American Bar Association – Section of Taxation

U.S. Activities of Foreign Taxpayers and Treaties

Something is Happening, But You Don't Know What It Is – Proposed International Tax Changes in the U.S.

Stanley C. Ruchelman
The Ruchelman Law Firm
New York, NY

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International Tax Reform

- Renewed interest in Congress regarding the opportunity to raise more tax revenue from income generated outside the U.S.
  - Permanently deferred taxes of publicly traded companies suggests significant revenue is being generated by U.S.-based groups without any U.S. tax and is being used in business operations outside the U.S. on a “pre-tax” basis
  - UBS/LGT affairs indicate that private individuals are hiding untaxed sums outside the U.S.
  - Transfer pricing rules have proven not to be the revenue raiser initially anticipated
- Current Administration is in agreement with the goals
- How will this play out?

FY2010 Budget

- Administration's 2010 budget in February
  - International proposals will focus on:
    - International enforcement initiatives,
    - Reforms to deferral of foreign income, and
    - Attacks on tax havens
  - Revenue goal is $210 billion over 10 years

FY2010 Budget

- Ways & Means and Finance Committee hearings
  - Emphasis on:
    - Enforcement of current rules and
    - Scale back of deferral opportunities from the use of tax havens by high income individuals and corporations
  - Deferral equated with tax avoidance

FY2010 Budget Outline

- Options under discussion within the Administration include –
  - Full repeal of the deferral of overseas profits,
  - Maintaining deferral of overseas profits but matching deferral of income with deferral of certain tax deductions allocated to deferred income
  - Attacking certain tax-haven transactions such as dividend equivalent payments paid to foreign investors from offshore entities and offshore funds managed from the U.S.
- First installment of Administration's proposals announced on May 4, 2009; others promised
- Reaction of Finance Committee Chairman Max Baucus
  - The Administration's proposals to ratchet up taxes on the foreign profits of U.S. firms are "controversial" and may not be enacted this year; tax haven proposals may move forward more quickly

May 4th Announcement

- Adoption of Chairman Rangel's 2007 Bill provisions regarding expenses
  - U.S. corporations that defer income from operations of C.F.C.'s would defer U.S. deductions allocated to deferred income
  - Allocations mandated under Regs. §1.861-8 *et* al now would affect computation of income on page 1 of Form 1120
  - First effective in 2011 and targeted to raise $60.1 billion

May 4th Announcement

- Restrictions on foreign tax credits
  - Blending of both current and accumulated earnings and foreign taxes into pools for foreign tax credit calculation
    - Eliminates the ability of a company to choose whether highly taxed or low taxed dividends are distributed
  - The foreign tax credit would no longer be allowed for foreign taxes paid on income not subject to U.S. tax
    - Attacks foreign tax credit enhancers peddled by investment banks
  - First effective in 2011and targeted to raise $43.0 billion from 2011 to 2019.

May 4th Announcement

- To provide businesses with certainty to encourage long-term investments in research and innovation, the R&E tax credit will become permanent in 2010
  - Targeted to reduce taxes by $74.5 billion
  - The credit is 20% of R&E over a base amount
  - 75% of the R&E are attributable to wages

May 4th Announcement

- Elimination of Check-the-Box planning opportunities that reduce foreign taxes through loans without a U.S. tax pick-up under Subpart F
  - First effective in 2011
  - Targeted to $86.5 billion from 2011 to 2019.

May 4th Announcement

- Revision of rules relating to the use of tax havens by individuals targeted to raise $8.7 billion over 10 years
- QI Program has two identified problems
  - KYC reporting for money laundering provides greater information on UBO than W-8BEN reporting which looks to identity of immediate taxpayer
  - QI's can be conduits to non-QI institutions
- Modification to QI Program
  - Foreign financial institutions that have dealings with the U.S. must agree to become a QI and share information about U.S. customers at a level that is comparable to rules applicable to U.S. financial institutions
  - Failure to enter into QI Program raises presumption that institution is facilitating tax evasion; U.S. financial institutions will be required to withhold 20% - 30 % of U.S. payments to individuals who use non-QI's.
  - Refund of withholding tax allowed only when investors disclose their identities and demonstrate that they're obeying the law
  - Pursuant to regulations, QI must not be related to non-QI's
  - KYC standard to QI reporting

May 4th Announcement

- Proposals regarding tax havens
  - Where a tax issue relates to the failure to report foreign financial accounts,
    - The statute of limitations is extended to 6 years
    - Penalties for noncompliance doubled
    - Negative presumptions imposed as to tax avoidance for individual except to the extent clear and convincing evidence exists to the contrary
      - All accounts at non-QI institutions must be reported on FBAR
      - Failure to report an account in excess of $200K is willful, thereby exposing taxpayer to increased penalties
  - 800 new employees devoted to international enforcement

International Tax Reform

- The May 4th Announcement is the beginning of the Administration proposals
- What else can be expected?
- Look at the past to project the future

Chairman Rangel's 2007 Bill

- A reduction in the withholding tax under any treaty for a deductible payment would be disallowed if –
  - The recipient is owned directly or indirectly by a resident of a third country and
  - No reduction of any kind or amount would be made under any treaty had the payment been made made directly to the foreign owner

Senator Dorgan's Imported Property Bill (S.260)

- Expansion of Subpart F
  - Definition of Foreign Base Company Income to include imported property income
  - This covers, *inter alia*, C.F.C. that manufactures abroad to serve the U.S. market or that works with a contract manufacturer for the U.S. market
- A new separate foreign tax credit basket would apply to imported property income to prevent cross crediting with high tax operations entirely conducted outside the U.S. for non-U.S. markets
  - What happens when same factory manufactures for U.S. and foreign market

Senator Kerry's 2007 Active Home Country Income Bill

- All income of a C.F.C. is subject to current U.S. tax except for active home country income
- Deferral allowed only for qualified property and services income of a C.F.C. from:
  - The active and regular conduct
  - Of one or more trades or businesses
  - Within the C.F.C.'s home country
- Exception provided for qualified resident of a treaty jurisdiction on the date of enactment, provided an exchange of information program existed at the time

Senator Levin's 2007 Stop Tax Haven Abuse (S. 396)

- Tax haven C.F.C.'s treated as domestic corporations for all purposes of the Code
  - An exception provided when substantially all of a C.F.C.'s income arises from the active conduct of trades or businesses within its home country
- Initial list of jurisdictions provided Lists countries treated as tax havens based on I.R.S. court filings to obtain information
  - Provides a legislative grant of authority to the I.R.S. to add or remove countries if certain criteria are met

Anguilla	Cook Islands	Jersey	St. Kitts and Nevis
Antigua and Barbuda	Costa Rica	Latvia	St. Lucia
Aruba	Cyprus	Liechtenstein	St. Vincent and the Grenadines
Bahamas	Dominica	Luxembourg	Singapore
Barbados	Gibraltar	Malta	Switzerland
Belize	Grenada	Nauru	Turks and Caicos
Bermuda	Guernsey/Sark/ Alderney	Netherlands Antilles	Vanuatu
British Virgin Islands	Hong Kong	Panama	
Cayman Islands	Isle of Man	Samoa	

The New Senator Levin Bill – Stop Tax Haven Abuse Act

- Reintroduced by Senator Carl Levin and Representative Lloyd Doggett in March (S. 506 & H.R. 1265)
- Supported by Administration in Ways & Means Committee Hearings, but somewhat less so in Senate Finance Committee Hearings

The New Senator Levin Bill

- Rebuttable evidentiary presumptions in the event of an I.R.S. examination, which can be overcome by clear and convincing evidence, but only by oral or written testimony that is subject to cross examination
  - A U.S. taxpayer who formed, transferred assets to, was a beneficiary of, or received money or property from an offshore entity, such as a trust or corporation, is in control of that entity
  - Funds or other property received from offshore are taxable income, and that funds or other property transferred offshore have not yet been taxed
  - A financial account controlled by a U.S. taxpayer in a foreign country contains enough money -- $ 10,000 -- to trigger an existing statutory reporting threshold and allow the IRS to assert the minimum penalty for nondisclosure of the account

The New Senator Levin Bill

- Securities law rebuttable presumptions in a securities law enforcement proceeding
  - A director, officer, or major shareholder of a U.S. publicly traded corporation that is associated with an offshore entity is presumed to control that offshore entity
  - Securities nominally owned by an offshore entity are presumed to be beneficially owned by any U.S. person who controls the offshore entity

The New Senator Levin Bill

- The presumption applies only if the tax haven entity is in an offshore secrecy jurisdiction
  - Initial list of jurisdictions is the one previously provided

The New Senator Levin Bill

- Expands the scope of the Patriot Act
  - Treasury to have authority to require domestic financial institutions and agencies to take special measures with respect to foreign jurisdictions, financial institutions, or transactions found to be impeding U.S. tax enforcement

The New Senator Levin Bill

- Examples of special measures
  - U.S. financial institutions having correspondent accounts for a designated foreign bank will be required to produce information on all of that foreign bank's customers
  - Treasury authority to prohibit U.S. financial institutions from opening accounts for a designated foreign bank, thereby cutting off that foreign bank's access to the U.S. financial system
  - Treasury authority to instruct U.S. financial institutions not to authorize or accept credit card transactions involving a designated foreign jurisdiction or financial institution

The New Senator Levin Bill

- Any U.S. financial institution that directly or indirectly opens a foreign account or establishes a foreign corporation or other entity for a U.S. customer must report that action to the I.R.S.
- Enforcement will be effected through the regulators of banks and securities firms and the I.R.S.

The New Senator Levin Bill

- Managed and controlled standard of residence
  - Targets
    - Almost 19,000 companies in Cayman have local offices in Ugland House; 9,000 have addresses in U.S.
    - The Cayman Islands has more registered businesses than residents, with a mutual fund or hedge fund for every five residents and two registered companies for every resident
  - Residue of the elimination of the “Ten Commandments” is now viewed to be an abuse

The New Senator Levin Bill

- Foreign corporations are treated as U.S. domestic corporations for income tax purposes if
  - Managed and controlled in the U.S. and
  - Either–
    - The stock is regularly traded on an established securities market or
    - The aggregate gross assets of the foreign corporation at any time during the taxable year or any preceding taxable year is $50 million or more

The New Senator Levin Bill

- The standard is based on concept of effective management and control that appears in the L.O.B. provision of the Netherlands-U.S. Income Tax Treaty
  - If substantially all of the executive officers and senior management of the corporation who exercise day-to-day responsibility for making decisions involving strategic, financial, and operational policies of the corporation are located primarily within the US., the foreign corporation is treated as managed and controlled in the US
  - Title is irrelevant and individuals who are not executive officers and senior management may be treated as such if warranted by the facts
  - The location of board of directors meetings is irrelevant

The New Senator Levin Bill

- Application of the managed and controlled test is not limited to foreign corporations organized in offshore secrecy jurisdictions
- If it applies to a foreign company, U.S. dividend-based payments to non-U.S. persons are taxable in U.S. as FDAP income and are subject to withholding
- The provision first applies to taxable years beginning on or after the date that is 2 years from the date of enactment

The New Senator Levin Bill

- The management and control provision does not apply to a C.F.C. if –
  - The U.S. parent has substantial assets held for use in the active conduct of a trade or business in the U.S. other than cash and cash equivalents and other than stock of foreign subsidiaries
  - The C.F.C., itself, is not publicly traded

The New Senator Levin Bill

- Special rules for hedge funds and investment management companies
  - Assets under management are taken into account in determining whether the asset threshold is met
  - If a foreign corporation has assets that are managed in the U.S. and decisions about how to invest the assets are made in the U.S., the foreign corporation is treated as being managed & controlled primarily in the U.S.

The New Senator Levin Bill

- Comparisons to Senator Kerry's 2007 Bill
  - Managed & controlled provision was applicable only to publicly traded companies
  - Carve-out for corporations organized in treaty countries is not included in the new Levin bill

The New Senator Levin Bill

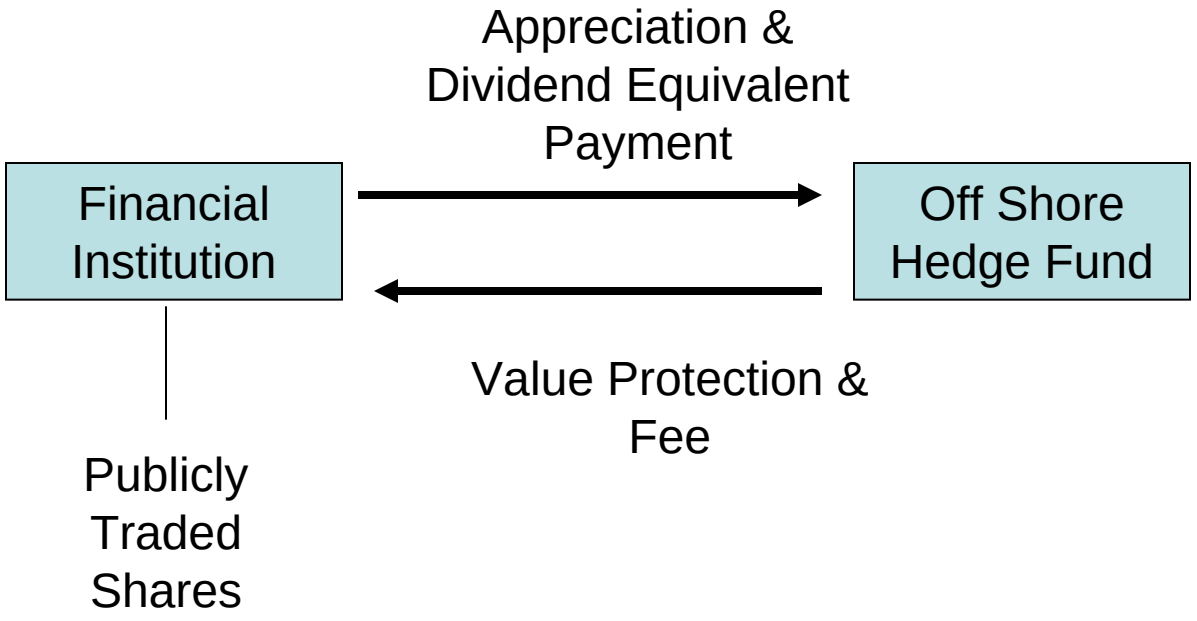
- Foreign trust rules tightened to make more foreign trusts grantor trusts and expand scope of distribution-type loans
  - Any powers held by a trust protector will be attributed to the trust grantor
    - Examples include replacing trustee at will and to advising on assets, distributions, and the naming of beneficiaries
  - Expansion of Section 679 so that any U.S. person actually benefiting from a foreign trust is treated as a trust beneficiary, even if not named and future or contingent U.S. beneficiaries are treated the same as current beneficiaries
  - Expansion of types of loans that are treated as distributions to real estate, jewelry and artwork

The New Senator Levin Bill

- Attack on protection afforded by “more-likely-than-not” legal opinions for trusts formed in secrecy jurisdictions
  - For any transaction involving an offshore secrecy jurisdiction, some other basis independent of the legal opinion will be needed to show that there was reasonable cause
  - The more-likely-than-not opinion would no longer be sufficient in and of itself to shield a taxpayer from all penalties if an offshore secrecy jurisdiction is involved
- Regulatory exceptions for “should opinions” to be identified an will apply to identified classes of business transactions
- Integration of MLTN opinion and FIN 48

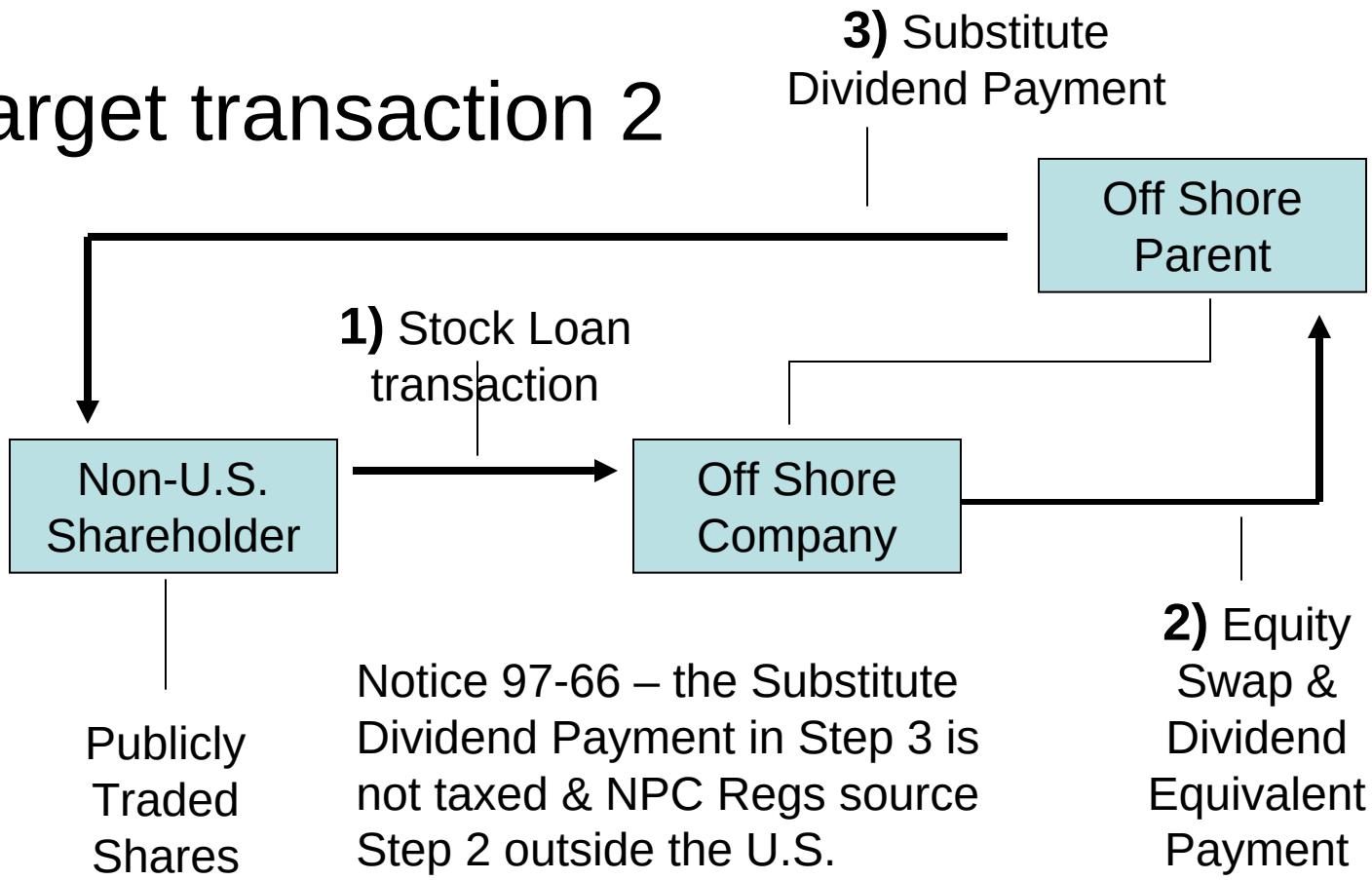
The New Senator Levin Bill

- Change in rules for equity swaps
- Target transaction 1



The New Levin Bill

- Target transaction 2



The New Senator Levin Bill

- Reverses application of notional principal contract source rules as they apply to equity swaps
- Dividends, dividend equivalent payments, and substitute dividend payments made to non-U.S. persons will be treated as U.S. source taxable income subject to withholding
- I.R.S. to issue regulations that will:
  - Eliminate double taxation when tax has been previously withheld
  - Provide for dividend withholding when dividends are netted in a larger swap
  - Nothing in amendment precludes a change in I.R.S. position under prior law

New Senator Levin Bill

- Expanded P.F.I.C. reporting for arrangements designed to avoid nominal ownership and reporting
- Forms 8621 to be filed by any U.S. person who:
  - Formed a P.F.I.C.
  - Sent assets to P.F.I.C.
  - Received assets from P.F.I.C.
  - Is a beneficial owner of P.F.I.C.
  - Has a beneficial interests in P.F.I.C.

New Senator Levin Bill

- Expansion of anti-money laundering rules to private hedge funds and private equity funds
  - Due diligence will be required before funds can be accepted
  - Compliance with information reporting if requested by Federal regulators
- Company formation agents will be subject to anti-money laundering obligations and must know the identity of the person for whom the entity is formed

New Senator Levin Bill

- Ease the burden on I.R.S. for obtaining a John Doe summons from a bank in a secrecy jurisdiction
  - In any John Doe summons proceeding involving a class defined in terms of accounts or transactions in an offshore secrecy jurisdiction, the court may presume that the case raises tax compliance issues; no need for repetitive showings for each person
  - Where the only records sought by the I.R.S. are offshore bank account records held by a U.S. financial institution where that offshore bank has an account, the bill would relieve the I.R.S. of the obligation to get prior court approval to serve the summons
  - In large "project" investigations where the I.R.S. anticipates issuing multiple summonses to definable classes of third parties, such as banks or credit card associations, the bill authorizes the I.R.S. to present an investigative project, as a whole, to a single judge to obtain approval for issuing multiple summonses related to that project

New Senator Levin Bill

- Expand the class of government agencies that can obtain FBAR information from I.R.S. without independent determination
- Enhanced penalty by changing measuring date of assets that form the base of the penalty

Senator Baucus Proposal

- Three broad initiatives
  - Entities transferring funds offshore, other than on behalf of publicly traded companies will be required to report to the I.R.S. the amount and destination or account information of the funds transferred
  - Extension of the statute of limitations for tax returns with certain international transactions to 6 years
  - Filing of FBAR Forms as part of the tax return

Other Possible Tax Law Changes – Oldies but Goodies

- Code § 163(j) earnings-stripping rules tightened
- Reducing scope of 15% tax rate on dividends in the international context
- Change basket rules under the foreign tax credit to remove intercompany royalties from active basket even though deductible from active profits of a C.F.C.
- Placing financial services income in a separate basket
- Limiting deductions for reinsurance premiums paid to affiliates not subject to US tax
- Change in title passage sourcing on export transactions so that all income from manufacturing and sale transactions is U.S. source income
- No foreign tax credit for provincial or local income taxes imposed in a foreign jurisdiction

End