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International Tax Services

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Proposed anti-tax-haven legislation could affect foreign-based multinationals and their U.S. subsidiaries

There is an increased likelihood that legislation addressing perceived "tax haven" abuses could be enacted this year. The Obama Administration has made the issue a priority, and key Members of Congress have conducted hearings and proposed bills. Depending on how final legislation is drafted, it could have unintended consequences for foreign-based multinationals and their subsidiaries, including, potentially, non-U.S. subsidiaries.

Administration Support

On February 26, President Obama released an overview of his fiscal year 2010 budget proposals. The President's budget includes several business tax increases, including a proposal to "implement international enforcement, reform deferral, and other tax reform policies," which is listed as raising \$210 billion over 10 years. The budget overview document does not provide any further description; however, Administration officials have confirmed that this item includes proposals targeting tax havens.

During the 2008 election campaign, President Obama said he would address offshore tax havens by creating an international "tax evasion" watch list and penalizing companies that report income from listed offshore tax havens. As a Senator, President Obama had co-sponsored an earlier, more limited version of the Levin anti-tax-haven bill as further described below.

Levin, Doggett Tax Haven Bills

The new Levin tax haven bill (S. 506) is co-sponsored by four Democratic Senators. A companion bill (H.R. 1265) introduced March 3 in the House by Rep. Doggett has 56 co-sponsors, including 14 of the 26 Democratic members of the Ways and Means Committee.

The Levin and Doggett anti-tax-haven bills would establish certain legal presumptions against the validity of transactions involving specified "offshore secrecy jurisdictions." Among other things, the proposed legislation would grant the IRS additional time to review tax returns involving offshore secrecy jurisdictions, and would limit the ability of taxpayers to use tax opinions to claim a "reasonable cause" exception to penalties on transactions involving offshore secrecy jurisdictions. The Levin and Doggett bills specify 34 offshore secrecy jurisdictions, including Bermuda, the Cayman Islands, Cyprus, Gibraltar, Hong Kong, Luxembourg, Malta, Panama, Singapore, and Switzerland. The Treasury Department would be authorized to add to or subtract from the list. The principal impact of this "blacklist" would be with respect to transactions with U.S. individuals.

In addition, the legislation would codify the "economic substance" judicial doctrine.

The most notable provisions affecting foreign multinationals are new provisions that would:

- Treat foreign corporations managed and controlled in the United States as domestic corporations for U.S. federal income tax purposes. This provision would be effective two years after the legislation is enacted, and
- Expand U.S. withholding tax on dividends to include dividend equivalents and substitute dividend payments. The Treasury Department would be authorized to issue regulations to prevent possible over-withholding and address other issues.

Management and control proposal - general rules

The management and control provision would apply to publicly traded foreign corporations as well as foreign corporations with

more than \$50 million in assets, including but not limited to those that primarily hold investment assets (e.g., alternative investment funds). The bill provides an exception for controlled foreign corporations (CFCs) that are subsidiaries of a common U.S. parent corporation. The bill does not contain an exception for foreign corporations that are resident in a tax treaty country, as did proposed legislation introduced in the prior Congress, or for subsidiaries of publicly-traded corporations. The proposal carries an effective date of two years after the date of enactment.

According to the bill, the prong of the test relating to management and control of the foreign corporation occurring primarily within the United States will be further clarified by regulations to be promulgated by the Treasury. The bill provides that such Treasury regulations shall provide that:

- the management and control of a corporation shall be treated as occurring primarily within the United States if substantially all of the executive officers and senior management of the corporation who exercise day-to-day responsibility for making decisions involving strategic, financial, and operational policies of the corporation are located primarily within the United States, and
- individuals who are not executive officers and senior management of the corporation (including individuals who are officers or employees of other corporations in the same chain of corporations as the corporation) shall be treated as executive officers and senior management if such individuals exercise the day-to-day responsibilities of the corporation as described in the preceding point.

In addition, the Levin Bill clarifies that the intent of this provision is to include foreign corporations with assets that are primarily managed on behalf of investors and the investment decisions regarding these assets are made in the United States.

PwC Observations

Since the trigger for U.S. taxation under the Levin Bill happens when a foreign corporation is managed and controlled primarily within the United States, either directly or indirectly and potentially including personnel in any corporation in the "chain of ownership," many foreign multinationals as well as alternative investment funds with assets over \$50 million would fall within this provision if there are U.S.-based executives or investment managers that make decisions on behalf of a foreign corporation or on behalf of investment funds. According to comments made by Senator Levin, he believes that "outrageous tax dodging" is occurring by investment funds incorporating in tax haven jurisdictions while having management of the funds performed in the United States, and he believes that these funds should be subjected to U.S. corporate income taxation. These comments were made in spite of changes made to federal income tax rules in 1997 that were intended to encourage U.S., rather than foreign employment in the investment/investment advisory industry.

While the intent of the Levin Bill seems clear, there are substantial portions of key provisions that are not currently defined and will need to be clarified by revising the existing law or by regulations yet to be promulgated. For example, while making investment decisions in the United States is stated as a trigger for a foreign corporation to be treated as a domestic corporation, there is no guidance as to the specific activities that will be viewed as making management decisions for purposes of this legislation.

In addition to the potential impact on alternative investment funds, the proposed legislation could have a significant impact on a foreign multinational's ability to use U.S.-based personnel for making global treasury-related investment decisions, including, in some cases, investment decisions relating to retirement funds. Furthermore, foreign multinationals' would potentially need to be vigilant with respect to the length of time spent by management-

level executives in the United States, since the accumulation of too much U.S. travel time by key personnel could potentially cause their foreign multinational employers to be treated as U.S. corporations. Similarly, the ability of foreign multinationals to recruit U.S. executives for key management positions may be restricted unless such U.S. executives are permanently relocated outside of the United States as a condition of employment. Additionally, certain industries that have historically enjoyed a substantial exemption from U.S. federal income taxes for reasons of international competition, regardless of the location of their management and control (e.g., foreign corporations engaged in the international transportation of passengers and/or cargo), could also suddenly find themselves wholly subject to U.S. federal income taxes.

In addition to a foreign corporation suddenly being treated as a U.S. corporation for federal income tax purposes, foreign multinationals could also find that some or all of their non-U.S. subsidiaries could suddenly be treated as controlled foreign corporations for U.S. federal income tax purposes, thus subjecting those subsidiaries to U.S. income tax jurisdiction as well.

The focus on management and control of a corporation and the location of senior executives marks a significant departure from more than ninety years of U.S. federal income tax history, under which a company's place of incorporation has been the key factor in determining which corporations are treated as U.S. corporations and which are treated as foreign.

The proposed management and control test looks at the key executives and where strategic business decisions are made, rather than where a corporation's legal and corporate matters are carried out and, as noted, the test is not limited to management employed by the target corporation. Senator Levin's published statements accompanying the release of the bill indicate that this proposal relies on the principles that underlie the corporate

inversion rules adopted in the American Jobs Creation Act of 2005 and is similar to the substantial presence test in the U.S. - Netherlands income tax treaty. One of the components of the substantial presence test in the U.S. – Netherlands income tax treaty ("the Dutch Treaty") examines the "primary place of management and control" as distinguished from the "place of effective management" test used in the OECD Model treaty, to satisfy the substantial presence test. The U.S. Treasury Department's Technical explanation to the Dutch Treaty states that a company's primary place of management and control will be located in a country where the executive officers and senior management employees exercise day-to-day responsibility for most of the strategic, financial and operational policy decision-making for both the corporation *and its subsidiaries*.

Dividend equivalent proposal

As indicated above, the Levin bill also contains a proposal that would subject certain dividend equivalents to U.S. withholding taxes. The intent of this provision is to tax certain payments received under financial instruments such as equity swaps where the recipient of income was not the owner of the underlying equity interest and thus, under current law, had been claiming an exemption from U.S. withholding taxes on amounts received with respect to the financial instrument.

Senate Finance Committee Action

Subsequent to the introduction of the Levin/Doggett Bills, the Senate Finance Committee circulated draft tax haven legislation of its own and plans to hold a hearing on March 17 that will address tax haven issues in part. Finance Committee Staff has circulated a "discussion draft" of a bill that focuses on providing the IRS with tools to address international tax non-compliance through the use of foreign bank accounts, foreign trusts, and other foreign financial arrangements. The discussion draft does not contain a management and control provision.

The most significant provisions in the Senate Finance Committee discussion draft bill that could potentially impact foreign multinationals are:

- A proposed extension of the 3 year statute of limitations to 6 years for Forms 926, 5471, 5472 and 8865, in addition to certain trust-related forms;
- The transfer of foreign financial account reporting oversight from the Financial Crimes Enforcement Network division of the U.S. Treasury to the Internal Revenue Service in order to strengthen penalty enforcement and allow taxpayers to file reporting forms with income tax returns;
- The proposed reporting by banks and financial institutions of offshore transfers of funds by U.S. customers (except for transfers by publicly traded companies but notably does not except transfers to publicly traded companies or their affiliates), which would apply to both U.S. and non-U.S. financial institutions with U.S. customers; and
- A proposal that would require treating as American employers for employment tax purposes any offshore entities that hire workers to perform services pursuant to a government contract (including pursuant to contracts entered into by U.S. affiliates), where such individuals perform more than 100 hours of service during a month.

PwC Observations

Although it is generally favorable that the Senate Finance Committee draft proposal does not contain a management and control provision, the extremely broad scope of most of the provisions and the absence of exceptions for ordinary course of business transactions for both U.S. and foreign multinationals could result in a great deal of uncertainty and additional reporting than would be required in the absence of the provisions. For example, the proposed provision requiring filing by financial institutions for offshore transfers by U.S. customers contains no exceptions for ordinary course of business transactions by

subsidiaries of publicly traded corporations or large privately-held multinationals, nor are there exceptions for reporting by foreign financial institutions for foreign-to-foreign transfers by U.S. customers.

We anticipate that the Obama Administration will issue a more detailed budget proposal in late March or early April. Although we do anticipate that several significant international tax reforms may be enacted this year, it remains to be seen which of the above-described or even new proposals will ultimately be enacted.

For more detailed information, please do not hesitate to contact your international tax services U.S. Inbound Tax Group:

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