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Confluence of Factors May Lead to More U.S. Audits of Foreign-Based Multinationals

It is well-known that the U.S. Internal Revenue Service (IRS) recently opened an initiative directed at examining Forms 1120-F (U.S. Income Tax Return of a Foreign Corporation) and detecting non-filing taxpayers with U.S. business activities. This followed a long period in which the IRS had no strategy for dealing with foreign business filers. There are several inter-related factors suggesting that, over the next months and years, the IRS is likely to pay increasing attention to foreign-controlled U.S. corporations, particularly in the transfer pricing area. Here too, U.S. auditors have not been very active.

Indeed, the IRS has had a relatively limited presence in the in-bound space for many years. In the 1980s and 1990s, in contrast, foreign-owned multinational enterprises (MNEs), in particular Japan-based automotive and electronics concerns, were singled out for scrutiny. For the past 10-15 years, however, the IRS has devoted virtually all of its transfer pricing enforcement resources towards examining outbound transfers of intangibles by U.S.-based companies. That focus may be running its course. Traditionally, the IRS seeks to maintain a broad enforcement footprint in order to ensure a credible presence in all sectors. Accordingly, there is reason to believe that the compliance pendulum will swing back in the direction of inbound activity.

Secondly, for many years the inventory of double-tax cases in the U.S. inventory has been heavily tilted towards foreign-initiated adjustments, which may be perceived by the IRS as hampering the U.S. negotiating position in mutual agreement procedures under tax treaties. In recent years, IRS executives have indicated that it would be desirable to re-balance the Mutual Agreement Procedure (MAP) inventory. Recent MAP statistics suggest that the number of U.S.-initiated adjustments is increasing as a percentage of the whole. Nevertheless, it is still less than 20 percent, leaving more room for improvement.

The third factor is the G20's Base Erosion and Profit-Shifting initiative (BEPS). The potential impact of BEPS is quite unpredictable. The U.S. and other developed countries can be expected to promote, officially, a consistent approach to profit allocation among jurisdictions that might lay claim. But if, as many observers anticipate, tax administrators elsewhere seize on BEPS as a reason to arrogate tax base to their jurisdictions, it is possible that the IRS will be tempted to follow suit. For example, the IRS has been willing to conclude Advance Pricing Agreements (APAs) with foreign-controlled low-risk distributors that allow the distributors to report very low operating margins. While these margins may be justified by arm's-length analysis, it is likely that analysis could credibly support higher margins. The authors are aware of at least one case in which the IRS is seeking significantly higher returns to "routine" functions in the context of an APA renewal.

Finally, the Large Business and International division of the IRS, which focuses on the largest corporate taxpayers, is struggling to train its workforce to handle international issues. On the table is an initiative that would provide basic international training to a group of domestic agents and then deploy them on transfer pricing files in the inbound space. This initiative dovetails with objectives described above.

It is, of course, impossible to predict whether, in fact, there will be an increase in compliance efforts by the IRS against foreign-based MNEs. But given the considerations outlined in this note, the risk is significant. That risk, together with the more general, global pressures related to

BEPS, should impel such enterprises to revisit their U.S. trading and pricing arrangements to ensure readiness to respond to questions from the tax authorities.

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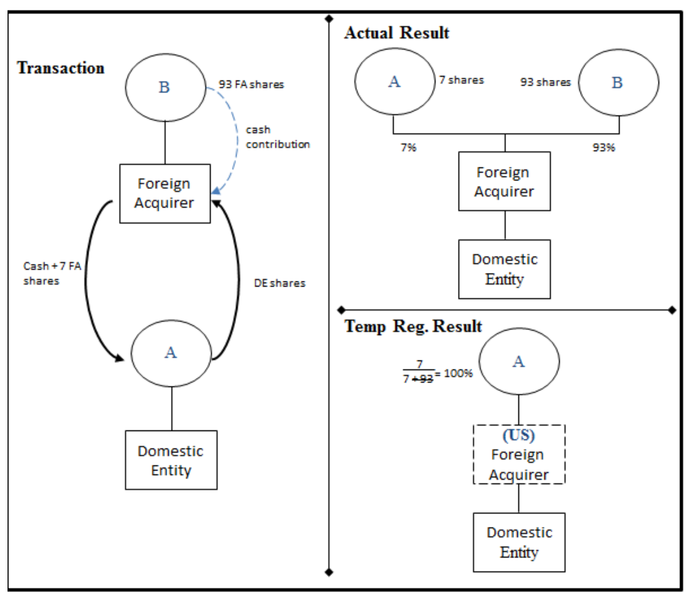
New Traps for the Unwary Under an IRS Inversion Notice—and More to Come

The contours of the Section 7874 anti-inversion legislation, enacted in 2004, are expanding in a manner that not only captures more and more transactions, but also creates significant traps for unwary non-US investors. In general, section 7874 can cause a U.S. target subject of an acquisition to recognize taxable gain on its assets or, worse yet, cause the foreign acquirer to be treated as a U.S. corporation, if pre-acquisition target shareholders end up owning a significant interest in the surviving company.[1] Recently released Notice 2014-52, amending Section 7874 temporary regulations issued in January 2014, broadens the category of transactions subject to Section 7874 by turning what would appear to be an insignificant interest into a significant interest for these purposes.



The Notice builds on existing temporary regulations. Under the existing regulations, certain stock of the surviving corporation is ignored as "disqualified stock" for these purposes if such stock (i) is transferred in exchange for "nonqualified property" — generally passive assets and cash — and (ii) increases the net assets of the foreign acquiring corporation. Consequently, a pre-acquisition target shareholder's continued ownership of the surviving corporation, even if relatively small, may become significant if a large enough portion of the other shareholders acquired their holdings for cash. Consider the following transaction in which investor B contributes cash to a newly formed foreign acquirer corporation (FA) in exchange

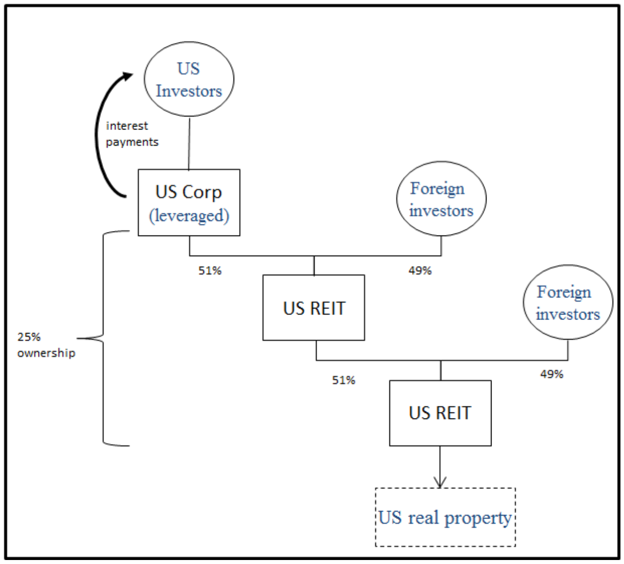
[1] If 60 percent or more by vote or value, but less than 80 percent is held by the former shareholders, the transaction is respected, but the statute imposes a special gain recognition requirement on the expatriated entity for the ten-year period following the acquisition. If the level of ownership continuity is 80 percent or more, the statute deems the foreign acquiring company to be a domestic corporation for all purposes of the Code.

for 93 shares of FA. Thereafter, A, the sole shareholder of the domestic target entity (DE), transfers all of its DE stock to FA for cash and a nominal seven shares of FA stock. The initial cash contribution constitutes nonqualified property and, thus, the FA stock issued in exchange for the cash is "disqualified stock." Therefore A's continued ownership is the only ownership that counts, there is "100 percent" continued ownership, and the acquisition is subject to section 7874. This is true even if A is not a U.S. person! At least under the existing regulations, however, the parties should be on notice of an issue as a result of the significant inflow of cash occurring as part of the transaction.

The Notice further expands the disqualified stock rule to apply even if such passive assets are not contributed as part of the acquisition, but rather if the foreign acquiring corporation simply holds substantial passive assets. The Notice provides that a ratable share of the stock of a foreign corporation which has at least 50 percent passive assets will be disregarded and excluded from the calculation. Thus, in the example above, the acquisition could be an inversion transaction if a predominant portion of the acquiring corporation's value is from passive assets.

Foreign Investors in REITs: Increased Opportunities to Invest in U.S. Real Estate

In contrast to the increasing bite of the inversion rules, real estate investment trusts (REITs) have long been tax-efficient vehicles for foreign investment in U.S. real estate. And recent developments may increase opportunities for new foreign investments through "domestically controlled" REITS, even where less than 50 percent of the ultimate beneficial owners are foreign persons. Interests in a domestically controlled REIT are not subject to the Foreign Investment in Real Property Tax Act (FIRPTA) upon a sale or disposition (in effect, stock gains are free of U.S. income tax). Moreover, based on recent developments, it appears that foreign investors may be able to participate in U.S. REITS with less direct and indirect U.S. beneficial ownership through a two-tiered REIT structure: the lower-tier REIT is domestically controlled by a higher-tier REIT, which is also domestically controlled, resulting in only a 25 percent indirect ownership by U.S. investors. The Senate Finance Committee has recently reconfirmed that such a two-tiered structure may be permissible in its recently introduced FIRPTA reform legislation,[2] providing foreign investors with additional certainty as to the domestic status of a REIT by adding a helpful presumption that a publicly-traded REIT that itself is a domestically controlled REIT would be treated as a U.S. person in whole, even if it did have some foreign shareholders. This is consistent with a prior IRS ruling that a domestic REIT may be considered domestically controlled when the majority of its common shares are held by domestic C-corporations. *See* PLR 200923001 (February 26, 2009). The results can be further enhanced by leveraging the



[2] Joint Committee on Taxation, *Description of the Chairman's Mark of Proposals Relating to the Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs) and the Foreign Investment in Real Property Tax Act (FIRPTA)* (JCX-30-15), February 9, 2015. While this is a critical step in the legislative process, the bill will need to be passed by the House and the Senate, and signed into law by the president before it becomes effective.

U.S. corporation, utilizing the interest deductions against any property gain relating to the domestically controlled REIT. This, in effect, increases the amount of stock foreign investors can beneficially hold while not being subjected to U.S. income tax on gains, and minimizes the income to be recognized by its U.S. co-investors.

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Investment into the United States: Key Tax Considerations

When an Asian company invests in the United States, the U.S. tax consequences depend heavily on the nature and structure of the investment. For example, an Asian investor may enter the U.S. economy by opening a branch, by incorporating a U.S. subsidiary, by acquiring an existing U.S. business or subsidiary, or by entering into a partnership or other joint venture with a U.S. company. Each approach has different income and withholding tax consequences. Many of those consequences are similar to those that follow an investment into any developed country, but a few are not.

For example, whether opening an office in the U.S. creates a taxable presence does not, as in some countries, depend on its legal status as a "branch" versus a "rep office." Outside of the banking industry, a "rep office" enjoys no official status. Whether an Asian investor has a taxable U.S. presence (U.S. trade or business or USTB) depends solely on the activities actually performed in the United States. For example, a U.S. office that services customers or concludes sales is engaged in a USTB, while a U.S. office that engages solely in marketing or purchasing is not.

If the Asian company resides in a country having a tax treaty with the U.S., even sales or customer service activities of an employee or agent will not give rise to a USTB unless the employee or agent works from a "permanent establishment." If there is no treaty, then sales or customer service activity of an employee and even of an independent agent may give rise to a USTB.

Whether or not an Asian manufacturer enjoys the benefits of a U.S. tax treaty, if it expects to conclude sales or pass title within the U.S., the company is best advised to form a U.S. subsidiary that will purchase the products from its parent and sell them to U.S. customers. The buy/sell arrangements can be fashioned to reduce the pricing risk to which the distributor is exposed, thereby limiting its U.S. taxable income to a "stripped-risk distributor" margin.

An Asian company with a U.S. office or agent that conducts a USTB will be taxed on substantially all of its income from U.S. sources and on certain categories of income from foreign sources that are attributable to that office or agency. However, U.S. tax law has two surprising exceptions to this rule. First, if the Asian company is not a dealer in securities or commodities, gain or loss from trading in securities or commodities is exempt from U.S. income tax regardless of the amount of activity. Second, if the U.S. office of an Asian company lends money or licenses intangible property to affiliated companies outside the United States, the interest and royalty payments are exempt from U.S. taxation. These unusual exceptions to an otherwise very inclusive tax regime create many planning opportunities, even in a post-BEPS world.

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Are Tax Information Exchange Initiatives and EU Data Privacy Regulations on a Collision Course?

The scope of automatic exchange for tax information is expanding rapidly, including from non-financial multinational corporations (MNCs), and potentially conflicts with data privacy laws, particularly in the EU.

FATCA was enacted on March 18, 2010, in response to U.S. Government concerns about reports of systematic tax evasion by U.S. individuals with undeclared bank accounts in Switzerland. To address this concern, FATCA requires all “foreign financial institutions” (FFIs) to report certain income and assets held directly or indirectly by U.S. tax-resident individuals.

As of July 1, 2014, FFIs generally were required to enter into an agreement (an “FFI Agreement”) with the IRS to collect information about existing and newly opened accounts beneficially owned by U.S. tax residents or owned by certain foreign entities that have “substantial U.S. owners” and to report information about such individuals and their accounts annually to the IRS. FFIs that do not enter into an FFI Agreement (or otherwise become FATCA-compliant under an “IGA,” as discussed below), or do not qualify for an exemption, generally are subject to withholding at 30 percent on U.S. source investment income.

When FATCA was first enacted, many U.S. trading partners indicated that their FFIs would not cooperate. Local data privacy laws would prohibit the transfer of personal financial information to another government, even if the information sought would be limited to that of U.S. taxpayers. In an effort to address these objections, the U.S. Treasury and the IRS entered into “intergovernmental agreements” (IGAs) with other governments. IGAs generally are bilateral agreements concerning the implementation of FATCA by the other government, typically based on a pre-existing income tax treaty between the U.S. and that other government, or a tax information exchange agreement between the two governments. The U.S. government has concluded over 100 IGAs to date.

Because the IGAs generally examine the activities of each entity to determine if it is an FFI, members of MNC groups may become subject to FATCA obligations even if the group as a whole is not a “financial services” group. For example, a group treasury center that borrows from and lends to group members, or a captive venture capital fund for the group, may meet the definition of an FFI required to report, depending on the nature of its activities and how the IGA partner jurisdiction has defined those terms. MNC group members that are in-scope generally are expected, just like a foreign bank, to register for FATCA and to gather and report information on US accountholders.

The expanding scope of automatic information exchange is not a U.S.-only phenomenon. A case in point is the Common Reporting Standard (CRS), a multilateral version of FATCA developed by the Organisation for Economic Co-operation and Development (OECD) at the urging of the G20 Finance Ministers. Countries adopting the CRS would agree to collect and to exchange automatically, on a multilateral basis, the same types of information required to be gathered under FATCA. CRS borrows many elements of FATCA, including the IGA definitions of FFIs subject to reporting. However, the information gathered under CRS would cover all tax residents of participating countries, not just U.S. taxpayers.

FATCA and CRS continue to raise privacy concerns, not only with respect to the scope of information being collected and disseminated to governments around the world, but also with respect to protections against unauthorized disclosure and misuse of the information transmitted. Concerns such as these have been brought to the attention national tax authorities and supra-national authorities such as the European Commission.

EU law contains strong privacy protections, including Directive 95/46/EC and Article 8 of the European Convention for the Protection of Human Rights and Fundamental Freedoms. The European Court of Justice recently cited these provisions to invalidate an EU Directive and resulting national legislation requiring the retention of communications by internet service providers and others for law enforcement purposes for a period of 6 months. In *Digital Rights Ireland*, C-293/12 & C-594/12 (April 2014), the ECJ found such legislation invalid. Among other reasons offered, the ECJ found that the communications were personal in nature, that the broad scope of data required to be gathered was not proportional to the law-enforcement objectives, and that there was no firm requirement to destroy the data collected.

It is possible that a similar challenge could be brought against countries that adopt the CRS, and on similar grounds. Bank account records are clearly personal information, and the interest of law enforcement in the automatic exchange of such records appears similar to the governmental interest alleged in Digital Rights Ireland. The CRS does not provide direct taxpayer protections, such as the right to inspect and if necessary to correct information before it is shared with other governments, the right to have the information destroyed after a given period of time, or the right to intervene to prevent transmission of the data to jurisdictions where it may be misused against the taxpayer.

EU litigation over the privacy of tax data collected by FFIs, including members of non-financial groups, is not merely of academic interest. Under the proposed EU General Data Protection Regulation, released January 25, 2012, the EU Commission would be authorized to levy fines for certain privacy violations of up to two percent of an entity’s worldwide revenue. Local governments typically would collect tax information under FATCA and the CRS from FFIS and disseminate it to other governments, which should make governments primarily responsible in the event of unauthorized disclosure or misuse of the data. However, it is untested whether the FFIs that collect the information in the first instance would be immunized.

The IRS and OECD are attempting to develop mechanisms, such as the IRS's International Data Exchange Services (IDES) protocol, to protect the privacy of data exchanged pursuant to multilateral exchanges. However, many key issues remain unresolved, such as how governments will monitor each other's data protection practices, how unauthorized disclosure could be traced to its source, and how it would be remedied. Given the broad scope of the data sought to be collected by CRS and FATCA, communication with national and supra-national authorities on protections for taxpayers and data collectors alike remains essential. At this developmental stage of automatic exchange, it should be a priority among stakeholders to ensure appropriate protections for FFIs under FATCA and CRS against privacy violations caused by governments.

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