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## IRS Advises Taxpayers to Engage U.S. Competent Authority Early

At a recent meeting of tax professionals in New York, Michael Danilack, Deputy Commissioner (International) of the IRS Large Business and International Division (LB&I) and U.S. Competent Authority under tax treaties, stated that U.S. taxpayers must contact the U.S. Competent Authority in relation to a proposed treaty country tax adjustment, which implicates a U.S. correlative adjustment. Danilack warned that without clearance by the U.S. Competent Authority, U.S. taxpayers should not rely on the use of U.S. foreign tax credit rules in the face of such foreign adjustments and urged U.S. taxpayers to focus on lowering foreign taxes through the mutual agreement procedure (MAP). Danilack noted that depending on the circumstances, the U.S. Competent Authority would choose among these alternatives:

- Grant the correlative adjustment without MAP.
- Allow the field to deal with the correlative issue (if the year in issue is under the jurisdiction of the field).
- Proceed with a normal MAP.
- Advise the taxpayer to pursue domestic remedies in the treaty country (and in some cases, even litigation).
- Deny the correlative, but allow the foreign tax credit.

Most tax treaties contain mutual agreement procedures pursuant to which a taxpayer may request competent authority assistance when a treaty country imposes foreign taxes that may be contrary to the treaty. The competent authority is a mechanism to resolve double taxation problems, address treaty interpretation problems and facilitate consultation between tax officials of the two governments. The issues addressed most often include allocation of income and deduction items, residence, income sourcing, withholding and permanent establishment issues. The competent authority mechanism is an important tool for U.S. taxpayers, as the U.S. Competent Authority is not limited by U.S. domestic law or policy. Danilack noted that the competent authority mechanism allows for “principled” decision-making regarding international tax issues. He emphasized that the process does not allow for an official role for U.S. taxpayers, although input from taxpayers is encouraged so long as the information provided by taxpayers to both governments is consistent. In fact, experienced tax professionals have honed mechanisms by which they facilitate MAP agreement without being present at the negotiations between the competent authorities.

Danilack noted the importance of the procedure in cases in which treaty country examiners discourage taxpayers from seeking competent authority involvement, threaten a higher adjustment when the taxpayer seeks competent authority involvement or coerces a taxpayer into accepting an adjustment. In these scenarios, Danilack noted that a taxpayer that pays a foreign tax without the involvement of the U.S. Competent Authority risks that the United States will treat the tax paid as voluntarily paid and, therefore, risk the disallowance of the foreign tax credit.

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Danilack's remarks also addressed scenarios in which "unprincipled or very large" adjustments are asserted in a country with which the United States has a treaty, even though they do not implicate a U.S. correlative adjustment. In such cases, before acquiescence, taxpayers should go to the U.S. Competent Authority first, which either on its own, or working with its foreign counterpart, determines whether an adjustment is consistent with the treaty and underlying principles. He made clear that a foreign tax credit may be available, but only as a "backstop." According to him, taxpayers should exhaust their administrative remedies by reaching out to the U.S. Competent Authority early on in the process — although the Competent Authority may advise that the taxpayer pursue the issue in the foreign country administratively (and in some cases, even litigate).

### *Final Anti-Inversion Regulations May Revive Business Activity Safe Harbor*

An IRS official, Ronald A. Dabrowski, Deputy Associate Chief Counsel (International Technical), recently provided taxpayers with the welcome news that a "substantial business activity" safe harbor, which had been removed from recent anti-inversion regulations, would likely be revived in final regulations still to come. Section 7874 generally applies to prevent entity inversions or expatriations by taxing inversion gain or, in some cases, by treating the foreign acquiring corporation as a domestic entity. A transaction comes within these rules where 1) a U.S. corporation or partnership transfers substantially all of its property to, or becomes a subsidiary of, a foreign corporation; 2) the owners of the U.S. entity acquire at least 60 percent of the foreign corporation by reason of their stock ownership in the U.S. entity; and 3) the foreign corporation and its expanded affiliated group (EAG) do not have "substantial business activities" in the foreign country of incorporation as compared to the total business activities of the group.

In 2006, the IRS had issued temporary regulations under Section 7874, which contained a safe harbor provision pursuant to which the foreign corporation and the EAG would be considered to be engaged in substantial business activities. The safe harbor test was met if after the acquisition: a) at least 10 percent of the EAG's employees were located in the country of the foreign corporation's incorporation, b) at least 10 percent of the EAG's assets (other than intangibles) were located in that foreign country and c) at least 10 percent of the EAG's sales occurred in that foreign country. In 2009, the 2006 temporary regulations were withdrawn and replaced by temporary regulations that omitted the safe harbor provision and required that taxpayers rely on a facts and circumstances test instead. Without the safe harbor provision, multi-nationals argued that it would be more difficult to determine whether a proposed inversion would be respected or disregarded under the anti-inversion rules.

According to the IRS official, the safe harbor had been removed in 2009 because the government believed that taxpayers were structuring transactions so as to meet the safe harbor provision. The IRS official stated that the government would use the revived safe harbor to "identify true multinationals that aren't U.S.-centered companies that have just flipped their headquarters overseas." He also noted that the new safe harbor test would not include bright line percentage tests as contained in the old safe harbor, but that the new safe harbor would elaborate on the number and types of employees that would need to be located in the foreign country.

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