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The Good, the Bad, and the Uncertain *An Examination of the International Tax Proposals from the Obama Administration, the HIRE Act, and the Tax Extenders Bill*

A Special Interview with Sullivan & Worcester LLP's Douglas S. Stransky

Recent tax legislation and tax proposals of the Obama Administration have taken aim at international transactions. On March 18, 2010, the HIRE Act¹ was enacted, in February, 2010, the government released its international tax proposals,² and on May 28, 2010, the so-called Tax Extenders Bill³ was passed by the House of Representatives. (*Practical International Tax Strategies* has reported on the legislation and proposals in a number of articles that followed each action.) In this interview, Sullivan & Worcester's Doug Stransky looks at all of the recent international tax changes and, from a practical perspective, notes the most challenging provisions and significant changes. Stransky is a Partner with the Boston office of Sullivan & Worcester. He concentrates his practice on international tax planning for clients in a wide range of industries with a particular emphasis on U.S.-based clients investing in foreign jurisdictions. He is a member of the Advisory Board of *Practical International Tax Strategies*.

Difficult Choices for Foreign Banks with Investments in the U.S.

Tax Strategies: The FATCA (Foreign Account Tax Compliance Act) provisions of the HIRE (Hiring Incentives to Restore Employment) Act require U.S. withholding tax on payments to banks or other financial institutions on certain U.S. source income. But the 30 percent withholding requirement is waived if the foreign bank provides information on all U.S.

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account holders and on foreign companies that have U.S. persons as owners of 10 percent or more of the foreign companies. What will be the role of the U.S. payor, as a practical matter?

Stransky: The law says unless the recipient provides certain information to the U.S. Treasury, the payor must withhold on a U.S. source payment. And it's important to note that this provision applies to more than just banks; it also applies to non-financial foreign entities. Essentially payors of U.S. source income are going to have to obtain information from the foreign-person recipient, in particular foreign financial institutions, which will require those institutions to look through their records to see if U.S. persons are beneficial owners. As to how that is implemented, I am not entirely certain because foreign banks traditionally were not required to obtain information about U.S. taxpayers. These banks don't have regular procedures to obtain that information. So from a practical perspective, the foreign banks will need to review their systems and make the necessary changes to capture this new information. But the fundamental question is whether a foreign bank will want to provide that information to the U.S. government. The bank could simply decide as a matter of practice that it won't provide the information.

Tax Strategies: And take the hit on withholding.

Stransky: Right. This probably isn't a good answer, but a foreign bank or other company could maintain the secrecy of its account holders if this is more important, or if the foreign bank simply does not want to be involved with the U.S. government.

Threshold Question

Tax Strategies: How will the foreign bank know if corporations that hold accounts have U.S. 10 percent owners?

Stransky: It is very likely the foreign bank won't know because it has not asked for that information before. It

may be very difficult to get this information. But even if the foreign bank obtained the ownership information on the company, the next question is whether or not the foreign bank has U.S. source income, because if it does not invest in the U.S., then it doesn't really matter. So, the easier question might be: Does the financial institution invest in the U.S.? Does it have U.S. source income? If the answer is no, then there is no withholding issue. If the answer is yes, and the foreign financial institution has significant U.S.-source income, then, the next question is how easy is it going to be for the foreign bank to obtain the required information about the U.S. account holders, if any, and how does the bank then go through the system that I just mentioned, i.e., what information is going to be required, and how do banks collect that information. Of course for some banks the first question might be whether local law, such as the Swiss bank secrecy laws, prevent the banks from turning information over to the U.S. government, and whether the banks now must develop a separate form to get waivers from their customers so that the banks can disclose this information. I would assume that banks will get waivers regardless of whether there is a foreign law restriction on the ability to provide that information, just to make it clear that the bank will provide this information to the U.S. government.

Tax Strategies: Will the IRS issue more guidance on this provision?

Stransky: The IRS has repeatedly said that it will issue more guidance. Prior to the enactment of this provision, during February's International Fiscal Association (IFA) meeting in Philadelphia for one, practitioners raised a number of issues over the administration of this provision and the IRS said that it would look at the comments that have been submitted and provide guidance. When that guidance will be issued, and whether it will be responsive, is anybody's guess at this point.

Tax Strategies: The 30 percent withholding tax also applies to non-financial foreign companies unless the foreign company certifies to the U.S. payor that it has no direct or indirect substantial U.S. owners, or the foreign company provides tax IDs on each substantial owner. What does indirect owner mean?

Stransky: I assume that the attribution rules will apply. If a foreign company is held by a foreign partnership, and the partnership is held by U.S. persons, the direct owner of the foreign company would be a foreign partnership, but in reality, it's the U.S. persons, because the partnership is a flow-through vehicle.

Tax Strategies: So multiple tiers will not offer protection?

Stransky: Generally in the attribution rules, if a U.S. entity is in the chain, the entity is a U.S. person. So,

theoretically, if the entity was a 7th or 8th tier foreign subsidiary with the U.S. parent at the top, that information would have to be disclosed.

Tax Strategies: What constitutes "substantial U.S. ownership"?

Stransky: Generally, 10 percent.

Check-the-Box

Tax Strategies: The Obama Administration in its budget proposals dropped the proposed changes to the check-the-box regime that it made last year. Are we likely to see changes to the check-the-box regime next year?

Stransky: The Treasury has said that it might still be looking at future changes here. There certainly has been much talk about international tax reform in general. The proposal last year would have made some selective changes to the regime. This proposal could be reintroduced in the future, or the Treasury could be looking at more significant changes. I would not be surprised to see a similar proposal in the 2012 budget.

Deferred Interest Expense Deduction

Tax Strategies: The Green Book proposals include a deferred interest expense deduction that basically blocks interest expense deductions until companies bring their foreign earnings back to the U.S. As a practical matter, how will U.S. companies with foreign subsidiaries deal with this dilemma?

Stransky: Take the example of a U.S. company that goes to the bank and borrows money to buy a subsidiary in the UK. The interest expense on that loan is deductible on the U.S. tax return. Under the current interest expense allocation rules, the U.S. company is required to allocate a portion of that interest expense against foreign source income. The company gets the full deduction on the U.S. return, but generally in the context of the foreign tax credit limitation calculation, the company must allocate interest expense against its foreign source income, which reduces the foreign source income, and therefore has an impact on its ability to credit foreign taxes. This proposal is not making changes to those rules, but is adding new rules. For example, if a company borrows \$100 in the U.S., the deduction for the interest expense associated with that borrowing would be deferred to the extent the foreign-source income associated with the expense is not currently subject to U.S. tax. The result will be that U.S. companies will borrow more offshore. U.S. companies also will use foreign funds that have built up in their foreign subsidiaries to make acquisitions and to move money around the group. In addition, you might think that if a U.S. company is going to be prevented from taking an interest deduction for a portion of its interest expense, then right away it would want to

bring back the money. But the problem with that is the Obama proposal regarding foreign tax credit pooling conflicts with this proposal and would likely mean that companies will not bring back the money from overseas. In other words, under this interest deferral proposal, the U.S. company is denied a deduction which is worth 35 cents, but on the other hand, under the foreign tax blending proposal that would reduce the amount of foreign tax credits available for credit in the U.S., a company loses a foreign tax credit that is a dollar-for-dollar credit. So, it is worth more than the interest deduction. To the extent that the company's effective rate on its foreign tax credit pool is reduced, the company does not want to bring the money back; the company would rather lose the 35 cents than lose the dollar.

Tax Strategies: *And what will happen if the foreign tax credit blending proposal is not passed?*

Stransky: Well, then potentially the company would have an incentive to bring the money back because it would get the full interest deduction and to the extent that it brings money back from high tax countries, it would get a full foreign tax credit.

Tax Strategies: *Would this proposed change bring more money into the U.S. Treasury?*

Stransky: Probably not, because if the company is using a foreign tax credit to offset the U.S. tax then that doesn't increase the fisc. And if the company gets the full interest deduction, that doesn't increase the fisc. So, the only thing that the proposal would do is to get more cash into the U.S. If a U.S. company has more cash, it is not necessarily going to rush out and hire more people. It might or it might not.

Changes to the Method of Calculating Foreign Tax Credits

Tax Strategies: *How would the foreign tax pooling proposals of the Green Book change the process of calculating foreign tax credits by U.S. companies?*

Stransky: Under the proposal, if a company has 10 CFCs and it pays dividends from four of the CFCs, it would add up the earnings and profits of all 10 CFCs and then add up the total dividends that it paid from the four. The numerator is the total of the four dividends, and the denominator is all the earnings and profits of the 10 CFCs. The company then must multiply that quotient by all of the taxes that it has available in all 10 CFCs, and the result is the company's foreign tax credit. Currently, when companies determine their foreign tax credit, the amount of the credit itself is determined on a CFC-by-CFC basis. So let's assume that CFC number one pays taxes in Japan where the tax rate is approximately 45 percent. CFC number two is in the Cayman Islands; it pays no tax. CFC number three is taxed at 12.5 percent; and CFC number four is taxed at 30 percent. Currently

the company pays the dividends in such a way that it would pay more of a Japan dividend so that the 45 percent becomes excess that can be used to offset the U.S. taxes in the other three jurisdictions, so that on a consolidated basis the company pays minimal or no U.S. tax on the repatriation. Under the proposal, if the company blends everything together, including the other six CFCs from which the company paid nothing, the 45 percent effective tax rate in Japan probably drops down, let's say, to 25 percent. So the overall effective rate of the dividends is 25 percent as opposed to 45 percent. A substantial difference.

Complex Calculations

Tax Strategies: *How difficult will it be for companies to calculate the pooled amounts as proposed, as opposed to a CFC-by-CFC basis as now?*

Stransky: Imagine the complexities of calculating one giant earnings and profit pool, where earnings and profits are kept in the various foreign currencies of each entity. How does the U.S. company translate 10 foreign currencies for purposes of the calculation, into one currency? The calculation is going to be a nightmare. And not just for companies, but for the IRS, too. How will the IRS be able to audit with this system? So the company gives the IRS a stack of documents and says, here's the giant calculation for all our CFCs. And further, this additional complexity will require numerous changes to other provisions in the [Internal Revenue] Code that deal with the calculation on an entity-by-entity basis, for example, Section 301, for purposes of determining whether a distribution is a dividend. How does a company determine the high tax exception to Subpart F, which is done on a CFC-by-CFC basis?

Tax Strategies: *Is this pooling provision likely to pass?*

Stransky: It does not seem likely to me, at least not soon, although the Treasury said that it structured these provisions so as to provide for quick passage. The government needs tax revenues, basically.

Tax Extenders Bill

Tax Strategies: *Speaking of the government's need for revenues, on May 20 the House and Senate released a summary of draft legislation that contained many international tax provisions. Some commentators said the Tax Extenders Bill seemed more focused on bringing in more revenue than in actually closing loopholes.*

Stransky: I would agree with that. There were several international tax proposals in the Tax Extenders Bill that were just out of left field. They had never been discussed and surprised many people. One would have thought that the lawmakers would have included provisions that had already been proposed.

Section 956

Tax Strategies: *One of the provisions in the Tax Extenders Bill limits the amount of foreign taxes that are considered as paid under Section 956. Could you explain this provision?*

Stransky: An interesting provision, and out of left field for two reasons. In 2008 the IRS issued Notice 2008-91 which was extended at the end of 2009. This Notice permitted more flexibility in the area of Section 956 in response to the liquidity crisis. Notice 2008-91 permitted U.S. companies to receive loans from their foreign subsidiaries without Section 956 inclusions, provided that they met the requirements specified in the notice. Furthermore, the IRS in several field service advisories blessed the affirmative use of Section 956. However, when one examines the proposal in the Tax Extenders Bill, it is much broader than just the affirmative use of Section 956. Let's say that a U.S. company has a Cayman subsidiary, and below the Cayman entity is a Luxembourg subsidiary. And assume that the Luxembourg subsidiary holds several European subsidiaries. Assume that the German subsidiary paid a dividend into Luxembourg. The earnings and profits from the German subsidiary now are mixed with the earnings and profits of the Luxembourg subsidiary, including the taxes. Then the dividend is paid into the Cayman Islands and back to the U.S. By the time the U.S. receives that dividend, the tax pool has been reduced substantially because the earnings and profits pool gets larger with each successive dividend. Well, if an entity has a larger earnings and profits pool with the same amount of taxes, the effective rate is reduced and so the company would pay more U.S. tax.

Tax Strategies: *What do companies do now in this situation?*

Stransky: If the U.S. company makes a Section 956 loan from the German CFC, the U.S. company avoids the earnings and profits that are in Luxembourg and the Cayman Islands by hop scotching around those two entities. Assuming that the U.S. company had the loan outstanding for an entire year, its earnings and profits, its foreign tax credit, and its dividend amount are based on the earnings and profits of Germany. In this way the U.S. company can avoid diluting its foreign tax credit pool. However, the government says that this structure is abusive. But what about the cases where the situation is the same, but where Luxembourg, for example, has a deficit in earnings and profits and the dividend from Germany isn't enough to offset the Luxembourg deficit?

The earnings and profits are still a negative number. The denominator is zero and the U.S. company will not get a foreign tax credit at all. Another example: Assume that from a U.S. tax perspective there isn't a deficit in earnings in Luxembourg, however, statutorily the Luxembourg subsidiary cannot pay a legal dividend because there are not enough reserves in Luxembourg and therefore once the money gets into Luxembourg, it's trapped. Both of these examples, using Section 956, are ways to avoid those problems. Or assume that the structure is similar except that one of the CFCs is in a jurisdiction with a withholding tax. The U.S. company does a Section 956 loan because that is not treated as a dividend in the foreign jurisdiction. So here are three examples that are not abusive, where a company used Section 956 affirmatively to help solve real business problems.

Tax Strategies: *From the IRS perspective, how much of a problem is abusive use of Section 956?*

Stransky: As a practical matter, most multinationals do not use Section 956 abusively. Now, the proposal results in an incredibly complex provision in the law that will apply to Section 956 loans in all contexts and the taxpayer is going to have to make a determination of the lesser of the tax under Section 956 or as if it paid the dividend up through the chain. Taxpayers are not going to have an opportunity to comment on this. The bill has already passed the House, with no changes to the international tax provisions. Perhaps we can hold it off in the Senate. But unlike the administration's proposal where article after article was written and people had plenty of opportunity to comment, there has not been much opportunity for discussion here.

¹Hiring Incentives to Restore Employment, enacted March 18, 2010.

²General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals (2010 Green Book), located at www.ustreas.gov/offices/tax-policy/library/greenbk10.pdf.

³HR 4213, the "American Jobs and Closing Tax Loopholes Act of 2010."

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