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Structuring and Financing International Operations

Using Hybrid Entities and Tax-Efficient Financing

BY HANNAH TERHUNE
(GREENTRADERTAX.COM)

This article considers the value of using various cross-border operating structures and financing techniques to conduct business abroad and to control your overall tax exposure at the same time.

As we all know, intense market pressures have forced many US companies to globalize. Moreover, the critical need for outsourcing solutions has forced a shift in not only manufacturing, but also in sophisticated service operations, to foreign locations. As the level of foreign activity increases, tax planning for US companies becomes more complex. This article reviews some of the key considerations in structuring and financing international operations, particularly those conducted as joint ventures with third parties.

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Building a Database of Foreign Equities Eligible for the New, Lower US Dividend Tax Rate

Marc D. Levy, Ernst & Young's National Director of Tax Services for the financial services industry, recently spoke with *Practical Strategies* about an important new development in the reporting of dividend income under US law.

The Internal Revenue Service has attempted to clarify the reporting requirements for dividends of foreign (*i.e.*, non-US) stocks qualifying for the new 15-percent US tax rate on dividend income. The "qualified dividends" are being reported now in Box 1b of IRS Form 1099-DIV for 2003. To avoid duplicating efforts this year, and to set a plan in motion for simplifying future reporting-year processes, a group of broker/dealers joined together at the end of 2003 and selected Ernst & Young to develop a database of "qualified foreign corporations."

January 31, 2004 is the deadline for reporting 2003 dividend information using IRS Form 1099-DIV. The US tax authorities recently denied a blanket request to extend that deadline for all brokerage firms and mutual funds that must report the dividend information to US shareholders.

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Using hybrid entities and tax-efficient financing techniques are two of the ways US enterprises doing business abroad control their tax costs and enhance their bottom lines. Our lead article lays out these strategies for you. *Page 1.*

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Database of Foreign Equities from page 1

"We are very pleased to have been selected to create a database of more than 17,000 securities," Mr. Levy said. "We used a series of tests to determine whether each is a 'qualified foreign corporation,' whose dividends are subject to the 15-percent maximum tax rate under the new IRS rules."

The IRS has attempted to clarify the reporting requirements for dividends of foreign (*i.e.*, non-US) stocks qualifying for the new 15-percent US tax rate on dividend income.

Ernst & Young's database is comprised of information about qualifying equity securities, and not the issuers of those securities *per se*, because many (if not most) companies issue a variety of securities, some of which will qualify for the new, lower US dividend tax rate and others that clearly will not.

Members of the Securities Industry Association took the initiative to avoid the duplication of

effort on the project, according to Levy.

Although broker/dealers are the direct users of the database, holding the qualifying equity securities as nominees for their customers, foreign issuers could be considered "indirect constituents," in that they will want to know whether the various securities they have issued are eligible for tax-favored treatment in the US.

Mr. Levy summarized the methodology used to evaluate each security to determine whether it qualifies for the new 15-percent dividend tax rate. The methodology applies a number of tests that have been prescribed in the regulations, including an equity test, a possessions test, a readily-tradable test, the treaty test, and a foreign investment company exclusion test.

Practical US/International Tax Strategies described these tests in detail in an article in our November 30, 2003 issue (Vol. 7, No. 21). The tests are summarized here.

Equity Test

The methodology applies the equity test in accordance with the simplified procedure for 2003 described in IRS Notice 2003-79. The test assumes that

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New Case Law on the Deductibility of Takeover Bid Costs Canadian Court Treats Certain Costs as Fully Deductible

BY KENNETH SNIDER
(BLAKE, CASSELS & GRAYDON)

In this article, the author examines the impact of a recent decision by the Tax Court of Canada regarding the treatment of certain takeover costs incurred by the target of an unsolicited takeover bid.

Corporations that become the subject of a takeover bid or agree to participate in a merger transaction may incur significant accounting, legal, financial advisory, and associated costs. The tax treatment of some of these costs has been a contentious issue for many years.

The Canada Customs and Revenue Agency (the "CCRA") has maintained that certain costs were either an "eligible capital expenditure" (only a portion of which can be amortized over a long period of time), or not deductible at all.

In a recent decision, *BJ Services Company Canada The Successor to Newsco Well Service Ltd. v. The Queen*, the Tax Court of Canada held that certain takeover costs incurred by the appellant as a target in an unsolicited takeover bid were fully deductible.

Newsco Well Service Ltd. ("Newsco") was a publicly-traded corporation that was approached (without solicitation on its part) by BJ Services to negotiate a "friendly merger" (the "Initial Proposal"). In response, the directors of Newsco convened a meeting at which an independent special committee was formed to deal with the proposal.

At the meeting, the board was advised by counsel of its duties and obligations, including an obligation to engage in an "auction" of Newsco and to retain financial advisors. Consequently, Newsco retained legal counsel, a Canadian investment banker, and a US industry-focused investment banker as its special advisors. The special committee retained Blake, Cassels & Graydon LLP as its legal advisor.

The Canadian financial advisor and the special committee advised the Newsco board that the Initial Proposal was "inadequate" and merited rejection. Subsequently, the directors of Newsco commenced negotiations with Great Lakes Chemical Corporation ("GLCC") to purchase Newsco.

Newsco and GLCC entered into a pre-acquisition agreement whereby GLCC agreed to bid for all of the shares of Newsco at a higher price than that initially offered by BJ Services. GLCC was en-

titled to receive a noncontingent fee (a "Hello Fee"), plus a contingency fee (a "Break Fee"), if an unsolicited proposal was made and accepted such that the GLCC offer was not accepted, or upon the occurrence of certain other specified events.

Subsequently, BJ Services submitted a higher second offer. The Newsco board recommended acceptance and the takeover was eventually completed.

Before trial, it was agreed that the legal and accounting fees would be deductible, together with certain other expenses. The issue before the Tax Court of Canada was the deductibility of the financial advisory fees and the Hello Fee and Break Fee paid to GLCC (collectively, the "Expenses").

In a recent decision, the Tax Court of Canada held that certain takeover costs incurred by the appellant as a target in an unsolicited takeover bid were fully deductible.

Newsco deducted the total amount of the Expenses of approximately \$48,000,000 in the tax year ending on the date of the takeover. CCRA disallowed the deduction on the basis that the Expenses were not incurred for the purpose of earning income or, alternatively, were on account of capital.

The first issue decided by the Canadian tax court was whether the expenses were deductible in computing income. The expenses would not have been fully deductible in computing income if they were not incurred for the purpose of earning income or were on account of capital.

The court stated that if the expenses are business in nature, instead of personal, the test for deductibility may be met by showing the expense satisfied a need of the company. Further, expenses incurred by a business, which are ancillary to its primary functions and activities, are not immediately excluded from being deductible.

While the Expenses were ancillary, the court

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Newsco retained legal counsel, a Canadian investment banker, and a US industry-focused investment banker as its special advisors.

Deducting Takeover Costs in Canada from page 3 stated that the Expenses must be viewed in the larger context of the commercial operations of Newsco. The court held that the Expenses not only satisfied a need of the company, but were necessitated in dealing with the practicalities of a take-over bid environment. The court focused on the legal and public financial market expectations of a public company during a take-over bid. The court saw no reason to exclude from deductibility those costs that a taxpayer must incur to comply with these obligations.

The Tax Court of Canada concluded that the costs were commercial in nature and, as part of the business activities of Newsco, were incurred for the purpose of earning income. The court rejected the Minister's argument (and longstanding administrative position of the CCRA) that the Expenses were incurred in the course of maximizing the share price on a potential disposition and could not meet the test of being incurred for an income-producing purpose.

The court concluded that this view was fun-

damentally inconsistent with the economic and business realities of the world of mergers and acquisitions and that the Expenses could not be divorced from the corporate activities of gaining and producing income.

The court considered whether the Expenses should be treated as capital outlays. The test applied was whether the payment was made with a view of bringing into existence an advantage for the enduring benefit of the appellant's business. The court saw no justification for capitalizing the Expenses. No capital asset was acquired or preserved and no enduring benefit was obtained, and the Expenses did not relate to any prior or subsequent period. □

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Business Deductions

US, Bahamas Information Exchange Agreement Takes Effect

Impact on Deductions for Convention/Meeting Expenses

US and Bahamian officials have exchanged diplomatic notes bringing into force a tax information exchange agreement between the two countries, which was signed in Washington in 2002.

The agreement to exchange information took effect on January 1, 2004, with respect to requests for information made in connection with criminal tax matters, and will take effect on January 1, 2006, with respect to requests for information made in connection with civil tax matters. Once the agreement is fully effective, it will be consistent with the standards for an exchange of information agreement described in the Internal Revenue Code.

At that point, US taxpayers will be able to deduct expenses associated with a convention held in the Bahamas in the same way they can deduct convention/meeting expenses incurred in certain other countries with tax information exchange agreements with the US.

Specifically, beginning on January 1, 2006, the Bahamas will be considered part of the "North American area" for purposes of determining whether US taxpayers may deduct expenses incurred in attending conventions, business meetings, and seminars in the Bahamas. Convention expenses that are incurred by US taxpayers for meetings in geographical areas considered part of the North American area and that otherwise are deductible as ordinary and necessary business expenses are allowed as deductions without regard to the additional limitations applicable to deductions for expenses associated with foreign conventions.

A list of geographical areas that currently are included in the North American area for purposes of the convention expense deduction rules is provided in Rev. Rul. 2003-109 and discussed in the September 2003 issue of *Practical US/Domestic Tax Strategies* (Vol. 3, No. 9), as sister publication of *Practical US/International Tax Strategies*.

Source: US Treasury Department Release No. JS-1075, December 31, 2003. □

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Structuring Offshore Operations

A US business has a number of choices with respect to how to operate offshore. For a primer on tax planning and business globalization, see "Business Globalization: Selecting the Proper Offshore Entity," published in *Practical US/International Tax Strategies*, Vol. 7, No. 3 (February 15, 2003).

Instead of operating through a branch in a foreign country, a US business might decide to include an industry or a host-country partner in its offshore operations, either through a contractual arrangement with that partner or through the creation of a hybrid entity.

The use of joint ventures and hybrid entities in international transactions has grown over the last several years, due at least in part to the US tax flexibility and efficiency offered by these structures. Here, a "hybrid" refers to an entity that is treated as a corporation for foreign law purposes and as a "pass through" entity for US tax purposes. A hybrid offers a number of significant advantages -- particularly, limited liability in the foreign country, combined with pass-through treatment of its tax attributes in the US.

International joint ventures can be established through contractual agreements or through structural arrangements. In everyday parlance, the international joint venture can be a "date" or a "marriage" between businesses. Deciding between the two is a function of the big picture (*e.g.*, whether the participants anticipate a single project or ongoing projects and whether limited liability is necessary).

For more discussion of this point, see "Structuring an International Joint Venture," published in *Practical US/International Tax Strategies*, Vol. 3, No. 17 (September 30, 1999).

Provided that there is a sharing of profits and losses between the US business and its partner, a contractual relationship (*e.g.*, the "date") with the industry or foreign partner will probably result in the creation of an economic activity treated as a partnership for US tax purposes.

Hybrid Entities

The use of hybrid entities (*e.g.*, the "marriage") in international transactions typically is encountered when a US business enters into a commercial venture in a foreign country, either with a local partner or with an unrelated US or third-country corporation. In most cases, the US business will have three basic tax goals:

- 1) minimize foreign taxes on the operations of the joint venture;
- 2) preserve the flexibility to defer US tax on joint venture profits; and
- 3) when joint venture profits are subject to US tax, maximize the use of foreign tax credits.

A US business can elect to have offshore operations housed in a hybrid entity (*e.g.*, an entity formed under foreign law that could be treated as either a partnership or a corporation for US tax purposes) even if the host country treats that entity as a corporation. This election is not available for an entity that US income tax regulations classify as a "*per se*" corporation.

The use of joint ventures and hybrid entities in international transactions has grown over the last several years, due at least in part to the US tax flexibility and efficiency offered by these structures.

It is necessary to file Internal Revenue Service Form 8832 to make the election. In addition, the shareholders' agreement, or other appropriate document among the owners of a hybrid entity, should include a provision obligating the non-US owners to follow the requests of the US owner with respect to filing a Form 8832, the maintenance of capital accounts, and the designation of the US business owner as the "tax matters partner."

If the international joint venture activity will incur moderate amounts of foreign income and any of its interest holders are individuals, "S" corporations, or "C" corporations that own less than a 10 percent interest in the venture, it is better to structure the joint venture as a partnership for US tax purposes. A partner is allowed a direct foreign tax credit in the amount of his or her proportionate share of foreign income taxes paid by the partnership.

Moreover, each partner may separately make the election to credit, instead of deduct, the partner's share of the partnership's foreign taxes. Each partner adds his or her distributive share of the foreign taxes paid or accrued by the partnership to any taxes paid or accrued by the partner (according to his or her method of treating the taxes), and may elect to use the total

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amount either as a credit against tax or as a deduction from income.

When the stock of a foreign corporation is owned by a partnership that has domestic corporations as its partners, eligibility for the deemed paid foreign tax credits with respect to taxes paid by the foreign corporation is determined as if each domestic corporate partner owned its proportionate share of the stock of the foreign corporation owned by the partnership. Thus, a domestic corporate partner is entitled to a credit for its share of the foreign taxes deemed to have been paid with respect to dividends received by the partnership from the foreign corporation.

The benefit of avoiding the separate limitation category is that excess foreign tax credits generated are eligible for cross-crediting (e.g., they can be used to offset US tax on other foreign-source income earned by the US corporate participant).

Even if all of the US interest holders are domestic companies that qualify for the deemed paid credit, structuring the joint venture as a hybrid entity permits US companies that own 50 percent or less of the venture to obtain "general limitation income" (rather than dividends from a noncontrolled §902 corporation) for foreign tax credit limitation purposes. The benefit of avoiding the separate limitation category is that excess foreign tax credits generated are eligible for cross-crediting (e.g., they can be used to offset US tax on other foreign-source income earned by the US corporate participant).

If the parties create a hybrid entity, and that entity is an eligible entity, it may elect to be treated as a partnership for US tax purposes. While the partnership will provide a flow through of tax items and direct foreign tax credits to the US business, it offers no opportunity for the deferral of US tax on the US partner's distributive share of the operating profits of the foreign partnership.

Controlled Foreign Corporations

As a result, the most planning flexibility exists, with respect to international joint venture operations, when business is conducted by a hybrid entity treated as a partnership for US tax purposes

in which the US partner owns such interest through a controlled foreign corporation (a "CFC"). This structure allows the effective deferral of US tax on the CFC's distributive share of profits from the foreign partnership, except to the extent that the partnership generates income that would be subpart F income if received directly by the CFC.

Under this structure, distributions from the foreign partnership will avoid US tax and remain eligible for use in other offshore ventures. When income is returned to the US joint venture participant by the CFC in the form of dividends, it will carry with it foreign tax credits for any tax paid by the foreign partnership and will most likely be general limitation income for foreign tax credit purposes.

Financing Offshore Operations

Often it will be a good idea in the foreign country of operations to finance a portion of the operating company's working or other capital requirements with loans. To the extent interest paid on the loans is deductible in the foreign country of operations, the interest expense lowers the effective rate of tax on foreign operations in the foreign country.

Moreover, distributions by the operating company that are characterized for foreign tax purposes as interest, rather than dividends, may be subject to a lower (or zero) withholding tax rate compared to the withholding tax imposed on dividend distributions by the operating company.

If the loans are treated as debt and the interest is received by a CFC (either directly or indirectly through a partnership), the interest income will constitute subpart F income taxable to the US corporation. However, if the instrument evidencing the loans can be characterized as indebtedness for foreign country tax purposes, but as an equity interest for US tax purposes, payments on the instrument by the operating company to the finance company will be characterized for US tax purposes as a distribution by a partnership of operating profits that are not subject to tax to the US business corporation as subpart F income.

To be in a position to treat an advance of funds to a foreign operating company (the borrower) as debt for foreign corporate and income tax purposes, but as an equity interest in a partnership for US tax purposes, the instrument evidencing the indebtedness (i.e., the note) should, if possible, possess most of the following characteristics:

- 1) the obligation to repay should be subordinated to all indebtedness of the borrower;
- 2) the note should not be secured by any assets of the borrower;

- 3) interest on the note should be payable only out of the net profits of the borrower;
- 4) the note should be renewable by the borrower, at its option, for additional periods of time and indefinitely if permissible under applicable foreign law; and
- 5) the principal amount of the note (together with any accrued but unpaid interest) should be payable at maturity in equity interests in the borrower.

Other advantages of using a partnership in foreign operations include the ability to deduct expenses, such as interest, in both the foreign jurisdiction and in the US without problems associated with the "netting" rule or the "soak-up" rule applicable to CFCs.

Under the netting rule, if a CFC is excessively financed by its US parent, the US parent's third-party interest expense equal to its interest income of this excessive portion is allocated directly or netted against the interest income. Thus, there is no net foreign-source interest income from the CFC and no US-source interest expense to the extent of the excessive financing.

Under the soak-up rule, if a CFC has "passive basket income," it must allocate its interest expense on inter-company debt against this passive income. Because the US parent is required to "basketize" its interest income from the CFC by reference to the income of the CFC against which its interest expense is allocated, interest income from the CFC is passive income to the US parent to the extent of the CFC's passive income.

Moreover, the allocation of the CFC's interest expense to its passive income reduces the foreign taxes paid or accrued by the CFC that are allocable to passive income and thus shifts those foreign taxes to the general limitation income basket. As a result, the passive interest income received by the US parent is unsheltered by deemed paid foreign tax credits.

Where the foreign joint venture is classified as a partnership, borrowing at the partnership level is more tax efficient than borrowing at the US partner level and reloaning the proceeds to the foreign partnership. If a US corporate partner is in an excess foreign tax credit position in the general limitation income basket, the allocation of the US partner's distributive share of the foreign partnership's interest expense against the US partner's domestic-source income, with the corresponding increase in the US partner's foreign-source general limitation income, may reduce the US partner's US tax on domestic-source income.

In effect, the interest expense incurred by the foreign partnership is fully deductible in computing the foreign income tax liability of the foreign venture and partially deductible, to the extent apportioned to domestic sources, in computing the US tax liability of the US partner on domestic source income. This approximates the result that could have been obtained had the foreign venture been conducted in corporate form, constituted a CFC, been financed by loans from its US parent, and not been subject to either the netting rule or the soak-up rule.

Other advantages of using a partnership in foreign operations include the ability to deduct expenses, such as interest, in both the foreign jurisdiction and in the US without problems associated with the "netting" rule or the "soak-up" rule applicable to CFCs.

If the foreign joint venture operations require the credit support of the US partner, it should come in the form of a guarantee rather than a "re-loan."

Conclusion

As mentioned at the outset of this article, intense market pressures have forced US manufacturing, retail, and distribution companies to "go global," using a variety of novel offshore operating and financing arrangements. With increased business opportunities abroad and more pressure to seize those opportunities has come greater tax complexity. This article has examined some of that complexity. □

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Effective International Intellectual Property Strategies to Mitigate US Taxes

BY DENNIS FERNANDEZ
(FERNANDEZ & ASSOCIATES)

In view of the increased globalization of various industries, particularly technology-based industries, such as electronics, multimedia, software, and biotechnology, there is a substantial increase in the international transfer of products, services, and revenues. Accordingly, these transfers have potential tax implications in the US and in the global arena. This article explains some basic tax and intellectual property ("IP") rights, as well as advanced strategies to reduce US and worldwide tax exposure.

Why IP? IP rights are essential in today's technology driven society. Almost every company has IP rights that require protection from excessive US tax exposure. To reduce US tax exposure, various international strategies regarding the development, manufacture, and marketing of IP must be utilized, especially issues pertaining to co-ownership and the sharing of IP rights on an international level. Taxpayers and business persons ought to take note of effective tax-mitigation strategies regarding specific cross-border IP rights and royalty transactions with certain countries.

IP rights are essential in today's technology driven society. Almost every company has IP rights that require protection from excessive US tax exposure.

Threshold Issues to Consider When Expanding into Foreign Markets

Before embarking on overseas operations such as product manufacturing, marketing, sales, or support services, a US company must consider several factors. The first factor is its US tax position. That is, what type of US shareholder it is (corporate, individual, or S corporation). The company should determine what the US foreign tax credit ("FTC") position is of the US shareholder, whether it has the ability to absorb foreign source losses, and/or if it has excess FTCs. The company should also look into what the impact of projected results under various assumptions (profits or losses) on the US tax position is.

A second factor to consider is local issues. What filing obligations are imposed in the foreign country? What customs duties could be applicable? What foreign taxes are payable when and if a company withdraws from the country (sale, liquidation, etc.)?

Thirdly, a US company must address its clients' planned operations. Who owns IP that will be used in business and where will future research and development activities ("R&D") take place? Where will manufacturing take place? How will sales be generated? How will future operations be funded? How

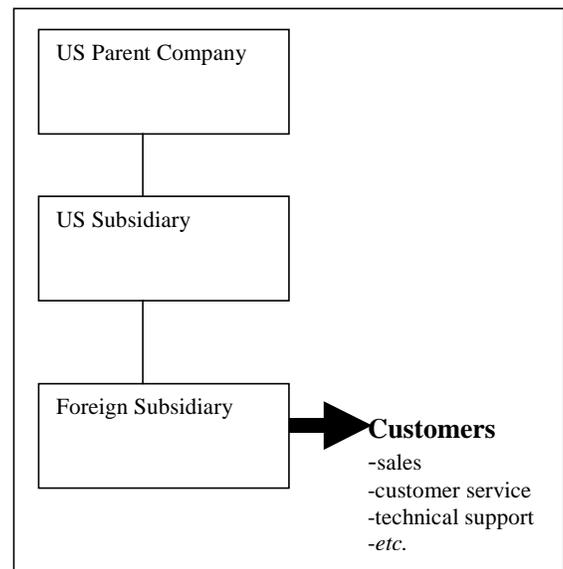
close must inventories be to customers?

A fourth factor a US company must consider when expanding into foreign markets would be the form of entity that will house its foreign operations. Foreign entities could be a foreign branch, a wholly-owned foreign subsidiary, a hybrid entity (*i.e.*, foreign subsidiary *plus* check the box election (equivalent to the US LLC)), or a joint venture (foreign subsidiary, foreign partnership, or a hybrid entity).

Fifth, it is important that the foreign entity is established with a clear understanding that its parent company's overall business objectives relate to establishing the foreign presence. The foreign entity must understand whether it is a sales office, a marketing/sales support office, customer service center, repair center, shared service center, *etc.*

Finally, a US parent company must consider the local legal, economic, and cultural factors of the foreign country, such whether the local customers prefer to deal with a local company rather than a branch of a foreign company; whether a local legal entity is required for legal reasons (*e.g.*, regulatory license of an investment advisor must be held by a legal entity); or whether local legal liability protection is desirable.

If a US company chooses to establish a foreign subsidiary, the following structure and legal characteristics would generally result in a tax efficient outcome:



Such a model entails formal incorporation of the legal entity, minimum capital requirements, formal transfer of assets to legal entity, regular board and shareholder meetings, statutory audit requirements, and formal liquidation requirements, among others.

The advantages of forming a foreign subsidiary are that economic activities of the foreign operation in a distinct legal entity are isolated; the local country provides legal liability protection; profits earned abroad generally are not taxable in the US until the company returns back home; and capital gain on sales of shares is generally exempt from the local country's taxes.

However, disadvantages include local incentives that are only available to subsidiaries.

Inbound vs. Outbound Transaction and Royalty Streams

When a multinational group is addressing the development of a new intangible, the subject of determining which member of the group should be the developer or owner of the property often arises. Depending on how the rights and obligations to the parties are structured, the arrangement could constitute a legal relationship such as a cost-sharing arrangement, licensing or sale of existing technology, and/or a partnership.

Cost-Sharing Arrangements

A cost-sharing arrangement is an agreement under which the parties agree to share the costs of the development of one or more intangibles in proportion to reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement. Under a valid cost-sharing agreement, both a domestic parent and its foreign subsidiary (for example) will incur R&D expenses and both will deduct them to reduce taxable income. However, if the foreign subsidiary is located in one of the tax havens like Bermuda or the Cayman Islands, where the tax rate is zero, the deduction will not arise for the foreign subsidiary.

A cost-sharing arrangement involves the joint development and use of intangible property through the agreement of more than one controlled or uncontrolled party to share the costs of the project. However, a different case occurs if an arrangement specifies that one party will provide the R&D services for another party, and that the second party will be responsible for the costs and risks, and therefore entitled to the project's benefits. Instead of being a cost-sharing arrangement, it would be a services arrangement under which one party is a service provider and the other is the owner (developer) of the technology.

Licensing or Sale of Existing Technology

If the terms of an arrangement are, in effect, that one party agrees to be responsible for the costs and risks of the project and, at the same time, to get a full deduction of incurred R&D expenses of the developed product, but the other party agrees to acquire certain rights in the intangible when the development project is complete, the arrangement for the development of technology could be an advance license or sale.

The other party might also agree to make an advance payment to the developer, and payment might be viewed as an advance royalty or purchase price. The form of consideration is not determinative of whether the arrangement is a license agreement. If a transferee of an intangible pays nominal or no consideration and the transferor has retained a substantial interest in the property, the arm's-length consideration will be in the form of a royalty, unless a different form is demonstrably more appropriate.

Partnerships

A partnership arrangement (also called a joint venture arrangement) typically involves a joint undertaking to conduct certain joint business activities. The terms of the respective rights and obligations of the partners, or ventures, are established in a detailed partnership agreement.

Taxpayers and business persons ought to take note of effective tax mitigation strategies regarding specific cross-border IP rights and royalty transactions with certain countries.

This is a much less inclusive undertaking than a cost-sharing arrangement, in which participants typically would come together solely for the purpose of jointly developing intangible property, not for jointly exploiting the property once it is developed or conducting any actual business operations. In this sense, a cost-sharing agreement is merely a contract to develop an intangible that each participant will have the right to exploit in its respective business operations. Under a partnership or joint venture arrangement, however, a separate legal entity is established to conduct the jointly owned enterprise.

How Does the Process Work?

When a US parent company files a patent with the USPTO, it is advisable that the filing takes place un-

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Intellectual Property

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der the Patent Corporate Treaty (the "PCT"), where all the listed countries, including the US, are designated.

Next, the US parent company sets up an offshore holding company (Foreign Sub 1) located in a low-tax jurisdiction, such as Bermuda.

Then, an offshore unit buys a stake in the parent's existing patent before it starts to generate any value. This patent is developed jointly by the parent company and Foreign Sub 1 under a cost-sharing arrangement.

Subsequently, the offshore unit licenses intangibles, such as the above-mentioned patent, to Foreign Sub 2, typically in a third country such as Ireland, which then collects royalties from foreign

subsidiaries (3, 4, 5) that sell the parent company's products to foreign customers.

Finally, royalties are returned by Foreign Sub 2 to Foreign Sub 1, which forwards one portion back to the US parent and keeps its own portion offshore, which is not subject to US taxes.

The benefit of this sort of transaction is the deferral of the transfer of income to a time that is tax-efficient for the US parent company.

A Comparison of Tax Havens

Before starting to license intangibles to foreign customers, a US parent company needs to decide where to park its IP, tax-free if possible.

When a US parent company files a patent with the US patent authorities, it is advisable that the filing take place under the Patent Corporate Treaty, where all the listed countries, including the US, are designated.

Tax Havens	Caymans	Bermuda	Ireland	Luxembourg
<u>Form</u>	Company, Unit Trust, Ltd Partnership	Company, Unit Trust, Ltd Partnership	Company, Unit Trust, Ltd Partnership	Fixed Capital Company, Variable Capital Unit Trust, Ltd. Partnership
<u>Type of Fund</u>	Open-End, Closed-End Class, Hybrid Scheme	Open-End, Closed-End	UCITS, Non-UCITS (including closed-end, venture capital, and real estate funds), Professional Investors Funds; Qualifying Professional Investors Funds	UCITS, Non-UCITS (including closed-end, venture capital, and real estates funds)
<u>Formation Time/Documentation</u>	1 week Memorandum and Articles of Association or Deed of Trust license to conduct business in the Caymans, unless: (1) minimum \$33,000 equity interest; or (2) fund listed on approved stock exchange	3 to 5 weeks Prospectus, Memorandum of Association or Deed of Trust and Application Document	2 to 3 months Memorandum and Articles of Association or Deed of Trust	3 to 5 months Prospectus and Articles of Incorporation or Deed of Trust
<u>Shareholder Meeting Required</u>	No shareholder meeting	Annual Meetings required, need not be in Bermuda	Annual Meeting must be in Ireland	Annual meeting must be in Luxembourg
<u>Taxation</u>	No individual income, corporate, capital gains, or transfer tax payable by funds or shareholders, no tax treaties.	No individual income, corporate, profit, withholding, capital gains, estate, duty, or inheritance tax payable by funds or shareholders, no tax treaties.	Special tax zone exempts funds and shareholders from income and capital gains tax. Tax benefits available for management company. Extensive tax treaty network.	No income, capital gains, withholding, or dividends tax on funds of nonresident shareholder. Tax benefits available for management company. Extensive tax treaty network.
<u>Exchange Information Between Foreign Authorities</u>	Mutual legal assistance treaty with the US provides for cooperation with regard to narcotic or fraud matters.	USA-Bermuda Tax Convention Act provides for mutual assistance in tax fraud matters; no other applicable treaties.	Under the Official Secrets Act, must maintain confidentiality, subject to limited circumstances.	Banking secrecy set by statute.

(These are mere examples or suggestions. While they have served the desired purposes in the past, the authors do not necessarily suggest or advise that these particular countries continue to provide such means. The reader is cautioned to do due diligence with regard to the current conditions of the tax haven under considerations.)

Conclusion

Companies that adopt this strategy typically cut their taxes by between five percent and 20 percent.

This effective tax-planning strategy has been employed by numerous Fortune 500 companies. □

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NatWest II Limits IRS Power to Determine Interest Expense of Foreign Companies

BY BOB COLE, SAM KAYWOOD, KEVIN ROWE,
AND EDWARD TANENBAUM (ALSTON & BIRD)

Following up on our coverage of the "NatWest decisions" (see the November 30, 2003 issue of *Practical Strategies*), this article considers the impact of those decisions on planning opportunities for certain UK and Japanese financial institutions and for other financial institutions with US permanent establishments that are not covered by the UK or Japanese treaty.

Overview

On November 14, 2003, in *National Westminster Bank, PLC v. United States* ("NatWest II"), the US Court of Federal Claims held that Article 7 of the old US-UK income tax treaty, signed December 31, 1975, and generally effective on April 25, 1980 (the "Treaty"), overrode US Treasury Department regulations that would impute additional capital to the US branch of a foreign bank and reduce the branch's interest expense deduction. *NatWest II* was the second ruling on the determination of the interest deduction of National Westminster Bank's US branch under the Treaty.

Background

Under standard provisions in US income tax treaties, a foreign company that is conducting business in the US through a branch is subject to regular US income tax on its US business income only if the business is conducted through a permanent establishment in the US (a "PE"), and only to the extent income is "attributable" to the PE. Under §1.882-5 of the US Income Tax Regulations, in determining the branch's taxable income, interest expense for the US branch is determined by apportioning the taxpayer's worldwide interest expense under a three-step apportionment formula.

Although the 1981 version of §1.882-5 of the regulations addressed in the *NatWest* cases was modified in 1996, both versions of the regulation are similar in using formulary apportionment to determine the interest deduction of the US branch.

Under the first step in the formula, the company determines the average aggregate tax basis of assets used in the US trade or business. Next, the company apportions liabilities to the US business assets, either by the actual ratio of the company's worldwide

liabilities to worldwide assets, or by a fixed ratio (95 percent for banks and 50 percent for all other companies). Finally, the interest deduction is determined by applying an interest rate to the apportioned liabilities determined under alternative formulae based on the interest rate on the liabilities shown on the books of the US business, or on the rate on dollar denominated liabilities not connected to the US business.

In each step of the formula, liabilities and interest expense associated with intra-company loans are disregarded.

Although the new UK and Japan treaties apparently override the *NatWest* cases, there may be planning opportunities for UK and Japanese financial institutions (other than insurance companies) because the diplomatic notes sanction the use of a method that is not found in §1.882-5 of the US income tax regulations.

NatWest I

Article 7 of the Treaty contains the standard provision that the profits attributable to a PE are those "it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently of the enterprise of which it is a permanent establishment."

In *National Westminster Bank, PLC v. United States*, 44 Fed. Cl. 120 (1999) ("*NatWest I*"), the court addressed whether the interest apportionment formula contained in §1.882-5 of the regulations was inconsistent with the plain language of the Treaty and whether the interest expense deduction must be based on the interest expense shown on the books of the US branch (taking into account intra-company borrowing with appropriate adjustments).

Relying heavily on Organization for Economic Cooperation and Development ("OECD") model treaty materials published in 1963, the court held that the application of the interest apportionment

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formula to the US branch of a banking corporation was "fundamentally incompatible" with Article 7 of the Treaty because branch interest expense must be based on liabilities shown on the books of the branch and not on a formula that treats the branch as a "unit of a worldwide enterprise."

The *NatWest I* court observed, nonetheless, that intra-company lending transactions must be scrutinized and possibly adjusted "as may be necessary for imputation of adequate capital to the branch and to insure market rates in computing interest expense." To the extent that capital is increased, an appropriate portion of debt would be treated as equity (with a corresponding reduction in interest expense).

Financial institutions other than insurance companies not covered by the UK or Japanese treaty may be able to invoke *NatWest* to limit the application of §1.882-5 in determining the interest expense of their US permanent establishments. However, this option may be limited.

NatWest II

How to test for "adequate capital" in the branch was the subject of *NatWest II*.

In *NatWest II*, the Internal Revenue Service proposed to adjust the capital on the branch's books by treating the branch as a separate corporation subject to US banking capital requirements (the "corporate yardstick approach"), and by looking to unrelated banks with comparable business (both in quality and quantity). In general, the required capital would be based on the capital requirements of the identified comparable banks.

The court rejected the corporate yardstick approach because, in its view, Article 7 requires only that the branch be treated as separate and distinct from the rest of the company for purposes of determining taxable income and not as a separate corporation subject to nontax capital requirements and other banking regulations that do not otherwise apply to the taxpayer.

Thus, the only permissible adjustments to the interest deductions claimed by the taxpayer are for interest deductions claimed in respect of advances labeled as capital on the books and records of the US branch or on amounts used to fund capital infrastructure and where the interest is not determined under an arms-length interest rate.

Treaty "Correction"

The new US-UK income tax treaty, effective March 31, 2003, and the recently signed but not yet effective US-Japan income tax treaty, would apparently overrule both *NatWest* cases. Diplomatic notes to both the new UK treaty and the Japanese treaty state that OECD Transfer Pricing Guidelines will apply for purposes of determining profits attributable to a PE and, in particular, that the PE "shall be treated as having the same amount of capital that it would need to support its activities if it were a distinct and separate enterprise."

With respect to financial institutions other than insurance companies, the notes continue that capital may be "attributed to a [PE] by allocating the institution's total equity between its various offices on the basis of the proportion of the financial institution's risk-weighted assets attributable to each of them."

Contrary to the *NatWest* cases, the diplomatic notes permit the attribution of capital. Moreover, the notes also sanction an apportionment method based on "risk-weighted assets" that is not found in §1.882-5 of the US income tax regulations.

Planning Considerations

Although the new UK and Japan treaties apparently override the *NatWest* cases, there may be planning opportunities for UK and Japanese financial institutions (other than insurance companies) because the diplomatic notes sanction the use of a method that is not found in §1.882-5 of the US income tax regulations.

In addition, financial institutions other than insurance companies not covered by the UK or Japanese treaty may be able to invoke *NatWest* to limit the application of §1.882-5 in determining the interest expense of their US PEs. However, this option may be limited because the version of §1.882-5 addressed in the *NatWest* cases was issued after the Treaty went into effect and the IRS would likely assert for "later in time treaties" that the treaty partner accepts the formula apportionment approach of §1.882-5 absent a contrary provision in notes accompanying the treaty. At some point, the courts will probably address this argument. □

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New US Budget Proposals Include Compliance/Enforcement Measures Affecting International Taxpayers

This article provides a concise summary of selected legislative initiatives in the Bush Administration's proposed 2005 federal budget, which would affect international taxpayers if enacted. Look for more discussion of these initiatives as the budget process gets underway in earnest in February.

The US Treasury Department has unveiled a number of legislative proposals that will be included in the president's proposed 2005 budget when it is released in February. The proposals are supposed to close tax loopholes, stop the use of several abusive tax avoidance transactions, and generally simplify the tax code. Some of the proposals include measures affecting international taxpayers. The proposed 2005 federal budget will also include a significant increase in the Internal Revenue Service operating budget.

The Bush Administration's legislative proposals for fiscal year 2005 reintroduce several prior-year tax compliance and enforcement measures, and make use of information gathered from recent IRS audits and other compliance efforts. The proposed 2005 budget also includes \$300 million for IRS compliance efforts, and increases the total IRS budget by 4.8 percent, which is significantly above the average for non-defense, non-homeland security discretionary spending. This marks the third year in a row that the Bush Administration has sought more funding for the IRS.

Finally, the administration has presented a number of proposals for simplifying the tax code for individuals and families, including provisions affecting a number of education assistance programs.

The following is a summary of selected compliance and enforcement initiatives in the proposed 2005 budget, which would affect international taxpayers. Look for more discussion of these initiatives as the budget process gets underway in earnest in February.

Penalties Concerning the Disclosure of Potentially Abusive Transactions

According to the Treasury Department, penalties for the nondisclosure of potentially abusive tax transactions by taxpayers and promoters are either nonexistent or insufficient. The

Department's March 2002 legislative proposals would have imposed significant penalties on taxpayers for failing to disclose potentially abusive transactions on a return, and on promoters for failing to comply with their registration and list-maintenance requirements. Those proposals from 2002 are being reintroduced in the administration's 2005 proposed budget.

In 2002, the US Treasury Department proposed denying foreign tax credits for foreign withholding taxes if the underlying property generating the income was not held for a specified minimum period of time. This proposal is being re-introduced now.

Other legislative proposals first introduced in 2002 (and being reintroduced now) would change the promoter registration and list-maintenance provisions of the tax code to establish uniform and consistent rules. The federal government would also receive the power to enjoin promoters that repeatedly disregarded the registration and list-maintenance requirements.

Penalty for Not Reporting Foreign Financial Accounts

Individual taxpayers must disclose on their tax returns interests in a foreign financial account, such as bank account. Under the Bush Administration's 2005 budget proposals, a new civil penalty would be imposed on the failure to disclose those accounts.

Cracking Down on Income-Separation Transactions

Legislative initiatives in the proposed 2005 federal budget also address transactions that separate a periodic income stream from an underlying income-producing asset to generate an immediate tax loss for one party and the conversion of current taxable

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income into deferred capital gain for another.

The Internal Revenue Code currently prohibits these transactions for bonds and preferred stock. However, enterprising taxpayers have been engaging in essentially identical transactions using similar assets, such as shares in a money-market mutual fund. Under the administration's proposals, an income-separation transaction would be treated as a secured borrowing, not a separation of ownership. Debt characterization would ensure that the transaction was taxed as the government wishes.

According to the Treasury Department, because of opportunities to reduce taxes on US operations through the use of foreign related-party debt, the department wants to tighten the limit on related-party interest expense.

Paring Back the Tax Practitioner Privilege

According to the Treasury Department, some non-corporate taxpayers and practitioners have asserted the statutory tax practitioner privilege to avoid the disclosure of the identity of taxpayers who have entered into potentially abusive transactions. The administration wants to expand the "corporate tax shelter" exception to the statutory tax practitioner privilege to all "tax shelters." It would also confirm that the identity of any person that a promoter must identify is not privileged and extend the statute of limitations for potentially abusive transactions that a taxpayer fails to disclose on a return until the transaction is disclosed to the IRS by the taxpayer or promoter.

Similar proposals were included in separate bills to repeal the Extraterritorial Income Exclusion Act (the "ETI Act"). Those bills were approved by the House Ways and Means Committee and the Senate Finance Committee in 2003, but have not come up for a floor vote. The full Senate passed the same tax-avoidance measures in charitable giving legislation (the "CARE Act of 2003"), although no further action was taken on the bill last year.

Transactions Involving Foreign Tax Credits

Under current US law, taxpayers may obtain

a credit for certain foreign (*i.e.*, non-US) taxes to eliminate the double taxation of foreign income (*i.e.*, taxation by both the US and the country in which the income is earned). Taxpayers have always sought ways to structure their transactions to use the US foreign tax credit to reduce their US tax liability on unrelated foreign income.

In 2002, the Treasury Department proposed denying foreign tax credits for foreign withholding taxes if the underlying property generating the income was not held for a specified minimum period of time. This proposal is being re-introduced now. Additionally, the Bush Administration would give the Treasury Department greater authority to prevent transactions that separate foreign taxes from the related foreign income to exploit the foreign tax credit when there is no risk of double taxation.

Leasing Transactions with Tax-Indifferent Parties

US taxpayers have used certain leasing transactions (*e.g.*, lease in/lease out ("LILO") and sale in/lease out ("SILO") transactions) to acquire significant tax benefits from tax-indifferent parties, such as foreign governments, in exchange for modest fees. According to the US tax authorities, LILO, SILO, and similar transactions often do not involve any useful economic activity, such as the acquisition or financing of business assets, and instead simply move a tax benefit, including depreciation, from a party that cannot use it (*e.g.*, the foreign government) to a party that can (the US taxpayer). The administration is introducing new rules that would sharply limit the tax benefits claimed by taxpayers in these transactions.

Deduction for Related-Party Interest Payments

Current law denies a deduction for certain interest paid by a company to a related party, to the extent that the company's net interest expenses exceed 50 percent of its taxable income (with certain adjustments). This limit only applies if the company's debt-to-equity ratio exceeds 1.5 to 1.0.

According to the Treasury Department, because of opportunities to reduce taxes on US operations through the use of foreign related-party debt, the department wants to tighten the limit on related-party interest expense. The Bush Administration would eliminate the current 1.5 to 1 debt-to-equity safe harbor and reduce the income threshold from 50 percent to 25 percent for related-party interest. The proposal would also limit the carryforward period for disallowed interest and

eliminate the carryover of limitation under current law so that taxpayers could not use disallowed interest expense in another year.

This proposal is similar to the earnings-stripping provision in the House Ways and Means Committee's ETI Act repeal legislation. It is a fairly big ticket item; the 10-year revenue effect of the proposal is estimated to be over \$3.1 billion.

Foreign Earnings Invested in US Property

The US shareholders of a controlled foreign corporation (a "CFC") must include in income their pro rata share of the earnings of the CFC that are invested in certain US property. Bank deposits are excluded from the definition of US property for this purpose, so that taxpayers operating through foreign subsidiaries are not discouraged from using US banks.

According to the Treasury Department, taxpayers have misinterpreted the "banking exception" and used it inappropriately. Thus, the proposed 2005 federal budget includes a provision that would alter the banking exception to eliminate the potential for abuse. It is not yet clear exactly how

the exception would be changed, however.

This proposal is similar to provisions included in both the House and Senate ETI Act repeal legislation.

Expatriate Taxation

If an individual gives up his or her US citizenship, or terminates their long-term US residency, with a principal purpose of avoiding US tax, the individual is subject to an alternative tax regime for 10 years. The Bush Administration is proposing to: (1) replace the subjective "principal purpose" test with an objective test; (2) provide that individual expatriates continue to be taxed as US citizens or residents until they give notice of the expatriating act or termination of residency; (3) provide special rules for individuals who are physically present in the US for more than 30 days per calendar year; (4) subject certain gifts of stock of closely-held foreign companies by these individuals to US gift tax; and (5) require annual reporting for these individuals.

Sources: US Treasury Department Release No. JS-1096 and Deloitte & Touche's Tax News & Views, January 13, 2004. □

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common and ordinary foreign shares (including depository receipts on such shares) are equity securities.

For securities other than common and ordinary shares, the methodology determines whether the foreign corporation has a public statement on file with the US Securities and Exchange Commission stating that the security "will be, should be, or more likely than not will be" properly classified as equity rather than as debt for US income tax purposes.

For securities identified as fixed-income securities, the analysis stops here and those securities do not qualify for the new 15-percent tax rate. For equity securities, the analysis continues.

Possessions Test

The methodology identifies securities that pay dividends from corporations organized in a US possession. If a security passes this test, it is analyzed under the foreign investment company exclusion

test (summarized below). For securities that do not pass the possessions test, the readily-tradable test (immediately below) is then applied.

Readily-Tradable Test

The methodology applies the readily-tradable test for 2003 in accordance with IRS Notice 2003-71. It identifies equity securities that are listed on an SEC-registered exchange or the NASDAQ Stock Market as readily-tradable securities.

If a security passes this test, it is then analyzed under the foreign investment company exclusion test (below). For securities that do pass the readily-tradable test, the following treaty test is applied.

Treaty Test

The methodology applies the treaty test in accordance with the simplified procedure for 2003, which is also described in IRS Notice 2003-79. The

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test identifies securities that pay dividends from foreign corporations: (1) that are organized in one of the treaty countries specified in IRS Notice 2003-69; and (2) if the treaty has a limitation on benefits provision, whose common or ordinary stock is listed on an exchange covered by the public trading test in that provision.

Levy summarized the methodology used to evaluate each security to determine whether it qualifies for the new 15-percent dividend tax rate. The methodology applies a number of tests that have been prescribed in the regulations.

If any of these companies has stated in its most recent SEC annual filing for the security that it is not eligible for benefits under the relevant treaty, the analysis stops here and the securities do not qualify for the new 15-percent US dividend tax rate.

For foreign companies that are *not* organized in one of the specified treaty countries, the analysis also stops here and the securities do not qualify for the 15-percent tax rate.

However, for foreign corporations that pass the treaty test, the security in question is then analyzed under the foreign investment company exclusion test (below).

Mr. Levy pointed out that the common or ordinary stock of a foreign issuer may be traded on an exchange in another jurisdiction (*i.e.*, in a jurisdiction other than the one the foreign issuer calls "home"), which must be covered by the public trading test. Thus, in creating the database, Ernst & Young had to identify the exchanges and equity securities traded on those exchanges that meet the test (*e.g.*, the stock of a Danish company traded on the Frankfurt exchange).

The result is a kind of "master list" of foreign-issued securities that are currently eligible for the lower US dividend tax rate.

Foreign Investment Company Exclusion Test

Finally, the methodology applies the foreign investment company exclusion test in accordance with the simplified procedure described in IRS Notice 2003-79. The application of this test excludes any foreign corporation that states in its most recent annual public filing with the SEC that it is, or expects to be, a foreign personal holding company ("FPHC"), foreign investment company ("FIC"), or passive foreign investment company ("PFIC") under US law.

Looking Beyond This Reporting Year

During his conversation with *Practical Strategies*, Mr. Levy highlighted two important points of particular interest to foreign (*i.e.*, non-US) issuers. First, the Ernst & Young database of more than 17,000 securities is currently *the* broker/dealer database for issuing foreign securities. Therefore, foreign issuers should care very much about whether their securities have been included in the database.

Further, going forward, the proposed "self-certification" process for foreign securities envisioned by the US tax authorities will require reporting to the IRS and to the broker/dealer and mutual fund communities that, practically speaking, are responsible for the mechanics of reporting dividends to US shareholders.

According to Levy, key issues that remain to be worked out include what those reporting mechanics will look like for 2004 and who will be the aggregator of the data that is ultimately required to be reported.

Levy noted that the reporting mechanics are not always so simple. For example, the tests under the new US dividend reporting rules must be applied annually, while not all foreign (or domestic) issuers are calendar year taxpayers. This fact alone raises important timing questions for everyone involved.

For more information about the US dividend reporting rules, see the November 30, 2003 issue of *Practical US/International Tax Strategies*. For more information about Ernst & Young's new database of foreign securities, visit the firm's website at www.ey.com. □

Practical Strategies wishes to thank Marc Levy, Ernst & Young's National Director of Tax Services - Financial Services Industry, for his cooperation in preparing this article. Mr. Levy can be contacted by telephone at 202-327-8079, or by email at marc.levy@ey.com.

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