# TEI-SJSU High Tech Tax Institute (31st Annual)

# Repatriation Strategies vs. Reinvestment Overseas

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# Outline of Topics

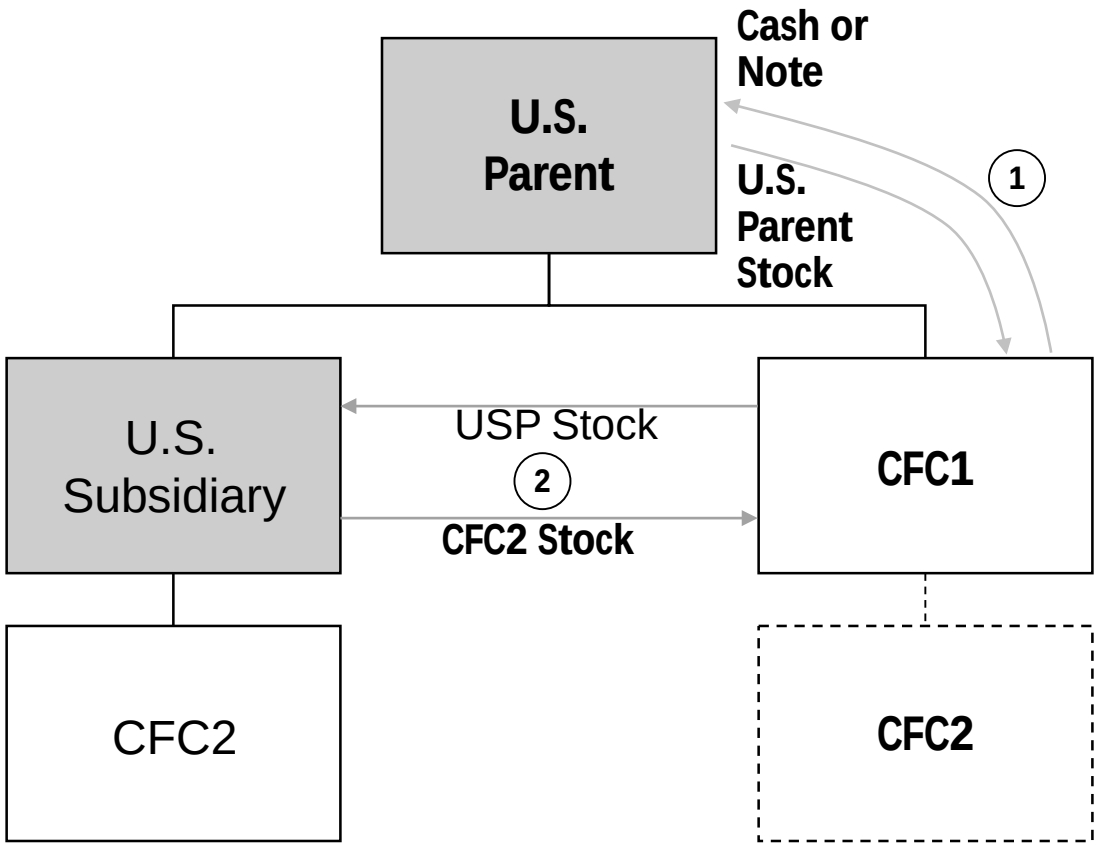
1.

# Repatriation Transactions

# A Brief History of Repatriation Transactions:

- Last decade has seen move and countermoves by Corporate taxpayers and IRS/Treasury
- Move: structures to utilize pre- or post-deal integration and other techniques to repatriate cash or move debt offshore, in each case in tax efficient manner and often to fund U.S. deals
- Countermove: IRS Notices, Regulations, CCAs, court challenges, etc. (as recent as Sept. 2015)

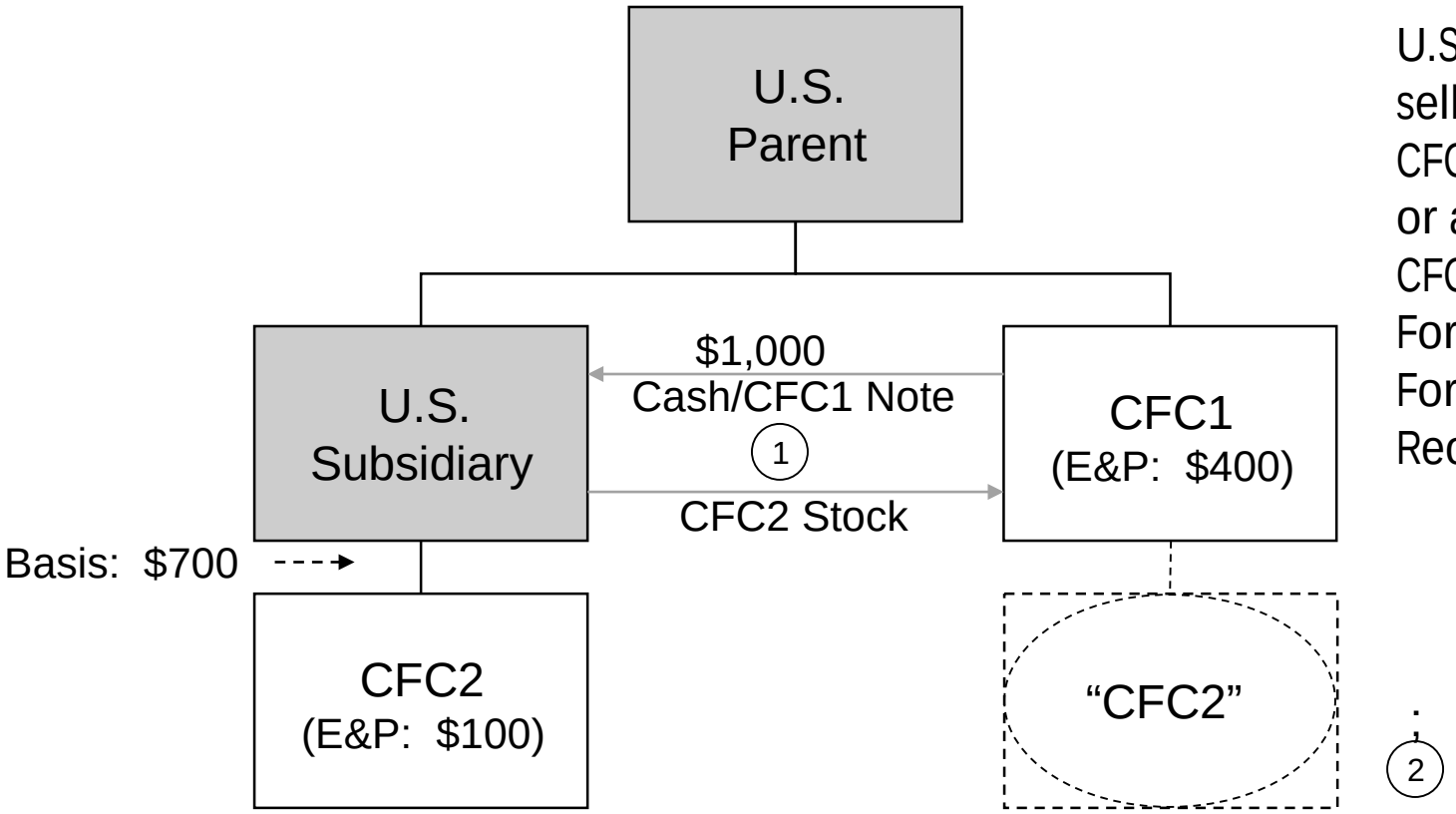
# Cash Triangular B Reorganization




1. CFC1 purchases U.S. Parent stock for cash or note.
2. CFC1 then uses U.S. Parent stock to acquire CFC2 from U.S. subsidiary.

CounterMove: IRS issues series of Notices and eventually Treas. Reg. § 1.367(b)-10, addressing "Killer B" transactions. Step 1 creates dividend. Note: Regulations do not apply unless transaction is Reorganization.

# Cash D Reorganization




U.S. Subsidiary sells CFC2 to CFC1 for cash or a note. CFC2 files CTB. Foreign-to-Foreign Reorganization.

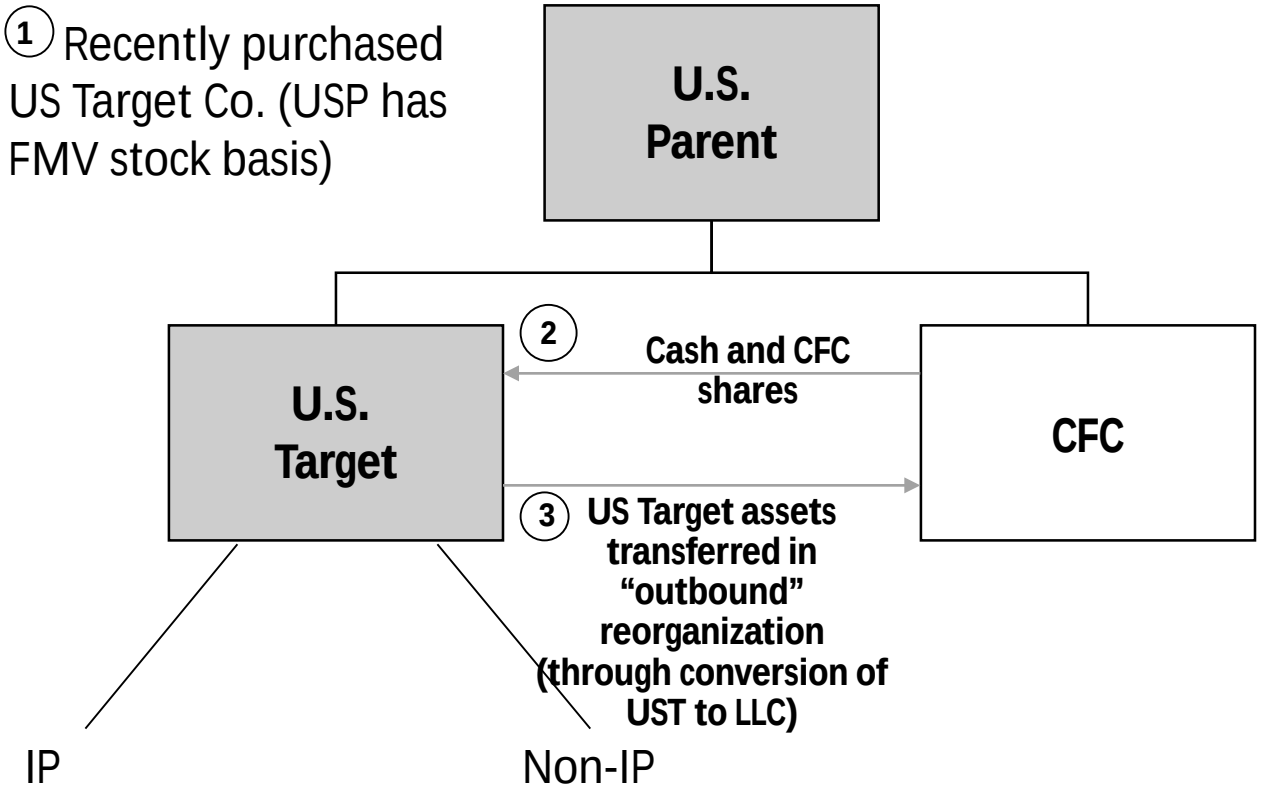
Not really a "repatriation" technique, but see Obama Greenbook Proposals to repeal "boot within gain" rule.

# Other Transactions

Transactions designed to access overseas cash to purchase a U.S. Target Company. Common elements:

1. Use of Code Section 367(d) to defer income recognition on repatriation (in lieu of dividend) or shield completely for goodwill/going concern (GW?GCV).
2. Avoid Section 956 inclusion.
3.

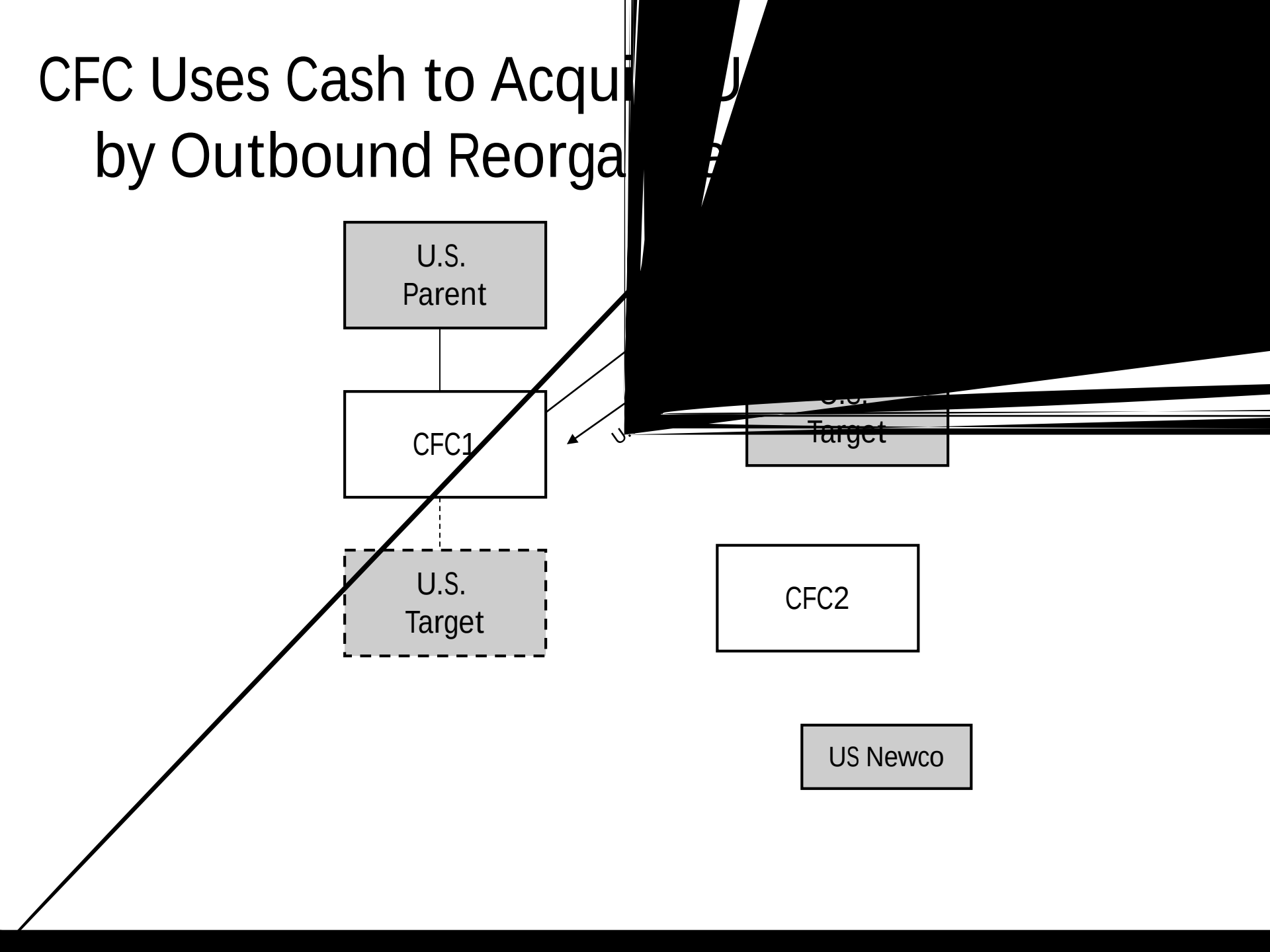
# Outbound Asset Reorganization in Exchange for Cash




Cash in Step 2 would not result in full current taxation through combination "boot within gain" rule and Section 367(d). Income inclusion over life of transferred IP.

# Outbound Asset Reorganization in Exchange for Debt Assumption

# CFC Uses Cash to Acqu U
# by Outbound Reorga e



# Countermove: Notice 2012-39

- July 13, 2012: IRS and Treasury published Notice 2012-39 to address "transactions that raise significant policy concerns."
- Applies to transactions occurring on or after July 13, 2012.
- Fundamental Points:

1. Cash received from CFC is treated as prepayment (currently taxable) of Section 367(d) amount.
2. "Nonqualified debt" assumed by CFC is treated as prepayment (currently taxable) of Section 367(d) amount.
3. Outbound reorganization of U.S. Target following its purchase by a CFC results in accelerated taxation under Section 367(d) because of no U.S. "qualified successor" for Section 367(d) inclusions.

# Countermove: New Section 367(d) Regs

- Released September 2015 (proposed to be effective on such date, despite proposed form)
- Eliminate the favorable treatment afforded FGW-GCV by removing the

# The 956 Amount

The 956 Amount is:

(1) the excess (if any) of:

(A) such U.S. shareholder's pro rata share of the average of the amounts of United States property ("U.S. Property") held (directly or indirectly) by the CFC as of the close of each quarter of such taxable year, over

(B) the amount of earnings and profits described in Code § 959(c)(1)(A) with respect to such U.S. shareholder, or

(2) such U.S. shareholder's pro rata share of the applicable earnings of such CFC.

# Mechanics

1. Adjusted Basis. The amount of U.S. property is the **ADJUSTED BASIS** of such property as determined for purposes of computing earnings and profits, reduced by any liability to which the property is subject.

2. Average of Quarterly Measurements. In the pre-1993 version of Code § 956, the computation of the 956 Amount considered the U.S. Property owned at the end of the taxable year by a CFC. This test was subject to controversy (i.e. successive short-term loans viewed by IRS as to avoid the yearly measurement). See, e.g., Rev. Rul. 89-73, 1989-1 C.B. 258; Jacobs Engineering Group, Inc. v. U.S., 79 A.F.T.R.2d (RIA) 1673 (DC CA 1997), aff'd 83 A.F.T.R.2nd (RIA) 1453 (9th Cir. 1999). In 1993, to address these perceived abuses, Congress revised the computation for the 956 amount to consider the average amount of U.S. property owned at the end of each quarter.

# Mechanics (cont.)

3. Previously Taxed Income Limitation. Once the four quarterly measurements have been averaged, such average amount is then reduced by the U.S. shareholder's previously taxed income ("PTI") account as defined by Code § 959(c)(1)(A).

4. Applicable E&P Limitation. The resulting amount is then limited by the amount of the current and accumulated earnings and profits of the CFC (reduced by distributions made during the taxable year and previously taxed income as described in Code § 959(c)(1)) ("Applicable E&P").

5. Computational Example.

| | |
|---|---|
| Average U.S. Property: | $200 |
| PTI: | $ 50 |
| Excess: | **$150** |
| Applicable E&P: | $135 |
| 956 Amount: | **$135** |

# Definition of U.S. Property

1. Definition. U.S. Property generally includes these types of property:

   - ¾ Tangible property (real and personal) located in the United States

   - ¾ Stock of a domestic corporation or obligation of a Unites States person each of which is a U.S. Shareholder or bears a 25% ownership connection to the CFC (Note important exclusions below, re: obligations)

   - ¾ Any right to use in the Unites States of (A) a patent or copyright, (B) an invention, model, or design (whether or not patented), (C) a secret formula or process, or (D) any other similar property right, which is acquired or developed by the CFC for use in the United States.

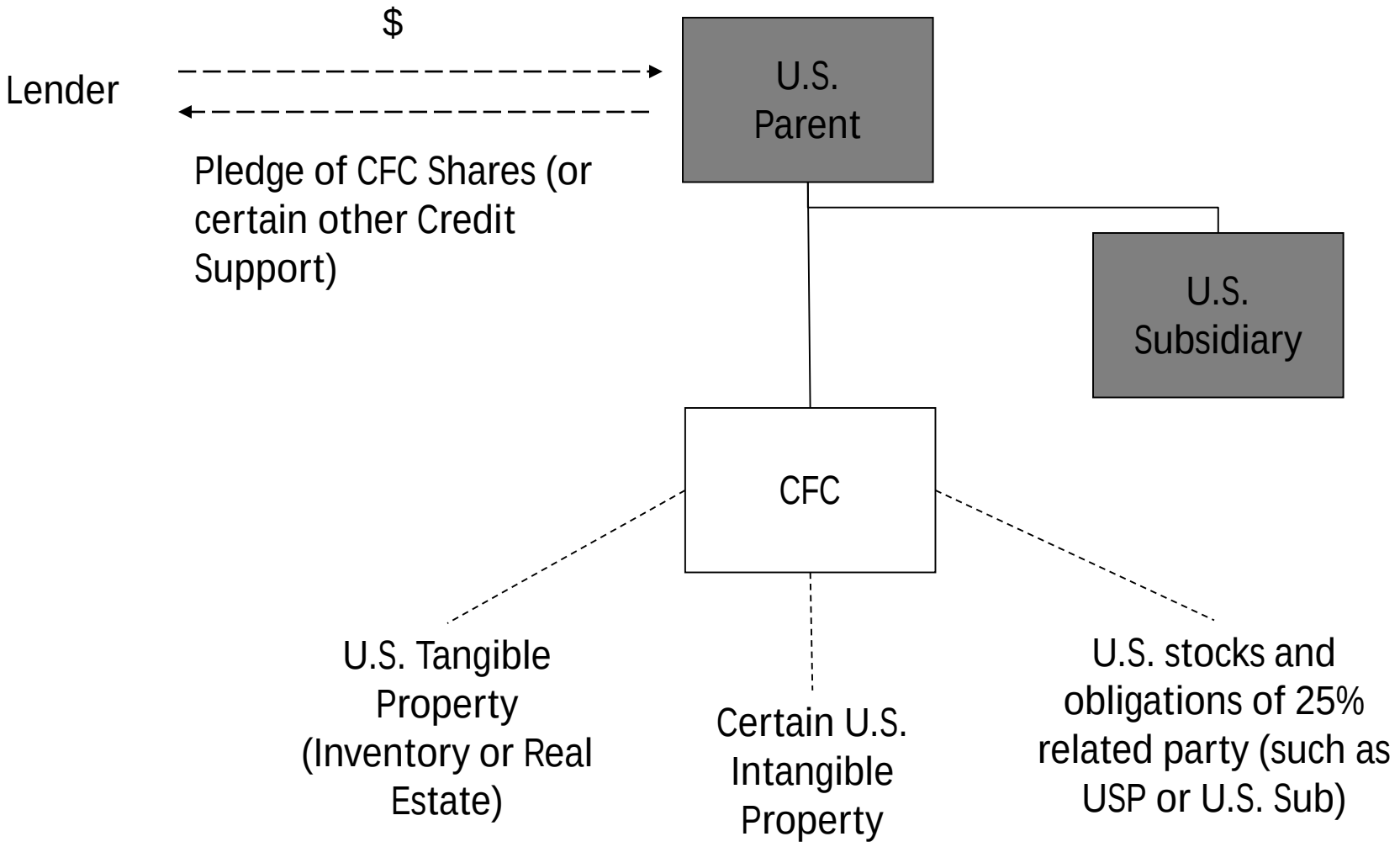
2.

# Definition of U.S. Property (cont.)

3. Marketable Securities Exception. An exception is provided for an obligation of a U.S. person to the extent the principal amount of the obligation does not exceed the fair market value of readily marketable securities sold or purchased pursuant to a sale and repurchase agreement or otherwise posted or received as collateral for the obligation in the ordinary course of its business by a U.S. or foreign person which is a dealer in securities or commodities.

4. Exception for U.S. Property Acquired Prior to CFC Status. An exception is provided for U.S. property which was acquired by a CFC before the first day on which the corporation was treated as a CFC. This exception is limited to the applicable earnings of the CFC accumulated before the first day on which it was treated as a CFC.

# Definition of U.S. Property: Summary



# Obligation of a U.S. person

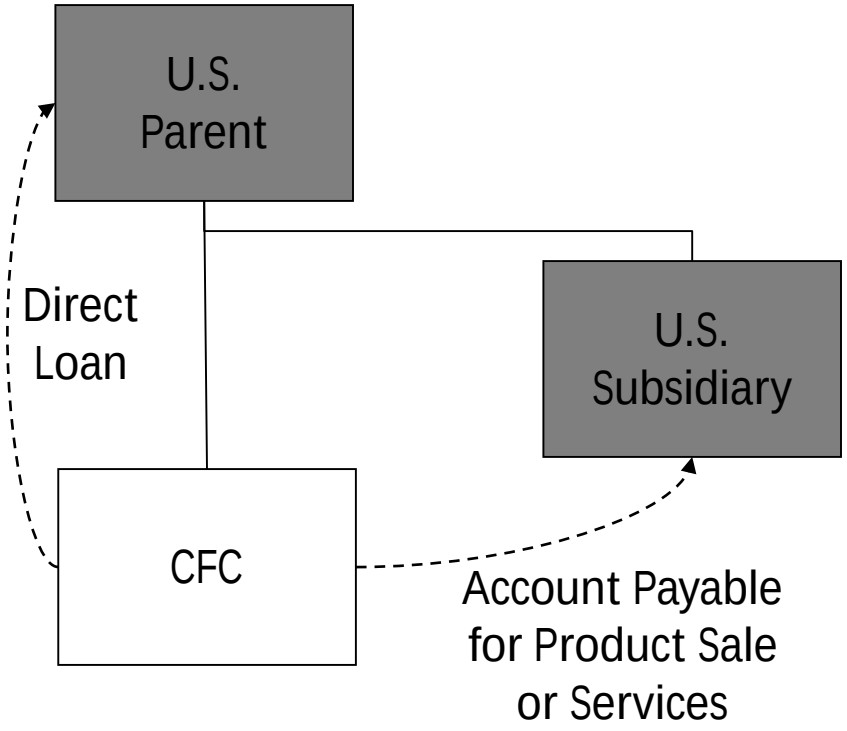
1. Definition. An obligation of a U.S. person is essentially any form of indebtedness of a U.S. person (including certain pledges and guarantees as discussed below). Clearly, a loan from a CFC to its U.S. Parent is an Obligation of a U.S. Person.

2. Direct Pledge or Guarantee by CFC. A CFC is treated as holding an obligation of a U.S. person if such CFC is a pledgor or guarantor of such obligation. This provision often creates conflict between borrower's counsel and lender's counsel.

3. Indirect Pledge or Guarantee by CFC. If the assets of a CFC serve as indirect security for an obligation of a U.S. person, then the CFC is considered the pledgor or guarantor of such obligation.

   - Shareholder Pledge of CFC Stock. A pledge of at least 66 2/3 percent of the stock of a CFC as security for a loan accompanied by negative covenants effectively limiting the CFC's ability to dispose of its assets and incur liabilities outside of the ordinary course of its business is treated as an indirect pledge of the assets of the CFC.

# Obligation of a U.S. Person (cont.)




Type of Obligations:

1. Direct loan from CFC to U.S. Cos. Problem
2. CFC sells or processes property to/for U.S. Cos. U.S. Co. has account payable. Depends on "ordinary and necessary".
3. CFC provides services to U.S. Cos. U.S. Co. has account payable. Depends on "ordinary and necessary". But 60-day safe harbor.

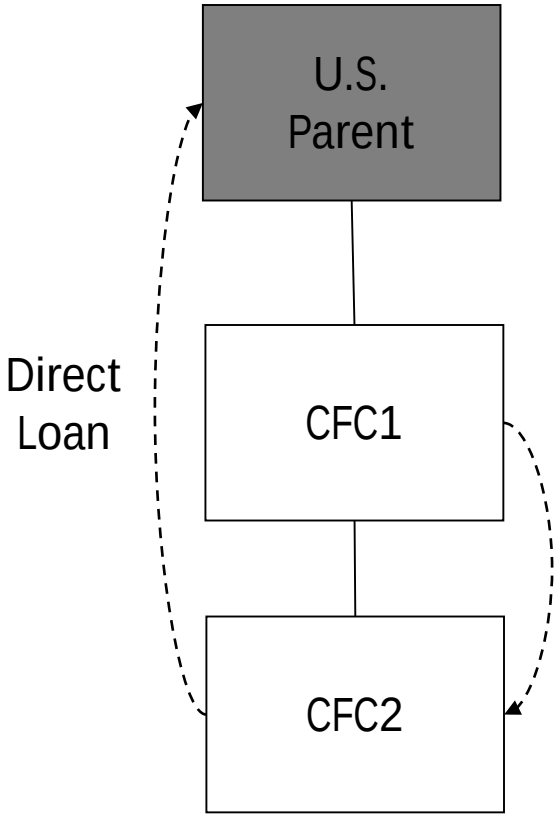
# Anti-Abuse Rule

1. A CFC is considered to hold indirectly an investment in U.S. Property held on its behalf by a trustee or a nominee.

2. At the discretion of the IRS, a CFC is considered to hold indirectly an investment in U.S. Property acquired by any other foreign corporation that is controlled by the CFC, if one of the principal purposes for creating, organizing, or funding such other foreign corporation is to avoid the application of Code § 956 with respect to the CFC.

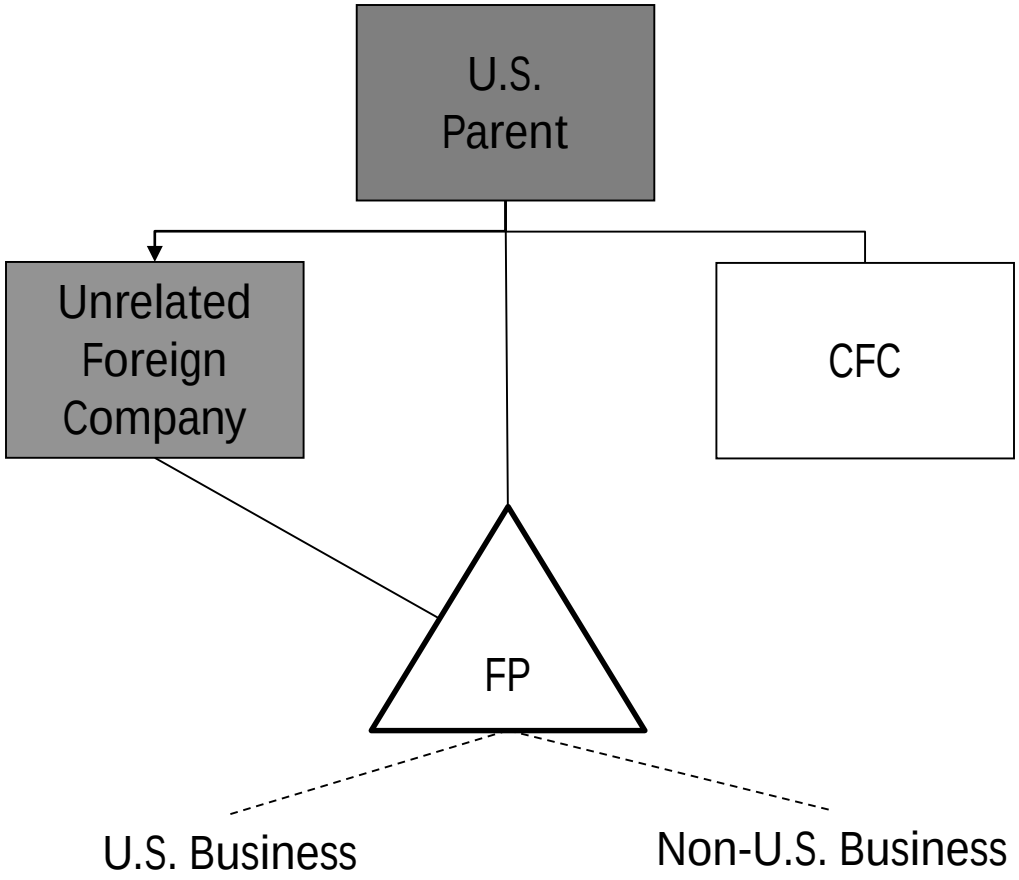
   - A foreign corporation is controlled by the CFC if they are related under Code § 267(b). Attribution rules apply for this purpose.

# Anti-Abuse Rule (cont.)



# Section 956

# Section 956 Proposed Regulations




General Application of Proposed Regulations:

1. CFC loans 100 to FP

Result: USP is treated as attributed 90 of obligation irrespective wh-5.4(p)-91h3

# Accounting for Income Taxes

# Current Environment – In the News

Repatriation in the news

- “US Companies Are Stashing $2.1Trillion Overseas To Avoid Taxes” (Bloomberg 3-4-15)
- “When Taxes and Profits Are Oceans Apart” (NYT 7-05-14)
- "Bring Back Our Dollars: Lululemon’s Overseas Cash is Coming Home " (WSJ 6-13-14)
- "EBay to Take $3 Billion Tax Charge" (WSJ 4-29-14)
- "Overseas Earnings Continue to Grow" (WSJ 3-31-14)

# Current Environment – at Regulatory Level

Focus of politicians, standard setters, and regulators

- Heightened focus on accessing foreign earnings and tax planning (e.g., inversions)
- FASB: Indefinite reinvestment assertion added to the disclosure framework project (considering adequacy of disclosures)
- SEC: Comment letters continuing to focus on Indefinite reinvestment assertions

# FASB – Disclosure Framework Project

- In response to the FAF's post implementation review of FAS 109 and feedback from the SEC, the FASB added unremitted foreign earnings to its existing disclosure review initiative
- Foreign earnings: the FASB made a "tentative board decision" that the following income tax disclosures related to foreign earnings should be required:
  - Earnings disaggregated between domestic and foreign earnings for public and non-public entities
  - Foreign earnings would be further disaggregated for any country that is significant to total earnings
  - Domestic tax expense recognized in the period for taxes on foreign earnings
  - Undistributed foreign earnings that are no longer asserted to be indefinitely reinvested during the current period. Separate disclosure for any country that is significant
  - Disaggregation of the cumulative amount of indefinitely reinvested foreign earnings disclosure to the extent any country represents at least 10 percent of the disclosed amount

# FASB – Disclosure Framework Project(cont.)

- Foreign earnings
  - The Board decided tentatively that the following disclosures would not be required:
  - Disaggregation of deferred tax liabilities recorded for unremitted foreign earnings by country
  - An estimate of the unrecognized deferred tax liability on the basis of simplified assumptions
  - Past events or current conditions that have changed management's plans for undistributed foreign earnings

# SEC – Areas of Focus in 2015

Most frequent income tax comment letter topics:

- Effective tax rate presentation
- Indefinite reinvestment of foreign earnings
- Valuation allowance
- Uncertain tax positions

# SEC – Areas of Focus in 2015 (cont.)

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# SEC Comment Letters

“Given

# SEC Comment Letters (cont.)

"We note you have disclosed that it is not practicable to determine the tax amounts that would be payable if the $[xx] million in undistributed foreign earnings were distributed to the U.S. Please explain why it is impracticable to determine the tax amounts in light

# SEC Comment Letters (cont.)

"We note that your reconciliation of the effective tax rate includes a line item with the caption "Foreign dividends." Please tell us whether or not this line item represents repatriation of foreign earnings during the periods presented. If it does, please tell us the nature, amount, timing and special circumstances surrounding each repatriation and tell us how you evaluated the criteria for the exception to recognition of a deferred tax liability in accordance with ASC 740-30-25-17 and 18 for undistributed earnings that are intended to be indefinitely reinvested. Please also describe the type of evidence that sufficiently demonstrates that remittance of earnings will be postponed indefinitely as disclosed on page [xx]."

"We note from page [xx] that at December 30, 2012 you hold a cumulative total of $[xx] million of undistributed earnings in non-U.S. subsidiaries that you plan to reinvest outside the U.S. indefinitely. As we note that your cash and cash equivalents totaled $[xx] million at that date, please tell us the amount of cash and equivalents and liquid investments held by your foreign subsidiaries at December 30, 2012 and quantify the amount that would not be available for use in the U.S. without incurring U.S. taxes"

# SEC Comment Letters (cont.)

"Based on your disclosure on page [xx] it does not appear that you repatriated any foreign earnings during fiscal 2013, though we note the relatively small impact therefrom in the tax rate reconciliation on page [xx]. However, you indicated that you repatriated $[xx] million at year end in the CFO's prepared remarks of the earnings call transcript. Please clarify or reconcile."

"We note your disclosure on page [xx] states that you "have removed your election to permanently reinvest foreign earnings for 2011, 2010 and 2009." We also understand that you may have repatriated some of these earnings in order to fund the redemption of the 1.75% convertible senior notes and the share repurchases in 2011. Please

# SEC Comment Letters (cont.)

We note

# PCAOB - Indefinite Reinvestment

PCAOB Inspection trends and themes – Income taxes

- Reviews continue to focus on audit evidence, procedures, and documentation with respect to judgments, estimates, assertions, and internal controls
- Estimates
  - Did not always identify and appropriately test key assumptions underlying significant judgments and estimates
  - Over reliance on discussions with client to support key assumptions
  - Insufficient documentation
- Internal controls
  - Insufficient evidence of testing of the control activities that constitute supervisory review

# Indefinite Reinvestment Accounting Issues

Overview

- Guidance
  - 740-30-25-18(a) provides that a deferred tax liability is not recognized for "an excess of the amount of financial reporting over the tax basis of an investment on a foreign subsidiary or foreign corporate joint venture that is essentially permanent in duration."
  - One of the few standards that speaks of management retaining evidence, in this case of reinvestment plans
  - Allows preparers to avoid recording a deferred tax liability in a framework that is generally seen as conservative
- Outside Basis Difference
  - Largest portion of the outside basis difference typically arises from unremitted earnings but includes differences rising from comprehensive income and other changes in the subsidiary's equity

# Indefinite Reinvestment Accounting Issues (cont.)

- Outside Basis Difference (cont.)
  - The difference between the book/tax basis in the investment represents a single outside basis difference
    - Entity should not record a DTA for one portion of the outside basis difference while not recording a DTL for another portion of the difference based on an indefinite reversal exception
  - Not meant to limit an entity's ability to assert that only a portion of the single outside basis difference is subject to the indefinite reversal exception
    - Entity can maintain a DTL on some, but not all, of the outside basis difference (whether or not such difference is caused by unremitted earnings or other factors) if its assertion is justified by the "evidence" and "plans" described in ASC 740-30-25-17

# Indefinite Reinvestment Accounting Issues (cont.)

- Disclosure considerations
  - Consistency throughout the financial statements on statements and assertions
  - Ability to assert indefinite reinvestment and evidence relied upon
  - Changes in assertion
  - Quantification of earnings deemed indefinitely reinvested
  - Tax liability for earnings deemed indefinitely reinvested
  - Events that could cause indefinitely reinvested earnings to become taxable in the home jurisdiction
  - Jurisdictions where foreign earnings are accumulated
  - Implications on liquidity and capital resources

# Indefinite Reinvestment Accounting Issues (cont.)

Question: Can an entity reverse its assertion in a period, due to facts and circumstances, and still have the ability to assert in a future period?

# Indefinite Reinvestment Accounting Issues (cont.)

- Changes in an assertion
  - What were the triggering events that caused the change in assertion?
  - Could a similar situation happen in the future?
  - Are they earnings truly indefinitely reinvested or are they available under the right circumstances
  - Does the Company's business activities make asserting difficult?

  Current economic environment – impact on ability to assert
  - Are significant payments due near-term, such as debt or pension funding?
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# What are External Auditors Looking for?

Specific plans for indefinite reinvestment assertions must be documented and maintained by management:

- When evaluating specific plans consider the following:
  - Forecasts and budgets of parent and subsidiary for both long & short term
  - Financial requirements of both parent and subsidiary for long & short term
  - Past history of dividend actions
  - Planned acquisitions
  - Tax consequences of a decision to remit or reinvest
  - Remittance restrictions in a loan agreement of a subsidiary
  - Remittance restrictions imposed by foreign governments that result in forced reinvestment in the country
  - Any U.S. government programs designed to influence remittances

# What are External Auditors Looking to do?

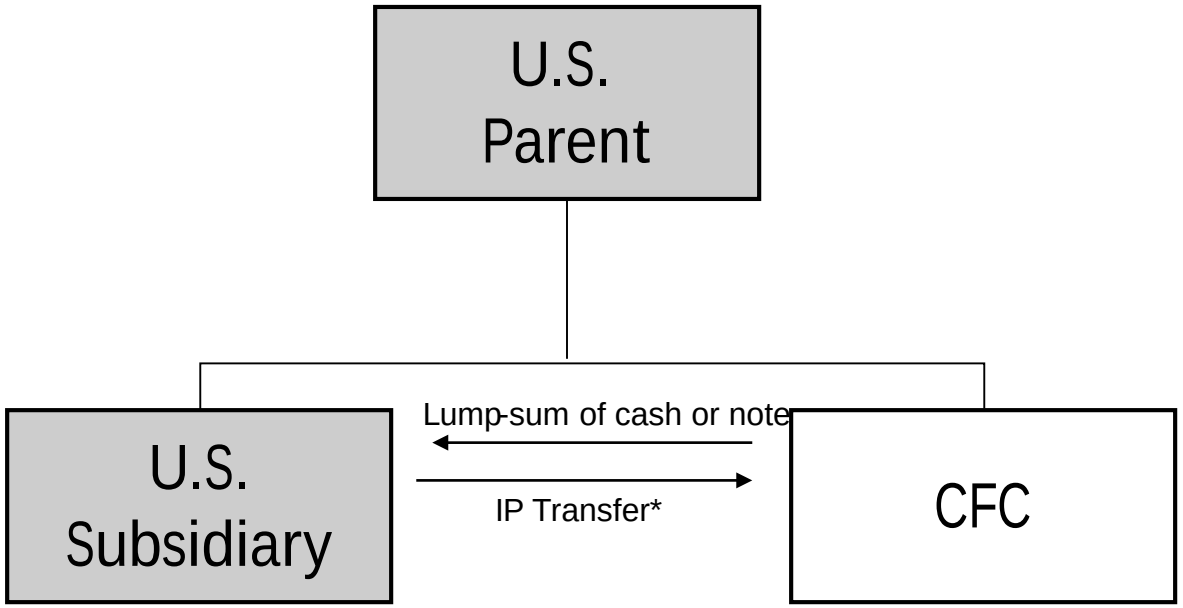
- Demonstrate their knowledge of a Company's organizational structure including which entities are asserting indefinite reinvestment versus those that do not in their documentation
- Demonstrate their knowledge of management's specific plans or other evidence supporting their indefinite reinvestment assertion
- Test the reasonableness of management's assertion
  - Test projections of U.S. and foreign uses of cash
  - Consideration of existing loan agreements for restrictions or other barriers to financing
  - A schedule of actual or deemed distributions to ensure assertions (current or prior) has not been violated
  - Identify entities that generate income that may be currently taxable (e.g., CFCs with Sub-part F income) to ensure management truly has ability to defer tax on earnings

# What are External Auditors Looking to do? (cont.)

- Assess the sufficiency and transparency of disclosures
- Test the recorded balances
  - Audit the measurement of deferred tax liabilities on outside basis
  - Test mathematical accuracy of analysis
  - Agree amounts to financial statements / other analyses

# Other Repatriation Techniques

# Sale of IP or Prepaid License of IP as Repatriation Valve




* Assume U.S. Subsidiary has previously licensed IP for annual royalty payments. In 2015, U.S. Subsidiary transfers IP for a term of years in exchange for lump-sum payment.

# Tax Treatment of IP Sale vs. License

1. Sale if: Exclusive, perpetual, irrevocable, right to sublicense, unlimited

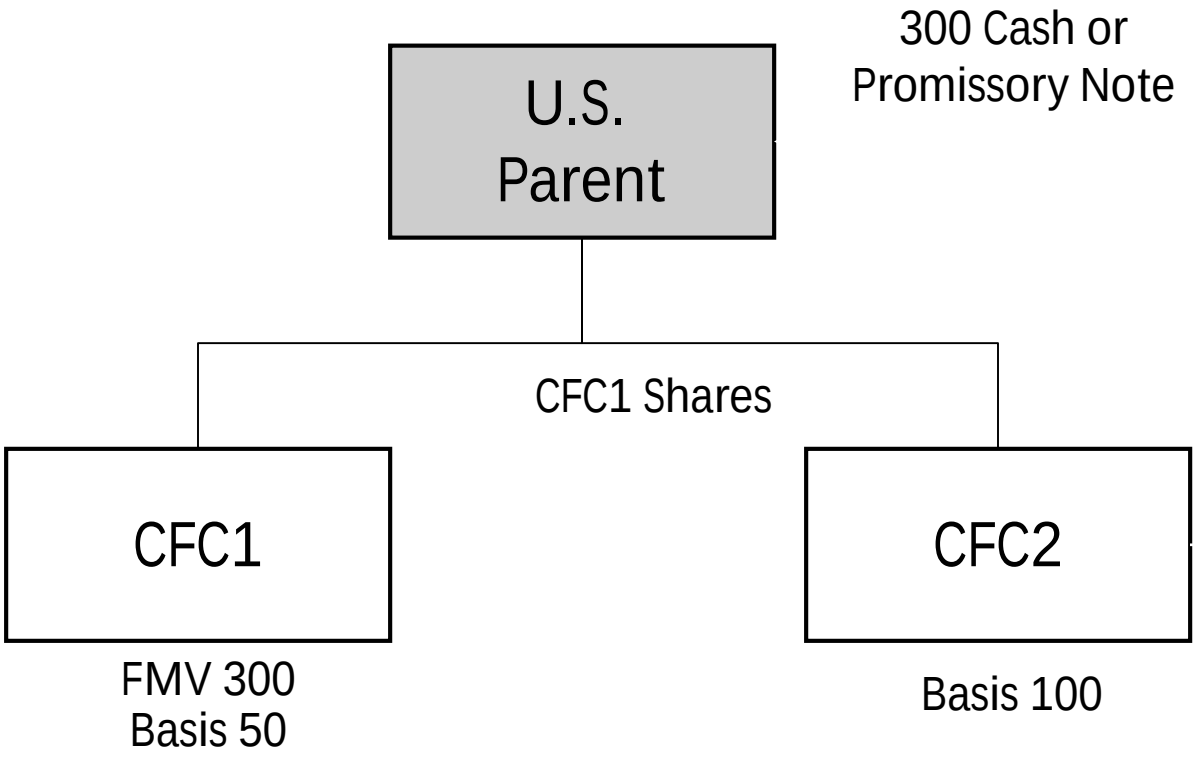
# Tax Treatment of IP Sale vs. License (cont.)

- Character, source and basis recovery depend on whether transaction is characterized as sale or license. Also CFC's deduction or amortization for U.S. E&P purposes.
- Sale typically generates capital gain, while license generates ordinary income. Note: Contingent Payment Sale can be treated as license.
- Tax law follows substance rather than form. "License" may be a true sale.
- Whether transfer of IP rights constitutes sale or license determined under "all substantial rights" test.
- Transfer of IP rights constitutes sale only if exclusive and perpetual right to use IP and to make, use, and sell the claimed technology or product in a particular geographic territory is transferred.
- "Transfer" of non-exclusive right to use IP, particularly for a period less than estimated useful life of the asset, generally results in license of the asset. Payments received by transferor / licensor constitute royalties (ordinary income).

# Summary of Anticipated U.S. Tax Results

| | Sale to a Foreign Entity (Non-Contingent) | License to a Foreign Entity |
|---|---|---|
| Foreign Tax Credit | Generally Passive Basket | General Limitation Basket |
| Source | Based on Residence of Seller (U.S.) | Based on Location of IP Use (Foreign) |
| Section 956 | Concern if U.S. rights to IP Transferred | N/A |
| Income Inclusion | Current (or subject to installment sale rules) | Current or Periodic |
| Treatment of Intercompany Note | - Debt/Equity Issues<br>- Terms of Note<br>- Ability to Service<br>- Cash Flow Coverage | Same issues |
| Impact on E&P of CFC | Amortize over IP life | Reduce E&P as paid |

# Section 304 Transactions – the Basic




CFC2 acquires CFC1 shares from U.S. Parent for 300.

# Section 304 Transactions – the Construct

1. U.S. Parent transfers CFC1 (issuing corporation) shares to CFC2 (acquiring corporation) in exchange for property.

2. Treated as if:

    a. U.S. Parent had transferred CFC1 to CFC2 in exchange for new shares of CFC2 in a transaction to which Section 351 applies

    and

    b. CFC2 had redeemed shares it was treated as issuing.

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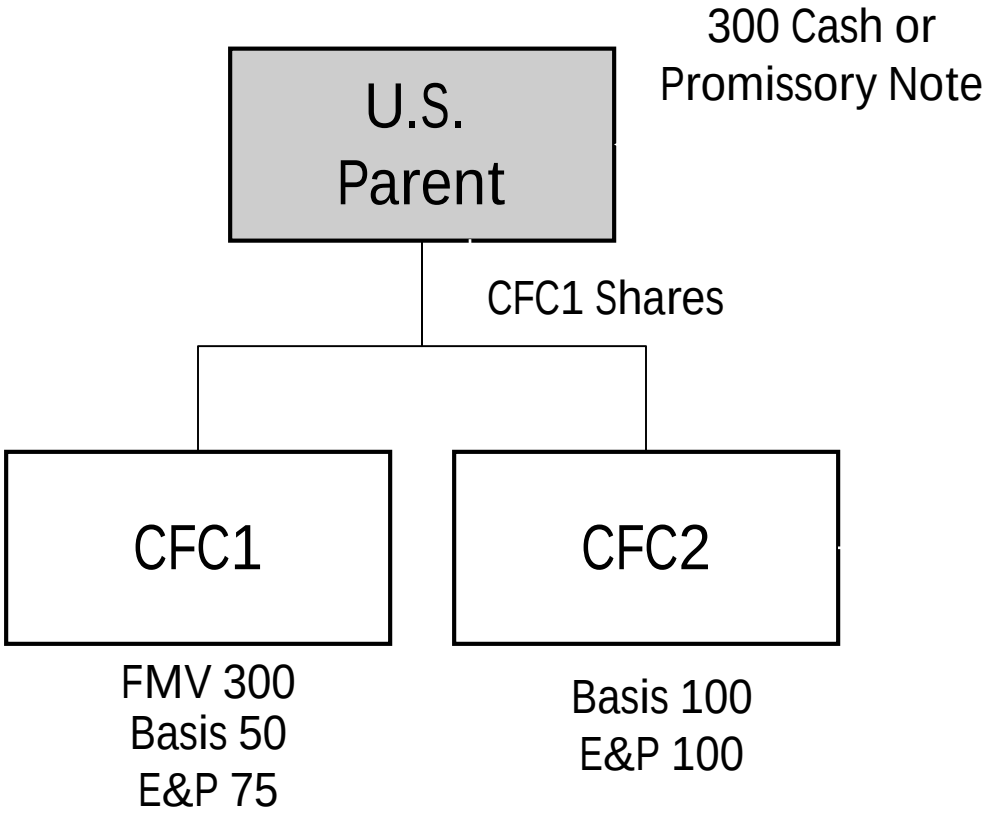
# Section 304 Transactions – the Math




The Construct: U.S. Parent is treated to have contributed CFC1 shares to CFC2 in exchange for CFC2 shares worth 300. Immediately, CFC2 is treated to redeem those CFC2 shares for 300 cash.

Tax Effect of the Redemption:

1. Dividend to extent of CFC2 E&P (100).
2. Dividend to extent of CFC1 E&P (75).
3. Return of basis (to extent of original basis in CFC1 (50).
4. Balance (75)?

Notice 2012-15 turns Section 367(a) GRA requirement on in case of deemed Section 351 transfer of CFC1 to CFC2.

# Section 304 Transactions – Added Complexity

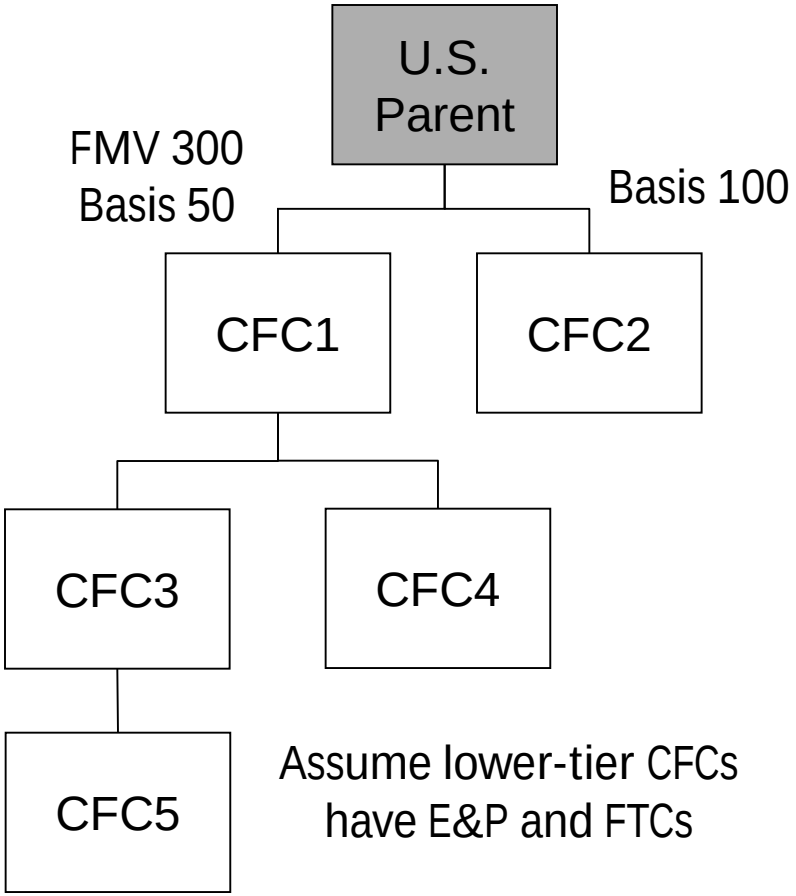
Temp. Treas. Reg. § 1.367(a)-9T. were issued to address basis calculations in cross border Section 304 transactions. The rules were extended and modified by Notice 2012-15. These rules impact:

- U.S. Parent's dividend income and potential gain.
- Basis of U.S. Parent in CFC2, and basis of CFC2 in CFC1.

Factors:

- U.S. Parent's basis in CFC1 and in CFC2.
- CFC1 and CFC2 total E&P.
- Lower-tier subsidiaries of CFC1 – stock basis, FMV, and E&P.

# Section 304 Transactions – Temp. Treas. Reg. § 1.367(a)-9T Application




Depending upon factors listed on prior page, sale of CFC1 by U.S. Parent to CFC2 could result in gain at U.S. Parent which is not dividend equivalent.

Key Issues for consideration:

1. Basis in first tier CFCs.
2. E&P and FTC pools in all CFCs.
3. Lack of GRA triggers Section 1248 in CFC1 (which includes E&P and FTCs at lower-tier (CFCs). But can result in more than 300 income.
4. Location of PTI.

# Holding Company Structures

# Other Issues/Techniques

1. Treasury severely curtailed the use of certain outbound reorganization techniques following acquisition of U.S. Target with new proposed regulations under 367(a) and (d).
2. Treasury/IRS continuing concerns over repatriation.
3. Continuing role of Section 956?
4. Tax Reform?

# Thank You

- Questions?  Comments?

## About this presentation

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