Practical US/International
Tax Strategies

WorldTrade Executive, Inc.
The International Business Information Source™

A Twice-Monthly Report on US/International Tax Planning

April 30, 2007
Volume 11, Number 8

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New Regulations Address Application Portfolio Interest Exemption to Foreign Partners

by Seth J. Entin (Greenberg Traurig, P.A.)

On April 11, 2007, the IRS and Treasury issued long-awaited final Regulations (TD 9323) under the "portfolio interest exemption" (Final Regulations). The Final Regulations are very favorable to foreign partners in partnerships—such as funds—that hold both equity and debt of U.S. companies. In addition, the Final Regulations are of significant interest to holders of interests in Canadian income trusts that fund their investments in U.S. target corporations with a combination of debt and equity.[1]

Background

By way of background, two different U.S. federal income tax regimes apply to nonresident aliens and foreign corporations. First, a nonresident alien or foreign corporation that is engaged in a trade or business in the United States is taxed on income that is "effectively connected" with that trade or business. Effectively connected income is taxed on a net basis (i.e., deductions allocable to that income are allowed)[2] at the applicable graduated U.S. individual or corporate rates.[3]

A different regime applies to income that is not effectively connected with a U.S. trade or business. Under this regime, a flat 30 percent tax is imposed on U.S. source "fixed or determinable, annual or periodical income" (such as interest, dividends, rents, royalties and similar types of income) earned by a nonresident alien or foreign corporation.[4] This tax is imposed on gross income, with no deductions allowed. In general, this tax is collected by means of withholding,[5] and is commonly referred to as the "30 percent withholding tax." The 30 percent withholding tax may be reduced or eliminated by bilateral income tax treaties to which the United States is a party.

Furthermore, it is possible, even without the benefit of a treaty, to avoid the 30 percent withholding tax on interest income. Since 1984, the 30 percent withholding tax does not apply to "portfolio interest" earned by a nonresident alien or foreign corporation.[6] This exemption from tax is commonly referred to as the "portfolio interest exemption."

Portfolio interest is interest (including original issue discount) that meets certain specific requirements. These requirements vary depending on whether the debt obligation is issued in "registered" or "bearer" form.[7]

Generally, interest on an obligation in registered form constitutes portfolio interest if the withholding agent receives a Form W-8 stating that the beneficial owner of the obligation is not a U.S. person.[8] Interest earned on an obligation that is not in registered form (i.e., in bearer form) can constitute portfolio interest if the issuer of the obligation complies with certain procedures generally designed to ensure that the holder of the obligation is not a U.S. person.[9]

There are, however, certain limitations on the availability of the portfolio interest exemption. For example, the portfolio interest exemption does not apply to:

- interest received by a "10 percent shareholder" of the borrower;[10]
- interest received by a controlled foreign corporation from a related person;[11]

The Final Regulations are very favorable to foreign partners in partnerships—such as funds—that hold both equity and debt of U.S. companies.

- interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business;[12]
- certain contingent interest.[13]

The 10 Percent Limitation

The portfolio interest exemption does not apply to interest received by a "10 percent shareholder" of the borrower. In the case of an obligation issued by a corporation, a "10 percent shareholder" is any person who owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote.[14] In the case of an obligation issued by a partnership, a "10 percent shareholder" is any person that owns 10 percent or more of the capital or profits interest in the partnership.[15] The § 318 attribution rules apply in determining ownership for purposes of the 10 percent limitation, with several important modifications.[16] One example, discussed later in this article, is that under the § 318 attribution rules, a person who owns an option to acquire stock is treated as owning such stock.[17] The portfolio interest statute, however, modifies that general rule. This modification provides that ownership of an option to acquire stock is not treated as stock ownership in applying the attribution rules to determine whether stock ownership is attributed

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Seth J. Entin (entins@gtlaw.com) is a Shareholder at the Miami office of Greenberg Traurig, P.A. He specializes in designing tax-efficient structures for foreign operations by U.S.-based multinational companies, as well as cross-border M&A, restructurings and asset transfers.

Final Dual Consolidated Loss Regulations

by Carl Dubert and Betsy Hecker (PricewaterhouseCoopers LLP)

On March 16, 2007, the IRS released new final regulations under section 1503(d), addressing dual consolidated losses. In general, the dual consolidated loss rules are designed to stop companies with tax residency in two jurisdictions from using the same losses to obtain tax benefits in both countries. These new regulations represent a substantial overhaul of the existing rules, although they retain the same fundamental framework. They introduce some new terminology, simplify certain of the rules, clarify many questions left unanswered by the "old" regulations that they replace—especially those raised by "check the box" structures—and contain a few surprises.

In general, under section 1503(d) and the "new" regulations, the domestic use of a "dual consolidated loss" (DCL) is not permitted. The term "domestic use" and the description of the basic rule as a "domestic use limitation rule" are new elements of these regulations, although their components are quite similar to the "old" regulations.

Dual Resident Corporations and Separate Units

The new regulations provide that a DCL may exist with respect to a "dual resident corporation," or with respect to a "separate unit" of a domestic corporation. DCLs of dual resident corporations and of separate units are addressed separately; thus the new regulations provide clarity where the "old" regulations could be confusing in their treatment of a separate unit as a dual resident corporation for some purposes but not for others.

A dual resident corporation is a domestic corporation that is subject to an income tax of a foreign country on its worldwide income or on a residence basis. A foreign insurance company that makes an election to be treated as a domestic corporation under section 953(d) and is treated as a member of an affiliated group, even if it is not subject to an income tax of a foreign country on its worldwide income or on a residence basis, is also a dual resident corporation.

A separate unit may be either a foreign branch separate unit or a hybrid entity separate unit.

A foreign branch separate unit is a business operation carried on outside the United States that, if carried on by a U.S. person, would constitute a foreign branch as defined in Treas. Reg. § 1.367(a)-6T(g)(1). However, a new rule, described below, provides that a business operation carried on in a branch (and not through a hybrid entity or a transparent entity) that is not a permanent establishment pursuant to a treaty between the United States and the country where the business operation is conducted is not a foreign branch separate unit.

A hybrid entity separate unit is an interest in an entity that is not taxable as an association for U.S. federal tax purposes but is subject to an income tax of a foreign country as a corporation (or otherwise at the entity level) either on its worldwide income or on a residence basis. Interests in non-hybrid partnerships and in non-hybrid grantor trusts are no longer separate units. In addition, the preamble to the new regulations confirms that domestic reverse hybrid entities are outside the scope of the DCL rules.

The dual consolidated loss rules are designed to stop companies with tax residency in two jurisdictions from using the same losses to obtain tax benefits in both countries.

The new regulations have an expanded separate unit combination rule. Under the old rule, only foreign branches in the same country owned by a single domestic corporation could be combined. Under the new rule, actual branches and interests in hybrid entities in the same country that are owned by members of a U.S. consolidated tax return group are combined and treated as a single separate unit. Dual resident corporations are excluded from this combination rule.

Insight: The new rule provides administrative simplicity, and may reduce the size of DCLs where some of the combined units are profitable and others have losses. However, a sale of one component of the combination may trigger recapture of the total combined DCL.

The regulations insert new rules for "transparent" entities, defined as an entity that is partially or wholly owned, directly or indirectly, by a domestic corporation, is not taxable as an association for U.S. federal tax purposes, is not subject to income tax in a foreign country as a corporation (or otherwise at the entity level) either on its worldwide income or on a

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Carl Dubert (carl.dubert@us.pwc.com) is a Principal with the Washington, D.C. office, and Betsy Hecker (betsy.hecker@us.pwc.com) is a Director with the Boston office, of PricewaterhouseCoopers LLP.

Three Foreign Tax Credit Schemes are Shut Down by the IRS

by Keith Martin (Chadbourne & Parke LLP)

The U.S. tax authorities proposed new regulations at the end of March that would shut down three types of arrangements that U.S. companies are using to generate foreign tax credits. The United States taxes U.S. companies on worldwide income, but allows credit for income taxes paid to another country so as to prevent double taxation. Credits may only be claimed for compulsory taxes, not taxes that a company pays voluntarily to another country.

One of the transactions the IRS is targeting is used by U.S. companies that borrow money from foreign banks. Rather than borrow directly, a company might borrow in a three-step arrangement that lets it borrow more cheaply after the tax results are taken into account.

The U.S. company forms a special-purpose subsidiary, or “SPV,” in the home country of the bank. It then “sells” the SPV to the bank for the amount it wants to borrow and agrees to return the money to the bank in five years as purchase price to buy back the SPV. Immediately before transferring the SPV to the bank, the U.S. company makes a capital contribution of the amount borrowed from the bank to the SPV and the SPV lends the money to another U.S. subsidiary of the U.S. company.

At the end of the day, the U.S. subsidiary pays interest on regular payment dates, and it repays the principal in five years. The SPV has to pay taxes on the interest in the home country of the bank. The bank is credited with having paid the taxes by its home country since it owns the SPV in form while the loan is outstanding. However, the U.S. company takes the position for U.S. tax purposes that it owns the SPV all along because it is bound to repurchase it. The U.S. company claims foreign tax credits.

Voluntary Tax

The IRS says in new proposed regulations that any foreign tax the U.S. company has to pay in such a case is a voluntary tax. The tax cannot be credited.

However, the regulations are so complicated that they will invite more planning to circumvent the new rules.

The IRS said it will treat foreign taxes paid in “certain structured passive investment arrangements” as voluntary taxes.

It then used almost 6,000 words to explain what it considers such an arrangement, with cross references to more than a half dozen other tax code sections that the reader must stop to read along the way. The agency would have done better to state what it will not allow in more general terms rather than try to describe the transaction structures at so granular a level.

The regulations are so complicated that they will invite more planning to circumvent the new rules.

Transferring Foreign Losses Among Group Members

The IRS also reassured taxpayers who operate through groups of companies that they will not be viewed as paying foreign taxes voluntarily where a foreign loss is transferred from one group member to another.

For example, company A may have a tax loss that it cannot use immediately. It allows the loss to be used to shelter income of its affiliate, company B. Company A will end up paying more foreign taxes in a future year because it no longer has the loss. The IRS said the higher tax company A will have to pay is not a voluntary tax. However, it did not say it as simply as this, which will require companies to pay careful attention to details. It said companies A and B will be treated as a single entity where a common U.S. parent owns at least 80 percent of both companies directly or indirectly. The U.S. parent must own at least 80 percent by both vote and value of any foreign entity that is a corporation for U.S. tax purposes. It must have at least an 80 percent profits interest—as opposed to voting interest—in any foreign entity that is a partnership for U.S. tax purposes.

The new rules are in section 1. 901-2(e)(5) of the IRS regulations. ❑

Keith Martin (kmartin@chadbourne.com) is a Partner with the Washington office of Chadbourne & Parke LLP. His practice is focused on tax and project finance. He is a member of the Advisory Board of *Practical Tax Strategies*.

Cross-Border Related Party Intangibles Transfers

by Kevin Rowe and Jack Cummings (Alston & Bird LLP)

IRS Memorandum AM-2007-007 (March 15, 2007) (Memorandum) is generic legal advice from the associate chief counsel (international) to the Large and Mid-Sized Business operating division of the IRS, answering questions about the section 482 commensurate with income standard for determining an arm's length royalty in the transfer of intangibles between related parties. One question in the memo is whether the taxpayer can affirmatively assert the commensurate with income standard in a section 482 adjustment. The answer predictably is no, although the memorandum states that the taxpayer must use the commensurate with income standard in arriving at a royalty.

The most interesting question is this: Does the word "income" in the phrase "commensurate with the income attributable to the intangible" in section 482 refer to income received prior to the transfer or license of an intangible (past profits), income anticipated to be received after the transfer or license of an intangible (projected profits), income actually received after the transfer or license of an intangible (actual profits), or some other measure of income?

Based on the common reference to the commensurate with income standard as a "super royalty," one might think the answer would be actual profits. No. The Memorandum's answer is reasonably projected profits, subject to the ability of the IRS to infer that the taxpayer's initial anticipation of profits was not reasonable, based on actual profits, and to thereby leave the burden on the taxpayer to prove why its anticipation was reasonable, despite the actual profits. This is not "new law," although section 482, and its interpretations, are not paragons of clarity.

Tax Reform Act of 1986

In 1986 Congress added a second sentence to section 482, which modifies the general rule of the section for transfers between related parties, with respect to the transfer or licensing of intangible property. The modification requires that "the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." This language was also added to section 367(d)(2) in 1986. In the Tax Reform Act of 1984, Congress enacted section 367(d) to treat outbound transfers of intangible property pursuant to tax-free transactions as sale of such property for a deemed annual payment that is contingent on the productivity and use of the transferred property. The commensurate with income standard replaced the contingent on productivity standard.

One obvious problem with the statutory language is the word "shall." It speaks of futurity. It says that the income that the secretary may attribute to the transferor of the intangible shall be commensurate with what sounds like future actual income.

The use of the word "shall" may make more sense in section 367(d)(2) to define the royalty that must be imputed when the taxpayer transfers the intangible abroad in a section 351 or 361 exchange rather than in section 482 as a means to evaluate the royalty for an intangible transfer between related parties. Normally there will be no stated royalty in such case (although there may be), and so the issue is not correcting an incorrect royalty but creating a royalty. One might have thought that section 367(d)(2) really did intend a profit split based on what actually happens, and not an arm's length front-end royalty, in contrast with section 482, which attempts to correct what is supposed to be an arm's length royalty. If there were such a difference, then the use of the word "shall" in section 482 should not mean what it means in section 367(d)(2).

But there is no such difference. In fact, there is a convergence of the two sections in regulations. Based on the legislative history of the Tax Reform Act of 1986, Reg. section 1.367(d)-1T(c)(1) states that an arm's length charge should be imputed based on section 482 regulations.

Back to the section 482 regulations, one would think that (1) it would be highly unlikely that a fixed front-end payment could suffice, and (2) a percentage of income royalty should be unassailable, if the percentage met comparability standards.

As it turns out, both points are wrong. Reg. sec. 1.482-4(f)(6) (effective after 2006) provides that lump sum royalties are permissible if equal to the present value of the equivalent required royalty. Reg. sec. 1.482-4(f)(2) Example 2 illustrates that not only the royalty rate, but the anticipated profits to which it would be applied, can be evaluated by the secretary on a look-back basis. If the intangible earns much more (or less) for the transferee than was anticipated at the time of the license, additional (or reduced) royalty may be imputed, even though the actual royalty payments rode up (or down) as a fixed percentage of the transferee's profits.

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Kevin Rowe (krowe@alston.com) is Counsel with the New York office of Alston & Bird LLP. A member of the firm's Federal and International Tax Groups, he specializes in the taxation of corporations and partnerships (including LLCs) and in international tax. Mr. Rowe is a member of the Advisory Board of *Practical Tax Strategies*. Jack Cummings (jack.cummings@alston.com) is a member of the Federal Income Tax and State and Local Tax Groups in the Washington, D.C. and Research Triangle offices of Alston & Bird. He specializes in corporate merger and reorganization tax issues, as well as state and local tax litigation.

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Same Standard for Super Royalty

Apparently the "worst case" is the lump sum royalty that does not take account of profits that actually occur. The Memorandum announces that the relevant "income" for the analysis is the projected profits, i.e., what uncontrolled taxpayers would have reasonably anticipated. This, of course, is but an embellishment on the normal rule of section 482 that the controlled taxpayers' pricing must approximate uncontrolled taxpayers' arm's length pricing. The embellishment directs a focus on profit potential, which would be an element of arm's length pricing in any event.

The key to the regulation's approach is Reg. sec. 1.482-4(f)(2), which allows periodic adjustments by the secretary to stated royalties. These must both be "commensurate with income attributable to the intangible" and also must be consistent with the arm's length standard generally applied. Let us presume that parties dealing at arm's length would not normally contractually provide for an uncontrolled renegotiation of their royalty deal if reality did not conform to the original expectations of the parties. Therefore, what can "commensurate with income" mean in this context? Can it possibly mean that the secretary can impute more royalties if the intangible hits a home run that could not reasonably have been anticipated by unrelated parties?

No. The Memorandum makes this clear. One wonders how that point could have been unclear 21 years after enactment of the second sentence of section 482. The Memorandum notes that taxpayers might argue that actual profits should control rather than anticipated profits. Presumably taxpayers would make this argument only if expectations were not met.

Conclusion

Why did this question have to be clarified and why has it taken so long? Presumably agents were enforcing the law based on hindsight alone and the National Office wanted to correct that, at least conceptually. Maybe it took so long to say this plainly because it is hard for the government to give up pure hindsight.

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from a partnership to its partner, from a trust to its beneficiaries or from a corporation to its shareholders (or vice versa).[18]

Whether the 10 Percent Limitation is Tested at the Partnership or Partner Level

Practitioners and commentators have long grappled with the question of how the 10 percent limitation is tested if the holder of the debt is a partnership that has foreign partners. The issue is whether the 10 percent limitation is tested at the partnership level (an "entity" approach) or at the partner level (an "aggregate" approach). Under the entity approach, the determinative factor is whether the partnership itself owns a 10 percent or greater interest in the U.S. borrower. If it does, the interest paid by the U.S. borrower will not qualify for the portfolio interest exemption, regardless of the magnitude of the foreign partner's interest in the partnership. On the other hand, if the 10 percent limitation is tested at the partner level, one would look to the proportionate indirect ownership interest of each foreign partner in the borrower to determine whether the foreign partner qualifies for the portfolio interest exemption on the partner's proportionate share of the interest income.[19]

> ***The Final Regulations are of significant interest to holders of interests in Canadian income trusts that fund their investments in U.S. target corporations with a combination of debt and equity.***

To illustrate this issue, assume that a partnership (U.S. or foreign) holds a debt instrument issued by a U.S. corporate borrower. The partnership also owns 20 percent of the voting stock of the borrower. One hundred unrelated nonresident alien partners each owns 1 percent of the partnership. If the 10 percent limitation is tested at the partnership level, the interest paid by the U.S. borrower will not qualify for the portfolio interest exemption, because the partnership owns 20 percent of the corporation's voting stock. However, if the 10 percent limitation is tested at the partner level, the interest income will qualify for the portfolio interest exemption, because none of the partners indirectly owns a 10 percent or greater interest in the U.S. borrower.

For some time, the only indication of the IRS' position was a 1994 Field Service Advice that took the position that the 10 percent limitation is tested at the partner level, not at the partnership level.[20] A Field Service Advice, however, is not binding authority. Therefore, practitioners have clamored for more formal IRS guidance.[21]

The IRS and the Treasury Department issued proposed regulations (REG-118775-06) addressing this issue (Proposed Regulations) on June 13, 2006. The Proposed Regulations, as well as the Final Regulations, adopt the taxpayer-friendly "aggregate" approach. Under this approach, when interest is paid to a partnership, the persons who are deemed to "receive" the interest for purposes of applying the 10 percent limitation are the nonresident alien individual partners and the foreign corporations that are partners in the partnership. The 10 percent limitation is then applied by determining each such person's ownership interest in the obligor. Therefore, in the above illustration, the interest would qualify for the portfolio interest exemption.[22]

Accordingly, under the Final Regulations, foreign partners in a partnership can earn their distributive share of the partnership's interest income free of the 30 percent withholding tax even if the partnership holds 10 percent or more of the equity in the U.S. borrower, as long as the partners do not each own a 10 percent or greater direct or constructive equity interest in the U.S. borrower.

The Preamble to the Proposed Regulations states that Treasury's adoption of the aggregate approach reflects its view that a partnership may be treated either as an aggregate of its partners or as an entity separate from its partners, depending on which characterization is more appropriate to carry out the purpose of the specific Code provision at issue. According to the Preamble, the aggregate approach in the case at hand is supported by the policy and structure of the portfolio interest statute.[23]

Application of the 10 percent Limitation to Trusts

The Final Regulations also provide rules applying the 10 percent limitation to interest paid to a "simple trust" or "grantor trust" of which a nonresident alien or foreign corporation is a beneficiary.

Although a trust generally computes its taxable income in the same manner as an individual,[24] the Code contains rules that generally permit a trust that is required to distribute all of its income currently (a "simple trust") to deduct the amounts it is required to distribute to beneficiaries.[25] To the extent that a simple trust claims a deduction for amounts it is required to distribute to its beneficiaries, the trust generally functions as a "pass-through" entity because such amounts are generally subject to taxation in the hands of the beneficiaries, retaining the same character and source as the amounts received by the trust.[26]

In addition, under the "grantor trust" rules, which generally apply to situations where a grantor or other person has certain retained rights or powers with respect to trust property or trust income, the grantor or other person may be considered the owner of all or a portion

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of the trust. To that extent, the grantor or such other person (and not the trust) is required to take into account the items of income, deduction, and credit of the trust.

When interest is paid to a simple trust or a grantor trust, an issue arises as to whether the 10 percent limitation should be applied at the trust level or the beneficiary or owner level. Under the Final Regulations, when interest is paid to a simple trust or grantor trust and the interest is distributed to or included in the gross income of a nonresident alien individual or foreign corporation that is a beneficiary or owner of the trust, as the case may be, the 10 percent limitation is applied at the beneficiary or owner level.

Time When 10 Percent Limitation is Tested

The statute does not explicitly provide the time when the 10 percent limitation is tested. The Final Regulations provide that the 10 percent limitation is tested with respect to a nonresident alien individual or foreign corporation that is a partner in the partnership at the time that a withholding agent, absent any exceptions, would otherwise be required to withhold under Sections 1441 and 1442 with respect to such interest.[27] For example, in the case of U.S. source interest paid by a domestic corporation to a domestic partnership or "withholding foreign partnership," the 10 percent limitation is applied when any distributions that include the interest are made to a foreign partner and, to the extent that a foreign partner's distributive share of the interest has not actually been distributed, on the earlier of the date that the statement required under Section 6031(c)[28] is mailed or otherwise provided to such partner, or the due date for furnishing such statement.[29]

Effective Date

The Proposed Regulations were proposed to apply to interest paid on obligations issued on or after the date that the Regulations are issued as final Regulations. What was curious about this position is that if Treasury truly believed that the aggregate approach reflected the proper interpretation of the statute, this interpretation should presumably control regardless of when the obligation was issued. Fortunately, the Final Regulations, while providing that the provisions relating to the 10 percent limitation are to apply to interest paid after the date the Regulations are published as final Regulations, also permit taxpayers to choose to apply the provisions to interest paid in any taxable year that is not closed by the period of limitations, provided that the taxpayer consistently applies the provisions to all relevant partnerships during such years.

Planning Opportunities

The Final Regulations present at least two important opportunities for foreign persons investing in the United States. First, the Final Regulations establish the general proposition that the 10 percent limitation is tested at the partner level. Therefore, if a partnership invests in the debt of a U.S. borrower, a foreign partner's distributive share of the interest income can qualify for the portfolio interest exemption even if the partnership owns a 10 percent or greater interest in the U.S. borrower, so long as the foreign partner's interest in the U.S. borrower is less than 10 percent. This significantly expands the opportunities for foreign investment in partnerships that hold U.S. debt instruments, such as funds.

Furthermore, it would appear that the Final Regulations may provide an opportunity for foreign investors, through a properly structured partnership investment vehicle, to obtain ownership potential in a

The Final Regulations expand the opportunities for foreign investment in partnerships that hold U.S. debt instruments, such as funds.

U.S. corporate or partnership borrower through an option or convertible debt without forfeiting the portfolio interest exemption. This is because, under the Final Regulations, the 10 percent limitation is tested at the partner level. Yet at the same time, as discussed above, an option (which generally includes a conversion right) is not attributed from a partnership to its partners under the statutory portfolio interest attribution rules. Therefore, when testing the 10 percent limitation at the partner level, a conversion right or option held by the partnership should not be attributed to the partners due to the statutory restriction on attribution.

For example, assume that two unrelated foreign persons, X and Y, wish to loan money to a U.S. corporation and to obtain upside equity potential and control potential in the U.S. borrower through convertible debt instruments. If X and Y were each to directly acquire a debt instrument convertible into a 10 percent or greater equity interest in the borrower, neither of them would be entitled to the portfolio interest exemption, and thus they would both be subject to the 30 percent withholding tax on the interest (subject to reduction by treaty).

On the other hand, suppose that X and Y formed a partnership that acquired a debt instrument convertible into a 10 percent or greater voting equity interest in the U.S. borrower. Under the Final Regulations, X and Y could obtain equity potential and control potential in the U.S. borrower without forfeiting the portfolio interest

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exemption. Although the partnership would be deemed to own a 10 percent or greater voting equity interest in the borrower by virtue of the conversion feature, that deemed ownership would not be attributed to X and Y due to the attribution limitation of § 871(h)(3)(C)(iii).

The Final Regulations may provide an opportunity for foreign investors to obtain ownership potential in a U.S. corporate or partnership borrower through convertible debt without forfeiting the portfolio interest exemption.

While this conclusion is surprising, this is indeed the result reached by the IRS in the 1994 FSA.[30]

As a result, X and Y could earn interest on the convertible debt instrument free of U.S. federal income tax. Moreover, if the value of the U.S. borrower increases, and X and Y wish to exercise their conversion rights[31] and then sell their stock in the borrower, X and Y could do so free of U.S. federal income tax.[32]

Conclusion

These Final Regulations should be of great interest to foreign investors who invest in the United States and to funds which seek to provide tax-efficient investment vehicles for foreign investors.

[1]The Canadian income trust market has recently been negatively affected by changes in the Canadian law that would significantly reduce the tax advantages of such trusts.
[2]§§ 873(a) and 882(c)(1)(A). All section references are to the Internal Revenue Code of 1986, as amended (Code) and the Treasury regulations thereunder, unless otherwise indicated.
[3]§§ 871(b) and 882(a). In the case of a foreign corporation, such income may also be subject to the branch profits tax. § 884.
[4]§§ 871(a) and 881.
[5]§§ 1441 and 1442.
[6]§§ 871(h) and 881(c).
[7]§§ 871(h)(2) and 881(c)(2).
[8]§§ 871(h)(2)(B) and 881(c)(2)(B).
[9]§§ 871(h)(2)(A) and 881(c)(2)(A).
[10]§§ 871(h)(3) and 881(c)(3)(B).
[11]§ 881(c)(3)(C).
[12]§ 881(c)(3)(A).
[13]§§ 871(h)(4) and 881(c)(4).
[14]§ 871(h)(3)(B)(i).
[15]§ 871(h)(3)(B)(ii).
[16]§ 871(h)(3)(C).
[17]§ 318(a)(4).
[18]§ 871(h)(3)(C)(iii).
[19]*See*, e.g., David C. Garlock, Federal Income Taxation of Debt Instruments (4th ed. 2000) § 17.04(C); Seth J. Entin, Partnerships and the Portfolio Interest Exemption, 100 Tax Notes 1171 (Sept. 1); Andrew W. Needham, A Guide to Tax Planning for Private Equity Funds and Portfolio Investments (Part 1), Tax Notes, 1215, 1239-40 (May 20, 2002); Robert J. Staffaroni, Partnerships: Aggregate v. Entity in U.S. International Taxation, 49 TAX LAW. 55, 123 (1995).
[20]1994 WESTLAW 1866354; 1994 FSA LEXIS 430 (Feb. 2, 1994).
[21]ABA Section of Taxation, The Need for Guidance on the Portfolio Interest Exemption, TAX NOTES 701 (May 10, 2004).
[22]Treas. Reg. § 1.871-14(g)(3)(i).
[23]The Preamble to the Proposed Regulations also states that no inference is intended as to whether the other limitations set forth in the definition of portfolio interest should be considered at the partner level, partnership level, or at both levels. Hopefully, such guidance will be forthcoming from the IRS and Treasury in the not-too-distant future.
[24]§ 641(b).
[25]§ 651.
[26]§ 652(b); Rev. Rul. 55-414, 1955-1 CB 385.
[27]Treas. Reg. § 1.871-14(g)(3)(ii).
[28]Section 6031(c) generally requires that nominees holding partnership interests for other persons provide the partnership with the name and address of the beneficial owner and any other information prescribed by the Secretary, and provide the beneficial owner with the information provided to the nominee by the partnership.
[29]Treas. Reg. § 1.871-14(g)(ii).
[30]Under current law, the IRS may be able to avoid the inconsistency resulting from the interplay of the aggregate approach and the option attribution rules if it were to use § 1.701-2 of the Regulations (partnership anti-abuse regulations), which were promulgated after the date of the 1994 FSA, to treat an option owned by a partnership as directly owned by the partners in testing the 10 percent limitation.
[31]*See* Rev. Rul. 72-265, 1972-1 C.B. 222 (no gain is realized upon the exchange of a convertible debenture for stock of the obligor corporation).
[32]Foreign persons are not subject to U.S. federal income tax on gain from the sale of stock that is not deemed to be effectively connected with a U.S. trade or business. *See* §§ 881(a)(2), (4); 871(a)(1)(B), (D); Treas. Reg. §§ 1.881-2(a)(1); 1441(c)(1); 1.1441-2(b)(2)(i); 1.1441-5(b)(2)(i)(B). If the stock constitutes a "U.S. real property interest," the gain from the sale of the stock will be deemed to be effectively connected with a U.S. trade or business. § 897.

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BRAZIL

Software Payments No Longer Subject to Brazilian CIDE Tax

by Eduardo Pupo and John Salerno (PricewaterhouseCoopers LLP)

According to recently-enacted Law no. 11452, certain cross-border software payments made by Brazilian companies to non-Brazilian residents are no longer subject to the CIDE tax.

When first introduced in the Brazilian tax system, CIDE was levied only on cross-border payments of royalties and technical assistance fees involving the transfer of technology. In subsequent years, however, the list of transactions subject to CIDE was expanded by the Brazilian tax authorities. In this regard, cross-border payments of service fees became subject to CIDE regardless of whether a transfer of technology was involved. Then, based on an interpretation that software payments are, by their nature, equivalent to royalties, the Brazilian tax authorities issued several rulings establishing that CIDE should also apply to software payments made by Brazilian companies to non-Brazilian companies. Note that CIDE is a tax levied at a 10 percent rate and is imposed on the Brazilian paying entity and not on the non-Brazilian payment recipient.

Law 11452 clarifies that cross-border software payments that do not involve the transfer of technology should not be subject to CIDE. This rule is retroactive to January 1, 2006, thus Brazilian taxpayers may, in principle, seek a tax refund or, alternatively seek to utilize excess CIDE paid in 2006 and 2007 to offset other Brazilian federal tax liabilities.

Note that payments under software license agreements involving the transfer of technology may continue to trigger CIDE.

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Eduardo Pupo (eduardo.pupo@us.pwc.com) is an International Tax Partner, and John Salerno (john.salerno@us.pwc.com) is an International Tax Director, with PricewaterhouseCoopers LLP in New York.

CANADA

New Amendments to Ontario's Partnership Act May Create Negative Tax Implications for Partners in Limited Liability Partnerships

by Rosanne M. Dawson (Gowling Lafleur Henderson LLP)

On August 1, 2007, new amendments to section 10 of the Ontario Partnerships Act[1] will come into force that create full shield limited liability protection. Because of these amendments, negative tax implications may occur for partners in a limited liability partnership (LLP).

The new amendments stipulate that a partner in a LLP is not liable, by means of indemnification, contribution or otherwise, for

- the debts, liabilities or obligations of the partnership or any partner arising from the negligent or wrongful acts or omissions that another partner or an employee, agent or representative of the partnership commits in the course of the partnership business; or
- any other debts or obligations of the partnership that are incurred.

However, this does not relieve a partner in a LLP from liability for:

- the partner's own negligent or wrongful act or omission;
- the negligent or wrongful act or omission of a person under the partner's direct supervision; or
- the negligent or wrongful act or omission of another partner or an employee of the partnership not under the partner's direct supervision if
  - —the act or omission was criminal or constituted fraud, even if there was no criminal act or omission, or
  - —the partner knew or ought to have known of the act or omission and did not take the actions that a reasonable person would have taken to prevent it.

Furthermore, full shield limited liability protection will not protect a partner's interest in the partnership property from claims against the partnership respecting a partnership obligation.

LLPs, continued on page 11

Rosanne Dawson is with the Tax Group in the Ottawa office of Gowlings.

LLPs *(from page 10)*

Until the new amendments come into force in August, the Ontario Partnerships Act provides only partial shield limited liability protection to a partner in a LLP for debts, obligations and liabilities of the partnership or any partner arising from negligent acts or omissions that another partner or an employee, agent or representative of the partnership commits in the course of the partnership business.

Negative tax implications may occur for partners in a limited liability partnership.

Tax Treatment of Partners

Because partial shield limited liability protection does not protect against the liabilities for the general debts of the partnership, partners in a partial shield LLP are treated as a general partner for income tax purposes. A partner in a full shield LLP is treated as a limited partner for income tax purposes because (1) their personal liability, including liability for the general debts of the partnership, is limited, and (2) they can withdraw capital or be allocated losses so that their interest in the LLP becomes negative.

Deemed Capital Gain

This means that a partner in a LLP must calculate their Adjusted Cost Base (ACB), and if their partnership interest is negative at fiscal year end, they will have a deemed capital gain equal to the amount by which the ACB is negative.

ACB is calculated by:

Adding:

- a partner's capital invested in the partnership; and
- all taxable income earned from the partnership while a partner; and
- any increases in ACB resulting from certain capital gains elections,

And then subtracting:

- allocations of partnership losses to the partner from previous fiscal periods; and
- all draws or distributions of partnership profit or capital.

In making this calculation, the Canadian Income Tax Act[2] provides that income from the partnership for each year is not added to a partner's ACB until immediately after the partnership's fiscal year-end. This creates a significant timing issue which frequently results in a negative ACB. The federal government has agreed to change the timing of the addition of taxable income from a LLP to the partner's ACB in their partnership interest to coincide with the partnership's fiscal year end, which should resolve the negative ACB issue for many partners in a full shield LLP, but not all.

ACB in a partnership interest may be negative in many other situations, such as when:

- partners have invested very little capital in the partnership, or when a partner has withdrawn capital from a partnership;
- a partner's income has been reduced, but his or her draws have not been adjusted during the year, and exceed taxable income;
- partners draw on accounting income and work in progress in excess of their taxable income;
- a partnership borrows to finance substantially all operations, including work in progress and disbursements; and
- new partners receive draws in excess of the income allocated to them in accordance with the terms of their partnership admission.

The bottom line is that partners will have to monitor their ACBs annually to ensure that they are not negative at any fiscal year-end to avoid this unintended tax consequence.

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[1] R.S.O. 1990, c. P.5.
[2] R.S.C. 1985, c. 1 (5th Supp.). ❑

Published by WorldTrade Executive, Inc.

Publisher: Gary A. Brown, Esq.
Managing Editor: Scott P. Studebaker, Esq.

Assistant Editor: Edie Creter
Contributing Editor: Alex Burgess
Special Interviews: Scott P. Studebaker
Marketing: Jon Martel
Production Assistance: Dana Pierce

WorldTrade Executive, Inc.
2250 Main Street
Suite 100, PO Box 761
Concord, MA 01742 USA
Tel: (978) 287-0301; Fax: (978) 287-0302.
Email: *info@wtexec.com*. Website: *www.wtexecutive.com*.

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New Enterprise Income Tax Law Enacted

by Chun Li (BDO Mccabe Lo)

On March 16, the National People's Congress enacted a new Law, which unifies the hitherto separate tax regimes for domestic Chinese companies and those with foreign investment (foreign-investment enterprises—FIEs).

The new Law sets a lower standard corporate tax rate of 25 percent than that provided in the existing Laws (33 percent), but removes many tax-rate reductions and tax holidays currently available to FIEs. A reduced tax rate of 20 percent will apply to small enterprises deriving small profits. Hi-tech enterprises encouraged by the Chinese government will enjoy a 15 percent rate. Tax incentives provided in the new Law are industry and technology-focused, rather than location, manufacturing and export-focused as in the existing Law for FIEs. This change coincides with China's shift from the previous economic strategies of bringing wealth to the people in particular regions first, securing employment of its masses and achieving growth through exports, to the current focus of bringing economic development to all regions of China and achieving growth through satisfying internal demand.

Certain transitional relief will be available. Enterprises that have received approval for establishment prior to the promulgation of the new Law and that are enjoying a preferential tax rate under the current rules are given five years to move progressively up to the standard tax rate under the new Law. Unused tax holidays available under the current rules are generally 'grandfathered' until expiry. Where a tax holiday has not started due to tax losses, it will be deemed to commence in the year in which the new Law comes into effect.

Resident vs. Non-Resident Enterprises

The Law applies to 'enterprises,' which are defined to include companies and other organizations that derive income. The concept of tax residence, which is new to China's income tax system is introduced. Resident enterprises will be those established under Chinese law and enterprises incorporated under foreign law but whose effective management is located in China. A resident enterprise will be subject to Chinese tax on its worldwide income, whereas a non-resident enterprise will be subject to tax on income derived from its establishment or place of business in China and on income earned outside China but effectively connected with that establishment or place of business.

One of the implications of these provisions is that domestic enterprises that have set up foreign companies as holding companies will have to consider whether these foreign companies will be caught in the Chinese tax net as resident, on account of having their place of effective management in China. Similar considerations will be relevant to companies incorporated outside China that have a substantive presence solely in China.

Chun Li (chun_li@bdo.com.hk) is a Director with BDO Mccabe Lo in Hong Kong.

Effect on Foreign Investment Enterprises

The new Law will increase the income tax burden of many FIEs that are currently in receipt of tax incentives. It will, however, decrease the income tax burden of some others, such as those engaged in service industries or wholesale or retail businesses, which are not entitled to tax rate reductions or tax holidays. Anti-avoidance provisions, such as controlled foreign company (CFC) rules and thin capitalization rules, are included, as well as the power for the tax authorities to make adjustments where arrangements that serve no commercial purpose are entered into.

The new Law will increase the income tax burden of many foreign investment enterprises that are currently receiving tax incentives.

The new Law takes effect on January 1, 2008, and in the meantime the Regulations for the Implementation of the new Law are expected.

Implications for Foreign Investors

Foreign investors will need to consider the impact of the new Law on their existing enterprises and future investments in China. They may wish to re-examine the tax planning strategies of their Chinese subsidiaries, including how best to make use of their existing tax incentives. For future investments, perhaps operational considerations such as availability of resources and infrastructure, proximity to markets, etc., will increasingly be the determining factor in choice of location, rather than tax considerations now that only limited location-based tax incentives will remain available. The ability to use new and high technology will take on increasing fiscal impact.

Now that China is ceasing to be a low-tax country due to the abolition of the broad-based tax incentives currently available to FIEs, and bearing in mind the introduction of various anti-avoidance provisions that are novel to China in the new Law, it is important for multinational groups with investments in China to revisit their international tax planning strategies to optimize global efficiency. ❑

DCL Regulations *(from page 3)*

residence basis, and is not a pass-through entity under the laws of the applicable foreign country. That is, its items of income and expense are not attributed to its owner(s) under the law of the foreign country in which the foreign branch separate unit is located or the foreign country that subjects the relevant hybrid entity or dual resident corporation to an income tax on its worldwide income or on a residence basis. A loss incurred by a transparent entity is not a DCL; rather, its items of income and expense are segregated from the other items of its owner for purposes of applying the DCL rules.

The new rule provides administrative simplicity, and may reduce the size of DCLs where some of the combined units are profitable and others have losses.

Determining the DCL

In the case of a dual resident corporation, a DCL is the net operating loss incurred in a year in which the corporation is a dual resident corporation. Net capital losses are not included, nor are any items attributable to a separate unit or an interest in a transparent entity of the dual resident corporation.

In the case of a separate unit, the old "otherwise attributable" approach has been replaced with more specific rules regarding the items that are attributable to a separate unit for purposes of determining its net loss (and thereby its DCL). Only those existing items of income, gain, deduction, and loss of the separate unit's domestic owner, as determined for U.S. tax purposes, are taken into account. The computation is made as if the separate unit were a domestic corporation, using items that are attributable to the separate unit. Items of income, gain, deduction, and loss that are otherwise disregarded for U.S. tax purposes are not regarded or taken into account for this purpose. For example, interest expense on a loan from a domestic corporation to its wholly-owned foreign branch will not create or increase a DCL in the foreign branch.

For a foreign branch separate unit, the principles of section 864(c)(2), (c)(4), and (c)(5), used for determining effectively connected income, generally apply. For purposes of determining the domestic owner's interest expense that is attributable to a foreign branch separate unit, the principles of Treas. Reg. § 1.882-5 are applied, except where the foreign country in which the foreign branch is located determines interest expense solely by reference to the branch's books and records. Foreign currency gains or losses of a domestic owner that are recognized under section 987 as a result of a transfer or remittance are not attributable to a separate unit or an interest in a transparent entity.

For a hybrid entity separate unit (and an interest in a transparent entity), the domestic owner's items of income, gain, deduction, and loss generally are attributable to the separate unit to the extent they are reflected on the books and records of the entity, as adjusted to conform to U.S. tax principles. However, this method is not available to the extent that the Commissioner determines that booking practices are employed with a principal purpose of avoiding the principles of the DCL rules. In such a case, the Commissioner may reallocate the items of income, gain, deduction, and loss.

Insight: There is no real guidance provided about the meaning of a booking practice or what booking practices might be deemed to have been used with a principal purpose of avoidance.

The new regulations do not permit "double counting" of tax items. That is, items of income, gain, loss, or deduction are attributable to only one hybrid entity separate unit, foreign branch separate unit, or transparent entity. The regulations also provide that gain or loss on the disposition of a separate unit or an interest in a transparent entity is attributable to the separate unit or the interest in the transparent entity rather than to its owner. Further, Subpart F inclusions arising from ownership of a controlled foreign corporation through a separate unit or an interest in a transparent entity are treated like dividends attributable to the separate unit or interest in a transparent entity.

Domestic Use / Foreign Use

The core element of these regulations is the domestic use limitation rule, which prohibits the "domestic use" of a DCL. In general, domestic use of a DCL occurs when the DCL is made available to offset, directly or indirectly, the income of a domestic affiliate in the taxable year in which the DCL is recognized or in any other taxable year, regardless of whether the DCL offsets income under the income tax laws of a foreign country and regardless of whether any income that the DCL may offset in the foreign country is, has been, or will be subject to tax in the United States.

This domestic use limitation rule does not apply if (1) there is an agreement regarding the use of DCLs between the United States and a foreign country, (2) the taxpayer demonstrates that no foreign use occurred in the year in which the DCL was incurred and there is no possibility that foreign use could occur in any other year by any means (the "no possibility of foreign use"

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DCL Regulations *(from page 13)*

exception), or (3) the taxpayer makes a domestic use election.

A "domestic use election" is the new regulations' analogue to the "(g)(2) election" that was available under the old regulations. To make such an election, the taxpayer must certify that there has not been, and will not be, a foreign use of the DCL during the certification period. Perhaps the most significant difference between the domestic use election under the new regulations and the (g)(2) election under the old regulations is that the old certification period (during which the taxpayer must *(i)* file an annual certification that there has been no foreign use of the DCL, and *(ii)* recapture the DCL and report it as income if certain triggering events occur) was 15 years, whereas the new certification period is only five years.

A foreign use of a DCL occurs when any portion of a deduction or loss taken into account in computing the DCL is made available under the income tax laws of a foreign country to offset or reduce, directly or indirectly, any item that is recognized as income or gain under such laws and that is, or would be, considered under U.S. tax principles to be an item of a foreign corporation or of a direct or indirect owner of an interest in a hybrid entity (that is not a separate unit).

The new regulations contain* de minimis *rules to provide relief in certain cases where only a limited foreign use occurs.

The regulations elaborate on what constitutes an indirect foreign use of a DCL. Indirect foreign use is deemed to occur if one or more items are taken into account as deductions or losses for foreign tax purposes, but do not give rise to corresponding items of income or gain for U.S. tax purposes and the item or items so taken into account have the effect of making an item of deduction or loss composing the DCL available for a foreign use.

DCL Regulations, continued on page 15

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DCL Regulations *(from page 14)*

For example, P owns a foreign disregarded entity located in Country Y (DEY), and DEY owns a foreign disregarded entity located in Country X (DEX). P's domestic subsidiary (S) owns 1 percent and DEX owns 99 percent of a Country X partnership (FRH) that has elected to be treated as a corporation for U.S. tax purposes. DEY borrows from a third party and on-lends the proceeds to DEX. DEY incurs interest expense on the third party loan, and DEX incurs interest expense on the loan from DEY that is generally disregarded for U.S. tax purposes. As a result, the interest expense incurred by DEX does not create a DCL with respect to the interest in DEX, and does not eliminate the DCL attributable to the interest in DEY. Thus, in Year 1, there is a DCL attributable to P's interest in DEY, but not to P's indirect interest in DEX.

The interest expense incurred by DEX is taken into account as a deduction for foreign tax purposes, but does not give rise to a corresponding item of income or gain for U.S. tax purposes. In addition, such interest has the effect of making an item of deduction or loss composing the DCL attributable to P's interest in DEY available for foreign use. This is because it may reduce or offset items of deduction or loss composing the DCL for foreign tax purposes, and creates another deduction or loss that may reduce or offset income of DEX for foreign tax purposes that, under U.S. tax principles, is treated as income of FRH, a foreign corporation. Accordingly, there is an indirect foreign use of the DCL attributable to P's interest in DEY, and P cannot make a domestic use election.

Insight: It is noteworthy that the regulations do not attribute the regarded interest expense to DEX under the "booking practice" anti-abuse rule in this example.

Similar results can occur when a hybrid instrument is used. Assume P owns foreign disregarded entity located in Country X (DEX), and DEX owns a Country X foreign subsidiary (FS). DEX borrows from a third party lender, and transfers the proceeds to FS in exchange for an instrument that is treated as equity for U.S. tax purposes and as debt for Country X purposes. Interest expense on the loan results in a DCL being attributable to P's interest in DEX. DEX does not elect to consolidate with FS. In Year 1, FS distributes its stock to DEX as a payment on the hybrid instrument. From a U.S. tax perspective, such payment is excluded from P's gross income under section 305, but for Country X tax purposes, such payment is treated as interest and gives rise to a deduction for FS and income for DEX. There has been an indirect foreign use of the Year 1 DCL, and P cannot make a domestic use election.

The regulations provide a narrow exception to the indirect foreign use rule where the taxpayer demonstrates to the satisfaction of the Commissioner that the item or items that gave rise to the indirect foreign use were not incurred or taken into account with a principal purpose of avoiding the domestic use limitation rule and were incurred or taken into account in the ordinary course of business. An item that is treated as interest for foreign tax purposes but is disregarded for U.S. tax purposes will be deemed to have been incurred or taken into account with a principal purpose of tax avoidance, as will an item incurred or taken into account as a result of an instrument that is treated as debt for foreign tax purposes and as equity for U.S. tax purposes.

The fundamental "mirror legislation rule" remains intact in the new regulations, so that a foreign use of a DCL is deemed to occur if the income tax laws of a foreign country would deny any opportunity for the foreign use of the DCL in the year in which the DCL is incurred, determined by assuming that such foreign country had recognized the DCL in such year, for any of the following reasons: (1) the dual resident corporation or separate unit that incurred the loss is subject to income taxation by another country (e.g., the United States) on its worldwide income or on a residence basis; (2) the loss may be available to offset income (other than the income of the dual resident corporation or separate unit) under the laws of another country; or (3) the deductibility of any portion of a deduction or loss taken into account in computing the DCL depends on whether such amount is deductible under the laws of another country. The new regulations, however, provide a stand-alone exception permitting domestic use of the DCL in spite of the foreign country's mirror legislation if the entity incurring the DCL has no affiliates in that country.

The new regulations contain *de minimis* rules to provide relief in certain cases where only a limited foreign use occurs. In particular, they apply where a separate unit disposes of assets below certain percentage thresholds, or where a domestic owner's interest in a hybrid entity is diluted to certain percentage thresholds.

Insight: The preamble indicates that, in the case of a combined separate unit, the asset *de minimis* rule applies on an aggregate basis. It is not clear from the regulations, however, whether or how the dilution *de minimis* rule would apply when a combined separate unit includes a hybrid partnership.

Triggering Events Requiring Recapture

After a domestic use election has been made, if there is a "triggering event" during the five-year certification period, the elector will be required to recapture and report as ordinary income the amount of such DCL on its tax return for the taxable year in which such triggering event occurs.

Triggering events include (1) foreign use of the DCL; (2) disaffiliation of an affiliated dual resident corporation or affiliated domestic owner of a separate

DCL Regulations, continued on page 16

DCL Regulations *(from page 15)*

unit that incurred a DCL from the consolidated group that made the domestic use election; (3) an unaffiliated dual resident corporation's or unaffiliated domestic owner's becoming a member of a consolidated group; (4) a transfer of 50 percent or more of the dual resident corporation's or separate unit's gross assets within a 12-month period; (5) a transfer by a domestic owner of 50 percent or more of the interests in a separate unit; (6) an unaffiliated dual resident corporation, unaffiliated domestic owner, or hybrid entity an interest in which is a separate unit, that incurred the DCL, becomes a foreign corporation; (7) an unaffiliated dual resident corporation or an unaffiliated domestic owner elects to be a regulated investment company, a real estate investment trust, or an S corporation; (8) the elector fails to file a required certification with respect to the DCL; (9) a DCL that was subject to the "stand-alone exception" mentioned above ceases to satisfy the conditions for that exception.

Notwithstanding the foregoing, an event described above will not constitute a triggering event if the elector demonstrates that there can be no foreign use of the DCL during the remaining certification period by any means, and certain asset transfers will not constitute a triggering event if the transfer of assets did not result in a carryover under foreign law of the losses, expenses, or deductions to the transferee.

After a triggering event has occurred, the DCL recapture occurs pursuant to an "all or nothing" rule. That is, the entire DCL that was subject to domestic use must be recaptured, even if all of the items comprising the DCL were not the subject of foreign use or otherwise implicated in the triggering event.

Some Odds and Ends

The "old" regulations provide that an S corporation is not treated as a dual resident corporation. The "new" regulations continue to exclude an S corporation from the scope of the DCL rules, but do so by providing that an S corporation is not treated as a domestic corporation and thus cannot be a dual resident corporation or own a separate unit. The new regulations also add regulated investment companies and real estate investment trusts, granting them the same treatment that is afforded to an S corporation.

The "old" regulations contain special basis adjustment rules that overrode the normal investment adjustment rules under the consolidated return regulations and subchapter K; those rules were intended to prevent the indirect deduction of a DCL. These special basis adjustment rules have been eliminated retroactively.

Insight: This rule change can result in a significant refund or effective tax rate benefit for clients that had triggering events involving or followed by a sale of the entity that incurred the DCL (or its direct or indirect owner). Careful analysis is required, however, with respect to the potential application of the loss disallowance rules and the impact on other tax attributes.

Note that, for purposes of computing a taxpayer's foreign tax credit limitation, the domestic use limitation rules are applied. Thus, items constituting the DCL are not taken into account until the year in which the items are absorbed.

Effective Date

In general, the new regulations apply to DCLs incurred in taxable years beginning on or after April 18, 2007. Taxpayers may elect to apply the new regulations to DCLs incurred in taxable years beginning on or after January 1, 2007. However, the new five-year certification period applies both to DCLs incurred under the new regulations and to DCLs incurred in prior periods. Thus, DCLs for which (g)(2) elections were made under the old regulations will be subject to the recapture and certification provisions only through the remaining five-year period from the date of the initial election (e.g., a DCL incurred in 2003 should be subject to recapture and certification until 2008; for DCLs incurred prior to 2002 the certification period should be deemed to have ended). The elimination of the special basis adjustments may also be applied retroactively.

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