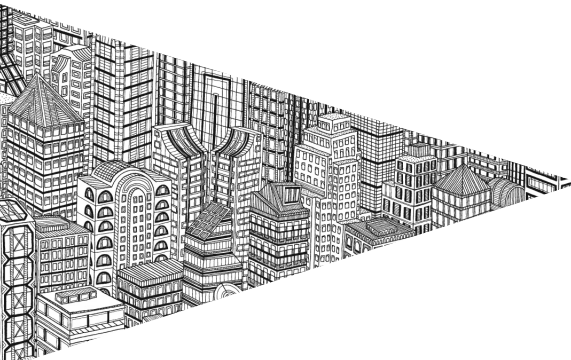


International Tax Alert



Ways and Means Committee Chairman unveils territorial tax proposal

Executive summary

On 26 October 2011, Ways and Means Committee Chairman Camp (R-MI) released an international tax reform proposal, *The Tax Reform Act of 2011* (the Proposal), as a discussion draft for comment. The Proposal, which includes draft statutory language and a detailed technical explanation, would reduce the maximum corporate tax rate to 25% and would move the United States to a largely territorial tax regime. The announcement indicated the Proposal would be combined into a comprehensive tax reform package with other individual and corporate tax changes.

Highlights of the territorial tax regime in the Proposal include:

- ▶ A 95% deduction for the foreign-source portion of dividends received by domestic corporations from controlled foreign corporations (CFCs) (foreign branches would be treated as a CFCs for this purpose);
- ▶ A 95% exemption for capital gains derived on the sale of qualified foreign corporation stock;
- ▶ An election for comparable treatment of dividends and gains with respect to so-called "10/50 companies;"¹
- ▶ A general retention of the subpart F rules;
- ▶ A "thin capitalization" rule that would deny a deduction for a portion of a domestic corporation's interest expense;
- ▶ A transition rule that would tax a CFC's accumulated deferred foreign earnings at a 5.25% effective tax rate with the tax payable in up to 8 equal annual installments; and
- ▶ Three alternative options to address the potential for erosion of the US tax base.

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Detailed discussion

Introduction

Chairman Camp released the Proposal as part of the Ways and Means Committee's effort on comprehensive tax reform. The announcement states that the broader package will include reforms of the individual tax regime that will lower individual tax rates, broaden the individual tax base, and simplify tax compliance. The Proposal's reduction of the maximum corporate tax rate to 25% is to be offset by base-broadening changes that are being developed by the Committee.

The announcement further indicates that the Committee released the discussion draft because the proposed territorial tax regime represents a fundamental change in the way the United States taxes cross-border activity and because input from stakeholders on such change is important. The announcement also indicates that it is intended that international tax changes in the context of comprehensive tax reform will be revenue neutral, so that international changes will not fund, and will not be funded by, tax policy changes in other areas.

Reduction in overall corporate tax rate

Under the Proposal, the top bracket of the corporate tax rate would be reduced to 25%. This is proposed to be effective for years beginning after 31 December 2012.

Dividends received deduction for dividends from CFCs

The Proposal would provide a Dividends Received Deduction of 95% for the foreign-source portion of dividends received from a CFC by a domestic corporation that is a US Shareholder (within the meaning Section 951(b)) of such CFC (95% DRD). The 95% DRD would apply only to the foreign-source portion of the dividend. As with certain European countries that provide a similar 95% exemption, the taxation of the 5% residual dividend amount is intended as a substitute for a disallowance of expenses incurred to generate the exempt income. The Proposal includes the 95% exemption rate in brackets, indicating that further consideration may be given to the appropriate exemption percentage.

The foreign-source portion of a dividend qualifying for the 95% DRD would be determined based on the ratio of the CFC's undistributed foreign earnings to total undistributed earnings. Undistributed earnings is defined as the earnings and profits of the foreign corporation computed under Sections 964(a) and 986, but including earnings previously included by the US Shareholder under subpart F. This provision is intended to coordinate with existing Section 245, under which a deduction is allowed for the US-source portion of a dividend from a foreign corporation.

The 95% DRD would be available only if the US shareholder satisfies a one-year holding period requirement with respect to the CFC. Specifically,

the 95% DRD would be available only if the domestic corporation holds the CFC stock for more than 365 days during the 731-day period that begins on the date that is 365 days before the ex-dividend date, provided the foreign corporation is a CFC and the domestic corporation a US Shareholder of the CFC at all times during such period. Additionally, the domestic corporation may not be under an obligation to make related payments with respect to positions in substantially similar or related property.

The 95% DRD also would be available for dividends paid from one CFC to another CFC if the dividend would qualify for the 95% DRD if paid directly to the US Shareholder. In this context, the 95% DRD would be taken into account in determining the subpart F income of the recipient CFC by reason of the dividend.

The Proposal would disallow the foreign tax credit (FTC) under Section 901 for any taxes paid or accrued (or treated as paid or accrued) with respect to any dividend for which the 95% DRD would be allowed. Additionally, no deduction would be allowed for any taxes that were disallowed as Section 901 FTCs because of the application of the 95% DRD.

As discussed below, the 95% DRD would apply to foreign branches of a domestic corporation, which would be treated as CFCs, and to so-called 10/50 companies for which an election to be treated as a CFC is

made. Regulatory authority also would allow Treasury to apply similar rules to a domestic corporation's interest in a partnership or other pass through entity that has a trade or business in a foreign country, but only where the domestic corporation would be a US Shareholder if such interest were stock in a corporation.

This provision is proposed to be effective for taxable years of foreign corporations beginning after 31 December 2012, and taxable years of US Shareholders in which or with which those taxable years of foreign corporations end.

Foreign branches of domestic corporations treated as CFCs and eligible for 95% DRD

Under the Proposal, a foreign branch of a domestic corporation would be treated as a CFC and the domestic corporation would be treated as a US Shareholder. Thus, as noted in the technical explanation to the Proposal: (1) foreign branches would become subject to subpart F; (2) all rules applicable to intercompany transactions (such as Sections 482 and 367) would apply to transactions between the foreign branch and its domestic corporation; and (3) no credit or deduction generally would be allowed for foreign taxes paid by the foreign branch (other than under Section 960 for a subpart F income inclusion with respect to the foreign branch). The technical explanation indicates that the rules and principles applicable in determining whether a foreign corporation is engaged in a US trade or business would apply to determine whether a foreign branch exists.

This provision is proposed to be effective for taxable years of foreign corporations beginning after 31 December 2012, and taxable years of US Shareholders in which or with which those taxable years of foreign corporations end.

Election to treat 10/50 companies as CFCs eligible for 95% DRD

Under the Proposal, a domestic corporation could elect to treat all its 10/50 companies as CFCs. As a result of the election, the domestic corporation would be treated as a US Shareholder with respect to each 10/50 company.

The election would be made by the domestic corporation and would cover all 10/50 companies of the domestic corporation. The election would apply on a controlled group basis (as determined under Section 1563(a) but by substituting "more than 50 percent" for "at least 80 percent"), such that if one group member makes the election, all other group members would be considered to have made the election with respect to their 10/50 companies. The proposal provides that an election would be required to be made by the due date for the tax return for the first taxable year for which the domestic corporation is a US Shareholder of one or more 10/50 companies, and could be revoked only with consent of the Treasury Secretary. The election would apply to 10/50 companies acquired after the election is made and to 10/50 companies that became 10/50 companies after the election is made.

As in the case of foreign branches, treatment of a 10/50 company as a CFC with respect to the electing US Shareholder would apply for all purposes of the Code. Thus, as noted in the technical explanation, this treatment of 10/50 companies would mean that: (1) dividends from the 10/50 company would be eligible for the 95% DRD; (2) subpart F would apply to the US shareholder of the 10/50 company; and (3) FTCs would be allowed only with respect to income includible under subpart F. It is also important to note that under the proposal, if the election is not made, neither a 95% DRD nor Section 902 FTCs would be allowed with respect to a dividend from the 10/50 company.

This provision is proposed to be effective for taxable years of foreign corporations beginning after 31 December 2012, and taxable years of US Shareholders in which or with which those taxable years of foreign corporations end.

95% exemption for gain from sale or exchange of qualified foreign corporation stock

The Proposal would exempt from gross income 95% of any gain recognized from the sale or exchange by a US Shareholder of stock in qualified foreign corporation, but only if the US shareholder has held such stock for at least 1 year. Any losses realized from such a sale or exchange would be disallowed.

For this purpose, a qualified foreign corporation would mean a CFC (including a foreign branch or 10/50 company treated as a CFC for

purposes of the 95% DRD) provided that at least 70% of the CFC's assets are active assets. An active asset for this purpose is any asset which does not produce foreign personal holding company income as defined under Section 954(c).

The determination of active assets would be measured both (1) at the time of the sale or exchange of the stock, and (2) at the close of each quarter of the corporation's prior 3 taxable years. If the corporation was not in existence for the entire 3-year period, the character of the assets would be tested at the close of each quarter for which the corporation was in existence. In making the determination required for purposes of the 95% exemption, any predecessor of the CFC also would be taken into account.

Section 1248 would not apply to the extent the 95% exemption applies to a sale or exchange of CFC stock.

The provision is proposed to be effective for sales and exchanges occurring after 31 December 2012, but would not apply to any sale or exchange occurring before the CFC's first taxable year beginning after 31 December 2012.

Modifications to current subpart F regime

The Proposal would modify but generally retain the current subpart F regime, which would be extended to foreign branches and 10/50 companies treated as CFCs for purposes of the 95% DRD. The technical explanation indicates that US Shareholders of a CFC would

remain subject to current US tax on "certain items of passive or highly mobile income" earned by the CFC. The technical explanation states that subpart F would be retained to ensure that the 95% exemption applies only to income from the conduct of an active foreign business.

The Proposal would modify the current subpart F regime as follows:

- ▶ Section 956 would be repealed because, as explained in the technical explanation, all the foreign earnings of a CFC generally would be eligible for the 95% DRD.
- ▶ Sections 959 and 961 would be repealed, which would mean that 5% of any earnings of a CFC that are currently taxed to a US Shareholder under subpart F would again be subject to US tax when actually distributed. Thus, at a maximum corporate tax rate of 25%, a distribution of subpart F income would be subject to additional US tax of 1.25%.

These provisions would be effective for taxable years beginning after 31 December 2012.

Modifications to the current law foreign tax credit regime

Under the Proposal, the 95% DRD would be the primary mechanism for relieving double taxation of foreign earnings. However, the FTC mechanism would continue to apply to subpart F income inclusions and other foreign income not eligible for the 95% DRD. In this context, the Proposal would make significant modifications to the current law FTC regime.

The Proposal would repeal Section 902 (which treats a domestic corporation as paying foreign taxes paid by a foreign corporation in which it holds a qualifying interest) and Section 78 (which requires a dividend "gross-up" for deemed paid credits under Section 902). The repeal of Section 902 would be significant with respect to 10/50 companies. A US Shareholder that does not elect to treat its 10/50 companies as CFCs for purposes of the 95% DRD would be subject to full US taxation on dividends received from such companies without any credit for foreign taxes paid by the 10/50 company with respect to the distributed earnings.

Notwithstanding the 95% DRD, under the Proposal, a US Shareholder of a CFC would continue to be taxed currently on any subpart F income of the CFC and would continue to be eligible for deemed-paid FTCs under Section 960. However, any foreign earnings previously taxed under subpart F would be treated as foreign undistributed earnings of the CFC for purposes of determining the foreign source portion of any dividend eligible for the 95% DRD. The same treatment would apply to any 10/50 company treated as a CFC for this purpose.

The Proposal would amend Section 960 to reflect the proposed changes to subpart F (including the repeal of Section 956, as discussed previously). This means that the "anti-hopscotch rule" of Section 960(c) would be repealed as part of the overall repeal of Section 956.

The Proposal would repeal the Section 909, "FTC splitter rules," but does not address the Section 901(m) rules on covered asset transactions.

Finally, the Proposal would substantially modify the FTC limitation rules of Section 904 by repealing the separate FTC baskets of Section 904(d). The Proposal also would limit the allocation of expenses in determining foreign source taxable income to only expenses that are directly allocable to such foreign source income. The technical explanation explains that directly allocable deductions would be deductions directly incurred as a result of the activities that produce the related foreign source income, which would not include stewardship, general and administrative, and interest expense.

In general, these changes are proposed to apply to taxable years beginning on or after 31 December 2012, including to foreign taxes carried to such taxable years from any taxable year beginning before 1 January 2013. The Proposal includes regulatory authority to address the carry back of foreign taxes to taxable years beginning on or after 1 January 2013.

Disallowance of interest expense deductions - "thin capitalization" rule

The Proposal would add a new subsection to Section 163 that may deny a deduction for interest expense of a US Shareholder that is a member of a worldwide affiliated group that includes at least one CFC. For this purpose, a worldwide

affiliated group would generally be determined under Section 1504(a) by including CFCs and using a "more than 50%" ownership threshold. The technical explanation explains that this provision is intended to address any potential for "excessive and disproportionate borrowing in the United States by limiting the deductibility of net interest expense."

The provision would deny a US Shareholder's deduction for interest expense if it fails: (1) a relative leverage test (which compares the leverage of the domestic group members to the comparable leverage of the group), and (2) a percentage of adjusted taxable income (ATI) test. The relative leverage test would treat all domestic members of the worldwide affiliated group as a single member to determine whether the group has excess domestic indebtedness. Excess domestic indebtedness would be the amount by which the debt to equity ratio of the US member exceeds 100% of the debt to equity ratio of the worldwide affiliated group. The percentage of ATI test references the earning stripping rules of Section 163(j) to determine whether the interest expense exceeds a specified percentage of ATI. The Proposal does not specify what percentage would be used for purposes of the percentage of ATI, and the 100% threshold specified in the relative leverage test is in brackets. Thus, both of these thresholds can be expected to be the focus of further consideration as the Proposal is further developed.

If both tests are failed, the interest expense deduction is reduced by the lesser of the two amounts determined under the tests. Interest expense disallowed under this provision could be carried forward to future tax years. Any amount disqualified under this provision would reduce the amount of interest expense disallowed under the earnings stripping rules of Section 163(j).

This provision is proposed to be effective for taxable years beginning on or after 31 December 2012.

Transition rule deemed inclusion of accumulated foreign earnings at reduced tax rate

The Proposal would include a transition rule that would tax accumulated deferred foreign earnings of CFCs (including 10/50 companies treated as a CFCs) at a 5.25% effective tax rate. Specifically, the Proposal would treat the accumulated deferred foreign earnings of a CFC as subpart F income in its last taxable year beginning prior to the adoption of the new territorial tax regime. For this purpose, a CFC's accumulated deferred foreign earnings would mean the CFC's undistributed earnings, excluding subpart F income under Section 951, previously taxed income excludable from gross income under Section 959, and income effectively connected to a US trade or business determined as of the close of the relevant taxable year. Undistributed earnings would mean the earnings and profits of the CFC computed under Sections 964(a) and 986.

The transition rule would provide a US shareholder an 85% deduction for its subpart F income inclusion (if any) related to a CFC's accumulated deferred foreign income, resulting in an effective rate of tax of 5.25% [85% x 35%]. The provision would allow a FTC (or deduction of foreign taxes paid) to be claimed only with respect to the 15% of the subpart F income inclusion that would be taxable. Additionally, the Section 78 "gross-up" would apply only to taxes with respect to the 15% portion.

Notably, the transition rule would apply to a 10/50 company whether or not the US shareholder elects to treat the 10/50 company as a CFC for purposes of obtaining the benefit of the 95%DRD.

The Proposal would permit the US shareholder to elect to pay any US tax on its subpart F income inclusion in equal annual installments over two to eight years, with interest. Under an acceleration rule, any unpaid balance would become immediately due at the time of one of the following events: (1) a failure to make a timely payment; (2) liquidation or sale of substantially all of the US Shareholder's assets; (3) the US Shareholder ceases its business; or (4) another similar circumstance arises.

The accumulated deferred foreign earnings subject to US tax under this transition rule also would be subject to US tax a second time when distributed, but then generally would be eligible for the 95% DRD resulting in additional US tax of 1.25%. However, if the case of a

10/50 company that is not treated as a CFC, a subsequent distribution of its accumulated deferred foreign earnings would be subject to full US tax (i.e., the 95% DRD would not be available for such distribution).

Alternative anti-abuse rules to address potential base erosion

The Proposal includes three alternative approaches for preventing potential erosion of the US corporate tax base. The three approaches are included in the discussion draft as options and the Committee has requested comments on these alternatives.

The first alternative option would treat as a new category of subpart F income any excess returns of a CFC from "covered intangible" property if such income is subject to a low foreign effective tax rate. This proposal was included first in the Obama Administration Budget Proposal for FY2011 and again in the FY2012 Budget Proposal. See International Tax Alert, *Administration's FY2012 Budget international proposals*, dated 17 February. This proposal also was included in the statutory text for the President's deficit reduction plan released on 23 September 2010. The option included in the Proposal is identical to the President's proposal.

The new category of subpart F income would be defined as the amount of gross income (excluding same country income) from transactions connected with or benefitting from "covered intangible" property that exceeds 150 percent

of the costs (excluding interest and taxes, but including research and development expenditures allocated based on business line) allocated and apportioned to such gross income. The amount of income treated as subpart F income would be reduced as the effective foreign income tax rate on such income increases. For example, if the effective foreign income tax rate is greater than 15%, none of the income would be so treated, if the effective foreign income tax rate is below 15% and above 10%, the amount so treated would be reduced based on a sliding scale reflecting such rate, and if the effective foreign income tax rate is 10% or below, the entire amount would be treated as subpart F.

A covered intangible would mean any intangible, as defined in Section 936(h)(3)(B), transferred to a CFC from a related US person, or a cost sharing agreement with one or more related persons with respect to an intangible.

This alternative option is proposed to be effective for income received in taxable years beginning on or after 1 January 2013, from transactions connected with or benefitting from covered intangibles.

The second alternative option would create a new category of subpart F income for "low-taxed cross border foreign income. This new category of subpart F income would include the gross income of a CFC that neither is subject to an effective tax rate greater than 10%, nor is derived in the home country of the CFC.

For this purpose, income would be considered derived by a CFC in its home country only if (1) the income is earned in the conduct of a trade or business of the CFC in such country, (2) the CFC maintains an office or other fixed place of business in such country, and (3) the income is derived from the sale of property for use, consumption or disposition in such country or from services that are provided in such country.

Whether the income is subject to an effective tax rate of greater than 10% would be determined under US federal income tax principles (excluding current or carry over losses) on a country by country basis. Thus, if a CFC has income in more than one country, such income and the effective tax rate with respect to such income would be separately analyzed for each country.

This alternative option is proposed to be effective for taxable years beginning on or after 31 December 2012.

The third alternative option would treat all of a CFC's foreign intangible income as a new category of subpart F income, foreign base company intangible income. At the same time, this option would provide a domestic corporation that is a US Shareholder of the CFC a 40% deduction for foreign intangible income, which would result in an effective 15% tax rate on such income of the US Shareholder, whether earned directly or indirectly as a subpart F income inclusion with respect to the CFC. This aspect of the option could be viewed as creating a form of "Patent Box" regime, a

concept that is included in the tax systems of several European countries that also have territorial tax regimes.

Foreign base company intangible income would be defined as intangible income earned by a CFC. Intangible income would be defined as gross income from the sale, lease, license or other disposition of intangible property (as defined in Section 936(h)(3)(B)), or from services related to intangible property. The technical explanation provides that foreign intangible income would be a subset of intangible income, and would be defined as intangible income derived in connection with property which is sold for use, consumption, or disposition outside of the United States or services provided with respect to persons or property outside of the US.

This alternative option is proposed to be effective for taxable years beginning on or after 31 December 2012.

Unaddressed issues

The announcement of the Proposal acknowledges that the discussion draft is silent on numerous technical and policy issues that might need to be addressed in any final product, including the treatment of (1) overall domestic and foreign loss accounts; (2) tax redeterminations; (3) other aspects of subpart F, including with respect to recapture accounts; (4) dual consolidated losses; (5) tax treaty implications; and (6) cross-border reorganizations. The announcement indicates that the Committee invites comments on how these issues

should be addressed.

Specific requests for comments

The announcement of the Proposal indicates that the Committee invites input on all aspects of the discussion draft. The announcement also states that the Committee wishes to highlight the following topics on which it particularly seeks constructive feedback:

- ▶ Which of the three base erosion options would best protect the US tax base with minimum impact on the competitiveness of American businesses? What modifications could be made to make one or more of the options more workable? If these three options are undesirable, what other effective options exist to deal with base erosion, especially with respect to intangibles?
- ▶ How can thin capitalization rules be designed to effectively protect the US tax base with minimum impact on the competitiveness of American businesses?
- ▶ What are the pros and cons of treating foreign branches as CFCs? Should foreign branches continue to be treated as disregarded entities instead?
- ▶ How should foreign partnerships with US corporate partners owning interests of at least 10% be treated? What special rules might be necessary to incorporate them into the new regime?
- ▶ Is the 95% exemption for certain capital gains appropriate? Are any additional anti-abuse rules needed in this area?

Implications

Chairman Camp released the Proposal advance debate on the important subject of international tax reform. The proposal builds upon a series of hearings in the Ways and Means Committee on issues regarding the competitiveness of the US international tax system and the need for international tax reform. Those hearings reflected an increasing focus on the potential for a move toward a territorial tax system in the United States.

As the Ways and Means Committee explored in a hearing in May 2010 that focused on the international tax approaches of major US trading partners, the use of a territorial tax approach, typically in the form of a dividend or participation exemption system, has become the prevailing approach among developed countries, including recent moves toward territorial taxation by Japan and the United Kingdom. Moreover, the President's National Commission on Fiscal Responsibility and Reform in its report released 1 December 2010 also included a territorial tax approach in its corporate tax reform plan.

The release of full draft statutory language and a detailed technical explanation will serve to focus the

debate because, as with any tax reform of this magnitude, the devil is in the details. The specifics provided in the discussion draft will allow stakeholders to consider carefully the full range of policy and technical issues. With the detail that has been provided, companies will be able to use modeling tools and do other in-depth analysis in order to understand what the proposal would mean for their businesses both currently and as anticipated for the future. Full information about the implications of the proposal will be invaluable in informing companies' engagement with policymakers in the debate over international tax reform. It will be critically important for companies to provide informed comments and reactions as this proposal, and others that may be developed, are considered and evolve through the legislative process.

Particular attention should be paid to the areas where the specifics of the proposal are bracketed or where alternative approaches are included in the discussion draft as these areas are a continuing focus for the Committee staff. In addition, consideration should be given to the particular requests for comments communicated by Chairman Camp in releasing the discussion draft.

At the same time, companies should look at all elements of the proposed system, from both a policy perspective and a technical perspective, to determine the aspects of the system that have the greatest impact for their businesses. Moreover, companies should focus on the transition rule included in the discussion draft, which would provide for an immediate deemed inclusion of all accumulated foreign earnings of their CFCs and 10/50 companies at a reduced tax rate as a transition into the new territorial tax regime being proposed. This deemed inclusion mechanism, which would generate federal revenues, is a key to Chairman Camp's goal of an international tax reform package that is revenue neutral in the context of broader comprehensive tax reform. Companies should begin to identify any steps that would need to be taken in order to be prepared for such a transition.

Chairman Camp's release of the Ways and Means Committee discussion draft is a significant development. It is an important step in the larger fundamental tax reform debate that will play out over the coming months. We will continue to provide updates regarding developments in this area as we work with companies and engage with policymakers.

Endnote

- 1 For purposes of the provision, a 10/50 company is a foreign corporation in respect of which a domestic corporation would be eligible for the Section 902 deemed-paid credit under present law. More specifically, the term means, with respect to any domestic corporation, any foreign corporation (other than, in the absence of the election, a CFC with respect to the domestic corporation) for which the domestic corporation satisfies certain direct or indirect ownership requirements. The direct ownership requirement is that the domestic corporation owns 10 percent or more of the voting stock of the foreign corporation. Under the indirect ownership requirement, the foreign corporation must be, with respect to the domestic corporation, a member of the same qualified group as another foreign corporation for which the domestic corporation satisfied the direct ownership requirement.

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP, International Tax Services, Washington, DC

- ▶ Barbara Angus +1 202 327 5824 barbara.angus@ey.com
- ▶ Jose Murillo +1 202 327 6044 jose.murillo@ey.com
- ▶ Amanda Helbling +1 202 327 6282 amanda.helbling@ey.com
- ▶ Stacy Wabeke +1 202 327 6757 stacy.wabeke@ey.com

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International Tax Services

- ▶ Global ITS, **Jim Tobin**, *New York*
- ▶ ITS Director, Americas, **Jeffrey Michalak**, *Detroit*
- ▶ ITS Director of National Washington, DC, **Margie Rollinson**, *Washington*

- ▶ Northeast
Craig Hillier, *Boston*
- ▶ East Central
Johnny Lindroos, *McLean, VA*
- ▶ FSO
Phil Green, *New York*
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Simon Moore, *Chicago*
- ▶ Southeast
Scott Shell, *Charlotte, NC*
- ▶ Southwest
Paul Palmer, *Houston*

- ▶ West
Julie Wooldridge, *Irvine, CA*
- ▶ Canada
George Guedikian, *Toronto*
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Sharon Shulman, *Tel Aviv*
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Koen Van 't Hek, *Mexico City*
- ▶ South America
Alberto Lopez, *New York*