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INSIGHTS

PRE-IMMIGRATION PLANNING: DROP-OFF TRUSTS + PRIVATE PLACEMENT LIFE INSURANCE – IF THE TOOLS FIT, USE THEM

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EDITORS' NOTE

In this month's edition of *Insights*, the following topics are addressed:

- **Pre-Immigration Planning: Drop-Off Trusts + Private Placement Life Insurance – If the Tools Fit, Use Them.** Wealthy persons moving to the U.S. often engage a tax adviser to craft a pre-immigration plan. Typically, the plans focus on harvesting gains, stepping up the basis in appreciated assets that cannot be sold, and simplifying structures to ensure that future gains will benefit from favorable long-term capital gains rates. However, the truly sophisticated client may wish to take a long-range approach that maximizes the accumulation of wealth during life. John F. McLaughlin and Shelly Meerovitch of Bernstein's Wealth Planning and Analysis Group, New York, explain the benefits of forming a pre-immigration drop-off trust to invest in a private placement life insurance ("P.P.L.I.") policy. In optimal circumstances, the P.P.L.I. investment portfolio can maximize the accumulation of wealth, provided the client obtains timely and competent legal advice in the country of residence and the U.S.

- **A Look at the House G.O.P.'s "Destination-Based Cash Flow with Border Adjustment."** Last June, the House Ways and Means Committee released its tax reform plan, which includes sweeping changes to the U.S. corporate income tax. The plan repeals the current corporate income tax and replaces it with a new regime, commonly referred to as the border adjustment tax. This regime, which taxes imports and exempts exports, is viewed to be the principal funding mechanism for reductions in the corporate and individual tax rates. Elizabeth V. Zanet explains the anticipated workings of the proposal.

- **Implementing the Border Adjustment Tax: Winners & Losers.** The border adjustment tax will harm certain companies and aid others. To be expected, exporters like the proposal and importers hate it. Philip R. Hirschfeld and Kenneth Lobo look at the industries that will be winners and those that will be losers if the border adjustment tax is adopted. Strangely, each side argues that employment will be increased if its position is adopted, an example of how voodoo economics support a politicized tax proposal.

- **New Developments in the World of Reverse Like-Kind Exchanges.** Tax planners to New York City real estate families understand that real estate should never be sold. Rather, it should be exchanged in a tax-free, like-kind exchange. The exchange can be bifurcated into two independent transactions – one a purchase and the other a sale – without affecting tax-free treatment, provided certain well identified rules are followed. Moreover, the replacement can be acquired before the sale of an existing parcel is effected. In a recent advisory opinion affecting property in New York State, the Department of Taxation and Finance issued a taxpayer-friendly advisory opinion involving real estate transfer tax exposure in a reverse like-kind exchange. Rusudan Shervashidze and Nina Krauthamer explain the ruling.

- **I.R.S. LB&I Announces 13 New "Campaigns" for Audit Guidance.** The I.R.S. Large Business and International ("LB&I") Division has announced 13 issue-based campaigns targeting specific "Practice Areas" for audit and other enforcement activity. The campaigns involve a combination of examinations, outreach, guidance, and other approaches. Galia Antebi and Stanley C. Ruchelman look at the new I.R.S. approach to tax examinations in an age of increased complexity and limited budgets for examiners.

- **India Budget 2017-18.** Provisions in Budget 2017-18 announced by the Finance Minister that relate to infrastructure, the financial sector, accountability, prudent fiscal management, and tax administration reflect a view that times are changing in India. The government appears to remain steadfast in its efforts to bring the Indian tax and regulatory environment up to global standards. Jairaj Purandare of JPM Advisors Pvt Ltd, Mumbai, explains the focus of the budget.

- **Basis Planning in the Usufruct and Bare Ownership Context.** Concepts of *usufruct* and bare legal ownership are widely used estate planning tools by parents resident in civil law jurisdictions in Europe. However, when the next generation is resident in a common law jurisdiction such as the U.S., the results are not always pretty. Fanny Karaman and Beate Erwin examine the tax consequences for the U.S. children and the steps available to the European parents that may limit adverse tax consequences in the U.S.

- **E.U. Data Protection and the Fight Against Tax Evasion: A Delicate Balance.** The tax world has seen an important shift in global policies, with an emphasis on tax transparency and exchange of information. The transparency measures are contained in tax-driven and non-tax-driven legislation, and while the goals of the legislation may be lofty, the policies may violate fundamental individual rights, including data protection. Fanny Karaman and Astrid Champion examine the E.U.'s non-fiscally-driven approach to tax transparency and, more precisely, the legal limits of such transparency as evidenced in recent cases.

We hope you enjoy this issue.

- The Editors

PRE-IMMIGRATION PLANNING: DROP-OFF TRUSTS + PRIVATE PLACEMENT LIFE INSURANCE – IF THE TOOLS FIT, USE THEM

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Tags
Drop-Off Trust
Estate Planning
Income Tax
Private Placement Life Insurance
Pre-Immigration Planning
Trusts

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INTRODUCTION

Given the worldwide reach of U.S. taxation, wealthy individuals who are contemplating a move to the U.S. will often seek advice on the construction of a pre-immigration plan that can minimize their tax exposure once in the U.S. Creating such a plan is no simple undertaking. It requires in-depth knowledge of myriad special rules and their exceptions. Care must be taken to ensure that the plan is compliant – not only with U.S. law but also with the laws of the home jurisdiction from which the individuals are planning to emigrate and, sometimes, other jurisdictions where assets are held. And, ultimately, the complexity and costs of pre-immigration planning often prevent individuals from achieving full implementation.

In this article, the use of the "drop-off" trust – a common planning tool that is often used in the pre-immigration planning context to reduce estate tax – is reviewed. When combined with private placement life insurance, the benefits may be substantially augmented. The results can be quite attractive.

PRE-IMMIGRATION PLANNING

Prior to immigrating to the U.S., nonresident aliens ("N.R.A.'s") are subject to U.S. income tax only on income sourced in the U.S. and to U.S. transfer taxes (*e.g.*, taxes on gifts, bequests, and generation-skipping transfers) on transfers of U.S.-situs real property and tangible property. Once an N.R.A. immigrates to the U.S., however, worldwide income is subject to U.S. income tax and worldwide assets are subject to U.S. transfer taxes once domicile in the U.S. is established.

Domicile results from a stronger connection to the U.S. than mere income tax residence. It requires both physical presence in the U.S. and no intent to leave at a later time.

Additionally, once an N.R.A. becomes a U.S. domiciliary, transfers of substantial assets outside the U.S. that could have been accomplished all at once before the establishment of domicile in the U.S. may require years to complete, because of strict limits on annual and lifetime gifts. Hence, it is generally best for wealthy individuals and families who intend to immigrate to the U.S. to implement tax plans *before* they immigrate, when they can still make unlimited transfers of property that does not have its situs within the U.S. without incurring U.S. taxes and without substantial delays.

One primary goal of pre-immigration planning is to minimize post-immigration exposure to U.S. transfer taxes by removing non-U.S.-situs property from the N.R.A.'s taxable estate before the N.R.A. establishes U.S. domicile. This goal is often

[1] Bernstein does not provide tax, legal, or accounting advice. In considering this article, a reader should discuss his or her individual circumstances with tax, legal, or accounting professionals before making decisions.

accomplished by having the N.R.A. create a properly structured irrevocable offshore trust that the N.R.A. funds with foreign property before immigration. This type of trust is sometimes referred to as a drop-off trust.

Drop-off trusts require certain precautions to ensure that they successfully protect the assets from U.S. transfer taxes after the N.R.A. immigrates to the U.S. Appropriate precautions include the following:

- Drop-off trusts should not be funded with all the grantor's assets to avoid an inference that the N.R.A. grantor expected to have access to such funds after moving to the U.S. Doing so could cause the assets to be included in the grantor's U.S. estate.

- No subsequent additions should be made to drop-off trusts to avoid tainting the otherwise exempt trusts.

- Distributions to trust grantors should be kept to a minimum or avoided altogether. If multiple distributions are made to the grantor or if such distributions follow a pattern, the grantor could be considered to retain an interest in the trust. This would cause the entire trust corpus to be included in the grantor's U.S. estate when the grantor dies, if the death occurs while the individual is domiciled in the U.S.

Thus, ascertaining the amount to be transferred to a drop-off trust is an important undertaking. If funded with too little, an opportunity to protect assets from U.S. transfer taxes is wasted. On the other hand, if funded with too much, the grantor may be left with insufficient funds to support an accustomed lifestyle in the absence of trust distributions, which jeopardize the benefits of the structure.

This is further complicated by the fact that, while a properly-structured foreign drop-off trust can be effective in protecting assets from U.S. transfer taxes, most do not shield the asset income from being subject to U.S. income tax once the grantor immigrates to the U.S. This is due to special rules applicable to foreign drop-off trusts that (i) have U.S. beneficiaries and (ii) are established within five years of the N.R.A.'s immigration to the U.S. Such trusts are known as grantor trusts, and all trust income is taxable to the grantor beginning as of the grantor's residency starting date.

Thus, the grantor must have the financial wherewithal to not only irrevocably part with the property in the trust but also to pay income tax on that property on an ongoing basis. Of course, it stands to reason that if a grantor could somehow not be liable for the payment of income taxes (Federal, as well as state and local) on income generated within a foreign drop-off trust, more assets can be transferred to the trust without causing economic discomfort for the grantor. This is where private placement life insurance can come into play.

PRIVATE PLACEMENT LIFE INSURANCE

Private placement life insurance ("P.P.L.I.") can offer a unique pre-immigration planning solution and relieve drop-off trust grantors of the burden of paying trust income tax after the grantors move to the U.S.

From an income tax perspective, the owners of life insurance policies do not realize taxable income from the policy's underlying investment accounts. Thus, investing a drop-off trust's assets in life insurance can reduce some, or all, of the trust's taxable income because income earned inside the policy is not taxed currently to the policy owner. Moreover, death benefits paid out of the policy to the drop-off trust are not subject to U.S. income tax and effectively enjoy a stepped-up basis, despite not being included in the grantor's estate.

However, a traditional life insurance policy ordinarily comes at a relatively high cost, comprised of commissions and fees, and offers somewhat limited investment options. Both factors often outweigh the tax benefits of the policy, and funds locked up in a traditional life insurance policy may not be readily accessible.

P.P.L.I. policies are potentially a better alternative to traditional life insurance policies, for several reasons:

- **P.P.L.I. policies are generally less costly**, primarily due to much lower or entirely nonexistent agent/broker compensation.
- **P.P.L.I. policies typically provide access to more investment options**, which can generate higher income and growth that may justify incurring the cost of a P.P.L.I. policy.
- **The insured can withdraw from the policy funds up to the policy's basis** without incurring tax, if the P.P.L.I. policy is not considered a modified endowment contract ("non-M.E.C.").
- **The insured can borrow funds from the policy in excess of the policy's basis** on favorable terms, if the P.P.L.I. policy is considered a non-M.E.C.
- **P.P.L.I. policies can be custom tailored to a client's needs.**

"A P.P.L.I. policy within a drop-off trust . . . could enable the dropped-off assets to grow income tax free, receive a stepped-up basis upon the death of the insured, and avoid U.S. estate tax."

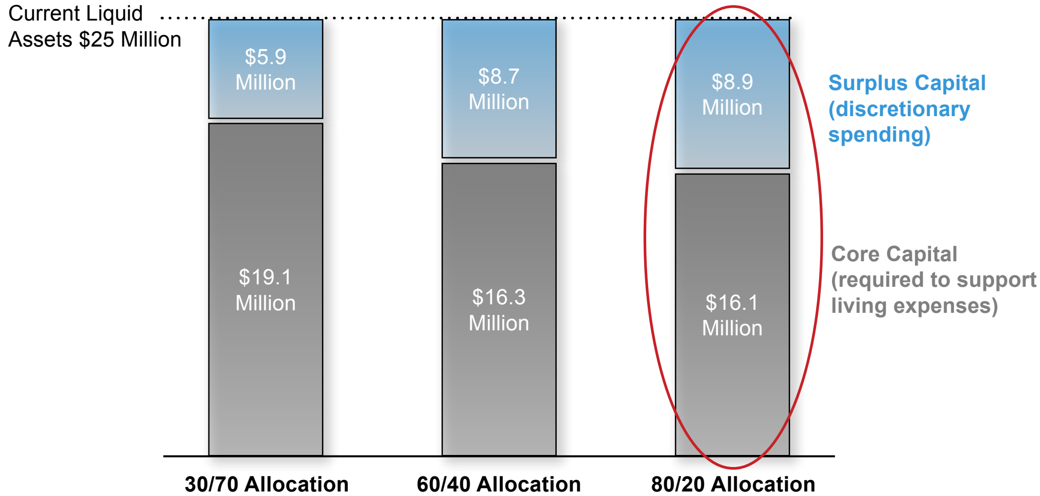
Mr. X, a 50-year-old executive, is preparing to relocate to the U.S. next year, along with his wife, of the same age, and their two teenage daughters. They intend to move to New York City to establish the presence of Mr. X's company there. The family's total liquid net worth is $25 million, held primarily in Mr. X's name. The couple expects to spend approximately $500,000 annually after their move. Mr. X's after-tax compensation should be sufficient to cover these expenses. Assuming that Mr. X will continue to work for 10 years, Mr. & Mrs. X will begin to draw from savings to support their spending needs in 2027.

Mr. & Mrs. X wish to implement a pre-immigration estate plan to reduce their taxable estate. Their attorney advises Mr. X to create and fund a foreign drop-off trust for the benefit of his wife and daughters. Mr. & Mrs. X require assistance in determining how much they can afford to dedicate to funding the drop-off trust.

The analysis begins by quantifying Mr. and Mrs. X's core capital requirement (*i.e.*, the amount of liquid capital they need today to support their lifestyle for the rest of their lives). The calculation takes spending and life expectancies into account, along with projected investment returns and inflation. In order to determine core capital with a high degree of confidence, one should assume poor returns in the capital markets, higher-than-expected inflation, and the possibility that Mr. and Mrs. X could live to be very old.

Using our Wealth Forecasting System,[1] the amount of core capital required to sustain Mr. & Mrs. X's spending for the next 40 years was calculated as follows:

Core Capital Based on Asset Allocation*



* Core capital is calculated at a 90% level of confidence of maintaining spending over 40 years.

The right-hand bar shows that if Mr. & Mrs. X invest for growth, allocating 80% to equities and 20% to bonds, their core capital would be $16.1 million. That would leave nearly $9 million of surplus capital – property that they are unlikely to need to support their lifestyle. In comparison, the other bars indicate that their core capital contribution would be greater, and their surplus capital smaller, if they invested in a less stock-heavy portfolio. In any case, it should be noted that surplus capital not otherwise disposed of will be subject to U.S. estate tax upon their deaths.

One could argue that Mr. X should contribute all his surplus capital to the proposed drop-off trust before moving to the U.S. to shelter it from future U.S. transfer taxes. However, such a plan would be fatally flawed, because it fails to account for Mr. X's ongoing income tax liability with respect to the $9 million of surplus capital contributed to the drop-off trust.

In funding a foreign drop-off trust, the key question should not address simply the computation of the grantors' surplus capital. Rather, it should focus on the amount the grantors can afford to part with if they continue to pay tax on income generated by that capital for the rest of their lives. The correct amount depends on the specifics of each case, including the ages of the N.R.A.'s involved, their tax brackets, their locality, and how the funds are invested. An older N.R.A. who intends to live in Florida will have a different tax burden than a younger N.R.A. who intends to live in a high-tax jurisdiction like New York or Los Angeles. The younger individual will

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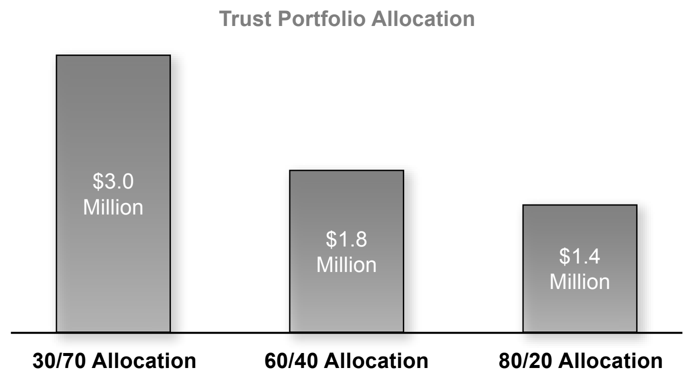
1 The Bernstein Wealth Forecasting SystemSM seeks to help investors make prudent decisions by estimating the long-term results of potential strategies. It uses the Bernstein Capital Markets Engine to simulate 10,000 plausible paths of return for various combinations of portfolios; and for taxable accounts, it takes the investor's tax rate into consideration. Data in this article do not represent past performance and are not a promise of actual results or a range of future results.

need to retain a greater portion of his or her capital to fund a higher tax liability for a longer period of time.

Given Mr. & Mrs. X's ages and their plan to move to New York City, the anticipated income tax liability was calculated on each $1 million of surplus capital invested for growth.

<u>Reserve Required to Pay Tax Liability*</u>



* Capital required to support payment of grantor trust taxes with 90% confidence over 40 years.

The chart shows that over 40 years, every $1 million of capital invested for growth will likely generate an income tax liability that requires a current reserve of $1.4 million to be included in core capital. As a result, Mr. X can afford to fund the drop-off trust with $3.7 million, as it would be necessary to keep $5.2 million of the nearly $9 million surplus capital in reserve to pay the trust's income tax liability.[2]

In practice, core capital (*i.e.*, money the investor will need) is often invested more conservatively than surplus capital (*i.e.*, money the investor doesn't need). If Mr. & Mrs. X invested their core capital more conservatively – with 30% allocated to stocks and 70% to bonds – they would require more than twice as much reserve capital: $3 million for each $1 million they put in the trust. This is because the trust's growth-oriented investments could outperform the core capital portfolio's more conservative investments.

In that case, the trust would generate a greater tax liability, which would be paid from the reserve. Mr. & Mrs. X's core capital requirement would also be higher if they adopted a more conservative allocation, as the previous chart showed, which would leave only $5.9 million in surplus capital. Subtracting the greater reserve from the reduced surplus capital would leave Mr. & Mrs. X with $1.5 million to fund the trust.

However, if Mr. & Mrs. X instead purchased a P.P.L.I. policy with the surplus capital, they wouldn't have to worry about paying income tax on the trust's income, allowing them to dedicate more of their surplus capital to the trust. They should, however, consider the costs incurred in issuing and maintaining the P.P.L.I. policy. Would the tax savings outweigh the costs of the P.P.L.I. policy? The charts below illustrate the answer.

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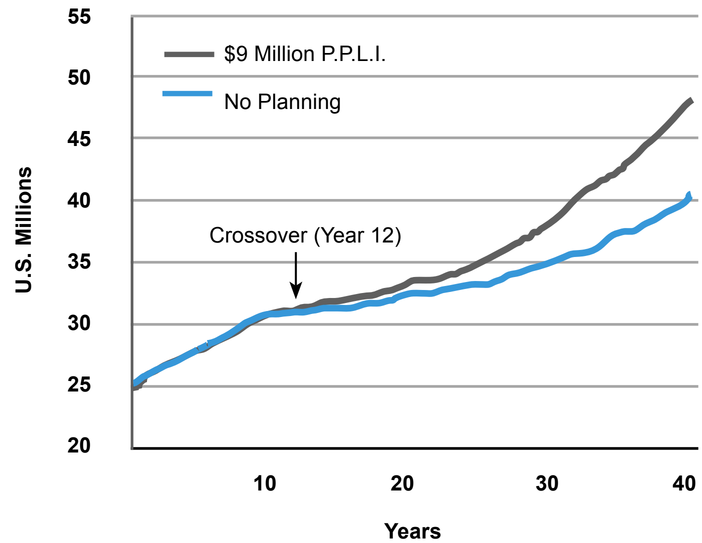
[2] The probability of sustaining spending and taxes for a $9 million grantor trust over 40 years is 41%.

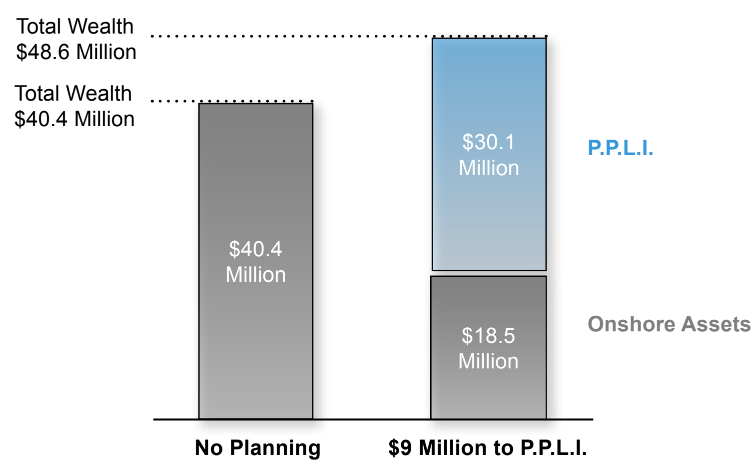
"The cumulative income-tax savings would begin to outweigh the costs of the P.P.L.I. policy after 12 years and, in 40 years, would result in an additional $8 million of wealth for the family."

Potential Income-Tax Benefits of P.P.L.I.*

Lifetime Wealth of Mr. & Mrs. X



Accumulated Wealth of Mr. & Mrs. X After 40 Years



* Charts reflect median outcomes (adjusted for inflation) based on estimates of the range of returns for the applicable capital markets over the periods analyzed. Asset values represent the estimated market value; if the assets were liquidated, additional capital gains or losses would be realized that are not reflected here.

If Mr. X were to fund the drop-off trust with $9 million, and the trust, in turn, were to use that amount to purchase a P.P.L.I. policy,[3] the cumulative income-tax savings would begin to outweigh the costs of the P.P.L.I. policy after 12 years and, in 40 years, would result in an additional $8 million of wealth for the family.

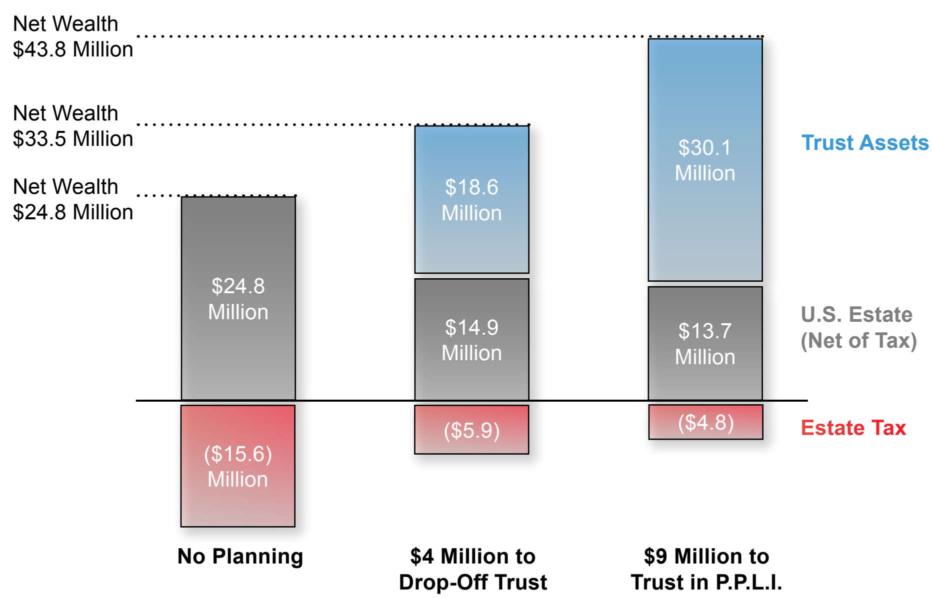
Using the P.P.L.I. policy for the trust investments would also give Mr. & Mrs. X greater flexibility to choose investments based on total-return potential. Their options could include tax-inefficient investments that are typically avoided for grantor trusts

[3] Because it is the desire of Mr. & Mrs. X to maximize flexibility and keep access to the funds, the policy can be structured as a non-M.E.C.

– when the grantor is responsible for paying the tax. It would also significantly reduce the cost of compliance for Mr. & Mrs. X with respect to the drop-off trust.

The final chart highlights the incremental estate- and income-tax savings achieved by combining a drop-off trust with a P.P.L.I. policy.

Potential Tax Savings*



* Chart reflects median outcome of the range of returns for the applicable capital markets for the next 40 years with 80/20 asset allocation. Estate tax calculation assumes combined Federal exclusion of $10.98 million (adjusted for inflation), marginal Federal estate tax rate of 40% on assets in excess of the exclusion amount, and marginal state estate tax of 16% on all assets.

It is estimated that if Mr. & Mrs. X were to pass away in 40 years without immigration planning, their after-tax family legacy would be $24.8 million (adjusted for inflation). Creating a drop-off trust and funding it with $4 million before immigrating to the U.S. would add $8.7 million (also adjusted for inflation) to their after-tax legacy. By adding a P.P.L.I. policy to their plan, Mr. & Mrs. X can pass an additional $10.3 million to their daughters, more than doubling the tax savings benefit of the drop-off trust.

Additionally, since Mr. & Mrs. X's P.P.L.I. policy is structured as a non-M.E.C. policy, in the highly unlikely event that their core capital proves to be insufficient, in 15 years' time they should be able to withdraw the $9 million of premiums and borrow the excess at a very reasonable cost, free of income tax, as long as the loan meets certain requirements.

CAVEATS

Life insurance policies commonly marketed to Europeans may be viewed as investment accounts rather than life insurance under U.S. tax laws. As a result, income accumulating inside such a policy may be recognized currently, rather than deferred, and the death benefit may not be wholly exempt from U.S. income tax.

Advisers planning for impending establishment of U.S. tax residence should coordinate with tax counsel in the N.R.A.'s home country to ensure that establishing a P.P.L.I. policy and/or drop-off trust prior to a move to the U.S. does not give rise to unintended adverse tax and other consequences in the home jurisdiction of the N.R.A. Matters related to information reporting under the Common Reporting Standard must also be taken into account during the pre-immigration period.

"P.P.L.I. is a variable policy supported by segregated accounts and, therefore, must satisfy a diversification test on a quarterly basis."

Compliance requirements in the U.S. are substantial. In order for a P.P.L.I. policy to be considered an insurance policy for U.S. tax purposes, several tests must be met:

- The contract must qualify as a life insurance contract under the law of the state or foreign country where issued.
- The contract must meet either (i) the cash value accumulation test or (ii) the guideline premium/cash value corridor test,[4] as follows:
    - The cash value accumulation test is met if the cash surrender value of the insurance contract may not, at any time during the life of the policy, exceed the net single premium that would have to be paid at that time to fund future benefits under the contract. This test is designed to ensure that the value of the policy does not exceed an amount that is reasonably appropriate for the death benefit to be met, using sound actuarial assumptions.
    - The guideline premium requirement is satisfied if the sum of the premiums paid under the contract does not at any time exceed the guideline premium limitation at that time as provided by U.S. tax law. The cash value corridor is satisfied if the death benefit under the contract at any time is not less than the applicable percentage of the cash surrender value determined under tables provided in the Internal Revenue Code. This test is intended to prevent a buildup of cash value beyond that required to fund the death benefit.
- P.P.L.I. is a variable policy supported by segregated accounts and, therefore, must satisfy a diversification test on a quarterly basis. Under the diversification test, the following requirements must be met each testing date:
    - There must be at least five different investments.
    - Not more than 55% of the value of the total assets of the account can be represented by any one investment.
    - Not more than 70% of the value of the total assets of the account can be represented by any two investments.
    - Not more than 80% of the value of the total assets of the account can be represented by any three investments.
    - Not more than 90% of the value of the total assets of the account can be represented by any four investments.

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[4] "Frozen cash value" policies arguably qualify for favorable U.S. income tax treatment, despite failure to comply with either the cash value accumulation test or guideline premium test. Investment in such a policy requires close consultation with competent tax and insurance advisers.

- Furthermore, the owner of a variable policy is restricted in his or her ability to control the investment choices under the policy.

Three final caveats should be considered in connection with this planning opportunity:

- First, for an individual to have tax-free access to the cash value of the P.P.L.I., it cannot be categorized for U.S. income tax purposes as a modified endowment contract, or M.E.C. An insurance policy is considered to be an M.E.C. where premiums are heavily front loaded. To avoid M.E.C. status, the total amount of premiums paid by the holder within the first seven years cannot exceed the amount required to have the policy be considered paid up within that time. If the P.P.L.I. is an M.E.C., gains are deemed distributed before capital and a 10% penalty is imposed on distributions prior to age 59½.

- Second, premium payments made to a foreign insurance company in connection with an insurance policy covering the life of a U.S. insured person are subject to a 1% excise tax. This excise tax may be eliminated under an applicable income tax treaty that covers the issuer of the policy and through certain elections under U.S. law by the insurance company.

- Finally, a P.P.L.I. is viewed to be a foreign financial account that must be reported to the I.R.S. Financial Crimes Enforcement Network. It is also a financial account under F.A.T.C.A. As a result, insurance companies located outside the U.S. must report information regarding U.S. policyholders and the policyholders must comply with reporting obligations with respect to Form 8938, *Statement of Specified Foreign Financial Assets*. Substantial penalties are imposed for noncompliance.

CONCLUSION

Pre-immigration drop-off trusts have long been used by practitioners as an effective technique to reduce estate tax. However, by combining the drop-off trust with a P.P.L.I. policy practitioners can turn the drop-off trust into a tool that reduces both estate and income taxes. Furthermore, the substantial income-tax savings should enable an N.R.A. to fund the drop-off trust with additional assets and ultimately achieve even greater U.S. estate-tax savings.

The ability to transfer assets freely out of one's estate without the use of exclusion amounts or the imposition of transfer taxes makes this combination particularly compelling in the pre-immigration planning context. However, planning that includes a P.P.L.I. policy should not be undertaken without input from a tax planner with experience.

A LOOK AT THE HOUSE G.O.P.'S "DESTINATION-BASED CASH FLOW WITH BORDER ADJUSTMENT"

Author
Elizabeth V. Zanet

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Border Adjustment Tax
Corporate Tax
Tax Reform

Last June, the House Ways and Means Committee[1] released its tax reform plan (sometimes referred to as the "House Blueprint"),[2] which includes sweeping changes to the U.S. corporate income tax.

With the Republicans now controlling both Houses of Congress and the presidency, there is a significant chance that the U.S. corporate income tax will undergo major changes. The chairman of the House Ways and Means Committee, Kevin Brady (R-T.X.), and the speaker of the House, Paul Ryan (R-W.I.), favor repealing the current corporate income tax and replacing it with a new regime referred to as the "destination-based cash flow with border adjustment." They believe that this new corporate tax will encourage corporations to stay in the U.S., incentivize exports, and discourage imports.

The following are some key features of the new corporate tax proposal:

- The tax rate would be lowered to 20%.
- Businesses could fully and immediately expense capital investments in the current year, rather than depreciate them over the useful life.
- Businesses would no longer pay U.S. corporate income tax on profits earned outside the U.S.
- Businesses would no longer be able to deduct interest as a business expense.
- The corporate tax would be "border adjusted."

THE CURRENT U.S. CORPORATE INCOME TAX SYSTEM

To understand the destination-based cash flow with border adjustment proposal and its potential impact, it is worth reviewing the current U.S. corporate income tax system.

The U.S. corporate income tax is a known as a "direct" tax because it is levied on the income of the person who pays it, rather than on the value of goods or services acquired from others.

The corporate income tax rules that are currently in effect impose a tax on the

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1 Under the Origination Clause of the U.S. Constitution, tax bills must originate in the House of Representatives. See U.S. Const. art. I, §6, cl. 1.

2 See "A Better Way Forward on Tax Reform," Ways and Means.

income of a corporation that is realized during the tax year. The starting point for computing the tax is the corporation's total gross income for the tax year. This consists of sales, less the cost of goods sold, plus other income. From that gross income, trade or business expenses, such as wages and occupancy costs for leased space, and expenses that are specifically identified as deductions, such as depreciation, amortization, and interest expenses, reduce gross income to arrive at the corporation's net taxable income for the tax year. The net taxable income is subject to the corporate income tax rate of 34%/35% plus applicable state and local tax.

The corporate income tax is imposed on a U.S. corporation's worldwide income during the tax year. Thus, income earned through operating a business outside the U.S. is subject to the corporate income tax. If the business is operated by a subsidiary that is a controlled foreign corporation ("C.F.C."), income from operations generally is taxed only when repatriated. However, if the income falls within an anti-deferral provision of U.S. tax law, the U.S. shareholder of the C.F.C. is tax immediately. To illustrate, if the earnings of a C.F.C. arise from operations carried on with unrelated parties in the country of residence of the C.F.C., the U.S. shareholder does not pay tax until the income is repatriated, generally in the form of a dividend. In comparison, if the earnings of the C.F.C. arise from items of passive income (*e.g.*, interest and dividends) or from certain purchases and sales of inventory property involving a related party in a third country and a sale for use, consumption, or disposition in a third country, the earnings generally are subject to immediate tax in the hand the U.S. corporation under Subpart F. Should the earnings be actually repatriated in a subsequent year, they generally are not taxed a second time at the level of the U.S. shareholder.

THE DESTINATION-BASED CASH FLOW WITH BORDER ADJUSTMENT, IN PARTS

To understand how the destination-based cash flow with border adjustment proposal works, it is useful to discuss its component parts.

"To understand how the destination-based cash flow with border adjustment proposal works, it is useful to discuss its component parts."

"Destination-Based"

As discussed above, under a worldwide system of income taxation, a corporation is taxed on the income it earns anywhere in the world. An alternative to the worldwide tax system is the territorial system of income taxation, under which a corporation is subject to income tax on domestic income but not on foreign income.

Under a destination-based tax system, tax is imposed based on where a corporation's goods end up (*i.e.*, their destination), rather than where they are produced or where the corporation's intellectual property is located (*i.e.*, their origin). Sales and use tax is an example of a destination system, as is a value-added tax ("V.A.T.") that zero rates exports and provides for a reverse charge on imports.

A destination-based system essentially starts in the same place as a territorial tax system. So, for example, overseas profits earned by U.S. multinationals that are repatriated as dividends would be exempt from U.S. corporate tax. However, unlike a territorial system, a destination system does not encourage overseas production by U.S. multinationals because all production for U.S. consumption would be taxable, no matter where the production occurred.

“Cash Flow”

As discussed above, the current U.S. corporate income tax is a direct tax on a corporation’s income, A corporation is required to compute its net income for the tax year, which requires it to determine the expenses attributable to the tax year. For example, it must determine the portion of the salaries paid during the tax year to generate taxable income year in order to compute its net taxable income for the tax year.

The new proposal would move toward an indirect tax in which consumption, rather than income, is subject to tax. An indirect tax follows the flow of cash because consumption is measured by cash to determine the tax base. Examples of indirect taxes are the sales tax and the V.A.T. The proposed system is not a true indirect tax because certain costs reduce the tax base.

Under the new proposal, a corporation would be allowed to deduct its asset acquisitions through full and immediate expensing, and the cost of goods sold but not expenses necessary to compute income such as depreciation and interest. There is one exception to the disallowance on deducting expenses to produce income: corporations would be allowed to deduct wages paid to employees. This appears to reflect a political compromise to promote job growth. However, it comes at a risk. If the new corporate tax is viewed as a direct tax, the border adjustments component (discussed below) will likely not be allowed under the World Trade Organization (the “W.T.O.”) rules because border adjustments are only allowed on indirect taxes. Possible solutions could include, dropping the deduction for wages, and thus making the new corporate tax a true V.A.T., or dropping the border adjustment component.

Under the cash-flow system, the incentive to shift profits would generally be eliminated. U.S. corporations would no longer be tempted to overstate costs in the U.S. and overstate profits outside the U.S. in order to avoid the relatively high U.S. corporate income tax rate. Further, since the interest expense deduction would no longer be permitted, there would be no incentive to use cross-border loans to shift profits.

“Border Adjustment”

The destination-based cash flow proposal would move the U.S. corporate tax system in the direction of becoming an indirect tax, like a V.A.T. A border adjustment is a typical and necessary component of a V.A.T. since the tax is imposed on consumption.

A border adjustment applies a tax on imports, but exempts exports from the tax. A U.S. corporation’s sales to U.S. customers would be taxed but its sales to foreign customers would not be taxed and the cost of inputs imported would no longer be deductible. U.S. customers would be taxed but sales to foreign customers would be exempt. In effect, the corporate tax would ignore revenues and costs associated with cross-border transactions and solely focus on raising revenue from business transactions from sales of goods in the U.S.

Since the U.S. imports much more than it exports, the border adjustment component of the new corporate tax proposal has the potential to raise tax revenues significantly. However, the lowering of the tax rate to 20% might offset any tax revenue increases.

Proponents of the border adjustment have argued that it will reduce the U.S. trade deficit. However, economists point to the fact that the border adjustment is a component of the V.A.T. of every country that imposes a V.A.T. Thus, the border adjustment imposed by the U.S. would be counterbalanced by the border adjustment imposed by a foreign country that has a V.A.T. However, for a customer who is itself a vendor for V.A.T. purposes, the input V.A.T. is a disguised loan to the government because the input is recoverable from the output V.A.T. collected from customers of the government in the form of a refund. In comparison, the border adjustment tax is a final tax.

THE REAL IMPACT

Most countries that impose a V.A.T. also impose a corporate income tax. The new corporate tax proposal would repeal the U.S. corporate income tax and replace it with the above-described V.A.T.-like tax. The U.S. would become one of the few countries without a corporate income tax. This could make the U.S. a very attractive place to do business from a tax perspective.

IMPLEMENTING THE BORDER ADJUSTMENT TAX: WINNERS & LOSERS

Authors
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Tags
Border Adjustment Tax
International Tax
Tax Controversy
Tax Reform
World Trade Organization

OVERVIEW

The House plan to tax imports and exempt exports (the "border adjustment tax" or "B.A.T.")[1] is part of a tax reform package that is expected to raise more than $1 trillion to offset lower income tax rates and improve U.S. competitiveness against global rivals. It is designed to encourage U.S. companies to move manufacturing operations back to the U.S. or use U.S.-based, rather than foreign-based, manufacturers.

Sixteen major U.S. companies, including Boeing Co., General Electric Co., and Caterpillar Inc., recently urged Congress to adopt the B.A.T. with an eye toward establishing more competitive pricing for U.S. manufactured goods.[2]

However, the B.A.T. also raises concerns for certain manufacturers – retooling to a U.S. supply line is costly and can take many years to setup. Of course, the severity of the retooling problem may be looked at as a driving reason for adopting a policy of encouraging manufacturing in the U.S. Ultimately, the B.A.T. will not be a winning proposition for all American businesses, as it benefits corporations that are net exporters to other countries, rather than companies who import goods to sell to the U.S. market.

On the international stage, the potential losers and others have already raised a loud outcry against adoption of the B.A.T. The proposal likely will be challenged in the World Trade Organization ("W.T.O.") by member nations that will be harmed by the tax.

Set forth below is a description of those industries that are expected to be helped and harmed by this proposal and an examination of the potential impact on U.S. currency. Also, set forth below are likely arguments that will support a challenge in the W.T.O. and a discussion of the impact on the American consumer – who may be the biggest loser if the plan is adopted. Note that most of the arguments addressed to consumers are championed by retailers that source inventory abroad.

EFFECT ON THE VALUE OF THE U.S. DOLLAR

There is some divergence as to whether the B.A.T. will result in an increase in the

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1 The tax on imports is actually an indirect tax since the proposal will deny a deduction for the cost of imported goods, which will increase the taxable gain when those products are later resold. By contrast, the proposal will exempt gain from the sale of exports from tax.

2 Ginger Gibson, "CEOs of 16 U.S. Companies Urge Congress to Pass Border Tax," Reuters, February 21, 2017.

value of the U.S. dollar. Since the border tax will materially alter the terms of trade between the U.S. and the rest of the world, the border tax could be expected to lead to a sharp increase in the value of the dollar.[3]

Per economic theory, there will be a reduction in U.S. demand for imported products, and as such, U.S. consumers will transfer fewer U.S. dollars to foreign sellers, thereby reducing the global supply and raising the value of the dollar. Consequently, it would be more expensive for foreign buyers to purchase U.S. goods and cheaper for U.S. importers to purchase goods from overseas. Yet, other analysts believe that the sale of goods will have very little effect on the dollar, as the U.S. has already transitioned from an economy principally based on goods to one based on knowledge and technology.[4]

"Technical economic observations that there will be no negative impact to American industry and the consumer have not been embraced by other commentators and have been silenced the critics of the tax."

The dollar could rally 25% – to levels not seen since the 1980's – according to economists, including Harvard University's Martin Feldstein, who was chairman of the Council of Economic Advisors under President Ronald Reagan.[5] U.S. holders of foreign assets would see the value of those foreign assets drop. This also suggests that the dollar denominated purchase price of foreign produced products will drop. Because many foreigners borrow in U.S. dollars, some commentators have speculated that a global debt crisis may follow for those that do not hedge foreign currency exposure in their home country.[6]

Martin Feldstein, however, believes that the critics of the border tax have not taken into account that the rise in value of the U.S. dollar will serve to offset any possible price adjustments that may result from the tax. Feldstein illustrates this by looking at the impact on an imported product that now costs $100. The purchase price of this imported product will rise to $125 so that the net effect of the 20% border tax will be a price of $100. Feldstein computes this as follows: the new $125 import price is reduced by a 20% tax on that amount (or $25) so the net price equals the present $100. Feldstein then asserts that "a 25% rise in the dollar would reduce the import cost to $80 – that is, $100 divided by 1.25. The border tax would then raise the domestic selling price to the original $100, so the importer could pay 20% of that and have $80 left to cover the cost of the import."[7] Feldstein's technical economic observations that there will be no negative impact to American industry and the consumer have not been embraced by other commentators and have been silenced the critics of the tax.

WINNERS AND LOSERS

Potential winners with regard to the B.A.T. will likely be (i) companies that are U.S. exporters and (ii) companies with significant input costs produced in the U.S.

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3 Holman Jenkins, "What's Behind the Border Tax Kabuki?," *Wall Street Journal*, February 17, 2017.

4 Julian Emanuel, "The Winners and Losers of a Border Adjustment Tax," interview, Bloomberg, February 14, 2017. Stefan Kreuzkamp, "The Border Tax and Other U.S. Tax Issues," Deutsche Asset Management, February 24, 2017.

5 Martin Feldstein, "The Illusory Flaws of 'Border Adjustment,'" *Wall Street Journal*, February 26, 2017.

6 Chelsey Dulaney, "Border-Tax Plan Draws Few Bettors," *Wall Street Journal*, February 14, 2017, B10.

7 Feldstein, "The Illusory Flaws of "Border Adjustment."

As previously mentioned, the C.E.O.'s of 16 major U.S. companies recently signed a letter to Congress endorsing the B.A.T. (the "Letter"). The signatories represent:

Boeing	Caterpillar	Celanese Corp.
Celgene Corp.	CoorsTek	Dow Chemical Co.
General Electric	Eli Lilly and Co.	McIlhenny Company
Merck & Co Inc.	Raytheon Co.	S&P Global Inc.
Oracle Corp.	United Technologies Corp.	Pfizer Inc.
	Varian Medical Systems Inc.	

While these businesses have clearly determined that they fit into one or both of the foregoing categories, the following discussion outlines the industries and sectors that are thought to be helped or harmed by the B.A.T.

Aircraft Manufacturers

Companies that produce American-made aircraft for commercial or private use are expected to benefit from the B.A.T. An example is Boeing, which argues that its primary competitor, Airbus, similarly benefits from V.A.T. refunds for non-E.U. sales while Boeing aircraft are subject to V.A.T. in the E.U. However, if Boeing or other aircraft manufacturers import parts or subassemblies as part of their supply chains, they will be adversely effected by the border tax. This may affect the makeup of supply chains for U.S. manufacturers.[8] However, the elimination of tax on exports of aircraft should far outweigh the cost of the B.A.T. on subassemblies.

American Consumers

A common theme echoed by many industries is that the B.A.T. will result in higher prices for the American consumer.[9]

The Americans for Affordable Products Coalition ("A.A.P.C."), a group of 150 businesses and trade coalitions, was formed to protest the B.A.T.[10] The A.A.P.C. estimates that the tax will raise the cost of everyday products like food, gas and medicine by up to 20% and threaten millions of jobs. It also indicated that this could have a harmful effect on middle-income American families and result in potentially evaporating 27% of their savings with the increased cost caused by the tax. Some notable members of A.A.P.C. are retailers like Target Corp. and Macy's, Inc., and import-focused trade associations like the National Association of Beverage Importers and the National Grocers Association.[11]

Americans for Prosperity ("A.F.P.") is a conservative political advocacy group in the U.S., which is funded by the businessmen and philanthropist brothers David H. Koch and Charles Koch. A.F.P. opposes the concept of funding lower corporate

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8 Kirk Johnson, "Trump Talk Rattles Aerospace Industry, Up and Down Supply Chain," *New York Times*, February 23, 2017.

9 Patti Domm, "A Plan to Tax Us Imports Has Better Odds of Becoming Law than Many People Think," CNBC, December 21, 2016.

10 Chavie Lieber, "100+ Retailers Are Joining Forces to Combat the GOP Border Adjusted Tax," Racked, February 1, 2017.

11 A full list of AAPC members who stand opposed to the border adjustment tax is set forth here.

rates by increasing consumer prices. It criticized the border adjustment plan as a tax on consumers.[12]

Automotive Industry

No matter where assembled, automobiles sold in the U.S. contain a large number of components produced abroad. One consulting firm recently prepared a report projecting the anticipated price increase that would result from the B.A.T. Ford Motor Co. would raise prices by an average of $282 per vehicle while GM would raise prices a $995 price hike. For other manufacturers, the projected increases are $1,312 for American Honda, $1,672 for Fiat Chrysler Automobiles, $2,298 for Nissan North America, and $2,651 for Toyota. Mazda Motors imports its full lineup and its projected increase is $5,156 per vehicle. The American International Automobile Dealers Association argues that impact of the B.A.T. will be to lower new car sales.[13]

Clothing and Apparel Industry

The U.S. clothing and apparel market comprises about 28% percent of the global total. Americans buy nearly 20 billion garments a year – close to 70 pieces of clothing per person. Roughly 2% of that is made in the U.S.[14] Thus, B.A.T. is likely to adversely affect this industry severely.

Companies with Locally Sourced I.P.

For politicians concerned about U.S. base erosion from royalty payments for the use of intangible property ("I.P.") owned outside the U.S., the B.A.T. may incentivize corporations to forego transfers of I.P. to foreign affiliates based in low-tax jurisdictions. Additionally, if the corporate tax rate falls to 20% or 15%, there may be little incentive left for U.S. corporations to move I.P. offshore.

Energy Sector: Oil Drillers and Refiners

The energy sector in America comprises both drillers and refiners. Domestic drillers stand to benefit from the B.A.T. and support the proposal. However, there is a split among refiners.[15]

The U.S. is the largest producer of shale oil in the world, and while the U.S. produces about 8.6 million barrels of crude oil per day, it imports about 8 million barrels of crude oil on the same basis. Under the B.A.T., the cost of imports would no longer be deductible. Most imports come from Canada, but others come from Mexico, Colombia, Venezuela, and Saudi Arabia. Saudi crude oil is shipped to the Saudi Aramco owned plant in Texas.[16] Refiners on the east or west coasts, such as Tesoro

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12 "Americans for Prosperity Holding Republicans Accountable," Americans for Prosperity, February 17, 2015.

13 Nick Bunkley, "Tax Threat Heightens Concern About Affordability," Automotive News, February 13, 2017.

14 Stephanie Vatz, "Why America Stopped Making Its Own Clothes," KQED News, May 23, 2013.

15 Christopher Mathews and Amy Harder, "Border Tax Divides Energy Sector," *Wall Street Journal*, February 24, 2017.

16 Domm, "A Plan to Tax Us Imports Has Better Odds of Becoming Law than Many People Think."

Corp. and PBF Energy, rely heavily on this imported crude and are opposed to the tax. Refiners with a better mix of domestic crude and the ability to export fuel products are more neutral to the idea.[17]

"Over the last decade, there has been a growing U.S. trade deficit in fresh and processed fruits and vegetables."

There is concern that gas prices may increase by up to 20% for consumers due to the increased tax on imported crude oil. Goldman Sachs Group Inc. projects that U.S. oil prices could surge to $65 a barrel from a recent $54, reflecting a sharp tightening in the supply-demand balance in the U.S. market.[18] Internal reports of the American Petroleum Institute have concluded that the proposal will raise gasoline prices by $0.20 per gallon or more in the short term.

This is somewhat less than a recent tax increase per gallon on gasoline sold in the State of New Jersey. Anecdotally, the price increase did not result in less congestion within the state.

Supporters of the proposal have argued that the B.A.T. will strengthen the U.S dollar, which will offset any short-term surge in gas prices. The American Fuel and Petrochemical Manufacturers ("A.F.P.M.") have also concluded that gas prices will surge. A.F.P.M. tends to represent refiners and cautions that the B.A.T. could have considerable impact on refiners, consumers, and the economy."[19]

Food and Agriculture Sector

California farmers supply much of the produce that is on the shelves of American supermarkets,[20] and most domestic producers – particularly U.S. corn exporters – stand to benefit from the tax. Nonetheless, foreign growers supply a substantial portion, too, especially in the winter months.

Over the last decade, there has been a growing U.S. trade deficit in fresh and processed fruits and vegetables. Although U.S. fruit and vegetable exports totaled $6.3 billion in 2015, U.S. imports of fruits and vegetables were $17.6 billion, resulting in a gap between imports and exports of $11.4 billion (excludes nuts and processed nut products). This trade deficit has generally widened over time as growth in imports has outpaced export growth. As a result, the U.S. has gone from being a net exporter of fresh and processed fruits and vegetables in the early 1970's to being a net importer of fruits and vegetables today.[21] This of course may change if consumers shy away from imported products from jams to fruits.

Mexico sold $10.4 billion of fruits and vegetables to the U.S, in 2015 making it the biggest supplier of produce from abroad. Products include tomatoes, avocados, peppers, grapes, cucumbers, melons, berries, and onions. Canada is the second biggest supplier with sales of $2.9 billion in 2015. Bananas are from tropical regions. Most of the bananas you buy are grown within 20 degrees on either side of the equator.[22]

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17 Mathews and Harder, "Border Tax Divides Energy Sector."

18 Dulaney, "Border-Tax Plan Draws Few Bettors."

19 *Supra*, note 17.

20 Brian Palmer, "The C-Free Diet: If We Didn't Have California, What Would We Eat?," July 10, 2013.

21 Renee Johnson, *The U.S. Trade Situation for Fruit and Vegetable Products*, Congressional Research Service report (Dec. 1, 2016).

22 "Map of Banana Farms," Chiquita Bananas.

Machinery Manufacturers

The American company Caterpillar is one of 16 signatories to the Letter supporting the B.A.T. It is expected that Caterpillar and its American competitor, John Deere, as net exporters, would stand to benefit from the B.A.T. In comparison, foreign competitors such as Komatsu and Mahindra will likely be damaged by the B.A.T. when they import machinery to the U.S. The comparison of U.S. manufacturers and their foreign competitors in this category illustrates a potential weakness of the B.A.T., as the B.A.T. may be construed as a subsidy that provides a financial benefit to U.S. residents. For example, while Caterpillar and John Deere can deduct the cost of goods sold in computing taxable income under the B.A.T., Komatsu and Mahindra are subject to a gross sales tax.

Military Contractors

Since the U.S. is the world's leading arms exporter,[23] companies manufacturing military arms and equipment are enthusiastic proponents of the B.A.T. Note that because U.S. law prevents U.S. military technology from being produced outside the U.S., most of the inputs are sourced in U.S. Raytheon and United Technologies are signatories to the letter endorsing the B.A.T.

Retail Industry

The retail industry is the nation's largest private-sector employer providing and supporting more than 42 million American jobs and many are undergoing significant changes brought about by the rise of online retailers. Major retailers such as Wal-Mart and Target, will be hit with increased cost as the merchandise they sell is sourced abroad, from apparel to electronics. Ninety-five percent of shoes and clothing sold in the U.S. are made elsewhere.[24]

These companies face a choice of absorbing some or all the cost of the tax or passing some or all of the cost to their customers. Neither result is favorable for the retailers. Walmart's announced position is that the added cost is likely to be passed on to the consumers in the form of higher prices when shopping at a bricks and mortar store or on the internet.

There is a view that the value of the U.S. dollar will increase as a result of the B.A.T. and that increase will soften price increases. However, officers of major brand clothing have argued it is disingenuous to argue that currency changes would even-out the impact of the B.A.T. The comment is reflective of the current almost universal view of U.S. retailers.[25]

Several major retail C.E.O.'s recently met with President Donald Trump and House Ways and Means Committee Chairman Kevin Brady (R-T.X.) at the White House to express concerns that the tax would hurt their industry.[26]

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23 Thom Shanker, "U.S. Sold $40 Billion in Weapons in 2015, Topping Global Market," *New York Times*, December 26, 2016.

24 Alex Parker, "Border Adjustment a 'Hidden Tax' on Consumers: Wal-Mart VP," *Daily Tax Reports* 32 (2017).

25 *Id.*

26 B. Popken, Trump Meets With Retail CEOs to Discuss Taxes, Jobs, And Economy, NBC News (Feb. 15, 2017),

Although retail is generally presumed to be on the losing side of the B.A.T., there are some retailers that could benefit from the tax. Stores that operate primarily in the U.S. and sell to customers who are less price sensitive are within this category. Examples are Neiman Marcus and Saks Fifth Avenue.

Pharmaceutical Industry

While U.S. drug manufacturers and net exporters Eli Lilly, Merck, Celgene, and Pfizer were signatories the Letter, the pharmaceutical industry, which imported over $86 billion in products in 2015, will be largely harmed by the border tax.

This industry is comprised of companies engaged in researching, developing, manufacturing, and distributing drugs for human or veterinary purposes. The U.S. is the world's largest pharmaceutical market with $333 billion in sales in 2015 – about triple the size of the second largest market, China. Generic drugs are less expensive for the American consumer and are favored by insurance companies for reasons of cost. India contributes around 30% of the overall volume of pharma products consumed in the U.S.

Directly and indirectly, the industry supports over 3.4 million jobs across the U.S. and added an estimated $790 billion to the economy in 2014.[27] No estimate is given by trade associations of the number of jobs that will be lost as a result of the B.A.T. or the reduction in sales that is projected.

Tourism and Higher Education

Tourism is a major industry in America. A stronger U.S. dollar means that, at the margins, fewer foreign persons may visit the U.S. as tourists.[28] A stronger dollar also means that Americans planning a vacation may find traveling abroad much less expensive. Thus, vacations outside the U.S. may increase, which would also be harmful to the U.S. tourism industry.

International students comprise a growing share of student population, especially in hard topics such as science and math.[29] For those who are not on U.S. dollar denominated scholarships, a stronger dollar increases the cost for a foreign students.

WORLD TRADE ORGANIZATION OPPOSITION

The World Trade Organization ("W.T.O.") was formed in 1995 and is composed of 164 member nations as of July 29, 2016. The W.T.O. provides a framework for negotiating trade agreements and a forum for resolving trade disputes among members.[30]

Many commentators have suggested that the B.A.T. would violate W.T.O. rules and

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27 U.S. Dept. of Commerce, International Trade Administration, *2016 Top Markets Report Pharmaceuticals.*

28 Jed Graham, "GOP Border-Tax Plan Would Sock U.S. Tourism – Including Trump Hotels," *Investor Business Daily*, February 15, 2017.

29 Stuart Anderson, "International Students Are Vital To U.S. Higher Education," *International Educator* Jan.-Feb. (2017).

30 See "World Trade Organization – Home page."

precipitate a challenge in the WTO by countries that export to the U.S. U.S. Congressman Kevin Brady is the Chairman of the House Ways and Means Committee and the principal advocate for the B.A.T. He is convinced the B.A.T. is compliant with W.T.O. rules. Others believe that it may violate W.T.O. rules because of the inability to include the cost of imports as part of cost of goods sold at the same time that the cost of locally made products can be included in such costs. This may be a form of subsidy that may violate the Agreement on Subsidies and Countervailing Measures.[31]

The definition of a subsidy is composed of three basic elements: (i) a financial contribution (ii) by a government or any public body within the territory of a W.T.O. member state (iii) that confers a benefit.[32] All three of these elements must be satisfied in order for a subsidy to exist. A financial contribution requires a charge on government funds. The term includes the relinquishment of government revenue or the failure to collect revenue (as would be the case with a credit or an exemption from tax generally due on domestic sales).[33]

In February, the German ambassador to the U.S. expressed concern that the B.A.T. may not be consistent with W.T.O. rules, but declined to say whether Germany might file a complaint with the W.T.O.[34]

THE TRUMP ADMINISTRATION'S POSITION

President Trump has not yet reached a final decision on whether to support or oppose the border tax proposal.[35] However, President Trump has expressed concern about the plan calling it "too complicated" in an interview with the Wall Street Journal.[36]

CONCLUSION

Like many controversial issues, belief in the potential adverse effects of the B.A.T. seems to depend on a company's status as a net exporter or net importer of inventory. To importers, adoption of the B.A.T. will harm major sectors of the American economy in a significant manner. They believe that the effect will be widespread and will embroil the U.S. in a controversy with its trading partners that will lead to a trade dispute that for resolution in the W.T.O. These companies argue that the ultimate consumers of their product may be the biggest losers through higher prices. Interestingly, industrial labor unions whose members are consumers seem to be quiet on the issue of the B.A.T.

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31 Martin Kohr, "The Planned US Border Tax Would Most Likely Violate WTO Rules – Part 2," Inter Press Service, February 17, 2017.

32 See Fanny Karaman, Stanley C. Ruchelman, and Astrid Champion, "European State Aid and W.T.O. Subsidies," *Insights* 9 (2016), pp. 9, 14.

33 Article 1 of the Agreement on Subsidies and Countervailing Measures and Article 16 of G.A.T.T. 1994.

34 Nick Wadhams & Margaret Talev, "German Ambassador Warns Import Tax May Violate WTO Rules," *Daily Tax Report* 36 (2017).

35 Kaustuv Basu & Aaron Lorenzo, "Confusion Continues on Trump's Take on Border Adjustment," *Daily Tax Report* 37 (2017).

36 Dulaney, "Border-Tax Plan Draws Few Bettors."

NEW DEVELOPMENTS IN THE WORLD OF REVERSE LIKE-KIND EXCHANGES

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Tags
Exchange Accommodation Titleholder
New York
Real Estate Transfer Tax
Real Estate
Reverse Like-Kind Exchange

Recently, the N.Y.S. Department of Taxation and Finance (the "Department") issued a taxpayer-friendly advisory opinion (the "Advisory Opinion")[1] in a reverse like-kind exchange. Under the like-kind exchange rules, a taxpayer disposes of a relinquished property before acquiring a replacement property. In a reverse like-kind exchange, a taxpayer first acquires the replacement property, generally, by using an Exchange Accommodation Titleholder ("E.A.T.") to allow the like-kind exchange under Code §1031 to proceed in the correct order. Additional information regarding the Federal requirements for a reverse like-kind exchange can be found in the October 2016 edition of *Insights*.[2]

In the Advisory Opinion, the Department addressed whether a conveyance of real property from an E.A.T. to a taxpayer as part of a reverse like-kind exchange is subject to Real Estate Transfer Tax ("R.E.T.T."). The Advisory Opinion was requested by the E.A.T. in question, who was an independent agent facilitating the reverence like-kind exchange.

The following article outlines the steps taken in a typical reverse exchange and examines the application of R.E.T.T. with respect to the various conveyances of property.

STEPS IN A REVERSE LIKE-KIND EXCHANGE

The Replacement Property

1. A taxpayer (the "Exchangor") and the E.A.T. first enter into an accommodation agreement to effectuate a reverse exchange. Pursuant to the agreement the E.A.T. is acting as the Exchangor's agent for all purposes, except for Federal and, as appropriate, state income tax purposes.

2. The Exchangor contracts to buy the replacement property and assigns its rights under the contract to the E.A.T.

3. The E.A.T. then closes on the property and acquires the legal title directly or through a disregarded entity such as a single-member limited liability company.

4. R.E.T.T. is paid on the conveyance of the replacement property to the E.A.T.

The E.A.T. acquires the legal title with the funds provided by the Exchangor (the "Loan"). The E.A.T. is not required to advance or expend any of its own funds.

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1 N.Y.S. Deptartment of Taxation & Finance, Advisory Op. No. TSB-A-16(2)R.

2 Nina Krauthamer and Rusudan Shervashidze, "Estate of Bartell Offers Taxpayers Relief in a Reverse Deferred §1031 Exchange," *Insights* 9 (2016).

Under the accommodation agreement, the E.A.T. will act as an agent, will be reimbursed for all its costs associated with the replacement property, and will receive fees for the services provided.

In order to keep the E.A.T. economically neutral with respect to the replacement properly during the so-called Parking Period, the E.A.T., as fee owner, will execute a master triple-net lease of the property to the Exchangor as master lessee (the "Lease Agreement"). The income and expenses reported by the E.A.T. during the Parking Period are designed to be a wash. Under the Lease Agreement, the amount of the rent due from the Exchangor is set equal to the outstanding monthly interest obligation of the E.A.T. under the Loan. Therefore, for Federal income tax purposes, the E.A.T. would report rental income and claim a matching deduction for interest paid to the Exchangor under the Loan.

The Relinquished Property

1. The Exchangor enters into a purchase and sale contract for the relinquished property with a purchaser.

2. Pursuant to an "exchange agreement," the Exchangor assigns its rights (but not its obligations) in the purchase and sale contract for the relinquished property to the Qualified Intermediary ("Q.I."). Under the purchase and sale contract, the Q.I.'s rights for the relinquished property are subject to the right of the purchaser to acquire the relinquished property.

3. At the Q.I.'s direction, the Exchangor transfers the relinquished property directly to the purchaser.

4. R.E.T.T. is paid on the conveyance of the relinquished property to the purchaser.

5. The Q.I. places the proceeds of the sale in a trust account for the benefit of the Exchangor (referenced below as the "trust account").

The Exchange

Through the Q.I., the Exchangor has effectuated selling the relinquished property to the purchaser. Next, the E.A.T. will purchase the replacement property with funds supplied by the Exchangor as one or more nonrecourse loans. The loans will consist of funds advanced by the Exchangor, including loans provided by one or more third-party lenders arranged by the Exchangor and secured by the replacement property. The E.A.T. will not be expected to pay any costs directly unless the Exchangor has provided the funds to the E.A.T. in advance.

The Exchangor then assigns its rights for the replacement property to the Q.I. under a Qualified Exchange Accommodation Arrangement ("Q.E.A.A."). Alternatively, the Exchangor contracts to purchase from the E.A.T. (i) the replacement property or (ii) the ownership interest in the disregarded entity of the E.A.T. that holds the title to the replacement property. Then, the Exchangor assigns its rights to acquire the replacement property under such contract to the Q.I.

Under either scenario, the Q.I. buys the replacement property from the E.A.T. with the funds from the trust account and the E.A.T. transfers the replacement property directly to the Exchangor. The E.A.T. repays the Exchangor any portion of the loans not funded by third-party lenders, and any mortgage is either extinguished or transferred along with the replacement property.

APPLICATION OF R.E.T.T. UNDER N.Y. TAX LAW §1402

N.Y. imposes R.E.T.T. on the conveyance of real property, or an interest therein, when the consideration exceeds $500. The consideration for the interest conveyed excludes the value of any lien or encumbrance remaining thereon at the time of conveyance.[3] "Conveyance" means the transfer(s) of any interest in real property by any method, including, but not limited to, sale, exchange, assignment, surrender, mortgage foreclosure, transfer in lieu of foreclosure, option, trust indenture, taking by eminent domain, conveyance upon liquidation or by a receiver, or transfer or acquisition of a controlling interest in any entity with an interest in real property.[4] Furthermore, an "interest in the real property" includes title in fee; a leasehold interest; a beneficial interest; an encumbrance; development rights; air space and air rights; or any other interest with the right to use or occupancy of real property or the right to receive rents, profits, or other income derived from real property. This includes an option or contract to purchase real property.

However, R.E.T.T. does not apply to conveyances of real property without consideration nor otherwise than in connection with a sale, including conveyances of real property as *bona fide* gifts.[5] "Consideration" means the price actually paid or required to be paid for the real property or interest therein, including payment for an option or contract to purchase real property, whether or not expressed in the deed and whether paid or required to be paid by money, property, or any other thing of value. It includes the cancellation or discharge of an indebtedness or obligation. It also includes the amount of any mortgage, purchase money mortgage, lien, or other encumbrance, whether or not the underlying indebtedness is assumed or taken subject to.[6]

As a Federal income tax matter, the Exchangor is considered to have exchanged the relinquished property for the replacement property, although the E.A.T. acquired the replacement property on the Exchangor's behalf prior to the sale of the relinquished property. The question raised in the Advisory Opinion was whether R.E.T.T. appied under N.Y. Tax Law §1402 to the transfer by the E.A.T. to the Exchangor of the replacement property.

In the Advisory Option, the Department[7] stated that there are only two conveyances that must be considered when dealing with a reverse like-kind exchange for the purposes of R.E.T.T.:

- The sale of the replacement property to the E.A.T. that obtains legal title directly or acquires the title indirectly through its ownership of its disregarded entity

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3 N.Y. Tax Law §1402.

4 N.Y. Tax Law §1401(e).

5 N.Y. Tax Law §1401(f).

6 N.Y. Tax Law §1405(b)(4).

7 N.Y. Tax Law §1401(d).

- The transfer of the relinquished property from the Q.I. to the purchaser

The sole purpose of the intermediate conveyances to the E.A.T. and the Q.I. is to conform the timing of the transfer of the relinquished property to the buyer, and of the acquisition of the replacement property by the Exchangor, to the structure required for a like-kind exchange under Code §1031.

Furthermore, the Department pointed out that during the reverse like-kind exchange the E.A.T. does not use any of its own funds to pay for the acquisitions of the properties, nor does it hold any responsibilities with regard to maintenance of the property. The E.A.T. is paid only its fees for services, and except for the limited responsibilities to pay income tax on those fees, it is held harmless in all other respects. If, after acquisition of the replacement property, the E.A.T. leases the property to the Exchangor prior to the conclusion of the exchange, the Exchangor's rent paid to the E.A.T. would equal any payment made by the E.A.T. on a mortgage that secures a loan for the purchase price. Thus, the E.A.T. remains economically neutral under the terms of the Q.E.A.A. The E.A.T. does not report gain or loss from the purchase or sale of the properties because the E.A.T. is serving as the agent or nominee for the Exchangor. No consideration is provided for the conveyance from the E.A.T. to the Exchangor. As such, the Department concluded that this conveyance is exempt from R.E.T.T. under N.Y. Tax Law §1405(b)(4).[8]

"There are only two conveyances that must be considered when dealing with a reverse like-kind exchange for the purposes of R.E.T.T."

[8] Advisory Op. No. TSB-A-16(2)R.

I.R.S. LB&I ANNOUNCES 13 NEW "CAMPAIGNS" FOR AUDIT GUIDANCE

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Tags
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On January 31, 2017, the I.R.S. Large Business and International ("LB&I") division announced the identification and selection of 13 campaigns targeting specific areas for audits and other enforcement activity. These campaigns represent the first wave of LB&I issue-based compliance work, with further campaigns to be identified, approved, and launched in the coming months. The campaigns may involve a combination of examinations, outreach, or guidance, as well as other possible treatment methods.

BACKGROUND

The issue-based campaigns are part of LB&I restructuring that was introduced last year in response to resource constraints. As of February 2016, the organization has moved to a structure based around "Practice Areas." This represents a more centralized issue selection approach that focuses on how to identify and address compliance risks. Returns will now be selected for audit based on issues rather than risks.

The new LB&I structure is divided into four geographic compliance areas – Western, Central, Eastern, and Northeastern – and five subject matters – Pass Through Entities, Enterprise Activities, Cross-Border Activities, Withholding & International Individual Compliance, and Treaty & Transfer Pricing Operations. LB&I plans to identify areas of noncompliance and strategically focus resources on those areas. Each Practice Area consists of a group of employees organized together to focus on one or more areas of concentration and expertise.

In the LB&I Fiscal Year 2016 Focus Guide, LB&I Commissioner Douglas W. O'Donnell laid out the operational goals for 2016, which included executing the new LB&I structure and operations. The new structure, as described by the LB&I Commissioner, focuses the organization's resources on different campaigns that represent observed or perceived noncompliance. The campaigns are intended to

- identify specific areas of potential noncompliance;
- identify intended compliance outcomes;
- identify specific tailored treatment streams to achieve those outcomes;
- identify the resources needed to execute these tailored treatment streams;
- identify training, guidance, mentors, and other support needed; and
- effectively use feedback from LB&I employees to quickly modify LB&I's approach as needed.

THE CAMPAIGNS

The initial campaigns were identified to improve return selection and identify issues representing a high risk of noncompliance. With respect to each announced campaign, the I.R.S. included a short description and identified the Practice Area, the lead executive responsible, and the treatment method. Because the 13 campaigns are "tailored," it is likely that a group of business taxpayers has already been identified by the I.R.S. and that taxpayers will be contacted by the I.R.S. in the coming months.

The 13 campaigns selected for this initial rollout are as follows:

> ***"It is likely that a group of business taxpayers has already been identified by the I.R.S. and that taxpayers will be contacted by the I.R.S. in the coming months."***

- I.R.S. 48C Energy Credit Campaign

  This campaign aims to ensure that the credit is claimed only by those taxpayers whose advanced energy projects were approved by the Department of Energy ("D.O.E."), and who have been allocated a credit by the I.R.S. These credits must be pre-approved through an extensive application submitted to the D.O.E.

  The treatment stream for this campaign will be soft letters and issue-focused examinations.

- O.V.D.P. Declines-Withdrawals Campaign

  This campaign addresses Offshore Voluntary Disclosure Program ("O.V.D.P.") applicants who applied for pre-clearance into the program but were either denied access to O.V.D.P. or withdrew from the program of their own accord.

  The I.R.S. will address continued noncompliance through a variety of treatment streams, including examinations.

- Domestic Production Activities Deduction, Multi-Channel Video Program Distributors ("M.V.P.D.'s") and T.V. Broadcasters

  This campaign targets M.V.P.D.'s and T.V. broadcasters that claim that "groups" of channels or programs are a qualified film eligible for a Code §199 deduction for domestic production activities. This is a 9% deduction – limited to 50% of wages paid – for qualified production activity income. Some taxpayers assert that they are the producers of a qualified film when distributing channels and subscription packages that include third-party produced content. LB&I has developed a strategy to identify taxpayers impacted by these issues and will develop training to aid revenue agents to address the issue in the course of an examination.

  The campaign will include the development of an externally published practice unit, published guidance, and issue-based exams where warranted.

- Micro-Captive Insurance Campaign

  This campaign addresses transactions described in Notice 2016-66, in which a taxpayer attempts to reduce its aggregate taxable income using contracts that are treated as insurance contracts and a related company that is treated as a captive insurance company. The contracts are interpreted, administered, and applied in a manner that is inconsistent with arm's length transactions and sound business practices. The campaign aims to review insurance premium deductions claimed by each entity treated as an insured entity under the contracts.

The treatment stream for this campaign will be issue-based examinations.

- Related-Party Transactions Campaign

  This campaign focuses on transactions between commonly controlled entities that provide taxpayers a means to transfer funds from a corporation to related pass through entities or shareholders. The campaign is aimed at the mid-market segment.

  The treatment stream for this campaign is issue-based examinations.

- Deferred Variable Annuity Reserves and Life Insurance Reserves I.I.R. Campaign

  This campaign is targeted at developing guidance to address uncertainties regarding issues relevant to the life insurance industry. The campaign's objective is to collaborate with industry stakeholders, Chief Counsel, and the Treasury to develop published guidance that provides certainty to taxpayers. The issues to be addressed include amounts to be considered in determining tax reserves for both deferred variable annuities with guaranteed minimum benefits and life insurance contracts.

- Basket Transactions Campaign

  This campaign addresses structured financial transactions, described in Notices 2015-73 and 201-74, in which a taxpayer attempts to defer and treat ordinary income and short-term capital gain as long-term capital gain. The taxpayer treats the option or other derivative as open until a "barrier event" occurs. Current period gains are deferred until the contract terminates, at which time the overall net gain is reported as a long-term capital gain.

  The treatment for this campaign will be issue-based examinations, soft letters to material advisors, and practitioner outreach.

- Land Developers – Completed Contract Method ("C.C.M.") Campaign

  This campaign targets large land developers that construct residential communities and may improperly be using C.C.M. accounting to defer all gain until the entire development is completed.

  The treatment includes development of a practice unit, the issuance of soft letters, and issue-based examinations when warranted.

- T.E.F.R.A. Linkage Plan Strategy Campaign

  This campaign focuses on developing new procedures and technology to work collaboratively with revenue agents conducting partnership examinations under the Tax Equity and Fiscal Responsibility Act ("T.E.F.R.A.") in order to identify, link, and assess tax to terminal investors that pose the most significant compliance risk.

- S-Corporation Losses Claimed in Excess of Basis Campaign

  This campaign focuses on S-corporation shareholders that claim losses and deductions to which they are not entitled because they do not have the sufficient stock or debt basis to absorb these items.

  The treatment streams for this campaign will be issue-based examinations, soft letters encouraging voluntary self-correction, conducting stakeholder outreach, and creating a new form for shareholders to assist in the proper computation of basis.

- Repatriation Campaign

  The goal of this campaign is to simultaneously improve issue selection filters while conducting examinations on identified high-risk repatriation issues, thereby increasing taxpayer compliance, including the proper reporting of repatriation of income on filed returns.

- Form 1120-F Non-Filer Campaign

  In this campaign, LB&I will use various external data sources to identify foreign companies doing business in the U.S. that are not meeting their filing obligations and encourage them to file the required tax returns.

  The treatment stream for this campaign will involve soft-letter outreach. If the companies do not take appropriate action, LB&I will conduct examinations to determine the correct tax liability. The goal is to increase voluntary compliance from foreign corporations with a U.S. business nexus. For companies that have neither a permanent establishment nor a subsidiary in the U.S., the opportunity to conduct an examination seems to be limited.

- Inbound Distributor Campaign

  This campaign will aid revenue agents as they examine U.S. distributors of goods sourced from foreign-related parties. In many cases, the U.S. taxpayer would be entitled to higher returns in arm's length transactions, and LB&I will review the losses and (small) profits reported, compared to the functions performed and risks assumed, by using Code §482.

  The treatment stream for this campaign will be issue-based examinations.

As each of the campaigns was assigned its own Practice Area, it is yet to be seen how the different Practice Areas will interact with one another, especially with regards to taxpayers with activities involving multiple Practice Areas and campaigns.

CONCLUSION

As LB&I moves toward issue-based examinations, LB&I will be able to decide which tax issues present a risk that requires a campaign while maintaining flexibility on the best steps to achieve compliance. As of today, no related practice unit has been published following the announcement, however, as LB&I begins implementation of the campaigns, certain practice units will likely be published to assist taxpayers (especially those who have identified any of the issues described above as applicable to them) in evaluating and preparing for the anticipated audit process.

INDIA BUDGET 2017-18

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India
Tax Policy

Jairaj Purandare is the Founder Chairman of JPM Advisors Pvt Ltd, a leading advisory, tax and regulatory services firm based in Mumbai, India. He has over three decades of experience in tax and business advisory matters, having served as Regional Managing Partner, Chairman – Tax and Country Leader – Markets & Industries for PwC India, Chairman of EY India, and Country Head of Andersen India's Tax & Business Advisory practice.

The Indian Finance Minister ("F.M.") presented the budget for financial year ("F.Y.") 2017 to 2018 ("Budget 2017-18") in parliament on February 1, 2017. Along with proposed amendments to the tax law, key economic numbers from the annual economic survey and additional policy proposals were announced.

Budget 2017-18 was presented in an economic environment fraught with the challenges of the recent demonetization exercise and weak investor sentiment, set amidst a V.U.C.A. world. This budget therefore posed a daunting task for the F.M., requiring him to achieve equilibrium between growth, job creation, and fiscal prudence on one hand and popular expectations on the other.

Budget 2017-18 is unique in three aspects. For the first time in Indian history, the Rail Budget has been folded into the country's fiscal plan, the bifurcation between plan and non-plan expenditures has been eliminated with a view towards focusing on capital and revenue expenditure, and the budget presentation to the parliament was advanced by a month.

Demonetization has caused short-term disruption in the Indian economy and has slowed down demand and consumption. The gross domestic product ("G.D.P.") growth forecast for F.Y. 2016-17 was reduced to 7.1% from the earlier estimate of 7.6%. The impact of demonetization on the G.D.P. is not, however, expected to spill over into the next year, and coupled with the roll out of the new goods and services tax ("G.S.T."), it is expected to spur G.D.P. growth in the long run. The wholesale price index ("W.P.I.") has reversed from -5.1% to 3.4%, while consumer price index ("C.P.I.") has declined from 6% in July 2016 to 3.4% in December 2016. The current account deficit has declined from 1% of G.D.P. in F.Y. 2015-16 to 0.3% of G.D.P. in the first half of F.Y. 2016-17.

Budget 2017-18 focuses on infrastructure, agriculture, rural development, and housing, in order to bolster growth through job creation and the elimination of black money. The F.M. outlined the Budget 2017-18 proposals under the "Transform, Energize and Clean India" agenda for the next year.

KEY POLICY ANNOUNCEMENTS

Some of the important policy announcements from Budget 2017-18 are described below.

Foreign Investment Policy

- The Foreign Investment and Promotion Board ("F.I.P.B.") is to be abolished in F.Y. 2017-18, and the roadmap to this end will be announced in the next few months.

- Further liberalization of the Foreign Direct Investment ("F.D.I.") policy is under consideration and pertinent announcements will be made in due course.

Financial Sector

- To improve ease of doing business, the registration process for financial market intermediaries, such as mutual funds, brokers, and portfolio managers, will now be handled online.
- With a view towards enhancing the operational flexibility and ease of access to Indian capital markets, a common application form will be introduced for the registration and opening of bank accounts and Demat[1] accounts, and for the issuing of permanent account numbers ("P.A.N.'s") for foreign institutional investors ("F.I.I.'s") and foreign portfolio investors ("F.P.I.'s").
- The commodities and securities derivative markets will be unified further through the integration of the participant, broker, and operational frameworks.
- Systematically important non-banking finance companies ("N.B.F.C.'s") that are regulated by R.B.I. and are above a certain net worth will be categorized as qualified institutional buyers, thereby making them eligible for participation in initial public offerings ("I.P.O.'s") with specifically earmarked allocations. This will help to strengthen the I.P.O. market and channelize more investments.

Digital Economy

- Digital payment infrastructure and grievance handling mechanisms will be strengthened.
- A proposal to mandate that all government receipts exceeding a certain amount be handled through digital means is being considered.

Labor Law Reforms

- Legislative reforms are to be undertaken to simplify, rationalize, and amalgamate the existing labor laws into four codes: wages, industrial relations, social security and welfare, and safety and working conditions.

Railways and Infrastructure

- About 7,000 stations with solar power are to be created in the medium term.
- A new Metro Rail Policy will be introduced with a focus on innovative models of implementation and financing, as well as standardization and indigenization of hardware and software.
- A new Metro Rail Act will be introduced to increase private participation and investment in construction and operation.
- Airports in Tier 2 cities will be taken up for operation and maintenance using the public-private partnership ("P.P.P.") model. The Airport Authority of India

[1] The term "Demat" refers to dematerialization of investment accounts. Stock certificates for publicly traded companies are being phased out and replaced with electronic accounts.

Act will be amended to enable the effective monetization of land assets. The resources, so raised, will be utilized for airport upgrades.

- 2,000 kilometers of coastal connectivity roads are to be constructed.

Housing

- By 2019, 10 million new houses are to be constructed.
- To facilitate greater investment in affordable housing, housing projects will be afforded the status of infrastructure, subject to certain conditions, thereby enabling such projects to receive the associated benefits.

KEY DIRECT TAX PROPOSALS

The direct tax proposals discussed below are effective for F.Y. 2017-18, *i.e.*, from April 1, 2017, unless otherwise specifically stated.

Rates of Tax

No change is proposed on the rates of tax, surcharges, and education cess for partnership firms, limited liability partnerships, and foreign companies for F.Y. 2017-18.

For domestic companies, the rate of tax is proposed to be reduced from 30% to 25% in cases where the company's total turnover or gross receipts for F.Y. 2015-16 did not exceed I.N.R. 500 million ($7.5 million).

"For individuals with a total income between I.N.R. 250,001 ($3,750) and I.N.R. 500,000 ($7,500), the rate of tax is proposed to be reduced from 10% to 5%."

For individuals with a total income between I.N.R. 250,001 ($3,750) and I.N.R. 500,000 ($7,500), the rate of tax is proposed to be reduced from 10% to 5%. It is further proposed to levy a surcharge at 10% where an individual's total income is between I.N.R. 5 million ($75,000) and I.N.R. 10 million ($150,000).

No change is proposed for the rate of Minimum Alternate Tax/Alternate Minimum Tax ("M.A.T./A.M.T."). However, the carryforward of M.A.T./A.M.T. credit is now proposed to be allowed for 15 years instead of the present limit of 10 years.

Indirect Transfer of Assets

Budget 2017-18 proposes to clarify that the provisions relating to the indirect transfer of assets will not apply to the transfer of an asset or a capital asset held by a nonresident, directly or indirectly, in an F.I.I. that has been notified by the government and has registered as a Category I or Category II F.P.I. with the Securities and Exchange Board of India ("S.E.B.I"). This clarification will help to alleviate the concerns of investors in F.I.I.'s and F.P.I.'s and is welcome. However, no similar relief is proposed to be provided to private equity funds or venture capital funds investing in Indian securities.

The proposed amendment is effective as of April 1, 2011, *i.e.*, from the year in which the provisions relating to indirect transfer of assets were introduced into domestic tax law.

Special Taxation Regime for Offshore Funds

Eligible offshore investment funds carrying out fund management activities in India through an eligible fund manager are neither considered to be resident in India nor to be constituting a business connection in India, subject to the fulfilment of certain conditions. One of the specified conditions is a requirement to maintain the fund's monthly average of the corpus at a minimum of I.N.R. 1 billion ($15 million). It is proposed to do away with this requirement in the year in which the fund is wound up.

The proposed amendment is effective from April 1, 2015, *i.e.*, from the year in which the special taxation regime for offshore funds was introduced into domestic tax law. However, no relief is proposed in respect to several other onerous conditions that are required to be fulfilled by offshore funds.

Interpretation of Terms Used in Agreements Entered into with Different Countries

Budget 2017-18 proposes to clarify that any term used in a double taxation avoidance agreement ("D.T.A.A.") entered into between the government of India and the government of any other country will be assigned the meaning as provided in the D.T.A.A. In cases where a term is not defined in the D.T.A.A., the term will be assigned the meaning as defined in Indian domestic tax law or any other explanation issued by the government of India. This amendment seeks to reverse the decision of the High Court in a past judgment, wherein it was held that unless the context otherwise requires, it would be impermissible to interpret a particular expression that was not defined in a D.T.A.A. by ascribing to it the meaning drawn from the definition of a different term in the domestic law.

Provisions Relating to Transfer Pricing – Secondary Adjustments in Transfer Pricing Cases

In order to align India's transfer pricing provisions with the O.E.C.D.'s transfer pricing guidelines and international best practices, Budget 2017-18 proposes that a resident taxpayer entering into an international transaction will be required to carry out secondary adjustments in cases where the primary adjustment has been made in any of the following ways:

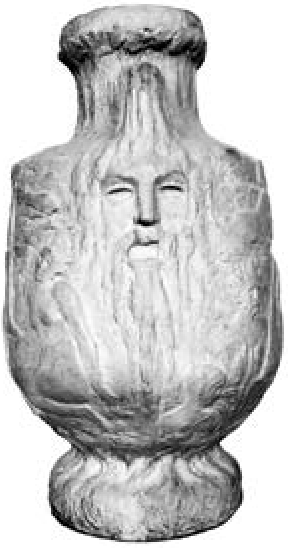
- *Suo moto* by the taxpayer in his return of income
- By the tax authority, and accepted by the taxpayer
- As determined by an advance pricing agreement
- As per safe harbor rules
- As a result of a mutual agreement procedure ("M.A.P.") under a D.T.A.A.

It is further proposed that where, due to a primary adjustment to the transfer price, there is an increase in total income or reduction in loss to the taxpayer and excess funds available to its associated enterprise ("A.E.") are not repatriated to India within the prescribed timeframe such excess will be deemed to be an advance made by the taxpayer to its A.E., the interest on which will be computed as income of the taxpayer.

However, the secondary adjustment would not be carried out if the following conditions were met:

- The amount of the primary adjustment made by the taxpayer in any F.Y. does not exceed I.N.R. 10 million ($150,000).

- The primary adjustment is made in respect to F.Y.'s prior to F.Y. 2016-17.



Thin Capitalization Rules

A new provision is proposed to be introduced to curb companies from enjoying excessive interest deductions. This provision will be in line with the recommendations of O.E.C.D. B.E.P.S. Action 4.

The new provision seeks to restrict the deduction for interest expenses paid or payable by an entity to its A.E.'s to 30% of its earnings before interest, taxes, depreciation, and amortization ("E.B.I.T.D.A."). This provision will be applicable to an Indian company or the permanent establishment ("P.E.") of a foreign company that pays interest exceeding I.N.R. 10 million ($150,000) on any form of debt issued to a nonresident or the P.E. of a nonresident and which is an A.E. of the borrower. Such excess interest will not be deductible in the hands of the Indian company or P.E.

Further, the debt will be deemed to be issued by an A.E. where it provides an implicit or explicit guarantee to the lender, or where it deposits a corresponding and matching amount of funds with the lender. Such disallowed interest expenses will be allowed to be carried forward for eight F.Y.'s immediately succeeding the F.Y. for which the disallowance was first made, and deduction against income computed under the heading of "profits and gains of business or profession," to the extent of the maximum allowable interest expenditure, will be permitted.

Banking and insurance businesses would be excluded from the scope of the thin capitalization provisions.

Minimum Alternate Tax ("M.A.T.")

Currently, companies are required to pay M.A.T. at 18.5% of their book profits (computation of which is specified by law) if the tax payable as per the regular provisions of the domestic tax law after considering all other allowable deductions is less than 18.5% of the book profits. The time limit for the carryforward of the difference between the M.A.T. paid and the tax payable under the normal tax provisions, referred to as M.A.T. credit, is now proposed to be increased to 15 years from the present limit of 10 years. No M.A.T./A.M.T. credit will be allowed if the credit relates to the difference between a foreign tax credit ("F.T.C.") allowed against the M.A.T./A.M.T. and an F.T.C. allowed against the tax computed under the regular tax provisions.

As the adoption of Indian Accounting Standards ("Ind. A.S.") is a mandatory requirement for certain companies as of F.Y. 2016-17, it is proposed to introduce a framework for the computation of book profits for such companies in the first year of their adoption of Ind. A.S. and thereafter.

Extending the Period to Claim Tax Deductions and Carry Forward Loss for Start-Ups

A 100% deduction of profits is available to eligible start-ups that were incorporated after March 31, 2016, and before April 1, 2019, and are engaged in the business of innovation, development, deployment, or commercialization of new products, processes, or services driven by technology or intellectual property. The deduction is available for any three consecutive F.Y.'s out of a block of five years after the date of incorporation of the start-up.

In view of the fact that start-ups may take time to derive profit from their business, it is now proposed to increase the period of the block from five years to seven years. It is also proposed that in the case of a change in the shareholding structure of an eligible start-up company during an F.Y., the loss incurred during the period of seven years beginning from the year in which such company is incorporated will be carried forward and set off against the income of that F.Y. if all the shareholders of such company who held shares carrying voting power on the last day of the year in which the loss was incurred continue to hold those shares on the last day of the F.Y. in which the loss is set off.

Capital Gains

Definition of Long-Term Capital Asset

To make the real estate sector more attractive to investors, it is proposed to reduce the holding period required to qualify as a long-term capital asset for land or buildings from 36 months to 24 months.

Shifting of Base Year for Computation of Capital Gains

The base year for calculating the indexed cost of acquisition for the purposes of computing capital gains has been proposed to be changed from the year beginning April 1, 1981, to the year beginning April 1, 2001. The cost of acquisition in relation to any capital asset acquired before April 1, 2001, will be the cost of the acquisition of the asset to the taxpayer or the fair market value ("F.M.V.") of such asset as of April 1, 2001, at the option of the taxpayer. Thereafter, the actual cost of improvement incurred after April 1, 2001 will only be considered when calculating the indexed cost of acquisition.

Conversion of Preference Shares to Equity Shares

To provide tax neutrality on the conversion of preference shares of a company into equity shares of that company, it is proposed that such conversion will not be regarded as a "transfer" for the purposes of capital gains. The cost of acquisition and the holding period of such preference shares will be considered to be part of the cost and the total holding period of the converted equity shares. Therefore, the conversion of preference shares into equity shares will not be considered a taxable event.

Fair Market Value to be Full Value of Consideration in Certain Cases

In cases were the full value of consideration for a transfer of shares of a company (other than quoted shares) is less than the F.M.V., the F.M.V. will be deemed to be the full value of consideration. This may impact private equity investors who are thought to sell stocks of closely held companies to other financial investors at prices that are lower than the F.M.V.

Tax on Certain Long-Term Equity Shares or Units

At present, any income arising from the transfer of specific long-term capital assets, *i.e.*, an equity share in a company, a unit of an equity-oriented fund, or a unit of a business trust, is exempt from tax provided that such transaction is subject to securities transaction tax ("S.T.T.").

It is proposed that the above exemption will not be granted to the transfer of equity shares in a company if the transaction to acquire such equity shares was entered into on or after October 1, 2004, without payment of S.T.T. However, to preserve the exemption for genuine cases where the S.T.T. could not have been paid (such as for the acquisition of shares in an I.P.O.; follow on public offering ("F.P.O."), bonus, or rights issue by a listed company; or an acquisition by nonresidents in accordance with the F.D.I. policy) it is proposed to eliminate the condition of chargeability to S.T.T. upon acquisition of shares in specific cases of transfer, which will be notified by the government.

Computation of Capital Gains in Case of Joint Development Agreement

For individuals and Hindu Undivided Families ("H.U.F.'s") entering into a specific agreement for the development of a project, capital gains arising from the transfer of a capital asset (whether land or building or both) will be taxable in the year in which a certificate of completion for the whole or a part of the project is issued by the competent authority.

The full value of consideration for the purposes of computing such capital gains will be the total of the stamp duty value of the taxpayer's share in the project on the date of issuance of the certificate of completion and the monetary consideration received, if any. The benefit of the proposed regime will not apply to a taxpayer if he or she transfers his or her share in the project to any other person on or before the date of issue of the certificate of completion, in which case the taxpayer will be liable for capital gains in the year in which the transfer takes place. The cost of acquisition of the share in the developed project in the hands of such taxpayer will be the amount that is deemed to be the full value of consideration. Tax at the rate of 10% will be withheld from the monetary consideration payable under the specific agreement.

This amendment has been proposed with the intent to minimize the ambiguity in the interpretation of the meaning of "transfer," which has long been the subject of litigation.

Extension of Capital Gains Exemption to Rupee-Denominated Bonds

The transfer of rupee-denominated bonds (issued by an Indian company outside India) held by a nonresident to another nonresident will be exempt from capital gains tax. Any gains arising due to forex appreciation of the rupee-denominated bonds in the computation of capital gains at the time of redemption will also be extended to secondary holders of such bonds.

Tax on Income from a Transfer of Carbon Credits

The taxation of carbon credits has been litigated in many cases, and various courts and tribunals have taken the view that such a credit is a capital receipt. However, one court held a sale of carbon credits to be revenue in nature, and this matter is pending before the Apex Court. Budget 2017-8 proposes to provide that the gross income from the transfer of carbon credits will be taxed at a concessional rate of 10% (plus surcharge and education cess). No expenditure or allowance in respect to such income will be allowable as a deduction.

Cost of Acquisition in a Tax Neutral Demerger of a Foreign Company

The transfer of shares of an Indian company by a demerged foreign company to the resulting foreign company is not regarded as a transfer under the domestic tax law.

It is proposed to clarify that the cost of acquisition of such shares in the hands of the resulting foreign company will be the same as it was in the hands of the demerged foreign company.

Widening the Scope of "Income from Other Sources"

Budget 2017-18 proposes to extend to all taxpayers the taxation of the receipt of any sum of money exceeding I.N.R. 50,000 ($750) or any movable or immovable property without consideration or with inadequate consideration (as defined). Currently, this provision is applicable only to individuals and H.U.F.'s, and to firms and companies only with respect to shares of unlisted companies.

Tax on Dividends

Budget 2017-18 proposes to expand the scope of the tax on dividends inserted by Finance Act 2016 that was applicable only to resident individuals, H.U.F.'s, and firms (including L.L.P.'s). Accordingly, the proposal will tax dividends exceeding I.N.R. 1 million ($15,000) in the aggregate in the hands of all resident taxpayers except the following:

- Domestic companies
- Certain approved trusts, funds, or institutions established for charitable or religious purposes

Nonresident taxpayers continue to remain outside the scope of this provision.

The proposed amendment eliminates any opportunity for tax planning by corporations and their promoters by setting up an intermediary trust or Association of Persons ("A.O.P.").

Transparency in Electoral Funding

Budget 2017-18 proposes that income received by political parties should be exempt, subject to the following conditions:

- No donations exceeding I.N.R. 2,000 ($30) are to be received in cash.
- All political parties are required to file a return of income on or before the prescribed due date.

An amendment is proposed to the Reserve Bank of India Act, 1934, to provide for the issuance of electoral bonds to facilitate the funding of political parties via banking channels. Political parties will not be required to furnish the name and address of the donors who contribute by way of electoral bond.

Withholding Tax Provisions

Interest Payable to a Nonresident Taxpayer on Borrowings in Foreign Currency

The concessional rate of 5% withholding tax on interest on borrowing made under a loan agreement or by way of any long-term bond, including a long-term infrastructure bond, which is applicable until July 1, 2017, is proposed to be extended to July 1, 2020. Further, the benefit of the lower rate of withholding tax of 5% is also proposed to be extended to rupee-denominated bonds issued outside India before July 1, 2020. The proposed amendment will be effective as of April 1, 2015.

Interest Payable to Qualified Foreign Investors

The concessional rate of 5% withholding tax, which is applicable to interest payments to F.I.I.'s and qualified foreign investors ("Q.F.I.'s") in respect to investments in government securities and rupee-denominated corporate bonds made before July 1, 2017, is now proposed to be extended to July 1, 2020.

Disincentives for Cash Transactions

"To promote digital transactions with a view towards transitioning to a 'less cash' economy and tackling the issue of growing black money, several amendments are proposed."

In order to promote digital transactions with a view towards transitioning to a "less cash" economy and tackling the issue of growing black money, several amendments are proposed to reduce the limit of permissible cash transactions. Specifically, no cash transactions will be permitted for amounts exceeding I.N.R. 300,000 ($4,500). Further, penalties are proposed to be introduced for contravention of the restrictions on to cash transactions.

KEY INDIRECT TAX PROPOSALS

Given the impending introduction of the G.S.T. by July 1, 2017 or thereabout, there are few noteworthy amendments and proposals regarding the indirect tax laws in Budget 2017-18. Nevertheless, the F.M. has tried to address issues such as inverted duty structure in the chemicals sector, de-incentivizing the drain of vital mineral resources from India, and boosting the renewable (solar and biogas) energy sector.

The F.M. asserted in his budget speech that the G.S.T., by far the biggest tax reform since India's independence, is on schedule and that preparation of the information technology ("I.T.") system for G.S.T. is progressing well. He assured the business community at large that extensive outreach efforts to trade and industry for G.S.T. will start from April 1, 2017.

The key indirect tax proposals are briefly discussed below.

Service Tax

- The effective service tax rate remains unchanged at 15% (service tax at 14%, *Swachh Bharat* cess at 0.5%, and *Krishi Kalyan* cess at 0.5%).
- Services provided by select airline operators to the government, including the transportation of passengers by air either embarking from or terminating at Regional Connectivity Scheme ("R.C.S.") Airport, weighed against consideration in the form of viability gap funding ("V.G.F."), have been exempted from service tax with effect from February 2, 2017. This exemption will not be available more than one year from the date of the commencement of operations at R.C.S. Airport, as advised by the Ministry of Civil Aviation.
- A one-time, upfront amount collected by the State Government Industrial Development Corporation Undertaking from industrial units for the grant of the long-term lease of industrial plots (for 30 years or more) is proposed to be exempted from service tax retrospectively from June 1, 2007, *i.e.*, when the service of the "renting of immovable property" was made exigible to service tax.
- For the purposes of the reversal of the central value added tax ("CENVAT") credit on common input services under Rule 6(3) or 6(3A) of the CENVAT

Credit Rules, 2004 ("C.C.R. 2004") by banks and financial institutions, including N.B.F.C.'s, the value of services provided by way of extending deposits, loans, or advances – insofar as the consideration is represented by interest or a discount – will form part of the value of the exempted services (with effect from February 2, 2017).

Customs Duty

- The standard ad valorem rate of basic customs duty ("B.C.D.") remains unchanged at 10%. The education cess and secondary and higher education cess will also continue to apply to B.C.D.
- The following proposals will be effective as of the date of assent on Finance Bill, 2017:
  - It is proposed that the provisions relating to unjust enrichment will not apply to cases where the refund is given in relation to excess duty paid by the importer prior to the order permitting the clearance of goods for home consumption and the same is evident from the bill of exchange filed.
  - Facilities for the storage of imported goods in public warehouses for up to 30 days has been extended to imported goods that cannot be removed for warehousing within a reasonable time.

Excise Duty

- The standard ad valorem rate of excise duty remains unchanged at 12.5%.
- In the case of a transfer of business undertakings or a change in ownership, a timeframe of three months has been prescribed for permission to be granted for the transfer of accumulated CENVAT credit under Rule 10 of C.C.R. 2004. This period could be further extended by six months by the Principal Commissioner/Commissioner of Central Excise (with effect from February 2, 2017).

CONCLUSION

The provisions in Budget 2017-18 that relate to infrastructure, the financial sector, accountability, prudent fiscal management, and tax administration reflect a view that times are changing in India. The government appears to remain steadfast in bringing the tax and regulatory environment up to global standards.

BASIS PLANNING IN THE USUFRUCT AND BARE OWNERSHIP CONTEXT

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Tags
Bare Ownership
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Usufruct

As explained in an earlier article,[1] a common civil law estate planning technique involves an older generation making a gift of bare ownership in an income generating asset – generally real property – to members of a younger generation. The person making the gift retains the *usufruct* interest, meaning the income from, and the use of, the property. This planning technique is beneficial for tax purposes in civil law countries. However, it can have adverse effects when a bare owner is or becomes a U.S. citizen or resident. This article addresses planning opportunities with the potential to resolve some or all those adverse tax consequences in the U.S.

BACKGROUND

In civil law jurisdictions, attributes of ownership can be divided into two separate categories:

- *Usufruct* – This attribute gives the holder the right to the enjoyment of the underlying asset and the right to the income generated by the underlying asset, typically for the balance of the holder's lifetime.
- Bare ownership – This attribute gives the holder the right to transfer the underlying asset during the period of the *usufruct* interest.

Generally, a *usufruct* right lasts for the lifetime of the holder. It can be compared to a life estate found in common law systems.[2] It can also last for a shorter period in certain countries. Upon the death of the holder of the *usufruct* interest, or at the end of its term, the *usufruct* right is automatically transferred to the bare owner, thereby providing the bare owner with full title to the underlying property.

As a general estate planning tool, parents will transfer the bare ownership to their children while retaining the *usufruct*. This provides the *usufruct* holder with the

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1 Fanny Karaman and Stanley C. Ruchelman, "Usufruct, Bare Ownership, and U.S. Estate Tax: An Unlucky Trio," *Insights* 8 (2016).

2 Rev. Rul. 66-86. See also P.L.R. 9121035, in which the usufruct interest was determined to constitute a trust. In this private letter ruling, the decedent named her son as heir in the entirety, and the son maintained the option to renounce his heirship. The decedent's will provided that, in the event her son renounced his heirship, he would be entitled to the usufruct right in all the decedent's properties, including operating businesses, with the bare ownership passing to the son's children. The decedent's will further provided that her son would be the administrator of her estate. The private letter ruling concluded that, under the terms of the will, a trust arrangement was created and the holder of the usufruct interest was a trustee. Note that a private letter ruling is a binding authority only for the taxpayer to whom it is issued; it may not be cited as an authority by others.

right to the income and the enjoyment of the property until death. As the transfer of the bare ownership is less than the transfer of the full ownership, the gift tax base is reduced, thereby resulting in a lower tax at the time the plan is initiated. Upon the parents' death, the *usufruct* is automatically carried over to the children, free of inheritance tax under foreign tax law, thereby granting full ownership in the property to the children.

ADVERSE U.S. TAX CONSEQUENCES: CARRY-OVER BASIS AND CAPITAL GAINS TAXATION

For tax law purposes in civil law countries, a beneficiary may receive a stepped-up basis as a result of (i) an *inter vivos* gift of bare ownership or (ii) a transfer at death of the *usufruct*.[3] In addition, the capital gain realized upon the sale of the property interest may be exempt from tax if the beneficiary holds the interest during a specific holding period. The holding period of the property generally starts on the earlier of the receipt of the bare ownership or the termination of the *usufruct* interest.[4] This allows for an efficient transfer for both foreign income tax purposes and foreign gift and succession tax purposes.

In comparison, U.S. tax law does not allow a step-up in basis upon a gift of bare ownership or the receipt of the *usufruct* interest upon death of its holder. This becomes a problem when the holder of the unified interests attempts to sell the property. U.S. income tax treaties contain a saving clause allowing the U.S. to tax its citizens and residents – as determined under the treaty – as if the treaty were not in effect. This provision generally allows the U.S. to tax capital gains realized on the sale of foreign assets by a U.S. person, whether the assets consist of real property or personal property.[5] The taxable gain constitutes the difference between the amount realized upon the sale and the property's adjusted basis in the hands of the donee.[6]

Generally, the treaty provides for a U.S. foreign tax credit for the amount of the foreign taxes paid by a U.S. citizen or resident.[7] However, under certain treaties, the foreign tax credit may be subject to a foreign tax credit limitation under U.S. domestic law. Further, if the foreign country does not impose tax because of the step-up in basis in the property for purposes of its tax law, the benefit of the foreign tax credit is ephemeral. The U.S. rules do not allow a step-up in basis, gain will exist, and the U.S. will impose tax on that gain. The imposition of U.S. tax renders the tax planning done under foreign law meaningless. It simply shifts tax revenue from the foreign country to the U.S.

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3 See, for instance, for rights in real property situated in France: BOI-RFPI-PVI-20-10-20-10, no. 350, September 12, 2012.

4 See, for instance, for rights in real property located in France: BOI-RFPI-PVI-20-20, no. 40, April 10, 2015.

5 See, for example, the France-U.S. Income Tax Treaty (the "France Treaty") currently in effect. Paragraph 2 of Article 29 (Miscellaneous Provisions) allows the U.S. to impose tax on income and gains from real property located in France when realized by a U.S. citizen or resident, notwithstanding paragraph 1 of Article 6 (Income from Real Property) and paragraph 1 of Article 13 (Capital Gains).

6 Code §1001(a).

7 See, for example, paragraph 2(a) of Article 24 (Relief from Double Taxation) of the France Treaty.

Absence of U.S. Gift Tax

Contrary to the principles followed in civil law countries, U.S. gift tax is imposed on the donor and not on the beneficiary.[8]

Gifts made by a non-citizen, nonresident individual to a U.S. person are not subject to U.S. gift tax if the gifted property has its situs located outside the U.S.[9] However, when the aggregate gifts received from a non-U.S. donor during the same year have a value in excess of $100,000, the U.S. beneficiary must report the gifts on Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*.[10] Failure to report the gift on Form 3520 can result in a penalty of 5% per month, based on the amount of the gift, capped at 25%.[11]

"Gifts made by a non-citizen, nonresident individual to a U.S. person are not subject to U.S. gift tax if the gifted property has its situs located outside the U.S."

Although no U.S. gift tax exposure exists at the time of the gift, income tax will be assessed on the U.S. donee on gain realized at the time of a subsequent sale.[12]

Basis in Bare Ownership Received as a Gift

For property received as a gift, the donee retains the donor's basis in the property (the donor's "carryover basis").[13] When the recipient sells the asset, tax is imposed on total gain, which includes the unrealized gain accrued by the donor prior to the date of the gift. An exception applies only to the extent of U.S. gift tax paid by the donor on the gift. As a result, if the donor previously received the property by gift, the donor's basis in the property carries over from the first person in the chain of donors.

To illustrate, if a grandmother gave property to a father and the father gives property to his daughter, the daughter's basis in the property is determined by reference to the grandmother's basis. Not only was that basis determined many years ago, there likely are no records of the grandmother's basis in the property and the currency that was used to acquire the basis is likely no longer in existence. Note that if the basis carries over from the donor, the donor's holding period carries over, too.[14]

No Stepped-Up Basis in Usufruct Interest of Certain Foreign Property

Generally, the basis of property acquired from or passed from a decedent at the time of death is the property's fair market value.[15] The terms "property acquired from" or "property passed from" a decedent include property acquired by reason of death, form of ownership, or other condition, if the property is required to be included in determining the value of the decedent's gross estate.[16] Thus, for example, a life interest generally is considered to be property acquired from a decedent if the property is required to be included in determining the value of the decedent's gross

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[8] Code §2501(a)(1).

[9] Code §2511(a); Code §2511(b).

[10] Code §6039F and Notice 97-34.

[11] Code §6039F(c).

[12] Code §1001.

[13] Code §1015(a). Special rules exist for loss property.

[14] Code §1223(2).

[15] Code §1014(a)(1).

[16] Code §1014(b)(9).

estate. However, an exception applies to a *usufruct* interest that is received by the bare owner of the property where the property is not included in a gross estate.[17] In this case, the property itself has a uniform basis, consisting of the basis in the life interest and the basis in the remainder interest. When the *usufruct* interest terminates, the bare legal owner takes the uniform basis in the property.

If no further step-up is allowed in the basis of the property, capital gains tax will be incurred by the U.S. child when the property is eventually sold.

U.S. BASIS PLANNING

Once the gift of the bare legal title is made, there typically is little that can be done by the holder to increase basis. However, prior to the gift, the parents may take steps to undergo a transaction that is tax free in the country of residence but would be taxable according to U.S. tax concepts. The goal of the transaction is to obtain an immediate step-up in basis to fair market value as of the date of the transaction and, in this way, minimize the problem that will be encountered when the *usufruct* terminates.

However, when a U.S. person owns an interest in a corporation that invests principally in passive assets, such as publicly traded shares, bonds, certificates of deposit, or certain real estate, additional planning must be undertaken after the step-up is achieved.

One possible method of accomplishing a step-up is for the non-U.S. parents to contribute the property to a foreign entity with limited liability for all its members. Thus, the entity is treated as a corporation for U.S. tax purposes. For reasons explained below, the foreign entity should not be a *per se* corporation.[18]

The capital structure of the entity should provide for a class of common shares and a class of nonqualified preferred stock, as defined for U.S. tax purposes.[19] Under Code §351(g), the use of nonqualified preferred shares will trigger recognition of gain under U.S. concepts and a step-up in basis of the shares.

For shares to be considered a class of preferred stock, they must be limited and preferred as to dividends.[20] This means that the shares do not participate in corporate growth to any significant extent.[21] Stock that can be converted into common stock does not constitute nonqualified preferred stock.[22]

For the class of preferred shares to be nonqualified, one of the following attributes must be applied to the class of preferred shares in the organizational documents of the entity:[23]

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17 Treas. Reg. §1.1014-2(b)(2).

18 Treas. Reg. §301.7701-3(a).

19 In France, for instance, a *société par actions simplifiée* ("S.A.S.") could be used.

20 Code §351(g)(3).

21 *Id.*

22 P.L.R. 200311002; P.L.R. 200411025.

23 Code §351(g)(2)(A).

- The holder of such stock is given the right to require the issuer or a related person to redeem or purchase the stock.[24]
- The issuer or a related person is required to redeem or purchase such stock.[25]
- The issuer or a related person is given the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised.[26]
- The dividend rate on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices.[27]

In applying the foregoing tests, the term "related person" has the standard meaning that appears in Code §267(b) or §707(b). Thus, the term includes, *inter alia*, brothers, sisters, spouses, ancestors, lineal descendants, an individual, and a corporation for which more than 50% in value of the outstanding stock is owned, directly or indirectly, by or for such an individual.[28] It also includes a corporation that is a member of a 50%-controlled group owned by an individual and a corporation that is otherwise under common control with another corporation. If the corporation owns a 50% interest in the capital or profits of a partnership, the partnership will be a related person.[29]

In light of the foregoing rules, once a foreign entity with the appropriate capital structure is formed, the plan would include the following steps:

1. The parents obtain a supportable valuation of the property. Two classes of shares are formed. One is a class of nonqualified preferred shares with capital equal to the maximum allowed under foreign law. The shares would (i) give the holder a preferential right to a fixed dividend that would be below the dividend amount distributed to shareholders of the common stock, so as to not significantly share in the growth of the company, and (ii) be based on Euribor.[30]
2. The parents contribute property to the corporation in return for the two classes of shares. Under U.S. tax concepts, but not foreign tax concepts, gain must be recognized with regard to property transferred in return for the nonqualified preferred shares.[31] For U.S. tax purposes, the parents receive a basis in the nonqualified preferred shares equal to the percentage of the contributed property's fair market value as attributed to the nonqualified preferred stock.[32] The common shares have a carryover basis.

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24 Code §351(g)(2)(A)(i).

25 Code §351(g)(2)(A)(ii).

26 Code §351(g)(2)(A)(iii).

27 Code §351(g)(2)(A)(iv).

28 Code §§351(g)(3)(B), 267(b)(1).

29 Code §707(b).

30 Under French law, for instance, such a fixed amount would be honored up to the French equivalent of earnings and profits out of which dividend distributions are made.

31 Code §351(g).

32 Code §358(a)(2).

3. The parents gift bare ownership of the shares of nonqualified preferred stock and common stock to their children, including the U.S. child. For U.S. tax purposes, the basis in the bare ownership of the common shares and the basis in the bare ownership of the nonqualified preferred shares are determined pursuant to actuarial tables set forth under Treas. Reg. §20.2031-7.[33] The balance of the basis is allocated to the *usufruct* interest.

At the completion of step 3, the opportunity to obtain a further tax-free step-up in basis for the U.S. child is unlikely.

> ***"If a non-U.S. corporation is a P.F.I.C., a U.S. shareholder will be subject to special tax treatment for excess distributions received from the P.F.I.C."***

P.F.I.C. ISSUES AFTER BASIS STEP-UP

Foreign Entity as a P.F.I.C.

Once the basis has been stepped up by reason of the asset transfer and the gift of bare ownership, the U.S. focus must be redirected to the character of the newly formed entity. If the assets of the entity are investment assets and the sole U.S. child's bare legal title (or that of all the U.S. children in the aggregate) does not amount to more than 50%, by vote or value, of the entity, the entity may be a passive foreign investment company ("P.F.I.C."). In broad terms, a P.F.I.C. is a foreign corporation if one of the following tests is satisfied:

- 75% or more of the non-U.S. corporation's gross income for the taxable year is passive income
- 50% or more of the value of the non-U.S. corporation's assets are of a kind that generate passive income[34]

Passive income is defined as income that would be considered foreign personal holding company income ("F.P.H.C.I.") under Code §954(c). Cash and assets that can be readily converted into cash, including the working capital of an active business, are considered passive assets.

Excess Distribution Regime

If a non-U.S. corporation is a P.F.I.C., a U.S. shareholder will be subject to special tax treatment for excess distributions received from the P.F.I.C. A distribution is an excess distribution if it exceeds 125% of the average of the distributions received in the three preceding taxable years. All gains recognized from the direct or indirect disposition of P.F.I.C. stock are treated as excess distributions.[35]

The "excess distribution" is taxed as follows:

- The excess distribution is allocated to each day in the holding period of the shares.
- To the extent that the excess distribution is allocated to a prior year when the non-U.S. corporation was a P.F.I.C., the distribution is taxed at the highest ordinary income tax rate in effect for that year.

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[33] See, for instance, P.L.R. 7101070280A.

[34] Code §1297.

[35] Code §§1291(a)(2), 1291(b)

- The tax for such earlier P.F.I.C. years is deemed to be paid late and late payment interest is imposed.
- An excess distribution that is allocated to a pre-P.F.I.C. year is taxed at ordinary income rates, not the favorable rates for qualified dividends or capital gains.

A U.S. investor must report the tax on Form 8621, *Information Return by a Shareholder of a Passive Non-U.S. Investment Company or Qualified Electing Fund*. The form must be filed even if no excess distribution is received. This alerts the I.R.S. that the taxpayer is a direct or indirect shareholder of a P.F.I.C.

Qualified Electing Fund Regime

Instead of the excess distribution regime, a U.S. investor in a P.F.I.C. may make a qualified electing fund ("Q.E.F.") election for the P.F.I.C. shares. If this election is made, the U.S. investor includes a *pro rata* share of the P.F.I.C.'s ordinary income and net capital gain in gross income each year.[36] In addition, the shares of a Q.E.F. may be sold and favorable long-term capital gain treatment is allowed so long as the Q.E.F. election was in effect from the first year in which it was a P.F.I.C. A Q.E.F. election can be made only if the P.F.I.C. agrees to timely provide sufficient information to the U.S. owner to compute its tax under the flow-through regime applicable to a Q.E.F. Without the company's cooperation, the election is not valid.

A U.S. investor may elect to defer the U.S. tax that is imposed under the Q.E.F. regime.[37] Interest accrues on the deferred liability.[38] The investor is treated as if an amount equal to the deferred tax were borrowed to pay the tax. Seen in this light, the interest charge under the Q.E.F. regime more accurately tracks the benefit of deferral than the excess distribution regime. This is especially the case for investments in low dividend, high gain P.F.I.C. shares. The excess distribution regime allocates that gain to every day in the holding period, which has the effect of de-linking the interest charge from the actual deferral of tax.

"Consideration should be given to making a Q.E.F. election to avoid the penalty taxes of the excess distribution regime that accompany P.F.I.C. status."

If a Q.E.F. election is made after the first year of ownership or immediately after a purging election, the election will not prevent the excess distribution rules from applying to a gain from the disposition of shares of the Q.E.F.

Path Forward for U.S. Bare Owners of P.F.I.C.'s

Consideration should be given to making a Q.E.F. election to avoid the penalty taxes of the excess distribution regime that accompany P.F.I.C. status. Because the Q.E.F. election will allow the income to pass through to shareholders, and a reasonable argument can be made that investment income passes through to the parents who own the *usufruct* interest, investment income of the entity should not be a problem for the U.S. child. However, because gains pass through to the holders of the bare legal title, the U.S. child may be taxed on the *pro rata* share of capital gains that are allocated to that child. At that point, income tax will be due and basis will be increased in the Q.E.F., or an election can be made by the U.S. child to defer the tax owed with regard to his share of the gain. Interest accrues on the deferred tax.

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[36] Code §1293(a).

[37] Code §1294(a)(1).

[38] Code §1294(g).

Entities that Avoid P.F.I.C. Status

If the assets owned by the parents consist principally of shares of an operating company and those shares represent an interest of at least 25% in the operating company, the P.F.I.C. issue should not be applicable. In applying the passive ownership and income tests, a look-thru rule is applied. If a non-U.S. corporation owns 25% or more of a lower-tier corporation, the shares in that corporation are ignored. The non-U.S. corporation is deemed to own its *pro rata* share of the assets of the lower-tier corporation, and the non-U.S. corporation is deemed to receive its *pro rata* share of that corporation's income for purposes of categorizing the non-U.S. corporation.[39] In this manner, the subsidiary's income and assets are "blended" with those of the non-U.S. corporation to determine whether the latter is a P.F.I.C.

CONCLUSION

The separation of property rights between bare legal title and *usufruct* interests makes enormous sense for a family that has no children residing in the U.S. Inheritance tax can be reduced substantially based on the age of the older generation at the time of the gift of bare legal title. However, difficult issues are faced in the U.S. when the property is a highly-appreciated asset. More importantly, where the separation of property rights has been followed through several generations, the appreciation may be measured as the growth in value from the original acquisition cost by the family member who first acquired the asset several generations earlier.

This article has proposed a method to bring the cost basis of assets up to the fair market value at the time that the property is owned by foreign parents. While this may effectively address all prior appreciation across the ages, it comes at a cost. P.F.I.C. rules may apply to the U.S. child in the next generation. For this individual, the Q.E.F. regime may be the best available answer.

[39] Code §1297(c).

E.U. DATA PROTECTION AND THE FIGHT AGAINST TAX EVASION: A DELICATE BALANCE

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INTRODUCTION

In recent years, the tax world has seen an important shift in global policies, with an emphasis on tax transparency and exchange of information. It is well known that recent tax legislation, such as the U.S. Foreign Account Tax Compliance Act ("F.A.T.C.A.") and the more European-driven B.E.P.S. Action Plan, has played an active part in this shift. What is less often addressed is how the shift has indirectly resulted from other non-tax-driven legislation, including anti-money laundering provisions and legislation enacted to fight terrorism. These measures often have a far broader scope than more limited tax-driven legislation.

The question then becomes whether non-tax-driven measures enacted to achieve tax transparency do not infringe on other rights, such as data protection or the European fundamental human right to privacy. This can be particularly critical in countries in which the sharing of personal data may not only result in an infringement of one's private life but in actual security threats to that person's life.

This article, while not aiming to provide a qualitative evaluation of the global policy shift, examines the E.U.'s non-fiscally-driven approach to tax transparency, including the consequences of the legislation with respect to individuals and, more precisely, the legal limits of such transparency.

TAX-DRIVEN EXCHANGE OF INFORMATION AND DATA PROTECTION UNDER E.U. LAW

On the European side of the Atlantic, personal data can only be gathered under strict requirements and for a legitimate purpose.[1] E.U. Member States that collect and manage personal information must assure the protection of certain fundamental rights by, *inter alia*, protecting the data so collected from misuse.

Directive 95/46/E.C.[2] (the "Data Protection Directive"), as currently in effect, constitutes the current European keystone in terms of personal data protection.[3] It seeks

1 "Protection of Personal Data," European Commission, last modified November 24, 2016.

2 Directive 95/46/E.C. on the Protection of Individuals with Regard to the Processing of Personal Data and on the Free Movement of Such Data, dated October 24, 1995.

3 The new E.U. data protection framework, in the form of the General Data Protection Regulation ("G.D.P.R.") (Regulation (E.U.) 2016/679), has been adopted and is directly applicable in all Member States without the need for implementing national legislation (Article 99 of Regulation 2016/679). The G.D.P.R entered into force on May 24, 2016, and shall apply as of May 25, 2018. Directive

to balance the protection of individual privacy and the free movement of personal data within the E.U. Essentially, the Data Protection Directive establishes limits on the collection and use of personal data and requires that every Member State set up an independent national body in charge of the supervision of any activity relating to personal data processing.

The content of Article 8 of the European Convention on Human Rights[4] (the "E.U. Charter") is incorporated into the Data Protection Directive. As a result, the Data Protection Directive guarantees an individual's right to privacy of his or her (i) personal and family life, (ii) home, and (iii) personal correspondence.

For purposes of the Data Protection Directive, personal data is defined as:

> [A]ny information relating to an identified or identifiable natural person; an identifiable person is one who can be identified, directly or indirectly, in particular by reference to an identification number or to one or more factors specific to his physical, physiological, mental, economic, cultural or social identity.[5]

"The Data Protection Directive establishes limits on the collection and use of personal data and requires that every Member State set up an independent national body in charge of the supervision of any activity relating to personal data processing."

Unrelated to these data privacy concerns, Directive 2011/16/E.U.,[6] as amended by Directive 2016/881/E.U.,[7] (together the "Administrative Cooperation Directive"), provides for administrative cooperation in the field of direct taxation. In order to achieve administrative cooperation, Member States must share "foreseeably relevant" information regarding direct taxes.[8] A Member State must exchange information upon request of the competent authority of another Member State.[9]

Both the E.U., through its Administrative Cooperation Directive, and the O.E.C.D., through its explanatory memorandum to Article 26 of the O.E.C.D. Tax Model Treaty[10] use the following broad phrasing when defining the key concept of "foreseeable relevance:"

> The standard of 'foreseeable relevance' is intended to provide for exchange of information in tax matters to the widest possible extent and, at the same time, to clarify that Contracting States [or Member

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95/46/EC is repealed with effect from May 26, 2018. In addition, since the G.D.P.R. does not apply to the processing of personal data in the course of activities in the areas of judicial cooperation in criminal matters and police cooperation, the E.U. Commission also adopted Directive 2016/680/E.U. on the processing of personal data by competent authorities for the purposes of the prevention, investigation, detection or prosecution of criminal offences, or execution of criminal penalties, dated April 27, 2016.

4 Charter of Fundamental Rights of the European Union, December 18, 2000.

5 Article 2 of Directive 95/46/E.C.

6 Directive 2011/16/E.U. on administrative cooperation in the field of taxation and repealing Directive 77/799/E.E.C, dated February 15, 2011.

7 Directive 2016/881/E.U. amending Directive 2011/16/E.U. as regards mandatory automatic exchange of information in the field of taxation, dated May 25, 2016.

8 Article 1 sec. 1 and Article 2 sec. 2 of Directive 2011/16/E.U.

9 *Id.*, Article 5.

10 O.E.C.D., *Update to Article 26 of the O.E.C.D. Model Tax Convention and Its Commentary*, (Paris: O.E.C.D. Publishing, 2012).

> States] are not at liberty to engage in 'fishing expeditions' or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer.[11]

This broadly drafted requirement of foreseeability for tax purposes, both at the E.U. and O.E.C.D. levels presents a potential violation of an individual's European privacy rights when examined in the data protection context.

Furthermore, the O.E.C.D. commentary on the Tax Model Treaty[12] adds an additional broad requirement to the one regarding foreseeable relevance. The O.E.C.D. comments provide that an information request can only be made if a "reasonable possibility" exists that the information will be relevant.[13] To assure that the exchange be efficient, the memorandum provides that:

> [O]nce the requesting State has provided an explanation as to the foreseeable relevance of the requested information, the requested State may not decline a request or withhold requested information because it believes that the information lacks relevance to the underlying investigation or examination.
>
> Where the requested State becomes aware of facts that call into question whether part of the information requested is foreseeably relevant, the competent authorities should consult and the requested State may ask the requesting State to clarify foreseeable relevance in the light of those facts. At the same time, paragraph 1 does not obligate the requested State to provide information in response to requests that are 'fishing expeditions', *i.e.* speculative requests that have no apparent nexus to an open inquiry or investigation.

PERSONAL DATA PROTECTION AND THE RIGHT TO AN EFFECTIVE JUDICIAL REMEDY

The E.U. Charter, legally binding since the entry into force of the Treaty of Lisbon in December 2009, enshrines in E.U. law a range of personal, civil, political, economic and social rights of E.U. citizens and residents, commonly shared by European countries.[14]

Article 47 of the E.U. Charter provides for the right to an effective judicial remedy against violations of an individual's fundamental rights, such that "everyone whose rights and freedoms guaranteed by the law of the [European] Union are violated has the right to an effective remedy before a tribunal in compliance with the conditions laid down in this Article."

Exchange of Information Among Member States

Berlioz Investment Fund SA v. Directeur de l'administration des Contributions

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11 *Id.*, para. 5; Whereas (9) of Directive 2011/16/E.U.

12 *Id.*

13 *Id.*

14 European Parliamentary Research Service, *The Role of the Charter after the Lisbon Treaty*, (2015), p. 10.

directes,[15] illustrates how article 47 of the E.U. Charter can be used by taxpayers to protect their fundamental rights. In this case, a French subsidiary, Cofima S.A.S., paid a dividend free of French withholding tax to its Luxembourg parent company, Berlioz Investment Fund ("B.I.F."). Based on the Administration Cooperative Directive, the French tax authorities requested their Luxembourg counterpart to collect information from the parent company in order to determine whether French tax law requirements granting the claimed exemption from withholding tax were met. B.I.F. provided all requested documentation except the names and addresses of the shareholders and the percentages and amounts of share capital held by each shareholder. In response, the Luxembourg tax authorities charged a penalty of €250,000 for failing to cooperate under Article 5(1) of the domestic law transposing the Administration Cooperative Directive.[16]

B.I.F. appealed the authorities' decision to the Administrative Tribunal of Luxembourg, which reduced the fine to €150,000. This decision did not address the substance of the Luxembourg company's complaint about the application of E.U. law, nor whether the information sought by the French authorities was relevant to their investigation. B.I.F. appealed this decision to the Administrative Court of Luxembourg claiming that the requested information was not foreseeably relevant and constituted a breach of its right to an effective judicial remedy guaranteed by the E.U. Charter. The court refused to determine whether the information order was well founded and requested a preliminary ruling from the E.C.J.

In a related opinion,[17] Advocate General Wathelet reached the following conclusion:

- A Member State's national legislation providing for penalties in the event individuals refuse to communicate information requested by application of the Administration Cooperative Directive, definitely entails the application of E.U. law, and consequently the E.U. Charter.
- Article 47 of the E.U. Charter is enforceable when the penalty is based on a request that may be unlawful.
- The foreseeable relevance of the information is a necessary requirement, which the requesting Member State must meet in order for the requested Member State to honor the request.

From the advocate general's opinion, it can be understood that the foreseeable relevance of the requested information must be demonstrated prior to the information request, as it "is a condition which the request for information must satisfy in order for the requested Member State to be required to comply with it."[18]

Domestic Recourse

One internal mechanism available to taxpayers whose personal information is at risk

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15 *Berlioz Investment Fund SA v. Directeur de l'administration des Contributions directes*, Case C-682/15.

16 The Law of 25 November 2014 "Laying Down the Procedure Applicable to the Exchange of Information on Request in Tax Matters and Amending the Law of 31 March 2010 Approving the Tax Conventions and Laying Down the Procedure Applicable Thereto in Relation to the Exchange of Information on Request."

17 Opinion of Advocate General Wathelet, delivered on January 10, 2017.

18 *Id.*

of being exchanged is to request that a domestic judge rule on the matter prior to the information being delivered to the requesting Member State. To ensure the effective and uniform application of E.U. law across the Member States, domestic courts may then refer the matter to the European Court of Justice ("E.C.J.") to clarify how the relevant E.U. law must be interpreted.

Another protective mechanism for individuals is available under Article 17 of the Administrative Cooperation Directive, which states the following:

> A requested authority in one Member State shall provide a requesting authority in another Member State with the information referred to in Article 5 [*i.e.*, information that is foreseeably relevant] provided that the requesting authority has exhausted the usual sources of information which it could have used in the circumstances for obtaining the information requested, without running the risk of jeopardising the achievement of its objectives.

Under this second safeguard, if the taxpayer shows that the requesting Member State had internal means for collecting the information sought in a particular context, the request can be challenged in front of domestic courts.[19]

NON-TAX-DRIVEN EXCHANGE OF INFORMATION AND THE PROPORTIONALITY PRINCIPLE

The European "proportionality principle" is intended to create an acceptable balance between the greater public interest and an individual's fundamental rights. As a result, legislation driven by the fight against terrorism, or the fight against money laundering, justify a violation of fundamental rights to a higher degree than legislation enacted to fight against tax evasion.

<u>The Proportionality Principle</u>

Article 52(1) of the E.U. Charter states that:

> Any limitation on the exercise of the rights and freedoms recognized by this Charter must be provided for by law and respect the essence of those rights and freedoms. Subject to the principle of proportionality, limitations may be made only if they are necessary and genuinely meet objectives of general interest recognized by the Union or the need to protect the rights and freedoms of others.

According to the E.C.J., only measures limiting the most serious crimes may restrict the fundamental right to privacy.[20] Since individuals do not have an absolute right to privacy, the courts are prompted to examine whether the violation is proportionate

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[19] The effective application of E.U. law is not only ensured by the E.U. courts; it also depends upon domestic courts and individuals to initiate proceedings in order to enforce individual rights under E.U. law. In its decision in *Costa v. Enel* in 1964, the E.C.J. ruled that E.U. law must be applied and protected by the domestic judge because it has direct effect if it is sufficiently clear and unconditional. See also E.C.R., *Van Gend & Loos* [1963], Case 26/62.

[20] E.C.J., *Al-Aqsa v. Netherlands*, November 15, 2012, C-539/10 (fight against terrorism).

and, thus, justifies a breach of fundamental rights.

In the *Digital Rights Ireland* case, the E.C.J. underlined that objectives of general interest, such as the fight against international terrorism and serious crime, are acceptable hampers to fundamental rights, if they respect the principle of proportionality.[21]

"The E.C.J. underlined that objectives of general interest, such as the fight against international terrorism and serious crime, are acceptable hampers to fundamental rights, if they respect the principle of proportionality."

Non-Tax-Driven Legislation

While recent E.U. Commission initiatives seek to refocus attention on tax evasion, the Anti-Money Laundering Directive[22] (the "A.M.L. Directive") and Directive 2009/101/E.C. were initially directed at fighting money laundering practices and the financing of terrorism through the use of illegal financial channels. Financial scandals, including the *Panama Papers* scandal, have shed yet a new light on tax avoidance and have incited the E.U. Commission to propose amendments to these directives (the "Proposed Amendments"), laying out new tools to enhance transparency in this context.[23]

In relevant part, the Proposed Amendments give Member States the choice to grant tax authorities and the public broader access to beneficial ownership information of trusts and similar legal structures. Member States, in transposing the finalized proposal, could allow every person "with a legitimate interest" to access such data.

While fighting terrorism and money laundering are goals that contain a strong justification for violating certain privacy rights, the balance between anti-tax-evasion measures and an individual's fundamental right to privacy is not always clear. As a result, when anti-tax-evasion measures are provided for by legislation that is not tax driven, the rights to data protection and privacy are at risk of being violated.[24]

Legislative Safeguards

When E.U. institutions draw up measures that relate to the processing of personal data, the E.U. Commission must submit those measures to the European Data Protection Supervisor ("E.D.P.S.") for consultation.[25] The E.D.P.S.'s recommendations are generally presented in E.U. Parliamentary Committees and relevant working groups, where they are used to improve the proposed regulations and form part of

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21 E .C.J., *Digital Rights Ireland*, April 8, 2014, Cases C-293/12 and C-594/12.

22 Directive 2015/849/E.U. of the European Parliament and of the Council of 20 May 2015 on the Prevention of the Use of the Financial System for the Purposes of Money Laundering or Terrorist Financing, Amending Regulation No. 648/2012 of the European Parliament and of the Council, and Repealing Directive 2005/60/E.C.

23 Proposal for a Directive of the European Parliament and of the Council Amending Directive 2015/849/E.U. on the Prevention of the Use of the Financial System for the Purposes of Money Laundering or Terrorist Financing and Amending Directive 2009/101/E.C., C.O.M./2016/0450 final.

24 Article 7 states that "everyone has the right to respect for his or her private and family life, home and communications," and Article 8.1 states that "everyone has the right to the protection of personal data concerning him or her."

25 Article 28(2) of Regulation No. 45/2001 on the Protection of individuals with regard to the processing of personal data by the Community institutions and bodies and on the free movement of such data, dated December 18, 2000.

the overall legislative process.[26]

In a response opinion,[27] the E.D.P.S. analyzed the Proposed Amendments. More precisely, it focused on their impact on fundamental rights to privacy and data protection by highlighting that the data transfers must serve a well identified purpose (as opposed to "a legitimate interest") and that the principle of proportionality must guide any limitation to the fundamental rights to privacy and data protection. More precisely, the E.D.P.S. concluded that:

- . . . [A]ny processing of personal data [must] serve a legitimate, specific and well identified purpose and be linked to it by necessity and proportionality. The data controller performing personal data processing shall be identified and accountable for the compliance with data protection rules.
- . . . [A]ny limitation on the exercise of the fundamental rights to privacy and data protection [must] be provided for by law, [must] respect their essence and, subject to the principle of proportionality, [must be] enacted only if necessary to achieve objectives of general interest recognised by the Union or the need to protect the rights and freedoms of others.
- . . . [A] proper assessment of the proportionality of the policy measures proposed in relation to the purposes sought [must be carried out], as emergency-based measures that are acceptable to tackle the risk of terrorist attacks might result excessive when applied to prevent the risk of tax evasion.
- . . . [S]afeguards [must be maintained] that would have granted a certain degree of proportionality (for example, in setting the conditions for access to information on financial transactions by FIUs).
- . . . [A]ccess to beneficial ownership information [must be designed] in compliance with the principle of proportionality, *inter alia*, ensuring access only to entities who are in charge of enforcing the law.[28]

The E.U. Commission will provide information to the E.D.P.S. on the implementation of the recommendations made in the opinion.[29]

CONCLUSION

Transparency has certainly become the norm in today's tax world. However, when implemented to the extreme, these measures can have an adverse effect on an individual's privacy. In a world were sharing personal data may not only result in an infringement of one's rights but in an actual threat to one's safety, the need for tax transparency most certainly reaches its limit. Fortunately, for individuals in Europe several remedies are available, such as under E.U. law, to address privacy violations.

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26 "Data Protection," E.D.P.S.

27 E.D.P.S., "EDPS Opinion on a Commission Proposal amending Directive 2015/849/EU and Directive 2009/101/EC, Access to Beneficial Ownership and Data Protection Implications," February 2, 2017.

28 *Id.*

29 Article 25(2) of the Decision of the European Data Protection Supervisor on the adoption of Rules of Procedure, dated December 17, 2012.

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