WASHINGTON TAX NEWS

Potomac Law Tax Newsletter—April 2016 Susan Rogers

The focus in Congress is on the Budget process and appropriations bills, while the **Presidential campaigns dominate politics and policy agendas** in Washington. House Speaker Ryan continues his plan to move a **Budget Resolution** through the House, but faces opposition from Republican conservative members who believe the 2015 budget deal spending cap is too high. House committees are working on **individual appropriations bills**, but they cannot be brought to the House Floor without an approved Budget Resolution until May 15th, when House leaders can bring the bills to the Floor even if the annual budget resolution has not been adopted. It would then be very difficult for the House to approve all 12 spending bills by September 30th when FY 2017 begins, due to the shortened legislative schedule allowing for recesses for the two political conventions. Failure to approve the appropriations bills would likely lead to a short-term Continuing Resolution at current spending levels with the possibility of a **lame duck session** consideration of these issues. In the Senate, there is less interest in advancing a Budget Resolution, with Republican leadership willing to follow the 2015 budget agreement, so regular appropriations procedures are moving forward.

President Obama's **nomination of Merrick Garland to the Supreme Court** has heightened political debate in the Senate between Republicans and Democrats, but Senate Minority Leader Reid (D-NV) has stated that he will not attempt to obstruct the movement of the appropriations bills in order to get leverage in the battle for consideration of Judge Merrick. Democrats could decide to challenge the advancement of the spending bills for other reasons, specifically if Republicans attempt to add controversial riders to the legislation.

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The Treasury Department has issued aggressive new rules targeting inversions by US companies who they argue are seeking to lower their taxes without significant changes in their business operations. The new rules also take broad aim at "earnings stripping" which companies use to lower their US profits.

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Congressional Activity—Tax Reform

The House Republican Budget Plan calls for Congress to enact tax reform that consolidates and lowers individual tax rates, reduces the corporate rate, repeals the Alternative Minimum Tax, simplifies the Code and transitions to a more competitive international tax system. Although there will be significant discussion about international tax reform in 2016, most Members of Congress believe that **comprehensive reform will have to wait for a new Administration.**

The **House Tax Reform Task Force,** led by W&M Chairman Brady (R-TX), held its first meeting with consideration of consumption taxes in addition to comprehensive reform of the income-based system helping to lay the groundwork for tax reform in 2017. The W&M Tax Policy Subcommittee held a hearing on March 22nd on several tax reform bills that propose moving away from income as the tax base and instead looking to **cash-flow or consumption.** A second hearing on April 13th will review tax reform bills that make fundamental reforms within the context of an income-based system. A revised **international tax reform draft**, which had previously been expected to be released by the Tax Policy Subcommittee in March, will be delayed.

Inversions and Earnings Stripping — New Treasury Rules

Treasury and the IRS issued **temporary and proposed regulations to further reduce the benefits of and limit the number of corporate tax inversions including by addressing earnings stripping**. Treasury Secretary Lew announced that the new rules will have an important effect on but cannot stop these transactions, so he urged Congress to move ahead with anti-inversion legislation this year. Treasury believes that inversions are not driven by genuine business strategies and economic efficiencies, but rather a desire to shift the tax residence of a parent entity to a low-tax jurisdiction in order to reduce or avoid US taxes.

The new rules will **limit inversions** by disregarding foreign parent stock attributable to recent inversions or acquisitions of US companies, thereby preventing a foreign company from using the resulting increase in size to avoid the current inversion thresholds for a subsequent US acquisition. They also **address "earnings stripping,"** which Treasury posits is often used after a corporate inversion to minimize US taxes by the US subsidiary taking a loan from the foreign parent and paying interest that is deducted from the US company's taxable income to their new foreign parent in a low-tax country.

W&M Chairman Brady called the new rules "punitive regulations that will make it even harder for American companies to compete and will further discourage businesses from locating and investing in the US." Business groups judged the rules to be too broad — penalizing foreign companies with long histories in the US for using legitimate intra-company loans to pay for investments in the US.

Congressman Levin (D-MI), the senior Democrat on the W&M Committee, has introduced a bill targeting "earnings stripping" and corporate inversions. SFC Chairman Hatch (R-UT) continues to work on draft legislation on corporate integration and inversions. Senators Brown (D-OH) and Schumer (D-NY) have introduced bills targeting inversion transactions, and Senator Wyden (D-OR) continues drafting an inversions bill covering hopscotch loans and "spinversions**"** (spinning off parts of a US company into a foreign entity).

Treasury/IRS

Treasury and the IRS have requested input from the public on the **new Priority Guidance Plan** that will cover July 1, 2016 through June 30, 2017, and will include regulations and other guidance that the IRS views as the most important to taxpayers and tax administrations.

The **IRS Large Business & International (LB&I) division** has finalized Publication 5125, setting forth the **new LB&I examination process**. The new process covers examinations from the initial contact with the taxpayer through the final stages of issue resolution. It reflects a shift to an "issue-based approach" for the IRS when conducting audits of taxpayers. Critical components of the process are increased transparency, enhanced communication and improved collaboration between the exam team and the taxpayer.

The IRS issued **Rev. Proc. 2016-19**, describing procedures for taxpayers to submit issues for consideration under its **Industry Issue Resolution (IIR) Program**, which works to identify and resolve "frequently disputed or burdensome tax issues that affect a significant number of business taxpayers."

The Netherlands, which currently holds the presidency of the Council of the European Union ending June 30, 2016, issued an EU-BEPS "roadmap" on February 19, 2016, that sets out plans to move forward with previous EU proposals as well as future proposals in areas related to the OECD's Base Erosion and Profit Shifting (BEPS) project. The Dutch government stated that they would prioritize action against tax evasion and tax avoidance based on the Final Reports from the BEPS project and proposals for the conversion of BEPS measures into European legislation to be carried out through EU Tax Directives.

The enactment of EU tax directives require full agreement from the 28 EU Member States because each Member State retains sovereign legislative power in the area of direct taxation. The EC presents draft proposals, which are discussed in the Council of Finance Ministers, and then Member States are given an opportunity to raise concerns and recommend changes to the draft directives.

The EU external communication strategy states that a coordinated effort is critical to increase Member States' collective success in tackling tax avoidance, ensuring effective taxation and creating a clear and stable environment for businesses in the single market.

European Union (EU) Anti-Tax Avoidance Directive (Anti-BEPS Directive)

This Directive is intended to establish a fixed framework for the 28 EU Member States to implement certain BEPS actions and other tax measures in a common form. The Directive is not completely in line with the BEPS Final Report recommendations and, in some cases, would require Member States to implement measures that the OECD did not agree to as being required "minimum standards." The Directive includes rules addressing hybrid mismatches, limits on the deductibility of interest and controlled foreign company (CFC) rules, as well as some measures not included in the BEPS Final Reports – a general anti-abuse rule (GAAR), a switch-over" clause, and an exit tax.

Hybrid Mismatches

Two or more Member States may give a different legal characterization to the same taxpayer/hybrid entity. The Directive proposes that the legal characterization given to the hybrid entity by the source-State (where expenses are incurred or losses suffered) should be followed by the other Member State so as to prevent a deduction being taken in both jurisdictions or a deduction taken in the source-State without an income inclusion in the other State.

Interest Deductibility

The aim is to provide a fixed level of minimum protection to Member States, and an entity-by-entity limit on borrowing costs of 30% of taxable earnings before interest, taxes, depreciation and amortization (EBITDA), or 1 million Euros, if higher. The Directive states that Member States may choose to introduce stricter rules. This recommendation differs from the OECD approach, which allowed countries to pick from the elements of each BEPS Action to fit their current tax regime and tax competitiveness strategy.

Controlled Foreign Corporations (CFCs)

The CFC provisions would impose a charge on undistributed profits of controlled non-listed entities that are subject to taxation at an effective rate lower than 40% of the equivalent effective rate in the controlling Member State, where the entity principally receives financial income (e.g., interest), royalties, dividends, leasing income, certain real estate income, income from insurance, banking and other financial activities, and intra-group service income.

General Anti-Abuse Rule (GAAR)

The EC proposes that all EU Member States should adopt a GAAR to address gaps that may exist in a country's anti-abuse rules and to counter certain forms of tax avoidance.

"Switch-over" Clause

Most Member States have tax exemptions for dividend income and for capital gains on the sale of qualifying shareholdings. The EC has proposed that every Member State should adopt a rule whereby dividends and capital gains from low-taxed companies (lower than 40%) should not be exempt, but instead should be taxable, with a tax credit granted for any overseas tax actually paid.

Exit Taxation

The Directive proposes an exit tax on specified transfers of assets or of residence that would require the EU Member State of origin to levy tax on the amount by which fair market value exceeds the tax book value of the assets. It has been a source of concern to some Member States that the European Court of Justice has ruled that Member States may not levy exit taxes when a company moves its tax residence to another EU country.

International Tax Policy and BEPS

Treasury and the EU State Aid Investigations: The European Commission responded to a letter sent in February by Treasury Secretary Lew which claimed that US companies appear to be targeted by EU State Aid investigations, stating that the State Aid investigations complement the BEPS initiative and "aim at a proper, non-discriminative, application of tax laws in Europe." A group of Senators (including SFC Chairman Hatch (R-UT), SFC Ranking Member Wyden (D-OR) and Senators Portman (R-OH) and Schumer (D-NY)) have urged Treasury to consider invoking Code section 891, which would allow the President to impose double taxes on corporations and people from countries deemed to be levying discriminatory or extraterritorial taxes on US entities. Treasury has responded in a letter dated March 2nd that it is closely reviewing the law and will "consider all modes of engagement to convey our strong view that the EC should reconsider its approach in these cases."

OECD Base Erosion and Profit Shifting (BEPS) Project: The OECD has agreed to a new proposal that provides a framework that will broaden participation in the BEPS project. The new forum will allow all interested countries and jurisdictions (particularly developing countries) to participate as BEPS Associates in an extension of the OECD's Committee on Fiscal Affairs (CFA). As BEPS Associates, they would work on an equal footing with the OECD and G20 members on the remaining standard-setting under the BEPS Project, as well as the review and monitoring of the implementation of the BEPS package. The framework's mandate will focus on the review of implementation of the four BEPS minimum standards in the areas of harmful tax practices, tax treaty abuse, Country-by-Country reporting, and improvements in cross-border tax dispute resolution.

Country-by-Country Reporting: The EU's automatic information exchange Directive was recently expanded in scope to cover information exchange of advance cross-border tax rulings and advance pricing arrangements. This Directive would implement the OECD's CbC reporting recommendations within an EU context and would require Member States to implement the exchange of CbC reporting between competent authorities in relation to multinational enterprises (MNEs) for fiscal years beginning on or after January 1, 2016. The exchange must take place within 15 months after the last day of the MNE group's fiscal year to which the CbC report relates, and the first reports must be exchanged for fiscal years beginning on or after January 1, 2016.

"Treasury should remain vigilant in oversight and be prepared to take action to ensure American businesses do not fall victim—retroactively — to a novel legal theory that undermines the US-EU tax treaty network and disproportionately targets US companies."— SFC Chairman Hatch in response to the Treasury letter to the European Commission

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