### The Chicago Tax Club

New Compliance Responsibilities



Teresa Peacock (Business Compliance Services)

Susan Stinnett (International Tax Services)

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- I. Proposed Form 1120, Schedule M-3
- II. Proposed Form 8858, Information Return of U.S. Persons with Respect to Foreign Disregarded Entities
- III. Section 987 Overview of applicable rules:
  - Qualified Business Unit concept
  - Functional currency concept
  - Section 987 & relevant calculations
  - Special issues
- IV. Reportable Transactions



### Form 1120, Schedule M-3



#### **Proposed Schedule M-3**

- Effective for tax years ending on or after December 31, 2004
- Corporations with > \$10M of total assets
- Still in draft format, IRS expected to issue final form later this year





- More detailed information than previous Schedule M-1
  - Information about financial statements
  - Reconciliation of financial statements to book income per tax return (can be on consolidated basis for Part II)
  - Detailed reconciliation of book to taxable income
    - Includes significantly more categories
    - Breakout of Permanent and Temporary differences



#### Form 8858 & IRC Section 987

## Form 8858, Information Return of U.S. Persons with Respect to Foreign Disregarded Entities



- Announcement 2004-4
- Required by U.S. persons that own a foreign disregarded entity either:
  - Directly
  - Indirectly or Constructively (via a U.S. person that owns a 10% or greater interest in FDE indirectly through a controlled foreign corporation (CFC) or controlled foreign partnership (CFP)).
  - FDE is an entity that is created or organized in a foreign jurisdiction and that is disregarded as separate from its owner under Reg. Sec. 301.7701-2 and -3.
- Effective for annual accounting periods on or after January 1, 2004.
- Due date: When the filer's U.S. income tax or information return is due, including extensions



## Form 8858, Information Return of U.S. Persons with Respect to Foreign Disregarded Entities

"The current lack of relevant information reporting with respect to FDEs has hindered the Service's ability to identify potential compliance issues efficiently and effectively. The Service is committed to reducing the length of the corporate examination process and improving the currency of examinations. The information to be reported on Form 8858 will help the Service identify issues more efficiently, ensuring that the Service can better focus resources and reduce exam cycle time"



## Form 8858, Information Return of U.S. Persons with Respect to Foreign Disregarded Entities

- •Schedule C Abbreviated income state information
- •Schedule F Abbreviated balance sheet information
- •Schedule H Summary information regarding taxable income or earnings & profits
- •Schedule M Transactions Between Foreign Disregarded Entity of a Foreign Tax Owner and the Filer or Other Related Entities
  - Related party transactions between an FDE owned by a CFC or a CFP and a related person other than the CFP and CFC.



### Section 987 – When Does it Apply?

Only if "Qualified Business Units" (QBUs)

#### <u>and</u>

 "Functional Currency" of QBU is different than that of taxpayer (including CFCs)



### **Section 987 Regime**

- Calculating branch profit or loss in the branch's functional currency and translating into taxpayer's functional currency
- Calculating currency gain/loss on branch "remittances" to taxpayer



#### Why is Section 987 a Hot Topic?

- Increased IRS scrutiny of check-the-box planning/use
- Current guidance unclear; room exists for interpretational positions
- Forthcoming guidance will likely restrict existing opportunities
- Proposed Form 8858, <u>Information Return of U.S. Persons with</u> <u>Respect to Foreign Disregarded Entities</u>
  - Requires reporting of Section 987 gain/loss amounts on Schedule C-1.



#### Overview — What is a QBU?

Separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records

- Separate and clearly identified unit
- Specific unified group of activities that constitute an independent economic enterprise carried on for profit
- Must engage in a trade or business (not defined)
- Must maintain separate books and records

Examples: check-the-box branches, partnerships, trusts/estates



#### **Overview** — Tax Functional Currency

- All determinations for U.S. Federal income tax purposes must be made in the taxpayer's functional currency
- U.S. Citizens, Residents, and Persons: in general, functional currency for all transactions is the U.S. dollar
- All other persons: functional currency is the currency of the economic environment in which a significant part of the activities are conducted <u>and</u> which is used to keep the books

#### **Section 987 Branch Accounting**



#### Section 987 provides rules for

- Computing branch income/loss
- Computing foreign currency gain/loss on remittances

### **Computing QBU Branch's P&L**



#### In General

- Preparing a profit and loss statement based on the QBU Branch's books and records as maintained in its functional currency;
- 2. Making adjustments to that statement in order to confirm the adjusted statement to U.S. tax principles; and
- 3. Translating the adjusted statement into the taxpayer's functional currency, using the weighted average exchange rate

#### **Special Items**

- 1. Subpart F and PFIC income are not included in the adjusted statement; and
- 2. Dividend and direct foreign tax credits (section 901 taxes) are translated at the spot rate





- A taxpayer must compute gains or losses of property transfers that involve a QBU branch, if:
  - The branch makes a "remittance," which is generally a transfer of property
  - If the branch "terminates," which generally occurs when the branch ceases its activities or when substantially all of its assets are sold or disposed





#### Remittances

- A transfer of assets to a QBU branch;
- A distribution of assets by the QBU branch;
- A transfer of liabilities to a QBU branch; and
- A distribution of liabilities from the QBU branch

#### **Termination**

- A transfer of branch assets in an outbound section 351 transaction;
- A sale of 10% or more stock in a foreign corporation causes its branch to terminate; and
- A change of a branch's functional currency to the taxpayer's functional currency, or to the Euro

### **Measuring Section 987 Gain/Loss**



#### Section 987 gain/loss is difference between:

- Remittance amounts in the branch functional currency translated to the taxpayer's functional currency at the spot rate, and
- Taxpayer's function currency basis allocable to the remittance

### **Allocating Basis**



Basis allocated to remittance =

Basis Pool x Remittance (QBU FC) Equity Pool (QBU FC)

#### **Section 987 Gain/Loss Example**



#### Example

#### Year 1

- •Basis pool = \$100
- •Equity pool = fc100
- •Exchange rate = \$1/fc1

#### Year 2

- •Branch earns fc10 in operating income
- •Average exchange rate = \$1.5/fc1
- •Branch income = fc10\*\$1.5 = \$15
  - •Basis pool = \$115 (100 + 15)
  - •Equity pool = fc110 (100 + 10)

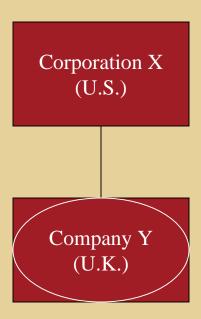
#### Year 3

- •Branch remits fc10
- •"Spot" exchange rate = \$2/fc1
- •"Spot" value of remittance = fc10\*\$2 = \$20
- •Basis allocable to remittance = \$10.45

fc10/fc110\*\$115 = \$10.45

•Section 987 gain or (loss) = \$9.55

\$20 - \$10.45 = \$9.55



Assume
Company Y is a
QBU of X

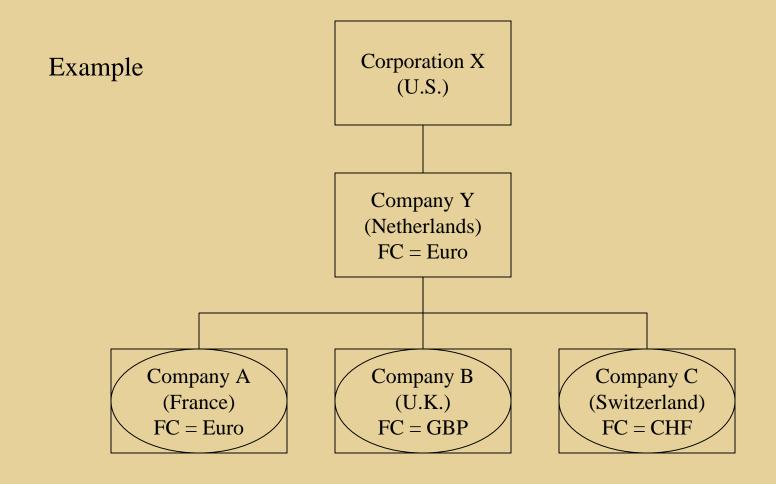
#### **Section 987 Current Issues**



- "Super Holdco" structures
- "Branch Holdco" structures
- Definition of "remittance" treatment of interbranch
- Branch terminations

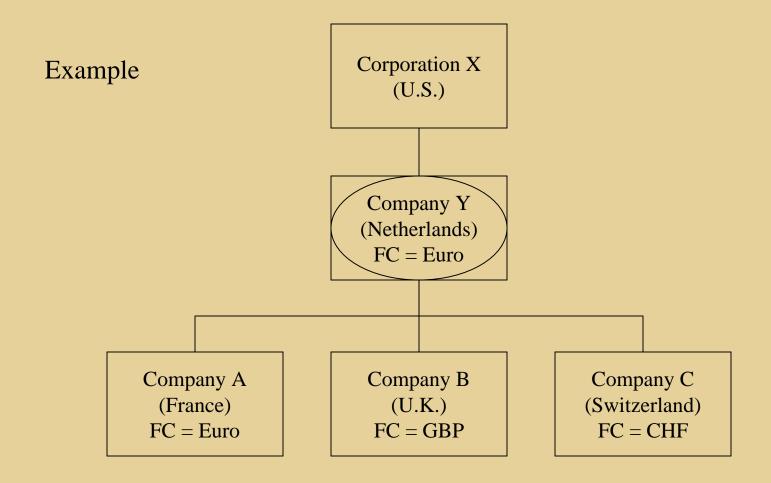






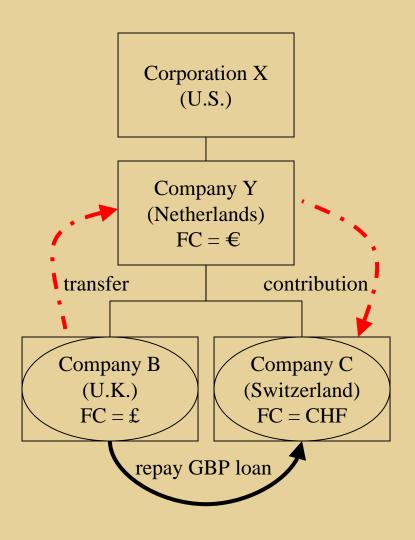






### **Section 987 Gain/Loss Example**

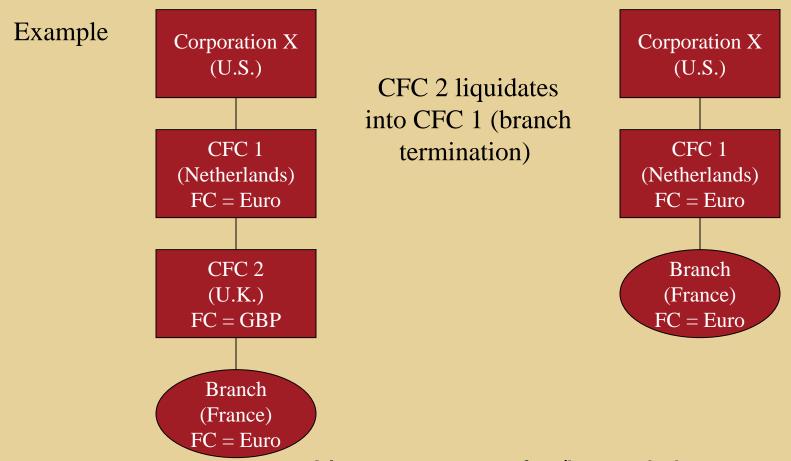




## Section 987 Termination



#### Foreign to Foreign Liquidation



Also: 351 transfer/branch incorporation



## **Reportable Transactions**

# Reportable Transaction Disclosure Regulations - Final Regulations Sec. 1.6011-4



On February 27, 2003, Treasury issued the Final Regulations, along with two Revenue Procedures:

- Rev. Proc. 2003-24 (Providing exceptions applicable to certain loss transactions)
- Rev. Proc. 2003-25 (Providing exceptions applicable to certain transactions with a significant book-tax difference)

#### Three Categories of Transactions:

- Listed Transactions\* –Treas. Reg. Sec. 1.6011-4(b)(2)
- Other Reportable Transactions Final Regulations Sec. 1.6011-4(b)
- "Noneconomic Substance "Transactions" proposed legislation

<sup>\*</sup>Not covered in today's presentation

# Reportable Transaction Disclosure Regulations - Final Regulations Sec. 1.6011-4



- The February 2003 Regulations replace these temporary disclosure regulations with more objective rules and, generally, apply to transactions entered into on or after February 28, 2003.
- Taxpayers can <u>elect</u> to apply the February 2003 regulations retroactively to transactions entered into on or after January 1, 2003

## "Top 12" Checklist for Achieving Compliance with Tax Shelter Disclosure Requirements



- Securing Management Buy-in
  - Working with other business units
  - Identifying transactions that originate within Treasury
  - Securing cooperation of CFCs
- Understanding Scope and Potential Impact
  - Determining what constitutes a "transaction"
  - Dealing with the confidentiality filter
  - Dealing with the book-tax difference filter
  - Dealing with the section 165 loss filter

# "Top 12" Checklist for Achieving Compliance with Tax Shelter Disclosure Requirements



- Managing Risk
  - Minimizing exposure under the regulations
  - Addressing risk management concerns
  - Dealing with record retention issues
  - Dealing with management and audit committees
  - Ensuring operational compliance



#### Other Reportable Transactions

- Under final regulations applicable to transactions entered into before January 1, 2003, these include certain transactions that are considered reportable under the 2-out-of-5 factor test.
  - Conditions of confidentiality
  - Contractual protection of tax benefits
  - Over \$100,000 in fees "contingent on participation"
  - Book-tax difference > \$5 million in any year
  - Participation of foreign person or tax-exempt entity
  - Difference in U.S. and foreign tax treatment [This factor was subsequently deleted in August 2000]





- 1. Confidential transactions
- 2. Transactions with tax advisor fees contingent on tax benefit
- 3. Certain loss transactions under section 165
- 4. Certain transactions with a significant (more than \$10 Million) book-tax difference
- 5. Certain transactions involving a brief asset holding period

#### 1. Confidential Transactions



Transaction offered to a taxpayer under conditions of confidentiality

Note: Under the revised final regulations, no disclosure is required unless an adviser

- (1) is paid a significant fee regarding a transaction that provides a tax benefit to the taxpayer and
- (2) imposes, for the benefit of the adviser, restrictions on the taxpayer's disclosure of the tax strategy.
- Regardless of whether confidentiality agreement is legally binding
- Any limitations on disclosure result in a confidential transaction
- Participation is defined as when a taxpayer's tax return reflects a tax benefit from the transaction and taxpayer's disclosure of transaction is limited

## 2. Transactions With Contractual Protection for Tax Advisor Fees



A transaction with contractual protections is one where:

- The taxpayer, or a related party, has the right to a full or partial refund of fees if all or part of the intended tax consequences from the transaction are not sustained, or
- The taxpayer has a fee arrangement contingent on realizing tax benefits

## Exception for Transactions with Contractual Protection



A transaction is not considered to have contractual protection:

- Solely because a party to the transaction has the right to terminate the transaction upon the happening of an event affecting the taxation of one or more parties
- If a person provides advice as to the potential tax consequences <u>only after</u> the taxpayer has entered into and reported the transaction on a <u>filed tax return</u> and previously has received no fees relating to the transaction

### 3. Section 165 Loss Transactions



Taxpayer	Single Year Loss Threshold	Combination of Years Losses
		Threshold
Corporations	\$10 Million	\$20 Million
Partnerships – Solely of Corporations	\$10 Million	\$20 Million
Others (Trusts, P/T of non-corporations, etc.)(except for certain 988 trans.)	\$2 Million	\$4 Million

- No netting of gains against losses
- Cumulative losses limited to current year plus 5 years





- A taxpayer participates in a loss transaction if the taxpayer's tax return reflects a 165 loss and the amount of the 165 loss equals or exceeds the threshold amount
- The tax return is deemed to reflect the full amount of the loss regardless of whether
  - the taxpayer can deduct the loss in the current year,or
  - the loss enters into the computation of an NOL or net capital loss that the taxpayer may carry over or carry back
- A U. S. shareholder of a CFC that has a reportable 165 loss is treated as a participant and must report the CFC's transaction





Rev. Proc. 2003-24 describes certain losses not taken into account in determining whether a loss transaction is reportable

- Losses from the sale or exchange of an asset with a qualifying basis (generally by reference to cash paid)
- Losses that include casualty and involuntary conversion losses
- Losses from properly designated hedging transactions described in 1.1221-2(b)
- Losses from marked to market under section 1256 or 475
- Losses on abandonment of depreciable business property with qualifying basis

### **Section 165 Losses: "Top 12" Unexpected Disclosures**



- 1. Scope of the loss filter, includes
  - Section 1231 involuntary conversion losses
  - Mark-to-market losses
  - Abandonment losses
  - Worthless stock deductions
  - Currency losses
  - Obsolescence losses
  - Investment losses triggered by the sale of stock
- 2. Disposition of stock or assets acquired in a carryover basis transaction
- 3. "Cash paid" exceptions

### Section 165 Losses: "Top 12" Unexpected Disclosures



- 4. Sale of stock where the seller's basis is not determined solely with reference to cash paid for such stock
- Assets the basis of which has been adjusted under various Code provisions
- 6. Sales subject to the wash sales rules (disclosure in year replacement securities are sold)
- 7. Impact of section 337 disallowances
- 8. Asset (or deemed asset) sales that produce net gains

### **Section 165 Losses: "Top 12" Unexpected Disclosures**



- 9. Hedging transactions without proper identification
- 10. Abandonment losses
- 11. Some Mark-to-market transactions
- 12. Assets acquired in consideration for assumptions of certain liabilities

### 4. Transactions With a Significant Book-tax Difference



#### \$10 Million book-tax difference in single year

- Gross Basis no netting
- Book Income determined under US GAAP unless US GAAP not used for any purpose
- Applies to SEC reporting companies and companies with gross assets of \$250 Million or more (based upon book values)
- Of any item or items of income, gain, expense or loss

#### Rev. Proc. 2003-25

 Provides 30 categories of book-tax differences that are not taken into account when determining whether a significant book-tax difference exists

## 4. Transactions With a Significant Book-tax Difference (cont'd)



#### Excluded Book-tax Differences include:

- Items to the extent a book loss or expense is reported before or without a loss or deduction for Federal income tax purposes
- Items to the extent income or gain for Federal income tax purposes is reported before or without book income or gain
- Depreciation, depletion under §612, and amortization relating solely to differences in methods, lives or conventions as well as differences resulting from the application of §§168(k), 1400l or 1400L(b)
- Capitalization and amortization under §§195, 248 and 709
- Items resulting from the application of §§354, 355, 361, 367, 368 or 1031, if the taxpayer fully complies with the filing and reporting requirements for these sections, including any requirement in the regulations or in forms

## 4. Transactions With a Significant Book-tax Difference (cont'd)



#### Excluded Book-tax Differences include:

- Bad debts or cancellation of indebtedness income
- Federal, state, local and foreign taxes
- Compensation of employees and independent contractors, including stock options and pensions
- Imputed interest income or deductions under §§483, 1274, 7872,
   or 1.1275-4
- Gains and losses arising under §§986(c), 987, and 988
- Section 481 adjustments
- Inventory valuation differences whether attributable to differences in last-in, first-out (LIFO) computations or obsolescence reserves



#### **US Shareholders of a CFC**

- US shareholders must disclose reportable transactions of their CFCs
  - Disclosed in the year the CFC participates in the transaction and the 5 succeeding years
  - A US shareholder need not disclose a CFC transaction with respect to a significant book-tax difference unless the transaction reduces Subpart F or PFIC inclusion

## **Significant Book-Tax Differences:** "Top 12" Unexpected Disclosures



- Significant book-tax differences, not Schedule M-1 adjustments
- Dealing with "top-side" adjustments
- Impact of consolidation rules
- Depreciation differences
- Reorganization transactions
- Potentially eligible reorganizations must satisfy reporting requirements

## **Significant Book-Tax Differences:** "Top 12" Unexpected Disclosures



- No exclusion is provided with respect to transaction costs
- Like-kind exchange transactions (exception if fully comply with filing and reporting requirements)
- Software development costs
- Items capitalized for book, but deducted for tax under section 162
- Section 1001 losses
- Extraterritorial income

## 5. Transactions Involving a Brief Asset Holding Period



- An asset resulting in a tax credit of more than \$250,000 (including a foreign tax credit) held for 45 days or less
  - See Compaq and IES cases
  - Exception provided where taxpayer is permitted to claim a foreign tax credit under Section 901(k)
- Taxpayer participates in a transaction involving a brief asset holding period when the taxpayer's tax return reflects items producing tax credits as described above, or when a CFC of a taxpayer enters into such a transaction





- Taxpayers required to retain "all documents and other records" relating to "transactions subject to disclosure" under the regulations until the statute of limitations has run
- Scope of required record retention is far broader than that generally required under Section 6001
- Taxpayer does not need to retain earlier drafts if the final document, or most recent draft, contains <u>all information in</u> <u>earlier drafts that is material to understanding the tax</u> <u>treatment.</u>

# Obligation to Retain Documentation (cont'd)



- For Listed and Other Reportable Transactions, taxpayers are required to retain all documents and other records, including:
  - Marketing materials
  - Written analysis
  - Correspondence with advisors, other parties
  - Analysis of tax benefits
  - Documents relating to business purpose
  - Internal e-mails

### **Questions?**



For more information regarding these issues, please contact:

Teresa Peacock (312) 298-4109

Susan Stinnett (312) 298-2839

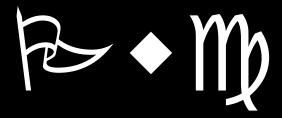
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