American Bar Association, Section of Taxation
Joint Session of FAUST, FLF, Transfer Pricing and USAFTT

Important Developments

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Loss Sharing Among Members of a Foreign Group – FTC Implications under Proposed Regulations

- Certain foreign jurisdictions permit foreign entities to share losses under a foreign group relief regime (e.g., the U.K.).
- One member of a foreign group generally will “surrender” its losses to offset the income of another member of the same group.
- This permits the efficient use of losses abroad and generally results, in the aggregate, in lower foreign income taxes.

Loss Sharing Among Members of a Foreign Group – FTC Implications under Proposed Regulations

- What are the foreign tax credit consequences of loss sharing for purposes of the requirement in Reg. 1.901-2(a) and -2(e)(5) that a payment of foreign income taxes be compulsory in order to claim a U.S. foreign tax credit?
  - Are those foreign income taxes paid by a loss member after sharing its losses with a profit member in a prior year creditable for U.S. federal tax purposes under section 901?

Loss Sharing Among Members of a Foreign Group – FTC Implications under Proposed Regulations

- **Section 901** generally permits taxpayers to claim a credit for income, war profits, and excess profits taxes paid or accrued (or deemed paid) during the tax year to any foreign country or U.S. possession.
  - However, for such taxes to be creditable, they must be compulsory payments (i.e., non-voluntary payments) to the foreign jurisdiction.
- **Reg. 1.901-2(a)** provides general guidance on the creditability of foreign income taxes and requires that a payment be compulsory for it to be creditable for U.S. federal tax purposes.

Loss Sharing Among Members of a Foreign Group – FTC Implications under Proposed Regulations

- **Reg. 1.901-2(e)** provides that the amount of income tax paid by the taxpayer is determined separately for each taxpayer.

- **Reg. 1.901-2(e)(5)** sheds further light on when a payment will be considered compulsory by a taxpayer.

- Unclear on how the IRS is applying the compulsory requirement under the current regulations in the context of loss sharing through a group relief regime (e.g., U.K. group relief).
  - Preamble suggests such loss sharing may be an issue because of the "taxpayer by taxpayer" approach of Reg. 1.901-2(e).

Loss Sharing Among Members of a Foreign Group – FTC Implications under Proposed Regulations

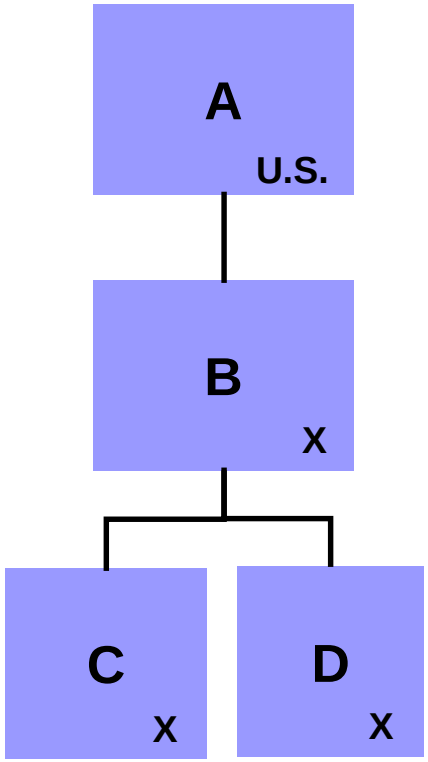
- Prop. Reg. 1.901-2(e)(5)(iii) treats all foreign entities that are part of a "U.S.-owned group" as **ONE** taxpayer.
  - U.S. person (as described in section 901(b)) must own (directly or indirectly) 80% by vote and value of the stock of a foreign corporation (or, directly or indirectly, an interest in 80% or more of the income of a non-corporate foreign entity) for such foreign corporation or non-corporate foreign entity to be a member of a U.S.-owned group.
  - All domestic corporations that are members of a consolidated group (as defined in Reg. 1.1502-1(h)) are treated as one domestic corporation.
  - Indirect ownership of stock or another equity interest (such as an interest in a partnership) is determined in accordance with the principles of section 958(a)(2), whether the interest is owned by a U.S. or foreign person.

Loss Sharing Among Members of a Foreign Group – FTC Implications under Proposed Regulations

- The proposed regulations also provide that, if one or more members of the U.S.-owned group enter into a combined settlement under foreign law of two or more issues involving different members of the group, the settlement will be evaluated overall, not issue by issue or entity by entity, in determining whether an amount is compulsory.

- The regulations are proposed to be effective for foreign taxes paid or accrued during taxable years of the taxpayer ending on or after the date on which the final regulations are published in the Federal Register.

Loss Sharing Among Members of a Foreign Group – FTC Implications under Proposed Regulations



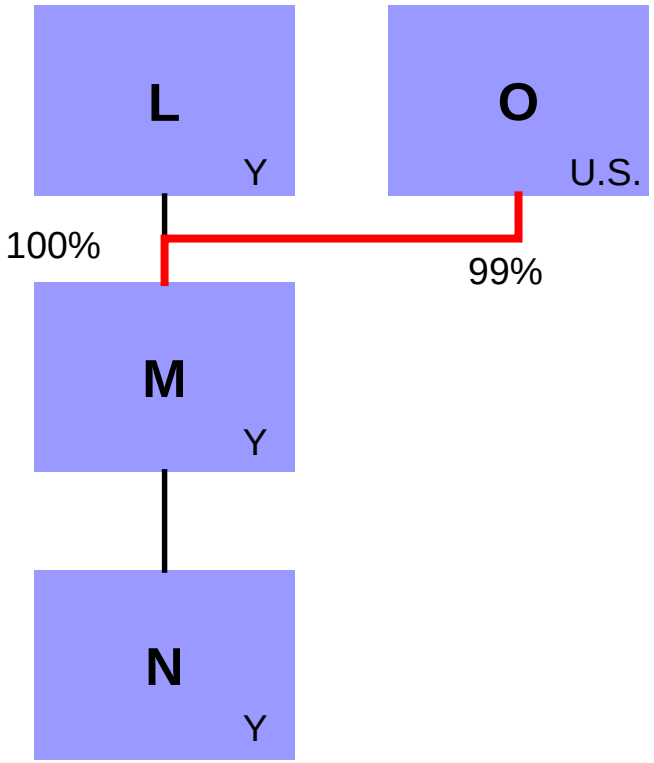
Example 1

Under t he country X group relief rules, a member with a net loss may choose to surrender the loss to another member of the group. Country X permits a 10 year loss carryforward.

	Year 1	Year 2
C's income/(loss)	(1,000)	3,000
Tax paid by C		900
D's income /(loss)	5,000	0
Reduction of D's tax under group relief	300	

The issue is whether any of the foreign income taxes paid by C in year 2 are potentially creditable foreign income taxes. See Prop. Reg. 1.901-2(e)(5)(iii)(C), Example 1. What is the result under the current regulations?

Loss Sharing Among Members of a Foreign Group – FTC Implications under Proposed Regulations



Example 2

O owns a security issued by M that is treated as debt for country Y tax purposes and as stock for U.S. tax purposes. L, M, and N participate in group relief in country Y.

	Year 1
L's income/(loss)	$15 M
M's income/(loss)	($10 M)
N's income /(loss)	$25 M
M's loss surrender to L	($10 M)

M chooses to surrender its year 1 loss to L.

Accordingly, in year 1, the loss surrender has the effect of reducing L's country Y tax by $3 M.

In year 1, N pays $7.5 M to country Y with respect to its net income of $25 M.

If M had surrendered its loss to N instead of L, N would have had net income of $15 M, with respect to which it would have owed only $4.5 M of country Y tax.

The issue is whether N's payment of the additional $3 M of country Y tax is treated as a noncompulsory payment of foreign tax. See Prop. Reg. 1.901-2(e)(5)(iii)(C), Example 2.

Loss Sharing Among Members of a Foreign Group – FTC Implications under Proposed Regulations

- Issues raised by the proposed regulations (and possibly the current regulations):
  - What are the consequences of loss sharing when there is no "U.S.-owned group" (e.g., several unrelated U.S. corporations own at least 10% of the stock of a parent of a foreign group with loss and profit members but no U.S.-owned group)?
  - Suppose B in Example 1 were owned 85% and 15%, respectively, by US1 and US2, two unrelated domestic corporations. Do different rules apply to US1 and US2 for purposes of loss surrendering and the compulsory requirement?
  - Why the 80% requirement in the proposed regulations? Compare 10% requirement in section 902(a)?
  - In Example 2, suppose L had shared its losses with M or N (or both) in a prior year.
    - What relevance (if any) does that fact have on the analysis?

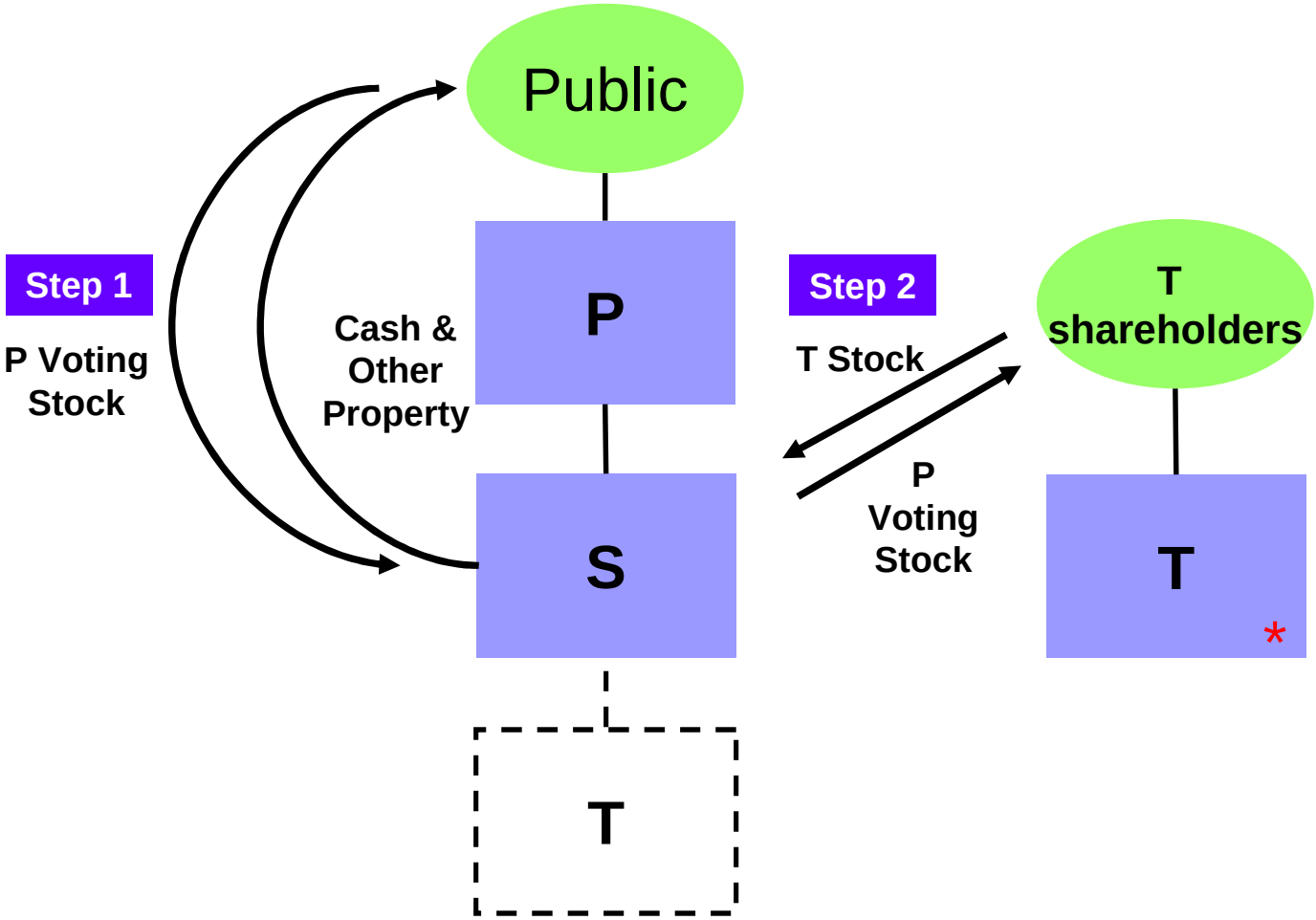
Loss Sharing Among Members of a Foreign Group – FTC Implications under Proposed Regulations

- Issues raised by the proposed regulations (and possibly the current regulations) continued:
  - Is a profit member of a "U.S.-owned group" required to seek the use of the losses of a loss member of the foreign group if such loss member is not a member of the "U.S.-owned group" in order to avoid having foreign income taxes paid by such profit member from being treated as a non-compulsory payment of foreign income taxes?
  - Is loss sharing required even if it would trigger a dual consolidated loss (i.e., what is the interaction of the proposed section 901 regulations with the dual consolidated loss regulations)?
  - What are the implications of the effective date of the proposed regulations?

"Killer B" Transaction with Public Shareholders

- In Notice 2007-48, the IRS and Treasury address transactions in which a subsidiary ("S") purchases the stock of its parent ("P") for property (e.g., cash, a note, etc.) from P's shareholders and such stock is used to effectuate a triangular reorganization with a target corporation ("T") when either S or P is a foreign corporation (or both are).
  - Notice targets a perceived repatriation of S's earnings and profits without the corresponding U.S. federal tax consequences of such a repatriation.
  - Notice 2007-48 follows on the heels of Notice 2006-85 which specifically addressed a similar transaction in which S or P (or both) is (are) a foreign corporation and S purchases P's stock from P to effectuate a triangular reorganization.

"Killer B" Transaction with Public Shareholders



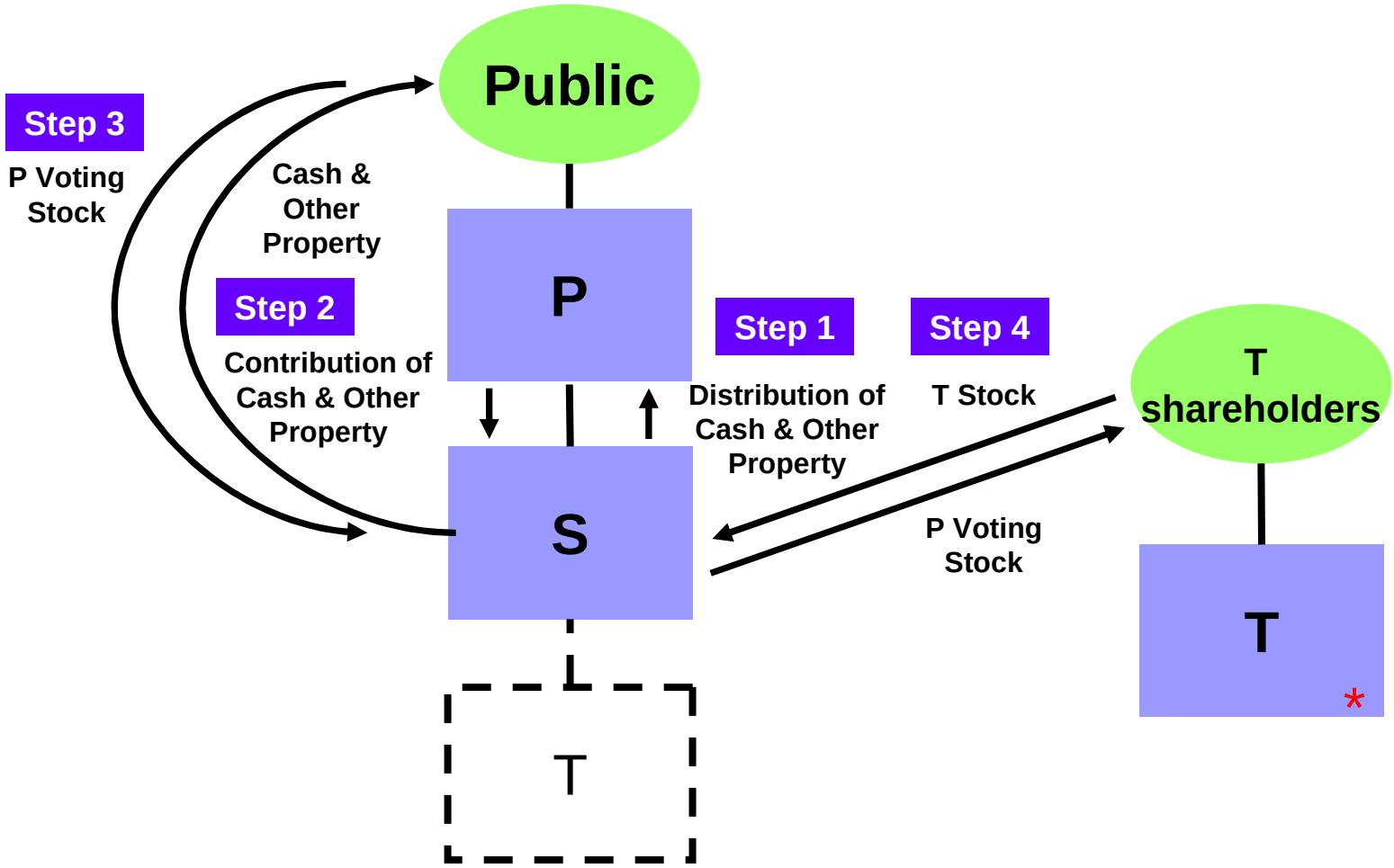
- T may be a related (e.g., a subsidiary of P) or an unrelated corporation

Diagram illustrates transaction without the application of Notice 2007-48

"Killer B" Transaction with Public Shareholders

- This notice provides that regulations to be issued under the authority of section 367(b) will make adjustments with respect to P and S that will have the effect of:
  - A deemed property distribution under section 301(c) by S to P of the property used by S to acquire the P stock from the P shareholders.
  - Followed by a deemed contribution of the property by P to S prior to giving effect to the actual transaction that occurs.
    - S's purchase of P stock from the P shareholders generally will be a section 304(a)(2) transaction.
- The regulations will address similar transactions in which S acquires the P stock from a related party that purchased the P stock in a related transaction.
- The regulations will include a rule that takes into account the earnings and profits of other corporations, as appropriate, if one of the principal purposes of creating, organizing or funding S is to avoid the adjustments described in Notice 2007-48 or Notice 2006-85. They cite Reg. 1.304-4T and Reg. 1.956-1T(b)(4) as provisions that apply similar rules.

"Killer B" Transaction with Public Shareholders



- T may be a related (e.g., a subsidiary of P) or an unrelated corporation

Diagram illustrates transaction with the application of Notice 2007-48

"Killer B" Transaction with Public Shareholders

- The IRS and Treasury also request comments on several other areas, including the treatment of transactions similar to those described in Notice 2006-85 that do not qualify as reorganizations (for example, because S issues minimal consideration to T in a transaction that otherwise would qualify for a reorganization under section 368(a)(1)(B)) and issues regarding the source and timing of the adjustments to be made with respect to P and S.

- The regulations described in the notice will apply to transactions occurring on or after May 31, 2007, with a binding commitment exception that provides that the regulations will not apply to a transaction that was completed on or after May 31, 2007, if certain requirements are met.

Other Issues

- What is the status of international tax legislation that has been proposed (e.g., S.396 relating to "tax haven" CFCs, Doggett Bill (H.R. 3160) relating to an amendment to section 894, etc.)?
- In TAM 200733024, the IRS concludes, after citing cases such as *International MultiFoods Corp and Affiliated Companies v. Commr*., 108 T.C. 579 (1997), that the language of section 1298(b)(5) is clear on its face and can be applied in the absence of enabling regulations. What are the implications under other Code sections (e.g., 336(e))?
- Will the IRS and Treasury be providing further guidance on "how" the look through rule of section 1297(c) applies? See e.g., PLRs 200604020 and 200015028.
- Will the IRS and Treasury be providing further guidance under section 7874?

Transfer Pricing: Application of CPM for Small Transactions

- Does the IRS National Office have a view on the application of the CPM in cases where the volume of intercompany transactions is small (as a percentage of sales or cost of goods sold) and the US tested party has losses?
  - Adjusting to the CPM range in such a case creates massive swings in the intercompany prices, often leading to transfer prices that are well below the cost of production of the other party or even leading to “negative” transfer prices.
  - Is an adjustment to an entire company P&L an appropriate application of the CPM when the percentage of intercompany transactions is small?

Transfer Pricing: Effective Date Issue for New Service Regulations

- Does Reg. Sec. 1.482-9T require inclusion in Total Services Costs (under either “exercise spread” or “financial statement value” methods) of stock-based compensation granted prior to the effective date of the regulations?
  - Note that financial statements amortize grant date value over expected option life and hence financial statements may include pre-January 1, 2007 grants.
  - Will the IRS follow the policy of the 2003 amendment to the cost share rules which only include stock based compensation issued in years beginning after the effective date of the regulations?

Transfer Pricing: Application of CPM to Intangible Licenses

- Does the IRS National Office have a view on using a CPM to determine the appropriate transfer price for an intangible?
  - IRS field examiners sometimes establish a CPM range for a foreign tested party and then ascribe all profits above the median to the US parent company's intellectual property.
  - This approach runs contrary to a number of empirical studies that demonstrate licensors and licensee share residual profits. This is also contrary to the typical practice of corporate license departments who often use a "rule of thumb" (licensor receives 1/4 to 1/3 of the residual).

German Corporate Tax Reform Act 2008: New Transfer Pricing Rules

- German Corporate Tax Reform Act 2008
  - requires German enterprise to charge "arm's-length" price for transfer abroad of business functions to a related party
  - transfer price must be based on profit potential inherent to the transferred function
  - can be adjusted by Revenue Agent based on "commensurate-with-income" standard

Transfer of business functions

- Definition of "transfer" under German administrative guidance
  - ➢ factual event
  - ➢ one or several tasks of "transferor enterprise" are
    - transferred to related "transferee enterprise"; or
    - assumed by related party in addition to the transferor enterprise ("multiplier effect")

Transfer of business functions (2)

- Definition ...
  - transfer can enhance the profit potential of the transferor enterprise (example: production of parts is transferred to a contract manufacturer on a cost-plus basis);
  - transfer can reduce the profit potential of the transferor enterprise (example: transferor discharges role of trader as principal and assumes role of commissionaire)

Types of transfers

- Typical occurrences
  - "relinquished functions": certain functions and concomitant profit potential are abandoned altogether (such as by moving entire production abroad)
  - "reduced functions": scope of certain activities and concomitant profit potential is diminished (such as by principal becoming commissionaire)
  - "outsourced functions": certain production activities or services are carried out by a contract manufacturer
  - Transfer relevant for tax purposes if it results in transfer of profit potential

Transfer Package

- Notion of transfer "package"
  - transfer involves functionally related assets; risk and opportunity; related services
  - all transfers involved form a transfer package
  - transfer package as a whole is subject to appraisal based on aggregate profit potential inherent to the package
  - no separate treatment of individual package components (e.g. seconded personnel; individual assets)

Profit Potential constitutes tax base

- Profit potential of transfer package defined as the profit
  - ➢ which can be derived from the transfer package from the perspective of both the transferor and the transferee enterprise and
  - ➢ which a sound and conscientious business manager of the transferor would not surrender free of charge and
  - ➢ which a sound and conscientious business manager of the transferee would be prepared to pay for

  in an arm's-length situation

Profit Potential constitutes tax base (2)

- The Reality:
  - The price chargeable for the transferred function is computed under standards similar to the sale of part of an entire business
  - going-concern basis
  - sustainable net revenues in perpetuity, discounted to NPV!

Profit Potential constitutes tax base (3)

Example: German publishing house P-GmbH transfers printing activities to SubCo abroad where production costs are significantly lower than in Germany.

P-GmbH derives annual profits of EUR 1 mil.

SubCo expects to derive annual profits of EUR 2 mil due to lower wages, rents etc. at its location.

The profit potential is EUR 1 mil from P's perspective and EUR 2 mil from SubCo's perspective.

Profit Potential > Business Opportunity

- Profit potential is more than a "business opportunity"; third party may be prepared to pay for profit potential from future business activities even in the absence of concrete business opportunities.
- Profit potential can be present even if transferor enterprise is not in a position to realize the profit potential using its own infrastructure
- Example: P-GmbH transfers the printing business to SubCo because it is unable to expand is printing facilities due to local circumstances. Despite P's inability to realize this profit potential itself, its transfer to SubCo attracts tax.

Finding the Transfer Price

- Transfer pricing for transferred business functions
  - Entrepreneur is free to take business decision to assume functions itself, to transfer or outsource them, to transfer or lease assets
  - Transfer price is based upon economic content of business decision, factual circumstances and transaction with related parties
  - Regardless of the individual transactions entered into, in the case of transfers of business functions the transfer package as a whole has to be evaluated in order to determine an arm's length price for the transferred profit potential

Finding the Transfer Price (2)

- The fact that certain intra-group transfers do not occur as between unrelated parties (such as secondment of personnel; granting of stock options to employees of related companies; transfers of entrepreneur functions and profit potential) does not mean that such transfers are to be disregarded for tax purposes.
- Based on a ″hypothetical arm's length test″ the amount of reasonable consideration that would have been paid between unrelated parties in respect of such transfers has to be determined.

Even Transferred Loss Potential may attract Transfer Price

- Even the transfer of loss potential from the transferor's perspective can require payment of a transfer price by the transferee if the transferee can expect to derive a profit from the transfer package
- Example: The German SubCo of a US-MNE sustains permanent losses from its local production, using intangibles developed by itself, due to high local wages, rents, energy costs etc. US-MNE therefore decides to transfer the production to Foreign SubCo, where wages are lower and environmental standards are more relaxed. Due to lower location costs Foreign SubCo can expect to operate at a profit, based on the acquired production facilities, know-how, customer base, other intangibles etc. Under the "hypothetical arm's length test", an unrelated party would have been willing to pay for the acquired profit potential, such as through a royalty, in order to obtain the transfer package.

Identifying the range for negotiated transfer price

- Determination of transfer price based upon notional minimum asking price of transferor and notional maximum bid price of transferee
  - Transferor: how much would a notional seller require so that it can reinvest the sales proceeds in a business with comparable risk profile and derive a comparable return
  - Transferee: based on profit projections of a notional buyer, how much would it be prepared to pay so that it can derive a reasonable return on its investment

The famous Median of the Range

- When in doubt, seller and buyer will meet in the middle!
- If the maximum bid price of the transferee remains below the minimum asking price of the transferor then another group entity, such as the parent, will normally derive benefits from the transfer which should be taken into account as an additional payment to the transferor!

Special Pricing Factors

- Special factors to be taken into consideration
  - Transferor's minimum asking price = surrendered profit potential + closure costs
  - If transferor sustains prolonged losses, closure may result in loss reduction and transferor will therefore accept transfer price below closure costs
  - Price adjustment clauses may be required if profit potential of transfer package is uncertain at closing

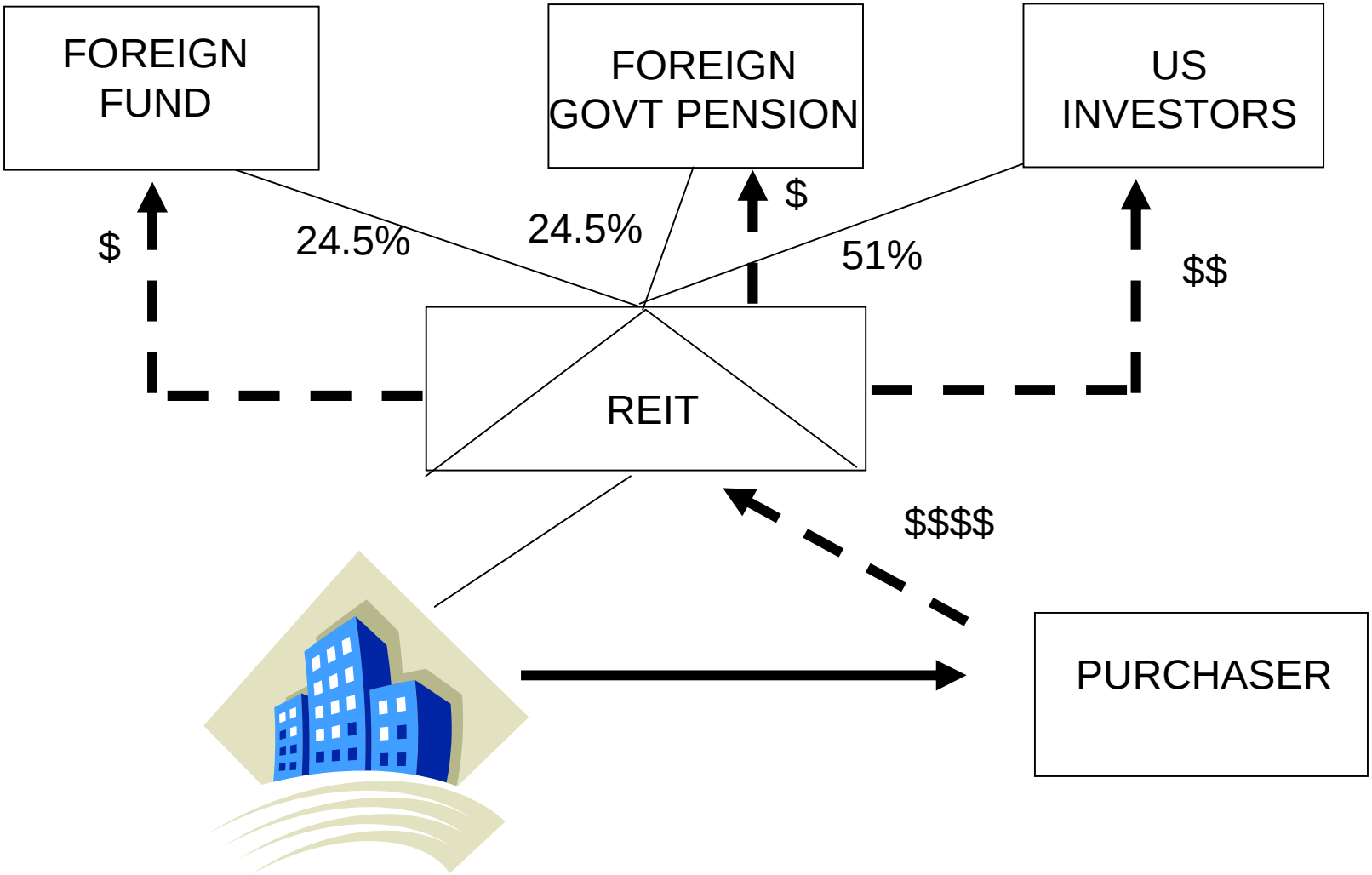
Subsequent "Commensurate-with-Income" Adjustments

- If transferor and transferee did not agree price adjustments and appraisal later turns out to be outside the original price range then
  - German revenue agent will adjust transfer price based upon notional price adjustment clause if actual price charged proves to be detrimental to the German fisc

- Caution!

  - German revenue agent will <u>not</u> adjust transfer price if actual price charged proves to be beneficial to the German fisc. Possible adjustment requires opening of competent authority proceedings.

Notice 2007-55 – R.E.I.T. Sale And Liquidation



Potentially Applicable Code Sections

- Section 331(a) -- Amounts received by a shareholder in complete liquidation of a corporation shall be treated as full payment in exchange for the stock.
- Section 331(b) – Section 301 (relating to effects on shareholder of distributions of property) shall not apply to any distribution of property (other than a distribution referred to in Section 2(B) of Section 316(b)) in complete liquidation.
- Section 331(c) – For general rule for determination of the amount of gain or loss recognized, see Section 1001.

Potentially Applicable Code Sections

- Section 897(h)(1) – Any distribution by a qualified investment entity to a nonresident alien individual, a foreign corporation, or other qualified investment entity shall, to the extent attributable to gain from sales or exchanges by the qualified investment entity of United States real property interests, be treated as gain recognized by such nonresident alien individual, foreign corporation, or other qualified investment entity from the sale or exchange of a United States real property interest.
- Section 897(h)(2) – Sale Of Stock In Domestically Controlled Entity Not Taxed.--The term ‘United States real property interest’ does not include any interest in a domestically controlled qualified investment entity.

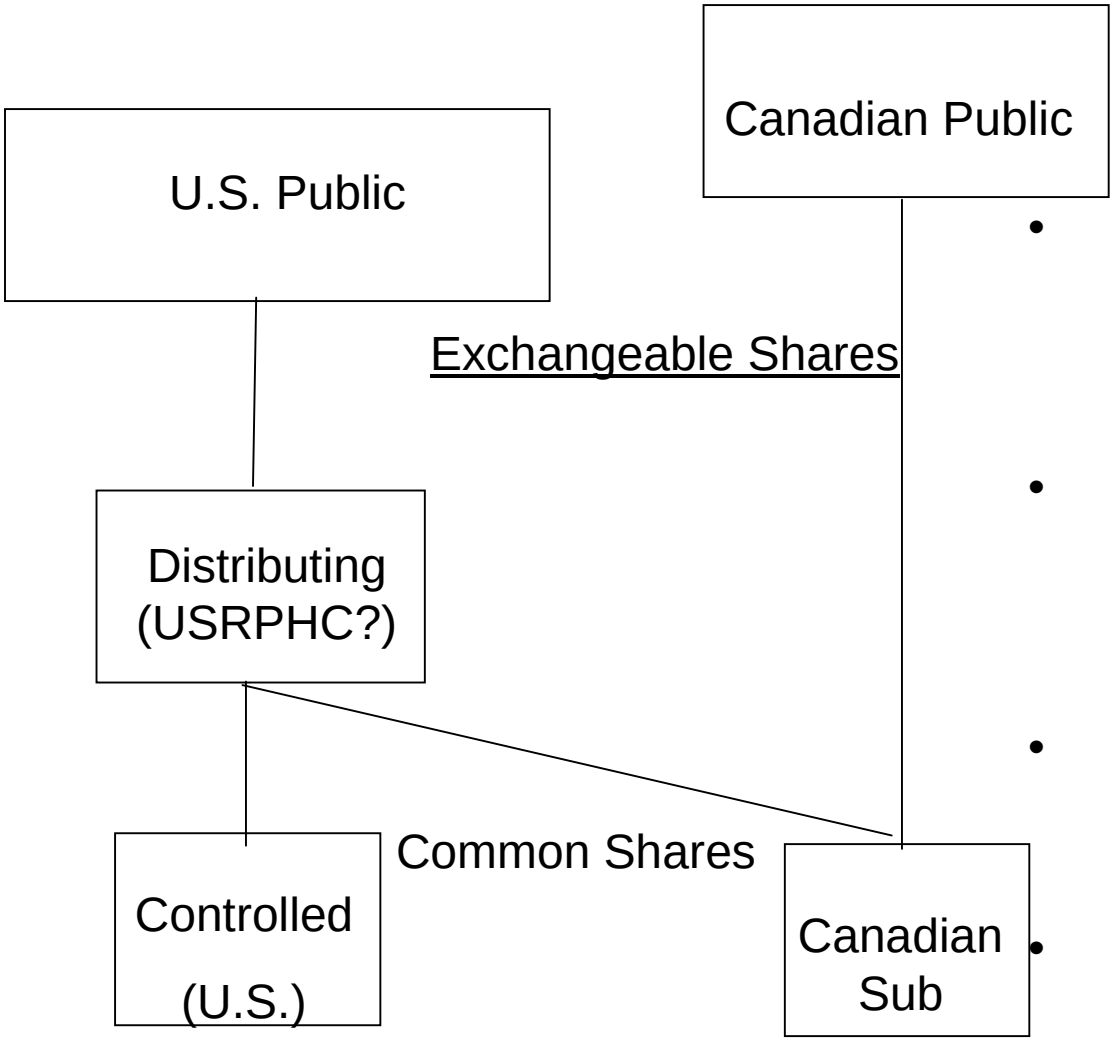
Potentially Applicable Code Sections

- Section 892(a)(1) –The income of foreign governments received from * * * investments in the United States in * * * stocks, bonds, or other domestic securities owned by such foreign governments * * * shall not be included in gross income and shall be exempt from taxation under this subtitle.
- Section 892(a)(2)(A) -- Paragraph (1) shall not apply to any income—(i) derived from the conduct of any commercial activity (whether within or outside the United States), (ii) received by a controlled commercial entity or received (directly or indirectly) from a controlled commercial entity, or (iii) derived from the disposition of any interest in a controlled commercial entity.

Notice 2007-55 Rulings:

- A foreign government is treated under Treas. Reg. 1.897-9T(e) as a foreign person with respect to USRPIs.
- Sections 897(h)(1) and 1445(e)(6) apply to all distributions to the extent attributable to gain from sales or exchanges by the qualified investment entity of a USRPI.
- The IRS will challenge under current statutory and regulatory provisions an assertion by any foreign taxpayer that section 897(h)(1) does not apply to distributions in complete liquidation under sections 331 and 332.
- Regulations will clarify that the application of section 897(h)(1) and withholding under section 1445(e) is not limited to distributions by qualified investment entities that are subject to section 316.
- The term “distribution,” as used in sections 897(h)(1) and 1445(e)(6), includes any distribution included under sections 301, 302, 331, and 332, where the distribution is attributable, in whole or in part, to gain from the sale or exchange of a USRPI by a qualified investment entity or other pass-through entity.

Private Letter Ruling 200718024



Rights of Exchangeable Shares

- The right to exchange for Distributing Common Stock on a one-to-one basis;
- The right to receive dividends on a per-share basis *pari passu* with Distributing Common;
- The right to vote *pro rata* at Distributing shareholder meetings;
- The right to participate *pro rata* in a liquidation of Distributing

Transaction (simplified)

- Distributing proposed to distribute all of the Controlled Common Stock on a *pro rata* basis Distributing Shareholders and to holders of the Exchangeable Shareholders
- The shares of Controlled Common Stock transferred to the Exchangeable Shareholders will not exceed their appropriate percentage of the Distributing Stock
- Under the laws of Country X, the transfer of the shares of Controlled Common Stock to the Exchangeable Shareholders will be taxable taxable

Rulings Issued

- The distribution will qualify as a D-reorg
- Distributing and Controlled are each a party to a reorganization under §368(b)
- Distributing will not recognize any gain or loss on the distribution under §361(c).
- Except to the extent required under §897 with respect to foreign >5% shareholders of Distributing, the Distributing shareholders will not recognize any gain or under §355(a)(1).
- Except in the case of a Distributing shareholder who recognizes gain or loss under § 897, basis will generally carryover under §358(a)(1), (b) and (c).
- Except in the case of a Distributing Shareholder who recognizes gain or loss under §897, the holding period of the Controlled common stock in the hands of each Distributing shareholder will include the holding period of the Distributing Common Stock

Issues for Which No Ruling was Expressed

- The Federal income tax treatment of the distribution of Controlled common stock to the Exchangeable shareholders
- The treatment of any aspect of the transactions under Subpart F (including related transfers)
- The consequences to any person under §897 as a result of the transaction, including but not limited to:
  - Whether any gain is recognized under §897 and
  - Whether Distributing was at a USRPHC
- The consequences under §367

Are the exchangeable shares an interest in U.S. Real Property?

- Regs. §1.897-1(d)(3)(i) -- For purposes of sections 897, 1445, and 6039C, an interest in an entity other than an interest solely as a creditor is * * *[a]n interest which is, in whole or in part, a direct or indirect right to share in the appreciation in value of an interest in an entity described in subdivision (A) [stock of a corporation], (B) [a membership interest in a partnership], or (C) [an interest in a trust or estate as a beneficiary or grantor] * * * or a direct or indirect right to share in the appreciation in value of assets of, or gross or net proceeds or profits derived by, the entity
- Regs. §1.897-1(c)(1) – The term "United States real property interest" means any interest, other than an interest solely as a creditor, in either * * * [r]eal property located in the United States or * * * [a] domestic corporation unless it is established that the corporation was not a U.S. real property holding corporation * * * . In addition, for the limited purpose of determining whether any corporation is a U.S. real property holding corporation, the term "United States real property interest" means an interest, other than an interest solely as a creditor, in a foreign corporation * * * .