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EDITORS' NOTE

In our last issue we announced the publication of a monthly journal. It was well received. We are happy to provide you with our second edition, which focuses on the following topics:

- **Recent Developments in Transfer Pricing**. Over the past 15 months, the I.R.S. and the O.E.C.D. separately published transfer pricing audit and administrative initiatives. We compare the two and provide our insights.

- **Automatic Exchange of Information**. Last month the O.E.C.D.'s global model standard for automatic exchange of information reporting was released, which essentially adopted F.A.T.C.A. We discuss the O.E.C.D. model global standard. We also discuss F.A.T.C.A.'s application to foreign trusts.

- **Portability of Exemption Amount for U.S. Estate Tax Purposes**. The I.R.S. recently released Rev. Proc. 2014-18, which provides relief for small estates that failed to make a late portability election. Taxpayers who initially missed the deadline should consider taking advantage of this election.

- **State and Local Taxation – New York**. The matter of *John Gaied* pushes back against the New York ability to tax individuals as "statutory residents." The matter *John Gaied* is important as the lower court rulings adopted a broad based interpretation of "statutory resident" that causes considerable consternation among New York tax practitioners. We provide our insights to this case and its practical application to those who face the statutory resident problem.

- **Tax 101 – Form 5471**. Filing Form 5471 is more important than ever in light of recent penalty initiatives by the I.R.S. and a recent government report recommending a tightening of I.R.S. penalty abatement procedures. However, the form is exceptionally complex. We summarize it in plain English.

- **Corporate Matters – Incorporation Basics**. In our last piece, written by Simon Prisk, we discuss the basics of, and the benefits to, incorporation and why one may want to consider it when doing business in the U.S.

We hope you enjoy this issue.

-The Editors

I.R.S. VS. O.E.C.D. – HOW ARE TAX AUTHORITIES PLANNING TO CONDUCT YOUR NEXT TRANSFER PRICING AUDIT

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Tags
Transfer Pricing
Audit

INTRODUCTION

This article addresses major developments in transfer pricing practice that will affect the way advice is given to clients and their ability to implement such advice. Over the past 15 months, the I.R.S. and the O.E.C.D. separately published transfer pricing audit and administrative initiatives that will significantly impact the way controlled transactions among related parties are reported. These initiatives are consistent with overall concerns raised in the Base Erosion and Profit Shifting ("B.E.P.S.") Report of the O.E.C.D. Each stands independently of B.E.P.S. and will likely be unaffected by the ultimate actions plans implementing B.E.P.S. goals.

U.S DEVELOPMENTS - OVERVIEW

Congress has not passed any significant transfer pricing legislation in recent years, and U.S. transfer pricing regulations remain essentially unchanged. As a result, the U.S. "best method" rule of transfer pricing remains the norm. That method entails an analysis of functions and risks borne by each party engaged in the controlled transaction with particular focus on (i) the relative business risk borne by each related party, (ii) the intangible assets it has developed, and (iii) the extent to which these intangible assets are used in the controlled transaction. The analysis focuses on products and markets, competitors, vendors, customers, and distribution channels resulting in a qualitative evaluation of the assignment of function and risks.

However, technical rules have intersected with the political fallout from high profile corporate situations, such as the failure of Enron and the low effective worldwide tax rates of GE, Apple, Starbucks, Google, and Amazon. As a result, transfer pricing policy is now subject to public scrutiny, as legislators and media look at tax planning that drives down effective tax rates as a form of global tax abuse. In recent years, congress conducted hearings on the international tax practices of several prominent U.S. companies, most notably Apple, Inc. As the public debate continues over whether multinational companies are paying their "fair share" of U.S. taxes, the Obama Administration has offered several proposals to combat perceived shifting of corporate profits to low-tax countries. At the same time, the I.R.S. continues to bolster its team of transfer pricing examiners and is refining its information exchange and advance pricing agreement procedures. From a BEPS perspective,

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each of these developments is "U.S. centric" and represents a government mindset that is independent of international developments in the transfer pricing area.

U.S. DEVELOPMENTS - LEGISLATIVE

In May of 2013, the U.S. Senate raised significant public and media awareness on the ability of U.S. companies to manage worldwide taxes through their transfer pricing policies. In a somewhat unprecedented event, senior executives from Apple, Inc., including the C.E.O. and C.F.O., testified before the Senate Committee on Homeland Security and Government Affairs' Permanent Subcommittee on Investigations. The hearing focused on the cost sharing arrangement between Apple and its Irish subsidiary, which was implemented under the initial U.S. tax transfer pricing cost sharing regulations. The Irish subsidiary was not an Irish tax resident under that country's "mind and management" determination of tax residency. For Irish purposes, it was managed and controlled in the U.S. For U.S. tax purposes the Irish subsidiary's tax residence was in Ireland, the country of its incorporation. Thus the Irish subsidiary was a company with no tax residence, a highly publicized aspect of Apple's situation. Apple reflected this tax structure in its 10K filed with the S.E.C. for the 2013 fiscal year. Its overall effective tax rate was 26.2%, reflecting a 5% tax rate on $30 billion of foreign pre-tax earnings, most of which were funneled through Ireland where transfer pricing arrangements with the Irish yielded favorable results on business income and even better results on investment income generated from retained earnings. In sum, Apple reported $54.4 billion of un-repatriated earnings for both cash and book tax purposes, on which $18.4 billion in tax would be due if the funds are ever repatriated.

Hewlett-Packard, another high profile U.S. multinational, was in a similar situation to Apple. It reported on its 10K for its 2013 that it enjoyed low tax rates in China, Ireland, Netherlands, Puerto Rico and Singapore. It reported a 21.5% effective tax rate and $38.2 billion of un-repatriated earnings for both cash and book tax purposes.

What is clear, for both companies, is that no laws were broken. While Apple's executives repeatedly stated that they had complied with all U.S. tax and transfer pricing regulations, they also noted that high U.S. corporate income tax rates had been an obstacle to repatriating the company's large cash reserves held outside the U.S.

What is clear, for both companies, is that no laws were broken

Even Senate members ultimately conceded that Apple had broken no laws and that many other well-known U.S. companies, such as Hewlett-Packard, Google and Amazon, have similar tax and transfer pricing structures. Faced with this reality, the hearings then sought to call attention to the role of transfer pricing policies in effectuating these arrangements. They also called for better global transfer pricing rules, as well as stronger anti-avoidance measures such as the U.S. Subpart F rules.

Whatever legislative proposals were made addressed the "results" of transfer pricing abuses rather than a wholesale change in rules.

Representative Dave Camp (R-Michigan), Chairman of the House Ways and Means Committee, recently introduced legislation that would tax on a current basis the income of a controlled foreign corporation ("C.F.C.") that is attributable to intangibles. The tax would be imposed on the U.S. shareholder owning more than 10% of the C.F.C. at a tax rate of 15%.

Senator Carl Levin (D-Michigan) introduced legislation, which would discourage the use of tax havens by taxing excess income earned from intangibles that have been transferred out of the U.S. To enforce these rules, country-by-country reporting of sales, profits and other financial information would be required in order to increase transparency for tax authorities. In addition, a C.F.C. viewed as being controlled and managed from the U.S. would be treated as a U.S. domestic corporation for tax purposes, thereby subjecting profits to immediate taxation.

As part of the budget process, the Obama Administration has also introduced a series of legislative proposals in both its 2014 and 2015 fiscal year budgets. The 2015 fiscal year budget proposal seeks about $276 million in increased tax revenues from U.S. multinational companies over the next ten years. By some accounts, this amounts to about 75% more than the tax increases requested in the 2014 fiscal year budget. The Subpart F rules would be extended to include certain excess income that an offshore C.F.C. earns from intangible assets transferred out of the U.S. when the C.F.C. is subject to an effective tax rate of 10% or less. The scope of intangible property that would give rise to U.S. tax under the transfer pricing rules would be expanded to include goodwill, workforce in place, and going concern value. Focus would also be placed on the provision of digital services outside the U.S., which, under current law, is not subject to U.S. taxation when and as earned.

I.R.S. INITIATIVES – AUDIT, COMPETENT AUTHORITY, ADVANCED PRICING AGREEMENTS

In the absence of legislation, the I.R.S. has significantly changed the U.S. transfer pricing landscape by exercising its administrative authority. The I.R.S. has significantly increased its examination efforts on transfer pricing matters. A dedicated Transfer Pricing Operations ("T.P.O.") group has been formed. The first Transfer Pricing Director has been appointed, and a large number of economists have been hired to assist with transfer pricing audits.

The I.R.S. has concluded that it needs to develop transfer pricing cases more thoroughly at an earlier stage in the audit process in order to identify and resolve issues without resorting to the appeals process. I.R.S. audit teams are spending more time on advance preparation. They now regularly research a company's business and industry and adopt a "big picture" approach to a case in lieu of a straightforward application of transfer pricing regulations.

As a backstop to the audit process, the I.R.S. issued Notices 2013-78 and 2013-79 setting forth proposed Revenue Procedures related to Competent Authority and Advance Pricing Agreements. The resulting proposed guidance represents the latest efforts on the part of the I.R.S. to improve its international dispute resolution programs.

The Audit Process

The T.P.O. group is part of the Large Business & International ("L.B.&I.") Division of the I.R.S. It includes field-based transfer pricing specialists and national, office-based U.S. competent authority and advanced pricing agreement program in a combined unit known as the Advanced Pricing & Mutual Agreement Program ("A.P.M.A.").

The drive to develop transfer pricing cases more thoroughly at an earlier stage is viewed by some advisers as an attempt to bypass the importance of the appeals process within the I.R.S. by placing an emphasis on building a litigation file. This approach significantly changes the dynamics of the audit process. Without the filter of good judgment, some transfer pricing audit teams are producing expansive and numerous Information Data Requests ("I.D.R.'s") that are time consuming and difficult to respond to on a timely basis.

In October 2013, the I.R.S. revised its policy on I.D.R.'s in an attempt to clarify the intent of information gathering burden for taxpayers. The revised policy states that for each I.D.R. issued in a transfer pricing audit, the I.R.S. exam team and the taxpayer will discuss a reasonable due date for the response, rather than a blanket 30-day deadline. In addition, the I.R.S. exam team is now required to explain the intent and significance of the information being requested. The intent is to achieve greater transparency for taxpayers undergoing a transfer pricing audit and also provide for more reasonable expectations regarding the delivery of information.

In February, the I.R.S. released its Transfer Pricing Audit Roadmap (the "Roadmap") which is intended to provide audit techniques and tools to plan, execute and resolve transfer pricing examinations. The Roadmap anticipates up to a 30 month timeline (6 months of planning and 24 months of audit) for the planning, execution and resolution of a "quality examination process" ("Q.E.P."). The Q.E.P. is based on certain fundamental assumptions. First, up-front planning is essential. Second, transfer pricing cases are usually won or lost on the facts. Third, a reasonable result under the facts and circumstances of any case should be attained. Finally, effective presentation can "make or break" a case.

"From the experience of the authors, many mid-sized taxpayers have been doing this in their transfer pricing reports."

Regarding up-front planning, the Q.E.P. emphasizes early identification and prioritization of transfer pricing issues. This will determine proper staffing and scope of the audit given the anticipated complexity of the case. Regarding the existence of facts to justify an adjustment, the Q.E.P. notes that the key is to put together a compelling story of what drives the taxpayer's financial success, based on a thorough analysis of functions, assets, and risks, and an accurate understanding of the relevant financial information. From the experience of the authors, many mid-sized taxpayers have been doing this in their transfer pricing reports. The analysis of the taxpayer's business model (value chain, market position and financial results) should drive the quality of its transfer pricing decisions. The Q.E.P. will be looking for scenarios that it believes are too good to be true. Similarly, the Q.E.P. notes that the transfer pricing team should avoid adjustments where the taxpayer's financial results are reasonable and the taxpayer's transfer pricing method fits its profile.

Regarding the reasonableness of the result, the Q.E.P. anticipates that the transfer pricing team's working hypothesis will serve as a guide to further detailed examination subject to new data. The Q.E.P. discourages fishing expeditions and encourages a commitment by the transfer pricing team to address in full the taxpayer's analysis. In this way, the Q.E.P. acknowledges that the taxpayer may have the more compelling position on the issue.

As to effective presentation, the Q.E.P. focuses on the notice of proposed adjustment. The Q.E.P. intends that the notice should serve as a persuasive argument for the accuracy of the transfer pricing team's position over the taxpayer's position. It should contain all of the relevant facts, both good and bad, and should lead to a conclusion that is self-evident. The Q.E.P. assumes that a well-presented notice of proposed adjustment will increase the odds of early resolution or a favorable result on appeal. Some advisers believe that, based on this assumption the transfer pricing team should prepare a position paper that is at least as good as the transfer pricing report of the taxpayer. One wonders about the standard that was used prior to the Q.E.P.

While the Q.E.P. process may seem reasonable on its face, further consideration raises two key questions:

1. Is this an audit or preparation for litigation? Notable in the Q.E.P. detail is an emphasis on documentation of the audit steps taken, facts discovered, preliminary risk assessment, ongoing factual analysis and ongoing coordination with various T.P.O. personnel and counsel. Preparation of a mid-cycle risk assessment to update the initial risk assessment and analysis is considered an important component of the Q.E.P. Finally, participation of the audit team in the appeals process itself with a view towards understanding of the appeals rationale and consideration of future years' risk assessments could be considered an expansion of normal audit team participation at that level.

2. Is the Q.E.P. approach consistent with current transfer pricing law and regulations? Remember that current transfer pricing law and regulations remain the same. The Q.E.P. "big picture" view may or may not align with existing transfer pricing laws and regulations that do not necessarily require a focus on overall economic or financial results.

Nevertheless, the facts that the T.P.O. organization is now the key I.R.S. transfer pricing administrative function and that the Q.E.P. represents the T.P.O.'s key transfer pricing enforcement mechanism imply that taxpayers will need to consider the goals and objectives of Q.E.P. in managing audits and in establishing or revising their future transfer pricing policies. This is especially true with respect to intangible property. The T.P.O. Director has repeatedly indicated that transfer pricing for intangibles will be the top priority for T.P.O. activities and that the exam approach should consider the overall economic outcomes achieved by the intercompany transactions involving intangibles and not just whether those transactions have complied with specified methods in the regulations. According to the T.P.O. Director, many related party intangible transactions achieve unrealistic results that would never be observed between independent entities. Whether this view will ultimately prevail may well depend on the quality of the Q.E.P. presentation, rather than the expectation of the T.P.O. Director.

Competent Authority

The proposed Revenue Procedure would allow the Competent Authority to request a pre-filing conference to discuss the case at hand. A pre-filing memorandum is now required for: (i) a foreign-initiated adjustment of more than $10 million, (ii) a taxpayer-initiated position (*e.g.*, a request for refund), (iii) the taxation of intangibles, and (iv) requests for discretionary limitations of benefits relief. The pre-filing memorandum must, in the case of a foreign-initiated adjustment, explain the factual and legal basis of the action and describe the steps undertaken in the foreign country and any communications with the foreign competent authority regarding the matter. Additionally, the pre-filing memorandum must state whether the taxpayer wishes to have a pre-filing conference with the Competent Authority and propose at least three possible dates for such a conference, whether or not the taxpayer wishes to have a conference.

The proposed guidance also greatly increases the Competent Authority's ability to expand the scope of a particular matter brought to its attention. Competent Authority would not be required to obtain I.R.S. field office consent or even wait for a taxpayer's request for an expanded scope. Instead, the proposed guidance permits the Competent Authority to seek to include other years where it is feasible, practicable, and in the interest of sound tax administration to do so. The proposed guidance further provides that the Competent Authority may expand the scope of issues in light of a strong interest in resolving all potential issues in a timely manner.

The new procedure makes timing a key issue, particularly where an examination resolution (fast track audit, closing agreement, etc.) has been agreed with the I.R.S. In this case, Competent Authority will accept a request for its assistance relating to a U.S.-initiated adjustment memorialized in such an examination resolution only if the terms are agreed to by the Competent Authority, in writing, prior to its execution. If the Competent Authority disagrees with the examination resolution, the Competent Authority will request that the examination team and the taxpayer amend the terms accordingly. With respect to fast track settlement proceedings, the Competent Authority will accept a request relating to a U.S.-initiated adjustment only if the Competent Authority was named as a participant and given a reasonable opportunity to participate in the proceeding (and related I.R.S. meetings).

Timing remains a key issue where Appeals is involved through the Simultaneous Appeals Procedure ("S.A.P."). Through S.A.P., as the procedure's name suggests, the I.R.S. appeals officer considers the same issues simultaneously with the Competent Authority. Current guidance provides that a taxpayer may request I.R.S. appeals assistance, at any time, after filing for Competent Authority assistance. Under the proposed guidance, a taxpayer has only 60 days after the Competent Authority accepts the taxpayer's request for assistance.

"The proposed guidance is intended to make the Competent Authority process more efficient. However, taxpayer's will be required to have 'skin in the game' for this . . . "

The proposed guidance is intended to make the Competent Authority process more efficient. However, taxpayer's will be required to have "skin in the game" for this, in the form of a pre-filing memorandum, a conference, and timing considerations. They will also have to agree to the wider scope of Competent Authority involvement and ability to expand the scope of its assistance.

The Advanced Pricing Agreement Process

The proposed Revenue Procedure concerning advance pricing agreements ("A.P.A.'s") focused on (i) taxpayer-initiated adjustments, (ii) statutes of limitations, (iii) documentation, (iv) roll-backs, and (v) unilateral versus multilateral agreements.

As with the Competent Authority procedures, taxpayers may seek a roll-back involving taxpayer-initiated transfer pricing adjustments, such as correlative adjustments or adjustments to the income of a foreign controlled party. Taxpayers are required to extend the U.S. statute of limitations for assessment of tax with respect to all years subject to the A.P.A. request, including any roll-back years. The filing of a complete A.P.A. request is a factor taken into account in determining whether the taxpayer satisfied the transfer pricing documentation provisions of U.S. tax law for the proposed A.P.A. years. A.P.A. roll-back to filed years that predate the proposed term of the A.P.A. is now a distinct possibility. Unilateral A.P.A. requests are discouraged while bilateral, and multilateral A.P.A. requests are encouraged; pre-filing memorandums will be required. Transparency will be sought through more robust informational requirements imposed on taxpayers seeking the A.P.A.

I.R.S. INITIATIVES - CONCLUSIONS

Glass Half-Full Perspective

The IRS finally appears to be coming around to a new, more modern, strategic approach to tax management involving the systematic assessment of tax risk and the corresponding targeting of resources and efforts accordingly. The approach is modeled after findings from the O.E.C.D.'s tax assessment and compliance research over the last 15 years, and programs implemented in Australia and the United Kingdom, thus reflecting the more positive international transfer pricing developments.

"This new approach envisions a more engaged, more cooperative style of examination and a greater use of prescriptive tools . . . against which taxpayers can be measured and evaluated . . . "

This new approach envisions a more engaged, more cooperative style of examination and a greater use of prescriptive tools, including the development of profiles, or templates, of required information and/or outcomes (based on statistical and other metrics), against which taxpayers can be measured and evaluated, with prescribed remedial action depending how the company matches up against the profile. Such action ranges from no action, to follow-up questions, and to a more detailed request. The I.R.S. has indicated that they have already developed several profiles.

The expectation, based on experiences in other countries, is that companies that fit the profile in terms of timeliness and completeness will experience a lighter, quicker and less costly I.R.S. examination. On the other hand, the approach is intended to quickly identify issues that can be given greater attention by more resources and more effective resources.

Glass Half-Empty Perspective

No I.R.S. administrative initiatives can be implemented in isolation of the overall paranoia, generated by Congress, the Administration and the press, that transfer pricing strategies should be categorized as inappropriate tax avoidance on a *per se* basis. The Q.E.P. reliance on profiling taxpayer business models in connection with the development and use of intangible property in a global business environment will result in a pre-determination of taxpayer transfer pricing issues and related assessments without consideration of taxpayer-specific arguments. The Q.E.P. profiling will almost certainly result in the compilation of lists of "hidden comparables," and taxpayers will be benchmarked against data that is not in the public domain.

In addition, the Q.E.P. essentially represents a reordering of the decision making process in regard to litigation. The effort that will be made in connection with the decision to proceed with a notice of proposed adjustment means that once a decision is made to issue the notice, the role of the appeals officer in resolving transfer pricing controversies will be reduced because the facts gathered by the transfer pricing team will be clear and convincing. The end result is that the risk of litigation assessment by the appeals officer will be perfunctory.

O.E.C.D. INITIATIVES

Not long before the release of the Roadmap, the O.E.C.D. released two documents that set out the current guidance to its 34 member states (as well as G-20 member states) on pre-audit risk assessment, transfer pricing documentation and country-by-country ("C-b-C") reporting.

The *Draft Handbook on Transfer Pricing Risk Assessment* (O.E.C.D., April 30, 2013) (the "Draft Handbook") is a collection of recent country procedures, methods and approaches intended to help tax administrations improve performance. The objective of the Draft Handbook is to promote more efficient audits by tax authorities in order to avoid the waste of resources by tax administrators when unsustainable positions result in litigation Competent Authority cases. While there are no mechanical rules prescribed by the Draft Handbook, countries are encouraged to follow regular and structured risk assessment steps. The Draft Handbook is not law, administrative practice, or even necessarily prescriptive in its approach. The O.E.C.D. makes it very clear that each country will need to develop its own approach to risk assessment.

The intent of risk assessment is to help an O.E.C.D. member tax authority determine the factual inquiries that it will make during the course of a transfer pricing audit, if a full audit is to be conducted. There is clear reference to the trade-off between the understanding of risk and the extent of information available for review at the risk assessment stage.

The Draft Handbook deals only with recommended pre-audit procedure. Chapter 4 of the O.E.C.D. Transfer Pricing Guidelines deals specifically with examination practices, albeit briefly.

The January 30 *Discussion Draft on Transfer Pricing Documentation and C-b-C Reporting* (O.E.C.D., January 30, 2014) ("the Discussion Draft") proposes a working version of a new standard of documentation and C-b-C information reporting that is considerably more extensive than the present Chapter 5 guidance.

As one of 15 BEPS Action Plan steps taken in a time of fiscal crisis, the Discussion Draft recalls the approach to serious crime in occupied North Africa taken by police Captain Renault in the classic film *Casablanca*: "Realizing the importance of the case, my men are rounding up twice the usual number of suspects." The volume and utility of the information requested in the Discussion Draft, as well as information security and confidentiality, has been roundly criticized by the tax community. The Discussion Draft states that information submitted to tax authorities (either documentation or the new C-b-C factual and financial reporting) can be used in either the pre-audit or case selection phase of a transfer pricing audit, or can be used in the early stages of an audit for the purpose of focusing such audits on the most important issues. Irrespective of how or if the information will be used, the Discussion Draft calls for more C-b-C reporting information that can be obtained by a tax authority before review of the transfer pricing documentation.

The U.S. developments with Q.E.P. have been independent of the C-b-C dialogue and, in fact, U.S. officials have expressed some reservation as to the logic of certain aspects of the C-b-C reporting requirements. This is an easy assessment for the U.S. to make, as it already has in place a robust reporting regime for international business operations of U.S. taxpayers. This regime is an integral part of the Q.E.P. planning phase which contemplates a detailed tax return review including: (i) Forms 5471 and 5472, regarding information on intercompany transactions, (ii) Form 8833, regarding treaty based return positions, (iii) Form 8858, regarding information on disregarded entities, (iv) Form 8865, regarding U.S. controlled foreign partnerships, (v) Schedule UTP, regarding uncertain tax position disclosures, and (vi) worldwide book to taxable income reconciliation Schedule M-3 of the Form 1120. Examination of the overall data requests required by these forms would reveal that a material amount of the information requested in the C-b-C reporting has been compiled. Note though that these forms demand the greatest amount of information from U.S.-based groups. The question arises whether the same degree of information should be demanded of local subsidiaries.

Also at issue are the usual suspects: (a) transactions with related parties in low-tax jurisdictions, (b) intra-group services, (c) excessive debt and/or interest expense, and (d) transfer or use of intangibles to/for related parties. Rather than setting out a risk-assessment process framework like the Audit Roadmap, the Draft Handbook places emphasis on fact patterns regarding the company and its transactions that are likely to increase transfer pricing risk.

The Audit Roadmap sets out a facts seeking theory approach to transfer pricing with the audit process as means of organizing fact gathering and formation of a theory of a case, as opposed to a theory seeking facts approach. We believe this is generally the correct way conduct a transfer pricing examination. To some extent, the increased information requirements of the proposed O.E.C.D. C-b-C reporting and the prescriptive issues lists in the Draft Handbook promote a theory seeking facts approach to transfer pricing risk assessment. We expect double tax issues between the I.R.S. and the tax authorities of its treaty partners will require further effort and time to align the fact development and robustness to the theory of the case where the treaty partner has reassessed tax based on a usual suspects approach.

"Taxpayers may want to closely examine their tax situations in 2014 both historically to open years and prospectively to future years so that they may measure the anticipated effect of the I.R.S. initiatives described above."

THE BOTTOM LINE

From the I.R.S. perspective, whether the glass is half full or half empty, there will be an expanded access to the I.R.S. audit team and other administrative personnel. Taxpayers may want to closely examine their tax situations in 2014 both historically to open years and prospectively to future years so that they may measure the anticipated effect of the I.R.S. initiatives described above. A robust transfer pricing report that tells a story and builds a case may be an elixir that ultimately provides a quicker, more cost-effective means to resolve their tax issues.

From the O.E.C.D. perspective, we anticipate that there may be information shortages in certain O.E.C.D. member countries, but expect that the matter will be solved with the introduction of more focused foreign reporting forms. In many ways, the O.E.C.D.'s emphasis on information requirements is understandable. Reliable information is required to assess risk and responsibly, select taxpayers, and further select particular tax positions for a robust examination. As the Draft Handbook remains in draft while other BEPS Action Plan items receive attention from the O.E.C.D. Centre for Tax Policy and Administration, we hope that the Audit Roadmap and other procedural developments will be finalized with double tax minimization in mind.

In sum, multinational businesses with a taxable presence in both the United States and in O.E.C.D. member states should be mindful of the similarities and differences between O.E.C.D. guidance and I.R.S. field guidance. Areas of difference are relevant to exam approaches, documentation approaches, and differences in the perspective of tax authorities conducting Simultaneous Examination Program audits. Tax authorities and the politicians to whom they report have determined that it is time for countries to take control of their tax borders. Transfer pricing examinations that focus on the use of intangibles and the provision of capital are to be expected.

THE O.E.C.D. ANNOUNCES GLOBAL STANDARD FOR AUTOMATIC EXCHANGE OF INFORMATION

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As we noted in our prior issue, the Leaders of the G-20 Summit endorsed automatic exchange of information reporting to combat tax evasion in September 2013. In particular, they stated:

> We commend the progress recently achieved in the area of tax transparency and we fully endorse the OECD proposal for a truly global model for multilateral and bilateral automatic exchange of information. Calling on all other jurisdictions to join us by the earliest possible date, we are committed to automatic exchange of information as the new global standard, which must ensure confidentiality and the proper use of information exchanged, and we fully support the OECD work with G20 countries aimed at presenting such a new single global standard for automatic exchange of information by February 2014 and to finalizing technical modalities of effective automatic exchange by mid-2014. In parallel, we expect to begin to exchange information automatically on tax matters among G20 members by the end of 2015.[1]

On February 13, 2014, the Organisation for Economic Co-Operation and Development ("O.E.C.D.") announced a global standard for automatic exchange of financial account information. Over 40 countries made a joint statement and committed to an early adoption of this standard.[2] On February 23, 2014, the G-20 finance ministers and central bank governors endorsed the proposal.

The O.E.C.D. global model standard is based on the following key drivers:

- A common standard on information reporting, due diligence and exchange of information;
- A legal and operational basis for the exchange of information, including confidentiality and protections against misuse of information gathered through this process; and

1 See G20 Leaders' Declaration, p. 51, September 2013.
2 See http://www.oecd.org/tax/transparency/Joint%20Statement.pdf.

"Essentially, the O.E.C.D. global model standard has adopted F.A.T.C.A. (and its intergovernmental agreement approach) for information reporting purposes."

- Common or compatible technical solutions.[3]

Essentially, the O.E.C.D. global model standard has adopted F.A.T.C.A. (and its intergovernmental agreement approach) for information reporting purposes. In particular:

- Financial institutions subject to reporting include depository and custodial institutions, investment entities, and specified insurance companies, unless they present a low risk of being used for evading tax.

- Reportable accounts include accounts held by individuals and entities (which includes trusts and foundations), and the standard includes a requirement to look through passive entities to report on the relevant controlling persons. In addition, accounts held by passive nonfinancial entities must also be reported, if they have as one or more of their controlling persons one of the above-listed individuals or entities.

- The financial information to be disclosed with respect to reportable accounts includes interest, dividends, account balances, income from certain insurance products, sales proceeds from financial assets, and other income generated with respect to assets held in the account or payments made with respect to the account.

- The required information will be exchanged within nine months after the end of the year to which the reported information relates. The currency in which the reported amounts are expressed must be stated. The competent authorities of the countries party to an agreement will settle on the data transmission method. The internal tax laws of the country exchanging the information will apply to determine the character and amount of payments made with respect to a reportable account.

- Due diligence procedures distinguish between pre-existing and new accounts and high value and low value accounts.

  - Due diligence for pre-existing individual accounts are based either on an "indicia" search or on enhanced due diligence procedures requiring a paper search and actual knowledge test of the relationship manager. For new individual accounts the standard contemplates self-certification.

  - For entity accounts, financial Institutions are required to determine: (a) whether the entity itself is a reportable person, which can generally be done on the basis of available information (A.M.L./K.Y.C. procedures) and if not, a self-certification would be needed; and (b) whether the entity is a passive non-financial entity and, if so, the residency of controlling persons. Pre-existing entity

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[3] The Global Standard Model does not address them and they are expected to be addressed by mid-2014.

accounts below 250,000 U.S.D. (or local currency equivalent) are not subject to review.

"What was once initially intensely resisted by much of the world is now being emphatically endorsed as a global standard."

What was once initially intensely resisted by much of the world is now being emphatically endorsed as a global standard. Even though political leaders cannot agree on many things, one thing can be said if this approach is adopted on a worldwide basis: raising revenue without raising taxes is politically tenable.

F.A.T.C.A. AND TRUSTS: A PRIMER

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Tags
F.A.T.C.A.
Trusts

The Foreign Account Tax Compliant Act ("F.A.T.C.A") requires that "foreign financial institutions" ("F.F.I.'s") and "non-financial foreign entities" ("N.F.F.E.'s") identify and disclose their U.S. accounts and substantial U.S. holders or be subject to a 30% withholding on certain U.S. source payments (including gross proceeds) made to a foreign entity.

F.A.T.C.A. affects <u>both</u>:

- U.S. tax residents owning assets outside the U.S.; and
- Non-U.S. tax residents holding assets inside the U.S. provided they are tax residents of a country subject to a Model Intergovernmental Agreement ("I.G.A.") that provides for reciprocity (*i.e.*, U.S. financial institutions reporting information on non-U.S. tax residents to their non-U.S. home country).

More notably, F.A.T.C.A. withholding may apply to all foreign entities including foreign trusts. However, F.A.T.C.A. withholding will not apply if the entity qualifies for an exemption or complies with specified reporting requirements.

The requirements by which a foreign entity must comply to avoid F.A.T.C.A. withholding differ on whether the entity is classified an F.F.I. or a N.F.F.E.. F.A.T.C.A. generally subjects F.F.I.'s to a higher compliance burden then N.F.F.E.'s. Consequently, it is important for the practitioner to first classify the trust in question as an F.F.I or N.F.F.E. in order to determine its compliance requirements. Similar distinctions apply when an I.G.A. applies.

As mentioned above, the U.S. may sign an I.G.A with different countries that may override the F.A.T.C.A. regulations. There are, in general, two types of I.G.A.'s ("Model 1 I.G.A." and "Model 2 I.G.A."), which are then further subdivided depending whether reciprocity is requested or whether there is a preexisting tax information exchange agreement or double tax convention in effect. Depending on which Model is selected, the obligations of the resident F.I.'s will vary.

CLASSIFICATION OF THE ENTITY

Final Regulations

There are four types of F.F.I's: depository institutions, custodial institutions, certain insurance companies, and investment entities. Trusts are most likely to be considered F.F.I.'s under the "professionally managed" prong of the investment entity provision; therefore, other F.F.I types will not be discussed further.

"Investment entities" can be subdivided into three categories, of which only "Type B" investment entities are relevant with respect to trusts.

To be a Type B investment entity, an entity must meet both of the following requirements:

- The entity's gross income must be "primarily attributable to investing, reinvesting, or trading in financial assets" (the "gross income" test); and

- The entity must be "managed by" a depository institution F.F.I., a custodial institution F.F.I., a specified insurance company F.F.I., or a "Type A" investment entity[4] (the "professionally managed" test).[5]

Under the "gross income" test, an entity's gross income is primarily attributable to investing, reinvesting, or trading in financial assets if the entity's gross income attributable to those activities equals or exceeds 50% of its gross income during a three-year look-back window.

Under the "professionally managed" test, a trustee must be an entity and actually act as a money manager. Merely soliciting investment advice or receiving fees from those services, without additional activity, should not cause a trust to be considered F.F.I. status under the investment entity prong of the regulations.[6]

For these purposes, financial assets include: securities, partnership interests, commodities, notional principal contracts, insurance or annuity contracts, or any interest (including a futures or forward contract or option) in a security, partnership interest, commodity, notional principal contract, insurance contract, or annuity contract.[7] However, financial assets do not include direct holdings of real estate.[8]

Entities that are not F.F.I's are considered N.F.F.E's. A trust may be considered an N.F.F.E. but may still have compliance requirements as outlined below.

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4 A Type A investment entity is an entity that conducts as a business various activities, such as trading in financial assets or collective portfolio management, for or on behalf of a customer. See Treas. Reg. §1.1471-5(e)(4)(i)(A).

5 Treas. Reg. §1.1471-5(e)(4)(i).

6 See Treas. Reg. §1.1471-5(e)(v), Example 1, 5, and 6. You can also read our announcement of this provision here).

7 Treas. Reg. §1.1471-5(e)(4)(ii).

8 See Treas. Reg. §1.1471-5(e)(v), Example 4.

Model I.G.A.s

The definition of "financial institution" ("F.I.") for purposes of the I.G.A.'s differ slightly but, in many respects, are practically the same. For example, the Model 1 I.G.A. defines a "Financial Institution" ("F.I.") as a "Custodial Institution," a "Depository Institution," an "Investment Entity," or a "Specified Insurance Company."[9] Both the Model 1 and Model 2 I.G.A.'s define the term "Investment Entity" as any entity that conducts as a business (or is managed by an entity that conducts as a business) one or more of the following activities or operations for or on behalf of a customer: (1) trading in money market instruments (cheques, bills, certificates of deposit, derivatives, etc.), foreign exchange, exchange, interest rate and index instruments, transferable securities, or commodity futures trading; (2) individual and collective portfolio management; or (3) otherwise investing, administering, or managing funds or money on behalf of other persons. However, both I.G.A.'s also provide that the definition "shall be interpreted in a manner consistent with similar language set forth in the definition of 'financial institution' in the Financial Action Task Force Recommendations" ("F.A.T.F."), and there is some unclarity as to its application.[10] In any event, foreign trusts that are professionally managed will fit within this prong and therefore will be considered an F.I. under the I.G.A.'s similar to the final regulations.

"Under the final F.A.T.C.A. regulations, if the trust is classified as an F.F.I., the trust must, in general, register with the I.R.S. as a participating F.F.I. in order to avoid withholding."

OBLIGATIONS AS FINANCIAL ENTITY OR NON-FINANCIAL ENTITY

Final Regulations

Under the final F.A.T.C.A. regulations, if the trust is classified as an F.F.I., the trust must, in general, register with the I.R.S. as a participating F.F.I. in order to avoid withholding. To register it will have to agree to certain terms, including undertaking due diligence, withholding, and information reporting obligations, particularly with

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9 Model 1 I.G.A., Article 1, paragraph 1(g).

10 The F.A.T.F. Recommendations generally define an F.I. as any natural or legal person who conducts as a business one or more of the following activities or operations for or on behalf of a customer: (1) acceptance of deposits and other repayable funds from the public; (2) lending; (3) financial leasing; (4) money or value transfer services; (5) issuing and managing means of payment (*e.g.*, credit and debit cards, cheques, traveller's cheques, money orders and bankers' drafts, electronic money); (6) financial guarantees and commitments; (7) trading in: (a) money market instruments (cheques, bills, certificates of deposit, derivatives etc.); (b) foreign exchange; (c) exchange, interest rate and index instruments; (d) transferable securities; (e) commodity futures trading; (8) participation in securities issues and the provision of financial services related to such issues; (9) individual and collective portfolio management; (10) safekeeping and administration of cash or liquid securities on behalf of other persons; (11) otherwise investing, administering or managing funds or money on behalf of other persons; (12) underwriting and placement of life insurance and other investment related insurance; and (13) money and currency changing. See F.A.T.F. Recommendations available at http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf.

respect to its U.S. beneficiaries that are treated as reportable U.S. accounts. Exceptions exist for "sponsored" or "owner-documented" F.F.I.'s, in which case a third party, in general, agrees to take on the trust's obligations as an F.F.I.

If a foreign trust is treated as an F.F.I., interests in the trust are treated as reportable U.S. accounts (*i.e.*, a "financial account") for these purposes if the U.S. person satisfies any of the following conditions:

- The U.S. person is treated as the owner of a portion of the trust for income tax purposes under the grantor trust rules;

- The U.S. person is entitled to a mandatory distribution from the trust; or

- The U.S. person receives a discretionary distribution from the trust but only if such person receives a distribution in the calendar year.[11]

Information to be reported includes the name of the U.S. beneficiary, the address, the taxpayer identification number, and the amount of any distributions to the beneficiary.

If a trust is classified as an N.F.F.E., a determination must then be made as to whether the trust has a "substantial U.S. owner."

An N.F.F.E. has a substantial U.S. owner if:

- A U.S. grantor is treated as the owner of the property under the grantor trust rules;[12] or

- A U.S. person "owns" more than 10% of the trust.

In general, ownership is determined for purposes of the 10% test as follows:

- The person receives, directly or indirectly, only discretionary distributions from the trust and the fair market value of the currency or other property distributed, directly or indirectly, from the trust to such person during the prior calendar year exceeds 10% of the value of either all of the distributions made by the trust during that year or all of the assets held by the trust at the end of that year;

- The person is entitled to receive, directly or indirectly, mandatory distributions from the trust and the value of the person's interest in the trust exceeds 10% of the value of all the assets held by the trust as of the end of the prior calendar year; or

- The person is entitled to receive, directly or indirectly, mandatory distributions and may receive, directly or indirectly, discretionary distributions from the trust, and the value of the person's interest in the

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[11] Treas. Reg. §§1.1471-5(a)(2), 1.1471-5(b)(3)(iii)(B).
[12] Code §§671-679.

trust, determined as the sum of the fair market value of all of the currency or other property distributed from the trust at the discretion of the trustee during the prior calendar year to the person and the value of the person's interest in the trust at the end of that year, exceeds either 10% of the value of all distributions made by such trust during the prior calendar year or 10% of the value of all the assets held by the trust at the end of that year.[13]

The regulations, however, provide a *de minimis* exception. A U.S. person is not treated as an owner if he/she receives less than $5,000 during the prior calendar year or the value of the mandatory distribution right is less than $50,000.[14]

An N.F.F.E. complies with F.A.T.C.A. by identifying its substantial U.S. owners including the name, address, and taxpayer identification number of each beneficiary.[15] The N.F.F.E can also comply with F.A.T.C.A. by certifying to U.S. withholding agents that it has no substantial U.S. owners or to F.F.I.'s with whom it maintains accounts on I.R.S. Form W-8BEN-E.[16]

As an alternative to the foregoing, the N.F.F.E. may elect to be a direct reporting N.F.F.E., in which case it will register with the I.R.S. and report directly the information as required under F.A.T.C.A. including, among other things, the name, address, and taxpayer identification number of each substantial U.S. owner, the total payments made to each substantial U.S. owner, and the value of the interest in the N.F.F.E.[17]

Model I.G.A.s

The Model 1 I.G.A. largely follows but diverges from the final regulations in certain respects. In particular:

- If treated as an F.I., withholding but not information reporting is eliminated unless there is significant non-compliance over an 18-month cure period. However, the F.I. must report information on its reportable U.S. accounts.

- Reportable U.S. accounts include not only *e.g.*, depository and custodial accounts, but also an equity interest in the foreign trust if the trust is treated as an "Investment Entity." The term equity interest is considered to be held by any person treated as a settlor or beneficiary of all or a portion of the trust, or any other natural person exercising ultimate effective control over the trust. A U.S. person is treated as being a beneficiary of a foreign trust if such U.S. person has the right to receive directly or indirectly (for example, through a nominee) a mandatory distribution or may receive, directly or indirectly, a discretionary distribution from the trust. There is no *de minimis* threshold for these purposes.

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13 Treas. Reg. §1.1473-1(b)(3).
14 Treas. Reg. §1.1473-1(b)(4).
15 See Code §1472(b).
16 See Part XXV, lines 39 b and c. of Form W-8BEN-E (currently in draft form).
17 Treas. Reg. §1.1472-1T(c)(3).

- Any F.I. that maintains a financial account, which may, as noted above, include an equity interest in a trust, must report information on U.S. individuals and "Controlling Persons" of entities who hold the "account." The term "Controlling Persons" means the natural persons who exercise control over an entity. In the case of a trust, the term means the settlor, the trustees, the protector (if any), the beneficiaries or class of beneficiaries, and any other natural person exercising ultimate effective control over the trust. The I.G.A.'s provide that the term "Controlling Persons" is interpreted in a manner consistent with the F.A.T.F. Recommendations.

- In general, the information to be reported includes the name of that person, the taxpayer identification number, the value of the "account," and the amount of payments made to the account holder.

The Model 2 I.G.A. follows the Model 1 I.G.A., including the reference to Controlling Persons, but also the F.A.T.C.A. final regulations in certain instances. Notably, for the Model 2 I.G.A., the definition of "financial account" cross-references the definition of financial account in the final regulations. Therefore, those rules will, in general, apply unless expressly stated otherwise by that I.G.A.[18]

Conclusion

The above discussion is only a short summary of the rules. F.A.T.C.A. is incredibly complex and it is now highly recommended that a taxpayer have a competent tax advisor to assist in any non-U.S. tax planning. We are here to assist.

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[18] An exclusion is provided for accounts listed in Annex II, which include *e.g.*, certain retirement and pension accounts.

THE I.R.S. EXTENDS THE TIME FOR ESTATE TAX PORTABILITY ELECTION FOR SMALL ESTATES

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Estate Tax
Portability Election

On January 27, 2014, the I.R.S. released Rev. Proc. 2014-18. This revenue procedure provides an automatic extension of time to file a late portability election for estates of the first to die of a married couple provided that certain requirements are met. "Portability" refers to the option of the surviving spouse to make use of any gift and estate tax exemption that was not used by the deceased spouse. Thus, if the executor missed the opportunity to elect portability, now is the time to take advantage of this election, as this opportunity will end on December 31, 2014.

BACKGROUND

In 2010, Congress amended §2010(c) of the Code to allow the estate of a decedent who is survived by a spouse to make a portability election, which allows the surviving spouse to apply the decedent's unused exclusion ("D.S.U.E.") amount toward the surviving spouse's own transfers during life and at death.[19]

Notice 2011-82, issued on October 17, 2011, provided preliminary guidance regarding the requirements to elect portability of the decedent's D.S.U.E. amount. Notice 2012-12, issued on March 3, 2012, provided temporary (and limited) relief by, in general, extending the deadline to file an estate tax return (Form 706, *Unified States Estate (and Generation-Skipping Transfer) Tax Return)* for portability election purposes by six months if certain requirements were met. In June 2012, temporary regulations were issued that provided more detailed guidance on portability.

In general, as noted above, the D.S.U.E. amount is the portion of the estate tax exemption amount which is <u>unused</u> and, more specifically, is calculated as follows: the D.S.U.E. amount is the lesser of (a) the basic exclusion amount in effect on the date of death of the person whose D.S.U.E. is being computed (*e.g.*, $5 million in 2011, $5.12 million in 2012, $5.25 million in 2013, as adjusted for inflation, respectively), or (b) the decedent's applicable exclusion amount less the amount of

[19] Estates of non-resident, non-citizens cannot take advantage of the portability provisions except as allowed under a treaty provision. See Treas. Regs. §20.2010-1T(d)(5).

the “taxable estate” plus the “adjusted taxable gifts.”[20] The taxable estate is the gross estate less exclusions and deductions (including the marital deduction for gifts left to the decedent’s spouse). Adjusted taxable gifts are generally the cumulative total of taxable gifts made after December 31, 1976.

> **Example 1**: Assume that the decedent, a U.S. citizen, died in 2011. The exclusion amount is $5 million. The decedent’s assets consist of a bank account holding investments in certificates of deposit. The account is valued at $3 million at death. The decedent leaves his entire estate to his spouse, a U.S. citizen. The decedent made no taxable gifts during his lifetime. Under these facts, the decedent’s gross estate is $3 million, the decedent’s taxable estate is $0 (due the $3 million marital deduction), and the decedent’s adjusted taxable gifts is $0. Thus the D.S.U.E. amount is $5 million, which can be ported over to the decedent’s spouse if certain requirements are met.

"The tax law requires that in order to take advantage of this portability election, the executor must timely file Form 706 . . . "

The tax law requires that in order to take advantage of this portability election, the executor must timely file Form 706, which must include a computation of the D.S.U.E. amount, even for estates that did not need to file a return because the gross value of the decedent’s assets plus the adjusted taxable gifts was less than the exemption amount. The due date to make this election is nine months after the decedent’s date of death or the last day of the period covered by an extension (if an extension of time for filing has been obtained). A late filing would mean that portability could not be used. If the taxpayer missed the opportunity to take advantage of this extension, special relief may, nonetheless, be available for the taxpayer under §9100.[21] Additionally, prior to Rev. Proc. 2014-18, the I.R.S. granted several lettering rules for an extension of time if certain requirements were met. However, a formal request and a user fee ($10,000 in 2013) would be required simply to have the request considered.

> **Example 2**: Assume the same facts as Example 1, but the executor did not elect, by timely fling Form 706, to port the D.S.U.E. amount. In this case the surviving spouse could not utilize the D.S.U.E. amount without §9100 relief, in which case a user fee would apply and the outcome would be uncertain.

Until recently, same sex spouses could not take advantage of tax law benefits given to married persons, including the portability provision, under the Defense of Marriage Act (“D.O.M.A.”). D.O.M.A. was struck down in *United States v. Windsor*, 570 U.S. ___, 133 S. Ct. 2675 (2013). Soon thereafter, the I.R.S. released Rev. Proc. 2013-17, which clarified that, for purposes of the Code and regulations, the

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[20] Generally, taxable gifts made after December 31, 1976 in excess of the annual gift exclusion amount must be added back into the taxable estate to determine the tax base.

[21] Section 9100 relief is unavailable if the rule at issue is prescribed by statute. If, however, the estate tax return is not required to be filed but the executor is permitted to file in order to elect portability, the I.R.S. states that §9100 relief is available because the regulations (and not the statute) govern the time to file. See Rev. Proc. 2014-18.

terms “husband and wife,” “husband,” and “wife” should be interpreted to include same-sex couples. Consequently, an executor of an estate of a deceased same sex married spouse may now amend the previously filed estate tax return to take advantage of the marital deduction and the portability election, among other options.

REV. PROC. 2014-18

The requirements for temporary relief pursuant to Rev. Proc. 2014-18 are as follows:

- The decedent must have a surviving spouse;
- The decedent must have died after December 31, 2010 and before December 31, 2013;
- The decedent must have been a U.S. citizen or resident on the date of death;
- The taxpayer is not required to file an estate tax return as determined on the value of the gross estate and adjusted taxable gifts;
- The taxpayer did not file an estate tax return within the time prescribed for filing an estate tax return required to elect portability (as mentioned above);
- The taxpayer must properly file a Form 706 on or before December 31, 2014. The person filing Form 706 must indicate at the top of the form that the return is “FILED PURSUANT TO REV. PROC. 2014-18 TO ELECT PORTABILITY UNDER §2010(c)(5)(A).”

If the requirements are met, Form 706 will be considered as timely filed for purposes of making this election. However, if, subsequent to the procedure, it is determined that the taxpayer was required to file an estate tax return because the taxpayer was not, in actuality, exempt from the filing requirement due to a higher value estate, the extension will be deemed void.

The Rev. Proc. also states that those who are not eligible for relief under this revenue procedure may request an extension of time to make the election by making a formal request under §9100. Otherwise, until January 1, 2015, those meeting the requirements of the Rev. Proc. must use it in lieu of requesting a letter ruling.

UPDATES AND OTHER TIDBITS

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Tags
O.V.D.P.
Streamlined Procedures
F.A.T.C.A.

UPDATE TO STREAMLINED PROCEDURES: DIFFERENT STROKES FOR THE SAME FOLKS

In our prior issue, Insights Vol. 1, No. 1, we noted that, for a U.S. taxpayer entering into the Streamlined Procedures (*i.e.*, fast-track program) in 2013, an I.R.S. agent informally advised filing tax returns for the years 2009, 2010, and 2011. Upon further discussions with the I.R.S., the agent revisited the issue, advising that a taxpayer entering into the program today would need to file the last three years of tax returns (*i.e.*, 2010, 2011, and 2012). In the event the taxpayer does not file a timely 2013 return prior to the submission, the applicable look-back period is 2011, 2012, and 2013.

This advice is consistent with the 2012 O.V.D.P. F.A.Q. # 9, which answers the question "What years are included in the OVDP disclosure period?" as follows:

> For calendar year taxpayers the voluntary disclosure period is the most recent eight tax years for which the due date has already passed. The eight-year period does not include current years for which there has not yet been non-compliance. Thus, for taxpayers who submit a voluntary disclosure prior to April 15, 2012 (or other 2011 due date under extension), the disclosure must include each of the years 2003 through 2010 in which they have undisclosed foreign accounts and/or undisclosed foreign entities. Fiscal year taxpayers must include fiscal years ending in calendar years 2003 through 2010. For taxpayers who disclose after the due date (or extended due date) for 2011, the disclosure must include 2004 through 2011. For disclosures made in successive years, any additional years for which the due date has passed must be included, but a corresponding number of years at the beginning of the period will be excluded, so that each disclosure includes an eight year period.
>
> For taxpayers who establish that they began filing timely, original, compliant returns that fully reported previously undisclosed offshore accounts or assets before making the voluntary disclosure, the voluntary disclosure period will begin with the eighth year preceding the most recent year for which the return filing due date has not yet passed, but will not include the compliant years. For example, a taxpayer who had historically filed income tax returns omitting the income from a securities account in Country A, who began reporting that income on his timely, original tax and information reporting returns for 2009 and 2010 without making a voluntary disclosure,

> and who files a voluntary disclosure in January 2012, the voluntary disclosure period will be 2003 through 2008.

DIRTY DOZEN TAX SCAMS: HIDING OFFSHORE INCOME

Each year the I.R.S. produces a list of twelve common tax scams a taxpayer may encounter. While taxpayers should be advised to these schemes (*e.g.*, identity theft, phishing, and return prepare fraud) throughout the year, publication of the list coincides with the peak in activity experienced during filing season. Since 2008, hiding income offshore has been listed as one of the top six dirty dozen tax scams by the I.R.S.[22] It was the first item listed in 2011. In 2009 and 2010, it was the second item listed, in 2012 and 2013, the third, and in 2008, the fifth. This year, it is listed as number six. In particular, the I.R.S. states:

> **Hiding Income Offshore**
>
> Over the years, numerous individuals have been identified as evading U.S. taxes by hiding income in offshore banks, brokerage accounts or nominee entities and then using debit cards, credit cards or wire transfers to access the funds. Others have employed foreign trusts, employee-leasing schemes, private annuities or insurance plans for the same purpose.
>
> The IRS uses information gained from its investigations to pursue taxpayers with undeclared accounts, as well as the banks and bankers suspected of helping clients hide their assets overseas. The IRS works closely with the Department of Justice to prosecute tax evasion cases.
>
> While there are legitimate reasons for maintaining financial accounts abroad, there are reporting requirements that need to be fulfilled. U.S. taxpayers who maintain such accounts and who do not comply with reporting and disclosure requirements are breaking the law and risk significant penalties and fines, as well as the possibility of criminal prosecution.[23]

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22 The topic was not listed in 2007, as such, but going back to at least 2003 it has been listed in some form or another.

23 See http://www.irs.gov/uac/Newsroom/IRS-Releases-the-%E2%80%9CDirty-Dozen%E2%80%9D-Tax-Scams-for-2014;-Identity-Theft,-Phone-Scams-Lead-List.

FINAL F.A.T.C.A. REGULATIONS REISSUED: ADDITIONAL TECHNICAL CORRECTIONS MAY BE FORTHCOMING

On February 20, 2014, the I.R.S. pre-released the final F.A.T.C.A. regulations.[24] They were officially submitted for publication on February 28, 2014, and speaking at a conference on that day, an I.R.S. official reaffirmed that the F.A.T.C.A. effective date, July 1, 2014, will not be delayed. Furthermore, the official stated that additional technical corrections to the final regulations will likely be forthcoming. As we have mentioned in prior publications, it is worth noting that the deadline appears to be real, and time is running out.

24 See http://www.irs.gov/Businesses/Corporations/Additional-FATCA-Guidance-Submitted-for-Publication.

IN THE MATTER OF *JOHN GAIED* – NEW YORK STATE'S HIGHEST COURT PUSHES BACK NEW YORK TAXING AUTHORITIES

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Tags
State and Local Tax
New York

New York State will tax as a "resident" of New York: a domiciliary of the State and a person treated as a "statutory resident." A domiciliary is generally a person whose permanent and primary home is located in New York. A statutory resident is a person who is not a domiciliary, but maintains a permanent place of abode in this state and spends in the aggregate more than 183 days of the taxable year in New York. In other words, to be a statutory resident for New York tax purposes, the person must be present in New York for more than 183 days (in the aggregate) AND maintain a permanent place of abode in New York.

New York's highest court was asked to determine what it means to "maintain" a permanent place of abode in New York. The New York State taxing authority's position is that a person can have a permanent place of abode, which he or she does not necessarily have to own or lease, if the person can stay there whenever he or she wants, even if he or she stays there occasionally or not at all. Special rules apply to corporate apartments, college students, and the military.[25]

The facts of the case, as stated in the opinion, are as follows: For the tax years in question, Mr. Gaied was domiciled in New Jersey. He owned an automotive service and repair business on Staten Island, New York and commuted daily to work, a distance of about 28 miles. He purchased a multi-family apartment building on Staten Island, located in the same neighborhood as his business, leased two units to tenants, and used one unit for his aged parents, who relied upon Mr. Gaied for their support. He paid the electric and gas bills for the apartment and maintained a telephone number for the apartment in his name. Mr. Gaied asserted, however, that he never lived at the apartment and did not keep any clothing or other personal effects there; nor did he have sleeping accommodations at the apartment. While he had keys to the apartment, he claimed that he did not have unrestricted access to the apartment, only staying there (sleeping on the couch) at his parents' occasional request to attend to their medical needs.

The facts in the case were in dispute, particularly as to whether Mr. Gaied had unfettered access to the apartment. He, in fact, listed the address under his

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[25] See New York State Tax Bulletin TB-IT-690 (December 15, 2011) and New York State 2012 nonresident audit guidelines.

"In any event, the Court of Appeals disagreed with the lower courts, stating that the taxpayer must have a 'residential interest in the property.'"

name for the utility and telephone bills and listed the address as his on the other apartment leases. The Court of Appeals was not asked to address the factual issues in dispute but only the legal interpretation adopted by a lower court (the "Tax Tribunal") that a taxpayer need not "reside" in the dwelling, but only maintain it, to qualify as "statutory resident." The Tax Tribunal court opinion caused some consternation among New York lawyers, who felt the decision represented an expansion of the New York State taxing authority's ability to tax out of state residents. In any event, the Court of Appeals disagreed with the lower courts, stating that the taxpayer must have a "residential interest in the property." Mr. Gaied won this round.

In the Matter of John Gaied demonstrates that there are limits to the New York State taxing authority's ability to tax nonresidents of the State. It stands for the proposition that occasional use of a family member's apartment - at the family member's request - may not be sufficient to cause the other family member to have a permanent place of abode, even if the other family member is subsidizing the apartment. For example, if a parent, who lives in New Jersey but works in New York, subsidizes an adult child's rental or purchase of an apartment and stays at the apartment at the request of the child (*e.g.*, to babysit the grandchild), the apartment should not be treated as a permanent place of abode of the parent. If the parent uses the apartment when convenient for the parent, such as a late night at the theater, the result may be different.

Ruchelman P.L.L.C. regularly advised its clients on their New York State tax obligations and would be pleased to answer any questions concerning this article.

TAX 101 – INTRODUCTORY LESSONS:

FORM 5471 – HOW TO COMPLETE THE FORM IN LIGHT OF RECENT CHANGES

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INTRODUCTION

As part of the obligation to file income tax returns, U.S. persons owning 10% or more of the stock of a foreign corporation – measured by voting power or value of the stock that is owned – are obligated to provide information on the foreign corporation. Ownership is determined by reference to stock directly held, indirectly held through foreign entities, and deemed held through attribution from others. The scope and detail of the information to be reported is dependent on the percentage of ownership maintained by the U.S. taxpayer. As the degree of ownership increases, the amount of information increases. The reporting vehicle is Form 5471 (Information Return of U.S. Persons with Respect to Certain Foreign Corporations). For returns that report on tax year 2013, this form also reports on the net investment income tax ("N.I.I.T.") arising through a controlled foreign corporation ("C.F.C.").

Great emphasis is put on international tax compliance, and from 2009, the I.R.S. systematically assesses penalties for late filing of Form 5471. In addition, the 2010 Foreign Account Tax Compliance Act ("F.A.T.C.A.") extended the statute of limitations for the I.R.S. to examine a tax return if certain information returns, including Forms 5471, were not timely or properly filed. The statute of limitations will remain open on the entire tax return and not only on Form 5471 if Form 5471 is not timely filed. Once the form is filed the statute of limitation will begin to run.[26] To assist the I.R.S. to spot inconsistencies, beginning in tax year 2012, the I.R.S. assigned a unique reference identification number to each foreign entity, which allows the I.R.S. to compare forms filed with respect to a certain company over several years.

The systematic penalty assertion where Forms 5471 were not filed or were filed improperly was examined by the Treasury Inspector General for Tax Administration ("T.I.G.T.A.") at the end of 2013. T.I.G.T.A. found that the systemic penalties were properly assessed, but that the abatement process required improvement as

[26] Code §6501(c)(8).

controls were insufficient to ensure the proper abatement of systemically assessed penalties.[27]

HOW TO FILL IN THE FORM

The rules determining when a Form 5471 is required and the degree of information that must be included are determined by many complicated, overlapping, and sometimes unclear provisions in the Code (primarily Code §6038 and §6046) and accompanying regulations. These rules are supplemented by instructions and I.R.S. publications. As the penalties are substantial, it is prudent for taxpayers with international operations to understand when the form is required and what must be included.

Form 5471 provides for four categories of U.S. persons who must file the form and lists the information required for each category of filer. The information required ranges from: (i) general information about the corporation and certain U.S. shareholders who acquired or disposed of ownership during the year to (ii) a full disclosure of the corporation's financial statements and related-person transactions. The most recent instructions to the form were released in January 2014 and apply to tax years beginning in 2013. These instructions clarify that the constructive ownership exception that previously only applied to two categories of filers will now apply to another category. This exception will be explained below in more detail.

As mentioned above, Form 5471 provides for four categories of filers, with each category requiring different degree of information to be disclosed. Those generally include the following beginning with Category 2 filers as the rules for Category 1 filers have been repealed:[28]

Category 2 Filer

A U.S citizen or resident who is an officer or director of a foreign corporation in which a U.S. person has acquired, directly or indirectly, stock ownership that meet certain requirements. The relevant requirements are: (i) stock ownership of 10% or more by vote or value (purchased in one or more transactions, during a single tax year or over multiple tax years) ("10% stock ownership requirement") or (ii) a purchase of an additional 10% or greater ownership interest.

A Category 2 filer is required to provide the following information:

1. The corporation's identifying information, including a description of the business activity;

2. Identifying information with respect to each U.S. person who, during the time he is an officer or director,[29] acquired stock meeting the 10% stock

[27] The T.I.G.T.A. report dated September 25, 2013 was released December 2, 2013.

[28] Category 1 was repealed by the American Jobs Creation Act of 2004.

[29] If a U.S. person acquired stock in a foreign corporation in September of year one and in December of that same year a U.S. person is appointed director, the

ownership requirements described above. This description should include the acquired stock and the date of the acquisition;[30] and

3. Answer specific questions designed to provide information on topics of current concern to the I.R.S., including:[31]

   a. Ownership of 10% or more of a foreign partnership;

   b. Ownership of an interest in a trust;

   c. Ownership of an interest in a disregarded entity;

   d. Participation in a cost-sharing arrangement;

   e. Participation in a reportable tax shelter transaction;

   f. Payment or accrual of foreign taxes for which credit is denied under Code §901(m) relating to covered asset acquisitions in which the U.S. tax basis of the asset is greater than the foreign tax basis; and

   g. Payment or accrual of foreign taxes for which credit was previously suspended under Code §909, relating to the matching of income and foreign tax credits.

Category 3 Filer:

A Category 3 filer is generally any person who meets one of the following three tests:

4. A U.S. person who acquires (or is deemed to acquire) stock meeting the 10% stock ownership requirement, whether in one block or in an amount that brings him to a 10% or greater ownership interest;

5. A U.S. person who disposes, directly or indirectly, of stock ownership in a foreign corporation so that his ownership is reduced to below 10%; or

6. A non-U.S. person who became a U.S. person while meeting the 10% stock ownership requirement.

A Category 3 filer is required to report most[32] of the information a Category 2 filer is required to provide, plus, *inter alia*:

   a. A description of the stock structure;[33]

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director will not be required to file the form. Treas. Reg. §1.4064-1(a)(3) Example 4.

30 This is done on Part I of Separate Schedule O (Form 5471).

31 Schedule G of Form 5471.

32 All information, other than Part I of Separate Schedule O (Form 5471), which reports that persons who acquired the required ownership during the tenor or a U.S. director or officer.

b. Information regarding all of the corporation's U.S. shareholders owning stock meeting the 10% stock ownership requirement;[34]

c. The corporation's U.S. and foreign income tax for the current year;[35]

d. The shareholder's acquisitions and dispositions;[36]

e. An income statement for the corporation and balance sheets as of the beginning and end of the corporation's accounting period.[37]

The income statement should be in the corporation's functional currency and in U.S. dollars, and the balance sheet should be prepared under U.S. generally accepted accounting principles ("G.A.A.P.") and in U.S. dollars. If Form 5471 is filed because an existing shareholder became a U.S. person, the residency starting date or the date on which U.S. status became effective should be reported. If the form is filed because of the shareholder's disposition of stock, the form should also include a description of the transaction and identifying information regarding the buyer.[38]

Category 4 Filer

A Category 4 filer is U.S. person who, directly or indirectly, controls a foreign corporation. For these purposes control means more than 50% of the vote or value for at least 30 days during the year.[39]

A Category 4 filer is required to provide most[40] of the information that a Category 3 filer is required to provide, plus, *inter alia*:

1. The current and accumulated earnings and profits,[41]

2. The Subpart F income and other items relevant to the application of the C.F.C. rules,[42] and

3. A description of business transactions between a foreign corporation that is a C.F.C. and any of the following: (i) the U.S. shareholder submitting the form, (ii) any domestic corporation or partnership controlled by the filer, (iii) any U.S. person meeting the 10% stock ownership requirements, (iv) any domestic corporation or partnership controlled by any 10% or greater U.S.

33 Schedule A of Form 5471.
34 Schedule B of Form 5471.
35 Schedule E of Form 5471.
36 Part II of Separate Schedule O (Form 5471).
37 Schedule C and Schedule F.
38 The instructions to Form 5471 for each Schedule.
39 Code §6038(a)(1).
40 All information, other than Part II of Separate Schedule O (Form 5471), which reports, inter alia, the shareholder's acquisitions and dispositions.
41 The current earnings and profits ("E&P") is reported on Schedule H of Form 5471. The accumulated E&P is reported on Separate Schedule J (Form 5471).
42 Schedule I of Form 5471.

shareholder, or (v) any 10% or greater U.S. shareholder of any corporation controlling the foreign corporation.[43]

Category 5 Filer:

A U.S. person who owns (or is deemed to own), directly or indirectly, shares meeting the 10% stock ownership requirements in a C.F.C. for at least 30 days, including on the last day of the tax year.[44] A C.F.C. is defined as a foreign corporation that has U.S. shareholders that own, directly, indirectly or constructively, more than 50% of the vote or value of the foreign corporation, on any day of the tax year.

A Category 5 filer is required to provide the following information:

1. The corporation's identifying information, including a description of the business activity;

2. Answer specific questions designed to provide information on topics of current concern to the I.R.S., as more elaborately described under Category 3 above;[45]

3. The current and accumulated earnings and profits;[46] and

4. The Subpart F income and other items relevant to the application of the C.F.C. rules.[47]

A U.S. person who fits within more than one category for a particular year is only required to file one Form 5471 for the year but must include all the information required for all applicable categories.

Note that if a U.S. person is required to file Form 5471 under any one of these categories, the fact that he may be exempt from U.S. tax with respect to his income from this corporation under a tax treaty with the country of his residence would not deter from his obligation to file this form.

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43 Separate Schedule M (Form 5471).

44 Instructions to Form 5471 (Rev. December 2013) and Code §6038(a)(4). Category 5 also includes a U.S. person who owns any amount of stock of a C.F.C. that is a captive insurance company.

45 Schedule G.

46 The current earnings and profits ("E&P") is reported on Schedule H of Form 5471. The accumulated E&P is reported on Separate Schedule J (Form 5471).

47 Schedule I of Form 5471.

What Constructive Ownership Rules Apply for Purposes of Determining Who Must File?

There are three separate sets of constructive and indirect ownership rules which apply for the purposes of the four different filing categories.

1. For purposes of determining who is required to file as a Category 2 or Category 3 filer the following attribution rules apply:[48]

   a. Entity attribution: a person is deemed to proportionately own stock owned directly or indirectly by a foreign corporation or a foreign partnership in which he is a shareholder or partner.

   b. Family attribution: an individual is deemed to own stock owned, directly or indirectly, by or for (i) his spouse, (ii) his children and grandchildren, (iii) his parents and grandparents and (iv) his siblings (including half-blood). Attribution rules apply from more remote ancestors if still living and great-grandchildren and more remote descendants, if any. Stock that a family member owns by attribution will not be reattributed to another member of his family. This rule caps multiple application of the attribution rules that would otherwise expand their scope indefinitely.

2. For purposes of determining who is required to file as a Category 4 filer the attribution rules of Code §318(a) apply, with some modifications, resulting in:[49]

   a. <u>Family attribution</u>: an individual is deemed to own stock owned, directly or indirectly, by or for: (i) his spouse, (ii) his children (including adopted), (iii) his grandchildren, and (iv) his parents. Stock that a family member owns by attribution will not be reattributed to another member of his family.

   b. <u>Partnership and estate attribution</u>: a person is deemed to proportionately own stock owned by or for a partnership or an estate in which he is a partner or a beneficiary. Stock owned by a partner of a partnership or a beneficiary of an estate is considered as owned by the partnership or the estate. Stock that is attributed to a partnership or an estate is not reattributed to other partners or beneficiaries.

   c. <u>Trust attribution</u>: a person is deemed to own stock owned by a trust of which he is a beneficiary in proportion to his actuarial interest in the trust. This assumes specific distribution patterns are mandatory. However, reliance on actuarial tables may be inappropriate where trust distributions are fully discretionary. In such instance, a trust beneficiary may be required to look at facts and circumstances to

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[48] Code §6046(c) and Treas. Reg. §1.6046-1(i).

[49] Code §6038(e)(2) and Treas. Reg. §1.6038-2(c).

determine actuarial interest.[50] This includes (i) patterns of past distributions, (ii) appropriate mortality assumptions, (iii) the trustee's fiduciary duties, and (iv) the relationships between the trustees and beneficiaries. Stock owned by a beneficiary of a trust is considered as owned by the trust, except if the beneficiary's interest in the trust is a remote contingent interest. Stock that is attributed to a trust is not reattributed to other beneficiaries.

d. Grantor trust attribution: a person is deemed to own stock owned by a grantor trust of which he is treated as the grantor. Stock owned by the grantor of a grantor trust is considered as owned by the trust.

e. Upward corporation attribution: a shareholder is deemed to proportionately own stock owned, directly or indirectly, by or for a corporation of which he owns 10% or more of the value. A person is deemed in control of a controlled subsidiary corporation if he is in control of the upper level corporation. This means that if the controlling person owns 60% of the upper-tier corporation and the upper-tier corporation owns 60% of a lower-tier corporation, the controlling person is deemed to own all 60% of the lower-tier corporation.

f. Downward Corporation attribution: a corporation will be deemed to own all stock actually owned, directly or indirectly, by or for any shareholder when the shareholder owns, directly or indirectly, 50% or more of the value of the corporation’s stock. Stock that is attributed to a corporation is not reattributed to other shareholders of the corporation under the upward corporation attribution rules discussed above.

g. Options attribution: a person who has an option to acquire stock is deemed to own this stock.

For purposes of Category 4 filers, attribution to corporations, partnerships, trusts, or estates would only apply from a U.S. shareholder, partner or beneficiary. Thus, there is no attribution from non-U.S. persons.

3. For purposes of determining who is required to file as a Category 5 filer the same attribution rules that apply to Category 4 also apply, with the following changes:[51]

a. There is no family attribution from nonresident individuals.

b. Attribution from corporations, partnership, trusts, and estates is expanded in relation to those that apply to Category 4 filers: if a

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[50] Private Letter Ruling 9024076. Note that a private letter ruling may be cited as authority only by the taxpayer to whom issued. Nonetheless, it may indicate the position of the national office of the I.R.S. at the time issued. Here, the ruling was issued 24 years ago.

[51] Code §958

partnership, estate, trust, or corporation owns, directly or indirectly, more than 50% of the total combined voting power in an entity, it is deemed to own all of the voting stock of that entity.

Exceptions from Filing:

As a result of the constructive ownership rules, some duplication in filing may result when two persons are treated as Category 3, 4, or 5 filers for the same shares. Additionally, some difficulties will result Category 3, 4, or 5 filers are not in possession of the information required on the form. The I.R.S. acknowledges some of those issues and applies certain exceptions from filing.

1. Category 3, 4, or 5 filers who have no actual or indirect ownership in a foreign corporation but are required to file solely due to constructive ownership are exempt if the U.S person whose ownership was attributed to them files Form 5471 and reports all the required information. Filers who do not file Form 5471 based on this exclusion need not include a statement to this effect.

2. In January 2013, the I.R.S. extended this exclusion to apply to Category 5 filers in addition to Category 3 and 4 filers and clarified that no statement of reliance in this respect is required. The exception applies to Category 5 filers only for tax years beginning in 2012 and afterward. The obligation to file remains for prior years. In the instructions published in January 2014, the I.R.S. corrected an omission to refer to the Code §958(a) attribution rules when determining that the Category 5 filer is required to file solely due to constructive ownership.

3. Because this exception is based on the expectation that another U.S. person will actually file Form 5471, it is prudent to confirm that the form was accurately and correctly filed.

4. A Category 2 filer is not required to file Form 5471 in either of the following cases:

    a. Immediately after a reportable stock acquisition, three or fewer U.S. persons own at least 95% of the value of the corporation and the U.S. person making the acquisition files the form as a Category 3 filer; or

    b. The Category 2 filer relying on the exception (i) does not have a direct interest in the corporation but is deemed to acquire stock under the constructive ownership rules and (ii) the person from whom the stock ownership is attributed files Form 5471 with all of the required information.

5. A Category 4 or 5 filer is not required to file if that person does not have a direct or indirect interest in the foreign corporation and was required to file solely due to constructive ownership from a nonresident alien.

6. All filers required to file information return with respect to a certain foreign corporation may file a joint Form 5471. If a joint form, is filed the person actually filing the form must identify all persons on behalf of whom the form

is filed, and such persons must attach a statement to their tax returns identifying the actual filer and I.R.S. service center receiving the completed form. A Category 3 Filer may only join a form of another if that other person has an equal or greater interest in the foreign corporation.

What Are The Penalties For A Failure to File?

Substantial penalties exist for those who are not in compliance with the Form 5471 filing obligation. In particular, the failure to file a timely Form 5471 or the failure to file a complete or accurate form may result in a penalty of $10,000 for each foreign corporation for each taxable year in which the failure occurs. If any failure continues for more than 90 days after notice of the failure, an additional penalty of $10,000 per 30-day period is imposed while the failure continues (up to a maximum of $50,000 for each failure).[52] In addition to the monetary penalties, the I.R.S. may reduce any foreign tax credits taken by the U.S. owner by 10%, whether related to this foreign corporation or not. These penalties are assessed in addition to any penalties with respect to any income tax return and even if no income tax is due on the income tax return. Additionally, if the failure is willful, criminal penalties may be assessed.

What Else is New On the 2013 Form?

Beginning in 2013, certain U.S. shareholders filing Form 5471 may be subject to the N.I.I.T. on Subpart F income from C.F.C.'s. Form 5471 refers to the draft instructions for Form 8960, Net Investment Income Tax - Individuals, Estates, and Trusts. The draft instructions for Form 8960 were released on January 2014 and will be discussed in a separate article.

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[52] For persons required to report acquisition and dispositions on Separate Schedule O (Category 3 filer) the penalty may be $10,000 for each failure for each transaction.

CORPORATE MATTERS: INCORPORATION BASICS

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Corporate Law
Incorporation

A foreign entity or individual planning on making an acquisition or conducting some other form of commercial activity in the United States must consider what type of U.S. entity to use in that endeavor. We thought it might be helpful to set out the options and answer an even more basic question for those considering activity in the United States: Why should you incorporate?

There are many advantages to conducting business through a properly formed business entity:

- **Asset Protection.** C corporations and limited liability companies generally allow owners to separate and protect their personal assets in the event of a lawsuit or claims against the business entity.

- **Name Protection**. Most states will not allow another business to form an entity with the same name as an already existing entity. Once you have filed an organizational document with a State's Secretary of State another entity cannot be formed with the same name.

- **Credibility.** In many instances, consumers, vendors and partners may prefer to do business with an incorporated entity.

- **Tax Flexibility.** Assuming you have no plans to go public, you generally will be able to choose whether your entity will be subject to a corporation income tax or whether profits and losses will be "passed through" to the shareholder, partner, or member.

Once the decision has been made to incorporate, consideration must be given to the type of entity to use. There are three main entity types in the U.S.:

- Corporations;

- Limited Liability Companies; and

- Partnerships.

CORPORATIONS

Corporations are a common business entity in the U.S. The benefit of doing business as a corporation is limited liability. There is no limit to the number of shareholders a corporation may have for corporate law purposes. If the entity has been properly formed, capitalized, and maintained (*i.e.*, the corporate formalities are respected), the owners should have limited liability (limited to the amount of their capital contribution) for the business debts and obligations of the entity. An exception exists for professional services corporations, in which case the shareholder providing the services may be personally liable for the services rendered but not the other liabilities of the corporation.

For U.S. Federal income tax purposes, corporations are subject to double taxation: income is taxed when received by the corporation and then in the hands of shareholders when distributed as dividends. The U.S. Federal corporate income tax statutory rate ranges from 34% to 35% under current law, but the effective tax rate can be substantially lower. Qualifying dividends are taxed at 20% plus a supplemental potential 3.8% net investment income tax for high income U.S. tax residents. Thus doing business in the corporate form is generally disadvantageous from the U.S. Federal income tax perspective, as there is a second layer of corporate income tax. However, if the corporation intends to go public (*i.e.*, raise money from the capital markets, *e.g.*, in an initial public offering) in the reasonably foreseeable future, it may be advantageous to be a corporation, and there will be no U.S. Federal income tax difference as "publicly traded partnerships" are generally treated as corporations for U.S. federal income tax purposes.

"Forming an entity in the U.S. can be done relatively quickly and inexpensively."

A corporation can make an S-Corp election. If it does so, profits and losses are generally "passed through" to the corporation's shareholders. However, there are limitations in an S-Corp ownership, which include:

- No more than 100 shareholders;
- Shareholders must be U.S. citizens or resident individuals; and
- The corporation can only have one class of stock.

Non-U.S. shareholders, in general, do not have to file a U.S. individual income tax return unless the non-U.S. shareholder receives dividends from the U.S. corporation (or otherwise has income from U.S. sources).

LIMITED LIABILITY COMPANIES

A Limited Liability Company ("LLC") can combine the corporate advantage of limited liability with potential tax advantages of "pass-through" taxation such as partnerships or sole proprietorships. It is a flexible form of entity, particularly for U.S. Federal income tax purposes. LLC's generally have no restrictions on membership eligibility or numbers. In general, LLC statutes provide default rules which may be overridden by contract (*i.e.*, the operating agreement).

In the case of an LLC, the LLC can be treated as a corporation by making a "check-the-box" election. Otherwise, it is (i) disregarded if it has a single member or (ii) a partnership, if it has more than one member. In the latter cases, profits and losses will be "passed through" to its member(s).

PARTNERSHIPS

Partnerships can be formed as general partnerships or limited liability partnerships ("LLP"). In the former case, the partners will not have limited liability. In the latter case, partners will have limited liability similar to LLC's. The lines between LLC's and LLP's can become murky. However, states may require that at least one partner in a LLP be a general partner unlike the LLC.

In the case of a partnership, like LLC's, there is, in general, no U.S. Federal income tax at the entity level and profits and losses are, in general, "passed through" to its partners. If the partnership is engaged in a trade or business in the U.S., foreign partners must, in general, file an income tax return and are subject to withholding by the partnership. A partnership may also have to withhold tax on a foreign partner's distributive share of passive income (*e.g.*, interest or dividends) not effectively connected with a U.S. trade or business.

ENTITY FORMATION

Forming an entity in the U.S. can be done relatively quickly and inexpensively. Delaware is the preferred jurisdiction for incorporation in the U.S. due to the fact it has been a leader in this front and a comprehensive body of laws has been developed over time. However, a Delaware entity may need to register to do business in another state if it conducts business in that other state. A corporation that does not conduct business in Delaware is not, in general, required to a file a Delaware corporate income tax return even if incorporated under the laws of Delaware, but it may nonetheless be subject to a franchise tax as discussed in more detail below.

STATE LAW TAX CONSIDERATIONS

State law business income tax considerations should not be overlooked in this discussion. An entity conducting business in a particular state may be subject to that state's corporate income tax (which may follow or not follow the U.S. federal income tax rules). The business may also be subject to local income taxes (*e.g.*, New York City) if it does business in that locality. State laws may also have a franchise tax which is generally based on or centered on net-worth rather than income. For example, if you incorporate in Delaware but conduct business outside of that State (and thus are not subject to Delaware corporate income tax), you may nonetheless be subject to a Delaware corporate franchise tax as noted above.

About Us

We provide a wide range of tax planning and legal services for foreign companies operating in the U.S., foreign financial institutions operating in the U.S. through branches, and U.S. companies and financial institutions operating abroad. The core practice of the firm includes tax planning for cross-border transactions. This involves corporate tax advice under Subchapter C of the Internal Revenue Code, advice on transfer pricing matters, and representation before the I.R.S.

The private client group of the firm also advises clients on matters related to domestic and international estate planning, charitable planned giving, trust and estate administration, and executive compensation.

The tax practice is supported by our corporate group, which provides legal representation in mergers, licenses, asset acquisitions, corporate reorganizations, acquisition of real property, and estate and trust matters. The firm advises corporate tax departments on management issues arising under the Sarbanes-Oxley Act. Our law firm has offices in New York City and Toronto, Canada. More information can be found at www.ruchelaw.com.

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