

PKF PERSPECTIVES

INTERNATIONAL "TAX GAP"

As reported in PKF Perspectives in 2009, the Obama Administration has made it clear that an important element of its tax legislation and administrative efforts is to target the perceived "tax gap" relating to international tax matters.

Of particular interest to the Treasury Department are multinational enterprises (MNEs) which conduct business across national borders, and global high net worth individuals who fail to pay their "fair share" of U.S. tax due to tax planning and, in more egregious situations, tax evasion. In some cases, such as the failure to report foreign bank accounts, the IRS paints taxpayers with a negative broad brush which can only be alleviated by complete and accurate compliance with filings and disclosure requirements.

To further exacerbate the situation, Congress has consistently complained that the IRS has failed to fulfill its enforcement duty to defend the U.S. tax base. **In response, the IRS has requested, and Congress has provided, funding to hire some 1,500 additional examiners, the majority of whom will be devoted to international taxation and transfer pricing matters.**

The expansion trend is expected to continue. **PKF Perspectives** will focus on some of the issues being targeted and disclosure requirements for international transactions. Specific issues which have been identified include the following.

Cross-Border Intercompany Transfer Pricing

Transfer pricing is concerned with whether U.S. MNEs are conducting business and entering into transactions with controlled, related foreign parties

at "arm's length". In general terms, the standard is that related parties should establish intercompany prices to be within a range at which an unrelated party would agree. If the standard is not met, the IRS can reallocate income, deductions, etc. and impose significant penalties.

Transfer pricing issues require an analysis of all cross-border transactions, including transfers of tangible and intangible property, provision of intercompany services and intercompany loans and advances. Recent IRS announcements have stated that significant emphasis is being placed on cross-border transfers of intangible property and cost-sharing arrangements for the development of intangibles.

To minimize risk, many large MNEs have entered into Advance Pricing Agreements with the IRS to provide some certainty in this area.

At a minimum, the IRS expects taxpayers to conduct transfer pricing studies to minimize the imposition of significant penalties.

Debt/Equity Issues

In the international tax context, how a U.S. subsidiary or non-U.S. subsidiary is capitalized is an important issue with IRS international tax examiners. The IRS scrutinizes related-party loan agreements to determine whether true debt exists; considers the debt/equity ratios for thin capitalization; and, also, whether unrelated creditors would enter into a debt obligation on similar terms.

In international tax examinations, MNEs are at risk for interest deductions in the case of inbound loans and imputation of interest income in outbound loan situations. Additionally, the IRS will determine whether the earnings-stripping provisions are being followed which can result in material limitations to current interest deductions.

Foreign Tax Credits

The IRS has made Foreign Tax Credits a primary tax examination issue and is aggressively challenging taxpayers who enter into international transactions motivated principally, or solely, for tax minimization purposes.

In addition, the IRS is examining taxpayers' determinations of whether income is foreign source, whether foreign taxes are refundable or possibly not legally owed to a foreign jurisdiction and also whether the foreign tax is creditable based on U.S. tax principles.

The goal of the IRS is to reduce foreign tax credits taken in situations where the taxpayer has aggressively sourced income as being foreign (and, thus, increasing the credit limitation) or, conversely, has not been aggressive enough in reducing foreign tax assessments (and, thus, paying more foreign tax than may be required).

Foreign Financial Account Reporting

Over the last year, the Treasury Department has made a concerted effort to enforce U.S. law which requires "U.S. persons" to report any foreign financial accounts owned, the maximum value held in such accounts, and related earnings.

Many voluntary disclosure agreements between the IRS and taxpayers were entered into with the

understanding that criminal charges may possibly not be enforced and limited civil penalties would be imposed. The IRS has announced it will continue to seek out global high net worth individuals who maintain foreign financial accounts and under report their gross income. They will perform coordinated tax examinations of an individual's worldwide business and investment activities to ensure these individuals are complying with U.S. tax law.

In this vein, the IRS commissioner has formed a specialized industry group to target wealthy individuals. The idea is to centralize IRS compliance efforts for high-wealth individuals who have sophisticated financial, business, and investment arrangements with complicated legal structures and tax consequences.

The task force will take a unified approach to its audits by focusing on the entire web of business entities controlled by a wealthy individual, including issues involving off-shore structures, income sources, and tax residency.

Questions One Could Expect from an International Tax Examiner

Questions could include those in the following areas.

Inbound Transactions

Foreign-based MNEs with a U.S. subsidiary or U.S. investments could expect these types of questions:

- Is the U.S. entity adequately capitalized to support the U.S. operations?
- Are intercompany loan interest rates, terms and collateral requirements

consistent with what an independent party would require?

- Are third-party loans guaranteed by a foreign party or are there any other forms of financial support, such as a comfort letter or compensatory balance in place?
- Has the proper U.S. withholding tax been remitted to the IRS for outbound payments of interest, dividends, royalties or other payments?
- Is the value reported for U.S. customs purposes consistent with the cost basis claimed on the U.S. entity's cost of inventory for income tax purposes?

Outbound Transactions

U.S.-based MNEs with non-U.S. subsidiary(ies) or investments could expect these types of questions:

- Does the U.S. company own at least ten percent of a foreign corporation and, if yes, do U.S. persons who also own at least ten percent, collectively own 50 percent of such foreign corporation? If yes, is there any Subpart F income?
- Does the U.S. company own any percentage of a foreign corporation that meets the definition of a Passive Foreign Investment Corporation (PFIC)? If yes, has consideration been given to the U.S. tax implications and elections available?
- Has the U.S. company transferred assets exceeding \$100,000 to a foreign

corporation or foreign partnership? If yes, has there been proper reporting?

Inbound and Outbound Activity

- Has the U.S. person properly addressed transfer pricing issues and has a transfer price study been conducted?
- Has there been a proper matching of income and expense items with cross-border related parties?
- Have accrual basis taxpayers been put on the cash basis with respect to certain intercompany loan situations?
- If a reduced rate of withholding is claimed under an applicable income tax treaty, has all proper documentation been completed and maintained as required by law?

Tax Forms

The following is a list of tax forms that should be completed in the international tax context.

Failure to file these tax forms can result in significant penalties and could be considered criminal if there is a willful intent to not provide the required information.

<i>Number</i>	<i>Form</i>
Form 5471	Information Return of U.S. Persons with Respect to Certain Foreign Corporations
Form 5472	Information Return of a 25 percent Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business
W8 BEN	Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding
W8 ECI	Certificate of Foreign Persons Claim that Income is Effectively Connected With the Conduct of a Trade or Business in the United States
Form 1042	Annual Withholding Tax Return for U.S. Source Income of Foreign Persons
Form 1042-S	Foreign Persons U.S. Source Income Subject to Withholding
Form 8865	Return of U.S. Persons With Respect to Certain Foreign Partnerships
Form 926	Return by a U.S. Transferor of Property to a Foreign Corporation
Form 8926	Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information
Treasury Form TD F 90-22.1	Report of Foreign Bank and Financial Accounts
Form 1120 Schedule N	Foreign Operations of U.S. Corporations
Form 8621	Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund
Form 3520	Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts

Although international tax legislation has taken a back seat to health care reform during the past year, it has returned to the front and center with the release of the Obama Administration fiscal year 2011 budget. The administration's agenda of international tax reform attempts to balance revenue raising in the current economic downturn while still being mindful of U.S. businesses remaining competitive with low tax countries.

PKF will continue to monitor developments in international taxation and report on proposals throughout 2010.

Authors Unknown

People who complain about taxes can be divided into two classes: men and women.

Of life's two certainties, the only one for which you can get an automatic extension is taxes.

A person doesn't know how much he has to be thankful for until he has to pay taxes on it.

A fine is a tax for doing something wrong. A tax is a fine for doing something right.

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