IVINS, PHILLIPS & BARKER
CHARTERED

M&A Tax, International Tax & Tax Accounting Update

October 2015

HIGHLIGHTS

Recently-Issued Guidance on Outbound Transfers Reflects a Sea Change

Recently proposed regulations under section 367 would significantly depart from IRS's long-standing approach to outbound transfers of business assets. If adopted, the regulations would tax all assets transferred for use in a foreign active business, unless identified on a narrowly-circumscribed list of "permitted" assets. In particular, these regulations would change current law by taxing under section 367 all outbound transfers of intangible assets, including foreign goodwill and going concern value. The proposed regulations would also eliminate the current 20-year cap on the useful life of a section 367(d) intangible. In short, all transfers of foreign goodwill and going concern value will be subject to tax – either immediately pursuant to section 367(a), or over time pursuant to section 367(d).

Because the proposed regulations are contrary to legislative history under section 367 and fail to distinguish between "permissible" and "abusive" outbound transfers, these regulations are susceptible to challenge under reasoning similar to that expressed in *Altera v. Commissioner* (see our September update).

Taxpayers presently contemplating a transfer of assets offshore (*e.g.*, by "unchecking-the-box" in respect of U.S.-held foreign operations) should review the proposed regulations to assess the possible tax consequences of such transactions in case these regulations are finalized and effective as of the proposed effective date of September 14, 2015.

In This Issue

1. Recently-Issued Guidance on Outbound Transfers Reflects a Sea Change
2. IRS Issues New Guidance on Tax Free Spin-offs
3. D.C. District Court Allows Judicial Review of Competent Authority Discretionary Action under a Tax Treaty
4. Second Circuit Denies Foreign Tax Credits on Economic Substance Grounds
5. Temporary and Proposed Section 956 Regulations Address U.S. Property Held by CFCs in Transactions Involving Partnerships
6. Final F Reorganization Regulations Provide Taxpayers with Additional Clarity and Flexibility
7. IRS Announces Major Changes to LB&I Audit Procedures and Organizational Structure

IRS Issues New Guidance on Tax Free Spin-offs

IRS released Rev. Proc. 2015-43 and Notice 2015-59, making changes to IRS's ruling policy with respect to certain section 355 transactions and describing issues IRS is considering in connection with potential future changes to section 355 regulations. In particular, Rev. Proc. 2015-43 provides that IRS "ordinarily" will not rule on section 355 transactions (i) involving active trades or businesses that constitute less than 5% of the gross assets of the distributing corporation or the controlled corporation or (ii) in which property owned by the distributing corporation or the controlled corporation becomes owned by a RIC or a REIT in connection with the section 355 transaction. In addition, IRS will not rule on certain transactions in which more than two-thirds of the assets of the distributing corporation or the controlled corporation consist of investment assets and certain other conditions are met.

These new "no-rule" policies appear to be aimed at "opco-propco" transactions in which a corporation spins off real estate into a newly-formed REIT and transactions similar to that currently proposed by Yahoo! with respect to its Alibaba stock. However, IRS has made clear that most of these new no-rule policies are expected to be temporary while IRS studies certain issues related to them. As a result, pending the issuance of future guidance by IRS, it may still be possible for certain transactions of these types to proceed on an opinion of counsel.

D.C. District Court Allows Judicial Review of Competent Authority Discretionary Action under a Tax Treaty

In *Starr International Co. v. United States*, the D.C. District Court refused to dismiss a refund suit relating to the U.S. Competent Authority's denial of treaty benefits to a Swiss-domiciled Panamanian company under Article 22(6) (the "discretionary limitation on benefits" provision) of the U.S-Switzerland tax treaty. The court, in rejecting the government's argument that the denial was immune from judicial review, found a meaningful standard for evaluating that governmental action in the treaty's Technical Explanation: the avoidance of "treaty shopping." The government has filed a motion for reconsideration.

IRS normally does not publish its decisions in these proceedings and maintains that denials are not subject even to administrative review. However, the court's holding that they are subject to *judicial* review should allow non-U.S. persons seeking treaty relief to gain insight into the decision-making process and develop greater leverage in these proceedings through the ability to challenge arbitrary decision-making.

Second Circuit Denies Foreign Tax Credits on Economic Substance Grounds

In *Bank of N.Y. Mellon v. Commissioner*, the Second Circuit affirmed two lower court decisions that applied the (pre-codified) economic substance doctrine to deny foreign tax credits stemming from "STARS" cross-border financial transactions. The court first rejected the taxpayers' argument that the economic substance doctrine is not applicable to foreign tax credits. The court's ultimate finding of lack of economic substance hinged on treating the foreign taxes incurred on the transactions as costs, while ignoring the related foreign tax credits, in calculating pre-tax profit from the transactions. The Second Circuit joined the Federal Circuit (in *Salem*) in viewing foreign taxes as a cost, a view not shared by the Fifth Circuit (in *Compaq*) or the Eighth Circuit (in *IES Industries*). IRS, meanwhile, has not yet taken up Congress's direction (in section 7701(o)(2)(B)) to identify the "appropriate situations" in which foreign taxes should be treated as a cost. Careful attention needs to be paid to business purpose and the evaluation of pre-tax profit in planning transactions that result in foreign tax credits.

Temporary and Proposed Section 956 Regulations Address U.S. Property Held by CFCs in Transactions Involving Partnerships

Under section 956, U.S. shareholders include in income a *pro rata* share of any increase in their CFCs' investments in U.S. property. Existing temporary regulations provide that a CFC will be considered – at IRS's discretion – to hold indirectly investments in U.S. property acquired by any other foreign corporation controlled by the CFC, if one of the principal purposes for creating or funding such other foreign corporation is to avoid the application of section 956. New temporary regulations (effective immediately) expand the scope of the term "funded" and remove the discretionary component of the rule. In addition, the temporary regulations expand the scope of the rule to include transactions involving partnerships controlled by the CFC.

Recently released proposed regulations further address how the section 956 rules should be interpreted in the context of transactions involving partnerships. These proposed rules require taxpayers to take an "aggregate" approach to the CFC's transactions with partnerships and treat an obligation of a foreign partnership as an obligation of its U.S. partners for purposes of determining the amount of the CFC's U.S. property. Under these rules, a CFC's loan to a foreign partnership would be treated as a loan made directly to each partner in proportion to the partner's profits interest in the partnership. As a result, to the extent of any U.S. partner's profits interest in such a foreign partnership, the loan would be treated as an investment in U.S. property. This look-through approach would apply regardless of whether the partnership actually distributes the loan proceeds to its partners. Until these proposed regulations are finalized, the new temporary regulations include an interim rule that applies only where an actual distribution is made that would not have been made but for the funding of the partnership. U.S. corporations with interests in foreign partnerships should carefully re-evaluate the capital structure of those partnerships in lights of these rules.

Final F Reorganization Regulations Provide Taxpayers with Additional Clarity and Flexibility

Long awaited final regulations under section 368(a)(1)(F) ("mere change" in identity, form, or place of organization of a corporation) provide rules for determining when a type-F reorganization begins and ends, and when it does not exist at all, in the context of a larger series of transactions. Proposed regulations issued in 2004 set forth a four-part test for determining when a transaction constitutes a "mere change"; and provided that redemptions and issuances of stock occurring in connection with (and even as part of) type-F reorganizations will ordinarily be respected as separate transactions. The final regulations give these rules effect, while also implementing two new requirements that deny type-F reorganization status to series of transactions that are either acquisitive or divisive in nature (and thus not "mere changes"). These regulations provide a useful planning tool in many situations by better defining when "step transaction doctrine" principles apply in the context of internal restructurings.

IRS Announces Major Changes to LB&I Audit Procedures and Organizational Structure

IRS announced that, in the first quarter of 2016, LB&I will implement sweeping changes to its audit procedures and organizational structure. The audit procedure changes will focus on creating "campaigns" that draw upon the institutional knowledge of IRS to identify the greatest risks to tax administration and deploy agency resources against those risks. This approach is intended to move away from identifying issues by scoring returns and continuously auditing the largest taxpayers without regard to their compliance risk. IRS said that the agency intends to be transparent as it develops campaigns and puts instructions out to the field.

IRS also announced significant changes to LB&I's organizational

structure. The current two deputy LB&I commissioner positions (international and domestic) will be replaced with a single deputy. Reporting directly to this deputy commissioner will be five subject matter practice areas (pass-through entities; enterprise activities; cross-border activities; withholding & international individual compliance; and treaty & transfer pricing compliance) and four geographically-arranged compliance practice areas. These practice areas will be responsible for studying compliance issues, suggesting and participating in campaigns, and developing training, audit tools, and technical content. In addition, a new position, deputy commissioner of compliance integration, will be created to ensure that campaigns are properly identified and staffed.

Who We Are

Ivins, Phillips & Barker, Chartered

1700 Pennsylvania Ave. NW, Suite 600

Washington DC, 20006

(202) 393-7600

http://www.ipbtax.com

Eric R. Fox — Tax Controversy
(202) 662-3406
ericfox@ipbtax.com

Leslie J. Schneider — Income Tax Accounting
(202) 393-7600
lschneider@ipbtax.com

Patrick J. Smith — Income Tax Accounting & Tax Controversy
(202) 662-3415
psmith@ipbtax.com

Jeffrey E. Moeller — Corporate & International
(202) 662-3450
jmoeller@ipbtax.com

Alex E. Sadler — Tax Controversy
(202) 662-3456
asalder@ipbtax.com

J. Brian Davis — Corporate & International
(202) 662-3424
bdavis@ipbtax.com

Jay M. Singer — M&A Tax
(202) 662-3457
jsinger@ipbtax.com

David D. Sherwood — Corporate & Partnership
(202) 662-3478
dsherwood@ipbtax.com

Douglas M. Andre — International
(202) 662-3451
dandre@ipbtax.com

IPB Comment Letter on 367 Regs

IPB attorneys intend to respond to the government's request for written comments regarding the proposed regulations under section 367 on or before the December 15, 2015 deadline. Taxpayers interested in participating in IPB's comment-writing effort (including on an anonymous basis) should feel free to reach out directly to Brian Davis or Pat Smith.