International tax perspectives*

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Foreword

It almost seems trite to begin with "we live in an increasingly complex world" … except that it is profoundly true, and a reality that pervades international tax planning.

We find ourselves at the intersection of two types of complexity. First, the efficient and effective management of a business on a global scale is more complex than ever. Global markets, new business models, ever changing operating environments, ongoing changes in the competitive landscape and regulatory environment, the impact of culture, the pace of change—and the influence of new information technologies on them all—have magnified the complexity of today's business environment. Then add to the mix a diverse and ever-changing web of legislative, regulatory and judicial developments in international taxation.

In this, our second issue of *International Tax Perspectives*, we have chosen to highlight some of the timely issues related to the complexity of international tax planning. It is not meant to be a comprehensive review of recent developments in international taxation, but rather a glimpse into some of the pressing issues and considerations facing you.

We begin with "Integrated global structuring," an article that addresses the need for multinational companies to manage tax complexities on a global scale, along with strategies for doing so. Other topics include IRS initiatives to target international tax compliance, tax developments in the European Union, an update on Belgium tax developments that may affect many multinational companies, a discussion of proposed regulations under Internal Revenue Code Sec. 987, and an analysis of Subpart F developments. We have chosen to close this edition with a comprehensive discussion of developments in the area of global supply chain security. While not a tax issue, this article addresses essential aspects of doing business in a complex world that all multinational companies should consider.

Today, as never before, multinational companies face challenges as they address business complexity side-by-side with the intricacies of global tax planning. We hope that you find this edition of *International Tax Perspectives* a useful tool in managing the complexities of your own business.

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Global markets, new business models, ever-changing operating and regulatory environments, competition, the impact of culture, the pace of change—and the influence of new information technologies on them all—have made the efficient management of a business on a global scale more complex than ever.

As a result, tax planning and compliance for multinational companies (MNCs) have also become more complex, with the need to address and manage multiple intricacies on a global scale. Best-in-class MNCs recognize that to manage these complexities, and to achieve and sustain a lower worldwide effective tax rate (ETR), they need global tax strategies that are aligned with corporate strategy, planning, and operations. Such strategies create opportunities for both financial efficiencies and long-term tax savings. Conversely, a lack of adequate planning can result in missed opportunities and can create unnecessary and potentially significant tax risks and costs.

This article explains some of the significant elements of an effective global tax strategy and analyzes the financial and tax drivers impacting an MNC's ability to achieve a sustainable reduction in ETR.

Global trends—doing business and tax planning in the 21st century

Even absent global trends, businesses face constant change. Changes in a company's business model or operating model, and new business initiatives, such as geographic expansion, cost reduction, changes in products, services, or supply chains, can result in changes to existing (or the creation of new) value-chains, transaction flows, cash flows, contractual rights and distribution patterns. Senior executives and tax planners must recognize that such changes create both tax opportunities and risks.

Now add global trends to the mix: the free movement of capital and labor, the shift of manufacturing base from high to low cost, and the gradual removal of trade barriers in connection with the integration of economic interests of nations into federations. Furthermore, there are subtle trends, such as the development of global brands, and the ever-increasing importance of developing, protecting and exploiting intellectual property (IP).

Increased globalization has enabled MNCs to reduce production costs and improve delivery of their products and services to market in less time which generally leads to increased profits and margins. In contrast, global competition, upward pressure on production and operating costs, and the escalating cost of research and development (R&D) typically create downward pressure on margins and profitability. To remain competitive, companies need to focus on increasing margins through innovation, improved quality, operational efficiency, and risk management.

On top of these global business trends, MNC's face unprecedented challenges in their global tax environment. Many "developed" countries are lowering their tax rates and broadening corporate tax bases to be competitive with the "developing" countries. This has led to aggressive, base-broadening audit challenges by revenue authorities around the world.

In the US, Congress has reinstated "pay-as-you-go" budget rules requiring tax legislation to be deficit-neutral and therefore requiring any tax cuts to be offset with either tax increases or reductions in spending. This has resulted in renewed interest in economic substance

codification and proposals to limit or repeal deferral of US tax on foreign earnings.

Furthermore, there has been a steady increase in coordinated enforcement activity and exchange of information between national tax authorities. FIN 48, with its related disclosures, and the IRS interest in tax accrual work papers (and definition thereof) is a significant challenge. These developments, among others, have created a climate of uncertainty when, for tax risk management and financial statement reporting purposes, companies seek a high degree of "certainty".

In response, MNC's are actively streamlining their operational structures and business models, by managing central functions and risks on a regional or global basis, revising their geographic footprint, and re-aligning their operations to both their core competencies and their expectations for growth.

As the following section will demonstrate, integrated global business strategies must also address the many facets and intricacies of global tax planning.

Effective tax planning and shareholder value

A key determinant of shareholder value is earnings per share (EPS). An important element of EPS, or the bottom line, is a company's effective tax rate. For a company with an ETR of 35% to 40%, any increase in earnings resulting from organic growth, acquisitions, or other corporate initiatives, is diluted by this same percentage. Thus, ETR significantly impacts EPS and, therefore, has a direct impact on shareholder value.

In order to have a long-term, positive impact on EPS, however, tax savings should be sustainable. Best-in-class MNCs do not rely purely on one-off or ad hoc tax planning ideas that tend to be more tactical than strategic. Such strategies may not be integrated with the business and generally may not sustain the ETR impact. Instead, these companies take steps to lower their worldwide ETR through a comprehensive and integrated approach to global tax strategy and planning that is aligned with the business strategy and operations and that, on balance, is more substantive in nature (i.e., is supported by operational substance and economic realities).

This approach tends to increase the likelihood that tax savings are both significant and sustainable, and mitigates exposure to anti-avoidance legislation and tax controversy. Conversely, failure to seriously consider and successfully execute an integrated global tax strategy in the broader context of business transformation may result in tax planning that is sub-optimal, or, worse, ill-aligned with business operations, and therefore unable to produce sustainable results.

Benchmarking global tax efficiency

An important first step in devising an integrated global structure is to make an assessment of the MNC's ETR relative to its peers, or similar companies, and evaluate the factors driving the enterprise's profit and related tax burden. In other words, it is important to understand the MNC's profit and tax drivers and whether (and why) the enterprise compares favorably or unfavorably to similar companies.

Benchmarking of global tax efficiency is the best way to determine whether tax expense can or should be reduced. This analysis involves determining the appropriate benchmark(s) and the right companies to benchmark against. The appropriate benchmarks are typically ETR and cash tax rate. However, certain adjustments to ETR may be required to account for non-recurring or abnormal items and to improve the reliability of the analysis. Further, benchmark companies may or may not be competitors and may or may not be within the MNC's same industry. A careful determination of the peer group is essential. While in practice, this exercise may not yield precise results, it should provide a MNC with valuable insight as to whether or not it is directionally well-positioned.

Both effective global tax planning and effective benchmarking require an understanding of the enterprises' profit drivers and identifying and ranking the corresponding tax rate drivers. A tax rate driver can be defined as any major financial or operational influence on a company's ETR. Tax rate drivers can be either positive or negative; i.e., those that reduce the tax rate (positive drivers) and those that increase it (negative drivers). While many profit drivers are also tax rate drivers, and vice versa, this is not always the case. For example, a tax credit is a tax rate driver but not a profit driver, and

a profit driver is not necessarily a tax rate driver if only minimal profits are earned in a high-rate country.

While specific goals will vary among companies, MNCs should focus on tax planning techniques which impact the significant profit and tax rate drivers.

Profit and tax rate drivers generally fall into two categories: financial drivers and functional drivers.

Financial profit drivers relate to financial risk. Financial profits represent the return on capital investments, intangible assets, and external and internal business risks, (such as the return on inventory risk, accounts receivable risk, warranty risk, product liability, and foreign exchange risks) as well as the return from internal deployment of capital and other income-producing assets (e.g., intangibles). Negative tax rate drivers common to this category include intangible profits in high-tax jurisdictions and capital deployed in high-tax jurisdictions. These negative drivers may be exacerbated by inefficient transfer pricing policies. Conversely, the migration of inventory and other risks (along with the related operational "substance") to a low-taxed principal company is a positive tax rate driver that can result in a sustained reduction in ETR.

Functional profit drivers relate to the critical business functions of the company and where those functions take place. Functional profits accrue from the core business functions of the company such as manufacturing, distribution, marketing, sales, services, and R&D. The location where such functions are performed and the level of risk borne (e.g., market risk and economic risk) can have a significant impact on where profits arise and thus on ETR. For example, the presence of core functions and the related risk in high-tax jurisdictions is a negative tax rate driver. Conversely, migrating core business functions (e.g., business unit / regional directors, procurement, production planning, inventory management, logistics, and marketing) and the risk associated with such functions to low-tax jurisdictions can result in a sustained reduction in ETR, provided the migration of income is supported by operational substance and arm's-length transfer pricing principles.

The functional and financial tax rate drivers with the most adverse impact on the ETR are full-risk, high-tax manufacturing locations, full-risk, high-tax marketing and distribution locations, intangible profits in high-tax locations, inefficient use of tax-favored locations, tax incentives or special regimes, and inadequate use of internal leveraging. In such situations, significant functions and risk, and therefore the associated profit, reside in high-tax jurisdictions, resulting in a relatively high ETR.

An integrated global structure

As previously mentioned, purely tactical or ad hoc, one-off planning is not a sustainable approach to global tax planning and usually results in a constant search for the next tactical solution. Developing global tax strategies that produce long-term results requires a deliberate, broad, and quantitative process that incorporates elements beyond taxes. Such strategies should support the enterprise's strategic vision and goals, blend tax strategy with corporate strategy and structure, and should be consistent with the company's objectives across other functional areas (e.g., treasury policy and objectives).

Developing and implementing a comprehensive global tax structure involves multiple steps: studying the global profit and tax drivers, setting goals, identifying strategies and planning techniques, weighing and choosing alternatives, implementing the plan, and periodically reviewing the plan's performance.

While there are many specific global tax-planning strategies, they can be grouped into three fundamental areas: profit management, attribute management, and treasury management. **Profit management** covers planning for the impact of where the business profits of the MNC initially arise and are taxed. **Attribute management** involves examining the opportunities available given the particular characteristics of an MNC and the tax systems of the countries in which it operates. **Treasury management** addresses all issues arising from situations in which cash is located in a different jurisdiction from where it is needed, whether for reinvestment or return to shareholders.

There are considerable overlaps and interdependencies between the three components. For example, a financing strategy designed to utilize the interest deductions in a particular territory is optimized if it provides deferral of home country taxation on the associated interest receipt, manages the foreign exchange exposures arising in the treasury center and allows for the income to be

reinvested without undue tax leakage. Once these interdependencies are fully addressed an MNC can claim to have a fully integrated global tax structure.

The remainder of this article analyzes each of these three fundamental areas.

Profit management

Profit management is at the heart of global tax planning and addresses both financial and functional profit drivers. Profit management should begin with a careful review of the company's transfer pricing policy and practices to confirm that profits are reported by the appropriate legal entities and jurisdictions in accordance with arm's-length principles. This review may uncover planning opportunities and should assist the company in managing its tax risks.

Next, MNCs should identify profitable operations or assets currently located in high-tax jurisdictions that could, if driven by appropriate operational substance and within risk tolerances, be migrated to lower-tax jurisdictions and permanently deferred (or effectively permanently deferred) from taxation through acceptable tax-planning actions.

The most common techniques for profit management are financing and leveraging strategies, using capital deployment and financial risk-shifting (or sharing) strategies. Finance and risk management involve effective placement or leveraging of capital, including the use of hybrid entities and instruments, dual-resident entities, and other tax-efficient lending techniques. Using these financing techniques and structures, MNCs can incur debt via inter-company asset or share sales (giving rise to interest deductions in the high-tax jurisdictions), tax-efficient factoring of receivables, and tax-efficient leasing. Although these financial techniques and structures may offer the simplest route to lower worldwide taxes, they are increasingly the target of specific anti-avoidance legislation.

Alternatively, if supported by the company's current or future operational model, more substantive profit management strategies involve the migration of assets, functions, risks, and/or IP to low-tax jurisdictions, often reducing the overall tax burden and ETR of the company on a more sustained basis. For example, a profit management strategy might involve the transition of an existing plant to a lower-tax country or opening a new plant in a low-tax jurisdiction or a jurisdiction that may grant a tax holiday. In recent years, some MNCs have established manufacturing operations in countries like China, thereby accessing lower labor costs and a large domestic market. In most instances, under China's Foreign Invested Enterprise laws, these MNCs have been granted tax holidays. A similar trend has been the movement of technology and service jobs to countries like India in order to take advantage of lower labor costs; another is the migration of manufacturing and technology to countries like Ireland and Singapore in order to take advantage of lower labor and operating costs and available tax holidays. These are examples of profit management and how management decisions can have a positive impact on taxes, and vice-versa.

A trend in the way certain companies conduct their business is the movement from country-specific operating models to models with centralized functions and risks at either a regional or global level. These models are associated with streamlined operations and business processes (internal and external), regional or global hubs, shared services, and outsourcing. Such business transformations can sometimes create an opportunity to relocate functions to low-tax jurisdictions for centralized headquarters or principal company operations, IP companies, shared service companies, contract or consignment (toll) manufacturing arrangements, commissionaire arrangements, limited-risk distributors, or procurement companies. Examples of popular locations for centralized principal operating models include Switzerland, Hong Kong, Singapore and the Netherlands.

The use of these strategies depends on an MNC's level of profitability, the profit drivers, the character of income, and, most importantly, whether the strategy is supported by the company's operational model.

Specific strategies exist for companies whose IP, technology, or brand assets are major profit drivers and therefore major tax drivers. Given the increasing importance of IP as a valuable profit driver, and given the potential legal implications of any IP migration strategy, special consideration should be given to IP in the development of an MNC's global tax strategy.

Often IP is owned and developed in the parent company jurisdiction or other high-tax jurisdictions. IP ownership

may be dispersed, and, depending on acquisition and development patterns, may or may not be well-managed. Further, legal ownership may or may not coincide with beneficial or economic ownership and inter-company transfer pricing policies may not properly reflect and reward the true economic or beneficial owner of key intangibles.

In conjunction with this operational planning, it may be possible to employ tax planning to enable the utilization of these key intangibles from a tax-favored location. In some cases, operational synergies can be achieved by centralizing ownership and management of intangible property in a single location. This can be accomplished through cost-sharing of intangible asset development costs, licensing arrangements (i.e., licensing of intangibles among affiliated companies), or by revising transaction flows to coincide with the beneficial ownership of intangibles.

Thus, profit management applies to various techniques, whether through the effective use of transfer pricing, financial techniques, or more substantive operational approaches that may involve a physical relocation of people, plants and equipment, or a retooling and realignment of intangible asset ownership and assumption of business risks to benefit from tax-favored locations and ownership. These planning ideas, if supported by arm's-length transfer pricing, can have a substantial impact on lowering an enterprise's ETR. There is no one best solution—corporate risk profile, personal experience, preference, and most importantly, alignment with business operations—drive the decisions to implement a specific strategy.

Attribute management

Attribute management involves examining jurisdictional or in-country planning opportunities. One attribute to manage is corporate structure, which refers to an enterprise's operational model, capital structure, and tax and legal structure. An integrated global structure provides the platform and allows a company to meet the multiple goals and objectives of global tax planning. Corporate structure can significantly impact an MNC's ability to achieve its global tax planning goals and objectives. For example, a significant tax attribute for all MNCs is the domicile of the parent company, normally associated with the historical origins of the company. However, changes in domicile of the parent do occur, and indeed are becoming more common, especially during cross-border mergers or through purely self-directed actions.

Other strategies are often domestic rather than cross-border, and are often referred to as local or "in-country" planning. Depending on the country, planning opportunities to reduce direct and indirect taxes may include the use of local-country consolidations, R&D tax credits or similar incentives, the use of tax loss carry-forwards and loss-refreshing transactions, tax-free asset step-ups and revaluations (e.g., intangibles), foreign tax credit planning, income-into-capital planning, or the use of tax holidays or special tax zones.

This fundamental area also includes domestic legislative and regulatory initiatives whereby corporations and coalitions discuss their views, concerns, and issues directly with governmental and regulatory authorities. However, the results of legislative work may reach beyond national borders. For example, domestic lobbying may seek reductions in cross-border withholding taxes or more favorable double-tax treaties.

Irrespective of the parent company location, in-country tax incentives (and disincentives) should influence the company's structure and activities across jurisdictions.

Treasury management

Treasury management relates to efficient offshore cash management/cash pooling, management of foreign exchange risks (book and tax), efficient redeployment

of offshore cash for use offshore, and efficient redeployment of offshore cash for use onshore (i.e., repatriation).

Treasury management is essential for sustaining a long-term reduction in ETR. Quite possibly, the migration of profitable operations to lower-tax jurisdictions or reductions in tax through in-country tax planning will be ineffective at reducing a company's ETR if the parent is located in a jurisdiction that taxes on a worldwide basis and does not have an exemption system, if such earnings must be repatriated back to the parent, or result in deemed repatriations under the parent company jurisdiction's "anti-deferral" (i.e., CFC) rules, and are taxed at a higher rate in the jurisdiction of the parent.

For example, let's assume that the parent company of the MNC is a US company. Given that the top corporate income tax rate in the US is 35%, if the migrated profits are repatriated, or deemed repatriated, to the US, then US tax of 35% would be due, with an offsetting foreign tax credit for the taxes incurred in the low-tax jurisdiction. This effectively eliminates the tax benefit of a migration strategy. To be effective for a US MNC, any migration strategy must be combined with a deferral strategy which relies on effective treasury management.

Repatriation relates to the redeployment of earnings back to the MNC's parent jurisdiction. The importance of repatriation as a determinant of ETR is dependent on whether the parent is located in a country that taxes income on a territorial or worldwide basis. If the parent jurisdiction taxes on a territorial basis (e.g., Hong Kong), the repatriation of earnings in the form of a dividend should not give rise to tax considerations beyond local-country withholding taxes. In this case, repatriation planning will be limited to avoiding or reducing withholding taxes. Similarly, if the parent is located in a country that taxes worldwide income, but dividends from foreign shareholdings are fully exempt or 95% exempt through an exemption system (e.g., the Netherlands and Germany, respectively), then repatriation planning will generally be limited to dividend withholding tax planning. In both instances, any withholding tax incurred on dividends will represent a true cost. The use of a holding company or holding company structure can play a significant role in reducing or eliminating dividend withholding taxes. Alternatively, debt instruments, including hybrid instruments (i.e., instruments that are treated as debt in one jurisdiction and equity in another jurisdiction), and other planning techniques can be used to eliminate or reduce withholding taxes.

Holding companies, in conjunction with financing strategies, entrepreneur and limited-risk supply chain structures, and IP planning, can be utilized in an integrated global structure to effectively address the efficient redeployment of cash (both offshore and onshore). An integrated holding company structure is essential as it effectively helps to preserve the benefits of global tax planning by permitting the redeployment of cash throughout the organization and across borders to where it is needed in the business operations in the most tax-efficient manner.

Conclusion

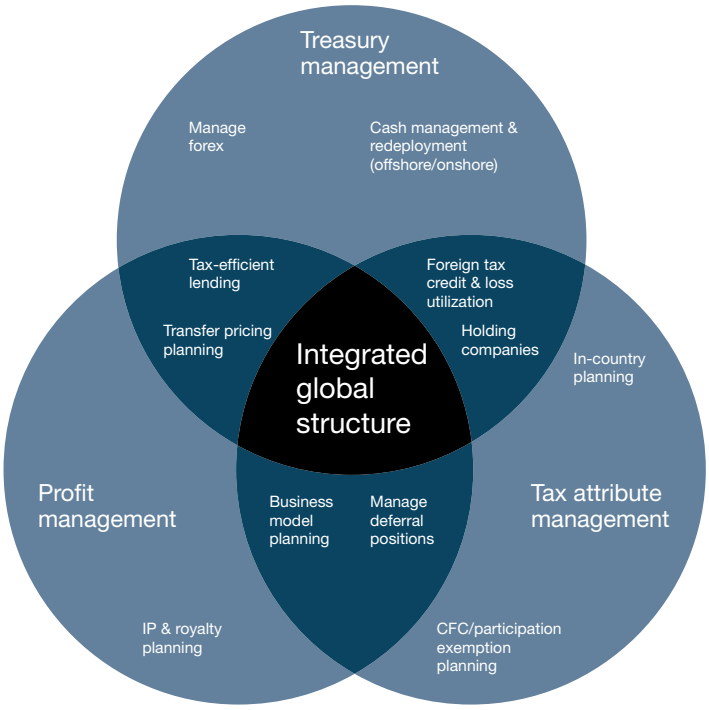
Today, as never before, integrated and comprehensive tax planning by MNCs is required to achieve sustained reduction in their effective rate. MNCs should focus on tax planning ideas that have an impact on the most significant tax rate drivers and can produce a sustainable reduction in ETR.

An integrated global structure should address all three fundamental components:

- Profit management—factors that impact where the business profits of the MNC initially arise and are taxed.
- Attribute management—examining the particular characteristics of an MNC and the tax systems of the countries in which it operates.

- Treasury management—all the issues arising from cash being located in a different jurisdiction from where it is needed, be that for reinvestment or return to shareholders.

Solutions related to each of these planning or impact areas are not independent of one another, but overlap. The following diagram underscores the complexity inherent in global tax planning and the importance of developing an integrated and comprehensive tax plan.



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Internal Revenue Service targets international tax compliance

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In 2006, then-IRS Commissioner Mark Everson declared in a hearing before the Senate Finance Committee that the IRS would target international tax compliance. And he kept good on his promise. In just a year, the IRS has reorganized management of its international program, added senior personnel, provided wider and more specific direction to field examination personnel, and increased cooperation with treaty partners in order to better identify and address potentially abusive cross-border transactions. This article addresses these and other recent IRS international tax compliance initiatives.

New and reorganized IRS personnel

Acting on his pledge, former Commissioner Everson increased international compliance personnel, including several new national level positions within the Office of the Commissioner of LMSB (Large and Mid-Size Business).The position of LMSB Deputy Commissioner (International) was established in order to consolidate international responsibilities within IRS. In addition, two new international executive positions were established in the office of the Deputy Commissioner (International). The first new position—Director, Treaty Administration and International Coordination—will focus on the competent authority and treaty administration areas, as well as exchange of information programs and international coordination activities. The second position—Director, International Compliance, Strategy, and Policy—will focus on field examination activities, developing compliance strategies, foreign resident compliance, and international information reporting.

The international compliance field structure has not changed. However, now that there is an executive directly responsible for field compliance, more specific compliance direction is now provided to field examination personnel regarding issue areas to be pursued and how to efficiently pursue them.

The IRS has also reorganized exam-level personnel to ensure that sufficient resources are available within the LMSB to administer the increased emphasis on international compliance. In early 2006, the IRS transferred approximately 150 revenue agents from its Small Business & Self-Employed Division (SB/SE) to the LMSB. These agents, who dealt with issues relating to non-resident aliens, expatriates, and foreign workers while in SB/SE, will bring this expertise to their new LMSB function. The IRS believes this transfer of revenue agents will allow it to focus more of its experienced resources on the most non-compliant international taxpayers.

Another important aspect of the reorganization of the international compliance program was the 2006 creation of the International Planning and Organization Council. The Commissioner established the Council to ensure accountability for the international compliance program and to promote IRS-wide international compliance initiatives. The Council is chaired by the Deputy

Commissioner (International) and its members include the five industry directors of LMSB, the IRS Chief Counsel, Appeals Officers, and representatives from the Criminal Investigation Division.

Tax treaty initiatives

Information exchange provisions in US tax treaties allow the United States and its treaty partners to share information in order to carry out treaty provisions and domestic laws pertaining to taxes covered in the treaties. The IRS has increased its emphasis on exchanging information with US bilateral treaty partners and plans to significantly increase direct face-to-face planning meetings and cooperation with numerous taxing authorities in treaty counties.

The IRS has five exchange of information programs:

- Routine Exchange of Information Program;
- Specific Exchange of Information Program;
- Spontaneous Exchange of Information Program;
- Industry-wide Exchange of Information Program; and
- Simultaneous Examination and Simultaneous Exchange of Information Programs.

Under the Routine Exchange of Information Program, the IRS automatically provides information that is not specifically requested by the receiving country. At this time, the information provided under this program is limited to the information reported on Form 1042-S (Foreign Person's US Source Income Subject to Withholding) relating to US source fixed or determinable income paid to persons claiming to be residents of the receiving treaty country. However, pursuant to a new initiative under the Routine Exchange of Information Program, it is our understanding that certain treaty partners have expressed an interest in receiving information reported on Form 8288-A (Statement of Withholding on Dispositions by Foreign Persons of US Real Property Interests) and Form 8805 (Foreign Partner's Information Statement of Section 1446 Withholding Tax). If the IRS decides to provide this information under the Routine Exchange of Information Program, the information will be provided automatically to the requesting treaty partners.

Other global tax initiatives

In addition to treaty initiatives, the IRS has been working to develop other strategies to address the increased compliance challenges resulting from globalization. As part of this focus, the Service is now working more closely with tax administrations of other countries. For example, in September 2006, former IRS Commissioner Everson chaired a meeting of 35 countries at the Organization for Economic Cooperation and Development's (OECD) Forum on Tax Administration, during which concerns and experiences of members were discussed.

Also, the IRS and the tax agencies of the United Kingdom, Canada, and Australia have established the Joint International Tax Shelter Information Centre (JITSIC), based in Washington, D.C. The aim of JITSIC is to identify non-compliance in the cross-border transaction area, including the identification and sharing of information about potentially abusive tax avoidance transactions. Recently, the tax commissioners of the founding countries decided to open a second JITSIC center in London in fall 2007. In addition, Japan has accepted an invitation to join JITSIC. Future plans for JITSIC include a measured expansion to cover North America, Europe and Asia, broadening the focus of its activities, further sharing best practice on risk assessment and other key areas of interest, and increasing the transparency of cross-border transactions.

The IRS is also working with the tax administrations of nine other countries as part of the 2006 "Leeds Castle group" initiative. The commissioners of the revenue bodies of these countries have agreed to meet regularly to discuss issues of global and national tax administration that present mutual compliance challenges.

These information-sharing arrangements, coupled with the IRS's promise to address criticism it received for not utilizing information received from treaty partners in the past, is a strong indication that the IRS will be sharing information and using information it receives in its compliance efforts in the future. This increased global focus will no doubt result in increased scrutiny of international transactions by a variety of international taxing authorities.

New "Issue Management Team" approach

A number of issue areas have been identified as "areas of emphasis" for LMSB's International Examiners (IEs). A major goal of the IRS is to achieve consistency with regard to how these issue areas are examined by IEs. These "areas of emphasis" include:

- Transfer of Intangibles Offshore and Cost Sharing
- Structured Foreign Tax Credit Transactions
- Hybrid Instrument Transactions
- Foreign Earnings Repatriation—Section 965
- Transfer Pricing
- Puerto Rico Exit Strategy—Section 936
- Domestic Production Deduction—Section199

These issue areas are being coordinated by Issue Management Teams (IMTs) that are working with the Office of Associate Chief Counsel (International) to develop strategies for the identification, development and resolution of issues. The IMTs include experts within each of the technical areas and are led by an IRS LMSB Executive.

International return selection process

The advent of electronic filing for corporate taxpayers will make the IRS selection process for returns of international taxpayers more efficient and effective. It will also enable the LMSB to target those international taxpayers who may have issues within the identified compliance areas discussed above.

For example, foreign controlled corporations with significant intercompany transactions reported on Form 5472 (Information Return of a 25% Foreign-Owned US Corporation or a Foreign Corporation Engaged in a US Trade or Business) will be targeted, particularly if they have low operating profits. In addition, issues related to Forms 5471 (Information Return of US Persons With Respect To Certain Foreign Corporations), such as transfer pricing, foreign tax credits, and Subpart F, will be more easily identified for examination as a result of electronic filing.

New IRS approaches for auditing Forms 1120-F

Taxpayers often file "protective" Form 1120-F returns to ensure they are allowed deductions and credits in the event an IRS examiner determines the taxpayer has a permanent establishment (PE) and there are business profits attributable thereto. Section 882(c)(2) requires that the foreign corporation file a "true and accurate" return to receive the benefit of deductions and credits. Treas. Reg. Section 1.882-4(a)(3) outlines the specific filing deadlines for "protective" Form 1120-F returns. Using a range of initiatives, the IRS has increased its emphasis on auditing both "protective" and "non-protective" Forms 1120-F.

One of these initiatives is a new IRS Compliance Initiative Project (CIP). A CIP is any activity involving contact with specific taxpayers within a group, using either internal or external data to identify potential areas of noncompliance within the group, for the purpose of correcting the noncompliance. As part of the initial CIP focused on protective 1120-Fs, started by the IRS close to a year ago, approximately 160 "protective returns" were selected for examination.

In addition to CIPs, we understand that Form 1120-F audits have been initiated across the country. In particular, US multinationals that have controlled foreign corporations have been targeted often when they are a party to a cost-sharing agreement with a US parent and are utilizing the intangibles in various foreign markets. International examiners are making efforts to develop PE or Section 882 issues in these instances where significant intangible income may be taxable in the United States. In addition, examinations are being pursued with regard to foreign corporations (i.e., non-US owned corporations) whose activities satisfy the applicable PE or Section 882 requirements.

Inquiries are also being made by IRS international exam agents with regard to potential delinquent Form 1120-F returns on other examinations. Form 1120-F returns are manually classified by international examiners rather than being subject to computer selection models.

Finally, the Service has expanded specific audit procedures for "protective"1120-F examinations. For "protective" return examinations, IRS examiners issue a

standard Information Document Request (IDR) outlining numerous questions to be responded to by taxpayers whose returns have been selected. However, it has come to our attention that certain additional examination procedures have been developed by the IRS that expand upon the previous "standard" IDR. In our experience, some of the procedures being recommended to examiners include the following:

- Ensure Form 8833 (Treaty-Based Return Position Disclosure under Sections 6114 or 7701(b)) is filed and that a statement is included indicating the taxpayer believes it has no "business profits" attributable to a PE.
- Review the specific treaty cited by the foreign corporation on Form 8883 examining the relevant treaty provisions, i.e., those primarily relating to business profits, PE, and residency. Also review the related Treasury Technical Explanation. The US Model Treaty and Treasury's Technical Explanation can help in the interpretation process as can the OECD Model Treaty and its Commentary.
- Perform a search utilizing an internet search engine in an effort to learn about the extent of the taxpayer's US operations. Searches should also be made of the taxpayer's parent corporation to secure information that may support a potential return filing requirement. If your search discovers activities related to a state or federal regulatory agency like the Securities and Exchange Commission, consider contacting that agency but follow the appropriate procedures for the contact.
- Conduct initial interviews with representatives of the foreign corporation who are located in the United States.
- Determine if the foreign corporation has any transactions with any related party that files a US tax return and determine if Form 5472 is filed.
- Perform a functional analysis similar to those performed for Section 482 or Treas. Reg. Section 1.861-8 issues. This analysis includes the determination of who performs certain functions, where they are performed, and where economic risks are present. Interview a representative of the foreign corporation to discuss the extent of operations in both the United States and abroad. Determine the functions being performed by both the foreign corporation and the related US entities, and where the functions are being performed.
- Determine if the foreign corporation has any clients in the United States and, if so, how the clients were secured. Consider summonsing the taxpayer's large clients located in the United States to see how the business was generated.
- Determine whether anyone in the United States performs services for the foreign corporation and if that person has authority, either expressed or implied, and exercises this authority to negotiate and execute agreements/contracts on the foreign corporation's behalf (i.e., a dependent agent).
- Determine if there are related federal income returns filed in the United States and, if so, review the returns.

Compliance Initiative Project for witholding tax

The IRS has initiated an extensive CIP to address non-compliance by taxpayers responsible for withholding income tax under IRC Sections 1441, 1442, and 1443. The IRS has initially selected approximately 200 taxpayers for withholding tax examination, with a long-range goal of examining 300 taxpayers in each of the five industry groups that comprise LMSB's jurisdiction.

According to an IRS official responsible for this compliance effort, IRS computer audit specialists and international examiners have been analyzing information reported on Form 5471 and Form 5472 to determine if reportable amounts reflected on those returns have been properly reported on Form 1042 (Annual Income Tax Return for US Source Income of Foreign Persons). Numerous instances of non-filing have been discovered and the IRS will contact those taxpayers. Also included in the project are withholding agents in the following industries: personal services providers (e.g., accounting firms, law firms, and architectural firms), real estate, heavy manufacturing, natural resources, entertainment, and pharmaceuticals.

The IRS decided to undertake this initiative based on information uncovered during its administration of the Voluntary Compliance Program ("VCP"), which was available to withholding agents for the payment,

withholding, and reporting of certain taxes due on payments to foreign persons. Under the VCP, a withholding agent could voluntarily disclose to the IRS any past non-compliance with the withholding tax regulations and not be subject to penalties.

Although the VCP ended on March 31, 2006, IRS officials have stated that taxpayers who voluntarily disclose non-compliance in the future would be looked upon favorably when the IRS considers whether to assess penalties. IRS officials also have stated that they will aggressively pursue penalties in instances where non-compliance with withholding regulations is discovered.

Compliance Initiative Project for Forms 5471 and 5472

The IRS has also initiated a CIP to identify non-compliance by US companies with respect to transfer pricing, withholding tax, and other areas. The results of the review of Forms 5471 and 5472 will be a significant factor in the return selection process.

This CIP could be important to foreign controlled corporations (FCCs) with significant intercompany transactions and limited profitability in the United States as well as those FCCs that pay US source income to foreign parties but do not file Form 1042. In addition, US corporations with significantly profitable controlled foreign corporations will also be considered for inclusion in the CIP.

International examiners and economists will be assigned to these examinations and will initially request any transfer pricing documentation prepared by the taxpayer to avoid potential Section 6662(e) penalties. After the initial review has been conducted, additional transfer pricing IDRs will be issued as necessary. Other international issues, including Form 1042 compliance, and domestic issues will be considered as part of these examinations.

The results of these examinations will be carefully reviewed so that audit selection criteria for tax returns with international features can be improved. The information from this CIP, along with the implementation of the electronic filing program (which includes Forms 5471 and 5472) should assist the IRS in their efforts to deploy international resources to those returns where significant non-compliance may exist.

Increased emphasis on accurate Forms 5471 and penalty assessment

As part of its emphasis on international compliance, the IRS is stressing that International Examiners make full use of information required to be reported on Form 5471. Over the last few years, the Office of the Treasury Inspector General for Tax Administration (TIGTA) has conducted a number of reviews to determine if the IRS is utilizing the information reported on Form 5471 during the return clas sification and examination processes. Based on those reviews, TIGTA has criticized the IRS for accepting incomplete forms and for not asserting penalties for failure to provide required information. In response to TIGTA's findings, the IRS will no longer accept incomplete forms and penalties are being asserted. Penalties for failure to file Form 5471 are at least $10,000 and could be higher for each incomplete or untimely filed form.

In addition, key IRS executives have issued instructions to examiners to take penalty enforcement more seriously. The penalty assertion trends have shifted from requesting permission to assert a penalty to requiring permission not to assert a penalty. For example, a Chief Counsel Notice (CC-2004-036) states that penalties assist the IRS by increasing the economic cost of noncompliance. The Notice further instructs staff to support imposition of penalties when the issue is properly developed. The Notice also directs staff to consider hazards of litigation for penalties independent of hazards of litigation for the actual tax at issue.

The Chief of Appeals has also issued a memo to staff that established a new policy under which Appeals Officers will no longer "trade penalty issues." The memo also stated that settlement of penalties is possible but must be based on the merits and hazards of litigation on the penalty issue alone.

Although IRS Commissioner Mark Everson resigned in May, 2007, his influence remains in the form of the many initiatives he set into motion during his tenure. He set out to target international compliance and he did so successfully. Business taxpayers whose returns contain international features should carefully consider the results.

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European Union tax developments: Confusion for multinational taxpayers?

Jonathan Hare, Peter Cussons, and Ewan Fryatt

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Developments in European Union (EU) taxation and, in particular, recent judgments issued by the European Court of Justice (ECJ), are addressing fundamental areas of international taxation and thus reshaping the taxation of cross-border transactions within the EU. It is therefore essential for all multinational groups operating in the EU to be aware of how these developments may impact their tax profile.

There are broadly two parallel trends in EU tax developments. One is the piecemeal development of tax systems within the EU, caused by application of ECJ judgments in different ways by courts in EU Member States. This is leading to a slow progression towards harmonization. In addition, there is a drive towards more rapid and overall harmonization, with initiatives such as the common consolidated corporate tax base, discussed below.

This article also looks at some recent ECJ cases, comments on the complexity taxpayers may face in applying certain convoluted judgments and discusses the fact that the ECJ left significant factors to be decided by the Member State Courts, leading to prolonged periods of uncertainty for taxpayers.

The European Court of Justice and EU taxation

The ECJ deals with disputes and upholds the Treaties of the EU, collectively known as the EC Treaty. The ECJ bases its decisions on the five fundamental freedoms enshrined in the EC Treaty: free movement of workers; freedom of establishment; free provision of services; and free movement of capital and payments. In the field of taxation the most important of these are freedom of establishment and free movement of capital.

The ECJ must ensure that European law is uniformly interpreted and applied throughout the Member States of the EU. One of its operating principles is to eliminate harmful or differential tax practices within the EU that act as a barrier to cross-border economic activity. An ECJ judgment overrides domestic legislation and is binding on all Member States with the same or substantially the same legislative position as the State concerned.

The ECJ has ruled on an increasing number of cases in the field of taxation over recent years. Recently, there have been a number of judgments, in relation to matters including cross-border loss relief, taxation on dividends, Controlled Foreign Companies (CFC) regimes, thin capitalization and migration of companies. These are clearly fundamental areas of international taxation and hence the impact of the ECJ on European tax systems is significant.

The ECJ sits in Luxembourg and is composed of 27 judges, one judge from each Member State. There are eight Advocate Generals whose role is to present opinions on the cases brought before the Court. While their opinions are often followed in the judgments, the opinions are not binding on the Court. In fact, the recent judgment in the *FII GLO Case*, discussed below, diverged significantly from the Advocate General's opinion. For cases where a Member State is party to the proceedings, a Court sits in a **Grand Chamber** of 13 judges. In this event, agreement among nine of the judges is required for a judgment. Only one judgment is actually published, so if there are dissenting views, they are not published.

Changes in ECJ approach

The prominence of ECJ cases concerning direct taxation began to increase in the early to mid-1990s. Early ECJ tax judgments tended to favor the taxpayer. Also, these

early ECJ judgments tended to be expressed in straightforward terms with clear principles. Many features of national legislation were subsequently amended in accordance with these ECJ judgments, such as German (and UK) thin capitalization rules following the case of *Lankhorst-Hohorst*.[1]

One of the first indications of a change in the approach of the ECJ came in December 2005 with the ECJ judgment in the *Marks & Spencer*[2] (M&S) case. The judgment in *Marks & Spencer* was one of the first examples of the ECJ's leaving the key clarifications to domestic courts. The case seems to have marked the start of things to come, and the trend in recent judgments has been to find less clearly in favor of the taxpayer. Taxpayers still appear to be winning in a number of the cases, but their victories are often "qualified" successes. There is also more confusion for taxpayers as ECJ judgments have become significantly more complicated and decisions are less clear-cut, with little guidance for the Member States on how to apply them.

Another recent development has been the accession to the EU of a number of (mainly smaller) States, bringing the total number of EU Member States to 27. The legal systems of these newer Member States are often quite different from those of the pre-accession States, and, likewise, the experience of judges from these newe Member States. This creates further uncertainty for the taxpayer as the judgments made predominantly by these "new" judges sometimes appear to differ in approach from the recent judgments handed down by judges from the older Member States.

Recent ECJ judgments—a sign of things to come?

Although there have been many ECJ judgments in tax cases since late 2005, a number are of particular interest to multinationals operating in Europe.

Marks & Spencer—a turning point in the view of the ECJ?

This case concerned Marks & Spencer's claim that, based on the EU freedom of establishment principle, it should be able to offset losses of its non-UK EU subsidiaries against its UK profits. The ECJ agreed that M&S's freedom of establishment was breached and that losses of other jurisdictions could be offset against UK profits, but only where the loss-making subsidiaries had exhausted all possibilities of using the loss in the local territory. The concept of "exhausting all possibilities" was not defined in detail by the ECJ. The ECJ also left open the question of exactly how and at what point in time the test would operate. The manner in which the ECJ left important questions of interpretation and application up to the domestic courts is an increasingly common feature of recent ECJ judgments and can lead to protracted litigation in the domestic courts even after an ECJ decision is handed down.

On February 20, 2007, the UK Court of Appeal determined that, based on the ECJ judgment, the UK group relief rules were only incompatible with the EC Treaty where the claimant could show that *at the time of making the operative claim* there is no *real possibility* of using the losses in the local jurisdiction. The case has now been remitted back to the Special Commissioners, the UK tribunal that hears direct tax appeals, to determine whether as a matter of fact M&S's overseas subsidiaries have exhausted all real possibility of using the loss locally.

The Court of Appeal judgment still leaves undecided some very important points for other claimants. For example, in order for loss relief to be available, does the surrendering company need to be a subsidiary of the claimant or can cross-border group relief be surrendered between brother/sister companies?

This and other points are likely to be the subject of further litigation in the UK and possibly further referrals to the ECJ. The saga of cross border loss relief is therefore far from over.

Other recent cases favoring the taxpayer

In the *Denkavit*[3] case, the issue in question was the 5% withholding tax levied by the French government on dividends paid by Denkavit's French subsidiary to its Dutch parent. Denkavit argued that the withholding tax was illegal under EU law because the tax breached its freedom of establishment since dividends paid by a French subsidiary to a French parent were not taxed. The ECJ agreed with Denkavit's argument and opened up the possibility for Denkavit to pursue the French Ministry for damages going back a number of years. The judgment is expected to have an effect on many EU countries, as the majority of them have at some

stage imposed a withholding tax regime on interest and dividends that differed from the treatment for companies from the same territory.

The *N*[4] case concerned exit taxes imposed by the Netherlands on individuals migrating abroad. The ECJ found that the exit tax was in breach of the EC Treaty. Although this decision only refers to the exit taxes on individuals, it has increased interest in the legality of exit taxes levied on companies transferring their residence, particularly since the N case referred not to individuals but to "taxpayers." Many EU countries, including the Netherlands, levy a tax on unrealized capital gains for legal entities transferring residence. This immediate taxation of capital gains could be considered to contravene the freedom of establishment principle, and it is likely that the ECJ will be asked to look at this issue in the near future.

The precedent of the *N* judgment would suggest that corporate exit taxes between EU countries may need to change significantly. However, this change may take many years, since governments in Member States may choose only to address rules which are currently under direct challenge in their particular State. This reactive rather than proactive approach is being adopted by most Member States. Such an approach can lead to periods of prolonged uncertainty for multinationals' operations in Europe where they are faced with current legislation that may well be in breach of the Treaty, coupled with a reluctance on the part of taxing authorities to change anything unless and until challenged through the courts.

Finding against the taxpayer

The FII GLO[5] case asked the ECJ to look at a number of features of the UK dividend system. One issue in the case was the difference in UK tax treatment between dividends received from UK companies which are exempt from tax, and those from other countries which are taxable at the UK rate with double tax relief available.

The judgment did find for the taxpayer on some issues. However, on the issue of the taxation of dividends from EU countries to the UK, which is likely to be one of the main issues of interest to multinationals, the judgment found against the taxpayer.

The ECJ released a convoluted judgment finding that taxing foreign dividends and exempting domestic dividends was not in contravention of the Treaty, provided that (1) credit is allowed for the foreign tax assessed, and (2) the overseas dividends are not taxed at a higher rate of taxation than UK dividends. This judgment was particularly surprising as it contradicts the Advocate General Opinion, an opinion which had led tax professionals to believe that taxing EU dividends would be found by the ECJ to be contrary to the fundamental freedoms of the EU. A difficulty with the judgment is that it is left up to National courts to determine how one goes about assessing whether foreign dividends have in fact suffered a higher rate of tax than UK dividends. This is likely to be the subject of further litigation in the UK.

The judgment therefore did nothing to simplify the UK tax system. As a result, US multinationals investing in Europe via a European Holding Company based in the UK will still need to do ongoing tax planning in order to deal with the complex double tax relief rules in the UK although Her Majesty's Revenue & Customs has recently announced a consultation process to consider, among other matters, the possibility of adopting a participation exemption regime for dividends.

Mixed judgments

The *Cadbury Schweppes*[6] case concerned the UK Controlled Foreign Company rules which, broadly speaking, tax a UK parent company on the undistributed profits of any non-UK subsidiaries that pay less than 75% of the tax which they would have to pay if taxed in the UK.

Cadbury Schweppes had set up subsidiaries in Ireland to raise financing for other group companies. The Irish profits were subject to Irish tax at 10 percent and were CFCs for UK tax purposes under UK law. Cadbury Schweppes maintained that it had incorporated the Irish subsidiaries to conduct a commercial business of raising and lending money and the UK taxing these profits contravened EU law.

The ECJ decided that the CFC regime does represent a restriction on the freedom of establishment principle, but that a national measure restricting freedom of establishment can be justified where it specifically relates to

"wholly artificial arrangements" aimed at circumventing the application of the [UK] legislation. CFC rules are not applicable if it can be shown by objective factors that the CFC carries on "genuine economic activities" in the overseas territory with particular regard to the extent to which the CFC physically exists in terms of premises, staff, and equipment. The motive for setting up the overseas companies was found not to be a relevant factor. The case is now pending with UK Courts to determine how the ECJ ruling fits the facts of the case.

This case did benefit taxpayers in that it established the relevant test for determining when CFC rules can apply as when the arrangements are "wholly artificial." This test is a much narrower test than a more general tax avoidance purpose test. The new test is therefore likely to cause less concern to taxpayers in a number of instances. It should be noted that the consultation process referred to above will also cover the UK's CFC rules.

The Cadbury-Schweppes judgment is of concern to at least nine other Member States that also have CFC rules. As for other ECJ judgments, it is left to the relevant national courts to decide whether their CFC legislation as currently drafted meets the criteria set out by the ECJ judgment.

Another recent case, *Thin Capitalization GLO*[7] is a further example of a mixed judgment. The case was brought against the UK thin capitalization rules (before the changes introduced following Lankhorst-Hohorst) and the ECJ judgment was handed down in March 2007.

Like the Cadbury-Schweppes case, the *Thin Capitalization* judgment represented a small victory for taxpayers. The Court held that a national measure restricting freedom of establishment may be justified where it specifically targets "wholly artificial arrangements," which do not reflect economic reality and which attempt to escape tax.

The ECJ held specifically that thin capitalization rules were precluded by the EC Treaty's freedom of establishment principle unless:

- the legislation provided for the consideration of objective and verifiable elements making it possible to identify the existence of a purely artificial arrangement entered into only for tax reasons, and also allowing taxpayers to produce, without undue administrative constraints, evidence as to the commercial justification for the transaction in question;
- where it is established that a purely artificial arrangement exists, the relevant legislation must treat interest as a distribution only in so far as it exceeds what would have been agreed upon at arm's-length.

It was left for UK Courts to determine whether the UK rules satisfy these criteria. Therefore, there are still elements of uncertainty relating to the judgment, and its application to specific situations.

The ECJ also dealt with claims by non-EU parents, whether lending directly or via an EU (non-UK) subsidiary, and found that there was no EC Treaty remedy where an EU (non-UK) company did not exercise a definite influence over a UK-resident borrowing company. Claims by non-EU parent companies will therefore have to be pursued in the domestic (UK) courts based on the non-discrimination article of the appropriate Double Tax Treaty (rather than the EU Treaty).

A judgment with wider implications?

Another case that may have an impact on EU tax planning is the *Halifax*[8] case, an indirect tax case that is leading to much debate in the area of direct taxation. Halifax had used a scheme to recover UK VAT and acknowledged that the purpose of the scheme was VAT avoidance. The ECJ upheld UK Customs' refusal to refund VAT to Halifax on the basis of the artificial nature of the scheme. UK Customs is already using the decision to reject transactions which apparently lack a commercial purpose.

The decision confirms that the "abuse of rights" principle may apply in VAT cases. This is a doctrine which prevents reliance on a particular piece of legislation in order to artificially obtain a financial advantage if this result is contrary to the purpose of the legislation in question. Halifax confirmed that the application of "abuse of rights" is restricted to situations where two conditions are met—first, that the tax advantage is sought for a purpose contrary to the intent of the

legislative provisions, and second, that there is no commercial justification for the transaction.

There is currently debate among tax practitioners concerning whether the abuse of law principle can be extended to direct taxation. It is perhaps unlikely that the UK Courts would be prepared to radically change their approach in direct tax cases. Halifax was an indirect case concerning VAT, which is governed by EU directives. The UK Courts already have a well-established approach to how direct tax provisions, which are contained in domestic legislation, are to be interpreted and applied, and this approach has been reaffirmed in a number of recent House of Lords decisions (*Barclays*[9] and *SPI*[10] etc).

It is clear that more decisions will be needed before the scope of the abuse of rights doctrine becomes clarified, particularly with respect to its application to direct taxes. Taxpayers will however be able to draw some comfort from the statements in the *Halifax* case that abuse of rights can only apply where the "essential aim of the transactions concerned is to obtain a tax advantage", and "the prohibition of abuse is not relevant where the economic activity carried out may have some explanation other than the mere attainment of tax advantages."

A common consolidated corporate tax base– the future of the EU taxation system?

Thereare clear indications that the EU is moving towards a more integrated system with potentially fewer opportunities for Member States to influence their domestic tax legislation. One specific example is the proposal for a Common Consolidated Corporate Tax Base ("CCCTB"). This system would provide a common legal basis for the computation of profits, such that multinationals could be taxed on a "European basis" with a prescribed method for the allocation of calculated profits to each Member State in which the enterprise has operations.

In 2001, the CCCTB was first proposed as a possible system of taxation in Europe. Then, in 2003, the EC decided to make it the only realistically viable option to eliminating fiscal obstacles to operating in more than one State.

Laszlo Kovacs, the EU Commissioner responsible for taxation, recently stated that he expects the CCCTB could be implemented in 2011. He has also expressed the view that this should be the first priority of the Commission in the tax field and a priority for 2007 such that the topic is expected to gain in prominence over the coming months. These indications would suggest that real developments might be expected over the next 6 months.

However, given current opposition by certain Member States, including the UK and Ireland, special action may be required by the Commission. This would likely take the form of an "enhanced cooperation" procedure to actually secure the required qualified majority vote. Eight Member States would need to support CCCTB, and this procedure would effectively override the right of veto given to Member States in matters of taxation. The CCCTB would then be adopted by the Member States voting in favor (the other States remaining outside the regime).

Assuming the CCCTB is eventually implemented, it will have significant implications for multinationals operating in the EU and for the Member States themselves. The CCCTB will share the total taxable income of multinationals operating in CCCTB Member States between these Member States according to an allocation method different than the current arm's length principles in operation in these States. The CCTB will therefore redistribute taxable profits between Member States. The allocation method will largely determine to which States the redistribution will swing. The most likely method to be agreed upon appears to be the double sales-weighted three-factor formula, a method well known to many US readers. Such an apportionment would be based on a formula in which sales in participating Member States would be double weighted, then added to factors based on payroll and the value (commonly book value) of real estate, buildings, plant and equipment. This is highly likely to lead to a material redistribution of the CCCTB harmonized tax base in favor of the larger Member States.

Since these States also tend to have the highest corporate income tax rates, the effect of the CCCTB would appear at first sight to drive up tax rates, and the implication would be that adoption by a multinational of the CCCTB may not be advantageous (the regime is likely to be elective with multinationals able to choose whether to adopt CCCTB but any election would be on an "all or nothing" basis).

Conclusion

The impact of EU law on the national tax systems of EU Member States is one of the most significant issues facing multinationals operating within these Member States.

There is considerable change taking place as a result of ECJ judgments and other EU developments, ranging from isolated changes to National systems arising from ECJ judgments to larger, more sweeping, changes such as the introduction of a common consolidated tax base for the EU.

The changes are creating uncertainty for all taxpayers, and it is vital that multinationals operating in the EU continue to monitor changes and the effect those changes may have on their tax profile.

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Footnotes

1 C-324/00—Lankhorst-Hohorst v. FA Steinfurt

2 C-446/03—Marks & Spencer plc v. David Halsey (HM Inspector of Taxes)

3 C-170/05 Denkavit International BV and Sarl Denkavit France (F)–Withholding tax on outbound dividends (paid to NL)

4 C-470/04 N. v. Insp. Belastingsdienst/Grote Ondernemingen

5 C-446/04 Test Claimants in the Franked Investment Income (FII) Group Litigation v. Commissioners of Inland Revenue (UK)

6 C-196/04 Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inl.Rev.

7 C-524/04 Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue (UK) Request from High Court of Justice (England & Wales)

8 C-255/02—Halifax and others v. Commissioners of Customs and Excise (UK)–arrangements exclusively designed to avoid tax

9 Barclays Mercantile Business Finance Ltd v. Mawson [2004] UKHL 51

10 IRC v. Scottish Provident Institution [2004] UKHL 52

Belgium: New tax planning opportunities

Bernard Moens and Gerard Cops

Belgium: New tax planning opportunities

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As today's multinationals become more integrated, they are increasingly seeking tax-effective intra-group financing and treasury platforms. In recent years, many multinationals took advantage of the Belgian coordination center regime, which provided tax benefits for multinationals with group finance centers in Belgium. Under pressure from the European Union, the Belgian coordination center regime is being phased out. However, the new Belgian "notional interest deduction" (NID) has created a viable alternative for multinationals seeking tax-effective finance company arrangements. The benefits of the NID are complemented by other recent Belgian tax changes enacted in order to increase the country's attractiveness for investors. The potential tax advantages of locating finance companies in Belgium are further enhanced by the provisions of the new Belgium-US double tax treaty. In particular, the new Belgium-US treaty, once it enters into force, may create opportunities for tax-effective US-inbound financing. This article describes each of these recent developments.

The NID: A new EU-compliant finance company alternative

Over the last decade, many finance company regimes in Member States of the European Union (EU) ended due to European Commission (EC) initiatives against unlawful state aid and harmful tax competition. One popular finance company regime for multinationals had been the Belgian Coordination Center (BCC) regime. Although the EC initially advised favorably on the compliance of BCC arrangements with EU rules, the EC concluded in 2003 that the BCC provisions constituted unlawful state aid. As a result, the BCC regime will be phased out by the end of 2010.

In response, the new so-called Belgian "Notional Interest Deduction" (NID) was enacted[1]. The NID applies to fiscal years ending on or after December 31, 2006.

The new law allows Belgian tax-resident companies and Belgian branches of non-resident companies an annual tax deduction for the deemed interest expense for equity invested in the Belgian company or branch. The NID is a deduction for tax purposes only; no cash outlay is required.

The NID is based on the concept of a deduction for risk capital. A main goal for introducing the NID was to encourage Belgian companies and branches to finance their investments through equity rather than debt and, therefore, to strengthen their capital structure. The provision was designed to equalize the tax treatment of equity and debt financing, since, while interest paid on debt is normally tax deductible, the cost of capital generally is not.

The NID is applicable to all Belgian tax-resident companies and Belgian branches of non-resident companies, with only few exceptions:

- Belgian Coordination Centers whose license is still running, implying they—as a general rule—are taxable on a limited cost-plus basis;
- So-called reconversion companies;
- Open-ended investment companies, closed-ended investment companies and securitization investment companies who—as a general rule—are only taxable on a limited cost-plus basis;

- Certain co-operative participation companies; and
- Certain shipping companies.

The deduction is available irrespective of a company or branch's activity, size, multinational character, nature or source of income, thereby assuring compliance with EU State Aid rules. Moreover, the benefits of the NID are automatic: the NID is a tax deduction in the Belgian corporate income tax return for which no advance ruling is required.

While the Belgian nominal corporate tax rate is 33.99%, the NID reduces the effective tax burden. The lower the actual return on equity realized, the lower the Belgian effective tax rate:

Return on Equity	4.00%	6.00%	8.00%	10.00%	12.00%	15.00%
NID rate FY07 (3.781%)	3.78%	3.78%	3.78%	3.78%	3.78%	3.78%
Taxable return on equity	0.22%	2.22%	4.22%	6.22%	8.22%	11.22%
Nominal tax rate	33.99%	33.99%	33.99%	33.99%	33.99%	33.99%
Effective Tax Rate†	1.9%	12.6%	17.9%	21.1%	23.3%	25.4%

†Assumption: no assets that need to be deducted from NID base (e.g., investment in shares, net foreign branch assets)

Calculation of the NID

The NID of a Belgium company or branch is calculated by multiplying (1) the NID basis, in essence the company or branch's Belgian GAAP equity, adjusted for certain items, by (2) the NID *rate*, fixed by reference to the 10-year Belgium Government Bond rate.

NID basis (risk capital). The starting point for the NID calculation is the company's equity as determined for Belgian GAAP purposes[2] and as of the last year-end date. Variations during the accounting year will be taken into account. They are deemed to take place on the first day of the month following the month in which they have occurred. In the case of a newly incorporated company, for which no "last year-end date" is available, the basis for calculation of the notional interest deduction for the first financial year will be based on the company's equity as of the incorporation date.

In order to avoid multiple deductions or an artificial increase of the company's equity, the following items are deducted from the Belgian GAAP equity:

- the fiscal net value of the company's own shares held by the company;
- the fiscal net value of financial fixed assets qualifying as "participations and other shares";
- the fiscal net value of so-called Equity-UCITS (i.e., investment companies whose dividends are eligible for the Belgian participation exemption);
- in cases where the company has foreign permanent establishments (PE) in tax treaty countries, the positive difference between the net book value of assets attributable to the foreign PE and the liabilities—other than equity—attributable to the PE;
- in cases where the company has real estate (rights) abroad, the income of which is tax-exempt in Belgium by virtue of a tax treaty, the positive difference between the net book value of that real estate and the liabilities—other than equity—attributable thereto;
- the net book value of tangible fixed assets of which costs unreasonably exceed the needs of the company;
- the book value of any other investment that is not acquired to produce regular income;
- the book value of real estate (rights) used by individuals having a director or liquidator mandate in the company or by their relatives;
- revaluation gains in respect of assets, other than the aforementioned assets;
- tax credits for R&D and capital subsidies.

The aforementioned assets must be subtracted from equity because they generate a return that is fully or largely exempt from taxation in Belgium, or because they do not generate any taxable return.

NID rate (risk-free interest rate).The standard NID rate, fixed annually, is equal to the average Belgian 10-year Government bond yield of the calendar year preceding the fiscal year. For small and medium-sized enterprises the standard NID rate is increased by 0.5%.

The annual change of the NID rate is in principle capped at 1% (both upward and downward) and the maximum NID rate is 6.5%. However, the law allows for deviation from the capping rules in certain circumstances.

The NID rate varies; for example, for fiscal years ending on December 31, 2007 the rate is 3.781%, up from 3.442% applicable to fiscal years ending on December 31, 2006, an increase that reflects the increase of the open market interest rate during 2006.

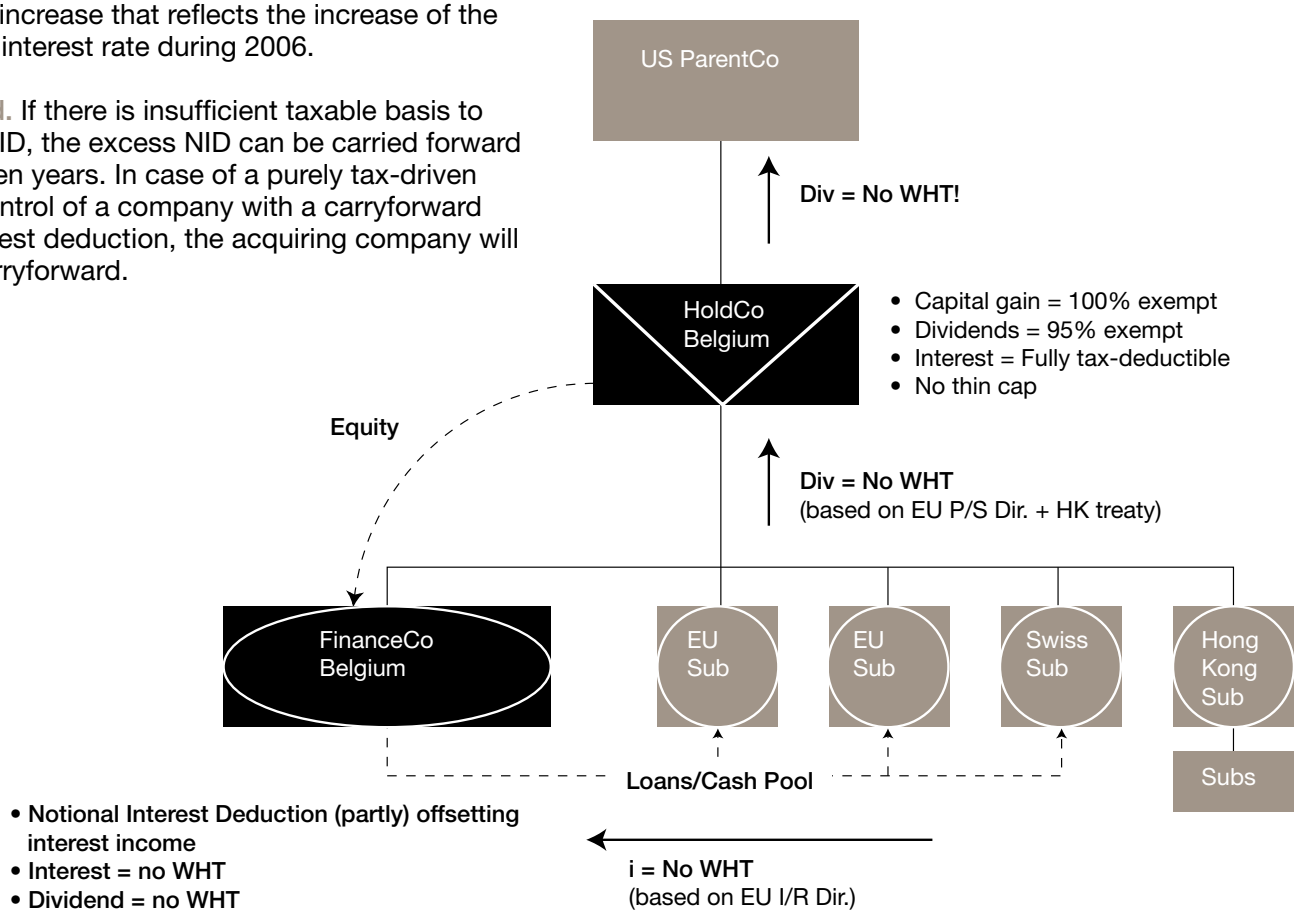
Carryforward. If there is insufficient taxable basis to deduct the NID, the excess NID can be carried forward for up to seven years. In case of a purely tax-driven change of control of a company with a carryforward notional interest deduction, the acquiring company will forfeit the carryforward.

Why locate finance companies in Belgium?

The Belgian notional interest deduction regime permits tax-efficient group financing transactions by allowing interest income of a Belgium-based finance company to be fully or partially offset by the NID, i.e., the deemed interest deduction on invested equity. In addition, due to the recent elimination of the Belgian withholding tax on dividends, discussed below, retained earnings can be distributed as dividends exempt from Belgian taxation.

In effect, the return on equity of a Belgium-based finance company is exempt from taxation up to the level of the NID rate. Any return exceeding the NID rate is effectively taxable at the standard corporate income tax rate.

The diagram below outlines one possible Belgian-based finance company structure:



The NID is particularly effective for finance companies generating a yield that is rather stable and that does not substantially exceed the level of the risk-free interest rate. This is very often the case for intra-group finance companies lending, either on a long-term or short-term basis, to affiliated companies having a solid solvency ratio. Loans to solvent borrowers generally generate a stable but low interest yield.

The NID can also be a very useful attribute for finance and treasury centers that are mainly engaged in short term lending, such as cash pool centers. Historically, the short-term interest rate has been lower than the long-term interest rate, with some exceptions. The NID rate is fixed by reference to a long-term interest rate, in essence the 10-year Belgian government bond rate. Hence, the NID commonly allows companies to substantially reduce the overall tax burden on short-term financing.

The finance center could opt to use a functional currency other than the euro (e.g., USD). It may apply for an advance Belgian tax ruling to exempt foreign exchange gains and interest rate differentials between the functional currency and the euro from taxation in Belgium

On the other hand, the use of a Belgium-based finance company might be less effective for high-yield financing or for engaging in speculative derivatives or multiple-currency transactions. Such activities may generate a return that substantially exceeds the NID.

Each case has to be assessed on the basis of its individual merits.

The new Belgium-US double tax treaty

The United States and Belgium signed a new income tax treaty on November 27, 2006. The new treaty provides for elimination of source-country taxation of qualifying dividends, interest and royalties, subject to a Limitation on Benefits (LoB) provision similar to the LoB provisions included in recent US protocols with other treaty partners.

The new tax treaty will become effective once ratified by both countries; each has expressed its intention to complete the ratification process during 2007. For taxes withheld at the source, the treaty will apply to amounts paid or credited on or after the first day of the second month following the date on which the new treaty enters into force. For other taxes, it will apply for taxable periods beginning on or after the first day of January following the date on which the new treaty enters into force.

The new withholding exemption for dividends. A withholding exemption will be introduced for dividends paid by a company resident in one country to a parent company resident in the other country, subject to the following conditions:

- The US company beneficially owns directly at least 10% of the capital of the Belgian company paying the dividends for a 12-month period ending on the date on which the entitlement to the dividend is determined. Alternatively, the Belgian company, directly or indirectly quoted, beneficially owns directly at least 80% of the voting power of the US company paying the dividends for a 12-month period ending on the date on which the entitlement to the dividend is determined; and
- The beneficiary meets the benefit requirements set out in the treaty's LoB provision.

The new withholding exemption for interest. Particularly interesting from a finance company perspective is the new treaty's elimination of source-country taxation for most interest payments to beneficial owners in the other contracting state. Under the previous Belgium-US treaty, the US was allowed to impose a 15% withholding tax on interest payments. There are few exceptions to the general withholding tax exemption, such as the exception relating to contingent interest.

The exemption from interest withholding tax could provide an opportunity to use Belgium-based finance companies for financing into the US, exempt from US interest withholding tax.

Limitation on benefits. The new treaty includes a LoB provision that is broadly similar to those recently agreed by the US with Germany, Sweden, Finland, Netherlands and other countries. The exemption from withholding tax on interest will apply if one of the following tests is met:

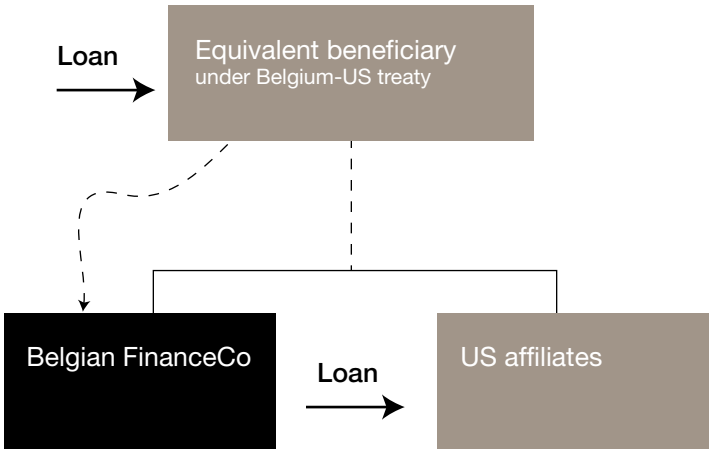
- publicly listed companies test (direct or indirect)
- person other than an individual ("shareholder test")
- derivative benefits test (Belgian company held by less than seven "equivalent beneficiaries" who are resident

in the European Union, the European Economic Area, the members of the North American Free Trade Agreement (NAFTA), or Switzerland)

- active trade or business test
- headquarter companies test
- eligibility by individual ruling

One important feature of the so-called "derivative benefits" test is that a Belgium-based company could qualify for the benefits of the new treaty when at least 95% of both the voting power and the value of the company's shares are held, directly or indirectly, by seven or fewer "equivalent beneficiaries" who are resident in the EU, the European Economic Area, Switzerland or NAFTA countries. To qualify as an equivalent beneficiary, these persons must be entitled to all the benefits of a treaty with the country of source and, furthermore, be entitled to the same or better rate of tax on the income on which the company is seeking benefits. In addition, to benefit from the exemption, any payments which are tax deductible in the residence country of the interest receiving company and which are paid to persons that are not equivalent beneficiaries cannot exceed 50% of the company's gross income. These payments do not include arm's-length payments for services, tangible property, and/or financial obligations to a bank.

Therefore, companies that are privately held or quoted on a recognized stock exchange as defined in the tax treaty, that reside in the EU, the European Economic Area, Switzerland or NAFTA countries and that qualify as "equivalent beneficiaries" under the treaty, may consider Belgium as a potential location for housing an intra-group finance company for the purpose of US-inbound financing:



Other relevant tax developments in Belgium

In recent years, Belgium has enacted several other advantageous tax measures relevant for multinationals with finance companies operating from Belgium:

Elimination of capital duty. Concurrent with the introduction of the NID, Belgium repealed the 0.5% proportional capital duty on contributions to share capital and capital surplus, effective January 1, 2006[3]. Contributions to share capital and capital surplus are now subject only to a fixed duty of €25 (approx. $32).

This new measure allows companies to increase the equity, and thus the NID basis, of Belgium-based (finance) companies without capital duty beyond the small fixed fee. Capital contributions can be made either in cash or in kind (for example, the contribution of intercompany receivables).

Virtual elimination of withholding tax on interest. While the standard interest withholding tax rate for Belgian source interest is 15%, several exemptions from interest withholding tax have existed for many years. However, in recent years, additional withholding tax exemptions have been provided under Belgian tax law. With the addition of these newer exemptions, withholding tax on interest in finance company contexts can often be avoided completely.

One important withholding tax exemption relates to interest paid by "financial companies" to non-resident tax payers[4]. A "financial company" is defined as a Belgian resident company or a Belgian permanent establishment, belonging to a group of affiliated companies, and rendering services of an exclusively or predominantly financial nature only for the benefit of affiliated companies. It must source any debt-funding exclusively from Belgian resident or foreign companies or other legal entities, related or unrelated, with the sole purpose of financing its own transactions or those of the group companies. In addition, it must not own shares of which the investment value exceeds 10% of the fiscal net value of the financial company. Therefore, interest paid by Belgium-based intra-group finance companies or branches is 'de facto' exempt from withholding tax in Belgium.

Another recently enacted withholding exemption applies to interest payments made to non-resident banks[5]. A general withholding tax exemption applies to interest paid by professional investors (basically all resident companies and branches) on loans granted by banks established in the European Economic Area or in a country which has concluded a double tax treaty with Belgium.

Elimination of withholding tax on certain dividend payments. Effective January 1, 2007, Belgium abolished its domestic dividend withholding tax for dividend payments made to certain corporate shareholders resident in a treaty country. This new initiative will allow companies using Belgium as their holding location for investments into Europe to repatriate European profits exempt from dividend withholding taxes[6].

A corporate shareholder resident in any country that has concluded a double tax treaty with Belgium will benefit from this dividend withholding tax exemption by virtue of Belgian domestic tax law (i.e., irrespective of any exemption provided by a treaty). Currently, Belgium has concluded double tax treaties with more than 85 countries.

The following conditions must be met in order to qualify for the exemption:

- The company receiving the dividend must have a participation of at least 15% in the Belgian company during an uninterrupted period of 12 months. This condition can be met retrospectively.
- The company must be subject to corporate tax and must not benefit from a "derogatory tax regime."
- The company must have a legal form similar to the ones enumerated in the EU Parent-Subsidiary Directive.
- Belgium and the country in which the recipient company is established must have concluded a double tax treaty that provides for a sufficient exchange of information clause. No limitation on benefits applies.

This domestic law exemption is potentially more beneficial than the exemption provided by many treaties, since no limitation on benefits applies under the Belgian domestic exemption. In addition, the domestic exemption requires only a 15% participation threshold to qualify for the benefit, which is in many cases more favorable than the thresholds provided by treaties.

Conclusion

As many multinational companies centralize their in-house finance and treasury functions, the Belgian notional interest deduction provides an EU-compliant alternative for housing such function in Belgium. The NID's compliance with EU rules is a valuable attribute in an era where the European Commission is intensifying its battle against selective tax incentives within the EU and, more recently, has been attempting to launch initiatives against harmful tax competition outside the EU borders.

The "de facto" abolishment of capital duty, dividend and interest withholding tax enhances these benefits. The new Belgium-US double tax treaty, once it enters into force, may create incentives to consider a Belgium-based finance company as an alternative for financing US-based affiliates, among other existing alternatives.

Example

Belgian Finance Company

Balance sheet			
Note receivable (interest rate: 4.5%)	1 bio	Equity	1 bio

P&L—Accounting profit			
Operating cost	0.2 mio	Interest income (4.5%)	45.0 mio
		Net profit before tax	44.8 mio

Taxable profit	
Accounting profit	44.8 mio
National interest deduction (Fiscal equity x NID rate (FY07 = 3.781%)	(37.81) mio
Taxable profit	6.99 mio
Corporate tax (Nominal tax rate 33.99%)	2.38 mio
Effective tax rate (FY07)	5.3%

Hypothetical example—Effective tax rate will be dependent on applicable interest rate

Footnotes

[1] The Notional Interest Deduction was enacted by law of 22 June 2005, published in the Belgian Official Gazette on June 30, 2005. The law has been complemented by other laws and Royal Decrees.

[2] Based on Belgian accounting law "equity" includes: share capital, share premiums, revaluation gains, reserves (legal reserve, unavailable reserves, tax exempt reserves and available reserves), retained earnings or losses, and capital investment subsidies.

[3] The law of 22 June 2005, published in the *Belgian Official Gazette* on June 30, 2005.

[4] Royal Decree of May 16, 2003.

[5] Royal Decree of July 3, 2005.

[6] Royal Decree of December 21, 2006.

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IRC Section 987—Let's fix the 1991 Proposed Regulations

L.G. "Chip" Harter and Jeffrey Maddrey

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On September 6, 2006, the IRS and Treasury Department issued much anticipated proposed regulations under Internal Revenue Code Section 987 governing the translation of income of foreign branches and disregarded entities (qualified business units, or QBUs), and the calculation of translation gains and losses with respect to such entities. These proposed regulations (the "2006 Proposed Regulations") take a dramatically different approach from the prior proposed regulations (the "1991 Proposed Regulations") and produce significantly different tax results. Given the widespread use of disregarded entities in international tax planning, the 2006 Proposed Regulations could have a profound impact on the US tax consequences of such structures.

These provisions would significantly increase the complexity and compliance burden of accounting for the income of QBUs. Additionally, the release of Form 8858 and the 2006 Proposed Regulations indicate that the IRS is making Section 987 compliance a higher priority.

This article provides background on Section 987 and the challenges posed by the new proposed regulations so that multinational companies can better understand the issues involved and the need to review their Section 987 planning and compliance.

Overview

The 2006 Proposed Regulations replace prior proposed regulations issued in 1991 (the "1991 Proposed Regulations").[1] The new proposed regulations would adopt a completely different method for the translation of income earned through QBUs that conduct business in a foreign currency[2] (the so-called "foreign exchange exposure pool method") rather than the "profit and loss" method contained in the 1991 Proposed Regulations.

In addition, the 2006 Proposed Regulations would require the owner of every QBU to:

- compute the owner's taxable income from the QBU in the owner's functional currency using the historical exchange rate tax basis for each asset or liability of the QBU;
- annually mark to market the value in the owner's functional currency of the QBU's financial assets and liabilities denominated in the QBU's functional currency, and to maintain a running pool of such "Net Unrecognized Section 987 Gains or Loss" at the QBU level; and
- take into account at the owner level the Net Unrecognized Section 987 Gain or Loss of the QBU as the QBU makes remittances to the owner.

The 2006 Proposed Regulations also include new rules excluding non-portfolio stock and associated debt from the QBU balance sheet as well as areas of clarification from the 1991 Proposed Regulations, including the (1) treatment of "tiered" disregarded entities and (2) the treatment of partnerships and the interaction with Subchapter K.

Concerns with the 2006 Proposed Regulations

According to the Preamble to the 2006 Proposed Regulations, the Treasury and IRS believe it is necessary to abandon the "profit and loss" approach of the 1991 Proposed Regulations to address certain transactions involving the recognition of section 987 losses. A careful examination reveals that the concerns are attributable either to the inclusion of assets in a QBU that do not belong in the QBU as a policy matter or to the fact that the triggers for recognition of section 987 gain or loss are somewhat artificial. These concerns are certainly legitimate.

The new "foreign exchange exposure pool method" of the 2006 Proposed Regulations addresses these concerns but raises others. We have three fundamental concerns with the 2006 Proposed Regulations. First, on a practical level, the regulations would impose significant compliance costs far out of proportion to their benefits. Second, in many situations the regulations would result in the recognition of "flipped" currency items (that is, the recognition of currency gains where there are overall currency losses and currency losses where there are overall currency gains). Third, the proposed regulations are unnecessarily inconsistent with the congressional design and mandate of section 987 and therefore, if adopted in their current form, would be of questionable validity.

We believe that the Service's concerns with the current operation of the profit and loss method of the 1991 Proposed Regulations could be addressed within the framework of the 1991 Proposed Regulations by carefully circumscribing the definition of a QBU and the assets that properly belong in it. Our specific suggestions for such modifications are described below.

The 1991 Proposed Regulations

The 1991 Proposed Regulations provide that a branch or QBU operating in a foreign currency environment must calculate its taxable income in its own foreign functional currency.[3] The taxable income calculated in its functional currency is then translated into dollars, or its owner's currency, using an average exchange rate for the year.[4] The 1991 Proposed Regulations thus would have adopted what is commonly known as a "profit and loss" method of branch translation (as the local-currency profit and loss statement is translated into the owner's currency).

The 1991 Proposed Regulations also provide that foreign currency translation gains or losses with respect to the owner's net equity investment (including retained earnings) in the QBU are recognized as the owner withdraws equity from the QBU, either through "remittances" (partial withdraws of equity) or upon the termination of the QBU.

Mechanically, the tracking of the net investment is done through maintenance of so-called "basis" and "equity" pools. A US owner of a QBU maintains a dollar basis pool representing its cumulative dollar basis in its equity investment in the QBU.[5] The owner also maintains a foreign-currency denominated equity pool, representing the local-currency amount of the owner's investment in the QBU.[6] When the owner withdraws equity from the QBU through a remittance, the remittance is treated as if it were a disposition of part of the owner's investment in the QBU. The owner computes gain or loss attributable to currency fluctuations in the remitted portion of the net equity (referred to as "section 987 gain or loss"). This amount equals the difference between the dollar value of the remittance and an amount of the dollar basis pool that corresponds to the portion of total branch equity represented by the remittance.[7]

The profit and loss method of the 1991 Proposed Regulations closely tracked the statutory language and legislative history of section 987. From an administrability and compliance perspective, the profit and loss method of the 1991 Proposed Regulations was sound. Calculating a QBU's taxable income under the profit and loss method was relatively straight-forward, because this method was generally consistent with the calculation of a QBU's income under both local law and financial accounting principles. This consistency is invaluable, especially when dealing with far-flung operations.

An important feature of the profit and loss method of translation as adopted by the 1991 Proposed Regulations was that the taxable income of a QBU was measured in the QBU's own functional currency and did not currently take into income economic gains and losses attributable to variations in the dollar value of the QBU's currency. Such translation gains or losses were recognized only as equity was remitted from the branch and therefore no longer subject to the risk of future foreign currency fluctuations.

If, for example, a European branch of a US corporation buys and sells inventory in euros, it will earn a mark up in euros. If it buys inventory for €100 then resells the inventory for €110, it will have €10 of income, measured in euros. The total economic income of the QBU's owner, measured in dollars, would also reflect the fact that the dollar value of the euros received on the sale could be different than the dollar value of the euros spent. In our example, if each euro was worth $1.00 on the date the inventory was purchased but $1.10 on the date the inventory was sold, the dollar cost of the inventory would be $100, whereas the dollar value of the sales proceeds would be $121. Although the profit on the sale would be €10 measured in euros, the total economic gain measured from the perspective of the dollar home office would be $21. The $10 difference between the $21 total economic gain and the $11 profit (€10 @ $1.10 per euro) measured in euros is due to the appreciation of the euro capital that is still in the QBU. Under the profit and loss method of accounting as adopted by the 1991 Proposed Regulations, only the $11 value of the profit measured in euros was currently taxed to the owner of the QBU. As long as the €110 continued to be used in the QBU's business and at risk to future currency fluctuations, the taxation of the $10 translation gain was deferred.

IRS and Treasury concerns with the 1991 Proposed Regulations

The Treasury and IRS withdrew the 1991 Proposed Regulations because they were concerned that some taxpayers have been able to report section 987 losses in ways that the IRS and Treasury viewed as inappropriate or abusive. The results the IRS views as inappropriate appear to be driven by two factors. First, under the 1991 Proposed Regulations it was possible to include in the equity base of the QBU assets that are not directly related to earning a revenue stream in the local currency. The less related an asset is to a revenue stream in the local currency, the less likely changes in the dollar-local currency exchange rate are to be reflected in changes in value of the asset. Without a meaningful correlation, the unrealized section 987 gains and losses attributable to the investment in the particular asset may appear unrelated to the overall economics of the investment and therefore may appear uneconomic. Second, under the 1991 Proposed Regulations, the triggers for realization of section 987 gains and losses (remittances and terminations) can vest in the owner broad discretion to "time" the inclusion of section 987 items.

Both of these factors can be at play when a QBU invests in equity of affiliates. The economics of a QBU's investments in stock of subsidiaries may bear little relation to the QBU's functional currency environment. For example, the dollar value of shares in a UK, Swiss, or Hong Kong affiliate held by a Dutch QBU may have little or no relation to the value of the QBU's euro functional currency. Similarly, the value of shares of an affiliate that has assets and operations in a number of functional currency environments may not correlate with the value of any single currency. If the value of an asset such as stock of an affiliate is not affected by the value of a QBU's functional currency, putting the asset into the QBU's equity pool can potentially mismeasure unrealized section 987 gains or losses.

In the case of investments in stock of affiliates, the tax effects of this mismeasurement can be compounded by triggering the unrealized items through a termination of the QBU. One simple way this termination can be accomplished is to check the box to regard the QBU as a corporation. This result appears inappropriate if one compares it to the results that would have been obtained had the owner invested in the affiliates directly and not through a QBU. In this case, no section 987 items would have been recognized upon the contribution of the stock of foreign affiliates to a new foreign corporation. The economic gain or loss on directly held shares attributable to currency fluctuations is recognized only when the shares are sold. If such directly held shares are exchanged for other shares in a corporate reorganization, non-recognition treatment is usually available. Including shares of affiliates in the equity pool of a QBU thus creates a significant discontinuity with the treatment of directly held shares.

The inclusion of mobile personal property in the equity base of a QBU can present similar distortions. The preamble to the 2006 Proposed Regulations states that some taxpayers have also claimed "non-economic" section 987 losses with respect to a QBU's ownership of mobile personal property, such as mining trucks or mobile oil drilling platforms.[8] The analysis of such an example in the preamble states, "The DE has minimal financial assets and conducts no activities other than

mineral extraction … A decline in the value of the Country X currency does not produce any economic loss for US Corp [the owner] because the assets of DE are not financial assets subject to currency fluctuations."[9] The IRS and Treasury appear to assume that currency fluctuations produce economic gains or losses only with respect to financial assets and liabilities of a QBU.

We believe that this assumption is incorrect. Where a QBU's assets are used in an active business conducted in the QBU's local currency, and the business therefore earns a revenue stream denominated in that local currency, the value of the assets is a function of the value of the foreign-currency denominated revenue stream that the assets produce. Stated differently, the owner of a QBU has an economic investment in the equity of the QBU and that equity includes all of the assets used in the active business of the QBU net of the liabilities associated with the business. Where the business of the QBU produces a foreign currency denominated revenue stream, the dollar value of the equity in that business is a function of the value of the foreign currency it earns. Even if the business has no financial assets, its dollar value can fall if the currency in which it earns its revenue depreciates against the dollar.

We can nevertheless imagine circumstances where it would not be appropriate to calculate section 987 gains and losses with respect to mobile equipment such as mining equipment. One such possibility would be where the revenue stream produced by the equipment is denominated in dollars, or the value of which is a function of the value of the dollar. If the mineral extracted is priced in dollars, the value of the extraction business is perhaps more a function of the value of the dollar than the value of the local currency. In this case, the QBU should have the dollar as its functional currency and section 987 should not apply at all.

A second circumstance where computing section 987 translation gains or losses with respect to an investment in mobile equipment might be non-economic is where the equipment is being used by the QBU on only a temporary basis. The equipment could be withdrawn from the QBU and used in a dollar operating environment for the balance of its useful life. The brief presence of the equipment in the QBU would not make its value a function of the value of the local currency. Under the 1991 Proposed Regulations, a fall in the value of a QBU's local currency would reduce the dollar basis of the equipment following its remittance out of the QBU, and would therefore reduce future depreciation deductions. Therefore the distortion is a timing issue. Nevertheless, a brief sojourn of the equipment through a weak currency QBU should not have this effect of accelerating the recovery of the cost of the equipment. We doubt that this type of planning is wide-spread, but if the IRS and Treasury are concerned about it, they could easily craft a rule excluding mobile personal property from a QBU's balance sheet if the property is not expected to spend its entire remaining useful life within the QBU.

A final defect of the 1991 Proposed Regulations has been that taxpayers could easily trigger recognition of section 987 losses opportunistically through circular cash flows or "check the box" incorporations of branches. They have thereby timed significant tax losses based on events that have no commercial effect.

The 2006 Proposed Regulations

The 2006 Proposed Regulations address these concerns by abandoning the profit and loss approach of the 1991 Proposed Regulations altogether. In their place, they adopt an entirely different regime: the so-called "foreign exchange exposure pool method." At their core, the 2006 Proposed Regulations seek to capture more of the economic effect of currency fluctuations on branch operations on a transactional basis, leaving less to be tracked on a pooled basis. If, for example, a QBU purchases and sells an asset in euros, and each euro it receives on the sale is worth more than the corresponding euro spent, that economic gain attributable to the change in value of the euro (as measured in dollars) would be recognized currently under the 2006 Proposed Regulations as additional gain on the sale of the asset. Recall our simple example, above, where the QBU buys inventory for €100, when €1=$1.00, then sells the inventory for €110, when €1=$1.10. Under the approach of the 2006 Proposed Regulations, the entire $21 economic gain would be taxed to the owner of the QBU on the sale. No portion of the gain would be captured by the pooled accounting to be later included upon remittances or terminations. Because the 2006 Proposed Regulations would capture more of the economic gains and losses attributable to foreign currency fluctuations in the tax treatment of the daily operations of a QBU, there

would be less pooled unrealized gain or loss available for taxpayers to manipulate by timing selective remittances or terminations.

The 2006 Proposed Regulations effectively adopt a method of translating income from non-financial transactions that is very close to a separate transaction method of accounting. The 2006 Proposed Regulations would not permit a QBU to calculate its taxable income in its own functional currency. They would instead require that the taxable income from the QBU's activities be calculated at the level of the owner of the QBU.[10] This calculation would be made in the owner's functional currency, which would be the dollar for a US owner. Separate items of income, basis, amount realized, deduction and loss would be translated back into the owner's functional currency on a transaction-by-transaction basis.[11] Each time a QBU bought and sold property, gain on the sale would be calculated in owner's functional currency, rather than in the QBU's functional currency.[12] The basis for each asset sold would be calculated by translating the QBU's local currency cost for that asset into the owner's functional currency at the spot rate for the date that the QBU acquired the asset.[13] The amount realized on each sale would be calculated by translating the QBU's local currency receipt into the owner's functional currency using the average exchange rate for the year of sale.[14] Gain or loss would be calculated in the owner's functional currency in this manner on a separate, transaction-by-transaction basis, for each disposition of each asset or liability that is an "historic section 987 item." Such items would comprise all assets and liabilities of a QBU other than financial assets or liabilities.[15]

The treatment of financial assets and liabilities denominated in the QBU's functional currency would be an exception to this separate transaction method of accounting. The dollar or home office currency value of these items, referred to as "section 987 marked items," would be marked to market at the end of each taxable year.[16] The resulting gain or loss would then be put into a cumulative pool referred to as the owner's "net unrealized section 987 gain or loss."[17] The net unrealized section 987 gain or loss would then be taken into income by the owner on a proportional basis as remittances are made from the QBU.[18] Unlike the 1991 Proposed Regulations, only gains or losses arising from currency fluctuations with respect to financial assets and liabilities would be pooled and recognized on a deferred basis as remittances are made. As described above, gains or losses arising from currency fluctuations with respect to non-financial assets would be recognized on a transactional basis.

Concerns with 2006 Proposed Regulations

We have two fundamental concerns with the operation of the 2006 Proposed Regulations.

The 2006 Proposed Regulations would be extremely difficult to comply with and administer. The primary difficulty arises from the fact that the foreign exchange exposure pool method does not build from the available materials of a local-currency profit and loss statement. Rather, it requires a new and separate set of essentially dollar-denominated books to be kept for each QBU. This loss of congruence with the profit and loss methods generally used to calculate local-currency denominated income under foreign law and financial accounting principles is significant. This difference will increase compliance burdens, distort the effective foreign tax rate on earnings, and produce significant new categories of book-tax differences that would have to be addressed in the financial accounting for income taxes.

A secondary difficulty lies in the structure of the foreign exchange exposure pool method itself. Translating individual items of basis, amount realized, income and deduction back into the dollar (or other home office currency) to calculate taxable income would be dramatically more burdensome and complex than simply calculating the QBU's income for the year in its own functional currency and translating that net income figure into dollars at the average rate for the year. Entirely new accounting systems would need to be put in place to track the dates individual assets were acquired and disposed of, and to match exchange rates to those dates and amounts. The cost of transitioning to and complying with the 2006 Proposed Regulations would be enormous. These issues do not arise under the profit and loss method of accounting embodied in the 1991 Proposed Regulations.

"Flipped" results under 2006 Proposed Regulations

A curious flaw of the foreign exchange exposure pool method is that in many cases it will produce a section 987 gain when there is an overall economic loss attributable to currency fluctuations, and a section 987 loss

when there is an overall economic gain. The phenomenon is driven by the foreign exchange exposure pool method's disparate treatment of financial liabilities (such as local currency borrowings) and non-financial assets. Under the method, financial liabilities are marked annually to determine currency gains and losses while non-financial assets are never marked.

To illustrate, consider a UK QBU which borrows pounds sterling to purchase an office building in London. If the pound appreciates against the dollar, the owner of the QBU would have marked to market losses with respect to the gross amount of the pound sterling mortgage. These losses would be added to the unrealized section 987 gain or loss pool. The dollar value of the office building, however, would likely be appreciating with the pound sterling, given that its value is largely a function of the value of the pound sterling rental streams that it is expected to produce. From an overall economic standpoint, a taxpayer that measures its wealth in dollars and that has net equity in the building (i.e., the value of the building in sterling is greater than the value of the mortgage encumbering it) will be better off in dollar terms as the sterling appreciates; the sterling net equity will be worth more dollars. Under the profit and loss method of the 1991 Proposed Regulations, this owner would have unrealized 987 gain trapped in its basis and equity pools attributable to the increase in value of the sterling in dollar terms. Some or all of this gain would be realized upon a remittance or termination. Under the foreign exchange exposure pool method of the 2006 Proposed Regulations, this same owner would have an unrealized section 987 losses added to its unrealized section 987 pool attributable to the increase in the US dollar value of the sterling-denominated mortgage. Some or all of this loss would be realized upon a remittance or termination.

US dollar owners are likely to view the results produced by the foreign exchange exposure pool method in this example as uneconomic and counterintuitive. As an economic matter, the US owner is going to enjoy a net accretion to wealth attributable to the change in the value of the pounds where the net equity is invested in a pound QBU and the pound appreciated. This taxpayer would expect an unrealized gain, not an unrealized loss. In our view, the result obtained by requiring the taxpayer to mark the gross liability but not the associated asset seems distortive and more "uneconomic" than any result obtained under the 1991 Proposed Regulations.

Of course, the "flipped" results work both ways. If the pound depreciates, the owner of the UK QBU containing a leveraged office building will experience an economic loss but have unrealized section 987 gain. Unfortunately for the fisc, the revenue effects may not be symmetrical given that realization of unrealized section 987 gain or loss items still depends on remittances and terminations, events that often have more tax effect than economic effect and therefore are within the control of a motivated taxpayer.

Our recommendations

We believe the concerns motivating the 2006 Proposed Regulations are legitimate and need to be addressed. As we discussed earlier, the problems with the profit and loss method of the 1991 Proposed Regulations seem to stem from either an overbroad base of assets eligible to be placed in the QBU or the relative ease with which built-in items can be triggered. These problems can easily be addressed within the framework of the 1991 Proposed Regulations. Addressing these concerns within a profit and loss method would have the added benefit of avoiding the issues with the 2006 Proposed Regulations discussed immediately above.

Specifically, we recommend that the Treasury and IRS revise the 1991 Proposed Regulations to incorporate many of the refinements in the 2006 Proposed Regulations and to add the specific rules described below. We believe that the refinements in the 2006 Proposed Regulations to the definition of a QBU, to the rules defining the assets and liabilities properly attributable to a QBU, and to the rules for measuring remittances from QBU are all important improvements. We recommend that they be retained and incorporated into the 1991 Proposed Regulations. We further recommend that the concerns described in the preamble to the 2006 Proposed Regulations be addressed by adding the following rules to the 1991 Proposed Regulations:

- Equity interests in affiliates, and indebtedness incurred to acquire or carry such interests, should not be treated as assets or liabilities of a QBU. This rule would help limit the base on which section 987 gains and losses are calculated to the assets and liabilities used in to the active business of the QBU within the local currency environment. This rule is contained in the 2006 Proposed Regulations and should be incorporated into the 1991 Proposed Regulations.

- Mobile personal property which is not expected to be used within a QBU's active business for the entire useful life of the property should not be treated as an asset of the QBU for purposes of section 987. Debt incurred to acquire or carry such assets should similarly be excluded. This rule would prevent section 987 gains or losses from arising with respect to mobile assets, the values of which are not expected to be affected by the value of the local currency.
- Intangible property, and debt incurred to acquire or carry such property, should not be treated as an asset of a QBU for purposes of section 987 to the extent that the intangible is not used by the QBU in its active trade or business to generate cash flows denominated in the QBU's functional currency. This rule helps limit the base on which section 987 gains and losses are calculated to the assets and liabilities that relate to the active business of the QBU within its functional currency environment.
- On an incorporation of a branch or other QBU, section 987 gain or loss should not be triggered. The amount of the unrealized section 987 gain or loss should instead be reflected in the basis of the shares received in the incorporation. This rule would eliminate a simple method for opportunistically triggering section 987 losses, and would allow necessary corporate restructurings to proceed without triggering section 987 gains. This rule would produce the same result as if the branch assets had always been held by the transferee corporation.

We believe that the concerns described in the preamble to the 2006 Proposed Regulations could thus be effectively addressed within the context of a profit and loss method of branch translation, and without creating unreasonable and unnecessary compliance burdens for taxpayers.

The statute and legislative history require a profit and loss translation method

As discussed above, we believe that there are compelling economic, policy, and compliance considerations which favor the adoption a circumscribed form of the profit and loss method of translation contained in the 1991 Proposed Regulations over the foreign exchange exposure pool method of the 2006 Proposed Regulations. We ultimately believe, however, that the clear statutory language and legislative history of section 987 requires the adoption of such a profit and loss method of accounting.

Functional currency accounting is the foundation of subpart J of the Code, as enacted by the Tax Reform Act of 1986 (the "Act"). The legislative history of the Act recites that the functional currency concept, as well as the profit and loss method of accounting, were based on Financial Accounting Standards Board Statement 52, adopted five years earlier.[19]

Section 985(a) provides that, "Except as otherwise provided in regulations, all determinations under this subtitle shall be made in the taxpayer's functional currency." Section 987 then provides a specific exception to this general rule for taxpayers with QBUs: "In the case of any taxpayer having 1 or more qualified business units with a functional currency other than the dollar, taxable income of such taxpayer shall be determined— (1) *by computing the taxable income or loss for each such unit in its functional currency*, [and] (2) *by translating the income or loss separately computed under paragraph* (1) *at the appropriate exchange rate* … ." (emphasis added).

The legislative history explains that section 987 is a codification of the profit and loss method of branch translation. The Conference Committee Report states:

> A taxpayer with a QBU whose functional currency is a currency other than the US dollar will be required to use the profit and loss method to compute income.
>
> For each taxable year, the taxpayer will compute income or loss separately for each QBU in the unit's functional currency, converting this amount to US dollars at the appropriate exchange rate … .
>
> In general, the appropriate exchange rate will be the weighted average exchange rate for the taxable period over which the income or loss accrued.[20]

The legislative history makes it clear that, under a profit and loss method, Congress intended gains to an owner of a QBU from appreciation of the QBUs functional currency to be taxed to the owner only upon remittance. Referring to foreign QBUs, the 1986 Blue Book states:

> The Congress recognized, however, that there are circumstances in which it is appropriate to measure the results of a US person's foreign operations in a foreign currency so that a taxpayer is not required to recognize exchange gain or loss on currency that is not repatriated but is instead used to pay ordinary and necessary expenses.[21]

Elsewhere the 1986 Blue Book similarly states:

> In certain circumstances, described below, a taxpayer is required to use a foreign currency as the functional currency of a "qualified business unit" (generally a self-contained foreign operation, referred to as a "QBU.") Under these circumstances, income or loss derived from a QBU is determined in a foreign currency (before translation into US dollars). In general, the use of a QBU will result in the deferral of exchange gain or loss from transactions conducted in that currency.[22]

Congress specifically distinguished between separate transaction accounting and a profit and loss method of translation, and required profit and loss translation where the QBU has its own functional currency:

> The Act utilizes the functional currency approach to distinguish between foreign business operations that are eligible to determine income or loss in a foreign currency (before translation into US dollars) and other foreign operations (the income or loss from which must be measured in dollars, transaction-by-transaction.) Under the Act, results recorded in a foreign currency *must* be translated into US dollars under a profit-and-loss method. [23]

The legislative history also explains why Congress chose to apply profit and loss translation to QBUs, rather than a net worth method or the separate transactions method:

> A profit and loss method can be viewed as *being more consistent with the functional currency concept* than a net worth method. Under a profit and loss method, the functional currency is used as a measure of income or loss, so that earnings determined for US tax purposes *bear a close relation to taxable income computed by the foreign jurisdiction*. Further, a profit and loss method minimizes the accounting procedures *that would otherwise be required to make item-by-item translations* under a net worth method.[24]

Congress specifically prohibited the net worth method, involving the comparison of a QBU's opening and ending balance sheets to measure gains or losses attributable to fluctuations in the value of a QBU's functional currency. An exception was made in only one limited circumstance:

> Nonetheless, the Act authorizes regulations to prescribed an approximate separate transactions method that does not accelerate the recognition of exchange gain or loss in limited circumstances.[25]
>
> . . . .
>
> The Secretary's authority to prescribe rules for the election of the US dollar even if books and records are not kept in dollars is limited. This regulatory authority was included to address the concerns of taxpayers operating in hyper-inflationary economies … There is no expectation that this exception will be made generally available to taxpayers who are not operating in hyperinflationary economies.[26]

Faced with this clear and unequivocal requirement in the statutory language and the legislative history of section 987 that a QBU calculate its taxable income in its own functional currency, the 2006 Proposed Regulations would nevertheless prohibit QBU's from calculating taxable income in their own functional currencies. The 2006 Proposed Regulations would instead impose an amalgam of separate transaction accounting and the net worth method. The preamble to the 2006 Proposed Regulations attempts to justify this approach by describing section 987 as "blending the features of both a profit and loss method and a net worth method."[27] This is a tortured characterization, at best. The fact that Congress anticipated that translation gains and losses would be recognized on remittances does not make section 987 resemble a net worth method of accounting. It in no way suggests or justifies a departure from accounting for the income of a QBU in the QBU's own functional currency.

Where an administrative agency is given regulatory authority to modify or provide exceptions to a clearly specified legislative regime, it is a fundamental principle of administrative law that such authority does authorize

regulations which are fundamentally inconsistent with that legislative regime. See, e.g., *MCI Telecommunications Corp. v. AT&T,* 512 US 218 (1994). We believe that the 2006 Proposed Regulations are fundamentally inconsistent with the profit and loss method of branch translation clearly articulated in the statutory language and legislative history of section 987. We therefore believe that the 2006 Proposed Regulations, if adopted in their current form, would be of questionable validity.

Conclusion

The 2006 Proposed Regulations would significantly increase the complexity and compliance burden of accounting for the income of QBUs. These provisions would also result in significantly different amounts of income and translations gains being reported compared with current law. The impact of the 2006 Proposed Regulations on a given QBU would depend on a number of factors, including whether the QBU has a strong or weak functional currency, the degree of leverage in the QBU, and the nature and holding period of its assets and liabilities. Although there are detailed transition rules onto the new regime, the changes could impact pre-existing transactions, given that gains, losses, and depreciation with respect to assets and liabilities acquired or incurred prior to the effective date would, following the effective date, be computed based on historical exchange rates.

Many taxpayers have not yet fully implemented section 987 accounting for their QBUs. The transition rules under the 2006 Proposed Regulations are potentially harsher on taxpayers who have not implemented a reasonable method of section 987 accounting for their QBUs for all years open as of the effective date of final regulations. Taxpayers may also find it beneficial to consider certain refinancings of their QBU's in anticipation of the effective date of final regulations to avoid adverse impacts under the transition rules.

Taxpayers would be well advised to review their Section 987 planning and compliance in light of the new 2006 Proposed Regulations.

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Footnotes

[1] REG-208270-86 (September 25, 1991).

[2] REG-208270-86 (September 7, 2006).

[3] Prop. Treas. Reg. § 1.987-1(b) (1991).

[4] Prop. Treas. Reg. § 1.987-1(b)(1)(iii) (1991).

[5] Prop. Treas. Reg. § 1.987-2(c)(2) (1991).

[6] Prop. Treas. Reg. § 1.987-2(c)(1) (1991).

[7] Prop. Treas. Reg. § 1.987-2(d) (1991).

[8] REG-208270-86, pp. 13-15 (September 7, 2006).

[9] REG-208270-86, p. 14 (September 7, 2006).

[10] Prop. Treas. Reg. § 1.987-3 (2006).

[11] Prop. Treas. Reg. § 1.987-3(a)(1)(ii) (2006).

[12] Prop. Treas. Reg. § 1.987-3(b)(2)(ii) (2006).

[13] Prop. Treas. Reg. § 1.987-3(b)(2)(ii)(B) (2006).

[14] Prop. Treas. Reg. § 1.987-3(b)(2)(i)(A) (2006).

[15] Prop. Treas. Reg. § 1.987-1(e) (2006).

[16] Prop. Treas. Reg. § 1.987-4(d) (2006). This mark would be accomplished under a seven step method of comparing the values of beginning and ending balance sheets measured in the owner's functional currency.

[17] Prop. Treas. Reg. § 1.987-4(b) (2006).

[18] Prop. Treas. Reg. § 1.987-5 (2006).

[19] General Explanation of the Tax Reform Act of 1986 Prepared by the Staff of the Joint Committee on Taxation (the "1986 Blue Book"), p. 1086 n. 36 (1987).

[20] Conference Report to Accompany H.R. 3838 (the "Conference Report"), vol. II, p. 672 (1986).

[21] 1986 Blue Book, p. 1086.

[22] 1986 Blue Book, p. 1092.

[23] 1986 Blue Book, p. 1089 (emphasis added).

[24] 1986 Blue Book, p. 1090 (emphasis added).

[25] 1986 Blue Book, p. 1090.

[26] 1986 Blue Book, p. 1095.

[27] REG-208270-86, p. 9 (September 7, 2006).

The “substantial assistance” rules under Notice 2007-13: An evolution in Subpart F planning for cross-border services

Timothy F. Anson, Carl Dubert, and Matthew Chen

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On January 9, 2007, the IRS and the Treasury Department issued Notice 2007-13, and in so doing, announced a major relaxation in the subpart F rules governing certain income from services. The notice deals principally with the "substantial assistance" provisions in the foreign base company services income (FBCSvI) rules and is effective for taxable years of controlled foreign corporations (CFCs) beginning on or after January 1, 2007.[1] Until the issuance of Notice 2007-13, substantial assistance rules remained virtually unaltered for nearly four decades, and have generated considerable interpretive and factual challenges for companies and the IRS alike.

Before issuance of Notice 2007-13, if a CFC provided services outside the country of its incorporation to a third-party customer, it could be deemed to generate foreign base company services income (FBCSvI) to the extent that it received substantial assistance from any related person (as defined under section 954(d)(3)), US or foreign, in providing that service. Such FBCSvI triggers currently taxable income to the CFC's United States shareholders, even in the absence of dividend payments from the CFC to those shareholders. In some respects, Notice 2007-13 offers taxpayers significant relief by narrowing the types of activities that can give rise to substantial assistance. As discussed below, however, in certain other respects the notice can be seen as broadening the reach of substantial assistance provisions.

This article provides an overview of the FBCSvI rules, with an emphasis on the substantial assistance provisions, summarizes the key changes made by Notice 2007-13, analyzes in detail the examples contained in the notice, and reviews certain open issues and planning considerations.

An overview of FBCSvI rules

Section 954(e) defines "foreign base company services income" as income of a CFC that is derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services, if it is performed "for or on behalf of" any related person and is performed outside of the CFC's country of incorporation.[2] For this purpose, "related person" is defined to mean a person that is related to the CFC by direct, indirect, or common ownership of greater than 50% stock voting power or beneficial interest.

In order for a CFC's income to be treated as FBCSvI, the income must be derived from services that are performed by the CFC "for or on behalf of a related person" and performed outside of its country of incorporation. For this purpose, the regulations provide four specific cases in which a CFC is treated as performing services "for or on behalf of a related person":

1. CFC performs services and is paid or reimbursed by a related person;[3]

2. CFC performs services that a related person is, or has been, obligated to perform;[4]
3. CFC performs services related to property sold by a related person, and the performance of such services constitutes a condition or material term of the sale;[5] or
4. CFC receives "substantial assistance" from a related person or persons.[6]

Notice 2007-13 deals principally with the "substantial assistance" rule. Under this rule, a CFC is treated as performing services for or on behalf of a related person, even if it is performing services directly for an unrelated customer, when "substantial assistance" contributing to the performance of the CFC's services has been furnished by certain related person or persons.

"Substantial assistance" under the 1968 regulations

Before Notice 2007-13, the rules governing "substantial assistance" were provided in a set of regulations finalized in 1968 (the "1968 regulations").[7]

Though the new regulations to be issued in accordance with Notice 2007-13 will supersede the 1968 regulations, the changes announced by the Notice can best be appreciated in comparison to the existing framework of rules.

The 1968 regulations provided specific rules for two categories of assistance. The first category comprises "direction, supervision, services, know-how," and the second comprises "financial assistance (other than contributions to capital), and equipment, material, or supplies." Each of the two categories of assistance is described below. The 1968 regulations apply different tests to each category of assistance for determining whether it is "substantial." Under Notice 2007-13, the same mechanical test applies for both categories.

Direction, Supervision, Services and Know-How. Under the 1968 regulations, a related person's provision of direction, supervision, services, or know-how is tested for "substantial assistance" only if it assists the CFC "directly."[8] According to a technical memorandum accompanying the 1968 regulations (the "1968 Technical Memorandum"), a related person's assistance is considered "substantial" under this test only if the assistance "contributes directly to the performance of the services" performed by the CFC, meaning that the assistance has provided the CFC with "essential facilities necessary" to its performance of such services and without which such services cannot be performed.[9]

If the related person's direction, supervision, services, or know-how assists the CFC "directly," then the related person assistance is considered "substantial" if it satisfies one of two tests. First, under a subjective "principal element" test, the assistance is considered "substantial" if it provides the CFC with "skills" that constitute a "principal element" in "producing the income" from the CFC's services. Second, under an objective test, the related person's direction, supervision, services, or know-how is considered "substantial" if the cost of the assistance furnished by the related person equals 50% or more of the CFC's cost of performing the services in question. For purposes of applying this 50% cost test, the cost of a related person's assistance is taken into account whether or not such assistance provides "skill" that satisfies the "principal element" test, discussed above;[10] provided, however, that the related person assists the CFC "directly."[11]

Financial assistance (other than contributions to capital), and equipment, material, or supplies. A different test of substantiality applies with respect to financial assistance, equipment, material, and supplies. First, the 1968 regulations contained an "arm's-length safe harbor," under which financial assistance (other than contributions to capital), equipment, materials, or supplies provided by a related person is considered "assistance" to a CFC only to the extent the arm's-length charge for the assistance exceeds the amount that is actually paid by the CFC.[12] The amount so considered "assistance" after applying the arm's-length safe harbor is compared with profits that the CFC derives from the performance of its services to determine whether or not the CFC has received "substantial" assistance. In other words, under the 1968 regulations, only the amount that is considered "assistance" after applying the arm's-length safe harbor is tested for "substantial" assistance.

As discussed below, although Notice 2007-13 does not highlight this change, it appears to have rendered this arm's-length safe harbor obsolete, on a prospective basis, for purposes of testing substantial assistance.

A new approach—why now?

The mere fact that a CFC receives "substantial assistance" from a related person does not, before or after Notice 2007-13, automatically cause its service income to be treated as FBCSvI.[13] The substantial assistance rule merely causes the CFC to be treated as performing services for or on behalf of a related person. In order for a CFC's services income to be treated as FBCSvI, the income must also be treated as derived from services performed outside of the CFC's country of incorporation. Therefore, income derived by a CFC from performing services for or on behalf of a related person is excluded from FBCSvI to the extent the income is attributable to services performed within the CFC's country of incorporation.

The 1968 substantial assistance regulations have engendered significant interpretative challenges and controversies. For example, commentators have pointed out that the definition of FBCSvI under the Code deals with services that a CFC performs for a related person, while the substantial assistance regulations deal with assistance that a related person provides to a CFC.[14] There are also unanswered questions as to whether a CFC and its related person's joint intangible development activities constitute a provision of "assistance" by the related person.[15] Moreover, the principal element test often raised difficult interpretive and factual questions as a result of its inherently subjective nature.[16]

With the growth in global services industries, brought on in significant part by advancements in Internet and telecommunications technologies, multinational companies have increasingly delivered integrated global services not only in serving third-party customers but also in supporting related persons in their delivery of services. As a result, companies have increasingly faced the adverse impact of the FBCSvI rules.

Summary of key provisions in Notice 2007-13

In Notice 2007-13, the IRS and Treasury announced that they will amend the 1968 regulations to limit the kinds of activities that will constitute "substantial assistance" to certain assistance provided, directly or indirectly, to a CFC by a related United States person or persons. In contrast, under the 1968 regulations, substantial assistance may be provided by any related person, US or foreign. Furthermore, for purposes of determining whether the assistance is "substantial," the forthcoming regulations will not only remove the subjective "principal element" test, but also raise the threshold of the objective cost test from 50% to 80%. "Cost" for this purpose is determined after accounting for any section 482 adjustments, a result unchanged by Notice 2007-13.[17] A related person's assistance that is subject to this rule will continue to include, but is not limited to, direction, supervision, services, know-how, financial assistance (other than contributions to capital), equipment, material, and supplies. In contrast to the 1968 regulations, under which different tests of substantiality apply depending on whether assistance is provided in the form of direction and supervision or equipment and supplies, Notice 2007-13 applies the same mechanical cost test to all forms of assistance.

Under the 1968 regulations, a CFC is treated as having received substantial assistance if the cost of direction, supervision, services, or know-how assistance provided to a CFC by any related person exceeds 50% of the CFC's cost of performing the services in question; under Notice 2007-13, a CFC is treated as having received substantial assistance if the cost of all assistance provided, directly or indirectly, by a related US person or persons equals or exceeds 80% of the CFC's cost of performing the services. In applying the 80% cost threshold, costs attributable to all forms of assistance provided by a related US person should be considered, rather than only costs of "services."[18] As an example, in a recent ABA Tax Section meeting, then Treasury International Tax Counsel was quoted as saying that costs of intangible development should be included in the substantial assistance test.[19] It remains to be seen as to whether and how intangible development costs will be addressed in forthcoming regulations.

The Notice states that, since the 1968 regulations were promulgated, the reach of the global economy has expanded substantially, "particularly in the provision of global services."[20] Many US multinationals that provide cross-border services, the notice goes on to observe, support unrelated customer projects using

globally integrated businesses with capabilities in different locations:

> For example, a CFC may contract with an unrelated person to provide installation and subsequent repair services. A related CFC, however, is the foreign corporation that provides the repair services. Although the foreign related CFC that is providing the support services will continue to have foreign base company services income to the extent that it performs those services outside of its country of incorporation, it does not seem appropriate in the current global economy to continue to treat the profits of the CFC contracting to furnish services to the unrelated person as foreign base company services income because of support services provided by a related foreign person.[21]

Although the government no longer deems it appropriate for CFCs that contract directly with unrelated customers to face a substantial assistance problem when they receive assistance from related foreign persons, the notice states that the government "remains concerned about the ability of related United States persons to shift profits offshore to CFCs organized in low tax jurisdictions in cases where the United States person or persons provides so much assistance to the CFC that the CFC cannot be said to be providing services on its own account and thus acting as an independent entity." This policy concern reflects, in significant part, those raised over forty years ago, before Treasury and the IRS issued the 1968 regulations.[22]

The regulations to be issued under the guidance of Notice 2007-13 will apply for taxable years of CFCs beginning on or after January 1, 2007.[23] Until the regulations are issued, taxpayers may rely on the guidance provided in Notice 2007-13.

Dual officers, directors, and employees

Notice 2007-13 states that services performed by the CFC itself are not considered assistance that is provided "indirectly" by a related US person or persons; however, employees, officers or directors of the CFC who are concurrently employees, officers or directors of a related US person ("dual employees") are considered those "solely" of the related US person. Thus, costs attributable to dual employees are counted as costs of the related US person's assistance for purposes of the objective cost test.

Although the notice does not expressly address this issue, assistance provided by individuals who are officers or directors of a US person and a related CFC that assists a second related CFC presumably constitutes assistance provided "indirectly" by the related US person to the second CFC. This result obtains even if those individuals were not employees or officers of the second CFC and the related US person does not provide any assistance directly to the second CFC. Under Notice 2007-13's treatment of dual employees, work performed by dual employees of an assisting CFC and a related US person presumably is treated as work performed exclusively by the related US person and not by the assisting CFC. As a result, their costs may need to be included in the 80% cost test for purposes of determining whether that second CFC has received substantial assistance from the related US person.

Discussion of Notice 2007-13 examples

Notice 2007-13 contains three examples to illustrate the proposed changes to the substantial assistance regulations. The following summarizes the key points specifically made in these examples, provides some initial planning observations and, where appropriate, compares results obtained under the notice with those under the 1968 regulations.

> **Example 1:** USP, a US corporation, wholly owns CFC1 and CFC2, each a foreign corporation. CFC1 enters into a contract with FP, an unrelated foreign person, to design a bridge for FP in Country Y, a foreign country that is not CFC1's country of organization. CFC1 incurs a total of $100x of costs to design the bridge for FP. USP performs supervisory services in Country Y for CFC1 with respect to the contract for which CFC1 pays USP a fee. CFC1 directly performs services related to the performance of that contract that cost CFC1 $15x. CFC2 performs centralized support services related to the performance of that contract in Country X, its country of organization, for which CFC1 pays CFC2 $10x. CFC1 is not treated as receiving substantial assistance in the performance of that contract

because more than 20% of the cost of that contract is attributable to services furnished directly by CFC1 or a related CFC (CFC2).

A comparison of results obtained under the 1968 regulations and Notice 2007-13 on this set of facts may highlight the changes made by the notice. Under the 1968 regulations, the form of related person assistance dictates the substantial assistance test to be applied. Because both CFC2 and USP provide CFC1 with services, the objective 50% cost test and the subjective principal elements test both apply. Under the 1968 regulations, however, these tests are applied if, and only if, CFC2's and USP's assistance to CFC1 is considered to assist CFC1 "directly" in the performance of its services.[24] Assuming this "directly" assist threshold is met, then CFC1 would have been treated as having received substantial assistance because the cost of all related persons' (USP and CFC2) assistance exceeds 50% of CFC1's cost of services. Even if the total cost of USP and CFC2's assistance were less than 50% of CFC1's costs of services, CFC1 could still be considered as having received substantial assistance if USP's "supervisory services" and/or CFC2's "centralized support services" were deemed to provide CFC1 with "skills which are a principal element" in producing CFC1's income.

In contrast, under Notice 2007-13, CFC1 is not treated as receiving substantial assistance because the cost of services provided by CFC1 and CFC2 exceeds 20% of CFC1's total cost of performing the services. CFC2's assistance is no longer considered in determining whether CFC1 has received substantial assistance; in fact, under Notice 2007-13 the cost of CFC2's assistance helps CFC1 to avoid being treated as receiving substantial assistance. This is because the cost of a related foreign person's assistance reduces a related US person's assistance as a percentage of the tested CFC's total cost of services. Under the new rules, whether or not CFC2 and/or USP provide CFC1 with skills that constitute a "principal element" of CFC1's services is irrelevant because the only test of substantiality is the objective cost test.

Example 2: USP, a US corporation, wholly owns CFC1 and CFC2, each a foreign corporation. CFC2 enters into a contract with FP, an unrelated person, to design a bridge in Country Y, a foreign country that is not CFC2's country of organization. With respect to the contract with FP, USP performs services in Country Y for CFC1 in the form of design and technical services for which CFC1 pays USP $85x. CFC1 contracts with CFC2 to provide those services and others to CFC2 for $90x. CFC2 uses those services together with services it performs itself that cost CFC2 $10x to design the bridge for FP. Pursuant to the cost test, USP provides substantial assistance to CFC2 in the performance of its contract for FP because USP indirectly furnishes assistance to CFC2 (through CFC1) that exceeds 80% of the total cost to CFC2 for performing the contract.

Example 2 illustrates that, in determining whether a CFC has received substantial assistance, the cost of a related US person's assistance is tested even if the related US person's assistance is provided (and charged) to the assisting CFC (CFC 1) rather than directly to the tested CFC (CFC2). In other words, it illustrates that a related US person's assistance is considered in the substantial assistance determination whether it is provided "directly or indirectly" to the tested CFC.

Note that the "assisting" CFC (CFC1) is treated as performing services for or on behalf of a related person not only because it performs services for CFC2 but also because it receives "substantial assistance" from USP, the cost of whose assistance appears to have exceeded 80% of CFC1's cost of performing services. Therefore, CFC1's income will be treated as FBCSvI to the extent derived from services performed outside of its country of incorporation.

As in the first example, this example illustrates the continuing importance of the same country exception. Suppose that CFC1 is incorporated under the laws of Country Y, in which the bridge design work in this example is performed, then the FBCSvI issues raised in this example may be addressed by making CFC2 a "check-the-box" disregarded subsidiary of CFC1. Using the facts from Example 2, the cost of related US person's assistance to the combined entity would still be $85x, and the combined entity's total cost of performing services would be $100x. The combined entity would be treated as performing services for or on behalf of a related person because the cost of USP's assistance ($85x) equals or exceeds the combined entity's total cost of services

($100x); however, the entity should not have any subpart F income because its income is derived from services performed within Country Y, its country of incorporation.

Example 2 contemplates CFCs performing a single service project with their US parent. In situations involving multiple service projects, questions may arise regarding the mechanics of applying the substantial assistance test. Suppose that CFC2 in this example performs two separate projects, Project A and Project B. On Project A, CFC2 receives, indirectly through CFC1, assistance from USP the cost of which is $85x. CFC1 and CFC2 directly incur service costs of $15x. CFC2's total cost of delivering Project A is $100x. On Project B, CFC2 receives, indirectly through CFC2, assistance from USP the cost of which is $79x. CFC1 and CFC2 directly incur service costs of $21x. CFC2's total cost of delivering Project B is also $100x. Both projects are performed outside of CFC2's country of incorporation.

If substantial assistance were tested by aggregating the costs of both Projects A and B, the CFC2 would be treated as receiving substantial assistance from USP on both projects because the total cost of the US-related person's assistance is $164, which exceeds 80% of CFC2's total cost of delivering services, $200. As a result, CFC2's income from both Project A and B would be treated as FBCSvI. If, on the other hand, substantial assistance were tested on a project-by-project basis, then while the cost to CFC2 of USP's assistance exceeds 80% of CFC2's cost of performing Project A, the cost of USP's assistance is less than 80% of CFC2's cost of performing Project B. As a result, while CFC2 has earned FBCSvI with respect to Project A, it has no FBCSvI with respect to Project B.[25]

Although Notice 2007-13 does not expressly address the manner of quantifying costs of projects and assistance in situations involving multiple projects or lines of businesses, the project-based or line of business approach, as opposed to an aggregated approach, would seem to be reasonable given that substantial assistance is an inherently factual inquiry, and the nature and extent of related person assistance will tend to vary from project to project, or business to business. It does not seem appropriate for one project, or a line of business, to alter the subpart F consequences achieved under another project or line of business. The IRS has agreed and stated as much in an Industry Specialization Program Coordinated Issue paper.[26] The project-based, or line of business, approach is reasonable and we recommend that Treasury and the IRS specifically adopt this approach when they issue regulations pursuant to Notice 2007-13.

> Example 3: USP, a US corporation, wholly owns CFC1 and CFC2, each a foreign corporation. CFC2 enters into a contract with FP, an unrelated person, to design a bridge in Country Y, a foreign country that is not CFC2's country of organization. With respect to the contract with FP, USP performs services in Country Y for CFC1 in the form of design and technical services for which CFC1 pays USP $60x. CFC1 contracts with CFC2 to provide those services and others to CFC2 for $70x. CFC2 uses those services together with services it performs itself that cost CFC2 $30x to design the bridge for FP. CFC2 is not treated as receiving substantial assistance in the performance of that contract because more than 20% of the cost of that contract is attributable to services furnished directly by CFC2.

This example shows that a CFC may avoid being treated as receiving substantial assistance either by showing that the cost of a related US person's assistance is less than 80% of its total cost of services, or that the cost of services incurred by the CFC itself and related CFCs exceeds 20% of its total cost of services. In this example, CFC2 directly incurs $30x of service cost and pays an additional $70x to CFC1. CFC1's costs include $10x of its direct costs and $60x that it pays to USP. Because costs directly incurred by CFC2 and CFC1, $40x, exceed 20% of the CFC2's total cost of services, CFC2 is not treated as receiving substantial assistance from USP.

As in the first two examples, the "assisting" CFC (CFC1) is treated as performing services for or on behalf of a related person because it is performing services directly for CFC2 and because it most likely has (as in Example 2) received substantial assistance from a related US person due to the magnitude of the cost of USP's assistance relative to CFC1's total costs. The income that CFC1 derives from assisting CFC2 is FBCSvI to the extent attributable to services performed outside of CFC1's country of incorporation.

Potential collateral impact on existing "safe harbors"

As discussed above, the 1968 regulations contain two important safe harbors. Although not expressly stated in the Notice, these two safe harbors appear to have been eliminated as a result of having a single objective cost test, under Notice 2007-13, that applies to all forms of related person assistance.

Under the 1968 regulations, financial assistance (other than contributions to capital), equipment, materials or supplies is treated as "assistance" only to the extent by which the arm's-length charge for such assistance exceeds the amount actually paid by the CFC. The amount so considered "assistance," after applying this arm's-length test, is compared with profits derived by the CFC in determining whether it constitutes "substantial" assistance. Because Notice 2007-13 replaces this profit comparison test with the 80% cost test, one might reasonably conclude that the "arm's-length safe harbor," which was directly tied to the profit comparison test, has been rendered obsolete.

Also, under the 1968 regulations a related person's direction, supervision, services or know-how is tested for substantial assistance under the principal element test and the cost test only if the "directly" assist requirement is met.[27] Because the substantial assistance test under Notice 2007-13 by its terms imposes no qualitative standard on the costs to be taken into account, and the examples in the Notice reach their conclusions without addressing whether such a requirement has been met, one might conclude that the "directly assist" requirement no longer applies. Such a change, however, would lead to added uncertainty in the application of the rules.

The potential adverse impact arising from a removal of the above two "safe harbors" may be illustrated by the following example:

> USP provides assistance to CFC in the form of equipment, the cost of which constitutes 60% of the CFC's total cost of performing its services. The CFC pays an arm's-length charge for the use of the equipment. USP also provides the CFC with certain administrative services, the cost of which constitutes 21% of the CFC's total cost of services. This administrative assistance does not assist the CFC "directly" within the meaning of Treas. Reg. § 1.954-4(b)(2)(ii)(e), though it may have some remote connection to the CFC's customer contract. The CFC receives no other assistance from any related US or foreign person.

Under the 1968 regulations, USP's provision of equipment to CFC is not considered "assistance," much less "substantial" assistance, by reason of the "arm's-length safe harbor." USP's administrative services do not constitute substantial assistance, under either the subjective or the objective test, by reason of the "directly assist" safe harbor. As a result of these two safe harbors, USP's assistance to CFC does not constitute substantial assistance.

But if these safe harbors were removed by Notice 2007-13, the CFC in this example would be treated as having received substantial assistance because the full cost of USP's equipment and the administrative services are included for purposes of the cost test, and that cost exceeds 80% of the CFC's total cost of services. If the new substantial assistance rules were intended to apply in this manner, then Notice 2007-13 in some cases would appear to have significantly expanded the reach of the substantial assistance rules.

Because the Treasury and the IRS did not intend for the substantial assistance rule to apply with respect to equipment for which a CFC has paid an arm's-length charge, and with respect to services that did not assist a CFC "directly" in the performance on its services under the 1968 regulations, query why these forms of assistance should cause a CFC to have a substantial assistance problems under Notice 2007-13. It may be that the IRS and Treasury wish to fully and mechanically capture all related US person's assistance, regardless of whether a CFC has paid an arm's-length price for the assistance and regardless of whether the assistance directly relates to the CFC's customer contracts, as the price for eliminating the subjective test, for raising the threshold of the objective cost test, and for excluding all foreign related party assistance. It may be that the IRS and Treasury chose to repeal the two safe harbors in order to make the new rules simple to administer and to prevent the shifting of profits out of the United States to CFCs that have little or no substance. To the contrary, however, the elimination of the "directly assists" test would add

considerable complexity to the application of the rules due to a blurring of the line as to which costs to include in the cost test. In any case, if the IRS and Treasury intend to eliminate one or both of these safe harbors, clarification is needed in the forthcoming regulations in the form of specific examples and an explanation of the policy reason behind such a change.

Conforming changes to be considered

Notice 2007-13 indicates that, in light of significant expansions in the global economy and integrated service delivery models, the IRS and Treasury no longer consider it appropriate to treat a related foreign person's assistance as substantial assistance. To implement this policy, it would seem appropriate to make certain conforming amendments to other parts of the existing substantial assistance regulations that are not specifically related to the substantiality tests.

For example, a CFC is considered performing services for or on behalf of a related person if it performs services that a related person is or has been obligated to perform.[28] In a globally integrated service model, a CFC may be called upon to perform services under a contract that a related CFC has entered into, as a result of its expertise or efficiencies. As a result of non-tax business reasons, a CFC may also be party to global service contracts along with related US and/or foreign affiliates to deliver services as units in an integrated global business to customers that are also globally situated. Given the policy reasons articulated in the notice, it seems appropriate to amend the regulations so that a CFC's performance on behalf of a foreign affiliate's initial obligation would not be treated as a performance of services for or on behalf of a related person.

Looking ahead—planning for cross-border services

On balance, Notice 2007-13 represents a significant relaxation of the substantial assistance rules. To take advantage of changes made in the notice, US multinationals may wish to align their cross-border service businesses so that CFCs contract directly with unrelated customers rather than subcontracting for a related party. While foreign related party assistance no longer presents a risk of substantial assistance, care should be exercised regarding "dual employees," discussed above, to minimize the risk that the contracting CFC is viewed as being assisted "indirectly" by a related US person. Further, the contracting CFC should have sufficient substance in its country of incorporation rather than subcontracting out all of the service activities to affiliates located in other countries, so as to maintain its ability to rely on the "same country" exception as a defense against having FBCSvI in the event that it enters into a related party transaction by reason other than substantial assistance.[29] Finally, companies should be aware of certain technical issues raised by the notice. In particular, significant questions exist as to the application of certain "safe harbors" that existed under the former substantial assistance regulations.

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Footnotes

[1] Notice 2007-13 also confirms that, notwithstanding the repeal of foreign base company shipping income rules, income that previously was foreign base company shipping income will continue to be foreign base company income to the extent that it falls within the definition of another category thereof. The notice addresses certain other aspects of foreign base company shipping income. These aspects of Notice 2007-13 are beyond the scope of this article.

[2] All section references are to the Internal Revenue Code of 1986, as amended, and Treasury Regulations promulgated thereunder. Section 954(e) has remained in substantially the same form since its enactment in the Revenue Act of 1962. The Senate Finance Committee report states, in relevant part:

> As in the case of sales income, the purpose here is to deny tax deferral where a service subsidiary is separated from manufacturing or similar activities of a related corporation and organized in another country primarily to obtain a lower rate of tax for the services income.

S. Rep. No. 87-1881, *reprinted in* 1962 USC.C.A.N. 3387 (1962). The bill as passed by the House did not contain a similar provision. *See* H. Conf. Rep. No. 87-2508, *reprinted in* 1962 USC.C.A.N. 3752 (1962).

[3] Or is released from an obligation to, or otherwise receives a substantial financial benefit from, that related person. Treas. Reg. § 1.954-4(b)(1)(i).

[4] Treas. Reg. § 1.954-4(b)(1)(ii).

[5] Treas. Reg. § 1.954-4(b)(1)(iii).

[6] Treas. Reg. § 1.954-4(b)(1)(iv).

[7] T.D. 6981, 1968-2 C.B. 314 (November 13, 1968).

[8] Treas. Reg. § 1.954-4(b)(2)(ii)(e).

[9] Technical Memorandum accompanying T.D. 6981, *reprinted in* 1968 WL 19604 (December 5, 1968).

[10] Treas. Reg. § 1.954-4(b)(2)(ii)(b). *See also* 1968 Technical Memorandum ("Unskilled services furnished by a related person or persons are to be taken into account under subdivision (2) of such subparagraph in applying the 50% test if such services contribute directly to the performance of the essential service by the controlled foreign corporation.")

[11] See Treas. Reg. § 1.954-4(b)(2)(ii)(e) ("[a]ssistance furnished [by the related person to the CFC] in the form of direction, supervision, services, or know-how shall not be taken into account under (b) or (d) of this subdivision [referring to the principal element and cost of assistance tests] unless the assistance so furnished assists the [CFC] directly.").

[12] Treas. Reg. § 1.954-4(b)(2)(ii)(c), first sentence, provides:

> Financial assistance (other than contributions to capital), equipment, material, or supplies furnished by a related person to a controlled foreign corporation shall be considered assistance only in that amount by which the consideration actually paid by the controlled foreign corporation for the purchase or use of such item is less than the arm's length charge for such purchase or use.

[13] Although certain language in Notice 2007-13 may be interpreted to mean otherwise. See Notice 2007-13, section 1 (the Treasury and the IRS "will amend Treas. Reg. § 1.954-4(b)(1)(iv) and (b)(2)(ii) and the examples thereunder, which provide that substantial assistance rendered by a related person or persons to a [CFC] is included within the definition of foreign base company services income[.]") This language could be read to mean that a finding of substantial assistance automatically results in FBCSvI, even though substantial assistance merely causes a CFC to be treated as performing services for or on behalf of a related person.

[14] *See*, *e.g.*, Eric T. Laity, *The United States' Response to Tax Havens: The Foreign Base Company Services Income of Controlled Foreign Corporations*, 18 Nw. J. Int'l L. & Bus. 1, 10 (1997) ("At first glance, specifying this relationship between the [CFC] and a related person as one of the types that produces tainted services income looks misguided. The Code calls for the [CFC] to render a service to the related person, and not the reverse.") The fact that the 1968 regulations have remained unchallenged in substantially the same form for almost forty years makes it difficult for taxpayers to successfully challenge their validity today.

[15] *See* Philip D. Morrison, Cost Sharing Intangibles in a Service Business—A Foreign Base Company Services Income Issue That Shouldn't Be, 32 Tax Mgmt Int'l J. 419 (August 8, 2003).

[16] The IRS itself had acknowledged difficulties in applying the substantial assistance rules. *See* IRS Publication 1150, *Tax Havens and Their Use by United States Taxpayers – An Overview*, reprinted in 93 TNT 119-22 (April 1, 1981). In this document, the IRS indicated that the FBCSvI rule "in effect, mandates regulations requiring difficult line drawing. It is unclear what facts and circumstances are necessary for the IRS to assert that substantial assistance has been rendered to [a CFC]."

[17] *Compare* former Treas. Reg. § 1.954-4(b)(2)(ii)(b) and section 2C of Notice 2007-13.

[18] When it was originally issued on January 9, 2007, Notice 2007-13 provided that "the cost test will be satisfied if the cost to the CFC of the *services* furnished by the related United States person equals or exceeds 80% of the total cost to the CFC of performing the services." (Underline added) Notice 2007-13 was later amended to provide that the cost test is satisfied if the cost to the CFC of the *assistance* furnished satisfies the 80% test.

[19] Lisa Nadal, "Cost of Intangibles Included in Subpart F Calculation, Hicks Says," 2007 TNT 14-8 (January 22, 2007).

[20] Notice 2007-13, section 2.B.

[21] Id.

[22] In G.C.M. 38065 (August 24, 1979), references were made to a 1966 internal government memorandum concerning a prior draft of the substantial assistance regulations:

> In drafting this rule, two cases were kept in mind in which it was thought to be desirable to treat the income of the [CFC] as being foreign base company service income. The first of these cases is one in which the US parent renders so much assistance to the foreign company that the foreign company may be treated as not being an independent entity … The second case which was kept in mind in drafting the regulations involves the situation in which the vast bulk of the costs incurred by the [CFC] in rendering services to an unrelated party are not on account of assistance rendered it by its affiliate but that assistance is a sine qua non to the ability of the foreign subsidiary to earn its services income. For example, a famous architect might set up a European company to render architectural services abroad. While any jobs obtained by the controlled foreign corporation would be the result of the reputation of the architect, most of the work on the job would be done by local employees. However, in all cases, the architect would take personal responsibility for the job and it would be the contribution of his services which would be the major factor in the ability of the foreign company to earn income …[Footnote omitted]

[23] Notice 2007-13, section 2.D.

[24] Treas. Reg. § 1.954-4(b)(2)(ii)(e).

[25] This result assumes that CFC2 is not otherwise treated as performing services for or on behalf of a related person under another form of related person transaction, such as performing services that a related person is or has been obligated to perform. See Treas. Reg. § 1.954-4(b)(1)(ii).

[26] *See* IRS Industry Specialization Program Coordinated Issue, Construction/ Real Estate Industry, "Use of IRC 482 and/or Subpart F for Services to CFCs," *reprinted in* 1992 WL 526256 (April 17, 1995) ("The determination of foreign base company services income is made on an item of gross income by item of gross income basis. Thus, the examiner must find substantial assistance with respect to a particular project or contract. *A general finding that related entities rendered substantial assistance to a CFC is inadequate since the substantial assistance may have related entirely to one particular project while other projects were performed by the CFC unassisted*.") (Underline added).

[27] Treas. Reg. § 1.954-4(b)(2)(ii)(e).

[28] Treas. Reg. § 1.954-4(b)(1)(ii).

[29] Because "substantial assistance" is only one of several ways that a CFC can be treated as performing services for or on behalf of a related person, the generally favorable changes announced in Notice 2007-13 have limited application in protecting CFCs from recognizing FBCSvI.

Global supply chain security: The business necessity

By Shannon Luttermoser, Gail Turner, and Domenick Gambardella

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In recent years, there has been an unprecedented global focus on supply chain security. This shift in focus to national and international security is shared by Customs administrations throughout the world, who have adopted a variety of initiatives to ensure secure borders and the flow of trade. While many in the trade community feel that stricter government-imposed security requirements hinder trade efficiency by adding cost and complexity to supply chains, there is a strong argument that these initiatives also provide collateral benefits for businesses that can outweigh the costs of investment in security.

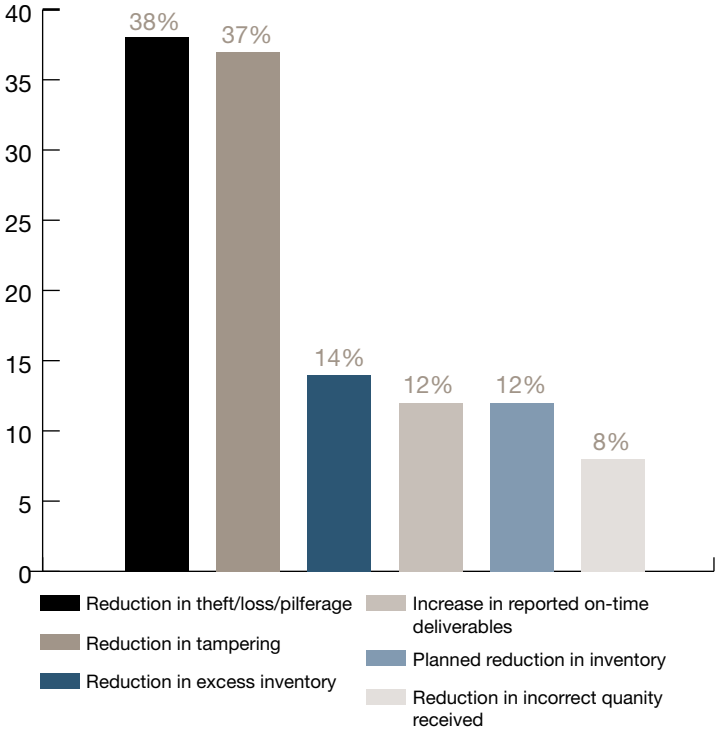
This article explains why businesses can benefit from these programs and provides an overview of some prominent US and global initiatives.

The need for participation in global supply chain security programs

For businesses that depend upon imports, it is essential to prevent supply chain disruption, e.g., following a terrorist attack occurring within the global trade supply chain. And, if the US border closed again as it did after 9/11, those businesses who are active participants in supply chain security programs will be the first ones allowed to start crossing borders again. But at what cost to a business are these supply chain security measures? Are the benefits of these programs worth the resources needed to join and comply?

There have been numerous studies based on risk/benefit analyses to measure the benefits that businesses receive by improving supply chain security. One noted study was the subject of a white paper published by The Manufacturing Institute in July 2006. The results of this study showed that, in addition to the security-related benefits a

Chart 1. Benefits related to inventory management & customer service (Part 1)



company receives by improving its supply chain security, there are other "collateral benefits", such as:

- Higher supply chain visibility;
- Improved supply chain efficiency;
- Increased customer satisfaction;
- Improved inventory management;
- Reduced cycle time and shipping time; and
- Cost savings.[1]

The study looked at eleven manufacturers and three logistics service providers that are considered innovative when it comes to supply chain security. Some of the specific benefits to the manufacturers that were measured included:

- Improved product safety (e.g., 38% reduction in theft/loss/pilferage, 37% reduction in tampering);
- Improved inventory management (e.g., 14% reduction in excess inventory, 12% increase in reported on-time delivery);
- More efficient customs clearance process (e.g., 49% reduction in cargo delays, 48% reduction in cargo inspections/examinations);
- Speed improvements (e.g., 29% reduction in transit time, 28% reduction in delivery time window); and
- Higher customer satisfaction (e.g., 26% reduction in customer attrition and 20% increase in number of new customers).[2]

The benefits described above are displayed in the charts, shown on the prior page and below, from the Manufacturing Institute report.

Chart 2. Benefits related to speed improvements

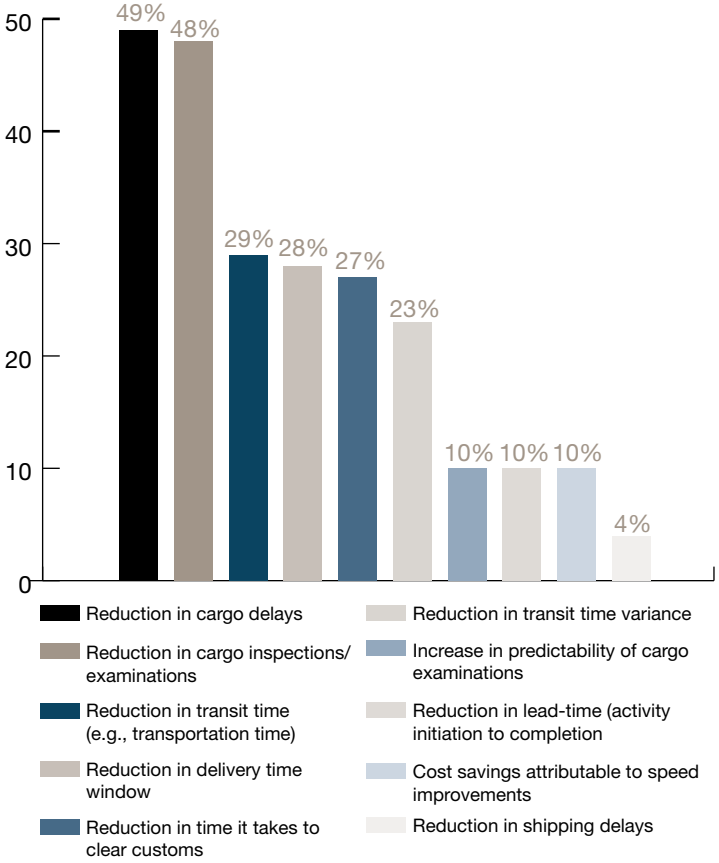
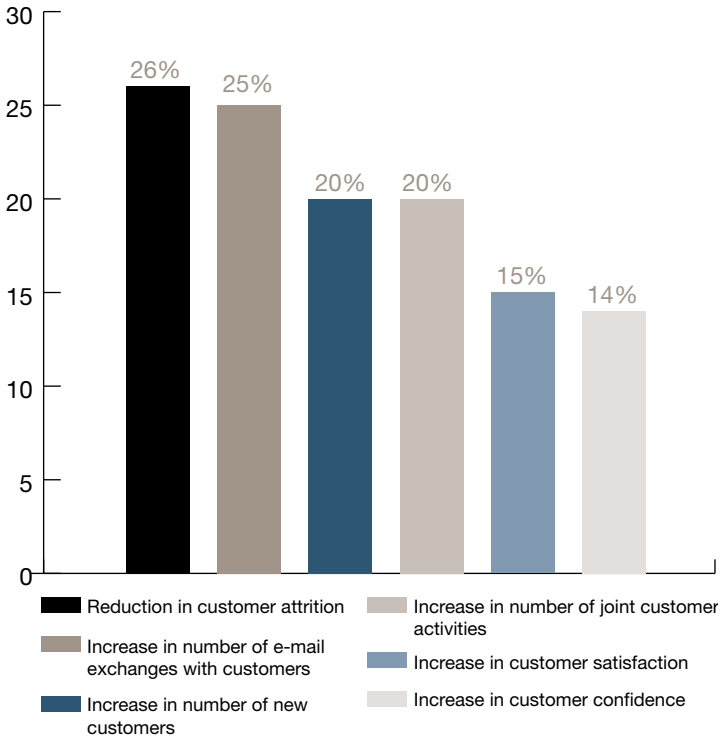


Chart 3. Benefits related to customer relationship



It is worth noting that although all the companies in the study experienced some type of benefit by implementing improved supply chain security, the level of the benefits varied by company. For example, while some of the companies in the study saw their level of cargo inspections drastically drop after joining Customs-Trade Partnership Against Terrorism (C-TPAT) (85–90%), as explained below, others reported only a slight decrease (5–10% reduction). The study also emphasized that benefits are not automatic and businesses should determine which security investments provide the most benefits.

Another publication[3] on supply chain security benefits described how companies may actually experience higher operating costs in a supply chain without sufficient security controls. These costs include higher freight and insurance rates, longer delays in moving goods through global supply chains, the need to abandon Just-in-Time and lean inventory processes to safeguard against unexpected security breaches and trade flow disruptions, and the need to source from higher cost but local suppliers.

Global initiatives

The World Customs Organization (WCO) and its 171 member customs administrations (representing 99% of global trade) adopted the *Framework of Standards to Secure and Facilitate Global Trade* (SAFE Framework) in June 2005. The SAFE Framework grew out of a recognized need for a standard set of requirements to secure and enhance global trade through increased partnership between the Customs and trade communities.

The SAFE Framework, developed using established guidelines from global customs programs, consists of four core elements:

- advanced electronic manifest information;
- a consistent risk management approach;
- at the request of the importing country, the exporting country's Customs administration will conduct an outbound inspection of high-risk cargo; and
- enhanced trade facilitation for legitimate trade that meets certain security standards.

As of January 2007, 144 of the 171 WCO members have expressed their intent to implement the SAFE Framework.

The WCO has also implemented its Columbus Program to assist members in implementing the SAFE Framework. As of February 2007, 60 countries had received diagnostic assessments through this program, and the goal was to perform preliminary assessments on 100 countries by July 2007.

The SAFE Framework incorporates the concept of an Authorized Economic Operator ("AEO"), which includes any party involved in the movement of goods (importers, carriers, brokers, etc.). In June 2006, the WCO council released guidelines for the implementation of AEO programs by national Customs administrations. The guidelines incorporate Customs-identified security standards and best practices, which members of the global trade community aspiring to AEO status are expected to adopt. However, the validation of a business as an AEO, and resulting benefits, is still the responsibility of the respective WCO member's Customs administration. Although the guidelines are the beginning of an internationally recognized set of standards for businesses involved in trade, an international system of mutual recognition of AEO status is still far away.

US supply chain security initiatives

Since 2001, the top priority of the United States Customs and Border Protection Agency (CBP) has been the prevention of terrorists and their weapons from entering the United States.

CBP has adopted several programs and initiatives that are in line with the core principles of the SAFE Framework. C-TPAT is at the forefront of security-related programs in the United States. C-TPAT is a joint government-business initiative designed by CBP to build cooperative relationships that strengthen overall supply chain and border security.

C-TPAT membership, which includes numerous entities involved in the supply chain, such as carriers, importers and brokers, continues to grow rapidly. Since May 2005, CBP has employed a three-tiered benefits structure in which those importers who do more to increase security throughout their supply chain receive greater benefits.

Depending on member category, CBP benefits can include:

- A reduced number of CBP inspections (reduced border delay times).
- Priority processing for CBP inspections. (Front of the Line processing for inspections when possible.)
- Assignment of a C-TPAT Supply Chain Security Specialist (SCSS) who will work with the company to validate and enhance security throughout the company's international supply chain.
- Potential eligibility for CBP Importer Self-Assessment program (ISA) with an emphasis on self-policing, not CBP audits.
- Eligibility to attend C-TPAT supply chain security training seminars.

C-TPAT membership has three membership categories, or "Tiers." Tier One, the lowest level of participation, is granted to those companies whose C-TPAT application has been accepted, i.e., "certified" by the CBP. As of February 2007 there were almost 7,000 certified partners in C-TPAT. Tier Two status is granted to those companies who have undergone validation and whose validation reveals that minimum security criteria have been met. Approximately 4,000 companies have earned Tier Two status. Tier Three status is granted to validated importers whose security measures exceed the minimum criteria and who have also adopted "best practices." C-TPAT members with Tier Three status currently number less than 300.

Approximately 400 partners have had their C-TPAT benefits either suspended or revoked due to non-compliance with C-TPAT requirements. CBP has announced their objective to complete validations for at least 70% of certified participants by the end of 2007. Canadian manufacturers have recently been added to the list of companies who are eligible to apply for membership in C-TPAT, although Canada also has its own security program, Partners in Protection (PIP).

Membership in C-TPAT is a prerequisite to admittance into the Free and Secure Trade ("FAST") program. FAST is a Border Accord Initiative between the United States, Mexico, and Canada designed to ensure security and safety while enhancing the economic prosperity of each country. The FAST program allows approved low-risk participants to receive expedited processing at US land borders, enabling CBP to focus its security efforts on shipments with high or unknown risk. Benefits for those that are accepted into the FAST program include:

- dedicated lanes (where available) for greater speed and efficiency in the clearance of FAST trans-border shipments;
- reduced number of examinations for continued compliance with Customs FAST requirements;
- a strong and ongoing partnership with the Canadian PIP and US C-TPAT administrations.

The Container Security Initiative

Another CBP global trade security program, launched in 2002, is the Container Security Initiative ("CSI"), which is intended to help increase security for containerized cargo shipped to the United States from around the world. Over two hundred million cargo containers move between major seaports each year. The four core elements of CSI are the:

- identification of high-risk containers through the use of automated targeting tools;
- pre-screening and evaluation of containers before they are shipped, generally at the port of departure;
- use of technology to ensure that screenings can be done without interruption to the movement of goods; and
- use of more secure containers, which will allow CBP officials to identify containers that have been tampered with during transit.

As of September 2006, there were 50 operational CSI ports throughout the world, covering approximately 90% of all international cargo imported into the United States. CSI is a reciprocal program, and therefore, offers its participant countries the opportunity to send their customs officers to major US ports to target ocean-going, containerized cargo being exported to their countries. CSI provides a heightened level of security for the global trading community as a whole, and pre-screened US bound cargo receives expedited processing by CBP upon arrival in the US.

Additional US initiatives

As part of the federal government's layered approach to port and container security, the Department of Homeland Security and the Department of Energy announced in December 2006 the first phase of the Secure Freight Initiative (SFI). This initiative is designed to build upon existing risk-based port security measures (e.g., C-TPAT, CSI) to enhance the federal government's ability to better assess the risk of inbound containers through nuclear and radiological scanning technology. The initial phase of the SFI will involve the deployment of sophisticated detection devices to six foreign ports in 2007. Containers will be scanned for risk factors before being allowed to depart for the United States, and data gathered on US-bound containers in the participating foreign ports will be transmitted to CBP officers. This data will be used in conjunction with other available risk assessment information to assist officials in improving risk analysis, targeting and scrutiny of high-risk containers overseas.

Two additional US initiatives are worth noting, both focused on the relationship between advance trade data transmission and supply chain security: e-Manifest requirements for truck carriers and the proposed "10+2" Security Filing.

In compliance with the Trade Act of 2002, which mandates electronic submission of advance cargo information, electronic manifests for truck carriers became mandatory at select ports in January 2007 and will be extended to all land-border ports by the end of the year. Generally, an e-Manifest must be received at least one hour prior to the carrier reaching the US port of arrival. The e-Manifest electronic filing increases efficiency and time savings at the border, and also enables CBP officers to pre-screen shipments and focus on suspicious cargo without delaying border crossings for compliant carriers.

CBP has also been working closely with the Commercial Operations Advisory Committee (COAC)[4] subcommittee in formulating the proposed 10+2 Security Filing (Security Filing) initiative. This initiative will require ten additional data elements from importers and two data sets from ocean carriers 24 hours prior to foreign lading. CBP is planning to implement the Security Filing through a nine to twelve month phase-in period, during which CBP will work closely with members of the trade to identify and address any issues that arise. The current proposal for the Security Filing is focused on ocean cargo only, although CBP plans to expand the requirements to other modes of transport in the near future.

Conclusion

Supply chain security is currently at the forefront of issues faced by the international trade community. As participation in these security programs increases and as more and more companies begin to require that their business partners adhere to the criteria set forth by these programs, the programs will become "mandatory"—perhaps not from a government perspective, but definitely as a prerequisite to doing business in the international trade arena. Investments by businesses in their supply chain security may not increase revenues, but are likely to prevent costs resulting from breaches in security. In addition, businesses investing in these programs can realize the collateral benefits of supply chain security and positively impact their bottom line.

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Footnotes

1 Barchi Peleg-Gillai, Gauri Bhat and Lesley Sept of Stanford University, "Innovators in Supply Chain Security: Better Security Drives Business Value", The Manufacturing Institute white paper, July 2006.

2 Ibid.

3 Hau L. Lee and Seungjin Whang, "Higher Supply Chain Security With Lower Cost: Lessons From Total Quality Management", Stanford University white paper, October 19, 2003, pp. 3-4.

4 The COAC is a 20-member advisory council started in the 1980s that represents importers, carriers, customs brokers and port authorities. Its purpose is to provide advice to the Departments of the Treasury and Homeland Security on trade compliance and facilitation, the securing of the supply chain and other trade and security issues of mutual concern.

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