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INSIGHTS

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EDITORS' NOTE

In this month's edition of *Insights*, our articles address the following:

- **2015 Summer Budget Announced in U.K.** The first Conservative budget in almost 20 years was announced in July. Large corporations are the winners. Non-domiciled individuals and hedge fund partners holding carried interests are the losers. More funds were appropriated for tax shelter witch-hunts. Martin Mann, Paul Howard, and John Hood of Gabelle L.L.P., London tell all.

- **Tax Rulings in the European Union – State Aid as the European Commission's Sword Leading to Transparency on Rulings.** Beate Erwin explains how non-tax concepts in the E.U. are being used by the European Commission to prevent multinationals from obtaining private comfort letters from tax authorities.

- **Eaton Corp.'s Transfer Pricing Trial Begins August 24.** The U.S. Tax Court's transfer pricing trial in *Eaton Corp. v. Commr.* will begin on August 24, 2015, despite attempts by the I.R.S. to delay the trial. Christine Long and Andrew Mitchel explain how the outcome could impact the I.R.S. Advance Pricing Agreement Program and the finality of these agreements with other taxpayers.

- **P.L.R. 201446025 – A Change of I.R.S. Direction?** When a tax exempt charity is formed, the organization seeks an I.R.S. ruling or obtains a determination letter confirming that status. What happens when an existing tax exempt charity moves its charter from one state to another or changes its structure? Nina Krauthamer reports on a recent private letter ruling that eases the reporting obligations of the entity.

- **S.T.A.R.S. Transactions – Interest Deduction Allowed but Foreign Tax Credit Disallowed.** No one at the I.R.S. likes an abusive tax shelter, and when one is discovered, all tax benefits are disallowed. However, tax jurisprudence in the U.S. gives recognition for tax purposes to transactions that impact a taxpayer's economic position. In *Salem Financial, Inc. v. United States*, an appeals court disallowed foreign tax credits arising from a financial product as a sham, but allowed deductions for interest expense arising from a *bona fide* loan to finance participation in the shelter. Stanley C. Ruchelman and Christine Long report on this Solomonesque approach to economic substance – very un-B.E.P.S.

- **Legislation to Relax F.I.R.P.T.A. Gets Bipartisan Support.** Watch out, the lobbyists are coming! Cast as tax legislation to encourage foreign investment in U.S. real estate made through R.E.I.T.'s, legislation to provide more funding and profits for large R.E.I.T. operators was recently introduced in both the House and the Senate. To make up for the tax loss, F.I.R.P.T.A. withholding on everyone else will be increased. Philip Hirschfeld reports.

- **Could an I.R.S. Employee's Comment Cause Yahoo! Stock to Fall?** In order to be tax free, a spinoff such as Yahoo!'s proposed spinoff of Alibaba stock must meet four basic statutory requirements, of which one requires both corporations to be engaged in an active trade or business. How big must that trade or business be? Yahoo! plans to expand the envelope. Elizabeth V. Zanet explains and describes how one I.R.S. attorney's innocent comment sent Yahoo! stock into a tail spin.

- **The Hewlett-Packard Debt v. Equity Case – Reply Brief Filed.** In the typical debt-versus-equity case, the I.R.S. argues for equity characterization and the taxpayer argues for debt treatment in order to deduct the interest. But that is not always the case and roles can be reversed, especially in cross border transactions. In *PepsiCo Puerto Rico, Inc. v. Commr.*, the taxpayer successfully argued that a debt instrument was properly treated as equity, but in *Hewlett-Packard Co. v. Commr.*, the taxpayer lost. The HP decision has been appealed. Galia Antebi, Nina Krauthamer, and Sheryl Shah discuss the facts that support the Tax Court's opinion and the basis of HP's appeal.

- **Reinsurance Case Invalidates Tax on Foreign-to-Foreign Withholding Transactions.** Congress often drafts legislation in the international provisions of the Code that literally can impose tax more than once as payments move through a stream of entities. In *Validus Reinsurance, Ltd. v. U.S.*, the Appeals Court held that a cascading Federal excise tax should not apply to reinsurance on a foreign-to-foreign transaction. A literal reading of the Code is not allowable where it results in extraterritorial application of U.S. tax law that is not specifically intended. Philip R. Hirschfeld and Kenneth Lobo explain.

- **More Swiss Banks Reach Resolution Under D.O.J.'s Swiss Bank Program.** Galia Antebi and Elizabeth V. Zanet discuss the Program for Non-Prosecution Agreements involving Swiss banks now that two years have elapsed since its announcement. As many as 106 banks have entered the Swiss Bank Program.

- **Can B.E.P.S. Survive without U.S. Support?** Rusudan Shervashidze looks at Action 15 of B.E.P.S., which involves the drafting of a multilateral instrument that will address misuse of income tax treaties. While 83 countries have expressed interest in joining the discussion to limit treaty benefits, one notable absentee is not among them.

- **Is an E.U. Financial Transactions Tax Coming in 2016?** Elizabeth V. Zanet and John Chown ponder whether the E.U. will adopt an F.T.T. now that 11 states have agreed to work on its implementation. Open issues exist.

- **Corporate Matters: Buy/Sell Arrangements.** Buy/Sell provisions deal with the transfer of ownership interests when one of the partners wants out, or, potentially, wants another partner out. Simon Prisk explains how a shotgun buy/sell provision works.

- **F.A.T.C.A. 24/7.** Each month, Philip R. Hirschfeld and Galia Antebi discuss recent developments involving F.A.T.C.A. This month, they address (i) F.A.T.C.A. implementation now that one year has passed since reporting obligations have "gone live"; (ii) the intersection of F.A.T.C.A. and C.R.S.; (iii) recent disputes between the U.S. and each of the U.K. and Canada regarding differences of opinion on self-certification of foreign accounts at time of opening; (iv) registration of sponsored entities; (v) recent I.D.E.S. F.A.Q.'s; (vi) rumors of additional regulations; (vii) F.A.T.C.A. events in Brazil, Belarus, and Cyprus; (ix) Q.I. applications in light of F.A.T.C.A.; and (x) the monthly list of current I.G.A. partner countries.

We hope you enjoy this issue.

\- The Editors

2015 SUMMER BUDGET ANNOUNCED IN U.K.[1]

Authors
Martin Mann
Paul Howard
John Hood

Tags
Investment Managers
Non-Dom Taxation
Seed Capital Schemes
U.K. Corporation Tax
U.K. Residential Property

The first Conservative budget for nearly two decades set out plans to cut welfare spending; commit to not raising income tax, National Insurance, or V.A.T. for the lifetime of this parliament; boost the minimum wage; and move the U.K. from a lower wage, higher tax, higher welfare economy to a higher wage, lower tax, lower welfare country. Large corporations appear to be winners, while individuals who have benefitted from the special treatment for non-domiciled individuals and hedge fund members benefitting from carried interests are the losers. The crackdown on tax avoidance continues to be a dominant theme.

CORPORATION TAX – REDUCTION IN RATE

The main corporation tax rate for April 1, 2016 is set at 20% for all profits other than ring-fenced profits from oil activities. The rate for all non-ring-fenced profits will reduce to 19% from April 1, 2017 and will further reduce to 18%, with effect from April 1, 2020.

NON-DOMICILED INDIVIDUALS – PERMANENT NON-DOM STATUS TO END

Individuals who are resident and domiciled in the U.K. are taxed on their worldwide income and gains. Individuals who are resident but not domiciled in the U.K. ("non-doms") may claim the benefits of remittance basis taxation so that they are taxed only when foreign income and gains are remitted to the U.K. Long-term non-doms are able to claim the remittance basis but are usually required to pay a remittance basis charge ("R.B.C.") of between £30,000 to £90,000 per annum for the privilege of retaining that status. The charge increases with the length of time non-dom status is maintained.

U.K. domiciled individuals are subject to inheritance tax ("I.H.T.") on worldwide assets. In contrast, non-doms are usually subject to I.H.T. only in relation to U.K. property, modified by certain anti-avoidance rules. For example, non-doms who are long-term residents are deemed to be U.K. domiciled for I.H.T. purposes after being resident in the U.K. for 17 of the most recent 20 tax years. As a result, they are liable to I.H.T. on worldwide assets. These long-term non-doms can lose their deemed domicile status only by being non-U.K.-resident for four tax years.

Some U.K.-domiciled individuals may acquire non-dom status by leaving the U.K. to settle in a foreign country on a permanent basis. Often, if they return to the U.K.

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[1] Also contributing to this article are Thomas Dalby, Priya Dutta, and Lawrence Adair, all of Gabelle LLP.

their U.K. domicile status reverts on their return, but in a small minority of cases, they may assert that they retain their non-dom status for some time.

Some non-doms settle offshore trusts. Provided the trust does not have any U.K.-source income and the individual does not remit the trust income to the U.K., the trust income may not be subject to tax in the U.K. Further, "excluded property trusts" may not be subject to I.H.T.

From April 2017, an individual who has been resident in the U.K. for 15 of the most recent 20 years will be taxed on worldwide income and gains. There will be no special grandfathering rules for those already in the U.K. The government will consult on whether split years will count toward the 15 years. They will also consult on the need to retain a *de minimis* exemption beyond 15 years where total unremitted foreign income and gains amount to less than £2,000.

In addition, an individual who has been resident in the U.K. for 15 out of the last 20 years will be subject to I.H.T. on worldwide assets. Individuals born in the U.K. to U.K.-domiciled parents will no longer be able to claim non-dom status if they leave the U.K. but then return and take up residency.

Special new rules will apply to offshore trusts. Non-doms who have set up offshore trusts and are deemed domiciled under the 15-year rule will not be taxed on the trust income and gains that are retained in the trust, and such excluded property trusts will have the same I.H.T. treatment as at present, subject to I.H.T. changes regarding the taxation of residential property, discussed below. Such individuals will be taxed on any benefits received from trusts on a worldwide basis from April 2017. Further details will be available during consultation.

Non-doms need to review their tax arrangements. Some long-term residents may wish to leave the U.K. before the new rules take effect and advice should be sought in this regard. Those that wish to remain and those coming to the U.K. will need advice on the new tax reality.

NON-DOMS – I.H.T. ON RESIDENTIAL PROPERTY CHANGES

As mentioned above, individuals who are domiciled (or deemed to be domiciled) in the U.K. are subject to I.H.T. on worldwide assets. In contrast, non-doms are subject to I.H.T. only on assets situated in the U.K. Foreign assets are excluded from the scope of I.H.T.

Where U.K. residential property is held directly by a non-dom individual, it is subject to I.H.T. at 40%, as reduced by applicable relief measures. If the non-dom individual holds shares in an offshore company that holds the U.K. property ("enveloping"), there is no I.H.T. charged upon death because the non-dom holds non-U.K. property – the shares in the offshore company. Similarly, offshore trusts are subject to I.H.T. on holdings of U.K. property but may avoid such charges by enveloping the property within an offshore company.

With effect from April 6, 2017 the government intends to amend the I.H.T. rules so that non-doms and offshore trusts owning U.K. residential property through an offshore company, partnership, or other opaque vehicle will pay I.H.T. on the value of

> *"Individuals who are domiciled (or deemed to be domiciled) in the U.K. are subject to I.H.T. on worldwide assets. In contrast, non-doms are subject to I.H.T. only on assets situated in the U.K."*

that property. This will be achieved by changing the status of the shares of offshore companies or similar structures to the extent that they derive their value directly or indirectly from U.K. residential property. The foreign shares will no longer be treated as excluded property

Where the company holds a number of assets, only the value of the residential property should be subject to tax. A deduction should be available for borrowings taken out to purchase the U.K. property, and the spousal exemption and other forms of relief may also apply.

The rules will only apply to U.K. residential property and not to U.K. commercial property or other U.K. assets. A special exemption will apply to widely-held vehicles that hold U.K. residential property.

The government will consult on the implementation of the proposals and further details will be provided in the consultation.

This is the latest line of attack on the holding of U.K. residential property through offshore corporate structures. The rules follow the introduction of the Annual Tax on Enveloped Dwellings ("A.T.E.D.") in April 2013 and the non-resident capital gains tax ("C.G.T.") in April 2015. Like the A.T.E.D. rules, the intention of these new rules is to encourage the de-enveloping of U.K. property.

In this respect, the A.T.E.D. rules were largely unsuccessful. Many retained corporate holdings of U.K. property because of the I.H.T. benefits and the tax costs associated with de-enveloping. It is intended that the new rules will remove such I.H.T. advantages. The government has also indicated that it will consider the costs associated with de-enveloping during the course of the consultation. As a result, it is expected that many corporate structures will de-envelope U.K. residential property in the coming months.

ANNUAL INVESTMENT ALLOWANCE PERMANENTLY INCREASED AT A REDUCED LEVEL

Since January 2013, an annual investment allowance ("A.I.A.") has been available to provide businesses with a 100% deduction for qualifying capital expenditures. When the legislation was introduced, the allowance was set at £25,000. However, there have since been a number of temporary changes to this limit, including the temporary increase to £500,000 that is currently in place for qualifying expenditures incurred in the period from April 2014 to December 31, 2015.

From January 1, 2016, the A.I.A. will be increased on a permanent basis from £25,000 to £200,000. Transitional rules will apply for any chargeable periods that straddle January 1, 2016.

Businesses looking to invest in a significant quantity of qualifying plants and machinery may wish to accelerate spending so that it falls with the higher threshold of £500,000 applicable up to December 31, 2015. Care will need to be taken with respect to expenditures incurred within the chargeable period straddling the change in allowances in order to maximize A.I.A. availability.

AMORTIZATION OF GOODWILL

Currently, when a company acquires goodwill or customer-related intangibles from an unrelated party, it can claim a corporation tax deduction for amortization recognized in its profit and loss account. Alternatively, the company can elect for a fixed deduction of 4% a year. If, on disposal, the company makes a loss, this usually forms part of the company's trading profit or loss for the year.

Legislation will be introduced to withdraw relief for all goodwill and customer-related intangibles acquired on or after July 8, 2015, except where the acquisition is pursuant to an unconditional obligation entered into before that date. If a loss arises on the disposal of assets falling into these new rules, it will be treated as a non-trade expense. This means that if the cost cannot be set off against other profits in the year of disposal, it will not be available to offset trading profits in subsequent years. A corporation tax deduction will continue to be available for amortization on other types of intangible assets.

Goodwill acquired before July 8, 2015 will continue to be treated under the old rules; so, a corporation tax deduction will continue to be available for amortization, and any loss on disposal will be treated as part of the company's trading profit or loss for the year of the disposal. The purpose of this new provision is to remove the tax relief available when a business acquisition is structured as an asset purchase so that goodwill can be recognized. This will bring the rules for business asset purchases into line with those for companies who purchase only the shares of the target company.

"Legislation will be introduced to withdraw relief for all goodwill and customer-related intangibles acquired on or after July 8, 2015, except..."

These provisions almost return companies to the position they held prior to the introduction of the intangible rules in 2002, except that indexation is not available when goodwill is disposed of at a profit. As a result, companies may have three types of goodwill on their balance sheets: pre-2002 goodwill that is dealt with under capital gains tax principles; goodwill acquired before July 8, 2015 with respect to which amortization can be deducted for corporation tax purposes; and new goodwill, which is dealt with under the intangible rules but for which amortization is not deductible for corporation tax purposes.

CORPORATION TAX – CONSORTIUM RELIEF AND LINK COMPANIES

A claim and surrender of group relief can currently be made between a company with a share in a consortium (a "member of the consortium") and the consortium company (the "company owned by a consortium").

Relief is extended to companies in the same group as a member of the consortium that is defined as a "link company" but only where the link company is located in the U.K. or (subject to meeting certain requirements) in either an E.U. Member State or in Iceland, Liechtenstein, or Norway.

In a measure first announced in Autumn Statement 2014, legislation will be introduced to remove the requirements relating to the location of the link company. This revision will have effect for consortium claims to group relief for accounting periods on or after December 10, 2014. Removing the location condition from the legislation will make the operation of the relief simpler and therefore more attractive to those looking to invest by entering into a consortium.

CARRIED INTEREST – CHANGES TO C.G.T. BASE COST CALCULATION

Employees of fund managers and private equity companies often participate in structures (typically partnerships) that allow them to benefit from some of the growth in the value of the assets they manage. The return that participants in these structures receive, generally known as a "carried interest," is taxable under the C.G.T. rules.

The treatment of the participants in a carried interest arrangement is the same as for any other member of a partnership and follows the scheme set out in Statement of Practice D12 ("S.P. D12"). In part, that statement applies when a partnership asset is revalued. Each partner is credited in his/her current or capital account with a sum equal to his/her fractional share of the increase in value. An upward revaluation of taxable assets is not itself an occasion to impose tax. The combined effect of S.P. D12 and various planning techniques can mean that book transactions undertaken by the partnership can boost an individual's base cost of the carried interest for C.G.T. purposes, so that it is higher than the actual amounts invested by that person. This has the effect that the individual will pay less C.G.T. than they would otherwise.

The proposed changes take effect immediately and are narrowly targeted at persons who provide investment management services for a collective investment scheme. The effects of the rule change will be that any amounts received from a carried interest partnership structure will be treated as being proceeds subject to C.G.T. and participants' base costs will be limited to the amounts that they actually paid to acquire interests in the carried interest vehicle.

At this stage, the impact of these changes is difficult to gauge; for participants in carried interest partnerships, the change is likely to increase the amount of tax that they will pay on profits; for the industry as a whole, the changes may result in a move to adopt alternatives to the partnership structures currently used for carried interest vehicles.

CONSULTATION ON TAXATION OF PAYMENTS TO INVESTMENT MANAGERS

The budget announces that the government will initiate a consultation process on taxation of performance linked rewards paid to asset managers.

Investment managers are typically rewarded in a number of ways, two of the most significant being:

- The opportunity to effectively invest in the assets that they are managing on behalf of their client or employer investment funds (*i.e.*, carried interest), the returns on which are treated as capital; and
- Performance based fees, which are treated as a reward for services and taxed as trading income.

The consultation is a response to the actions taken by some investment managers to attempt to reclassify their trading activities as investment activity. This would lead to the performance based fees being classified as capital rather than income and being taxable under the C.G.T. rules rather than the income tax rules.

The consultation follows on from the introduction of legislation on disguised management fees in Finance Act 2015 and proposes to set out tests in legislation to clarify which performance fees are capital and which are taxable under the income tax rules.

The consultation document outlines alternative potential statutory regimes that could be adopted and seeks respondents' views on the relative merits of the two proposals. One approach would list particular activities that are, in the government's view, clearly investment activity such that a performance linked interest in a fund vehicle performing such activities may be charged to tax as chargeable gains provided certain conditions are met. The alternative would focus on the length of time for which the underlying investments are held.

It is not anticipated that the treatment of performance related rewards which have historically been subject to capital gains tax will change as a result of this consultation.

AMENDMENTS TO TAX-ADVANTAGED VENTURE CAPITAL SCHEMES

Tax-advantaged venture capital schemes are subject to E.U. state aid rules, which were changed last year.[2] As a result of the changes, a number of amendments needed to be made to the existing provisions governing investments in Enterprise Investment Schemes ("E.I.S."), Seed Enterprise Investment Schemes ("S.E.I.S."), and Venture Capital Trust Schemes ("V.C.T.") that are eligible for tax reliefs (referred to collectively as "risk finance investments" or "R.F.I.'s"). The amendments were subject to consultation, and draft legislation was published on March 24, 2015. The consultation closed on May 15, 2015.

A number of changes to the E.I.S., S.E.I.S., and V.C.T. rules have now been proposed. Unless stated otherwise, the measures take effect from the date of Royal Assent.

- If an individual subscribes for additional shares in a company, the new shares will not be eligible for E.I.S. relief, unless the individual has either made an R.F.I. in the company before Royal Assent or the individual's prior shares in the company (excluding founders' shares) were qualified as an R.F.I.
- A new requirement will be introduced for the money to be used for the growth and development of the company (or subsidiary company).
- The rule prohibiting the use of money for the acquisition of shares will be extended to all investments made by V.C.T.'s on or after Royal Assent.
- A new rule will be introduced to prevent companies from using E.I.S. and V.C.T. investments to acquire a business.

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2 See the article authored by Beate Erwin on this point that appears in this edition, here.

- Companies must raise their first investment under R.F.I. within seven years of making their first commercial sale or ten years if the company is a knowledge-intensive company (as defined in Summer Finance Bill 2015). However, no age limit will apply to companies raising an investment where the amount of the investment is at least 50% of the company's annual turnover, averaged over the previous five years.

- In addition to the existing £5 million cap on annual investments, a new cap will be introduced on the total amount of investments a company may raise under an R.F.I., *i.e.*, £12 million in general and £20 million for knowledge-intensive companies. Any R.F.I.'s used by a business previously owned by another company will count towards the total funding limit.

- Knowledge-intensive companies are permitted to have up to 500 employees for raising capital by R.F.I.'s.

- Companies will no longer need to use at least 70% of S.E.I.S. funds before raising funds under E.I.S. or V.C.T. (with effect from April 6, 2015).

- E.I.S. relief of investors in companies that redeem the shares of S.E.I.S. investors will no longer be reduced, so long as the S.E.I.S. relief on the redeemed shares is repaid (with effect from April 6, 2014).

- Farming outside the U.K. will not be an eligible activity for E.I.S., S.E.I.S., V.C.T., and Enterprise Management Incentives.

"For accounting periods that straddle July 8, 2015, the relief will be restricted on a just and reasonable basis."

C.F.C. LOSS RESTRICTION

The U.K. controlled foreign company ("C.F.C.") regime targets profits that have been diverted from the U.K. Under current rules, a C.F.C. charge is computed by reference to the profits of the C.F.C. during an accounting period. A claim can be made to offset certain expenses and losses to reduce the amount of tax payable.

Where profits arise within a C.F.C. accounting period starting on or after July 8, 2015, relief for these expenses and losses will no longer be available. This specifically includes:

- Losses and surplus expenses arising in the current year or brought forward from previous years; and

- Losses and surplus expenses arising in other group companies.

For accounting periods that straddle July 8, 2015, the relief will be restricted on a just and reasonable basis.

This change, which will affect large U.K. companies with overseas subsidiaries in low-tax jurisdictions, is part of the measures to counter perceived tax avoidance (particularly by multinational groups) and maintain the competitiveness of the U.K. corporation tax regime.

TRANSFERS OF STOCK AND INTANGIBLES BETWEEN CONNECTED PARTIES

There are special rules that apply to the transfer of shares of stock for corporation tax and income tax purposes, and to transfers of intangible assets for corporation tax purposes. These provisions typically provide that transfers are treated as taking place at market value ("fair market value rules"). However, where the transfer pricing legislation contained in Chapter 1 of Part 4 of Taxation (International and Other Provisions) Act 2010 ("T.I.O.P.A.") applies, it supersedes the fair market value rules. Under the transfer pricing rules, it is possible to obtain a tax advantage by fixing a transfer pricing price that is lower than the market value of the stock transferred.

Legislation will be introduced to revise the interaction between the fair market value rules and Part 4 of T.I.O.P.A. so that a further adjustment can be made under the market value rules in the Corporation Tax Act ("C.T.A.") or the Income Tax (Trading and Other Income) Act ("I.T.T.O.I.A."). The measure will have effect for transfers of trading stock or intangible fixed assets made on or after July 8, 2015.

These amendments will ensure that disposals made outside the normal course of business are brought into account for tax purposes at full fair market value. This amendment will stop corporate groups from using a transfer pricing rule to manipulate the value of assets in intragroup transfers.

H.M.R.C. TO INVEST £800 MILLION TO RAISE £7.5 BILLION FOR TREASURY

The Chancellor of the Exchequer announced in March that H.M.R.C. was expected to raise £5 billion from investigating tax avoidance and evasion. The budget announces that £800 million is budgeted to recover £7.5 billion in tax, showing that H.M.R.C. intends to dedicate compliance resources to investigate U.K. residents that have participated in tax avoidance schemes or evaded taxes.

H.M.R.C. was criticized by the Public Accounts Committee earlier this year for not prosecuting more people in relation to the HSBC Swiss data provided by the French government, and it is not surprising that criminal investigations are set to triple. To enhance the powers available to H.M.R.C. to identify tax evasion, H.M.R.C. wants the authority to formally obtain data from online intermediaries and payment providers on U.K.-resident businesses to ensure that their tax affairs are in order.

H.M.R.C. is continually looking at ways to obtain additional information from suppliers and intermediaries that could be used to target tax evasion and the hidden economy. This raises questions about how the information is retained and the safeguards in place to ensure that it is used only for the purpose for which it was obtained.

There will also be an increased focus on businesses and individuals who participate in tax avoidance schemes, with the threat of serial avoiders being named and shamed, as well as subjected to surcharges on the most recent tax returns.

TACKLING OFFSHORE EVASION

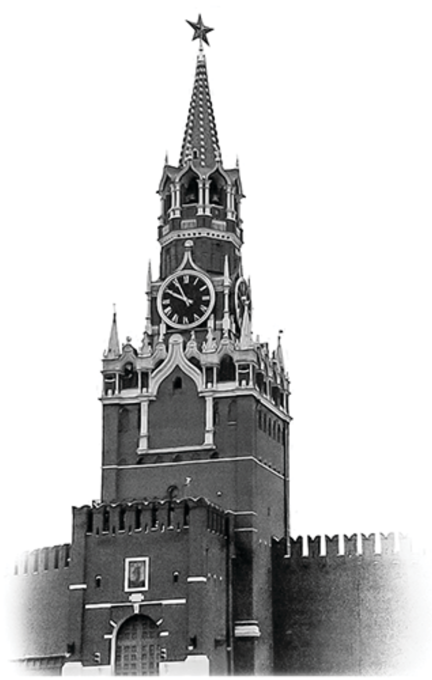
The U.K. has already entered into agreements to automatically exchange information with the U.S. under the F.A.T.C.A. legislation and with the U.K. Crown Dependencies under automatic exchange of information agreements. The U.K. will also receive information from the British Overseas Territories on U.K. residents holding assets in those territories.

The O.E.C.D. has also introduced a Common Reporting Standard for the automatic exchange of information between member states, which is scheduled to start in 2017.

From early 2016, following consultation with professional and representative bodies, H.M.R.C. wishes to introduce legislation that will require financial institutions, tax advisers, and other professionals ("relevant persons") to notify their clients that information will be automatically exchanged. The legislation will also require a disclosure of the type and detail of the information to be exchanged, and the criminal and civil penalties that apply in relation to tax evasion.

H.M.R.C. realizes that it is essential that U.K. residents are made aware that most countries will automatically exchange information from 2017 on and that it will be very difficult to hide income and/or gains overseas. This initiative may well be connected to the proposed strict liability offence in relation to non-disclosure of overseas assets.

H.M.R.C. believes that there are still significant overseas assets that have not been disclosed. The purpose of this initiative is to "shake the tree" and ensure that U.K. intermediaries and professionals notify clients of the risks involved in not ensuring their tax affairs are in order. This is almost certainly linked to the statement that H.M.R.C. intends to triple the number of criminal investigations for tax evasion.



TAX RULINGS IN THE EUROPEAN UNION – STATE AID AS THE EUROPEAN COMMISION'S SWORD LEADING TO TRANSPARENCY RULINGS

Author
Beate Erwin

Tags
E.U. Commission
Germany
State Aid
Transparency
T.F.E.U.

The European Union's plan on putting an end to corporate tax breaks granted by means of letter rulings ran into German privacy concerns as E.U. Finance ministers met on June 19, 2015. The initiative, aimed at implementing an automatic exchange of letter rulings granted by E.U. Member States, will affect E.U. businesses as well as European operations of foreign multinationals, including those based in the United States. Examples of the latter are already under review by the E.U. Commission with regard to letter rulings issued by Ireland and the Netherlands, respectively, to local operations of Apple and Starbucks. Although the E.U. Commission, the executive body of the European Union, has no direct authority over national tax systems, it can investigate whether certain fiscal regimes, including those that issue advance private tax rulings, constitute an infringement of E.U. principles, in particular "unjustifiable" State Aid to companies. Such allegedly incompatible State Aid would comprise, *inter alia*, selective tax advantages granted by an E.U. Member State to companies with operations in its jurisdiction.

The Commission is very clear on its intent to use its powers and pursue its initiative vigorously. The financial press has widely reported a statement made by a spokesman for Competition Commissioner Margrethe Vestager that combating tax evasion and avoidance is a top priority of the Commission. In line with that concern, the Commission is taking a structured approach when using its State Aid enforcement powers to investigate selective tax advantages that distort fair competition.[1]

The following provides an overview on the legislative framework with respect to State Aid, developments and an outlook on the future of tax rulings in an environment of increased tax transparency.

WHAT IS STATE AID IN GENERAL?

Article 107 sec. 1 of the Treaty on the Function of the European Union ("T.F.E.U.") provides that any aid granted by a Member State or through state resources, in any form whatsoever, distorting or threatening to distort competition by favoring certain undertakings is incompatible with the internal market as far as it affects the trade between the Member States.[2] A measure qualifies as "State Aid" if the following conditions are met:

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1 *Out-law.com*, April 2015.

2 See: Matthias Scheifele, "State Aid, Transparency Measures and Reporting Standards in the EU," in Chapter 274 of *The Corporate Tax Practice Series: Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Reorganizations & Restructurings 2015*, ed. Louis S. Freeman (Practicing Law Institute).

> *"A measure qualifies as 'State Aid' if the following conditions are met..."*

- The relevant intervention is granted by a Member State or through State resources.[3]
- The intervention provides an economic advantage to the recipient.[4]
- The intervention affects or may affect competition and trade between the Member States.[5]
- The advantage is selective, *i.e.*, it is only granted to specific recipients.[6]

Even if a measure fulfills those prerequisites, certain exemptions set forth under Article 107 sec. 2 or sec. 3 T.F.E.U. may apply to exempt the measure from State Aid status. For example, State Aid having a social character and being granted to individual consumers and State Aid eliminating damages caused by natural disasters are considered compatible with the internal market under such exemptions.[7] In addition, State Aid promoting economic[8] and cultural[9] development is not considered to be unlawful. Also allowable is State Aid promoting the execution of projects of common interest or projects to remedy serious disturbances in the economy[10] of a Member State,[11] as well as other categories of aid specified by decision of the Counsel on proposal from the Commission.[12]

If a Member State intends to implement a new State Aid measure, it must notify the Commission,[13] whereas existing State Aid measures are constantly reviewed by the Commission.[14] Procedural basis for the Commission's authority to review the status of State Aid is Council Regulation (EU) No. 734/2013[15] ("Procedural Regulation").[16] Pursuant to the Procedural Regulation, the Commission decides whether

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3 "Commission notice on the application of State aid rules to measures relating to direct business taxation," *Official Journal C 384* (December 10, 1998): p. 3, ¶10.

4 *Id.*, ¶9.

5 *Id.*, ¶10.

6 Jestaedt, §8 in *European State Aid Law*, ed. Martin Heidenhain (München: Verlag C.H. Beck, 2010).

7 Consolidated Version of the Treaty on the Functioning of the European Union art. 107(2), Oct. 26, 2010, 2012, *Official Journal C 326* [hereinafter "T.F.E.U."].

8 *Id.*, art. 107(3(a)).

9 *Id.*, art. 107(3(d)).

10 In particular, this exemption was of importance in context with the financial crises, see: Blumenberg, Jens, and Wulf Kring. "Europäisches Beihilferecht Und Besteuerung." *IFSt*, no. 473 (2011): 21(f).

11 T.F.E.U., art. 107(3(b)).

12 *Id.*, art. 107(3(e)).

13 *Id.*, art. 108(3).

14 *Id.*, art. 108(1).

15 Council Regulation 734/2013/EU of July 22, 2013 amending Regulation 659/1999/E.C. laying down detailed rules for the application of Article 93 of the E.C. Treaty, *Official Journal L 204* (July 31, 2013): p. 15 [hereinafter "Procedural Regulation"].

16 T.F.E.U. Article 109 authorizes the Council (on proposal from the Commission and after consulting the Parliament) to implement any appropriate regulation regarding the application of the State Aid provisions, which the Council utilized to adopt the Procedural Regulation.

a notified measure constituting State Aid is compatible with the internal market.[17] If the Commission finds that an existing State Aid measure is incompatible with the internal market, it decides whether the Member State granting the State Aid should amend or abolish the respective measure within a period of time determined by the Commission.[18] Illegal State Aid must be recovered from the recipient entity.[19]

STATE AID AND DIRECT BUSINESS TAXATION

Principles set forth under E.U. law supersede national laws of Member States ("Supremacy Principle"). The Supremacy Principle guarantees the superiority of European law over national laws. It is a fundamental principle of European law. The Supremacy Principle applies to all European acts with a binding force. Therefore, Member States may not apply a national rule that contradicts European law. This rule is not inscribed in the Treaties. Rather, it is based on European Court of Justice ("E.C.J.") decisions.[20]

One of these principles under E.U. law overriding domestic law is the incompatibility of State Aid with the internal market. The latter applies to aid "in any form whatsoever."[21] Given this broad definition of State Aid, national provisions regarding direct business taxation may be considered as State Aid if the preconditions of the T.F.E.U. are met. In 1998, the Commission clarified these requirements with respect to national tax provisions and adopted the Commission Notice on the application of State Aid rules to measures relating to direct business taxation.[22]

Measures in the area of direct business taxation may amount to unlawful State Aid if the following conditions are met:

- Economic Advantage

  First, the tax measure must grant an economic advantage. In the case of tax rulings, an advantage will in principle exist where the tax payable under the tax ruling is lower than the tax that would otherwise be paid under the normally applicable tax system. The general rule is that the allocation of profit between companies of the same corporate group must comply with the "arm's-length principle" as set forth in Article 9 of the O.E.C.D. Model Tax convention. In the case of transfer pricing agreements, this means that arrangements between companies of the same corporate group must not depart from arrangements that a prudent independent operator acting under normal market conditions would have accepted. The E.C.J. has confirmed that if the method of taxation for intra-group transfers does not comply with the arm's-length principle and leads to a lower taxable base than would result

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17 Procedural Regulation, art. 7.

18 T.F.E.U., art. 108(2).

19 Procedural Regulation, art. 14.

20 See *Van Gend & Loos v. Netherlands Internal Revenue Administration*, Case 26/62 [1963] CMLR 105, and *Costa v. E.N.E.L.*, Case 6/64 [1964] ECR 585, CMLR 425,593.

21 "Commission notice on the application of State aid rules to measures relating to direct business taxation," *Official Journal C 384* (December 10, 1998): p. 3, ¶2.

22 *Official Journal C 384* (December 10, 1998).

from correct implementation of that principle, a selective advantage is provided to the company concerned.[23]

- State Resource Based Financing

  Second, the advantage must be financed through State resources. In cases where a tax authority lowers the effective tax rate that would otherwise be payable, the resulting loss of revenue for the State is equivalent to the use of State resources.[24] This applies even if the tax relief might indirectly have a positive effect on overall budget revenue.[25] Furthermore, the State support may not just be provided by legislation but also through the practices of the tax authorities.[26]

- Distortion or Threat to Distort Trade and Competition Between Member States

  Third, the tax measure must distort or threaten to distort trade and competition between Member States. Where the beneficiary carries out an economic activity in the E.U., this criterion is easily met.

- Selective Character of the Tax Measure

  Finally, the tax measure must be specific or selective in that it benefits "certain undertakings or the production of certain goods." According to the Commission, "every decision of the administration that departs from the general tax rules to the benefit of individual undertakings in principle leads to a presumption of State Aid and must be analyzed in detail."[27] Thus, a tax ruling that merely interprets general tax rules or manages tax revenue based on objective criteria will generally not constitute State Aid, while a ruling that applies the authorities' discretion to apply a lower effective tax rate than would otherwise apply may amount to State Aid. In the case of transfer pricing agreements, a tax ruling that deviates from the arm's-length principle is likely to be considered as specific and hence qualify as State Aid under E.U. law.

Tax rulings are "comfort letters" from national tax authorities giving specific companies clarity on how their corporate tax will be calculated, or on the use of special tax provisions such as transfer pricing arrangements ("Advance Pricing Agreements" or "A.P.A.'s"). As long as such letter rulings are used to provide guidance on the respective tax authority's interpretation of tax rules, they would not be considered harmful with respect to E.U. principles. However, if used to provide selective advantages to a specific company or group of companies, tax rulings may involve State Aid within the meaning of the E.U. rules, resulting in an infringement of E.U. law as outlined above.

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23 See: *Belgium and Forum 187 v. Commission*, Joined Cases C-182/03 & C-217/03, [2006] E.C.R. I-5479, ¶97.

24 "Commission notice on the application of State aid rules to measures relating to direct business taxation," *Official Journal C 384* (December 10, 1998): p. 3, ¶10.

25 E.U. Commission, "Report on the implementation of the Commission notice on the application of State aid rules to measures relating to direct business taxation," C(2004)434 at ¶19 (February 9, 2004).

26 "Commission notice on the application of State aid rules to measures relating to direct business taxation," *Official Journal C 384* (December 10, 1998): p. 3, ¶10.

27 *Id.*, ¶22.

If one of the tax measures in question constitutes State Aid, it could in principle benefit from an exemption under the T.F.E.U., but such exemptions generally apply to tax relief granted for a specific project, such as investing in disadvantaged areas or promoting culture and heritage conservation, and are limited to the costs of carrying out such projects. However, the Commission has indicated in its opening decisions that, at this stage of the investigations, no indication exists for the contested rulings to benefit from an exemption under the T.F.E.U.

CONSEQUENCES OF UNLAWFUL STATE AID

If an existing tax provision comprises State Aid within the meaning of Article 107 sec. 1 T.F.EU, and if no exemption within the scope of Article 107 sec. 2 or sec. 3 T.F.E.U. applies, the Member State is obliged, upon a decision of the Commission, to recover the unlawful State Aid from the beneficiary.

The Commission may only refrain from its decision regarding the recovery in two defined cases. If the recovery of unlawful State Aid is contrary to a general principle of the Community law, no recovery will be required.[28] Those general principals provide for an exemption when the recovery is absolutely impossible[29] or a legitimate expectation[30] argues against the recovery. However, these exemptions are rarely applicable. The recovery of unlawful State Aid can be applied to unlawful State Aid that was received within the prior ten-year period.[31] Recovery cannot go back further. Apart from theses exceptions and pursuant to Article 14 sec. 1 Procedural Regulation, Member States must take all necessary measures to recover unlawful State Aid from the beneficiary and to impose interest on the deferred payment.[32] Hence, consequences for the businesses at issue may be harsh.

WHO IS ON THE E.U. COMMISSION'S RADAR?

While the Commission is very clear that only selective tax rulings in the sense of the State Aid legislation are targeted, it is also very clear on its determination to establish a new set of rules in this respect.

E.U. Commissioner for Taxes Pierre Moscovici said in an interview with Euranet Plus that tax rulings are not illegal and that the Commission is not seeking to question the system itself. The Tax Commissioner went on to say that an exchange of information on tax rulings will simply force E.U. Member States to take a fair approach to tax competition, and as a result, companies will avoid tax abusive strategies.

According to Competition Commissioner Vestager, the European Commission will not be able to move quickly enough to tackle anti-competitive tax practices by the different Member States without "at least" a single corporate tax base and automatic exchange of information on the tax rulings (discussed in more detail below).

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28 Procedural Regulation, art.14(1(2)).

29 Sinnaeve, §32 in *European State Aid Law*, ed. Martin Heidenhain (München: Verlag C.H. Beck, 2010).

30 *Ibid*.

31 Procedural Regulation, art.15(1).

32 *Id.*, art. 14(2).

> If Member States do not provide the necessary information, we can give injunctions. We can launch infringement procedures and we can take them to court if we do not get the info we need to do our work. But for the Commission to work in a dedicated, fast and just manner, we need at least the automatic exchange of information on tax rulings and a common consolidated tax base. We might also have to prepare guidelines for Member States to explain in detail what is allowed and what is not. But for that we need more case law.

The European Commission has been investigating Member State practices in granting tax rulings since June 2013. To date, requests for data on rulings have been received by Austria, Belgium, Cyprus, the Czech Republic, Denmark, Finland, France, Germany, Great Britain, Hungary, Ireland, Italy, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Rumania, Sweden, Slovakia, and Spain. According to the European Commission, no need was observed to ask Bulgaria, Greece, Croatia, Latvia, and Slovenia for tax rulings,[33] which some interpret as the "white list" of countries deemed compliant in this respect.

In March 2014, the Commission adopted two injunctions ordering Luxembourg to deliver information requested by the Commission regarding tax rulings and intellectual property tax regimes. In June 2014, the Commission opened formal investigations into individual rulings issued by (i) Irish tax authorities on the calculation of taxable profit allocated to the Irish branches of Apple Sales International and of Apple Operations Europe, (ii) the Netherlands in relation to the calculation of the taxable basis in the Netherlands for manufacturing activities of Starbucks Manufacturing, and (iii) Luxembourg in relation to Fiat Finance and Trade.

"The European Commission will not be able...to tackle anti-competitive tax practices by the different Member States without 'at least' a single corporate tax base and automatic exchange of information on the tax rulings."

Regarding Ireland, the Commission stated that the results of its preliminary investigation into Apple's arrangements were that A.P.A.'s in Ireland may have given the company unfair advantages incompatible with E.U. State Aid laws. While the Irish Finance Minister, Michael Noonan, claimed that the European Commission does not have a very strong case, Competition Commissioner Vestager told Irish state broadcaster RTÉ that there are reasonable doubts about the legitimacy of the rulings. Regarding the Netherlands, the Commission's preliminary view into the agreement between the Dutch tax authorities and Starbucks was that the agreement amounted to unlawful State Aid; according to State Aid experts, the Commission may have gone too far on its conclusions in relation to Starbucks.

Regarding all three cases, the Commission stated:

> The Commission has reviewed the calculations used to set the taxable basis in those rulings and, based on a preliminary analysis, has concerns that they could underestimate the taxable profit and thereby grant an advantage to the respective companies by allowing them to pay less tax. The Commission notes that the three rulings concern only arrangements about the taxable basis. They do not relate to the applicable tax rate itself. Selective tax advantages may amount to State Aid. The Commission does not call into question the general tax regimes of the three Member States concerned.[34]

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[33] See: "State aid: Commission orders Estonia and Poland to deliver missing information on tax practices; requests tax rulings from 15 Member States," *European Commission Press Release Database*, published June 8, 2015.

[34] *Out-law.com*, June 12, 2014.

In October 2014, the Commission opened an investigation regarding rulings given to online retailer Amazon in Luxembourg. In January, the European Commission stated that corporation tax arrangements agreed between Luxembourg and Amazon in 2003 may have conferred such a "selective advantage" on Amazon.

In February this year, the Commission announced it was investigating Belgium's tax regime, which allows companies to reduce their tax liability on the basis of excess profits tax rulings.

In June 2015, the Commission issued two injunctions ordering Estonia and Poland to deliver requested information on their tax ruling practices within one month. In its press release, the Commission notes that in the case of non-compliance with these injunctions it may refer the Member State to the E.C.J.

"The E.U. Commission unveiled new proposals to help identify corporate tax avoidance by announcing a policy that would enhance information sharing between Member States."

WHERE DO WE STAND NOW AND WHAT IS NEXT?

The E.U. Commission unveiled new proposals to help identify corporate tax avoidance by announcing a policy that would enhance information sharing between Member States. The Tax Transparency Package was presented on March 18, 2015. It follows an earlier proposal for an exchange of information on tax rulings released in December 2014 and aims to ensure that Member States have the information they need to protect their respective tax bases.

The Commission has proposed the setting up of an automatic exchange of information between countries on cross-border tax rulings. Member States will be required to exchange information automatically on private tax rulings and A.P.A.'s. The exchange would be made within a strict timeline: every three months, all Member States would be obliged to report all rulings issued during that period to all other Member States and the Commission. This report would be sent via a secure email system and would contain a pre-defined standard set of information. The recipient Member States would have the right to request more detailed information that is relevant to the administration of its tax laws. Each year, Member States would provide statistics to the Commission on the volume of information exchanged.

In addition to this quarterly exchange of information, an obligation is imposed with regard to rulings issued during the ten-year period prior to the effective date of the proposed Directive, discussed below. This obligation applies only to rulings that remain valid on that date.

The instrument under which all such exchange would occur is Directive 2011/16/EU on Administrative Cooperation in the Field of Taxation ("D.A.C.").

The Tax Transparency Package includes a second proposal that relates to initiatives to "advance the tax transparency agenda" of the Commission. These initiatives are:

- New transparency requirements for companies, including the public disclosure of some tax information by multinational companies;
- A review of the Code of Conduct on Business Taxation;
- An attempt to develop a reliable estimate of the level of tax evasion and avoidance across Member States; and
- The repeal of the Savings Tax Directive (*i.e.*, the legal framework on

automatic information exchange on financial accounts, including savings related income), which the Commission believes has been "overtaken by more ambitious EU legislation." Repealing the Saving Tax Directive is intended to create a streamlined framework for the automatic exchange of financial information and prevent any legal uncertainty or extra administration for tax authorities and businesses.

This proposal was endorsed by Finance Ministers at their informal E.C.O.F.I.N. meeting in Riga in April of this year, and technical negotiations in this respect are progressing in the Council.

To implement such legislation, unanimity is required. While it has been stressed in press releases that work on the initiative of an automatic exchange of tax rulings is in progress, some pushback has been encountered: Germany, Estonia, and Poland have addressed fiscal secrecy as a main concern in providing tax rulings. However, on July 15, 2015, the German government reportedly approved two bills authorizing the automatic exchange of tax information with other E.U. Member States and third countries. The exchange would be effective in 2017.

Additionally, in the E.C.O.F.I.N. meeting on June 19, 2015, Germany, Poland and Slovenia addressed concerns about the ten-year timeframe, *i.e.*, tax rulings dating back ten years. Tax Commissioner Moscovici denied that retroactivity exists. His position is based on the fact that retroactivity refers to rulings that have continuing effect. Hence, the proposal is not retroactive.

The Commission has stressed in press releases that work on the initiative of an automatic exchange of tax rulings is in progress. With respect to the confidentiality issues, it stated that, Member States could not invoke professional secrecy[35] for refusing to provide information requested by the Commission.

It is envisaged to enter into force as of January 1, 2016.

On June 17, 2015, an action plan was adopted to make corporate taxation fairer, more efficient and more transparent. The action plan set out key actions to tackle corporate tax avoidance including:

- A relaunch of the Common Consolidated Corporate Tax Base ("C.C.C.T.B."), its 2011 proposal on a framework to ensure taxation of profits where they are generated;
- Creating a better business environment;
- Measures ensuring effective taxation such as harmonizing corporate tax rates across the E.U.;
- Measures increasing transparency, building on the Transparency Package adopted in March 2015 (see above); and
- Improving E.U. coordination.[36]

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35 Commission Communication C(2003) 4582, *Official Journal C 297* (December 9, 2003): 0006 – 0009.

36 See: "Commission presents Action Plan for Fair and Efficient Corporate Taxation in the EU," European Commission Press Release Database, published on June 17, 2015; see also "Action Plan on Corporate Taxation," European Commission Taxation and Customs Union, published June 2015.

The transparency-related measures include a list of third countries and territories blacklisted by Member States. The list is available online.[37]

CONCLUSION

The details of the proposed automatic exchange of information on tax rulings are currently under negotiation. A unanimous decision may take longer than expected and could affect the scheduled implementation date of January 1, 2016. Apart from the issues outlined above with respect to secrecy and the ten-year lookback period, more fundamental issues arise, such as granting the Commission direct access to practices of the tax administrations of each Member State. The concern is that such access is beyond the institutional role of the Commission.

Nonetheless, the political pressure should not be underestimated and may be increased by the European Parliament, which is currently investigating tax rulings.[38] Depending on its findings, the European Parliament may approve the D.A.C., or propose even stricter provisions, notwithstanding the Parliament's consultative role in issues such as these.

Finally, the Tax Transparency Package proposed by the Commission is only one part of a wider set of connected initiatives aiming at increased overall levels of tax transparency. In particular, the Tax Transparency Package must be viewed in conjunction with Action 13 of the O.E.C.D.'s B.E.P.S. project, which requires companies to report taxes paid via the country-by-country reporting template and to maintain a Master File and Local Files. Businesses with E.U. operations are advised to closely monitor these developments. A significantly changed tax landscape is clearly ahead.

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37 See: "Tax good governance in the world as seen by EU countries," European Commission Taxation and Customs Union.

38 In February 2015, the European parliament set up a Special Committee on Tax Rulings and Other Measures Similar in Nature or Effect ("TAXE Committee") to look into tax rulings and "other measures similar in nature and effect" going back to January 1, 1991. With 45 members and the same number of substitutes, the TAXE Committee's role is primarily to investigate the compatibility of tax rulings with the rules of State Aid and tax law. The TAXE Committee will then draft a report, including recommendations on how to improve transparency and cooperation between Member States, to the benefit of the internal market, European companies and citizens. It will review the way that the European Commission treats State aid in Member States and the extent to which those Member States are transparent on their tax rulings, and make recommendations for the future.

EATON CORP.'S TRANSFER PRICING TRIAL BEGINS AUGUST 24

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Tags
Advance Pricing Agreement
Eaton Corp.
Puerto Rico
Transfer Pricing

The U.S. Tax Court's transfer pricing trial of *Eaton Corp. v. Comm'r*[1] will begin on August 24, 2015, despite attempts by the I.R.S. to further delay the trial until 2016. The controversy between the parties began in 2011, when the I.R.S. used its discretionary power to cancel its advance pricing agreements[2] with Eaton Corp. and issued a notice of deficiency. Eaton Corp. filed a petition in 2012 challenging the I.R.S. cancellations and claiming that the agreements should be upheld on the basis of contract principles. The outcome of the trial could have a substantial impact on the I.R.S. Advance Pricing Agreement Program and impact the finality of these agreements with other taxpayers.

The trial was originally scheduled to begin August 5, but the I.R.S. filed a motion to delay the trial for five months. In response to the motion, Judge Kathleen Kerrigan ordered a 19-day continuance. The I.R.S. filed another motion to reconsider the five-month delay, which Judge Kerrigan denied. The I.R.S. argued that Eaton Corp. has failed to cooperate during the discovery process and that it requires additional time to prepare for trial in light of new developments. Judge Kerrigan denied a further delay of the trial because she doubts that the hostile relationship between the parties will improve with additional time.

Eaton Corp. is the first taxpayer to contest the cancellation of an advance pricing agreement by the I.R.S. The case is a Code §936 restructuring issue that concerns companies with operations in Puerto Rico before the Code §936 credit began phasing-out in the year 2005. Code §936 restructuring cases generally focus on (i) whether the goodwill, going concern, and workforce-in-place values in Puerto Rican operations can be compensated for under Code §367(d) when transferred from the taxpayer's U.S. Code §936 corporation to a new foreign corporation; and (ii) the valuation of the taxpayer's transfer pricing methods between its U.S. entities and its new foreign corporation under Code §482.

Eaton Corp. and the I.R.S. entered into their original advance pricing agreement in 2000 for tax years 2001 to 2005. This agreement recognized Eaton Corp. as the distributor in the process of producing commercial and residential circuit breakers. The arrangement consisted of Eaton Corp. licensing technology to its Caribbean subsidiaries operating in Puerto Rico and the Dominican Republic to manufacture breaker products in exchange for royalty fees. The subsidiaries would then sell the manufactured breaker products to Eaton Corp. The advance pricing agreement established the best method for determining the arm's length rates under Code §482 for Eaton Corp.'s purchase of the breaker products. In 2005, the I.R.S. and Eaton

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1 *Eaton Corp. v. Commr*, T.C., No. 5576-12.

2 An "advance pricing agreement" is an agreement between a taxpayer and the I.R.S. that determines the acceptable transfer pricing methodology for covered transactions in the years subject to the agreement.

Corp. renewed their advance pricing agreement to cover tax years 2006 to 2010.

In 2011, Eaton Corp. attempted to renew its advance pricing agreement again, but the I.R.S. claimed that Eaton Corp. failed to comply with the terms and conditions of the agreements and that it withheld information that would have prevented the I.R.S. from initially entering into the original agreement. The I.R.S. also contended that Eaton Corp. manipulated its transfer pricing methods and the company failed to implement a standard for accuracy. Eaton Corp. has adamantly denied it concealed information from the I.R.S. while negotiating the advanced pricing agreements and submitted responses to about 200 Information Document Requests during the negotiating process.

On December 16, 2011, the I.R.S. cancelled its advance pricing agreements with Eaton Corp. It issued Eaton Corp. a notice of deficiency and made adjustments to the transactions the company had with its subsidiaries in the Caribbean by applying an alternative transfer pricing method. Under Internal Revenue Code §§482 and 367(d), the I.R.S. adjusted Eaton Corp.'s income by $368.6 million in addition to tax and penalties for 2005 to 2006.

In February 2012, Eaton Corp. filed a petition with the Tax Court disputing the I.R.S.'s nearly $370 million proposed adjustment. The company claimed the advance pricing agreements were wrongly cancelled because the I.R.S. relied on one consultant's report, which failed to account for Eaton Corp.'s relationship with its subsidiaries, the sole owners of the manufacturing plants in Puerto Rico. Eaton Corp. has argued the deficiency notice erroneously calculated the amounts Eaton Corp. was required to pay its subsidiaries because the amounts were incorrectly based on the subsidiaries projections instead of their actual sales, which would have caused the manufacturing plants to pay unreasonable royalty rates. Furthermore, Eaton Corp. claimed it forfeited certain tax benefits for the purpose of entering into the advance pricing agreements with the I.R.S.

"The I.R.S. adjusted Eaton Corp.'s income by $368.6 million in addition to tax and penalties for 2005 to 2006."

ABUSE OF DISCRETION

The I.R.S.'s authority to cancel advance pricing agreements is based on revenue procedures that grant discretion to the I.R.S. Chief Counsel. Revenue Procedure 96-53[3] applied to Eaton Corp.'s original advance pricing agreement for tax years 2001 to 2005, while Revenue Procedure 2004-40[4] applied to Eaton Corp.'s renewed advance pricing agreement for tax years 2006 to 2010. Revenue Procedure 2006-09[5] is the current advance pricing agreement authority and is incorporated by reference into such agreement, in addition to the terms established in the agreement itself. At issue in the partial summary judgment motions filed by Eaton Corp. and the I.R.S. is whether the government abused its discretionary power in cancelling the advance pricing agreements.

In a June 2012 motion for partial summary judgment, Eaton Corp. contended the advance pricing agreements are binding agreements that should be enforced as "binding contracts." Eaton Corp. asserted that the Tax Court should apply contract principles to determine whether the I.R.S. had the right to cancel the agreements.

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[3] 1996-2 C.B. 375.

[4] 2004-29 I.R.B. 50.

[5] 2006-1 C.B. 278, as modified by Rev. Proc. 2008-31, 2008-1 C.B. 1133.

The company acknowledged that the advance pricing agreements are not closing agreements under Code §7121, which are the only final agreements the I.R.S. executes, and are instead enforceable as contracts.

In its opposition to Eaton Corp.'s motion and cross-motion for partial summary judgment, the I.R.S. asserted that the burden should shift to Easton Corp. to prove the government abused its discretionary power in cancelling the advance pricing agreements. The Tax Court ruled that Eaton Corp. bears the burden of proving the government abused its discretion.

"Eaton Corp. is the only taxpayer to date to have challenged the cancellation of an advance pricing agreement by the I.R.S."

The outcome of *Eaton Corp. v. Commissioner* could significantly impact the I.R.S.'s advance pricing agreement process. If Eaton Corp. prevails, other companies are likely to follow suit. Eaton Corp. is the only taxpayer to date to have challenged the cancellation of an advance pricing agreement by the I.R.S. A success for Eaton Corp. could encourage taxpayers to continue entering into advance pricing agreements. On the other hand, if the I.R.S. prevails and advance pricing agreements are not found to be binding agreements, taxpayers may be deterred from entering into such agreements.

P.L.R. 201446025 – A CHANGE OF I.R.S. DIRECTION?

Authors
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Tags
Application for Tax-Exempt Status
Change of Domicile
Charities

INTRODUCTION

U.S. charities are required to obtain I.R.S. approval in order to be exempt from federal income tax under §501(a) of the Internal Revenue Code (the "Code"). Under Code §508(a), new organizations must notify the Secretary of the Treasury that they are applying for recognition of Code §501(c)(3) status. In order to establish such exemption, Treasurey Regulation §1.1501(a)-1(a)(2) requires that an organization must file an appropriate application form with the district director for the internal revenue district in which the principal place of business of the organization is located. Furthermore, any rulings or determination letters holding the organization exempt are effective so long as there are no material changes in the organization's character, purposes, or methods of operation. To be tax-exempt under §501(c)(3), an organization must be organized and operated exclusively for exempt purposes and none of its earnings may inure to any private shareholder or individual.

This begs the following question: If a charity changes its organizational structure or state of incorporation, will a new application be required?

REVENUE RULING 67-390

In Revenue Ruling 67-390,[1] the I.R.S. considered whether new applications for exemption are required in four situations where organizations that are already exempt from federal income tax under §501(a) changed their structures.

- Case 1. The organization is an exempt trust that is reorganized and adopts a corporate form to carry out the same purposes for which the trust was initially established.
- Case 2. An exempt unincorporated association is incorporated and continues the operations which had previously qualified for exemption.
- Case 3. An exempt organization that was incorporated under state law is reincorporated by an Act of Congress to continue carrying out the same operations.
- Case 4. An exempt organization incorporated under the laws of one state is reincorporated under the laws of another state with no change in its purposes.

In these four cases, the I.R.S. found that new legal entities had been created, which must each reestablish their entitlement to exemption from federal income tax.

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1 Rev. Rul. 67-390, 1967-2 C.B. 179.

There are risks and burdens associated with requiring the refiling of the tax exemption form. Refiling means re-inviting the I.R.S. to scrutinize the organization's activities and financials and potentially being denied the exemption. The filing of the form itself is a burden, especially for long-established organizations that have a substantial number of programs, contracts, and relationships to disclose. With the recent decline in funding and resources, I.R.S. delays are ever-increasing. Donors may also misinterpret this process and suppose that the organization's charitable status has been revoked.

PRIVATE LETTER RULING 201446025

A recent private letter ruling has indicated that the I.R.S. may permit a charitable entity to effect changes in their organizational structure without the need for a new exemption letter.

Private Letter Ruling 201446025 (November 14, 2014) held that a change in the state of domicile of a nonprofit corporation was not a substantial change in the entity's character, purposes, or methods of operations, and therefore, the entity could rely on the previously-issued determination of tax-exempt status and would not be required to file a new application for exemption.

This letter ruling involved a nonprofit corporation formed on Date 1 by a certificate of formation filed in State 1. On Date 2, the entity received recognition of exemption under Code §501(c)(3) retroactive to its date of formation. The entity intended to file "Articles of Domestication" with State 2 and a "Certificate of Conversion" with State 1. The effect of these filings would be that the state of domicile would change from State 1 to State 2. The governing law of State 2 states that the filing of the Articles of Domestication will not affect the nonprofit's date of incorporation, which would remain Date 1. Further, the laws of State 2 provide that the entity is the same corporation as the one that existed under the laws of State 1. Similarly, the laws of State 1 provide that following the filing of a Certificate of Conversion, the entity will continue to exist without interruption, maintaining the same liabilities and obligations. The ruling stated that the nonprofit made this change because the laws of State 2 offered more flexibility. The charitable purposes and operations of the nonprofit did not change.

The letter ruling made reference to *American New Covenant Church v. Comm'r*, 74 T.C. 293, 301 (T.C. 1980), which considered the question of whether a new organization was formed when an exempt unincorporated association changed its name and also presented articles of incorporation bearing this new name. The I.R.S. determined that a new entity had been formed by the filing of these articles of incorporation. It concluded that (i) the newly-formed corporation was distinctive from the unincorporated association that had previously filed an application for exemption and (ii) the newly-formed corporation needed to file its own application. The United States Tax Court agreed, ruling "that the two organizations [should] be treated as separate, independent legal entities." It stated that the I.R.S., "was entirely justified in insisting that [the newly formed corporation] submit a new application in order to determine whether it met the regulation requirements for tax-exempt status." Rev. Rul. 77-469, 1977-2 C.B. 196 reached a similar conclusion, holding that that an organization that filed its application for exemption less than 15 months after its incorporation under state law was exempt as of the date of its incorporation, even though it had operated as an unincorporated association for three years prior to its incorporation. The ruling highlighted that the corporation was a new legal entity from the unincorporated one. This position is understandable, as the legal status and governance rules of corporations and unincorporated associations are significantly different.

It also made reference to Rev. Rul. 67-390, 1967-2 C.B. 179, described above.

The I.R.S. held that the entity's State 2 domestication was not comparable to those of the organizations in Rev. Rul. 77-469, *American New Covenant Church v. Commissioner*, 74 T.C. 293, 301 (T.C. 1980), and Rev. Rul. 67-390 Cases 1 and 2. The organizations in those instances changed from an unincorporated association to a corporation or from a trust to a corporation, which was not the transaction under consideration. The domestication was held to be closer to Cases 3 and 4 of Rev. Rul. 67-390, both of which involved a reincorporation of an existing corporate entity. There was, however, a significant difference. Cases 3 and 4 involved a creation of a new legal entity, while under the domestication procedure in question, no new entity was created. The nonprofit simply filed an amendment to its formation document, rather than filing a new one, and therefore, the I.R.S. concluded that no new entity had been formed.

CONCLUSION

P.L.R. 201446025 is a major step in the right direction for the I.R.S., and some practitioners have suggested that this position be formalized in a published ruling.[2] Perhaps the I.R.S. will also recognize that there is no meaningful distinction between a change of state of domicile by conversion and a change by merger. If so, it would be an even greater step forward if Rev. Rul. 67-390 were revoked to eliminate the need for a new exemption letter when a charity changes its state of incorporation.

"Donors may also misinterpret this process and suppose that the organization's charitable status has been revoked"

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[2] Nina Krauthamer was the primary author of a letter sent to the I.R.S. by the Non-Profit Organizations Committee of the New York City Bar requesting a formal ruling. That letter appears here.

S.T.A.R.S. TRANSACTIONS – INTEREST DEDUCTION ALLOWED BUT FOREIGN TAX CREDIT DISALLOWED

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Tags
Double Dip Foreign Tax Credit
Economic Substance Doctrine
S.T.A.R.S. Transaction
Tax Shelter

In a partial reversal of the I.R.S. position, a U.S. financial institution was allowed to deduct interest expense on borrowings that formed part of a S.T.A.R.S. transaction in *Salem Financial, Inc. v. United States*.[1] While the Appeals Cout held that the taxpayer could not claim foreign tax credits for the U.K. taxes paid pursuant to the S.T.A.R.S. transaction, it allowed deductions for interest paid on a loan.

Branch Banking & Trust Corporation ("BB&T"), a North Carolina financial holding company, and Barclays Bank PLC ("Barclays"), a U.K. bank were the participants in a financial product transaction BB&T entered into a structured trust advantaged repackaged securities ("S.T.A.R.S.") transaction with Barclays from August 2002 through April 2007. Generally, the economic benefit of a S.T.A.R.S. transaction is to increase yields on investments by affixing an interest expense deduction and a double dip of foreign tax credits to the total return of the investor. Barclays invented the S.T.A.R.S. transaction structure along with the international accounting firm based in the U.K., KPMG L.L.P.

BB&T's S.T.A.R.S. Transaction

The transaction produces tax credits in the U.K. for Barclays and in the U.S. for the U.S. customers by circulating the U.S. income through a U.K. entity, usually a trust. The S.T.A.R.S. transaction that BB&T entered into with Barclays involved the following steps.

- First, BB&T created a trust, for which it appointed a trustee with U.K. tax residence. This caused the trust to be subject to U.K. income tax.
- Nearly $5.77 billion of BB&T's U.S.-based income-generating assets were held in the trust under BB&T's control.
- Barclays then made a loan of $1.5 billion cash to the BB&T trust in exchange for the trust's equity interests, but Barclays was contractually obligated to sell its interests back to BB&T upon completion of the S.T.A.R.S. transaction.
- Barclays made monthly payments to BB&T, which were approximately half of the U.K. tax benefits Barclays received from the trust component.
- The arrangement provide BB&T with the economic benefit of a foreign tax credit for the taxes paid by the trust to the U.K. while deducting the interest payments incurred on the loan with Barclays.

The following example from the case illustrates how the financial product worked in principle based on $100 of Trust income (ignoring fees).

[1] 786 F.3d 932 (Fed. Cir. 2015).

The Trust income was subject to U.K. taxation at a 22 percent rate. Therefore, $22 for every $100 of Trust income was set aside for payment of the U.K. taxes, leaving the Trust with $78 after the U.K. tax payment. Because of its nominal equity interest in the Trust, Barclays was also taxed on the Trust income under U.K. law at a corporate tax rate of 30 percent, or $30 for every $100 of Trust income. Barclays, however, was able to claim a $22 U.K. tax credit for the $22 of tax paid by the Trust as an "imputation credit" that partially offset the higher corporate tax imposed on the Trust's distributions. As a result, Barclays effectively paid $8 in U.K. tax.

The Trust distributed the after-tax amount of $78 of Trust income to the Barclays Blocked Account, from which that sum was immediately re-contributed to the Trust. Under U.K. law, Barclays was able to treat the recontributed $78 as a "trading loss," thereby claiming a trading loss deduction. At the 30 percent tax rate, that deduction was worth $23.40. Barclays' $8 U.K. tax liability was then completely offset by the $23.40 tax deduction, leaving Barclays with a net tax benefit of $15.40.

In the example, the Bx payment that Barclays paid to BB&T, which was predetermined to be equal to 51 percent of the Trust's U.K. [pg. 2015-1838] tax payments, would be approximately $11. Barclays would then deduct the $11 Bx payment from its U.K. corporate taxes, which at the 30 percent tax rate yielded another tax benefit worth $3.30. The net benefit to Barclays, for every $100 in Trust income, was thus $7.70, based on U.K. tax credits and deductions (the net tax benefit of $15.40 minus the Bx payment of $11, plus the tax benefit of $3.30 attributable to the deduction for the Bx payment).

For its part, BB&T, having paid the $22 U.K. tax on the Trust income, would claim a foreign tax credit of $22 for the entire amount of the Trust's U.K. taxes. However, having received the $11 Bx payment from Barclays, BB&T would have a net gain of $11.

The U.K. government effectively collected $3.30 in tax for every $100 of Trust income, because the Trust paid $22 in U.K. taxes while the U.K. government gave back $18.70 in tax benefits to Barclays ($15.40 attributable to the trading loss deduction plus $3.30 attributable to the Bx payment deduction). Based on the structure of the transaction and the amount of the income-generating assets in the Trust, BB&T anticipated receiving approximately $44 million per year from the STARS Trust transaction in addition to the revenue generated by the assets themselves.

"In essence, the transaction appears to be functionally similar to the abuse described in the O.E.C.D. B.E.P.S. action on hybrid mismatch arrangements."

In essence, the transaction appears to be functionally similar to the abuse described in the O.E.C.D. B.E.P.S. action on hybrid mismatch arrangements.[2] The capacity of the S.T.A.R.S. transaction to generate profits for Barclays and BB&T depended both on Barclays' obtaining the expected tax benefits from the U.K. and on BB&T's obtaining the expected foreign tax credits from the U.S. Because of the risks associated

[2] "Public Discussion Draft BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Law)."

with obtaining those tax benefits, the parties incorporated features that were designed to minimize those risks. The agreement included a "makewhole" provision under which BB&T was obligated to reimburse Barclays if the credits generated by the Trust failed to match the parties' expectations. The parties also agreed to an indemnity provision, which would be triggered if the Trust paid no tax, either because it was not treated as a collective investment scheme under U.K. law or because it was not deemed a U.K. resident. BB&T's indemnity payment to Barclays would be approximately one-half of the U.K. tax that the Trust would have paid. Finally, both parties were entitled to terminate the S.T.A.R.S. transaction for any reason, subject to 30 days' notice.

For its 2002 through 2007 tax returns, BB&T claimed foreign tax credits for the U.K. taxes it paid through the trust and claimed deductions for interest paid on its loan from Barclays. The I.R.S. denied both of BB&T's claims and levied accuracy-related penalties. BB&T paid the tax and filed suit in the Court of Federal Claims for a refund of taxes, interest, and penalties from the I.R.S. The court ruled in favor of the I.R.S. in September 2013.[3] The Court of Federal Claims applied the economic substance doctrine to conclude that the trust and loan components of the S.T.A.R.S. transaction were "economic shams" that lacked economic substance.[4]

BB&T appealed to the U.S. Court of Appeals for the Federal Circuit, which affirmed in part and reversed in part on May 14, 2015. The decision:

- Upheld the accuracy-related penalties on BB&T and disallowed the foreign tax credits,
- Allowed BB&T to deduct the interest expense on the Barclays loan involved in the S.T.A.R.S. transaction, and
- Remanded the case for the reassessment of the penalties for BB&T.

The Court disregarded the trust component of the S.T.A.R.S. transaction because it lacked economic substance, even though it complied in form with U.S. tax law. BB&T argued that the foreign tax complied with a provision of the foreign tax credit regulations which define creditable taxes. Such taxes must not be offset by a rebate or subsidy.[5] The I.R.S. conceded that no subsidy exists. Nonetheless, the Court, citing *Frank Lyon Co. v. United States*[6] and other cases, refused to apply the foreign tax credit regulations without looking at the general economic substance of the transaction. The trust served only to produce foreign tax credits, without any legitimate business purpose.

> What is critical is to identify transactions lacking economic reality, *i.e.*, those that do not alter the taxpayer's economic position in any meaningful way apart from their tax consequences, typically entailing no risk and no significant possibility of profit other than as a result of tax considerations. This is to ensure that tax benefits are available only if "there is a genuine multiple-party transaction with economic

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[3] *Salem Fin., Inc. v. United States*, 112 Fed. Cl. 543 [112 AFTR 2d 2013-6168] (2013).

[4] *Salem Fin., Inc. v. United States*, 112 Fed. Cl. at 588–89.

[5] Treas. Reg. § 1.901-2(e)(3).

[6] 35 U.S. 561 (1978).

> substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels." Frank Lyon, at 583–84. Even if there is some prospect of profit, that is not enough to give a transaction economic substance if the prospect of a non-tax return is grossly disproportionate to the tax benefits that are expected to flow from the transaction. See, *e.g.*, Knetsch v. United States, 364 U.S. 361, 365–66 (1960) (the taxpayer's transaction with the insurance company "was a fiction," because for a claimed interest deduction of $233,297.68, the taxpayer's annual borrowing only kept a net cash value "at the relative pittance of $1,000").

The Appeals Court emphasized that statutory anti-abuse rules will not prevent the common-law economic substance doctrine from being applied to complex transactions. It found that none existed with regard to the foreign tax credit element of the financial product.

> In this case, the trial court's finding that the Trust transaction lacked economic reality was supported by more than just the absence of a prospect for profit. The trial court found that the Trust transaction consisted of "three principal circular cash flows," which, apart from their intended tax consequences, had no real economic effect. 112 Fed. Cl. at 585. Through those circular cash flows, BB&T (1) created an entity that it used to make monthly distributions to the Trust, which the Trust immediately returned to that entity, resulting in subjecting the income to U.K. taxes; (2) caused the Trust to deposit a predetermined amount of funds into a blocked account and then to withdraw those funds immediately, enabling Barclays to claim a U.K. tax loss even though the transaction had no net economic effect; and (3) "cycled tax through the U.K. taxing authority, then to Barclays, and then back to [BB&T]." Id. None of those transactions, the court found, had any economic substance.
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> As explained above, we do not accept the trial court's characterization of the Bx payment as simply a rebate of the Trust's U.K. tax payments; we agree with the trial court, however, that the Trust transaction was a contrived transaction performing no economic or business function other than to generate tax benefits. The trial court correctly concluded that the income "from BB&T's preexisting assets cycled through the STARS Trust was not [economic] profit from STARS," but was akin to the "transfers of income-producing assets to controlled entities that do not imbue an arrangement with substance," because "the transfer has no incremental effect on the taxpayer's activities." 112 Fed. Cl. at 586 (citing cases). As the trial court found, the Trust transaction reflected no meaningful economic activity by BB&T: the incremental profit potential of the Trust (beyond the income already generated by the underlying assets) depended entirely on Barclays' and BB&T's anticipated tax benefits; it exposed BB&T to no economic risk (other than the risk that the IRS would challenge the tax treatment of the transaction); and it had no realistic prospect of producing a profit (apart from the effect of the foreign tax credits).

The Court ruled the loan component of the S.T.A.R.S. transaction had economic substance because "BB&T obtained unrestricted access to $1.5 billion in loan proceeds."

> While it may be true that the Loan operated partly to camouflage the Bx payment, it also resulted in a substantive change in BB&T's economic position. As a result of the Loan transaction, BB&T obtained unrestricted access to $1.5 billion in loan proceeds. An impact of that sort cannot be said to have resulted in no change in the economic benefits enjoyed by the taxpayer. See *Coltec*, 454 F.3d at 1355 ("[T]ransactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration."); *Kerman*, 713 F.3d at 865 (noting that the taxpayer did not have unfettered access to all the loan proceeds under the sham transaction).
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> Obtaining financing of that magnitude, in and of itself, would "appreciably affect" the beneficial interest of a commercial bank such as BB&T. See *ACM P'ship*, 157 F.3d at 261–62 (allowing deduction of economic losses that were "separate and distinct from the $87 million tax loss that did not correspond to any actual economic loss"); *Lee*, 155 F.3d at 586 (reciting the "undoubted proposition that interest on loans incurred to support an economically substantive investment is not disqualified as a deduction merely because the borrower is also motivated by favorable tax consequences"); *Rice's Toyota World*, 752 F.2d at 95–96 ("[I]t does not follow that the sham nature of the underlying transaction supports the Tax Court's conclusion that the recourse note debt was not genuine.... [A] sham transaction may contain elements whose form reflects economic substance and whose normal tax consequences may not therefore be disregarded."); *Coors*, 572 F.2d at 835 ("Since plaintiffs received insurance coverage of this magnitude during the years in issue, it is hard to accept defendant's repeated assertion that plaintiffs during those years received nothing of substance from the various policy advances or loans except a purported interest deduction.").

"This decision comes at a critical time, as many S.T.A.R.S. cases involving U.S. financial institutions have been deferred pending the decision in BB&T."

Thus, BB&T was allowed to deduct the loan interest payments it made to Barclays. The only remaining issue in BB&T's S.T.A.R.S. dispute is the amount of accuracy -related penalties to be imposed upon BB&T.

This decision comes at a critical time, as many S.T.A.R.S. cases involving U.S. financial institutions have been deferred pending the decision in BB&T. For example, Bank of New York Mellon has appealed the disallowance of its 2013 loss in the Tax Court to the Second Circuit Court of Appeals in a S.T.A.R.S. transaction with Barclays. American International Group, Inc. ("AIG") has also appealed the disallowance of its claimed foreign tax credits in a transaction. Wells Fargo and Bank Santander are among the banks in the midst of S.T.A.R.S. disputes before U.S. courts. The critical decision is whether the I.R.S. will accept the B.B.&T decision by the Federal Circuit Court of Appeals as controlling on the other cases or whether it will continue to litigate, hoping to obtain a conflict in the circuit courts of appeals so that the matter can be presented to the U.S. Supreme Court.

LEGISLATION TO RELAX F.I.R.P.T.A. GETS BIPARTISAN SUPPORT

Author
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Tags
F.I.R.P.T.A.
Withholding
R.E.I.T.

Tax legislation to encourage foreign investment in U.S. real estate made through real estate investment trusts ("R.E.I.T.'s") was recently introduced in both the House and the Senate. Representatives Kevin Brady (R-T.X.) and Joe Crowley (D-N.Y.), introduced H.R. 2128, the "Real Estate Investment and Jobs Act of 2015." The measure, backed by 22 bipartisan members of the U.S. House of Representatives, would make significant changes to the Foreign Investment in Real Property Tax Act ("F.I.R.P.T.A."). The bill is similar to legislation Representatives Brady and Crowley introduced in the last session of Congress, as well as a companion version introduced in the U.S. Senate this year, co-authored by Senators Mike Enzi (R-W.Y.) and Bob Menendez (D-N.J.), S. 915. The Senate version would adopt additional changes including a proposed increase in F.I.R.P.T.A. withholding tax rates that would complicate investing by those not benefitting from the proposals. Enactment of the significant provisions in H.R. 2128 and S. 915 would signify an important step toward achieving F.I.R.P.T.A. reforms that have been advocated for by a number of real estate organizations for many years.

R.E.I.T. QUALIFICATION

A R.E.I.T. is a creation of the tax law. Any corporation, trust, or unincorporated entity may qualify as a R.E.I.T. if it meets the requirements of Code §856. A benefit of R.E.I.T. status is that it is a conduit for tax purposes, provided distributions are made to shareholders. No tax is imposed on the R.E.I.T. if it distributes all its income to its owners. The R.E.I.T. claims a deduction for dividends that it pays to its shareholders. In addition, a shareholder of the R.E.I.T. may be able to treat a dividend from the R.E.I.T. as taxable at capital gains rates if the underlying income of the R.E.I.T. that generates the dividend arises from the sale of an asset.

Qualifying as a R.E.I.T. requires compliance with many rules. Some of the primary requirements are the following:

1. Income Tests. For each taxable year of the R.E.I.T., the R.E.I.T. must meet two income tests: a 75% test and a 90% test. The purpose of these tests is to ensure that the primary source of the R.E.I.T.'s income is real estate rentals, interest on real estate mortgage loans, gains from the sale of real estate, and certain other passive income.

2. Asset Tests. On the last day of each quarter of the R.E.I.T.'s taxable year, 75% or more of its assets must be real estate assets, cash and cash items, or governmental securities.

3. Distribution Requirement. A R.E.I.T. must annually distribute 90% or more of its income to its shareholders. However, because the R.E.I.T. remains taxable on its retained income, most R.E.I.T.'s will distribute 100% of income

to shareholders in order to eliminate all corporate level tax on the R.E.I.T.

4. Non-Closely Held Requirement. Ownership of more than 50% of the value of the R.E.I.T.'s shares cannot be held by five or fewer individuals. Sometimes, all the common stock of a R.E.I.T. may be owned by a corporation or mutual fund. In that case, a "look-through" rule applies so that a single corporate shareholder is permissible as long as five or fewer individuals do not own more than half of the R.E.I.T. as determined under attribution rules for determining the R.E.I.T.'s shareholders.

5. 100-Shareholder Requirement. The R.E.I.T. must have 100 or more shareholders. This rule is usually satisfied by the R.E.I.T. issuing preferred stock to 100 or more persons. To illustrate: each person buys preferred stock for $1,000, which entitles them to an annual dividend equal to a specified percentage of the $1,000 (such as 12% of $1,000) and a return of their $1,000 upon liquidation of the R.E.I.T.

6. Election Requirement. The corporation must elect to be treated as a R.E.I.T.

7. Domestic Corporation Requirement. A non-U.S. entity cannot elect R.E.I.T. status. If the R.E.I.T. election is not made, the entity must be taxed as a domestic corporation. This means that it must be formed under the laws of one of the 50 states or the District of Columbia.

TAXATION OF R.E.I.T.'S AND THEIR FOREIGN SHAREHOLDERS

F.I.R.P.T.A. imposes U.S. Federal income tax on the gain realized by a foreign investor on the sale of stock of any U.S. corporation that is a U.S. real property holding corporation ("U.S.R.P.H.C."). Investments in R.E.I.T.'s are one way a foreign investor can choose to invest in U.S. real estate. Some R.E.I.T.'s are held by an appropriately sized private group, while others have shares that are publicly traded. In either case, the sale of R.E.I.T.'s stock can subject the foreign investor to U.S. tax under F.I.R.P.T.A., subject to certain exceptions. The proposals seek to expand the list of exceptions.

In addition, a R.E.I.T. can make two types of distributions to its shareholders: (i) ordinary dividends that can come from real estate rental income or interest on real estate mortgages and (ii) capital gains dividends that can come from the sale of real estate owned by the R.E.I.T. Ordinary dividends are not subject to U.S. tax under F.I.R.P.T.A. but are subject to the regular 30% U.S. withholding tax imposed on passive income. The rate of tax may be subject to reduction by operation of a tax treaty, although typically the rate is not reduced below 15% and applies to persons holding a limited interest in the R.E.I.T. By contrast, capital gains dividends are subject to tax under F.I.R.P.T.A. The R.E.I.T. is required to withhold tax from the dividend at the highest relevant tax rate on capital gains and the investor is required to file a U.S. tax return and to pay 30% branch profits if the investor is a corporation.

LEGISLATIVE PROPOSALS

Certain exceptions to F.I.R.P.T.A. can apply to capital gains dividends; the proposals seek to expand those exceptions in order to encourage greater equity investment into U.S. real estate. The legislative proposals would increase the amount of stock in a publicly-traded R.E.I.T. that a foreign investor may hold without becoming subject to tax under F.I.R.P.T.A. on the disposition of that R.E.I.T. stock. The goal is to encourage foreign ownership of R.E.I.T. stock, which may enhance foreign investment in U.S. real property.

"The bills would increase the level of ownership that may be held without taxing gain on the sale of those shares. The 5% threshold under current law would be increased to 10% for investment in a publicly traded R.E.I.T."

The proposals may be summarized as follows:

- Current law allows for a F.I.R.P.T.A. exception when a foreign shareholder sells stock in a publicly traded corporation in which the investor holds 5% or less of the outstanding stock during the relevant stock ownership period. Publicly traded R.E.I.T.'s tend to take advantage of this exception. The bills would increase the level of ownership that may be held without taxing gain on the sale of those shares. The 5% threshold under current law would be increased to 10% for investment in a publicly traded R.E.I.T. If the threshold is not exceeded, the sale of stock in the publicly traded R.E.I.T. will not be subject to U.S. tax. However, the 5% threshold would continue for investment in a publicly traded corporation that is a U.S.R.P.H.C. but not a R.E.I.T.

- Current law allows for a publicly traded R.E.I.T. to classify a capital gains dividend as an ordinary dividend if paid to a shareholder owning 5% or less of its stock. Ordinary dividend treatment eliminates application of F.I.R.P.T.A. and the requirement to file U.S. tax returns and possibly pay branch profits tax. The proposed bills would increase the 5% threshold to 10%.

- A new exemption from tax under F.I.R.P.T.A. is proposed for any R.E.I.T. stock held by a qualified shareholder owning not more than 10% of the R.E.I.T. directly or through attribution from others. If an investor holds more than 10% of the R.E.I.T. stock and the shareholder is a qualified shareholder, only a portion of the shares will be considered to be a U.S.R.P.I. A qualified shareholder is defined as a foreign person that:

    - Is eligible for the benefits of a comprehensive income tax treaty that includes an exchange of information program;

    - Is a qualified collective investment vehicle;

    - Has its principal class of interests listed and regularly traded on one or more recognized stock exchanges (as defined in the applicable treaty); and

    - Maintains records on the identity of each person who, at any time during the qualified shareholder's taxable year, is the direct owner of more than 10% of that principal class of interests.

- A new exemption from F.I.R.P.T.A. is provided for foreign pension funds investing in any U.S.R.P.I., which includes an investment in a R.E.I.T. or a direct investment in U.S. real estate or an investment in a partnership holding U.S. real estate. Proposed §897(i) adds this new exemption and defines a foreign pension plan to be a non-U.S. entity that is formed to provide retirement or pension benefits to beneficiaries who are current or former employees of one or more employers. Other conditions for foreign pension fund status are also required. The House and Senate proposals differ on this point, as the Senate bill does not contain this new exemption.

- Current law provides that an investment in a domestically controlled R.E.I.T. is not a U.S. real property interest subject to F.I.R.P.T.A. This exemption applies to an investment in a publicly traded R.E.I.T. or a private R.E.I.T. There is no restriction on how much stock can be held to take advantage of this exemption. A foreign investor can own 1%, 5%, or 25% of the R.E.I.T. and still get the exemption. A R.E.I.T. is domestically controlled if less than 50% of the value of the R.E.I.T. shares is held by non U.S. persons at all times within the five-year period ending on the date of disposition of the R.E.I.T. stock. In PLR 200923001, the I.R.S. ruled that a U.S. corporation is a U.S. person and not a foreign person even if the U.S. corporation is controlled by foreign persons. However, determination of whether a R.E.I.T. is domestically controlled can be very difficult. The provision contains several new presumptions for purposes of determining if a R.E.I.T. is domestically controlled. Again, the House and Senate proposals differ, as only the Senate bill contains this provision.

- As a mechanism for enforcement, F.I.R.P.T.A. imposes a withholding tax on the buyer of the U.S. real estate. This compliance provision currently imposes a 10% withholding tax on the amount realized on the sale. The Senate Finance Committee is concerned that some foreign persons may fail to file the required U.S. tax returns under F.I.R.P.T.A. since the tax they owe may be more than the tax withheld. Those persons may escape paying the full U.S. tax on their gain from the disposition of the U.S.R.P.I. Therefore, the Senate bill (but not the House bill) has proposed to increase the 10% F.I.R.P.T.A. withholding obligation to 15%. There is an exception to the increased rate of withholding for sales of residences intended for personal use by the acquirer, with respect to which the purchase price does not exceed $1,000,000. No matter what the rate, relief from over-withholding exists if, prior to a sale, a Form 8288-B was filed requesting reduced withholding tax or its elimination in order to match the amount withheld with actual tax liability.

- Additional changes are contained in the Senate bill. Of these, an important change is a disclosure requirement of U.S.R.P.H.C. status for any U.S. corporation.

CONCLUSION

While proposals to liberalize F.I.R.P.T.A. have been made many times before, they have never been enacted. Now, these bipartisan efforts signal the chance that new legislation may finally be on the horizon.

COULD AN I.R.S. EMPLOYEE'S COMMENT CAUSE YAHOO! STOCK TO FALL?

Author
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Tags
Active Trade or Business
Alibaba
Spinoff
Yahoo!

Recently, the Internal Revenue Service ("I.R.S.") Office of the Associate Chief Counsel (Corporate) announced that it may hold off on issuing ruling requests to taxpayers seeking assurance on the "active trade or business" requirement ("A.T.B.") of a tax-free spinoff under Code §355. In light of recent market transactions, the I.R.S. is in the process of considering, how much A.T.B. is enough for a spinoff to qualify for nonrecognition treatment.

YAHOO! CIRCUMSTANCES

The announcement also placed doubt on whether ruling requests already submitted to the I.R.S. would be issued. Speaking at a District of Columbia Bar Association event, a senior technical reviewer at the Office of the Associate Chief Counsel (Corporate) stated that the I.R.S. will hold off on issuing new ruling requests starting on May 19, 2015. He said that requests that were submitted before that date will be reviewed in the normal course, but that position may also change depending on what is decided in the next few months.

This was bad news for Yahoo! Inc. ("Yahoo!"), which announced earlier this year that it is planning to spinoff its stake in the Chinese e-commerce giant, Alibaba Group Holding Ltd. ("Alibaba"). Yahoo! holds shares in Alibaba worth approximately $40 billion and has been under pressure by key investors to return the value of the Alibaba shares to Yahoo! shareholders. However, if it simply sold those shares or distributed the shares in a taxable dividend, Yahoo! would face a hefty Federal tax bill of 35% on the sale. That amount would be increased by applicable state and local taxes.

Yahoo! Chief Executive Officer Marissa Mayer, said that after considering many alternatives, the company decided it would spinoff the shares of Alibaba, in a transaction under which Yahoo! would contribute its Alibaba shares to a new company, along with a relatively small legacy operating business. The new company, known as a "spinco" in corporate reorganization parlance, is designed to meet the A.T.B. requirement under Code §355(b). Shares in Spinco would then be distributed to the Yahoo! shareholders, thus separating shares in the operating business of Yahoo! from shares in the legacy business and Alibaba.

Since the value of the Alibaba shares is considerable, it is expected that the legacy operating business dropped into Spinco to meet the A.T.B. requirement will represent a relatively small percentage of Spinco's total assets.

YAHOO! STOCK FELL 10% A FEW MINUTES LATER

Though the I.R.S. employee did not mention Yahoo! by name, his comments were apparently enough to cause the company's stock price to fall that day to $40.90, down from $44.36 on the day before.

THE ROLE OF A.T.B. IN A TAX-FREE SPINOFF

In order to be tax free, the Yahoo! spinoff must meet four basic statutory[1] requirements under Code §355, as follows:

- Only the stock or securities of Spinco must be distributed to Yahoo! shareholders with respect to the stock of Yahoo!, or to the security holders in exchange for Yahoo! securities;
- The distribution must not be a device for distributing earnings and profits;
- Both Yahoo! and Spinco must be engaged in an A.T.B.; and
- Yahoo! must distribute all of the Spinco stock and securities it holds or enough to constitute control (as defined) of Spinco.

The A.T.B. requirement is imposed by Code §355(b)(1)(A) and requires, in the Yahoo! context, that both Yahoo! and Spinco be engaged in an A.T.B. immediately after the spinoff.

Yahoo! and Spinco will be considered to be engaged in an A.T.B. immediately after the spinoff if they were engaged in an A.T.B. throughout the five-year period ending on the date of the spinoff and those businesses were not acquired in a taxable transaction within that five-year period.[2]

Neither the Code nor the I.R.S. regulations require that a specific percentage of Spinco's assets be devoted to the A.T.B. In a past revenue ruling, the I.R.S. approved a spinoff in which only 5% of the corporation's assets met the A.T.B. requirement.[3]

HOW MIGHT THE I.R.S. RETHINK A.T.B.?

Though it is unclear at this time what sort of guidance the I.R.S. might provide, one possibility is that it might establish a bright-line, objective test, which would require a certain threshold percentage of the assets of Spinco to be engaged in an A.T.B.

However, since the Code does not require a specific percentage of Spinco's assets to be engaged in an A.T.B. in order to meet the aforementioned requirement under

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[1] In addition to the four basic statutory requirements under Code §355(a)(1), described above, a spinoff must also meet the requirements prescribed by the case law, that is: the business purpose, the continuity of business enterprise, and the contituity of interest requirements.

[2] Code §355(b)(2).

[3] Rev. Rul. 73-44, 1973-1 C.B. 182, clarified by, Rev. Rul. 76-54, 1976-1 CB 96.

Code §355(b)(1)(A), taxpayers such as Yahoo! may feel emboldened to proceed with a spinoff and challenge a bright-line, objective test in court.

It is believed that the focus of this rethinking is not taxpayer-specific; the concern is cash-rich spinoffs (*i.e.*, spinoffs with spincos that hold off cash and marketable securities with a relatively small trade or business) and R.E.I.T. spinoffs.[4] This is illustrated by the following hypothetical, designed in the extreme to prove the point being made:

> Company A has a legacy business involving a hot dog stand. It has been operating for the requisite five-year period. Company A drops the hot dog stand into Spinco. At that point, Spinco is worth $1 million. Company A then drops $99 million in highly appreciated securities into Spinco. Is it believable that Company A would drop in $99 million in securities to be used as collateral in support of a loan to Spinco to provide funds to expand its newly-acquired hot dog stand?

"It is believed that the focus of this rethinking is not taxpayer-specific; the concern is cash-rich spinoffs (i.e., spinoffs with spincos that hold off cash and marketable securities with a relatively small trade or business) and R.E.I.T. spinoffs."

YAHOO! MOVING FORWARD?

It was reported on July 22, 2015 that Yahoo! will move forward with the plan to spinoff its Alibaba shares even without a favorable I.R.S. ruling. One possible reason for its confidence is that its legal team includes an alumnus of the Associate Office of the Chief Counsel (Corporate) who was involved in rulings for companies seeking to spinoff cash and marketable securities with a relatively small trade or business.[5]

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4 In 2001, the I.R.S. ruled that R.E.I.T.'s can be engaged in an active trade or business within the meaning of Code §355(b). Rev. Rul. 2001-29, 2001-26, I.R.B. 1348.

5 Bloomberg BNA Tax and Accounting Center, Weekly Report, *Yahoo's Tax-Free Alibaba Deal Could be Held Up, But It's Not Dead*, Laura Davison, Jesse Drucker, and Richard Rubin, May 20, 2015.

THE *HEWLETT-PACKARD* DEBT V. EQUITY CASE – REPLY BRIEF FILED

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Tags
Debt-Equity
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INTRODUCTION

The focus of a debt-versus-equity inquiry generally narrows to whether there was intent to create a debt with a reasonable expectation of repayment and, if so, whether that intent comports with the economic reality of creating a debtor-creditor relationship. This determination has led various courts of appeals to identify and consider a multi-factor test for resolving such inquires.

In the typical debt-versus-equity case, the I.R.S. will argue for equity characterization whereas the taxpayer will endeavor to secure debt characterization to obtain an interest deduction. In some cases, the roles are reversed, but this does not require that courts apply different legal principles.[1] Some courts consider 10 factors, while others consider as many as 16 factors.[2] No matter how many factors are considered, the multi-factor test is the established, standard analysis used in such disputes.

While in the domestic context debt-versus-equity inquiries have been in dispute for decades, the examination of such disputes in the international context is relatively new. Two 2012 rulings by the United States Tax Court dealing with investment among related parties in the international arena went in different directions. In both cases, the taxpayers wanted the investments to be treated as equity for U.S. tax purposes. In *PepsiCo*,[3] the taxpayer prevailed and equity treatment was upheld. In contrast, the I.R.S. prevailed in the *Hewlett-Packard*[4] case, where the Tax Court was convinced that the transaction should be categorized as a loan rather than an equity contribution. In the *Hewlett-Packard* ("HP") case, the court did not limit the analysis to the investment instrument and the parties' rights and obligations under such instrument but rather looked to other documents it found integral to the transaction, including relationships with parties other than the issuer of the instrument.

THE HP CASE: SUMMARY OF FACTS

HP purchased preferred stock in a Dutch corporation ("FOP") from AIG. Additionally, HP assumed AIG's put and call option agreement with the other shareholder in FOP.

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1 *Segel v. Commr.*, 89 T.C. 816 (1987), citing Regland Inv. Co. v. Commr., 52 T.C. 867 (1969).

2 *Fin Hay Realty Co. v. United States*, 398 F.2d 694, (3rd Cir. 1968) discussing 16 factors; *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972) discussing 13 factors; and *United States v. Uneco, Inc.*, 532 F.2d 1208 discussing 10 factors.

3 *PepsiCo Puerto Rico, Inc. v. Commr.*, T.C. Memo. 2012-269 (9/20/12).

4 *Hewlett-Packard Co. v. Commr.*, T.C. Memo. 2012-135 (5/14/12).

The put agreement allowed HP to exit the investment for no cause on two specified dates (in January 2003 and January 2007). Exercising the put option without cause was to be made for a price equal to the fair market value of the preferred shares on the date the option was exercised. Eventually, the put option was extended, and HP exercised the option in January 2004. Under FOP's Shareholders Agreement, HP had a preferred entitlement to dividend distributions. FOP's Articles of Incorporation provided that the dividends shall be declared and payable to the holders of the preferred shares. Under the Shareholders Agreement, in certain circumstances, including the failure of FOP to pay any dividend when due and payable, the holders of the preferred shares had the authority to convene a shareholders' meeting at which the shareholders could (i) cause the other shareholder to redeem or repurchase the preferred shares or (ii) cause FOP to dissolve. As a major holder of the preferred shares, HP would have the majority vote in such shareholders' meeting. If the shares were redeemed, HP would receive proceeds that would compensate for the present value of the expected FOP dividends, plus an amount representing the present value of the expected foreign tax credits. Lastly, the Shareholders Agreement provided that the parties should take all actions that might be required to give effect to the dividend provision in the Articles of Incorporation and that the shareholders and FOP would undertake necessary or appropriate actions to implement the valid exercise of the put and call option agreement.

During the period that HP held the preferred shares of FOP, it claimed indirect foreign tax credits with respect to Dutch taxes paid by FOP, as a shareholder owning more than 10% of the voting stock. Additionally, HP claimed foreign tax credits with respect to the Dutch withholding tax that applied to dividend distributions it received from FOP. The I.R.S. disallowed the foreign tax credits on the basis that the investment was more appropriately characterized as debt, rather than equity.

THE TAX COURT'S DECISION

The Tax Court agreed with the I.R.S. position that HP's investment in FOP should be characterized as debt. The Tax Court recognized that the case would likely be appealed to the U.S. Court of Appeals for the Ninth Circuit and therefore applied the factors ordinarily considered by the Ninth Circuit. As a preliminary matter, the Tax Court noted that while the transaction was meticulously structured so that no action could be taken by FOP to undermine the put and call option agreement, the Shareholders Agreement nevertheless added an obligation for FOP and all its shareholders to undertake any necessary or appropriate actions to implement the valid exercise of the put and call option agreement. As a result, the Tax Court construed the put agreement and all agreements mentioned in the Shareholders Agreement as an integral part of the investment documents.

The Tax Court focused on the question of whether repayment was intended at the time of the investment, and determined that – when viewed in its entirety, taking into account all documents – HP never intended to assume the risk of the FOP venture. In applying all factors listed by the Ninth Circuit – even those not addressed by either of the parties – the Tax Court noted the following:

1. The put and call option agreement assured HP an exit option once the tax benefits of the transaction ended;

2. Based on the language of the Articles of Incorporation, the Board of Directors

lacked discretion to declare dividends payable to HP, thus making the payments to HP predetermined;

3. FOP's earnings, out of which dividend payments were to be made, were fixed and predetermined;

4. The only risk related to incoming cash was if the other shareholder defaulted on the agreement, which in the court's opinion was a low risk;

5. In the event that the other shareholder defaulted on its payments to FOP or that FOP did not pay dividends to HP, the Articles of Incorporation and the Shareholders Agreement worked in tandem to provide a mechanism by which HP would be made whole;

6. HP's tax benefit ceased in 2003, and therefore, HP had an economic disincentive to continue the transaction beyond 2003 (the initial put date), which should be interpreted to means that the 2003 option date was in essence a fixed maturity date; and

7. The Articles of Incorporation and the other agreements afforded HP a device to enforce creditor-like rights.

APPEAL

In October 2014, HP filed a notice of appeal to the Ninth Circuit and in January 2015 filed its opening brief. In its opening brief, HP argued that the Tax Court's finding that the investment "exhibited more qualitative and quantitative indicia of debt than equity" was based on misapplied established legal principles and was clearly erroneous.[5]

HP claimed that the debt-versus-equity dispute is to be resolved under an analysis of the multi-factor test that, in this case, was not even-handedly applied. HP noted that the facts do not support a claim that the transaction was a sham or that it lacked economic substance, and furthermore, the Tax Court did not address such alternative contentions by the I.R.S.

HP claimed that the debt-to-equity analysis should be based on the legal rights and obligations of the parties to the instrument, and nothing more.

REPLY BRIEFS

In April 2015, the I.R.S. filed its reply brief to the Ninth Circuit. The brief reiterated the earlier arguments and supports the Tax Court's decision.

On May 18, HP filed its reply brief stating its position that the Tax Court misapplied established legal principles when considering the multi-factor test. In the heart of the brief, HP claims that while Congress and the Treasury leave the resolution of debt-versus-equity questions to the long-standing judicial approach, and although the I.R.S. has consistently applied the judicial multi-factor test in its administrative rulings, in this case, the I.R.S. merely paid "lip service" to the multi-factor test and consistently invoked a vague "substance over form" principle whenever a factor indicated equity.

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[5] *Hewlett-Packard Co. v. Commr.*, 9th Cir., No. 14-73047, brief filed 4/12/15.

In HP's view, by adding an additional "substance over form" inquiry in analyzing each individual factor, the I.R.S. deviated from the proper application of that test. HP claims that applying the multi-factor test is the means to determine if a transaction has "substance" in a debt-versus-equity dispute. The I.R.S.'s deviation from such principles can enable courts to disregard the actual rights and obligations of the parties – which in HP's view is the "substance" of a debt-versus-equity dispute – and bypass any factor on the grounds that the relevant rights and obligations "do not fit the overall 'substance' of the transaction."

"HP's appeal rests on the premise that the Tax Court erred in reaching its decision. HP claims that the multi-factor test is the standard for debt-versus-equity disputes and that the Tax Court did not apply this test appropriately."

In HP's view, a court must faithfully apply the multi-factor test to examine whether the rights and obligations are more like debt or equity. To do otherwise departs from long-standing precedent and threatens to undermine the ability of taxpayers to engage in transactions with predictability.

With respect to the Tax Court's focus on the put agreement in deciding its case, HP claims that the put agreement should not be viewed to establish a fixed maturity date for the investment and should not be viewed to ensure HP's repayment of its investment for the following reasons:

- The put and call option was not exercisable for the first seven years, and indeed, HP ultimately only exercised it a year after the initial 2003 put date;
- The purchase price of the preferred shares under the put and call option agreement did not guarantee recouping the investment, as the counterparty could have had financial difficulties (and indeed did have significant difficulties a few years later), and such decline in fair market value would not have been offset by the dividend reset provision of the Articles of Incorporation;[6] and
- In any event, a fixed maturity date for preferred stock does not defeat equity treatment.

CONCLUSION

HP's appeal rests on the premise that the Tax Court erred in reaching its decision. HP claims that the multi-factor test is the standard for debt-versus-equity disputes and that the Tax Court did not apply this test appropriately. It claims that the "substance over form" principle is embodied in the multi-factor test and should not be an added layer to the analysis of each and every factor. Furthermore, HP claims that, by departing from the multi-factor analysis in favor of looking for the economic substance in the investment instrument, the Tax Court ignored certain rights and obligations of the instrument and bypassed certain significant factors.

The parties do not dispute the multi-factor test applied by the Tax Court, but rather the manner in which such factors are applied. HP argues that the analysis is that of the legal relationship created by the instrument; the I.R.S. claims that the economic relationship is what the factors seek to discover. In deciding this case, the Ninth Circuit will be required to determine how the debt-versus-equity factors are to be applied and whether a "substance over form" argument is embedded in the factors (argued by HP) or whether it is an implicit additional factor that must be considered.

6 The dividend reset provision provided a feature for the preference shares beginning in 2003 that would "cause the Shares B, insofar as possible, to have a market value that is equal to their par value."

REINSURANCE CASE INVALIDATES TAX ON FOREIGN-TO-FOREIGN WITHHOLDING TRANSACTIONS

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Tags
Cascade Tax
F.D.A.P.
Foreign-to-Foreign Transaction
Insurance Excise Tax
Withholding

A "cascading tax" is a tax that is enforced more than once on the income from the same transaction or related transactions. A common example involves a back to back license in which:

- A non-U.S. individual or corporation ("A Co.") licenses the rights to use intellectual property ("I.P.") in the U.S. to another non-U.S. corporation ("B Co."); and
- B Co. then sub-licenses the same rights to use the I.P. to a U.S. corporation ("C Co.").

Neither A Co. nor B Co. are engaged in a U.S. trade or business. C Co. pays a royalty to B Co., and then, B Co. pays a royalty to A Co. for the use of the same I.P. The 30% U.S. withholding tax on fixed or determinable annual or periodic ("F.D.A.P.") income technically applies to both royalties even though they are paid for the use of the same I.P., which results in double taxation, *i.e.*, a cascading tax. From the U.S. point of view, the much-contested issue is whether such withholding tax should be applied and, if so, whether anyone is collecting it. In the recent case *Validus Reinsurance, Ltd. v. United States*,[1] the U.S. Court of Appeals for the District of Columbia Circuit (herein the "Federal Court of Appeals") held that a cascading "federal excise tax" should not apply to reinsurance on a foreign-to-foreign transaction on the grounds that the statute did not have an extraterritorial reach. The consequences of this determination may affect the application of 30% U.S. withholding tax on "F.D.A.P." income such as royalties involving entities that are not engaged in a U.S. trade or business.

INTRODUCTION: FOREIGN-TO-FOREIGN WITHHOLDING ON F.D.A.P. INCOME

If income generated by a foreign person is from U.S. sources but is not "effectively connected" with a U.S. trade or business, it is generally subject to a 30% withholding tax if it is F.D.A.P. income. F.D.A.P. income consists of items of income such as interest, dividends, and royalties. Treaty relief may be available to reduce F.D.A.P. withholding, and F.D.A.P. income can also be reduced or eliminated through various means specified in the Internal Revenue Code (the "Code").

The I.P. example described above is a case where both royalty payments are U.S.-source and therefore subject to 30% withholding tax. This treatment is confirmed by Rev. Rul. 80-362,[2] wherein the I.R.S. confirmed that both royalties are subject to

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1 Ct. Cl. No.14-5081 (May 26, 2015), aff'd 19 F. Supp. 3d 225 (February 5, 2014)

2 1980-2 C.B. 208.

the 30% tax. In *SDI Netherlands*,[3] the U.S. Tax Court addressed another back-to-back license arrangement, but in this case, the parties were all related. Additionally, the license from A Co. to B Co. was for the worldwide rights to the I.P., but most of the use by B Co. was in the sublicense of the U.S. I.P. rights to C Co. The U.S. Tax Court held that Rev. Rul. 80-362 had no "significant support" and the 30% foreign-to-foreign withholding did not apply because the court refused to trace any of the worldwide royalties paid by B Co. to A Co. back to the U.S. The anti-conduit regulations issued by the I.R.S. after SDI Netherlands did not apply to the years under review in this case; those regulations did not follow *SDI Netherlands* and Rev. Rul. 80-362.[4] Code §871(m)(6) also seems to permit a foreign-to-foreign withholding in the case of dividend equivalents if the dividend equivalent is based on an underlying U.S. stock. Accordingly, the F.D.A.P. withholding regulations seem to permit withholding on certain foreign to foreign transactions, but only if the underlying income is sourced in the U.S.

" The consequences of this determination may affect the application of 30% U.S. withholding tax on 'F.D.A.P.' income such as royalties involving entities that are not engaged in a U.S. trade or business."

INSURANCE EXCISE TAX

What about non-F.D.A.P. taxes? Under the Code, there exists a 1% excise tax on reinsurance of a "casualty insurance policy" or an "indemnity bond."[5] The excise tax does not apply to the extent that the premium paid to the foreign insurer is effectively connected with the conduct of a U.S. trade or business by the insurer.[6] The earlier case *U.S. v. Northumberland Insurance Co. Ltd.*[7] held that the excise tax applied on reinsurance from an Australian insurance company to a Swiss reinsurance company because it reinsured U.S. risk – even though neither entity was engaged in a U.S. trade or business. The holding clarified that even though the "reinsured" was a foreign entity, the excise tax applied because the underlying policy was issued to a foreign person who insures a risk in the U.S – thus rendering the entity liable for the tax under the court's interpretation of the statute.

THE *VALIDUS* DECISION

In the recent *Validus* decision, the taxpayer was a Bermuda reinsurance company, Validus Reinsurance, Ltd. ("Validus"), that was not engaged in U.S. trade or business. The decision involved two different, but similar, insurance policies. First, Validus entered into a reinsurance policy with a U.S. insurance company. The reinsurance policy provided that if the U.S. insurance company had to pay a claim from a customer then Validus would pay the U.S. insurance company that same amount. In consideration for this benefit, the U.S. insurance company paid a reinsurance premium to Validus, which all parties agreed was subject to a 1% excise

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3 *SDI Netherlands B.V. v. Commr.*, 107 T.C. 161 (1996).

4 Example 11 of Reg. §1.881-3(e) in effect restates Rev. Rul. 80-362.

5 Code §§4372(b)-(c). "Casualty insurance" is defined as any policy or other instrument by whatever name called whereby a contract of insurance is made." An "indemnity bond" is defined as any "instrument by whatever named called whereby an obligation of the nature of an indemnity, fidelity or surety bond is made."

6 Unless the premium is exempted from U.S. tax pursuant to an income tax treaty as per Code §4373(1).

7 82-2 USTC, 521 F. Supp 70 (D.N.J. 1981).

tax. Second, Validus entered into a retrocession policy with another foreign company. The retrocession policy provided that if Validus had to pay a U.S. insurance company under its reinsurance policy, then the other foreign company would pay Validus that same amount. In consideration for this benefit, Validus would pay the other insurance company a retrocession premium (*i.e.*, a cash payment). The issue was whether the 1% excise tax applies to this retrocession premium when both parties are not engaged in a U.S. trade or business.

The Federal Court of Appeals held that the excise tax would not apply to the retrocession premium even though the tax should apply under a literal reading of the Code. The court applied a non-tax law doctrine called the "doctrine of the presumption against extraterritoriality," which they said applied since this related to a payment from one foreign company to another foreign company. The appellate court refused to follow the holding of *Northumerland* and held that the extraterritoriality of a tax (*i.e.*, the application of the tax in a foreign-to-foreign transaction) can only apply if congressional intent was expressly written into the statute. In this case, the statute was written in a broad manner that did not justify extraterritoriality, and therefore the insurance excise tax did not apply.

CONCLUSIONS & UNANSWERED QUESTIONS

Based on the *Validus* decision, an argument can be made that a foreign-to-foreign tax cannot apply unless congressional intent is clear in the statute. Even though the tax in question was an insurance excise tax, the reasoning may be applicable to the F.D.A.P. withholding rules. Both *SDI Netherlands* and Code §871(m) preceded the *Validus* decision, and accordingly, neither addresses the "congressional intent" reasoning found in *Validus*. Thus, some questions remain unanswered, namely: Will a future court apply the "congressional intent" and "extraterritoriality" reasoning in its interpretation of F.D.A.P. withholding regulations? Will Code §871(m) be overturned? Time will tell.

MORE SWISS BANKS REACH RESOLUTION UNDER D.O.J.'S SWISS BANK PROGRAM

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Tags
F.A.T.C.A.
O.V.D.P.
Swiss Banks Program

The U.S. Department of Justice's ("D.O.J.") "Swiss Bank Program" (officially called the "Program For Non-Prosecution Agreements"), was announced in August 2013 and provided a path for Swiss banks to resolve potential criminal liabilities in the U.S.

Swiss banks eligible to enter the program were required to advise the D.O.J. by December 31, 2013 that they had reason to believe that they had committed tax-related criminal offenses in connection with undeclared U.S.-related accounts. Banks that were already under criminal investigation related to their banking activities were expressly excluded from the program.

The Swiss Bank Program also provided a path to resolution for Swiss banks that were not engaged in wrongful acts with U.S. taxpayers, but nonetheless wanted a resolution of their status. Under the Program, a small group of banks were allowed to show that they met certain criteria for deemed-compliance under the Foreign Account Tax Compliance Act ("F.A.T.C.A."), and thus could be granted a "non-target letter."

The Swiss Bank Program borrows many concepts from the Intergovernmental Agreement ("I.G.A.") between Switzerland and the U.S., which was signed on February 14, 2013. However, rather than applying prospectively, as F.A.T.C.A. does, the Program looks back to 2008. Additionally, the Swiss Bank Program applies more extensive obligations to participating banks. For example, it provides that all banks (other than the small group that is eligible to claim deemed-compliance under F.A.T.C.A., see above) must close ''recalcitrant accounts." In contrast, under the I.G.A., the closing of accounts is not required.

As many as 106 banks have entered the Swiss Bank Program. Under the Program, banks are required to provide the D.O.J. with information about their cross-border business, agree to cooperate in any related criminal or civil proceedings, demonstrate their implementation of controls to stop misconduct, and pay penalties in exchange for the D.O.J.'s agreement not to prosecute them for tax-related criminal offenses.

Since the Swiss Bank Program was implemented, 15 Swiss banks reached an agreement with the D.O.J., agreeing to pay a combined $268.17 million. The first bank to reach a resolution was BSI S.A., on March 30, 2015. It agreed to pay a penalty of $211 million. Most recently, on July 2, 2015, the D.O.J. reached a resolution with Privatbank Von Graffenried AG.

While most U.S. taxpayers who enter the Internal Revenue Service's Offshore Voluntary Disclosure Program ("O.V.D.P.") to report previously unreported foreign accounts will pay a penalty of 27.5% on the highest year's aggregate value of their foreign accounts, those taxpayers who have an account at any of the banks that reached an agreement with the D.O.J. will have to pay a higher penalty. This is because the I.R.S. announced in August 2014 that if, at the time that a taxpayer initiates his offshore voluntary disclosure, a foreign bank with which the taxpayer had an account was publicly identified to be under investigation, the penalty under the O.V.D.P. will be increased to 50% of the value of the account.

CAN B.E.P.S. SURVIVE WITHOUT U.S. SUPPORT?

Author
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Tags
Action 15
B.E.P.S.
L.O.B.
Multilateral Instrument
O.E.C.D.
P.P.T.

On May 28, 2015, the O.E.C.D. announced the countries that will participate in a meeting to begin substantive work on drafting a multilateral instrument under B.E.P.S. Action 15. Currently, more than 83 countries have expressed interest in joining the discussion, which will take place on November 5 and 6, 2015. The United States was noticeably absent from the list. However, the O.E.C.D. hopes that support will continue to grow in the intervening months and that the meeting may ultimately include as many as 100 countries.

The U.S. Treasury chose not to participate in negotiating a multilateral instrument under B.E.P.S. Action 15. After a careful review of the agenda for the discussion on the multilateral instrument, the U.S. Teasury felt that participation did not seem like a good use of its scarce resources. This decision was prompted by the question, "What is there for U.S. to gain by participating in the discussions?"

The U.S. Treasury believes that a Limitation on Benefits ("L.O.B.") clause is sufficient to prevent "treaty shopping" and that the multilateral instrument would not offer any new mechanisms. The L.O.B. provision in most U.S. treaties limits treaty shopping by requiring that meaningful contact must exist between a corporation and its country of residence before tax treaty benefits are extended.

That contact may include any of the following fact patterns:

- The corporaton's shares are publicly traded on a local exchange and those shares are reglarly traded in substantial volume;
- The corporation is a subsdiary of a corporation that has publicly traded shares, as described above;
- The corporation is (i) predominantly owned by one or more local residents, U.S. residents and U.S. citizens, and (ii) the company is not a conduit to residents in third countries, except in certain well defined circumstances;
- The company is owned by the national government or a local authority;
- The company serves as a headquarters company for a multinational corporate group;
- The company is engaged in an active trade or business that is substantial in relation to the business activity conducted in the U.S. and is not a conduit to residents in third countries, except in certain well-defined circumstances (in which chase only income connected to the business qualifies for treaty benefits); or
- The competent authorities agree that neither the formation of the company nor the fact that it is availed of to carry out a transaction has as one of its principal purposes the avoidance of tax.

Treaty shopping is, in essence, an attempt by a resident of a third country to derive the benefits of a particular treaty by channeling investments through an entity that is in a particular jurisdiction but has no meaningful contact with that country.[1] The L.O.B. provision in a treaty is designed to reduce or eliminate such abusive practices by requiring the taxpayer to have sufficient connection with that country in order to justify entitlement to treaty benefits.

The principal purpose test ("P.P.T.") is to have transactions vetted under a broadly drafted general purpose rule. It is subjective, less precise, and in relation to a typical L.O.B. provision, has the potential to be have a lower or higher threshold for accessing the benefits of an incomet tax treaty. The U.S. Treasury has recognized that a company that is a resident of a Contracting State for valid business purposes may be primarily owned by residents of third countries, and/or may make substantial deductible payments to residents of third countries, in the ordinary course of business; the P.P.T. is designed to permit such a company to enjoy treaty benefits.[2] The L.O.B. provision can reach the same result, as indicated by the meaningful contact requirements listed above. The difference, however, is that good facts with a bad intention may prevent a treaty obligation from being obtained under a P.P.T., whereas bad facts with good intentions may not be a hindrance where competent authority relief is granted.

"Good facts with a bad intention may prevent a treaty obligation from being obtained under a P.P.T., whereas bad facts with good intentions may not be a hindrance where competent authority relief is granted."

The U.S. Treasury's decision has been welcomed by Catherine Schultz, the president of the National Foreign Trade Council ("N.F.T.C."), an organization that represents the global interests of 250 major U.S. companies. Ms. Schultz believes that if other counties are given the choice of between an L.O.B. or a P.P.T., they will not choose the more stringent L.O.B. provisions – which in fact will cause more tax revenues to go to countries other than the U.S. based on nebulous principal purpose reasoning.[3]

It is believed that the U.S. may sign the multilateral instrument if it includes mandatory binding arbitration. On June 8, 2015, G-7 leaders encouraged more countries to join in its commitment to mandatory binding arbitration. At this stage, it is not clear what will happen or if the U.S. Treasury will eventually join other countries in the negotiation of a multilateral instrument.

Even if the U.S. Treasury signs onto the multilateral instrument, it would still be subject to the guidance, oversight, and ratification by the U.S. Senate. Historically, the U.S. Senate has refused to ratify a treaty that contained a P.P.T. The rejection has been based on the fact that the P.P.T. adds uncertainty to results under a treaty because it is subjective and vague. The test is dependent upon the intent of the taxpayer, which is difficult to evaluate, and exclusive reliance on intent is inconsistent with present U.S. treaty policy.

What would be the fate of the B.E.P.S. deliverables without U.S. support? Will the project survive? We may get the answer to these questions very soon. Even if the B.E.P.S. project were to fail as a global attack on abusive tax planning, it may already be a success in light of the number of countries that have signed on to the multilateral instrument and to the adoption of local laws to implement B.E.P.S. principles.

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1 Rev. Rul. 84-15, 1984-2 C.B.

2 Treas. Technical Explanation, U.S.-Indonesia treaty.

3 Bell, Kevin A., "NFTC Offical Welcomes U.S. Refusal to Join Multilateral Instrument Negotiation," *BNA Snapshot*.

IS AN E.U. FINANCIAL TRANSACTIONS TAX COMING IN 2016?

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Tags
Financial Transactions Tax
F.T.T.
Tobin Tax

Although the origins of the Financial Transactions Tax ("F.T.T.") date back to the 1970's,[1] the European Commission first proposed a European Union-wide financial transactions tax in 2011. The proposal came at a time when many Europeans were concerned about the bad behavior of large banks and several E.U. countries were spending billions of dollars to bail out failing banks, while imposing austerity measures to counterbalance the impact on their budgets.

So far, 11 of the 28 E.U. countries have agreed to work toward a plan for the F.T.T., and their last meeting took place in June.[2] After that meeting, the French Finance Minister told reporters that a proposal is expected to come out in July and will likely consist of a tax with a broad base but a low rate.

THE DEVELOPING PROPOSAL

Although the proposal is still developing, the rough outline for the F.T.T. has been established as follows: A tax on all transactions involving financial instruments between financial institutions when at least one party to the transaction is located in the E.U. For exchanges of shares and bonds, the proposed tax rate may be 0.1%, and for exchanges of derivatives, the proposed tax rate may be 0.01%.

The tax could apply to a financial transaction if either a participant to the financial transaction or the issuer of the financial instrument is located in a participating state.

OPEN ISSUES

Some of the issues being considered are:

1. Whether there should be an exemption from the tax for market makers;
2. Implementation of tax collection and revenue-sharing mechanisms;[3] and
3. The impact of the anticipated high cost of compliance.

WILL THE F.T.T. ARRIVE BY ITS DEADLINE?

Although the deadline for the introduction of the F.T.T. was set for January 2016, many experts believe it is unlikely to be implemented by that time because consensus is building slowly and the open issues are complex.

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1 The origins of the F.T.T. date back to the economist, James Tobin, who proposed a tax on currency transactions as a way to manage exchange-rate volatility.

2 The 11 participating countries are: Germany, France, Spain, Italy, Belgium, Austria, Portugal, Greece, Estonia, Slovakia, and Slovenia.

3 *E.g.*, if one of the participants to the financial transaction and the issuer of the financial instrument are in participating states, who would collect the tax and who would receive the revenue from that tax?

CORPORATE MATTERS: BUY/SELL ARRANGEMENTS

Author
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Tags
Buy/Sell Provisions
Ownership Interest
Right of First Refusal

In our May issue, we discussed the implications and importance of drafting governance documents to cover the death of a business partner. We thought an appropriate follow-up would be a brief examination of buy/sell provisions.

Buy/Sell provisions deal with the transfer of ownership interests, typically within a business enterprise, when one of the partners wants out, or, potentially, wants another partner out. In either circumstance, it is not uncommon for each partner to want to carry on with the business – just as long as the other partner is excluded.

One buy/sell provision that is designed to deal with this situation is the "shotgun" buy/sell provision. As dire as this provision sounds, it is designed to be a fair way to transfer ownership in the event of a dispute. Its use is perhaps best suited to 50/50 ownership structures where the parties are on equal financial footing, but it can also be used in situations involving multiple owners.

When a shotgun clause is triggered, one shareholder makes an offer to the other shareholder to either sell his or her shares or to purchase all of the shares owned by the partner. The offer must set out the terms detailing what the offeror believes is an appropriate transaction value for the shares and appropriate terms to consummate the transaction. At that point, the recipient of the offer is either a buyer of the shares of the shareholder making the offer or a seller of his or her shares to the offeror. The shotgun buy/sell provision is potentially fair to both parties, as the initial offeror does not know whether the price and terms contained in the initial offer will be accepted (so that he or she has sold the interest) or rejected (so that he or she has purchased the interest of the offeree). The specified price must, therefore, be carefully considered as rejection creates an obligation for the offering party to buy the offeree's interest at the same price at which the offeror was willing to sell.

While a shotgun buy/sell provision is typically used only in the event of a deadlock caused by an irreconcilable disagreement between parties on an issue that is fundamental to the existence of an entity, it is can also be be drafted so that it can be triggered at any time by one of the partners. When a deadlock triggers its use, the type of deadlock may be defined in the governing documents and can include matters such as a failure to approve an operating budget for successive years. One also sees agreements where either party may invoke the provision after a certain time. We would not advise a client to use the procedure in this way, as it creates a situation where the partners are living with the constant threat of the shotgun provision being triggered by the other party, and this is definitely not conducive to a harmonious relationship.

As mentioned earlier, the shotgun buy/sell provision works best with two shareholders or two clearly defined groups of shareholders. In an 80/20 scenario, the 20% owner would have to come up with four times the funds as the 80% owner, and if the minority owner wanted to leave the entity, he or she could potentially end up in a situation where he the 80% owner of a company must be bought out in order for the minority shareholder to exit.

In practice, the fairness of the procedure can also be questioned, especially when the parties have unequal access to capital. The procedure favors the party with the deepest pockets, as an owner with the most money is able to put together an offer that the other party cannot match and can live with a resulting premium, if so required.

An exit strategy that avoids this potential for unfairness is a right of first refusal. Rather than making an offer for the other shareholder's interest, a shareholder who wants to exit the entity is entitled to find a buyer for his or her shares with the only restriction being a right of first refusal in favor of the other shareholders. While selling shares in a closely-held company is often difficult, this can still be a meaningful exit strategy. Closely related to a right of first refusal is a right of first offer. Here, the party wishing to exit sets a price below which he will not sell and payment terms and conditions that are acceptable and offers to sell at that price to the offeree partner. The offeree party can accept that offer under those terms or let it pass. At that point, the offeror has a period of time to identify a purchaser willing to pay an amount that is not less than the price set in the offer under terms that are not less favorable. As can be seen the difference between these two approaches is that in the former, the offeree need not act until the end of the process, when a *bona fide* offer is received. In the latter, the offeree must make his decision at the start of the process.

Many legal advisers believe that a right of first refusal limits the universe of purchasers for the shares because the potential purchaser cannot be certain that a deal has been struck until the holder of the right of first passes on his right to make the purchase.

As can be seen from the above, the shotgun buy/sell is not necessarily suitable for all situations. In the controlling documents, provisions may need to be made for many different exit strategies depending on the particular circumstances. Care should be taken in choosing the correct mechanism in order to avoid uncertainty and litigation following a triggering event.

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Tags
F.A.T.C.A.
I.G.A.

F.A.T.C.A.'S FIRST ANNIVERSARY: AN ASSESSMENT

On July 1, the Foreign Account Tax Compliance Act ("F.A.T.C.A.") celebrated the first anniversary of its implementation. F.A.T.C.A. was created to improve international tax compliance and combat offshore tax evasion. Notwithstanding dire predictions about its impact on the financial community when F.A.T.C.A. was first enacted in 2010, the sky has not yet fallen as of its first anniversary.

F.A.T.C.A. compliance has proved to be a burdensome task, but the financial community has been able to cope with those burdens. The O.E.C.D. common reporting standard ("C.R.S.") that is set to go into effect on January 1, 2016 for dozens of countries is still lurking as a possible compliance nightmare for the financial community, given the lack of meaningful guidance as to implementation. Coordination of F.A.T.C.A. with the C.R.S. is another step that needs to be taken.

F.A.T.C.A. compliance has nonetheless been difficult due to a variety of factors.

- First, there are over 100 Inter-Governmental Agreements ("I.G.A.'s") signed or about to be signed that greatly assist in F.A.T.C.A. compliance. Model 1 I.G.A.'s generally require local foreign financial institutions ("F.F.I.'s") to send account information to their own taxing authorities, which then transmits the information to the U.S. Model 2 I.G.A.'s require local F.F.I.'s to send that information directly to the I.R.S. However, there is a lack of guidance notes or regulations regarding implementation issued by many of the countries that have signed I.G.A.'s, which leaves advisors and the financial community up in the air as to how to actually comply.

- Second, while a Model 1 I.G.A., which is the most common form of I.G.A., gives great latitude to local countries for implementation and enforcement, the I.R.S. has at times stepped in to give its own views as to implementation that may contradict local guidance. The U.K. and Canada have said that new individual accounts can be opened without the need for a F.A.T.C.A. status self-certification from the individual. In reaction, the I.R.S. in F.A.T.C.A. General Compliance Question 10 has taken a different view and said no individual account can be opened without a self-certification. These conflicting views leave some financial institutions in an awkward position as to which path should be followed. For further information, see the article below as well as articles in our February and May issues.

- Third, there is a lack of consistency among the I.G.A.'s and the guidance that has been issued. That inconsistency can be seen in each I.G.A.'s Annex II, which creates exceptions particular to that country, but other inconsistencies also exist. For example, each country has its own set of compliance deadlines and obligations. There is no uniformity, which adds to the burden placed on the finance industry.

- Fourth, due diligence continues to be required for pre-existing accounts. That task is also complex.
- Fifth, despite the I.G.A.'s and the various forms of guidance issued to assist in compliance, F.A.T.C.A. is still a complex statute. In addition, completion of the variety of I.R.S. Forms W-8 is also complex, but necessary to avoid imposition of F.A.T.C.A. withholding.
- Sixth, F.A.T.C.A. has spawned the birth of the C.R.S., which has been adopted by dozens of countries. The coordination of these two tax reporting regimes is an important task that needs to be done soon so as to aid the financial community.

F.A.T.C.A. has added an administrative and financial burden that has started to decline, but that burden will not disappear. It is hoped that burden will produce benefits for the U.S. in added tax revenue, but so far, it is hard to determine if the benefits of F.A.T.C.A. outweigh the burdens it has placed on the financial community.

INTERSECTION OF F.A.T.C.A. AND THE COMMON REPORTING STANDARD

Since the 2010 enactment of F.A.T.C.A., other jurisdictions have taken up the task of gaining tax information from cross-border investments by adopting the common reporting standard ("C.R.S.") advanced by the O.E.C.D. On October 29, 2014, 51 countries signed a multilateral competent authority agreement to automatically exchange information based on Article 6 of the Multilateral Convention. Subsequent signatures of the agreement brings the total number of countries to 61. This agreement specifies the details of what information will be exchanged.

While both F.A.T.C.A. and the C.R.S. seek the automatic exchange of similar information, the inconsistencies between the two systems create unnecessary complexity that becomes worse when local country rules are applied.

F.F.I.'s are required to apply multiple classifications to the same entities, depending on whether they are being classified under F.A.T.C.A. or the C.R.S. and which jurisdictions are involved.

The differences in the definitions applied under the two regimes mean that financial institutions are unable to simply apply the work from F.A.T.C.A. for C.R.S. and in many cases, will need to rebuild their systems.

I.R.S. MAINTAINS POSITION ON OBTAINING SELF-CERTIFICATION TO OPEN NEW INDIVIDUAL ACCOUNTS

The I.R.S. maintains its position that financial institutions resident in I.G.A. countries must obtain self-certification of tax residency from new individual customers at the time they open accounts. The U.K. and Canada have said that resident financial institutions can open new accounts without getting a self-certification form, provided that they treat such accounts as reportable accounts. This disagreement was covered in our February and May issues.

In an annual forum sponsored by the Executive Enterprise Institute on international tax withholding and information reporting, two I.R.S. officials spoke on the matter. They said that "the I.G.A.'s are clear on their face," and that "self-certifications are required upon opening. It's a literal reading of the I.G.A.'s." As a result, institutions are caught between the more severe I.R.S. view and the more relaxed view of some countries.

SPONSORED ENTITIES REGISTRATION TO LAUNCH IN LATE SUMMER

"On May 20, 2015, the I.R.S. announced that in late summer it will launch the process for sponsoring entities to get registration numbers for their sponsored entities."

Until January 1, 2016, a sponsored investment entity may use the Global Intermediary Identification Number ("G.I.I.N.") of its sponsoring entity when submitting a Form W-8BEN-E (or a Form W-8IMY for pass-through entities and grantor trusts) or when a U.S. account is reported on their behalf. However, by January 1, 2016, sponsored entities must have their own G.I.I.N. and the sponsoring entities are required to register their sponsored entities. Notwithstanding the aforementioned, the F.A.T.C.A. Frequently Asked Questions state that sponsoring entities who want to register sponsored entities must wait for the I.R.S. to publish a streamline procedure for this purpose.

On May 20, 2015, the I.R.S. announced that in late summer it will launch the process for sponsoring entities to get registration numbers for their sponsored entities. Once launched, sponsoring entities will be able to download a template to use in requesting G.I.I.N.'s for their sponsored entities. The template will allow them to add sponsored entities individually or through a bulk upload to the I.R.S. system. The G.I.I.N.'s for these sponsored entities will then appear on an I.R.S. list showing they are associated with the sponsoring entity.

I.D.E.S. F.A.Q.'S NEW SECTION ADDRESSING F.A.T.C.A. I.D. NUMBER AND OTHER ISSUES

The International Data Exchange Service ("I.D.E.S.") system is a secure platform for the U.S. to exchange F.A.T.C.A. information with foreign jurisdictions. On May 8, 2015, the I.R.S added a new section to the Frequently Asked Questions ("F.A.Q.'s") concerning the I.D.E.S. The new section deals with the format, structure, and transmission of F.A.T.C.A. information. Among other issues, it provides guidance on obtaining a F.A.T.C.A. identification number ("F.I.N.") to allow entities that are not required to obtain a G.I.I.N. to use the system.

Additionally, the new F.A.Q.'s address the situation of a sponsoring entity that is a resident of a country with a Model 1 I.G.A. where the sponsored entity is a resident of a country with a Model 2 I.G.A. In such circumstances, the sponsoring entity should follow the steps set forth in the F.A.Q. response to obtain a second G.I.I.N. reflecting a Model 2 I.G.A. or non-I.G.A. jurisdiction. The I.R.S. provides that the new (second) G.I.I.N. should have been obtained by May 21, 2015 in order for the sponsoring entity to use the I.D.E.S. system in time for the June deadline for submission of F.A.T.C.A. reports for Model 2 I.G.A.'s and non-I.G.A. jurisdictions.

MORE F.A.T.C.A. REGULATIONS?

Speaking on May 19, 2015 at an annual forum sponsored by the Executive Enterprise Institute in New York on international tax withholding and information reporting, John Sweeney, chief of Branch 8 in the I.R.S. Office of Associate Chief Counsel, said that the I.R.S. will take more time before finalizing the 2014 temporary regulations and that the I.R.S. may include some further regulations under Chapter 4.

FIRST F.A.T.C.A. REPORTING EXPECTED IN SEPTEMBER IN BRAZIL

Brazil is the largest country in Latin America. It is the world's fifth largest country, both by geographical area and by population. On September 23, 2014, Brazil and the U.S. signed a Model 1 I.G.A. The first exchange of information under F.A.T.C.A. is scheduled to occur in September under the U.S.-Brazil I.G.A.

The U.S.-Brazil I.G.A. is a Model 1 I.G.A., which will operate by facilitating an annual automatic exchange of information on a reciprocal basis of specific account holder information that financial institutions ("F.I.'s") in each country will report to their own governments as required under local law. The I.G.A. provides that Brazilian F.I.'s will refer American taxpayer information to the Brazilian Federal Revenue ("R.F.B."), which will then transfer it to the I.R.S. In turn, U.S. tax authorities will send to the R.F.B. information about the financial operations of Brazilian taxpayers in U.S. F.I.'s

The adoption of the U.S.-Brazil I.G.A. may allow for greater discussion on tax matters between these two major countries and also lead to the eventual adoption of a U.S.-Brazil income tax treaty, though negotiations have not yet started. The Senate Finance Committee that is responsible for tax treaties has been blocking approval of many treaties, and that factor is the real obstacle to an income tax treaty.

BELARUS HOUSE OF REPRESENTATIVES RATIFIES MODEL 1 I.G.A.

On June 26, the Belarusian House of Representatives (lower house of the National Assembly) approved a draft law ratifying the Belarus-U.S. Model 1 I.G.A. under F.A.T.C.A., which was signed on March 18, 2015.

CYPRUS EXTENDS F.A.T.C.A. REPORTING DEADLINE

The Cypriot Tax Department on June 24 extended the reporting deadline under F.A.T.C.A. from June 30 to July 31, 2015. The Cypriot-U.S. Model 1 I.G.A. was signed on December 2, 2014.

"The I.R.S. has finally released the long-awaited application to become a qualified intermediary under F.A.T.C.A."

QUALIFIED INTERMEDIARY STATUS UNDER F.A.T.C.A.

The I.R.S. has finally released the long-awaited application to become a qualified intermediary ("Q.I.") under F.A.T.C.A., Form 14345, which is available on the I.R.S. forms webpage.

The Q.I. system was designed to simplify U.S. tax withholding and reporting obligations for payments of income made to an account holder through one or more foreign intermediaries such as an F.F.I. A Q.I. is an eligible entity that enters into a contract with I.R.S. (*i.e.*, a Q.I. Agreement) to assume certain responsibilities related to compliance with the U.S. tax withholding and reporting regime for its withholding agents under chapter 3 (regular 30% withholding on fixed or determinable annual or periodic income) and chapter 4 (F.A.T.C.A. withholding).

The I.R.S. updated the frequently asked questions on June 22 under Question 1 in the section dealing with Q.I., withholding foreign partnerships ("W.P.") and withholding foreign trusts ("W.T.") to indicate that taxpayers will soon be able to get the new version of Form 14345, Qualified Intermediary Application. The I.R.S. then released the form on its webpage.

While the I.R.S. didn't provide contact information for its Q.I. team under Question 1, the I.R.S. said under Question 3 that applicants for Q.I./W.P./W.T. status can apply to:

IRS-Foreign Intermediary Program
Attn: QI/WP/WT Applications
290 Broadway, 12th Floor
New York, NY 10007

Overall, the I.R.S. indicated that the process of applying to become any of these three types of entities hasn't changed under F.A.T.C.A.

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:

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

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

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 will continue to grow.

IN THE NEWS

GGI GLOBAL DELEGATE

Sheryl Shah is one of five GGi delegates selected to participate in *Global Village on the Move*. The ten-day leadership conference, taking place in Mumbia, India this fall, is a mobile version of Lehigh University's highly acclaimed Global Village for Future Leaders of Business and Industry. Ms. Shah will join young professionals from across the world to address the necessity of leadership, entrepreneurial skills, and business and industry knowledge – the keys to success in the new global marketplace.

AS SEEN IN...

Stanley C. Ruchelman and Kenneth Lobo are featured in the June 2015 edition of the Canadian Tax Foundation's *Canadian Tax Highlights.* Their article, "The US Net Investment Income Tax," addresses tax-planning concerns for Canadian residents wanting to buy realty in New York City, which have changed significantly in recent years.

OUR RECENT AND UPCOMING PRESENTATIONS

On April 17, 2015, Stanley C. Ruchelman participated 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 outlined 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 explored the obligations imposed on taxpayers and the overlapping nature of these separate regimes.

On April 23-26, 2015, Galia Antebi attended the *GGi European Regional Conference* in Lausanne, Switzerland, where she led a workshop on "The Post F.A.T.C.A. Form W-8." Through real world situations, particpants learned to navigate the complexities of Form W-8 and its equivalents, by which entities provide F.A.T.C.A. status certification from over 30 possibilities. Ms. Antebi also led a discussion on "Wealth Planning in the New Information Age" as part of the Trust & Estate Planning Practice Group. The panel addressed the impact information demands, information exchanges, and erosion of taxpayer confidentiality have on the modern approach to client work.

On May 8, 2015, Philip R. Hirschfeld participated in a panel on "FIRPTA, Section 892 and REITS" at the *A.B.A. Annual May Meeting* in Washington D.C. The presentation focused on efficient tax structuring for a non-U.S. person's investment in U.S. real estate and acquisition of U.S. mortgage debt by foreign investors. It addressed direct investment as well as investment in partnerships, L.L.C.'s, R.E.I.T.'s, and other investment entities holding these assets. It also addressed concerns of special investors such as foreign governments that benefit from Code §892.

In May 2015, Stanley C. Ruchelman and Beate Erwin attended the *2015 ITSG European Conference* in Madrid, Spain. Mr. Ruchelman and Ms. Erwin participated on the panel "Problems of U.S. Person Living in Europe," which addressed banks that close accounts of U.S. persons, coming into compliance with tax return and F.BA.R. reports, and planning for expatriation. In conjuction with the conference, Mr. Ruchelman also spoke on the "Common Reporting Standard in the E.U."

On July 23, 2015, Philip R. Hirschfeld presented on the panel "Foreign Persons Investing In U.S. Real Estate: Partnership And Other Structures, Opportunities and Traps" as part of the *NYU Advanced Summer Institute in Taxation*. The summer institute is offered annually by NYU's Advanced International Tax Institute. Mr. Hirschfeld's presentation focused on ways to structure a non-U.S. person's investment in U.S. real estate in ways that minimize taxation. Investments in mortgage debt securities, partnerships, L.L.C.'s, and R.E.I.T.'s were covered.

Copies of our presentations are available on the firm website at www.ruchelaw.com/publications.

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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