Corporate Loss Utilization through Aggressive Tax Planning

1. US Rules on Utilization of Losses

US federal income tax rules generally allow net operating losses (NOLs) of a corporation to be carried back as a deduction against income for two years and thereafter forward for 20 years. An NOL carry-back claim benefits from the procedure of “tentative refund”, under which the amount of the refund claimed is generally remitted within three months of a request without having to await any audit of the loss year.

In 2009, as a response to the economic downturn, Congress amended the statute to allow corporations to elect a five-year carry-back for losses incurred during the years 2008 and 2009. That provision – in combination with the tentative refund procedure – was particularly beneficial at a time at which many companies faced difficult credit markets.

Capital losses, although formally included in the definition of NOLs, are subject to different and generally more severe limitations: they are deductible by a corporation only against its capital gains; they are carried back up to three years and forward for five years; however they may not be used to the extent that they would create or increase an NOL. The contrast between the relatively liberal regime for ordinary (non-capital) losses and the stringent restrictions on the use of capital losses often causes substantial economic losses to be effectively unrecoverable by corporate taxpayers. In light of the fact that capital gains are generally taxable to corporations at the same rate as ordinary income, the disparity between the treatment of capital and ordinary losses is harsh.

As US federal tax rules allow for full consolidation of the income of affiliated US groups, losses of one member of a consolidated group may be used to offset income of another member of the group. Immediately before it joins a consolidated group, the taxable year of the new member ends. Accordingly, there is generally not the opportunity to avoid the limitations (discussed below) on the use of acquired losses by timing the purchase of a loss corporation before year-end.

The United States has multiple rules to combat loss trading – i.e. the acquisition of corporations with NOLs or built-in (unrealized) losses (loss corporations) to gain the tax benefits of such NOLs or built-in losses. The most wide ranging and formidable of such rules is section 382, which sweeps within its fold not just the outright purchase of loss corporations, but also reorganizations and changes in shareholding that cumulatively, over any three-year period, result in what is termed an “ownership change”, which is defined as an increase of at least 50 percentage points in the aggregate ownership of one or more significant shareholders (or groups of shareholders).

The effect of the section 382 ownership change is not a disallowance, but an annual limitation on the amount of the loss-corporation’s NOL or built-in loss that may be used in subsequent years. The limitation is based on the value of the loss corporation at the time of the ownership change. In the simple case of a corporation that has little value aside from the tax benefits of an NOL, the effect of section 382 is to make such NOL essentially without value to purchasers. In the more complex case of a corporation that has experienced substantial losses and declines in value, the section 382 limitation may make it costly for the corporation to accept significant new investments that (in combination with other transactions over the preceding three years) result in an ownership change. This can pose a significant hurdle to companies that need new capital to enable them to recover from a business downturn.

In 2008, the Internal Revenue Service (IRS) and Department of the Treasury sought to assist distressed banks by exempting their loan assets from the built-in loss limitations of section 382. That exemption, while obviously beneficial to banks that were forced by severe declines in the value of loan assets to seek new investors or new owners, was publicly unpopular and was perceived as encroaching on the prerogatives of Congress. It was terminated by legislation in 2009.

As US corporations are taxed on their worldwide income, losses of a foreign permanent establishment (PE) of a US corporation are generally deductible by the US corporation. Such foreign PE losses, however, are limited by “dual consolidated loss” rules, which disallow the loss to the extent that a foreign corporation uses (or could in the future become entitled to use) the loss. The dual consolidated loss rules apply equally to foreign subsidiaries of US corporations in the case where elections have been made (under the “check-the-box” rules) to treat such foreign

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1. Note that the discussion here is confined to the federal Income Tax Code. Those states that impose income taxes do not necessarily conform to federal rules with respect to carryovers of losses.
2. The government can, of course, recover a tentative refund to the extent that it is later determined that the amount of the NOL is less than the amount stated in the claim for tentative refund.
3. In this section, “foreign” refers to any country other than the United States; “domestic” refers to the United States.
4. In this context, a foreign permanent establishment is a branch in a foreign country that is subject to tax by such foreign country on either a worldwide or residence basis. That would include a permanent establishment as defined in bilateral income tax treaties.
subsidiary as fiscally transparent (i.e. as a partnership or branch) for US federal income tax purposes.

If a foreign PE gives rise to losses that are deducted by a US corporation, such losses may be subject to recapture if and when the assets of the foreign PE are transferred to a foreign corporation. This “branch loss recapture” rule applies, for example in the case that a foreign subsidiary is set up to continue the business of a foreign PE at the point that the business is turning from early-stage losses to profits.

US shareholders of a controlled foreign corporation (CFC) are subject to tax on their pro rata share of the “Subpart F” income of the CFC. Subpart F income includes most types of investment income. Thus, for example if a CFC invests profits in portfolio assets, any income generated from such assets will generally be taxable to the US shareholders of the CFC as if the profits had been distributed to the US shareholders as a dividend. Losses from such portfolio investments, however, are generally not allowed to offset any other Subpart F income inclusions in the loss year or any other year.

In place of thin capitalization rules, the United States limits the deductibility of interest paid by a US corporation to a related party that is not subject to US tax on the interest (or that is subject to reduced taxation under a tax treaty). The restrictions are significant in the case of foreign direct investment in the United States. They apply at fairly low levels of debt and can limit the amount of deductible interest to 50% of the “adjusted taxable income” of the corporation.

2. Focus of Anti-Abuse Efforts

Many of the transactions described in the OECD Report on Corporate Loss Utilization through Aggressive Tax Planning are transactions that have long been the focus of audit and legislative action in the United States. Much of the recent focus in that regard has been in three areas: (1) distressed asset/distressed debt transactions, in which actual economic losses are transferred through a partnership arrangement from a party that is indifferent to the US tax consequences to a US shareholder, as if the profits had been distributed to the US shareholder as a dividend. Losses from such portfolio investments, however, are generally not allowed to offset any other Subpart F income inclusions in the loss year or any other year.

3. Transfer Pricing Planning and Documentation

Any move by the IRS to restrict abusive transfer pricing practices may make it more difficult for companies with real losses, or companies making strategic business moves to strengthen their operating position during loss periods, to achieve the tax relief the legislature had intended. In order to avoid having the legitimate allocation of operating or capital losses appear to be an abusive transfer pricing scheme, it is important for companies to plan ahead by setting transfer pricing policies and writing intercompany agreements that account for loss situations. When losses do occur, it is equally important to support the allocation of the losses among related parties through proper transfer pricing documentation.

If a multinational enterprise takes actions that are not provided for in its intercompany agreements, makes significant changes to its transfer pricing policies when losses occur or treats similar transactions in an inconsistent manner in different jurisdictions, it will be difficult to convince tax authorities that such actions are not evidence of abusive transfer pricing. Instead, it is imperative for companies to create transfer pricing policies that account for both profitable and unprofitable periods, such that while actual prices may change, the policy itself does not need to be altered. In doing this planning, it is critical that companies keep the arm’s length principle at the forefront of their consideration, and support their

Abusive transfer pricing has not been the subject of recent legislative action, but has been a key area of regulation and audit attention by the Department of the Treasury and the IRS. The formerly broad safe harbour provision under which many services provided by a US corporation to foreign affiliates could be charged at cost was sharply narrowed through regulations (issued in temporary form in 2006 and finalized in 2009). The undeniable benefit in equity (to the fisc) comes at the cost of complexity in compliance, documentation and audit disputes.

Much of the audit and regulatory focus, however, has been on the always contested area of transfer of intangibles. As with many countries, the United States provides incentives (in the form of deductions and tax credits) for research activities conducted in the United States. Naturally, the tax authorities expect that, if and when the research activities come to fruition, the United States will share in the benefit through taxation of the resulting income. Such an expectation would be frustrated if the intangibles created by the research were transferred to a related foreign party for less than adequate consideration. The problem, of course, is that valuable intangibles are, by their nature, not commodities, the value of which is readily discernible. Determining the appropriate arm’s length price, in other words, may depend not on observations of comparable market prices (the bedrock of application of the arm’s length principle) but on indirect measures and economic reasoning.
transactions with evidence from unrelated-party transactions.

During a recession, internal reorganizations are quite common. The consolidation of services and functions; closures of plants, warehouses, and service offices; and the transfer of strategic assets are often key components of a company’s recovery plan. These recovery activities may lead to expenses related to the winding-up of a subsidiary’s operations being borne by the parent company. Distinguishing the ordinary and necessary business expenses borne by a parent from a tax scheme to shift deductions, as discussed in the OECD Report, depends on proper support and documentation. A transfer pricing policy must be able to handle these changes in circumstances as well as the movement in functions, risks, and intangibles that may result from these operating changes.

4. The Importance of Intercompany Agreements

The OECD Report specifies various asset transfers, including the sale of distressed assets by a party other than the holder of the asset, as examples of schemes that the member countries are looking out for. From a US perspective, the costs or benefits associated with asset impairment, sales or transfers may be attributed to a party other than the one that holds the assets as long as it occurs under the terms of an intercompany agreement that is demonstrably consistent with arm’s length behaviour. These kinds of events happen in arm’s length relationships between unrelated parties and can be supported using arm’s length agreements as evidence. For example a contract with a foreign subsidiary may specify that the US parent purchases and owns the assets in the subsidiary’s plant, and is responsible for impairment charges on those assets. In the case of a sale of those assets, the US parent would likewise record the benefit.

Severance costs are another example of one-time costs arising because of the recession that a company may seek to transfer from one group member to another. For example, suppose that a US parent decides to consolidate manufacturing operations among its subsidiaries and it closes a foreign plant. It may be argued that the closure costs should remain with the plant that incurred them, which may result in NOLs that cannot be used to offset future profits. It may also be argued that the costs should be charged to the plant to which the production is transferred, as it will benefit from the “profit opportunity” it receives from the parent. Finally, the costs might be charged to the party that made the decision to shut down the plant, in this case, the US parent. The appropriate approach should be based on the facts and circumstances of the specific transaction, the assignment of risks in the company’s transfer pricing policy and examples of third-party transactions under similar circumstances.

An example of good planning that a company may utilize for recessionary times is to include an excess capacity clause in the intercompany agreement with a manufacturing subsidiary. If a foreign manufacturer has unused capacity because the recession has caused a decrease in demand, or the parent consolidates by moving some production to other plants, the carrying cost of this capacity can be borne by the parent company if a provision to do so is included in the intercompany contract. Such an agreement would generally take the form of a retainer clause whereby the US company agrees to pay for access to the full capacity of the plant, even if it is not utilized. If a company sought to have the US parent pay for unutilized capacity without providing for such a circumstance in the intercompany agreement, the IRS may consider this to be a loss shifting scheme and disallow the deduction for the US company.

5. Profits and Losses in Limited Risk Operations

Another situation that will attract attention from the IRS as a possible loss shifting scheme involves reported losses by limited-risk operating companies. In recent years, a number of companies have sought to reduce their US income by limiting the functions and risks of their US operations, allowing residual profits to flow to offshore entrepreneurs. By stripping away risks and functions, for example a full-fledged US marketer/distributor can be reduced to a limited-risk distributor, allowing the company to significantly reduce its US profit during good times. However, the IRS will expect the distributor to continue to be profitable during a recession if it does not bear market risks in good times and bad. Reporting losses in a limited-risk distributor may be viewed as inconsistent with the arrangement under which the offshore entrepreneur bears the business risks.

This does not mean that a distributor cannot bear losses. Depending on the transfer pricing policy that is put in place prior to the losses, a company may be able to demonstrate that losses in the distributor are appropriate. This support usually starts with the industry analysis that is required for US transfer pricing purposes. The industry analysis should provide detail on industry standards for the assignment of functions and risks, as well as the value of intangible property. That industry analysis then becomes the basis for comparisons between the company’s operating entity (the tested party) and comparable companies used to benchmark the tested party’s return. If there are differences between the tested party and the comparable companies in regards to functions, risks and intangibles, adjustments are required to account for those differences. These factors should all be specified in the company’s transfer pricing documentation. If the transfer pricing policy prescribes the same risks to the tested party that the comparable companies face, the financial results of the comparable companies during a recession can be used to support a reduction in profits or even a loss for the tested party during the same period.\(^5\)

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5. In times of recession, the standard three year look-back period for documenting the financial results of the comparable companies may not be appropriate to capture the effects of the current economic situation. Using only the most recent year, or even using quarterly data from the current year, may be necessary to properly assess the profitability of the comparable companies.
The same characterization can be made for contract manufacturing companies and service providers. Like distributors, independent companies that provide manufacturing and other services may suffer losses in lean times in order to maintain business relationships and sustain their workforce during times when demand for their services are reduced. For controlled companies, if these service providers have sufficient substance, e.g. decision making power and risk bearing, it may be appropriate for them to bear losses in bad times. If, however, the substance has been stripped out of these entities as a method of reducing profitability during good years, the IRS will likely insist that they remain at the same level of profitability during down years.

6. Transfer Pricing of Intangible Property

Transfer pricing with regard to intangible property is an area that can be conducive to aggressive tax planning schemes because it may be difficult for the tax authority to properly ascertain the value of the intellectual property. As mentioned above, the outbound transfer of intellectual property, the development of which was aided by US tax breaks, has been an area of focus for the IRS and Treasury. In addition to the transfer of intellectual property through assignment or cost sharing agreements that divide the rights to developed intellectual property among multiple parties, companies may use transfer pricing techniques to shift profits or reduce losses, attributed to intellectual property during recessionary times.

One method of shifting profits attributable to intellectual property that may be viewed as aggressive tax planning by the IRS, but could also be based on legitimate business planning, is changing or forgiving a royalty based on the profitability of the licensee. There are many reasons that a company may want to have the leeway to reduce or forgive royalties from a licensee based on market conditions. For example a royalty may be forgiven during a market penetration period, to assist the licensee in establishing market position resulting in larger royalties down the road when the licensee becomes profitable. A company may similarly agree to reduce or forgive royalty payments during a recession to help the licensee maintain its market position during difficult times. The key for a company to defend these policies is documentation and consistency. If a US company forgives a royalty owed by a foreign affiliate, thus reducing its US income, in a manner that is not consistent with past actions in similar circumstances, or if a provision for such a forgiveness is not stipulated to in an intercompany agreement, the IRS may overrule the forgiveness of the royalty and assign the income to the US company.

During difficult periods, it is especially important for companies to be mindful of future ramifications when making changes to their transfer pricing policy in regards to the development of intellectual property. One example of how a change that may be beneficial in the short term could have long term consequences involves contract R&D services. As noted above, it may be appropriate for contract service providers to have losses during an economic slowdown if it is consistent with the results of independent companies operating in the same industry. It is important to continue to pay a mark-up on contract R&D services, however, even if losses are occurring elsewhere. The key factor in this case is that R&D, unlike manufacturing or back-office services, creates an intangible. If an arm’s length mark-up to a US contract R&D service provider is not paid, even for a limited time, it may lead the IRS to determine that a portion of the intangibles created are owned in the United States. Royalties owed on this intellectual property in the future may far outweigh any short-term benefit of a reduction in R&D expenses.

7. Financial Arrangements

Internal restructuring, changes in ownership or capitalization, and new financial arrangements are discussed in depth in the OECD Report, and are presented as a key focus of tax authorities looking out for aggressive tax planning. Demonstrating a clear and supportable business justification for these transactions, which can be documented through comparable transactions among unrelated parties, will generally be more difficult with regard to financial transactions than for tangible, intangible and asset transfers. The OECD Report provides several examples of how companies may try to shift profits through issuing new shares for a loss-making company; setting up trusts to transfer dividends or interest payments; and splitting hedges so that the risk-taking party is different from the benefactor. In most of the examples cited, it would be difficult to provide a business justification for the transaction, and the IRS has rules in place to prevent such transactions.

There are, of course, financial transactions that do serve a business purpose and can be supported by third-party comparables. One area of interest for tax authorities in recent years has been loan guarantees. Loan guarantees can be an important form of securing low interest loans for operating companies, especially for ones that are thinly capitalized. They can also be an effective method for shifting profits, as the volume of loans can be extremely large and even a small variation in the guarantee fee can amount to a significant shift in unencumbered cash flow. While the IRS and other tax authorities will likely audit loan guarantee fees, the fees can be defended if properly set. Once again, establishing documentation based on comparable transactions between independent parties and being consistent in the application of fees among all related parties are key to supporting these types of financial transactions.

8. Conclusion

The last few years show that the IRS and Congress have both made some provisions to help business navigate through the current recession, but both are also concerned with giving away too much or allowing abusive tax schemes. In recognition of the tax authorities’ concern with preventing abuses, companies need to be particularly conscientious in
setting their policies and documenting their transfer pricing such that their deductions are supportable. Overly aggressive enforcement by the IRS and overly stringent regulation by the Department of the Treasury could effectively penalize companies operating in the United States and put US-based companies at a disadvantage in competition with foreign counterparts. The recent regulatory efforts in the area of cost sharing transactions may be an example of overly stringent regulation that effectively penalizes corporations that develop and own intangibles in the United States. These actions, along with the high tax cost associated with the “repatriation” of earnings of CFCs, have created an environment where US companies regard potential targets as much more attractive if they are foreign corporations and have a foreign R&D workforce than if they are US companies conducting research in the United States. Such a preference will tend to act as an inhibitor of US-based R&D creation. None of these developments bode well for the US economy, either in regards to jobs or the future tax base.

The increasing disparity between the US corporate tax rate (35%) and tax rates applicable in the rest of the developed world creates an incentive for multinational corporations to shift losses to the United States, as well as shifting profits outside the United States. Efforts to limit such abuse, however, if cast too broadly, or acted on too vigorously, could act as a brake on US-based business. The urge to curb abuse is understandable, but it should be tempered with an understanding that US-based multinational corporations compete with foreign-based multinationals that generally benefit from a lighter tax burden. Ensuring that US-based companies with real economic losses are able to receive tax benefits to help them survive the difficult economic periods and better compete with their foreign counterparts will ultimately benefit the government and the US economy.

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