

Taxation Law



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President's Message

by Paige Davis

With the end of the first quarter of 2012 quickly approaching, I wanted to provide you with an update and overview of the Taxation Section's recent and upcoming activities.

As you will see from the reports included in this newsletter, the Taxation Section committees have been busy organizing CLE presentations and engaging with the Department of Revenue on issues that are important to taxpayers and tax administration, while also keeping committee participants informed on topics of interest through practical discussions at committee meetings. The new Pro Bono Committee now provides tax practitioners with an opportunity to give back to the community by connecting tax counsel with low-income taxpayers. The Young Lawyers Committee is busy promoting the Taxation Section and the practice of tax law to upcoming tax lawyers. If you are not already involved with a committee, I strongly encourage you to participate. Committee involvement is an excellent opportunity to stay current on issues that affect your tax practice and impact your clients, while also providing an opportunity for members to interact with other practitioners in relevant areas of tax law. A list of the committees can be found at <http://www.wsba.org/Legal-Community/Sections/Taxation-Section>.

In 2011 the Tax Section hosted a number of events and CLEs for its members, including a CLE in December titled "Hot Topics in State and Federal Tax: Offshore, Online and in the Cloud," and a two-part series with the IRS regarding the use of alternative dispute resolution for federal tax controversy matters. In addition, we increased our social media presence. Members can now stay connected and share ideas through the WSBA Tax Section's LinkedIn Group, which is open to all Section members (search LinkedIn for "WSBA Taxation Section").

In 2012 we will continue to reach out to new and future tax lawyers to ensure that they understand the benefits of Tax Section membership. To further that goal, Taxation Section Executive Committee members were present at the Open Section Night hosted by the WSBA Young Lawyers Division, introducing new lawyers to the Tax Section. Further, on April 26th, the Tax Section and the University of Washington School of Law LL.M Taxation Program will be host a joint reception at Lane Powell in Seattle for LL.M Taxation students and members of the Taxation Section. The Executive Committee will be providing committee reports and updates on areas of interest to the Tax Section. All Taxation Section members are invited to the

reception, which will start at 5:00pm. You should receive a formal invitation shortly.

Be on the lookout for our upcoming events, which include the reception with the LL.M students, a young lawyers social event (lawyers of all experience levels are encouraged to attend and network with these new tax professionals), and, of course, the annual WSBA Taxation Section Luncheon and election of officers. This year's luncheon will be held on May 15th at the Columbia Tower Club in downtown Seattle. The Taxation Section is pleased to have Russ Brubaker, an assistant Director at the Department of Revenue and the new president of the Streamlined Sales Tax Governing Board (the group of 24 states working to streamline the sales tax system) as our keynote speaker at the luncheon. We look forward to seeing you there!

On a final note, as many of you are aware, a referendum was filed with the WSBA to roll back our license fee. The Taxation Section Executive Committee has reviewed the referendum and has voted unanimously to oppose it. You have received a ballot by e-mail from the WSBA. The Executive Committee encourages you to vote and to please vote "NO."

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Tax Amnesty in Washington State

by Jeffrey Mahan

During 2011, the Department of Revenue conducted the first tax amnesty program for Washington State. The idea of a tax amnesty program had been previously discussed at various levels of state government. In 2009, a report by the Washington State Auditor's Office identified Washington as one of only four states that had never conducted an amnesty program. They proposed that such a program might generate significant funds. Facing a considerable revenue shortfall for the 2011 legislative session, the Legislature passed Substitute Senate Bill 6892, creating Washington State's first amnesty program. The revenue estimates for the program were \$24,436,000 for the state, and \$3,873,000 for local governments.

Key aspects of the program included:

- It was a temporary program that ran from February 1, 2011, through April 30, 2011.
- It applied to business and occupation tax, state public utility tax, or state and local sales and use tax liabilities due before February 1, 2011.
- Taxpayers were required to submit a completed application no later than April 18, 2011, along with all outstanding tax returns including amended returns.
- Taxpayers were required to submit full payment prior to May 1, 2011, of all tax

due on any invoice for which they were seeking amnesty.

- Participating taxpayers were required to timely file and pay, in full, all tax returns that came due during the amnesty program.
- Taxpayers were required to waive their right to seek a refund or challenge the taxes on any amount granted amnesty.

More than 9,000 taxpayers applied, with 5,095 granted amnesty. The program generated approximately \$345.8 million in state and local tax, far exceeding the original estimate of \$27.8 million in state and local tax. Penalties and interest waived totaled \$91 million. Some interesting program statistics include:

- **Applications received*** 10,974
- **Number of duplicates** 1,676
- **Applications approved** 5,420
- **Businesses granted amnesty*** 5,095
- **Businesses that registered and paid taxes for the first time** 508, totaling \$29.9 million.
- **Applications denied**** 3,631

Top reasons for denial:

- Filed a late return during amnesty 34%

- Requested amnesty for invalid period 24%
- Never submitted amnesty payment 23%
- **Applications rescinded** 247
- **Appeals of amnesty denials** 410

*Some businesses submitted applications for each liability they had.

**Businesses could have multiple reasons for being denied.

By any measure, the program was a success. It provided needed revenue for state and local governments, as well as certainty and reduced liability for many taxpayers during difficult economic times. While this amnesty program was extremely successful, it would be very challenging to bring in any significant amount of revenues with another short-term amnesty and the impacts on voluntary collections could be detrimental. However, if the state ever chooses to run another amnesty like program in the future, the lessons learned here will be very beneficial. For more information on the program and lessons learned, go to <http://dor.wa.gov/Content/Home> and click on 2011 Amnesty Report under News and Announcements.

**When you have finished reading this newsletter,
please pass it on to someone else in your firm.**

Adoption of a Territorial Tax System: The Good, the Bad, and the Indifferent

by Gary P. Tober – Garvey Schubert Barer – Seattle, Washington and Lisa Findlay – Tax Consultant, WSBA member

I. Introduction

International tax reform has been a subject of Congressional examination since at least 1918, when the first foreign tax credit was enacted.¹ Until now, arguably the most significant comprehensive changes to how the United States taxes income from cross-border trade and investment occurred in 1962² and 1986.³ That may be about to change.

As part of the ongoing push for broader tax reform, House Ways and Means Committee Chairman Dave Camp released the proposed Tax Reform Act of 2011 (the “Proposal”), which would fundamentally alter how the United States taxes cross-border activity of U.S. corporate taxpayers.⁴ The Proposal would largely move the United States to a territorial tax regime, exempting foreign source business income from U.S. income tax by means of a 95%⁵ exemption for dividends, and similar income from foreign branches, attributable to such foreign-source business income.

This article is not intended to be an exhaustive review of the Proposal, but provides a brief overview of each provision of the Proposal. The specific provisions of the Proposal are summarized in Part III. In Part IV some issues that were not addressed in the Proposal but should be considered in moving forward are considered. Additionally, this article looks at some specific structures and planning arrangements frequently utilized by U.S. corporate taxpayers to manage their overall effective tax rate. In Part V the viability and usefulness of specific planning arrangements and how such arrangements may be impacted by the Proposal is discussed.

II. The Need for Reform

There have long been calls for reform of the U.S. corporate tax system, particularly as it relates to foreign business income. Recently, competitiveness worries have dominated discussions of U.S. corporate tax reform. This is especially true as other countries have moved to a territorial or exemption system and corporate tax rates have fallen around the world. A relative

high corporate tax rate hinders U.S. competitiveness in the global marketplace by increasing the cost of conducting business and limiting the after-tax return on investment. The U.S. corporate tax rate, the argument goes, makes it harder for the United States to attract and retain capital. The result is an outmigration of jobs and increased investment in low-tax jurisdictions, besides the rise of aggressive tax avoidance.

But what might that reform look like? The Proposal offers one view of what reform might look like and focuses in on what many consider the most dysfunctional aspects of the U.S. corporate income tax: high tax rate and tax avoidance.

III. Summary of the Proposal

A. Overview

The Proposal establishes an exemption system for foreign business income, but largely retains subpart F of the Internal Revenue Code (the “Code”)⁶ to treat certain types of passive and highly mobile income as currently includible in the taxable income of a U.S. shareholder, whether or not repatriated, and generally allows foreign tax credits (“FTC”) for this type of income.

The Proposal envisions taxation of cross-border income received by U.S. corporate taxpayers from related foreign corporations and foreign branches (excluding passive foreign investment companies) (“PFICs”)⁷ under a combination of three regimes depending on the type of income:

1. Foreign business income. Dividends received from controlled foreign corporations (“CFC”)⁸ and electing 10/50 companies,⁹ as well as similar income of foreign branches, derived from non-subpart F foreign income (gross of any foreign withholding tax) would be eligible for a 95% exemption via a dividends received deduction.
2. Portfolio investment income. Portfolio investment income, including dividends (gross of any foreign

withholding tax) from non-electing 10/50 companies, foreign companies in which the U.S. shareholder owns less than a 10-percent interest, and CFCs and electing 10/50 companies for which the required one-year holding period is not satisfied, would be subject to full taxation. A direct FTC under section 901 for any foreign withholding taxes withheld would be available. No indirect FTC would be allowed under section 902, which is to be repealed under the Proposal.

3. Subpart F income. Subpart F income of CFCs and electing 10/50 companies, as well as similar income of foreign branches, would continue to be subject to current U.S. income tax. Subpart F inclusions would continue to be eligible for section 78 gross-up and credits for indirect section 960 credits as well as direct section 901 credits for foreign taxes paid.

B. Dividends received deduction for dividends from CFCs

The Proposal would create a new section 245A that provides for a 95% dividends-received deduction (“DRD”) for qualified foreign-source dividends received by a corporate 10-percent U.S. shareholder from a CFC, subject to a 365 day holding period. The taxation of the 5% residual dividend amount is intended as a substitute for a disallowance of expenses incurred to generate the exempt income.

The 95% DRD would apply only to foreign-source dividends. The foreign-source portion of a dividend qualifying for the 95% DRD would be determined based on the ratio of the CFC’s undistributed foreign earnings to total undistributed earnings. Undistributed earnings is defined as the earnings and profits of the foreign corporation computed under sections 964(a) and 986, including earnings previously included by the U.S. shareholder under subpart F.

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C. Foreign branches of domestic corporations treated as CFCs and eligible for 95% DRD

The Proposal would treat any foreign branch of a U.S. corporation, including check-the-box branches constituting disregarded entities (“DRE”), as CFCs for all purposes of the Code. A foreign branch of a U.S. corporation is intended to be determined under rules and principles applicable in determining whether a foreign corporation is engaged in a U.S. trade or business... of such domestic corporation in a foreign country.”

By treating foreign branches as CFCs, income from foreign branches would be eligible for the 95-percent DRD regime. However, foreign branches would be treated as CFCs for all purposes of the Code which also means that foreign branches would become subject to subpart F, sections 482 and 367 would become applicable to all transactions between the foreign branch and its domestic corporation and no credit or deduction generally would be allowed for foreign taxes paid by the foreign branch, other than under section 960 for a subpart F income inclusion with respect to the foreign branch.

D. Election to treat 10/50 companies as CFCs eligible for 95% DRD

Under the Proposal, any corporate U.S. shareholder of a 10/50 company in the top three tiers of a foreign corporate chain may elect to treat the 10/50 company as a CFC. As a result, such 10/50 company would be eligible for the 95% DRD, but also subject to all other provisions of the Code applicable to CFCs, including subpart F. A 10/50 company below the third tier would be ineligible for the election, and would also be denied section 902 credits which is to be repealed under the Proposal. Further, dividends from a 10/50 lower tier 10/50 company ineligible for the DRD would generally result in subpart F income in the hands of a CFC payee.

E. 95% exemption for gain from sale or exchange of qualified foreign corporation stock

The Proposal would create a new section 1247, providing an exemption for 95% of any gain recognized from the sale or exchange by a U.S. Shareholder of stock in qualified foreign corporation, but only if the U.S. shareholder has held such stock for at least one year. For this purpose, a qualified foreign corporation would mean a CFC (including a foreign branch or 10/50 company treated as a CFC for purposes of the 95% DRD) if at least 70% of the CFC's assets are active assets both at the time of the sale or exchange and during a three-year testing period.

Any losses realized from such a sale or exchange would be disallowed. The rules for gains and losses from non-qualifying sales of foreign corporation stock, including sales by CFCs of CFC and 10/50 company shares, would be unchanged by the Proposal.

F. Modifications to current subpart F regime

The Proposal would modify but generally retain the current subpart F regime. Subpart F would be retained to ensure that the 95% exemption applies only to income from the conduct of an active foreign business. The Proposal would modify the current subpart F regime as follows:

1. Section 956 would be repealed as all non-subpart F foreign earnings of a CFC generally would be eligible for the 95% DRD.
2. Sections 959 and 961 would be repealed, meaning that 5% of any earnings of a CFC that were currently taxed to a U.S. Shareholder under subpart F would again be subject to U.S. income tax when actually distributed.

In addition, as noted previously, CFC rules would be extended to foreign branches and 10/50 companies treated as CFCs for purposes of the 95% DRD.

G. Modifications to the current law foreign tax credit regime

The Proposal provides a number of modifications to the current U.S. FTC

regime. The principal change is the repeal of the deemed-paid foreign tax credit with respect to actual dividends. Under the Proposal, the 95% DRD would be the primary mechanism for relieving double taxation of foreign source business income. However, the deemed-paid FTC regime under section 960 would continue to apply to subpart F income inclusions and other foreign income not eligible for the 95% DRD. Multi-year pooling would be eliminated for section 960 credits.

Although the new FTC regime would preserve the FTC limitation, it would place all foreign taxes in one basket. In addition, the recently enacted section 909 rules, regarding separation of foreign income from associated taxes, would be repealed. Another change is that only directly-allocable expenses would be considered in determining the FTC limitation. “Directly allocable deductions” are defined as “deductions that are directly incurred as a result of the activities that produce the related foreign-source income.” The Technical Explanation provides that directly allocable expenses may include such items as salaries of sales personnel, supplies, and shipping expenses directly related to the production of foreign-source income, but not “stewardship expenses, general and administrative expenses, or interest expense.”

H. Disallowance of interest expense deductions – “thin capitalization” rule

To prevent erosion of the U.S. tax base through borrowing in the United States to finance exempt income, the Proposal includes a new section 163(n) limiting deductibility of net interest expense. Generally, in the case of a U.S. corporation and its CFCs, the Proposal would disallow a portion of the U.S. corporation's net interest expense if (1) the U.S. corporation is overleveraged compared to the worldwide affiliated group (the “relative leverage test”), and (2) the U.S. corporation's net interest expense exceeds an unspecified percentage of adjusted taxable income (the “ATI test”), using existing section 163(j) rules.

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If both tests are failed, the interest expense deduction is reduced by the lesser of the two amounts determined under the tests. Interest expense disallowed under this provision could be carried forward to future tax years. Any amount disqualified under this provision would reduce the amount of interest expense disallowed under the earnings stripping rules of section 163(j).

I. Transition rule deemed inclusion of accumulated foreign earnings at reduced U.S. tax rate

The Proposal includes a mandatory inclusion of all pre-enactment deferred earnings of CFCs and 10/50 companies (regardless of whether an election is made to treat the 10/50 company as a CFC for purposes of the 95% DRD) by 10-percent U.S. shareholders. A DRD, tentatively set at an 85-percent rate, would be allowed. Code rules in effect before enactment of the Proposal, including the applicable tax rate, deemed-paid credits, PTI rules, and the separate basket rules of section 904, would apply in determining the 10% U.S. shareholder's tax liability as a result of the mandatory inclusion.

With an 85-percent DRD, the maximum tax rate on pre-enactment foreign earnings for U.S. corporations would be 5.25 percent (35 percent of 15 percent). The provision would allow a FTC (or deduction of foreign taxes paid) to be claimed only with respect to the 15% of the income inclusion that would be taxable. Additionally, the section 78 "gross-up" would also apply only to taxes with respect to the 15% portion. Under mechanics specified in the Proposal, taxpayers could elect to pay the tax on the deemed repatriation of pre-enactment earnings in two to eight equal annual installments, with interest.

The accumulated deferred foreign earnings subject to U.S. tax under this transition rule also would be subject to U.S. tax a second time when distributed, but then generally would be eligible for the 95% DRD. However, if the case of a 10/50 company that is not treated as a CFC, a subsequent distribution of its accumulated deferred foreign earnings would be subject to full U.S. tax (i.e., the 95% DRD would not be available for such distribution).

J. Alternative anti-abuse rules to address potential base erosion

The Proposal highlights concerns that U.S. corporate taxpayers would try to create exempt income by shifting highly mobile income to foreign jurisdictions through the migration of intangible property ("IP"). To address these concerns the Proposal includes three distinct approaches to address potential base erosion caused by the shifting of IP. Each approach involves the creation of a new category of subpart F income and is intended to mitigate concerns that increased base erosion from shifting IP to foreign jurisdictions will result under a territorial system.

The first of the three alternative approaches would treat excess returns of a CFC from covered intangibles as a new category of subpart F income if such income is not subject to a specified minimum foreign income tax. This approach was first included in the Obama Administration Budget Proposal for FY2011 and again in the FY2012 Budget Proposal.

For purposes of the excess return test, a covered intangible would mean any intangible, as defined in section 936(h)(3)(B), transferred to a CFC from a related U.S. person, or a cost-sharing agreement with one or more related persons with respect to an intangible. Returns with respect to a covered intangible would be considered excess returns to the extent gross income (excluding same country income) from the covered intangible exceeds 150 percent of the costs allocated and apportioned to such gross income (costs for this purpose exclude interest and taxes, but include research and development expenditures allocated based on business line).

The second approach would treat as subpart F income "low-taxed" cross border foreign income, including gross income of a CFC that neither is subject to an effective tax rate greater than 10% (determined under U.S. federal income tax principles), nor is derived in the home country of the CFC. For this purpose, income would be considered derived by a CFC in its home country only if (1) the income is earned in the conduct of a trade or business of the CFC in such country, (2) the CFC maintains an office or other fixed place of business in such

country, and (3) the income is derived from the sale of property for use, consumption or disposition in such country or from services that are provided in such country.

The last of the three alternative approaches would treat all of a CFC's foreign intangible income as "foreign base company intangible income" and provide a deduction for a domestic corporation of 40%¹⁰ of its income from exploitation of intangibles. Foreign base company intangible income would consist of income from the sale of goods or services attributable to IP without regard to where the IP is developed or exploited. Foreign base company intangible income would be eligible for the high-tax exception if the effective rate of tax exceeds 60%¹¹ rather than 90% of the maximum federal income tax rate.

IV. Unaddressed issues

The announcement of the Proposal acknowledges that both the Discussion Draft and Technical Explanation are silent on numerous technical and policy issues that would need to be addressed in any final legislation. Some of these issues are discussed briefly below.

Under the Proposal, the DRD regime would apply only to U.S. subchapter C corporations, but other provisions of the Proposal would apply to all taxpayers. The applicability of the participation exemption to partnerships with corporate partners is unclear and as drafted; the Proposal applies only to U.S. corporations, not individuals, who own 10% or more of a foreign corporation. Consequently, the Proposal appears to move only U.S. subchapter C corporations to a modified territorial tax regime, while, in some instances, increasing the U.S. tax burden on other U.S. shareholders of foreign corporations.

Treating a foreign branch as a CFC raises a number of situations that are not addressed fully by the Proposal or Technical Explanation. For example, treating foreign branches as CFCs would cause payments (e.g., interest and royalties) between branches and the home office to become regarded as transactions between separate entities for U.S. tax purposes. Presumably such transactions would be subject to section 482, but if so, how rigorously should the transfer pricing rules be applied. Treating

foreign branches as CFCs may also cause deemed asset sales to the new CFC on the effective date to the extent that disregarded loans become regarded; this could result in taxable gains, section 304 transactions, etc. There is also currently no guidance on whether section 367 and various loss recapture rules would apply to branch assets on the effective date as a result of the deemed CFC incorporation on that date.

The Proposal is also silent on the treatment of overall domestic and foreign loss accounts; tax redeterminations; dual consolidated losses; tax treaty implications; and cross-border reorganizations.

V. Reassessment of Current U.S. Tax Planning

A countless variety of strategies have been utilized by U.S. corporate taxpayers over the years to manage their U.S. income tax on cross-border business and investment income. Some of these arrangements and the impact of the Proposal are discussed below. In light of the changes set forth in the Proposal, many companies will have to reconsider their current planning arrangements. Additionally, companies engaged in foreign business will have to decide whether to continue a push for a repatriation holiday or wait for a broad overhaul of U.S. tax law.

A. IC-DISC

The Interest Charge-Domestic International Sales Corporation (IC-DISC) is a “paper” entity which can provide permanent tax-savings for U.S. based exporters that operate as S corporations, LLCs or closely held C corporations. The IC-DISC tax benefit comes by way of a deductible commission payment from the U.S. exporter to the IC-DISC and either deferral of the commission income (subject to a nominal interest charge) or return of the commission payment in the form of a qualified dividend.

Under the IC-DISC regime a U.S. exporter establishes a related domestic entity that acts as commission agent for the U.S. exporter’s export sales. Due to its status, the IC-DISC is presumed to have participated in the export sales activity for which it is entitled to earn a commission. The commission payment to the

IC-DISC is fully deductible by the U.S. exporter. An IC-DISC entity itself is not subject to U.S. tax, but instead IC-DISC shareholders are taxed when the income is either actually distributed or “deemed” distributed. Generally, shareholders may defer up to \$10,000,000 of annual commission income in the IC-DISC. If the shareholders decide not to defer, the IC-DISC commission income is taxable currently to the shareholders as a dividend. From now through 2012, U.S. exporters that operate as S corporations, LLCs or closely held C corporations can elect to tax this dividend income at the 15% dividend rate – effectively converting 35% ordinary income to 15% dividend income.

The Proposal alone will probably not encourage U.S. corporate taxpayers currently utilizing IC-DISCs who have no other non-U.S. presence to head overseas and establish foreign operations to take advantage of the 95% DRD for foreign source business income. However, the value of the IC-DISC benefit is tied to both the capital gains and dividend tax cuts and the disparity between the ordinary income rate and the capital gain rate. Both of these tax rates are scheduled to sunset on December 31, 2012. Thus, the expiration of the capital gains and dividend tax cuts will require taxpayers utilizing an IC-DISC to look for a new tax planning vehicle, and the Proposal may just provide one.

B. Corporate Inversions

The term “inversion” is used to describe a broad category of transactions through which the corporate structure of a global group of corporations with a U.S. parent is altered such that after the transaction, the ultimate parent of the corporate group is a foreign corporation. The new foreign parent is typically based in a jurisdiction without a corporate income tax or with a low corporate income tax rate.

Prior to tax law changes in 2004, there was a marked increase in the frequency, size, and profile of U.S. corporations undergoing inversion transactions. Market conditions likely played a role; although an inversion triggers potential tax at either the shareholder or corporate level, depending on the transactional form, that tax liability

may have been less significant because of economic and market factors. Shareholders may have had little or no gain inherent in their stock or the company may have had net operating losses to offset any gain at the company level.

While market conditions may help facilitate inversion transactions, they are not what motivate a company to undertake an inversion. U.S.-based corporate taxpayers and their shareholders make the decision to reincorporate outside the United States largely because of the prospect of the long term tax savings. The primary reason corporations have stated for considering or undertaking an inversion is to reduce their effective income tax rate on income earned from foreign sources. Without broad U.S. international tax reform, this incentive will continue. However, with the Proposal’s 95% DRD and potentially lower corporate income tax rate, fewer companies may be willing to pay the up-front tax cost associated with inversion transactions for the potentially minimal tax savings that would result on a yearly basis.

C. Foreign Tax Credit Generators

A FTC generator is generally a highly structured transaction that uses the difference between U.S. tax law and foreign tax law to result in a U.S. FTC. In the most extreme examples, these transactions are designed to recover the foreign tax claimed as a FTC, so that, in substance, the transaction incurs no foreign tax cost. Alternatively, the transaction is structured to eliminate the income that results in the FTC. Some arrangements do both, and in either case, the United States considers the FTC generated through these transactions as inappropriate because the taxpayer claims a FTC where no double taxation of income occurs.

Under the Proposal’s 95% DRD, no FTC will be allowed with respect to any dividend for which the 95% DRD is allowed. This includes a disallowance for a direct FTC under section 901 for foreign withholding taxes assessed on a dividend. A deduction for all such foreign taxes paid in respect of a deductible dividend also is denied. By contrast, a FTC is still allowed for foreign taxes imposed on income in-

cluded under subpart F and for foreign tax paid directly by a domestic corporation on foreign source income.

D. Foreign Branches

The proposed change to treat any foreign branch of a domestic corporation as a CFC is consistent with the intention to move from a worldwide tax system to a territorial tax system in which the foreign business profits of a U.S. corporate taxpayer would be 95% exempt from U.S. tax. Under current law, foreign branches are not considered separate but treated as part of the U.S. corporate taxpayer with income and deductions of the foreign branch being included in the determination of the U.S. corporate taxpayer's taxable income. In contrast, a CFC is a separate legal entity whose income and losses are not currently included in the U.S. corporate taxpayer's income tax return (except as otherwise provided by the Code, e.g., subpart F).

The change included in the Proposal is also consistent with closing a potential loophole that could arise in a territorial tax system. Because branches do not benefit from deferral, any branch income and losses are combined as part of the U.S. corporate taxpayer's net income or loss. If the current rules for foreign branches are not changed, a U.S. corporate taxpayer anticipating losses from foreign operations would have an incentive under a territorial system to set up a foreign branch rather than a CFC. The losses could be deducted currently against its U.S. income while profitable operations in CFCs could be repatriated to the U.S. 95% exempt from U.S. tax.

Many U.S. corporate taxpayers establish foreign operations in branch or DRE form for many reasons including simplicity in recordkeeping and tax compliance and to take advantage of subpart F exceptions. The Proposal's treatment of foreign branches will certainly introduce a new level of complexity in recordkeeping requirements. If the branch is treated as a CFC for all purposes of the Code, any transaction between the domestic corporation and its foreign branch would be regarded for U.S. tax purposes as a transaction between two separate companies, with the corresponding documentation and recordkeeping.

Additional complexity results because once a foreign branch is treated as a CFC for all purposes of the Code, new rules previously inapplicable to branch transactions come into play. These include rules under section 367 potentially imposing a toll charge on the outbound transfer of assets in the deemed incorporation of a branch, the transfer pricing rules under section 482 for sales, services and other transactions between the domestic corporation the branch. The domestic corporation would also have to apply the rules of subpart F to each branch to determine if the branch has subpart F income.

E. Tax Treaty Shopping

Income tax treaties entered into by the United States provide a foreign tax benefit to U.S. taxpayers in various treaty countries by reducing foreign tax in the other treaty jurisdiction. Parties not otherwise entitled to tax treaty benefits may engage in treaty shopping to secure the tax relief provided by a treaty. Generally speaking treaty shopping means arrangements, implemented by a taxpayer who is not entitled to the benefits of a certain tax treaty, to make use of the benefits of such a treaty. If a party not otherwise entitled to treaty benefits utilizes a foreign company in a treaty jurisdiction the taxpayer may be able to access the benefits of an existing treaty between two countries. Typically the access to the treaty benefit is arranged by forming a subsidiary or entering into transactions that shifts the tax consequences. In most cases the reason for such structures are either the reduction or elimination of withholding taxes or favorable tax treatment of certain types of income in the relevant country in which the structure is implemented. U.S. tax treaties frequently contain provisions to hamper or eliminate treaty shopping for inbound investments and operations.

It is conceivable that a foreign party would establish a U.S. corporate entity to access the U.S. treaty network to minimize tax in a foreign jurisdiction and take advantage of the territorial tax system. Whether U.S. tax policy should be symmetrical on treaty shopping arrangements may be determined on the basis of the adoption

of a territorial tax regime rather than tax treaty criteria.

F. Sourcing of Transportation Income

The taxation of U.S. corporate taxpayer's engaged in international shipping has been the subject of extensive legislation. Prior to 1975, shipping income of CFC's was eligible for deferral, like most other active foreign business income. The Tax Reduction Act of 1975, Congress designated foreign shipping income of a CFC as subpart F income, but provided that such income would not be subject to the subpart F current taxation rule to the extent the income was reinvested by the CFC in its foreign shipping operations. The 1986 Act repealed the reinvestment exception eliminating deferral entirely for foreign shipping income of CFCs. Availability of deferral was returned when the 2004 Jobs Act eliminated foreign shipping income as a category of subpart F income.

In general, other countries do not tax foreign shipping income earned by their resident companies. The Proposal brings the United States more in line with the rest of the world and it is argued make U.S. corporate taxpayers engaged in international shipping more competitive with its foreign-based competition.

G. Cost-sharing Agreements

Cost-sharing arrangements are commonly used to eliminate U.S. federal income tax on foreign intellectual property ("IP")-related income until such IP income is repatriated to the United States. In the typical cost-sharing agreement, the U.S. Parent company sells non-U.S. rights to the IP to a subsidiary established in a low tax jurisdiction ("Non-U.S. IP Holding Company"). U.S. Parent and Non-U.S. IP Holding Company share costs for the future development of the IP. If properly structured, revenues derived from non-U.S. IP rights are not subject to U.S. federal income tax until a dividend is paid to the U.S. Parent company.

As drafted, the Proposal includes three alternate provisions intended to eliminate base erosion pursuant to cost-sharing arrangements and which would impact the current utilization of cost-sharing struc-

tures. Each of these alternatives would create a new category of subpart F income resulting in current taxation of foreign IP-related income regardless of whether repatriated. Given the significant costs associated with entering into a cost-sharing agreement, including a section 482 pricing study, U.S. multi-nationals currently considering a cost-sharing agreement may want to take a wait-and-see approach until the prospects for proposed legislation is clarified.

VI. Conclusion

The adoption of a territorial system of taxation would represent a fundamental change in the way the United States taxes cross-border activity. Change and proposals for change create uncertainty and the need to assess the impact of a new tax environment. While a territorial tax regime would be a conceptual step towards

simplification, the carve-out for investment activities and the transition rules result in haunting complexity. Further, the tax situation in the foreign jurisdictions will have significant impact on global effective tax rates for U.S. companies.

The Proposal is intended to advance the discussion on how best to reform the U.S. international tax rules. No immediate legislative action on the Proposal should be expected. Additionally, while the Proposal may give an indication of where the U.S. discussion of international tax reform is headed, it is likely that the Proposal will be subject to significant changes before full legislative action, if any, is taken.

- 1 Revenue Act of 1918, Ch. 18, 222(a) (1), 238(a), 240(c). 40 Stat. 1057, 1073, 1080–82 (1919).
- 2 Revenue Act of 1962, P.L. 87-834, 87th Cong. 2d Sess. (Oct. 16, 1962) (enacting Subpart F of the Internal Revenue Code).
- 3 Tax Reform Act of 1986, P.L. 99-514, 99th Cong., 2d Sess. (Oct. 22, 1986) (hereafter referred to as the “1986 Act”).

- 4 As currently drafted, the majority of the Proposal’s provisions would apply only to U.S. subchapter C corporations, thus the term U.S. corporate taxpayer is used throughout this article.
- 5 The Proposal includes the 95% exemption rate in brackets, indicating that further consideration may be given to the appropriate exemption percentage.
- 6 All section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder unless otherwise indicated.
- 7 A PFIC is generally defined as any foreign corporation if 75% or more of its gross income for the taxable year consists of passive income, or 50% or more of its assets consists of assets that produce, or are held for the production of, passive income. Section 1297.
- 8 A CFC generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation’s stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only). Sections 951(b), 957, 958.
- 9 A 10/50 company is a foreign corporation with respect to which a domestic corporation owns 10 percent or more of the stock, but which does not qualify as a CFC because ownership by U.S. shareholders does not exceed 50 percent. (A 10/50 company is also referred to as a noncontrolled section 902 corporation. See, section 904(d)(2)(E)).
- 10 The 40% exemption rate is in brackets, again indicating that further consideration may be given to the appropriate exemption percentage.
- 11 The 60% rate is in brackets and is subject to change.

Online Directory of Pro Bono Opportunities

The WSBA is pleased to announce the launch of www.ProBonoWa.org, an online directory of pro bono opportunities around the state. Designed to link attorneys with opportunities to serve low- and moderate-income clients in Washington, ProBonoWa.org will connect attorneys with organizations in need of pro bono attorneys.

As part of WSBA’s strategic goal to enhance the culture of service among its members, the WSBA is excited to maximize the valuable work and dedicated commitment of pro bono attorneys. The WSBA will maintain and update www.ProBonoWa.org ensuring that attorneys seeking volunteer opportunities have the most up-to-date information available needed to link their skills with the clients who need it most.

Special thanks to the [Northwest Justice Project](#), [Probono.net](#), and the [Washington Young Lawyers Division Pro Bono & Public Service Committee](#) for their invaluable partnership and support to launch ProBonoWa.org!

CLE Committee Report

by Bob Boeshaar

The CLE Committee sponsored a Continuing Legal Education class entitled “Hot Topics in State and Federal Tax: Offshore, Online and in the Cloud” on December 15, 2012. The presenters spoke about (1) Washington’s taxation of software, automated services, and the multistate taxation of remote internet sellers, (2) the international tax implications of various cloud computing models, and (3) the representation of taxpayers undergoing an “offshore audit.” We had over 20 people who attended in-person, and over 40 more who attended live online, including one from Paris. It was a successful CLE. If you have any ideas for future CLEs or would like assistance in preparing or promoting your CLE, please contact Bob Boeshaar, Chair, at Robert.V.Boeshaar@irs.counsel.treas.gov, or Amber Quintal, Co-Chair at aquintal@omlaw.com.

Estate and Gift Tax Committee Report

by Lora L. Brown

The Estate and Gift Tax committee meets approximately every six to eight weeks, and our meetings are open to all members of the Taxation Section. The EGT committee’s meetings for the first half of 2012 are scheduled for noon on the following dates:

Friday, April 13
Friday, June 15

We do not meet over the summer (July and August) but will begin again in the fall. Our committee meetings are currently held at noon in the Seattle office of K/L Gates (925 Fourth Avenue, Suite 2900). Out-of-area members (whether you’re across the state, the lake or just across town) may also participate by phone.

If you would like to receive messages from the EGT Committee’s list serve, which provides agendas and reminders

for upcoming meetings, as well as occasional information of importance to the group, please send me a note (Lora@LLBrownLaw.com). You can also request to join the committee through the link on the Taxation Section’s website – <http://www.wsba.org/Legal-Community/Sections/Taxation-Section>. The website also has information about the numerous committees of the Taxation Section, not just the EGT Committee.

In the past few years the committee has been significantly involved with several legislative projects, many of which were adopted in the 2011 legislative session. The committee was involved with the state estate tax apportionment bill (HB 2224) which is scheduled for signature by the Governor. (Thanks to Ben Porter for his unwavering dedication and his recent testimony in support of the bill.) You can find information about HB 2224 at <http://apps.leg.wa.gov/billinfo/summary.aspx?bill=2224&year=2011>.

In addition to our agenda of hot topics, we also enjoy practical discussions at our committee meetings. We also are thankful for the continuing participation by representatives from the Department of Revenue who attend and are happy to accept questions from the group and provide invaluable feedback on issues of policy and procedure.

At the next meeting (April 13) the committee will also be discussing preliminary plans for a CLE in the first quarter of 2013 on expected changes to the federal estate tax rules. If you have an interest in speaking or participating in the organization of the committee’s CLE, please let me know. We hope to see you at a meeting soon.

IRS Liaison Committee Report

by Sandra Veliz

Melissa Hilty, of IRS Counsel, and Sandra Veliz, of LeSourd & Patten, P.S., are currently serving as co-chairs of the IRS Liaison Committee. The committee held a meeting on February 9, 2012, where Carl Inskip and Melanie Senick from the IRS Office of Chief Counsel spoke about Counsel’s perspective (both from the Large Business and Small Business side) of the Appeals process as part of the IRS Liaison Brown Bag Lunch Series. Previously, on December 8, 2012, Appeals Officer Andrew Marshall spoke about Alternative Dispute Resolution within the Internal Revenue Service. Our next Brown Bag lunch is planned for April 19th. The speaker is SBSE Manager, Blake Becker, and he will speak about coordinating civil and criminal cases including the application of I.R.C. § 6201(a)(4) enacted in 2010. This statute allows the assessment of restitution as a tax without notice of deficiency procedures.

Pro Bono Committee Report

by Tiffany Gorton

The Pro Bono Committee has been successful in recruiting volunteer attorneys to prepare individual tax returns, as needed, for clients of the University of Washington Low Income Taxpayer Clinic (UW LITC). The committee is now looking for volunteer attorneys to take on low-income taxpayers from the UW LITC as pro bono clients and help them work through their federal tax controversy issues. This is an excellent opportunity for pro bono work, and free CLE credits are available for both the training session and for volunteering. Please contact Tiffany Gorton at trgorton@rauipc.com for additional information.

Scholarship Committee Report

by Cory L. Johnson

For the last ten years, the Tax Section has offered a \$5,000 scholarship to an individual planning to attend a Tax LL.M. program at an accredited law school and who appears likely to become an active member of the WSBA. The Tax Section is pleased to announce it plans to award the Eleventh Annual Tax LL.M. scholarship at its upcoming annual luncheon.

The Scholarship Committee is seeking section members' support to help fund the scholarship. Please consider contributing as support from section members is critical to the Tax Section's ability to offer this opportunity and make grants to the low income taxpayer clinics. Contributors will be acknowledged at the Tax Section's Annual Luncheon on May 15, 2012, on the Tax Section's website, and in an email announcement to the section members.

The deadline for scholarship applications is April 29, 2012. The Scholarship Committee seeks candidates who have demonstrated a strong academic record, a financial need, and the intent to become an active member of the WSBA Tax Section upon completion of his/her LL.M. tax education. For more information, please visit <http://www.wsba.org/Legal-Community/Sections/Taxation-Section/Scholarship-Committee>.

State and Local Tax Committee Report

by Michelle DeLappe

The SALT Committee is meeting quarterly, with its last meeting on February 9, 2012. We are working on the following issues:

- Steps to simplify city and state business and occupation taxes;
- Improvements in Washington's tax appeals process; and
- Clarification as to when the Administrative Procedures Act applies to Department of Revenue actions.

Among other news, the Governor has filled the vacancy at the state Board of Tax Appeals: Marta Powell is scheduled to start as the new Board member on March 27.

If you have questions or suggestions or would like to get involved and receive e-mail notifications of our meetings, please contact Committee Chair Michelle DeLappe at mdelappe@gsblaw.com.

Transactional Tax Committee Report

by Kevin Sullivan

The Transactional Tax Committee began its meetings for this calendar year on February 22, 2012. At that meeting, we were fortunate to have Kate Adams and Mark Bohe, both from the Department of Revenue, lead a discussion on the status of the proposed Tax Avoidance Rule pertaining to RCW 82.32.655, .660.

The Transactional Tax Committee meets at noon on the fourth (4th) Wednesday of every other month at the law offices of Riddell Williams in Seattle. The next scheduled meeting is April 25, 2012. I, and all of the committee members, would like to thank the former Chair of the Committee, Chris Brown, for his past service in preparing, presenting, and moderating these exceptional meetings.

The Taxation Law Section newsletter invites its readers to submit articles, items of interest, and announcements for publication in upcoming issues. Share your expertise, your knowledge, and your insights for the benefit of your colleagues.

So you have an idea you would like to flesh out, or a finished article ready to go?

Please contact the Newsletter Editor, Jennifer Gellner, by sending an e-mail to jennifer@gellnertaxlaw.com.

We would like to read what you have to say.

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Did you know that easy-to-understand pamphlets on a wide variety of legal topics are available from the WSBA? For a very low cost, you can provide your clients with helpful information. Pamphlets cover a wide range of topics:

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Each topic is sold separately. Pamphlets are \$9 for 25, \$15 for 50, \$20 for 75, and \$25 for 100. Pricing for larger quantities is available on request.

To place your order or for more information, please contact the WSBA Service Center at 800-945-WSBA or 206-443-WSBA. Sales tax is applicable to all in-state orders.

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Section membership dues cover October 1, 2011, to September 30, 2012.

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