disregarded entities by creating a separate foreign tax credit limitation basket with respect to any item of income and associated foreign tax credits:
 - If any item of income would be treated as U.S. source (without regard to any treaty obligation);
 - Under a treaty obligation, such item is treated as foreign source; and
 - The taxpayer elections to claim the benefits of the treaty.
- By putting each item of resourced income in a separate basket, the rule prevents taxpayers from pooling high-taxed foreign source income with low-taxed resourced income to make excess foreign tax credits on the high-taxed foreign source income available to offset U.S. tax on the low-taxed foreign source income.

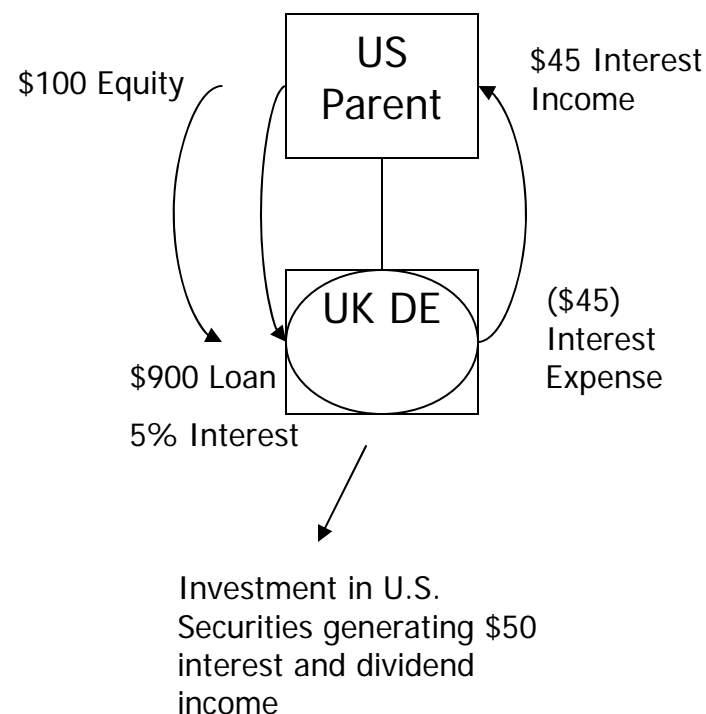
Separate Foreign Tax Credit Limitation for Certain Items Resourced Under Treaties: Example

- US Parent, a domestic corporation, forms a UK corporation that is disregarded for U.S. tax purposes ("UK DE").
 - US Parent capitalizes UK DE with \$900 debt and \$100 equity.
 - UK DE invests these funds in U.S. securities.
 - UK DE is subject to tax in the UK at 30%.
 - USP has \$10 in foreign tax credit carryforwards in the general basket.
- Under prior law:
 - For U.K. tax purposes, UK DE has \$50 in income and \$45 in interest expense. Its \$5 in taxable income is taxed at 30%, so its UK tax is \$1.5.
 - US Parent's foreign tax credit limitation in the *general* basket will be \$17.5 (\$50 income * 35% tax rate).
 - US Parent's foreign tax credits will be:
 - \$1.5 current year (general basket)
 - \$10 carryforward (general basket)



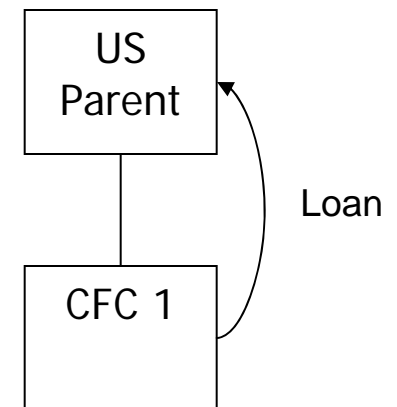
Separate Foreign Tax Credit Limitation for Certain Items Resourced Under Treaties: Example

- Under the new law:
 - ❑ For U.K. tax purposes, UK DE has \$50 in income and \$45 in interest expense. Its \$5 in taxable income is taxed at 30%, so its UK tax is \$1.5.
 - ❑ There will be a separate foreign tax credit limitation basket for amounts of U.S. source income treated as foreign-source income by virtue of a U.S. treaty.
 - As a result, US Parent's foreign tax credit limitation in the *separate* basket will be \$17.5 (\$50 income * 35% tax rate).
 - ❑ US Parent's foreign tax credits will be:
 - \$1.5 current year (separate basket)
 - Can be utilized (\$17.5 separate basket limit)
 - ❑ US Parent's \$10 carryforward in the general basket cannot be utilized.



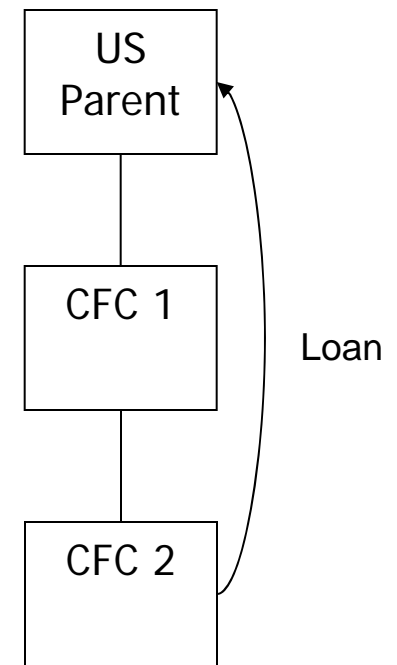
Limitation on Foreign Taxes Deemed Paid With Respect to Section 956 Inclusions

- Under sections 951 and 956, a CFC's increase of its investment of earnings in U.S. property may be subpart F income to the U.S. parent.
 - In the example to the right, US Parent may be allowed a deemed paid credit for taxes paid or accrued on the earnings of CFC 1.
 - US Parent will be treated under section 960 as having paid its pro rata share of the foreign taxes paid by CFC 1 on those earnings, generally to the same extent as if it had received a dividend distribution of those earnings, and may claim foreign tax credits for those taxes.



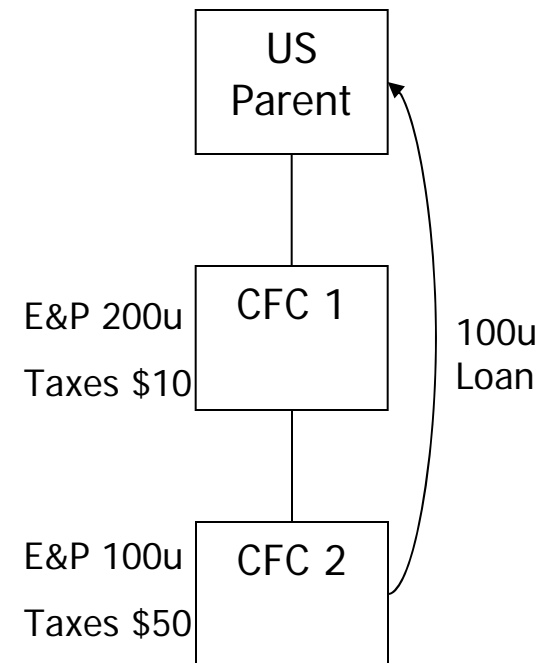
Limitation on Foreign Taxes Deemed Paid With Respect to Section 956 Inclusions

- Under prior law, the deemed distribution from the CFC 2 loan would be taxed to US Parent as if CFC 2 paid a dividend directly to US Parent without regard to the income of CFC 1.
 - As a result, if CFC 1 is in a lower-tax jurisdiction, the tax credit resulting from the section 956 investment in U.S. property is higher when CFC 2 makes the loan than if the amount had been distributed up the chain.



Limitation on Foreign Taxes Deemed Paid With Respect to Section 956 Inclusions

- Before the new rule, US Parent would have a section 956 inclusion of 100u.
 - US Parent would also have a foreign tax credit of \$50.

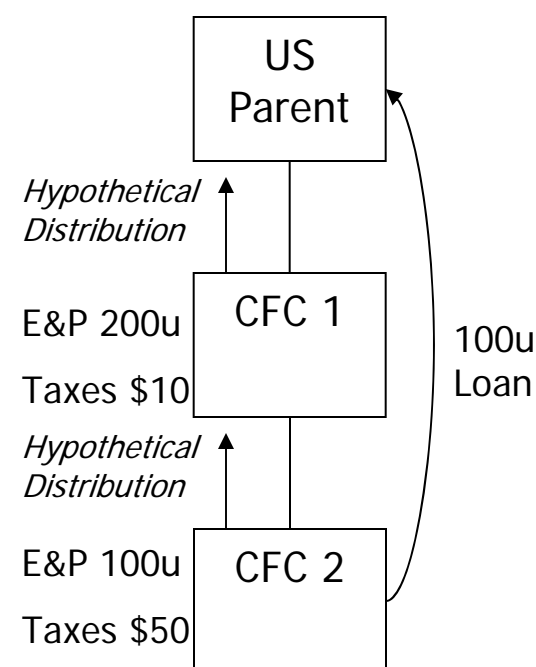


Limitation on Foreign Taxes Deemed Paid With Respect to Section 956 Inclusions

- Under the new rule (new section 960(c)), for section 956 inclusions attributable to U.S. property acquired by a CFC after the effective date, the amount of foreign taxes deemed paid is limited to the lesser of:
 - The foreign taxes deemed paid with respect to the U.S. shareholder's section 956 inclusion (without regard to the provision) (the "tentative credit"), or
 - The hypothetical amount of foreign taxes deemed as computed under the provision (the "hypothetical credit").
 - The "hypothetical credit" is the amount of foreign taxes that would have been deemed paid if an amount equal to the section 956 inclusion had been distributed through the chain of ownership that begins with the CFC that holds an investment in U.S. property and ends with the U.S. shareholder.
 - Any withholding/income taxes that would have been paid are not taken into account.
- Effective Date: Applies to acquisitions of U.S. property made by CFCs after May 20, 2010

Limitation on Foreign Taxes Deemed Paid With Respect to Section 956 Inclusions: Example Under New Rule

- The tentative credit would be \$50 ($100\% \times \50).
- The hypothetical credit would be calculated as follows:
 - CFC 2 to CFC 1:
 - CFC 2 tax pool = \$50
 - CFC 2 E&P pool = 100u
 - Hypothetical Dividend = 100u
 - Hypothetical Dividend as % of E&P = 100%
 - Taxes Distributed to CFC = 100% of \$50 = \$50
 - CFC 1 to US Parent
 - CFC 1 tax pool = \$10
 - + \$50 in taxes from CFC 2
 - = \$60 total adjusted tax pool
 - CFC 1 E&P pool = 200u
 - + 100u hypothetical distribution from CFC 2
 - = 300u adjusted E&P
 - Hypothetical Dividend = 100u
 - Hypothetical Dividend as % of E&P = 33%
 - Hypothetical Credit = 33% of 60 = \$20
- Because the hypothetical credit is lesser than the tentative credit, the amount of taxes deemed paid will be limited to the hypothetical credit.

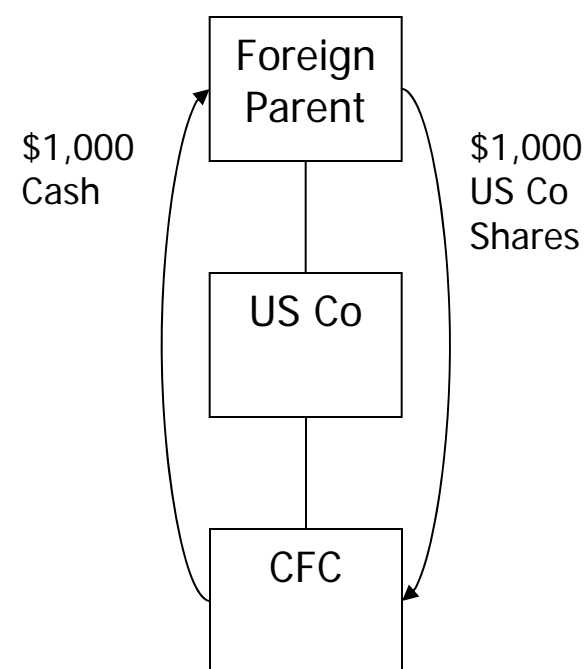


Special Rule with Respect to Certain Redemptions by Foreign Subsidiaries

- Under section 304, if one corporation (the “acquiring corporation”) purchases stock of a related corporation (the “target corporation”) in exchange for property, the transaction is generally treated as a redemption.
- To the extent a section 304(a)(1) transaction is treated as a distribution under section 301, the transferor and acquiring corporation are treated as if:
 - The transferor had transferred the stock of the target corporation to the acquiring corporation in exchange for stock of an acquiring corporation in a transaction to which section 351(a) applies, and
 - The acquiring corporation had then transferred the property to the transferor in redemption of the stock it is deemed to have issued.
- The amount and source of a dividend are determined as if the property were distributed by the acquiring corporation to the extent of its E&P, and then by the target company to the extent of its E&P.
 - If the acquiring corporation is foreign, however, in general the foreign acquiring corporation’s E&P that is taken into account is limited to the portion of such E&P that was accumulated after the foreign corporation became a CFC and such stock was owned by the transferor or related person.

Special Rule with Respect to Certain Redemptions by Foreign Subsidiaries: Example Under Prior Law

- Foreign Parent owns 100% of US Co stock. US Co has \$2,000 in E&P.
- US Co owns 100% of CFC. CFC has \$1,000 in E&P.
- CFC purchases US Co shares worth \$1,000 and pays \$1,000 cash to Foreign Parent.
- Under prior law, the purchase is recast under section 304 as a deemed dividend from CFC to Foreign Parent of \$1,000.
 - The movement of cash from CFC is not subject to U.S. tax.
 - Although CFC's ownership of US Co shares is an investment in U.S. property under section 956 to the extent of CFC's E&P, CFC's E&P is zero after the section 304 transaction.

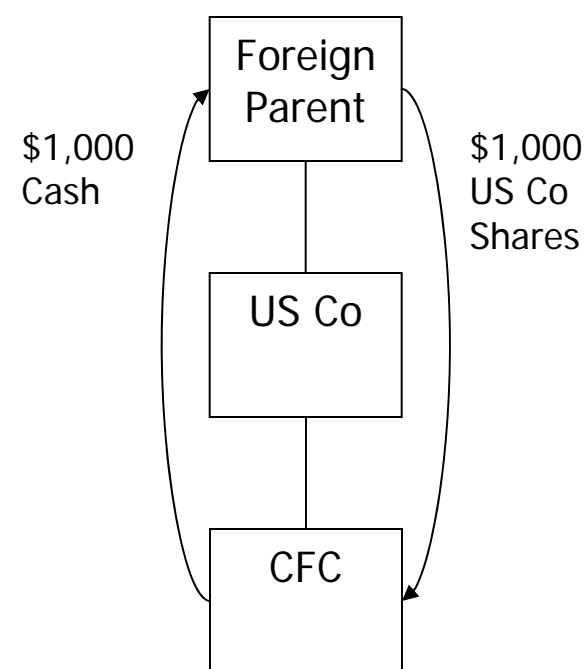


Special Rule with Respect to Certain Redemptions by Foreign Subsidiaries: New Rule

- The provision generally provides a special rule so that, where the acquiring corporation is a CFC and the seller is a foreign person, the E&P of the foreign acquiring corporation cannot be taken into account.
 - ▣ The rule applies if 50% of dividends arising from a stock acquisition recharacterized as a redemption in which the acquiring corporation is a foreign person would not be either:
 - Subject to U.S. tax in a year in which the dividend arises, or
 - Includible in the E&P of a CFC.
- Effective Date: Effective for acquisitions after the date of enactment (August 10, 2010)

Special Rule with Respect to Certain Redemptions by Foreign Subsidiaries: New Rule

- Foreign Parent owns 100% of US Co stock. US Co has \$2,000 in E&P.
- US Co owns 100% of CFC. CFC has \$1,000 in E&P.
- CFC purchases USP shares worth \$1,000 and pays \$1,000 cash to Foreign Parent.
- Under the new law, we look to only US Co's E&P.
 - The \$1,000 dividend from US Co to Foreign Parent is subject to 30% withholding (or less, if reduced by treaty).
 - CFC's ownership of US Co shares is treated as an investment in U.S. property under section 956 to the extent of CFC's E&P of \$1,000.



Modification of Affiliation Rules for Purposes of Allocating Interest Expense

- Under section 864(e), interest expense is apportioned by reference to the interest expense of the “affiliated group.”
 - The affiliated group generally does not include foreign corporations, unless
 - At least 80% of vote or value of the foreign corporation is owned directly or indirectly by members of the affiliated group, and
 - 50% or more of the foreign corporation’s gross income for the taxable year is effectively connected income.
 - Under Treas. Reg. 1.861-11T(d)(6), if 80% or more of the foreign corporation’s gross income is effectively connected, all assets and interest expense are taken into account. If between 50% and 80% of a corporation’s income is effectively connected income, only the corporation’s assets that generate effectively connected income and a ratable percentage of interest expense equal to the percentage of its assets that generate effectively connected income are taken into account.

Modification of Affiliation Rules for Purposes of Allocating Interest Expense

- Taxpayers have used techniques to minimize foreign source interest expense, which then effectively increased foreign source income (which generally allows more foreign tax credits to be used).
 - The regulations were intended to prevent taxpayers from excluding foreign interest expense from the foreign tax credit limitation calculation by placing it in foreign subsidiaries.

Modification of Affiliation Rules for Purposes of Allocating Interest Expense

- The new rule essentially codifies the regulations with a difference in calculation that may increase certain taxpayer's foreign income expense.
- Under the new rule, all of a foreign corporation's assets and interest expense are taken into account for purposes of allocating and apportioning interest expense of domestic members of an affiliated group if:
 - At least 80% of either vote or value of all outstanding stock of such foreign corporation is owned directly or indirectly by members of the affiliated group, and
 - More than 50% of the foreign corporation's gross income for the taxable year is effectively connected income.
- The new rule is effective for taxable years beginning after the date of enactment (i.e., taxable years beginning after August 10, 2010).

Elimination of 80/20 Rules: Prior Law

- In general, dividends and interest paid by a U.S. person are U.S. source income to the recipient.
 - As a result, they generally are subject to 30% withholding tax (unless reduced by a treaty) if paid to a foreign person.
- A special rule (the “80/20 rules”) existed, however, if at least 80% of the gross income of the resident alien individual or domestic corporation payor was foreign source and attributable to the active conduct of a foreign trade or business.
 - If the rule applied, otherwise U.S. source interest would be treated as foreign source.
 - U.S. source dividends would be treated as U.S. source but exempt from withholding tax.
 - The testing period generally was the three-year period preceding the year in which the interest or dividend was paid.

Elimination of 80/20 Rules: New Rule

- The new law repeals the 80/20 rules for taxable year beginning after December 31, 2010, subject to two grandfather rules.
 - Grandfather Rule 1:
 - A payment of dividends or interest after December 31, 2010 by an existing 80/20 company that meets the following requirements is exempt from withholding tax to the extent of the company's active foreign business percentage:
 - Meets the 80/20 test for its last taxable year beginning before January 1, 2011;
 - Meets a new 80/20 test with respect to each taxable year beginning after December 31, 2010; and
 - Has not added a substantial line of business after the date of enactment of this provision.
 - The new 80/20 test is the same as the present law 80/20 test with the following exceptions:
 - For purposes of determining its active foreign business percentage, the existing 80/20 company and all of its subsidiaries (foreign and domestic) are treated as one corporation.
 - A subsidiary means any corporation in which the existing 80/20 company owns (directly or indirectly) stock meeting the requirements of section 1504(a)(2), determined by substituting 50 percent for 80 percent and without regard to section 1504(b)(3) (thus, includes foreign corporations).

Elimination of 80/20 Rules: New Rule

- Grandfather Rule 2:
 - The repeal of the present law 80/20 rules does not apply to payments of interest to persons not related to the 80/20 company on obligations issued before the date of enactment.
 - A significant modification of the terms of any obligation is treated as the issuance of a new obligation.

Limitation on Extension of Statute of Limitations for Failure to Notify Secretary of Certain Foreign Transfers

- The general statute of limitations on assessment is three years from the date of filing.
 - Section 6501(c)(8), however, provides an exception to this general rule by suspending the running of the limitations period where information returns were not filed with respect to certain foreign transactions.
 - Prior to the 2010 Hiring Incentives to Restore Employment ("HIRE") Act (i.e., the Act that added the FATCA provisions), this exception provided that the statute of limitations is suspended *with respect to any event or period* related to information required to be reported under the following provisions:
 - Section 6038 (return of U.S. person who controls a foreign corporation/partnership);
 - Section 6038A (25% foreign-owned corporation's return of transaction with related parties);
 - Section 6038B (return of U.S. person who transfers property to foreign corporation/partnership);
 - Section 6046 (return of officer, director, or 10% shareholder of foreign corporation);
 - Section 6046A (return of person who acquires, disposes of, or has substantial changes in, interests in foreign partnership); and
 - Section 6048 (return regarding transfer to or creation of foreign trust).

Limitation on Extension of Statute of Limitations for Failure to Notify Secretary of Certain Foreign Transfers

- The 2010 HIRE Act added the following sections containing returns to the section 6501(c)(8) list:
 - Section 1295(b) (election by a PFIC shareholder to have the PFIC treated as a qualified electing fund);
 - Section 1298(f) (annual report required by a U.S. person that is a PFIC shareholder); and
 - Section 6038D (self-reporting of specified foreign financial assets, i.e., the "Title 26 FBAR").
- The 2010 HRE Act modified the language in section 6501(c)(8) from providing that the statute of limitations with respect to any "event or period" relating to the return would expire three years after the filing of the return to any "*tax return, event, or period.*"
 - As a result, all items on the taxpayer's overall tax return would be subject to the expanded statute of limitations even if they didn't relate to the items that caused the suspension to apply.
 - No special rule applied where a failure to disclose information was due to reasonable cause.

Limitation on Extension of Statute of Limitations for Failure to Notify Secretary of Certain Foreign Transfers

- The new “loophole closers” act modifies the scope of the exception to the three-year assessment limitations period if the failure to provide information on cross-border transactions or foreign assets is shown to be due to reasonable cause and not willful neglect.
 - If the failure to furnish the information referred to in section 6501(C)(8)(A) is due to reasonable cause and not willful neglect, the suspension of the assessment limitations period will apply only to the items related to that failure.
 - For this purpose, the “related items” include:
 - Adjustments made to the tax consequences claimed on the return with respect to the transaction that was the subject of the information return;
 - Adjustments to any item to the extent the item is affected by the transaction even if it is otherwise unrelated to the transaction; and
 - Interest and penalties that are related to the transactions or the adjustments made to the tax consequences.
- The new provision is effective as if included in the HIRE Act.
 - Thus, it applies for returns filed after March 18, 2010, the date of enactment of the HIRE Act, as well as for any other return for which the assessment period specified in section 6501 had not yet expired as of that date.

Uncertain Tax Positions Reporting

Uncertain Tax Positions Reporting - Background

- In Announcement 2010-9, the IRS introduced a proposed reporting requirement on certain business taxpayers to provide information about uncertain tax positions affecting their federal income tax liability.
 - In Announcement 2010-17, the IRS extended the comment period for the proposal and stated that it planned to require the filing of the new schedule for returns relating to calendar year 2010 and for fiscal years that begin in 2010.
 - In Announcement 2010-30, the IRS announced the release of the draft schedule ("Schedule UTP") and instructions, comments on which were due by June 1, 2010.

Schedule UTP – Reporting Requirements

- In general, Schedule UTP requires a corporation with assets equal to or exceeding \$10 million to report its federal income tax positions for which the corporation or a related party has (i) recorded a reserve in an audited financial statement or (ii) not recorded a reserve based on an expectation to litigate or an IRS administrative practice.
 - The draft schedule and instructions require only corporations filing a Form 1120, Form 1120 F, or Form 1120 L or Form 1120 PC to file a Schedule UTP beginning with the 2010 tax year.
 - Accordingly, the IRS will not require for 2010 tax years a Schedule UTP from real estate investment trusts, regulated investment companies, pass-through entities, tax-exempt organizations, or other entities that do not file the Forms 1120 described above.
 - The IRS stated in Announcement 2010-30 that it will determine the timing of the proposed reporting requirement for these entities after comments have been received and considered.
 - An audited financial statement includes financial statements prepared under GAAP, IFRS, or another country-specific accounting standard that requires a taxpayer to record a reserve for federal income tax purposes.

Schedule UTP – Reporting Requirements

- Schedule UTP and its instructions define a related party broadly to include any entity that is related to the corporation under sections 267(b), 318(a), or 707(b), or any entity that is included in a consolidated audited financial statement in which the corporation is also included.
 - The draft schedule contains a box that must be checked if the corporation is unable to obtain information from related parties sufficient to determine whether a tax position must be disclosed.

Schedule UTP – Reporting Requirements

- A tax position must be reported on a Schedule UTP and attached to a particular year's return if (i) at least 60 days before filing the tax return a reserve has been recorded with respect to that tax position, or at least 60 days before filing the tax return a decision was made not to record a reserve based on an expectation to litigate or an IRS administrative practice, and (ii) the tax position has been taken by the corporation in a tax return for the current tax year or a prior tax year.
 - A tax position is taken in a tax return if it would result in an adjustment to a line item on that tax return (or would be included in a section 481(a) adjustment) if the position is not sustained. Thus, a tax position would include positions related to temporary differences as well as permanent differences.
 - A corporation generally is not required to report a tax position if it reported the tax position on a Schedule UTP filed with a prior tax return. However, an exception applies if there is a transaction that results in tax positions taken in more than one tax return.
 - The draft instructions provide for a transition rule under which a corporation is not required to report on Schedule UTP a tax position taken in (i) a tax year beginning before December 15, 2009, or (ii) a tax year beginning on or after December 15, 2009, and ending before January 1, 2010, regardless of whether or when a reserve was recorded with respect to that tax position.

Schedule UTP – Concise Description

- A corporation must provide a concise description of each uncertain tax position, including information that reasonably can be expected to apprise the IRS of the identity of the tax position and the nature of the uncertainty. According to the IRS, this description should, in most cases, not exceed a few sentences.
 - ❑ The description must include (i) a statement that the position involves an item of income, gain, loss, deduction, or credit against tax, (ii) a statement whether the position involves a determination of the value of any property or right or a computation of basis, and (iii) the rationale for the position and the reasons for determining the position is uncertain.
 - ❑ The draft instructions contain several examples of what constitutes an acceptable concise description.

Schedule UTP – Maximum Tax Adjustment

- A corporation must also disclose the maximum tax adjustment for a tax position, which is an estimate of the maximum amount of potential U.S. federal income tax liability associated with the tax year for which the tax position was taken.
 - For tax positions relating to items of income, gain, loss, and deduction, total amounts are estimated in dollars and multiplied by 35 percent. For items of credit, the total amount of credits is estimated in dollars. These amounts do not include penalties or interest, and do not reflect offsets except to the extent of items relating to the same tax position.
 - A determination of a maximum tax adjustment amount is not required for valuation or transfer pricing positions. A corporation can provide a ranking of these tax positions based on either the amount recorded as a reserve for the position, or the estimated tax adjustment relating to the position. The corporation is not required to describe the method chosen or report the reserve or adjustment amounts.

Schedule UTP – Other Required Information

- Other information that must be indicated on the Schedule UTP with respect to an uncertain tax position includes:
 - ❑ the primary IRC sections relating to the tax position;
 - ❑ whether a tax position creates temporary or permanent (or both) differences;
 - ❑ if the tax position relates to a position of a pass-through entity, such entity's EIN; and
 - ❑ whether the tax position must be reported because it was determined that the IRS would not challenge the position based on IRS administrative practice.

Schedule UTP – Coordination with Other Reporting Requirements

- The draft instructions state that the IRS will treat a complete and accurate disclosure of a tax position on a Schedule UTP as if the corporation filed a Form 8275, Disclosure Statement (or Form 8275-R, Regulation Disclosure Statement), with respect to the tax position.
- The IRS is also reviewing the extent to which the proposed Schedule UTP duplicates other reporting requirements, and is considering other circumstances under which a tax position reported on Schedule UTP does not need to be separately reported on the tax return or another disclosure statement.

Schedule UTP - Penalties

- In Announcement 2010-9, the IRS indicated that it is evaluating options for penalties to be imposed with respect to taxpayers who fail to disclose adequately their uncertain tax positions.
 - ❑ An option under consideration by the IRS is to seek legislation imposing a penalty for failure to file the new schedule or to make an adequate disclosure.
 - ❑ The draft Schedule UTP and instructions reserve on the issue of “other disclosures and penalties.”

Application of Section 7701(o), the Codified Economic Substance Doctrine

Economic Substance Codification - Overview

- On March 30, 2010, the Health Care and Education Reconciliation Act of 2010, H.R. 4872 (the “Health Care Reconciliation Act”) was signed by President Obama.
 - ❑ Section 1409 of the Health Care Reconciliation Act “codified” the economic substance doctrine.
 - ❑ The statute adds new subsection 7701(o), “Clarification of Economic Substance Doctrine.”
 - ❑ The statute provides for a strict liability penalty for transactions that lack economic substance.
- The statute generally applies to transactions entered into after the date of enactment.

New Section 7701(o)

(o) CLARIFICATION OF ECONOMIC SUBSTANCE DOCTRINE.—

(1) APPLICATION OF DOCTRINE.—In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—

(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and

(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

(2) SPECIAL RULE WHERE TAXPAYER RELIES ON PROFIT POTENTIAL.—

(A) IN GENERAL.—The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

(B) TREATMENT OF FEES AND FOREIGN TAXES.— Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit under subparagraph (A). The Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.

New Section 7701(o)

(3) STATE AND LOCAL TAX BENEFITS.—For purposes of paragraph (1), any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.

(4) FINANCIAL ACCOUNTING BENEFITS.—For purposes of paragraph (1)(B), achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax.

(5) DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

(A) ECONOMIC SUBSTANCE DOCTRINE.— The term ‘economic substance doctrine’ means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

(B) EXCEPTION FOR PERSONAL TRANSACTIONS OF INDIVIDUALS.—In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

(C) DETERMINATION OF APPLICATION OF DOCTRINE NOT AFFECTED.—The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.

(D) TRANSACTION.—The term ‘transaction’ includes a series of transactions.

Application of the Doctrine - Overview

- Section 7701(o) applies to transactions taking place after March 30, 2010.
 - Considerable uncertainty exists regarding when and how section 7701(o) will be applied.
- How the codified economic substance doctrine may apply will depend on a variety of factors, including:
 - When will the economic substance doctrine be considered “relevant” to a transaction?
 - What is the relevant “transaction” to be tested?
 - How will the IRS assert the codified doctrine and associated no-fault penalty?
 - How will the IRS/courts apply the two-prong test?
 - Will taxpayers be able to obtain advance certainty on the application of the doctrine?

When Does the Codified Doctrine Apply?

- The two-prong test of section 7701(o) applies “[i]n the case of any transaction to which the economic substance doctrine is relevant.” Section 7701(o)(1).
 - This test raises several questions, including:
 - What is the “economic substance doctrine”?
 - Section 7701(o)(5)(A) defines the economic substance doctrine as “the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.”
 - When is the economic substance doctrine “relevant” to a transaction?
 - What is a “transaction”?

When is the Doctrine “Relevant”?

- Section 7701(o)(5)(C) states that “[t]he determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if [section 7701(o)] had never been enacted.”
 - The JCT Technical Explanation further states “the provision does not change present law standards in determining when to utilize an economic substance analysis.”
 - What are these “present law standards?”
 - The JCT Technical Explanation describes two general types of tax results not intended to be altered by codification:
 - “If the realization of the tax benefits is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate.”
 - “[T]he 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.”

When is the Doctrine “Relevant”? Consistent with Congressional Purpose or Plan

- According to the JCT Technical Explanation, “[i]f the realization of the tax benefits is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed.”
 - “[I]t is not intended that a tax credit . . . be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage.”
 - The JCT Technical Explanation provides an example of a tax credit “in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage,” such as the section 42 low-income housing credit, section 45 production tax credit, section 45D new markets tax credit, section 47 rehabilitation credit, and section 48 energy credit.

When is the Doctrine “Relevant”? Consistent with Congressional Purpose or Plan

- How does a taxpayer determine whether the “realization of the tax benefits is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate?”
 - How does one determine the “Congressional purpose or plan”?
 - Purposes will not always be apparent.
 - What if a benefit was not clearly completed by Congress but still technically results from the statute?
 - If a taxpayer satisfies the technical requirements of the Code and regulations, should the doctrine apply if no clear statutory purpose or plan is circumvented?
- The JCT Technical Explanation specifically mentions credits—does the same standard for credits apply for deductions and other tax benefits?

When is the Doctrine “Relevant”?

“Basic Business Transactions”

- The JCT Technical Explanation also states that codification “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.”
- The JCT Technical Explanation provides several examples of these “basic business transactions” (and states that the list is illustrative, not exhaustive):
 - 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 a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and
 - the choice to utilize a related-party entity in a transaction, provided that the arm’s length standard of section 482 and other applicable concepts are satisfied.

When is the Doctrine “Relevant”?

Safe Harbors?

- Should the two categories of tax benefits described in the JCT Technical Explanation (benefits consistent with a Congressional purpose or plan and “basic business transactions”) be considered “safe harbors”?
 - To what extent may taxpayers rely on statements made in a JCT Technical Explanation?
 - JCT reports are technically not legislative history because they are “authored by Congressional staff and not by Congress.” *Hutchinson v. Commissioner*, 765 F.2d 665 (7th Cir. 1985).
 - But several courts have viewed them, however, as “highly indicative of what Congress did, in fact, intend.” *See, e.g., id.*
 - JCT Technical Explanations available to lawmakers before a statute is enacted may be considered more authoritative than post-enactment JCT reports, such as the Blue Book.

When is the Doctrine “Relevant”?

Safe Harbors?

- Should/will Treasury and the IRS issue guidance on when the doctrine is “relevant”, perhaps using these safe harbors?
 - ❑ Whether section 7701(o) even applies is a significant question—if economic substance is not “relevant,” no need to apply the two-prong test.
 - ❑ The Treasury/IRS could confirm the JCT “safe harbors” in guidance.
 - The use of “safe harbors” in guidance has recent precedent—the final section 355(e) regulations provide a “super safe harbor,” safe harbor, and facts and circumstances to be considered in determining whether a distribution and acquisition are part of a plan.
 - ❑ Some have proposed an “angel” list that would generally not be subject to an economic substance inquiry.
 - But Treasury and IRS officials have said an “angel list” is unlikely—their position is that codification has not changed the application of the doctrine.

What is a “Transaction”?

- The two-prong test applies “[i]n the case of any transaction to which the economic substance doctrine is relevant.” Section 7701(o)(1).
 - Section 7701(o)(5)(D) defines the term “transaction” as including “a series of transactions.”
 - This statement appears to confirm that the step transaction doctrine should be applied in testing a transaction for economic substance (consistent with long-standing judicial precedent).

What is a “Transaction”?

- In contrast to section 7701(o)’s statement regarding transaction including a series of transactions, the JCT Technical Explanation states that:
 - “This provision does not alter the court’s ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine. For example, the provision reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits.”
- The JCT Technical Explanation cites *Coltec*’s statement that “[W]e must focus on the transaction that gave the taxpayer a high basis in the stock and thus gave rise to the alleged benefit upon sale.”
- How does the statute “reiterate” bifurcation/disaggregation?
- Consistent with its recent post-*Coltec* briefs, the IRS is likely to assert a narrow definition of the transaction.
 - Will this likely IRS approach and the JCT statement lead courts to shift toward a disaggregate approach (i.e., will a court be more likely to disaggregate post-codification as compared to prior periods)?
 - If it does, hasn’t codification changed “present law standards?”

The Two-Prong Test: Objective Component

- The transaction must change the taxpayer's economic position in a meaningful way (apart from Federal income tax effects). Section 7701(o)(1)(A).
 - The taxpayer can rely on profit potential to satisfy the objective prong only if the "present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected." Section 7701(o)(2)(A).
 - Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit. Section 7701(o)(2)(B).
 - Treasury "shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases."
 - A state or local tax effect related to a federal income tax effect shall be treated in the same manner as a federal income tax effect.

The Two-Prong Test: Objective Component

- What is a “meaningful” change in economic position?
- If taxpayer relies on profit potential:
 - How does one calculate present values?
 - When is profit “reasonably expected”?
 - When is pre-tax profit “substantial” when compared to the expected net tax benefits?
 - Can a taxpayer satisfy the prong without actual profit?
- What are the other ways to show a “meaningful” change in economic position?
 - Cost savings, others?
- What are the “appropriate cases” in which foreign taxes should be taken into account?
 - The *Compaq* and *IES* foreign tax credit cases, which applied economic substance to pre-foreign tax profit, motivated this language.

The Two-Prong Test: Subjective Component

- The taxpayer must have a substantial purpose (apart from Federal income tax effects) for entering into such transaction. Section 7701(o)(1)(B).
 - ❑ The taxpayer can rely on the substantial net profit standard to satisfy the subjective prong as well as the objective prong. Section 7701(o)(2)(A).
 - ❑ Achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of federal income tax. Section 7701(o)(4).

The Two-Prong Test: Subjective Component

- What is a “substantial” purpose?
 - Is a purpose “better” because it relates to the core business of the taxpayer?
 - The JCT Technical Explanation cites *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189 (1997), which stated that “the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer’s conduct and useful in light of the taxpayer’s economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry.”
 - Statute itself has no “core business” requirement
 - Significance for the financial services industry?

No-Fault Penalty

- New section 6662(b)(2) imposes a strict liability penalty of 20% (40% for undisclosed transactions) of an underpayment attributable to the disallowance of claimed tax benefits by reason of a transaction lacking economic substance or “failing to meet the requirements of any similar rule of law.” Section 6662(b)(6).
 - There is no exception for reasonable cause (opinions and in-house analysis will not provide penalty protection)
 - What is “any similar rule of law”?
 - Sham transaction?
 - Business purpose doctrine?
 - Step transaction?
 - Substance over form?
 - The numerous anti-abuse and business purpose requirements in the Code and regulations?
 - According to the JCT Technical Explanation, “It is intended that the penalty would apply to a transaction the tax benefits of which are disallowed as a result of the application of the similar factors and analysis that is required under the provision for an economic substance analysis, even if a different term is used to describe the doctrine.”

No-Fault Penalty: Adequate Disclosure

- What is adequate disclosure?
 - Language in new provision is the same as in section 6664(d)(2)(A) with respect to reportable transactions.
 - Under section 6664(d)(2)(A), the relevant facts affecting the tax treatment of the item must be adequately disclosed in accordance with the regulations prescribed under section 6011.
 - The section 6011 regulations provide a form for disclosure of the expected tax treatment and all potential tax benefits and any tax result protection and require the taxpayer to describe the transaction in sufficient detail for the IRS to be able to understand the structure and identify the parties.
 - An amended return or supplement to a return is not taken into account if filed after the taxpayer has been contacted for audit or such other date as is specified by the Secretary.

IRS Assertion and Application of the Doctrine

- IRS officials have generally downplayed the significance of the statute, stating that the statute mandates a conjunctive analysis (circuits were previously split in how the doctrine should be applied), but otherwise does not change the application of the doctrine.

IRS Assertion and Application of the Doctrine

- How the IRS will apply the doctrine in practice is unclear.
 - ❑ When must the doctrine and penalty be asserted?
 - Can the doctrine first be raised in litigation?
 - ❑ How can taxpayers challenge the penalty?
 - ❑ Must an agent obtain approval before asserting the doctrine?
 - ❑ Will the IRS assert the doctrine (a) by determining first whether economic substance is “relevant” or (b) when one or both of the two prongs is violated, without regard to the “relevance” of the doctrine?
 - ❑ Will the IRS continue to assert a *Coltec* disaggregation approach?

IRS Assertion and Application of the Doctrine

- Some have suggested that the IRS provide audit guidelines to agents to describe when and how section 7701(o) should be applied (both procedurally and substantively).
 - Guidelines could help promote consistency and certainty.
 - A formal process could be adopted for the assertion of section 7701(o) and the no-fault penalty.
 - This process could address:
 - When the doctrine and penalty must first be raised;
 - How taxpayers can challenge the penalty;
 - What procedures must be carried out before the penalty is formally asserted.
 - A review process for economic substance could require chief counsel approval, as was required in a prior Senate version of economic substance codification.

IRS Assertion and Application of the Doctrine: Ability to Obtain Advance Certainty?

- Will taxpayers be able to obtain advance certainty?
 - “No action letter”/special PLR program
 - IRS could develop a “no action” letter process/special economic substance PLR program to provide taxpayers with certainty that their transaction will be not challenged on economic substance grounds.
 - “Angel list”?
- Will any substantive guidance be issued?

Transfer Pricing Developments

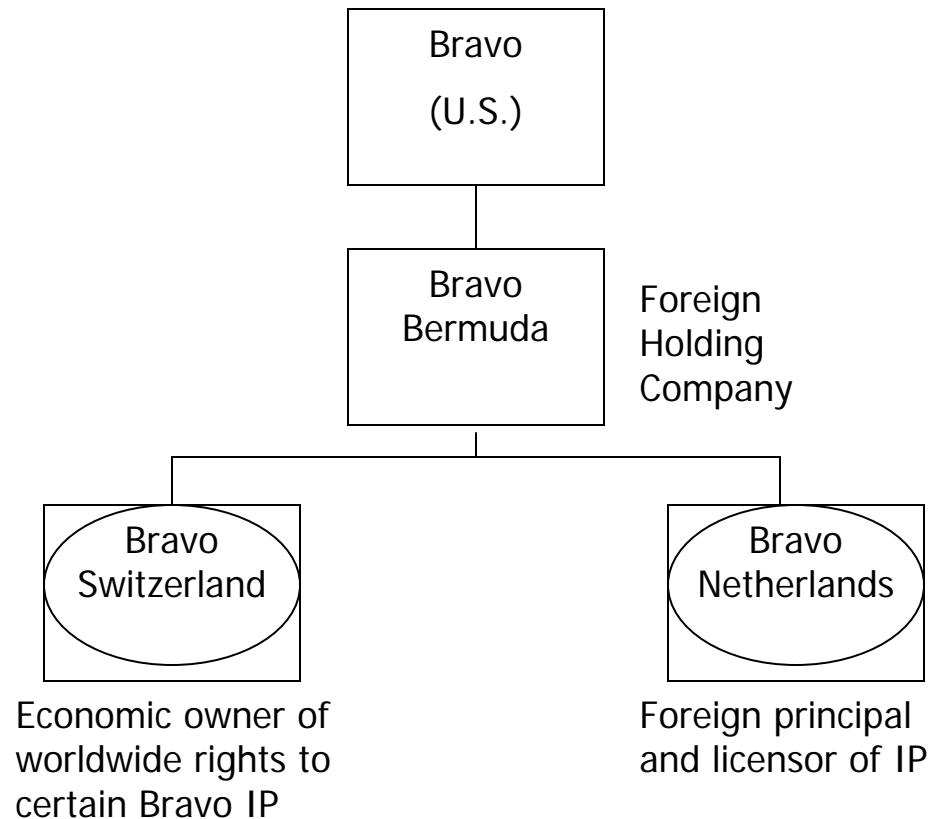
Transfer Pricing Hearing

- On July 22, the House Ways & Means Committee held a hearing on transfer pricing.
 - Acting Ways & Means Chair Levin (D-MI) stated that the hearing was intended to help legislators understand “the mechanics of transfer pricing and how big an issue this is for the federal government.”
 - Stephen Shay, Treasury Deputy Assistant Secretary for International Tax Affairs, said the Obama administration continued to support the arms'-length standard and that its transfer pricing proposals are “fully consistent with the arm's-length standard and are part of our continuing efforts to improve the administration and enforcement of our international tax rules.”
- In a related report, the JCT presented case studies of U.S.-based multinational taxpayers to “help explain how the interaction between business operations and tax planning could result in low reported average U.S. and worldwide tax rates by some taxpayers.”

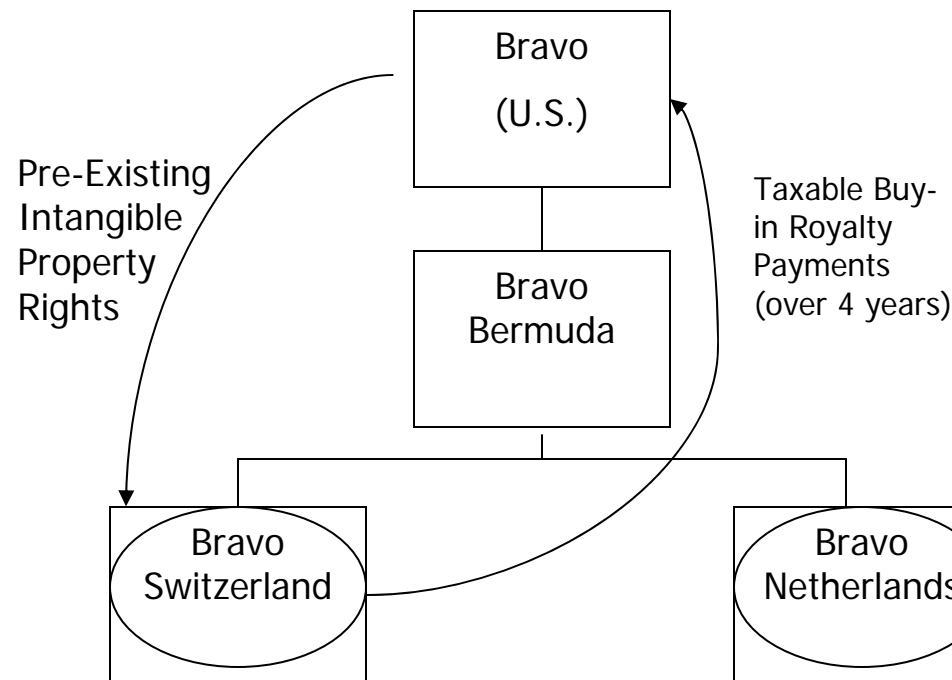
JCT Case Studies

- The JCT reviewed public documents filed by over 100 public corporations with significant operations and sales in both the United States and abroad.
- Each of the six cases selected had an effective tax rate on worldwide income of less than 25% during at least one multi-year period since 1999.
- The JCT stated that it found the following “common features” among its case studies:
 - ❑ Significant portion of income was earned offshore where it was subject to relatively low average tax rates
 - ❑ Permanent reinvestment assertion for substantial amount of accumulated earnings offshore so that no U.S. tax was accrued for U.S. financial statement purposes
 - ❑ U.S. pre-tax income as a percentage of worldwide pre-tax income was lower than U.S. sales as a percentage of worldwide sales

JCT Case Study Example: “Bravo” Company

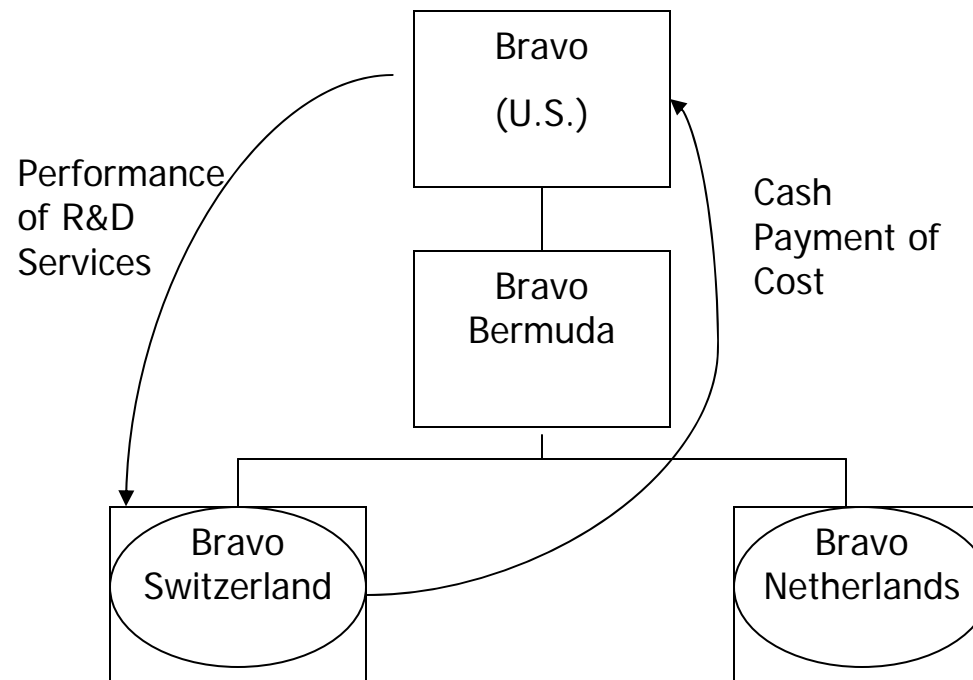


JCT Case Study Example: “Bravo” Company: Buy-in Payment



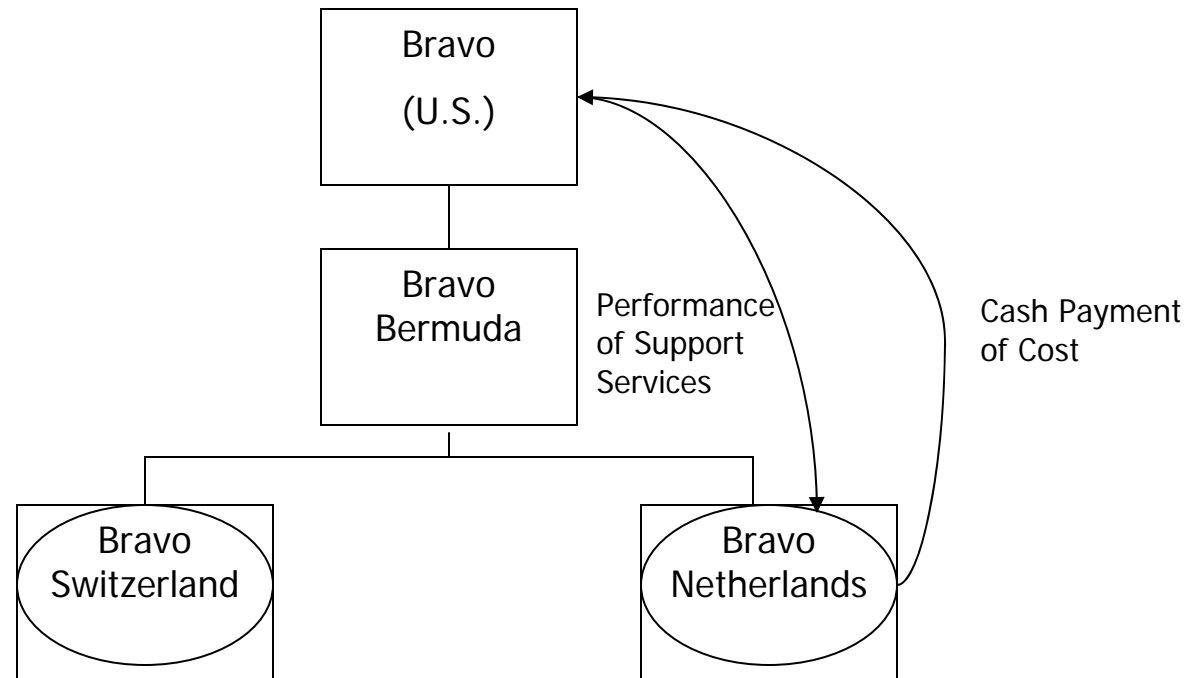
- To allow Bravo Switzerland to use pre-existing intangible property made available through a cost-sharing agreement, Bravo Switzerland made a buy-in payment to Bravo U.S.
- Tax Results: Taxable income in the United States, deduction in Switzerland

JCT Case Study Example: “Bravo” Company: Cost-Sharing Arrangement



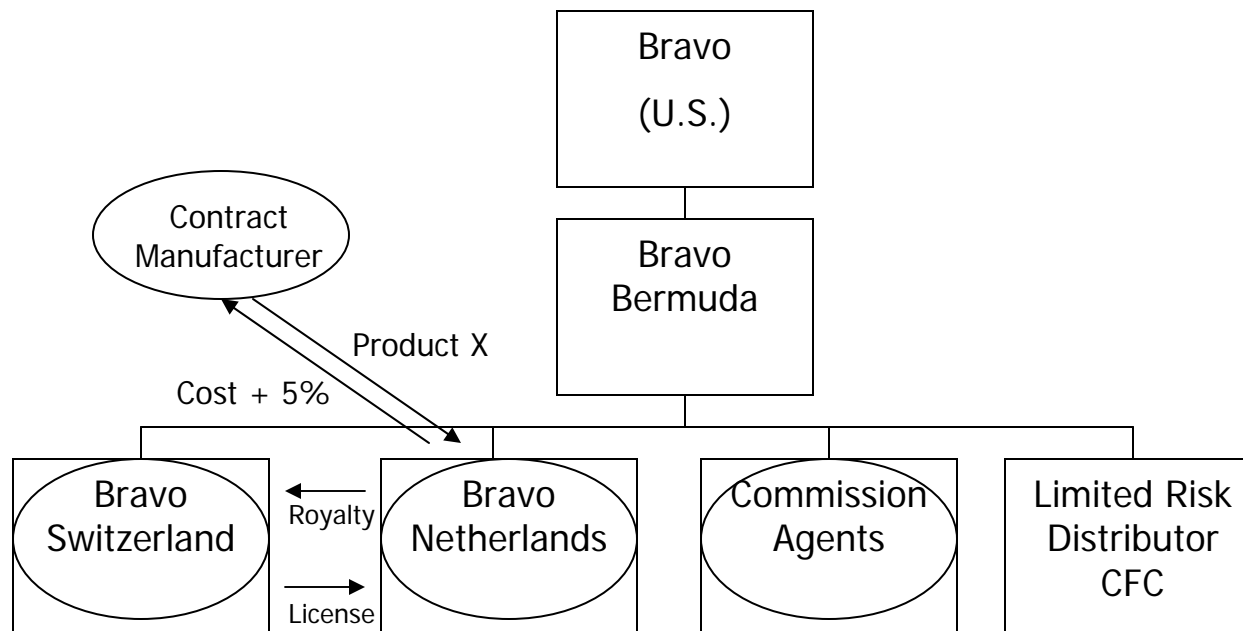
- Under the cost-sharing agreement, Bravo Switzerland paid for R&D performed by Bravo U.S. based on a percentage of Bravo worldwide sales attributable to intangible property rights owned by Bravo Switzerland.
- Tax results: U.S. taxable income offset by U.S. R&D deduction (may be eligible for R&D credit); Swiss tax deduction

JCT Case Study Example: “Bravo” Company: Supportive Services



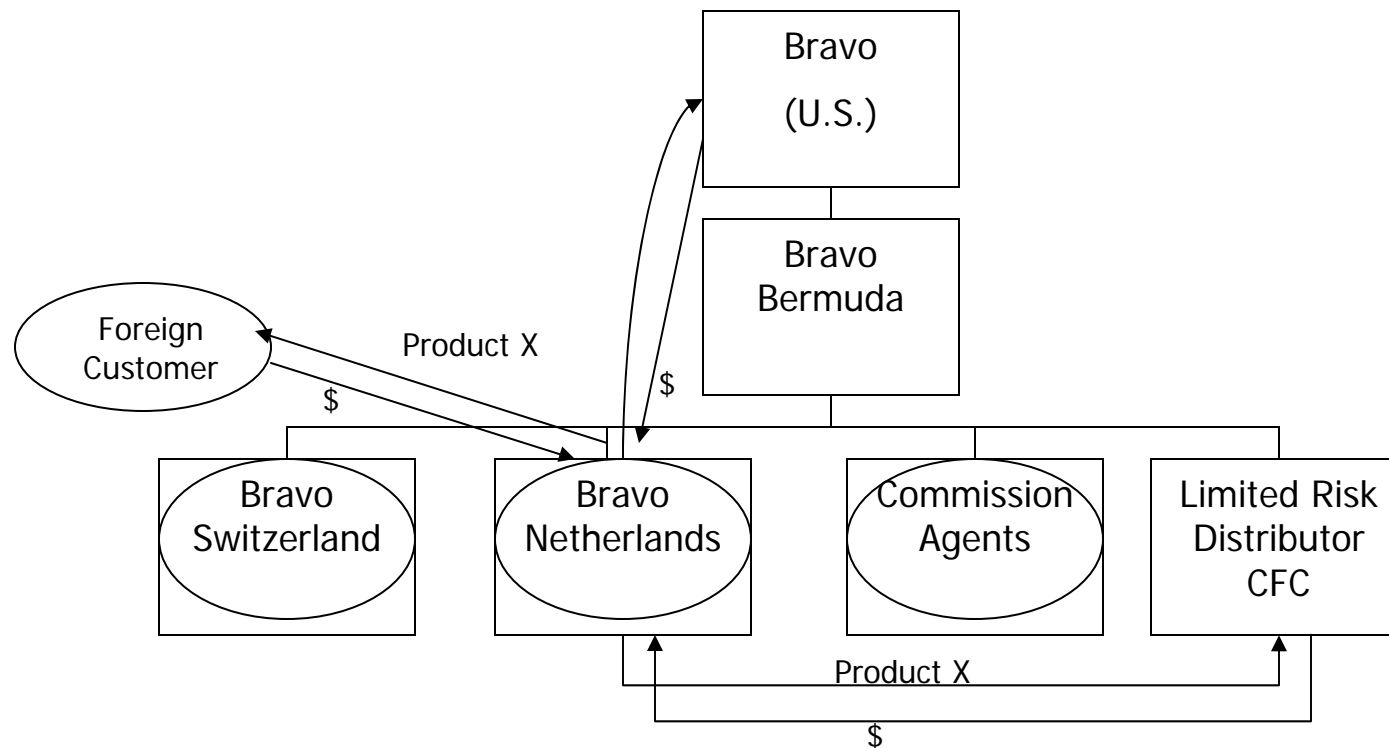
- Bravo Netherlands relies on employees of Bravo U.S. to perform supportive services including marketing and sales support; factory, procurement, quality control, and similar services related to the manufacture of goods; training, support, and professional services; and treasury, tax, and other general and administrative services.
- Tax results: U.S. taxable income to the extent of mark-up; Dutch tax deduction

JCT Case Study Example: “Bravo” Company: Manufacture of Product X



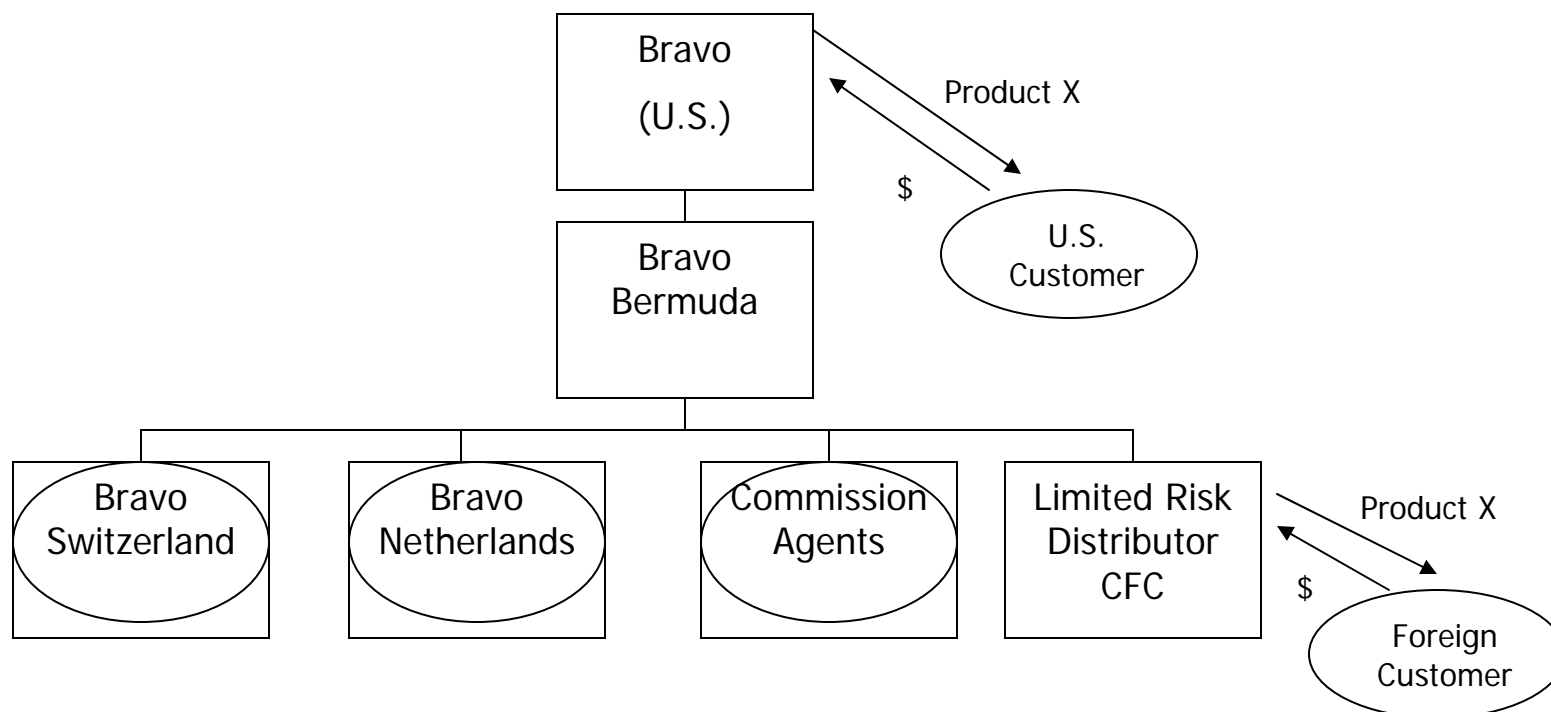
- Step 1: Bravo Netherlands licenses intangible property rights from Bravo Switzerland and engages a third party contract manufacturer to assist with manufacturing of Product X.

JCT Case Study Example: “Bravo” Company: Manufacture of Product X



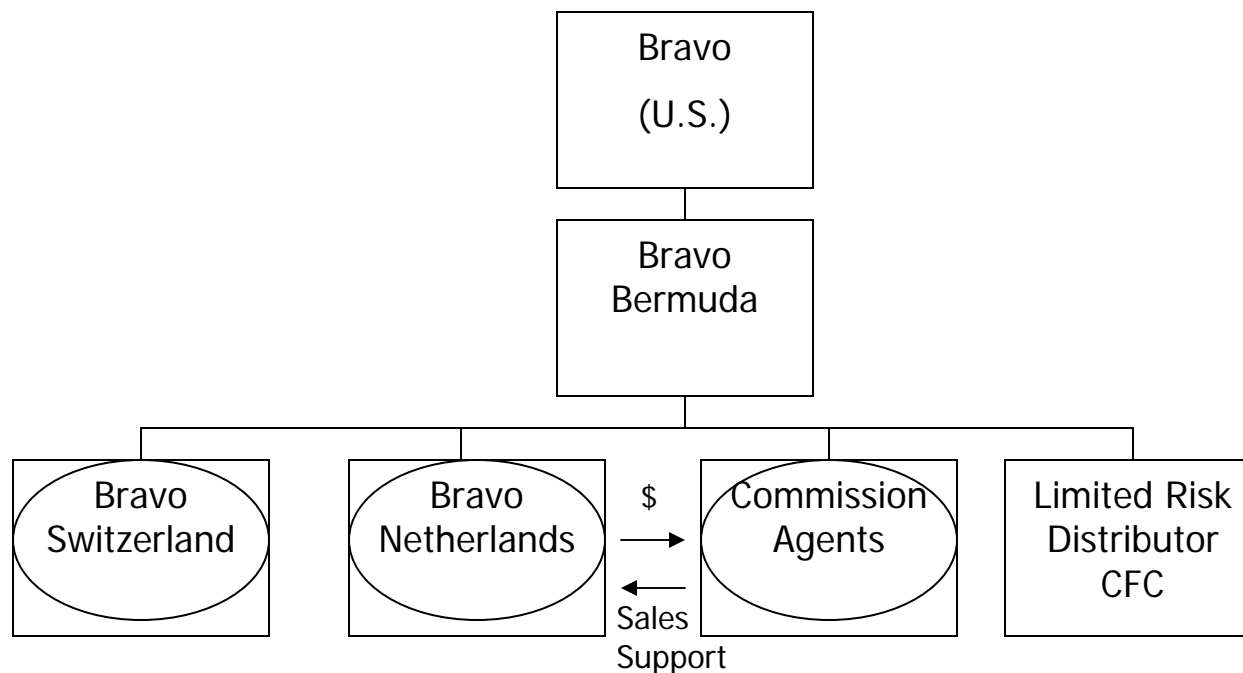
- Step 2: Bravo Netherlands sells Product X directly to foreign consumers and Bravo U.S. and the Bravo limited risk distributor CFCs

JCT Case Study Example: "Bravo" Company: Resale to U.S. and Foreign Third Party Customers



- Step 3: Bravo U.S. and the Bravo limited risk distributor CFCs resell Product X to U.S. and foreign customers

JCT Case Study Example: "Bravo" Company: Commission Payment for Sales Support



- Step 4: Bravo Netherlands makes a commission payment to European (disregarded entity) commission agents for sales assistance

JCT Case Study Example: “Bravo” Company: Summary

- The bulk of manufacturing and sales income for foreign operations is earned by Bravo Netherlands for serving as principal
 - A significant royalty is paid to Bravo Switzerland for the use of intangible property rights, so only a limited amount of income is subject to tax in the Netherlands at a 25% tax rate.
- Royalty income received by Bravo Switzerland taxed at less than 5% tax rate
- From a U.S. tax perspective:
 - No subpart F income due to:
 - Intragroup transactions (royalties and sales) being disregarded under Bravo Bermuda
 - Manufacturing exception to subpart F through attribution of third-party contract manufacturer activities
 - Bravo U.S. has taxable income for its limited risk distributor activities and performance of supportive services.

JCT Case Studies: Overall Summary

- The case studies show somewhat complex, but not uncommon or particularly surprising (at least to tax professionals), tax structures. The taxpayers in the case studies:
 - ❑ Concentrate more profitable functions in foreign jurisdictions where the average tax rate is lower and concentrate less profitable functions in jurisdictions where the average tax rate is higher
 - ❑ Exploit intangible property rights through cost sharing or licensing
 - ❑ Defer foreign income by managing exposure to subpart F rules
 - Check-the-box use

Veritas, 133 T.C. 14

Background

- The Tax Court decided *Veritas Software Corp. v. Comm'r*, 133 T.C. 14 (2009) on December 10, 2009.
 - The Tax Court rejected the IRS's proposed reallocations of income to a U.S. software company related to a buy-in payment under a cost sharing agreement between the U.S. software company and its Irish subsidiary.
- Pursuant to the cost-sharing agreement, the U.S. software company transferred to the Irish subsidiary the right to use certain pre-existing intangibles in the Middle East, Africa, and Asia. In exchange, the Irish subsidiary agreed to share future costs and make a buy-in payment. The amount of the buy-in payment was originally \$166 million. The taxpayer later adjusted that amount to \$118 million.
 - The taxpayer determined the amount of the buy-in payment using the comparable uncontrolled transaction ("CUT") method.
 - The CUTs used by Veritas were licenses that Veritas had entered into with unrelated original equipment manufacturers ("OEMs") such as Sun, HP, and Dell to sell Veritas's software with the OEMs' hardware.
 - The IRS used an income method and determined the amount of the buy-in should be \$2.5 billion. The IRS later amended its position and reduced the amount to \$1.675 billion.

Veritas : Arguments

- The taxpayer argued that the IRS could require a “buy-in” based only on the value of *pre-existing* intangibles at the time they are contributed to a cost-sharing pool.
- The IRS argued that the amount of the buy-in should take into account income to be derived from future further development of the intangible under the cost-sharing agreement.

Veritas : Tax Court Decision

- The court held that the IRS's adjustment was arbitrary, capricious, and unreasonable.
 - ❑ The court stated that the IRS disregarded Treas. Reg. § 1.482-7(g)(2), which limits buy-in payments to the transfer of pre-existing intangibles. The IRS attempted to include income from future intangibles in the computation of the buy-in payment.
 - ❑ In addition, the court determined that the IRS valued short-lived intangibles as if they had a perpetual useful life and used an inappropriate discount rate and an unrealistic growth rate.
 - ❑ The court accepted the taxpayer's comparable uncontrolled transaction method, with certain adjustments.

Veritas : Comments

- The Tax Court's opinion represents a rejection of several of the positions stated in the IRS's 2007 Coordinated Issue Paper ("CIP") on buy-in payments in cost sharing agreements, including:
 - The IRS's view that it may be appropriate to evaluate the buy-in in the aggregate (including "operating intangibles" such as research workforce, marketing intangibles, and synergy effects)
 - The Tax Court rejected the IRS's "akin to a sale" method and stated that the aggregated approach "certainly does not produce the most reliable result"
 - The court stated that the IRS's allocation took into account items not transferred or that had little or no value
 - The IRS's aversion to inexact comparable uncontrolled transaction methods.
 - In its 2007 CIP, the IRS concluded that, in "typical" fact patterns, the income method and the acquisition price method generally are the best methods for valuating intangibles under a CSA.
 - The IRS stated in the CIP that the CUT method is generally unreliable because those transactions do not involve a transfer of platform intangibles and thus cannot provide a reliable method for valuing the required buy-in.
 - *Veritas* accepted CUT as a potentially reasonable method.
 - *Veritas* likely increases the IRS's hazards of litigation when the taxpayer has reasonable CUTs.

Joint Committee on Taxation Staff's Comments on the CUT Method

- Note that the staff of the Joint Committee on Taxation commented in its description of the Obama Administration's Fiscal Year 2010 budget proposal that the CUT method may be appropriate in only certain limited circumstances.
- The report stated:
 - The regulations provide that if an uncontrolled transaction involves the transfer of the same intangible under the same, or substantially the same, circumstances as the controlled transaction (i.e., an exact comparable), the CUT method generally is the most direct and reliable measure of the arm's length result for a controlled transaction. Exact comparables are rare, however, in the case of high-value intangibles. If an exact CUT cannot be identified, uncontrolled transactions that involve the transfer of comparable intangibles under comparable circumstances (i.e., inexact comparables) may be used to apply the CUT method, but the reliability of the method will be reduced. The regulations require that a taxpayer consider whether the intangible that is the subject of the uncontrolled transaction has "similar profit potential" to the taxpayer's intangible in determining whether the uncontrolled transaction is comparable. However, this method does not otherwise consider or directly reflect the income attributable to the taxpayer's intangible.

Veritas : Comments

- The Tax Court (in dictum) also rejected an expansive definition of “intangible” under Section 936(h)(3)(B). In footnote 31, the court stated:
 - “‘Access to research and development team’ and ‘access to marketing team’ are not set forth in sec. 936(h)(3)(B) or sec. 1.482-4(b), Income Tax Regs. Therefore, to be considered intangible property for sec. 482 purposes, each item must meet the definition of a ‘similar item’ and have ‘substantial value independent of the services of any individual’. Sec. 936(h)(3)(B); sec. 1.482-4(b), Income Tax Regs. The value, if any, of access to VERITAS US’ R&D and marketing teams is based primarily on the services of individuals (i.e., the work, knowledge, and skills of team members).”
 - But note that, in the case, this observation did not have much significance because the Tax Court made a factual finding that Veritas Ireland’s access to Veritas’s marketing team had minimal value and the IRS’s stipulation that Veritas Ireland’s access to Veritas’s R&D team had no value for which it was not compensated through the cost-sharing payments.

Veritas : Comments

- What is the significance of *Veritas* for other taxpayers? How might it affect FIN 48 analysis?
 - Is the case a general repudiation of the income method or did it turn primarily on findings of fact?
 - The IRS expert was unreliable
 - The IRS improperly attempted to include income from future intangibles in computing the buy-in payment
 - The IRS improperly ascribed perpetual life
 - The IRS used bad discount and growth rates
- The case is appealable to the Ninth Circuit.
 - Judge Foley, who decided *Veritas* in the Tax Court, also decided *Xilinx* in the Tax Court. His *Xilinx* decision was reversed by the Ninth Circuit, in a decision later withdrawn, and then replaced by an opinion affirming his Tax Court decision.
- Findings of fact can only be reversed by clear error, though the Ninth Circuit could review the issue *de novo* if it determined that the issue involved a mixed question of law in fact.

Xilinx : Facts

- Xilinx is a U.S. technology company that researches, develops, manufactures and sells integrated circuit devices and related development software systems.
 - ❑ Xilinx established an Irish subsidiary and entered into a cost sharing agreement with that subsidiary.
 - ❑ Xilinx offered its employees certain employee stock options (“ESOs”), but did not include the costs of such options in the allocations under the cost sharing agreement with its Irish subsidiary.
 - ❑ The IRS contended that the costs of the ESOs should have been included in the cost sharing agreement.

Xilinx: Tax Court Decision

- The Tax Court held in favor of the taxpayer and determined that the costs of ESOs were not costs that unrelated third parties would include in a cost sharing agreement and therefore such costs did not need to be included in the agreement between Xilinx and its Irish subsidiary. *See Xilinx Inc. v. Commissioner*, 125 TC 37 (2005).

Xilinx : Ninth Circuit

- The Ninth Circuit reversed the decision of the Tax Court in an opinion issued on May 27, 2009. *See Xilinx, Inc. v. Comm’r*, 567 F.3d 482, (9th Cir. 2009).
 - The court focused on the language in Treas. Reg. § 1.482-7(d)(1) that required “all costs” be shared between related parties in a cost sharing agreement.
 - The court acknowledged that this language was inconsistent with other language in Treas. Reg. § 1.482-1(b)(1) that stated “the standard to be applied in every case is that of a taxpayer dealing at arm’s length with an uncontrolled taxpayer.”
 - The court reasoned that Treas. Reg. § 1.482-7(d)(1) was more specific and therefore controlled.
 - Accordingly, the court determined for the first time that in certain circumstances section 482 required something other than the arm’s length standard to be applied to determine the appropriate allocations between related parties.
- However, on January 13, 2010, the Ninth Circuit withdrew its opinion.

Xilinx : Ninth Circuit

- On March 22, the Ninth Circuit reversed its previous decision and affirmed the Tax Court's decision.
 - The panel rejected its earlier use of the regulation to trump the general arms' length rule.
 - The panel also noted that the Treasury Technical Explanation to Article 9 of the U.S.-Ireland tax treaty states the article "incorporates in the Convention the arm's length principle reflected in the U.S. domestic transfer pricing provision." The panel stated that it didn't need to decide whether the treaty was "binding federal law enforceable in United States courts" but that "[i]t is enough that our foreign treaty partners and responsible negotiators in the Treasury thought that arms' length should function as the readily understandable international measure."
 - Note: Why is the treaty relevant?

Xilinx: Impact on FIN 48 Analysis

- Are the 2003 amendments to the 1995 regulations (which were at issue in *Xilinx*) invalid?
 - How does this affect taxpayer's FIN 48 analysis?

Potential Legislative Activity

- Does the IRS's setbacks in *Veritas* and *Xilinx* increase the prospect of future legislative measures?
- Two current legislative proposals:
 - Obama administration's proposed changes to definition of "intangible"
 - Excess returns proposal

Prospects for Tax Reform

Acknowledgments for material in this section to Eric Solomon, Pam Olson, Rosanne Altshuler

Prospects for Tax Reform: Political Environment

- All House of Representatives seats and 1/3 of the Senate will be at issue in the upcoming November 2010 elections.
 - Although the Democrats control the presidency and both houses of Congress, concerns about the economy are casting doubt over those legislative majorities.

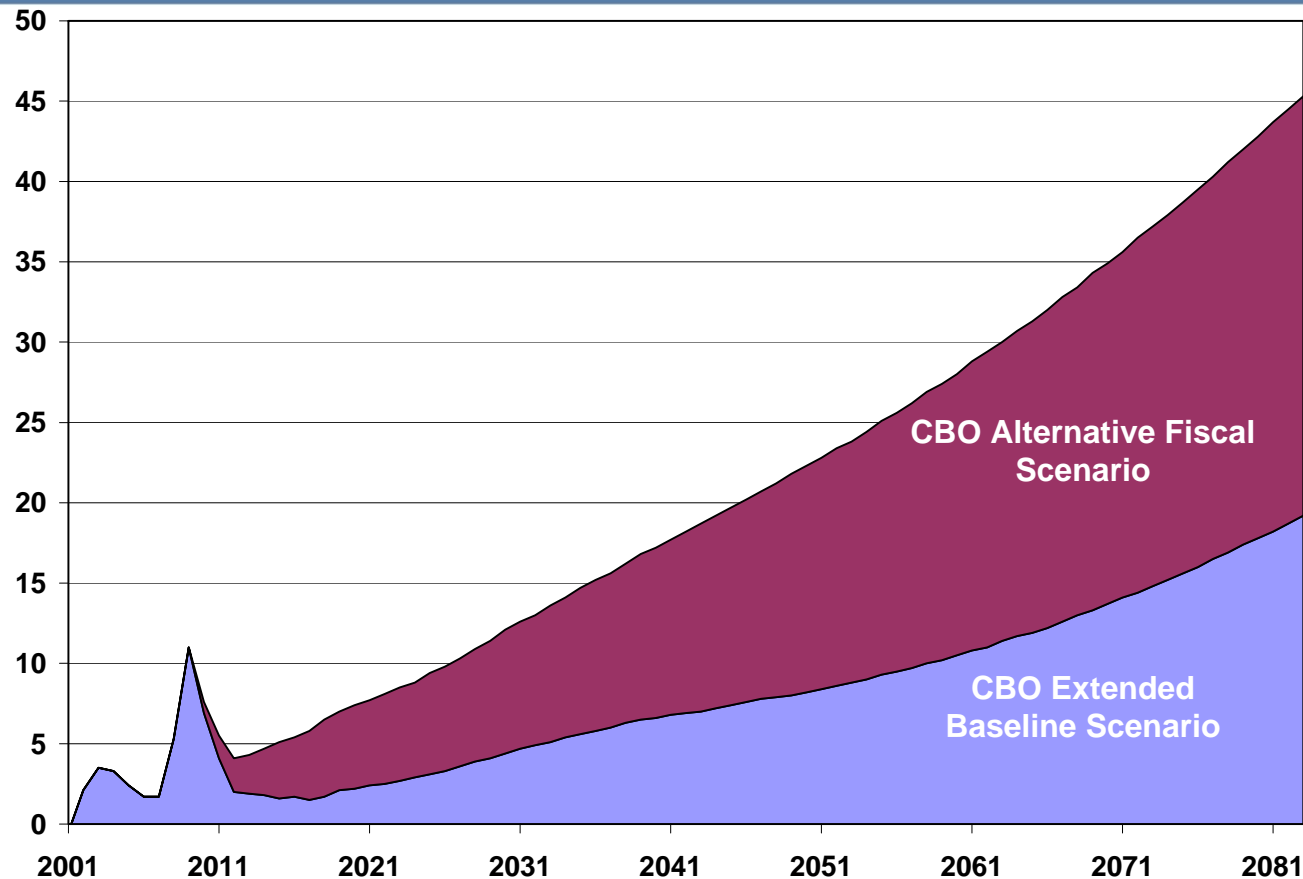
Prospects for Tax Reform: Economic Environment

- Although there are signs that the U.S. economy may be improving, the national debt and the country's general economic fundamentals are major concerns.
- President Obama formed a bipartisan fiscal commission, which held its first public meeting April 27.
 - The fiscal commission is charged with identifying policies and proposing recommendations designed to balance the budget, excluding interest payments on the debt, by 2015.
 - The report is due by December 1, 2010.
 - Congressional leaders have promised to put the commission's recommendation to a vote in the House and Senate if 14 out of the 18 commission members are able to reach agreement.
 - The commission comprises six Republican lawmakers, six Democratic lawmakers, and six presidential appointees.

Prospects for Fundamental Tax Reform: Growing Deficit

- The growing deficit is another potential driver of fundamental tax reform.
 - ❑ The federal deficit is projected to hit 10% of gross domestic product in 2010 and average 5% of gross domestic product over the next decade.
 - ❑ Social Security, Medicare, and Medicaid expenditures are expected to rise, along with interest payments on the national debt.
 - ❑ Tax expenditures are significant.

Long-Term Deficits as a Percent of GDP



Note: Unlike the CBO “extended baseline,” the “alternative fiscal scenario” extends 2001 and 2003 tax relief, indexes the AMT for inflation, and reverses scheduled reductions in Medicare physician reimbursements.

Top Tax Expenditures (2010 JCT Staff Analysis) – Individual Taxes

Top 10 Individual Tax Expenditures	FY09-13 (\$billions)
Mortgage interest deduction	\$573
Employer-provided health insurance exclusion	\$568
Net exclusion of pension contributions and earnings	\$533
Reduced rates of tax on dividends and long-term capital gains	\$419
Exclusion of Medicare benefits	\$317
Earned income tax credit (including refundable portion)	\$261
Deduction of non-business state and local taxes	\$250
Deduction for charitable contributions	\$238
Child tax credit	\$160
Exclusion of capital gains at death	\$159

Source: Joint Committee on Taxation

Top Tax Expenditures (2010 JCT Staff Analysis) – Corporate Taxes

Top 10 Corporate Tax Expenditures	FY09-13 (\$billions)
Deferral of active income of controlled foreign corporations	\$60
Credits for alcohol fuels	\$42
Exclusion of interest on public purpose state and local government bonds	\$42
5-year delay of inclusion of income arising from business indebtedness discharged in 2009 or 2010 by the reacquisition of a debt instrument	\$40
Deduction for income attributable to domestic production activities	\$38
Classification of certain farm property placed in service after 12/31/09 as 5-year property	\$35
Low-income housing tax credit	\$29
Expensing of R&E expenditures	\$24
Inventory methods and valuation, including LIFO and LCM	\$20
Reduced rates on first \$10 million of corporate taxable income	\$16

Source: Joint Committee on Taxation

Prospects for Fundamental Tax Reform: Other Potential Drivers

- Many individual tax cuts enacted in 2001 and 2003 will expire in 2010.
 - The current ordinary income rates for individuals will revert to pre-2001 rates, which will result in higher rates for most taxpayers—the top rate would increase to 39.6% from 35% and the bottom rate would increase to 15% from 10%.
 - The current capital gains tax rates of zero and 15% would revert back to 10% and 20%.
 - Dividends, which are currently taxed at 0% and 15%, would be taxed as ordinary income.
 - Other credits and incentives would be eliminated or reduced.
 - The reach of the AMT into the middle class will continue unless Congress continues to pass regular “AMT patches,” which generally temporarily increase the AMT exemption for individuals.

Prospects for Fundamental Tax Reform: Competitiveness Concerns

- In addition to expiring legislation and the growing deficit, a perception that the U.S. corporate tax rate unduly burdens American businesses and is out of line with international norms also may drive reform.
 - In order for U.S. companies to compete globally, some argue, the cost of operating in the United States cannot be disproportionately higher than it would be for those companies to operate abroad.
 - In the current distressed economic environment, lawmakers may be increasingly receptive to such arguments.

Prospects for Fundamental Tax Reform: Potential Drivers – Competitiveness Concerns: Corporate Tax Rate

- The U.S. statutory corporate income tax rate is high by international standards – what is the effect on U.S. investment?
 - ❑ U.S. has higher statutory corporate tax rate than all but one other OECD country.
 - ❑ U.S. statutory corporate income tax rate is 50% higher than the OECD average.
 - ❑ Dividends bear a second level of tax (at rate post-2010 yet to be determined).
- Lowering the corporate tax rate likely would:
 - ❑ Increase incentives for U.S. and foreign companies to invest in the U.S.
 - ❑ Make the U.S. a more attractive location for multinational corporations' headquarters.

Prospects for Fundamental Tax Reform: Potential Drivers – Competitiveness Concerns: International Tax System

- The U.S. has a “worldwide” system under which U.S. citizens, residents, and corporations pay U.S. tax on income earned around the world.
 - ❑ A U.S. corporation can claim credits for foreign taxes paid, which are intended to prevent double taxation.
 - ❑ A U.S. corporation may also defer U.S. tax on its active foreign earnings (but not passive/mobile income) until those earnings are repatriated to the U.S.
 - ❑ The current system likely results in a disincentive to repatriate foreign earnings.

Prospects for Fundamental Tax Reform: Potential Drivers – Competitiveness Concerns

- Most U.S. trading partners have adopted a “territorial” system that exempts their corporations’ foreign earnings (other than passive/mobile income) from home country tax.
 - ❑ The UK and Japan adopted territorial systems in 2009.
 - ❑ Under a territorial system, there is no residual tax on repatriation of dividends.

Headquarters Location of Global 500 Companies in 2000 & 2009

Country	2000			2009			Taxation of Foreign Source Income, 2009
	Total Revenue (\$billions)	Number of companies	Statutory Corporate Tax Rate 1/	Total Revenue (\$billions)	Number of companies	Statutory Corporate Tax Rate 1/	
United States	4,681	179	39.2%	7,544	140	39.1%	Worldwide with deferral and FTC
Japan	2,931	107	43.3%	2,980	68	41.3%	95% dividend exemption enacted in 2009
Germany	1,217	37	52.0%	2,259	39	33.0%	95% dividend exemption
France	922	37	37.8%	2,166	40	34.4%	95% dividend exemption
China	200	10	33.0%	1,661	37	25.0%	Worldwide with deferral and FTC
United Kingdom	765	38	30.0%	1,585	27	28.0%	100% dividend exemption enacted in 2009
Netherlands	391	10	35.0%	1,044	12	25.5%	100% dividend exemption
Italy	264	10	39.5%	699	10	30.3%	95% dividend exemption
Korea	242	12	30.8%	603	14	24.2%	Worldwide with deferral and FTC
Switzerland	293	11	24.9%	566	15	21.2%	100% dividend & branch exemption
Total Top 10 1/	11,904	451	39.8%	21,106	402	32.1%	
Other	792	49	35.7%	4,069	98	28.4%	
Total Global 5001/	12,696	500	39.2%	25,175	500	31.1%	

Source: Fortune Global 500, Ernst & Young LLP

1/ Average statutory tax rates, including state and local taxes, weighted by number of Global 500 companies in the country excluding the U.S.

Alternative International Tax Systems: Territorial

- Territorial
 - Used by most other developed countries
 - Main features
 - Exemption (or near-exemption) of active foreign income
 - Full U.S. taxation of other foreign income
 - Allocation and apportionment of expenses
 - Structural issues
 - Transfer pricing
 - Allocation and apportionment of expenses
 - Transition issues
 - Treatment of previously untaxed earnings
 - Renegotiation of tax treaties
 - Potential economic effects
 - May encourage repatriation

Alternative International Tax Systems: End Deferral

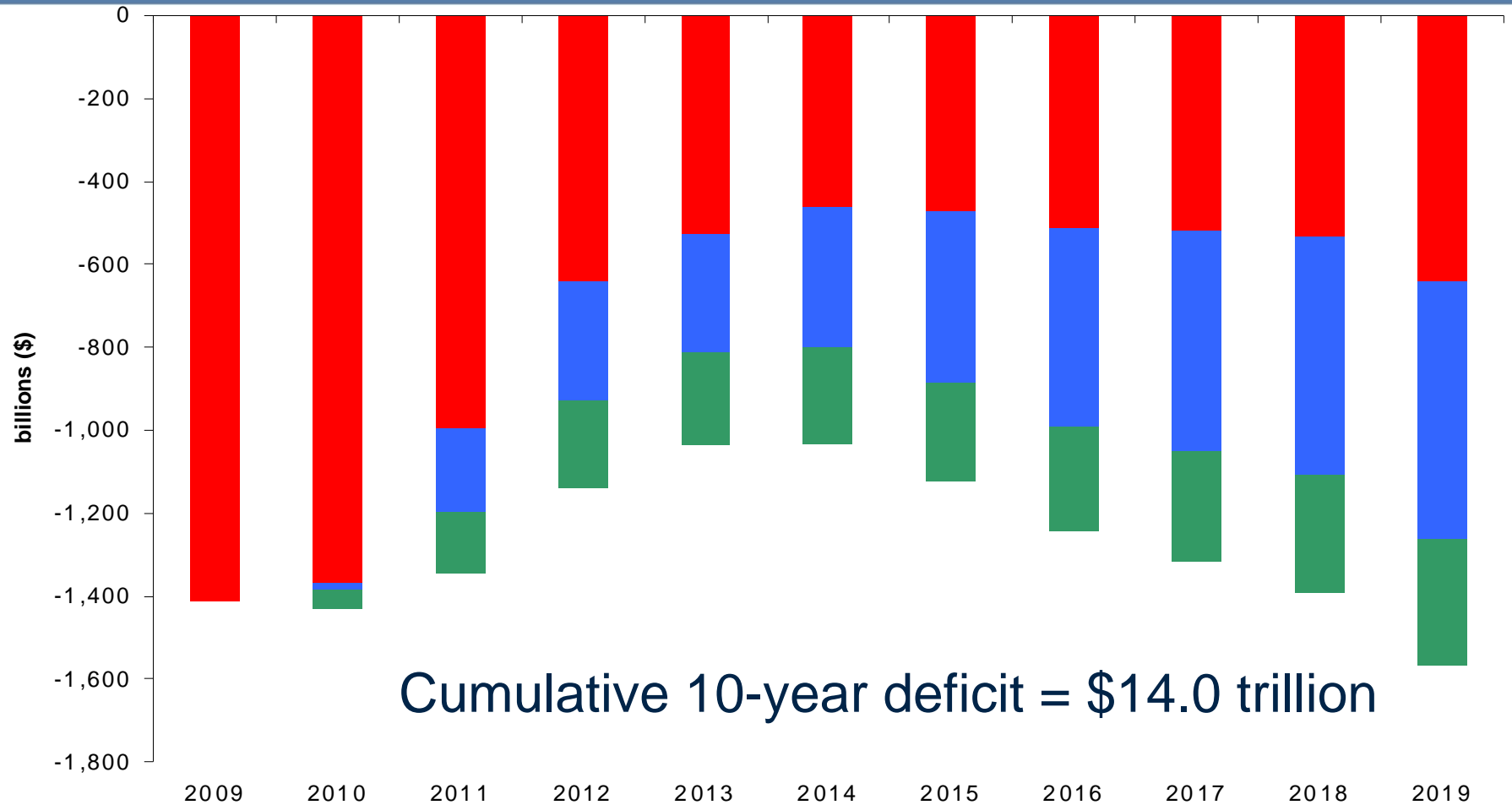
- End Deferral (Full Inclusion Regime)
 - Could raise significant revenue
 - Main features
 - Full taxation of income earned by U.S. companies' foreign subsidiaries
 - Structural issues
 - May require more stringent foreign tax credit limitation rules
 - Minority shareholders
 - Likely easier to enforce because less incentives for aggressive transfer pricing or tax haven use
 - Potential economic effects
 - Could impose significant burden on U.S. multinationals and make them less competitive

Prospects for Fundamental Tax Reform: Timing

- Despite expiring tax provisions, a perceived need for reform in many areas of tax law, and the growing deficit, politics and other pressing priorities will push tax reform into another year.
 - Major tax reform is not on the agenda for this year, although the Senate Finance Committee is planning hearings on the topic.
 - Although the 2010 sunset of many individual tax relief items may suggest that Congress must act on taxes to some extent, its recent failure to pass timely estate tax repeal legislation or an extenders bill suggest that action is not inevitable.

Projected Budget Deficit, 2009-2019

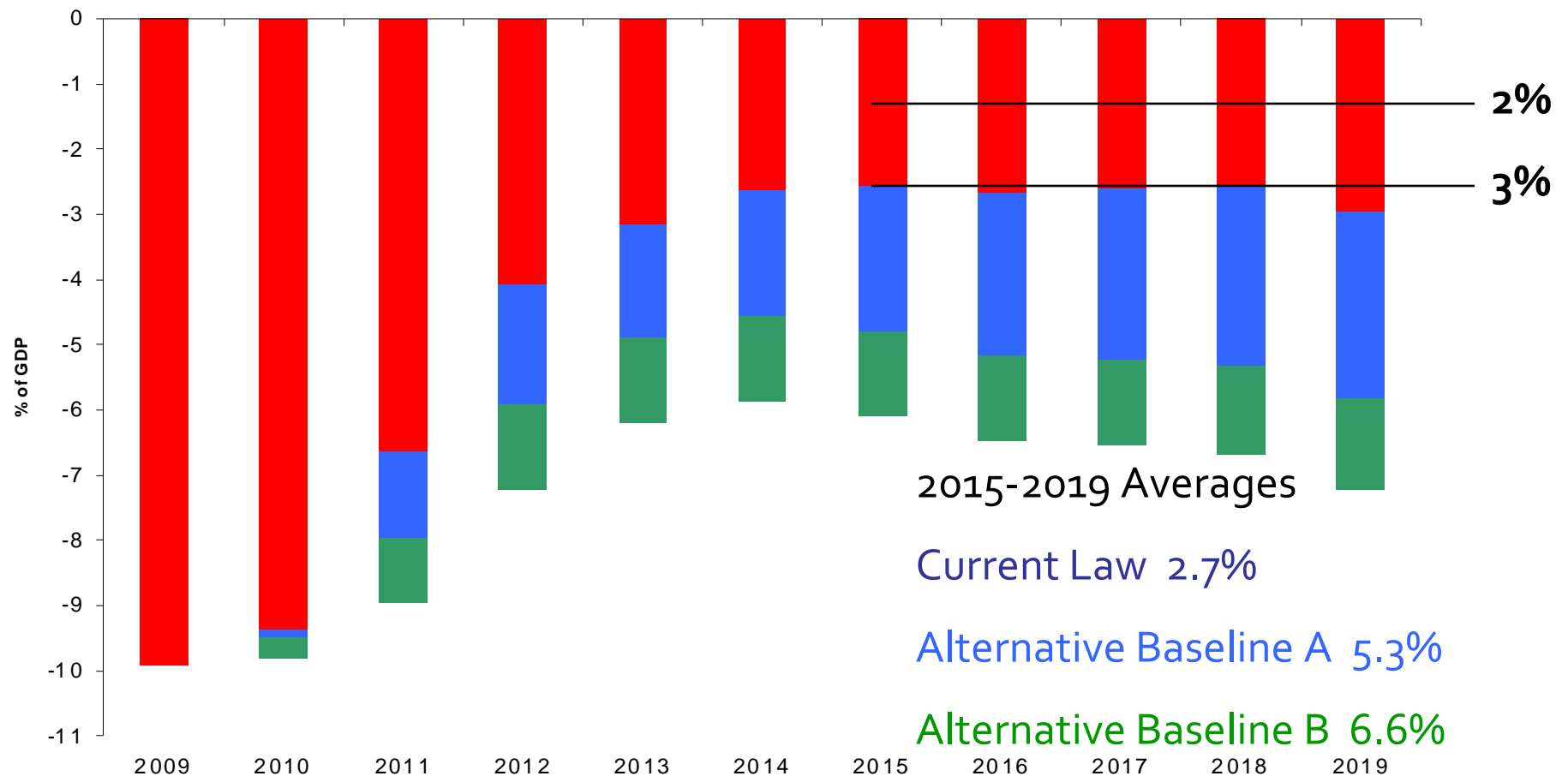
Alternative Baselines A and B



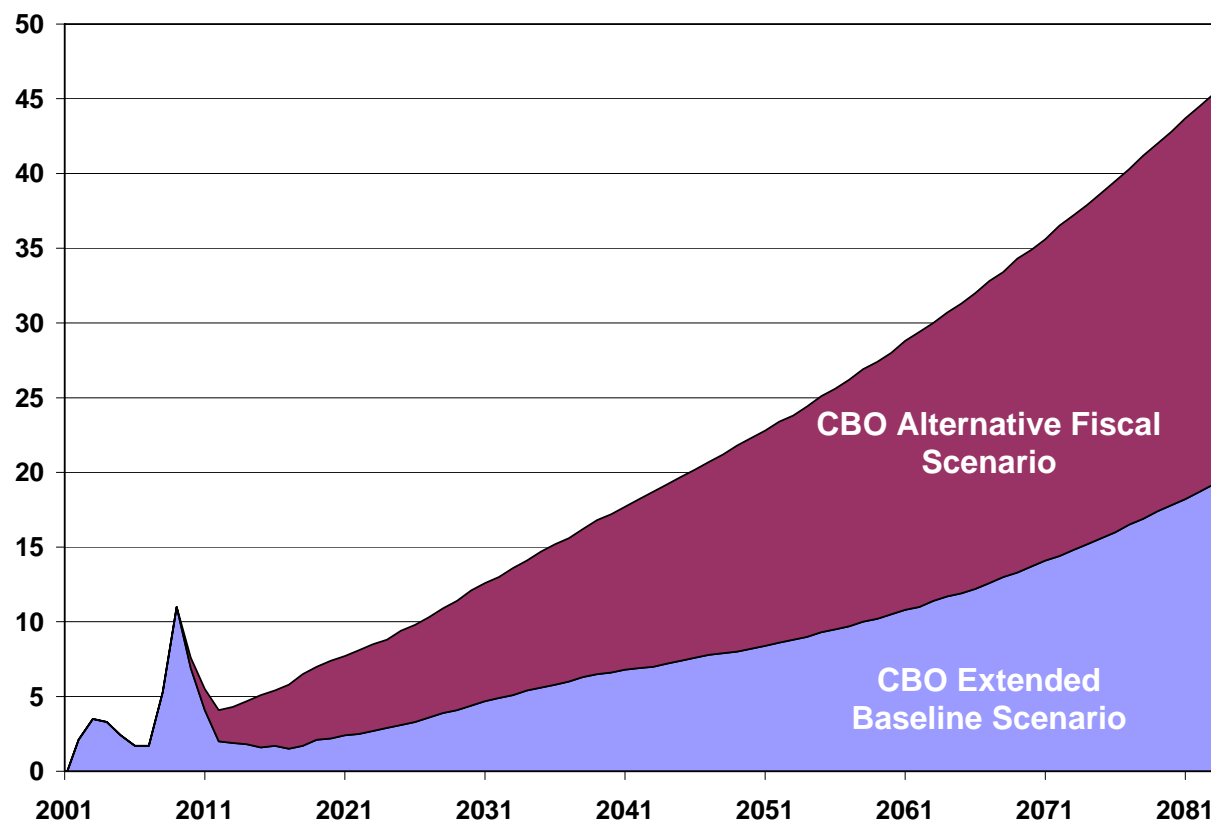
Assumptions

- Current law assumes
 - 2001 and 2003 tax cuts sunset as scheduled in 2010
 - Congress stops “patching” the alternative minimum tax
- Alternative Baseline A assumes
 - 2001 and 2003 tax cuts are extended
 - Estate tax is maintained at 2009 parameters
 - 2009 AMT patch is extended
 - AMT exemption, rate bracket threshold and phase-out exemption thresholds are indexed for inflation
 - and includes the budgetary effects of the 2010 healthcare reform act
- Alternative Baseline B is
 - Alternative Baseline A plus
 - extension of several expiring provisions of ARRA including Making Work Pay credit, American Opportunity Tax Credit, exclusion of certain amounts of unemployment benefits
 - extension of expiring provisions

Projected Budget Deficit, 2009-2019 (Percentage of GDP)



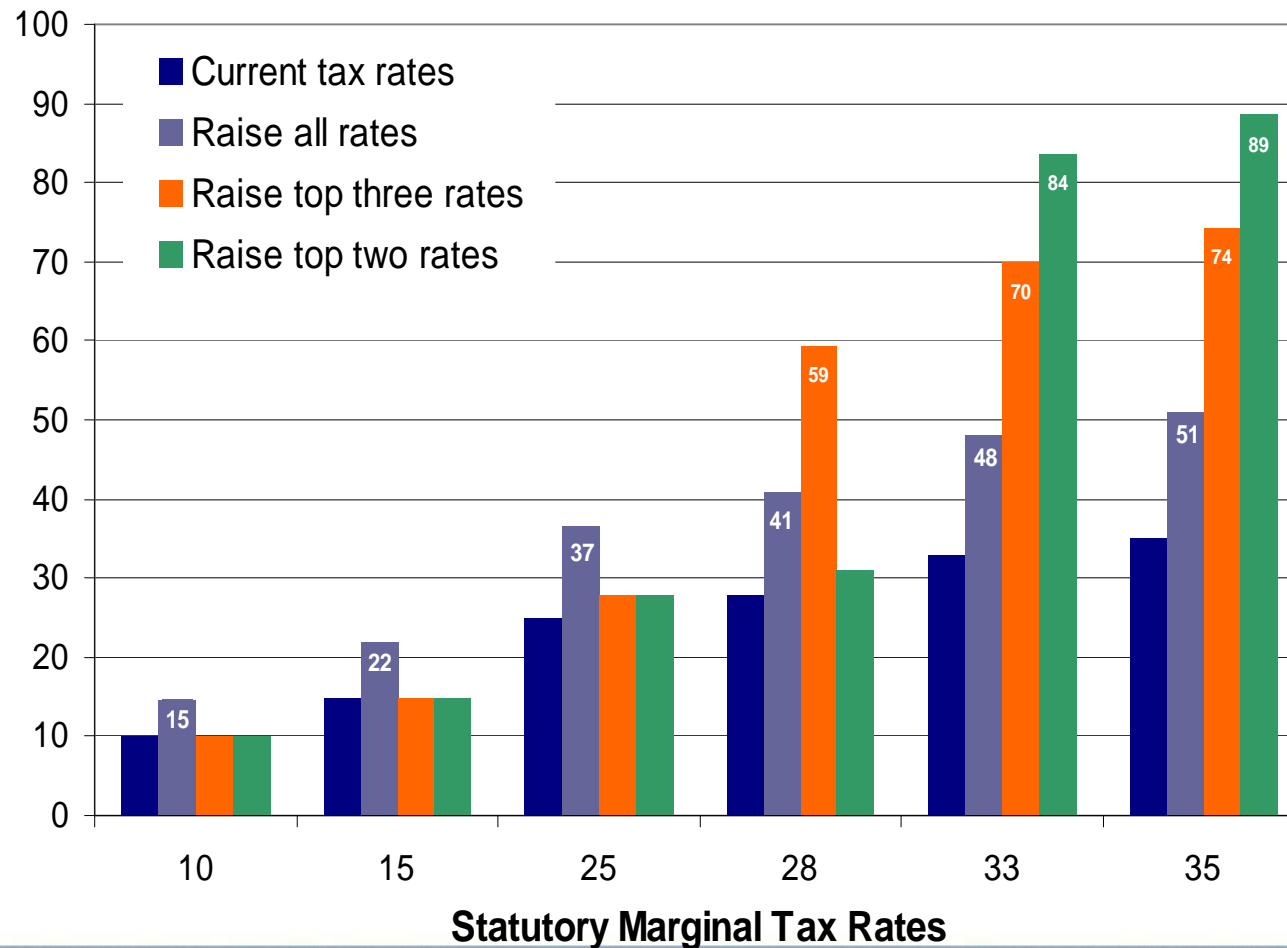
Long-Term Deficits as a Percent of GDP



Note: Unlike the CBO “extended baseline,” the “alternative fiscal scenario” extends 2001 and 2003 tax relief, indexes the AMT for inflation, and reverses scheduled reductions in Medicare physician reimbursements.

3% Deficit Target: Alternative Baseline B 2019

What Tax Increases Would Reduce the Deficit?



Potential for Alternative Tax Systems?

- In view of increasing revenue needs, should another revenue source be considered?
- A value-added tax (VAT) and a carbon tax have both been suggested as candidates for a new revenue base.
 - ❑ Both a VAT and a carbon tax would affect a broad segment of taxpayers.
 - ❑ A 2006 CRS study estimated each one percentage point of a broad-based VAT would raise \$50 billion.
 - ❑ A VAT is consistent with apparent trend toward excise taxes (e.g., medical device tax, securities transaction tax, large bank fee/tax).
 - ❑ A 2008 CBO report proposed a carbon tax as an alternative to cap-and-trade.
 - ❑ A carbon tax proposal developed by the American Enterprise Institute would raise about \$80 billion per year.

Potential for Alternative Tax Systems? Political Response

- House Financial Services Chairman Barney Frank (D-MA) has said a VAT has “zero chance” of passage and is “dead as a doornail.”
- In 2009, the U.S. Senate voted 85-13 on a resolution condemning the VAT as “a massive tax increase.”
 - ▣ In 2010, lead by Senator John McCain, the Senate voted 84-13 on a resolution stating: “It is the sense of the Senate that the Value Added Tax increase will cripple families on fixed income and only further push back America’s economic recovery.”
- But House Speaker Nancy Pelosi (D-CA) has said a VAT is “on the table”
- Debt Commission Co-chairman Erskine Bowles has said, “There are many good arguments that you can make for a value-added tax.”
- House Budget Committee Ranking Member Paul Ryan’s comprehensive fiscal reform “road map” contains a VAT.

Prospects for Fundamental Tax Reform: Proposals

- Wyden/Gregg “Bipartisan Tax Fairness and Simplification Act of 2010”
- Paul Ryan Tax Plan
- PERAB Tax Subcommittee Report

Fundamental Tax Reform Proposals: Wyden/Gregg

- On February 23, 2010, Senators Ron Wyden (D-OR) and Judd Gregg (R-NH) introduced the “Bipartisan Tax Fairness and Simplification Act of 2010,” which would fundamentally reform the U.S. tax system.
 - ❑ The bill would reduce the number of tax brackets from six to three, eliminate the AMT, and retain the most commonly-claimed individual tax credits and deductions.
 - ❑ With respect to corporate taxpayers, the bill would (in relevant part):
 - Tax corporations at a flat 24% rate;
 - Repeal deferral;
 - Require information reporting for payments to corporations;
 - Codify the economic substance doctrine (enacted); and
 - Index the corporate interest deduction for inflation.
- Senator Gregg is retiring and the bill is unlikely to receive major attention soon.

Fundamental Tax Reform Proposals: Ryan Tax Plan

- Paul Ryan, the Ranking Member of the Budget Committee and a member of the Ways and Means Committee, has proposed tax reform under his “Roadmap for America’s Future.” With respect to individual taxes, his plan would (in sum):
 - ❑ Repeal the AMT;
 - ❑ Eliminate taxation of individual interest, capital gains, or dividend income;
 - ❑ Eliminate the estate tax;
 - ❑ Increase standard deduction and personal exemptions.
- The plan would also make significant changes to Social Security, Medicare, and Medicaid.
- From 2010 through 2019, nondefense discretionary spending would be frozen at 2009 levels in nominal terms.

Fundamental Tax Reform Proposals: Ryan Tax Plan

- With respect to business taxes, Ryan's plan would (in sum):
 - Eliminate the corporate income tax; and
 - Create a 8.5% business consumption tax on goods and services, which would be calculated and administered based on the "subtraction method," under which a business determines its tax liability by subtracting its total purchases from its total sales.
 - Would be imposed on foreign imports when they enter the United States but not on U.S. exports when they leave the United States.
- Major dispute about revenue impact

Fundamental Tax Reform Proposals: PERAB Report on Tax Options

- On August 27, 2010, the President's Economic Recovery Advisory Board ("PERAB") tax subcommittee released its report on "options for changes in the current tax system to achieve three broad goals: simplifying the tax system, improving taxpayer compliance with existing tax laws, and reforming the corporate tax system."
 - As the PERAB notes in the report Preface:
 - It did not include options that would raise taxes for families with incomes less than \$250,000 a year;
 - It did not, and was not asked to, recommend major overarching tax reform; and
 - Its report does not represent Administration policy.
 - These factors, along with the report's significant delay (was supposed to be released at the end of 2009) and the subsequent formation of the deficit commission, should limit the report's impact.
- N.B., the principal author was the new CEA Chair, Austan Goolsbee.

Fundamental Tax Reform Proposals: PERAB Report on Tax Options: Simplification Options

- Mostly focused on individual income tax
- Offers six option groups with various option subgroups:
 - ❑ Simplification For Families
 - ❑ Simplifying Savings and Retirement Incentives
 - ❑ Simplify Taxation of Capital Gains
 - ❑ Simplifying Tax Filing
 - ❑ Simplification for Small Businesses
 - ❑ AMT

Fundamental Tax Reform Proposals: PERAB Report on Tax Options: Compliance Options

- Offers eight options:
 - ❑ Dedicate More Resources to Enforcement and Enhance Enforcement Tools
 - ❑ Increase Information Reporting and Source Withholding
 - ❑ Small Business Bank Account Reporting
 - ❑ Clarifying the Definition of a Contractor
 - ❑ Clarify and Harmonize Employment Tax Rules for Businesses and the Self-Employed
 - ❑ Voluntary Disclosure Programs
 - ❑ Examine Multiple Tax Years During Certain Audits
 - ❑ Extend Holding Period for Capital Gains Exclusion on Primary Residences

Fundamental Tax Reform Proposals: PERAB Report on Tax Options: Corporate Tax Reform

- Offers two option groups
 - Reducing Marginal Corporate Rates
 - Broadening the Corporate Tax Base
- Considers Four International Tax Options:
 - Territorial System
 - Worldwide System with Lower Corporate Tax Rate
 - Limit or End Deferral with the Current Corporate Tax Rate
 - Retain the Current System but Lower the Corporate Tax Rate