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INSIGHTS

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- **Final Stages of B.E.P.S. Implementation and Its Effects.** As the conclusion of the O.E.C.D.'s B.E.P.S. project draws ever nearer, Rusudan Shervashidze examines domestic implementation efforts in a number of foreign countries and the unanticipated tax ramifications for multinational enterprises.
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- **Corporate Matters: Are You Doing Business in New York?** Clients with entities formed in a state other than New York often ask if they should seek authority to transact business in New York. Simon H. Prisk reflects: The answer to this questions is not as clear cut as one might think.
- **F.A.T.C.A. 24/7.** Philip R. Hirschfeld and Galia Antebi report on Republican-led efforts to curtail F.A.T.C.A., new F.A.Q.'s released by the U.S. and Mauritius, publication of the St. Kitts and Nevis I.G.A., updated foreign account reporting procedures, and much more.

We hope you enjoy this issue.

- The Editors

THE PAST, PRESENT, AND FUTURE OF LUXEMBOURG SPECIAL PURPOSE COMPANIES

Author
François Petit

Tags
B.E.P.S.
Holding Companies
Luxembourg
S.P.V.

Amid a global context of widespread budget deficits, it seems that politicians have finally discovered that multinational enterprises, entrepreneurs, and high net worth individuals have recourse to legal frameworks that allow for the tax efficient structuring of investments.

For decades, countries such as the Netherlands, Ireland, Cyprus, and Luxembourg have been well known as jurisdictions of choice for savvy international tax planning. However, even if such structuring is legal, today it appears to be considered immoral or unethical in the eyes of the non-initiated public, who often find it difficult to discern between tax optimization and tax fraud. While the former is legal, the latter is not.

This article addresses the evolution of tax planning through the implementation of Luxembourg special purpose companies ("S.P.V.'s") from its origin to projections for the future in light of ongoing discussions involving the member countries of the Organization for Economic Co-operation and Development ("O.E.C.D.") and others.

1929 LUXEMBOURG HOLDING COMPANIES

The evolution of the contemporary Luxembourg S.P.V. begins with the creation of the 1929 Luxembourg holding companies (the "H29 Companies").

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He advises a wide range of multinational groups on predominantly Luxembourg corporate tax for acquisitions, project financing, real estate, structured finance, securitizations, private equity and venture capital funds, corporate reorganization (mergers and takeovers), I.P. rights, the acquisition of distressed debt, and transfer pricing.

Background

The H29 regime was governed by the Law of 31 July 1929 (the "H29 Law").

The primary purpose of an H29 Company was to hold a portfolio of equities (*e.g.*, shares or bonds) or patents, but it could also grant loans and advances or guarantees to the companies in which it had a direct participation.

An H29 Company enjoyed a preferential tax regime designed to eliminate double taxation of income from a securities portfolio. It was exempt from the following taxes in Luxembourg:

- Corporate income tax,
- Municipal business tax,
- Net wealth tax, and
- V.A.T.

In addition, no withholding tax in Luxembourg was levied on dividends paid by an H29 Company to nonresident shareholders.

Because of the H29 Law, H29 Companies were excluded from the application of double tax treaties. In today's parlance, the exclusion prevented double non-taxation. H29 Companies were subject only to an annual subscription tax of 0.2% (calculated on the amount of paid-up capital and bonds issued) and the capital duty.

Illegal State Aid – An End to the H29 Companies

In a July 19, 2006 decision, the European Commission determined that "the tax scheme currently in force in Luxembourg in favor of holding companies exempted on the basis of the Law of 31 July 1929 is a state aid scheme incompatible with the common market."[1] The H29 Law was subsequently repealed pursuant to a Luxembourg law dated December 22, 2006.

Consequences

A transitional period was granted through December 31, 2010. As of January 1, 2011, all H29 Companies, in the absence of any restructuring, were automatically considered to be fully taxable companies for Luxembourg tax purposes. Thus, they became liable for corporate income tax and municipal business tax (levied at the aggregate rate of 28.8% for the 2011 fiscal year when established in Luxembourg City), as well as a 0.5% net wealth tax on the net asset value of the company on each January 1. Any dividend distribution became subject to a 15% withholding tax (17.65% on a gross basis) unless reduced by an applicable double tax treaty or exempt under the conditions of the E.U. Parent-Subsidiary Directive, as discussed below.

25 YEARS OF SUCCESS FOR THE S.O.P.A.R.F.I.

Background

In 1990, Luxembourg enacted federal implementation of the E.U. Parent-Subsidiary Directive (the "E.U.P.S.D."),[2] which applies to fully taxable companies resident in Luxembourg.

The E.U.P.S.D. is designed to eliminate tax obstacles in the area of profit distributions between groups of companies operating in the E.U. by:

- Abolishing withholding tax on dividend payments between associated companies in various E.U. Member States and
- Preventing double taxation at the parent company level on the profits of a subsidiary.

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1 2006/940/EC: Commission Decision of July 19, 2006 on aid scheme C 3/2006 implemented by Luxembourg for 1929 holding companies and billionaire holding companies.

2 Council Directive 90/435/EEC of July 23, 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

Subject to certain exceptions, all dividends, capital gains, and liquidation proceeds from qualifying participations are exempt from corporate income and municipal business tax in Luxembourg if they are received or realized by a fully taxable Luxembourg company. In the same spirit, dividends paid by a fully taxable Luxembourg company to a qualifying parent company are not subject to Luxembourg withholding tax. Qualifying participations may also be exempt from net wealth tax.

"Subject to certain exceptions, all dividends, capital gains, and liquidation proceeds from qualifying participations are exempt from corporate income and municipal business tax in Luxembourg if they are received or realized by a fully taxable Luxembourg company."

More recently, a new type of entity has developed known as the Normally Taxable Holding Company, generally called a "S.O.P.A.R.F.I."[3] A S.O.P.A.R.F.I. is an ordinary commercial company established in Luxembourg, governed by the commercial company law of 1915 and fully subject to tax, *i.e.*, it does not benefit from an advantageous tax regime. However, a S.O.P.A.R.F.I. may reduce its tax burden by initially limiting its activity to the holding of participations in Luxembourg or foreign companies and structuring such participations so as to take advantage of the provisions of the E.U.P.S.D.

These provisions apply to all normally taxable companies. Thus, provided the conditions of the E.U.P.S.D. are satisfied, all Luxembourg companies could benefit from the E.U.P.S.D. Moreover, being that a S.O.P.A.R.F.I. is fully subject to tax, like any other commercial company, it also benefits from the provisions of double tax treaties concluded by Luxembourg.

In practice, the scope of activities realized by a S.O.P.A.R.F.I. has been widened, allowing it to (i) perform financing activities, (ii) purchase, sell, or exploit intellectual property ("I.P.") rights, and (iii) acquire shares in real estate companies or own real estate property directly. As a result, Luxembourg has reinforced its position in the international business scene by introducing a series of tax measures favoring inbound and outbound investments. Today, Luxembourg is well known as a go-to jurisdiction for investment management, holding, financing, I.P. activities, and private wealth management.

Rulings

Concurrent with the rise of the S.O.P.A.R.F.I., a new practice was developed in Luxembourg: the granting of tax rulings[4] or advance tax clearances (collectively, "Rulings").

At the beginning, the granting of Rulings was an administrative practice.[5] Its proliferation in Luxembourg can be traced to the migration of Dutch tax advisors in the early 1990's and to the cooperation of the Luxembourg tax authorities, who established a tax office fully dedicated to S.O.P.A.R.F.I.'s and the granting of Rulings.

Today, Rulings practices exist in most European countries.

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3 S.O.P.A.R.F.I. is the French acronym for *Société de Participation Financière*.

4 For the purposes of this article, a ruling may be defined as a confirmation granted by the tax authorities to a taxpayer of how their tax will be calculated.

5 As of January 1, 2015, amendments have been introduced to the General Tax Law that set down a legal framework for advanced tax clearances. See "Advance Tax Agreements ('A.T.A.'s'): Legal Process" below.

Tax Planning: 1990's to July 1, 2013

For more than 20 years, the granting of Rulings was common practice in Luxembourg, and Big 4 accounting firms and specialized law firms developed strong tax planning practices in Luxembourg and attracted talent from all over Europe. A pro-active and business-friendly government, an efficient tax administration, and the neo-liberal politics of the European Union all served to encourage this practice, resulting in a win-win situation for Luxembourg and for multinational companies that desired to invest abroad through a politically and economically stable country in a tax efficient and predictable way. Through the implementation of Luxembourg S.P.V.'s, multinational enterprises, entrepreneurs, and high net worth individuals have been able to reduce global tax burdens, even after leaving an arm's length remuneration in Luxembourg to adequately compensate the Luxembourg S.P.V. for the risks incurred and the functions performed.

All this was (and still is) completely legal, as any structuring through a Luxembourg S.P.V. was done through the application of Luxembourg's double tax treaties, E.U. directives, and Luxembourg law. Specifically, Rulings were granted on the basis of competitive tools provided by applicable legislation and a favorable income tax treaty network, including:

- Luxembourg income tax law[6] and administrative circulars, which include investment tax credits, a fiscal unity regime, an intra-group financing activities regime, an I.P. regime, tax neutral reorganization rules (*e.g.*, share-for-share, merger or division), a Special Limited Partnership regime (as of 2013), a carried interest regime (also as of 2013), and an expatriate regime;
- Specific laws regarding Specialized Investment Funds ("S.I.F.'s"), Specialized Investment in Capital at Risk ("S.I.C.A.R."), Private Assets Management Companies ("S.P.F.'s"), and Securitization Vehicles ("S.V.'s"); and
- Luxembourg's network of more than 70 tax treaties.

However, the political and economic environment that facilitated this practice has been altered by the 2008 "subprime mortgage crisis" and the 2009 "European debt crisis" that plunged the U.S. and the E.U. into recession. National governments became tasked with finding additional financial resources to reduce budget deficits.

THE O.E.C.D. BASE EROSION AND PROFIT SHIFTING ACTION PLAN

Background

At the request of G20 Finance Ministers, in July 2013, the O.E.C.D. launched its Base Erosion and Profit Shifting ("B.E.P.S.") Action Plan.

B.E.P.S. refers to "tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no

[6] And resulting from the implementation, into Luxembourg law, of E.U. directives.

economic activity, resulting in little or no overall corporate tax being paid."[7] The main goal of the Action Plan is, in some circumstances, to prevent double non-taxation.

Strategies associated with B.E.P.S. in regard to direct taxation are as follows:

- Elimination of taxation in the market country by avoiding a taxable presence,
- Low or no withholding tax at the source,
- Low or no taxation at the level of the recipient (via low-tax jurisdictions, preferential regimes, and/or hybrid mismatch arrangements) with entitlement to substantial non-routine profits via intra-group arrangements, and
- Eliminating or reducing tax in the country of the ultimate parent.

The B.E.P.S. Action Plan contains 15 specific actions intended "to equip governments with the domestic and international instruments needed to address this challenge."[8] These 15 actions are organized around three main pillars:

1. The coherence of corporate tax at an international level;
2. A realignment of taxation and substance; and
3. Transparency, coupled with certainty and predictability.

Some actions are particularly relevant for Luxembourg, such as:

- Action 6: Preventing the granting of treaty benefits in inappropriate circumstances.
    - The O.E.C.D. recommends the introduction of a Limitation of Benefits ("L.O.B.") clause and/or a "Principal Purpose Test" that would be introduced into all treaties. If the L.O.B. tests and the motive test cannot be met, treaty benefits would be denied.
    - This action item is potentially relevant to the real estate industry, wherein the provisions of a tax treaty may be used to benefit from a capital gains exemption upon disposal of real estate investments via a share deal.
- Action 4: Interest deductions and other financial payments.[9]
    - This action covers best practices in the design of rules to prevent base erosion through the use of interest expense, for example, through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments.

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7 "About BEPS." OECD: Better Policies for Better Lives. 2015.

8 *Id.*

9 Work to be completed by September 2015.

- Action 2: Neutralizing the effects of hybrid mismatch arrangements.
    - Such arrangements include the tax treatment of certain financial instruments or entities that potentially lead to double non-taxation or a long-term tax deferral.
    - For instance, it is common for U.S. investors to hold financial instruments that qualify as debt in the borrower jurisdiction and as equity from a U.S. tax standpoint (*i.e.*, the subscriber jurisdiction). As a result, the taxation of U.S. investors will be deferred until actual payment is made by the borrower, and even then, the "dividend" payment may be accompanied by an indirect foreign tax credit.
    - The O.E.C.D. proposal provides an exception to this rule in the event that the mismatch is due only to a reasonable timing difference between the recognition of the income and its taxation. However, no standard is prescribed for determining that a timing difference is reasonable.

Beyond Luxembourg, recommendations regarding hybrid mismatches are likely to have a significant impact on the structures and financing of multinational companies, as domestic law is affected on a global basis and extensive coordination will be required. European countries have already amended the E.U.P.S.D. in this respect (see "Amendments to the E.U.P.S.D." below).

The scope of tax benefits from intra-group debt funding likely will be tightened. A number of the proposals will require changes to domestic law. These include limitations on deductibility of interest expense, C.F.C. rules, and anti-abuse treaty provisions.

The impact of the political pressure on tax planning cannot be underestimated – some states have already begun to change domestic tax rules. In Luxembourg, the government is committed to ensuring that the state retains a competitive tax framework while also supporting broader European initiatives towards tax transparency and the O.E.C.D.'s work to combat B.E.P.S.

Direct Implications for Luxembourg – New Rules Already Implemented

E.U. Savings Directive

During the transitional period in Luxembourg that ended on December 31, 2014, the E.U. Savings Directive allowed individuals resident in other E.U. Member States who received interest from a Luxembourg paying agent to opt for exchange of information or application of a 35%[10] withholding tax on interest income. This option no longer exists. From January 1, 2015, Luxembourg automatically exchanges information on interest payments made by a paying agent established in Luxembourg to individuals resident in other E.U. Member States.[11]

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[10] Previously, the rate was 15% as of July 1, 2005. It was then raised to 20% in 2008 and 35% as of 2011.

[11] Interest paid by a Luxembourg paying agent to a Luxembourg resident individual

Advance Tax Agreements ("A.T.A.'s"): Legal Process

As of January 1, 2015, a formal legal process has superseded the administrative Rulings practice for A.T.A.'s; it is now expressly included in the Luxembourg Tax Law.[12] The aim remains to provide taxpayers with legal certainty regarding the tax treatment of transactions while maintaining uniform and egalitarian treatment for all taxpayers.

Corporate taxpayers[13] who wish to obtain an A.T.A. must now pay an administrative fee in order to compensate for the administrative costs borne by the tax authorities in relation to the A.T.A. process. Depending on the complexity of the request and the workload it requires of the tax authorities, the fee may range anywhere from €3,000 to €10,000.

Transfer Pricing

Given the globalization of transactions and the resulting increased focus on transfer pricing matters,[14] the Luxembourg government is implementing a more solid framework for applying the arm's length principle to associated enterprises.

Article 56 of Luxembourg income tax law now makes an explicit reference to the "arm's length" conditions used between independent businesses as the standard for evaluating the conditions used by related parties. This standard is applied for both resident and nonresident related parties. Based on the new wording of Article 56, profits may be adjusted upwards or downwards for transfer pricing purposes.

Disclosure and documentation requirements that are imposed currently on taxpayers in support of individual tax return positions will also apply to transactions between associated enterprises. These rules are in addition to documentation requirements already in place for intra-group financial intermediation activities.

"A formal legal process has superseded the administrative Rulings practice.... The aim remains to provide taxpayers with legal certainty regarding the tax treatment of transactions while maintaining uniform and egalitarian treatment."

2016 AND BEYOND

Transparency

F.A.T.C.A.

On March 28, 2014, Luxembourg and the U.S. signed an intergovernmental agreement ("I.G.A.") on the implementation of the Foreign Account Tax Compliance Act ("F.A.T.C.A.") in Luxembourg. On the basis of this agreement, U.S. and Luxembourg tax authorities will automatically exchange information regarding the assets of (i) U.S. citizens and (ii) U.S. residents held by financial institutions in Luxembourg. Exchange of information must be operational by September 30, 2015.

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remains subject to a final 10% withholding tax.

12 See the new §29a of the General Tax Law, known as the *Abgabenordung*.

13 A.T.A.'s can now be granted for both individuals and corporations.

14 Reference is made to the O.E.C.D. B.E.P.S. Action Plan.

Automatic Exchange of Information for Tax Purposes

On March 12, 2014, Council Directive 2011/16/EU regarding the mandatory and automatic mutual exchange of information in the field of taxation was implemented into Luxembourg law. The law applies to:

- Income from employment,
- Director's fees, and
- Pensions.

On December 9, 2014, the E.U. Council adopted Council Directive 2014/107/EU amending Directive 2011/16/EU of February 15, 2011 on administrative cooperation in the field of taxation. The amended directive extends the scope of the automatic exchange of information for tax purposes among E.U. Member States to interest, dividends, account balances, and sales proceeds from financial assets. It is based on the O.E.C.D.'s Common Reporting Standard and should become effective as of January 1, 2016 for early adopters, with the first exchanges of information between tax authorities scheduled for 2017.

Automatic Exchange of Tax Rulings

According to the European Commission, tax transparency is an essential element in combating corporate tax avoidance.

> Corporate tax avoidance is understood as a situation when certain companies use aggressive tax planning in order to minimize their tax bills. It often entails companies exploiting legal loopholes in tax systems and mismatches between national rules, to artificially shift profits to low or no tax jurisdictions. As such, it goes against the principle that taxation should reflect where the economic activity occurs.[15]

On March 18, 2015, upon the request of Mr. Jean-Claude Juncker,[16] the European Commission presented a package of measures to boost tax transparency. A key element of this package is a proposal to introduce "the automatic exchange of information between member states on their tax rulings."

Amendments to the E.U.P.S.D.

On July 8, 2014, the E.U. Council adopted an amendment to the E.U.P.S.D. to eliminate double non-taxation resulting from mismatches in the tax treatment of profit distributions in various E.U. Member States, in particular, in relation to hybrid financing arrangements. A Member State in which a parent company is tax resident must refrain from taxing profits distributed by qualifying subsidiaries located in another

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15 "Transparency and the Fight against Tax Avoidance." European Commission: Taxation and Customs Union.

16 Mr. Juncker was Luxembourg's Minister for Finance from 1989 to 2009 and Prime Minister from 1995 to 2013. As of November 1, 2014, he is the President of the European Commission.

Member State, but only to the extent that the distributions are not tax deductible in the Member State of the subsidiary. If the profit distributions are tax deductible in the Member State in which the subsidiary is located, then such distributions must be taxed by the Member State of the parent company. The amendment must be implemented into domestic law before January 1, 2016.

On January 27, 2015, the European Council formally adopted a binding general anti-abuse rule ("G.A.A.R.") in the E.U.P.S.D. This amendment is a significant step towards preventing tax avoidance and aggressive tax planning by corporate groups. Member States must implement the amendment into domestic legislation by the end of 2015. Once G.A.A.R. comes into effect, a holding company must have "valid commercial reasons which reflect economic reality" to justify its inclusion in any ownership chain, meaning that a holding company will need real substance.

"Marketing-related I.P., such as trademarks, will no longer benefit from preferential tax regimes."

I.P. Tax Regime

In February 2015, the O.E.C.D. and G20 countries released the "Action 5: Agreement on the Modified Nexus Approach for I.P. Regimes," which requires a "nexus" between favorable tax treatment of I.P. income and the exercise of substantial economic activity undertaken for the development of that I.P. in the same jurisdiction (the "Modified Nexus Approach"). Consequently, marketing-related I.P., such as trademarks, will no longer benefit from preferential tax regimes. Further guidance will be produced regarding the exact scope of I.P. assets that do not benefit from patent protection, such as copyrighted software or innovations from technical development or technical scientific research.

All existing I.P. regimes will be closed to new entrants following the introduction of a new preferential regime compliant with the Modified Nexus Approach or, if one is not introduced, after June 30, 2016. Member States may apply grandfathering clauses until June 30, 2021.

The above provisions will impact the Luxembourg I.P. regime, as the current regime must be aligned with the Modified Nexus Approach. The legislative process to replace or amend the current I.P. regime is slated to begin by the end of 2015.

Luxembourg Tax Reform

The Luxembourg government has committed itself to overhauling the current Luxembourg tax regime by 2017. In the intervening time, final reports will be issued under the B.E.P.S. Action Plan and some countries will adapt domestic fiscal legislation to comply with O.E.C.D. and G20 recommendations.

Although the government has not provided specific details, the market is expecting that the standard aggregate corporate income tax rate will be reduced to between 15% and 20% (compared to the 29.22% rate today in Luxembourg City) in order to compete with other E.U. jurisdictions (*e.g.*, the Netherlands and the U.K.). However, should the tax rate be reduced, a broader taxable basis will be required in order to maintain a balanced budget. The expectation of the government is that multinational enterprises have become comfortable in Luxembourg and that as long as the

tax burden is comparatively low, Luxembourg will remain an attractive financial and headquarters location.

CONCLUSION

The rules of the game have changed, and as a result, multinational enterprises, entrepreneurs, high net worth individuals, and tax advisors must all adapt the way they globally structure their investments and wealth. Those who wish to follow historic tax plans will encounter the fate of the dinosaurs – the plans and the groups wishing to follow them will become extinct.

There is a trend toward full transparency regarding various types of income received by taxpayers. However, beyond mere words no reliable assurance exists that such private and sensitive information will be absolutely protected by receiving governments.

Substance will surely play a key role. Substance in this context refers to real offices, having computers and phones, where competent human resources are employed to carry on business, as demonstrated by regular correspondence and telephone records. The days of part-time employees having limited credentials and working a few hours each week are over. Facilities must be matched by individuals who possess highly-valued skills and are empowered to make decisions at the level of the Luxembourg S.P.V. However, no clear definition of the required substance is provided for sectors, such as real estate and accounting consolidation centers, where the need for management on a day-to-day basis by highly skilled executives is not required by the business.

On the other hand, innovation, new technologies, and economic globalization have changed the way corporations operate and invest. Through the internet, it is now possible to manage a business from any location, and an owner is no longer required to be sitting in an office in order to be effective. For many organizations, the flexibility afforded by the internet and remote management is the factor that allows a business to flourish.

Although a final report has been issued under the B.E.P.S. Action Plan with regard to the digital economy, it does not reach firm conclusions or recommendations. However, it seems that at least within the E.U., paper-only, mailbox-type entities will no longer be tolerated. This could be an opportunity for Luxembourg to diversify its economy by attracting new talents and developing new activities. In other words, this could be the chance Luxembourg needs to begin providing less “back-office” services and more added-value services similar to those provided by the most important global financial centers.

Since the A.I.F.M. Directive[17] was implemented in Luxembourg, the funds industry has been very active and the assets managed in the country have reached record

[17] Directive 2011/61/EU of the European Parliament and of the Council of June 8, 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

highs. Many large U.S. companies and Chinese banks have already transferred European headquarters to Luxembourg, and if more asset managers and private equity houses follow, the benefits for Luxembourg will be considerable. In our view, this trend will strengthen in the coming years. Luxembourg's business-friendly government and strong relations with the private sector should enable it to implement attractive measures for business that are in line with international standards.

Until national governments implement the final B.E.P.S. Action Plan, it is difficult to assess the future role of Luxembourg S.P.V.'s. However, it is certain that substance, transfer pricing, and the utilization of double tax treaty networks must be carefully monitored and kept in line with economic reality by taking into consideration other national and international factors such as C.F.C. rules, general anti-avoidance rules, and other similar provisions.

"The rules of the game have changed, and as a result, multinational enterprises, entrepreneurs, high net worth individuals, and tax advisors must all adapt the way they globally structure their investments and wealth."

FINAL STAGES OF B.E.P.S. IMPLEMENTATION AND ITS EFFECTS

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Tags
B.E.P.S.
Incentives
Income Tax
Mexico
O.E.C.D.
Patent Boxes
V.A.T.

The Organization for Economic Co-operation and Development ("O.E.C.D.") is entering into the final implementation stages for the Base Erosion and Profit Shifting ("B.E.P.S.") Action Plan. Many countries are attempting to meet the domestic implementation requirements by making some of the most significant changes in international taxation in decades.

According to one U.S. tax official, the changes enacted in chapters 1 and 6 of the O.E.C.D.'s transfer pricing guidelines on nonrecognition and intangibles will not result in radical policy changes. However, forthcoming changes to Actions 8, 9, and 10, which will not be disclosed until early October, are likely to have a more substantial impact.

CHANGES IN MEXICO

For many years, Mexico has been attracting companies with corporate tax breaks. But, encouraged by the O.E.C.D.'s campaign to fight profit shifting (which Mexico officially joined in 2014) and faced with decreasing oil exports, the government has recently begun looking for alternative sources of revenue.

V.A.T. Refunds

Since President Enrique Peña Nieto took office in late 2012, Mexico's tax authority, the *Servicio de Administración Tributaria* ("S.A.T."), has held back more than $384 million in Value Added Tax ("V.A.T.") refunds from Procter & Gamble, Unilever, and Colgate and initiated probes of 270 other multinationals for possible tax avoidance.

Many believe that the Mexican government is attempting to gain leverage in negotiations with multinationals that use tax planning to reduce corporate income tax. The apparent goal is to convince multinationals that they have no other choice but to submit to paying higher corporate income taxes in exchange for refunds of V.A.T.

It is believed that Unilever has reached an agreement to pay more income tax in Mexico and receive an estimated $131 million in V.A.T. refunds, while Procter & Gamble and Colgate have yet to settle any agreement. However, the three corporations declined to comment on V.A.T. refund and income tax matters in Mexico. A panel of six tax experts interviewed by one news agency expressed a uniform view that linking V.A.T. refunds to income tax agreements violates Mexico's constitution. Other experts have been less absolute, stating that the Mexican government is operating in a gray area.

In Mexico, V.A.T. is imposed on the sale of goods as well as services and is part of the principal taxes in the Federal tax structure. For those unfamiliar with the V.A.T. regime, the amount of V.A.T. paid by a business within a specified period is measured against V.A.T. collected from end users. If the payments of V.A.T. exceed the collections, the excess is refunded to the business.

The Mexican constitution, as interpreted by the courts, allows the government to act only when expressly authorized by law and provides that taxation must be proportionate. Mexican law requires that authorities refund any amount due and treat taxpayers in the least "onerous" way possible.

Cathy Schultz, vice president for tax policy at the National Foreign Trade Council, a U.S.-based trade group, said its members have complained about the practice in Mexico, using terms such as "strong-arm tactic" and "political extortion," she said.

Previously, the top 132 foreign corporations paid less than 1.5% in corporate tax as a percentage of gross income in Mexico. But now, the taxes paid have increased as a percentage of gross income. The campaign to join other countries in the fight against profit shifting to low-tax countries and delays associated with the V.A.T. refunds may make Mexico an unwelcoming country for the big businesses.

The S.A.T. denies the delay in V.A.T. refunds are part of a plan to pressure companies into paying more income tax. One S.A.T. spokesperson suggested that the government encountered inconsistencies in some refunds and decided that detailed reviews were required before refunds would be issued. The government focused on companies with the largest refunds, as a matter of proper risk management.

IMPLEMENTATION IN CHINA

China is also planning to adopt key concepts from the B.E.P.S. project and is expected to release a revised draft of Circular No. 2 (2009) that would revamp the nation's transfer pricing rules. China's State Administration has been an active participant in the B.E.P.S. project and has placed bilateral advance pricing arrangements on hold in order to fully devote international tax resources to the project.

COUNTRY-BY-COUNTRY REPORTING

Action 13 will include a country-by-country reporting template, master file, and local file. Many countries have embraced these proposed changes; the question no longer is whether the measures will be adopted but rather when and how they will be adopted.

Australia has issued draft legislation that is scheduled to be adopted on or before January 1, 2016. South Korea has adopted the master file and local file for income years beginning on or after January 1, 2016 and will wait to adopt a country-by-country reporting template until action by other countries has been reviewed.

STATELESS INCOME

The concept of stateless income has significantly effected international tax policy and has been a major point for the B.E.P.S. Action Plan. The changes implemented as a result of the country-by-country reporting template and revised transfer pricing guidelines are expected to encourage multinational companies to move cash entities from zero-tax to lower-tax jurisdictions. Leaving such entities in a zero-tax jurisdiction will increase audit risk for multinational companies. As for changes to the transfer pricing guidelines, companies will be required to allocate risks to countries where risks can actually be controlled or to countries that have the financial capacity to bear those risks. In other words, the mere undertaking of a legal risk without the wherewithal to make payment when the risk materializes will not be tolerated by tax authorities.

"Many believe that full implementation of the B.E.P.S. Action Plan will eliminate tax benefits that enticed U.S. corporations to move intangible property ownership to jurisdictions having Patent Box Regimes."

PATENT BOXES

The rise of the so-called Patent Box Regime is an unintended consequence of the B.E.P.S. project. A patent box imposes a special, ultra low tax rate on business income that is derived from intangible property. Germany and the U.K. have developed an acceptable Patent Box Regime that has been incorporated into Action 5. The U.K. Patent Box Regime has a 10% rate for patent-related profits, which is roughly half the country's overall corporate tax rate. Germany will wait until the B.E.P.S. project is complete to decide whether to adopt a Patent Box Regime.

The final B.E.P.S. instrument will be approved on September 23, and it will be delivered by the C.F.A. to the G20 finance ministers in Lima, Peru on October 8, 2015. Many believe that full implementation of the B.E.P.S. Action Plan will eliminate tax benefits that enticed U.S. corporations to move intangible property ownership to jurisdictions having Patent Box Regimes. The unknown factor is whether these U.S. corporations will return the ownership of intangible property to the United States.

NOTICE 2015-54 ON REALLOCATION TO FOREIGN PARTNERS – THE BEGINNING OF THE END?

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Tags
Allocation
Contribution
Foreign Partners
Notice 2015-54
Partnerships
Remedial Method

The I.R.S. announced in Notice 2015-54, 2015-34 IRB 210 (8/06/2015) that it intends to issue regulations that would change the nonrecognition rules on certain property contributions to partnerships and L.L.C.'s with foreign partners. The new regulations, generally effective for transfers occurring on or after August 6, 2015, would require that income or gain attributable to property be taken into account by the U.S. transferor either immediately or periodically. Regulations would also be issued under §§482 and 6662 of the Internal Revenue Code (the "Code") that apply to controlled transactions involving partnerships to ensure appropriate valuation of such transactions.

BACKGROUND

Since enactment of the Taxpayer Relief Act of 1997 (the "1997 Act"), transfers to foreign partnerships generally do not attract U.S. tax, although there are information reporting obligations.[1] Regulatory authority was granted to override the partnership nonrecognition provisions in Code §721. The latter relates to gain realized on the transfer of property to a partnership (domestic or foreign) if the gain, when recognized, would be includible in the gross income of a person other than a U.S. person. Additionally, the 1997 Act gave regulatory authority to apply the rules of §367(d)(2) to "outbound" transfers of intangible property to partnerships. Such regulations have never been issued.

CURRENT LAW

Code §367 prevents U.S. persons from avoiding U.S. tax by transferring appreciated property to foreign corporations using nonrecognition transactions. Section 367(d) treats a U.S. person that transfers intangible property to a foreign corporation as having sold such property in exchange for payments that are contingent upon the productivity, use, or disposition of such property, and receiving amounts that reasonably reflect the amounts that would have been received annually in the form of such payments over the useful life of such property, or, in the case of a disposition following such transfer (whether direct or indirect), at the time of the disposition. Because Code §367 only applies to the transfer of property to a foreign corporation, absent regulations, a U.S. person generally does not recognize gain on the contribution of appreciated property to a partnership with foreign partners.

[1] See, *e.g.*, Code §§6038, 6038B, and 6049A.

Section 721(a) provides that no gain or loss is recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. However, §704(c)(1)(A) requires partnerships to allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership, so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution. This prevents shifting of tax consequences among partners with respect to pre-contribution gain or loss. The Treasury regulations[2] describe three methods of allocation to effect this result, including the "remedial" allocation method under which a partnership may eliminate distortions caused by the so-called ceiling rule,[3] which prevents allocations of gain, loss, and deduction in excess of the total partnership tax gain, loss, or deduction. This is accomplished by making remedial allocations of income, gain, loss, or deduction to the non-contributing partners equal to the full amount of the limitation caused by the ceiling rule and offsetting those allocations with remedial allocations of income, gain, loss, or deduction to the contributing partner.

REASONS FOR CHANGE

Under the current rules, some taxpayers subject to U.S. Federal income tax have been able to contribute property to a partnership, with the partnership allocating the income or gain from the contributed property to related foreign partners that are not subject to U.S. tax. In effect, such re-allocation allows appreciation of certain types of property to escape U.S. taxation. In such scenarios, many taxpayers choose a §704(c) method of allocation other than the remedial method and/or use valuation techniques that are inconsistent with the arm's length standard. By way of example, a partnership agreement might provide a domestic partner with a fixed preferred interest in exchange for the contribution of an intangible that is assigned a value that is inappropriately low, while specifically allocating a greater share of the income from the intangible to a related foreign partner.

Remedial allocations can have the effect, in part, of ensuring that pre-contribution gain from contributed property is properly taken into account by the contributing partner. Allocating gain, income, loss, and deduction associated with the contributed property in a consistent manner, with respect to the contributing partner and any related foreign partner, can help to ensure that (i) the built-in gain associated with contributed property is properly taken into account by the contributing partner and (ii) income is not inappropriately separated from related deductions.

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2 Treas. Reg. §1.704-3.

3 See Treas. Reg. §1.704-3(b)(1). The other methods are the "traditional" method (which most favors the contributing partner) and the "curative allocation" method (which most favors the non-contributing partner). The remedial allocation method benefits the contributing partner by permitting greater depreciation deductions in earlier years and is a disadvantage to the non-contributing partner because of lesser depreciation over a longer period of time; it falls somewhere in between the other two methods.

Under these circumstances, the Treasury regulations will continue to allow tax-free contributions of appreciated property to partnerships[4] but only if the conditions described in §4.03 of Notice 2015-54 are satisfied (the "Gain Deferral Method"), as follows:

1. The remedial allocation method is adopted for Built-in Gain[5] with respect to all §721(c) Property[6] contributed to the §721(c) Partnership[7] pursuant to the same plan by a U.S. Transferor and all other U.S. Transferors that are Related Persons.

2. During any taxable year in which there is remaining Built-In Gain with respect to an item of §721(c) Property, the §721(c) Partnership allocates all items income, gain, loss, and deduction under Code §704(b) with respect to that property §721(c) Property in the same proportion. For example, if income with respect to an item of §721(c) Property is allocated 60% to the U.S Transferor and 40% to a Related Foreign Person in a taxable year, then gain, deduction, and loss with respect to that §721(c) Property must also be allocated 60% to the U.S. Transferor and 40% to the Related Foreign Person.

3. New reporting requirements (described in §4.06 of Notice 2015-54) are satisfied. The I.R.S. intends to modify Schedule O, Transfer of Property to a Foreign Partnership, of Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, or its instructions, for taxable years beginning in 2015 to require supplemental information for contributions of §721(c) Property to §721(c) Partnerships. New regulations describing additional reporting requirements for a U.S. Transferor for each taxable year in which the

"The Treasury regulations will continue to allow tax-free contributions of appreciated property to partnerships but only if the conditions described in §4.03 of Notice 2015-54 are satisfied."

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4 The regulations also will apply to transactions involving tiered partnerships.

5 Built-in Gain is the value of the property for book purposes over the contributing partner's adjusted tax basis in the property at the time of the contribution (and does not include gain created when a partnership revalues partnership property).

6 Section 721(c) Property is property with Built-in Gain, excluding (i) cash equivalents, (ii) any asset that is a security within the meaning of Code §475(c)(2), without regard to Code §475(c)(4), and (iii) any item of tangible property with Built-in Gain that does not exceed $20,000. In addition, under a *de minimis* rule, Code §721(a) will continue to provide non-recognition treatment for contributions of property with built-in gain if (i) the built-in gain in all §721(c) Properties contributed in the same year by a U.S. partner (or a group of related U.S. partners) does not exceed $1 million, and (i) the partnership is not otherwise applying the Gain Deferral Method with respect to a prior contribution by such U.S. partner (or a group of related U.S. partners).

7 A partnership (domestic or foreign) is a §721(c) Partnership if a U.S. Transferor contributes appreciated property to the partnership, and, after the contribution and any transactions related to the contribution, (i) a Related Foreign Person is a direct or indirect partner in the partnership, and (ii) the U.S. Transferor and one or more Related Persons own more than fifty percent of the interests in partnership capital, profits, deductions or losses. A U.S. Transferor is a United States person within the meaning of Code §7701(a)(30) (U.S. person), other than a domestic partnership. A Related Person is a person that is related (within the meaning of §§267(b) or 707(b)(1) to a U.S. Transferor. A Related Foreign Person is a Related Person (other than a partnership) that is not a U.S. person.

Gain Deferral Method applies will be issued. Furthermore, such regulations will provide that, as an additional requirement for applying the Gain Deferral Method, a U.S. Transferor, and in certain cases a §721(c) Partnership must extend the limitations period for assessment of tax with respect to all items related to the §721(c) Property contributed to the §721(c) Partnership through the close of the eighth full taxable year following the taxable year of the contribution.

4. The U.S. Transferor recognizes Built-in Gain with respect to any item of §721(c) Property upon an Acceleration Event[8] (described in §4.05 of Notice 2015-54) as if the partnership had sold the item of §721(c) Property immediately before the Acceleration Event for its fair market value.

5. The Gain Deferral Method is adopted for all §721(c) Property subsequently contributed to the §721(c) Partnership by the U.S. Transferor and all other U.S. Transferors that are Related Persons until the earlier of (i) the date that no Built-in Gain remains with respect to any §721(c) Property to which the Gain Deferral Method first applied, or (ii) the date that is 60 months after the date of the initial contribution of §721(c) Property to which the Gain Deferral Method first applied.

ANTI-ABUSE RULE

If a U.S. Transferor engages in a transaction (or series of transactions) with a principal purpose of avoiding the application of the regulations, the transaction (or series of transactions) may be disregarded or the arrangement may be recharacterized (which may include disregarding an intermediate entity) in accordance with its substance.

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[8] An Acceleration Event is any transaction that would either (i) reduce the amount of remaining Built-in Gain that a U.S. Transferor would recognize under the Gain Deferral Method if the transaction had not occurred or (ii) defer the recognition of the Built-in Gain. Furthermore, an Acceleration Event is deemed to occur with respect to all §721(c) Property of a §721(c) Partnership for the taxable year of the §721(c) Partnership in which any party fails to comply with all of the requirements for applying the Gain Deferral Method. However, an Acceleration Event will not occur if (i) a U.S. Transferor transfers an interest in a §721(c) Partnership to a domestic corporation in a tax-free transaction to which either Code §§351(a) or 381(a) applies, or (ii) a §721(c) Partnership transfers an interest in a lower-tier partnership that owns §721(c) Property to a domestic corporation in a transaction to which Code §351(a) applies, provided that in both cases the parties continue to apply the Gain Deferral Method by treating the transferee domestic corporation as the U.S. Transferor. An Acceleration Event will not occur if a §721(c) Partnership transfers §721(c) Property to a domestic corporation in a transaction to which §351(a) applies. If a §721(c) Partnership transfers §721(c) Property (or an interest in a partnership that owns §721(c) Property) to a foreign corporation in a transaction described in §351(a), an Acceleration Event will not occur to the extent the §721(c) Property is treated as being transferred by a U.S. person (other than a domestic partnership) pursuant to Treas. Reg. §§1.367(a)-1T(c)(3)(i) or (ii). The stock in a transferee corporation received by a §721(c) Partnership in a transaction described in this §4.05(4) will not be subject to the Gain Deferral Method.

RULES REGARDING CONTROLLED TRANSACTIONS INVOLVING PARTNERSHIPS

Regulations will be issued regarding the application of certain rules to controlled transactions involving partnerships. These include rules currently applicable to cost sharing arrangements and, in particular, the application of specified methods for such controlled transactions as appropriately adjusted in light of the differences in the facts and circumstances between such partnerships and cost sharing arrangements.[9]

"Notice 2015-54 is very clear on the I.R.S.'s intention to shut down certain schemes to avoid U.S. taxation."

The Treasury Department and the I.R.S. also are considering issuing regulations under Treas. Reg. §1.6662-6(d) to require additional documentation for certain controlled transactions involving partnerships. These regulations may require, for example, documentation of projected returns for property contributed to a partnership (as well as attributable to related controlled transactions) and of projected partnership allocations, including projected remedial allocations for a specified number of years.

BOTTOM LINE

Notice 2015-54 is very clear on the I.R.S.'s intention to shut down certain schemes to avoid U.S. taxation through what some may have considered a loop-hole under applicable partnership rules, *i.e.*, by means of re-allocation measures in the context of a partnership with foreign partners. In this respect, a partnership arrangement should not allow for more beneficial tax structuring than a corporate scenario. While certain exceptions to such anti-avoidance rules will exist under Notice 2015-54, it will most likely put an end to some arrangements that may have worked in the past. Thus far, respective Treasury regulations have not been issued. However, taxpayers are advised to consult with tax counsel before entering into contribution of property agreements and to closely monitor developments in this respect.

[9] Treas. Reg. §1.482-7(g).

I.R.S. PROPOSES NEW PARTNERSHIP RULES UNDER CODE §956

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Tags
§956 Inclusions
C.F.C.
Investing in U.S. Property Partnerships

The I.R.S. recently released temporary and proposed regulations to limit the use of foreign partnerships to avoid income inclusions under Code §956.

BACKGROUND

A U.S. shareholder who owns 10% or more of the voting shares of a controlled foreign corporation ("C.F.C.") must include in gross income the amount of the C.F.C.'s earnings invested in U.S. property to the extent such earnings have not already been included in the shareholder's income.[1]

U.S. property generally includes obligations of related U.S. persons. For the purposes of Code §956, an "obligation" may be a bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other indebtedness, whether or not issued at a discount and whether or not bearing interest.[2] Consequently, if a C.F.C. loans funds to a related U.S. person, the U.S. shareholder of the C.F.C. must include the amount of the loan in income to the extent it has not already done so in prior years. If the amount of the loan increases during the year, the increase in the loan is the amount included in the income of the U.S. shareholder.

The amount of the inclusion is limited to the earnings of the C.F.C.[3] However, under an anti-abuse rule (the "Principal Purpose Rule"), one C.F.C. can be considered to hold U.S property acquired by another C.F.C. if one of the principal purposes is to avoid Code §956.[4] Therefore, an inclusion cannot be avoided by funneling the investment in the U.S. property through an entity that has little or no earnings.

EXISTING RULES FOR PARTNERSHIPS

If a C.F.C. is a partner in a partnership that owns property that would be U.S. property if owned directly by the C.F.C., the C.F.C. is treated as holding a proportionate interest in the property equal to its interest in the partnership (the "Proportionate Interest Rule").[5]

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1 Code §§951 and 956.

2 Treas. Reg. §1.956-2T(d)(2).

3 Code §§956(a)(2) and (b)(1).

4 Treas. Reg. §1.956-1T(b)(4).

5 Treas. Reg. §1.956-2(a)(3).

TEMPORARY REGULATIONS

The Temporary Regulations[6] provide a number of new rules that are not limited to the application of Code §956 for partnerships.[7] However, in this article we limit our discussion to the new rules for partnerships under Code §956.

The Principal Purpose Rule discussed above only applied to C.F.C.'s and not to partnerships. The Temporary Regulations expand the Principal Purpose Rule to partnerships that are controlled by C.F.C.'s. Thus, if a principal purpose of acquiring U.S. property through a partnership that is controlled by a C.F.C. is to avoid Code §956, the C.F.C. will be treated as holding the U.S. property.

However, because the C.F.C. may already be treated as holding a portion of the U.S. property owned by the partnership under the Proportionate Interest Rule discussed above, a coordination rule is provided so that the Principal Purpose Rule applied to the partnership will only cause the C.F.C. to hold the U.S. property to the extent it exceeds the amount already treated as held under the Proportionate Interest Rule.

The Temporary Regulations also provide a new rule for foreign partnerships funded by C.F.C.'s. Where a C.F.C. funds a foreign partnership (or guarantees a borrowing by a foreign partnership) and the foreign partnership makes a distribution to a U.S partner that is related to the C.F.C., the partnership obligation is treated as an obligation of the distributee U.S. partner (the "Temporary Regulation Fund & Distribution Rule"). Consequently, even though the C.F.C. does not directly or indirectly hold an obligation of a related U.S. person, the funding/distribution is treated as though the C.F.C acquired an obligation of a related U.S. person. This rule is subject to some limitations, and it will be removed when the Proposed Regulations (discussed next) are finalized.

The Temporary Regulations generally apply to taxable years of C.F.C.'s ending on or after September 2, 2015.

PROPOSED REGULATIONS

The Proposed Regulations have a number of new rules, including:

- The Foreign Partnership Obligation Look-Through to Partners Rule,[8]
- The Partnership Guarantee of an Obligation of a U.S. Person Rule,[9]

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6 Treasury Decision 9733.

7 See, for example, our article in this issue of *Insights*, "Temporary Regulations Alter C.F.C.'s Active Rents and Royalties Exception to Subpart F," discussing new rules for the active rents and royalties exception to foreign personal holding company income.

8 Prop. Reg. §1.956-4(c)(1).

9 Prop. Reg. §1.956-2(c)(1).

- The Foreign Partnership Fund & Distribution Rule,[10] and
- The C.F.C. Partner's Liquidation Value Percentage Rule.[11]

The Foreign Partnership Obligation Look-Through to Partners Rule

Under the Foreign Partnership Obligation Look-Through to Partners Rule, an obligation of a foreign partnership is treated as an obligation of the partners to the extent of each partner's share of the obligation as determined in accordance with the partner's interest in partnership profits. For example, if a C.F.C. loans $100 to a foreign partnership and the U.S. shareholder of the C.F.C. owns 50% of the foreign partnership, the C.F.C.'s loan to the foreign partnership is treated as $50 of U.S. property. The Foreign Partnership Obligation Look-Through to Partners Rule does not apply where neither the C.F.C. nor any person related to the C.F.C. is a partner in the partnership.[12]

"The look-through to partners rule, combined with the guarantee rule, can create an investment in U.S. property where a C.F.C. guarantees the debt of a foreign partnership."

The Partnership Guarantee of an Obligation of a U.S. Person Rule

The Partnership Guarantee of an Obligation of a U.S. Person Rule applies to both domestic and foreign partnerships. Under this rule, any obligation of a U.S. person with respect to which a partnership is a pledgor or guarantor will be considered to be held by the partnership.[13] For example, assume a C.F.C. is a partner in a foreign or domestic partnership. If the partnership guarantees a loan for the U.S. parent, the C.F.C. will be treated as holding a share of the obligation.

This guarantee rule previously only applied to C.F.C.'s. The new rule continues to apply to C.F.C.'s, and under the Proposed Regulations would be extended to partnerships. The look-through to partners rule, combined with the guarantee rule, can create an investment in U.S. property where a C.F.C. guarantees the debt of a foreign partnership. For example, assume a foreign partnership borrows $100 from a bank, and a C.F.C. (that may or may not be a partner in the partnership) guarantees the bank debt. If the U.S. shareholder of the C.F.C. owns 50% of the foreign partnership, the C.F.C.'s guarantee of the bank loan causes the C.F.C. to be treated as holding $50 of U.S. property.

The Foreign Partnership Fund & Distribution Rule

The Foreign Partnership Fund & Distribution Rule is similar to, but not the same as, the Temporary Regulation Fund & Distribution Rule discussed above. The Foreign Partnership Fund & Distribution Rule increases the amount of a foreign partnership's obligation that is treated as U.S. property when the following requirements are satisfied:

1. A C.F.C. lends funds (or guarantees a loan) to a foreign partnership whose obligation is U.S. property with respect to the C.F.C. pursuant to proposed §1.956-4(c)(1);

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[10] Prop. Reg. §1.956-4(c)(3).

[11] Prop. Reg. §1.956-4(b).

[12] Prop. Reg. §1.956-4(c)(2).

[13] Prop. Reg. §1.956-2(c)(1).

2. The partnership distributes the proceeds to a partner that is related to the C.F.C. and whose obligation would be U.S. property if held by the C.F.C.;

3. The foreign partnership would not have made the distribution but for a funding of the partnership through an obligation held (or treated as held) by the C.F.C.; and

4. The distribution exceeds the partner's share of the partnership obligation as determined in accordance with the partner's interest in partnership profits.

For example, assume a U.S. shareholder of a C.F.C. that is related to the C.F.C. has a 60% interest in the profits of a foreign partnership and the C.F.C. lends $100 to the partnership. If the partnership, in turn, distributes $100 to the U.S. shareholder in a distribution that would not have been made but for the funding by the C.F.C., the C.F.C. will be treated as holding U.S. property in the amount of $100. As mentioned above, when this is finalized, the comparable rule in the Temporary Regulations will be removed.

The C.F.C. Partner's Liquidation Value Percentage Rule

Under the existing Proportionate Interest Rule[14] (discussed above), the current regulations do not provide a method for how to measure the C.F.C.'s proportionate interest in the partnership. Under the Proposed Regulations, a C.F.C. partner will be treated as holding its share of partnership property determined in accordance with the C.F.C. partner's "liquidation value percentage." Very generally, the liquidation value of a partner's interest in a partnership is the amount of cash the partner would receive with respect to the interest if the partnership sold all of its assets for cash equal to the fair market value of such assets, satisfied all of its liabilities, and then liquidated.

The Proposed Regulations are proposed to generally become effective after final regulations are published.

"The Proposed Regulations are quite broad. If finalized in the current form, the Proposed Regulations would cause most C.F.C. loans to partnerships with related U.S. partners to be investments in U.S. property."

CONCLUSION

The Temporary and Proposed Regulations are intended to target transactions that the I.R.S. believes are contrary to the policies under Code §956. The Temporary Regulations are more limited in their scope while the Proposed Regulations are quite broad. If finalized in the current form, the Proposed Regulations would cause most C.F.C. loans to partnerships with related U.S. partners to be investments in U.S. property.

[14] Treas. Reg. §1.956-2(a)(3).

TEMPORARY REGULATIONS ALTER C.F.C.'S ACTIVE RENTS AND ROYALTIES EXCEPTION TO SUBPART F

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Tags
Active Rents & Royalties
C.F.C.
Subpart F
Temporary Regulations

The I.R.S. has issued temporary regulations (T.D. 9733)[1] to limit the use of the active rents and royalties exception to foreign personal holding company income ("F.P.H.C.I.") under subpart F of the Internal Revenue Code ("the Code"). The new Treas. Reg. §1.954-2T provides that when a controlled foreign corporation ("C.F.C.") leases or licenses property to an unrelated person, the C.F.C.'s own officers or staff of employees, not a third party, must perform the required functions in order to qualify for the active rents and royalties exception under subpart F. The temporary regulations clarify that a C.F.C. may still qualify for the exception when the officers and employees performing those functions are located in more than one foreign country. Furthermore, the temporary regulations provide that the active rents and royalties exception cannot be met through cost sharing arrangements, and such payments will not count towards determining whether an organization is "substantial" based on its active leasing or licensing expenses.[2]

BACKGROUND

Generally, for a U.S. shareholder of a C.F.C., the *pro rata* share of the C.F.C.'s subpart F income must be included as a deemed dividend in the shareholder's gross income.[3] One type of subpart F income is F.P.H.C.I., which refers to foreign passive income and includes certain rents and royalties.[4] However, rents and royalties that are derived from the active conduct of a C.F.C.'s trade or business, and are received from an unrelated person, are excluded from F.P.H.C.I. treatment.[5] This active rents and royalties exception prevents a C.F.C.'s income from being subjected to the harsh tax regime of subpart F.

Treas. Reg. §§1.954-2(c) and (d) enumerates four scenarios in which a C.F.C.'s rental income is considered active and two in which royalty income is considered active. The newly issued temporary regulations modify three of the six ways that rental or royalty income can qualify for the active exception.

Rents earned by a C.F.C. (acting as the lessor) are considered to be income derived from an active trade or business if they are attributable to:

> (i) Property that the lessor has manufactured or produced, or has acquired and added substantial value to, but only if the lessor is

1 T.D. 9733, 09/01/2015, Treas. Reg. §1.954-2T, Treas. Reg. §1.954-2.

2 T.D. 9733, 09/01/2015, Treas. Reg. §1.954-2T, Treas. Reg. §1.954-2.

3 Code §951.

4 Code §§954(a)(1) and 954(c).

5 Code §954(c)(2)(A) and Treas. Reg. §1.954-2(b)(6).

"The newly issued temporary regulations modify three of the six ways that rental or royalty income can qualify for the active exception."

> regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, property of such kind [known as the "active development test"];
>
> (ii) Real property with respect to which the lessor, through its own officers or staff of employees, regularly performs active and substantial management and operational functions while the property is leased;
>
> (iii) Personal property ordinarily used by the lessor in the active conduct of a trade or business, leased temporarily during a period when the property would, but for such leasing, be idle; or
>
> (iv) Property that is leased as a result of the performance of marketing functions by such lessor if the lessor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property [known as the "active marketing test"].[6]

Royalties earned by a C.F.C. (acting as the licensor) are considered to be income derived from an active trade or business if they are attributable to:

> (i) Property that the licensor has developed, created, or produced, or has acquired and added substantial value to, but only so long as the licensor is regularly engaged in the development, creation or production of, or in the acquisition of and addition of substantial value to, property of such kind [the "active development test"]; or
>
> (ii) Property that is licensed as a result of the performance of marketing functions by such licensor if the licensor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and that is substantial in relation to the amount of royalties derived from the licensing of such property [the "active marketing test"].[7]

Under a safe harbor provision in the regulations, an organization is considered to be "substantial" if the active leasing or licensing expenses are 25% or more of the adjusted leasing or licensing profits.[8] The regulations generally define active leasing expenses and active licensing expenses as deductions that are properly allocable to rental or royalty income and that would be allowable under Code §162 if the C.F.C. were a domestic corporation, subject to certain exceptions.[9]

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6 Treas. Reg. §1.954-2(c)(1)(i)-(iv).

7 Treas. Reg. §1.954-2(d)(1)(i)-(ii).

8 Treas. Reg. §§1.954-2(c)(2)(ii) and (d)(2)(ii).

9 Treas. Reg. §§1.954-2(c)(2)(iii) and (d)(2)(iii).

TEMPORARY REGULATIONS

The purpose of Treas. Reg. §§1.954-2(c) and (d) is to clarify when rental or royalty income is not merely passive or investment income but is earned from the active business conduct of a C.F.C. The newly issued temporary regulations ensure that the exception from subpart F treatment only applies to active rents and royalties by specifying that the C.F.C.'s employees, not third parties, must perform the required functions in order to qualify for the exception. This modification effectively encourages the local development or creation of property.

The temporary regulations modify what qualifies as active rents and royalties under Treas. Reg. §1.954-2 in the following three ways:

1. The temporary regulations expressly provide that in order for the active rent or royalty exception to apply, the C.F.C. lessor or licensor must perform activities through its own officers or staff of employees.

2. The officers or employees that perform the activities associated with the rents or royalties may be physically located in more than one country.

3. The officers or employees will not be treated as performing the relevant activities if there are payments made by the C.F.C. under a cost sharing arrangement or platform contribution transaction because such arrangements involve another person actually performing the activities. Furthermore, payments made under such arrangements are non-deductible and do not count towards establishing whether an organization has "substantial" active leasing or licensing expenses under the safe harbor provision.[10]

"The purpose of Treas. Reg. §§1.954-2 (c) and (d) is to clarify when rental or royalty income is not merely passive or investment income but is earned from the active business conduct of a C.F.C."

The text of Treas. Reg. §1.954-2T(c)(1)(i) specifies that rents will be deemed active when activities are performed through the C.F.C.'s own officers or employees as follows:

> (i) Property that the lessor, *through its own officers or staff of employees*, has manufactured or produced, or property that the lessor has acquired and, *through its own officers or staff of employees*, added substantial value to, but only if the lessor, *through its officers or staff of employees*, is regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, property of such kind;[11]
>
> (iv) Property that is leased as a result of the performance of marketing functions by such lessor *through its own officers or staff of employees located in a foreign country or countries*, if the lessor, through its officers or staff of employees, maintains and operates an organization *either* in such country *or in such countries (collectively), as applicable*, that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property.[12]

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[10] Treas. Reg. §§1.954-2T(c)(2)(ii) and (viii); Treas. Reg. §§ 1.954-2T(d)(2)(ii) and (v).

[11] Treas. Reg. §1.954-2T(c)(1)(i); emphasis added.

[12] Treas. Reg. §1.954-2T(c)(1)(iv); emphasis added.

The text of Treas. Reg. §1.954-2T(d)(1)(i) specifies that royalties will be deemed active when activities are performed through the C.F.C.'s own officers or employees as follows:

> (i) Property that the licensor, *through its own officers or staff of employees*, has developed, created, or produced, or property that the licensor has acquired and, *through its own officers or staff of employees*, added substantial value to, but only so long as the licensor, *through its officers or staff of employees*, is regularly engaged in the development, creation, or production of, or in the acquisition and addition of substantial value to, property of such kind; or
>
> (ii) Property that is licensed as a result of the performance of marketing functions by such licensor through its own officers or staff of employees located in a foreign country *or countries, if the licensor, through its officers or staff of employees*, maintains and operates an organization *either* in such foreign country *or in such foreign countries (collectively), as applicable*, that is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and that is substantial in relation to the amount of royalties derived from the licensing of such property.[13]

The temporary regulations under Treas. Reg. §§1.954-2T(c)(2)(ii),(viii) and §§1.954-2T(d)(2)(ii),(v) further clarify that cost sharing arrangements ("C.S.T.") or platform contribution transactions ("P.C.T.") will not enable a C.F.C. to qualify for the active rent or royalty exception:

> C.S.T. Payments or P.C.T. Payments (as defined in §1.482-7(b)(1)) made by the lessor or licensor to another controlled participant (as defined in §1.482-7(j)(1)(i)) pursuant to a C.S.A. (as defined in §1.482-7(a)) do not cause the activities undertaken by that other controlled participant to be considered to be undertaken by the lessor's or licensor's own officers or staff of employees.

By specifying that a C.F.C.'s employees must perform certain functions, the temporary regulations effectively ensure that only active rental and royalty income derived from a C.F.C.'s trade or business will be excluded from F.P.H.C.I.

The effective date of the temporary regulations applies to rents or royalties received or accrued during the tax years of a C.F.C. ending on or after September 1, 2015.[14]

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[13] Treas. Reg. §1.954-2T(d)(1)(i)-(ii); emphasis added.

[14] Treas. Reg. §1.954-2T(j).

INADEQUATE GIFT DESCRIPTION – I.R.S. TRIES FOR A SECOND BITE AT THE APPLE

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Tags
Adequate Disclosure
Gift Tax
Form 709
Statute of Limitations

Any individual who makes a taxable gift in a taxable year is required to file a Form 709, *United States Gift Tax Return*, under Code §6019. The I.R.S. generally has three years to assess the amount of tax owed, but it may indefinitely assess and collect the tax on any gift or property required to be '"shown" on a return that is not "adequately shown."

TAXABLE GIFTS

Any transfer to an individual, either directly or indirectly, where full consideration for fair market value is not received in return is considered to be a gift. Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under the compulsion to buy or to sell and both having reasonable knowledge of relevant facts.[1]

All gifts are taxable gifts except for (i) gifts that are not more than the annual exclusion for the calendar year; (ii) tuition or medical expenses paid for someone; (iii) gifts to spouse; (iv) gifts to a political organization for its use; and (v) charitable gifts.

The annual exclusion[2] applies to a gift to each donee and changes every year. The annual gift exclusion for 2015 is $14,000 per individual and $28,000 per couple.

ADEQUATE DISCLOSURE

A gift is considered "shown" on a tax return when it has been disclosed in a manner that is adequate to apprise the I.R.S. of the nature of the gift. To meet this requirement, the following is necessary:[3]

1. A description of the property transferred and consideration received;
2. The identity of and the relationship between the transferor and each transferee;
3. A trust identification number if the donee is a trust;

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1 Treas. Reg. §§20.2031-1

2 To fall under the annual exclusion, a gift must be a present interest that the donee can use immediately. A gift to a trust are not present interests if the beneficiary's interest in the trust does not vest immediately.

3 Treas. Reg. §§301.6501(c)-1(f)(2)

4. A detailed description of the method used to determine the fair market value, including but not limited to appraisal copies, discounts, marketability, transfer documents, and documentation of any unusual items shown on the return; and

5. A description of any position taken that is contrary to the regulations.

LEGAL ADVICE MEMORANDUM 20152201F (5/29/2015)

Legal Advice Memorandum 20152201F addresses whether the statute of limitations was considered open against a deceased donor who transferred two gifts to his daughter and filed an allegedly lacking Form 709. The decedent's estate disputed the I.R.S.'s position, stating that the disclosure was adequate, and refused to extend the statute of limitations. If the statute has expired, the I.R.S. must bear the burden of proving that an exception to the statute of limitations is present. This field service legal advice memorandum summarizes those grounds.

"The I.R.S. must bear the burden of proving that an exception to the statute of limitations is present."

The donor filed a Form 709 claiming two gifts were transferred to the donor's daughter: partnership interests in two family limited partnerships whose common general partner was a subchapter S corporation. The assets held by the partnerships were primarily farm land, which was appraised by a certified appraiser. The gifts were described on the form and the annual deduction was claimed. An additional document with a single paragraph description of the valuation methods was attached.

The I.R.S. found that despite satisfying certain criteria, the return failed the adequate disclosure test. The I.R.S. claimed that the taxpayer failed to clearly identify the partnerships whose interests were transferred and to adequately describe the interests transferred and appraisal methods used. It cited that the full legal names of the partnerships were not reported and that the tax identification number of one the partnerships was missing a digit. Further, the appraisals that had been completed were for the land held by the partnerships, rather than for the partnership interests themselves. Additionally, the return's valuation did not explain the method used to determine the value reached and was found to be vague. Therefore, the gift was not considered shown on the tax return.

CONCLUSION

The gift tax return is essential for allowing the I.R.S. to timely assess taxes, but more importantly, it causes the statute of limitations to run on the value of the gift, if adequately disclosed. The adequate disclosure criteria ensure that a taxpayer sufficiently describes the property transferred and valuation methods used. Failure to comply leaves the statute open against the taxpayer and allows the I.R.S. to levy a tax at any time. What constitutes adequate disclosure continues to be a source of dispute between taxpayers and the I.R.S.

ALBEMARLE: REFUND CLAIMS RELATING TO FOREIGN TAX CREDITS

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Tags
Cash & Accrual Method
Foreign Tax Credits
Statute of Limitations

INTRODUCTION

A recent U.S. Court of Appeals case affirmed a lower court's decision that certain refund claims were barred by the statute of limitations.

In a case decided on October 20, 2014, *Albemarle Corp. v. United States*,[1] the U.S. Court of Federal Claims ruled in favor of the government. The court held that the taxpayer's claims for refunds, attributable to foreign tax credits, were time-barred in certain years.

The case involved withholding taxes on payments of interest to Albemarle Corp. ("Albemarle") from its Belgian subsidiary during the years 1997 to 2001. In 2001, the Belgian tax authorities asserted that the interest payments were subject to withholding tax, and in 2002, Albemarle agreed to pay, and did pay, Belgian withholding tax on these payments. The Belgian taxes were then allocated to each of the taxable years involved, 1997 to 2001.

In May 2009, Albemarle filed an amended U.S. income tax return for the 2002 taxable year in which it claimed foreign tax credits with respect to each of the years 1997 to 2001 for the Belgian withholding taxes paid in 2002. The Internal Revenue Service ("I.R.S.") permitted the refund claims for the 1999 to 2001 years but denied the refund claims attributable to 1997 and 1998. The I.R.S. determined, and the U.S. Court of Federal Claims agreed, that the 1997 and 1998 refund claims had not been filed within the ten-year statute of limitations provided in Code §6511(d)(3)(A). The claims for refunds attributable to foreign tax credits for the 1997 and 1998 taxable years (the "origin years") should have been filed on or before March 15, 2008 and March 15, 2009, respectively.

APPEAL

Albemarle appealed to the U.S. Court of Appeals for the Federal Circuit.[2] The Federal Circuit affirmed the lower court ruling, holding that the 1997 and 1998 refund claims had not been filed within the required ten-year period. With regard to the 1997 claim, the filing period was governed by the pre-1998 version of the statute, whereas the filing period for the 1998 refund claim was governed by the post-1997 version.

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1 114 AFTR 2d 2014-6184 (118 Fed. Cl. 549).

2 116 AFTR 2d 2015-5609.

Post-1997 Code §6511(d)(3)(A)

Under the amended statute, the ten-year period runs from the date prescribed by law for filing the return for the year in which the taxes were actually paid or accrued.

Albemarle contended that "actually" in Code §6511(d)(3)(A) should be given its ordinary meaning of "in fact" or "in reality," and thus, the 1998 tax liability could not accrue until it was finally established in 2002. Conversely, the I.R.S. claimed that "actually" indicated that the taxes accrue in the year of origin (*i.e.*, 1998) for purposes of the foreign tax credit. The Federal Circuit held that the government's interpretation was correct, since it is well established that a contested foreign tax is counted toward the credit limitation of the origin year.

Had the appeal succeeded, Albemarle's interpretation of the phrase "actually…accrued" would lead to a bizarre result, whereby the taxpayer could take a tax credit for a contested foreign tax in the year of origin (*i.e.*, 1998) but the credit would be counted toward the limitation applicable to the "contested resolution year" (*i.e.*, 2002). This would be contrary to the intent of the statute.

The phrase "actually…accrued" in the post-1997 statute appears to have been taken directly from Treas. Reg. §1.904-2(c). Congress's usage of the same phrase in the post-1997 statute suggests that it was meant to have the same meaning as the regulation, which stipulates that a foreign tax "actually accrues" in the year of origin.

"Foreign taxes relate back to the year of origin for purposes of the foreign tax credit and foreign taxes 'actually accrue' in the year... in which the foreign tax liability arose."

Relying on *Dixie Pine Products v. Commr.*,[3] where the Supreme Court established what is known as the "contested tax doctrine," Albemarle argued that contested foreign taxes cannot "actually accrue" for purposes of Code §6511(d)(3)(A) until the contest is over and the liability is established.

Albemarle also argued that the "all events test" for contested foreign taxes under Code §461 cannot be satisfied until the taxpayer's liability is finally established, which is the year in which the tax is "actually accrued." This would be 2002, the year in which the taxpayer resolved its dispute with the Belgium government.

The court rejected Albemarle's arguments that the year that the foreign tax "actually…accrued" was controlled by *Dixie Pine Products* or Code §461. The court stated that it "has long been recognized that the contested tax doctrine, which is derived from the law regarding deductions, is not strictly applicable to claims of foreign tax credits." Rev. Rul. 58-55,[4] indicates that the contested tax doctrine applies to the accrual of foreign taxes for deduction purposes but not for credit purposes.

The court concluded that contested foreign taxes relate back to the year of origin for purposes of the foreign tax credit and foreign taxes "actually accrue" in the year of origin, *i.e.*, the year in which the foreign tax liability arose. Thus, the court concluded that the ten-year statute of limitations for filing a refund claim of Albemarle's 1998 Belgian withholding taxes started to run on March 15, 1999, which was the due date for filing the return for the 1998 tax year. As a result, Albemarle's May 2009 claim for credit of its 1998 Belgian taxes was time-barred.

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[3] 320 U.S. 516 (1944).

[4] 1958-1 C.B. 266.

Pre-1998 Code §6511(d)(3)(A)

Under the prior version of Code §6511(d)(3)(A), a claim for a credit or refund attributable to foreign taxes paid must have been brought within ten years of the date prescribed by law for filing the return for the year with respect to which the claim is made.

Albemarle claimed a credit for its 1997 Belgian withholding taxes and intended to use that credit to offset its U.S. tax liability for the 1997 tax year. Therefore, Albemarle's refund claim was with respect to the 1997 tax year. The date prescribed by law for filing the 1997 tax return was March 15, 1998. Thus, Albemarle's May 2009 claim for a refund of the 1997 taxes was untimely.

CONCLUSION

As *Albemarle* demonstrates, taxpayers seeking to file tax refund claims must keep a careful eye on the statute of limitations or risk losing the ability to obtain a refund. In the case of a refund claim based on a foreign tax credit, Code §6511(d)(3) provides that the refund claim must be filed within ten years of the prescribed date for filing the relevant U.S. tax return. If the period of contest for the foreign tax is approaching ten years, a taxpayer should consider extending the statute of limitations by entering into an agreement with the I.R.S. under Code §6511(c).

CORPORATE MATTERS:
ARE YOU DOING BUSINESS IN NEW YORK?

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Corporate Law
Doing Business
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Due to the nature of our practice, many clients contemplating a transaction in the United States contact us very early in the process. Despite the fact that the final structure of a transaction may not be in place, we are often asked to form an entity that will eventually be used in the transaction. The entity is formed for a variety of reasons, including opening bank accounts, immigration issues, and asset transfers.

For reasons stated in an earlier article,[1] we typically recommend Delaware as the state in which to incorporate. Although there are times when we recommend New York, such as when an entity is being formed solely to hold real estate located in New York, Delaware is usually the jurisdiction of choice.

Recently, clients with entities formed in Delaware or another state other than New York that carry on operations from a base outside New York have asked if they should seek authority to transact business in New York. Typically, the client is concerned that operations in New York exist and is looking for a definitive answer as to the obligation to register. A fear that often inhibits a company from pursuing registration is the expectation that registration brings with it New York State and New York City tax obligations.

The answer to these questions is not as clear cut as one might think. Section 1301 of the New York Business Corporation Law (the "Act")[2] states that:

> A foreign corporation shall not do business in this state until it has been authorized to do so as provided in this article. A foreign corporation may be authorized to do in this state any business which may be done lawfully in this state by a domestic corporation, to the extent that it is authorized to do such business in the jurisdiction of its incorporation, but no other business.

Determining what constitutes doing business in New York would be a lot easier with some guidance from the statute. The statute does not set out what constitutes doing business in New York. However, it gives some guidance by listing some activities that do not constitute doing business in New York. The Act states that a foreign corporation will not be considered to be doing business in this state, by reason of carrying out any of the following activities:

- Maintaining or defending any action or proceedings;
- Holding meetings of its directors or shareholders;

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1 *Insights*, Vol. 1 No. 8, "Corporate Matters: Delaware or New York L.L.C.?"

2 N.Y. Bus. Corp. Law §1301(a).

- Maintaining bank accounts; or
- Maintaining offices or agencies only for the transfer, exchange, and registration of its securities, or appointing and maintaining trustees or depositaries with relation to its securities.

The above list is not exclusive, and other activities may not rise to the level of doing business within New York. So, the Act is helpful only to a point, and most of the law surrounding the issue of whether an entity is doing business in New York is found in case law. As with all matters resolved through litigation, each case is determined according to its particular facts.

In reaching the conclusion that an entity is or is not conducting business in New York, the amount and regularity of activity is a significant factor.[3] A corporation will be required to apply for authority to transact business in New York where its New York transactions evidence a continuous and regular conduct of business.[4] The courts have held that isolated and occasional transactions will not be enough to require compliance with the Act. The fact that a corporation has made one or two contracts in New York will usually not constitute doing business.

"The Act is helpful only to a point, and most of the law surrounding the issue of whether an entity is doing business in New York is found in case law."

Another important factor used in making the determination is the relationship of the activity to the regular business of the entity. If the activity being conducted in New York in essential to the entity's out-of-state business, it is likely that the entity will need to comply with the statute. If, on the other hand, the activity is merely tangential to its out of state business, it is less likely that the entity will be considered to be doing business in New York.

A review of the case annotations to the relevant section of the Act reveals some circumstances where the courts have determined that entities are not doing business in New York:

- Maintaining an office in New York;[5]
- Maintaining a bank account;[6]
- Letterhead with the address of a New York office;[7] and
- Maintenance of action in a New York court.[8]

The above decisions have considered the actions mentioned in isolation. In other words, only one activity was carried on and the court was asked to look at that activity in isolation. The results obviously would be different if an activity is part of a broader association within New York State.

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3 44 Fordham Law Review 1042 (1976).

4 *International Fuel & Iron Corp. v Donner Steel Co.*, 242 N.Y. 224, 230, 151 N.E. 214, 215-16 (1926).

5 *Id.*

6 *Star Poultry Co. v Spinelli*, 156 N.Y.L.J. at col. 3 (Sup Ct. Nov. 23, 1966).

7 *Lebanon Mill Co. v. Kuhn*, 145 Misc. 918 N.Y.S. 172,176 (N.Y. City Mun. Ct. 1932).

8 *De Ran Landscaping Service, Inc. v De Ran Industries, Inc.* (1985, 3d Dept) 109 A.D. 2d 1040, 487 N.Y.S. 2d 160.

Failure to obtain authority to conduct business in New York leaves the entity without access to the courts. Section 1312 of the Act states:

> A foreign corporation doing business in this state without authority shall not maintain any action or special proceeding in this state unless and until such corporation has been authorized to do business in this state and it has paid to the state all fees and taxes imposed under the tax law or any related statute, as defined in section eighteen hundred of such law, as well as penalties and interest charges related thereto, accrued against the corporation. This prohibition shall apply to any successor in interest of such foreign corporation.[9]

The failure to obtain authority to do business in New York does not impair the validity of any contract entered into by the foreign entity or the right of any other party to the contract to maintain legal action based thereon.[10]

As can be seen from the above, there is no one guideline to be used when determining whether an entity is doing business in New York. It is likely that this vagueness will continue, and clients should be prepared to detail their activities in New York and, in conjunction with their lawyers, make the decision whether to apply for authority based on the individual circumstances. For more information, the General Counsel's Office of the New York State Department of State provides a memorandum on the.[11]

9 N.Y. Bus. Corp. Law §1312(a).

10 *Id.*, (b).

11 "'Doing Business' In New York: An Introduction to Qualification General Guidelines," New York Department of State, February 2000.

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

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Tags
F.A.T.C.A.
I.D.E.S.
I.G.A.

VENDOR ACCESS TO F.A.T.C.A.-RELATED DATABASE IS PERMISSIBLE

In e-mailed advice dated September 4, 2015, the I.R.S. advised an I.R.S. employee that allowing a vendor access to the I.R.S.'s F.F.I. database for a demonstration of technical services to assist in the administration of F.A.T.C.A. would be permissible under Code §6103(k)(6).

Section 6103(k)(6) authorizes I.R.S. employees to disclose return information "in connection with [their] official duties relating to any audit, collection activity, or civil or criminal tax investigation or any other offense under the internal revenue laws" to the extent the disclosure is necessary in obtaining information that is not otherwise reasonably available, or "with respect to the enforcement of any other provision of [Title 26]." In this case, the disclosures would be made in order to determine whether or not the I.R.S. would enter into a contract with the vendor for the performance of technical services to identify non-compliance with F.A.T.C.A.

F.A.Q.'S CLARIFY BRANCH AND DISREGARDED ENTITY REGISTRATION REQUIREMENTS AND UPDATE I.D.E.S. RULES

The I.R.S. has recently updated its list of frequently asked questions ("F.A.Q.'s") to clarify branch and disregarded entity ("D.R.E.") registration requirements under the Foreign Account Tax Compliance Act ("F.A.T.C.A."). Subject to specific exceptions, a branch – including disregarded entities located in jurisdictions that either do not have an Intergovernmental Agreement ("I.G.A.") or have a Model 2 I.G.A. – must register as a branch of its owner, rather than as a separate entity. The I.R.S. added Q5 to instruct branches that inadvertently registered as separate entities on how to correct their registrations.

The I.R.S. clarifies that a branch in a Model 1 I.G.A. jurisdiction (but not a D.R.E. treated as a separate entity for purposes of its reporting to the applicable Model 1 jurisdiction) must generally be registered as a branch of its owner and not as a separate entity. Furthermore, the I.R.S. states that the Financial Institution ("F.I.") of which the branch is a part must revise its registration to include the branch by the end of 2015. An F.I. registering for the first time must register its branches (including an appropriate lead F.I. or sponsoring entity) when completing Part 1 of F.A.T.C.A. registration.

Leniency for Withholding Agents

The I.R.S. has offered leniency to withholding agents who know, or have reason to know, that an incorrectly registered branch has provided a Form W-8BEN-E, *Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities)*.

These agents can rely on the form (if otherwise valid) for payments made by the end of the 2015 calendar year.

Amending I.D.E.S. Reports

The I.R.S. also updated its F.A.T.C.A. I.D.E.S. Technical F.A.Q.'s. The I.D.E.S. is the International Data Exchange Services that allows the I.R.S. to exchange taxpayer information with foreign tax authorities.

The main change was the addition of two new questions on using F.A.T.C.A. XML Schema to void a record reported in error or to amend a F.A.T.C.A. Report.[1] The I.R.S also updated Data Transmission, Question D12, "Can we get individual confirmation that our files were received and approved by the IRS?"

F.A.T.C.A. COMPLIANCE IS UNDERWAY IN BRAZIL

On September 1, Brazilian banks began providing information to the Brazilian tax authorities on the monthly financial operations of U.S. companies and individuals with bank deposits of $50,000 or more as part of its I.G.A. to facilitate reporting under F.A.T.C.A. Brazil signed a Model 1 I.G.A. with the U.S. on September 23, 2014.

The first report, according to a Model 1 I.G.A., will be sent to the U.S. authorities on September 30, 2015 and will cover the year 2014. Information will be collected by financial institutions on a monthly basis, and reports regarding the preceding six months will be sent to tax authorities on the last working days of February and August of each year.

"The Philippine Bureau of Internal Revenue has recently announced that reporting will not take place on September 30, 2015, as required under the I.G.A."

THE PHILIPPINES AND CROATIA POSTPONE F.A.T.C.A. INFORMATION REPORTING

The Model 1 I.G.A. between the Philippines and the U.S. was signed on July 13, 2015, but an agreement in substance was reached on November 30, 2014. Nevertheless, the Philippine Bureau of Internal Revenue has recently announced that reporting will not take place on September 30, 2015, as required under the I.G.A. As a result, financial institutions resident in the Philippines will not be required to submit information under the I.G.A. until the second quarter of 2016.

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[1] See Data Format and Structure, Question C22, "How do I void a record reported in error using FATCA XML Schema?" and Question C23, "How do I amend a FATCA Report using FATCA XML Schema?"

However, reporting F.F.I.'s must take the necessary steps to prepare for full implementation of the terms of the I.G.A. and the concomitant submission of information on reportable accounts beginning the second quarter of 2016. Reporting F.F.I.'s are also reminded that the first batch of reports to be submitted shall include information relating to 2014 and 2015 reportable accounts, as detailed in the I.G.A.

The Model 1 I.G.A. between Croatia and the U.S. was signed on March 20, 2015. On September 10, 2015, the Croatian Ministry of Finance announced that the exchange of information under the I.G.A. that was to take place on September 30, 2015 will also be postponed until a date next year, but will in no event be later than September 30, 2016.

"Sen. Rand Paul (R-KY) joined the plaintiffs of a suit...arguing that F.A.T.C.A. is unconstitutional."

F.A.T.C.A. UNDER ATTACK: INJUNCTIVE RELIEF SOUGHT TO CURTAIL F.A.T.C.A.

On July 14, 2015, Sen. Rand Paul (R-KY) joined the plaintiffs of a suit, filed by Republicans Overseas Action, Inc. and others, arguing that F.A.T.C.A. is unconstitutional. The lawsuit maintains that the Obama administration violated the rights of Mr. Paul, a candidate for the Republican presidential nomination, and 99 other senators to advise and consent on agreements with foreign countries.

Specifically, the lawsuit argues that the I.G.A.'s settled between the Treasury Department and foreign governments violate the Constitution's Article II, Section 2, which requires two-thirds of U.S. senators to be present and voting in order to approve a foreign treaty. The suit also claims the law has inflicted unprecedented hardships on American expatriates, who are prevented from receiving banking services overseas, and has caused many to renounce U.S. citizenship in order to avoid onerous financial penalties and invasions of privacy.

On September 4, attorneys for the Justice Department faced off against attorneys representing the plaintiffs at a hearing in the U.S. District Court for the Southern District of Ohio. on whether F.A.T.C.A. is unconstitutionally burdening U.S. citizens overseas (*Crawford v. Dep't of Treasury*). The attorneys clashed over whether F.A.T.C.A., its agreements, and other requirements to report U.S.-owned accounts and assets held abroad are allowable under the Constitution, as well as other potential injury issues.

The hearing was regarding a motion for injunctive relief filed in July, along with a lawsuit seeking to get the statute overturned. The Justice Department is expected to file a motion to dismiss in the next week or two.

In order to succeed, the taxpayers must prove direct harm; an indirect chain of causation is not enough. The plaintiffs also contend that the withholding is a draconian penalty that is unconstitutional, although in reality, this is merely a tax. Additionally, it will be quite a challenge for the plaintiffs to show that the I.G.A.'s are not within the president's authority, since the administration has negotiated tax exchange information agreements with a number of jurisdictions without the need for Senate action.

At the hearing, Judge Thomas M. Rose gave little indication about whether or not he will grant the injunction sought by the plaintiffs seeking to bar the enforcement of F.A.T.C.A.

PORTUGAL ELIGIBLE FOR MORE FAVORABLE REPORTING PROCEDURES

The Treasury Department has added Portugal to its list of countries with early versions of agreements under F.A.T.C.A. that may use the more favorable procedures for reporting new accounts available in later pacts.

In late July, the Treasury announced that it would notify 40 countries of the positive option and released a letter regarding the newly available terms. The addition of Portugal on August 18 expands the list of countries eligible for this benefit by one jurisdiction, bringing the total number to 41.

The move not only offers conformity between I.G.A.'s, but eases the reporting requirements for banks in many nations. For a detailed discussion of the Treasury letter please refer to our article in last month's edition of Insights.[2]

MAURITIUS REVENUE AUTHORITY ISSUES F.A.T.C.A. F.A.Q.'S

The Mauritius Revenue Authority has issued frequently asked questions and answers about F.A.T.C.A. and the U.S.-Mauritius I.G.A. The F.A.Q.'s address registration, information reporting procedures, financial institutions and nonfinancial foreign entities, and technical issues.

THE FEDERATION OF ST. KITTS AND NEVIS SIGNS A MODEL 1 I.G.A.

On August 31, 2015, the text of the St. Kitts and Nevis I.G.A. was published. This I.G.A. is a Model 1 non-reciprocal I.G.A. Pursuant to this agreement, the government of St. Kitts and Nevis will compile information from local F.I.'s as to relevant accounts to be reported and submit this data to the I.R.S.

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.

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[2] *Insights*, Vol. 2 No. 8, "F.A.T.C.A. 24/7."

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

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

AS SEEN IN...

Stanley C. Ruchelman and Kenneth Lobo's article "Indian Investors Purchasing U.S. Real Estate – From a U.S. Point of View" was featured in the September 2015 edition of *International Taxation*. In addition to the broad application of the U.S. Federal income tax regime, the article is concerned with the two principal tax problems that affect every real estate investment: F.I.R.P.T.A. and U.S. estate tax.

Taxsutra published a two-part series by Kenneth Lobo on "Tax Planning for Indian Businesses Investing in the U.S." Part I of the series provides an overview of the U.S. Federal and state income tax regimes for Indian tax practitioners advising clients who seek to expand operations in the U.S. Part II addresses taxing obligations associated with direct operations by an Indian-owned U.S. subsidiary and the relationship to the U.S.-India Income Tax Treaty.

OUR RECENT AND UPCOMING PRESENTATIONS

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.

On October 6, 2015, Stanley C. Ruchelman and Galia Antebi will speak on "Understanding U.S. Taxation of Foreign Investment in Real Property" as part of the two-day conference Current U.S. Tax Planning for Foreign-Controlled (Inbound) Companies hosted by Bloomberg BNA in New York. Thier discussion will cover legal and tax aspects of structuring U.S. real estate investments and will specifically address §871(d) net gain elections, special considerations for partnerships and withholding taxes, including the preparation of statements to reduce F.I.R.P.T.A. withholding tax, and U.S. tax aspects of cross-border M&A transactions involving U.S. R.P.I.'s.

In October 2015, Beate Erwin will attend the International Bar Association Annual Conference held in Vienna, Austria, where she will participate on the panel "Tax Structuring for Private Clients." The panel will utilize case studies to focus on how tax issues impact structures used for private clients.

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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