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The Changing Tax Landscape for Multinational Corporations

The Regulatory Landscape for Corporate America in 2010: A
Series of Background Conversations with Reuters

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Agenda

- LMSB's International Enforcement Focus
- New Disclosure Requirement for Uncertain Tax Positions
- Challenges for Complying with Economic Substance Doctrine
- Obama Administration's International Reform Agenda
- Is the U.S. Moving Away from Arm's Length Standard?

LMSB's Increasing Focus on International Tax Compliance and Enforcement



LMSB's Increasing Focus on International Tax Compliance and Enforcement*

* Please refer to slides 6-10 for more detail

Drivers

- Increasing globalization
- Global economic crisis
- Success in UBS case/voluntary disclosure

Corporate Focus

- Many new agents/economists
- Tier 1 issues: transfer pricing, hybrids and withholding

Individual Focus

- Voluntary disclosure audits
- High net worth individual audits

Challenges

- Workforce constraints
- New legislation (Healthcare, FATCA)
- Competing audit initiatives

Increasing Importance of International Tax Compliance and Enforcement - General

- Increasing globalization of economy. 3,000 multinational enterprises in 1990, to 63,000 in 2007. 71% increase in FTCs claimed by corporations between 2000 and 2007.
- Global economic crisis has tax administrators scrambling for revenue. More foreign audits, and more disputes going to competent authority.
- IRS success in UBS case and offshore voluntary disclosure program.
- Version of Foreign Account Tax Compliance Act (FATCA) enacted 3/28/10 to foster tax compliance by account holders in foreign banks.
- 2010 landscape includes increased global transparency and government scrutiny of foreign activity by banks, individuals, and corporations.

Increasing Importance of International Tax Compliance and Enforcement - General

- Drivers are (i) exponential growth in taxpayers doing business overseas and (ii) belief that some taxpayers are exploiting complexities between international and US law.
- Main area of noncompliance for individuals are offshore bank accounts.
- Key issues for corporations are transfer pricing, hybrid structures and foreign withholding.
- UBS matter changed IRS mindset. IRS is now working with other governments to share information.
- Continued use of issue specialization (e.g., issue management teams).

LMSB's Increasing Focus on International Issues for Corporations

- Several hundred new international examiners and 40 economists
Development of transfer pricing practice within LMSB.
- Over half of Tier 1 issues are international in nature, including section 482 cost sharing, foreign tax credit generators, international hybrid instrument transactions, foreign earnings repatriation, section 936 exit strategies, and section 1441 withholding.
- LMSB will continue to work with other countries to establish a joint audit process.
- LMSB will work with financial institutions to develop FATCA implementation procedures.

LMSB's Increasing Focus on International Issues for Individuals

- LMSB will continue pursuing broad variety of transparency and enforcement initiatives.
- One key focus will be carefully examining data provided by nearly 15,000 individuals who came in under IRS's program to voluntarily disclose offshore assets.
- New 2010 initiative is LMSB industry group focused on high-net worth individuals. Field examiners are in place; audits are beginning with help of senior flow-through specialists and international examiners.

Challenges for LMSB's International Focus

- Workforce constraints. Many (1/3) have less than 5 years experience and have learned mostly on tax shelters, and other 1/3 is eligible for retirement.
- New legislation imposing more demands on IRS (e.g., 15,000 agents required to implement Health Care Legislation, implementation of FATCA procedures).
- Other audit initiatives competing for experienced agents (e.g., high net worth, payroll tax).
- Currency requirements.



New Challenges of Uncertain Tax Position Disclosure and Economic Substance

Historic LMSB Policy regarding Examination of Uncertain Tax Positions*

* Please refer to slides 13-21 for more detail

Uncertain Tax Positions

- Attach description of uncertain tax positions
- Broader than FIN 48 reserves
- No materiality threshold
- Effect on restraint policy?
- Impact on auditor relationships?
- Impact on compliance budgets?
- Section 482 liabilities

Economic Substance

- Forces conjunctive test
- Applies wherever relevant under current law
- 20/40% strict liability penalties
- Similar rule of law?
- Impact on uncertain tax positions?

Historic LMSB Policy regarding Examination of Uncertain Tax Positions

- IRS usually asks questions through “IDRs”. Taxpayers generally provide documents or written answers.
- IRS exam process is about the IRS finding issues.
- IRS examiners often review public filings and focus on references to financial accounting reserves (e.g., FIN 48 reserves).
- IRS policy of restraint still applies with respect to tax accrual workpapers.
- Notwithstanding *Textron*, taxpayers are still asserting work product privilege for tax accrual workpapers.

Announcements 2010-9 and 2010-17

- IRS is creating a new schedule for corporate tax returns in which taxpayers are required to disclose all “uncertain tax positions.” Effective for returns relating to 2010 taxable year.
- “Uncertain tax position” is any position for which a reserve must be established under FIN 48 or other accounting standards (IFRS and/or local GAAP).
- Will include any position for which taxpayer or related entity has not recorded a tax reserve because
 - i. taxpayer expects to litigate the position, or
 - ii. taxpayer has determined that IRS has a general administrative practice not to examine the position.

Announcements 2010-9 and 2010-17

- The schedule will require:
 - A “concise description of each uncertain tax position for which the taxpayer or a related entity has recorded a reserve in its financial statements”; and
 - A statement of “the maximum amount of potential federal tax liability attributable to each uncertain tax position (determined without regard to the taxpayer’s risk analysis regarding its likelihood of prevailing on the merits).”
 - No materiality threshold. Disclosure of maximum potential tax liability even if a very small reserve is recorded.
- Taxpayer is not required to disclose its risk assessment or tax reserve amounts. IRS says it is “otherwise retain[ing] its existing policy of restraint as described in Announcement 2002-63....”

Announcements 2010-9 and 2010-17

- To be sufficient, the description must contain:
 - A list of the Code sections potentially implicated by the position;
 - A description of the taxable year or years to which the position relates;
 - A statement of whether the position involves an item of income, gain, loss, deduction or credit against tax;
 - A statement of whether the position involves a permanent inclusion or exclusion of any item, the timing of that item, or both;
 - A statement whether the position involves a determination of the value of any property or right; and
 - A statement whether the position involves a computation of basis.
- The new form will apply to all corporate taxpayers with total assets in excess of \$10 million.

Observations about Announcements 2010-9 and 2010-17

- Announcement 2010-9 will change landscape of disclosure and provide IRS with increased and detailed information.
- Auditors may be put under even more pressure now not to reserve.
- Corporations will face difficulties of reaching sufficient comfort level (MLTN? Should?) to avoid tax reserve, on issues for which there are no easy answers.
- Impact on corporation's tax compliance budget

Observations about Announcements 2010-9 and 2010-17

- Valuing maximum potential exposures is inherently problematic in section 482 area.
- For example, what is the maximum amount of potential federal tax liability that should be ascribed to a marketing intangible for a potential IRS adjustment under § 482?
 - There can be wide variances between the IRS's position and taxpayer's position. See, e.g., *Veritas v. Commissioner*, 133 T.C. No. 14 (December 10, 2009).

“Health Care and Education Reconciliation Act” Codifies Economic Substance Doctrine

- Whenever economic substance is “relevant” under current law standards, it shall be applied in a conjunctive fashion: *a transaction does not have economic substance unless both (i) the transaction changes in a meaningful way the taxpayer’s economic position, and (ii) the taxpayer has a substantial business purpose.*
- Forcing a conjunctive test significantly changes current law. Only two circuits (Federal and 5th) have applied a conjunctive test.
- Most all other circuits have avoided the question by finding that either both requirements were met or both requirements failed.

“Health Care and Education Reconciliation Act” Codifies Economic Substance Doctrine

- Provision “is not intended to alter the tax treatment of certain basic transactions that, under longstanding judicial and administrative practice are respected”
- Examples in legislative history include choices
 - i. between capitalizing an enterprise with debt or equity,
 - ii. between using a foreign corporation or a domestic corporation to make a foreign investment,
 - iii. to enter into a corporate organization or a tax-free reorganization, or
 - iv. to use a related party providing section 482 standards are met.
- Taxpayers will agonize over whether particular structure or transaction is exempt from economic substance scrutiny; if not, it must be determined if sufficient business purpose is present.

“Health Care and Education Reconciliation Act” Codifies Economic Substance Doctrine

- Provision imposes strict liability under section 6662 for an understatement related to a transaction that is found to lack economic substance *or the requirements of any similar rule of law*.
- Taxpayers may not assert reasonable cause defense.
- Penalty is 20% but increased to 40% if taxpayer does not disclose relevant facts on tax return.
- *What is a similar rule of law? Step transaction? Substance over form?*



Obama Administration's International Reform Agenda

Where are Things Going in 2010?

Obama Administration's International Reform Agenda: Where are Things Going in 2010?*

* Please refer to slides 24-36 for more detail

- Already Crowded 2010 Legislative Tax Agenda
- 2011 Budget Proposals
 - Excess income shifting proposal
 - Expand definition of intangible property
 - Extend look-through exception
 - Defer interest deductions
 - Blend FTC pools
 - Other
- HIRE Act (including FATCA)
- Small business legislation

Already Crowded 2010 Legislative Agenda for Tax

- Hiring Incentives to Restore Employment (HIRE) Act, enacted on 3/18/2010 (includes FATCA)
- Health Care and Education Reconciliation Act, enacted on 3/20/2010 (includes economic substance)
- Small Business and Infrastructure Jobs Tax Act, passed by House on 3/25/10
 - Repeals 80/20 company rules
 - Limits treaty benefits on deductible payments made by U.S. subsidiaries to foreign parents
- Obama Administration's Proposed 15% Tax on Unpaid TARP Monies

Already Crowded 2010 Legislative Agenda for Tax

- Extenders package passed by Senate on 3/10/2010
 - extend approximately 40 tax provisions expiring at end of 2009
 - extend approximately 50 tax provisions expiring at end of 2010
 - extend the individual AMT patch
- Obama Administration's 2011 Budget Proposals
- Fundamental tax reform as well? Congressional movement on tax reform is unlikely this year.

Obama Administration's 2011 Budget Proposals

- Significant changes compared to the 2010 Budget and May 2009 proposals:
 - Check-the-box proposal dropped; extend look-through rule for CFCs
 - New “excess income shifting” proposal
 - Expand definition of “intangible property” for 367(d) and 482
 - Deferral of deductions limited to interest expense
- Question: Do these proposals make U.S. further anti-competitive for U.S.-based companies and jobs?

“Excessive Income Shifting” Proposal in Administration’s 2011 Budget

- If a U.S. person transfers an intangible from the U.S. 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.
 - Effective for taxable years beginning after December 31, 2010.
- This proposal could affect taxpayers who are in full compliance with Section 482, and could have a significant impact on many cost sharing structures.

“Excessive Income Shifting” Proposal: Questions?

- Should this proposal be considered only in the context of reform?
- Should we be moving away from the internationally accepted standard of arm's-length pricing, which is the basis for resolving double taxation in U.S. tax treaties?
- How can this proposal and the new cost sharing regulations be reconciled with *Xilinx* decision?
- Could this change have a dramatic impact on market capitalization of many U.S. companies, making them easier acquisition targets for foreign multinationals?

Proposal in Administration's 2011 Budget to Expand Definition of "Intangible Property"

- This provision would, for purposes of §§367(d) and 482, “clarify” the definition of “intangible property” to include workforce in place, goodwill and going concern value.
 - Effective for taxable years beginning after December 31, 2010.
- Issue is source of considerable controversy between the IRS and taxpayers currently at Exam and Appeals. *Veritas* decision questioned the Service’s position on this issue.
- Amounts at issue are substantial. The transfer of intangibles is often done as part of cost-sharing buy-in transactions. Cost-sharing buy-in payments are a Tier I compliance issue.
- **Question:** Would this provision effectively put an end to outbound incorporations?

Proposal in Administration's 2011 Budget to Extend Look-Through Exception

- Extend look-through treatment for controlled foreign corporations, from 2010 through 2012 (effect of 2009 expiration now reflecting in Q1 financials).
- **Question:** If this sunsets after 2012, will the ability to compete for capital be impeded by the increased cost of doing foreign-to-foreign lending?
 - If there is US taxable income on intercompany lending after 2012, the US companies would have a cost of borrowing that its competitors do not face.
 - It is costly when a company moves cash from one entity to another and incurs a 35 percent tax.

Proposal in Administration's 2011 Budget to Defer Interest Deductions

- Proposal would defer deduction for interest expense that is properly allocated and apportioned to a taxpayer's foreign-source income that is not currently subject to U.S. tax.
 - Effective for taxable years beginning after December 31, 2010.
- **Question:** Would this provision magnify the distortion under current law from the overallocation of interest expense to foreign subsidiaries' income, because now the allocation will affect the timing of deductions in addition to FTCs?
 - Consider impact of delay of worldwide allocation of interest, to taxable years beginning after December 31, 2020.
- **Question:** Would this provision disproportionately impact companies with large amounts of U.S.-based borrowing?

Proposal in Administration's 2011 Budget to Blend FTC Pools

- Taxpayers required to determine deemed paid foreign tax credits on consolidated basis by aggregating creditable foreign tax and E&P pools for all subsidiaries for which the taxpayer is eligible to claim indirect FTCs.
 - Effective for taxable years beginning after December 31, 2010.
- Proposal would eliminate FTC benefits from use of high-tax and low-tax chains.
- Taxpayers could no longer maximize foreign tax credits by selectively repatriating income from high-tax foreign subsidiaries while continuing to defer U.S. tax on income of low-tax foreign subsidiaries.

Other International Tax Proposals in Administration's 2011 Budget

- Foreign Tax Credit Splitting Structures: New rules to combat *Guardian Industries* (Fed. Cir. 2007) type structures by changing the technical taxpayer rules. Effective for taxable years beginning after December 31, 2010.
- Strengthen interest stripping rules of §163(j) for expatriated entities.
- Change the boot-within-gain limitation of §356 as applied to cross-border transactions. Limits boot to the lesser of gain realized in the exchange or the amount of boot. Valuable mechanism to repatriate untaxed deferred E&P if the taxpayer has high basis/little or no gain in the target entity.
- Repeal 80/20 sourcing exceptions applicable to dividends and interest paid by certain U.S. corporations. (Included in House's Small Business and Infrastructure Jobs Tax Act).

Other International Tax Proposals in Administration's 2011 Budget

- Limitation on deductions for certain reinsurance premiums paid to affiliate foreign reinsurance companies.
- Prevent the use of equity swaps to avoid dividend withholding tax (included in HIRE Act).
- Strengthening dividend withholding tax rules.
- Modify “dual capacity taxpayer” rules with respect to creditable foreign taxes.
- Increase withholding tax provisions and reporting to combat under-reporting of income with respect to payments made through foreign financial institutions (“FFIs”).
- Increased reporting for certain recipients of FDAP income or gross proceeds.

FATCA Provisions in “Hiring Incentives to Restore Employment Act”

- FATCA puts in place a host of requirements for foreign banks to report and disclose accounts with U.S. owners. Will change the landscape for these and the agents who handle cross-border payments.
- FATCA requires banks to report accounts with U.S. owners to U.S. tax authorities. 30 percent withholding is required where where information on the account holder is not properly disclosed.
 - In the process, FATCA creates a category of “withholdable transactions” that represents a dramatic change in the withholding system. Existing systems or procedures will need extensive review.
- FATCA reaches beyond traditional financial institutions and will affect the offshore fund industry.

Other International Tax Provisions in “Hiring Incentives to Restore Employment Act”

- Provision delays application of worldwide allocation of interest, from taxable years beginning after December 31, 2017, to taxable years beginning after December 31, 2020.
- Dividend equivalent treatment currently imposed on securities lending transactions expanded to certain cross border swaps by changing the sourcing rule of payments made under such swaps to be US source if the payment is made to a non-US person by a US person.
 - Effective for payments made after September 14, 2010, with respect to "specified notional principal contracts."
 - However, rules apply to ALL notional principal contracts made after March 18, 2012 unless the Treasury determines that such contracts do not have potential for tax avoidance.