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INSIGHTS

GERMANY – ANTI-TREATY SHOPPING RULE INFRINGES ON E.U. LAW

HYBRID MISMATCHES: WHERE U.S. TAX LAW AND A.T.A.D. MEET

OPPORTUNITY ZONE TAX BENEFIT – HOW DOES IT WORK AND CAN FOREIGN INVESTORS BENEFIT?

AND MORE

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EDITORS' NOTE

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

- **German Anti-Treaty Shopping Rule Infringes on E.U. Law.** When do attacks on cross-border tax planning move from enough to too much? The European Court of Justice ("E.C.J.") provided an answer in connection with German tax rules limiting access to the E.U. Parent Subsidiary Directive for dividends leaving Germany. For many years, German law provided an irrebuttable presumption of fraudulent or abusive tax planning when a multinational structure failed to meet a "one size fits all" set of factual parameters. The provision was struck down by the E.C.J. last year, modified slightly in response, and struck down again in June of this year. Pia Dorfmueller of P+P Pollath explains why the German tax law was found to violate European law – it provided a response that was not proportional to the alleged wrong-doing.

- **Hybrid Mismatches: Where U.S. Tax Law and A.T.A.D. Meet.** When U.S. tax planners attend foreign conferences, it is not uncommon to hear pointed barbs that the U.S. is an outlier when it comes to rules enforcing "best practices" on global business transactions. However, when it comes to reverse hybrids and hybrid mismatches, the rules are not all that different on both sides of the Atlantic. Fanny Karaman and Beate Erwin compare approaches taken by A.T.A.D. 2 with U.S. tax law after the Tax Cuts and Jobs Act.

- **Opportunity Zone Tax Benefit – How Does It Work and Can Foreign Investors Benefit?** State Aid to entice investment and development in a specific region is bad in Europe but encouraged in the U.S. The Tax Cuts and Jobs Act added an important new provision that is expected to unlock unrealized gains and defer the tax on the gain when it is invested in active operating businesses in distressed areas designated as "Opportunity Zones." The tax is deferred until the targeted investment is sold, or until 2026 at the latest. A progressive partial step-up in basis is also granted if the investment is held for a minimum of five years. The entire appreciation in value of the new targeted investment is excluded from tax if held for ten years. In a plain English primer, Galia Antebi and Nina Krauthamer explain the concept and the necessary implementation steps and consider whether the new provision can eliminate F.I.R.P.T.A. tax for foreign investors.

- **F.A.T.C.A. – Where Do We Stand Today?** When F.A.T.C.A. was adopted in 2010, the hoopla from the U.S. Senate promoted the idea that the I.R.S. would become invincible in rooting out recalcitrant Americans not wanting to pay tax and the financial institutions willing to assist them. In principle, information in U.S. tax returns could be compared with F.A.T.C.A. reporting by foreign financial institutions to identify which taxpayers remained offside and which banks had insufficient reporting systems. A recent report by the Treasury Inspector General for Tax Administration ("T.I.G.T.A.") concluded that after spending nearly $380 million, the I.R.S. is still not prepared to enforce F.A.T.C.A. compliance. In their article, Rusudan Shervashidze and Nina Krauthamer summarize the principal shortfalls and possible solutions identified by T.I.G.T.A. and which suggested action plans the I.R.S. will contemplate.

- **Tax Considerations of I.P. When Expanding a Business Offshore.** If a client asks a U.S. tax adviser about the U.S. tax cost of contributing intangible property ("I.P.") to a foreign corporation for use in an active business, the response can be a dizzying array of bad tax consequences beginning with a deemed sale in a transaction that results in an ongoing income stream. While that is a correct answer, it need not be the only answer. Elizabeth V. Zanet and Stanley C. Ruchelman explore alternatives to a capital contribution of I.P. to a foreign corporation, including (i) the use of a foreign hybrid entity and (ii) licensing the I.P. to a foreign entity in order to benefit from the F.D.I.I. tax deduction. Each alternative may provide interesting tax results, but attention to detail will be required.

- **O.E.C.D. Discussion Draft on Financial Transactions – A Listing of Sins, Little Practical Guidance.** In July, the O.E.C.D. Centre for Tax Policy and Administration released Public Discussion Draft on B.E.P.S. Actions 8-10: Financial transactions (the "Discussion Draft") addressing financial transactions (*e.g.*, loans, guarantees, cash pools, captive insurance, and hedging). Michael Peggs and Scott R. Robson review the draft guidance and express disappointment. The Discussion Draft is not a thought leader, as tax authorities have successfully litigated the issues inherent in intercompany loans. Decided cases generally reflect a "not in my back yard" approach to deductions for interest expense. The Discussion Draft makes statements regarding allocation of risks in financial transactions that are inconsistent with arm's length evidence. It also promotes decisions based on 20-20 hindsight. All these lead to several unanswered questions: What is the ultimate meaning of the term "arm's length" when used in a cross-border financial transaction? Is it the terms and conditions that exist in actuality among lenders and borrowers, or is it the terms and conditions that should exist in the mindset of the tax authorities?

- **Updates and Other Tidbits.** This month, Rusudan Shervashidze, Neha Rastogi, and Nina Krauthamer look at several interesting updates and tidbits, including (i) potential tax reasons for Cristiano Ronaldo's move to Italy, (ii) a law suit brought by high-tax states against the U.S. Federal government in connection with the T.C.J.A. limitations on deductions for state and local taxes, (iii) the finding of the European Commission that the aid given to McDonalds by the Luxembourg government did not constitute illegal State Aid, and (iv) a successful F.A.T.C.A. prosecution against a former executive of Loyal Bank Ltd.

- The Editors

GERMAN ANTI-TREATY SHOPPING RULE INFRINGES ON E.U. LAW

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Tags
Germany
Tax Refund
Tax Treaties
Treaty Abuse

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INTRODUCTION

On June 14, 2018, the European Court of Justice ("E.C.J.") ruled on the compatibility of the current version of the German anti-treaty and anti-directive shopping rule, section 50d paragraph 3 German Income Tax Act ("I.T.A.") 2012, with E.U. law, in particular the E.U. Parent Subsidiary Directive ("E.U. P.S.D."). German national law was found to be incompatible with those provisions of E.U. law.

The ruling marks the end of a saga that began on December 20, 2017, when the court rejected the 2007 version of German national law, section 50d paragraph 3 I.T.A. 2007. This article outlines developments beginning with the E.C.J.'s December 2017 ruling in companion cases involving Deister Holding and Juhler Holding, proceeding to the German Federal Ministry of Finance's response, and concluding with the June 2018 ruling in the GS case. Steps for foreign parent companies inside and outside the E.U. are suggested, as well.

DECEMBER 20, 2017: *DEISTER HOLDING* AND *JUHLER HOLDING* RULING

Facts and Background

The appellants, Deister Holding (formerly Traxx Investments) and Juhler Holding,[1] were both companies registered in E.U. countries. Deister was resident in the Netherlands and Juhler was resident in Denmark. Each that held shares in companies resident in Germany for tax purposes. Deister Holding held a 26.5% or greater interest in several German companies. Its only shareholder was a person who was tax resident in Germany. Juhler Holding held up to a 90% interest in 25 German companies and also maintained a property portfolio. Its only shareholder was a company registered in Cyprus, whose only shareholder was, in turn, an individual tax resident in Singapore.

The German tax authorities refused to grant refunds to Deister Holding and Juhler Holding for withholding taxes paid on dividends received from their respective German subsidiaries, as both ran afoul of the conditions of section 50d paragraph 3 I.T.A. 2007. That rule stated that withholding tax relief will not to be granted in the following combined circumstances:

- Person(s) holding ownership interests in the foreign parent company would not be entitled to the refund or exemption if they derived the income directly.

[1] *Deister Holding A.G. & Juhler Holding A./S. v. Bundeszentralamt für Steuern,* Joined Cases, C-504/16 & C-613/16, [2017] E.C.J.

- Any one of the following three conditions exists:
  - **Intent**: There are no economic or other valid reasons for the interposition of the foreign parent company.
  - **Business Activity**: The foreign company does not earn more than 10% of its gross income from its own business activity.
  - **Business Premises**: The foreign company does not take part in the general economic commerce via a suitably equipped business establishment.

Section 50d paragraph 3 I.T.A. 2007 does not apply to a foreign parent company having its principal class of stock regularly traded in substantial volume on a recognized stock exchange. Similarly, it does not apply to a foreign company that qualifies as an investment corporation within the meaning of the Investment Tax Act.

Both Deister Holding and Juhler Holding filed appeals in the Cologne Tax Court. The Cologne Tax Court then asked the E.C.J. whether section 50d paragraph 3 I.T.A. 2007 infringes on the E.U. P.S.D. and/or the E.U. fundamental freedoms, namely the free movement of capital or the freedom of establishment.

The E.C.J. Decisions

Regarding the *Deister Holding* (C-504/16) and *Juhler Holding* (C-631/16) cases, the E.C.J. stated that the aim of the E.U. P.S.D. is to provide a level playing field for E.U. and domestic parent companies, thereby facilitating the creation of cross-border groups. This goal requires the elimination of any tax obstacles to cross-border dividend distributions. Therefore, Member States are obliged to provide tax refunds for withholding taxes levied on dividends paid by domestic subsidiaries to their E.U. parents.

The E.U. P.S.D. allows Member States to enact exemptions from this rule where appropriate to combat tax abuse and fraud. However, those exemptions must be in line with the general principles of E.U. law, especially the principle of proportionality. The court further specified that an exemption could be considered proportional only if it solely targets "wholly artificial structures."

Concerning the German rule, the E.C.J. found this requirement was not fulfilled. Instead of requiring the tax authorities to provide at least a *prima facie* indication that a certain structure is fraudulent or abusive, section 50d paragraph 3 I.T.A. 2007 constituted an irrebuttable presumption of fraud or abuse once one of the three generic criteria was met. Moreover, it did not allow the taxpayer to prove on the basis of its unique facts, that its structure was not wholly artificial. Under these circumstances, the E.C.J. declared section 50d paragraph 3 I.T.A. 2007 was not proportional and thereby violated the E.U. P.S.D.

In addition, the court found the principle of freedom of establishment was at issue. Both Deister Holding and Juhler Holding held stakes in German subsidiaries that allowed them to exercise a certain degree of control over their subsidiary's business as opposed to a mere financial investment. The German rule was found to restrict the principle of freedom of establishment, as it discriminated against E.U. parent companies with German subsidiaries when compared to German parent companies.

When setting up a German subsidiary, an E.U. parent company and a domestic parent company would be in the same position at the outset. However, while the latter would always receive tax relief for withholding taxes on dividends paid by domestic subsidiaries, the former would only be granted a relief if it did not fall within the scope of Section 50d paragraph 3 I.T.A. 2007. Therefore, the rule was likely to hinder an E.U. parent company's ability to set up a subsidiary in Germany and thereby constituted a restriction of the principle of freedom of establishment.[2]

APRIL 4, 2018: THE GERMAN FEDERAL MINISTRY OF FINANCE'S CIRCULAR LETTER

In reaction to the E.C.J. decision, the German Federal Ministry of Finance published a circular letter[3] on April 4, 2018, governing the application of Section 50d paragraph 3 I.T.A. 2007 and, its successor clause, Section 50d paragraph 3 I.T.A. 2012 in E.U. P.S.D. cases.

The Ministry ruled that the 2007 rule should no longer be applied in pending E.U. P.S.D. cases. Concerning the 2012 version, the German Ministry of Finance modified its criteria in E.U. P.S.D. cases in order to secure compliance with E.U. law. This time, section 50d paragraph 3 I.T.A. 2012 stated that withholding tax relief will not to be granted in the following combined circumstances:

- Person(s) holding ownership interests in the foreign parent company would not be entitled to the refund or exemption if they derived the income directly.
- The gross earnings of the foreign parent company for the respective fiscal year do not originate from its own business activity.
- One of the following two conditions is met:
    - **Intent**: There are no economic or other valid reasons for the interposition of the foreign parent company.
    - **Business Premises**: The foreign company does not take part in the general economic commerce via a suitably equipped business establishment.

Again, the rule does not apply to a foreign parent company having its principal class of stock regularly traded in substantial volume on a recognized stock exchange. Similarly, it does not apply to a foreign company that qualifies as an investment corporation within the meaning of the Investment Tax Act.

According to the circular, a less rigid standard would be applied when determining whether relief would be granted. As a result

- economic or other substantial reasons for the interposition of the parent company could now also be found in the context of group strategy or group structure;

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2 The court further considered, but later denied, a justification of this restriction along the line of arguments already given in regard to the E.U. P.S.D.

3 German Federal Ministry of Finance (*Bundesfinanzministerium*, B.M.F.), B.M.F. IV B 3 – S 2411/07/10016-14, circular letter of April 4, 2018.

- the holding of shares in other companies can be considered participation in economic commerce, as long as shareholder rights are actively exercised; and
- the parent company would no longer be required to permanently employ staff to establish an appropriate business presence.

The circular letter was received with skepticism from the tax community. Several commentators doubted that the circular was enough to ensure Germany's compliance with E.U. law. Despite the modifications, Section 50d paragraph 3 I.T.A. 2012 struggled to meet several stipulations in the *Deister Holding* and *Juhler Holding* case. The most striking of its shortcomings pertained to the methodology for determining abusive structures, which continued to follow general criteria and not case-by-case facts and circumstances. Additionally, Section 50d paragraph 3 I.T.A. 2007 was only suspended for E.U. P.S.D. cases. The fundamental freedoms could continue to be violated in cases outside the scope of the E.U. P.S.D. Examples include a refusal of tax relief on grounds of a double tax treaty with an E.U. Member State or a non-E.U. country with a most-favored-nation clause.

"The approach taken in the past must be modified so that a 'one-size-fits-all' approach based on concerns over abusive tax planning is abandoned in favor of a facts and circumstances approach."

Moreover, the circular did not address royalties and interest paid by domestic subsidiaries to their E.U. parents, which also are exempt from tax according to E.U. directives but may fall under the scope of Section 50d paragraph 3 I.T.A. 2012. Hence, it was widely believed that the amended view of the Ministry of Finance on the 2012 version would not achieve compliance with the E.C.J. ruling in *Deister Holding* and *Juhler Holding*.

JUNE 18, 2018: E.C.J. RULING ON *GS*

Facts and Background

In many ways, the *GS* case (C-440/17)[4] resembles *Deister Holding* and *Juhler Holding*. GS was a holding company registered in the Netherlands. It held stakes in several subsidiaries in different jurisdictions – among those, a 90%-stake in a company tax resident in Germany. GS's sole shareholder was an individual tax resident in Germany. Apart from administering its shares, GS mainly purchased raw materials, resold them to its subsidiaries, and provided loans to its subsidiaries. For these purposes, GS had three employees in the Netherlands.

The German tax authorities refused to grant GS relief from withholding tax on dividends paid by its German subsidiary on the grounds of Section 50d paragraph 3 I.T.A. 2012. GS appealed this decision to the Cologne Tax Court, who in turn again referred the case to the E.C.J.

The E.C.J. Decision

The E.C.J. mainly relied upon the arguments already given in the *Deister Holding* and *Juhler Holding* ruling. The E.C.J. stated that Section 50d paragraph 3 I.T.A. 2012, as well as its predecessor rule, contravened the E.U. P.S.D. and restricted E.U. fundamental freedoms. Following the argumentation in *Deister Holding* and *Juhler Holding*, the court stated that a restriction of the E.U. P.S.D. and the fundamental freedoms could only be proportional, and therefore justifiable, if only

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[4] *GS v. Bundeszentralamt für Steuern*, C-440/17, [2018], E.C.J.

"wholly artificial structures" fell within scope of the rule.

In the view of the court, Section 50d paragraph 3 I.T.A. 2012 constituted an irrebuttable assumption of fraud and abuse once the generic criteria were fulfilled. It did not allow taxpayers to prove on a case-by-case basis that the respective structure was not wholly artificial. Therefore, the E.C.J. again held the German rule to be disproportionate, in accordance with the *Deister Holding* and *Juhler Holding* ruling. Consequently, Section 50d paragraph 3 I.T.A. 2012 was found to be noncompliant with the E.U. P.S.D. as well as the principle of freedom of establishment.

PATH FORWARD

Foreign Corporate Shareholders May Collect Tax Refunds and Obtain Relief

Both E.U. and non-E.U. parent companies located in a treaty country with a most-favored-nation clause should now be eligible for a withholding tax exemption or tax refund if economic or other valid reasons for the interposition of the foreign parent company exist per the *GS* case. Therefore, it is highly recommended that shareholders apply for a withholding tax refund if tax relief has been refused in past.

Statute of Limitations for Tax Refund

The statute of limitations for filing the refund request is four years from the end of the year in which the dividends were derived. All pending refund requests must be approved by the tax authorities now.

Royalties

The same applies to German-source taxation of royalties and interest, if any.

REACTION TO *GS* PENDING

The German legislature is now required to act. In light of clear rulings by the E.C.J. on the German anti-treaty shopping rule, the approach taken in the past must be modified so that a "one-size-fits-all" approach based on concerns over abusive tax planning is abandoned in favor of a facts and circumstances approach. The Ministry of Finance is expected to repeal the April 4, 2018, circular letter and significantly narrow the scope of the 2017 version or to suspend the provision until modifications are finalized. In addition, it appears likely that the amendment of the anti-treaty and anti-directive shopping rule will be introduced into the 2018 Annual Tax Bill.

HYBRID MISMATCHES: WHERE U.S. TAX LAW AND A.T.A.D. MEET

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Tags
A.T.A.D.
Hybrid Mismatch

This article focuses on the interaction between certain hybrid mismatch provisions of A.T.A.D. 2 and certain provisions of U.S. tax law. As will be shown in later examples, A.T.A.D. 2 can be seen as a concerted E.U. effort to target overseas earnings of U.S. multinationals.

BACKGROUND

European Council Directive 2016/1164 ("A.T.A.D. 1") was adopted on July 12, 2016. It lays out the rules against tax avoidance practices directly affecting the functionality of the E.U.'s internal market.

It contains the following provisions, some of which were inspired by U.S. tax law, while others appear to have inspired the 2017 Tax Cuts and Jobs Act ("T.C.J.A."):

- An interest deduction limitation rule very similar to revised Code §163(j)
- Exit tax provisions that resemble the underlying logic of Code §367
- Controlled Foreign Corporation ("C.F.C.") provisions that resemble U.S. C.F.C. provisions
- Hybrid mismatches arising in transactions involving the corporate tax systems of E.U. Member States[1]

A.T.A.D. 2, adopted on May 29, 2017, entirely replaces the hybrid mismatch rules of A.T.A.D.1.[2] It includes rules on hybrid mismatches with non-E.U. countries, where at least one of the parties involved is a corporate taxpayer, or an entity in an E.U. Member State. This follows a request by the Economic and Financial Affairs Council of the E.U. for "rules consistent and no less effective" than those recommended by the O.E.C.D. under the B.E.P.S. initiative.[3] In addition, A.T.A.D. 2 adds provisions on reverse hybrid mismatches, or imported mismatches, and tax residency mismatches.[4]

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1 A.T.A.D. 1 must be implemented by E.U. Member States by December 31, 2018.

2 Article 9 of A.T.A.D. 2. A.T.A.D. 2 must be implemented by E.U. Member States by December 31, 2019. Only reverse hybrid mismatch rules are subject to an extended deadline for implementation of December 31, 2021.

3 Preamble of A.T.A.D. 2 at (5) with reference to the O.E.C.D. Report on Neutralizing the Effects of Hybrid Mismatch Arrangements, Action 2 — 2015 Final Report ("O.E.C.D. B.E.P.S. Report on Action 2").

4 Article 9a of A.T.A.D. 2.

DEFINITION OF HYBRID MISMATCHES UNDER A.T.A.D. 2

Hybrid mismatches exist in the following situations involving taxpayers or entities:[5]

- **Hybrid Transactions**: Certain payments under financial instruments that give rise to an income deduction in the hands of the payor but no income inclusion in the hands of the payee constitute hybrid mismatches. Payments fall under this category when (i) they are not included in the payee's income within a reasonable timeframe[6] and (ii) the mismatch in treatment is due to differences in the characterization of the payment or the underlying instrument. For this purpose, a financial instrument is defined as any instrument giving rise to either a financing or an equity return subject to tax laws relating to debt, equity, or derivatives under the laws of either the payor's or the payee's jurisdiction.[7]

- **Hybrid Entities**: Payments to hybrid entities that give rise to an income deduction in the hands of the payor and no income inclusion in the hands of the payee constitute a hybrid mismatch where there is a difference in the allocation of the payment between the jurisdiction in which the hybrid entity is established or registered and the jurisdiction of any person holding an interest in such hybrid entity.[8] For purposes of both A.T.A.D. 1 and A.T.A.D. 2, a hybrid entity is defined as an entity or arrangement treated as a taxable entity under the laws of one jurisdiction and whose income or expenses are considered belonging to one or more other persons (entities or individuals) under the laws of another jurisdiction. An example for a hybrid entity falling within the scope of this rule would be an entity treated as a taxpayer under the laws of an E.U. Member State that made an election to be treated as a partnership or a disregarded entity for U.S. income tax purposes.

"A.T.A.D. 2 includes rules on hybrid mismatches with non-E.U. countries, where at least one of the parties involved is a corporate taxpayer, or an entity in an E.U. Member State."

- **Permanent Establishments**: Certain payments to or from permanent establishments give rise to hybrid mismatches.

- **Disregarded Payments**: Deductible payments by hybrid entities that are not included in income by the payee because the payment is disregarded under the laws of the payee's jurisdiction are another form of hybrid mismatch.

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5 Article 2(9) of A.T.A.D. 2.

6 For this purpose, a reasonable timeframe means either (i) an inclusion within 12 months of the end of the payer's tax period or (ii) a reasonable future inclusion expenctancy, when the terms of the payment are arm's length.

7 An exception will apply if these rules would lead to unintended outcomes in the interaction between the hybrid financial instrument rule and the loss-absorbing capacity requirements imposed on banks. Without prejudice to State Aid rules, E.U. Member States should be entitled to exclude from the scope of A.T.A.D. 2 intra-group instruments that have been issued with the sole purpose of meeting the issuer's loss-absorbing capacity requirements and not for the purposes of avoiding tax. Preamble of A.T.A.D. 2 at (17).

8 However, if the payee is treated as a tax-exempt entity under the laws of its country, this rule should not apply since this would result in a hybrid mismatch in any event. The same principle should apply to a deduction without inclusion in the case of payments by disregarded permanent establishments. Preamble of A.T.A.D. 2 at (18) and (19).

Such payments only constitute hybrid mismatches if the jurisdiction of the payor allows the deduction from income that is not included in both the payor's and the payee's hands.

- **Double Deductions**: Certain payments resulting in double deductions constitute hybrid mismatches if the jurisdiction of the payor allows a deduction from income that is not included in both the payor's and the payee's hands.

  For this purpose, a double deduction or a deduction without inclusion does not constitute a hybrid mismatch unless it arises

  - between associated enterprises,
  - between a taxpayer and associated enterprises,
  - between a head office and a permanent establishment,
  - between two or more permanent estabalishments of the same entity, or
  - under a structured arrangement.[9]

  Generally, for hybrid mismatch and reverse mismatch purposes, an associated enterprise is defined as follows:[10]

  - An entity in which the taxpayer has a direct or indirect voting, capital, or profits interest of 50% or more
  - An entity or individual holding a direct or indirect interest by vote, capital ownership, or profits in the taxpayer of 50% or more
  - An entity that is part of a consolidated group for financial accounting purposes
  - An enterprise in which the taxpayer has a significant management influence
  - An enterprise that has a significant management influence in the taxpayer

  Further, for purposes of defining associated enterprises, a person acting with the owner of the voting rights or the capital of an entity is deemed to own all the voting rights or the capital of such owner.

TREATMENT OF HYBRID MISMATCHES UNDER A.T.A.D. 2

The general treatment of hybrid mismatches with respect to payments that involve at least one party based in an E.U. Member State under A.T.A.D. 2 is as follows:

- If a hybrid mismatch results in a double deduction, the state of the recipient

[9] Article 2(9) of A.T.A.D. 2.

[10] Article 2(4) of A.T.A.D. 2.

of the payment must deny the deduction. If the recipient's state does not deny the deduction, the payor's state must deny the deduction. The latter could occur when the recipient's state is not an E.U. Member State, such as the U.S.

- If a hybrid mismatch results in a deduction for the payor with no income inclusion for the recipient, the payor's state must deny the deduction. If the deduction is not denied, the payment must be included in income in the recipient's state. The latter could occur when, for instance, the payor is located in the U.S.
- A state can disallow a deduction for a payment when the payment directly or indirectly funds a deductible expenditure giving rise to a hybrid mismatch through a transaction or series of transactions between certain related parties or entered into as part of a structured arrangement, except to the extent that one of the jurisdictions involved has already made an equivalent adjustment with respect to the hybrid mismatch.

Accordingly, an ordering rule sets forth which state will first make an adjustment, such as a denial of deductbility. A.T.A.D. 2 includes limitations to the scope. More specifically, it makes the following clarifications:

- The adjustment to the mismatch shall be limted to the "extent of the resulting undertaxed amount."[11]
- Any adjustments that are required to be made under A.T.A.D. 2 should, in principle, not affect the allocation of taxing rights between jurisdictions laid down under a double taxation treaty.[12]
- Where mismatches are subject to adjustments under the Directive or neutralized under similar rules, no further adjustments under A.T.A.D. 2 shall be required.[13]

In this context, it will be interesting to see how, once A.T.A.D. 2 becomes effective, the ordering rules will be aligned with these limitations in practice.

TREATMENT OF REVERSE HYBRID MISMATCHES AND U.S. TAX LAW

When (i) one or more nonresident associated enterprises own a direct or indirect 50% interest (by vote, capital, or profits) in a hybrid entity that is incorporated or established in an E.U. Member State and (ii) the nonresident associated entities' jurisdictions treat the hybrid entity as the taxpayer, that E.U. Member State must tax the income of the entity as the income of a resident entity to the extent that the income is not otherwise taxed under the laws of the Member State or any other jurisdiction.

The following constitutes an example of a reverse hybrid mismatch that would fall under A.T.A.D. 2:

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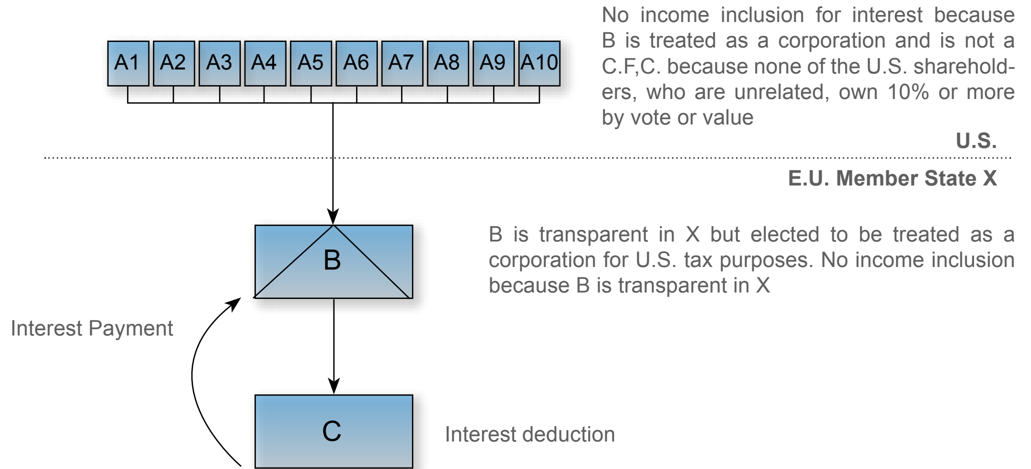
[11] Preamble of the A.T.A.D. 2 at (16).

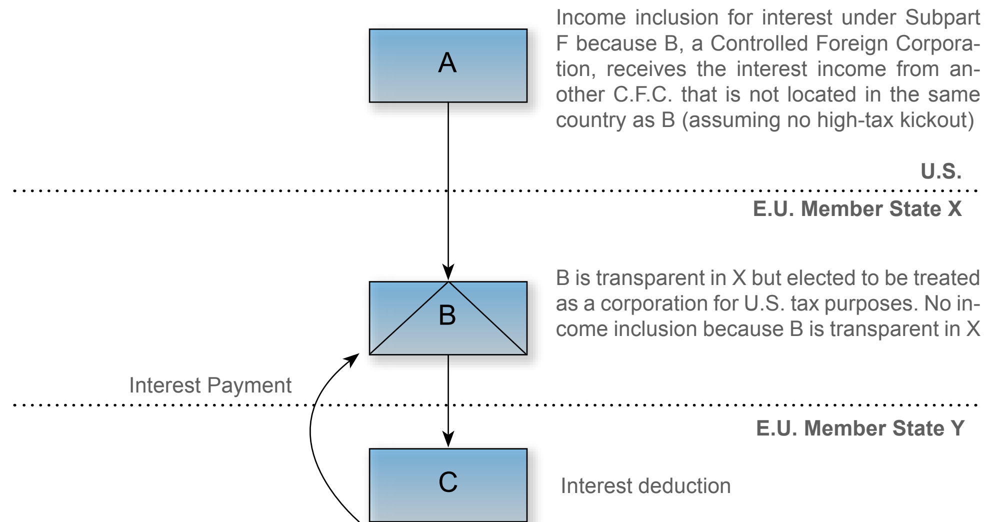
[12] Preamble of the A.T.A.D. 2 at (11).

[13] Preamble of the A.T.A.D. 2 at (29) and (30).



In the above example, E.U. Member State X must tax B's income, since the interest income would not otherwise be included in income by E.U. Member State X nor the U.S.

The following illustration constitutes almost the same scenario but where the interest income is taxed to A under the U.S. C.F.C. regime:[14]

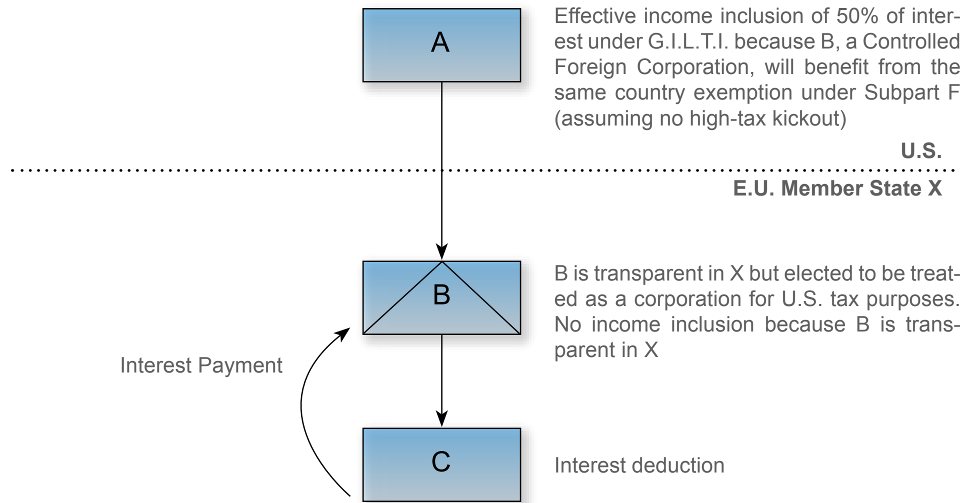


In this scenario, the interest income would be fully included in A's U.S. gross income. Since A.T.A.D. 2 provides that as long as the income is "otherwise taxed under the

[14] Since C is not incorporated in the same E.U. Member State as B, the interest is subject to a Subpart F Income inclusion under the C.F.C. regime in the hands of A. This assumes the exemption from Subpart F inclusion under the high-tax kickout does not apply. The threshold is 90% of U.S. tax, which is 21% for corporations from 2018 onwards, hence 18.9%.

laws of the E.U. Member State or any other jurisdiction," E.U. Member State X would not be required to tax B on the income.

In comparison, if B and C were resident in the same country, the outcome, taking into account the changes under the T.C.J.A., will differ:



Here, B is a C.F.C. owned by A. Thus, A has a yearly income inclusion of B's Subpart F Income. As a general rule, interest income constitutes Subpart F Income and C's interest payment must be included in A's gross income. However, a Subpart F exclusion exists for interest received from related entities that operate an actual trade or business in the same country as the C.F.C.'s country of incorporation. As a result, C's interest payment to B would not constitute Subpart F Income at B's level. Since it is excluded from Subpart F, and assuming that the tax rate in Member State X is not higher than 18.9%, the interest income would be included in A's gross income under G.I.L.T.I. Given that A is a corporation, it would be entitled to a 50% deduction on such inclusion and only 50% of that interest income would be taxable to A. In this fact pattern, it is unclear whether Member State X would be required to include the remaining 50% of the interest income and tax it to B.

HYBRID PAYMENTS UNDER U.S. LAW AND A.T.A.D.2

New Code §267A disallows a deduction for certain related party amounts paid or accrued pursuant to (i) a hybrid transaction or (ii) by, or to, a hybrid entity.

This Code section only applies to related party interest, royalty amounts paid or accrued to a related party if

- the payment is not subject to tax or a corresponding inclusion in the income of the related party under the tax laws of the related party's country, or
- the related party is allowed a deduction with respect to such amount.

In broad terms, this would be referred to as a deduction without inclusion or as a

double deduction by A.T.A.D. 2.

For this purpose, a person is a related person with respect to the payor if

- the person is an individual, corporation, partnership, trust, or estate that controls or is controlled by the payor, or
- such person is a corporation, partnership, trust, or estate that is controlled by the same person or persons that control the payor.

Under this new U.S. hybrid payment provision, "control" is defined as[15]

- more than 50% direct or indirect ownership, by vote or value, of a corporation, or
- more than 50% direct or indirect ownership, by value, of the beneficial interests in a partnership, trust, or estate.

"New Code §267A disallows a deduction for certain related party amounts paid or accrued pursuant to (i) a hybrid transaction or (ii) by, or to, a hybrid entity."

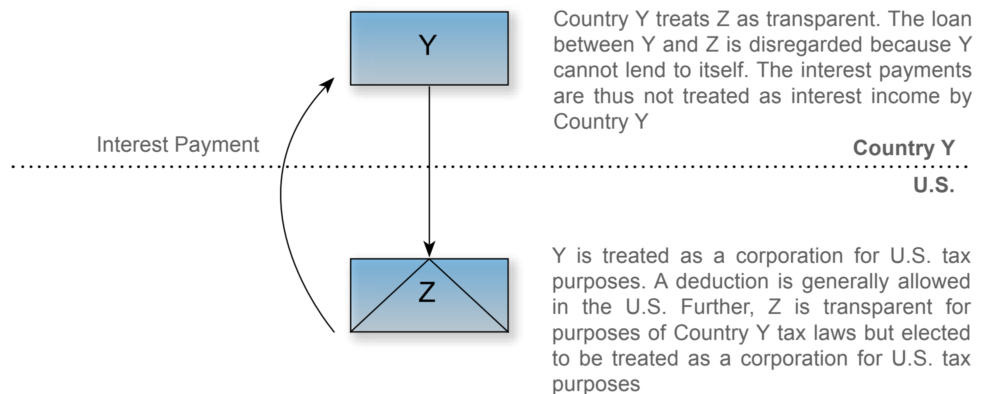
Regarding hybrid transactions, Code §267A applies to any transaction, series of transactions, agreement, or instrument giving rise to payments that are treated as royalty or interest payments under U.S. law but not by the country in which the recipient is subject to tax or of which the recipient is a resident for tax purposes.

Regarding hybrid entities, Code §267A applies to are any entities that are either

- non-U.S. entities that are treated as transparent for U.S. tax purposes but not as transparent in their country of residence or the country where they are subject to tax, or
- non-U.S. entities that are not treated as transparent for U.S. tax purposes but are treated as transparent for purposes of the tax laws of their country of residence or the country where they are subject to tax.

Under an exception, a disqualified related party amount does not include any payment to the extent such payment is included in the gross income of a U.S. Shareholder under Code §951(a).

The following describes the scenario targeted by Code §267A in the case of a hybrid payment:



[15] Indirect and constructive ownership rules apply. See Code §954(d)(3), as referred to by Code §267A(b)(2).

Under Code §267A, the U.S. would deny the deduction if interest paid by Z to Y is not included in Y's income. A similar scenario to this fact pattern would be a hybrid instrument that is treated as debt from a U.S. tax perspective while considered to be equity under the tax law of the recipient's jurisdiction, such as the participation exemption under the E.U. Parent/Subsidiary Directive as implemented into local law.

Contrary to the A.T.A.D. 2, Code §267A does not include an ordering rule.[16] In other words, as long as there is no double deduction nor deduction or non-inclusion for the interest paid by Z to Y, Code §267A is not triggered. In our example, if an inclusion were to occur on the recipient's side in Country Y, Code §267A would not deny the deduction. Hence, from a mere U.S. perspective the taxpayer appears to be in a position to choose – or "cherry-pick" – the tax benefit (*i.e.*, either treating the interest payment as tax deductible in the U.S. and thereby reducing its U.S. taxable profit while subjecting it to tax in Country Y or vice versa). Typically, the choice will depend on the effective tax rate in each country taking into account tax attributes such as the availability of N.O.L. carryforwards, as well as the applicable tax rate. However, if Country Y is an E.U. Member State that has implemented A.T.A.D. 2, in principle, the ordering rules described above would apply. In this case, it would mean that the U.S. as the payor's country would have to deny deductibility – a result the I.R.S. will definitely not object to. It will be interesting to see how the tension between these anti-abuse provisions will be handled by the two countries at issue, especially in cases where the taxpayer does not follow the ordering rule – as neither Code §267A nor A.T.A.D. 2 appear to prevent the taxpayer from doing so.

CONCLUSION

As with other provisions affecting international transactions, A.T.A.D. 2 cannot be looked at solely from one side of the transaction. When dealing with transactions involving an E.U. Member State and the U.S., A.T.A.D. 2 and U.S. tax law must be looked at simultaneously, especially with regard to hybrid payments.[17] This is especially important not just to avoid double inclusions but also to plan for the country of inclusion or deduction.

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[16] Note that regulations mandated under Code §267A(e) to carry out the purposes of this new rule have not been promulgated as of August 2018.

[17] Please note that new Code §245A also contains provisions relating to certain hybrid dividends. The present article does not discuss this provision.

THE OPPORTUNITY ZONE TAX BENEFIT – HOW DOES IT WORK AND CAN FOREIGN INVESTORS BENEFIT?

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Opportunity Zones
Qualified Funds
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The U.S. Federal, state, and local governments typically offer tax benefits to businesses to encourage economic growth and investment in certain industries and geographic areas. The Tax Cuts and Jobs Act of 2017 ("T.C.J.A.") added an important new provision that provides a tax break aimed at bringing together private capital and low-income communities, which otherwise would not have been the recipients of similar investments. The goal is to unlock unrealized gains (estimated at over $6 billion) and direct the gains to be invested in funds that are active in distressed areas designated as "Opportunity Zones" because they fall within low-income community census tracts.

New Code §1400Z-2 provides for the following three tax benefits:

- A temporary deferral of gains realized prior to 2026 on a sale or exchange of an appreciated asset
- A step-up in basis for the interest in the "Qualified Opportunity Fund" of up to 15% of the deferred gain that was invested in the Qualified Fund
- A complete exclusion of capital gains on the appreciation of the interest in the Qualified Fund if held for at least ten years

This article will discuss the elements of the provision and the potential ability of non-U.S. investors, who generally are not subject to U.S. taxation on dispositions of capital property other than U.S. real property, to utilize the new provision.

A QUALIFIED OPPORTUNITY FUND

A Qualified Opportunity Fund ("Qualified Fund") is an investment vehicle that can be organized as a corporation or a partnership and that was formed for the purpose of investing in "Qualified Opportunity Zone Property" (herein, "Eligible Property," as explained below). If the criteria is met, it will offer investors the attractive tax breaks discussed in this article.

To qualify, at least 90% of the fund's holdings must be in Eligible Property (other than another Qualified Fund) purchased after December 31, 2017.

The 90% test is determined by an average of the Eligible Property measured at two points in time:

- After the first 6 months of the taxable year
- On the last day of the taxable year

This is designed to put the investment to work quickly and to make sure available capital is reinvested. Regulations will provide rules to ensure that a fund has

reasonable time to reinvest the return of capital on Eligible Property.

If the 90% test isn't met, and a reasonable cause exception doesn't apply, the fund will pay a penalty for each month that it fails to meet this test, calculated as a percentage of the amount by which the Eligible Property is short of the 90% requirement.

What Is an Opportunity Zone?

An Opportunity Zone is an economically distressed community that has been designated by the state and certified by the I.R.S. Roughly 8,700 areas in all 50 states have been designated.[1] Qualified Opportunity Zones retain their designation for ten years.

What Is a Qualified Opportunity Zone Property?

Eligible Property includes

- "Qualified Opportunity Zone Stock" (herein, "Qualified Stock"),
- "Qualified Opportunity Zone Partnership Interests" (herein, "Qualified Partnership Interest"), and
- "Qualified Opportunity Zone Business Property" (herein, "Qualified Business Property").

Qualified Stock is stock in a domestic corporation purchased after December 31, 2017, for cash at original issue. A Qualified Partnership Interest is a capital interest or profits interest in a domestic partnership purchased for cash after December 31, 2017. The corporation or partnership in which a Qualified Fund wishes to invest must operate a "Qualified Opportunity Zone Business" (defined below) at the time the fund purchases the interest and during substantially all of the fund's holding period.

Qualified Business Property is tangible property acquired after December 31, 2017, to be used in a trade or business in the opportunity zone, provided that the purchased property is new (or was not already used in the opportunity zone by the seller) or that previously used property is substantially improved by the fund. For the property to be treated as a Qualified Business Property, the fund may not use the property in a meaningful way outside the opportunity zone.

What Is a Qualified Opportunity Zone Business?

A Qualified Opportunity Zone Business ("Qualified Business") is generally any trade or business in which substantially all of the property owned or leased is Qualified Business Property (as defined above) and which meets the following two tests:

- At least 50% of the taxpayer's gross income is from the active conduct of the business.
- Less than 5% of the average unadjusted basis of all of the property may be attributable to nonqualified financial assets.

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[1] The full list of designated zones, and a map, is available here: Opportunity Zones Resources

Certain businesses are prohibited *per se*, including, *inter alia*, casinos, liquor stores, golf courses, and country clubs.

How Does a Fund Become Qualified?

The statute does not require a special qualification process. Consistent with the language of the law, I.R.S. frequently asked questions ("F.A.Q.'s") stipulate that no I.R.S. approval or action is required for a fund to become a Qualified Fund. Based on the F.A.Q.'s, an eligible fund self-certifies its status on a form to be published by the I.R.S., which must be included on the fund's Federal tax return for the tax year.

THE OPPORTUNITY ZONE TAX BENEFITS

"An Opportunity Zone is an economically distressed community that has been designated by the state and certified by the I.R.S."

There are two main benefits available under the new provision:

- The first benefit relates to the gain from a sale of an existing appreciated property, which includes two tax benefits:
  - The tax on such gain can be deferred up to 2026 (the "Tax Deferral Benefit").
  - If held for at least five years, up to 15% of the gain realized can be exempt (the "Partial Step-Up Benefit").
- The second benefit relates to the appreciation of the investment in the opportunity fund, which may be completely tax free if held for ten years or more (the "Appreciation Step-Up Benefit").

The benefits are available only with respect to gain realized before December 31, 2026 and invested within the timeline.

How Does the Tax Deferral Benefit Work?

To receive the Tax Deferral Benefit, taxpayers must

- sell an appreciated property to an unrelated person before December 31, 2026,
- make an election to defer the gain (or the invested amount, if lower) in the tax return for the year of the sale,
- not have another election to defer the tax in effect with respect to the same sale or exchange, and
- invest the deferred gain in one or more Qualified Funds within 180 days from the day of the disposition.

While the tax is deferred, the disposition transaction must be reported in the year it was made on Form 8949 (Sales and Other Dispositions of Capital Assets), which will also be used to make the election to defer the tax, pending further instructions from the I.R.S.

What Types of Appreciated Properties Qualify?

While initially aimed at capital assets, with a particular view to a capital market's

unrealized gain, the Code doesn't limit the type of property to which the provision applies. Gain from the disposition of any property may be invested in a Qualified Fund and benefit from the provision.

There is also no limitation on the amount of gain that can be deferred by reinvestment, provided that the amount deferred is invested in accordance with the provision.

Who Is a Related Person?

The disposition of the appreciated property must take place through in a transaction with an unrelated person. In determining whether the two persons are related, certain modified constructive ownership rules apply. Thus, the following persons, among others, are treated as related:

- Members of a family[2]
- An individual and a corporation if more than 20% of the value of the corporation is owned directly or indirectly by or for the individual
- Two corporations that are members of the same controlled group or the same persons own more than 20% of the value in each
- Two partnerships in which the same persons own, directly or indirectly, more than 20% of the capital or profits interests
- A grantor and a fiduciary of any trust
- A fiduciary of one trust and a fiduciary of another trust established by the same grantor
- A fiduciary and a beneficiary of a trust
- A fiduciary of a trust and a beneficiary of another trust established by the same grantor
- A fiduciary of a trust and a corporation if more than 20% of the value of the corporation is owned, directly or indirectly, by or for the trust or by or for the grantor of the trust

What Is the Timeframe to Make the Investment in a Qualified Fund?

The deferred gain must be invested in a Qualified Fund within 180 days of the day of disposition of the property. Unless further guidance is issued, this period includes weekends and holidays.

No intermediary is required to hold the funds during the period between the disposition of the property and the investment in the Qualified Fund. This requirement differs in an exchange under Code §1031, which prohibits a taxpayer from taking possession of the proceeds from a sale made in the interim period before investment in the replacement property. The I.R.S. indicated on its F.A.Q. webpage that gains realized in 2017 (the proceeds of which must have already been received by the taxpayer) can also be invested in Qualified Funds and enjoy the tax benefits, as

[2] This includes an individual's spouses, siblings, parents, grandparents, great-grandparents, children, grandchildren, and great-grandchildren, etc.

long as they are invested within 180 days. Thus, it is possible that no intermediary will be required even after further guidance is issued.

Can Funds from Other Sources Benefit?

"The deferred gain must be invested in a Qualified Fund within 180 days of the day of disposition of the property."

Cash investments from other sources do not qualify. This includes investments of more than the realized gain in a sale of an appreciated property and could include situations in which only part of the gain realized was initially invested, and thereafter, the taxpayer wishes to invest the remaining realized gain in the same Qualified Fund. This may be the result due to the limitation on election, under which if an election with respect to the same sale or exchange was made and is in effect, no additional election may be made.

When mixed funds are invested, the fund must segregate the amount of investment and treat the investment as two separate investments. All potential step-up benefits would only apply to the investment of the deferred gain to which an election applies.

Until When Can the Tax on the Realized Gain be Deferred?

The tax is deferred until the earlier of

- the date the investment in the Qualified Fund is sold or exchanged, or
- December 31, 2026.

Note that if the inclusion date is in 2026 and no corresponding disposition takes place, taxpayers will have tax on phantom income, which they should take into account and have cash available.

What Is the Basis Received in the Investment in a Qualified Fund?

The basis received in the investment is zero. The zero basis is subject to several potential adjustments:

- A step-up by 10% of the deferred gain
- A step-up by 15% of the deferred gain
- A step-up through the recognized gain
- A step-up to the fair market value of the investment in the Qualified Fund

The step up for the recognized gain seems to be relevant only for investments that are held past the mandatory recognition time of December 31, 2016. Therefore, depending on the holding period at this time, this step-up is in addition to the Partial Step-Up that is already granted based on the holding period discussed below, resulting in potentially tax-free appreciation of the gain reinvested under the provision.

How Much of the Deferred Gain Is Recognized?

At the time of the disposition or, if earlier, on December 31, 2016, the taxpayer includes in their gross income

- the full amount of the deferred gain or, if less, the fair market value of the investment and
- the taxpayer's basis in the investment.

How Does the Partial Step-Up Benefit Work?

After five years, the taxpayer is eligible for a step-up in the basis of the investment in the fund. The step-up amount is 10% of the deferred gain.

After seven years, the taxpayer is eligible for an additional 5% step-up, resulting in a total step-up of up to 15% of the deferred gain.

Thus, a taxpayer who sells an appreciated asset and invests it in a Qualified Fund can exempt up to 15% of its realized gain if it held on to the investment for at least seven years.

Since 2026 is a mandatory inclusion date, in order to benefit from the full Partial Step-Up Benefit of 15%, taxpayers should invest in Qualified Funds by December 31, 2019.

How Does the Appreciation Step-Up Benefit Work?

If an investment in a Qualified Fund is held for at least ten years, at the election of the taxpayer, the basis in the interest is stepped-up to the fair market value of the interest at the time of the disposition.

While no more than 15% of the deferred gain can be exempt from tax (because of the mandatory inclusion in 2026), the full appreciation may be tax exempt.

APPLYING THE PROVISION[3]

The application of the new provision is best illustrated through an example.

In October 2018, a taxpayer sells appreciated property with built-in gain of $1,000,000. No tax is paid in 2018 on the realized gain of $1,000,000 because within 180 days, the taxpayer invests the full amount into a Qualified Fund. The investment appreciates 6% per year.

- If the investment is sold in less than five years, the following will apply:
  - The investment is assumed to be worth $1,120,000.
  - The basis in the investment is zero.
  - Therefore, the tax is due on $1,120,000 – $0 = $1,120,000.
  - If broken into its elements, deferred gain and appreciation, $1,000,000 ($1,000,000 – $0) of the 2018 deferred gain is included in the taxpayer's gross income for the year of the sale, and the appreciation ($1,120,000 – $1,000,000) is taxed in full.
  - Federal tax applied to the 2018 realized gain is $200,000.
  - Federal tax applied to the appreciation is $24,000.
- If the investment is sold prior to 2026 after it was held for more than five years but less than seven years, the following will apply:

[3] For ease of computation, the example uses a 20% Federal rate and does not apply the 3.8% N.I.I.T.

- The investment is assumed to be worth $1,400,000.
- After five years, the taxpayer receives a step-up in the basis of the investment of 10% of the deferred gain. The adjusted basis is $100,000.
- Therefore, the tax is due on $1,400,000 – $100,000 = $1,300,000.
- If broken into its elements, deferred gain and the appreciation, $900,000 ($1,000,000 – $100,000) of the 2018 deferred gain is included in the taxpayer's gross income for the year of the sale, and the appreciation ($1,400,000 – $1,000,000) is taxed in full.
- Federal tax applied to the 2018 realized gain is $180,000.
- Federal tax applied to the appreciation is $80,000.

- If the investment is sold after 2026 when it was held for more than seven years but less than ten years, the following will apply:
  - The investment is assumed to be worth $1,700,000.
  - After seven years, the taxpayer receives a step-up in the basis of the investment to 15% of the deferred gain. The adjusted basis is $150,000.
  - In 2026, notwithstanding that the investment is not sold, the taxpayer must recognize the 2018 realized gain. Of the deferred gain, $850,000 ($1,000,000 – $150,000) is included in the taxpayer's gross income for the year 2026.
  - The new basis in the investment is then $150,000 (the Partial Step-Up received after holding the investment for seven years) + $850,000 (the step-up received after recognizing the gain on the deferral) = $1,000,000.
  - When the taxpayer sells the investment after 2026 but before the ten-year mark, the appreciation is taxed [*i.e.*, the fair market value over the new basis ($1,700,000 – $1,000,000)].
  - Federal tax applied to the 2018 realized gain (in 2026) is $170,000.
  - Federal tax applied to the appreciation is $140,000.
- If the investment is sold after 2026 when it was held for more than ten years, the following will apply:
  - The investment is estimated to be worth $2,000,000.
  - In 2026, the taxpayer includes $850,000 of the 2018 deferred gain as explained above. Following such recognition, the taxpayer's basis is stepped up from $150,000 (received after seven years) to $1,000,000 by adding the gain recognized to the basis.
  - At the election of the taxpayer (at the time of sale after ten years), the basis in the investment is stepped-up further to the fair market value of the investment on the date of the sale (*i.e.*, $2,000,000 in this example).

- Federal tax applied to the 2018 realized gain (in 2026) is $170,000.
- Federal tax applied to the appreciation is $0.

For comparison, if the taxpayer invested in a private equity fund that isn't a Qualified Opportunity Zone fund, the $200,000 tax due on the $1,000,000 gain realized in 2018 would have been due in 2018. Only the net amount of $800,000 would have been available for investment, and the appreciation would have been fully taxed.

CAN FOREIGN TAXPAYERS BENEFIT?

The provision does not limit the type of taxpayer that can benefit from this provision; accordingly, foreign investors, including trusts, may benefit from the new provision.

Under U.S. tax law, non-U.S. investors are generally not subject to U.S. tax on the sale of appreciated capital assets not treated as a U.S. real property interest ("U.S.R.P.I."). Therefore, as it applies to unrealized gains in capital markets, non-U.S. investors are not anticipated to liquidate their portfolios in time for a 2019 investment in a Qualified Fund.

The provision does not address the applicability to U.S.R.P.I. and F.I.R.P.T.A. withholding. In principal, non-U.S. investors may sell appreciated real property and reinvest the gain in a Qualified Fund. Since the consideration may be subject to 15% F.I.R.P.T.A. withholding, investors may find it complicated to utilize the new provision.

However, just like in a non-simultaneous exchange under Code §1031, where taxpayers may apply to the I.R.S. and request a withholding certificate to eliminate the withholding, it is assumed that non-U.S. sellers would be able to do so in these circumstances. There is no doubt that this would impose some complications; however, unless regulations impose limitations, the benefits may be worth it. The process to obtain an I.R.S. withholding certificate normally takes 90 days and first requires the issuance of a U.S. Tax Identification Number, which isn't a simple process either, but well-advised taxpayers who plan in time may be able to invest the proceeds within the required 180-day window and benefit from this new provision.

In comparison with a Code §1031 exchange, under the new provision, if the "replacement" property is held for more than ten years, the appreciation would be completely tax free and only 85% of the deferred gain would be taxed.

Interests in some of the Qualified Funds will surely be treated as an investment in U.S.R.P.I. It is yet to be seen how F.I.R.P.T.A. withholding will apply to a disposition of interests throughout the lifetime of the investment and whether it is necessary to obtain an I.R.S. determination letter for a disposition that occurs after ten years and on which no gain should be taxable.

OTHER STRUCTURES USED BY NON-U.S. PERSONS THAT MAY BENEFIT

Many non-U.S. persons use U.S. domestic trusts in their structures with the intention of accommodating U.S. beneficiaries. These trusts may have invested in the U.S. stock market and may now take the opportunity to cash out on appreciated

portfolios and benefit from the tax benefits described above.

U.S. non-domestic trusts have seen a rise in popularity in recent years following C.R.S. Trusts used for these purposes are often treated as foreign trusts for U.S. tax purposes. While these trusts would not have unrealized gain in U.S. stock markets, they may have appreciated F.I.R.P.T.A. assets.

"The provision does not limit the type of taxpayer that can benefit from this provision; accordingly, foreign investors, including trusts, may benefit from the new provision."

CONCLUSION

A battle, like the one for Amazon's second headquarters, is expected to begin among states that wish to attract Qualified Funds to their opportunity zones. It is possible that taxpayers will rush to dispose of appreciated assets for a timely reinvestment in Qualified Funds, no later than December 31, 2019, a timeline that would allow them to utilize the 15% Partial Step-Up in basis by the time of the mandatory gain recognition.

The current requirements are somewhat relaxed compared to other deferral provisions in the Code (*e.g.*, Code §1031) indicating the possibility of further changes as new guidelines and proposed regulations are issued.

It is yet to be seen whether this initiative will be successful in developing the identified zones while at the same time providing benefits for investors.

F.A.T.C.A. – WHERE DO WE STAND TODAY?

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On July 5, 2018, the Treasury Inspector General for Tax Administration ("T.I.G.T.A.") issued a final audit report on enforcement of the Foreign Account Tax Compliance Act ("F.A.T.C.A.") enacted in 2010. It concluded that after spending nearly $380 million, the I.R.S. is still not prepared to enforce F.A.T.C.A. compliance. According to the report, the I.R.S. has taken limited or no action to follow the activities outlined in the F.A.T.C.A. Compliance Roadmap, last updated in 2016.

T.I.G.T.A. found that many Foreign Financial Institutions ("F.F.I.'s") and withholding agents did not include correct Taxpayer Identification Numbers ("T.I.N.'s") for individuals, and as a result, the I.R.S. has not been able to match the data from the forms filed by F.F.I.'s, withholding agents, and taxpayers.

T.I.G.T.A. provided six recommendations to the I.R.S. on how to improve F.A.T.C.A. compliance, of which the I.R.S. agreed to four. This article will cover the recommendations and the I.R.S. response.

BACKGROUND

In conjunction with the Hiring Incentives to Restore Employment Act of 2010, F.A.T.C.A. introduced Chapter 4, which added Code §§1471-1474 and §6038D. It was designed to improve compliance with reporting of foreign financial assets and offshore accounts and was projected to raise $8.7 billion from fiscal years 2010 to 2020.

The F.A.T.C.A. reporting obligation applies not only to individual taxpayers but also to F.F.I.'s and withholding agents. It also goes much further than previous international agreements: F.A.T.C.A. requires F.F.I.'s to report to the I.R.S. about their U.S. customers on an annual basis.

Who has a reporting obligation under F.A.T.C.A.?

> **Individual Taxpayers** – Code §6038D requires individuals to file Form 8939, *Statement of Specified Foreign Financial Assets*, with their income tax returns if the aggregate value of the foreign financial assets exceeds certain dollar thresholds.
>
> **F.F.I.'s** – To avoid a 30% withholding on U.S.-source income, certain F.F.I.'s must register with and agree to report certain information about their U.S. account holders to the I.R.S.[1] In 2014, there were more than 77,000 entities registered with the I.R.S. This list has increased to 293,020 in 2017.

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[1] The reporting obligation extended to foreign entities that have a U.S. account holder.

The U.S. Department of Treasury has negotiated Intergovernmental Agreements ("I.G.A.'s") with many foreign governments to implement F.A.T.C.A. The privacy laws of many foreign countries prevent F.F.I.'s from reporting account information directly to the I.R.S. To remove an F.F.I.'s legal impediments to report the accounts, the I.R.S. created two model I.G.A.'s: (i) the Model 1 I.G.A., where an F.F.I. reports U.S.-related accounts to their home country tax authority, which in turn will automatically provide the information to the I.R.S., and (ii) the Model 2 I.G.A., where an F.F.I. reports U.S.-related accounts directly to the I.R.S in a manner consistent with F.A.T.C.A. regulations.

A participating F.F.I. files Form 8966, *F.A.T.C.A. Report*, annually with the I.R.S. The form must reflect the name, address, and T.I.N. of each specified U.S. person; the account number; the account balance or value; and gross receipts and gross withdrawals or payments from the account. The reporting obligation for the form took effect in 2015.

Withholding Agents – Withholding agents are required to withhold 30% on payments of U.S.-source income to the following:

- Non-participating F.F.I.'s and nonfinancial foreign entities
- Any account holder of a participating F.F.I. who fails to provide
    - the information required to determine whether the account is a U.S. account,
    - the information required to be reported by the F.F.I., or
    - a waiver of a foreign law that would prevent reporting to the I.R.S.

Withholding agents use Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, and Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, to report payments and amounts withheld. The information required to be reported for the payor and payee includes (i) name, (ii) address, (iii) T.I.N., (iv) Chapter 4 status of each payee, (v) the gross amount paid, (vi) the tax withheld, and (vii) the identifying information of the withholding agent.

T.I.G.T.A. FINDINGS AND RECOMMENDATIONS

During the review, T.I.G.T.A. determined that the I.R.S. continues to experience delays in implementing its F.A.T.C.A. compliance strategy. There seem to be many causes for the delay.

The issues identified by the I.R.S. include (i) a lack of automated processes, (ii) the need for development and implementation of additional system requirements, (iii) the prioritization of F.A.T.C.A. work by the information technology organization, (iv) the timing of regulatory deadlines, (v) the lack of data to verify compliance, and (vi) the categorization of activities as low risk and low priority in terms of I.R.S. operations.

Error Notices

Form 8966 filed by the F.F.I. is scanned in the first two stages of review[2] for improper encryption, improper electronic reporting format, failed decryption, an invalid Form 8966 X.M.L. schema reporting format, an invalid digital certificate, a failed virus scan, and validation errors caused by missing data.

If the file is rejected at the first stage, the filer will receive an alert containing a general description of the cause for the rejection. In contrast, if a file is rejected at the second stage, the filer will receive an overview of the error, the cause for file rejection, and the potential resolution.

F.F.I.'s have 120 days from the date an alert or notification was sent to resolve the issue(s) that caused the rejection. Filers may contact the helpdesk if they need further assistance.

After the original alert or notification, the I.R.S. only follows up with Model 1 I.G.A. rejected files. It does so by sending a follow-up letter at the 60-day mark and maintains communication until all errors or substantially all errors are corrected. Currently, follow up in Model 2 I.G.A. jurisdictions is not available, but the I.R.S. has indicated that it is in the process of creating a follow-up process for stage one error notices.

Once the file successfully passes through the first two stages of processing, the form is tested for data elements or fields at the record level. If a mandatory data element is missing, such as the name of the filer, the filer's identifying number (*e.g.*, Global Intermediary Identification Number), the name of account holder, the accountholder's T.I.N., etc., the case is handled as a record-level error. Nonetheless, the file is accepted, and the I.R.S. will issue a notification to the filer regarding any failure relating to mandatory data elements.

However, it appears that not all record-level errors get resolved. For example, the calendar years 2014 and 2015 were regarded as a transition period, during which the I.R.S. did not treat a missing T.I.N. as an error. In addition, Model 1 I.G.A. F.F.I.'s were not required to obtain and report T.I.N.'s related to certain preexisting U.S.-owned accounts if the U.S. accountholder's T.I.N. was not on record. These F.F.I.'s were given until January 1, 2017, to develop a rule to obtain T.I.N.'s for subsequent years. In September 2017, the Department of the Treasury and the I.R.S. noted that some reporting Model 1 I.G.A. F.F.I.'s needed additional time to implement procedures to obtain and report the required T.I.N.'s. As a result, Model 1 I.G.A. jurisdictions will be considered compliant for the calendar years 2017, 2018, and 2019.

Recommendation #1: T.I.G.T.A. recommends the I.R.S. establish follow-up procedures and initiate actions to address error notices related to file submissions rejected at the early stages, to ensure that non-I.G.A. F.F.I.'s and Model 2 I.G.A. F.F.I.'s submit F.A.T.C.A. reports properly, and to address unresolved record-level errors to ensure that the F.F.I.'s correctly provide data for mandatory fields.

I.R.S. Response: The I.R.S. agreed with this recommendation and will establish a compliance initiative to address error notices and unresolved record-level errors,

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[2] Files containing Form 8966 records are processed first through the International Data Exchange Service ("I.D.E.S.") and then through the International Compliance Management Model ("I.C.M.M.").

including follow-up procedures, to improve the accuracy of data in F.A.T.C.A. reports.

Missing Forms 8938

A penalty for failing to file Forms 8938 may be assessed on specified domestic entities or individuals. Thus far, there has not been a penalty assessment against specified domestic entities, as the filing requirement began after December 31, 2015. However, the I.R.S. has indicated that, between October 1, 2016, and September 30, 2017, 75 failure-to-file Form 8938 penalty assessments were made on individuals. These penalties totaled $1,180,000, of which $660,000 was initial penalties and $520,000 was continuation penalties. These penalties were asserted through the normal examination process. The I.R.S. noted that some taxpayers may have submitted delinquent or incomplete/incorrect Forms 8938 as part of the Streamlined Program or Offshore Voluntary Disclosure Program.

Recommendation #2: T.I.G.T.A. recommends the I.R.S. initiate compliance efforts to address taxpayers who did not file a Form 8938 but who were reported on a Form 8966 filed by an F.F.I.

I.R.S. Response: The I.R.S. agreed with this recommendation and will continue its efforts to systemically match Form 8966 and Form 8938 data to identify non-filers and underreporting related to U.S. holders of foreign accounts and to F.F.I.'s. The I.R.S. has initiated development of a data product to automate risk assessments across the F.A.T.C.A. filing population.

Thus far, the I.R.S.' efforts to match information between these forms have been significantly hindered, primarily due to the absence of T.I.N.'s on a high volume of Forms 8966 filed during the transition period.

Global Intermediary Identification Numbers

For the 2016 tax year, Form 8938 was updated to include a Global Intermediary Identification Number; the I.R.S. believes that this will help match records with missing T.I.N.'s. However, at this stage, the information on the Form 8938 is still optional, as requiring the Global Intermediary Identification Number would place a potential burden on taxpayers.

Recommendation #3: T.I.G.T.A. recommends the I.R.S. reduce the burden on taxpayers when locating a Global Intermediary Identification Number for an F.F.I.

I.R.S. Response: The I.R.S. agreed with this recommendation and will update Form 8938 instructions to provide a search tool for identifying an F.F.I.'s Global Intermediary Identification Number.

Missing Forms 8966

As of November 1, 2017, there were 293,030 F.F.I.'s registered and approved to participate in the F.A.T.C.A. program. Out of these, only 104,692 F.F.I.'s have filed Forms 8966. This is possibly due to the fact that certain F.F.I.'s do not have to file Form 8966 if the thresholds are not met.

Recommendation #4: T.I.G.T.A. recommends the I.R.S. initiate compliance efforts to address and correct missing or invalid T.I.N.'s on Form 8966 filings by non-I.G.A. F.F.I.'s and Model 2 I.G.A. F.F.I.'s.

I.R.S. Response: The I.R.S. disagreed with this recommendation as such a system would be cost prohibitive and the steps taken under Recommendation 1 would address the issue.

Form 1042-S Filings

"T.I.N. accuracy is critical in granting a credit to a taxpayer based upon Form 1042-S withholding."

When issuing a refund to the taxpayer, the I.R.S. must match the withholding agent's and recipient's copies of Form 1042-S. If the taxpayer does not provide all the required forms, the I.R.S. will communicate with the taxpayer to obtain the information. The I.R.S. follows the same procedure if there is a mathematical error on the return filed by the taxpayer. At this stage, the I.R.S. does not have a tally of the number of refunds denied to taxpayers.

The Compliance Initiative Project, relating to Chapter 3 and Chapter 4 withholding, was replaced by the "Form 1120-F Withholding" campaign.[3] This campaign will focus on verifying that, for every Form 1042-S on which the taxpayer claims a credit, a corresponding Form 1042-S has been filed by the withholding agent. The campaign does not include reconciling withholding agent filings and deposits, as the I.R.S. has decided it would be better to address withholding agent compliance in a separate campaign. The "Form 1042/1042-S Compliance" campaign will address filing inconsistencies through several filters, including Forms 1042-S that do not have a corresponding Form 1042 and insufficient deposits by withholding agents.

T.I.G.T.A. observed that 66% of the Form 1042-S documents received for the tax year 2014 did not have a valid T.I.N. and 88% of the Form 1042-S documents received for the tax year 2015 did not have a valid T.I.N. In the tax year 2015, 62,398 Forms 1042-S with invalid T.I.N.'s reported more than $717 million in U.S.-source income, of which just over $47 million was withheld.

Recommendation #5: Expand compliance efforts to address and correct invalid T.I.N.'s on all Form 1042-S filings by non-I.G.A. F.F.I.'s and Model 2 I.G.A. F.F.I.'s.

I.R.S. Response: The I.R.S. agreed with this recommendation to the extent that it will strengthen overall compliance efforts directed toward improving the accuracy of reporting by Form 1042-S filers. The I.R.S. already initiated compliance initiatives that address invalid T.I.N.'s on Forms 1042-S filed by non-I.G.A. F.F.I.'s and Model 2 I.G.A. F.F.I.'s. Specifically, the "Verification of Form 1042-S Credit Claimed on Form 1040NR" campaign matches credits claimed on Form 1042-S with Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, and the "Form 1120F Chapter 3 and Chapter 4 Withholding" campaign matches the credits claimed on Forms 1042-S with the Form 1120-F. In addition, the upcoming "Withholding Agent Compliance" campaign (which has not yet been publicly announced) will match Form 1042 with Form 1042-S and will include proper withholding rates.

Further, the I.R.S. stated that T.I.N. accuracy does not have an effect on revenue collection if withholding occurs at the correct rate. However, T.I.N. accuracy is critical in granting a credit to a taxpayer based upon Form 1042-S withholding.

Form 1099 Filings

F.A.T.C.A. requires information reporting on transactions for which F.F.I.'s may

[3] Form 1120-F is filed to obtain refund on the withholding that is reported on Form 1042-S.

already be issuing Form 1099 series information returns. F.F.I.'s may elect to comply with the F.A.T.C.A. Form 8966 reporting requirements by continuing to file Forms 1099 through enhanced Form 1099 reporting.

Recommendation #6: T.I.G.T.A. recommends the I.R.S. initiate compliance efforts to compare Form 1099 filings with valid T.I.N.'s to corresponding Form 8938 filings to identify non-filers or mismatches in reporting of foreign financial assets.

I.R.S. Response: The I.R.S. disagreed with this recommendation. In their response, I.R.S. management stated that they have already assessed the risks associated with Forms 1099 filed by F.F.I.'s and determined the risk was minimal. The number of forms filed relative to Forms 8966 was very low once a significant 2015 filing error was identified and corrected.

Furthermore, the I.R.S. stated that T.I.N. accuracy does not have an effect on revenue collection if withholding occurs at the correct rate. However, T.I.N. accuracy is critical in granting a credit to a taxpayer based upon Form 1099 withholding.

CONCLUSION

It has been eight years since F.A.T.C.A. was enacted. The compliance program is still ongoing, and its real impact is not entirely clear at this time. Delays in implementing F.A.T.C.A. compliance should not be interpreted as an opportunity for taxpayers to remain non-compliant. Taxpayers should take this opportunity to obtain all the necessary information to come into compliance.

In the near future, Model 2 I.G.A. jurisdictions should expect first stage error follow-up similar to that available in Model 1 I.G.A. jurisdictions.

The I.R.S. may delay matching Forms 8938 and Forms 8966 due to missing T.I.N.'s, but it has implemented Global Intermediary Identification Number requirements on Form 8938 regardless. At this stage, including a Global Intermediary Identification Number on the form is merely advised. However, once the I.R.S. makes Global Intermediary Identification Numbers readily available on their website, their inclusion is expected to be mandatory.

The I.R.S. is not expected to match information on Forms 1042 with that on Forms 1042-S, as inaccuracies between these forms do not affect revenue collection. Taxpayers should make sure that the correct Form 1042 was filed by the withholding agent to avoid delays in the refund process.

Delays in implementing F.A.T.C.A. compliance should not be interpreted as an opportunity for taxpayers to remain non-compliant. Taxpayers should take this time to obtain all the necessary information to come into compliance.

TAX CONSIDERATIONS OF I.P. WHEN EXPANDING A BUSINESS OFFSHORE

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Tags
F.D.I.I.
G.I.L.T.I.
Intellectual Property
Joint Venture
Outbound Transfers
T.C.J.A.

INTRODUCTION

U.S. tax law contains several provisions designed to discourage erosion of the U.S. tax base by moving U.S. businesses offshore. Code §367(a) relates to the transfer of most assets, and unless a transfer of business assets or shares of stock falls within an exception, gain is recognized immediately by the U.S. transferor.[1] Under that section, a U.S. person must recognize gain on the transfer of appreciated property to a foreign corporation in a transaction that would otherwise be tax-free, such as a contribution to a controlled corporation that is made by a shareholder or a transfer incident to a reorganization.

The outbound transfer of intangible assets, such as intellectual property ("I.P."), is the subject of a provision within Code §367 because intangible assets are generally easy to move from one country to another and, for that reason, a transfer to a foreign entity in a low-tax jurisdiction could more easily erode the U.S. tax base. As an example, I.P. developed and patented by a U.S. parent corporation may be sold or transferred to its foreign subsidiary corporation with legal title to the I.P.; possession of all of the accompanying rights would also be transferred to the foreign subsidiary corporation simply through the execution of a document and the filing of registration papers. In comparison, when tangible property, such as machinery and equipment, is transferred, the assets must be disassembled and shipped, and factory premises must be constructed or leased.

In the case of outbound transfers of intangible property, Code §367(d)(2) is the counterpart to Code §367(a). It provides that a transfer of I.P. to a foreign corporation in an otherwise tax-free transaction is treated for U.S. income tax purposes as if the I.P. were sold in exchange for payments that are contingent upon its productivity, use, or disposition. In broad terms, the transfer generates an ongoing income stream for the transferor akin to a stream of royalty payments.

While Code §§367(a) and (d) are negative incentives, the Tax Cuts and Jobs Act ("T.C.J.A.") provides a rather broad tax benefit for the use of intangible property, which is defined in the form of a new regime for foreign-derived intangible income ("F.D.I.I."). F.D.I.I. is the portion of a U.S. corporation's specified income derived from serving foreign markets that is broadly defined to be in excess of a return on the tangible assets of a controlled foreign corporation ("C.F.C."). Under Code §951A, F.D.I.I. is included in the income of a U.S. Shareholder (*i.e.*, 10% owner), but under Code §250, F.D.I.I. derived by a U.S. corporation is eligible for a deduction

[1] The T.C.J.A. eliminated one principal exception that allowed gain to be deferred in connection with a tax-free transfer of assets to a foreign corporation when the assets would be used in an active trade or business. See "Tax Cuts and Jobs Act Adopt Provisions to Prevent Base Erosion," *Insights* 5, no 1 (2018), pp. 40, 46-47.

of 37.5% for tax years beginning before 2026 and 21.875% thereafter.[2] At the U.S. corporate income tax rate of 21%, the deductions have the effect of reducing the tax rate on F.D.I.I. to 13.125% for tax years beginning before 2026 and 16.406% for tax years beginning after 2025.

This article will examine the following topics:

- The deemed royalty imposed on transfers of I.P. to a foreign corporation
- In the case of a U.S. corporation, the possibility of benefitting from the F.D.I.I. regime by licensing the use of the I.P. to a related or unrelated foreign company
- Using a foreign partnership to avoid deemed royalty treatment in the special (but arguably common) situation of starting up or expanding operations offshore with financing from an investor, such as a private equity fund

DEEMED ROYALTY TREATMENT FOR OUTBOUND I.P. TRANSFERS

Suppose a U.S. business wants to transfer I.P. to a foreign joint venture that is operated in corporate form. The I.P. will be used in the business operations of the joint venture corporation and is likely contributed as an offset to other contributions by a local co-venturer. The transfer will be subject to Code §367(d), which applies when a U.S. person transfers property to a foreign corporation in a transfer that would be tax-free as a contribution of property to a corporation that is controlled by all the transferors.[3]

A U.S. person is a U.S. citizen or resident, a domestic corporation, a domestic partnership, an estate other than a foreign estate, or a trust that meets a statutory test that determines whether a trust is controlled by U.S. persons or subject to the jurisdiction of U.S. courts. In that case, the otherwise tax-free contribution in exchange for stock is treated as a taxable sale. If hard assets are contributed, the U.S. person generally must recognize built-in gain with respect to the property. The gain cannot be reduced by any built-in loss. Code §367(a) is said to impose a toll charge on the outbound transfer of appreciated property to a foreign corporation.

If the property contributed to the foreign corporation is I.P., the outbound transfer is governed by the rules of Code §367(d), which take precedence over those of Code §367(a). Under Code §367(d)(2), the contribution is treated like a sale in exchange for payments that are contingent upon the productivity, use, or disposition of the intangible property. In other words, the U.S. person is treated as if it sold the property in exchange for a stream of payments. Note that Code §367(d) controls the tax consequences to the U.S. transferor; it has no effect on the business deal of the parties. The stream of income inclusions must reasonably reflect the amounts that would have been received annually over the useful life of the property in an arm's length sale for ongoing payments. The deemed payments are taxed as ordinary income of the U.S. transferor. The U.S. person must prepare a valuation of the intangible property in accordance with rules set forth in the Treasury regulations.

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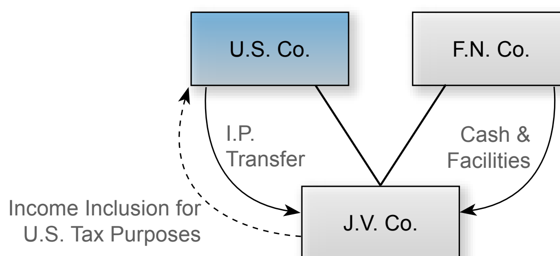
[2] Note that the amount of the Code §250 deduction is capped by the U.S.

[3] Code §351(a).

If the foreign corporation subsequently disposes of the I.P., the U.S. transferor is treated as if it received a final payment on that disposition. The following diagram illustrates the transaction.



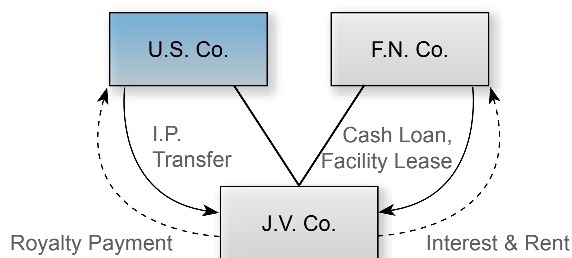
> ***"The F.D.I.I. regime could apply and ultimately result in reduced U.S. tax for the U.S. participant."***

For Code §367(d) purposes, intangible property is listed in Code §367(d)(4) as including patents, invention, formula, process, design, pattern, know-how, copyright, trademark, trade name or brand name, franchise, license or contract, and other items with a value (or potential value) that is not attributable to tangible property or the services of any individual.

KEEPING I.P. ONSHORE FOR F.D.I.I. TREATMENT

The first alternative to a contribution of I.P. to a foreign corporation is a license of the I.P. as part of a modified structure.

If, instead of forming a foreign corporation that would fully operate a business abroad, the U.S. company retained its I.P. and licensed it to the foreign joint venture in return for an actual royalty payment, Code §367(d) would not be applicable. Rather, the F.D.I.I. regime could apply and ultimately result in reduced U.S. tax for the U.S. participant. Consequently, the foreign co-venturer would likely demand a comparable payment in return for its assets, leading to a somewhat different structure.



The F.D.I.I. of any U.S. corporation is its "deemed intangible income" multiplied by a ratio consisting of its "foreign-derived deduction eligible income" as the numerator and its global "deduction eligible income" (*i.e.*, U.S. and foreign) as the denominator.

The U.S. corporation's deemed intangible income is effectively all of its income [net of allocable deductions and certain exclusions such as its Subpart F Income and global intangible low taxed income ("G.I.L.T.I.")] inclusions reduced by a deemed

routine return of 10% of its adjusted tax basis in its depreciable tangible property.

Perhaps the most important component of F.D.I.I. is the foreign-derived deduction eligible income. In broad terms, foreign-derived deduction eligible income is any deduction eligible income (*i.e.*, gross income, reduced by allocable deductions and certain exclusions) derived in connection with

- property that is sold by the taxpayer to any person who is not a U.S. person and established to be for foreign use or
- services provided by the taxpayer that are established to be provided to any person not located in the U.S. or with respect to property not located in the U.S.

The terms "sold," "sells," and "sale" include any lease, license, exchange, or other disposition. Foreign use means any use, consumption, or disposition outside the U.S.

Property sold to another person (other than a related party, as discussed below) for further manufacturing or other modification in the U.S. is not treated as sold for a foreign use, even if the other person subsequently uses the property for foreign use. Similarly, services provided to another person (other than a related party, as discussed below) located in the U.S. do not generate foreign-derived deduction eligible income even if that other person uses the services in providing services that generate foreign-derived deduction eligible income for itself. Here, those limitations should be inapplicable as the joint venture corporation is a foreign corporation with actual foreign operations. Hence, the license – the equivalent of a sale – is to a foreign corporation, which depending on the character of the I.P., will either use the licensed I.P. to manufacture abroad or will use the licensed I.P. to sell abroad.

If the property is sold to a foreign related party,[4] the sale is not treated as for a foreign use, unless the property is ultimately sold by the foreign related party to another person who is unrelated and foreign, and the taxpayer establishes to the satisfaction of the I.R.S. that the property is for foreign use. Similarly, if a service is provided to a related party who is not located in the U.S., the service is not treated as provided for foreign persons or with regard to property located outside the U.S., unless the taxpayer establishes to the satisfaction the I.R.S. that the service is not substantially similar to services provided by the related party to persons located in the U.S.

The F.D.I.I. regime presents the possibility of keeping I.P. in the U.S. and licensing it to a foreign joint venture corporation for use in manufacturing or selling a product for use outside the U.S. The license would not run afoul of Code §367(d) and would generate F.D.I.I. for the U.S. corporation. If the licensee is a foreign related party for F.D.I.I. purposes, the joint venture corporation will be required to demonstrate that the I.P. was used to service foreign markets.

The U.S. corporation's tax rate on the F.D.I.I. (*i.e.*, the royalty income from the license to the foreign subsidiary) will be 13.125% (16.406% for tax years beginning

[4] For this purpose, a related party is determined under the rules for determining whether a corporation is a member of an affiliated group of corporations within the meaning of Code §1504(a) by substituting "more than 50%" for "at least 80%" and certain other adjustments (Code §250(b)(5)(D)).

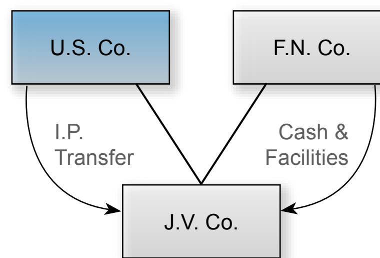
after 2025). This is clearly more favorable tax treatment than that imposed under Code §367(d)(2) since the deemed royalty income would be subject to U.S. corporate income tax at 21%.

Note that there is a G.I.L.T.I. component to the planning, as well. A U.S. Shareholder of a C.F.C. will be subject to tax on the G.I.L.T.I. of that C.F.C. A full discussion of G.I.L.T.I. is beyond the intended scope of this article. Nonetheless, it is important to note that the G.I.L.T.I. provision, like F.D.I.I., is a new regime introduced by the T.C.J.A. It imposes an immediate tax on the G.I.L.T.I. of a C.F.C., which in broad terms is all income of the C.F.C. with certain exceptions, including (i) Subpart F Income otherwise taxed in the hands of a U.S. Shareholder (excluding the effect of exemptions from Subpart F), (ii) effectively connected income taxed in the U.S., and (iii) a base amount of the C.F.C.'s gross income that is attributable to a routine return on depreciable tangible property, as mentioned above.

The tax rate on G.I.L.T.I. generally is 10.5% (13.125% for tax years beginning after 2025), although the computation of the rate is subject to the variable of foreign taxes paid or accrued on the G.I.L.T.I. Proposed regulations under Code §951A, other than rules related to the foreign tax credit for a G.I.L.T.I. inclusion, were published by the I.R.S. on September 14, 2018.[5]

NO DEEMED ROYALTY ON TRANSFER TO PARTNERSHIP

The second alternative is to use a foreign partnership as the joint venture vehicle. Under Code §721(a), neither a partnership nor any of its partners will recognize gain or loss on the contribution of property to the partnership in exchange for an interest in the partnership. This is illustrated in the following diagram, where the joint venture corporation makes a "check-the-box" election to be treated as a partnership for U.S. income tax purposes. In principle, J.V. Co. remains a separate company for purposes of the tax in its country of residence and in F.N. Co.'s country of residence.

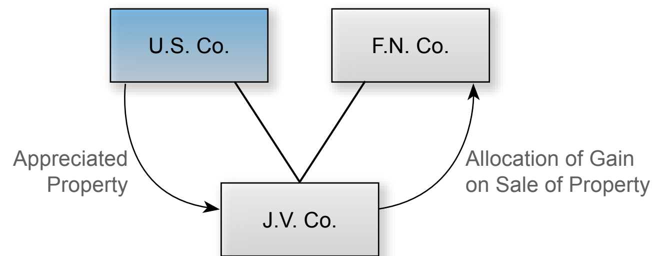


There are several exceptions to the general rule nonrecognition tool of Code §721(a), including Code §721(c), which grants the I.R.S. the authority to draft regulations that override the Code §721(a) nonrecognition rule when the contribution of appreciated property to a partnership will result in a foreign person recognizing the built-in gain. The concern addressed by Code §721(c) is the shifting of the built-in gain from a U.S. person to a foreign person through the contribution of the appreciated property to the partnership.

[5] REG-104390-18, September 14, 2018.

Code §367(d)(3) states that the I.R.S. may issue regulations applying the deemed royalty treatment of Code §367(d)(2) (discussed above) to a transfer of intangible property by a U.S. person to a partnership. Code §721(d) cross-references Code §367(d)(3) for regulatory authority to treat transfers of intangible property as sales. Thus, under §721(c) the I.R.S. has the authority to issue regulations to turn off the Code §721(a) nonrecognition rules and under Code §721(d) it has authority to issue regulations to apply the deemed royalty treatment of Code §367(d)(2) to an outbound transfer of intangible property to a partnership. To date, the I.R.S. has issued temporary regulations under Code §721(c) but has not issued regulations under Code §721(d).

The temporary regulations issued under Code §721(c) address the contribution of appreciated property by a U.S. person to a partnership (domestic or foreign) in which (i) a related foreign person[6] is a direct or indirect partner and (ii) the U.S. person and the related persons own, directly or indirectly, 80% or more of the interests in the partnership capital, profits, deductions and losses.



The appreciated property, referred to as "Code §721(c) property," is broadly defined as property other than "excluded property." Excluded property is cash, securities, tangible property with *de minimis* built-in gain, and an interest in a partnership in which effectively all of its assets consist of the foregoing excluded property. As a result, Code §721(c) property includes intangible property.

Importantly, the nonrecognition treatment of Code §721(a) may nonetheless apply to such a contribution if the partnership takes certain steps. In broad terms, the partnership must elect to apply a certain method of allocating the built-in gain with respect to the contributed property, referred to in the regulations as the "gain deferral method" and follow certain administrative procedures. The gain deferral method ensures that partnerships will not be able to shift the tax on the built-in gain contributed property to the related foreign person and thereby escape U.S. taxation. If the

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[6] Whether the persons are related is governed by the rules of Code §§267(b) or 707(b)(1). Code §§267(b)(1) through (13) describe related parties, including, *inter alia*, family members and entities that are controlled by the same persons. Individuals are considered related if they are spouses, siblings, ancestors, and lineal descendants. A corporation and a partnership are related if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or the profits interest, in the partnership. Under §707(b)(1), a partnership and a partner are related if the person owns, directly or indirectly, more than 50% of a capital or profits interest in the partnership, and two partnerships are related if the same persons own, directly or indirectly, more than 50% of the capital interests or profits interests.

partnership fails to follow these steps, the gain recognition rules of the temporary regulations are triggered.

Although the I.R.S. has issued guidance under its authority to treat outbound transfers of property, including intangible property, to a partnership as taxable, the guidance covers the narrowed circumstances of a partnership with a foreign partner that is related to the U.S. transferor. To date, the I.R.S. has not used its authority to issue guidance or regulations that override the Code §721(a) nonrecognition rule and impose a deemed royalty in the case of intangible property transferred to a partnership for use outside the U.S.

In the case of a U.S. person negotiating a foreign joint venture to service foreign markets where the business terms contemplate a transfer of I.P. to the foreign joint venture corporation, a check-the-box election to treat the joint venture as a partnership may solve the deemed royalty issue under Code §367(d)(2).

However, the solution comes with a tax cost. The U.S. corporation will not benefit from the low tax under F.D.I.I. because foreign branch income does not qualify for the deduction and will not qualify for the low tax under G.I.L.T.I., because only a C.F.C. triggers income under Code §951A and the deduction under Code §250. Nonetheless, it may provide tax results that are in line with the business deal under negotiation by the U.S. corporation and the foreign co-venturer.

If the I.P. relates to a trademark or a trade name, the transfer of the I.P. must meet the tests of Code §1253 in order to be treated as a sale or exchange of property. Under the general rule of Code §1253(a), the transfer of trademarks, trade names, and franchises is not treated as a sale or exchange of a capital asset if the transferor retains any "significant powers, right, or continuing interest" with respect to the subject matter of the franchise, trademark, or trade name.

"A check-the-box election to treat the joint venture as a partnership may solve the deemed royalty issue under Code §367(d)(2)."

A significant power, right, or continuing interest includes but is not limited to, a right to

- disapprove any assignment of the interest, or any part thereof,
- terminate at will,
- prescribe the standards of quality of products used or sold, or of services furnished, and of the equipment and facilities used to promote such products or services,
- require that the transferee only sell or advertise products or services of the transferor,
- require that the transferee purchase substantially all of his supplies and equipment from the transferor,
- payments contingent on the productivity, use, or disposition of the subject matter of the interest transferred, if such payments constitute a substantial element under the transfer agreement.

If the transferor retains any significant power, right, or continuing interest in the franchise, trademark, or trade name, any payments contingent on the productivity, use, or disposition of the property, it will generally be treated as ordinary income of the transferor. Although not relevant to this type of planning, any payments received

that are not contingent payments described above will be treated as gain from the sale of a capital asset of the transferor.

The key to addressing control of a product that is to be sold under a brand name without having the U.S. corporation run afoul of Code §1253 is to build the prescribed factors into the shareholder's agreement rather than the license agreement. This approach can be used to ensure that the operations of the joint venture corporation are carried on in a way that does not adversely affect the value of the trademark in other parts of the world. However, reliance on a shareholder's agreement will not protect the U.S. corporation from losing control of the trademark within the country in which the joint venture corporation operates in the event of a bankruptcy of the joint venture corporation. Protection against that risk may require an option to acquire the trademark at fair market value in the event of a filing for court protection against claims of creditors.

CONCLUSION

When expanding operations abroad, the transfer of ownership of I.P. or use of I.P. requires careful planning. With proper structuring, it is possible that a license arrangement in return for an arm's length royalty may provide benefits under the F.D.I.I. and G.I.L.T.I. rules by reducing the rate of U.S. Federal corporate income tax from 21% to as little as 13.125% for F.D.I.I. and 10.5% for G.I.L.T.I. However, in a cross-border joint venture where the U.S. party is contributing I.P., the need to pay a royalty may not fit the business deal. In that set of circumstances, use of a joint venture corporation that makes a check-the-box election may be the easiest structure to implement if the U.S. corporation is amenable to transferring ownership of the I.P. within a specific geographical location to the joint venture hybrid entity. Care must be taken to ensure that the transfer of a trademark in return for a partnership interest is viewed to be a transfer of property and not a *de facto* license by reason of Code §1253.

O.E.C.D. DISCUSSION DRAFT ON FINANCIAL TRANSACTIONS – A LISTING OF SINS, LITTLE PRACTICAL GUIDANCE

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Tags
Financial Transactions
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INTRODUCTION

In early July, the O.E.C.D. Centre for Tax Policy and Administration ("C.T.P.A.") released Public Discussion Draft on B.E.P.S. Actions 8-10: Financial Transactions (the "Discussion Draft"). The Discussion Draft addresses financial transactions (*e.g.*, loans, guarantees, cash pools, captive insurance, and hedging). Like many of the other initial B.E.P.S. Project drafts, the Discussion Draft does not represent a consensus among the O.E.C.D. Member States and requires commentary, input, and further work before becoming a chapter in the O.E.C.D. Transfer Pricing Guidelines.

THE O.E.C.D. IS LATE TO THE TABLE

A reader might wonder how or why the Discussion Draft has emerged at this particular point in time, as tax authorities and legislators in various countries have already provided guidance on a unilateral basis. In a short recap of developments in financial transaction transfer pricing, we arrived at this point in approximately the following chronology:

- **1972 –** Decision in *Mixon v. Commr.*, 464 F. 2d 394 (5th Cir 1972), establishes thirteen factors that can be determinative of *bona fide* debt
- **1998 –** Decision in *Laidlaw Transportation Inc., et al v. Commr.*, T.C. Memo 1998-232, further establishes that certain of the thirteen factors can be determinative of *bona fide* debt
- **2009 –** *DSG* decision from the U.K. Tax Tribunal on captive insurance pricing
- **2009 –** "Implicit support" of a subsidiary by a parent (discussed below) emerges from the *GE Capital Canada* case
- **2010 –** GE Capital Canada "guarantee fee" case decided for the taxpayer on appeal
- **2013 –** The B.E.P.S. Project decides not to abandon the arm's length principle in favor of formulary apportionment
- **2014 –** Draft reports are issued on B.E.P.S. Actions 4 (interest deductibility), 8, 9, and 10
- **2015 –** O.E.C.D. C.T.P.A. signals the start of a project on transfer pricing for financial transactions
- **2016 –** The U.S. issues proposed regulations under Code §365 issued on treatment of related-party indebtedness

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- **2017 –** McDonald's loan case decided in Spain in favor of the tax authority
- **2017 –** Chevron loan case decided in Australia in favor of the tax authority
- **2017 –** Hesse Norge A.S. loan case decided in Norway in favor of the tax authority
- **2017 –** Adverse S BV loan case decided in Sweden in favor of the tax authority
- **2017 –** The O.E.C.D. issues revised O.E.C.D. Transfer Pricing Guidelines (the "2017 Guidelines")
- **2017 –** The U.S. Tax Cuts and Jobs Act amends the Code §163(j) business interest deduction limitation
- **2018 –** Exxonmobil Production Norway Inc. loan case decided in favor of the tax authority
- **2018 –** The Discussion Draft is released for comment

As the reader can see, the Discussion Draft is somewhat late in providing guidance. This is unusual for the O.E.C.D., which typically provides transfer pricing guidance prior to tax law, administrative guidance, and jurisprudence. Stated differently, O.E.C.D. guidance generally has been issued where little authority existed, and in a multilateral context, it has provided direction to minimize double taxation.

The Discussion Draft arrives at a time when several of the key questions in financial transaction pricing have been settled in a substantive way, though not necessarily by all O.E.C.D. Member State tax authorities. Any resulting O.E.C.D. guidance will be applied in conjunction with already existing tax law, administrative guidance, and jurisprudence when determining the appropriate treatment of a controlled financial transaction. The potential for double taxation may arise where treaty partners give varying deference to particular O.E.C.D. guidance. The lack of consensus amongst O.E.C.D. Member States on the Discussion Draft may foreshadow difficult double-tax cases between competent authorities.

CONDITIONS FOR RECHARACTERIZING DEBT

The Discussion Draft deals at length with the conditions that must exist before a treaty partner may recharacterize a debt instrument or a guarantee as equity and the means by which recharacterization could be achieved. It suggests that descriptions of recharacterized outcomes will be a focus of future work. The Discussion Draft strongly signals that the tax authority's view on financial transactions appears to skew toward transaction recharacterization, and away from providing guidance that will help companies characterize financial transactions appropriately at the issue date or help tax authorities adjust a transaction price in a reasoned way. This likely will be an area that attracts significant industry comment and demand for examples and guidance on how to be compliant given different fact patterns.

It is not uncommon for foreign tax authorities and transfer pricing practitioners to give the 2017 Guidelines the deference of enacted law. However, in the Discussion Draft, one could argue that no deference is appropriate. There are too many instances of gratuitous comments concerning the behavior of independent parties

that are not confirmed with empirical evidence. Rather than making law, the document is better construed as making recommendations on best practices.

An example of an unsubstantiated statement is found in Box B.4 of the Discussion Draft. It states that if a lender lacks the functions to manage lending, it should receive a risk-free return while the managing entity receives the residual return. This is contrary to what is seen in the market. Companies and individuals pay fund managers a fee to invest capital because, ultimately, the risk to capital resides with the individual or entity investing the funds. An investment advisor may be unhappy that its client lost 50% of their investment in a risky venture, but it is the client that loses that capital, not the advisor. If this approach is adopted, we may see asset and risk considerations take a backseat to functions, contrary to market evidence.

"The Discussion Draft asks commentators to entertain a controversial presumption that an independently derived group credit rating may be taken as the credit rating for each member."

Similarly, cross-guarantees are stated in paragraph 131 of the Discussion Draft to have no value despite the well-established practice of banks requiring cross-guarantees on material loans. Collateral is also stated to be valueless in the related-party context in paragraph 52, as ownership of shares is assumed to imply ownership and control of assets.

CREDIT RATINGS

Credit ratings and their determination are discussed at length in the Discussion Draft. Several controversial ideas on how to calculate and apply credit ratings in an intercompany context are advanced.

Credit ratings are issued either for a company or for a specific issue of debt, not a corporate group in the aggregate. The rating tells the market what the odds are that a borrower will meet its debt obligations. While ratings are not issued for a corporate group, certain market participants may make the simplifying assumption that group members share the same credit rating.

In Box C.2, the Discussion Draft asks commentators to entertain a controversial presumption that an independently derived group credit rating may be taken as the credit rating for each member. The question is whether this would be useful for tax administrations and tax compliance. The answer is no, unless multiple nations agreed to create a safe harbor of this presumption. Why? Because the assumption fails to hold in important ways. Except in rare circumstances, a subsidiary can never have a higher credit rating than its parent company. A company can have less liquidity than a parent or sister company, greater relative debt service burdens, or sovereign factors that make it more prone to default. Therefore, the assumption of a group credit rating fails when tested, unless one makes strong assumptions about implicit support.

IMPLICIT SUPPORT, OR THE CREDIT "HALO EFFECT"

The Discussion Draft takes the presumption of implicit support as a given. Implicit support, which assumes a Multinational Enterprise ("M.N.E.") group member is too big to fail and therefore any default would be backstopped by the M.N.E. group or parent, is not supportable in an arm's length analysis. The Discussion Draft starts with passive association but makes a logical leap to the assumption that (i) due

to the importance of an entity to a group, it would be bailed out, and as such, its creditworthiness should be somehow elevated and (ii) this credit enhancement is not compensable. This ignores the O.E.C.D.'s consensus in the 2017 Guidelines at 1.159 on synergistic benefits of group membership:

> A deliberate concerted action involves one associated enterprise performing functions, using assets, or assuming risks for the benefit of one or more other associated enterprises, such that arm's length compensation is required.

This assumption, which was stated in a footnote, may have been overlooked in the rush to issue the Discussion Draft. However, the prior guidance is still logically sound. The 2017 Guidelines suggest that deliberate support in a financial transaction context is compensable. However, the Discussion Draft indicates that a guarantee exists by default, for which no compensation is warranted.

Many descriptions of implicit support are akin to hand-waving exercises for which hard data does not exist. The Discussion Draft disparages the use of bank opinions at paragraphs 92-93 as being a departure from an arm's length approach, yet a bank opinion is likely the most credible evidence of a quantification of implicit support. In fact, in an example that references the 2017 Guidelines at paragraph 1.164, implicit support is predicated on what seems to be a bank opinion. It also fails to clarify how a potential financial bailout does not represent a (compensable) commitment of assets as described in paragraph 1.159 of the 2017 Guidelines.

Further, the Discussion Draft provides no guidance on how to measure the credit rating impact of implicit support. In the examples given at 1.164-1.166 of the 2017 Guidelines and at paragraphs 157-159 of the Discussion Draft, the credit rating effect of implicit support is simply assumed, with no guidance on quantitative estimation. Taxpayers are asked to quantify implicit support in the absence of concrete guidance, akin to asking a company to describe an unknown counterfactual state. Regrettably, the world of tax compliance places a low priority on forgiveness of flawed prior assumptions.

This lack of detail will make competent authority proceedings difficult for both tax authorities and taxpayers, where achieving relief from double taxation will be inhibited by a lack of common approach founded on reliable principles.

PRACTICAL GUIDANCE AND EXAMPLES ARE LACKING

The Discussion Draft lacks practical guidance on how to evaluate transactions. Though there are some useful points, the Discussion Draft does not offer guidance on how to analyze transactions to determine if adjustments are necessary and how to adjust terms to achieve comparability. Worse, in some cases, the proposed approach is inconsistent with arm's length practices.

In paragraphs 62 through 66, the Discussion Draft does contain a reasonable discussion of the factors taken into account to arrive at a credit rating. The comment at paragraph 62 correctly observes that it is challenging to estimate a credit rating for certain entities (*e.g.*, start-ups, special purpose vehicles, etc.). While this is true, as is the statement that independent lenders would conduct a due diligence process,

there is no guidance or request for comments on what that process looks like practically. In effect, the draft says it is easy to sin here but doesn't give guidance on how to stay on compliant.

A useful observation is made in paragraph 65. It suggests that related-party transactions can influence any quantitative ratios and should be adjusted. Practitioners will be looking for some qualification to these observations to say that, to the extent controlled transactions influence the credit rating, those transactions must be shown to be at arm's length for the credit rating exercise to be reliable. Making such a qualifying statement and emphasizing the order in which transactions are examined would be important and would assist companies computing synthetic credit ratings and tax administrations evaluating the computations.

The insurance industry is as close as possible to the ideal of a transparent pricing model. In Box E.2, commentators are asked whether an actuarial analysis is an appropriate method for determining non-arm's length premiums. There is a widely-promulgated set of general methodologies available to actuaries, with available data, clear assumptions, and guidance on their application. To the extent, related-party transactions are truly insurance transactions and actuarial models exist that fit the transactions (as proposed in paragraph 166), the O.E.C.D. clearly has the opportunity to advance a robust principles-based arm's length pricing approach. We expect some debate from commentators about when such an approach is warranted. Such debate would indicate good progress toward multilateral guidance.

The Discussion Draft makes several statements about the consequences of recharacterization that are somewhat impractical. For example, in paragraph 140, the proposition indicates when a related party receives a guarantee that enhances not just its credit rating but also raises its debt capacity, a portion of the borrowed funds should be deemed to have been borrowed by the guarantor and considered a capital contribution to the borrower. There is no basis, of which we are aware, in the arm's length market. Further, how tax administrations and M.N.E.'s would go about executing a recharacterization is unexplained, likely for good reasons. A guarantee can be considered analogous to insurance for a lender. The proposed approach implies that, in some circumstances, the insurer should gain an equity interest in the borrower or policyholder in exchange for its pledge to the third-party lender. Surely, a more practical approach would be to price the impact of the credit enhancement and then price the value of the debt capacity enhancement, both of which are feasible exercises that would acknowledge the fact that the guarantor is not actually borrowing from the lender.

One might question whether some of the "solutions" to common problems proposed in the Discussion Draft should have made it into a document for public commentary. For example, the question to commentators in Box C.7 is a request to identify situations in which an M.N.E. group's average interest rate paid on external debt could be considered an internal "C.U.P." (comparable uncontrolled price). The answer seems to us to be clearly never, if we were to recognize that an average is derived from more than one number. Borrowing is highly dependent on the term of the loan, the date of the transaction, the creditworthiness of individual borrowers, etc. And, stepping back to definitions, a C.U.P. is an average of prices that, absent comparability considerations, does not constitute a price. At best this would be an alternative method, without logical underpinnings. The lack of justification for this proposition undermines the creditability of the Discussion Draft.

HINDSIGHT AND TIMING IN FINANCIAL TRANSACTIONS

Financial transactions are entered into at a specific point in time. They are based on the best quantitative and qualitative data available at this time. In hindsight, transactions can look unnecessary or excessive, such as insurance premiums paid for a fire that never occurs. The Discussion Draft acknowledges the importance of timing when it considers economic circumstances but fails to give this factor its due consideration.

The ability to manipulate the timing of a financial transaction – even within a given year – can lead to significant changes in the effective interest rate and should be of concern to tax administrations. To counteract this impact, certain requirements could be imposed, such as a requirement to demonstrate that credit analysis occurred before the issue date or that fund movements inform pricing dates and the requisite analyses.

Pricing is incredibly sensitive to timing and transactional terms can have a significant impact on interest rates. The discussion regarding the ready availability of loan data in paragraphs 83-84 does not address the fact that loans are not liquid or traded instruments and that loan data may not always be available or relevant. This is the reason why bonds, with clear terms that generally are consistent with the terms of loans and trade at volumes resulting in the reporting of pricing and other issue data, provide a practical alternative to loans when considering a source of pricing data.

Use of bond data in concert with credit ratings also addresses the fact that credit ratings are issued for issuers and securities that are actively traded. Public companies and bond issues are the primary sources of credit ratings. The Discussion Draft does not raise the comparability risks that may arise in using a credit rating to determine an arm's length interest rate on an illiquid intercompany loan. The draft skirts around the edges of this difference in paragraph 63, discussing how banks and alternative lenders utilize their own models for determining credit worthiness in special circumstances. However true, these models are specialized and proprietary and, therefore, not helpful when companies and tax authorities attempt to verify the pricing approach the other has taken.

Somewhat surprising is the Discussion Draft's lack of caution against the use of hindsight. Within the 2017 Guidelines, there are eight references to hindsight and the care required when this approach is used. Hindsight and restructuring or recharacterization go hand in hand. Paragraph 1.123 of the 2017 Guidelines cautions that restructuring of legitimate business transactions would be wholly arbitrary and lead to inequity. Therefore, great care should be taken in "delineating" between debt and equity where clear forward-looking guidance is not provided by tax administrations. This guidance is quite common and takes the form of debt-equity ratio rules, E.B.I.T.D.A.-denominated thresholds, or other mechanisms.

SUMMARY

Perhaps a plain-spoken Discussion Draft for the penitent multinational could have stated that manipulation of credit ratings can significantly impact interest rates and then recommended certain approaches to prevent companies using pricing

techniques that are recognized as either non-arm's length or gross simplifications. This could have been followed by some illustrative numerical examples. A "safe list" of commercially common terms to a loan transaction, such as prepayment terms, lack of security, and liquidity requirements, would have been helpful. A "less safe list" could have been established based on how exotic a particular term is in the market and how much judgment is required to price the marginal effect of the term in practice.

"We hope the O.E.C.D.'s aggressive opening bid will be met by a request for a return to principles and practical guidance."

The O.E.C.D. released a final report on how to value "H.T.V.I." (hard-to-value intangible assets) at the same time as it released the Discussion Draft. The H.T.V.I. report was intended for use by tax authorities. The preface to the Discussion Draft does not exclude multinational corporations as a user group. Nonetheless, the O.E.C.D. has clearly signaled that it intends to depart significantly from both well-established financial transaction pricing practices and standards that are market-based or can be understood with reference to market data.

For U.S. subsidiaries of parents resident in an O.E.C.D. Member State, the Discussion Draft suggests that, eventually, loans may be accorded different treatment depending on the jurisdiction of the borrower. This may require significant modification to a multinational company's generalized global transfer pricing policy for financial transactions at the country level.

One might question whether the Discussion Draft trades clarity, for tax authorities and companies, for adherence to the arm's length principle. Commentary is invited on a number of potential approaches that are not arm's length as we have pointed out. We expect companies will tell the O.E.C.D. that this compromise in principles is not needed. We hope the O.E.C.D.'s aggressive opening bid will be met by a request for a return to principles and practical guidance that can coexist with country tax law and the behavior of financial market participants.

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CRISTIANO RONALDO'S MOVE TO ITALY – WAS IT FOR LOVE OF THE GAME OR THE TAX LAW?

In a flurry of tax evasion rulings, Spain has levied substantial back taxes and penalties on high net worth celebrities, including footballers Cristiano Ronaldo and Lionel Messi and singer Shakira.[1]

Early this summer, Cristiano Ronaldo chose to leave Spain and moved to Italy amid speculation that tax penalties were a motive. Ronaldo was fined €18.8 million for tax evasion. Similar to Messi, he was found to be using offshore entities to conceal earnings from image rights. In early May 2017, Lionel Messi and his father were convicted of tax fraud and were forced to pay €4.4 million for unreported income. According to Spanish authorities, Messi and his father used Belizean and Uruguayan entities to conceal earnings from image rights.

Colombian singer Shakira, was also ordered to pay more than €20 million in back taxes to Spain. According to news outlets, she owns a home in the Bahamas and claimed the Bahamas as her tax residence in 2011 through 2014. Spanish authorities prevailed in treating Shakira as a Spanish resident for those years.

In addition to back tax and penalties, the soccer players were sentenced to incarceration, but neither is actually expected to serve time in prison. In Spain, first-time offenders who are sentenced to less than two years can serve the time under probation.

Ronaldo and Messi are not the only soccer players in hot water with Spanish authorities; according to Forbes,[2] Filipe Luis, Diego Costa, Radamel Falcao, and others have been involved in tax disputes with Spanish authorities.

After the hefty penalty, it is not surprising Ronaldo chose to leave Spain. It is anticipated that even with less pay in Italy, Ronaldo will retain a higher net income than when he was in Spain (Ronaldo's deal is worth a reported U.S. $117 million).

In 2017, Italy introduced a new law intended to encourage individuals to move to Italy.[3] This measure has become a useful tool to attract high net worth individuals. Under the law, Italy offers a resident non-domiciled tax regime to wealthy individuals that allows them to pay ordinary taxes on the income generated in Italy and a single,

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1 See "Updates and Other Tidbits," *Insights* 5, no. 3 (2018).

2 Kelly Phillips Erb, "8 Soccer Players At the World Cup Who Have Been Caught Up in Tax Scandals," *Forbes* (June 28, 2018).

3 "Italy Introduces a 15-Year Preferential Tax Regime for Wealthy Individuals Taking Up Tax Residence In Italy," *Insights* 4, no. 2 (2017).

fixed tax payment of €100,000 to cover taxes on non-Italian-source income.

Ultimately, the new Italian law may benefit the country's budget as well as its sports teams by enabling them to attract other foreign star players.

NEW YORK AND NEIGHBORING STATES BRING ACTION AGAINST THE FEDERAL GOVERNMENT

The Tax Cuts and Jobs Act ("T.C.J.A.") placed a $10,000 cap on the amount of state and local tax ("S.A.L.T.") an individual taxpayer can deduct on his or her Federal income tax returns. The states of New York, New Jersey, Connecticut, and Maryland brought a suit against the Federal government challenging the validity of the restriction on the S.A.L.T. deduction alleging it to be an "unconstitutional assault" on the state's sovereign choices.

The legal argument requires an interpretation of the 10th Amendment, concerning states' rights, and the 16th Amendment, which establishes Federal powers of income taxation. The action argues that the new law effectively overturns a longstanding precedent that the Federal government's income tax power was and would remain subject to federalism constraints. It also argued that the limits on the deduction, and the potential economic damage as a result of its implementation, deliberately seek to compel certain states to reduce their public spending.

The complaint alleged that as a result of the new cap, New York taxpayers will be burdened with an additional $14.3 billion in Federal taxes in the tax year 2018 and an additional $121 billion between 2018 and 2025, the year when the new cap is set to expire. The other plaintiff states will experience similar effects. The plaintiff states argued that they will bear the cost of paying for the new tax cuts and will receive the least benefits from the T.C.J.A. The plaintiff states allege that, by unfairly and disproportionally benefiting taxpayers of other states at the expense of their own taxpayers, the T.C.J.A. has injured their sovereign and quasi-sovereign interests.

"The complaint alleged that as a result of the new cap, New York taxpayers will be burdened with an additional $14.3 billion in Federal taxes in the tax year 2018."

The complaint further states that the new cap on the S.A.L.T. deduction is likely to adversely affect the plaintiff's states' real estate market. Under the pre-T.C.J.A. law, homeowners were allowed to deduct the full cost of property taxes on their Federal income tax returns. The new limitation on the deduction will increase the cost of owning a home, which will in turn depress home values.

The plaintiff states further allege that they attempted to take legislative action to combat the harmful effects of the new cap; however, in response to these efforts, the Federal government has signaled that it intends to prevent such action. The complaint contends that the Federal government is not only intentionally targeting the plaintiff states for adverse treatment but is also intentionally seeking to interfere with the states' sovereign authority over taxation and fiscal policy.

HAPPY ENDING FOR THE HOME OF THE HAPPY MEAL – NO ILLEGAL STATE AID TO MCDONALD'S

On September 19, 2018, the European Commission issued a decision that nontaxation of certain McDonald's profits in Luxembourg was not illegal State Aid.

The decision ends a lengthy saga that began in 2015, when the European Commission alleged that two rulings by the Luxembourg authorities provided McDonald's with a selective advantage. These rulings enabled McDonald's European subsidiary to pay no corporate tax in Luxembourg despite recording large profits from royalties paid by franchisees operating in Europe and Russia. According to the first 2009 ruling, McDonald's Europe Franchising did not pay corporate taxes in Luxembourg on the grounds that the profits were subject to tax in the U.S.; McDonald's was required to submit proof every year that the royalties were declared in the U.S. and subject to tax there. In a second ruling, issued six months later, the Luxembourg authorities removed the requirement to produce proof of tax payment; according to Luxemburg law, McDonald's Europe Franchising had a taxable presence in the U.S.

Article 107(1) of the Treaty on the Functioning of the European Union ("T.E.F.E.U.") identifies illegal State Aid as "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market."

In the September 19 decision, the European Commission ruled that Luxembourg did not break the E.U. State Aid rule but relied on a double taxation treaty between Luxemburg and the U.S. (the "Treaty"). The benefit was the result of a mismatch under the Treaty, rather than a selective advantage.

The benefit to McDonald's occurred because the definition of permanent establishment is different under Luxembourg and U.S. tax laws. The Treaty states that Luxembourg cannot tax the profits of a company if it may be taxed in the U.S. because it operates a permanent establishment there. Under U.S. tax law, the U.S. branch of McDonald's Europe Franchising was not treated as a permanent establishment, and therefore, it was not taxed in the U.S. However, the same U.S. branch was treated as a U.S. permanent establishment under Luxembourg tax law, thereby exempting its income under the Treaty and resulting in double non-taxation.

While McDonald's appears to have succeeded where other major multinationals (such as Fiat, Amazon, Starbucks, and Apple) failed, the victory is not without consequences. To prevent future abuse, the Luxembourg government is taking steps to prevent such situations by strengthening the definition of permanent establishment under its tax code. Once the change is adopted, taxpayers will be required to provide a certificate of residency in the other country to obtain a tax exemption in Luxembourg, thus proving that the other country recognizes the existence of a taxable permanent establishment of the company.

D.O.J. RESORTS TO UNDERCOVER OPERATIONS TO SECURE FIRST CONVICTION UNDER F.A.T.CA.

Adrian Baron, the former Chief Business Officer and former Chief Executive Officer of Loyal Bank Limited, has become the first person ever convicted for failing to comply with the Foreign Account Tax Complinace Act ("F.A.T.C.A"). Mr. Baron faces a maximum sentence of five years in prison.

Loyal Bank is an offhsore bank with offices in Budapest, Saint Vincent, and the

Grenadines. In June 2017, an undercover agent met with Mr. Baron and explained that he was a U.S. citizen interested in opening several corporate bank accounts. Although the agent would be the true beneficial owner of the accounts, he expressed concern that he did not wish to appear as the account holder on the bank records because the accounts would be used in multiple stock manipulation schemes. Mr. Baron responded that the bank could open such accounts.

One month later, the agent again met with Mr. Baron and described how the stock manipulation scheme operated, including the need to circumvent reporting under F.A.T.C.A. Mr. Baron responded that the bank would not submit a F.A.T.C.A. declaration to regulators unless the paperwork indicated "obvious" U.S. involvement. The bank opened multiple bank accounts and did not request information required under F.A.T.C.A. from the agent.

Mr. Baron was extradited to the U.S. from Hungary in July. He plead guilty to conspiring to defraud the U.S. by failing to comply with F.A.T.C.A. provisions.

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We provide a wide range of tax planning and legal services for foreign companies operating in the U.S., foreign financial institutions operating in the U.S. through branches, and U.S. companies and financial institutions operating abroad. The core practice of the firm includes tax planning for cross-border transactions. This involves corporate tax advice under Subchapter C of the Internal Revenue Code, advice on transfer pricing matters, and representation before the I.R.S.

The private client group of the firm also advises clients on matters related to domestic and international estate planning, charitable planned giving, trust and estate administration, and executive compensation.

The tax practice is supported by our corporate group, which provides legal representation in mergers, licenses, asset acquisitions, corporate reorganizations, acquisition of real property, and estate and trust matters. The firm advises corporate tax departments on management issues arising under the Sarbanes-Oxley Act.

Our law firm has offices in New York City and Toronto, Canada. More information can be found at www.ruchelaw.com.

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