G8 summit calls for greater transparency with tax authorities

The G8 issued a communiqué and supporting documents at the conclusion of a summit meeting on 18 June 2013, expressing support for greater transparency with tax authorities and endorsing the OECD’s ongoing work on base erosion and profit shifting (BEPS).

The language in the communiqué regarding tax matters affirmed the strong interest of the G8 member countries in the work of the OECD on addressing BEPS, on enhancing exchange of information between tax authorities, and on providing support for the tax administrations of developing countries.

The communiqué called on the OECD to develop a common template for reporting by multinationals on their income and taxes by country. The G8 also committed to establishing an automatic exchange of information between tax authorities as the new global standard and expressed their intention to work together with the OECD and the G20 on this objective.

The communiqué also addressed the concerns of developing countries with respect to collection of taxes and exchange of tax information. The G8 lauded the work of the OECD regarding assistance to tax administrations with respect to complex tax cases and asked the OECD to find ways to address developing countries’ need to access information for effective administration of transfer pricing rules.

The G8 Declaration further included a recommendation that tax collectors and law enforcement should be able to obtain information about the ownership of companies. This is detailed in a policy paper titled, G8 action plan principles to prevent the misuse of companies and legal arrangements, which was attached to the communiqué as an annex.

The G8’s emphasis on these matters underscores the significance of the OECD report that will be issued in July detailing its work plan going forward on the BEPS project.
The Obama Administration on same day (18 June) also reiterated the point expressed in the G8 recommendations with respect to company information, releasing a US action plan on transparency of company ownership and control, including a beneficial ownership definition, among other issues.

Finally, the OECD on 18 June released a report it had delivered to the G8 in advance of the summit titled, *A step change in transparency: Delivering a standardised, secure and cost effective model of bilateral automatic exchange for the multilateral context*. The OECD report outlines four concrete steps for putting into practice an effective model of automatic exchange of information.

**OECD provides update on base erosion and profit shifting project**

The OECD’s project on base erosion and profit shifting (BEPS) dominated the discussion at the annual OECD tax conference in Washington, DC held on 3-4 June 2013.

The OECD issued an initial report, *Addressing Base Erosion and Profit Shifting*, on 12 February 2013 on issues relating to BEPS and multinational businesses. The OECD has organized the BEPS project around three work clusters: Countering Base Erosion, Jurisdiction to Tax, and Transfer Pricing. The future work of the OECD in these areas will be outlined in a much anticipated “action plan” document to be released by the OECD in July 2013.

The conference provided more insight into the OECD’s thinking with respect to the BEPS project:

- The BEPS project is focused on addressing instances of what is referred to as “double non-taxation.” The objective is to develop one standard to provide consistent results and avoid double taxation, although that does not necessarily mean a single set of rules.
- Regarding PEs, the aim of the project is not to make wholesale revisions to increase source-country taxing rights.
- In the work cluster to counter base erosion, the focus is on hybrids, treaty abuse, interest deductibility, preferential tax regimes, mandatory disclosure to tax authorities, and anti-avoidance measures.
- Hybrid instruments and entities are a top priority, with recommendations to be developed relatively quickly.
- Inappropriate use of treaties is another top priority, with a focus on developing a treaty-based solution to avoid domestic treaty overrides.
- Developing an approach for the treatment of leverage will require further work.

Further consideration will be given to possible mandatory disclosure approaches, such as the UTP rules in the US.

A US Treasury official addressing the OECD conference also affirmed the US’s strong commitment to the BEPS project. The official was quoted as saying that from a US perspective, the BEPS project is about the transfer of income from high-tax to low- or no-tax jurisdictions, and not about a “fundamental reexamination of residence and source country taxation.”

It will be important for companies to carefully review the action plan when it is released by the OECD in July and to evaluate the implications for their business models of the areas that are being targeted for potential change. At the same time companies should consider becoming part of the global tax dialogue on the international tax issues that are of greatest significance to them by engaging with the OECD and with tax policymakers in the countries where they operate.

**US tax reform**

**House Ways and Means hearing highlights MNCs’ use of tax havens**

The House Ways and Means Committee on 13 June held a hearing on “U.S. and foreign multinational corporations’ use of tax havens (low- and no-tax jurisdictions) to avoid tax and shift
profits outside the United States and erode the U.S. tax base.” In his opening statement, Ways and Means Committee Chairman Dave Camp (R-MI) said base erosion and profit shifting is the result of “bad laws, not bad companies.”

Referencing the committee’s October 2011 discussion draft on international tax reform, Chairman Camp said of the three options offered to mitigate base erosion, “Option C (the carrot and stick approach) received, and continues to receive the most support from the business community.”

Under Option C in the Discussion Draft, foreign income attributable to intangibles – regardless of whether it is owned by a US parent or a foreign subsidiary – would be taxed at a reduced effective tax rate of 15% (minus any credits for foreign taxes paid). US multinationals would receive a deduction for foreign source income related to intangibles (the carrot) and an immediate inclusion for income related to intangibles earned by a CFC (the stick). This approach, the chairman said, would eliminate the incentive to “shift income to low-tax jurisdictions because that income would be taxed at the same rate - whether it is earned in the United States or Bermuda.”

More specifically, this third draft 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 a 40% deduction for foreign intangible income, which would result in a 15% effective tax rate on such income of the US corporation, whether earned directly or indirectly as a subpart F income inclusion with respect to its 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.

**Senate Finance Committee Chairman supports “clean” federal debt ceiling increase**

Senate Finance other Committee Chairman Max Baucus (D-MT) reportedly supports a “clean” federal debt ceiling increase this fall, i.e., without any corresponding spending reductions. Congressional Republicans generally favor coupling the pending increase in the debt ceiling this fall with spending cuts.

Ways and Means Committee Chairman Camp also has suggested somehow tying an increase in the debt ceiling with moving tax reform forward as part of broader fiscal strategy. Earlier, Chairman Baucus reportedly instructed his staff to come up with a tax reform draft that could be part of debt ceiling discussions if the negotiations were to move in that direction. President Obama meanwhile continues to say he will not negotiate when the time comes to increase the federal debt limit.

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**IRS news**

**IRS expands automated Form 5471 penalty program to Form 5472**

The IRS has begun applying automatic penalties to late-filed Forms 5472 (Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Under Sections 6038A and 6038C of the Internal Revenue Code)), as it has been doing for several years with respect to late-filed Forms 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations).

In recent weeks EY has become aware of businesses receiving penalty notices similar to the Form 5471 notices, except applying to Form 5472. In confirming this situation, we were made aware of an internal IRS transmittal document issued 21 March 2013, adding to its Penalty Handbook, a paragraph providing for a “new systemic penalty for late-filed Forms 5472.”

Section 6038A requires US corporations with a certain level of foreign ownership to file Forms 5472 to report information with respect to transactions with related parties. Section 6038C requires foreign corporations engaged in US business to file Form 5472 reporting similar information. The Form 5472 must be filed with the US corporation’s Form 1120 (or foreign corporation’s...
Form 1120-F) on or before the date required by law for the filing of corporation’s return.

Section 6038A(d) and Section 6038C(c) provide for a monetary penalty of $10,000 for each Form 5472 that is filed after the due date of the income tax return (including extensions) or that does not include the complete and accurate information required by 6038A(b) and 6038C(b).

As in the case of Forms 5471, the Section 6038A and Section 6038C penalties for late-filed Forms 5472 apply even if no tax is due on the Form 1120 or Form 1120-F.

Since 2009 many businesses have received penalty notices generated by the automated 5471 penalty program. Obtaining abatement of the penalty has frequently been difficult. Part of the difficulty is due to the penalty being a deficiency penalty, generally requiring payment before a business can appeal the assessment.

The IRS administration of this penalty program has received a large amount of criticism. While improvements have been made since its inception, obtaining abatement at any level of the IRS can be a challenge. Taxpayers may be able to avoid Section 6038A and 6038C penalties if reasonable cause exists for the failure to file timely the Forms 5472. In addition, such penalties asserted for omissions of, or errors with respect to, information contained in otherwise timely filed Forms 5472 may be avoided if the taxpayer can show substantial compliance with the information reporting requirements.

As most of the penalties have been asserted for a late filing, Ernst & Young is encouraging greater diligence with respect to the filing of Forms 7004 requesting an extension of time to file. Incorrect or missed extensions have frequently been the cause of the automated penalty. We anticipate that not unlike what occurred with Forms 5471, many businesses will find themselves the subject of 5472 penalties; this may prove especially true for US inbound businesses.

**IRS rules no gain or loss on domestication of parent company**

In a recently released private letter ruling (PLR 201321007), the Service ruled that the domestication of a foreign parent corporation holding a United States real property holding corporation (USRPHC) will not result in the foreign corporation recognizing gain or loss under Section 897.

The Parent is a foreign corporation that wholly owns Sub, a domestic corporation that owns significant United States real property interests (USRPIs) and is a USRPHC under Section 897(c)(2). Parent was traded on both domestic and international markets until delisting from the international market. Parent plans to reincorporate into the United States for valid business reasons.

This is the second PLR that the Service has issued in connection with the domestication of a foreign corporation into the United States in what is intended to be an reorganization under Section 368(a)(1)(F). The first ruling, PLR 200803005, involved a corporation that had two foreign shareholders and was not publicly traded either before or after the reorganization. Therefore, the application of the regularly traded exception did not arise in the context of meeting the subject to tax requirement of Temporary Regulation Section 1.897-5T(c)(4)(ii)(A) or the Toll Charge.

The instant ruling is the first guidance that the IRS has issued that applies the regularly traded exception in any Section 897 context. The Service’s rationale for allowing the Parent, for purposes of the subject-to-tax requirement of Temporary Regulation Section 1.897-5T(c)(4)(ii)(A), to ignore those foreign shareholders that would meet the regularly traded exception immediately after the domestication if they would have met the same requirement had the Parent been a US corporation immediately prior to the domestication is sensible and appears to adopt some of the rationale in IRS Notice 99-43.

In Notice 99-43, the Service treated US corporations that undergo reorganizations under Section 368(a)(1)(E) and Section 368(a)(1)(F) as the same corporation
in situations where a foreign shareholder gives up stock in a USRPHC but receives non-USRPHC stock in an E or F reorganization (i.e., the stock given up retained the USPRI taint but the stock received in the reorganization is not a USRPI as the corporation is no longer a USRPHC).

In PLR 201321007, the Service appears to be treating those foreign persons that meet the regularly traded exception immediately before and after the domestication as in effect owning stock in the same corporation.

IRS rules on PFIC treatment for domestic subsidiary

The IRS in PLR 201322009 addressed the application of the PFIC stock characterization and “look-through” rules to a foreign corporation which wholly owned a chain of domestic subsidiaries.

The ruling seemingly resolves the overlap between Sections 1297(c) and 1298(b)(7) in relation to 25%-owned domestic corporations in favor of Section 1298(b)(7). This can be a favorable result if the lower-tier domestic corporation owns passive assets because the foreign corporation, through its ownership of the first-tier domestic corporation, would be treated as owning stock of lower-tier entity (rather than owning an indirect interest in the assets of that lower-tier company) and such stock would be treated as an active asset. Moreover, rather than eliminating any distribution from lower-tier domestic corporation pursuant to Section 1297(c), that distribution is taken into account and considered active income for PFIC testing purposes.

Foreign corporations potentially subject to the PFIC rules that own tiers of domestic corporations should consider the implications of the ruling, especially when a second-tier or lower domestic corporation earns income or holds assets that are treated as passive under the PFIC rules.

Tax information exchange

US-Brazil TIEA is effective

Brazil’s President Dilma Rouseff enacted Decree 8003/13 on 16 May 2013, which made effective the Tax Information Exchange Agreement (TIEA) negotiated between Brazil and the United States in 2007.

Under this Agreement, the US and Brazil will be obliged to exchange tax information as per request of the other country. From a Brazilian perspective, the TIEA encompasses exchange of information with respect to the corporate income tax (IRPJ), withholding tax (IRRF), social contribution on net profits (CSLL), federal VAT (IPI), financial tax (IOF), rural land tax (ITR) and turnover taxes (PIS/COFINS).

Brazil and the United States do not have a tax treaty; consequently this Agreement obligates only the exchange of information and administrative assistance.

IRS retroactively applies principles of Notice 2012-39 to outbound F reorganization

In IRS Chief Counsel Advice (CCA) 201321018, the Service retroactively applied the principles of Notice 2012-39 to an outbound F reorganization. More specifically, the IRS took the position that a US corporation undertaking an outbound F reorganization must recognize gain on its IP (rather than including in income deemed royalty payments under Section 367(d)) to the extent that its stock was owned by a CFC.

In this regard, the CCA is consistent with the principles of Notice 2012-39, 2012-31 I.R.B. 95, although the transaction described in the CCA occurred prior to the Notice. Ernst & Young believes a strong argument can be made that the conclusion reached by the CCA is incorrect as applied to transactions occurring before the effective date of the Notice. An extensive EY ITS Alert, CCA retroactively applies principles of Notice 2012-39 to outbound F reorganization, dated 6 June 2013 provides details.
US, Japan sign FACTA “statement”

The US and Japan on 11 June 2013 signed a “statement” that establishes a Model 2-type intergovernmental cooperation framework for implementing the Foreign Account Tax Compliance. Styling the framework as a statement, rather than an agreement, reportedly is meant to avoid having to have the Japanese Diet approve the accord.

Under Model 2 IGAs, financial institutions provide information directly to the IRS rather than to the tax authorities in their own jurisdictions, and the financial institutions are required to enter into Foreign Financial Institution (FFI) Agreements with the IRS. To date, the US has only signed one Model 2 IGA, with Switzerland.

Transfer pricing news

UN launches Practical Manual on Transfer Pricing for Developing Countries


The Manual is designed to be in accordance with the “arm’s length principle,” an approximation of the market based pricing provided for in both the UN Model and the OECD Model Conventions. Such an approach seeks to minimize potential double taxation disputes among countries, while combating potential mispricing of internal transactions within a multinational enterprise (MNE) for profit shifting between jurisdictions.

The Manual addresses the difficulties faced, especially by developing countries, in applying the OECD Transfer Pricing Guidelines and the need for clear and practical guidance for those countries on the policy and administrative aspects of applying transfer pricing analyses to transactions of MNEs. While consistent with the OECD Transfer Pricing Guidelines, the Manual in effect provides a novel and needs-based approach to explain what those guidelines mean for developing countries, and how they can be applied in practice in a way that responds to their priorities and realities.

Interestingly, Chapter 10 of the Manual is devoted to country practices. The chapter compiles four papers on country practices from China, India, Brazil, and South Africa. The papers were prepared by country officials and each case seeks to inform the readers/users of specific country experience in dealing with transfer pricing issues in its specific country conditions. The Manual does not take any position on whether or not the described cases follow the “arm’s length” approach. It is explicitly noted that this is not a chapter agreed by consensus, however.

Because of its focus on practicality, the launch of the Manual is much welcomed by many developing countries trying to implement or apply transfer pricing rules. The Manual is anticipated to be updated on a “rolling” basis. The next version is likely to address transfer pricing of intangibles and to deal in greater detail with the provision of services by one group entity (such as Head Office) to another.
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