Inbound Roundtable Newsletter

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This Inbound Roundtable Newsletter is designed to provide the Sutherland Inbound Roundtable group with up-to-date information on important international tax developments. In this issue, we discuss the status of the first notice under the economic substance codification; an update on transfer pricing audit; Notice 2010-6, the status of the UTP initiative, including the proposed regulations issued on September 7, 2010; and the new amendment to section 304 contained in the international tax provisions of the August 2010 Education Jobs and Medicaid Assistance Act, which essentially eliminates section 304 repatriation strategies for inbound companies. We also discuss the new FATCA guidance, Notice 2010-60, which provides details concerning the classification of entities under FATCA and the due diligence requirements to identify account holders . We hope that you will enjoy this newsletter. We welcome your comments and suggestions for future newsletter topics.

In This Issue

November 11, 2010 New York Meeting

On November 11, 2010, Sutherland will host its New York Inbound Roundtable in our offices in the Grace Building, 1114 Avenue of the Americas, 40th Floor. We invite participants to join us at 8:00 a.m. for a continental breakfast. The discussion will begin at 8:30 a.m. and formally end at 11:00 a.m. For those who can stay, we invite you to join us for an early lunch and continued conversation.

At this time, we anticipate discussing the new economic substance guidance, audit and transfer pricing issues, the status of the UTP initiative, the impact of new legislation on inbound companies, shared services centers, the impact of the new FATCA guidance, and any new hot topics that may arise by November 11, such as new tax legislation.

If you would like to attend, please send an email to Andrea Christman at andrea.christman@sutherland.com. We look forward to seeing you on November 11.

New Economic Substance Codification Guidance – Notice 2010-62

On September 13, 2010, the IRS issued its first guidance under section 7701(o), Notice 2010-62, which codifies the economic substance doctrine. The following day, September 14, the IRS issued an Industry Directive that proposed Section 6662 (b)(6) penalties must be reviewed and approved by the appropriate Director of Field Operations. Notice 2010-62 confirms that the government will not provide an angel's list or entertain private letter ruling requests concerning whether section 7701(o) applies. In addition, Notice 2010-62 provides the following guidance, none of which is surprising or new.

- Notice 2010-62 notes that existing case law will apply to determine if a transaction has economic substance and if it has a business purpose.
- Because section 7701(o) requires a conjunctive test, the IRS will challenge a taxpayer that applies prior case law to treat a transaction as having economic substance if the case law applies a disjunctive test.
- Furthermore, Notice 2010-62 provides that the determination of whether the economic substance test applies to a transaction is made in the same manner as under prior case law.
- Moreover, section 7701(o) is relevant only if the economic substance doctrine is relevant.
- "Reasonably expected pre-tax profit" requires that the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the expected net tax benefits applying relevant case law and other published guidance. Although Part II of Notice 98-5, which provided several examples of the application of this test was withdrawn by Notice 2004-19, Notice 2004-19 stated that the IRS would continue to scrutinize abusive transactions that are designed to generate foreign tax credits.
- Regulations will be issued that require foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases. Presumably any regulations would overrule the *Compaq* and *IES* cases.
- Disclosure requirements (except for reportable transactions) will be met if there is adequate disclosure on a timely filed original return (including extensions) or a qualified amended return under Treas. Reg. §1.664-2(c)(3). Disclosure must be made on a Form 8275 or 8275R in order to be considered adequate.
- Comments are requested concerning the disclosure requirements, especially concerning the interplay of Rev. Proc. 94-69, proposed Schedule UTP,) and the compliance assurance process (CAP) program.

Transfer Pricing Audits Heat Up at the Federal and State Levels

Recent Congressional and Treasury focus on perceived U.S. earnings stripping transactions continues to fuel an increasing number of transfer pricing audits by the Internal Revenue Service. In response, the IRS (including the newly restructured national LB&I Division discussed below) is retooling its transfer pricing examination activities at the national level with the appointment of a new transfer pricing director and a chief economist.

On the ground, we are seeing more and more transfer pricing challenges arising in cases where transfer pricing policies have been in place and unchallenged by the IRS for years. In some cases, the IRS is resorting to nontraditional analyses to challenge pricing policies, including ignoring the rights of the parties under existing contracts or imputing

arrangements where no contract exists. Some of the more questionable IRS rationales appear to be designed simply to inflate the adjustment. We have seen some success in overturning poorly reasoned transfer pricing adjustments in Appeals, particularly where an Appeals economist has agreed that the IRS analysis was flawed. Surprisingly, we have not seen many cases returned to IRS examination by Appeals for further development, which is always a concern when choosing to protest a case under the administrative Appeals process.

Significant strategy decisions are involved in determining whether a taxpayer seeks competent authority in lieu of, or simultaneously with Appeals, or dockets the case and attempts to invoke competent authority. Any strategy formulation requires a good understanding of the strengths and weaknesses of the case and the interests of the United States and the foreign competent authority involved. As we know from the *Glaxo* experience, competent authority is not a panacea in every case, especially high-ticket cases. As more transfer pricing disputes increase, there will be increased pressure on the countries with which the United States has a treaty, which includes a mandatory arbitration clause. In the past, the conventional wisdom was that a mandatory binding arbitration provision would serve more as a stick to ensure that taxpayers get some relief from double taxation. Certain competent authorities have openly declared that no cases would likely reach the mandatory arbitration stage because competent authorities would hammer out some agreement in order to avoid yielding sovereignty to an arbitrator in a baseball arbitration proceeding. These incentives may produce unsatisfactory results for taxpayers faced with significant U.S. initiated transfer pricing adjustments. In this regard, the best defense is always an offensive strategy as a taxpayer prepares its transfer pricing documentation. The lesson from *Xilinx* is that transactional documentation still reigns supreme in establishing what constitutes an arm's-length price.

Finally, the state governments are not immune from the transfer pricing fever. This rush to augment government treasuries with transfer pricing adjustments has also been tapped by some enterprising individuals who are selling their transfer pricing services to some state governments on a contingent fee basis. (One such organization, Chainbridge was actually issued a patent for its "computer-implemented method" software in May 2010.) State governments (such as the District of Columbia and possibly New Jersey) have engaged these transfer pricing service providers to run a transfer pricing analysis and proposed state tax adjustment wholly based on publicly available data. Some of these reports are void of any detailed functional and factual analyses of the taxpayer and its actual activities in the relevant state although such analyses purport to follow section 482 arm's-length principles. Many companies experiencing these adjustments have determined that, as a practical matter, they must fight these seriously flawed transfer pricing adjustments (no matter how small) or else more states will start to contract these service providers.

Impact on Inbound Companies of International Tax Provisions in the Education Jobs and Medicaid Assistance Act (P.L. 111-226)

The revenue provisions in this legislation were primarily international tax provisions, most of which were designed to curtail U.S. multinational foreign tax credit planning. However, one provision will directly affect foreign-owned U.S. companies that had engaged in certain transactions to repatriate their U.S. profits free of U.S. withholding tax.

Under the newly enacted legislation, the use of section 304 by foreign multinationals to repatriate earnings of their U.S. groups without U.S. taxation on that repatriation through a cross-group sale of a subsidiary will no longer be available. Similar to the section 956 "hop-scotch," under current law, earnings bypassed any intermediary shareholders. The result was a foreign-to-foreign dividend that was not subject to U.S. withholding tax under section 1442. New section 304(b)(5)(B) prohibits earnings and profits from being taken into account under section 304 when the acquiror is foreign. This provision prevents the movement of earnings and profits from U.S. companies to foreign companies. Under the new provision, the earnings and profits are retained in the U.S. target company. Under prior law, the earnings and profits were treated as dividends distributed directly by a foreign company to a foreign company under section 304(a), which were not subject to U.S. withholding tax.

Also of interest was the technical correction to the proposed amendment to section 6501(c)(8) that provides a reasonable cause exception that limits the extension of the statute of limitations only to items related to the failure to provide information returns, including Form 5472. A prior amendment would have extended the statute of limitations for the entire return.

Not included in the August legislation was a provision to source guarantee payments similar to interest payments, *i.e.*, residence of the obligor, and not as services compensation, the source of which is determined by where the services are performed. That provision had previously been proposed in the Extenders' Bill to overrule the decision in *Container Corporation v. Com'r,* 134 T.C. No. 5 (Feb. 17, 2010). This provision would impact guarantees by foreign parent corporations and affiliates of U.S. companies. This provision is included in the Small Business Jobs Act of 2010, which is expected to be enacted by Congress in the near future.

Update on UTP Initiative

The IRS issued proposed regulations on September 7, 2010, amending section 6012, which requires affected corporate taxpayers to file Schedule UTP with their corporate tax returns, effective for tax years beginning after December 15, 2009, and ending after the date the proposed regulations become final. A hearing on the regulations is scheduled for October 15, 2010, which would permit the final regulations to be issued prior to the end of 2010. Finalization before the end of 2010 would mean that Schedule UTP would need to be filed with 2010 calendar year returns as previously announced by the IRS.

While the proposed regulations add authority to the Schedule UTP filing requirement, the question of penalties for failure to file Schedule UTP remains. In Announcement 2010-9, the IRS stated that it was evaluating additional options for penalties or sanctions to be imposed when there was inadequate disclosure of information concerning uncertain tax positions, with one option being a request for legislation to impose a penalty.

Surprisingly, the question of what penalties may be imposed for a failure to file a schedule with a return is not clear. Although section 6103(a) defines a return as including information returns, that provision is limited by its terms to section 6103 disclosures. Interestly, Heather Malloy, Commissioner of LMSB, has been quoted as saying at the April 22 New York TEI Chapter meeting that the consequences for not filing Schedule UTP are the same as not filing any other form attached to a return schedule. What those consequences are is not clear.

On October 1, 2010, LMSB will be replaced by LM&I, which will have a Director of International Business Compliance (IBC) who will report directly to the Deputy Commissioner of LM&I. The Director of IBC will undoubtedly be involved in matters involving the Schedule UTP.

FATCA Update – Notice 2010-60 Issued on Aug. 27, 2010

The first guidance on the implementation of chapter 4 (sections 1471-1474) was issued on August 27, 2010. Notice 2010-60 announces that it provides preliminary guidance on priority matters, which would seemingly indicate that the guidance provided by Notice 2010-60 may be subject to change. In fact, Notice 2010-60 is tentative in many areas as well as not providing any developed guidance with respect to other issues such as entities that have U.S. investments but purport to have no U.S. account holders.

Notice 2010-60 addresses which foreign financial institutions will be treated as subject to the more extensive due diligence, withholding, and reporting provisions of section 1471 (FFIs) and which foreign entities will be subject to the less burdensome requirements imposed on non-foreign financial entities ("NFFE") Importantly, Notice 2010-60 provides details on how an FFI's due diligence obligations may be met, with somewhat less burdensome temporary requirements for existing accounts, *i.e.*, accounts opened prior to the execution of an FFI's agreement with the IRS. Moreover, Notice 2010-60 provides guidance for U.S. financial institutions ("USFI") that will be the primary withholding agents for withholdable payments made to FFIs and NFFEs.

In addition, guidance is provided for grandfathered obligations, the treatment of U.S. branches of foreign financial entities, controlled foreign corporations, retirement plans, certain insurance companies, and entities exempt from chapter 4.

Significantly, arm's-length payments made for goods and services in the ordinary course of business by withholding agents that are not USFIs to NFFEs engaged in an active trade or business are not exempt from the chapter 4 procedures. However, Notice 2010-60 states that the IRS and Treasury are considering allowing reliance on the chapter 4 status certifications as long as the withholding agent does not know or have reason to know that such certification is not correct.

Many questions remain, however, because Notice 2010-60 requests numerous comments and leaves many open questions for later guidance. Draft certifications and FFI Agreements will be released for comment at a later date.

If you have any questions regarding these developments or the Inbound Roundtable, please contact:

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