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INSIGHTS

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We hope you enjoy this issue.

- The Editors

DEOFFSHORIZATION IN RUSSIA: C.F.C. LEGISLATION COMES INTO EFFECT

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Tags
Beneficial Owner
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Federal law No. 376 of November 24, 2014, *On Amendments to Part One and Part Two of the Tax Code of the Russian Federation* (concerning the taxation of controlled foreign companies and foreign organizations), and commonly referred to as the "C.F.C. Law," came into force on January 1, 2015. It marks the beginning of deoffshorization of the Russian economy and introduces entirely new tax rules for Russian businesses having affiliates based outside Russia.

The C.F.C. Law introduces the following three new legal concepts, previously non-existent in Russian tax legislation:

- Controlled foreign company ("C.F.C."),
- Russian tax residence for foreign companies, and
- Beneficial owner of income.

The C.F.C. Law establishes the obligation of taxpayers to notify the tax authorities of their participation in foreign entities. It also establishes rules for computing and taxing C.F.C. profit and share transactions of companies that own real estate in Russia. It provides for recognition of foreign non-corporate structures (such as trusts, private foundations, partnerships, etc.) as separate taxpayers.[1]

Following the O.E.C.D. lead in the B.E.P.S. proposals, these amendments have two broad goals: (i) they ensure business transparency and (ii) they combat the use of low-tax jurisdictions to obtain unjustified tax benefits.

CONTROLLED FOREIGN COMPANIES

A controlled foreign company is a foreign entity (or non-corporate structure) that is:

1. Not a tax resident of the Russian Federation and
2. Controlled by Russian tax residents, either legal entities or individuals ("Controlling Persons").

There are three tests for a foreign entity to be considered a C.F.C. Under the general rule, a foreign entity is considered a C.F.C. if a Russian resident holds (directly or indirectly) more than 25% of its shares (50% during the transition period that ends January 1, 2016). Under an aggregation rules, a foreign entity may be a C.F.C. if a Russian resident owns 10% of shares, provided that more than 50% of the entity's

[1] Previously, Russian law did not know the concept of trusts. Russia has not ratified the 1985 Hague convention on laws applicable to trusts and their recognition. Consequently, trusts were not recognized as taxpayers in Russia.

shares are, in the aggregate, owned by tax residents of the Russian Federation.[2] Finally, under an economic substance rule, a foreign entity will be characterized as a C.F.C. if a resident of the Russian Federation can exercise significant influence on the decisions of the entity in terms of distribution of profit. This would include persons managing assets of a foreign non-corporate structure.

When a corporation is a C.F.C., its Controlling Person pays (i) personal income tax in the Russian Federation or (ii) corporate profit tax on that person's share of the C.F.C.'s retained profit.[3] In this manner, a C.F.C.'s profit is attributed to the Controlling Person on a *pro rata* basis.

From 2017 onward, a C.F.C.'s income over 10 million rubles is subject to Russian taxation in the hands of a Controlling Person. A phase in period exists for the imposition of tax. In 2015, the tax is imposed if the C.F.C.'s profits exceed 50 million rubles and in 2016 the tax is imposed if the C.F.C.'s profits exceed 30 million rubles.

The rate of tax will depend on the status of the Controlling Person as an individual or a corporation. If the former, the profit is taxed at the rate of 13% and if the latter, the profit is taxed at the rate of 20%. Before enactment of the C.F.C. Law, Russian tax on the profits of foreign entities was deferred until distributed in the form of dividends.

"The C.F.C. law contains several exceptions under which tax will not be imposed."

The C.F.C. law contains several exceptions under which tax will not be imposed:

- Russian residents controlling a company with a registered office in a country that signed a tax information exchange agreement with the Russian Federation will not be taxed under the C.F.C. law where the effective tax rate on profits 75% or more of the weighted average rate of profit tax in the Russian Federation.[4] To illustrate how this is intended to work, the Russian corporate income tax rate on operating income is 20% and the Russian corporate income tax rate on dividend income is 13% unless the dividend qualifies for the participation exemption regime. It is anticipated that the make-up of the income of the C.F.C. will form the basis on which the hypothetical Russian tax is computed, using both rates if applicable. The hypothetical Russian tax will be compared with the actual paid or accrued by the C.F.C. to determine whether the 75% tax target is reached.
- Similarly, Russian residents controlling a company with a registered office in a country that signed a tax information exchange agreement with the Russian Federation will not be taxed under the C.F.C. law provided that:
    - Russia has concluded a double taxation avoidance agreement with that country and
    - The income from passive activities does not exceed 20% of the total income of the company. Passive activity income includes dividends, interest, royalties, gain from the sale of shares or real estate, and

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2 Para. 3, art. 25.13, Tax Code of Russian Federation.

3 Para. 2, art. 25.15, Tax Code of Russian Federation.

4 Subpara. 3, para. 7, art. 25.13, Tax Code of the Russian Federation.

income from the performance of personal services such as consulting, legal, accounting, and audit services.[5]

- Finally, in a foreign non-corporate structure, a Russian resident that is the settlor of the structure will not be taxed when the resident is not entitled to benefit from the assets within the structure. Examples include the inability to obtain ownership of the entity's assets or to sell rights in the entity to a third party.[6]

RUSSIAN TAX RESIDENCY FOR A FOREIGN COMPANY

In certain instances, foreign entities can be considered to be Russian tax residents. For a foreign company, this means registration in the Russian Federation for profit tax purposes, reporting obligations, and its own profit tax calculation and obligation to pay profit tax of 20%. If a foreign company is recognized as a resident of the Russian Federation, it can no longer be considered a C.F.C. with respect to the Russian Controlling Persons.[7]

Unless otherwise provided by an applicable income tax treaty, a foreign company can be a tax resident of the Russian Federation by operation of law. Alternatively, it can become a tax resident of the Russian Federation on its own initiative.

In the first case, a foreign company is recognized as a Russian tax resident if the place of actual management of the company is located in the Russian Federation. According to the C.F.C. Law, the place of actual management is located in the Russian Federation if one of the following conditions is met:

- Most of the board of directors meetings are held in the territory of the Russian Federation;
- Executive board/senior (managing) officers perform their activities in the territory of the Russian Federation; and
- Accounting or managerial accounting, records management, and personnel operating management are located in Russia.

If an entity can provide documents, confirming that actual management is performed outside the Russian Federation (*i.e.*, commercial activities are conducted abroad using its own personnel and assets), it cannot be considered as a tax resident of the Russian Federation.

In the second case, a foreign entity can become a tax resident of the Russian Federation on its own initiative in the following instances:

- It is registered in a country with which an agreement on tax matters has been signed;

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5 Subpara. 4, para. 7, art. 25.13, Tax Code of the Russian Federation.

6 Subpara. 5, para. 7, art. 25.13, Tax Code of the Russian Federation.

7 Subpara. 1, para. 1, art. 25.13, Tax Code of the Russian Federation.

- It is involved in projects under production sharing contracts, concessional, license and service agreements with the government of the respective country; and
- A shareholder owning at least 50% of the share capital in the company is a Russian resident and has owned these shares for at least 365 days and:
    - Over 50% of the company's assets are investments in foreign subsidiaries that are at least 50% owned and
    - The foreign entity either has no income or dividends from the subsidiaries account for 95% of the entity's total income.

"If a foreign company cannot demonstrate that it is the beneficial owner of the income, Russian source income will be taxed at normal rates provided under domestic law."

BENEFICIAL OWNER OF INCOME

According to the new provisions of the, the application of reduced taxation rates or tax exemptions provided by income tax treaties will not apply to income from sources in the Russian Federation if the foreign entity is not the beneficial owner of the income.[8] If a foreign company cannot demonstrate that it is the beneficial owner of the income, Russian source income will be taxed at normal rates provided under domestic law.

For this purpose the income recipient is considered to be the beneficial owner ("Beneficial Owner") only if it can demonstrate that, by reason of direct or indirect participation in the Russian company or by reason of control over the Russian company, or due to other circumstances, it is entitled to independently use and/or dispose of the income, taking into account the functions performed and risks assumed.

A person is not the Beneficial Owner of income if it:

- Has limited authority;
- Carries out an intermediary function; and
- Does not perform any other functions and does not assume any risks because it is a conduit of the income to others.

The concept of Beneficial Ownership is directed against practices that abuse the provisions of international treaties. The law is enforced by imposing tax obligations on the withholding agent. The withholding agent has the right to request confirmation that the recipient is the Beneficial Owner that is entitled to such income for application of the provisions of the tax treaties.[9] If it is subsequently determined that the foreign payee is not the Beneficial Owner, the tax agent will be held responsible for the tax and penalties can be imposed.[10]

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8 Art. 7, Tax Code of the Russian Federation.

9 Para. 1, art. 312, Tax Code of the Russian Federation.

10 According to the position set out in the decision of Russian Federation Superior Commercial Court Plenum No. 57 of July 30, 2013.

SHARE DEALS WITH COMPANIES OWNING RUSSIAN REAL ESTATE

The new law adopts a "F.I.R.P.T.A." concept on share sales of Russian real property holding companies. The income of foreign companies from the sale of shares in any company is subject to profit tax if more than 50% of the value of the assets of the target company consists of Russian real estate, directly or through other companies.[11]

NOTIFICATION

The C.F.C. Law provides for a new obligation of Russian tax residents to notify tax authorities of involvement in certain in foreign structures:[12]

- Participation in foreign entities if the ownership is more than 10%; if the ownership drops below 10%, reporting is also required;
- Setting up foreign non-corporate structures and control over them or beneficial entitlement to the income; and
- A C.F.C. with regard to which the resident is a Controlling Person.

"The C.F.C. Law provides for a new obligation of Russian tax residents to notify tax authorities of involvement in certain in foreign structures."

Notification regarding participation in foreign entities including non-corporate structures is to be made within one month after the one of the foregoing conditions is first met. For existing structures, the deadline for submission of the notification of participation is April 1, 2015. The notification deadline regarding a C.F.C. is March 20th of the year following the tax period in which the profit share of the controlled foreign company is subject to registration with the supervisory authorities.

In addition, foreign entities owning real estate in Russia must submit information regarding their participants to the tax authorities at the place where the real estate is located. For foreign non-corporate structures this includes information on settlors, beneficiaries, and managers.

If a Russian Controlling Person has not filed a notification with regard to a C.F.C. and the tax authorities obtain information indicating control exists, the tax authority will notify the resident that information must be provided within 20 days. If, the tax authority establishes a basis to conclude the resident is a Controlling Person in regard to a C.F.C. Controlling Person, the taxpayer will be notified and will have the right to contest the determination within three months. Until a final decision of a court is reached, a taxpayer cannot be recognized as a Controlling Person.

TAXATION OPTIMIZATION IN LIGHT OF NEW CIRCUMSTANCES

Due to changes in the tax law, Russian tax residents who own foreign entities or non-corporate structures and use them in their activities should review existing

11 Subpara. 5, para. 1, art. 309, Tax Code of the Russian Federation.

12 Para. 3.1, art. 23, Tax Code of the Russian Federation.

business structures promptly in order to identify possible risks. Once risks are identified, the Russian resident has three basic options:

1. Refuse to use offshore entities and transfer assets to the Russian Federation;

2. Retain the existing business structure and disclose information; and

3. Reorganize the holding, change the business model, and disclose information.

Let's look at each of these options.

Option 1: Abandoning Offshores

Such a decision is appropriate if, for example, there are no real activities abroad, no business purpose for using offshore companies, or if the existence of an offshore company in the holding simply becomes unprofitable in the new conditions. The benefits of this solution are the reduction of offshore company maintenance costs and tax risks.

Once the decision is made to abandon offshore entities, they must be liquidated before January 1, 2017.[13] The law provides for a mechanism for preferential return of offshore assets in the case of liquidation. Income resulting from liquidation of a foreign company is not included in the tax base of a shareholder who is recognized as a Controlling Person.[14] In addition, the Controlling Person of a Russian organization can receive property from a foreign company at no cost. In the case of a Russian Controlling Person holding a share of more than 50%, the property will not be taken into account when determining the profit tax base.[15]

Option 2: Retaining the Existing Business Structure

When a foreign company is used for asset protection advantages of a foreign jurisdiction may include the application of foreign law or effective judicial protection, the existing structure of the group of companies may be preserved. This will allow the company to retain the existing business ties and continue to be protected by a foreign country's laws. In this situation, payment of taxes in the Russian Federation is effectively a charge for the soundness of the asset.

It should be noted that there is a need to disclose information on participation in foreign companies, as well as to ensure compliance with the criteria of "real presence" in a foreign jurisdiction, in order to prevent such foreign companies from being recognized as Russian tax residents.

1. To maintain a reasonable tax burden, it is possible to optimize the taxation of the group in the following ways:

2. Dividends distribution[16] (possible application of a tax rate of 0%[17]);

13 Para. 3-5, article 3, C.F.C. Law.

14 Paragraph 2.2, art. 277, Tax Code of the Russian Federation.

15 Subpara. 11, para. 1, art. 25.15, Tax Code of the Russian Federation.

16 Para. 1 and 4, art. 25.15, Tax Code of the Russian Federation.

17 Subpara. 1, para. 3, art. 284, Tax Code of the Russian Federation.

3. Admission of the factual right of Russian resident to income in the form of dividends;[18]

4. Apportionment of losses incurred by a C.F.C.;[19] and

5. Credit for foreign tax paid.[20]

Option 3: Restructuring the Business

If a group of companies is active abroad and participates in international projects, then the companies and financial flows within that group should be structured so as to prevent the foreign entities or non-corporate structures from being recognized as C.F.C.'s or their profits from being taken into account with regard to taxation of Russian Controlling Persons. This will optimize the taxation and business processes and adapt them to the new circumstances.

The options for group and financial flow restructuring are as follows:

1. Change the jurisdiction of the companies that are profit centers to transfer such centers to another company in a country with a favorable tax regime, which meets the criteria set out in subparas. 3 and 4, para. 7, art. 25.13 of the Tax Code of the Russian Federation. The country must have signed an agreement on exchange of information on tax matters and the company's effective profit tax rate must not be less than 75% of the weighted average rate of profit tax in the Russian Federation. Alternatively, that country and the Russian Federation must have signed a Tax Information Exchange Agreement and concluded an income tax treaty. The profits of such companies will not be taxed with the Russian Controlling Persons.

2. Change the residence of an individual who is a Controlling Person. This method carries some tax risks. For example, the person may become tax resident of a country imposing tax at a rate that exceeds the Russian tax rate of 13%. In addition, he may lose personal income tax privileges in Russia when engaging in transactions involving Russian property.

3. Transfer the assets to a discretionary trust[21] where the settlor has no right to dispose of property and income of the trust, the beneficiary is not specified, and all decisions are made by an independent trustee.

4. Subdivide financial flows in such a way that the profit made by a C.F.C., is less than 10 million rubles (50 million in 2015 and 30 million in 2016, respectively). However, this is inconvenient in case of large financial flows.

5. Reduce the participation interest in a foreign company (based on the requirements of para. 3, art. 25.13 of the Tax Code of the Russian Federation). This method is associated with an increase in expenditures on company maintenance and nominee service, and risks recognition of the companies as tax residents of the Russian Federation.

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18 Para. 1.1-1.4, art. 312, Tax Code of the Russian Federation.

19 Para. 6-7, art. 309.1, Tax Code of the Russian Federation.

20 Para. 3, art. 232; para. 11, art. 309.1, Tax Code of the Russian Federation.

21 Subpara. 5, para. 7, art. 25.13, Tax Code of the Russian Federation.

CONCLUSION

Ultimately, the amendments to the Tax Code of the Russian Federation related to deoffshorization signify a new approach to tax planning and optimization – without the use of offshore companies, and only through tax relief and deduction.

Russian residents will have to give up semi-legal schemes and nominees, use “white” (legal onshore) jurisdictions, and act in compliance with the framework established by the law.

The comfortable offshore days are gone and will never be back. Therefore, over the next few years, Russian entrepreneurs will have to change their mentality and business models.

THE FUTURE OF IRELAND AS A PLACE TO CARRY ON BUSINESS IN LIGHT OF RECENT E.U. & O.E.C.D. INITIATIVES

Author
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Tags
Apple
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Ireland
Foreign Direct Investment

INTRODUCTION

Ireland has long been established as the onshore location of choice for the world's leading multinational enterprises ("M.N.E.'s"). Although Ireland's attractiveness as a location for foreign direct investment is based on a number of factors, the low corporate tax rate of 12.5% is crucial.

Ireland's corporate tax regime has received persistent and pervasive scrutiny from international media in recent times, focusing on topics such as the "Double Irish," the O.E.C.D. B.E.P.S. initiative, and the Apple investigation. What must not be forgotten in the midst of such coverage is that Ireland has nothing to hide and nothing to fear from any of the above issues. Ireland is a small jurisdiction, and as far back as the 1950's, the cornerstone of the economy has been foreign direct investment ("F.D.I.").

Ireland makes no secret of its wish to compete with other jurisdictions for F.D.I., and its highly competitive corporate tax regime, including the 12.5% tax rate, forms part of a broader strategy that allows Ireland to "play to win."

This article will discuss some of the main O.E.C.D. and E.U. initiatives impacting Ireland and the effects such initiatives are likely to have on Ireland and the M.N.E.'s which are based here.

E.U. INVESTIGATION INTO APPLE IN IRELAND – ALL SMOKE AND NO FIRE

Content & Scope of the Investigation

The European Commission (the "Commission") has made an initial finding that Ireland conferred an unfair tax advantage on Apple in relation to tax arrangements reached with the multinational on the amount of corporate tax payable in Ireland. The Commission's investigation focuses on tax rulings given by the Irish tax authorities in 1991 and 2007 that validated transfer pricing arrangements of two Irish-incorporated, non-Irish tax resident branches of Apple Inc. On this basis, the Commission launched an in-depth investigation into whether the arrangements constituted illegal State aid that is contrary to E.U. law. This investigation is by no means isolated. The Commission is examining tax ruling practices across the E.U. Similar investigations have been launched in the Netherlands and Luxembourg in relation to Starbucks and Fiat Finance & Trade, respectively. The opening of the in-depth investigation allows third parties to provide comments and is not a final judgment on the matter. The Irish Government has stated that the Commission has a weak case and if the investigation results in a determination against Ireland, it will appeal to the European Court of Justice (the "E.C.J.").

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Ireland has an open and transparent tax system and does not generally provide tax rulings to companies operating in Ireland. Although it is the Commission's position that there is nothing illegal about the provision of tax rulings, an issue arises if the rulings provide unfair tax advantages for recipient companies. Tax rulings are particularly prevalent in the area of transfer pricing, *i.e.*, the appropriate price that should be charged for commercial transactions between group companies. Although Ireland did not have transfer pricing rules at the time of the tax rulings in question, the Commission's investigation is based on what it refers to as "transfer pricing rulings."

> ***"Ireland has an open and transparent tax system and does not generally provide tax rulings to companies operating in Ireland."***

Apple Operations Europe ("AOE") has been described by the Irish tax authorities as essentially being a contract manufacturer and provider of shared services for related Apple entities. In the 1991 ruling, it was agreed that the net profit attributable to AOE would be the lower of (i) the overall profits of the Irish operations or (ii) an amount equal to 65% of the operating expenses up to the value of $60-$70 million and 20% thereafter. In 2007, this agreement was revised so that the branch profits would be a 10%-20% margin on branch operating expenses.

Apple Sales International ("ASI") was considered by Irish tax authorities to carry out routine, albeit important, functions in the procurement and onward sale and supply of goods for Apple. It would therefore have no special valuable assets. In the 1991 ruling, it was agreed that 12.5% tax would be charged on all branch operating costs excluding material for resale. In 2007, this agreement was revised and a modified basis for determining net profit was agreed to with an 8%-18% margin on branch operating costs excluding those not attributable to the Irish branch (such as material costs).

The Commission's preliminary finding is that these rulings conferred an unfair and selective tax advantage on Apple on the following basis:

- The rulings did not consistently apply the transfer pricing method chosen by the Irish tax authorities when determining the profit allocation for AOE and ASI and, therefore, did not comply with the arm's length principle.
- The rulings appeared to have been negotiated, rather than substantiated by comparable transactions. The Commission noted that no transfer pricing report was submitted by Apple regarding its proposals. It should be noted that Ireland did not have transfer pricing legislation at the time of the ruling, and therefore, the absence of such a report may well be explained by this simple fact.
- The rulings do not adequately explain the selection of the appropriate transfer pricing method used to calculate the allocation of the profit.

The Commission further concluded that the State aid could not be justified and therefore, constituted illegal State aid.

Ireland's Response

Ireland's Minister for Finance has indicated that he believes the investigation will cease at the conclusion of the in-depth examination. However, if the final conclusion of the Commission remains unchanged, the Irish Government has indicated that it will challenge the finding before the E.C.J. and has stated that it has been legally advised that Ireland would win the case easily, as the Commission's case against Ireland is weak. It must be hoped that proceedings will not reach that stage, as one would have to conclude that such a drawn out legal challenge would ultimately inflict damage on Ireland's reputation, even if such damage is unjustified and Ireland ultimately succeeds before the E.C.J. Ireland has an extremely open and transparent tax system – the rate is clear and straightforward, and no rulings are provided in relation to deductions or deemed deductions as in other jurisdictions. Therefore, a timely resolution to the E.U. investigation must be hoped for lest any damage be caused by a lengthy legal battle.

Comparison with the U.S. Senate Investigation

An interesting anomaly has arisen in the interaction between the Commission's investigation and the U.S. Senate investigation into Apple's tax affairs in Ireland. The Senate was aggrieved by Apple allegedly syphoning billions of dollars of profits away from the U.S. and into Ireland, whereas the Commission's investigation is premised upon not enough profits being taxed in Ireland. This exemplifies the complex area of international tax arrangements.

THE DOUBLE IRISH - THE GRADUAL PHASING OUT BEGINS

Ireland's position is that the ability of a company to structure its tax affairs in such a manner is primarily derived from U.S. tax law, not solely from Irish tax law. However, in response to increasing criticism of the use of the so-called "Double Irish" structure, Ireland has introduced changes to its corporate tax residency rules.

To allow companies ample time to restructure their affairs (and some would say to allow the newly announced patent box time to be fully operational and successful) a very extensive grandfathering period of six years will apply, whereby the previous tax residency rules remain applicable. Therefore, it is not envisaged that the changes will adversely impact M.N.E.s' current operations in Ireland.

THE O.E.C.D.'S B.E.P.S. INITIATIVE – CHALLENGES & OPPORTUNITIES

The O.E.C.D.'s B.E.P.S. initiative presents as many opportunities as it does challenges for Ireland. The B.E.P.S. project is about two things; aligning taxing rights with substance and preventing double non-taxation. This alignment of taxing rights and substance is in line with Ireland's own tax policy, which seeks to attract substantive investment to the country. Ireland's F.D.I. strategy has always focused on substance in Ireland and attracting companies that bring employment and valuable economic activities to Ireland. The Irish Government has stated that it welcomes the O.E.C.D. initiative. As a small country, Ireland believes it is advantageous for discussions to take place on tax reform and the prevention of aggressive tax planning at O.E.C.D. level. Ireland wants to have a voice in the discussions and to contribute to negotiations. It believes that a multi-lateral approach to dealing with aggressive tax planning is superior to the unwelcome alternative, which would be uncoordinated and unrestrained unilateral actions.

Challenges

The B.E.P.S. project certainly presents challenges for Ireland. In a paper prepared by the Irish Government on the impact of the project for Ireland, the introduction of C.F.C. rules and potential restrictions on interest deductions were cited as areas of concern.

The introduction of C.F.C. rules to all countries poses an issue for Ireland, as it does not currently have C.F.C. rules for taxing international profits of foreign subsidiaries. Instead, such income is taxed once it is remitted to Ireland.

It is also proposed to introduce a Limitation of Benefits Clause, which would mean that countries could only rely on the provisions of a double taxation agreement where a certain list of criteria is satisfied. This is seen as potentially problematic for smaller jurisdictions, such as Ireland, particularly if the criteria are restrictively drafted. The U.S., on the other hand, is strongly in favor of the introduction of Limitation of Benefits Clause.

Opportunities

The B.E.P.S. project is not focused on the applicable tax rate in a country; therefore, it poses no threat to Ireland's 12.5% rate. The Irish government again confirmed its steadfast commitment to the 12.5% rate at the speech announcing the 2015 Budget and launching the *Road Map for Ireland's Tax Competitiveness*.

Preferential I.P. Regimes

Ireland was not mentioned in the interim report on harmful tax practices; this should have an immediate positive effect for Ireland.

"The work being carried out in relation to transfer pricing offers a significant opportunity for Ireland to establish itself as the optimal location for M.N.E.'s needing to relocate their offshore intangible assets on shore."

This Action on preferential tax regimes will deal largely with patent boxes and preferential I.P. regimes. Ireland announced the introduction of its own patent box regime known as the "Knowledge Development Box" as part of the Government's *Road Map for Ireland's Tax Competitiveness*. It will be legislated for at the end of 2015 and will be in keeping with O.E.C.D./E.U. agreed guidelines while aiming to be best in class. The Knowledge Development Box encourages investment in the development of I.P. by allowing a preferential tax regime for income derived from such development. It will allow a lower effective corporate tax rate in order to encourage companies to locate high-value employment related to the development of I.P. in Ireland. The precise guidelines for patent boxes are yet to be agreed at E.U. and O.E.C.D. level.

Ireland's new Knowledge Development Box will be complemented by pre-existing I.P. regimes, such as our research & development tax credit and capital allowances regime for intangibles. It is hoped that the combination of this I.P. tax offering, in addition to the 12.5% rate, will make Ireland the location of choice for F.D.I.

Transfer Pricing

The work being carried out in relation to transfer pricing offers a significant opportunity for Ireland to establish itself as the optimal location for M.N.E.'s needing to relocate their offshore intangible assets on shore. The focus of the work on transfer pricing in the B.E.P.S. project is to align the location of profits with value creation. This will clearly impede current structures in which all the valuable I.P. of a company is kept in an offshore jurisdiction in which little or no tax is payable. In a post-B.E.P.S. world, this will no longer be possible and M.N.E.'s will be faced with two options:

- Move the value creation and substantial operations to the offshore location; or

- Move the valuable I.P. rights to an onshore location.

Given the lack of infrastructure in many prominent offshore locations, the former option is not seen as a likely choice. The question therefore becomes to which onshore location should the I.P. be moved and where should substance be developed. Many of the world's leading M.N.E.'s already have headquarters and substantial operations in Ireland. Critically, much of the I.P. housed offshore is already owned by Irish registered companies; therefore, Ireland is, if nothing else, the most straightforward and obvious choice.

WHY IRELAND IS A PRIME A LOCATION FOR F.D.I.

Whether or not M.N.E.'s already have operations in Ireland, a combination of both tax and non-tax related reasons means Ireland will be at the forefront of many M.N.E.'s minds when deciding where to focus their substantive operations. Ireland's F.D.I. agency (the "I.D.A.") specifies the "4 T's" as making Ireland the destination of choice for foreign direct investors: Talent, Track Record, Taxation, and Technology.

Taxation

The tax-related reasons have been largely discussed above and include:

- A 12.5% corporate tax rate on trading income;

- An extensive double tax treaty network (currently Ireland is a signatory to 72 treaties, with 68 in effect);

- A best in class I.P. regime, including a 25% research & development tax credit, intangible asset capital allowances regime, and the introduction of the Knowledge Development Box;

- An attractive holding company regime; and

- An effective zero tax rate for foreign dividends.

However, the non-tax issues are also compelling.

Track Record – History of F.D.I. in Ireland

Ireland's major competitive advantage over other jurisdictions competing for F.D.I. is experience; F.D.I.'s history in Ireland goes back as far as 1917, when the Ford Motor Company set up manufacturing operations here. In the 1950's, the government of the time developed an economic plan with F.D.I. as the cornerstone; it acknowledged that, as a small jurisdiction, Ireland had to be outward looking and encourage inward investments from foreign companies. In 1956, tax relief was introduced, which granted relief from tax for companies that manufactured their output; and in 1981, Ireland introduced an effective 10% corporate tax rate for manufacturing activities, which was extended to financial services in 1987. These were all predecessors to the 12.5% corporate tax rate on trading income, which was announced in 1998.

From the humble beginning of the Ford Motor Factory, Ireland is today home to:

- Nine of the top 10 pharmaceutical companies;
- Nine out of the top 10 software companies,
- Nine out of the top 10 internet companies,
- Twelve of the top 15 medical tech companies;
- Fifteen of the top 20 financial services companies; and
- Nine out of the top 10 aircraft leasing companies.

With the arrival of Google, Facebook, and eBay, Dublin's so-called "Silicon Docks" have become a leading location for established and start-up technology companies to set up non-U.S. operations. In addition, owing largely to Ireland's moderate climate, Ireland has become a very popular destination for the location of data centers.

"With the arrival of Google, Facebook, and eBay, Dublin's so-called "Silicon Docks" have become a leading location for established and start-up technology companies to set up non-U.S. operations."

This reflects the success of Dublin's International Financial Services Centre, which has been a leading international hub for the funds sector and aircraft finance leasing companies since the 1980's. Although the economic downturn had hugely negative effects on individuals in Ireland, the downturn also reduced the cost of doing business in Ireland and streamlined costs, with the result that Ireland is now a much more affordable place to do business than it was during the so-called "Celtic tiger" era.

It is therefore not surprising that Forbes recently announced that Ireland was the best country in the world in which to do business and Ireland topped the table in the Euro Zone for ease of doing business.

Ireland is well ahead of the curve in attracting F.D.I. and is accustomed to the presence of M.N.E.'s and their international workforces.

Talent

Ireland has a highly educated and skilled workforce with a higher percentage of third level (university) graduates than the U.K., U.S., or the O.E.C.D. average. In addition, Ireland has a predominantly young, ambitious, and mobile workforce, with the median population age being 35 – the lowest in the E.U.

Because Ireland has been a hub for certain sectors (such as the pharmaceutical industry, and the aircraft leasing and funds industries), there is a highly skilled and experienced talent pool from which to draw employees. This is in addition to an extensive selection of highly specialized firms to provide legal, tax, and administrative support. For example, since the establishment of the IFSC in 1987, Ireland has established itself as a leading jurisdiction for alternative investment funds. Over 50 licensed fund administrators are established here, including not just the big names but also more bespoke and niche operations; this has contributed to Ireland being a global leader for the servicing of alternative investments, with over 40% of global hedge funds being serviced in Ireland, and making it the largest hedge fund administration center in the world.

Similarly, aircraft financing has a very long history in Ireland, going back almost 40 years. Owing to Ireland's focused attention on creating the optimal legal and tax environment for the development of this industry, it has remained a world leader, with nine out of the top ten global lessors located here and 50% of the world's commercial aircraft fleet being managed from Ireland.

"Unfortunately, Ireland's personal tax regime is not as attractive as the corporate tax regime. The marginal tax rate is currently 51%."

Therefore, for any new entrant setting up operations in Ireland in such sectors all of the economic, technical, and human resources are already in place, resulting in a much more streamlined and straightforward process than in jurisdictions with less experience and expertise.

Other Factors

In addition to the 4 T's, Ireland's strong education system, easy access to the European market, and the fact that English is the country's first language all contribute to its success in attracting F.D.I.

LIVING IN IRELAND

Personal Taxation Regime

In a post-B.E.P.S. environment, if companies choose Ireland as a location for developing their operations, what does it mean for the staff that may be moved here? What can they expect from life in Ireland?

To start with, unfortunately, Ireland's personal tax regime is not as attractive as the corporate tax regime. The marginal tax rate is currently 51%, which is obviously higher than what one may be accustomed to in the U.S. It compares unfavorably to the O.E.C.D. average of 46%, and the situation is compounded by the fact that the rate applies at a low level of income (€32,800 for a single person). Therefore, companies would need to make up the difference for any employees relocated to Ireland in order to ensure that the tax rates here do not act as a deterrent for those being relocated; this would be an additional cost to the company for relocating staff to Ireland.

In a bid to alleviate this problem, the Irish Government introduced the Special Assignee Relief Programme in 2009 (the "S.A.R.P."). The S.A.R.P. is relief aimed at facilitating foreign employers who wish to relocate their executives to their Irish operations. It allows a reduction in the taxable employment earnings of an individual assigned to work in Ireland of up to 30%. It therefore reduces the cost to the employer of relocating its executives to Ireland. The program, which dates back to 2009, came into effect in its current form in 2012. Due to a number of onerous requirements and a limit of €500,000 being applied on the amount of salary which could be reduced, the up-take on the S.A.R.P. was very low. In 2012, only 15 employees applied for the S.A.R.P. In light of this, major improvements were announced as part of the 2015 Budget and became effective from January 2015. The improvements will enable a broader scope of people to qualify by removing previous restrictions. The upper salary threshold of €500,000 has being removed; this will make the S.A.R.P. attractive for executives moving to Ireland, as they will be entitled to reduce their taxable income by 30% once certain conditions are met.

Non-tax Factors – Society & Environment

Ireland is a small island with a population of approximately 4.6 million people. Despite some problems in the past in Northern Ireland, modern Ireland is peaceful and has a stable political system. It is a long standing member of the European Union and is a member of the Euro currency. Although much of the island is rural, the majority of the population density is in the cities, with 60% residing in cities and 40% in rural areas. The capital city, Dublin, is home to over 1 million people and is the main financial and business district in Ireland. Galway, on the west coast, and Cork, in the south, are much smaller cities but are surrounded by some of the most beautiful scenery and beaches in Ireland and are home to many of the medical/tech companies and pharmaceutical firms in Ireland.

Ireland's education system is made up of primary level, (5-12 years of age), secondary level (13-18 years of age) and third level (university) education. It was recently ranked ninth in the world in a global league table which looked at 40 countries and compared performances in skills such as reading, math, and science, in addition to graduation rates from second and third level. The vast majority of primary and secondary students are in public schools; however, in Dublin, private schools exist and are popular. Third level education in Ireland is also free. The main universities are located in the major cities, Dublin, Cork, Galway and Limerick. Although the universities do not rank as high as their U.K. contemporaries (such as Oxford or Cambridge) in many of the international polls, world class universities exist, and Trinity College Dublin is an example. In any event, the close proximity to the U.K. means that university age children of a foreign executive assigned to Ireland may conveniently attend university in the U.K.

The health system in Ireland could certainly not be described as a jewel in its crown; although a public system exists, waiting lists to see consultants are extremely long, emergency departments are often over-crowded, and people regularly have to wait on trolleys for days before getting a bed in a public hospital. In 2014, Ireland dropped eight places to 22nd in the Euro Health Consumer Index. A private system of health care also exists but at a cost, which renders it inaccessible to many families. In comparison to the cost of health care in the U.S. it is, however, relatively inexpensive.

Ireland has a moderate climate owing to the influence of the Atlantic Ocean and does not experience the same range of temperatures throughout the year as continental European countries. Air temperatures in the summer generally reach approximately 68 degrees (Fahrenheit) and 46 degrees in winter. Most Irish winters are free from snowfall, with only small falls on higher ground. However, this does mean that when infrequent snowfalls occur, they result in serious disruptions, particularly to public transportation. Because of its geographical location, Ireland does not experience major natural events such as earthquakes, hurricanes or tsunamis nor does it have any poisonous animals. Despite the high levels of rainfall in both summer and winter, Ireland is a haven for outdoor enthusiasts. As an island, one is never far from a beach; Dublin is on the coast, and coastal walks and beaches are reachable on public city transport. Ireland has innumerable championship golf courses around the country, most notably the Royal Dublin, the Island, the European, and (home to the 2006 Ryder Cup) the K Club.

CONCLUSION

Ireland's future as a place to carry on business in light of recent E.U. and O.E.C.D. initiatives is mixed. Whilst the E.U. investigation and B.E.P.S. initiative pose challenges, they are certainly not insurmountable. The Irish Government is strongly committed to maintaining the 12.5% corporate tax rate and to creating an optimal business environment to attract F.D.I. In a post-B.E.P.S. world, M.N.E.'s will have to ensure profits and substance are aligned; therefore, it will be necessary to relocate executives and persons involved in decision making to the jurisdiction where the profits of an entity arise. Ireland is a modern jurisdiction with advanced infrastructure, technology, and expertise to facilitate the establishment and ongoing development of operations; and therefore, it is hoped that M.N.E.'s will choose Ireland as the location to center operations post-B.E.P.S.

"The Irish Government is strongly committed to maintaining the 12.5% corporate tax rate and to creating an optimal business environment to attract F.D.I."

U.S. RESIDENCY CERTIFICATION: PITFALLS & CONSIDERATIONS

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Tags
Form 6166
Form 8802
Residency Certificate

INTRODUCTION

Income from sources within one country paid to residents of other countries often is subject to withholding tax in the source country at a rate that is set by the source country's internal law. The withholding tax rate can be reduced or eliminated if (1) an income tax treaty exists between the source country and the residence country and (2) the taxpayer is a resident of that second country for purposes of the treaty. This article explains how a U.S. resident taxpayer demonstrates that residence classification in order to claim benefits under an income tax treaty.

FORM 6166

For U.S. residents with non-U.S. source income, proving residency in order to obtain an income tax treaty is accomplished by obtaining a Residency Certificate from the I.R.S. This document certifies that the taxpayer is a resident of the U.S. for Federal income tax purposes. The certification is provided on Form 6166, which certifies to the withholding agent that for a specific year, the taxpayer was a resident of the U.S. for U.S. tax purposes. In the case of a fiscally transparent entity, Form 6166 will certify that the entity, when required, filed an information return and its partners, members, owners, or beneficiaries filed income tax returns as residents of the U.S. As partnerships (including L.L.C.'s treated as partnerships) and disregarded entities are not considered U.S. residents within the meaning of the residence article of most U.S. income tax treaties. As a result, the Form 6166 that is issued by the I.R.S. to will include a list of U.S. resident partners, members or owners. Each person's ownership percentage does not accompany the names on the list, as with limited exception, the I.R.S. does not have that information.

Upon receiving the Residency Certificate, the taxpayer forwards it to the withholding agent in the treaty partner country. Because residency is not the only requirement for treaty benefits, a U.S. resident must be prepared to meet whatever requirements appear in the treaty.

FORM 8802

Form 6166 is obtained by submitting a Form 8802 Application for United States Residency Certification.

Procedure

The application requires the following information and certifications:

1. Name, address and tax identification number ("T.I.N."). For individuals the tax I.D. is their social security number; for entities, it is their employee identification number ("E.I.N."). The I.R.S. will use this tax I.D. to search its records for the applicant's pervious tax returns or other such documents to confirm residence. In the event of a name change, the I.R.S. must be notified of the change prior to requesting a Residency Certificate. Husband and wife may request separate certification if needed.

2. If the applicant is a fiscally transparent entity the application must include:

    a. The name and T.I.N. of each partner, member, owner or beneficiary for which certification is requested,

    b. An authorization (for example, Form 8821 (Tax Information Authorization) or Form 2848 (Power of Attorney and Declaration of Representative) from each partner, member, owner or beneficiary explicitly allowing a third party requester to receive the partner, member, owner or beneficiary's tax information; if the applicant is a lower-tier partnership in a tiered partnership arrangement, information regarding the members of upper-tier partnerships must be provided, and

    c. Unless the requester is a partner, member, owner or trustee during the tax year for which certification is requested, authorization from the transparent entity must be included allowing the requester to receive information of the transparent entity.

3. If an application on behalf of an individual or a corporation is completed by a third party appointee, in lieu of using Form 2848 or Form 8821, the applicant may sign the application and a written authorization will be deemed to have been provided.

4. The form is prepared under penalties of perjury. All information must be true, accurate, and complete.

It is suggested that the completed Form 8802 and accompanying payment should be submitted at least 45 days before Form 6166 is required. For first time filers, the form typically is submitted shortly after the threat of withholding tax is first made by the payer in the treaty country. The earliest date allowed for submitting Form 8802 is December 1 of the preceding year.

Processing Fee

The taxpayer is required to pay a nonrefundable user fee of $85 per form. The user fee can be paid by check, money order or electronic payment on the I.R.S. website. The same fee is applied to each Form 8802, regardless of the number of certificates requested or the number of countries listed on the form.

Eligibility

Any individual or entity that is treated as a U.S. resident due to citizenship, place of incorporation, holding a green card, or meeting the substantial presence test may request a Residency Certificate. However, the following taxpayers are not eligible to file Form 8802:

- Taxpayers who did not file a required U.S. tax return for the certifying year,
- Taxpayers that are fiscally transparent with no U.S. partners, members, owners or beneficiaries, and
- Taxpayers who file as nonresidents or who claim nonresidence based on a treaty tiebreaker provision are ineligible to file Form 8802.

"Filing international can prove to be difficult. A strong suggestion for an electronic system that allows for the filing and the tracking of progress has been made."

CRITICISMS

Issues concerning the collection of the required information and the accuracy of the response process have been raised.

1. Agent Designation – the I.R.S. will contact an applicant after 30 days if a delay in processing the application is anticipated or if further information is required. Inquiries and responses to requests for additional information cannot be sent in to the specific agent at the I.R.S. Instead, the I.R.S. representative who receives the information will make a note on the file and the taxpayer may find that that the note is properly attached to his file.
2. Annual Requirement – Taxpayers have complained that there is no benefit to having to apply each year if no information has changed. The process is unnecessary and cumbersome.
3. Word Truncation – The number of characters that can be entered in the name field on Form 6166 is limited and thus very often entity names are abbreviated. This may cause problems when the Form 6166 is submitted to the paying agent, especially in countries that emphasize form over substance.
4. Electronic Process – Filing international can prove to be difficult. A strong suggestion for an electronic system that allows for the filing and the tracking of progress has been made.

Although many changes and improvements have been made, a need remains for an electronic system to allow instant application upload, response, and tracking of progress. An option for communication and comments on the electronic system will allow for relatively prompt resolution of minor problems and misunderstandings. The efficiency of an electronic system is evident in the introduction of the e-pay system for payment of user fees.

APOSTILLE

An Apostille is the authentication of a public document for use in foreign countries. An authentication certifies the signature and the capacity of the official who has executed the document. The authentication may also authenticate the seal of the official. Under the 1961 Hague Convention on the Requirement of Legalization for Foreign Public Documents, local legalization procedures were replaced by a simplified process of certification among signatory countries. This allows for recognition of public documents, including notarized documents, if such documents carry the internationally recognized form of authentication known as an Apostille.

Certain countries require that the Form 6166 be authenticated by means of an Apostille. This means that once the certificates have been received from the I.R.S., they need to be sent with an accompanying Apostille/Certificate of Authentication. In New York State an Apostille/Certificate of Authentication Request Form[1] is generally used to request Apostille. A $10 fee for each Apostille request is charged. Documents are processed within 4 business days and returned via prepaid mail in the sender's choice. Documents submitted in person are generally returned on the spot.

CONCLUSION

A U.S. Residency Certificate is an important tool that resident individuals and corporations can use to alleviate their foreign withholding tax. U.S. taxpayers must pursuing treaty benefits to reduce tax. Turning one's back on the treaty and claiming foreign tax credits instead may cause the I.R.S. to construe the tax payment as a voluntary contribution that is not a creditable tax. The application process is simple in principle, but may become unnecessarily lengthy if completion of the form is not pristine.

"Turning one's back on the treaty and claiming foreign tax credits instead may cause the I.R.S. to construe the tax payment as a voluntary contribution that is not a creditable tax."

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[1] NYS Department of State, Division of Corporations, State Records and Uniform Commercial Code. "Apostille/Certificate of Authentication Request."

PROPOSED LEGISLATION FOR ITALIAN PATENT BOX REGIME

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Tags
Action 5
B.E.P.S.
Intellectual Property
Patent Box

INTRODUCTION

Currently, the E.U. and the O.E.C.D. are finalizing new rules for the design of acceptable tax regimes for intangible property ("I.P.") box companies. The stated intent of this legislation is to promote the development of high-value jobs associated with the creation of I.P. The concern of the E.U. is that the tax benefit is a form of illegal state aid. The concern of the O.E.C.D. is that the real intent behind the patent box tax regimes is to attract movable income to a low tax environment that has no tangible connection to the I.P. or its development. Thus, Action 5 of the B.E.P.S. Action Plan proposes that preferential tax regimes are acceptable only if there is a direct proportionate nexus between the I.P. income and the R&D activity that generated that income.

It is thought the E.U. attack on I.P. box companies is championed by Germany, France, Spain, and Italy. However, Italy recently introduced its own I.P. tax incentive plan, known as a "patent box regime."

TAX BENEFITS OF ITALIAN PATENT BOX REGIME

The Italian legislation provides reduced tax – or no tax in some instances – on income derived from qualifying I.P. Businesses are exempt from tax on a percentage of income derived from I.P. The exempt percentage is 30% of income in 2015, 40% in 2016, and 50% in 2017 and later years. Consequently, the standard tax rate of 31.4% will be reduced to 15.7% by 2017. In addition, if I.P. is sold and 90% of the sales proceeds are reinvested in the development of similar I.P. by the end of second fiscal year following the year of sale, the entire gain will be tax-free.

Activities that must be performed in order to benefit from the regime can be performed directly or outsourced under research agreements with various institutions, such as universities or research centers.

Businesses must make an election to apply the regime. The election is irrevocable for five years. Nonetheless, the patent box incentive can be used in conjunction with other Italian tax incentive regimes.

A foreign corporation that has a permanent establishment in Italy can elect the benefits of the patent box regime but only if it is a tax resident of a country that has a tax treaty with Italy containing an exchange of tax information clause.

ASSETS THAT QUALIFY FOR TREATMENT

Activity related to the development of patents and non-patented I.P. equivalents will give rise to income that qualifies for the incentive program. Purely commercial brands and trademarks are specifically excluded. A carve-out is provided for commercial brands and trademarks that require ongoing R&D expenditure.

Taxpayers must generally enter into an Advanced Pricing Agreement ("A.P.A.") with the Italian Revenue Agency to access the regime with respect to such aspects as intra-group royalties or intra-group transfers of ownership. The A.P.A. is intended to prevent Italian companies from moving excessive income from a 31.4% tax environment to a 15.7% tax environment. Income from third-party royalties or transfers of ownership does not require an A.P.A.

UNANSWERED QUESTIONS

The statutory commentary accompanying the Italian legislation makes explicit reference to the nexus requirement mentioned in the B.E.P.S. Action Plan. To receive favorable tax treatment, substantial R&D activity must take place and the income benefitting from reduced tax must be related to that activity. No definitional standard is provided under which activity will be viewed to be substantial. In addition, the types of trademarks that that generate income benefiting from the patent box regime has not been explained.

FOLLOW-UP DRAFT OF REPORT ON ACTION 6 (TREATY ABUSE) AND PUBLIC COMMENTS RELEASED

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Tags
Action 6
B.E.P.S.
Collective Investement Vehicles
Limitation on Benefits
O.E.C.D.
Preventing Treaty Abuse
Principal Purpose Test

Comments on the O.E.C.D.'s public discussion draft to the follow-up work on B.E.P.S. Action 6 (the "Follow-Up Draft") were released on January 12, 2015. Action 6 of the B.E.P.S. Action Plan focuses on preventing treaty abuse and treaty shopping, which the O.E.C.D. has identified as being one of the most important sources of B.E.P.S. concerns.

The Follow-Up Draft modifies the "Report on Action 6 (Prevent the granting of treaty benefits in appropriate circumstances)" and identifies 20 issues on which interested parties may provide comments. It focuses on matters related to the application of the limitation on benefits ("L.O.B.") rule and principal purpose test ("P.P.T.") as well as the treaty entitlement of collective investment vehicles ("C.I.V.'s") and non-C.I.V. funds. The 20 issues identified by the Follow-Up Draft and addressed in the comments are as follows:

<u>Issues Related to the L.O.B. Provision</u>

- C.I.V.'s: application of the L.O.B. and treaty entitlement,
- Non-C.I.V. funds: application of the L.O.B. and treaty entitlement,
- Commentary on the discretionary relief provision of the L.O.B. rule,
- Alternative L.O.B. provisions for E.U. countries,
- Requirement that each intermediate owner be a resident of either Contracting State,
- Issues related to the derivative benefit provision,
- Provisions dealing with "dual-listed company arrangements,"
- Timing issues related to the various provisions of the L.O.B. rule,
- Conditions for the application of the provision on publicly-listed entities, and
- Clarification of the "active business" provision.

<u>Issues Related to the P.P.T. Rule</u>

Application of the P.P.T. rule where benefits are obtained under different treaties,

- The suggestion that countries consider establishing some form of administrative process,
- Whether the application of the P.P.T. rule should be excluded from the arbitration process,

- Aligning the Commentary on the P.P.T. rule and the L.O.B. discretionary relief provision,
- Whether some form of discretionary relief should be provided under the P.P.T. rule, and
- Drafting of the alternative "conduit-P.P.T. rule."

"The main concern reflected throughout the comments is that the procedures for claiming treaty benefits are already onerous and that the Follow-Up Draft's proposals may be a disproportionate response to remedying treaty abuse."

Other Issues

- List examples in the Commentary of the P.P.T. rule,
- Application of the new treaty tie-breaker rule,
- Design and drafting of the rule applicable to permanent establishments located in third States, and
- Proposed commentary on the interaction between tax treaties and domestic anti-abuse rules.

Over 750 pages of comments were submitted by interested parties. The main concern reflected throughout the comments is that the procedures for claiming treaty benefits are already onerous and that the Follow-Up Draft's proposals may be a disproportionate response to remedying treaty abuse. Overall, the comments acknowledge the need to prevent treaty abuse but conclude that Action 6 should remain focused on removing double taxation and promoting international trade. There also appears to be a general consensus among commentators that resolving abusive tax avoidance should be achieved primarily through domestic law.

The majority of the comments were concerned with the Follow-Up Draft's implementation of the L.O.B. and P.P.T. provisions, which is seen as causing significant uncertainty and making treaty application more complicated. The L.O.B. provisions eliminate the subjectivity of determining when treaty benefits apply, but are technical and complex in their application. On the contrary, the P.P.T. provisions embrace a simple approach but their subjectivity does not offer much guidance on whether treaty benefits will be allowed.

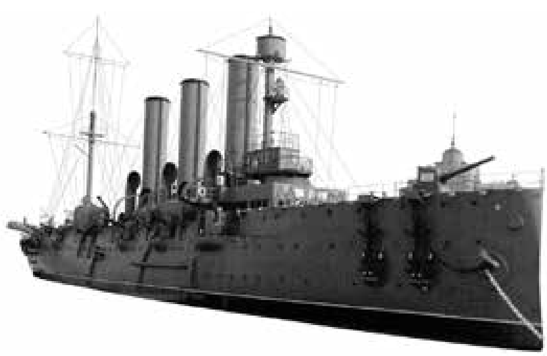
Commentators warn that in order to comply with the L.O.B. rules, the C.I.V.'s will be overburdened with tedious documentation requirements, which could hinder legitimate transactions. Many comments advise against a uniform approach to C.I.V.'s because the various structures and diverse investment base of C.I.V.'s would prevent them from accessing treaty benefits. For determining eligibility for treaty benefits, many commentators suggest that non-C.I.V.'s should be considered "look at" rather than "look through" entities, which seems to mean opaque rather than transparent. This would prevent increased reporting requirements and would be consistent with the Foreign Account Tax Compliance Act ("F.A.T.C.A.") and the Common Reporting Standards, which do not have a requirement to "look through" these entities.

There is significant concern that the L.O.B. provision requiring each intermediate owner to be a resident of a Contracting State would deny treaty benefits when there is a legitimate entitlement to such benefits. Although the L.O.B. provision is designed to deny treaty benefits when there is treaty shopping, the L.O.B. provision will also deny treaty benefits in situations when there is no treaty abuse, especially where intermediary companies are being tested along with the ultimate beneficial owners.

Many commentators favored eliminating the testing of intermediary companies because it would facilitate international trade, eradicate double taxation, and prevent companies not engaged in treaty shopping from being denied treaty benefits. Overall, there is a consensus that the L.O.B. rule should focus on the state of the ultimate beneficial owner and not the intermediate companies.

The comments in response to the Follow-Up Draft on Action 6 collectively acknowledge the need to prevent treaty abuse but are concerned that Action 6's proposals create onerous and unnecessary compliance requirements that would preclude the enjoyment of treaty benefits.

The entire report of comments on the Follow-Up Draft can be accessed through the following link: http://www.oecd.org/ctp/treaties/public-comments-action-6-follow-up-prevent-treaty-abuse.pdf.



IMPROVING DISPUTE RESOLUTION: THE WORLD OF B.E.P.S.

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Tags
B.E.P.S.
Comments
M.A.P.
Mutual Agreement Procedure

The Discussion Draft on Action plan 14 (the "Draft") received an overwhelming response. On January 19, 2015, the O.E.C.D. published over 400 pages of comments on how to make dispute resolution mechanisms more effective.

Many believe that as a result of the B.E.P.S. program, the number of treaty-related tax disputes will increase. To accommodate this surge in tax cases, it is crucial to develop an effective dispute resolution mechanism that will enhance cross-border trade.

The Draft reflects a lack of consensus regarding the Mutual Agreement Procedure ("M.A.P."). Most of the comments support creating a M.A.P. that facilitates final and binding decisions within a set timeframe. It is seen as a step towards improving the efficiency and effectiveness of the B.E.P.S. project as a whole. Creating an efficient M.A.P. will demonstrate the O.E.C.D.'s commitment to creating a mechanism that will provide progress.

Making the M.A.P. mandatory may not be enough, as other issues come into play. Here is a sampling of comments that appear in the 400 pages that were released:

- The fact that the initiative in solving the dispute remains with the Contracting States leaves the taxpayer with a limited role.[1] As a result, the opportunity of having a smoothly functioning M.A.P. with taxpayer input bows to need protecting a States' right to tax.
- The Draft pointed out that a taxpayer should not have an active role in the M.A.P. This is rooted in the belief that the involvement of the taxpayer will result in a lengthier process, which is more costly to the Contracting States. This observation may not be correct in all cases; the involvement of a taxpayer may motivate the Competent Authorities to promptly reach a good-faith agreement at an accelerated pace.[2]
- Competent Authorities initiate M.A.P. with a belief in the validity of their position. Believing in the justification of their position will make it hard for a Competent Authority to concede. As a result, the Competent Authorities may have difficulty in preserving an atmosphere necessary to reach a solution through reconciliation.[3]
- Arbitration panels should interact with the taxpayers. This interaction, which will shed light and better explain the background of the case to the panel, should facilitate the M.A.P.[4]

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1 Comments from A.O.T.C.A.-C.F.E.

2 Comments from B.D.O.

3 Comments from E.E.P.S. Monitoring Group.

4 Comments from Brose.

> *"In a normal year, this legislation would then go through several Parliamentary stages before being signed into law. This year, though, the General Election on May 7 will intervene."*

- Competent Authorities should develop a collaborative mindset and relationship with taxpayers and their advisors in order to seek the "right answer" using an objective approach rather than a self-interested approach. This may require significant cultural changes in the administrative practices of tax authorities in order to facilitate dispute resolution.[5]
- It is important to ensure that the administrative process promotes the prevention and resolution of treaty-related disputes. The Competent Authority should be independent of other parts of the revenue authority if it is to be fully effective. Nonetheless, taxpayers will see Competent Authorities as part of revenue authorities, no matter what, and that will result is disrespect for the outcome of the M.A.P.[6]
- In practice, the initiation of the M.A.P. to challenge a tax assessment in one country may trigger a tax audit in the other country. This practice can be seen as an obstacle for effective use of the M.A.P. to resolve double tax issues. The risk of facing tax examinations in both countries promotes the use of self-help by the taxpayer. Also seen as a problem is the use of ongoing and continuous requests for additional information from the taxpayer. This is frequently viewed as a *sub rosa* attempt by Competent Authorities to discourage use of M.A.P., which fosters distrust of the process.
- The obligation for the Contracting States to resolve cases in a "principled, fair and objective" manner should be expressly stated in the M.A.P. provisions of income tax treaties in order to prevent self-interest of a Competent Authority from being a roadblock to relief. The language should be "shall resolve" or "are obligated to seek to resolve." In addition, many comments suggest clarification of the meaning of "principled, fair and objective."
- Several comments suggested use of mediation in some cases. Mediation can be seen as an excellent way of resolving treaty disputes domestically or bilaterally that are relationship-based.
- The presence of a mandatory binding arbitration clause in a double tax treaty may prevent cases from being settled by the tax authorities under M.A.P. Taxpayers may believe that binding arbitration provides more complete, cost-effective, and timely relief than never-ending M.A.P. discussions between the Competent Authorities. This causes some to believe that the threat of arbitration is more effective than mandatory resort to arbitration because it will encourage timely decisions affording relief under the M.A.P.
- Access to M.A.P. should only be denied when both Contracting States agree that *prima facie* evaluation shows that the taxpayer's objection is not justified.[7]
- The existing M.A.P. process is usually lengthy. In many instances, taxpayers are required to pay the tax in both countries as a condition of initiating M.A.P. Some persons commented that an alternative provision should be adopted allowing a taxpayer to pay into escrow a single amount that is equal to the

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[5] Comments from B.D.O.

[6] Comments from I.B.A. Taxes Committee.

[7] Comments from BusinessEurope.

higher of the two deficiencies. The Competent Authorities would not have access to the cash until relief is agreed. Refunds of any excess escrow payment would be made to the taxpayer.[8]

- Some commentators suggested use of a mediator or a Professional Facilitator ("P.F.") to facilitate the granting of relief on a timely and principled basis. The P.F. could be a neutral person appointed jointly to manage the M.A.P. process and serve as a chairman/secretary at meetings. The P.F. would not be involved in assessing the case itself, but would be involved in procedural matters designed to speed-up up the M.A.P. process.[9] Alternatively, the P.F. could fulfil an important role in assisting in managing M.A.P. proceedings, establishing and preserving a collaborative working relationship between competent authorities, assessing legal and technical merits of a dispute, making factual determinations, and identifying viable pathways to resolution.[10]

- The process must be streamlined and sped up. This can be achieved by simplifying the process when small businesses are involved or the amount of the dispute is not significant. Guidelines for the simplified procedure would be helpful.[11]

- Making dispute resolution a simpler and cheaper process will allow developing countries to use M.A.P. as a tool in dispute resolution.[12]

- Secrecy undermines the goal of the B.E.P.S. initiative. Transparency will help M.N.C.'s and other taxpayers in planning their activities within the rules and avoid double taxation and the need for M.A.P. assistance.[13]

- Under established international law, local remedies must be exhausted before International Dispute Resolution can be accessed. The Draft suggests bypassing this established procedure and giving priority to M.A.P. However, going through the domestic channels will develop cases where all the issues are clear and will identify the international issues.[14]

- Paragraph 32 should be revised to clearly state that a taxpayer can choose either a domestic remedy or M.A.P. and if the taxpayer choses one, it does not result in the forfeiture of the other option.

- Some commentators suggested that choosing M.A.P. will result in undue delay for some taxpayers. The better solution would be for participating countries to commit to making counter-adjustments when a domestic law remedy applies.[15]

- Others commented that governments do not always act in good faith. For example, many governments enact domestic legislation that expressly or

8 Comments from A.O.T.C.A.-C.F.E.

9 Comments from Arnaud Booij.

10 Comments from TRIBUTE.

11 Comments from B.D.O.

12 Comments from Christian Aid.

13 Comments from B.E.P.S. Monitoring group.

14 B.E.P.S. Monitoring group, pg. 36

15 Comments from BusinessEurope.

> implicitly overrides tax treaties. Less openly, M.A.P. can be abused readily by a government seeking to delay or avoid resolution in order to prevent payment of a tax refund. Consequently, objective standards are required of governments that can be enforced by taxpayers and counter parties in the M.A.P. through recourse to domestic or international courts.

The M.A.P. process is always subject to serious practical limitations unless backed-up by an accessible arbitration system.[16]

While the overall comments approve the direction the O.E.C.D. has taken, the consensus is that the rules neither go far enough nor are they specific enough. Action 14 remains a "softball" for recalcitrant governments not acting in a principled way.

[16] Comments from I.B.A. Taxes Committee.

TRANSFER PRICING LITIGATION FROM A TO Z

Authors
Michael Peggs
Cheryl Magat

Tags
Administrative Procedures Act
Tax Court
Arm's length transactions
Cost-sharing
Transfer Pricing
Tax Litigation

A number of transfer pricing cases, many with potentially significant precedent value and tax provision consequences, are either at trial or proceeding to trial. We selected two interesting cases, *Altera* and *Zimmer*, to brief and also offer our transfer pricing commentary.

ALTERA CORP.

Altera Corp.[1] is a California-based manufacturer of programmable semiconductors and related products. It has sales of $1.8 billion world-wide. The taxpayer petitioned the U.S. Tax Court, challenging adjustments in the amount of $96.6 million, most of which relates to the inclusion by the I.R.S. of costs associated with employee stock options in its cost-sharing agreement ("C.S.A.") with its Cayman Island affiliates for years 2004 through 2007.

The taxpayer's challenge to the adjustments considers the validity of the 2003 cost-sharing regulations,[2] The Violation of Administrative Procedures Act, and the legal standard of review.

Altera claims that the 2003 Cost Sharing Regulations, which are amendments to the 1995 Regulations, violate the arm's length standard by requiring the related parties to share stock-based compensation, a transaction that is not undertaken by unrelated parties. Therefore, Treas. Reg. §1.482-7(d)(2), which requires the inclusion of stock options in the cost pool, is invalid as a matter of law because it is inconsistent with the arm's length standard set forth in Treas. Reg. §1.482-1(b)(1). In fact, the intention of I.R.C. §482 is to achieve tax parity, which can only occur if the activities of unrelated parties are considered.

The I.R.S. claims that the sharing of options costs is governed by the commensurate-with-income-standard, which does not require that third-party activities be considered, but only that it "achieves an arm's length result." Accordingly, the behavior of unrelated parties isn't relevant to determining whether its cost-sharing transaction terms are consistent with the arm's length standard, and it can be determined in any way as long as the desired result is achieved. The I.R.S. position is that stock-based compensation is an economic cost that must be included in the pool, otherwise it would distort income.

Judge Marvel asked the I.R.S. how they could analyze an issue to determine if it achieved an arm's length result if it did not take into consideration what uncontrolled parties were doing in the same situation. In response, the I.R.S. said that tax parity

1 *Altera Corp. v. Com'r., T.C.*, Nos. 6253-12, 9963-12, argument on cross motions for partial summary judgment, 7/24/14.

2 I.R.C. §482, Treas. Reg. §1.482-7(d)(2).

is achieved "if you reflect true taxable income." Therefore, taxpayers that follow the qualified cost-sharing regime achieve parity. Marvel replied, "It sounds to me like you are saying the only relevant standard is the commensurate-with-income and not the arm's length standard."

Marvel further noted that while the preamble to the 2003 Regulations states that evidence submitted by stakeholders was not sufficient, the agency did not explain why it came to that conclusion. Furthermore, the record does not support the I.R.S.'s position. "Shouldn't there be something in the rulemaking record that supports your belief that the failure to share stock-based compensation leads to distortion?" Marvel asked.

"The intention of I.R.C. §482 is to achieve tax parity, which can only occur if the activities of unrelated parties are considered. underlying statute implement."

Under the Administrative Procedures Act ("A.P.A."), a final rule cannot be enforced unless it is the product of "reasoned decision making" and is "consistent with the underlying statute it is designed to implement." Altera pointed out that the I.R.S. in fact adopted the stock-based compensation provision over the objections of multiple stakeholders, who testified that no unrelated party ever shares such costs in development deals.

Altera says that the Regulations require the I.R.S. to rely on the arm's length standard, but the administrative record does not show that the sharing of equity-based compensation ever occurs among unrelated parties. The I.R.S. is obligated under the A.P.A. to consider that record. If not, it is not the product of reasoned decision-making and the regulation should not pass review.

With regard to the final issue of the legal standard of review, the I.R.S. claims that the 2003 Regulations meet the two-step test set out by *Chevron*[3] and is further supported by *Mayo*,[4] which held that agency rules deserve deference from reviewing courts because the formulation of the policy requires "more than ordinary knowledge respecting the matters subjected to agency regulations," so as long as it is reasonable.

Altera claims that the standard should satisfy *Chevron* and *Motor Vehicle Manufacturer's Ass'n*,[5] in which the Supreme Court held that in amending a regulation, an agency must examine "relevant data" and "articulate a satisfactory explanation." If an agency fails to do so, the change is arbitrary and capricious and cannot be upheld. Altera therefore claims that the change from the 1995 Regulations to the 2003 Regulations cannot be upheld.

The Altera case is one of a number of cost-sharing cases in process. It is unique however in that it is, for all intents and purposes, a retrial of the issue of stock option expense inclusion in a C.S.A. as decided in *Xilinx*.[6] Considerable evidence of the behavior of independent signatories to joint technology development agreements was offered in amicus briefs and motions during the *Xilinx* trial proceedings. The

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3 *Chevron USA Inc. v. Natural Resources Defence Council*, 467 U.S. 837 (1984).

4 *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704, 2011 BL 6645 (2011).

5 *Motor Vehicle Manurateres Ass'n. of the U.S. Inc. v. State Farm Mutual Auto Insur. Cos.*, 463 U.S. 29 (1983).

6 125 T.C. 37 (2005), *rev'd*, 567 F.3d 482 (9th Cir. 2009), *opinion withdrawn*, 592 F.3d 1017 (9th Cir. 2010), *and aff'd*, 598 F.3d 1191 (9th Cir. 2010)

evidence submitted by trade groups and experienced industry participants supported the notion that arm's length parties do not share stock option costs.

The I.R.S. position will require clarification of the meaning of the arm's length standard. Does the standard apply to make parties transact as arm's length parties would, or cause transacting parties (or one transacting party, usually known as the tested party) to report an arm's length outcome (in this case income)?

Given that an apparent shortcoming in the I.R.S. position is its failure to adequately consider the actions of uncontrolled parties in the same situation, we considered the general definition of costs in one of the most R&D intensive industries – defense.

Defense contractors are required to account for their costs in conformity with the Federal Acquisition Regulation ("F.A.R.") Cost Principles. One of the elements of cost that is allowable under a cost plus R&D contract is stock option expense incurred as a result of the options issuance to employees carrying on the specified R&D activity. Stock appreciation rights are treated like options for F.A.R. cost purposes under these rules. Stock options only have a positive cost attribute if the option is in the money on the issue date (*i.e.*, the first date on which the number of units and the option price are known), implying that stock option cost is not always positive (if in fact the F.A.R. Cost Principles are appropriate guidance under I.R.C. §482.

Determining whether the F.A.R. principles are relevant to the pricing of joint development, joint venture of cost-sharing agreements require an analysis of comparability of attributes of the agreements carried out under Reg. §1.482-1(d). It is this comparability standard that the I.R.S. contends is of relative unimportance when contrasted with the commensurate-with-income standard in the case of Altera. Whether either an accepted standard or evidence of the behavior of third parties, such as the F.A.R. Cost Principles, is persuasive evidence in the view of the courts remains to be seen. As always, transfer pricing matters are won and lost on some combination of legal analysis and empirical evidence.

ZIMMER HOLDINGS INC.

Zimmer Holdings Inc.[7] is a publicly traded company based in Warsaw, Indiana, with worldwide operations and annual sales of $4.4 billion. Its Dutch subsidiary, Zimmer Manufacturing B.V., produces medical products through its Puerto Rico operations.

Zimmer is challenging income adjustments made by the I.R.S. of $228.5 million related to the licensing of its intangibles to its Dutch subsidiary, claiming that the adjustments made by the I.R.S. are incorrect and no tax is due for the years 2005 through 2007.

The I.R.S. has taken three separate positions. The first addresses the transfer pricing adjustments under I.R.C. §482. Zimmer claims the adjustment is incorrect because the intercompany pricing is arm's length. The intercompany agreements provide that Zimmer Manufacturing B.V. assumes all risks associated with the production of medical products and indemnifies the parent company for all liabilities, losses, claims, and costs.

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[7] *Zimmer Holdings Inc. v. Comm'r,* T.C., No. 19703-14, filed 8/13/12.

Though at opposite ends of the docket's alphabet, *Zimmer* shares at least one important trait with *Altera* from a transfer pricing perspective. The evaluation of comparability under I.R.C. §482 may well become part of the arguments of both parties and be instructive to the decision.

Where we considered the availability of third-party conventions on stock option expense treatment in the circumstance of *Altera*, the terms in agreements between independent licensors and licensees may become relevant in the case of *Zimmer*. While a review of the contractual terms pertaining to risk in the Zimmer Manufacturing B.V. agreement against other licensing agreements may lead to the conclusion that the Zimmer dealings occurred at arm's length, the actual risks incurred by the parties and the economic circumstances of the parties in the context of the intercompany licensing transaction may in fact have departed from the intent expressed in the agreement. In this case, substance determines the treatment of the transaction for transfer pricing purposes. Also relevant may be evidence from arm's length contracts and other evidence of the outcomes of commercial arrangements, which may or may not accord with the actual conduct of the parties.

Intercompany agreements are essential to have in place in the case of intangible assets transactions. Agreements evidence the intent of the parties, and are often the first line of defense in a comparability dispute. We expect *Zimmer* may, in some part, be decided on the basis of comparing intent as expressed in the intercompany agreement with actions as properly evidenced. Cooperation and communications between tax function leaders in companies and their operations and legal colleagues go a long way, in our view, to making sure form matches substance.

The second position regarded alternative adjustments under I.R.C. §367(d). Zimmer claims that that §367(d) does not apply as there were no transfers specified intangibles under I.R.C. §936(h)(3)(B), specifically goodwill and workforce-in-place. Zimmer also claims in passing its regulations under I.R.C. §367(d), the I.R.S. violated the Administrative Procedures Act. Additionally, it maintains that the §367 allegations are "internally inconsistent" because they apply royalty rates to an erroneous revenue base.

As a third alternative argument, the I.R.S. argued that intellectual property was transferred under §367(a) and imputes a transfer of $1 billion in underlying intangibles from the U.S. parent to the Dutch subsidiary. The intellectual property license agreements worth $880 million, workforce-in-place valued at $2.5 million, and goodwill valued at $11.6 million, has zero basis and therefore the transfer results in a taxable gain of $998.6 million.

Zimmer argues that no license agreements were transferred to Zimmer manufacturing, so the adjustment based on valuation of property isn't subject to §367(a)(1). Further, neither goodwill nor workforce-in-place is subject to §367(a)(1).

TAX 101:

UNDERSTANDING U.S. TAXATION OF FOREIGN INVESTMENT IN REAL PROPERTY – PART III

Author
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Tags
Branch Profits Tax
Disposition
Estate Tax
F.I.R.P.T.A.
Gift Tax
Inversion
Like-Kind Exchanges
Mortgages
Sale of Real Estate
Section 1031
Section 163
Withholding Tax

INTRODUCTION

This is the final article in a three-part series that explains U.S. taxation under the Foreign Investment in Real Property Tax Act of 1980 ("F.I.R.P.T.A."). This article looks at certain planning options available to taxpayers and the tax consequences of each.

These planning structures aim to mitigate taxation by addressing several different taxable areas of the transaction. They work to avoid gift and estate taxes, and double taxation of cross-border events and corporate earnings, while simultaneously striving for preferential treatment (*e.g.*, long-term capital gains treatment), as well as limiting over-withholding, contact with the U.S. tax system, and liability. Often, such structures are helpful in facilitating inter-family transfers and preserving the confidentiality of the persons involved.

PRE-PLANNING

As with everything else, planning can go a long way when it comes to maximizing U.S. real estate investments. Here are a few questions to ask:

Investor Background

1. Where is the investor located?

2. Where is the investment located?

3. What kind of business is the investor engaged in?

No planning can take place without asking these questions. Not only is it important to determine whether the investor's home country is relevant and whether treaties that eliminate taxes or limit benefits are applicable but also whether the investor has ties to the U.S. that could change applicable tax status. In addition, the investor's background can affect withholding and compliance requirements as well as estate and gift taxes that may be incurred.

Investment Objectives

1. What is the investment being held for?

Whether an investment is held for personal use, such as real estate being used as a residence, or for business use affects the tax treatment of the income derived from the investment.

A foreign person may decide to purchase a home in the U.S. for a number of reasons, *e.g.*, temporary stays, short-term vacation homes, job postings or for their children who may be U.S. citizens, residents or students. The tax implications that apply to a purchase of a U.S. property for personal use by a foreign person are complex in their own manner.[1]

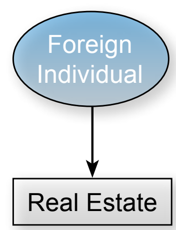
If an investment is because held for business or investment purposes, it will, or will have the potential to, produce some sort of income. As we saw in the first article of this series, different types of income are taxed differently.[2] Income must be identified as rent, interest, dividends, capital gains, or portfolio interests. The investment objective will determine whether the capital invested is held as equity or debt, as well as the type of entity that should hold the investment. Finally, the duration and method of exit should to be determined before an investment terminates.

"Although directly owning U.S. real estate may seem like a simpler transaction than a structured holding, the tax consequences can be severe for a foreign person."

STRUCTURED INVESTMENT OPTIONS

This section will look at a few of the planning options available to foreign persons when considering investing in U.S. real property.[3]

Option 1



Although directly owning U.S. real estate may seem like a simpler transaction than a structured holding, the tax consequences can be severe for a foreign person.

If the foreign person's ownership of U.S. real estate is part of a U.S. trade or business, current net rental income will be taxed at ordinary income tax rates.3 If the foreign person is not involved in a U.S. trade or business (and does not elect to be so treated), a 30% withholding tax on the gross rental income will apply.

A 10% F.I.R.P.T.A. withholding tax applies to a transfer of U.S. real estate by a foreign person. While the withholding tax is calculated based on the amount realized on the sale, the actual tax on disposition can be higher or lower depending on the amount of gain realized upon the transfer.

The potential U.S. estate tax consequences are the key disadvantage. On the death of the foreign person, U.S. estate tax of approximately 40% can apply.

U.S. tax laws provide for only a $60,000 exemption from said tax, although an estate tax treaty may provide a different result. Consequently, a foreign person may want to consider planning the investment through an entity or procure life insurance to provide liquidity upon death for any U.S. estate tax.

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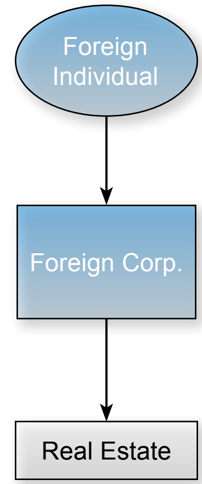
1 See *TAX NOTES*, Sept. 3, 2007, p. 863, "Home Thoughts From Abroad: Foreign Purchases of U.S. Homes."

2 See *Insights* Vol. 1 No. 10, "Tax 101: Understanding U.S. Taxation Of Foreign Investment In Real Property – Part I."

3 See "Foreign Ownership of U.S. Real Estate."

4 See *Institutional Investment Real Estate Magazine*, "Tax Structuring of Foreign Investment in U.S. Real Estate."

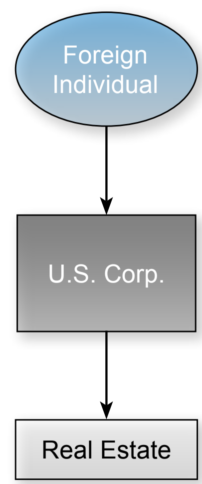
Option 2



Although the corporate level taxes on current income may be slightly lower than the maximum rates applicable to individuals, taxes on the sale of real estate and repatriation of funds may be higher for a corporation owning U.S. real property. In addition, current income and income from the disposition may be subject to an additional branch profits tax of up to 30%, and even when branch profits tax does not apply at the sale and wind-up of the U.S. investment, the sales proceeds must be kept out of the U.S. for three years and the statute of limitations must be extended to six years. If this is not done, branch profits tax can be imposed on the gains and deferred branch profits tax can be triggered.

However, owning U.S. real estate through a foreign corporation also has its advantages. The sale of stock in the foreign corporation will be tax-free to a nonresident alien individual or foreign corporate holder, and U.S. estate tax will not apply where the real property owner is a foreign corporation rather than an individual. The nonresident alien individual decedent holds an interest only in non-U.S. situs property, and therefore, the asset is not subject to U.S. estate tax.

Option 3



Although owning U.S. real estate through a U.S. corporation will eliminate the branch profits tax, the holding will incur tax on all other fronts and is ordinarily not recommended.

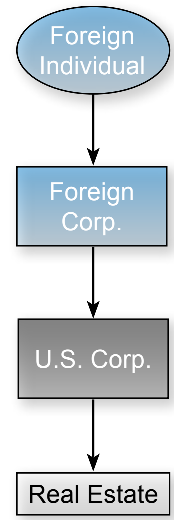
The sale of stock in a U.S. corporation owning exclusively U.S. real estate is taxable since it would constitute the sale of a F.I.R.P.T.A. asset. Distributions by the U.S. corporation may be subject to a 30% withholding tax. The withholding tax may be reduced by treaty.

Shares of a domestic corporation are U.S.-situs property for U.S. estate tax purposes. The single level corporation does not shield the real property from being subject to estate tax in the absence of an estate tax treaty. Regrettably, relatively few estate tax treaties exist in comparison to income tax treaties and fewer still are in the process of being negotiated.

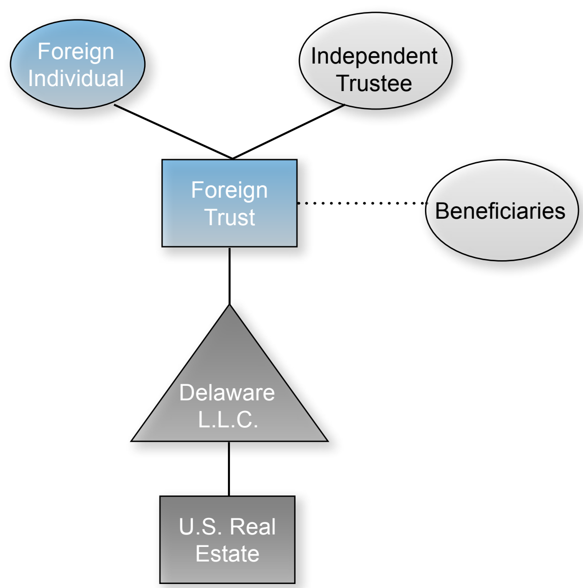
Option 4

A triple tiered investment (where a foreign individual owns stock in a foreign corporation that, in turn, owns a U.S. corporation holding real estate) is a commonly recommended structure, with significant tax advantages.

Branch profits tax will not be applicable, although dividend distributions may attract a withholding tax. However, liquidating distributions after the sale of all U.S. real property interests by the U.S. corporation will not attract U.S. withholding tax. In addition, U.S. estate or gift tax will not apply. However, cash distributions to shareholders funded by the proceeds of a refinancing will probably be taxed.[5]



Option 5



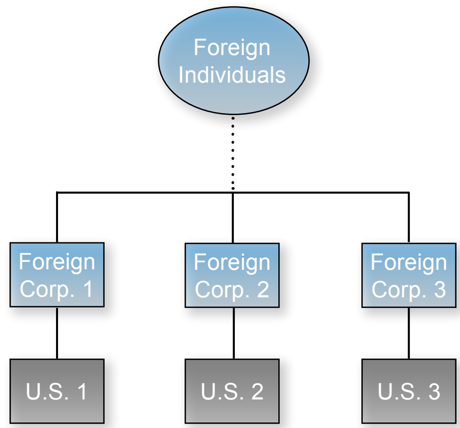
In this structure, a foreign trust is used to own U.S. real estate through a Delaware L.L.C. The trust will be treated like an individual for tax purposes (subject to the individual, not corporate, rates), and the transfer of cash is not subject to a gift tax, if properly structured. Assets in the trust are not subject to estate tax at the time of demise provided that the taxpayer did not retain the right to income during lifetime, the trust is not revocable or amendable, and the individual does not retain any dominion or control over the trust or its assets. A foreign trust is not subject to net investment income tax.

5 *Id.*

Multiple Property Structures

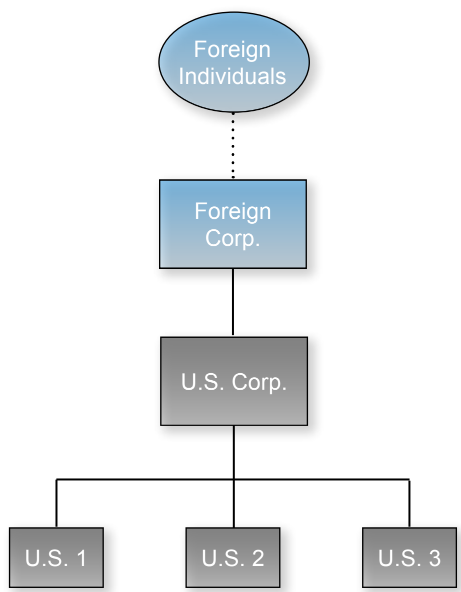
"The advantage of creating a U.S. consolidated group permits gains and losses of each property to offset each other."

Option 1



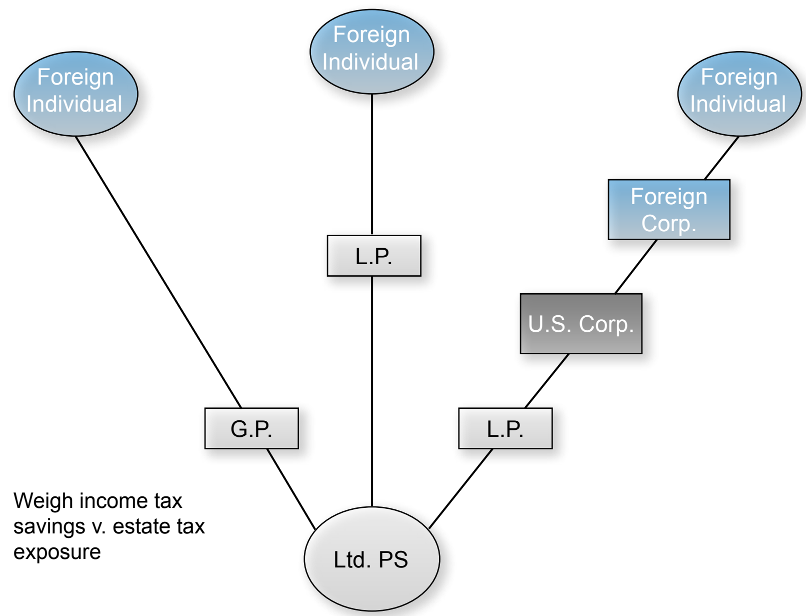
The advantage of brother-sister corporations owned by separate foreign corporations is the ability to sell one property and distribute the proceeds free of further U.S. withholding tax. Gains and losses from one U.S. property cannot be offset against gains and losses of another U.S. property.

Option 2



The advantage of creating a U.S. consolidated group permits gains and losses of each property to offset each other, potentially saving tax dollars on a current basis. However, a distribution of sales proceeds may be subject to U.S. withholding tax if the group continues to own U.S. real property.

Traditional Partnership Structure



Note that in this structure, there is an investment in a U.S. flow-through entity (a partnership) owned indirectly by an individual using the structure in Option 4.

FINANCING CONSIDERATIONS

Debt Equity

Being financed through debt gives an entity the opportunity to deduct some of the interest payment and reduce the overall tax obligation.[6] The I.R.S. will look at debt-or-creditor relationships carefully where the parties are related to make sure these loans are not equity disguised as debt.

To ensure financing of real estate is not classified as equity, certain guidelines must be followed. All of the loans should be documents, and the overall terms should be at arm's length. The payment terms must be achievable, and the interest rates reasonable. The terms should be observed and lender must take steps an unrelated lender would take to monitor and enforce the loan. It is generally prudent to pay interest at least annually and to amortize some portion of the loan balance.

Earnings Stripping – "Disqualified Interest"[7]

Earnings stripping reduces the amount of taxable income by paying excess interest to related third parties, known as Disqualified Interest. Section 163(j) aims to limit deductions for Disqualified Interest but may only do so if the debt/equity ratio exceeds 1.5 to 1.

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6 See *Insights* Vol. 1 No. 3, "Tax 101: Financing a U.S. Subsidiary – Debt vs. Equity."

7 §163(j).

Disqualified Interest comes in three forms:

1. Untaxed interest paid to a related person;
2. Interest paid to a third party when no U.S. gross basis tax is imposed and the debt is supported by a foreign related person; and
3. Interest paid by a taxable R.E.I.T. subsidiary to a R.E.I.T.

Earnings stripping limits the deduction for net interest expense to 50% of "adjusted taxable income," which is the functional equivalent of E.B.I.T.D.A. with a limited number of adjustments. Excess interest is carried forward to future years.

Applicable High Yield Debt Obligation ("A.H.Y.D.O.")[8]

A.H.Y.D.O. applies if:

- The borrower is a corporation;
- The term exceeds five years; and
- The original issue discount is at a rate greater than AFR + 5%.

"The branch profits tax generally applies if the foreign corporation directly owns the U.S. property."

Where these factors exist, the excess interest (*viz.*, interest in excess of AFR + 5%) is non-deductible. If the lender is related, the non-excess is not deducted until it is paid. If the lender is related, §267(a)(3) interest and §163(e)(3) original issue discount ("O.I.D.") defer deduction until interest is paid.

Branch Profits Tax Considerations

Branch profits tax is the tax applied to earnings from a foreign corporation's branch entity in the U.S. The branch profits tax generally applies if the foreign corporation directly owns the U.S. property. It is a 30% tax paid in addition to income tax paid by a foreign corporation abroad, unless reduced by treaty.

The tax may not adversely affect foreign investors in U.S. real property if the foreign corporation directly owns U.S. real estate and that property is not income producing. A branch profits tax may apply when that property is eventually sold, unless all U.S. operations are terminated and the conditions mentioned above are met.[9]

Generally, the branch profits tax is eliminated by having a U.S. corporation own all of the U.S. income-producing real property.

Like-Kind Exchanges[10]

Section 1031[11] allows for the deferral of tax if the gain from the disposition of real property is reinvested in similar property that constitutes a "like-kind exchange." Most fee interests in real estate are like-kind to each other, including improved-to-unimproved property and residential-to-commercial property, provided they are used in a trade or business or are held for investment. In addition, a lease of 30 years or more is considered like-kind to a fee interest. While foreign properties can be

8 §163(e)(5) & (i).

9 See "Branch profits tax for nonresident investors in U.S. real estate."

10 See "Like-Kind Exchanges Under IRC Code Section 1031."

11 §1031.

exchanged for each other, U.S. and non-U.S. property are not treated as like-kind.

Like-kind exchanges are not limited by taxpayer type. Any taxpayers may participate in a like-kind exchange.

There must be an exchange of properties to fall under a like-kind exchange. The different types of exchanges are as follows:

- Swaps: One property is 'swapped' for another, *e.g.*, a building for a building;
- Deferred Exchanges: A disposal of property is followed by the acquisition of one or more other like-kind replacement properties. A disposal and subsequent purchase is usually taxable. However, for a like-kind exchange, the transactions must be mutually dependent parts of an integrated transaction constituting an exchange of property. Qualified intermediaries are generally used to effect a non-simultaneous like-kind exchange; and
- Reverse Exchanges: Replacement property is acquired through an exchange accommodation titleholder with whom it is parked for no more than 180 days, during which the previous property is relinquished.

As mentioned above, the properties involved must be held for use in a trade or business or for investment. Property used for personal use does not qualify. The properties must be of a similar nature, character, or class to qualify as like-kind. Most real estate will usually be considered like-kind to other real estate except for non-U.S. property. Real property is never considered like-kind to personal property.

There is a 45-day limit from the disposition of one property in which to identify potential replacement properties in writing to the seller of the replacement or intermediary. In addition, the replacement property must be received and the exchange completed within the earlier of 180 days of the sale of the exchanged property or the due date of the income tax return of the year.

The gain in a like-kind exchange will be deferred and the taxpayer must keep track of the basis in the new property. The basis will be the same as the basis of the property disposed of, which will preserve the deferred gain for later. On the other hand, the resulting depreciable basis of the replacement property will be calculated as much lower than if the property was acquired in a taxable transaction.

"Like-kind exchanges are not limited by taxpayer type. Any taxpayers may participate in a like-kind exchange."

A like-kind exchange must be reported on a Form 8824; otherwise, the taxpayer may be held liable for taxes, penalties, and interest.

Section 1031 exchanges involving a F.I.R.P.T.A. asset are subject to F.I.R.P.T.A. withholding unless certain exceptions apply. It is not uncommon to obtain a withholding certificate if there is no tax due or if the tax on the exchange is less than the amount required to be withheld.

CONCLUSION

Foreign investment in U.S. real property is fraught with minefields. However, there are a number of options available to individuals and corporations. These structures maximize treaty benefits and limit tax liability when exercised in the proper manner. But they require detailed planning and may affect other corporate or personal transactions.

CORPORATE MATTERS:
LIMITED LIABILITY COMPANY AGREEMENTS

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Tags
Capital Accounts Distributions
L.L.C.
Operating Agreement
Ownership Interest
Tax Allocations

In a previous issue, we discussed shareholder agreements and set out items that one should look for in such an agreement.[1] A related topic, but one with subtle differences – particularly on the tax side – concerns the agreements used to govern the management and operation of limited liability companies. In the Delaware Limited Liability Company Act,[2] these agreements are referred to as "limited liability company agreements," and in the New York Limited Liability Company Law,[3] they are referred to as "operating agreements." In practice, however, the terms are used interchangeably. For purposes of this article, we will use limited liability company agreement ("L.L.C. Agreement"), as Delaware is the state most frequently used for limited liability company formation.

STATE REQUIREMENTS

Although many states do not require a limited liability company to have an executed L.L.C. Agreement, it is prudent to outline the internal governance procedures of the entity in a legal document. There really is no reason why the members of a limited liability company should not have a functioning governing document. An L.L.C. Agreement does not necessarily have to be a long or complicated document; it will allow you to effectively structure your financial and working relationship with your co-owners in a way that is suited to the type of business you are engaged in. Furthermore, having an agreement will help protect your limited liability status, particularly for single-member limited liability companies, as well as prevent management disagreements and ensure that the business is governed by rules of your making, rather than as stipulated by a particular state statute.

Care should be taken in drafting the agreement, however, as although many statutes provide a lot of discretion for members of a limited liability company to define the terms of their relationship – state statutes contain fundamental governing provisions that members of a limited liability company can contract out of – courts have relied on the plain language contained in the contracts and have resisted creating ambiguities based on extrinsic evidence.[4]

Oral contracts could lead to uncertainty if the relationship deteriorates, as a court may look to the applicable state statute to provide terms for the parties' L.L.C. Agreement with the possibility that the court-imposed terms will differ from any oral agreement settled between the parties.

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1 See *Insights* Vol. 1 No. 3, "Corporate Matters: Shareholder Agreements."

2 6 *Del*. C. §18-101 *et seq*.

3 N.Y. Ltd. Co. Law § 101 *et seq.*

4 *In re Nextmedia Investors, LLC,* C.A. No. 4067-VCS (Del. Ch. May 6, 2009)

AGREEMENT

Ownership Interest

Ownership interest is typically expressed as a percentage interest and usually determined by the initial capital contribution to the company. Capital contributed in return for an ownership interest can be in the form of cash, property, services, or promissory note. If assets other than cash are contributed, a value is usually attributed to the asset; this can be negotiated between the parties. In most cases, ownership certificates will not be issued and a member's interest is evidenced by the executed L.L.C. Agreement. However, ownership "units" can be created and unit certificates obtained which give a limited liability company more of the look and feel of a corporation.

The ownership interest comprises an economic interest and a management interest in the company. Interests can be non-voting and different classes of ownership can be created, such as convertible and preferred, etc.

Capital Accounts

Each member of a limited liability company has a capital account, which essentially keeps a record of a member's equity investment in the partnership determined by reference to the principles or practices of the financial accounting method used by the partnership. Additionally, for allocation of partnership income, gain, loss, or deduction to have "substantial economic effect" under applicable federal tax rules, such amounts must be reflected as debits or credits to capital accounts in a manner described in the Treasury Regulations. It is therefore possible for a partner to have two different capital accounts if the partnership maintains a set of financial accounting books and also maintains proper capital accounts for tax allocation purposes. Note that both types of capital accounts must be carefully distinguished from a partner's "outside" tax basis in his partnership interest. There is an important and useful mathematical relationship between a partner's tax capital account and his adjusted tax basis in his partnership interest: Generally, a partner's tax basis in his partnership interest is equal to the sum of his tax capital account and his share of partnership liabilities.

"Ownership interest is typically expressed as a percentage interest and usually determined by the initial capital contribution to the company."

Tax Allocations and Distributions (in Liquidation or Otherwise)

The "economics" of the limited liability company are reflected in its tax allocation and distribution sections. As indicated above, an allocation to a member of his or her share of profits or losses of the limited liability company under the terms of the L.L.C. Agreement will be respected for tax purposes if it has "substantial economic effect" or if it is in accordance with the members' "interests" in the limited liability company. There are several approaches to drafting these important provisions. In many if not most agreements, a member's share of capital contributions, profits, losses, and cash flow will be the same. In such cases, these provisions are fairly straightforward and, generally, are based on the member's percentage interest in the limited liability company.

Not all distributions to members are "straight up" distributions based on percentage interests. Often, there are so-called "waterfall" distribution provisions. Under such provisions, the anticipated distributions are set forth in the agreement in order of priority, with the tax allocations adjusted to be consistent with the cash distributions to the members. In other cases, a member may be granted a so-called "carried interest," which offers that member the right to future profits without a commensurate capital contribution (often in connection with services rendered or to be rendered to the limited liability company). In this case, the tax allocations drive the distributions because the carried interest member is not entitled to share in pre-admission profits or "value."

Tax law mandates certain allocations. For example, §704(c) of the Internal Revenue Code provides that income, gain, loss, or deduction attributable to property contributed to a limited liability company by a member must be allocated to the contributing member solely for tax purposes. This prevents the shifting of tax consequences among members with respect to pre-contribution gain or loss. A limited liability company is required to allocate income, gain, loss, and deduction for contributed property so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution.

"Tax law mandates certain allocations."

It is common for the L.L.C. Agreement to provide for preferred returns to some members, to distinguish between operating profits and profits from extraordinary "capital" events, and to include a provision that delays the payment of equity capital until the liquidation and dissolution of the limited liability company. Many agreements provides for tax distributions, recognizing that members will be taxed on limited liability company profits whether they are distributed or not. It is important to read and draft the tax allocations and distribution provisions in a manner so that these provisions work consistently.

MANAGEMENT

Management of a limited liability company can be by the members, a managing member, or a board of managers. If a managing member is selected, care should be given to stipulating in the agreement the range of activities he can conduct for the company. Limits on his or her authority can also be important and a common way of doing this is to include a list of actions that can only be undertaken following a super-majority vote or the authorizing vote of an identified member. If a board of managers is appointed, the agreement should lay out how it is appointed, how members are removed, and how to replace members.

TRANSFER

Limited liability companies often have the same transfer restrictions as partnerships and corporations. The most typical transfer restriction is a right of first refusal. Depending on the industry, a list may be prepared of individuals or companies to which an ownership interest cannot be transferred. Members may also have a veto right on transfers. Often, permitted transferees are identified, enabling members to transfer interests to affiliated entities or for estate planning purposes.

LIQUIDATION AND DISSOLUTION

Most L.L.C. Agreements provide the procedures for dissolving the limited liability company and liquidating (and distributing) its assets. In the absence of procedures set forth in the L.L.C. Agreement, the law of the state in which the limited liability company is organized will provide default procedures. L.L.C. Agreements often require dissolution upon the occurrence of one or more specified events, such as the sale of substantially all the assets of the company, or may provide for a fixed term.

F.A.T.C.A. 24/7

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Tags
F.A.T.C.A.

GLOBAL TAX TRANSPARENCY IS RISING

The Foreign Account Tax Compliance Act ("F.A.T.C.A.") enacted in 2010 has been the driving force and the primary impetus for global tax transparency across borders. It has led to a ginormous administrative challenge for banks and other financial institutions as well as withholding agents in 2015. The O.E.C.D.'s recent release of the common reporting standard has led Treasury Department officials to view it as "the multilateralization of F.A.T.C.A."

The U.S. has negotiated more than 100 Intergovernmental Agreements ("I.G.A.'s") with nations across the globe to implement F.A.T.C.A and allow tax information to be shared between governments, which has set the stage for discussion for the onset of global exchange of tax information. More than 50 I.G.A.'s had already been signed and the remainder are treated as in effect and should be signed soon.

I.G.A. Challenge

The I.G.A.'s represent a growing trend in global tax transparency, though implementation has posed a challenge to some nations. Implementing an I.G.A. may require changes to local legislation, such as approving actions that are required to be taken under the I.G.A. and thus essentially making F.A.T.C.A. a part of the law of that country. The Internal Revenue service ("I.R.S.") said in December 2014 that jurisdictions with I.G.A.'s treated as agreed-in-substance will have more time to get the pacts signed if they can demonstrate "firm resolve" to finalize them, which is subject to a monthly review. Given the uncertainty of whether all agreed-in-substance I.G.A.'s will eventually be signed, and what the language of the signed I.G.A. will provide, 2015 will pose a growing concern for foreign financial institutions ("F.F.I.'s"), who are required to navigate multinational F.A.T.C.A. compliance, and for banks, who must put new procedures in place.

Common Reporting Standard

On January 12, the I.R.S. has launched the system that foreign banks and tax authorities will use to send U.S. account information to the U.S. under F.A.T.C.A., known as the International Data Exchange Service. Additionally, the U.S. can use its double-encryption mechanism to send data to other countries in cases involving reciprocal I.G.A.'s.

The global movement toward a common reporting standard ("C.R.S.") continues to gather steam internationally, though implementation may still prove difficult. Fifty countries have agreed to be early adopters of C.R.S., but the U.S. isn't among them. Treasury officials have said that while the U.S. strongly supports C.R.S., putting the regime in place in the U.S. could take several years due to the legislative fixes necessary. Given the U.S.'s lack of involvement in the C.R.S., it is possible U.S. investment funds will get negative treatment outside the U.S., such as F.F.I.'s becoming reluctant to deal with U.S. funds.

B.E.P.S.

The existence of different tax regimes across the globe has led to many opportunities when trying to find the best place to do business or own intellectual property that can be licensed to affiliates. However, this jurisdiction shopping has fostered extreme complexity, revenue loss for many nations (including the U.S.), and additional compliance and audit activities, burdening companies and local tax authorities. The O.E.C.D.'s base erosion and profit shifting ("B.E.P.S.") project started several years ago to address this situation and create a more uniform global tax environment to address the situation where companies might face multiple levels of tax on the same income. Among other things, B.E.P.S. addresses transfer pricing and the use of hybrid entities and other special purpose entities. The B.E.P.S. initiative is also trying to create uniformity as certain countries implement local B.E.P.S.-inspired legislation or regulations. Detailed B.E.P.S. guidance is expected later this year.

O.V.D.P. to Remain Open

In a January 28 news release, the I.R.S. announced that its Offshore Voluntary Disclosure Program ("O.V.D.P."), which allows U.S. citizens and taxpayers to disclose to the U.S. government their overseas assets in exchange for a set penalty and protection from criminal prosecution, will remain open until otherwise specified.

Taxpayers and practitioners have indicated a strong interest in the O.V.D.P. I.R.S. Commissioner John Koskinen stressed that with his agency's string of successful enforcement actions, "It's a bad bet to hide money and income offshore."

Despite several years of budget cuts, "the I.R.S. continues to pursue cases in all parts of the world, regardless of whether the person hiding money overseas chooses a bank with no offices on U.S. soil," the I.R.S. cautioned.[1]

Conclusion

Given the increased flow of cross-border information brought on by globalization in the digital age and the increased information reporting achieved by treaties and agreements, there will be an ever increasing focus on international tax audits. The borders between more jurisdictions are increasing their transparency and in some cases account information can even be spontaneously sent to the U.S. Thus, taxpayers can no longer focus only on their U.S. exposure, but rather must look to global compliance.

F.A.T.C.A. DUE DILIGENCE REQUIREMENT UPDATE – ACTION NEEDED

Once an entity has determined that it is a Foreign Financial Institution ("F.F.I.") and registered on the I.R.S. F.A.T.C.A. webpage to get a G.I.I.N., then the F.F.I. has

[1] IR-2015-09, "Hiding Money or Income Offshore Among the 'Dirty Dozen' List of Tax Scams for the 2015 Filing Season."

to start the due diligence process to determine if it has any U.S. account holders. For those F.F.I.'s based in I.G.A. countries, Annex I provides the procedures for conducting that due diligence. Local guidance will also govern that process, provided that such guidance does not frustrate the purpose of the I.G.A.

The I.R.S. issues general guidance on the due diligence process and constantly updates their website with relevant Questions and Answers ("Q&A's") which provide further guidance and clarifications. Such guidance may also apply to I.G.A. F.F.I.'s, and while it would not govern the actual I.G.A., it may govern local guidance which deviates from the I.G.A.

This was demonstrated in the I.R.S.'s recent update to the F.A.T.C.A. Q&A. The I.R.S. recently added a new Question 10 to its list of questions relating to General Compliance. The question asked whether a Reporting Model 1 F.F.I. or a Reporting Model 2 F.F.I. can open an individual account if it does not have a Form W-8BEN or acceptable self certification form from the individual. The I.R.S.'s answer was no; a Reporting Model 1 or 2 F.F.I. cannot open an *individual* account unless it has a Form W-8BEN, a substitute Form W-8BEN, or a self-certification from the individual account owner. While this is consistent with the language of Annex I in Model 1 I.G.A.'s, this addition clarifies that no change to such directive may be made in local guidance.

"A substitute Form W-8 can be in a foreign language, provided that an English translation of the form and its contents is made available to the I.R.S. upon request."

While the furnishing of a Form W-8 is the best procedure to use to determine the F.A.T.C.A. status of an account owner, self-certification may be an acceptable alternative. Based on Question 9 in the General Compliance section of the I.R.S.'s F.A.T.C.A. Q&A, to be acceptable, a self-certification must be signed, dated, and contain the following items:

1. Name of account owner;
2. Residence address of the account owner for tax purposes;
3. Jurisdiction of residence for tax purposes—a U.S. citizen living abroad is still a U.S. tax resident;
4. Taxpayer identification number—a U.S. Person must give their U.S. taxpayer identification number while a non-U.S. person must give the taxpayer identification number they use for their tax residence country;
5. In the case of an entity, the entity's F.A.T.C.A. status (*e.g.*, Reporting Model 1 F.F.I., Passive N.F.F.E., etc.); and
6. In the case of an account owner that is a Passive N.F.F.E., the name, residence address for tax purposes, and taxpayer identification number of any Controlling Person who is a Specified U.S. person (*e.g.*, a U.S. citizen who owns the company).

The answer to Question 8 in the General Compliance section also notes that a substitute Form W-8 can be used. The answer says a substitute Form W-8 can be in a foreign language, provided that an English translation of the form and its contents is made available to the I.R.S. upon request.

More guidance is given in these Questions and Answers. While this source of information is helpful, it does complicate F.A.T.C.A. compliance since it means there is an additional place that must be checked before certainty on a F.A.T.C.A. issue can be obtained.

F.A.T.C.A. INELIGIBLE FOR I.R.S. RULINGS

In Revenue Procedure 2015-7, 2015-1 IRB 231, effective January 2, the I.R.S. has released an updated list of international tax matters for which they will not issue rulings or determination letters. F.A.T.C.A. is on the list of areas where the I.R.S. will not rule.

Item 27 on the list of the areas in which rulings or determination letters will ordinarily not be issued states:

> (27) Sections 1471, 1472, 1473, and 1474 - Taxes to Enforce Reporting on Certain Foreign Accounts. - Whether a taxpayer, withholding agent, or intermediary has properly applied the requirements of chapter 4 of the Internal Revenue Code (sections 1471 through 1474, also known as "FATCA") or of an applicable intergovernmental agreement to implement FATCA.

The I.R.S. has made this determination based upon the issue in question being either inherently factual or for other reasons, such as F.A.T.C.A.'s complexity.

THE DUTCH F.A.T.C.A. GUIDANCE NOTES

On January 22, the Dutch Ministry of Finance published the Dutch guidance notes in relation to the I.G.A. concluded between the Netherlands and the United States with respect to the intergovernmental implementation of F.A.T.C.A. The guidance notes contain a clarification of certain definitions and procedures to be followed by companies that are considered Dutch financial institutions for F.A.T.C.A. purposes. The publication of the Dutch guidance notes follows the approval of the I.G.A. by the Dutch House of Representatives. The I.G.A. is still subject to the approval of the Dutch Senate (voting is planned to take place in the first quarter of 2015).

CURRENT I.G.A. PARTNER COUNTRIES

To date, the U.S. has signed or reached an agreement to sign more than 100 Model 1 I.G.A.'s. An I.G.A has become a global standard in government efforts to curb tax evasion and avoidance on offshore activities and encourage transparency.

At this time, the countries that are Model 1 partners by execution of an agreement or concluding an agreement in principle are:

"To date, the U.S. has signed or reached an agreement to sign more than 100 Model 1 I.G.A.'s."

Algeria
Angola
Anguilla
Antigua & Barbuda
Australia
Azerbaijan
Bahamas
Bahrain
Barbados
Belarus
Belgium
Brazil
British Virgin Islands
Bulgaria
Cabo Verde
Cambodia
Canada
Cayman Islands
China
Colombia
Costa Rica
Croatia
Curaçao
Cyprus
Czech Republic
Denmark
Dominica
Dominican Republic
Estonia
Finland
France
Georgia
Germany
Gibraltar
Greece
Greenland
Grenada
Guernsey
Guyana
Haiti
Holy See
Honduras
Hungary
Iceland
India
Indonesia
Ireland
Isle of Man
Israel
Italy
Jamaica
Jersey
Kazakhstan
Kosovo
Kuwait
Latvia
Liechtenstein
Lithuania
Luxembourg
Malaysia
Malta
Mauritius
Mexico
Montenegro
Montserrat
Netherlands
New Zealand
Norway
Panama
Peru
Philippines
Poland
Portugal
Qatar
Romania
Saudi Arabia
Serbia
Seychelles
Slovak Republic
Slovenia
South Africa
South Korea
Spain
St. Kitts & Nevis
St. Lucia
St. Vincent & the Grenadines
Sweden
Thailand
Trinidad & Tobago
Tunisia
Turkey
Turkmenistan
Turks & Caicos Islands
Ukraine
United Arab Emirates
United Kingdom
Uzbekistan

The countries that are Model 2 partners by execution of an agreement or concluding an agreement in principle are: Armenia, Austria, Bermuda, Chile, Hong Kong, Iraq, Japan, Macao, Moldova, Nicaragua, Paraguay, San Marino, Switzerland, and Taiwan.

This list is expected to continue to grow.

UPDATES & OTHER TIDBITS

Authors
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Tags
Action Plan 5
B.E.P.S.
Code §1014(b)(9)
Failure to Report
Private Client Practice
Remittance Basis
Remittance Charge
Step-Up Basis
Tax Evasion
Transfer Pricing
United Kingdom

BUSINESSMAN PLEADS GUILTY TO CONCEALING $8.4 MILLION

A Connecticut business executive, George Landegger, pled guilty to willfully failing to report $8.4 million held in Swiss bank accounts to the I.R.S.[1] During the early 2000's until 2010, Landegger maintained undeclared accounts which reached a maximum value of over $8.4 million at an unidentified Swiss bank.

While Landegger's defense attorney confirmed that Landegger has not been accepted to the Offshore Voluntary Disclosure Program ("O.V.D.P."), Landegger, according to the prosecutors, repeatedly rejected the possibility of disclosing his undeclared accounts to the I.R.S. through the O.V.D.P. and instead proactively took steps to conceal his accounts. Landegger held his undeclared accounts in a sham entity formed by a Swiss lawyer under the laws of Liechtenstein. In August 2013, the Swiss lawyer pled guilty to tax fraud conspiracy charges and has been cooperating with prosecutors.

Landegger agreed to pay a civil penalty of over $4.2 million and more than $71,000 in back taxes as part of his plea, entered on January 15, 2015. Landegger's sentencing will be held May 12. He faces a maximum sentence of five years in prison. In his statement, I.R.S. Acting Special Agent-in-Charge Thomas E. Bishop stressed that uncovering hidden offshore accounts and income is the Service's top priority and that it will continue working with the Department of Justice to do so. This case illustrustrates the importance of a timely O.V.D.P. submission.

OBAMA PROPOSES INCREASE IN CAPITAL GAINS TAX, ELIMINATION OF STEPPED-UP BASIS ON INHERITED ASSETS

President Obama has proposed a 28% tax rate on capital gains for couples with $500,000 in annual income and eliminating the stepped-up basis on inherited investments. Obama believes that these tax increases will help to pay for expanded benefits for middle- and low-income households. Congressional Republicans have indicated that they would not support Obama's proposal.

Obama's increase of the "step-up" basis rule mentioned in Code §1014(b)(9) might have consequences in the private client sphere. Under the gift tax regime, in general, the transferee receives a "carryover" basis from the transferor as opposed to a stepped up basis, which eventually may result in a higher capital gains tax on a gift

1 *United States v. Landegger*, S.D.N.Y., No. 15-cr-00032, *guilty plea* 1/16/15

as opposed to an inheritance. Obama's rule change may result in planning where the gift of an asset is preferred over inheriting an asset, as it may avoid ancillary fees, such as probate. States which have their own estate tax but lack a gift tax might also oppose the bill, as they would face a loss of revenue if transfer of an asset is made during the individual's lifetime.

B.E.P.S. NEWS: COUNTRY-BY-COUNTRY REPORT THRESHOLD SET AT €750 MILLION

Multinationals who have annual gross revenue over €750 million in their country of residence will be required to report, on a country-by-country basis, information on revenues, profits, and taxes accrued and paid, along with some other activity indicators to other countries, through a reporting template. The reporting will begin in 2016 and administrators will begin exchanging the reports in 2017.

In order to protect confidentiality, the O.E.C.D. believes that the primary way of reporting this information should be done through a tax treaty or information exchange agreement, and that such information should be remitted automatically. However, in the event that a country that is entitled to receive a report does not due to administrative errors, a secondary method, such as a local filing, may be used instead.

"Setting the threshold at €750 million only addresses the concerns regarding the costs companies will be confronted with to comply with these requirements."

The reporting requirements the O.E.C.D. has introduced under the B.E.P.S. action plan on transfer pricing have already raised concerns with respect to the amount of information that companies will have to share with tax authorities under the country-to-country reporting system. Setting the threshold at €750 million only addresses the concerns regarding the costs companies will be confronted with to comply with these requirements. It is yet to be seen how confidentiality of such information will be ensured across multiple countries.

SHIFTING PROFITS OVERSEAS

In its latest report, the Congressional Research Service found that U.S. corporations have been increasingly shifting profits from high-tax to low-tax jurisdictions without any economic motive.

The multinational companies have used techniques such as debt shifting and earnings stripping to save on taxes. Foreign profits have resulted in low-tax jurisdictions that are considered tax havens in a greater proportion in relation to their gross domestic product.

Earnings stripping is when profits are shifted by borrowing more in high-tax jurisdictions and less in low-tax areas, allocating more interest to the high-tax jurisdiction. Since interest expense is deductible, the interest paid back from a high-tax jurisdiction will bring down the overall tax consequence. In addition, interest income may receive favorable treatment if it meets the conditions set forth under both domestic law as applicable income tax treaties, if any. This is seen when a foreign parent lends to its U.S. subsidiary.

The Congressional Research Service report publishing these findings was released on the same day as the Stop Corporate Inversions Act of 2015 ("the Proposal") was

proposed by Senate Minority Whip Dick Durbin (D-IL), House Ways and Means Committee Ranking Member Sander Levin (D-MI), Senator Jack Reed (D-RI), and Representative Lloyd Doggett (D-TX). The Proposal was originally introduced by Levin and three dozen other Democrats in May 2014 and addresses U.S. companies inverting by shifting their parent entity to a tax haven. It aims at reducing the incentive to invert by treating the combined foreign corporation as a domestic corporation for tax purposes if the historic shareholders of the U.S. corporation own more than 50% of the combined foreign corporation, or if the affiliated group is managed and controlled in the U.S. and engaged in significant U.S. business activities. The proposed legislation is said to save the U.S. nearly $34 billion in revenue, according to a recent estimate from the Joint Committee on Taxation. Inversions have been on the legislative radar since 2004 and have been heavily targeted in various drafts the past few years, most recently, prior to this Proposal, in Notice 2014-52, 2014-42 IRB 712. It is notable that, if enacted, the proposed legislation would be effective for any inversion transactions completed after May 8, 2014.

'THE WHOLE TRUTH' – I.R.S.

The latest forms 14653 and 14654 for the Streamlined Offshore Voluntary Disclosure Program require a "narrative statement of facts" explaining the taxpayer's failure to disclose offshore assets. Without a detailed explanation certifying that the taxpayer's conduct was non-willful, penalty relief will not be granted. Under the Streamlined Domestic Offshore Procedure, the penalty is 5% of the foreign assets giving rise to the tax compliance issue, and as low as 0% under certain circumstances for the Streamlined Foreign Offshore Procedure. On June 14, 2014, the I.R.S. announced changes in its offshore voluntary compliance program. These changes included an expansion of the streamlined filing compliance procedures announced in 2012 by eliminating the following requirements:

- That the taxpayer have $1,500 or less of unpaid tax per year; and
- The completion of the risk questionnaire.

However, it also introduced a requirement for the taxpayer to certify that previous failures to comply were due to non-willful conduct. While practitioners were already aware of the explanation requirement to be met or access would be denied by the I.R.S., the new forms have made it official: the easing of some of the requirements is not to be construed to mean that access to the Streamlined Offshore Procedure will be granted without adequate explanation for non-willful failure to comply.

U.K. NON-DOMICILED REMITTANCE CHANGES PROPOSED

In order to attract foreign-domiciled individuals to U.K. residency, the U.K. allows a non-domiciled resident individual to pay tax on the remittance basis rather than the arising basis. As a result, U.K. tax on non-U.K. source income is deferred until the income is brought into the country. This enables wealthy persons from outside the U.K. to fund living costs in the U.K. exclusively from accumulated capital, leaving offshore income untouched and untaxed.

This benefit is obtainable free of any compensating charges for seven years. Thereafter, the U.K. imposes a "remittance basis charge." The charge for non-domiciled U.K. residents who have been resident for more than seven of the most recent nine prior years is £30,000. The charge is £50,000 for those who have been U.K. resident for 12 out of the most recent 14 tax years.

The U.K. government has proposed modifications to the way the remittance basis charge is imposed.

- The charge for individuals who have been resident 12 out of the last 14 years will be increased to £60,000.
- The charge for, for individuals who have been resident for 17 out of the last 20 years will be increased to £90,000.
- For those individuals who are subject to the charge, remittance basis taxation must be elected in three-year tranches in order to eliminate the opportunity to elect in and out of remittance taxation in a way that takes advantage of bunching income in a year in which remittance taxation is elected so that there is little taxable income reported in a year when no election is made.

IN THE NEWS

SPONSORSHIP

For the second year running, Ruchelman P.L.L.C. will sponsor the *ABA/IFA Tax Planning Strategies U.S. and Europe Conference* in Munich, Germany on April 15-17, 2015. Now in its 15th year, the annual conference focuses on recent legislative developments impacting global companies with panel discussions featuring industry leaders, senior government officials, and leading tax practitioners from the United States and Europe. Key topics will include the E.U. Commission investigations into illegal State Aid, new Treasury rules aimed at deterring corporate inversions of U.S. corporations, and the furture of exchange of information in light of new G-20 and O.E.C. D. agreements, the B.E.P.S. Action Plan, and F.A.T.C.A.

OUR RECENT AND UPCOMING PRESENTATIONS

On November 3-4, 2014, Galia Antebi presened "F.A.T.C.A. and the I.G.A. – How German Businesses, U.S. Citizens, and German Financial Advisors are Affected" before the American German Business Club in Munich and Frankfurt, Germany. The presentation included a top level review of Form W-8BEN-E for German businesses, Form W-9/W-8BEN for German resident individuals, and the due diligence process for the financial services sector.

On November 12, 2014 Stanley C. Ruchelman and Kenneth Lobo presented at the Halton-Peel C.P.A. Association's *Life of a U.S. Investment – U.S. Tax Issues Commonly Encountered* in Mississauga, Ontario. The discussion, entitled "U.S. Tax Points to Remember in a Cross Border Investment," addressed a full range of topics involved in managing inbound and outbound investments, including entity classification, tax treatment under §367 of asset transfers, working with Subpart F, working with P.F.I.C.'s, U.S. rules designed to eliminate excessive benefits, international attacks on excessive benefits, and permanent establishment issues.

On November 13, 2014, Nina Krauthamer lectured on "Understanding U.S. Taxation of Foreign Investment in Real Property: F.I.R.P.T.A. and Beyond" at New York Law School. The program, aimed at demystifying U.S. tax considerations for a foreign person investing in U.S. real estate, explained basic income, estate, and gift tax rules; presented special tax planning considerations; and considered common tax traps for the unwary foreign investor.

On November 24, 2014, Stanley C. Ruchelman and Kenneth Lobo lectured at the *U.S. Tax Bootcamp* hosted by Cadesky and Associates in Toronto, Canada, where they discussed inbound investment into the U.S., including the U.S. estate and gift tax regime, structures to avoid when purchasing U.S. real property, and strategies when purchasing U.S. rental properties.

On December 19, 2014, Stanley C. Ruchelman and Kenneth Lobo presented "The Life of an Outbound Investment from the U.S. into Canada" to the B.C. chapter of the Canadian Bar Association in Vancouver, Canada. The topics addressed included entity classification, tax treatment under §367 of asset transfers, Subpart F, P.F.I.C.'s, U.S. and international attacks on excessive benefits, and permanent establishment issues.

On January 18-20, 2015, Stanley C. Ruchelman participated in the *ITSG 2015 Conference* in Calgary. Presentations included: "Double Irish Sandwich: Google Feasts, European Governments Suffer Heartburn," on international pushback on C.F.C. planning arragements; "How Much Equity is Enough Equity in a U.S. Entity?" regarding characterization of intercompany loans; and "Action 4: Limit Base Erosion - Interest Payments and Other Financial Payments," which addressed O.E.C.D. guidance for combatting B.E.P.S.

On April 17, 2015, Stanley C. Ruchelman will participate in the panel "Exchange of Information Going Global: FATCA, OECD, EU and Beyond" as part of the *ABA/IFA Tax Planning Strategies U.S. and Europe Conference* in Munich, Germany. The discussion will outline the evolution of global exchange of tax information, beginning with the U.S. enactment of F.A.T.C.A. in 2010 and continuing on to the proliferation of similar programs across the globe. It will explore the obligations imposed on taxpayers and the overlapping nature of these separate regimes.

Copies of our presentations are available on the firm website: www.ruchelaw.com/publications, or by clicking the links 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.

Disclaimer

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