U.S. International Taxation

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This article provides a brief and selective overview of 2003 developments in U.S. international taxation.

I. Treaties

The year 2003 saw the approval of U.S. income tax treaties with Australia,[1] Mexico[2] and the United Kingdom,[3] as well as the signing of a new treaty with Japan to replace the 1971 Convention.[4] The hallmark of these treaties[5] is the conditional elimination of withholding taxes on certain qualifying dividends. All four treaties are expected to have a significant and favorable effect on cross-border investment into and out of the United States.

In the new protocols with Australia and Mexico as well as in the new treaty and protocol with the United Kingdom, the United States agreed to a zero rate on dividends paid to public companies holding at least 80 percent of the voting power of the distributing company over a defined period of time. The treaty with Japan has a more generous scope, applying the zero rate if the parent company owns more than 50 percent of a subsidiary and other tests are satisfied. Although the new dividend provisions in the four agreements

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1. Ratified May 12, 2003. For withholding taxes on dividends, interest and royalties, the Protocol's provisions, with exceptions, took effect on July 1, 2003.
2. Entered into force on July 3, 2003. With respect to both countries, the dividends provisions are effective for dividends paid or credited after August 31, 2003.
3. Entered into force March 31, 2003. For taxes withheld at source, the provisions apply in both countries for amounts paid or credited on or after May 1, 2003.
4. The treaty entered into force March 30, 2004. The withholding provisions are effective in the United States for amounts paid or credited on or after July 1, 2004, and, in Japan, for amounts taxable on or after that date.
5. The agreements can be found at http://www.irs.gov/businesses/corporations/article/0,,id = 96739,00.html (last visited May 28, 2004).

do not mirror one another exactly, there can be additional criteria to receiving the zero rate, such as a twelve-month holding period, as well as eligibility under the more restrictive limitation on benefits provisions of the treaty.

II. Transfer Pricing

Worldwide, 2003 could be considered the year of transfer pricing, with many countries introducing transfer pricing tax legislation for the first time. The United States, with its comparatively long history of such legislation, presented major amendments to previous regulations and agreed on a final intergovernmental transfer pricing documentation package with fellow members of the Pacific Association of Tax Administrators (PATA).

A. Transfer Pricing Regulations

The IRS issued final rules[6] requiring that stock-based compensation be included in the cost pools of qualified cost sharing arrangements (QCSAs). The final rules are essentially identical to the proposed regulations published in 2002 and are effective with respect to stock-based compensation granted in taxable years beginning after August 27, 2003. Among the provisions in the final rules are: (1) a new provision requiring that all costs attributable to stock-based compensation be taken into account in determining the controlled participant's operating costs; (2) an elective method of measurement and timing for options on publicly traded stock of companies subject to financial reporting under U.S. GAAP (or acceptable equivalents), if the stock is traded on a U.S. securities market; (3) consistency rules to ensure that controlled participants in a QCSA use the same method of measurement and timing for all options on publicly traded stock, with respect to a particular arrangement; and (4) an amendment to Reg. § 1.482–5(c)(2)(iv) to add a provision that, in applying the comparable profits method, material differences between the tested part and the uncontrolled comparable, regarding stock-based compensation, are an appropriate basis for comparability adjustments.

The IRS also proposed regulations[7] under § 482 that address the tax treatment of intercompany service transactions and the allocation of income and deductions from intangibles. Specifically, the proposed rules would replace the transfer pricing rules covering the performance of services for a related party with new controlled service transactions rules. The proposed regulations also would revise the transfer pricing rules regarding the ownership and development of intangibles, focusing on the treatment of services contributing to the value of intangibles owned by a related party. The proposed controlled service transactions rules provide specific methods to be used in determining the arm's length price in a service transaction. The proposed regulations include the simplified cost-based method, which replaces the long standing cost-only safe harbor in the current regulations. This new method would be used for routine "low-margin" services such as certain headquarters and back-office functions.

6. Compensatory Stock Options Under Section 482, 68 Fed. Reg. 51171 (Aug. 26, 2003) (to be codified at 26 C.F.R. pts. 1, 602).

7. Treatment of Services Under Section 482; Allocation of Income and Deductions From Intangibles, 68 Fed. Reg. 53448 (proposed Sept. 10, 2003) (technical corrections were published in 68 Fed. Reg. 70214 (proposed Dec. 17, 2003) and 69 Fed. Reg. 47 (proposed Jan. 2, 2004) (to be codified at 26 C.F.R. pts. 1, 301)).

The proposed intangible owner/assistor rules set forth a new standard for identifying owners of intangibles and revised rules for determining compensation for contributing to the development or enhancement of an intangible owned by a related party. To determine ownership of an intangible, the proposed rules first provide that the owner is the individual who is considered the taxpayer and legal owner pursuant to the relevant jurisdiction's intellectual property laws. Alternatively, the owner is the holder of rights constituting an intangible pursuant to contractual terms, such as the license terms or other legal provisions. With respect to income allocations, the proposed regulations would allocate intangible income among related parties in accordance with each party's significant contributions to the development or enhancement of the intangible's value. The examples in the proposed regulations also expand the IRS's authority to impute contractual terms to match economic substance.

B. Final PATA Documentation

PATA, an intergovernmental tax organization comprised of Australia, Canada, Japan and the United States, released its final transfer pricing documentation package on March 12, 2003.[8] The documentation package offers multinational taxpayers the option of preparing uniform documentation that will provide penalty protection in all PATA jurisdictions. The package sets forth a framework whereby taxpayers may *voluntarily* prepare uniform transfer pricing documentation that complies with three operative principles: (1) reasonable efforts; (2) contemporaneous documentation; and (3) timely production as delineated by the relevant PATA member's rules. Specifically, taxpayers must make reasonable efforts to establish their transfer pricing in accordance with the arm's length principle.

III. Regulatory Projects

In addition to the 2003 transfer pricing regulatory projects, the U.S. Department of Treasury (Treasury) issued regulations—both proposed and final—in areas such as foreign currency,[9] entity classification, information reporting, shipping income, subpart F income, and partnership withholding as well as regulations clarifying a number of minor points not addressed in this article.

A. Entity Classification

Treasury finalized[10] regulations relating to amending Reg. § 301.7701-2 and -3 of the current "check-the-box" regulations. The final regulations adopt proposed regulations

8. IRS News Release IR-2003-32 (Mar. 12, 2003).

9. Guidance Regarding the Treatment of Certain Contingent Payment Debt Instruments With One or More Payments That Are Denominated in, or Determined by Reference to, a Nonfunctional Currency, 68 Fed. Reg. 51944 (proposed Aug. 29, 2003) (technical corrections made in 68 Fed. Reg. 66776 (proposed Nov. 28, 2003) (to be codified at 26 C.F.R. pt. 1)). The complexity of the proposed rules put them beyond the scope of an overview article. The rules, which address contingent payment debt instruments denominated in a foreign currency, fill the regulatory gap between regulations addressing non-contingent debt instruments denominated in a foreign currency and contingent payment debt instruments not denominated in a foreign currency. *Id.*

10. Special Rules for Certain Foreign Business Entities, 68 Fed. Reg. 60296 (Oct. 22, 2003) (to be codified at 26 C.F.R. pt. 301).

without substantive change, except that the "extraordinary transaction" rule was withdrawn as announced in Notice 2003–46. Specifically, the final regulations adopt the following provisions from the proposed regulations: (1) the rule terminating the grandfathered status of certain foreign business entities when there has been a 50 percent change of ownership of such entity; (2) the provision clarifying that a foreign eligible entity, with respect to which an entity classification election is made, which is not otherwise relevant for federal tax purposes, is deemed relevant only on the effective date specified on a Form 8832, "Entity Classification Election"; and (3) modifications to the classification rules for certain foreign eligible entities that have never been or no longer are relevant for federal tax purposes.

B. Information Reporting

Treasury updated[11] temporary and proposed information reporting regulations issued in 2002 under § 6043(c) for domestic reporting corporations that have undergone certain large corporate transactions, if the corporation or any other shareholder must recognize gain (if any) under § 367(a) (such as from certain inversion transactions). Proposed regulations, once finalized, would apply regardless of the application of § 367(a). The 2002 regulations also impose a reporting requirement on brokers who received a Form 1099-CAP from the reporting corporation as the record shareholder but held the relevant stock on behalf of another. The 2003 regulations seek to ease the reporting burden on brokers and plug reporting gaps. Specifically, most U.S. publicly issued securities are held by clearing organizations on behalf of brokerage firms. Consequently, many brokers were not directly receiving Form 1099-CAP from the reporting corporations, so there was no reasonable trigger of the brokers' reporting obligations. To address this gap, Treasury and the IRS intend to: (1) act as a central repository for corporations electing to have information publicly posted on the IRS web site; and (2) take advantage of the existing information flow between clearing organizations and brokers *without imposing reporting obligations on clearing organizations.*

C. Shipping Income

Treasury issued final regulations[12] on the treatment of income derived by foreign corporations from the international operation of ships and aircraft. The final regulations generally follow regulations proposed in 2002 and are usually effective for taxable years of foreign corporations beginning thirty days or more after August 26, 2003, with the option to apply the rules to any open years beginning after 1986. Overall, the final regulations provide, that a foreign corporation organized in a qualified foreign country and engaged in the international operation of ships or aircraft excludes qualified income, if the corporation can satisfy certain ownership and related documentation requirements.

11. Information Reporting Relating to Taxable Stock Transactions, 68 Fed. Reg. 75119 (Dec. 30, 2003) (to be codified at 26 C.F.R. pt. 1).

12. Exclusions From Gross Income of Foreign Corporations, 68 Fed. Reg. 51394 (Aug. 26, 2003) (to be codified at 26 C.F.R. pts. 1, 602).

D. Subpart F

The IRS finalized,[13] without substantive changes, 2002 proposed regulations under § 954 that expand the exceptions to subpart F for certain "qualified hedging transactions" and currency gains and losses related to certain interest-bearing liabilities of a controlled foreign corporation (CFC). Under Reg. § 1.954–2(f)(2)(v), with an exception for § 988(c)(1) transactions, a "qualified hedging transaction" excludable from subpart F income would include "commodities transactions reasonably necessary to the conduct of any business by a producer, processor, merchant or handler of commodities in a manner in which such business is customarily and usually conducted by others."[14] Examples of such transactions provided in the regulations are a manufacturer's hedge against fluctuations in the price of aluminum used in its manufactured products and an airline's hedge against fluctuations in the price of jet fuel. The final regulations also provide that the interest-bearing liabilities of a CFC will be treated (if certain other conditions are met) as dealer property if denominated in a currency so as to manage the CFC's currency risk with respect to dealer property held by the CFC. Consequently, currency gains and losses would meet the "business needs" exception and would not be categorized as subpart F income as opposed to being allocated between subpart F and non-subpart F income.

E. Withholding

The IRS issued proposed regulations[15] under § 1446 regarding the determination, reporting, and collection of withholding taxes on effectively connected taxable income (ECTI) of U.S. and foreign partnerships with foreign partners. Pursuant to § 1446, a partnership with one or more foreign partners is required to withhold tax on ECTI earned by the partnership that is allocable to its foreign partners, whether or not the income is distributed, at the rates applicable to U.S. citizens and residents. The current rules related to § 1446 withholding are contained in revenue procedures, and the proposed rules retain the current rules for the most part, with some modifications. A summary of the key differences between the rules as they currently apply and the proposed regulations follows. First, the proposed regulations generally would follow the requirements specified in the § 1441 regulations for determining partner status and classification. Subject to alternatives, the proposed regulations also would require a partnership to obtain valid Forms W-8BEN, W-8IMY or W-9 from its partners to determine the status of the partners. Second, the proposed regulations provide that the determination of a partnership's ECTI is made under the aggregate theory of partnerships. Valid partner deductions, however, are not taken into account in calculating a partner's allocable share of partnership ECTI (e.g., percentage depletion) for § 1446 purposes, but they may still be claimed by the foreign partner when computing its U.S. tax liability. Unlike the current rules, the proposed regulations provide special rules for the amount of interest expense that would be taken into account by a partnership when

13. Guidance Regarding the Definition of Foreign Personal Holding Company Income, 68 Fed. Reg. 4916 (Jan. 31, 2003) (to be codified at 26 C.F.R. pt. 1); Guidance Regarding the Definition of Foreign Personal Holding company Income, 67 Fed. Reg. 31995 (proposed May 13, 2002) (to be codified at 26 C.F.R. pt. 1).

14. 68 Fed. Reg. 4916.

15. Section 1446 Regulations, 68 Fed. Reg. 52466 (proposed Sept. 3, 2003), *corrected by* 68 Fed. Reg. 62553 (proposed Nov. 5, 2003) (to be codified at 26 C.F.R. pts. 1, 301).

determining a foreign partner's allocable share of partnership ECTI. Third, unlike the current rules, the proposed regulations would, if certain requirements are met, allow a lower tier partnership to look through a partner that is a partnership in determining whether the lower tier partnership should withhold under § 1446.

IV. Revenue Rulings and Notices

A. Section 482

The IRS ruled in Rev. Rul. 2003-96 that the fact that parties were acting in concert or with a common goal to arbitrarily shift income or deductions among themselves could not act as the sole basis for applying § 482 in a lease stripping transaction.

B. Worthless Stock Deductions

In Rev. Rul. 2003-125, the IRS ruled in connection with foreign subsidiaries that, when a check-the-box election is made to convert to a disregarded entity, the U.S. shareholder is allowed a worthless stock deduction under § 165(g)(3), if the fair market value of the assets (including goodwill and going concern value) does not exceed the entity's liabilities. The deemed check-the-box liquidation is an "identifiable event" that fixes the shareholder's loss with respect to the stock of a foreign subsidiary.

C. Stapled Stock

In Notice 2003-50, the IRS indicated that use of stapled stock strategies to deconsolidate and avoid foreign tax credit limitations, as well as the apportionment of interest expense, will be restricted by new regulations.