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Taxpayers that use a check-the-box election to convert an insolvent foreign corporation into a partnership should find to their liking a recent memorandum by the IRS. The memo appears to answer the question of when a buyer can claim basis in an asset that exceeds the asset's value by assuming excess debt. Page 2

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## IRS Memorandum Offers Taxpayer Benefits Relating to Conversions of Insolvent Foreign Corporations into Partnerships

By Michael J. Wilder (McDermott Will & Emery LLP)

**The Internal Revenue Service (IRS) recently issued a Generic Legal Advice Memorandum (GLAM) that should provide beneficial results to certain taxpayers that use a check-the-box election to convert an insolvent foreign corporation into a partnership.**

### Overview

The Internal Revenue Service (IRS) recently issued a Generic Legal Advice Memorandum (GLAM), AM2011-003, that is quite noteworthy. The IRS memorandum addresses a common fact pattern where a check-the-box election is made to convert an insolvent foreign corporation into a partnership. As described below, the GLAM will be of primary significance for taxpayers under audit or in litigation.

Although the GLAM was issued by the Passthroughs and Special Industries Division of the Office of Chief Counsel at the IRS, it appears likely that five divisions at the IRS participated in drafting the GLAM, and that the GLAM was approved by the Chief Counsel. The GLAM thus can be viewed as the current position of the entire IRS with respect to the transaction it addresses.

The GLAM takes on the conceptually challenging issue of how to reconcile fictional tax transactions—deemed liquidations, partnership formations, and debt assumptions—with the common law treatment of actual transactions on which these fictions are modeled (if imperfectly). The IRS should be commended for its willingness to publish its thinking on these difficult questions.

The conclusions reached in the GLAM are interesting and, for the most part, very favorable for taxpayers.

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Moreover, the few conclusions that could be viewed as adverse should not be binding on taxpayers, because the GLAM does not have the force of law.

There are significant questions regarding the extent to which the favorable results described in the GLAM can be relied upon by taxpayers when planning transactions or reporting uncertain tax positions. First, the GLAM does not address a central issue (a debt-equity concern) presented by its facts that would need to be developed

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**The GLAM appears to answer the age-old question of when a buyer can claim basis in an asset in excess of the asset's value by assuming excess recourse or nonrecourse debt.**

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in an actual case. Second, the GLAM's reasoning appears to depart from the IRS's previously stated positions on several prominent issues (including an IRS notice addressing a listed transaction). Third, a GLAM cannot be used or cited as precedent. Finally, the GLAM was not issued in consultation with the Treasury Department, and thus Treasury's views regarding the GLAM are unclear. In short, it may be difficult to issue legal opinions based on the GLAM with respect to some of the GLAM's most important conclusions.

Nonetheless, taxpayers under audit or otherwise before the IRS should be entitled to invoke the GLAM, as it represents the current position of the Chief Counsel. In addition, taxpayers can cite the GLAM as evidence of the IRS's informal views on a variety of issues that may arise in litigation.

Following is a technical analysis of the GLAM, with a focus on corporate tax issues and some discussion of more general tax principles that are implicated by the GLAM.

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# New Generation of Canadian Income Trusts Offers Monetization Opportunity for U.S. Assets

By Ross Bentley, Chad Schneider, Edward Rowe and Carrie Aiken Bereti (Blake, Cassels & Graydon LLP)

In December 2010, Eagle Energy Trust closed its initial public offering (IPO) of trust units in Canada, resulting in the first of a new generation of cross-border income trusts to access the Canadian capital markets. Since then, Parallel Energy Trust completed its IPO in April 2011 and Argent Energy Trust has recently filed a preliminary prospectus for a proposed IPO.

Each of these new trusts owns or will acquire an underlying energy business carried on in the U.S. However, and as discussed in further detail below, there is generally no restriction on other types of U.S. businesses being owned by these income trusts. The suitability of a particular business for these trusts will largely turn on the results of economic modeling based on anticipated deductions in computing U.S. income (i.e., deductions for interest, depreciation, depletion, etc.).

Owners of U.S. domiciled energy or other businesses, including corporations and private-equity funds, as well as dealers and brokers, may find that the new generation of Canadian cross-border income trusts provides an attractive monetization opportunity for stable, long-lived income generating energy and other assets.

This article examines the new generation of cross-border income trusts, highlighting various tax, securities and commercial issues that must be evaluated when considering this structure.

## **Background on First Generation of Income Trusts**

From the time the first Canadian royalty trust, which

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owned producing Canadian oil and gas assets, became a publicly-traded entity in Canada in the late 1980s, the use of the trust model expanded to include publicly-traded trusts owning a wide array of resource and other businesses that were generally carried on principally in Canada. In 2006, in the Canadian oil and gas subsector alone, there were 31 royalty trusts and income funds with a combined market capitalization of over \$83 billion (Canadian).

In simple terms, the first generation of income trusts was structured to flow through all taxable income generated by an underlying business to holders of units

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**The new generation of cross-border trusts can avoid payment of federal income tax provided all income of the trust is distributed to holders of its units in the year.**

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in the trust, resulting in neither the trust nor any of its subsidiaries paying Canadian federal income tax. The holders of such units often received preferential tax treatment on distributions from the trust, and where such units were held by non-taxable entities or in tax-deferred plans, the net result was a complete tax deferral on the income distributed to such holders. These vehicles paid holders of units regular monthly cash distributions on a pre-tax basis thus providing yield-oriented investors with an attractive investment product, particularly over the past decade of relatively low interest rates. Their tax-efficient structures also allowed these trusts to acquire assets on a tax-advantaged basis resulting in a cost of capital that was often more competitive than could be achieved by corporate issuers.

On October 31, 2006, the Minister of Finance (Canada) announced the Canadian federal government's proposal to change the tax treatment of publicly-traded income trusts through the enactment of the SIFT (Specified Investment Flow-Through) rules. The SIFT rules were introduced to level the playing field between publicly-traded income trusts and corporations and eliminated the tax advantages associated with the use of a trust. Essentially, under the SIFT rules, the Canadian-source

*Income Trusts*, continued on page 15

## State Transfer Pricing Traps: Don't Get Caught!

By Nicole Crighton and Brian Trauman (KPMG LLP)

For multinational enterprises, transfer pricing can be a significant issue, with much at stake. Typically, the focus is on the arm's length pricing between two or more countries. Because the starting point for calculating state taxable income in virtually all U.S. states is federal line 28 or 30 of Form 1120, taxpayers frequently assume that if their transfer pricing meets with federal approval, states will follow. However, many taxpayers have learned the hard way that this is not always the case.

Cash-strapped states are increasingly getting more aggressive on audits and transfer pricing has become a much more significant area of focus for state taxing authorities. While there are no clear cut rules for when a state will disregard the existence of a federal transfer pricing study, it is clear that certain states' current practice of hiring outside transfer pricing auditors makes having a robust transfer pricing report even more important.

### State Acceptance of Federal Transfer Pricing Studies

Many states have adopted provisions that mirror or incorporate the principles contained in IRC Section 482,<sup>1</sup> which authorizes the Secretary of the Treasury to "distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among" commonly controlled entities "in order to prevent evasion of taxes or clearly to reflect income."<sup>2</sup> The corollary state provisions often allow state taxing authorities to adjust state taxable income in the name of "clearly reflecting" income attributable to the state or ascertaining the taxpayer's "true earnings."<sup>3</sup>

Recent guidance issued by the New Jersey Division of Taxation reminds taxpayers of the Division's broad authority to make adjustments related to transfer pricing, despite the fact the IRS has either reviewed or confirmed a transfer pricing arrangement.<sup>4</sup> In TAM-17, the Division cites to several statutory and regulatory provisions that, in its view, provide the State "a strong audit tool"—essentially broad authority to make adjustments to a tax return deemed necessary to make a "fair and reasonable" determination of the amount of tax payable under New Jersey law. The Division's regulations define "fair and reasonable tax"

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as "the tax that would have been payable by a taxpayer reporting the same transaction(s) on a separate entity basis where the parties to the transaction(s) had independent economic interests."

The TAM notes in most cases when determining what a "fair and reasonable" tax is, the Division will use Section 482 standards. Thus, when a taxpayer can demonstrate it has met the Section 482 standards, no adjustments are likely to occur above Line 28 on Schedule A. However,

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**There are no clear cut rules for when a state will disregard the existence of a federal transfer pricing study.**

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in the Division's view, the New Jersey statutory and regulatory provisions are also much broader in scope than the federal counterparts. As such, although the Division will, for example, consider the relevance of an Advance Pricing Agreement when examining the "appropriateness of intercompany pricing and the determination of a fair and reasonable tax," it is not bound by the federal determination. Furthermore, the Division is not limited to indices, trade practices, cost sheets, Internal Revenue Reports or any other factor in determining the appropriate transfer price for goods, services, intangibles or other dispositions made to related parties. If the Director determines an adjustment to net income is appropriate, he or she may also make a corresponding adjustment to the allocation factor. The burden falls on each taxpayer to show by "clear and convincing evidence" the tax return reports the "true earnings" of the taxpayer.

The Indiana Department of Revenue recently rejected several taxpayers' arguments that transactions were at arm's length for state tax purposes because the taxpayer had a federal transfer pricing study. In one ruling, the Department of Revenue attempted to address what it deemed "excess" markup by adjusting the taxpayer's Indiana income so that the taxpayer had the same profit margin as the enterprise as a whole.<sup>5</sup> The taxpayer protested this adjustment, relying on its transfer pricing study to justify its pricing and costs structures. However, the Department rejected the reliance on the transfer pricing study, as it was explicitly intended to only address federal tax issues. In yet another recent ruling, the

*Transfer Pricing Traps*, continued on page 5

## Transfer Pricing Traps *(from page 4)*

taxpayer argued that the Department's auditor should have accepted its transfer pricing study because the IRS scrutinized the study and did not make any adjustment.<sup>6</sup> The Department noted once again that the study did not address state tax implications. Furthermore, in the Department's view even if, for the sake of argument, it

### **Taxpayers should not assume that their federal transfer pricing will be sufficient on its own for state purposes.**

agreed that the transfer pricing study set bona fide arm's length rates for the taxpayer's intercompany transactions, under Indiana law, the "analysis does not stop there."<sup>7</sup>

While these examples only address two states, they illustrate that while state law may incorporate IRC Section 482 principles, state taxing authorities are not bound by studies performed for federal tax purposes.

#### **Increased Use of Third Party Auditors**

To take things one step further, state examiners may not have significant transfer pricing or economics experience, and are increasingly relying on outside transfer pricing consultants to conduct the examinations of multistate and multinational enterprises. Notably, in the last few years Louisiana, New Jersey and the District of Columbia have all tapped the services of outside consultants to assist in transfer pricing audits.

States may compensate these consultants, either directly or indirectly, on a contingency basis; that is, the consultants are paid a percentage of any amounts ultimately collected on a transfer pricing adjustment that the transfer pricing consultants proposed. Not surprisingly, certain recent legislative proposals would have allowed or required the use of contingency-fee transfer pricing auditors.

California S.B. 69, as passed by the legislature, would have allowed the Franchise Tax Board to enter into "contingent obligations for vendor services associated with the development of a transfer pricing audit program in an amount not to exceed \$600,000."<sup>8</sup> This bill was vetoed by the Governor.

Minnesota H.F. 904 and S.F. 740 would have required the state to enter into a two-year contract with a third party "to enhance the state's ability to identify and collect tax revenues from taxpayers that are using abusive transfer pricing schemes."<sup>9</sup> The bills were not voted on by either house of the legislature, but it is certainly possible that they could be reintroduced in a future session.

Regardless of how auditors are compensated, the

techniques they utilize have been the subject of much debate. For example, a certain firm hired to perform transfer pricing audits uses a patented software process that compares a taxpayer's information with that of taxpayers in related industries. However, the firm purportedly uses only publicly available information, rather than examining a taxpayer's own books and records.<sup>10</sup> It has been reported that the firm not only performs taxpayer audits but also selects potential audit candidates. In this situation, a robust transfer pricing report would be an especially valuable tool to defend the auditor's high-level analysis.

#### **Conclusion**

Given the continued weakness of state budgets and the lingering economic uncertainty, states are not likely to stop using outside auditors in the near future. Rather, it appears likely that the use of such arrangements could proliferate. As such, prudent companies need to proactively consider and document their state transfer pricing. Taxpayers should not assume that their federal transfer pricing, whether covered by an Advance Pricing Agreement, or agreed to by a federal examiner, will be sufficient on its own for state purposes.

<sup>1</sup>Unless otherwise noted, all "Section" references are to the Internal Revenue Code of 1986, as amended.

<sup>2</sup>IRC Section 482.

<sup>3</sup>See e.g., Ind. Code § 6-3-2-2(m), La. Rev. Stat. Ann. § 47:287.480(2), N.Y. Tax Law § 211(5).

<sup>4</sup>N.J. Div. Taxation, TAM 17 (June 6, 2011).

<sup>5</sup>Indiana Dep't of Revenue, Letter of Findings No. 2010-0620 (May 1, 2011).

<sup>6</sup>Indiana Dep't of Revenue, Letter of Findings No. 2010-0220 (July 1, 2011).

<sup>7</sup>*Id.*

<sup>8</sup>Cal. S.B. 69, 2011-2011 Sess. (2011), vetoed June 16, 2011.

<sup>9</sup>Minn. H.F. 904, S.F. 740, 87th Legis. Sess. (2011).

<sup>10</sup>John Buhl, "Private-Sector Reps Warn NCSL Task Force About Bounty Hunter Auditors," State Tax Today, May 9, 2011, *Doc 2011-9809, 2011 STT 89-1*.

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#### **Submission of Articles**

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# Senate's Permanent Subcommittee on Investigations Issues Report on Effects of 2004 Tax Repatriation Provision in Section 965

By Barbara Angus, Margaret O'Connor, Amanda Helbling and Maria Martinez (Ernst & Young LLP)

## Executive Summary

On October 11, 2011, the Permanent Subcommittee on Investigations (PSI), part of the Committee on Homeland Security and Governmental Affairs (the PSI), chaired by Senator Carl Levin (D-MI), issued a majority staff report, *Repatriating Offshore Funds: 2004 Tax Windfall for Select Multinationals*, on the effects of the Dividends Received Deduction of Section 965 (referred to as the 2004 repatriation provision) enacted by the 2004 American Jobs

Creation Act (AJCA).

The report explains the findings of research conducted by the PSI involving 20 U.S.-based multinational corporations that used the 2004 repatriation provision, including the 15 corporations that reported the highest amounts of repatriation. The top 15 corporations together brought back a total of \$150 billion in offshore earnings,

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## Repatriation Report *(from page 6)*

representing close to half of the \$312 billion total funds repatriated as qualifying dividends. The study focused on how the repatriated funds had been used by the corporations in four key areas: job creation, R&D, executive compensation, and stock repurchases.

The report includes findings that there were no job increases or acceleration of R&D spending as a result of the repatriation and that there was an increase in stock repurchases and executive pay. The report also states that the repatriation benefited a narrow portion of the U.S. economy, primarily pharmaceutical and technology corporations, and that funds were repatriated primarily

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**The report includes findings that there were no job increases or acceleration of R&D spending as a result of the repatriation.**

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from low tax or tax haven jurisdictions. Additionally, the report states that since the repatriation companies have accumulated funds at a greater rate than before 2004.

The report concludes that the 2004 repatriation cost Treasury an estimated net revenue of \$3.3 billion over ten years, produced no appreciable increase in U.S. jobs or research investments, and led to U.S. corporations directing more funds offshore. On this basis, the report recommends against enactment of any similar repatriation initiative.

### Detailed Discussion

#### *Temporary Dividends Received Deduction*

The temporary dividends received deduction enacted by the AJCA in Section 965 generally provided U.S. corporate shareholders of controlled foreign corporations (CFCs) an election to claim for one year a deduction equal to 85 percent of cash dividends received in that election year from CFCs (CFC cash dividends) in excess of a base-period amount of CFC dividends that reflects the CFCs' dividend-paying history. The 85 percent deduction was available, however, only if the amount of the cash dividends generating the deduction was invested in the United States pursuant to a properly approved domestic reinvestment plan.

Further, the cash dividend amount eligible for the 85 percent deduction was limited to the greater of: (a) \$500 million, (b) the amount shown on the applicable financial statement of the corporate U.S. shareholder as earnings permanently reinvested outside the United States, or (c) if a specific amount of permanently reinvested earnings was not shown, but a specific amount of tax

liability attributable to such earnings was shown, then the amount equal to such liability divided by 0.35. All U.S. shareholders that were members of an affiliated group of corporations filing a U.S. consolidated tax return were treated as a single corporate U.S. shareholder for purposes of Section 965.

The election was available for either the U.S. corporate shareholder's last taxable year that began before October 22, 2004, or the first taxable year that began during the one-year period beginning on October 22, 2004.

Notice 2005-10,<sup>1</sup> issued on January 13, 2005, provided guidance on how to satisfy the domestic reinvestment requirement, as well as more general definitional and compliance issues. Such Notice provided that the permitted investments specifically included: (1) expenditures for the funding of worker hiring and training only to the extent attributable to services performed by the workers in the United States; and, (2) R&D expenditures described in Treas. Reg. Section 1.174-2, but also only to the extent that the R&D activities are performed in the United States.

In addition, the Notice described prohibited investments: (1) executive compensation; (2) intercompany transactions between members of the same consolidated group described in Treas. Reg. Section 1.1502-12; (3) acquisition of debt; (4) distributions with respect to stock and stock redemptions and repurchase agreements; (5) certain portfolio investments in business entities; and (6) tax payments.

#### *PSI Majority Staff Report*

The PSI's review of the consequences of the 2004 repatriation provision started in 2009. As part of this review, PSI staff sent a questionnaire to 20 U.S. multinational corporations, including the 15 companies that had repatriated the highest amounts of funds back to the U.S. The PSI staff also gathered information from SEC filings, IRS published data, interviews, and other research.

The report describes data and findings in nine areas, which lead the PSI to recommend against enacting a second corporate repatriation provision:

1. *U.S. jobs*—The report states that the primary purpose of the 2004 repatriation provision was to stimulate job growth. Accordingly, the report looks at the level of repatriation of the companies surveyed and the changes in the size of their U.S. workforce. For the top 15 repatriating corporations, the survey data showed an overall reduction in U.S. jobs from 2004 to 2007.

2. *R&D expenditures*—The report indicates that the survey data showed that the top 15 repatriating corporations increased R&D expenditures from 2004 to 2007. However, the report notes that the growth is slightly slower than the growth occurring before

*Repatriation Report, continued on page 8*

## Repatriation Report *(from page 7)*

repatriation. The report states that the fact that the 2004 repatriation did not require corporations to document their use of the repatriated funds, and the fungibility of the dollar, it is impossible to determine a correlation between the repatriation and this slight increase in R&D expenditures, and notes that there are studies that show no difference in R&D expenditures between repatriating and non-repatriating corporations. Accordingly, the report concludes that the repatriation provision did not result in an increase in R&D expenditures.

3. *Stock repurchases*—The report states that stock repurchases and shareholder dividends were explicitly prohibited as a use of the repatriated funds. However, the report indicates that research demonstrates a parallel between an increase in repatriated funds and an increase in share buybacks at repatriating corporations. Based on the data collected by the PSI, the rate of stock repurchase and buy-back transactions accelerated after the repatriation compared to the years before repatriation, with the steepest increase between 2005 and 2006. The report finds that in the years following the repatriation, the 20 surveyed corporations more than doubled the amount of their average stock repurchases from \$2.2 billion in 2004 to \$5.3 billion in 2007.

4. *Executive compensation*—The report indicates that similar to stock repurchases, despite a specific prohibition of use of repatriated funds for executive compensation, the data shows that such payments increased by 27 percent from 2004 to 2005 and by 30 percent from 2005 to 2006. The report further notes that 18 of the surveyed companies increased restricted stock awards to their senior executives in the two years (2005 and 2006) following the repatriation.

5. *Industry sectors benefiting from repatriation*—Based on the data analyzed, the report states that the 2004 repatriation provision benefited only a narrow sector of U.S. multinational companies. Namely, the benefited industry sectors were larger multinationals, mainly in the pharmaceutical and technology industries. According to the report, the repatriation provision thus unfairly benefited large U.S. corporations, and undermined U.S. competitiveness by shifting the tax burden to medium and small domestic businesses.

6. *Source of repatriated funds*—Another finding noted in the report was that the survey data showed a significant amount of the repatriated amounts flowed from low tax jurisdictions, including Bahamas, Bermuda, BVI, Cayman Islands, Costa Rica, Hong Kong, Ireland, Luxembourg, the Netherlands Antilles, Panama, Singapore, and Switzerland.

7. *Corporate funds held offshore post-repatriation*—The report also states that there is evidence of an increased buildup of offshore funds since the 2004 repatriation

provision. The report notes that the data collected demonstrates that nine of the top 10 companies repatriating the most cash under the 2004 repatriation provision have increased their offshore funds every year since their use of such provision.

8. *Current domestic cash assets*—The report states that U.S. corporations collectively hold more domestic cash assets in 2011 than in 2004, so that lack of cash would not be a constraint to hiring and making domestic investments and such goals should not be viewed as a rationale to justify a second repatriation initiative.

9. *2004 repatriation did not achieve intended stimulus effect*—The report states that supporters of the 2004 AJCA repatriation tax break contend that the repatriated funds had a stimulus effect on the U.S. economy, resulting in more jobs and domestic investment, but that such supporters are unable to cite persuasive research to support those claims. The report states that not only did the 2004 repatriation not achieve the job creation and R&D goals intended, but it has increased the shifting of corporate dollars and investments offshore, as U.S. corporations are hoping for a second repatriation provision as advantageous as the 2004 one.

### Implications

Senator Carl Levin has been investigating offshore activities of U.S. individuals and U.S. corporations for several years and has introduced legislation aimed at stopping what he considers abusive practices that avoid U.S. taxes by increasing foreign activities. He has been a vocal critic of repatriation proposals in the past. It is not surprising that this report has been released while there are multiple bills that have been introduced in the House and in the Senate that include some sort of repatriation “holiday.”

The findings of the PSI may make it more difficult for the advocates of another repatriation provision to gain support given the current economic and financial environment and the focus on job creation and U.S. growth stimulation. The current proposals do attempt to more closely tie repatriation to job creation. For example, the provision proposed by Senators Kay R. Hagan, D-NC and John McCain, R-AZ, would provide for an additional benefit beyond the 75 percent dividends received deduction with respect to repatriated earnings if the taxpayer expands its “qualified payroll” in the U.S. by 10 percent during 2012. Moreover the proposal would impose a penalty on companies that reduce their payroll at a rate of \$75,000 per full-time employee that is eliminated. However, it remains to be seen whether discussion of a new repatriation holiday will gain traction in the current environment.

<sup>1</sup>2005-1 C.B. 474.

## Tax Cuts, Corporate Breaks Urged by Top Republican

By Kevin Drawbaugh and Patrick Temple-West (Reuters)

Tax rates would be slashed and U.S. corporations would get big tax breaks on their offshore profits under a plan offered on October 26 by a senior congressional Republican.

In a move that shifts the tax reform and deficit debate, Dave Camp, chairman of the tax-writing House Ways and Means Committee, called for cutting the top tax rates for individuals and corporations to 25 percent from 35 percent. He proposed adopting a territorial system that would exempt 95 percent of corporations' overseas profits from the U.S. corporate income tax. In addition, he urged a transitional tax of 5.25 percent on corporate profits currently stashed offshore, "whether or not such earnings are repatriated."

Camp's plan taps into proposals that likely could pass the Republican-controlled House of Representatives. Democrats would put up a fight over them in the House

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**The measure, if passed, would adopt a territorial system that would exempt 95 percent of corporations' overseas profits from the U.S. corporate income tax.**

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and Senate, but some of the proposals already have bipartisan support. A summary on the committee's website said the plan "would lower top tax rates for both individuals and employers to 25 percent" and "transition the United States ... to a territorial system."

Camp said he wants to offset the tax cuts that he proposes with unspecified "base-broadening provisions." That would likely mean closing tax loopholes and ending certain deductions and credits. Camp provided no details on how to do that. "For individuals, this plan would almost certainly result in another massive tax cut for many of the very wealthy," said Representative Sander Levin, the top Ways & Means Democrat. Levin said the Camp plan would likely shift more of the tax burden onto working families by ending middle class tax benefits such as the mortgage interest deduction.

Camp's proposals come as the pace of negotiations within Congress' "super committee" on deficit reduction accelerates toward a November 23 deadline. By that date, the panel must find at least \$1.2 trillion in budget savings over 10 years.

### Camp Issues Challenge

Camp is a member of the panel, but he made his tax reform proposals on his own, in his role as chairman, throwing down a challenge to Democrats hours after their super committee members released a deficit-cutting plan.

Democrats on October 25 unveiled a plan proposing up to \$3 trillion in measures to slash the budget deficit, including revenue increases and cuts to the Medicare health program.

With budget deficits topping \$1 trillion annually, ratings agencies are watching closely for signs that Congress and the Obama administration can put the U.S. fiscal house in order.

Corporations issued a barrage of statements praising the Camp plan only minutes after it was released. "We are pleased that Chairman Camp included foreign earnings repatriation in his tax reform proposal," said Karen Olick, campaign manager for WIN America, a lobbying group backed by large multinationals including Apple Inc., Cisco Systems Inc., Google Inc., Microsoft Corp., Oracle Corp. and Pfizer Inc. The Business Roundtable, a lobbying group for chief executives of major corporations, also praised Camp's plan.

Taking a critical view, Democratic Representative Lloyd Doggett said, "While Halloween approaches, no matter how you dress up this proposal, a territorial tax system is about shipping more jobs and profits to another country's territory. It encourages U.S. multinational corporations to expand abroad rather than at home."

### Foreign Profits in Focus

Under current law, U.S. corporations must pay tax—most at the top rate of 35 percent on profits earned at home or abroad, minus credits for taxes paid to foreign governments. For overseas profits, the U.S. corporate income tax need not be paid, however, until earnings come into the United States.

While some companies regularly bring home, or repatriate, their foreign income, many do not. Instead, they park these profits overseas to avoid taxes. An estimated \$1.2 trillion to \$1.5 trillion is stashed abroad for this reason.

Corporations have been waging a multimillion-dollar lobbying campaign for months seeking an offshore profits tax repatriation holiday and a territorial system.

Public interest groups immediately attacked the Camp plan, with the left-leaning Tax Justice Network saying the plan's foreign profits provisions would worsen the deficit and encourage companies to shift profits and jobs overseas. □

## Conversions of Foreign Corporations *(from page 2)*

### Analysis

The GLAM discusses two situations. In Situation 1, the foreign corporation is insolvent because of recourse debt owed to a shareholder. In Situation 2, the foreign corporation is insolvent because of nonrecourse debt owed to a third party.

Following is a summary of Situation 1. The facts set forth below are simplified and modified in order to highlight the GLAM's key conclusions of law.

### *Simplified Facts*

Domestic corporation P owns 100 percent of foreign corporation S and 80 percent of foreign corporation T; S

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### **The conclusions reached in the GLAM are, for the most part, very favorable for taxpayers.**

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owns the remaining 20 percent of T. P has a \$100 basis in the T stock and S has a \$30 basis in the T stock.

P also owns a \$100 recourse note from T (Note). T has a single asset (Asset X) that is worth \$5, and T is insolvent because of its debt to P.

T elects to be a partnership under the entity classification regulations. As a result, T is deemed to distribute all its assets and liabilities in liquidation to P and S; P and S are then deemed to contribute these assets and liabilities to a newly formed partnership (New T). (See Treas. Reg. 301.7701-3(g)(1)(ii).)

The GLAM provides the IRS's views on the consequences of the deemed liquidation of T and the deemed formation of New T.

### *Consequences of the Deemed Liquidation of T*

Although the Note is extinguished in the deemed liquidation, it is also reconstituted immediately thereafter upon the formation of New T (i.e., it becomes a \$100 obligation from New T to P). The GLAM concludes that this series of deemed transactions does not result in a significant modification of the Note under the rules governing the modification of debt instruments in Treas. Reg. § 1.1001-3 because the Note is never extinguished. In effect, the GLAM is applying a type of step transaction doctrine under the modification regulations; it looks at the Note before the check-the-box election and then at the end of the series of deemed transactions (disregarding the momentary extinguishment of the Note), and concludes that the Note remains essentially the same.

In the abstract, a step transaction analysis for debt modifications makes logical sense. However, as described below, the GLAM extends this concept—which is the

driving force behind the remaining analysis in the GLAM—so broadly that several dramatic conclusions are reached.

The first point regarding the GLAM's analysis of the debt modification regulations is that it does not mention recently issued Treas. Reg. § 1.1001-3(f)(7). This provision clarifies that a modified debt instrument will not be treated as equity solely by virtue of a deterioration in the financial condition of the issuer (which, helpfully, prevents many routine debt modifications from resulting in a taxable exchange of debt for equity). However, Treas. Reg. § 1.1001-3(f)(7)(ii)(B) provides that the relief from a debt-equity analysis in the regulation does not apply when there is a substitution of a new obligor on the debt instrument.

In the GLAM, New T is a new obligor on the debt to P. Therefore, Treas. Reg. § 1.1001-3(f)(7) would not appear to protect the newly issued obligation to P from being re-tested for debt-equity status. Accordingly, taxpayers should undertake a debt-equity analysis when applying the GLAM rationale to their transactions.

Because P does not receive any payment for the T stock in the deemed liquidation, P has a \$100 worthless stock deduction that may qualify as an ordinary loss if the requirements of Section 165(g)(3)<sup>1</sup> are otherwise met. (See, e.g., Rev. Rul. 2003-125.) For the same reason, S has a \$30 worthless stock deduction from deemed liquidation, which may also qualify as an ordinary loss under Section 165(g)(3). (See Treas. Reg. § 1.1502-34.)

As mentioned above, the Note is not treated as extinguished in the deemed liquidation; therefore, P does not obtain a \$95 loss from the liquidation. This is one of the few adverse conclusions in the GLAM. However, if the Note were treated as extinguished, P's loss would likely be capital (see Section 1271(a)). By deferring P's loss on the Note, the GLAM positions P to claim a partial bad debt deduction of \$95 in the future (which would be ordinary).

As the GLAM indicates in a footnote, the Note would be extinguished under Rev. Rul. 2003-125 if T were a wholly-owned subsidiary of P that elected to become a disregarded entity. In that case, the Note would not be reconstituted immediately after the liquidation, and the extinguishment would thus be permanent.

The GLAM adheres to the fiction in the check-the-box regulations that the assets and liabilities of T are deemed distributed to its shareholders, and interprets the regulations as requiring that the distribution be pro rata based on the proportionate stock ownership of P and S. However, in an actual liquidation under state law, P would generally receive all of T's assets (since the Note provides P with a priority claim over all equity holders of T), and S would neither receive any portion of the T assets nor consent to an assumption of liabilities in excess

## Conversions of Foreign Corporations *(from page 10)*

of the value of the T assets. Thus, the GLAM's analysis moves further towards a regime in which deemed liquidations and actual liquidations are treated in a materially different manner, both economically and for federal tax purposes. One obvious consequence of this disconnect is that the pro rata liquidation model will (as described below) shift some loss away from P to S, and permit S to claim noneconomic losses in excess of its \$30 investment in T.

Perhaps most significantly, the GLAM appears to answer the age-old question (left unresolved by the Supreme Court in *Crane v. Commissioner*<sup>2</sup> and *Tufts v. Commissioner*<sup>3</sup>) of when a buyer can claim basis in an asset in excess of the asset's value by assuming excess recourse or nonrecourse debt. The GLAM suggests that, as long as the debt was not originally created in a tax shelter, *Estate of Franklin*,<sup>4</sup> *Pleasant Summit*<sup>5</sup> and a number of other leading cases do not limit the buyer's basis in an asset resulting from a subsequent assumption of the debt.<sup>6</sup> Therefore, the buyer is entitled to basis in the asset equal to the full face amount of the assumed liability. Although the fact pattern discussed in Situation 1 involves recourse debt, the GLAM provides the same answer for excess nonrecourse debt in Situation 2. In addition, although the disparity between the value of the T assets and the amount of excess debt assumed in the actual GLAM facts is smaller than in our simplified facts, the GLAM contains no suggestion that its reasoning is limited to situations involving a small disparity.

Accordingly, by virtue of a deemed assumption of the \$100 Note, the buyers are entitled to a \$100 basis in Asset X, although Asset X, and the Note, are only worth \$5. The GLAM essentially permits P to retain a \$95 built-in loss in the Note while replicating that loss through a \$100 basis in Asset X, all in connection with a taxable transaction.


Considering the IRS's vigorous pursuit of basis-inflation transactions, many of which have exploited assumed liabilities, it is interesting that the IRS would voluntarily renounce the principles of *Estate of Franklin* and similar common-law authorities that limit basis from excess debt and enable such planning opportunities (particularly in connection with a check-the-box election). For example, in Notice 2002-21, the IRS designated as listed transactions certain arrangements where taxpayers claimed inflated basis in property from the assumption of excess recourse debt that was not intended to be satisfied by the entity assuming the debt. Notice 2002-21 has not been revoked.


The GLAM does not mention the cases the IRS cited in Notice 2002-21 to challenge the listed transactions described in the notice.<sup>7</sup> The GLAM may thus reflect a deliberate choice by the IRS to construe *Estate of Franklin* principles narrowly. Accordingly, the IRS currently

appears to believe that taxpayers may claim basis in property for assumed liabilities in excess of the amount that will be repaid, but that such transactions must nonetheless be disclosed under Notice 2002-21. This generous interpretation of *Estate of Franklin* should have far-reaching consequences outside of the check-the-box context.

In addition, because P, T and New T are related parties, it is unclear whether the deemed off-market sale of Asset X for the assumption of excess liabilities would be respected under Section 482. It is possible that the IRS believes that Section 482 does not apply to excess debt assumptions where the initial debt was incurred in a bona fide transaction, or perhaps even that Section 482 does not apply to check-the-box elections. However, the GLAM does not discuss Section 482 at all. Therefore, Section 482 is another provision that should be carefully analyzed before relying on the GLAM reasoning.

*Conversions of Foreign Corporations*, continued on page 12


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## PRACTICAL INTERNATIONAL TAX STRATEGIES

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## **Conversions of Foreign Corporations** *(from page 11)*

The main downsides for taxpayers are that (i) \$95 of potential cancellation of indebtedness income (COD) is preserved for the future (because the Note will continue to have an adjusted issue price of \$100 and a value of \$5 after the transaction), and (ii), as discussed immediately below, the liquidation may result in gain for T. However, these issues will be manageable in many cases. In all events, the GLAM analysis should not be binding on taxpayers that choose to report the transaction using more traditional principles.

Although the GLAM focuses on the treatment of P and S, the treatment of T in the liquidation could be quite adverse in some circumstances.

When a subsidiary that is insolvent by virtue of debt to its parent liquidates, the treatment of the transaction at the subsidiary level is not completely settled. Under Rev. Rul. 2003-125, an insolvent liquidation is clearly not a “complete liquidation” under Section 331. However, there has been some debate about whether the subsidiary is treated as distributing its assets to the parent, subject to the liability, in a complete liquidation for purposes of Section 336(b). The alternative is to treat the subsidiary as repaying its debt to the parent in a Section 1001 exchange.

Section 1001 treatment is almost always preferable from T’s standpoint. Under the Section 1001 characterization, T would be treated as repaying \$5 of its debt with Asset X, and having \$95 of COD that would be excluded from T’s income under Section 108(a). By contrast, if Section 336(b) (which adopts the principles of *Tufts*) is applied, T would be treated as selling Asset X to P in exchange for P’s assumption of \$100 of debt. Thus, if T has a \$5 basis in the asset, Section 1001 will not result in any income or gain to T, while Section 336(b) will cause T to have \$95 of gain.

The IRS has issued at least two private letter rulings indicating that Section 1001 should apply in these cases. We believe the IRS will continue to rule that Section 1001 applies when the debt is extinguished (e.g., where T becomes a disregarded entity). However, since the debt is treated as assumed by P under the GLAM facts, it appears that the IRS will apply Section 336(b) (or at least *Tufts*) when T becomes a partnership. The GLAM facts obscure this issue of potential gain recognition at the corporate level because T has a built-in loss in Asset X under the actual facts stated in the GLAM. However, because T is a foreign corporation, any gain recognized from the deemed liquidation may be exempt from U.S. tax if Asset X does not give rise to Subpart F income.

As mentioned, P and S are deemed to receive their pro rata share of the assets and liabilities of T in the deemed liquidation. Thus, P is treated as receiving \$4 of Asset X and assuming \$80 of the liability on the Note, while S is treated

as receiving \$1 of Asset X and assuming \$20 of liability on the Note. P obtains an \$80 basis in its portion of Asset X, and S obtains a \$20 basis in its portion of Asset X.

The significance of treating P and S as receiving the assets and liabilities of T pro rata, based on their stock ownership in T, is more dramatic when S owns the majority of the T shares but no T debt. For example, if S owns 99 percent of the T shares but no T debt, then S

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### **Taxpayers under audit or otherwise before the IRS should be entitled to invoke the GLAM, as it represents the current position of the Chief Counsel.**

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would be treated as receiving 99 percent of Asset X and assuming \$99 of T’s liability on the Note (and S would thus obtain a \$99 basis in Asset X). Once again, this result generally would not arise in actual state law liquidation, as P would be entitled to all of Asset X (and all of the resulting basis in Asset X) in such a case unless P consents to S’s receipt of the Asset X and liability assumption.

#### ***Consequences of the Deemed Formation of New T***

P and S are deemed to contribute the assets and liabilities of T to New T. The GLAM concludes that the transfer of assets and liabilities to New T qualifies for tax-free treatment under Section 721.

The question of whether the transfer of assets encumbered by excess liabilities to a partnership qualifies as a Section 721 exchange (in whole or in part) has been debated for many years. The IRS and Treasury Department issued proposed regulations in 2005 (the “no net value” regulations) which generally take the position that transfers of underwater assets to a corporation do not satisfy the “exchange” requirements in Sections 351 or 368 because the transferor does not, economically, receive any stock in the transaction. However, these regulations have not been (and may never be) finalized. The GLAM thus rejects the theory of the no net value regulations for Section 721 transactions.

The GLAM’s conclusion regarding Section 721 transactions is interesting, and may be correct from a policy standpoint. Unfortunately, the GLAM provides no analysis for the Section 721 conclusion. Therefore, it may be difficult to rely on the GLAM’s conclusion unless and until further guidance is issued by the IRS or Treasury Department.

If a newly formed partnership issues a debt instrument to a transferor in connection with a Section 721 exchange, the debt is treated as property for purposes of Section 707. (See Treas. Reg. § 1.721-1(a)). The GLAM

*Conversions of Foreign Corporations, continued on page 13*

## Conversions of Foreign Corporations *(from page 12)*

implicitly concludes that the reconstituted Note held by P following the Section 721 exchange is not taken into account as property under Section 707. This conclusion is consistent with the general theory of the GLAM that the Note is an “old and cold” liability that is being assumed by New T.

For purposes of Section 752(c), Asset X is treated as property subject to the \$100 liability on the Note, and New T is treated as assuming such liability, but only to the extent of the \$5 value of Asset X. Thus, P and S transfer their portions of Asset X (with bases of \$80 and \$20, respectively) to New T, and New T assumes \$5 of liability on the Note.

P is treated as having \$4 of liability assumed and, because P bears the economic risk of loss for the \$5 liability, P’s share of partnership liabilities also increases to \$5. Therefore, P has a net increase in its basis in New

COD for P.

Finally, New T obtains a \$100 basis in Asset X under Section 723.

To summarize the IRS’s position regarding the consequences from the check-the-box election, (i) P and S will recognize the entire amount of their stock losses from the deemed liquidation, (ii) P will not be able to claim an immediate \$95 loss on the Note but will retain a \$95 built-in loss in the Note, (iii) T will have \$95 of gain from the deemed liquidation (which may not trigger any U.S. tax), (iv) P will have an \$81 built-in loss in its interest in New T while S will have a \$19 built-in loss in New T, and (v) New T will have a \$95 built-in loss in Asset X. After the transaction, P and S collectively should be entitled to accelerate a \$95 loss if New T disposes of Asset X. In addition, P should be entitled to claim a \$95 partial bad debt deduction for the Note (see Section 166(a)(2) and Treas. Reg. § 1.166-3(a)), although P may someday recognize \$95 of COD if New T is subsequently liquidated or the Note is repaid for its \$5 value.

### The deemed liquidation is treated in a materially different manner than an actual liquidation occurring under state law.

T of \$1 under Section 752. P ends up with a total basis in New T of \$81 (\$80 from Asset X plus \$1 from the Section 752 adjustments).

S is treated as having \$1 of liability assumed, resulting in a net decrease of \$1 in S’s basis in New T under Section 752. S ends up with a basis in New T of \$19 (\$20 from Asset X minus \$1 from the Section 752 adjustments).

These results are curious. S invested only \$30 in T and yet is permitted to obtain both a \$30 loss on the deemed liquidation and, in the future, a subsequent \$19 loss on the disposition, abandonment or write off of its worthless partnership interest. This result occurs because S is credited with a momentary assumption of \$20 of liability in the deemed liquidation, even though this liability immediately shifts back to P under Section 752. P, on the other hand, will have \$19 less of future loss with respect to its basis in New T.

While New T is treated as assuming only \$5 of liabilities for Section 752 purposes, New T is also apparently treated as assuming the entire \$100 of liability for other purposes. For example, because the Note has not been modified under the Treas. Reg. § 1.1001-3 regulations, it appears that (as mentioned above) the adjusted issue price of the Note for New T would be \$100, and that a subsequent repayment of the Note for \$5 would result in \$95 of cancellation of

### Conclusion

Thus, both the specific conclusions of law described above and the overall timing results for the recognition of losses under the GLAM analysis are interesting. Before the check-the-box election, P and S had lost \$225 of their combined \$230 stock and debt investments. Under the GLAM analysis, P and S recognize \$130 of the stock loss immediately (which is not surprising), but P must defer \$95 of its loss on the Note. However, after the check-the-box election, P and S should be able to recover the \$95 loss through the sale of Asset X and, in addition, P should be entitled to claim another \$95 loss (by writing down the Note) while deferring any COD income that remains on the Note.

Once again, tax advisors should be cautious in relying on this analysis, both because the GLAM cannot be used or cited as precedent and because other technical issues or tax doctrines may apply in a particular case. The GLAM is nonetheless very helpful in clarifying the IRS’s current thinking regarding check-the-box elections.

<sup>1</sup>Unless otherwise noted, all “Section” references are to the Internal Revenue Code of 1986, as amended.

<sup>2</sup>*Crane v. Commissioner*, 331 U.S. 1 (1947).

<sup>3</sup>*Tufts v. Commissioner*, 461 U.S. 300 (1983)41.

<sup>4</sup>*Est. of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976).

<sup>5</sup>*Pleasant Summit Land Corp. v. Commissioner*, 863 F.2d 263 (3rd Cir.1988), cert. denied, 493 U.S. 901, (1989).

<sup>6</sup>See *Bergstrom v. U.S.*, 37 Fed. Cl. 164 (1996), and cases cited therein.

<sup>7</sup>These cases include *Lemmon v. Commissioner*, 77 T.C. 1326 (1981), *Webber v. Commissioner*, T.C. Memo 1983-633, aff’d 790 F.2d 1463 (9th Cir. 1986), and *Majestic Securities Corp. v. Commissioner*, 42 B.T.A. 698, 701 (1940), aff’d 120 F.2d 12 (8th Cir. 1941).

## Update on the Mutual Agreement Procedure Program

By Dale C. Hill, Mark Kirkey and Jim Wilson (Gowling Lafleur Henderson LLP)

### **Background: The MAP Program**

The Mutual Agreement Procedure (MAP) article, found in the bilateral income tax convention between Canada and a trading country, serves as an avenue through which taxpayers of either country may seek relief from taxation not in accordance with the convention, including double taxation.

The Competent Authority Services Division (CASD), a growing section of the International and Large Business Directorate, is specifically designed for dealing with MAP cases. The cases may be negotiable or non-negotiable and may be Canadian or foreign initiated. Negotiable cases require the co-operation of both treaty countries' competent authorities unlike non-negotiable cases where taxpayers only deal with the CASD. Canadian initiated cases are assessed once relevant information is gathered from the taxpayer and the trading country's tax services office. A position paper is created and sent to the trading country, which results in either mutual agreement or further negotiation. The taxpayer has the right to reject the decision and pursue other available resources.

The Canada-United States Income Tax Convention (1980) (Canada-U.S. Treaty) contains an additional binding amendment, the Fifth Protocol. It requires mandatory arbitration of the respective countries' competent authorities in the event where an issue is deemed irresolvable. While the target timeline for completing a case is 24 months, exogenous pressures such as lack of taxpayer co-operation or difference of timeframes in which the foreign competent service authorities operate, often make this target unattainable.

### **Trends in the MAP Program for 2011**

The Canada Revenue Agency (CRA) issues an annual MAP Program Report for each fiscal year ended March

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31st. This annual report provides statistical and general information on the dispute resolution process concerning MAP cases. On July 29, 2011, the CRA released its MAP Program Report for the fiscal year ending March 31, 2011. This article summarizes key aspects of the report.

### **Completion Time**

The average completion time for Canadian-initiated negotiable MAP cases in the 2011 fiscal year has risen by 41 percent from 2010. However, a reduction of 33 percent was recorded in the average completion time for foreign initiated cases in the same time period. The 2011 average

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**Taxpayers that bring their case to competent authority should prepare a detailed submission explaining all facts and issues in a clear and concise manner.**

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completion time of both Canadian and foreign initiated cases was over 26 months, which is slightly higher than the CRA's target of 24 months. However, the average completion time of Canadian-initiated cases was 32.16 months, a significant increase over the previous fiscal year's average of 22.73 months.

### **Increased Activity/No Relief**

Of the 740 resolved MAP cases in 2011, 95 were negotiable. Eighty-one of the negotiable cases received full relief, one received partial relief and 13 received no relief. Of the 13 cases which received no relief, only 2 resulted from the inability of the trading country's competent authority to provide administrative relief. As for the remaining 11 cases: 3 were due to complications involving the foreign tax administration; 3 were filed outside of the prescribed time limit; 2 of the requests were not covered under the convention; 2 received no relief because the CRA could not agree on the interpretation of the tax convention; and 1 taxpayer withdrew its request from the other competent authority.

The rising trend in accepted and completed cases was also seen in 2011, with an increase of 73 percent and 76 percent, respectively. This development is related to withholding tax cases, which represent 96 percent of completed non-negotiable MAP cases in 2011, and is not

*MAP Program, continued on page 15*

**MAP Program** (from page 14)

expected to continue. In 2011, the number of negotiable cases increased by 9 percent, rising from 78 to 95, while the number of non-negotiable cases increased by 89 percent, rising from 342 to 645.

**Category/Industry/Individuals**

Associated Enterprises, similar to related enterprises, represented 78 percent of all completed negotiable cases, followed by cases regarding Residency and Permanent Establishment (6 percent), Gains (2 percent), and other (14 percent). Negotiable MAP case completions were mostly seen in the automobile and other transportation equipment industry (12 percent), followed by individuals (11 percent) and the petroleum industry (9 percent).

**Transfer Pricing Methods**

The transactional net margin method (TNMM) remained the most often used transfer pricing methodology in 2011, representing 59 percent (43 of 73) of negotiable MAP case completions. The total cost plus was the most commonly used profit level indicator among these TNMM completed cases (23 cases), followed by the operating margin (14 cases), berry ratio (5 cases), and return on assets (1 case). As for non-TNMM methods, the cost plus method was used in 19 cases, the Comparable Uncontrolled Price (CUP) method in 10 cases, and the resale method in one case. No transfer pricing methodology was applicable in 23 percent of the cases (generally where the MAP case involves an issue of taxation contrary to a convention or an allocation of costs between related parties).

**Perspective on Recent Trends**

The 2010-2011 MAP Report confirms that certain trends which we have seen are common to many MAP cases. The average completion time for Canadian-initiated cases has increased significantly in 2011, which reaffirms the importance of the new arbitration provision introduced in the Fifth Protocol of the Canada-U.S. Treaty.

The increase in time to complete a file is in large part

the result of staffing issues and increased workload. Over the past 10 years there has been a significant increase in the number of international audits and an increased focus on international issues. This has resulted in many adjustments being brought before the competent authority to relieve double taxation, however staffing within the competent authority has not been able to keep pace with this increased demand for assistance.

Arbitration under the Canada-U.S. Treaty is an option available to taxpayers that have been assessed by either the U.S. or Canadian tax authorities on certain income including transfer pricing adjustments and where such assessment results in double tax that the two countries cannot resolve within a 24 month period. If the competent authorities are unable to reach a resolution after 24 months from the determined commencement date, the taxpayer has the right to request arbitration. Cases first became eligible for arbitration on December 15, 2010. The CRA is not releasing statistics about arbitration proceedings, however, it is understood that the first few arbitration cases are now being heard and concluded.

The MAP report also supports our understanding that the TNMM method continues to be widely used and is the method most commonly used to resolve transfer pricing cases, despite the Organization for Economic Co-Operation and Development's (OECD) position that the TNMM is the "method of last resort." The OECD recently changed its position on the TNMM, accepting that it is widely used and can provide reliable results, which may result in an even higher proportion of TNMM-resolved cases in the coming years.

Taxpayers that bring their case to competent authority should prepare a detailed submission explaining all facts and issues in a clear and concise manner. All documents and supporting documents explaining both the CRA's position (i.e., proposal letters) and the taxpayer's position (prior submissions and new supporting facts) should be submitted in a timely manner to help move the process along efficiently. By providing all documents to the competent authority at the outset of filing a competent authority request the taxpayer can ensure that when an analyst is assigned to the case they should have all of the information needed without having to incur further delays requesting information. □

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**Income Trusts** (from page 3)

income of certain publicly-traded mutual fund trusts would be subject to an entity-level tax at a rate comparable to the combined Canadian federal and provincial corporate tax rate and the income distributed to holders of units in such trusts would be taxed as dividends.

The proposed SIFT rules, which were ultimately

enacted through amendments to the Income Tax Act (ITA), had a dramatic impact on Canadian capital markets and immediately curtailed the introduction of these vehicles. As a result of the adoption of the SIFT rules, many royalty trusts and income funds converted to corporations or were acquired by third parties. By way of illustration, by September 30, 2010, there remained only

*Income Trusts, continued on page 16*

## **Income Trusts** *(from page 15)*

12 oil- and gas-focused royalty trusts and income funds, with a combined market capitalization of \$51 billion (Canadian) and virtually all of these entities converted to corporations by December 31, 2010 or are expected to do so by December 31, 2012.

### **Overview of New Generation of Cross-Border Income Trusts**

The successful IPO by Eagle Energy Trust in December 2010 reintroduced the income trust model to Canadian capital markets, resulting in what appears to be a rapidly developing sector involving this new generation of income trusts. This new generation of income trusts

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### **The restriction on non-resident ownership in a mutual fund trust does not apply if all or substantially all of the trust's property is not taxable Canadian property.**

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involves key structural refinements compared to the first generation of trusts in order to respond to the SIFT rules, but on balance, these new income trusts look familiar to investors in the Canadian capital markets relative to the large population of income trusts that existed in Canada before October 31, 2006.

#### **Tax Benefits**

As with the first generation of income trusts, the new generation of cross-border trusts are established and operated so as to qualify as "mutual fund trusts" under the ITA, which allows them to avoid payment of any federal income tax provided all income of the trust is distributed to holders of its units in the year. In general terms: (i) a mutual fund trust must be restricted to investing its funds in property (and it may not directly carry on business); (ii) the units of such a trust must be (a) qualified for distribution to the public and be distributed to the public with at least 150 holders of units holding not less than a minimum number of units and (b) redeemable on demand; and (iii) the trust cannot be established or maintained primarily for the benefit of non-residents of Canada. Interestingly, the restriction on non-resident ownership in a mutual fund trust does not apply if all or substantially all of the trust's property is not taxable Canadian property (TCP), which aligns with the requirements of the SIFT rules (discussed below) that also preclude the ownership of TCP by the trust. As a result, one of the sometimes vexing issues faced by the

first generation of income trusts—how to regulate the level of non-Canadian ownership of a trust's units—is no longer an issue with the new cross-border income trusts, which would allow greater placement/ ownership of the units of these trusts in the U.S. (subject to U.S. securities law considerations) and potentially U.S. listings.

#### **Minimize Tax Leakage**

Under the SIFT rules, a publicly-traded trust or other flow-through entity (e.g., a partnership) cannot at any time in a taxation year carry on business in Canada or hold any "non-portfolio property," including the securities of Canadian or certain foreign entities unless such entities qualify as a "portfolio investment entity," which is an entity that does not itself carry on business in Canada and does not hold any "non-portfolio property." For the purpose of these rules, non-portfolio property generally includes:

- securities of a corporation resident in Canada, a trust resident in Canada, a Canadian resident partnership (unless the entity qualifies as a "portfolio investment entity");
- securities of a non-resident person or partnership if its principal source of income is one or any combination of sources in Canada (unless the entity qualifies as a "portfolio investment entity");
- Canadian real, immovable or resource property if at any time in the taxation year the total fair market value of all such properties is greater than 50 percent of the equity value of the trust; and
- properties held by the trust that the trust (or a person or partnership that does not deal at arm's length with the trust) uses in the course of carrying on business in Canada.

As a result, a properly constituted trust that invests in a U.S. domiciled energy or other business (which is itself not a non-portfolio property) through entities that qualify as portfolio investment entities is not subject to the SIFT rules, and income derived from such a business is eligible for the flow-through treatment that was available to the old generation of income trusts pre-SIFT rules. These trusts are also designed to allow income of the underlying business to be flowed back to the Canadian income trust through interest on notes issued by an underlying U.S. operating entity to the trust and dividends and other distributions in the most tax-efficient manner possible so as to minimize overall tax leakage within the trust structure for an extended period of time.

The income trust elects to be treated as a corporation for U.S. income tax purposes to provide certainty with respect to eligibility for the benefits of the Canada-United States Income Tax Convention and the applicable rate of U.S. withholding taxes. Additionally, certain U.S. business items (jurisdictional/ state taxes and federal

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**Income Trusts** (from page 16)

landholdings) may further affect structuring decisions in the U.S. It is also essential that inter-entity debt within the income trust structure that is used to shelter taxable income be respected as such for U.S. interest deductibility purposes.

**Canadian IPO Process**

U.S. vendors that seek to monetize U.S. domiciled assets by vending such into a Canadian income trust will need to understand the process by which an IPO can be completed in Canada, from a timing, diligence and securities law perspective. A number of the key considerations in this regard include:

- the IPO process in Canada can take three to four months, including time required to negotiate the definitive acquisition agreement relating to the assets or business to be indirectly acquired by the income trust, the drafting of structure and administration documents for the income trust and its subsidiaries, completion of due diligence, drafting and clearing a prospectus with Canadian provincial securities regulators and completion of marketing activities relating to the sale of the trust’s units to public investors;
- both the income trust and the underwriters will undertake detailed diligence investigations relating

to the U.S. assets or business to be acquired, including commercial, title, environmental, and interest deductibility due diligence, and the trust and the underwriters will require substantial certainty on purchase price adjustments, rights-of-first-refusal and third-party/regulatory consents required prior to closing of the IPO;

- it will be necessary to consider whether the vendor of the U.S. assets or business will constitute a “promoter” under Canadian provincial securities laws, which analysis may turn on the role of the vendor in founding, organizing or substantially reorganizing the business of the income trust;
- Canadian provincial securities laws require that the prospectus for the IPO includes three years of audited (plus interim unaudited) financial statements relating to the underlying business to be acquired by the income trust or, in the context of an oil and gas business, operating statements and an engineering evaluation of oil and gas assets prepared in accordance with such securities laws, and historical operating information relating to the business to be acquired by the income trust; and
- other key issues including corporate governance considerations, founder and executive compensation matters, stock exchange listing requirements and escrow/lock-up requirements for founders and insiders. □

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# The EU Financial Transactions Tax Draft Directive and the Implications for the Global FS Industry

By David Newton, Richard Collier and Matthew Barling (PricewaterhouseCoopers)

This article provides an overview of the draft directive released by the EU Commission September 28 that seeks to introduce the Financial Transactions Tax (FTT) within the EU by a specified start date of January 1, 2014. It is also the intention of the EU to explore ways to introduce the FTT at a global level through the G-20. Our comments and observations of the potential impact of these new developments on the business community are provided below.

## Background

In the wake of the global financial crisis in 2008 there were widespread calls for the introduction of additional taxes on the financial sector to ensure that the sector makes a fair and substantial contribution toward paying for the costs of the crisis and for any burden associated with future government interventions in the sector.

In response to a request by the G-20 leaders, in April 2010 the IMF conducted a study into potential additional taxes that might be imposed on the financial sector including a FTT. This study concluded that a "FTT does not appear well suited to the specific purposes set out in the mandate from the G-20 leaders" and appetite for the introduction of such a tax at a global level has been limited.

Notwithstanding this, the EU has continued to push for the introduction of a FTT and in March 2011 the European Parliament resolved that the EU should continue to promote the introduction of a FTT at a global level and, failing this, the EU should implement a FTT at a European level as a first step. As the euro-zone sovereign debt crisis has developed over the summer, the introduction of a FTT has also been identified by EU leaders as a key element of raising revenues for the European Union in the future and could be seen as a first step towards closer fiscal union among the Member States.

The release of the draft Directive indicates that the EU Commission is committed to pressing ahead with introduction of a FTT at an EU level although it remains to be seen whether this commitment will be shared by all Member States.

## The Draft Directive

The principal features of the proposed FTT regime

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as outlined in the draft Directive are as follows:

### *Scope of Transactions Covered*

The scope of transactions covered by the FTT will be wide and will include all transactions in financial instruments including equities, bonds, foreign currency (excluding spot contracts) and derivatives whether conducted on a regulated market or on an OTC basis. The

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**The scope of transactions covered by the FTT will include all transactions in financial instruments including equities, bonds, foreign currency and derivatives.**

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transactions covered will include purchases and sales of financial instruments together with sale and repurchase (repo) and securities lending transactions. The FTT will apply to both transactions between third parties and intra-group transactions.

### *Taxable Amount and Rate*

In the case of financial transactions other than derivatives, the taxable amount will be the consideration payable between the parties for the transfer of the financial instruments under the transaction. The taxable amount in relation to derivative transactions will be the notional principal amount specified in the contract at the time the derivative is entered into.

The draft Directive provides that the rate of FTT will be fixed by each Member State subject to a minimum rate 0.1 percent for financial transactions other than derivatives and 0.01 percent for derivatives.

### *Scope of Persons Within the Charge to FTT*

In order to concentrate the FTT charge on the financial sector (rather than citizens), it is proposed that the FTT will apply to any financial transaction undertaken by a "financial institution" established within the EU. The FTT charge will apply to the financial institution irrespective of whether it is acting in a principal or agency capacity.

The definition of "financial institution" for this purpose is broad and includes investment firms, organized markets, credit institutions, insurance and re-insurance institutions, collective investment schemes

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## Financial Transactions Tax *(from page 18)*

and their managers, pension funds and their managers, holding companies, leasing companies and special purpose vehicles.

Central Counterparties (CCPs), Central Securities Depositories (CSDs) and International Central Securities Depositories (ICSDs) where carrying on their respective functions will not be liable to the FTT. Transactions with the European Central Bank and national central banks will also be excluded from the scope of the FTT.

A financial institution will be deemed to be established in the territory of a Member State if it is authorized in that Member State, has its registered office in the Member State, is resident in the Member State or is acting through a branch located in the Member State.

Hence, where a financial institution established in a Member State is party to a financial transaction it will be subject to FTT irrespective of the location of the counterparty or the location of trading.

### *Compliance with FTT*

The relevant financial institution will be liable to account for the FTT to the tax authority of its local Member State. Each Member State will be required to adopt measures in its local law to ensure that the FTT is payable immediately if the relevant financial transaction is carried out electronically and within three working days in all other cases. Member States will also be required to adopt measures to prevent evasion or avoidance of the FTT.

### *Timing*

The draft Directive specifies a start date for the FTT regime of January 1, 2014.

### *Next Steps*

In order to be implemented, the draft Directive needs to be discussed and agreed unanimously among the 27 EU Member States at the EU Council of Ministers.

The Commission also intends to continue to explore ways to introduce a FTT at a global level through the G-20.

### *Impact of the VAT Exemption on Financial Services*

In the press release of September 28, the European Commission stated that the financial services sector “is currently undertaxed by comparison with other sectors.” The main reason for this according to the EU, is that “the financial sector enjoys a tax advantage of approximately €18 billion per year because of VAT exemption on financial services.” However as the European Commission says itself “these estimates are very rough approximations and should be interpreted with caution.” We would agree with this last comment mainly because the sector already

pays a very significant amount of irrecoverable VAT and even if VAT were chargeable on financial services, business consumers would recover it (i.e., governments would not receive additional VAT). It is, in our view, too early to conclude that the VAT exemption represents a tax advantage and the issue needs further study. It is possible that such further study could reach the opposite conclusion (i.e., that the VAT exemption is not a tax advantage at all), in which case this justification for an FTT would be undermined.

## Comments

### *Policy v Politics*

We believe the proposed FTT regime gives rise to a number of fundamental concerns at a tax policy level—in particular the distortive impact on financial market activity and the cost to final consumers—which led to the conclusion in the 2010 IMF study that a FTT was not the preferred mechanism for ensuring the financial sector makes a “fair and substantial contribution.” While the potential impact of these may be mitigated if a FTT were to be introduced at a global level, the prospect of a global accord on the introduction of a FTT appears remote. Implementation of a FTT at an EU level only would seem, if anything, to amplify these concerns. We believe there is a very real risk that these genuine tax policy concerns will be overtaken by the broader political agenda at play within the EU with the result that it could affect the competitiveness of the EU as a location for global financial services business.

### *Distortion of Financial Markets*

The introduction of the FTT would have a distortive impact on financial markets activities both in terms of location and nature. Specifically, it would encourage financial trading to be undertaken outside the EU among non-EU financial institutions. It would also discourage short term trading activity.

### *Impact on Financial Institutions and Consumers*

At a time when financial institutions within the EU are being encouraged to build up their capital base and when EU consumers are being encouraged to reduce personal debt and increase savings (which in many cases will be held in collective investment schemes and pension funds), it would seem counter-intuitive to introduce an additional tax that will impact adversely on both of these activities.

### *Disproportionate Impact Across the EU*

The FTT would have a disproportionate adverse impact on certain EU Member States—the United Kingdom in particular would suffer given the City of London’s position as a global financial center. For this reason, achieving the unanimous agreement among

*Financial Transactions Tax, continued on page 20*

## Analysis: South African Carbon Tax Plan Hurts Job Ambitions

South Africa's carbon tax plan has run into opposition from industry. The government wants to cut CO2 emissions by 34 percent over the next decade but has little flexibility to make fast changes with major employers among the top polluters and its cash-strapped power sector almost fully reliant on coal.

The government said it would consider sector-specific tax reductions and exemptions to protect key industries, although these would be temporary, raising fears the proposed tax will force some mining or industrial operations to close. "The carbon tax as currently proposed would certainly kill the South African steel industry," said Nonkululeko Nyembezi-Heita, chief executive ArcelorMittal South Africa.

Under the government's plan, the tax would be levied on all measured emissions at a rate of 75 rand (\$9) a tonne of CO2 and eventually rising to around 200 rand (\$25) a tonne, although analysts said the rates were high. The benchmark EU Allowances carbon price is at just under 11 euros (\$14.6) per tonne of CO2.

Nearly all of South Africa's power is generated by state-utility Eskom's coal-fired plants, making it impossible for

companies to choose less carbon-heavy electricity.

South Africa is investing heavily to diversify its energy mix away from coal and to have renewable energy and nuclear power supply a big portion of its electricity, but it may take decades until such measures materialize.

A carbon tax would put further strain on industries that are already battling with steep increases in power tariffs, meant to help Eskom pay for new power plants and avoid a repeat of a crisis that brought industry to a halt in early 2008.

Eskom's chief executive Brian Dames said any cost of a carbon tax will be fully passed to consumers, with analysts saying it could raise tariffs by up to 30 percent.

ArcelorMittal said industries should be given allowances based on global benchmarks and be taxed if they exceed them. "Then you would be taxed on something over which you have some control and which you can manage down overtime by implementing improvement projects," said Siegfried Spanig, the steelmaker's environmental manager. — *By Agnieszka Flak, Reuters*

## Financial Transactions Tax *(from page 19)*

the 27 EU Member States which would be required to introduce the FTT on an EU-wide basis is likely to be

difficult in practice. In view of this, a potential alternative outcome may see the FTT introduced at a euro-zone level which may put euro-zone FS institutions and domiciles at a competitive disadvantage and encourage switching of business outside the euro-zone.

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### ***Inconsistent Application within the EU***

Given that each Member State will be required to implement the FTT under its own local laws, there is a very real prospect that there will be inconsistent application of the regime among the different Member States which could lead to distortion of financial markets within the EU itself.

### ***Compliance Burden***

At a time when banks and other financial institutions are already having to deal with a huge array of additional compliance obligations imposed by the myriad of new financial sector regulatory measures, imposing further complex and costly compliance requirements in connection with the FTT will place further pressure on profitability across the sector.