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INSIGHTS

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EDITORS' NOTE

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

- **B.E.P.S. Initiative Spawns Unfavorable Permanent Establishment Court Decisions.** Two court cases in different parts of the world attack tax plans premised on the absence of a permanent establishment. Pertinent U.S. income tax treaties, with Japan and India respectively, were effectively ignored in each case. Taketsugu Osada, Christine Long, and Stanley C. Ruchelman explain.

- **Apple in Europe – The Uphill Battle Continues.** U.S. multinationals are the target of a global trade war initiated by the European Commission, resulting from its attack on State Aid in the form of advance rulings. Christine Long and Beate Erwin explain the latest developments and the brewing response in the U.S. Congress.

- **Partnership Tax Traps and Recent Guidance.** At the end of 2015, the I.R.S. issued a notice designed to limit the instances in which contributions of property to foreign partnerships benefit from nonrecognition of gain. In January, the I.R.S. came under pressure to modify its announced position in final regulations that are currently being developed. Philip R. Hirschfeld explains.

- **A Concise Guide to Acquisition Vehicles for Purchase of U.S. Real Estate by Foreign Individuals.** Question: How many ways are there to structure an investment in U.S. real property by a foreign person? Answer: Many. Nina Krauthamer describes five.

- ***3M* Case to Test "Foreign Legal Restrictions" Regulations Under Code §482.** Who knows best, the I.R.S. or the U.S. Supreme Court? Refusing to give up on its position that Code §482 trumps a foreign law that caps amounts used in related-party transactions, the I.R.S. is challenging 3M, a corporation that is acting in compliance with Brazilian law. Elizabeth V. Zanet and Galia Antebi delve into a legal issue that most adviser though was settled years ago by the U.S. Supreme Court.

- **Tax 101: Corporate Reorganizations Part I – Types A & B.** Tax 101 is back, this time addressing the basic concepts of tax-free A- and B-reorganizations. The first relates to statutory mergers and the latter relates to share-for-share exchanges. Rusudan Shervashidze and Andrew P. Mitchel explain the basic concepts for non-tax savvy readers.

- **Field Procedures for Handling Foreign-Initiated "Specific" Requests Under E.O.I. Agreements.** *Insights* looks at I.R.S. International Practice Units once again, this time focusing on how the I.R.S. deals with information exchanges at its field level. Sheryl Shah and Stanley C. Ruchelman explain the procedure followed by the Large Business & International division.

- **F.A.T.C.A. 24/7.** This month, Philip R. Hirschfeld looks at the I.G.A. experience in Mexico; updated Form W-8BEN-E and instructions; an announcement on forthcoming regulations that will ease burdens on F.F.I.'s; new I.G.A. competent authority arrangements signed with Norway, Barbados, Romania, Spain, Italy, and Costa Rica; a new I.G.A. with St. Lucia; and the most recent list of I.G.A. partner countries.

- **Updates & Other Tidbits.** This month, Stanley C. Ruchelman, Rusudan Shervashidze, Philip R. Hirschfeld, and Sheryl Shah look at the latest development in the deferred prosecution agreement with Swiss banks, a property tax increase in Jerusalem for "ghost apartments," Canadian procedures to exempt foreign employers from withholding tax on salaries paid to certain individuals that are resident outside of Canada but work in Canada from time to time, and the adverse effect outside the U.S. of deferred CbC reporting for U.S.-based multinationals.

We hope you enjoy this issue.

- The Editors

B.E.P.S. INITIATIVE SPAWNS UNFAVORABLE PERMANENT ESTABLISHMENT COURT DECISIONS

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Tags
India
Japan
Permanent Establishment
Principal-Agent

INTRODUCTION

Over the past few months, two court decisions in different parts of the world found that a permanent establishment ("P.E.") existed in structures that appeared to be risk free. These decisions serve as warnings that reliance on the business profits and P.E. articles of an income tax treaty may have to be rethought. The provisions may not provide benefits when most needed: during the course of a tax examination abroad.

TOKYO DISTRICT COURT JUDGED PRODUCT SHIPPING FACILITY FOR ONLINE SHOPPING SERVICES AS A P.E.

Background

Sometimes, it is dangerous to anticipate that a standard provision of an income tax treaty will be applied in a straightforward way to achieve a desired goal. This was recently illustrated by a Tokyo district court case that was asked to apply one of the more prevalent provisions of an income tax treaty.

The case apparently ignored the plain meaning of the of the Japan-U.S. Income Tax Treaty ("the Treaty"), and expanded its interpretation to conclude that a storage facility for inventory could rise to the level of a P.E. The case involved the following fact pattern:

- A U.S. resident operated an online shopping service directed to Japanese customers. It rented an apartment and warehouse in Japan (hereinafter the "Japanese Facilities") in order to store products prior to their shipment to Japanese customers. All orders were placed through the internet.
- The Japanese tax authorities asserted that the U.S. resident was taxable on the resulting business income because the Japanese Facilities qualified as a P.E. under the Treaty.
- The taxpayer asserted that the Japanese Facilities used for storage and delivery purposes could not qualify as a P.E. because they were maintained for preparatory or auxiliary purposes.

The court affirmed the position of the Japanese tax authorities and held that the Japanese Facilities amounted to a P.E. under the Treaty.

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Treaty Provisions

Article 7 (Business Profits) of the Treaty addresses the threshold of contact with Japan that must exist before a U.S. tax resident may be taxed on its business profits. Paragraph 1 provides as follows:

> The profits of an enterprise of a Contracting State shall be taxable only in that Contracting State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in that other Contracting State but only so much of them as is attributable to the permanent establishment.
>
> Article 5 (Permanent Establishment) of the Treaty addresses facts that must exist in order for a U.S. resident to be considered to maintain a P.E. in Japan. The starting point is the general rule in paragraph 1: For the purposes of this Convention, the term 'permanent establishment' means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Paragraph 2 contains specific examples of facts that would be considered to comprise a P.E.:

> The term 'permanent establishment' includes especially
>
> a) a place of management;
>
> b) a branch;
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> c) an office;
>
> d) a factory;
>
> e) a workshop; and
>
> f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

Paragraph 4 contains express exclusions from P.E. status for certain places of business that are used for preparatory and auxiliary purposes. It provides as follows in pertinent part:

> Notwithstanding the preceding provisions of this Article, the term 'permanent establishment' shall be deemed not to include
>
> a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
>
> b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
>
> * * *

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

The Technical Explanation prepared by the Treasury Department in connection with the approval process in the Senate explains the exception in the following way:

> This paragraph contains exceptions to the general rule of paragraph 1, listing specific activities that may be carried on through a fixed place of business, but which nevertheless do not create a permanent establishment. The use of facilities solely to store, display or deliver merchandise belonging to an enterprise does not constitute a permanent establishment of that enterprise. The maintenance of a stock of goods belonging to an enterprise solely for the purpose of storage, display or delivery, or solely for the purpose of processing by another enterprise does not give rise to a permanent establishment of the first-mentioned enterprise. * * * Subparagraph 4(f) provides that a combination of the activities described in the other subparagraphs of paragraph 4 will not give rise to a permanent establishment if the combination results in an overall activity that is of a preparatory or auxiliary character. This combination rule, derived from the OECD Model, differs from that in the U.S. Model. In the U.S. Model, any combination of otherwise excepted activities is deemed not to give rise to a permanent establishment, without the additional requirement that the combination, as distinct from each constituent activity, be preparatory or auxiliary. If preparatory or auxiliary activities are combined, the combination generally also will be of a character that is preparatory or auxiliary. If, however, this is not the case, a permanent establishment may result from a combination of such activities.

Issue Presented

The issue presented to the court was whether the Japanese Facilities have a "preparatory or auxiliary character." Presumably, that was because both a stock of goods and a storage facility were maintained. The court held that the Japanese Facilities were not of a "preparatory or auxiliary character" based on the following facts:

- The U.S. resident conducted sales activities in the Japanese Facilities as sales offices, even though all sales were placed on the U.S. entity's website.
- Employees actually performed important operations of the online shopping service in the Japanese Facilities, such as the storing, wrapping, and shipment of products and the receipt of returned products.[1]

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[1] Judged on May 28, 2015.

Analysis

Critical to the judge's ruling was the fact that the U.S. resident emphasized on its website, which was written entirely in Japanese, that the U.S. business could deliver goods imported from the U.S. soon after a purchase order was placed. The judge acknowledged that such quick delivery was possible because the Japanese Facilities stored goods imported from the U.S. beforehand. In order to fulfill one of the conditions of the service's contract with their customers, *i.e.*, that they would deliver goods quickly, the Japanese Facilities were playing an important role for the online shopping service provided by the U.S. resident, and as such, their character was beyond preparatory or auxiliary.

The logic of the court is somewhat unique. The Treaty does not limit the exclusion for storage facilities that are slow, or that ship goods in unwrapped condition, or only in packages with delivery addresses written in English. Yet the court seemed to distinguish storage facilities that are effective and that store inventory prior to sale to Japanese customers from other storage facilities. Presumably, efficiency is the enemy of preparatory or auxiliary activity. U.S. businesses are cautioned that neither the Japanese tax authorities nor the courts are willing to allow competition from businesses designed to be efficient, and nothing in the Treaty will be applied to the contrary.

BROADCASTER'S TAX LIABILITY IN INDIA BASED ON P.E. RULES

An Indian tax court, the Mumbai Bench of the Income Tax Appellate Tribunal ("I.T.A.T."), held that a U.S. broadcaster owes tax to India on the income generated from the independent sale of advertising airtime by its Indian network subsidiary because such subsidiary is considered a dependent agent and constitutes a P.E. of the broadcaster. Despite the existence of principal-principal contractual provisions and arm's length payments, the court in *NGC Network Asia LLC v. Joint Director of Income Tax*[2] found that the entities had a principal-agent relationship. The tax liability created by this principal-agent characterization is expected to impact how foreign broadcasters enter into contracts and advertise in India.

The case involved NGC Network Asia LLC Co. ("NGC Asia"), which is a Delaware subsidiary of U.S. Fox Entertainment Group, Inc., and the Indian tax authority. NGC Asia owns the television channels National Geographic and Fox International, which the company broadcasts in India as well as other countries. NGC Asia entered into an advertisement sales agreement with one of its subsidiaries, NGC Network (India) Private Limited ("NGC India"), in which NGC Asia sold to NGC India the rights to distribute its two television channels and to sell advertising airtime in exchange for a lump sum. Under the agreement, NGC India made arm's length payments to NGC Asia for the income derived from the distribution rights and from the advertising profits. The agreement provided that NGC India bear all the risks for the sale of advertising airtime as well as determine the terms of the airtime sales to advertisers. NGC Asia and NGC India intended to establish a principal-principal arrangement and viewed NGC India as an independent agent.[3]

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2 *NGC Network Asia LLC v. Joint Director of Income Tax*, ITA No. 7994/Mum/2011.

3 Amrit Dhillon, "Foreign Broadcasters Risk PE Findings After Indian Ruling," *BNA International Tax Monitor*, January 15, 2016.

NGC Asia did not regard NGC India as a P.E. and therefore considered its income from the sale of distribution rights and airtime to NGC India to be excluded from tax. However, the Indian tax authority determined that NGC India is a dependent agent P.E. of NGC Asia and, as such, NGC Asia's income from the sale of distribution rights and advertising airtime was taxable in India. The tax authority also determined that "advertisement airtime" does not constitute goods that can be sold because "time" cannot be stocked or delivered in advance, or in this case, cannot be separated from the channel airing the advertisement.[4] NGC Asia challenged the determination and the case went up to the I.T.A.T. in Mumbai.

"The tax liability created by this principal-agent characterization is expected to impact how foreign broadcasters enter into contracts and advertise in India."

The I.T.A.T. agreed with the Indian tax authority, and on December 16, 2015, it that since the agreements NGC India entered into in India were binding on NGC Asia, NGC India is a dependent agent P.E. of NGC Asia.[5]

The court affirmed that airtime is not capable of sale and that NGC India is an agent dependent on NGC Asia because NGC India cannot use the advertising airtime without NGC Asia's transfer of rights.[6] Thus, the court held that NGC Asia and NGC India have a principal-agent relationship, despite the fact that the advertising sales agreement intended to establish a principal-principal relationship between the companies.

The I.T.A.T. further refuted NGC Asia's reliance on *DIT v. Morgan Stanley & Co.*[7] and its argument that the arm's length payments by NGC India did not trigger a tax obligation for NGC Asia, even if NGC India is a P.E. The I.T.A.T. stated that *DIT v. Morgan Stanley & Co.* is limited to the situation in which a foreign company makes payments to its associated entity or P.E. in India – it does not apply to an entity in India making payments to an associated entity abroad.[8]

NGC Asia will probably appeal the I.T.A.T.'s decision in the Mumbai High Court. In the meantime, however, the tax court's decision creates uncertainty about tax liability for foreign broadcasters selling advertising airtime in India and concerns that a contractual principal-principal relationship will be viewed as principal-agent with an Indian P.E.

CONCLUSION

Emboldened by the O.E.C.D.'s attack on base erosion and profit shifting ("B.E.P.S."), tax authorities are looking at new ways to assert the existence of a permanent establishment. In the Japanese case, it was web-based advertising in the Japanese language, combined with a local delivery service. In India, it was furnishing media content to a local subsidiary. Tax advisers who remember the world before the B.E.P.S. initiative are likely surprised by these cases. Nonetheless, in a post-B.E.P.S. world, they may represent the new normal.

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4 *Id.*

5 *Id.*

6 *Id.*

7 *DIT v. Morgan Stanley & Co.*, (2007) 292 ITR 416 (SC).

8 Dhillon, "Foreign Broadcasters Risk PE Findings After Indian Ruling."

APPLE IN EUROPE – THE UPHILL BATTLE CONTINUES

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Tags
Apple
European Commission
State Aid

Apple Inc. ("Apple") may owe up to $8 billion in back taxes if the European Commission (the "Commission") determines that Ireland's tax arrangements with Apple amount to unjustifiable State Aid in violation of E.U. anti-competition laws. If the Commission determines that Ireland provided a selective tax advantage, and thus illegal State Aid, to Apple, Ireland would be forced to recoup taxes from Apple over a ten-year period. The Commission could reach a decision in the spring.

U.S. officials assert that the European Commissioner for Competition, Margrethe Vestager, is targeting U.S. multinational companies and has no right to claim U.S. companies' offshore profits. Competition Commissioner Vestager rejects U.S. criticism and claims she is examining potential State Aid violations involving several non-U.S. companies. The Commission has been investigating various E.U. Member State's individual tax rulings with U.S. companies, including Starbucks in the Netherlands, Google in the U.K., and Amazon in Luxembourg. U.S. senators have recently been encouraging the U.S. Treasury Department to strike back by increasing taxes on European companies.

APPLE'S IRISH TAX AGREEMENTS

Irish tax officials issued letter rulings[1] or advance pricing agreements ("A.P.A.'s")[2] in favor of Apple in 1991 and 2007. These two rulings gave Apple guidance on how the company could attribute profits to its Irish branches of Apple Sales International and Apple Operations Europe. Apple calculated its taxable profits in accordance with the agreements and the Irish tax authorities determined that Apple's branch attributions were legal. Apple's foreign tax rate is less than 2% and it generates over half of its revenue outside the U.S.[3]

In June 2014, the Commission formally began investigating Ireland's tax rulings for Apple. According to the Commission's preliminary findings, Apple's A.P.A.'s with

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1 A tax letter ruling is a letter from a national tax authority to an individual company that either provides guidance on the interpretation of law or clarifies how the company's corporate tax will be calculated. State aid disputes target the latter if deemed to provide unjustified advantages to certain taxpayers. See Beate Erwin, "Tax Rulings in the European Union – State Aid as the European Commission's Sword Leading to Transparency on Rulings," *Insights* 6 (2015): pp. 13-14.

2 An A.P.A. is an agreement between a taxpayer and a national taxing authority that resolves potential disputes prior to a set of transactions amongst related parties over a fixed period of time.

3 Adam Satariano, "Apple May Face $8 Billion Tax Bill After Eurorpe Probe," *BNA Daily Tax Report*, January 15, 2016.

Ireland may have provided unfair tax advantages to the U.S. company in violation of State Aid laws. The Commission contends that the agreements allow Apple to calculate profits using more beneficial accounting methods since Apple can use low operating costs to determine its Irish taxes. Competition Commissioner Vestager doubts the legality of the agreements and is accusing Apple of using its Irish branches to avoid paying taxes on income generated outside the U.S.

The Commission must show that Apple unfairly benefited from its tax arrangements with Ireland in order to establish that Apple received illegal State Aid. If the Commission finds that Ireland's agreements provided a selective tax advantage to Apple, the company would be liable for back taxes for up to ten years. The amount that may be recovered from a recipient of State Aid is difficult to determine. According to Apple's U.S. Securities and Exchange Commission filing in April 2014, Apple anticipates that the amount of back taxes reflective of disallowed State Aid could be "material," which under U.S. securities law is 5% of a company's average pre-tax earnings for the last three years. If the Commission imposes harsher standards of accounting, Apple could be hit with a 12.5% tax rate on $64.1 billion of revenue earned from 2004 through 2012.[4]

Apple's potential $8 billion tax charge in Europe may be considered damages and not "tax" for purposes of double tax relief under U.S. tax law. Thus, such repayments of State Aid by a U.S. company do not automatically qualify for a foreign tax credit, and even if they do qualify, the amount of credit is limited.[5] U.S. companies facing State Aid charges from their European operations may thus be hit twice, with significant payments to European tax authorities that are only partially, or even not at all, offset by tax credits towards U.S. tax liabilities for the years at issue.

"The Irish government has indicated that it would initiate a legal battle against the Commission if it decides that Ireland's tax arrangement with Apple amount to unlawful State Aid."

The Irish government has indicated that it would initiate a legal battle against the Commission if it decides that Ireland's tax arrangement with Apple amount to unlawful State Aid and that it could challenge the Commission's decision in the E.U. Court of Justice.[6]

> As far as Ireland is concerned and we've been very clear about this – we've dealt with all the issues about reputational damage, about comments that Ireland was some sort of tax haven which was completely without foundation and utterly untrue.

Edna Kenny, Taoiseach (head of government) of Ireland, said in an interview with Bloomberg TV in Davos, Switzerland on January 21, 2016. "From our perspective we're very clear that our Revenue Commissioners have never done specific deals or a favorable deal with any particular company."[7]

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4 *Id.*

5 See Heather Self cited in "Apple tax State Aid decision expected before Christmas, says Irish Finance Minister," Out-law.com, November 10, 2015. The unanimous view amongst tax experts is that the nature of the State Aid back taxes is unclear at this time.

6 Joe Brennan, "Ireland Seen Losing Apple Tax Skirmish, Triggering Legal Battle," *Bloomberg Business*, September 4, 2015.

7 *The Irish Times*, January 21, 2016.

STATE AID

The Commission is concerned with anti-competitive tax practices by E.U. Member States. Accordingly, the Competition Commissioner has vowed to crackdown on corporate tax avoidance. The Commission estimates that tax evasion occurring throughout the E.U. costs about $1.11 trillion a year.[8]

The Commission does not have direct power over Member States' tax systems; however, it does have the power to investigate a national tax authority's actions that potentially infringe on E.U. laws. Member State's grant of a tax advantage to a certain company operating within its jurisdiction could amount to unlawful State Aid in violation of E.U. anti-trust laws. The Commission asserts that it is taking a structured approach when using its State Aid enforcement powers to investigate selective tax advantages that distort fair competition.[9]

As explained in a previous Insights article, "Tax Rulings in the European Union – State Aid as the European Commission's Sword Leading to Transparency on Rulings,"[10] State Aid is any aid granted by a Member State or through Member State resources, in any form whatsoever, that distorts or threatens to distort competition by favoring certain undertakings and is incompatible with the internal market as far as it affects the trade between Member States.[11] A measure qualifies as "State Aid" if the following conditions are met:[12]

- The relevant intervention is granted by a Member State or through Member State resources.[13]
- The intervention provides an economic advantage to the recipient.[14]
- The intervention affects or may affect competition and trade between the Member States.[15]
- The advantage is selective, *i.e.*, it is only granted to specific recipients.[16]

The Commission has the authority to review existing State Aid measures under

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8 *Id.*

9 Out-law.com, April 2015; Erwin, "Tax Rulings in the European Union," pp. 13-14.

10 *Id.*, pp. 13-14.

11 Treaty on the Function of the European Union ("T.F.E.U."), Art. 107, sec. 1; See Matthias Scheifele, "State Aid, Transparency Measures and Reporting Standards in the EU," in *The Corporate Tax Practice Series: Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Reorganizations & Restructurings*, ed. Louis S. Freeman (Practicing Law Institute, 2015).

12 Erwin, "Tax Rulings in the European Union," p. 13-14.

13 "Commission Notice on the Application of State Aid Rules to Measures Relating to Direct Business Taxation," *Official Journal C* 384 (December 10, 1998): p. 3, ¶10.

14 *Id.*, ¶9.

15 *Id.*, ¶10.

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

T.F.E.U. art. 108(1).[17] If the Commission finds that an existing State Aid measure is incompatible with the internal market, it then decides whether the Member State granting the State Aid should amend or abolish the respective measure within a period of time determined by the Commission.[18] Under Council Regulation (E.U.) No. 734/2013, art. 14, illegal State Aid must be recovered from the recipient entity, and the recovery period is limited to ten years.[19]

Tax rulings or A.P.A.'s between a Member State's tax authority and an individual company are compliant with E.U. anti-trust laws if they serve as guidance on the respective tax authority's interpretation of the tax laws. However, such arrangements may involve State Aid and be in violation of E.U. anti-trust laws if a Member State's tax authority provides selective advantages to a specific company, or related companies, and such advantage is not justified by general economic development, as outline above.[20] Therefore, in order for the Commission to establish that Apple received illegal State Aid, it must show that Ireland provided a tax advantage to Apple and that Apple benefited from its tax arrangements.

U.S. REACTION

U.S. officials claim that the Commission is targeting U.S. multinational corporations in its State Aid investigations. In 2014 and 2015, the Commission initiated formal State Aid investigations involving the following U.S. companies: Apple in Ireland, Starbucks in the Netherlands, Fiat Finance & Trade in Luxembourg, Amazon in Luxembourg, and McDonald's in Luxembourg.[21] In 2016, the Commission determined that Belgium must recoup corporate taxes from unlawful State Aid, and the Commission may also investigate Google's recent tax settlement with the U.K.

Robert Stack, Deputy Assistant Secretary for International Tax Affairs at the U.S. Treasury Department, questions the "basic fairness" of Commissioner Vestager's examinations of U.S. multinational companies, and he asserts that the Commissioner is making unreasonable demands.[22] Other U.S. officials are also expressing concerns about the Commission's State Aid probes.

On December 1, 2015, the Senate Finance Committee held a hearing on "International Tax: O.E.C.D. B.E.P.S. and E.U. State Aid," during which Mr. Stack testified that the Treasury Department is concerned that the Commission's investigations

- appear to disproportionately target U.S. companies;
- potentially undermine U.S. rights under its bilateral tax treaties with E.U. Member States;
- take a novel approach in applying E.U. State Aid rules and apply that approach retroactively, rather than prospectively;

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17 Erwin, "Tax Rulings in the European Union," p. 14.

18 T.F.E.U., art. 108(2); Erwin, "Tax Rulings in the European Union," p. 14.

19 *Id.*, p. 15.

20 *Id.*, p. 16.

21 "European Commissioner Rejects U.S.'s Criticism of EU State Aid Probes Targeting U.S. MNEs," *Checkpoint International Taxes Weekly*, February 9, 2016.

22 Stephanie Bodoni, "U.S. Tax Official Criticizes EU Probes of American Companies," *BNA Snapshot*, January 29, 2016.

“Articulating their concerns about the impact of the Commission’s State Aid investigations... the senators even requested that the President consider utilizing Code §891 to impose double tax rates on E.U. citizens or corporations.”

- could give rise to U.S. companies paying E.U. Member States billions of dollars in tax assessments that may be creditable foreign taxes, resulting in U.S. taxpayers “footing the bill;” and

- substantively amount to E.U. taxation of historical earnings that, under internationally accepted standards, no E.U. Member State had the right to tax.[23]

The House Ways and Means Subcommittee on Tax Policy also held a hearing where Mr. Stack testified that the Treasury Department questioned the Commission’s imposition of authority over Member States, as well as the right to go after offshore profits held by U.S. companies.[24]

On January 15, 2016, a bipartisan group of senators from the Senate Finance Committee wrote to Treasury Secretary Jacob Lew articulating their concerns about the impact of the Commission’s State Aid investigations on U.S. policy. The letter, written by Senators Orrin G. Hatch (R-U.T.), Ron Wyden (D-O.R.), Rob Portman (R-O.H.), and Charles E. Schumer (D-N.Y.), stated:

> We recognize that the EU Commission believes it is on solid ground in pursuing these cases and enforcing EU competition law against its EU member states…It alarms us, however, that the EU Commission is using a non-tax forum to target U.S. firms essentially to force its member states to impose taxes, looking back as far as ten years, in a manner inconsistent with internationally accepted standards in place at the time. By all accounts, these cases have taken the member states, companies, and their advisors by surprise.[25]

The letter further urges the Treasury Department to caution the Commission. The senators even requested that the President consider utilizing Code §891 to impose double tax rates on E.U. citizens or corporations due to the E.U.’s “discriminatory or extraterritorial taxes” on U.S. citizens or corporations.[26]

On January 29, Deputy Secretary Stack met with three European Commission officials: Ditte Juul-Joergensen and Linsey McCallum, heads of Vestager’s cabinet, as well as Gert-Jan Koopman, the Commission’s Deputy Director-General for State Aid. During the meeting, Stack conveyed the U.S.’s enumerated concerns that the Commission’s State Aid investigations single out U.S. companies.[27]

Although Commissioner Vestager did not attend the meeting with Stack, she met with Tim Cook, Apple’s Chief Executive Officer, a week prior to discuss the State Aid probe into Apple’s tax arrangements with Ireland.[28]

On February 1, Commissioner Vestager announced that she dismissed the U.S.’s criticism of her crackdown on U.S. companies and asserted that she has been targeting European companies as well. At a conference organized by the Global

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23 “European Commissioner Rejects U.S.’s Criticism.”

24 *Id.*

25 Alex M. Parker, “Hatch, Wyden Seek U.S. Retaliation for EU State Aid Probe,” *BNA Snapshot*, January 15, 2016.

26 *Id.*

27 “European Commissioner Rejects U.S.’s Criticism.”

28 *Id.*

Competition Law Centre, Vestager stated, "Just as it is an obvious right for U.S. tax authorities to tax revenues when they are repatriated, it is also for European tax authorities to tax money that is made in the member states."

On February 11, Secretary Lew took the four senators' suggestion and wrote a letter to the President of the European Commission, Jean-Claude Junker, urging him to reconsider the Commission's approach to State Aid investigations of U.S. companies.

Secretary Lew expressed the U.S.'s apprehensions that the Commission's "sweeping interpretation of the EU legal doctrine of 'state aid' threatens to undermine [the progress of state governments working together]…to curtail the erosion of our respective corporate tax bases."[29] Secretary Lew further conveyed the U.S.'s disappointment that the Commission "appears to be pursuing enforcement actions that are inconsistent with, and likely contrary to, the BEPS project."

The letter also reiterates the concerns recently enumerated by Deputy Secretary Stack about the Commission's disproportionate targeting of U.S. companies, retroactive imposition of penalties on income that rightfully belongs to the U.S., and extent of other states' right to tax under international standards, as well as concern that the Commission's approach could undermine U.S. tax treaties with E.U. Member States. Lastly, Secretary Lew cautions President Juncker that the "Treasury department is not alone in this view. Many Members of our Congress have strongly echoed these concerns, and have urged Treasury to take strong action."[30]

Secretary Lew also met with the House Ways and Means Committee on February 11 to discuss President Obama's Fiscal Year 2017 Budget, where he "expressed support for immediate U.S. business tax reform and stopping corporate inversions."[31]

The latest move toward finding a solution to this controversy came on February 18, 2016, in the form of a recommendation from former French Finance Minister Alain Lamassoure, now the chairman of the European Parliament's Special Committee on Tax Rulings ("T.A.X.E.").[32] Mr. Lamassoure suggested a joint session of the U.S. Congress and E.U. Parliament, in which multinationals would testify about their tax arrangements in order to determine whether European nations have targeted U.S. companies more than other multinationals.[33]

The panel, headed by Lamassoure, is expected to travel to the U.S. in May for this joint session. This would follow hearings by the T.A.X.E. scheduled for March 14 and 15. Apple Inc.'s Chief Executive Officer ("C.E.O."), Tim Cook,[34] has been asked to testify before the committee on March 15, along with Google Inc.'s C.E.O. And

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29 Treasury Secretary Jacob Lew's Letter to European Commission President Jean-Claude Junker, February 11, 2016, p. 1.

30 *Id.*, p. 2.

31 "U.S. Treasury Secretary Addresses EU State Aid, Inversions, & Obama's FY 2017 Budget," *Checkpoint International Taxes Weekly*, February 16, 2016.

32 The T.A.X.E. is the special committee formed by the E.U. Parliament to investigate tax rulings. See Erwin, "Tax Rulings in the European Union."

33 *Bloomberg BNA International Tax Monitor*, February 18, 2016.

34 In January, 2016 Apple C.E.O. Tim Cook met privately with Margrethe Vestager. Neither Apple nor the commission disclosed the substance of their discussion (*The Irish Business Times*, February 12, 2016).

as if to prove that not only U.S. companies are being targeted, T.A.X.E. has also asked for testimony from officials of the Italian-U.S. company Fiat Chrysler Automobiles NV and the Swedish company Inter-Ikea Group. In what will be the second request for testimony, McDonald's Corp. and Starbucks Corp.[35] were invited to answer questions about their respective corporate tax policies – as were officials from independent tax haven territories, including the Cayman Islands, Jersey, Guernsey, and Liechtenstein.[36] At this time it is unknown whether officials from Apple, Google, Fiat Chrysler, and McDonald's will attend the March 15 hearing.

Meanwhile, the Commission's position remains determined: "We will make it very clear to Secretary Lew that the investigations are not discriminating against U.S. companies but are designed to make sure that companies do not receive favorable tax treatment," E.U. Tax Commissioner Moscovici recently said. "That is the sole purpose of these investigations. We also will reject the claim that the investigations undermine the O.E.C.D. B.E.P.S. reforms."[37]

"As if to prove that not only U.S. companies are being targeted, T.A.X.E. has also asked for testimony from officials of the Italian-U.S. company Fiat Chrysler Automobiles NV and the Swedish company Inter-Ikea Group."

CONCLUSION

The number of Commission investigations into tax agreements bewteen Member States' and multinational companies is steadily increasing. These are high-profile cases, not only because they target some of the biggest companies in the world but also because of the way the Commission's exercise of its investigatory powers affects autonomous Member States and the U.S.

U.S. officials are obviously frustrated by the Commission's investigations, which disproportionately target U.S. companies, and fear that the Commission is taking away income that rightfully belongs to the U.S. As the global crackdown on corporate tax avoidance intensifies, it will continue to impact the policies of the U.S., the Commission, and other states; and it will significantly impact the environment for multinationals structuring their enterprises.

E.U. Member States are also expressing increased concerns that the Commission is overreaching in its capacity in these cases. Does this mean the U.S. will have allies in its efforts to push back against the Commission's State Aid investigations? Whether common ground can be found, remains to be seen. However, the Commission's determination of whether Ireland's agreements with Apple constitute unlawful State Aid will be the next cornerstone in this regard, and U.S. companies with European operations would be wise to monitor the developments closely.

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35 According to European Parliament officials, Starbucks declined the invitation because it plans to appeal the Commission's October 15 decision that it received illegal State Aid.

36 So far only the latter three were reported to have accepted the invitation (see *Bloomberg BNA, International Tax Monitor*, February 23, 2016).

37 *Bloomberg BNA International Tax Monitor*, February 17, 2016.

PARTNERSHIP TAX TRAPS AND RECENT GUIDANCE

Author
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Tags
Partnerships
Property Transfers
Withholding Tax

TRANSFERS OF PROPERTY TO FOREIGN PARTNERSHIPS – GUIDANCE EXPECTED SOON

The I.R.S. has come under pressure from practitioners demanding it relax proposed guidance regarding a contribution of property to a partnership that has foreign partners related to the contributing partner. In Notice 2015-54, issued last year, the I.R.S. stated a contribution of property with built-in gain to a partnership with related foreign partners may be taxable *unless* the partnership uses the remedial method of allocating depreciation deductions to the noncontributing partners.[1] The I.R.S. has indicated that guidance will presumably come in the form of temporary and proposed regulations that could be released in the first half of 2016.

Background

Property can generally be contributed by a partner to a partnership without recognition of gain or loss.[2] In that case, the partnership gets a carryover tax basis for the property equal to the tax basis the contributing partner had for the property.[3] As compared to the partnership getting a tax basis in the property equal to its fair market value or book value on the date of contribution, that carryover basis means that the unrealized gain is, in effect, deferred and may be recognized when the partnership later sells the property.

In the case of the contribution of property to a partnership where the partnership gets a carryover tax basis in the property, Code §704(c) and the regulations issued thereunder require the partnership to make certain special allocations of taxable income and loss at the partnership level to account for the tax differences that result from the partnership receiving a contribution of property with built-in gain. Under Code §704(c), if non-depreciable property (such as land) is contributed to a partnership with a built in gain (*i.e.*, the fair market value is greater than its tax basis), then when the property is later sold by the partnership, the built-in gain in the property is specially allocated to the contributing partner.

If depreciable property is contributed to the partnership with a built-in gain, then the §704(c) regulations require the partnership to choose one of three methods, whose goal is to specially allocate depreciation deductions each year to the non-contributing partners so as to put them in the same position they would be in if the contribution was a taxable event and the partnership would have had a stepped up tax basis in the contributed property equal to its fair market value or book value. The three

1 See Beate Erwin and Nina Krauthamer, "Notice 2015-54 On Reallocation To Foreign Partners – The Beginning Of The End?," *Insights* 8 (2015).

2 Code §721(a).

3 Code §723.

methods are (i) the traditional method, which is generally most favorable to the contributing partner; (ii) the traditional method with curative allocations; and (iii) the remedial method, which is generally most favorable to the non-contributing partners.[4]

The traditional method specially allocates the actual depreciation deductions claimed by the partnership for the contributed property to all the non-contributing partners so as to give them the same depreciation deductions they would have obtained if the tax basis of the contributed property was equal to its fair market value.[5] However, this rule is limited by the actual depreciation available for the contributed property. As a result, there may be a shortfall in depreciation deductions that can be allocated to the non-contributing partners to make them whole.

The remedial allocation method starts with the traditional method. If that method does not make the non-contributing partners whole since there are not enough actual depreciation deductions to specially allocate to the non-contributing partners, the remedial method creates (i) "notional" depreciation deductions to allocate to the non-contributing partners to make up the shortfall and (ii) a matching amount of "notional" income to allocate to the contributing partner.[6] These two notional amounts offset one another so that the aggregate income or loss of the partnership is not actually changed. However, under the remedial method, the non-contributing partners are made whole while the contributing partner bears the burden of recognizing added taxable income.

"The Notice indicated that the rules, when adopted, would have a retroactive effective date so as to be applicable to transfers made on or after August 6, 2015."

Special Rule for Contributions to Foreign Partnerships

In 1997, Congress enacted Code §721(c), which gives the Treasury Department the power to write regulations providing that when a U.S. person transfers certain property to a partnership that has related foreign partners, income or gain attributable to the property will be taken into account by the transferor either immediately or periodically. The purpose behind Code §721(c) is to make sure that income that may be taxed in the hands of a U.S. person is not shifted to a non-U.S. related person through the use of a foreign partnership so that U.S. tax may be eliminated.

Last year, the I.R.S. issued Notice 2015-54 (the "Notice"), which stated that the I.R.S. will issue regulations requiring gain to be recognized when appreciated property is contributed to a foreign partnership with related foreign partners unless the partnership elects to use the Gain Deferral Method, which requires (i) the use of the remedial allocation method under Code §704(c); (ii) compliance with the proportionate allocation rule, which makes sure that any other items of income, gain, loss, or deduction with respect to the contributed property are allocated in the same manner; and (iii) compliance with certain reporting requirements.[7] The Notice indicated that the rules, when adopted, would have a retroactive effective date so as to be applicable to transfers made on or after August 6, 2015.[8]

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4 Treas. Reg. §§1.704-3(b), (c), & (d).

5 *Id.*, 3(b).

6 *Id.*, 3(d).

7 Notice 2015-64, §4.03.

8 *Id.*, §6.

TRANSFERS OF PROPERTY TO FOREIGN PARTNERSHIPS – A.B.A. COMMENTS RELATING TO §482

Code §482 provides that the Secretary may make allocations between or among two or more organizations, trades, or businesses that are owned or controlled by the same interests in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses. Treasury Regulation §1.482-7 provides methods to be used to evaluate whether a cost sharing arrangement produces results consistent with an arm's length result.

The Notice discussed above indicates that the I.R.S. will also issue guidance under Code §482 to deal with contributions of property to a partnership that has foreign partners who are related to the contributing partner.[9] The Notice indicated that regulations will be issued regarding the application to controlled transactions involving partnerships under the rules set forth in Treasury Regulation §1.482-7, which are currently applicable to cost sharing arrangements.

In comments submitted to the I.R.S., practitioners have urged the I.R.S. to clearly state whether the I.R.S. position primarily addresses (i) traditional transfer pricing issues, including valuation and allocations of partnership income or (ii) application of Code §482 to override non-recognition provisions of the Code. Concern has been expressed that it is unclear whether the cost sharing regulations would be particularly useful in the partnership area without substantial modifications.

U.S. PARTNERSHIP FOREIGN TAX ALLOCATION REGULATIONS UPDATED

A partnership's allocation of taxable income, gain, loss, and deductions among its partners must have substantial economic effect under Code §704(b). Extensive regulations have been written to implement the substantial economic effect requirements.[10] If substantial economic effect is lacking, then the I.R.S. has the power under Code §704(b) to reallocate the item among the partners based on the partners interest in the partnership.[11]

In 2006, the I.R.S. issued regulations under Code §704(b) addressing the allocation by partnerships of "creditable foreign tax expenditures,"[12] which are are foreign taxes paid or accrued by a partnership under Code §901(a).[13] The regulations provide that allocations of creditable foreign tax expenditures do not have substantial economic effect, and accordingly, a creditable foreign tax expenditure must be allocated in accordance with the partner's interest in the partnership.[14] The regulations provide a safe harbor under which creditable foreign tax expenditure allocations are

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[9] *Id.*, §5.

[10] Treas. Reg. §1.704-1.

[11] *Id.*, 1(b)(3).

[12] *Id.*, 1(b)(4)(viii).

[13] *Id.*, 1(b)(4)(viii)(b).

[14] *Id.*, 1(b)(4)(viii)(a).

deemed to be in accordance with a partner's interest in the partnership. This safe harbor requires the partnership to first determine the different categories of creditable foreign tax expenditures that a partnership has; second, it must determine the partnership's net income to which each creditable foreign tax expenditure category applies; and third, it must allocate the partnership's creditable foreign tax expenditures for each category in the same way as the related net income is allocated.[15]

"The revisions add further guidance and will improve the operation of the existing safe harbor that is used to determine if allocations of creditable foreign tax expenditures are in accordance with a partner's interest in the partnership."

In February, the I.R.S. updated parts of the creditable foreign tax expenditure regulations when it issued new Temporary Regulations.[16] The revisions add further guidance and will improve the operation of the existing safe harbor that is used to determine if allocations of creditable foreign tax expenditures are in accordance with a partner's interest in the partnership.[17] These new rules are generally effective for taxable years that begin on or after January 1, 2016.[18]

One clarification was made to address what happens if a partner ("Selling Partner") sells its interest in the partnership to another person ("Buying Partner") and the partnership has, in effect, an election under Code §754. If such election is made and the partnership holds appreciated property, then such election will serve to increase the "inside basis" of partnership assets allocable to the Buying Partner to match the purchase price for the partnership interest paid to the Selling Partner.[19] This election only affects the Buying Partner and serves to generate (i) added depreciation deductions from the partnership or (ii) decreased gain (or a loss) on the sale of partnership assets.[20] The I.R.S. clarified that this election should not be considered in allocating creditable foreign tax expenditures since it is unique to the Buying Partner.[21]

Another set of changes tries to stop taxpayers from attempting to use payments to disregarded entities that are subject to foreign withholding taxes in order to circumvent the rules. In these cases, taxpayers have taken the position that withholding taxes assessed on the first payment in a series of back-to-back payments to disregarded entities are not apportioned among the creditable foreign tax expenditure categories that include the income out of which the payments are made.[22] The revised rules include examples that clarify that the withholding taxes must be apportioned among the creditable foreign tax expenditure categories that include the related income.[23]

WITHHOLDING BY PARTNERSHIPS WITH FOREIGN PARTNERS

On January 19, 2016, the I.R.S. updated its online guidance "Helpful Hints for

15 *Id.*, 1(b)(4)(viii)(d).

16 *E.g.*, Treas. Reg. §§1.704-1T(b)(4)(viii)(c), (d).

17 T.D. 9748 (February 4, 2016).

18 *Id.*, §V.

19 Code §743 provides for these adjustments.

20 T.D. 9748, §I.

21 Treas. Reg. §1.704-1T(b)(4)(viii)(c)(3)(i).

22 T.D. 9748, §III.

23 Treas. Reg. §1.704-1T(b)(5), Exs. 36 & 37.

Partnerships with Foreign Partners." The update noted how a partnership with foreign partners that sells U.S. real estate may appear to be caught by two separate withholding regimes: Code §1445 requires a partnership to withhold U.S. tax on a foreign partner's allocable share of gain from the sale of real estate under the Foreign Investment in Real Property Tax Act ("F.I.R.P.T.A") and Code §1446 requires a partnership to withhold U.S. tax on a foreign partner's allocable share of income that is effectively connected with a U.S. trade or business. In this case, the I.R.S. said the partnership should comply only with Code §1446.

CONCLUSION: USE WITH CAUTION

Partnerships (including limited liability companies) offer great flexibility in reducing or eliminating tax both domestically and in the international context. Partnerships can eliminate concerns about controlled foreign corporation or passive foreign investment company status as well as allow for the creditability of foreign taxes. However, as the discussion above shows, partnerships are also very complicated to use, and that complexity is increasing as the I.R.S. tries to clamp down on uses that it sees as inappropriate. As a result, while beneficial use of partnerships still continues, greater care is needed so as to not succumb to any tax traps.

A CONCISE GUIDE TO ACQUISITION VEHICLES FOR THE PURCHASE OF U.S. REAL ESTATE BY FOREIGN INDIVIDUALS[1]

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Tags
Estate and Gift Tax
Foreign Corporation
Foreign Investment
Foreign Trusts
Real Estate
Partnership

Purchases by foreign individuals of U.S. real estate for personal use, investment, or development continue to boom. Those individuals will face particular U.S. income, estate, and gift tax issues. Choice of a proper investment vehicle is critical.

Direct ownership by the foreign individual is generally discouraged, as it may create the need for an ancillary probate proceeding in the state where the property is located as a condition of a transfer in the event of the death of the individual. Ownership of the real estate at death or ownership through a disregarded entity, such as a single-member L.L.C., could result in onerous U.S. estate taxes of roughly 40%, plus possible state estate taxes, as well. In this regard, it is imperative to analyze (i) the income, estate, and gift taxes of the individual's country of residency (with the help of local counsel) and (ii) the possible application of an estate tax treaty between the U.S. and the individual's country of residence. U.S. estate tax treaties may change the situs rules for the imposition of the estate tax (althought not ordinarily in the case of real property), may offer an enhanced exemption from tax or a marital deduction, and, of equal importance, may require that the home country permit a credit against the estate tax imposed by the other taxing jurisdiction. Extensive U.S. tax planning may not prove to be necessary if the home country's estate tax is comparable to the U.S. estate tax and a credit for U.S. tax is available in the home country.

It is important to consider whether the individual will be using his or her own funds to make the acquisition, or whether the acquisition will be financed by borrowing. If the individual can procure nonrecourse financing to purchase the property (ordinarily difficult in a personal context), the amount subject to U.S. estate taxes would be limited to the fair market value of the property net of the amount of the nonrecourse financing.

Several structures are potentially available to hold a U.S. real estate investment. They include the following.

TWO-TIER STRUCTURE

In the case of development property, where it is likely that the income to be realized is ordinary income, a two-tier corporate structure is quite popular. Typically, the foreign individual (or a foreign trust) owns a foreign holding corporation (sometimes referred to as a "foreign blocker"), which in turn owns a U.S. real estate corporation. (Use of a U.S. L.L.C. is not desirable, as a single-member L.L.C. would be disregarded, and therefore, the foreign corporation would be treated as owning the property for U.S. tax purposes.) Stock of a foreign corporation is treated as a

[1] This article was originally published in the November 2015 edition of the ABA Section of Real Property, Trust and Estate Law's *RPTE eReport* and has been altered for this publication.

non-U.S. situs asset and therefore not subject to U.S. estate tax. The corporate formalities imposed under the laws of the jurisdiction of the foreign corporation (and consistent with U.S. tax principles) associated with ownership by a corporation must be carefully observed.

This two-tier corporate structure may be used for other types of acquisitions if estate tax certainty is an important goal. If the U.S. real estate is personal use property, some practitioners recommend that the property be rented for fair market value, supported by a broker's market analysis, and that the rent be used to pay all operating costs and carrying charges. Other practitioners believe that for personal use property, rent could be limited to the operating costs and carrying charges; some practitioners believe that rent need not be charged at all.

"Foreign trusts are often desirable in the case of personal use property or long-term passive real estate investments where it is desirable to capture the lower capital gains rates applicable to individuals (and trusts)."

Gain on the sale of the property would be subject to tax at the corporate rates of tax (35% Federal and, *e.g.*, approximately 12% N.Y.S. and N.Y.C. after consideration of the Federal deduction), which are higher than the rates applicable to sales of U.S. property by nonresident, non-citizen individuals, and foreign trusts (20%, or 25% on depreciation recapture, Federal and, *e.g.*, approximately 9% N.Y.S.). After a sale, cash can be distributed without further tax if the U.S. real estate corporation is liquidated; cash distributions in a non-liquidation context could be taxed as dividends, subject to U.S. withholding tax. This structure provides for a high level of U.S. estate tax certainty but at a cost of higher income tax rates in certain circumstances.

ONE-TIER STRUCTURE: FOREIGN CORPORATION

For personal use property, some practitioners recommend a one-tier foreign corporate structure whereby a foreign corporation purchases personal use property directly (or through a single-member L.L.C.) for use by shareholders of the corporation, with rental at less than full fair market rent. Those practitioners believe that, at worst, the foregone rent would be treated as a disguised dividend to the shareholder – generally with no adverse U.S. tax consequences, as a dividend by a foreign corporation is not subject to U.S. withholding tax. Other practitioners believe that there could be a risk that under these circumstances the I.R.S. may impose both a corporate tax and an additional branch profits tax on imputed rental income. A sale of the property would give rise to tax on gain at the corporate rates above, although the additional branch profits would not apply if the corporation terminates its U.S. business (and certain other conditions are met).

FOREIGN IRREVOCABLE DISCRETIONARY TRUST

Foreign trusts are often desirable in the case of personal use property or long-term passive real estate investments where it is desirable to capture the lower capital gains rates applicable to individuals (and trusts). Generally, a purchase of U.S. real property by a trust with cash contributed to the foreign trust by a foreign individual would not trigger adverse U.S. estate or gift tax consequences where the individual retains no rights to the income or assets of the trust. A foreign trust is defined by the U.S. tax laws to mean any trust that is not a "domestic" trust. A trust will be considered domestic if (i) a U.S. court can exercise primary supervision over trust administration (the "Court Test") and (ii) U.S. persons control all substantial trust decisions (the "Control Test").

It is ordinarily not necessary to rent personal use property at full fair market rental, unless the intended user is a U.S. person. In that case, a failure to charge rent would be treated as a distribution to the U.S. person in the amount of the fair market value of the use of such property.

It is possible for the settlor (grantor) of the trust to be a potential beneficiary of the trust without causing a U.S. estate tax inclusion upon the death of the settlor (grantor). This generally requires an institutional trustee and no "understanding" as to the settlor's entitlement to discretionary distributions of income or capital. The settlor cannot be a trustee or trust protector. Essentially, the grantor loses control over the property and proceeds from its sale. Any use of the property by the settlor would require the payment of rent at full fair market value.

Tax on the sale of the property is calculated using the rates applicable to individuals (the 3.8% "net investment income tax" does not apply to foreign individuals and foreign trusts). Withholding under the Foreign Investment in Real Property Tax Act of 1980, or "F.I.R.P.T.A.," (generally under recent law changes a 15% withholding tax upon the sale of U.S. real estate by a foreign person) would be applicable in the event of a sale or distribution of the U.S. property. Generally, the cost of establishing and maintaining a foreign trust may prove to be higher than the cost of establishing and maintaining a foreign corporation.

A U.S. trust may also be a suitable vehicle, although in that case, capital gain income would attract the additional "net investment income tax" unless distributed to a foreign individual. F.I.R.P.T.A. withholding would not apply.

FOREIGN GRANTOR TRUST

A foreign individual will be treated as the owner of U.S. real property, subject to the favorable income tax rates applicable to individuals, if the property is owned by a grantor trust. In the case of a foreign individual grantor, a trust will be so treated if either the grantor reserves the right to revoke the trust solely or with the consent of a related or subordinate party (and revest title to the assets to himself), or the amounts distributable during the life of the grantor are distributable only to the grantor and/or the spouse of the grantor. The individual is treated as the owner of the property for U.S. income tax purposes and there is no need to rent the property.

This structure does not afford protection against U.S. estate tax. It is recommended for those individuals who can procure life insurance (generally term insurance) at a reasonable cost to provide for estate taxes upon the death of the individual. While the U.S. real estate is subject to U.S. estate tax, life insurance proceeds with respect to nonresident, non-citizen individuals are not subject to U.S. estate tax.

If a residuary beneficiary of the trust is a U.S. person, it is important that the grantor retain the right to direct the income of the trust to achieve a step-up in basis upon the death of the grantor, reducing the tax on a future actual sale of the property.

PARTNERSHIPS AND MULTI-MEMBER L.L.C.'S

A partnership, or a multi-member L.L.C. taxed as a partnership, is a flow-through entity for U.S. tax purposes. Investment in U.S. real estate through such a vehicle would afford the individual member or partner the lower capital gains rates applicable to individuals if the real estate is a capital asset. However, ownership of U.S. real property through a U.S. or foreign partnership is generally discouraged because of the uncertainties concerning the situs of a partnership interest for U.S. estate tax purposes, as well as a potential withholding tax applicable to foreign partners. Some practitioners believe that a case can be made for the non-U.S. situs of an interest in a foreign partnership. If the underlying assets of the partnership are situated in the U.S., while there is no specific statutory authority, an interest in a foreign partnership may be subject to U.S. estate tax if the death of a partner causes dissolution of the partnership under local law, or even if it does not, if the partnership carries out business in the U.S. Certain estate tax treaties with the U.S. may offer relief from taxation.

Investment in U.S. real property by a foreign individual requires a careful examination of an appropriate acquisition vehicle. It is often challenging to structure an acquisition that can minimize exposure to both income and estate taxes. However, a failure to consider U.S. taxes could result in an onerous tax burden for the foreign investor.

"Ownership of U.S. real property through a U.S. or foreign partnership is generally discouraged because of the uncertainties concerning the situs of a partnership interest for U.S. estate tax purposes."

3M CASE TO TEST "FOREIGN LEGAL RESTRICTIONS" REGULATIONS UNDER CODE §482

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Tags
3M
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Procter & Gamble
Transfer Pricing

INTRODUCTION

It is anticipated that by May of this year, the United States Tax Court (the "Tax Court") will begin considering the case of *3M Co. v. Commissioner* ("*3M*"), which will be decided on written record.[1] This decision could be an important challenge to the §482 regulation that addresses the issue of when the I.R.S. can make transfer pricing allocations without regard to foreign legal restrictions.[2] The *3M* case involves the petition of 3M Company ("3M" or the "Company") for redetermination of deficiencies for income tax in the amount of $4.8 million for the 2006 tax year issued by the I.R.S. According to 3M, the I.R.S. erroneously allocated $23.7 million of royalty income to 3M from its wholly-owned subsidiary, 3M do Brasil LTDA ("3M Brazil") under Code §482 even though Brazilian law prohibits payment of these royalties to 3M.

The §482 regulation at issue was adopted in 1994, shortly after the I.R.S. lost the *Procter & Gamble*[3] case, where the Tax Court, as well as the Court of Appeals for the Sixth Circuit, held that because foreign law, and not control over an affiliate, was the reason for the distortion of income, the I.R.S. could not reallocate income between the parties. The court relied on the Supreme Court decision in the case of *First Security Bank*,[4] where it held that when Federal law prevents a payment, the I.R.S. cannot use Code §482 to reallocate income between related parties.

THE FACTS OF THE *3M* CASE

3M Brazil has been doing business in Brazil since 1946. In 2006, it had approximately $563 million in sales and employed approximately 3,120 employees in its corporate headquarters and at four manufacturing sites.

In 1997, 3M and 3M Brazil entered into a license agreement (the "1997 License Agreement"), effective as of January 1, 1997, which permitted 3M Brazil (i) license to produce: an exclusive and non-assignable license to make, convert, process, and/or use certain licensed products of 3M in Brazil; (ii) license to market: a non-exclusive and non-assignable license to market, lease, distribute, and/or offer for sale the licensed products falling within the scope of 3M's licensed patents; (iii) non-patented technology: the availability of certain 3M data and know-how; and (iv) trademarks and copyrights: a non-exclusive and non-assignable license to use 3M trademarks and copyrights in Brazil. Under the 1997 License Agreement, 3M Brazil

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1. *3M Co. v. Commr.*, T.C., No. 5816-13, order, 1/7/16.
2. Treas. Reg. 1.482-1(h)(2)(i) and (ii).
3. *Procter & Gamble Co. v. Commr.*, 95 TC 323, Aff'd 961 F.2d 1255 (6th Cir. 1992).
4. *Commr. v. First Security Bank*, 405 U.S. 394 (1972).

was to compensate 3M with a royalty payment equal to 4% of the net selling price of products manufactured in Brazil by or for 3M Brazil.

Under Brazilian law, such agreements must be recorded with the Brazilian Patent and Trademark Office (the "B.P.T.O.") to facilitate the payment of royalties to non-Brazilian licensors. The parties attempt to record the 1997 License Agreement with the B.P.T.O. was rejected. To facilitate the recordation and the payment of royalties thereunder, 3M entered into three new agreements with 3M Brazil that granted 3M Brazil the right for an exclusive and non-assignable license to use, within Brazil, 3M's trademarks. Under these new agreements, royalties were set at 1% of the price invoiced by 3M Brazil for products that use 3M trademark and are sold in Brazil. These agreements were approved by the B.P.T.O. and were recorded.

3M decided that it was not able to amend or replace the 1997 License Agreement with respect to the intellectual property ("I.P.") other than trademarks due to objectionable B.P.T.O. rules, *e.g.*, those requiring that all improvements to technology belong to the improving party and requiring that licenses of certain older technology be royalty-free. As a result, 3M was not able to record the 1997 License Agreement. Since agreements must be recorded in order for the payment of royalties to be permitted under Brazilian law, only the 1% royalties on the trademarks could be remitted outside Brazil, and royalties for other items included in the 1997 License Agreement were not permitted.

In 1999, 3M formed 3M IPC, a Delaware corporation, for the purpose of holding certain I.P. Under the standard agreement for licensing the I.P. to many of 3M's domestic and international affiliates, the affiliates pay a marketing royalty of 1% of net sales and a manufacturing royalty of 6% of net sales. Both royalties are paid regardless of whether the customer is a related or unrelated person. 3M Brazil and 3M IPC did not enter into the standard agreement because 3M was advised by Brazilian counsel that the standard agreement would not satisfy the requirements of the B.P.T.O. and could not be recorded.

In 2006, 3M received trademark license fees from 3M Brazil in the amount of $5.1 million. But, since the payment of royalties other than trademark royalties was unlawful under Brazilian law, 3M did not receive any other royalties.

In the notice of deficiency issued to 3M, the I.R.S. stated that the restrictions on the payment of royalties under Brazilian law would not be taken into account for purposes of computing the arm's length amount of royalty income because the conditions of Treasury Regulations §§1.482-1(h)(2)(i) and (ii) had not been met. As discussed in detail below, those regulations state that the I.R.S. will take into account the effect of a "foreign legal restrictions" (also described below) to the extent that such restriction affects the results of transactions at arm's length. That is, it must be shown that the restriction affected an uncontrolled taxpayer under comparable circumstances for a comparable period of time. The foreign legal restrictions may be temporary or permanent, and the following conditions must be met:

- The restrictions are publicly promulgated, generally applicable to all similarly situated persons (both controlled and uncontrolled), and not imposed as part of a commercial transaction between the taxpayer and the foreign sovereign.
- The taxpayer (or other member of the controlled group with respect to which the restrictions apply) has exhausted all remedies proscribed by foreign law

or practice for obtaining a waiver of such restrictions (other than remedies that would have a negligible prospect of success if pursued).

- The restrictions expressly prevented the payment or receipt, in any form, of part or all of the arm's length amount that would otherwise be required under Code §482 (*e.g.*, a restriction that applies only to the deductibility of an expense for tax purposes is not a restriction on payment or receipt for this purpose).
- The related parties subject to the restrictions did not engage in any arrangement with controlled or uncontrolled parties that had the effect of circumventing the restrictions, and have not otherwise violated the restrictions in any material respect.

"In 1992, Proctor and Gamble ('P&G') won a case on blocked income with a similar fact pattern.…

The Tax Court held that the I.R.S.'s allocation of income was unwarranted and that there was no deficiency."

3M contends that the I.R.S. has no authority under Code §482 to allocate income to a taxpayer from a related party where the related party is legally prohibited from paying income to the taxpayer, and where the taxpayer did not in fact receive the income from the related party.

THE *PROCTER & GAMBLE* CASE

In 1992, Proctor and Gamble ("P&G") won a case on blocked income with a similar fact pattern.

P&G owned all of the stock of Procter & Gamble A.G. ("A.G."), a Swiss corporation. A.G. was engaged in marketing P&G's products, generally in countries in which P&G did not have a marketing subsidiary or affiliate.

P&G and A.G. were parties to a "License and Service Agreement," known as a package fee agreement, under which A.G. paid royalties to P&G for the nonexclusive use by A.G. and its subsidiaries of P&G's patents, trademarks, tradenames, knowledge, research and assistance in manufacturing, general administration, finance, buying, marketing and distribution. The royalties were based primarily on the net sales of P&G's products by A.G. and its subsidiaries. A.G. entered into agreements similar to package fee agreements with its subsidiaries.

In the late 1960's, P&G made plans to organize a wholly-owned subsidiary in Spain, called P&G España S.A. ("España"), to manufacture and sell its products in Spain. It was determined that A.G., rather than P&G, would hold a 100% interest in España.

Spanish laws in effect at that time closely regulated foreign investment in Spanish companies, including the amount of capital that could be contributed to a Spanish company by a foreign investor, and restricting payments to foreign investors for the transfer of technology. Accordingly, España was restricted from paying a package fee for royalties or technology to A.G. during the years at issue in the lawsuit.

In 1985, consistent with its membership in the European Economic Community, Spain liberalized its system of authorization of foreign investment. In light of these changes, España filed an application for removal of the prohibition against royalty payments. This application was approved, as was España's application to pay package fees retroactive to July 1, 1987.

The I.R.S. determined that a royalty of 2% of España's net sales should be allocated to A.G. as royalty payments under Code §482 for 1978 and 1979 in order to reflect A.G.'s income. The I.R.S. also argued that España should have paid a dividend to A.G. in the amount of the arm's length royalty payments that were not allowed.

The Tax Court held that the I.R.S.'s allocation of income was unwarranted and that there was no deficiency. It concluded that allocation of income under §482 was not proper in this case because Spanish law, and not any control exercised by P&G, prohibited España from making royalty payments. The Court of Appeals for the Sixth Circuit affirmed the Tax Court's decision, for the following reasons:

- The regulations under Code §482 recognize that in order for the I.R.S. to have authority to make a §482 allocation, a distortion in the taxpayer's income must be caused by the exercise of the control between two parties. But, in the *Procter & Gamble* case, there was no evidence that P&G or A.G. used its control over España to manipulate or shift income. Rather, the failure of España to make royalty payments was a result of the prohibition against royalty payments under Spanish law.
- The Supreme Court held in *First Security Bank* that the I.R.S. is authorized to allocate income under Code §482 only where a controlling interest has complete power to shift income among its subsidiaries and has exercised that power. That was not the case of P&G with respect to España.
- *First Security Bank* is a controlling case even though the Supreme Court's analysis was limited to instances in which allocation under Code §482 was contrary to Federal law, and not foreign law. The court stated that the Supreme Court focused on whether the controlling interests utilized their control to distort income. The court stated that the fact that foreign law is involved may require a heightened scrutiny to be sure the taxpayer is not responsible for the restriction on payment, but that otherwise, the analysis should not be altered when foreign law, as opposed to Federal law, causes the distortion.
- In response to the I.R.S.'s argument that P&G could have legally received, under Spanish law, an annual "dividend" to compensate it for the I.P. used by España the court held that even if España had the profits to pay dividends (there was evidence that it did not), it had no such obligation – a taxpayer has no obligation to arrange its affairs so as to maximize taxes, as long as a transaction has a legitimate business purpose. Further the court firmly disagreed with the I.R.S.'s suggestion that P&G should purposely evade Spanish law by making royalty payments under the guise of calling the payments something else.
- Treas. Reg. §1.482-1(b)(6), the so-called "blocked income" regulation, did not apply to the case. That regulation contemplates the situation where a temporary restriction under foreign law prevents payments, and defers the allocation of income until such time as the payments are no longer restricted. In the *Procter & Gamble* case, the payments to P&G were not temporarily restricted. Rather, Spanish law *prohibited* payment of royalties altogether. This prohibition cannot be viewed as temporary because it was ultimately repealed in 1987. At the time in question, there was no reason for P&G to believe that the Spanish government would lift this ban. Thus, the payments that España was prohibited from making under Spanish law cannot be viewed as temporarily blocked payments.

- The prohibition on royalty payments cannot be viewed as temporary because, as the I.R.S. argued, at some future time P&G could have liquidated España and taken its capital out of Spain. The court stated that this argument was meritless because P&G was not obligated to organize its subsidiaries in such a way as to maximize its tax liabilities.

THE 3M CHALLENGE

While the facts in the *3M* case are generally similar on their face to the facts in the *Procter & Gamble* case, the I.R.S. proposed income allocation based on a regulation promulgated after the *Procter & Gamble* decision. This regulation permits the allocation of income made by the I.R.S. in this case. However, 3M is claiming this regulation is invalid. More specifically, it is claiming that the I.R.S. exceeded its legal authority when it adopted this regulation and that the addition of prerequisites that the foreign legal restriction be applied similarly to controlled and uncontrolled parties is invalid. This poses the question of whether this regulation and the imposition of those conditions is consistent with the holding of the Supreme Court as to how Code §482 is to be interpreted in relation to the question of legal restrictions, and whether this is enough to invalidate a regulation. Note that the language of Code §482 – on that respect – was the same when the I.R.S. issued the notice to 3M as it was when the *First Security Bank* and the *Procter & Gamble* cases were decided (and is the same today).

"3M is claiming this regulation is invalid. More specifically, it is claiming that the I.R.S. exceeded its legal authority when it adopted this regulation."

Additionally, while the *3M* petition provides that the recordation of agreements is required prior to remittance of royalty payments abroad to a related or unrelated party, the petition does not discuss whether the rules governing the recording of an agreement by the B.P.T.O. are applicable in the same manner to related and unrelated persons, and this fact can influence the controlling element of the parties, required under Code §482. Further, 3M Brazil made a dividend payment to 3M in 2006, and the I.R.S. may attempt to use this fact to distinguish the *3M* case from the Procter & Gamble case, potentially claiming that this shows 3M could have exercised the control needed for Code §482 to be applied regardless of this regulation.

CONCLUSION

This case is the first challenge of the Code §482 regulations on legally restricted payments, and it may have ramifications beyond the treatment of taxpayers having business operations in jurisdictions such as Brazil. The decision in this case may affect how regulations that conflict with judicial interpretations of a statute are addressed.

TAX 101:

CORPORATE REORGANIZATIONS PART I – TYPES A & B

Authors
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Tags
Corporate Reorganizations
A-reorganization
B-reorganization
Continuity of Interest

CORPORATE TAXATION IN GENERAL

The income of a C-corporation is taxed at both the corporate and shareholder levels. First, the income is taxed directly to the corporation.[1] Second, when corporate earnings are distributed to shareholders as dividends, the shareholders are subject to tax.[2] Appreciated corporate assets are generally subject to corporate-level tax if they are distributed to the shareholders, yielding the same corporate tax result as if the assets had been sold by the corporation and the proceeds distributed to the shareholders.[3]

If the stock of a corporation is sold, the selling shareholders pay tax on any gain from their sale of stock.[4] The acquiring shareholder holds the acquired stock at its purchase price basis,[5] but the basis of assets inside the acquired corporation does not change to reflect the stock purchase price unless an election is made to pay "inside" corporate-level tax on any gain associated with this "inside" asset basis change. Such an election may generally be made only if 80% of the stock was acquired by a purchasing corporation, within any 12-month period, in a taxable purchase.[6]

If the assets of a corporation are sold, the selling corporation pays corporate-level tax, and the buyer obtains a purchase price basis for the assets. If the proceeds of the sale are then distributed to the shareholders of the selling corporation, the shareholders are generally subject to shareholder-level tax on such distribution.

TAX-FREE CORPORATE TRANSACTIONS

A number of special provisions enable corporations to combine or separate businesses, and permit corporate shareholders to shift investment interests to the combined or separated enterprises, without the tax impact that would otherwise generally occur on an exchange of appreciated corporate assets for other assets, or of shareholder investment interests for other interests.

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1 Code §11.

2 Code §§1 or 11, depending on whether the shareholder is an individual or a corporation.

3 Code §311(b).

4 Code §1001.

5 Code §1012.

6 Code §338.

"In addition to the statutory requirements, most reorganizations are subject to certain judicially developed requirements."

There are three broad categories of reorganizations:

- *Acquisitive transactions*, in which one corporation acquires the stock or assets of another
- *Divisive transactions*, in which one corporation divides its business or subsidiaries into entities separately owned by the corporate shareholders
- *Nonacquisitive, nondivisive reorganizations*, in which there is an adjustment to the corporate structure of a single, continuing corporate enterprise

The types of reorganizations are often referred to by reference to the particular subparagraph of Code §368(a)(1) (defining such transactions) in which they are described. Acquisitive reorganizations generally include statutory mergers ("A-reorganizations"), stock for stock acquisitions with 80% control ("B-reorganizations"), and stock for asset acquisitions ("C-reorganizations" and "D-reorganizations"). In Part I of this article, we discuss A- and B-reorganizations. In Part II, we will discuss C-reorganizations and acquisitive D-reorganizations.[7]

If a transaction qualifies as a "reorganization," it is generally tax free both to the shareholders and to the corporation. However, to the extent non-stock consideration (such as cash or other property, often referred to as "boot") is received, gain is generally recognized. The shareholders generally take a substituted basis for the stock or securities they receive. Similarly, the corporation generally takes a substituted basis for the assets it receives. However, basis adjustments are made for both the shareholders and the corporation for the receipt of nonqualified consideration (*i.e.*, to the extent gain or loss was recognized).

In addition to the statutory requirements, most reorganizations are subject to certain judicially developed requirements. These judicial requirements have been adopted by the Internal Revenue Service ("I.R.S.") in its regulations and administrative guidance. These requirements include "continuity of business enterprise,"[8] "continuity of interest,"[9] and "business purpose."

STATUTORY MERGER OR CONSOLIDATION (TYPE "A" REORGANIZATION)

One type of acquisitive reorganization is a statutory merger or consolidation, or an A-reorganization.[10] This type of reorganization offers relatively flexible rules for structuring a transaction and is subject to fewer pitfalls than any other acquisitive reorganization. The A-reorganization does not statutorily require that a particular percentage or type of stock consideration be given to old "target" company shareholders, or that a particular percentage of the target corporation's historic business assets be transferred in the reorganization. The statute only requires that there be "a statutory merger or consolidation." However, an important limitation on A-reorganizations is the judicially developed "continuity of interest" doctrine (discussed below).

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7 D-reorganizations can qualify as both "acquisitive" and "divisive." Part II will be limited to acquisitive D-reorganizations.

8 Treas. Reg. §1.368-1(d).

9 Treas. Reg. §1.368-1(e).

10 Code §368(a)(1)(A)).

In a “merger,” two corporations are combined with only one of the corporations “surviving.” The acquiring corporation is the surviving corporation. The target corporation is sometimes referred to as the “disappearing” corporation. The target corporation is “merged into” the acquiring corporation.

In a “consolidation” (sometimes referred to as an amalgamation), two or more corporations are combined with the creation of a new entity. None of the pre-existing combining entities survive after the consolidation.

Under an A-reorganization, the acquiring corporation (“Acquiror”) absorbs the corporate enterprise of the target corporation (“Target”). The assets and liabilities of the Target transfer to the Acquiror by operation of law.

“If a reorganization fails to qualify as an A-reorganization, and if it cannot be characterized as any other type of tax-free reorganization, it will be treated as a taxable sale of assets between Target and Acquiror, followed by a taxable liquidation of Target.”

Prior to 2006, a merger involving one or more foreign corporations could not qualify as an A-reorganization. The previous regulations provided that to qualify as an A-reorganization, the merger or consolidation had to be pursuant to state or Federal merger or consolidation laws. In 2006, final regulations were issued that expanded the term “merger or consolidation” to include mergers or consolidations pursuant to foreign law.[11]

If a reorganization fails to qualify as an A-reorganization, and if it cannot be characterized as any other type of tax-free reorganization, it will be treated as a taxable sale of assets between Target and Acquiror, followed by a taxable liquidation of Target.[12]

Continuity of Interest

If the continuity of interest requirement is not met, the transaction cannot qualify as an A-reorganization. The purpose of the continuity of interest requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations. Continuity of interest requires that in substance, a substantial part of the value of the proprietary interests in Target be preserved in the reorganization.[13]

Continuity of interest is generally satisfied if at least 40% of the consideration received by Target’s shareholders is in the form of Acquiror’s stock.[14] There is no requirement that Target’s shareholders receive Acquiror’s voting stock, or even that they receive Acquiror’s common stock.

Deemed Steps

It has been said that “[t]he simplicity of modern mergers obscures the steps that are

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11 Treas. Reg. §1.368-2(b)(1).

12 Rev. Rul. 69-6, 1969-1 C.B. 104.

13 Treas. Reg. §1.368-1(e)(1)(i).

14 Treas. Reg. §1.368-1(e)(2)(v), Ex 1. The 40% threshold is the amount that the I.R.S. has deemed to be sufficient to meet the continuity of interest requirement. However, case law suggests that a lower percentage may still qualify as an A-reorganization. See, *e.g.*, *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935), where 38% of preferred stock was sufficient to meet the continuity of interest requirement.

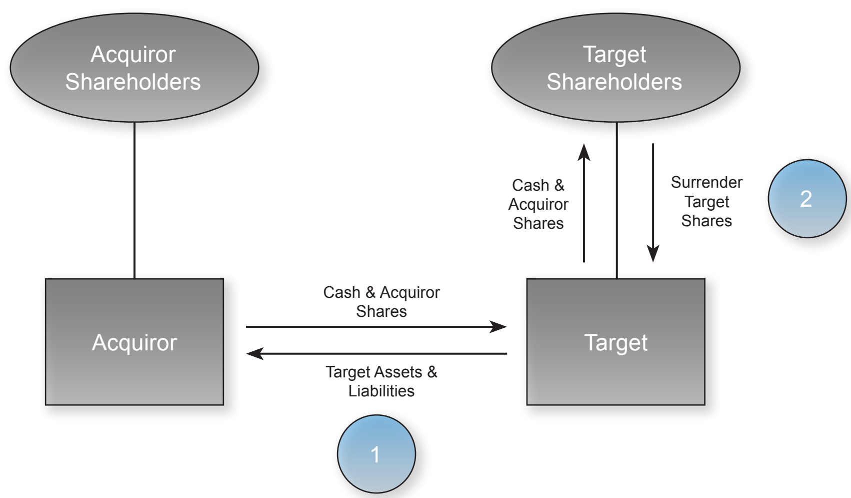
deemed to occur [in a merger] for tax purposes."[15] Thus, although the assets and liabilities of Target transfer to Acquiror by operation of law, the two steps below are deemed to take place for tax purposes.

In the example, it is assumed that, pursuant to the terms of a merger, Target's shareholders receive both cash and common shares of stock of Acquiror, with cash representing less than 60% of the total consideration received and the shares of Acquiror representing at least 40% of the total consideration received.

In the first step, Acquiror is deemed to transfer cash and its stock to Target in exchange for Target's assets and liabilities. Acquiror recognizes no gain or loss on the deemed receipt of the property in exchange for its stock.[16] Target recognizes no gain or loss on the deemed receipt of the cash and Acquiror's stock in exchange for its assets.[17] Acquiror takes the same bases in Target's assets as in Target's hands.[18]

In the second step, Target is deemed to distribute the cash and Acquiror's shares (which Target was deemed to have just received) in a complete liquidation. Target's shareholders receive the cash and Acquiror's stock and surrender their shares in Target. Target recognizes no gain or loss on the deemed distribution.[19] Target's shareholders recognize gain equal to the lesser of gain realized or cash received (*i.e.*, "boot" received).[20] For Target's shareholders, the bases in Acquiror stock received are generally the same as the bases in Target stock exchanged.[21]

Diagram of Deemed Transfers



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[15] B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 12.22[1], pp. 12-49 (6th ed. 1999).

[16] Code §1032.

[17] Code §361(a) and (b).

[18] Code §362(b).

[19] Code §361(c).

[20] Code §356(a). Note that all or a portion of the gain recognized may be recharacterized as a dividend. Code §356(a)(2).

[21] Code §358.

STOCK FOR STOCK ACQUISITION (TYPE "B" REORGANIZATION)

Another type of acquisitive reorganization is a stock for stock acquisition, or a B-reorganization. In a B-reorganization, one corporation ("Acquiror") acquires all or part of the stock of another corporation ("Target") solely in exchange for "voting stock" of Acquiror (or of Acquiror's direct parent corporation, but not both). Immediately after the acquisition, Acquiror must have "control" of Target.

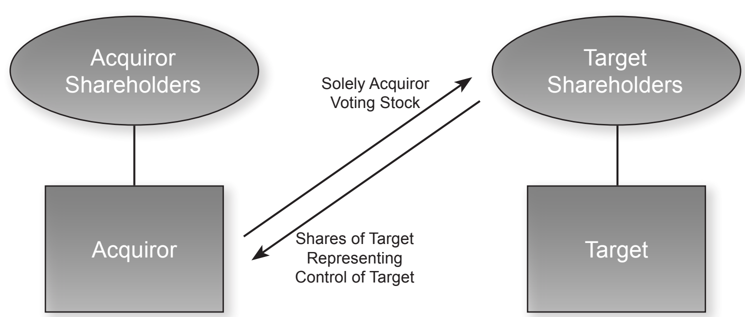
Control

"Control" for this purpose is defined as the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock.[22] As for the statutory phrase "solely for voting stock," the Supreme Court has stated that "'[s]olely' leaves no leeway. Voting stock plus some other consideration does not meet the statutory requirement."[23] However, the I.R.S. and lower courts have allowed some flexibility, ruling that the "solely" for voting stock requirement was not violated when Acquiror issued cash in lieu of fractional shares.[24]

"Creeping" Acquisitions

At times, Acquiror may purchase shares of Target on a stock exchange for cash (the "First Acquisition"), without anticipating that in the future Acquiror may want to acquire control of Target in a B-reorganization. If Acquiror later exchanges its own voting stock for control of Target (the "Second Acquisition"), the question arises as to whether the "acquisition" includes both the First Acquisition and the Second Acquisition, or whether the "acquisition" only includes the Second Acquisition. If both exchanges are part of the same acquisition, it will not qualify as a B-reorganization because Acquiror did not exchange "solely" its voting stock for shares of Target. On the other hand, if only the Second Acquisition is considered, the exchange can qualify as a B-reorganization. It is a facts and circumstances test to determine whether both transactions should be considered part of the "acquisition."

Diagram of a B-Reorganization



In this article we have discussed A- and B-reorganizations under Code §368(a)(1). In Part II, we will discuss C- and D-reorganizations.

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22 Code §368(c).

23 *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942).

24 *Mills v. Commr.*, 39 T.C. 393 (1962), Rev. Rul. 66-365. 1966-2 C.B. 116.

FIELD PROCEDURES FOR HANDLING FOREIGN-INITIATED "SPECIFIC" REQUESTS UNDER E.O.I. AGREEMENTS

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Tags
Automatic Exchange of Information
Compulsory Spontaneous Exchange of Information
Industry-Wide Exchanges
Joint Audits
Mutual Legal Assistance Treaty
Simultaneous Criminal Investigation Program
Specific Requests

INTRODUCTION

For some clients, questions regarding exchanges of information between the I.R.S. and the tax authorities of another country are a matter of concern. For a business, the worry may not be directed to automatic exchanges of information, because those exchanges are part of a global attack on noncompliance. Rather, the concern involves ordinary business operations. Can the I.R.S. obtain information regarding the U.S. business transactions of a foreign corporation, and if it can, will the information be turned over to a foreign tax authority?

In December 2015, the I.R.S. issued three International Practice Units describing how the I.R.S. treats requests for exchanges of information ("E.O.I.'s") from foreign tax authorities. These International Practice Units are listed below:

- Document E.O.I./P.U.O./P_20.2_04(2015) – Field Procedures for Handling Foreign Initiated "Specific" Requests under E.O.I. Agreements
- Document E.O.I./C.U./P_20.1_01(2015) – Overview of Exchange of Information Programs
- Document E.O.I./C.U./P_20.1_02(2015) – Types of E.O.I. Exchanges

An E.O.I. involves the coordination of taxpayer information related to examinations, inquiries, or investigations generally resulting from an on-going examination of a particular tax return, collection matter, criminal investigation, or other tax administrative procedure. A foreign-initiated specific E.O.I. request involves a foreign country that is a party to a tax information sharing agreement (*i.e.*, a foreign partner). The foreign partner initiates a specific request for tax-related information that is sent to the the U.S. Competent Authority. The information request is disseminated to various operating divisions within the the I.R.S. in order to obtain the requested information.

These International Practice Units describe the processes and procedures for I.R.S. field personnel to follow when complying with a foreign-initiated E.O.I., the different types of exchanges, and the variety of information that can be requested.

E.O.I. AGREEMENTS[1]

The international tax sharing agreements that may lead to an exchange of tax-related information include the following:

- Tax treaties, which are primarily intended to prevent double taxation

1 Document E.O.I./C.U./P_20.1_01(2015).

- Tax information exchange agreements ("T.I.E.A.'s"), which are designed to facilitate the exchange of tax-related information between foreign partner countries

- Mutual legal assistance treaties, which authorize the E.O.I. for the purpose of enforcing criminal laws, including criminal tax laws

- Multilateral agreements to which the U.S. is a party and which authorize E.O.I. for tax purposes

- Tax implementation or coordination agreements, which are bilateral agreements that allow for exchanges of tax-related information between the United States and its five territories (American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands)

- Intergovernmental agreements, which are bilateral agreements involving mutual promises by the contracting states intending to prevent double taxation or perhaps double non-taxation

Many of the E.O.I. articles in such treaties are based on Article 26 of the U.S. Model Income Tax Convention (the "Convention"). The Convention permits the Competent Authorities to exchange information that may be relevant to the assessment, collection, enforcement, or prosecution of the taxes covered by the treaty. Information received under Article 26 is expressly required to be confidential and to be used only for tax purposes.

Competent Authorities are responsible for international tax information sharing exchanges and agreements. The U.S. Competent Authority is the Secretary of the Treasury, and the functions have been delegated to the Deputy Commissioner (International) of the Large Business & International ("LB&I") Division. That authority has been delegated to certain officers within the Office of the Deputy Commissioner, LB&I.

All E.O.I.'s under tax treaties and T.I.E.A.'s are administered by (i) the Program Manager, Exchange of Information in Washington, D.C.; (ii) the Revenue Service Representative ("R.S.R.") in Plantation, F.L.; (iii) the Tax Attachés stationed at the various overseas I.R.S. posts; and (iv) the Program Manager, Joint International Tax Shelter Information and Collaboration ("J.I.T.S.I.C.") in Washington, D.C. J.I.T.S.I.C. was originally established in 2004 as the Joint International Tax Shelter Information Centre to combat cross-border tax avoidance. Building on its initial achievements, the J.I.T.S.I.C. network was re-established in 2014 as part of the Forum for Tax Administration ("F.T.A."), and all members of the F.T.A. may participate.

Improper disclosure of returns and return information, as defined under Code §6103(b), may result in civil or criminal penalties under Code §§7431 and 7213. To avoid such complications, and to ensure compliance with applicable disclosure and confidentiality rules, only I.R.S. employees assigned to the E.O.I. headquarters, the R.S.R. office, the attaché offices, and J.I.T.S.I.C. may contact, provide any information to, request any information from, or exchange any information with a foreign tax official.[2]

[2] For transfer pricing and mutual agreement proceedings, employees assigned to the Advance Pricing and Mutual Agreement Program and the Treaty Assistance and Interpretation Team may contact foreign tax officials with taxpayer information.

THE PROCESS[3]

Process Steps

When a specific E.O.I. request is received from a foreign partner country, the request is assigned to a particular I.R.S. employee who determines whether the request falls within the scope of the applicable tax sharing agreement. Once the request is determined to be appropriate, the analyst reaches out to the pertinent field office to fulfill the request, as some documents may already be part of ongoing investigations. Taxpayer-specific information may only be provided to a foreign authority through the U.S. Competent Authority under a tax information sharing agreement. This means that, as previously stated, I.R.S. field personnel cannot contact a foreign government office directly in connection with an examination.

Step 1: E.O.I. Request to Field

Once the E.O.I. analyst determines that the assistance of I.R.S. civil examiners or criminal agents is required, the analyst forwards the following to the appropriate civil group manager or executive director:

- A cover memorandum and attached guidance[4]
- An Information Document Request ("I.D.R."), which is the way the I.R.S. requests information from a person
- An administrative summons,[5] which must be issued and served, if necessary, when the I.D.R. has been unproductive
- Any other additional documentation or instructions pertinent to the request

I.R.S. personnel generally have 60 days from the date of the E.O.I. memorandum to fulfill the request. In the event the deadline cannot be met, I.R.S. field personnel must notify the E.O.I. analyst and provide a status report. Once the requested information is secured by field personnel, it is sent to the E.O.I. analyst. If the field personnel believe any of the information should not be disclosed to the foreign tax authority, the specific rationale must be provided.

"A foreign-initiated request for information does not require the existence or initiation of an I.R.S. examination and does not constitute an I.R.S. examination."

A foreign-initiated request for information does not require the existence or initiation of an I.R.S. examination and does not constitute an I.R.S. examination. If an I.R.S. examination is contemplated as a result of the request, the I.R.S. field personnel must advise the E.O.I. manager.

Step 2: Field Response to E.O.I. Request

All information obtained by I.R.S. field personnel is sent to the E.O.I. analyst at the address provided via secure email or regular mail in a traceable manner. The I.R.S. personnel may not directly provide any information to the foreign authorities.[6] Any such contact constitutes improper disclosure.

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3 Document E.O.I./P.U.O./P_20.2_04(2015).

4 I.R.M. 4.60.1.2.2.3.

5 *Id.*

6 Code §6103.

Step 3: Use of Summons to Fulfill an E.O.I. Request

A summons may be issued by I.R.S. personnel pursuant to an E.O.I. request even if the U.S. has no tax interest in the matter. These summonses may be prepared only by E.O.I. program personnel. Administrative summonses are prepared to request information from banks or other financial institutions.

EXCEPTIONS

Tax sharing agreements limit the information that can be requested by the use of language such as "are not obligated to be exchanged" or "will not be exchanged," usually referring to any trade, business, industrial, commercial, or professional secret or process that would harm a taxpayer's competitive position. Consequently, all exchanges of information pursuant to tax information sharing agreements are subject to strict considerations of disclosure and confidentiality, including confidentiality attached to trade and other business secrets.[7]

TYPES OF EXCHANGES[8]

Specific Requests

These requests involve both inbound and outbound requests for information pertaining to a specific taxpayer, entity, or group under examination or investigation for a specific tax period, and may arise from collection, criminal, or other administrative matters. All domestic means of obtaining the requested information should be exhausted unless it would give rise to disproportionate difficulties.

Spontaneous Exchanges

These exchanges involve the exchange of information that may not have been specifically requested but which the providing authority deems may be of interest to a foreign partner for tax purposes. The information may pertain to nonresident aliens, United States citizens, domestic or foreign corporations, or other taxpayers.

Automatic Exchanges

These exchanges are coordinated through the E.O.I. headquarters, and the information exchanged generally includes "fixed, determinable, annual or periodical" income data routinely reported by payors in one country reporting for payees in the other. This information may be used by countries to verify whether the information is being correctly reported in those countries.

Industry-Wide Exchanges

These exchanges take place in the form of meetings between tax officials of two or more partner countries that do not involve specific taxpayer information and focus on trends, policies, and operating practices of particular industries.

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7 See I.R.M. 4.60.1.1.2.5, Limitations on Exchange of Information – Trade Secrets.

8 Document E.O.I./C.U./P_20.1_02(2015).

Simultaneous Examinations

Under the oversight of an E.O.I. analyst, representatives of the I.R.S. and its foreign partners conduct separate independent examinations of select taxpayers within their respective jurisdictions. The objective of this program is to facilitate E.O.I.'s between the United States and its foreign partners, and to mutually secure other tax compliance efficiencies and benefits. This program is coordinated through E.O.I. headquarters.

"All exchanges of information pursuant to tax information sharing agreements are subject to strict considerations of disclosure and confidentiality, including confidentiality attached to trade and other business secrets."

Joint Audits

During the course of the examination, representatives of the I.R.S. and the foreign partner coordinate strategies to jointly examine issues central to the two tax administrations. Joint audits are not the same as the simultaneous examination program. A joint audit involves two or more countries joining together to form a single audit team to examine transactions of one or more related taxpayers with cross-border business activities, and in which the countries have a common or complementary interest. The taxpayer jointly makes presentations and shares information with the countries. The audit team may include an LB&I Advance Pricing and Mutual Agreement Program representative to address double taxation issues from each country. This program is currently coordinated through J.I.T.S.I.C.

In contrast, a simultaneous examination is an arrangement between two or more tax administrations to examine simultaneously the tax affairs of taxpayers in which they have a common or related interest, with a view to exchanging any relevant information obtained. Each country conducts its audit in its own territory.

Simultaneous Criminal Investigation Program ("S.C.I.P.")

A combination of the previous two examinations, the S.C.I.P. involves the exchange of information and conducting of separate, independent criminal income tax investigations by the countries within their respective jurisdictions. During the course of these investigations, the personnel may meet to coordinate and discuss issues under the oversight of the assigned analyst. This program is coordinated through E.O.I. headquarters.

S.C.I.P.'s may be conducted pursuant to written working arrangements entered into by the U.S. Competent Authority (*i.e.*, the Deputy Commissioner (International), LB&I) and the Competent Authority of a foreign partner. However, the absence of a working arrangement does not preclude the I.R.S. from conducting a simultaneous criminal investigation with another tax administration.

Mutual Legal Assistance Treaty ("M.L.A.T.")

The Department of Justice, Office of International Affairs, Criminal Division is authorized to act as the U.S. Central Authority for M.L.A.T.'s. They receive and execute requests and administer the treaty relationship. Requests received by the United States from foreign treaty partners may require I.R.S. involvement in the form of financial investigative assistance and the production of tax returns and/or tax return information.

The role of E.O.I. headquarters is limited to obtaining tax returns and tax return information, with the assistance of I.R.S. Associate Chief Counsel (International), Branch 7 and the I.R.S. Disclosure Headquarters. I.R.S. Criminal Investigation addresses all other components of the request, including any financial investigative assistance.

Mutual Collection Assistance Request (“M.C.A.R.”)

Certain U.S. tax treaties provide for mutual collection assistance, including income tax treaties with the following countries:

- Canada (Article XXVIA)
- Denmark (Article 27)
- France (Article 28)
- The Netherlands (Article 31)
- Sweden (Article 27)

The Office of the Commissioner, LB&I has a working arrangement with designated Revenue Officers of the Small Business/Self Employed Division (“S.B./S.E. M.C.A.R. Coordinators”) to process M.C.A.R.’s. Analysts at E.O.I. headquarters coordinate with these designated officers to fulfill each M.C.A.R.

Author
Philip R. Hirschfeld

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

UPDATE FROM THE U.S. & MEXICO: I.G.A. IMPLEMENTATION PROCEEDING WELL

On January 29, at the A.B.A. (American Bar Association) Tax Section 2016 Midyear Meeting in Los Angeles, representatives from Mexico and the U.S. discussed implementation of their reciprocal Model 1 I.G.A. (Inter-Governmental Agreement) at a panel on the expanding global reach of F.A.T.C.A. (the Foreign Account Tax Compliance Act), which was chaired by the writer of this "F.A.T.C.A. 24/7."

According to Aida Gabriela Contreras Delgado, the Mexican Tax Administration Service's ("S.A.T.'s") Sub-administrator for International Tax Rulings, despite some initial concerns, the S.A.T. is pleased with the pace of implementation of F.A.T.C.A. and its adoption by Mexican financial institutions ("F.I.'s"). Ms. Delgado reported that 615 Mexican F.I.'s have registered and obtained Global Intermediary Identification Numbers ("G.I.I.N.'s") from the I.R.S. So far, the Mexican government has received 410 certificate requests, which are the first step an F.I. must take to access the Mexican platform that allows for electronic F.A.T.C.A. file transmission. Only 222 Mexican F.I.'s have complied with the obligation to file a report (including nil reports) with the S.A.T., which is the final step in the annual requirements of F.A.T.C.A. compliance. This disparity, Ms. Delgado said, is due to several problems caused by technical issues and a lack of understanding among those completing the necessary forms. However, she sees participation growing as better a understanding of the rules and the process is obtained.

In response to Ms. Delgado's comments, Elena Virgadamo, Attorney-adviser, U.S. Treasury Office of International Tax Counsel, said that the Treasury and the I.R.S. are aware of the complications foreign financial institutions ("F.F.I.'s") and governments are having with the process, and that they are working to resolve the issues as quickly as possible.

Ms. Delgado stated that since the O.E.C.D.'s Common Reporting Standard ("C.R.S.") for exchange of information was modeled after F.A.T.C.A., the Mexican government has looked to the commentary on the C.R.S. to assist in implementation of the I.G.A. Responding to Ms. Delgado's remarks, the writer observed that It would be desirable to fully integrate F.A.T.C.A. and the C.R.S., but that may take a long time to achieve, if it can ever be done.

Erica Gut, a managing director of PricewaterhouseCoopers, said that several of her clients have had difficulty processing the necessary F.A.T.C.A. forms and developing the required X.M.L. submission platform. However, Ms. Gut said that they are having fewer issues as clients become more familiar with the system.

Ms. Gut remarked that many foreign clients are also changing their positions regarding entity classification. “As companies have become more familiar with the reporting and filing requirements of F.A.T.C.A., we are transitioning to an era where companies want to be classified as F.F.I.’s, as opposed to Active or Passive N.F.F.E.’s [Nonfinancial Foreign Entities].” She explained that once the initial filing requirements are satisfied for F.F.I.’s, there is actually less work required than for N.F.F.E.’s.

One concern of a Passive N.F.F.E. is that it has to report the identity of any substantial U.S. owner to every U.S. withholding agent, which can be very burdensome.[1] However, it should be noted that a Passive N.F.F.E. can elect to become a Direct Reporting N.F.F.E., which does not have to report the identity of its substantial U.S. owners to withholding agents. Such information is instead reported directly to the I.R.S. in a similar way as done by Participating F.F.I.’s.

I.R.S. RELEASES DRAFT OF UPDATED FORM W-8BEN-E AND INSTRUCTIONS

On January 15, the I.R.S. released a updated draft of Form W-8BEN-E and its instructions, which make three main changes to the current form. As this draft form has not yet been adopted, it is not currently available on the I.R.S. webpage for tax forms. The three notable changes are the following.

Accounts That Are Not Financial Accounts

Line 5 in Part I requires checking the box for the chapter 4 F.A.T.C.A. status of the person completing the form. (Some of the popular categories include Participating F.F.I., Reporting Model 1 F.F.I., and Reporting Model 2 F.F.I.) A new checkbox has been added to Line 5 for payments made to payees not with respect to financial accounts.[2]

Limitation On Benefits (“L.O.B.”) for Treaty Claims

Part III of Form W-8BEN-E needs to be completed to obtain treaty benefits. In order to claim treaty benefits, an entity must not only be a resident of the treaty country but also (i) derive and beneficially own the item of income and (ii) satisfy the L.O.B. article of the applicable treaty.

New checkboxes have been added to Part III representing each of the main tests that can be met to satisfy an L.O.B. provision. A taxpayer is required (i) to check the box associated with the L.O.B. test it has met in order to claim the treaty benefits associated with this form or (ii) to check a box indicating that it has obtained a favorable discretionary determination from the U.S. Competent Authority stating that it qualifies for the treaty benefits associated with this form.

Nonreporting I.G.A. F.F.I.’s

With respect to the F.A.T.C.A. status of a Nonreporting I.G.A. F.F.I., the updated draft instructions require that the qualifications for such status under the I.G.A. be coordinated with the chapter 4 regulations Deemed-Compliant status. An F.F.I. that

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1 Reporting of substantial U.S owners is made in Part XXVI of Form W-8BEN-E.

2 Treas. Reg. §1.1471-5(b)(2) defines non-financial accounts.

meets the requirements of both a Nonreporting I.G.A. F.F.I. under the I.G.A. and a Deemed-Compliant F.F.I. under the regulations should certify that it is a Nonreporting I.G.A. F.F.I. An F.F.I. that meets the requirements for an Owner-Documented F.F.I. should certify to that status under the regulations, rather than to Nonreporting I.G.A. F.F.I. status.

I.R.S. ANNOUNCES FORTHCOMING REGULATIONS THAT WILL EASE BURDENS ON F.F.I.'S

On January 19, the I.R.S. issued Notice 2016-8. Notice 2016-8 indicates that the I.R.S. intends to amend the regulations under chapters 3 and 4 that will ease the burden of F.A.T.C.A. compliance for F.F.I.'s. In particular, Notice 2016-8 addresses when to submit pre-existing account and periodic certifications, and transitional reporting of accounts of Nonparticipating F.F.I.'s, as well as when a withholding agent may rely on electronically furnished Forms W-8 and W-9.

"Notice 2016-8 indicates that the I.R.S. intends to amend the regulations under chapters 3 and 4 that will ease the burden of F.A.T.C.A. compliance for F.F.I.'s."

Pre-existing Account Certifications by Participating F.F.I.'s and Reporting Model 2 F.F.I.'s

When F.A.T.C.A. first entered into effect on July 1, 2014, F.F.I.'s primarily focused on ensuring that on-boarding procedures complied with F.A.T.C.A. in order to properly account for new investors. F.A.T.C.A. also imposes obligations on F.F.I.'s to review pre-existing accounts and to determine whether they are held by U.S. investors or otherwise U.S.-controlled.

Pre-existing accounts are defined as accounts that were outstanding on the effective date of the F.F.I. Agreement[3] signed by the Participating F.F.I. Generally, this means accounts that were outstanding on June 30, 2014, since F.F.I. Agreements first became effective on July 1, 2014. However, due to the difficulty of acquiring sensitive information from existing customers, F.F.I.'s were given more time to deal with pre-existing accounts, and the deadline for pre-existing account certifications was extended to 60 days following the date that is two years after the effective date of the F.F.I. Agreement.[4] As a result, pre-existing account certifications would generally be due by August 29, 2016.[5]

In response to comments and in an attempt to reduce compliance burdens, the Treasury and I.R.S. have indicated that they will amend the regulations so as to require the pre-existing account certifications at the same time that Participating F.F.I.'s, and Reporting Model 2 F.F.I.'s, must submit their first periodic certifications of compliance with F.A.T.C.A. As a result, the pre-existing account certifications will not be due until July 1, 2018.[6]

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3 Treas. Reg. §1.1471-1T(b)(104).

4 Treas. Reg. §1.1471-5(g)(3)(i)(B). For high value accounts (*i.e.*, accounts of one million dollars or more), the F.F.I. had to act before this date.

5 These same requirements apply to a Reporting Model 2 F.F.I. but not to Reporting Model 1 I.G.A. F.F.I.'s, which are not required to sign an F.F.I. Agreement and comply under the terms of an I.G.A.

6 Section I(B) of Notice 2016-8.

Pre-existing Account Certifications by Local F.F.I.'s and Restricted Funds and Periodic Compliance by Registered Deemed-Compliant Reporting Model 2 F.F.I.'s

A Registered Deemed-Compliant F.F.I. that is a local F.F.I. or restricted fund is required to make a one-time certification regarding its pre-existing accounts, similar to that required of Participating F.F.I.'s.[7] Restricted funds must make this certification within six months after the date the F.F.I. registers as a Registered Deemed-Compliant F.F.I. Also, every three years, a Registered Deemed-Complaint F.F.I. must certify that all of the requirements for such status have been satisfied since the later of (i) June 30, 2014 or (ii) the date the F.F.I. registers as a Registered Deemed-Compliant F.F.I., until the date of such certification.

Notice 2016-8 provides that the regulations will be amended to give more time for these filings. Local F.F.I.'s and restricted funds will be allowed to submit one-time pre-existing account certifications at the same time they submit their first periodic certifications of Registered Deemed-Compliant status. In addition, the first certification of compliance by a Registered Deemed-Compliant F.F.I. will cover a period that will end at the close of the three-year period following the date it first became registered as such. As a result, this change will delay the filing date for pre-existing account certifications and the first required certifications as to overall compliance until July 1, 2018.[8]

Transitional Reporting of Accounts of Nonparticipating F.F.I.'s

A Participating F.F.I. or Registered Deemed-Compliant F.F.I. that maintains an account of a Nonparticipating F.F.I. must provide transitional reporting to the I.R.S. of all foreign reportable amounts paid to such account for calendar years 2015 and 2016.[9] In response to concerns about the burdens placed on F.F.I.'s, reporting will not be required for 2015 payments.[10]

Electronically Furnished Forms W-8 and W-9

A withholding agent may establish a system for a payee to furnish a Form W-8 or W-9 electronically.[11] If the payee is a nonqualified intermediary ("N.Q.I."), nonwithholding foreign partnership ("N.W.P."), or nonwithholding foreign trust ("N.W.T.") then the payee must provide documentation to the U.S. withholding agent to establish the tax status of the beneficial owners of the payment or partners in the partnership. The withholding agent can rely on such documentation unless the withholding agent has "actual knowledge" that the documentation is unreliable or incorrect.[12]

Nevertheless, due to the lack of existing I.R.S. guidance, commentators have indicated that the industry practice has been for withholding agents to reject forms supplied by an N.Q.I., N.W.P., or N.W.T. because they cannot confirm the electronic

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7 Treas. Reg. §§1.1471-5(f)(1)(i)(A)(7), 1.1471-5(f)(1)(i)(D)(6).

8 Section II(B) of Notice 2016-8.

9 Treas. Reg. §1.1471-4(d)(2)(ii)(F).

10 Section III(B) of Notice 2016-8.

11 Treas. Reg. §1.1441-1(e)(4)(iv).

12 Treas. Reg. 1.1441-1(b)(2)(vii), 1.1471-3(e)(4)(vi).

signature of the beneficial owners or partners.[13] Notice 2016-8 responds to this concern by providing that the standards of knowledge in the regulations[14] will be modified to allow for reliance on documentation obtained from an N.Q.I., N.W.P., or N.W.T., provided that (i) the N.Q.I., N.W.P., or N.W.T. is a direct or indirect account holder of the withholding agent, (ii) the agent obtains a written statement from the N.Q.I., N.W.P., or N.W.T. confirming that the electronic documentation was generated from a system that meets the requirements of Treasury Regulation §1.1471-3(c)(6)(iv) or Ann. 98-27, and (iii) the withholding agent does not have actual knowledge that such statement is incorrect.[15]

"The first C.A.A. was signed with the U.K. and Australia last year, and the pace of this process is now accelerating."

I.G.A. COMPETENT AUTHORITY ARRANGEMENTS SIGNED WITH NORWAY, BARBADOS, ROMANIA, SPAIN, ITALY, & COSTA RICA

To facilitate exchanges of information under F.A.T.C.A. and to establish and prescribe rules and procedures necessary for implementation of certain provisions, an I.G.A. will generally provide that the Competent Authorities of the U.S. and the foreign country that is a party to the I.G.A. (*i.e.*, the foreign partner) will sign a Competent Authority Arrangement ("C.A.A.").

All C.A.A.'s will become operative on the later of (i) the date the applicable I.G.A. enters into force or (ii) the date the C.A.A. is signed by the U.S. and the foreign partner. The first C.A.A. was signed with the U.K. and Australia last year, and the pace of this process is now accelerating:

- On April 15, 2013, Norway and the U.S. signed a reciprocal Model 1 I.G.A. Pursuant to Article 3(6) of the I.G.A. On January 21, 2016, the Competent Authorities signed a C.A.A. to implement the information reporting and withholding tax provisions of F.A.T.C.A.
- On November 17, 2014, Barbados and the U.S. signed a reciprocal Model 1 I.G.A. Pursuant to Article 3(6) of the I.G.A. On February 1, 2016, the Competent Authorities signed a C.A.A. to implement the information reporting and withholding tax provisions of F.A.T.C.A.
- On May 28, 2015, Romania and the U.S. signed a reciprocal Model 1 I.G.A. Pursuant to Article 3(6) of the I.G.A. On February 1, 2016, the Competent Authorities signed a C.A.A. to implement the information reporting and withholding tax provisions of F.A.T.C.A.
- On May 14, 2013, Spain and the U.S. signed a reciprocal Model 1 I.G.A. Pursuant to Article 3(6) of the I.G.A. On January 19, 2016, the Competent Authorities signed a C.A.A to implement the information reporting and withholding tax provisions of F.A.T.C.A.
- On January 10, 2014, Italy and the U.S. signed a reciprocal Model 1 I.G.A. Pursuant to Article 3(6) of the I.G.A. On February 18, 2016, the Competent

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13 Section IV(B) of Notice 2016-8.

14 Treas. Reg. §§1.1441-7(b)(10), 1.1471-3(e)(4)(vi)(A)(2).

15 Section IV(B) of Notice 2016-8.

Authorities signed a C.A.A. to implement the information reporting and withholding tax provisions of F.A.T.C.A.

- On November 26, 2013, Costa Rica and the U.S. signed a reciprocal Model 1 I.G.A. Pursuant to Article 3(6) of the I.G.A. On February 8, 2016, the Competent Authorities signed a C.A.A. to implement the information reporting and withholding tax provisions of F.A.T.C.A.

ST. LUCIA I.G.A. SIGNED

On January 19, 2016, St. Lucia and the U.S. signed a reciprocal Model 1 I.G.A. While the I.G.A. was just signed, it is applicable as of June 30, 2014, so as to require reporting of accounts in existence in 2014. However, Article 3(3)(a) limits the information that St. Lucia must provide for the 2014 and 2015 years so that a full exchange of information will only start for the 2016 year.

CURRENT I.G.A. PARTNER COUNTRIES

To date, the U.S. has signed, or reached an agreement to sign, more than 100 Model 1 and Model 2 I.G.A.'s. An I.G.A. has become the global standard in government efforts to curb tax evasion and avoidance on offshore activities and to encourage transparency.

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

Algeria	Gibraltar	Netherlands
Angola	Greece	New Zealand
Anguilla	Greenland	Norway
Antigua & Barbuda	Grenada	Panama
Australia	Guernsey	Peru
Azerbaijan	Guyana	Philippines
Bahamas	Haiti	Poland
Bahrain	Holy See	Portugal
Barbados	Honduras	Qatar
Belarus	Hungary	Romania
Belgium	Iceland	Saudi Arabia
Brazil	India	Serbia
British Virgin Islands	Indonesia	Seychelles
Bulgaria	Ireland	Slovak Republic
Cabo Verde	Isle of Man	Slovenia
Cambodia	Israel	South Africa
Canada	Italy	South Korea
Cayman Islands	Jamaica	Spain
China	Jersey	St. Kitts & Nevis
Colombia	Kazakhstan	St. Lucia
Costa Rica	Kosovo	St. Vincent & the Grenadines
Croatia	Kuwait	Sweden
Curaçao	Latvia	Thailand

Cyprus
Czech Republic
Denmark
Dominica
Dominican Republic
Estonia
Finland
France
Georgia
Germany
Liechtenstein
Lithuania
Luxembourg
Macao
Malaysia
Malta
Mauritius
Mexico
Montenegro
Montserrat
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.

UPDATES & OTHER TIDBITS

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Tags
Canada
CbC Reporting
Ghost Apartments
Israel
Property Tax
O.V.D.P.
Swiss Bank Program

SWISS BANK PAYS SECOND LARGEST PENALTY TO ESCAPE CRIMINAL PROSECUTION

The Department of Justice ("D.O.J.") Swiss Bank Program provides a path for Swiss banks to resolve potential tax-related criminal offenses arising from the maintenance of undeclared accounts of U.S. clients. In combination with the Offshore Voluntary Disclosure Program ("O.V.D.P.") in effect since 2009, it is the principal way by which the U.S. has combated offshore tax evasion by American individuals. In 2015, the D.O.J. concluded 75 non-prosecution agreements with Swiss banks. While criminal prosecutions are avoided, non-prosecution agreements provide for civil penalties that are significant.

Under the Swiss Bank Program, banks are required to

- make a complete disclosure of their cross-border activities,
- provide detailed information on an account-by-account basis for accounts in which U.S. taxpayers have a direct or indirect interest,
- cooperate in treaty requests for account information,
- provide detailed information as to other banks that transferred funds into secret accounts or that accepted funds when secret accounts were closed,
- agree to close accounts of account holders who fail to come into compliance with U.S. reporting obligations, and
- pay appropriate penalties.

Bank Lombard illustrates the lengths to which Swiss banks have gone in order to adopt regulatory-compliant policies without necessarily coming into compliance. In 2008, the bank adopted a policy ostensibly forcing U.S. clients to disclose undeclared assets to the I.R.S. Typically, that entailed the execution of I.R.S. Form W-9, *Request for Taxpayer Identification Number and Certification*. The failure of a U.S. account holder to submit a fully completed form resulted in a threat to freeze all funds in the account. However, a more benign policy existed for favored account holders. They were allowed to make large cash or gold withdrawals and, in some cases, were permitted to make gifts to relatives and charities without the need for submitting a Form W-9.

In 2009 alone, U.S. clients made 14 cash withdrawals that exceeded $1 million. In one instance, more than $3 million in gold was withdrawn. The bank closed at least 12 other accounts held by U.S. persons with gifts to fictitious non-U.S. holders of other accounts. Over $15.7 million was involved.

The D.O.J. concluded a non-prosecution agreement with Lombard Odler & Co. ("Lombard") shortly before the end of 2015. Lombard agreed to pay $99.8 million, which is the second largest amount paid under the Swiss Bank Program. Lombard has set aside funds to cover the settlement amount.

"Bank Lombard illustrates the lengths to which Swiss banks have gone in order to adopt regulatory-compliant policies without necessarily coming into compliance."

JERUSALEM DOUBLES THE PROPERTY TAX ON "GHOST APARTMENTS"

Jerusalem Deputy Mayor Ofer Berkowits is trying to combat the fiscal crisis in the Israeli capital by encouraging young people to live in the city and to revitalize it. However, the housing market has made Jerusalem economically unattractive to young people. The real estate market is notoriously expensive in Jerusalem and the price of housing units continues to rise faster than average income. Mr. Berkowits sees the wealthy overseas homeowners that spend not more than one or two months each year in Jerusalem as a contributing cause of rising prices. These people own existing housing stock in the city and gobble up additional units put up for sale. According to the Jerusalem Development Authority, there are as many as 11,000 so-called ghost apartments in the capital.

Recently, the Jerusalem Municipality announced that effective January 1, 2016, the property tax will increase to 223.56 shekels on absentee owners from the previous rate of 115.50 shekels. The increase in the property tax is part of an initiative to encourage absentee homeowners to rent out property and follows measures recently enacted in the U.K.[1]

The ghost apartments are mostly located in wealthy neighborhoods, and come fully furnished. Most of the absentee owners do not see the need to rent out the apartments and can afford to pay additional property tax. Some of the owners are willing to consider the rental option, but they are looking for very specific tenants and often exclude first-time renters.

Mayor Berkowits seems to understand that doubling the property tax may not discourage wealthy property owners. Many of these wealthy absentee owners do not view themselves as the cause of the problem. These people maintain the view that the market for luxury apartments is completely separate from the normal real estate market. For them, the mayor's action is simply a tax grab directed at persons who may not vote regularly.

CANADA ISSUES FORM TO EXEMPT NONRESIDENT EMPLOYERS FROM WITHHOLDING

Under new guidelines published by the Canada Revenue Agency ("C.R.A."), "qualifying nonresident employers" can use newly released Form RC473 to avoid withholding of income taxes from salary payments made to "qualifying nonresident employees" in Canada.

Qualifying nonresident employers are employers residing in countries with which

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[1] See Naomi Lawton, "The Meanderings of the Taxation of U.K. Real Estate – Where are We Going?" *Insights* 1 (2016), p. 12.

Canada has a tax treaty or partnerships in which at least 90% of the partnership income is allocated to partners that reside in a country having in effect a tax treaty with Canada. Qualifying nonresident employees are individuals who meet the following three tests:

- They are residents in a country that has an income tax treaty in effect with Canada;
- They are not liable to income tax in Canada because of a provision of the relevant income tax treaty; and
- They work in Canada for less than 45 days or are present in Canada for less than 90 days in a 12-month period.

The application must be received by the C.R.A. at least 30 days before a qualifying nonresident employee begins employment in Canada. Certified nonresident employers must maintain their certification by fulfilling several obligations including documenting the employees' pay and physical presence in Canada, filing appropriate returns, and making records available for inspection. Certification will remain valid for up to two years but may be revoked earlier if the employer does not meet its tax obligations.

CBC REPORTING DELAYS

A proposed delay in the timing of U.S. country by country ("CbC") reporting obligations could create a range of logistical, privacy, and pecuniary problems for companies.

The Boustany Bill proposes a one-year delay and seeks protections for affected corporate taxpayers, such as halting the transmission of the master files containing company information in the event of abuse.

There have been concerns that, in light of such delays and restrictions, countries that have already adopted the O.E.C.D. CbC reporting obligations could institute alternative reporting processes that would require more disclosure. For example, in France, a penalty of up to €100,000 could apply to a French subsidiary if the parent company is not required to submit a CbC report to France. France is an early adopter of CbC reporting. French subsidiaries will be required to report if the foreign parent country would be required to report in France and there is no automatic CbC information exchange with France. A subsidiary can avoid the restriction by showing that the report has been filed by another group entity in France or in a country that automatically exchanges information with France.

For sophisticated companies with global revenue in excess of $850 million, the uncertainty surrounding a U.S. delay in mandating CbC reporting for large U.S.-based groups results in unnecessary problems. These companies view themselves as good corporate citizens on a global basis and find themselves adversely affected by U.S. politics.

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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