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Tax

U.S. Inbound Corner

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In this issue:

BEPS Action 7 – *Preventing the Artificial Avoidance of PE Status* – Potential Effect on Inbound Supply Chains

On October 31, 2014, the OECD released a public discussion draft on BEPS Action 7, *Preventing the Artificial Avoidance of PE Status* ("the Draft"). The Draft set forth options for changes in three central elements of Article 5 of the OECD Model Tax Convention, which defines "Permanent Establishment" ("PE"):

- Paragraphs 5 and 6, the "agency PE provisions";
- Paragraph 4, the "specific activity exemptions"; and
- Paragraph 3, the "12 month rule."[1]

[1] "Article," "paragraph," and "subparagraph" references herein are to the OECD Model Tax Convention (the "OECD Model"), and not to any US tax treaty now in force. Typically, many provisions of a US tax treaty now in force will have been based to a greater or lesser extent on the language of the OECD Model, or one of its predecessors, as it read at the time such US tax treaty was negotiated. Future changes to the OECD Model will not affect any US treaty in force then (or now) unless and until the President (with the advice and consent of the Senate) ratifies a treaty or protocol, to be negotiated in the future, that amends a US tax treaty then in force.

Many of the options target commissionaire structures, which are not generally used to sell into the United States (for a full analysis of the potential changes proposed by the Draft, see United States tax alert, December 3, 2014). However, some of the options are worded broadly enough that they might, if incorporated into US tax treaties and interpreted sufficiently loosely, impact supply chains that are commonly used in the United States, such as limited risk distributor ("LRD") and toll manufacturing arrangements.
URL: http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-unitedstates-031214.pdf?id=us:em:na:usic:eng:tax:021615

Changes to Definition of "Dependent Agent PE"

The Draft articulates four options to broaden the scope of Article 5(5), which creates PEs when dependent agents act in one Contracting State on behalf of an enterprise of the other Contracting State. The four options would replace the words "exercises…an authority to conclude contracts in the name of the enterprise." Each of the options changes the phrase "exercises…an authority to conclude contracts" in one of 2 ways, and changes the phrase "in the name of the enterprise" in one of 2 ways, resulting in 4 possible permutations. The phrase "exercises…an authority to conclude contracts" would be replaced with either:

1. "Engages with specific persons in a way that results in the conclusion of contracts," or
2. "Concludes contracts, or negotiates the material elements of contracts."

The 2 options for changing the phrase "contracts in the name of the enterprise" are as follows:

1. "Contracts *a)* in the name of the enterprise, or *b)* for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or *c)* for the provision of services by that enterprise," or
2. "Contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise."

One may speculate whether it would be possible for a tax authority to broadly interpret either of these last 2 formulations so that an LRD could be said to create a PE for a supplier (e.g., a related supplier) on which the LRD is "dependent," even though the LRD (and not the LRD's customer) is the *supplier's* direct purchaser. The first formulation challenges transfers of "property owned by" an enterprise, and if a sales contract between the LRD and its customer "results in" a transfer of property *from* the supplier *to* the LRD (or even affects material terms of that transfer), then perhaps it might be asserted (by the tax authority in the LRD's jurisdiction) that any action by the LRD that could be said to be "on behalf of" the supplier causes the supplier to have a PE in the LRD's country of operation. The argument might be particularly attractive to the tax authority in the LRD's jurisdiction if the supplier-LRD transaction and the LRD-customer transaction happen close in time, and one follows seemingly automatically from the other, such as in a "flash title" transaction.

The second of the two formulations focuses on the *legal* relationship between the enterprise and the agent and the enterprise's transactions and risk arising from contracts that result from actions of, or are negotiated in material respects by, the agent. On the one hand, a transaction between a supplier and an LRD typically allocates the predominant risks of the transaction to the supplier, suggesting that the customer transactions in which an LRD engages result in risk being assumed by its supplier. On the other hand, the Draft explains that what matters for this purpose is the legal, and "not" the "economic" relationship of the enterprise and "the intermediary," and the Draft goes on to explain that this language "would cover a relationship created, for example, by an agency contract, a commissionaire contract, an employment contract, a partnership contract or even a trust deed through which a trustee would act on behalf of an enterprise." No mention is made of a buy-sell relationship. Thus, it may be that the drafters did not intend this language to impose a taxable presence in a jurisdiction on an enterprises simply because the enterprise sells into the jurisdiction through LRDs.

Thus, it is not clear whether the above proposed changes are intended to address LRD structures. On the one hand, the Draft only mentions commissionaires and not LRDs. On the other hand, the economic results of LRDs can be similar to commissionaires in terms of the amount of income that must be allocated to them under transfer pricing rules. It will be helpful if future BEPS Project developments clarify whether or not a resident of one country that sells to an LRD in another country is intended to be treated as having a "dependent agency PE" in the second country under the OECD Model provisions that are ultimately proposed.

Elimination of PE exception for activities not of a preparatory and auxiliary character

Many a US-inbound supply chain relies on a toll manufacturing arrangement in which one entity (a manufacturing services provider) performs processing in the United States for another entity (the principal) resident in a treaty country. Ordinarily, when a non-US principal engages a toll manufacturer in the United States, the principal sells the finished goods to a distributor as soon as the manufacturing process is complete. Another person (perhaps even an associated enterprise), warehouses and sells the inventory. This allows the foreign principal to avoid a PE in the United States by reference to language in the applicable US treaty that corresponds to Article 5(4)(c) of the OECD Model, which provides an exception to the definition of PE for "the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise."

Such tolling arrangements might not be exempted from PE consequences under an option in the Draft which would require, as a condition for the application of Article 5(4)c) (or any other of the subparagraphs a) through d)), "that such activity" be "of a preparatory or auxiliary character."[2] In other words, the Draft suggests, either or both the maintenance of the stock of goods for the purpose of processing, or the processing activity itself, would have to be "preparatory or auxiliary" in order for such maintenance *not* to constitute a PE. Considering the essential nature of the maintenance of the stock, and the processing, to the overall business,

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[2] The current OECD Model already provides an exception to the definition of a PE for "the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs *a)* through *e)*, *provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory and auxiliary character*" (the "combination rule"). When the principal sells the finished goods to a distributor as soon as the manufacturing process is complete, and another person warehouses and sells the inventory, it may generally be unnecessary to consider whether the "preparatory and auxiliary" standard in the combination rule is met by the principal, as the maintenance of the stock belonging to the principal for processing by another enterprise (a single activity described in subparagraph *c)* may be *the principal's* only activity in the United States.

this might raise questions that are difficult to answer confidently. This option does not to distinguish between cases where the manufactured goods are sold domestically and cases where they are exported.

Anti-fragmentation rule

Finally, the Draft seems to take a pierce-the-corporate-veil approach to an enterprise of one Contracting State which has *any* fixed place of business of a preparatory and auxiliary character in the other Contracting State (and to which it could otherwise apply the exemptions of Article 5(4)), if the enterprise *also* has an *associated enterprise* operating in that state. Currently, paragraph 27.1 of the OECD Commentary on Article 5 states that an enterprise "cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity." The Draft offers two options for applying the above principle more broadly to operations that are carried on by *separate*, but associated, enterprises. Either option would render the Article 5(4) exemptions from PE status inoperative for an enterprise if: (a) an associated enterprise carries on business activities in the same Contracting State where the first enterprise's fixed place of business is used or maintained; (b) the activities of the two enterprises in that state "constitute complementary functions that are part of a cohesive business operation"; and (c) these activities constitute a PE for the enterprise *or* the associated enterprise. Moreover, one of these options would also de-activate the Article 5(4) exemptions under conditions (a) and (b) above, without regard to whether condition (c) above is met, if the overall activity resulting from the combination of the activities carried on by the two enterprises is not of a preparatory or auxiliary character.

These options would result in a PE for an enterprise that could otherwise satisfy the Article 5(4) requirements when using a manufacturing services provider in the United States, if the enterprise also has an associated enterprise with its own PE in the United States and the activities carried on by the two enterprises in the United States constitute complimentary functions that are part of a cohesive business operation. This option would seem to capture tolling arrangements for US domestic supply where there is an associated enterprise that sells in the United States through a buy-sell distributor. However, it may not capture properly structured toll manufacturing for export, where the group has no other fixed place of business in the United States.

The second option would result in a US PE for the enterprise where the associated enterprise does not have a US PE, if the combined US activities of the two enterprises are not preparatory or auxiliary in character. This could potentially affect not only toll manufacturing for US domestic supply, but also for export if there are other group company activities that occur in the United States, even if they do not independently constitute a PE.

Incorporating BEPS Action 7 into US treaties

To the extent they were ultimately to enter into force as US tax treaty provisions, the options described above would affect the US tax treatment of supply chains of foreign companies with operations inbound to the United States. There are principally two different ways in which BEPS Action 7 recommendations, once they are ultimately solidified, could become part of the US tax treaties in force. The first is through bilateral amendments of existing treaties (and the bilateral negotiation of new bilateral treaties). This method would be likely be gradual and may

take years to accomplish. A second method, which was determined by the BEPS Project negotiators to be “feasible” as a general matter (see the September 2014 “deliverable” on Action 15, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties*), would be to amend existing bilateral treaties via a multilateral instrument which, to the extent acceded to, might change a group of treaties at a single stroke. As outlined in a special edition BEPS Dbriefs webcast archive, September 17, 2014, Action 15 suggests that such an instrument could permit countries to “tailor their commitment,” using either opt-in or opt-out provisions for individual provisions.
URL: http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/september/dbriefs-base-erosion-and-profit-shifting-beps-update-change-is-in-the-air.html?id=us:em:na:usic:eng:tax:021615

With the Draft currently under review and a public consultation meeting just completed on January 21, 2015, inbound companies should be cognizant of the potential changes set forth in the Draft, as developing a supply chain is a significant investment and any changes ultimately made to US tax treaties could affect supply chain arrangements commonly used today.

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Putting It All Together: Using technology to drive tax business processes

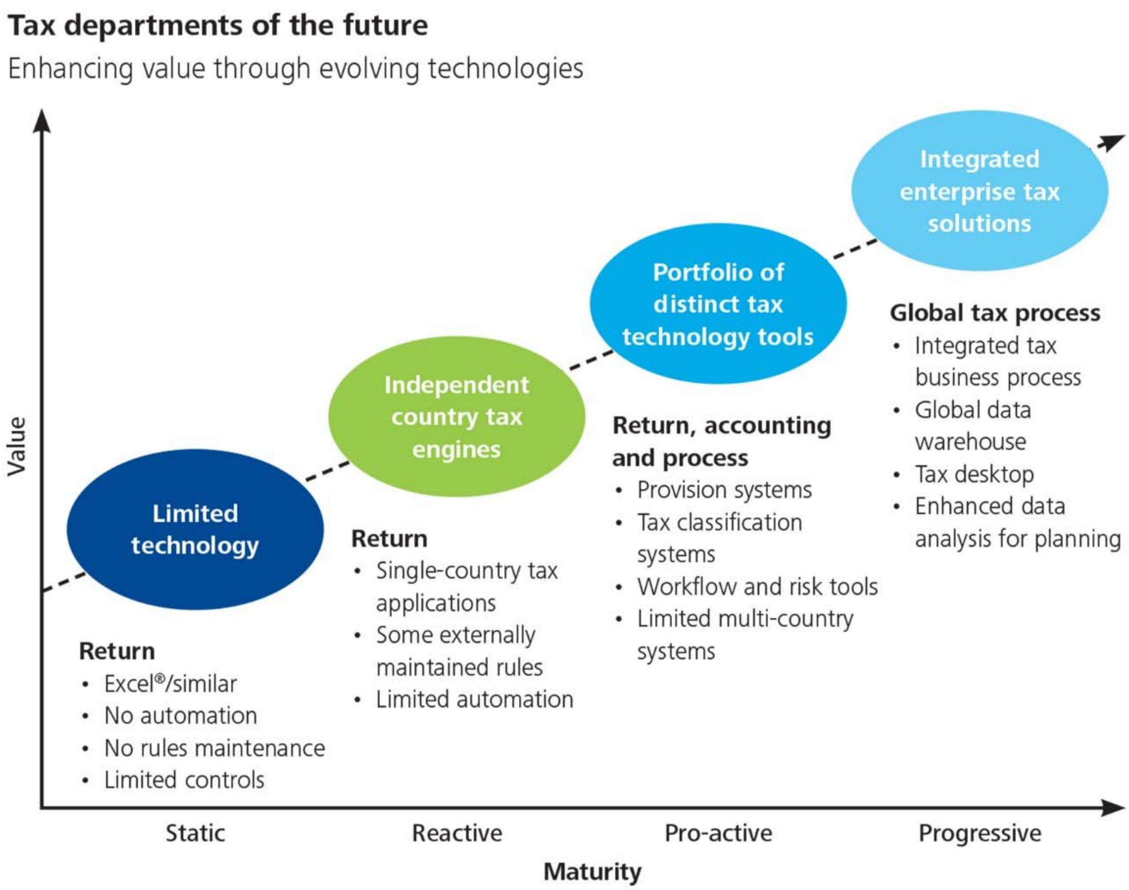
For tax departments, the record-to-report cycle involves several distinct “mega processes” – compliance, cash management, estimates and extensions, provisions, controversy management, and tax planning – not to mention the day-to-day administration of department operations. In many organizations, the groups responsible for each of these tax mega processes operate in “silos.” These groups often utilize internally designed tools (often based on Microsoft® Office Excel® or Microsoft® Office Word®) for many tasks, and these tools are typically not connected across tax mega processes – much less with other corporate functions. As a result, many tax departments move data across these “mega processes” manually.

This may limit them from capitalizing on possible synergies and efficiencies across functional areas. It may also potentially expose them to the compliance risks if the environment has a limited audit trail, lesser control points, and inconsistent management reporting and capabilities.

The integrated tax lifecycle

We view tax as a lifecycle that incorporates standardized processes, shared data, and the right tools to deliver an integrated view of tax reporting. This approach:

- Limits tax process silos.
- Streamlines data usage across multiple tax processes.
- Helps manage risk of errors in financial and tax compliance reporting.
- Enables multiscenario tax forecasting and analysis.



Technological maturity within the tax department

Compared to other corporate departments (e.g., finance, information technology), the tax function historically has been slow to follow technology trends and to begin incorporating technology and process management into its efforts. The exhibit “Tax department of the future” suggests that tax technology adoption lies on a continuum, with more advanced and integrated solutions increasing the value that tax can offer to the business.

Many tax departments fall toward the bottom left of the diagram above – in the “static” state characterized primarily by Microsoft Excel®-based technology, with little or no automation and highly manual controls. Tax departments in the “reactive” state use single-country tax engines, which are more effective at addressing country-specific compliance issues but still offer little or no automation and interactivity with other tools. The “proactive” model emphasizes use of tax-specific technologies, such as compliance and provision software. More often than not, though, these remain largely stand-alone systems with little or no interaction with other systems. To the far right of the continuum is the “progressive” model – a “tax department of the future” that utilizes integrated processes and technologies, centralized data, and embedded controls, providing better visibility to management and consistent reporting and other outputs throughout the tax lifecycle.

To move from left to right on this continuum, tax departments should develop a solid foundation based on:

- **People and organization:** A sophisticated tax function’s personnel have the right tools and training. They have clearly defined and communicated career paths. They operate under a common vision and strategy.
- **Processes and policies**: In a mature tax function, processes are enabled by data and a comprehensive technology vision, and they facilitate cross-discipline interaction. Tax policies are well aligned with the function’s strategic intent.
- **Technology and systems:** A mature tax function has automated noncore tax activities and embedded planning decisions in its tax technology. Its tax systems are integrated where appropriate.
- **Data and information:** The ability to capture, store, and use common data across tax disciplines is the foundation from which improvements are derived. The key to an effective data layer – tax-sensitized enterprise source data – sounds simple, but achieving it is among the most complicated challenges for tax functions today.

Ultimately, the tax department of the future produces results in four areas: cost effectiveness, process efficiency, quality, and value-adding activities. The table below summarizes potential benefits in each of these areas, with particular areas of importance highlighted in bold.

Tax departments of the future produce results that are:

Cost effective	Process efficient	High quality	Value adding
Responsibilities require tax core competencies. **Professionals are focused on critical, relevant tasks.** Organization is designed to handle change. Workforce numbers and skills are balanced. **Workload is distributed to appropriate skill levels.** Performance measures are tied to goals and are monitored.	**Processes are standardized across tax functions.** **Processes and data are integrated in the tax function and with the accounting/finance functions.** Processes are automated where appropriate. **Documentation is effective and managed for easy access.** Knowledge is captured and leveraged. **BBBWorkflow is managed to prevent surprises.**	High-level, specific skills are accessible when needed. High-level or specifically skilled staff are not overburdened. **Review steps are appropriate for specific tasks.** Communication is effective across tax functions. Succession planning and short-term backup are in place. Continuous training is required for staff.	Tax function goals are aligned with corporate and business unit goals. **Tax planning is part of strategic business decisions and balances opportunities and risks.** Tax provides on-site support to business units for tactical and strategic issues. Business leaders are aware of tax positions and compliance risks. Tax “value” is defined with business leaders using common and agreed-upon metrics. **Tax processes are documented with appropriate controls**

Leveraging available technologies

Whether it’s enterprise level solutions or stand-alone tax solutions, tax departments that embrace these new technologies and fully utilizes their capabilities is likely to find itself on the path to the “tax department of the future” and playing a more strategic role in the enterprise.

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Taxation of US Real Property Transactions

Inbound investors should be wary of the imposition of additional tax, withholding obligations, and information-reporting requirements under the Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”). Under FIRPTA, dispositions of US real property interests may result in a US tax cost and multiple reporting obligations. In addition, there are potential FIRPTA consequences whenever a foreign person disposes of an interest in a privately held US corporation, regardless of whether the corporation holds real property. Due to the potential tax cost and complicated reporting requirements under FIRPTA, foreign investors should analyze transactions involving US real property or stock of a US corporation prior to any disposition. In many cases, some action is required by the date of the disposition, even where no tax is due.

Taxation of US real property transactions

Generally, when a foreign person disposes of a capital asset, the United States does not tax the transaction unless the resulting gain is “effectively connected” with a US trade or business. However, the Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”) provides a significant exception to this rule for US real property interests (“USRPI”). The FIRPTA rules treat the gain or loss on the “disposition” of a USRPI as “effectively connected” with a US trade or business, thereby subjecting the transaction to US tax and filing reporting requirements. Moreover, the FIRPTA rules may apply regardless of whether the “disposition” otherwise qualifies as nontaxable under another provision of the Internal Revenue Code.

A USRPI consists of any interest, other than an interest held solely as a creditor, in real property located in the United States or the US Virgin Islands. In addition, the FIRPTA rules include a presumption that stock of a US corporation is a USRPI unless the taxpayer affirmatively establishes otherwise (“USRPI presumption”). There are a few exceptions to the USRPI presumption, including the disposition of less than or equal to 5% of a publicly traded company.

Due to the USRPI presumption, compliance with the FIRPTA reporting requirements is very important, as failing to comply with these requirements may result in interest and penalties, even if no tax is otherwise due, and may turn-off otherwise available non-recognition provisions.

Stock of a US corporation is not USRPI if such corporation was at no time a US real property holding corporation (“USRPHC”) during the shorter of i) the taxpayer’s holding period or ii) the five year period preceding the disposition date. A US corporation is a USRPHC if the fair market value of its USRPI is 50 percent or more of the aggregate fair market value of its real property and operating assets.

A “disposition” of a USRPI is defined broadly. In addition to a sale, a disposition includes capital contributions, gifts, redemptions, distributions, and deemed dispositions involving USRPI (e.g., when certain section 338 elections are made). In addition, the FIRPTA rules apply regardless of whether the transfer occurs between related or unrelated parties.

Subject to a few exceptions, the transferee is required to withhold 10 percent of the amount realized by a foreign transferor of the USRPI. Exceptions to such withholding obligation include the purchase of a principal residence subject to a dollar limitation, where the transferor furnishes a certification of non-foreign status, or where the property is stock in a US corporation that is regularly traded on an established securities market. Additional rules for withholding may apply in certain circumstances, such as a 35 percent withholding and remittance on certain distributions by foreign corporations. Failure to withhold may result in interest and penalties, even if the US person later establishes that the foreign transferor owed no tax, or paid the tax when due.

Reporting requirements

Compliance with the FIRPTA reporting requirements can be complex and time consuming. For example, to establish that the disposition of stock in a US corporation is not a USRPI, several procedural requirements must be satisfied:

1. Prior to the disposition, the foreign transferor must request a statement of non-USRPI status from the US corporation;
2. Prior to the disposition, the US corporation must confirm that it was not a USRPHC during the relevant look-back period and provide a statement of non-USRPI status to the transferor;
3. No later than the disposition date, the transferee must receive the US corporation's statement of non-USRPI status (in order to avoid a withholding obligation under section 1445);
4. Within 30 days of the date that the US corporation provides the statement of non-USRPI status to the transferor or transferee, the US corporation must send a notice of its determination of non-USRPI status (together with a copy of its statement of non-USRPI status) to the IRS; and
5. If the transferor did not receive a statement of non-USRPI status from the US corporation prior to the disposition date, the transferor must obtain such statement on or before the due date of the tax return for the year in which the disposition occurred (to avoid a US tax liability and a requirement to file a US federal income tax return).

Conclusion

Any time a foreign person directly or indirectly transfers or disposes of an interest in US real property or stock in a US corporation, the FIRPTA consequences and reporting requirements should be analyzed and appropriate action taken. In many cases, the process of certifying that stock is not USRPI is time intensive, as the calculation can be quite complex. For this reason, it is important that this analysis commence in advance of the proposed transaction date. Moreover, in some circumstances taxpayers are required to take certain actions no later than the date of the proposed transaction. Therefore, foreign investors should keep the potential application of FIRPTA in mind when planning transactions involving US real property and stock of US corporations.

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Earnings Stripping Considerations of Section 163(j) for Inbound Investors

Inbound investors should be aware of the US earnings stripping limitation rules of section 163(j) when structuring US acquisitions due to the tax risks and opportunities involved. When introducing debt, an inbound company should consider if the debt will be treated as such for US tax purposes, the interest expense on the debt will be deductible, and the interest deduction will be limited under US earnings stripping rules. US income tax deductions for interest expense paid to a foreign related party, or paid to a bank but guaranteed by a related party ("related party interest"), must be paid in order to be tax deductible. However, even if interest payments to a related party are paid, interest deductions may be disallowed under section 163(j). This article discusses the principles of section 163(j), because careful consideration of section 163(j) during the process of acquiring a US target is needed to create a tax-efficient financing structure.

Summary

Inbound investors should consider US earnings stripping limitation rules under section 163(j) when financing an acquisition. In general, section 163(j) limits the amount of interest a US company can deduct for US income tax purposes on intercompany loans to foreign related parties and on loans to third parties if a related party guarantees the loan ("Disqualified Interest"). Therefore, inbound companies should carefully plan the financing arrangements surrounding their US investments to determine that interest expense is fully tax deductible in the United States.

General operation of section 163(j)

For US federal income tax purposes, related party interest must be paid in order to be tax deductible. However, section 163(j) must be considered to evaluate if interest expense tax deductions may be limited. One way inbound companies can confirm section 163(j) will not limit US interest expense tax deductions is to comply with the section 163(j) safe harbor (i.e., the debt to equity ratio of the US group does not exceed 1.5 to 1). When determining whether to rely on this ratio, inbound companies should keep in mind that the ratio is computed in a specialized manner and may differ significantly from the debt to equity ratio the company computes based on its financial statements.

If an inbound company does not satisfy the section 163(j) safe harbor, it is still possible that related party interest deductions would not limited by section 163(j). Profitable inbound companies may wish to exceed the safe harbor because interest deductions are only limited if the interest expense exceeds the section 163(j) limit. The section 163(j) limit is equal to 50 percent of adjusted taxable income ("ATI"). ATI must be computed based on the guidance, but is similar to EBITDA. If the company's net interest expense exceeds the section 163(j) limit, the excess interest expense may not be deductible. Conversely, if the section 163(j) limit exceeds the net interest expense, the excess section 163(j) limit may be carried over for up to three years, thereby increasing the section 163(j) limit in future years. Interest that is limited by section 163(j) and not deductible in the current year may be carried over indefinitely.

When considering the ATI threshold, net interest expense includes all interest, regardless of whether it is Disqualified Interest, so all debt must be taken into account when determining whether the threshold is exceeded. However, only Disqualified Interest is subject to disallowance.

Potential planning opportunities

During a US acquisition, there are several planning opportunities to consider in connection with section 163(j). The first is an inbound company may acquire a Target's section 163(j) attributes (i.e., the excess limit carryforward or disallowed interest carryforward). Many US Targets have never been limited under section 163(j) prior to the acquisition, and may be unaware that they have a valuable excess limit carryforward that may be used following the acquisition. If the Target is part of an existing consolidated group, and the entire group is not being acquired, there are intricacies with the carryforwards that should be considered, including the fact that no excess limitation will be attributed to the Target.

Another planning opportunity involves deciding how to calculate ATI and the debt to equity ratio. US tax authorities have issued proposed regulations for section 163(j) that have never been finalized. Therefore, although the taxpayer must generally be consistent from year to year, the taxpayer may initially choose to compute the section 163(j) calculation under the statute or the regulations.

In general, the regulations build on the statute and require additional adjustments in arriving at the debt to equity ratio and ATI. Notably, if adopted, the regulations would require adjustments to ATI for changes in accounts receivable, accounts payable, and depreciation recapture on disposed assets. Additionally, the regulations and statute differ in which US entities must be included in the calculation. The regulations require aggregation of all US entities owned directly or indirectly by the same foreign parent for the purpose of the calculation, a concept referred to as the "expanded affiliated group," whereas the statute requires the calculation on the basis of each affiliated group (within the meaning of section 1504(a)).

The differences in the regulations and the statute represent potential planning opportunities. Generally, for corporations that frequently dispose of depreciated assets, the statute may be the better choice. For other corporations, the regulations may deliver a better result. Careful tax planning is therefore essential to increase the benefits that may be achieved when structuring cross-border acquisitions.

In the acquisition context, we encourage inbound investors to complete an analysis of the facts to evaluate potential opportunities and limitations related to US tax deductibility for related party interest. Specifically, inbound investors should evaluate if i) debt will be treated as such for US tax purposes, ii) the interest expense on the debt will be deductible, iii) the interest deduction will be limited under US earnings stripping rules and iv) they have chosen a tax efficient method for computing the section 163(j) limitation.

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Frequently Asked Questions about the Changing Expatriate Environment: How are you affected by the US individual expatriation tax rules?

The US imposes income tax on the worldwide income of its citizens and green card holders even if they reside overseas. US citizens and certain green card holders residing overseas are also subject to US gift and estate tax on transfers of worldwide assets. As a result, such individuals sometimes consider relinquishing their citizenship or green card with the hope of freeing themselves from the US tax system. However, giving up US citizenship or a green card on or after June 17, 2008 – the date of enactment of the Heroes Earning Assistance and Relief Tax (HEART) Act, P.L. 110-245 – may cause the expatriating individual to be subject to an exit tax and treated as if all assets were sold on the day before the expatriation date. Furthermore, US persons receiving gifts from persons expatriating under the HEART Act may be subject to tax.

This publication provides a brief overview of the US expatriation rules under the HEART Act. Please note that the HEART Act repealed the expatriation rules that were previously enacted under the American Jobs Creation Act of 2004 (AJCA). However, any individual who expatriated prior to the date of enactment of the HEART Act may be subject to the AJCA rules, including the information reporting requirements of such AJCA rules, which extended for up to a 10-year period from the year of expatriation. Please consult your tax advisor in order to determine whether any of the HEART Act rules, AJCA rules, or prior expatriation rules apply in your specific situation.

Who is subject to the US expatriation rules?

All US citizens who relinquish or “give up” their citizenship status on or after June 17, 2008, and “former long-term residents” who give up their green cards after June 17, 2008 are subject to the new expatriation rules under the HEART Act if they meet any of the following three tests:

- Net income tax test: For the five-year period before expatriation, the individual had an average annual US income tax liability of at least $139,000 in 2008, (adjusted annually thereafter).
- Net worth test: The individual’s net worth is at least $2 million.
- Certification test: The individual fails to certify that he or she satisfied all applicable US tax obligations for the five years before expatriation.
- An individual who is subject to the expatriation rules contained in the HEART Act is referred to as a “covered expatriate.”

What is the definition of “former long-term resident”?

A “former long-term resident” is an individual who has held a green card for any portion of at least eight of the fifteen tax years preceding expatriation. Please note that one day is considered a portion of a tax year; therefore, if an individual obtained his or her green card on December 31, 2002, and relinquishes the green card on January 1, 2009, he or she will have held his or her green card for a portion of eight tax years and will therefore be considered a former long-term resident for purposes of these rules.

An individual who has been resident in the US for eight years under any other immigration status, such as a work visa, is not a long-term resident for purposes of the expatriation rules. For example, if an individual was resident in the US for seven years under a work visa and for six more years under a green card, he or she would not be considered a long-term resident.

What steps do you need to take to be considered to have “expatriated” for purposes of these rules?

Under the HEART Act, the actual act of expatriation for a US citizen for tax purposes occurs when the individual formally renounces US citizenship.

A US citizen shall be treated as relinquishing his or her citizenship on the earliest of the following dates:

1. Date on which he or she renounces nationality before a diplomatic or consular officer of the US.
2. Date on which he or she furnishes a signed statement of voluntary relinquishment to the US Department of State.
3. Date on which US Department of State issues to the individual a certificate of loss of nationality.
4. Date on which a US court cancels a naturalized citizen’s certificate of nationalization, provided that renunciation or relinquishment under (1) or (2) above is subsequently approved by the issuance to the individual of a certificate of loss of nationality by the US Department of State.

A green card holder shall be deemed to have expatriated on the date that lawful permanent resident status ceases. This occurs either on the date a green card is determined to have been revoked or judicially or administratively abandoned, or on the first day of a tax year for which a long-term resident invokes a tax treaty to be treated as a resident of a foreign country and does not waive the benefits offered by the treaty to residents of such foreign country. Appropriate advisors, including immigration counsel, should be consulted before a treaty position is taken, and anytime planning is conducted that affects an individual’s residency status for tax purposes.

Please note that under prior law, an additional step was required in order for an individual to be considered to have expatriated for tax purposes (the filing of a specific tax form). This additional step is not required under the HEART Act.

If you are a "covered expatriate," how will you be taxed?

The new expatriation rules under the HEART Act contain two key components: a deemed sale of all assets as of the day before expatriation, and a tax on the receipt of gifts or bequests by a US person from an individual who expatriated on or after the date of enactment of the rules.

Deemed sale: An individual will be deemed to have sold all assets on the day before the date of expatriation for fair market value. Losses may be taken into account, but only to the extent of gains; therefore, application of the expatriation rules may not result in a loss for tax purposes. The first $600,000 of net gain is excluded for each expatriating individual; this $600,000 amount will be indexed annually. Note that this exclusion is not applicable with respect to certain deferred compensation assets, certain interests in non-grantor trusts, and specified tax-deferred accounts.

A basis adjustment will be applied to all property subject to the deemed sale provisions; such adjustment will ensure that an actual sale at a future date would not result in double taxation due to the prior application of the deemed sale rules.

For purposes of determining the basis of property subject to the deemed sale rules, property that was held by an individual on the date the individual first became a resident of the US shall be treated as having a basis equal to the fair market value of such property on the residency start date. An individual may elect not to have this step-up in basis apply. Basis of property acquired after the residency start date would be computed under the "standard" basis rules.

Special rules apply to certain deferred compensation assets, certain interests in non-grantor trusts, and specified tax-deferred accounts.

Tax on gifts and bequests: A US person who receives a gift or bequest from a covered expatriate is subject to US tax on the receipt of such gift. The total value of the gift is first reduced by the available annual exclusion ($12,000 in 2008), and tax is then assessed at the highest applicable gift tax rate at the time of the gift (in 2008, the top gift tax rate is 45 percent).

Are any exclusions or deductions available under the tax imposed on gifts from covered expatriates?

Yes, marital and charitable deductions are available for transfers to a US citizen spouse or a qualified charity.

What are the special rules applicable to deferred compensation assets, interests in foreign trusts, and specified tax-deferred accounts?

Special rules apply to deferred compensation assets, tax-deferred accounts, and trust interests.

In general, deferred compensation includes all types of employer retirement plans including foreign plans, qualified retirement plans, and nonqualified retirement plans. In addition, it includes property transfers or the right to future property transfers that an individual is entitled to receive in connection with the performance of services to the extent that amounts have not been previously included in taxable income. Tax-deferred accounts include individual retirement plans, qualified tuition plans, Coverdell education plans, health savings accounts, and Archer MSAs.

Eligible deferred compensation items and interests in nongrantor trusts: For eligible deferred compensation items and nongrantor trusts from which a distribution is made to a covered expatriate subsequent to his or her expatriation date, the plan administrator or trustee is required to withhold US tax at the rate of 30 percent on the taxable portion of a distribution. This withholding tax at the time of distribution is imposed in lieu of the application of the deemed sale rules on the day before the expatriation date. For grantor trusts, the mark-to-market rules apply and this special withholding rule is not applicable. The expatriating individual may elect not to have this deferral/withholding rule apply and may instead treat the eligible deferred compensation asset or interest in the nongrantor trust as having been distributed on the day before the expatriation date.

Tax-deferred accounts and other deferred compensation: For other deferred compensation and tax-deferred accounts, the account will be treated as having been distributed on the day before the expatriation date. With respect to property transfers or the right to transfers, amounts are assumed to have been transferred and not subject to a substantial risk of forfeiture on the day before the expatriation date. The deemed distribution will be subject to income tax at ordinary income rates, but the penalties that normally apply to early withdrawals from such accounts will not apply to a deemed distribution under the expatriation rules. A basis adjustment will be made to reflect the taxation incurred as a result of the deemed distribution under the expatriation rules.

What is eligible deferred compensation?

Eligible deferred compensation is any deferred compensation item with respect to which:

- The payor is either a US person or certain non-US persons who elect to be treated as a US person for purposes of withholding, and
- The covered expatriate notifies the payor of the covered expatriate status and irrevocably waives any claim to withholding reduction under any US treaty.

How should employers prepare for the application of these rules?

Employers will need to focus on three areas when preparing for the application of these rules:

- **Compliance:** Employers will need to adopt processes to ensure proper withholding and/or reporting related to taxation under the HEART Act. Further, pending guidance concerning the valuation of certain deferred compensation such as retirement plans, employers will need to determine appropriate valuation for purposes of compliance with these rules.
- **Policy Review:** Employers will need to review their human resource policies to determine if they have any potential obligation to reimburse the taxes resulting from this Act. For example, policies covering relocation and international assignments may

contain tax reimbursement provisions that could be used to seek reimbursement of these taxes.

- **Education:** Employers may want to take steps to help their employees understand the implications of expatriation and its potential tax impact. Such education may be directed at employees who are in the process of obtaining their green card or who are permanently leaving the United States.

What if you have a deemed sale event under the expatriation rules and you do not have cash available to pay the tax?

A covered expatriate may elect to defer the tax resulting from the application of the deemed sale rules (but not the special rules for deferred compensation, tax-deferred accounts, or nongrantor trusts) until the later of:

- The due date of the tax return for the year in which a particular asset for which the deferral election was made is actually sold or otherwise disposed of, or
- The due date of the individual's final income tax return in the case where the covered expatriate dies owning property for which the deferral election was made.

Interest is charged during the period the election is in place with respect to the deferred gain, and security must be posted as collateral.

The deferral election may be made for all assets subject to the deemed sale rules or only for certain select assets. The election to defer tax under the HEART Act expatriation rules may compromise the ability of a covered expatriate to take certain treaty positions. Note that the deferral election is not applicable with respect to deferred compensation, specified tax accounts, and foreign trusts. Please discuss with your tax advisor.

Are there any exceptions to the HEART Act expatriation rules?

The HEART Act contains two very limited exceptions to the expatriation rules. In order to be exempt from the expatriation rules, an individual must meet one of the following requirements:

- **Dual-Citizen Exception:** An individual will meet this exception if the following three factors are met:
  - The individual was born with dual citizenship (i.e., US and some other country),
  - The individual retains his or her non-US citizenship and is taxed as a resident of such other country, and
  - The individual has been a resident of the US for no more than 10 taxable years during the 15 taxable years prior to (and including) the expatriation year.
- **Exception for Certain Minors:** An individual will meet this exception if: the individual relinquishes US citizenship before reaching age 18½, and the individual was not a US resident for more than 10 years preceding expatriation.

Any expatriate who meets the net worth or net income tax tests, or who fails to meet the certification requirement, will be subject to the expatriation rules unless he or she falls under one of the two exceptions listed above. Obviously, these exceptions are very narrow; therefore, very few expatriates will meet the exceptions.

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Country Spotlight:
Switzerland: Draft legislation on Corporate Tax Reform III published

On 22 September 2014, the Swiss federal government published draft legislation on the Corporate Tax Reform III, the most comprehensive corporate tax reform in more than 50 years. The main objective of the reform, which likely will become effective on January 1, 2019, is to enhance Switzerland's attractiveness as a location for multinational companies.

Many Swiss companies would benefit from lower taxation under the reform. The proposed measures generally would ensure that companies that currently benefit from a lower tax rate under one of the special tax regimes that would be abolished (see below) effectively could retain their beneficial tax rate for up to 10 years following the reform. Assuming the reform takes effect in 2019, the current tax rate for these companies essentially would be guaranteed up to 2029, i.e. for a period of 14 years, which would offer considerable certainty for affected companies.

The reform would phase out all special corporate tax regimes, such as the mixed, domiciliary, holding and principal company regimes, as well as the Swiss finance branch regime, likely as from 1 January 2019.

A number of measures are included in the Corporate Tax Reform III to compensate for the elimination of the beneficial tax regimes. The main measures that would improve the attractiveness of Switzerland as a location include the following:

- Introduction of a patent box that would apply to all income arising from the exploitation and use of patents;
- Introduction of a notional interest deduction on equity;
- Allowing a step-up (including self-created goodwill) for direct federal and cantonal/communal tax purposes upon the migration of a company to Switzerland;
- Allowing a step-up (including self-created goodwill) for cantonal/communal tax purposes for companies transitioning out of tax privileged cantonal tax regimes (such as mixed or holding companies) into ordinary taxation;
- Reduction of the general tax rates (i.e. the cantonal/communal corporate tax rates) at the discretion of the individual cantons;
- Abolition of the 1% capital issuance tax on equity contributions; Transition from an indirect to a direct participation exemption regime on dividends and capital gains to avoid tax leakage, with no minimum threshold and no minimum holding period requirement;

- Extension of the seven-year loss carryforward period to an indefinite period, with 20% of the profit as the minimum tax base;
- Allowing parent companies to assume losses from Swiss and foreign subsidiaries that cannot be used at the subsidiary level; and
- Reduction of the cantonal/communal annual net wealth tax for holding participations, group loans or intellectual property, at the discretion of the individual cantons.

Revenue-raising measures

The main revenue-raising measure would be the introduction of a capital gains tax for individuals on the disposal of shares and other securities, under which capital losses would be available for indefinite carryforward. Only 70% of capital gains on sales of shares and dividends from shares would be taxed, with no minimum ownership threshold. Capital gains tax for individuals also would apply in cases where an individual exits (i.e. migrates from) Switzerland.

Measures to attract companies to Switzerland

Patent box: A broad patent box regime would be introduced that would encompass income that is embedded in the sales price of a product, provided the Swiss company substantially contributed to the development of a patent related to the product (e.g. through a control function in the case of contract R&D). Qualifying patent income would be calculated based on a residual method, i.e. all income of a company would be considered patent income that is not specifically deducted as nonpatent income (nonpatent income would include financing income and income attributable to routine functions). The cantons would be able to exempt up to 80% of the patent income from taxation for cantonal/communal tax purposes, which generally would result in an effective tax rate of between 8% and 10% on qualifying patent income, taking into account the expected general rate reductions for the cantons. (The rate could be even lower taking into account the potential notional interest deduction on equity.) The patent box may be further refined once the recommendations of the OECD are published.

Notional interest deduction on equity: A notional interest deduction would be granted on surplus equity, which would be defined for each asset class. While most companies likely would benefit from the regime, it is designed generally to favor financing companies. The notional interest deduction rate would be equal to the 10-year Swiss government bond rate, plus 50 basis points, but would be no less than 2% (for example, if a Swiss finance company provides loans at a 2% interest rate and the corporate tax rate is 12%, the effective tax rate would be 1.8%).

Step up: A step-up would be allowed for direct federal and cantonal/communal tax purposes (including on self-created goodwill) for companies migrating to Switzerland and companies transitioning out of any of the tax privileged regimes (such as mixed companies). The step-up could be amortized for tax purposes on a straight-line basis over a maximum period of 10 years. The rationale for the step-up is that Switzerland would not tax any increase in value that did occur outside the Swiss taxing jurisdiction, either because the company was abroad or because the income was partly or fully exempt under a former privileged Swiss tax regime. The step-up essentially would grandfather the existing tax rates available under privileged tax regimes so they would continue to apply for a period of up to 10 years after the reform becomes effective.

Reduction of corporate tax rates: Many cantons would reduce their headline corporate tax rates that currently range from approximately 12% to 24% (combined federal/cantonal/communal rate). While the cantons of Lucerne and Schwyz (certain areas) already are at approximately 12%, Zug, for instance, has announced plans to reduce its rate to approximately 12%, Geneva to approximately 13% and Vaud to approximately 14%, to just to name a few of the planned reductions.

Comments

The draft legislation will be subject to an extensive consultation process where interested parties, such as political parties and the business community, can comment on the legislation and suggest changes. The consultation period will last through 31 January 2015; the government is expected to submit formal legislation to the parliament in June 2015, so that the parliament still would be able to pass the legislation during 2015. There also may be a referendum and a national vote on the legislation.

Cantonal tax laws subsequently would have to be amended to reflect the changes, so the most likely date for the law to become effective would be 1 January 2019.

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Calendars to watch

Each edition, be sure to mark your calendars for some of the more important events (recent and upcoming) as well as tax developments making in impact on businesses investing into the United States.

Recent and Upcoming Activities

January 28	Dbriefs webcast archive: New Proposed Changes to BEPS Transfer Pricing Rules: Risk, Recharacterization, and Profit Splits Watch now **URL:** http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/january/dbriefs-new-proposed-changes-to-beps-transfer-pricing-rules-risk-recharacterization-profit-splits.html?id=us:em:na:usic:eng:tax:021615

February 6	Dbriefs webcast archive: Research Tax Credits: New Opportunities for Software Development Expenses Watch now **URL:** http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/february/dbriefs-research-tax-credits-opportunities-for-software-development-expenses.html?id=us:em:na:usic:eng:tax:021615
February 10	Dbriefs webcast archive: Steering Clear of Accuracy-Related Penalties Watch now **URL:** http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/february/dbriefs-steering-clear-accuracy-related-penalties.html?id=us:em:na:usic:eng:tax:021615
February 17	Dbriefs webcast: The Global Transformation of Indirect Tax: What is your Five-Year Strategy? Register now **URL:** http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/february/dbriefs-global-transformation-indirect-tax-what-five-year-strategy.html?id=us:em:na:usic:eng:tax:021615

Recent Tax Developments

December 20	OECD Discussion Draft Released on Deductibility of Interest Expense View alert **URL:** http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-oecd-201214.pdf?id=us:em:na:usic:eng:tax:021615
December 22	OECD Releases Five Transfer Pricing Discussion Drafts View alert **URL:** http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-tpalert-25-221214.pdf?id=us:em:na:usic:eng:tax:021615

Have a question?
If you have needs specifically related to this newsletter's content, send us an email at clientsandmarketsdeloittetax@deloitte.com to have a Deloitte Tax professional contact you.