2013 DEVELOPMENTS IN U.S. INTERNATIONAL TAX

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U.S. international tax is a constantly evolving field, and this was certainly true in 2013. This article highlights several of the developments during the past year.

FOREIGN ACCOUNT TAX COMPLIANCE ACT (FATCA) CONTINUES TO SHAKE THE GLOBE

Provisions of the Internal Revenue Code (Code) commonly known as the Foreign Account Tax Compliance Act (FATCA) became law in March 2010, but many of FATCA's details are still being phased in. One significant aspect of FATCA involves reporting by foreign financial institutions with respect to their U.S. accountholders. Because the U.S. government would have trouble asserting direct jurisdiction over foreign financial institutions with no U.S. operations, FATCA requires, among other things, that persons making payments to a foreign financial institution withhold 30% unless the foreign financial institution has agreed to comply with FATCA's requirements.

If the payor does not withhold as required under FATCA, the payor becomes liable for 100% of the amount that should have been withheld, so it is important that any persons making payments to foreign entities understand their obligations under FATCA.

Governments of many other countries are entering into intergovernmental agreements (IGAs) with the United States. These IGAs require foreign financial institutions to report about their U.S. customers. In many cases, IGAs also require financial institutions in the U.S. to report about foreign customers to the foreign country's government. IGAs have already been signed with a number of countries, including the United Kingdom, Denmark, Mexico, Ireland, Switzerland, Norway, Spain, Germany, France, Costa Rica, and the Cayman Islands, and many other IGAs are underway.

FATCA compliance is still being phased-in. The most significant looming dates are April 25, 2014, which is the date by which many foreign financial institutions will need to be registered with the IRS to avoid withholding, and June 30, 2014, which is the date that FATCA withholding provisions will begin to apply to payments made to foreign entities.

Although it is still too early to predict the precise impact of FATCA, it is assured that this novel piece of legislation will greatly increase financial transparency and tax reporting around the globe.

TRANSFER PRICING CONCERNS HIT THE MIDDLE MARKET

Transfer pricing refers to the price at which affiliated companies transfer goods and services among themselves. When affiliates are located in different taxing jurisdictions, or have different tax attributes, there is opportunity to set prices in a way that will result in lower effective tax rates. Not surprisingly, tax authorities around the globe consider transfer pricing a high priority issue.

Likewise, the U.S. government has become increasingly concerned with transfer pricing. In 2013, transfer pricing was at the front and center of initiatives within the IRS and U.S. Congress. Among other things, senior executives from Apple and other companies were called to testify before the Senate about the structure of, and perceived abuses relating to, international intercompany transactions.

While transfer pricing initiatives may have historically focused on large multinational enterprises like Apple, the IRS is expanding its initiative into the middle market. Specifically, the IRS is stepping-up its transfer pricing efforts with respect to taxpayers with assets of $10 million to $250 million. Furthermore, the IRS has been hiring and training additional staff for transfer pricing audits, and has invested in developing additional enforcement tools, such as enhanced information reporting and more transparent exchange of information.

Middle market businesses, which may have historically "flown under the radar" with respect to transfer pricing issues, will need to review their intercompany relationships and pricing structures to ensure they are compliant with applicable tax rules.

CONTINUING EVOLUTION OF ADVANCE PRICING AGREEMENTS

Advance pricing agreements (APAs) can be important tools for protecting taxpayers with international activity from double taxation. An APA is an agreement between the IRS and a taxpayer as to appropriate transfer pricing of goods and services among a taxpayer and its affiliates. An APA can also be multilateral, involving the U.S. and another country, to ensure consistent pricing for the taxpayer and its affiliates in the U.S. and the other country.

Unfortunately, the IRS has a significant backlog of more than 400 pending APA applications, and it takes an average of nearly three and a half years for the IRS to process an APA. In an effort to improve and streamline the APA processes, the IRS has formed the Advanced Pricing and Mutual Agreement Office, and is undertaking specific training and process improvements to handle requests more quickly and efficiently. As part of its improvements, the IRS released proposed revisions to the procedural guidance for APA applications.

Although the backlog of APA requests may take years to address, it is notable that the IRS has identified the importance of improving this program. Taxpayers with transfer pricing concerns should consider the use of APAs where appropriate to help reduce the risks associated with transfer pricing audits.

SUBPART F PROVISIONS ALLOWED TO EXPIRE

The Code includes a number of temporary provisions that are regularly extended by Congress. (This allows Congress to balance the budget in a magic trick that only Congress and its accountants fully understand!) Two of the temporary provisions that expired at the end of 2013 are particularly important for multinational business and investments. These provisions are part of Subpart F of the Code, and provide important exceptions with respect to "controlled foreign corporations" (CFCs).

By way of background, U.S. shareholders of a CFC are taxed on so-called "Subpart F income" earned by the CFC, regardless of whether it has been distributed as a dividend. Subpart F income includes passive income, like interest, dividends, rents and royalties, as well as certain income where an affiliated party is in the supply chain. In general, Subpart F is intended to capture income that is generated abroad in a manner that might improperly defer or eliminate U.S. taxes – but it is not intended to capture income generated from unrelated third parties with respect to an active foreign business.

With this background in mind, the Code has long included certain exceptions for income such as interest, dividends, rents and royalties. One exception is for such income generated in the active conduct of a banking, financing, or similar business; the other is for such income received by one CFC from a related CFC, which (on a look through basis) is attributable to non-Subpart F income of the related CFC.

These exceptions have been part of the tapestry of Subpart F for a long time and, as a result, have been relied upon by many multinational enterprises in structuring their global operations. Needless to say, enterprises must review their organizational structures to determine the relevance of these exceptions, and closely monitor developments in Congress to understand whether restructuring may be necessary.

SENATOR BAUCUS'S PROPOSAL TO OVERHAUL U.S. INTERNATIONAL TAX RULES

As part of his broad plan for tax reform, Senate Finance Committee Chairman Max Baucus (D-Mont.) has proposed sweeping changes to the Code, with a related overhaul of U.S. international tax policy. The Senator's proposal consists of three main reforms: (1) tax all income of U.S. companies and their subsidiaries immediately or not at all; (2) eliminate tax avoidance techniques; and (3) modernize and simplify the international tax rules.[1] The tax reforms would be packaged together with a reduction in the U.S. corporate income tax rate, in an attempt at making the U.S. system more competitive globally.

Tax all income of U.S. companies and their subsidiaries immediately or not at all

The most significant proposed change would subject income of U.S.-owned companies, regardless of location, to U.S. income tax. As a general matter, the current policy taxes income only when it is brought into the U.S., with exceptions for Subpart F income and other anti-deferral mechanisms. This incentivizes the permanent investment of funds in foreign countries. Baucus proposes to tax all income when it is earned. Passive income, such as investments, royalties, etc., and sales to U.S. customers would be taxed at the full U.S. rates. Sales to foreign customers would be subject to tax at a discounted rate (proposed discounts are between 60% and 80%).

The plan includes a number of provisions to avoid double taxation and encourage voluntary compliance. There would be a full credit for taxes paid to another country, to the extent that the income is subject to U.S. tax, and all foreign income taxed under the plan would be exempt from U.S. taxes when repatriated. Finally, the plan proposes a one-time reduced tax (at approximately 20%) on foreign subsidiary income earned prior to the effective date, which would have an eight-year payment period to encourage repatriation of funds held abroad.

Eliminate avoidance techniques

The plan also proposes to eliminate or revise provisions of the current tax code which may be thought to enable tax avoidance. These proposed changes include:

- Limiting domestic interest deductions where the U.S. company is overleveraged (as compared to foreign affiliate);
- Limiting income shifting through intangible property transfers;
- Repealing the domestic international sales corporation rules; and
- Restoring withholding taxes for foreign employees.

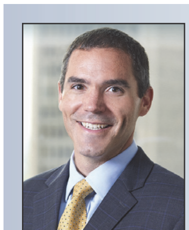
"Modernize and simplify" rules

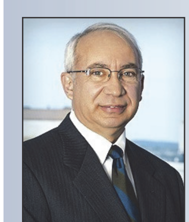
Finally, the plan proposes to update and simplify the Code to reflect changes in the world economy. These proposed changes include:

- Eliminating foreign subsidiary "check-the-box" rules;
- Apportioning interest expenses on worldwide basis; and
- Modernizing taxation of overseas banking and insurance businesses.

Many of the concepts proposed by Senator Baucus have been raised in the past. This plan is revolutionary, not necessarily in terms of its individual provisions, but because of the comprehensive scale of the proposed reforms. To effectuate the suggested changes, virtually the entire Code would need to be revised and many longstanding principles of U.S. tax law would be changed.

At this stage, it is impossible to predict whether this plan will ultimately be enacted as law, but multinational businesses and investors, and their advisors, should be aware of the proposals and the possible impact on business operations and structures.





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[1] On February 6, 2014, the U.S. Senate confirmed the appointment of Senator Baucus as U.S. Ambassador to China. It remains to be seen how this development will impact the progress of the Senator's tax reform initiative.