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INSIGHTS

TRUST REGULATIONS AND PAYMENT SERVICES: DUTCH LAW IN 2019

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EDITORS' NOTE

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

- **Trust Regulations and Payment Services: Dutch Law in 2019.** The Dutch government has taken steps in recent months to enhance regulatory oversight. The new Act on the Supervision of Trust Offices 2018 adopts serious best practices for trust companies designed to prevent Dutch entanglement in the next set of Panama Papers. KYC due diligence must be real. At the same time, the Second Payment Services Directive ("P.S.D. II") was transposed into Dutch law. With customer permission, companies involved in payment service businesses will have greater access to information on spending habits of customers. This generates a win-win scenario – a miracle for companies engaged in marketing activities and insights for consumers into their spending patterns, enabling them to make better financial decisions. Lous Vervuurt of Buren N.V., the Hague, explains how the new rules work, including new standards of account security.

- **Strategies for Foreign Investment in Indian Start-Ups.** Foreign investment in Indian high-tech start-ups can yield significant profit opportunities for savvy investors. During 2018, over 1,000 deals were struck, reflecting $38.3 billion in new investments. If these investments turn out to be profitable, the tax exposure for the investor will vary with the form of the investment. Choices of investment vehicles include (i) L.L.P.'s, (ii) Category I, Subcategory I alternative investment funds ("A.I.F.'s") registered with the Securities Exchange Board, (iii) Category III A.I.F.'s, and (iv) trusts. Each has unique tax consequences for investors receiving dividends and realizing gains. Raghu Marwah and Anjali Kukreja of R.N. Marwah & Co L.L.P., New Delhi, explain the entities choices and the resulting tax costs.

- **F.B.A.R.'s — What You Need to Know.** April 15 is almost here, and while most people know this date as the filing deadline for individual tax returns, it is important to another filing requirement: the Report of Foreign Bank and Financial Accounts ("F.B.A.R."). Although the form has been around since the 1970's, many people continue to profess ignorance of its existence. Others are simply confused about the requirements. A recent Federal case illustrates the perils of failing to file a required F.B.A.R. Rusudan Shervashidze and Nina Krauthamer explain that penalties are high, and courts are skeptical about claims of ignorance of the law, especially when taxpayers have accumulated several million dollars placed in an offshore account.

- **More Permanent Establishments: The Dwindling Preparatory and Auxiliary Activities Exception.** Nothing is certain in this world, except death and taxes – and even taxes are subject to change. The ever-expanding definition of a permanent establishment ("P.E.") and ever diminishing exceptions to a P.E. under the O.E.C.D.'s B.E.P.S. Project has made one thing clear – the restrictions local jurisdictions put on activities by foreign taxpayers to trigger taxation are tightening. The dwindling preparatory and auxiliary activities exception is a prime example. Neha Rastogi and Beate Erwin explain.

- **The I.R.S. Approach to the Dependent Agent Concept.** When foreign corporations have certain limited activities in the U.S., a question that arises is whether a taxable presence exists in the U.S. for Federal income tax purposes. A foreign corporate taxpayer with direct activities or operations in the U.S. is subject to U.S. corporate income tax and branch profits tax if it conducts a U.S. trade or business generating effectively connected income. Recently, the I.R.S. Large Business and International division published an international practice unit ("I.P.U.") addressing the creation of a P.E. through the activities of a "dependent agent." Fanny Karaman and Beate Erwin lead the reader through the I.P.U. and explain the four-step process that is used by the I.R.S. to evaluate whether a permanent establishment exists.

- **Democrats Turn to Tax Reform to Reduce Wealth Disparity.** The U.S. Federal deficit is expected to reach $1 trillion in 2019. Meanwhile, a hedge fund billionaire recently purchased a New York City condominium for $238 million, and it is estimated that the top 0.1% possess almost the same amount of wealth as the bottom 90% of all households. Clearly there are wealth disparities and funding needs in U.S. When it comes to tax policy, Democrats have traditionally focused on tax relief, including a negative income tax, for poor and working-class families. Several recent pronouncements and extensive press coverage indicate a new approach, designed to tax the wealthiest individuals at significant rates of tax. Nina Krauthamer explains how current Democratic Party policy makers are planning to even out the distribution of wealth.

- **Who's Got the B.E.A.T.? Special Treatment for Certain Expenses and Industries.** Code §59A imposes tax on U.S. corporations with substantial gross receipts when base erosion payments to related entities significantly reduce regular corporate income tax. The new tax is known as the base erosion and anti-abuse tax ("B.E.A.T."). In the second of a two-part series, Rusudan Shervashidze and Stanley C. Ruchelman address (i) the coordination of two sets of limitations on deductions when payments are subject to B.E.A.T. and the Code §163(j) limitation on business interest expense deductions, (ii) the computation of modified taxable income in years when an N.O.L. carryover can reduce taxable income, (iii) application of B.E.A.T. to partnerships and their partners, and (iv) the application of the B.E.A.T. to banks and insurance companies.

Enjoy the read.

- The Editors

TRUST REGULATIONS AND PAYMENT SERVICES: DUTCH LAW IN 2019

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Tags
Payment Services
Trust Services
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Recently, Dutch legislators introduced a number of amendments to the Dutch financial regulatory environment. Two important changes are the new Act on the Supervision of Trust Offices 2018 (*Wet Toezicht Trustkantoren 2018*, or "W.T.T. 2018") and the implementation of the second Payment Services Directive ("P.S.D. II") into[1] Dutch law.

W.T.T. 2018

On January 1, 2019, the Act on the Supervision of Trust Offices was repealed and replaced by W.T.T. 2018. W.T.T. 2018 regulates the licensing and market conduct of Dutch trust offices (*trustkantoren*).

Under the new Dutch law, a trust office is defined as a legal entity, partnership, or natural person that provides one or more trust services on a commercial basis, whether or not in conjunction with other persons, legal entities, or partnerships.

The definition of trust services includes, *inter alia*, the following activities:

- Function as a managing director of a legal entity or as a partner of a partnership, on the instructions of a natural person or legal person that does not belong to the same group of companies as the managing director or partner.
- Provide domiciliation services (including a mailing address and/or physical address) for natural persons, legal persons, or partnerships in conjunction with one or more of the following services:
    - Providing legal advice
    - Arranging for the filing of tax returns and ancillary services
    - Providing services in connection with the preparation, review, or auditing of annual financial statements
    - Recruitment of directors for a legal person or partnership
- Make use of conduit companies (*i.e.*, legal entities that belong to the same group of companies as the principal but are used to provide trust services) on behalf of a client.
- Function as a trustee on the instructions of a natural person or legal person that does not belong to the same group of companies as the trustee.

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1 Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC.

Market for Trust Services

Europe is an important market for trust offices. Approximately 57% of trust offices worldwide are domiciled in Europe, primarily servicing internationally operating corporations. The Netherlands is a big market for trust services due to the favorable business climate in the country. In the Netherlands, approximately 3,500 people are engaged in providing trust services, and they service approximately 20,000 companies. Most trust officers are highly qualified, having university-level educations.

Nonetheless, the Dutch legislator is of the view that providers of trust services enable international groups to carry out abusive tax plans. Dutch companies were involved in some of the structures revealed in the Panama Papers and the Paradise Papers. Those trust companies usually did not meet in person with corporate clients and their ultimate beneficial owners. Instead, they relied primarily on written instructions from law firms and tax advisers.

As the Netherlands has concluded a fair number of tax treaties, tax-driven structures were often used in international planning – and frequently involved offshore jurisdictions. Increasingly these structures were aimed at providing as little transparency as possible through a daisy chain of asset-protection structures. Hence, a need existed to tighten regulations and intensify supervision.

Licensing Trust Services

As under prior law, W.T.T. 2018 prohibits anyone with a seat in the Netherlands from providing trust services in the pursuit of a profession or business without a license from the Dutch Central Bank ("D.N.B."). A similar prohibition applies to anyone with a seat outside the Netherlands to provide trust services in the pursuit of a profession or business from that home country into the Netherlands or from a branch office located in the Netherlands without a license from the D.N.B.

The prohibition does not apply to natural persons, legal entities, or partnerships who are engaged in providing management and organizational services on an interim basis (*e.g.*, an interim manager), insofar as these activities qualify as trust services.

Financial legislation within the E.U. and the European Economic Area ("E.E.A.")[2] is harmonized. All national legislation regarding banking services, investment services, and institutions for collective investment has been based on either E.U. directives or E.U. regulations. In comparison, the regulation of trust services is based on local law. This means that trust offices with a license to provide similar services in their home country cannot make use of a passporting regime under which a license in one member country enables the holder to operate in all member countries, as is common for most financial services. A company licensed to provide trust services in a member country outside the Netherlands must apply for a full license with the D.N.B. in order to operate from a base in the Netherlands.

W.T.T. 2018 contains a reciprocity provision allowing the Dutch legislator to designate states that have adequate supervision so that trust offices in those states may perform their services in the Netherlands without procuring a license from the D.N.B. Nonetheless, no designation has yet been made yet.

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[2] The E.E.A. is comprised of the member states of the E.U. plus Liechtenstein, Norway, and Iceland.

Changes to Dutch Law under W.T.T. 2018

W.T.T. 2018 provides measures to (i) strengthen the integrity and professionalism of trust offices, (ii) improve client identification procedures, and (iii) extend the administrative instruments of the supervisory authority (*i.e.*, the D.N.B.) to enhance supervision and enforcement.

Organization of Trust Offices

With regard to strengthening integrity and professionalism, the main provisions adopted in W.T.T. 2018 are as follows:

- In order to obtain a license from the D.N.B., a trust office with seat in the Netherlands must be organized in the form of a public or private limited liability company under Dutch law or a *Societas Europaea*, which is a public limited liability company that can operate in different European countries using a single set of rules. Natural persons are no longer eligible for a license under W.T.T. 2018.
- A trust office must have a minimum of two people who are charged with the day-to-day policy making within the trust office to safeguard continuity, quality of service, and general governance.
- Each trust office must appoint a compliance officer. This function cannot be outsourced, as was allowed under prior law.

Client Identification

With regard to client identification procedures, the main provisions adopted in W.T.T. 2018 are as follows:

- Specific rules have been introduced regarding the provision of services to specified legal entities, including partnerships and trusts. In addition, rules apply to each specific trust service that is provided to a client.
- The concept of ultimate beneficial owner is expanded, thereby requiring a trust office to go beyond the formal control structure and examine the structure of *de facto* control.
- A trust office may no longer rely on client identification procedures carried out by an accountant, tax advisor, lawyer, or civil law notary; the trust office must independently carry out its client identification.

"The concept of ultimate beneficial owner is expanded, thereby requiring a trust office to go beyond the formal control structure and examine the structure of de facto *control."*

Segregation of Trust Services from Tax Advice

A specific prohibition has been adopted under which trust services cannot be provided if they relate to the implementation of tax advice given to the client by the trust office itself or by a natural person, legal person, or other entity forming part of the same group of companies as the trust office.

Expansion of Trust Services

The Decree on the Supervision of Trust Offices 2018 (*Besluit Toezicht Trustkantoren 2018*), promulgated under W.T.T. 2018, expands the definition of "trust services" to include acting as an attorney in fact on the basis of a power of attorney, insofar as such power of attorney extends to exercising general managerial powers for the company receiving the service.

IMPLEMENTATION OF THE PAYMENT SERVICES DIRECTIVE II IN DUTCH LAW

In December 2018, the Dutch senate approved draft legislation transposing P.S.D. II into Dutch law. As of February 19, 2019, both the legislative proposal for P.S.D. II and the decree to implement P.S.D. II have entered into force. Most terms of P.S.D. II have been implemented into the Dutch Act on the Financial Supervision (*Wet op het financieel toezicht*, or the "A.F.S.") whereas certain terms have been implemented into Book 7 of the Dutch Civil Code (*Burgerlijk Wetboek*). P.S.D. II should have been implemented in the legislation of all E.U. Member States by January 13, 2018, and the Dutch legislator missed that deadline. This is not the first time that the Netherlands implemented E.U. directives on a delayed basis.

What Is P.S.D. II all About?

P.S.D. II is the replacement for the first Payment Services Directive ("P.S.D. I"),[3] which regulates payment services and payment service providers throughout the E.U. and the E.E.A. The goal of the P.S.D. I was to enhance competition within the E.E.A. and to facilitate participation in the financial sector. Special focus was placed on the creation of a level playing field with respect to consumer protection and the rights and obligations of payment services providers and their customers/users. P.S.D. I introduced a new category of payment services providers: the payment institution.

Payment services are defined as[4]

- services enabling cash to be placed on a payment account as well as all operations required for operating a payment account,
- services enabling cash withdrawals from a payment account as well as all operations required for operating a payment account,
- execution of payment transactions, including transfers of funds on a payment account with the user's payment service provider or with another payment service provider (including but not limited to execution of direct debits, execution of payment transactions through a payment card or a similar device, and execution of credit transfers),
- issuing of payment instruments and/or acquiring of payment transactions,
- payment initiation services, and
- account information services.

The last two services are new in P.S.D. II and are, as of the implementation of P.S.D. II into Dutch law, subject to an authorization requirement.

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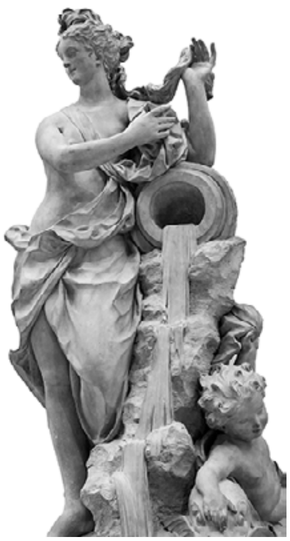
3 Directive 2007/64 EC.

4 As mentioned in Annex I to P.S.D. II.



Changes to Dutch Law under P.S.D. II

A brief overview of certain major changes imposed by P.S.D. II is given below. These changes have been recently enacted into Dutch law. Generally, most have been published in the *Official Journal of the European Union*. The scope of account information services may create opportunities with respect to financial services, costs savings, and marketing. However, this may expose consumer's personal data and financial information.

Two-Factor Authentication

Strong Customer Authentication ("S.C.A.") under P.S.D. II requires that businesses use two-factor authentication for verifying online payments from accounts or for initiating electronic payment transactions (*e.g.*, through credit cards). As of September 14, 2019, transactions that do not meet the new authentication requirements and do not qualify for an exemption may be declined.

Two-factor authentication is defined as a combination of two out of three possibilities:

- "Something you know" (*e.g.*, password, passphrase, pin, secret fact)
- "Something you own" (*e.g.*, mobile phone, wearable, smart card, token)
- "Something you are" (*e.g.*, fingerprint, facial features, voice patters, DNA signature)

This means that credit card payments that make use of the card number and the Card Verification Code ("C.V.C.") will not be sufficient in the future.

One Leg Transactions

"One leg" transactions are transactions that are executed partly within the E.E.A. and partly outside of the E.E.A. These transactions fall within the scope of P.S.D. II. However, P.S.D. II legislation only covers the European part of the transaction. Entities established within the E.E.A. will be subject to a license requirement (or should register for an exemption), irrespective of the country to which payments are made. Transparency and conduct rules apply only to payments that are executed within the E.E.A. in an official currency of one of the E.E.A. countries.

Payment Initiation Services

Payment initiation services are made for use by holders of an account that is manageable online. Banks must grant third parties access to their customers' payment accounts in order to initiate payments by such customers. Payment initiation service providers may, subject to approval of the account holder, ask the bank to execute a payment order on behalf of the account holder, and the bank will process the order. These services are a new manner of making online payments and offer an alternative for credit card payments or payments through PayPal.

Account Information Services

Under P.S.D. II, banks must provide third parties with access to the payment accounts of their customers in order to access the account holder's payment data. These account information providers will be in the position to collect payment data and compile overviews and payment profiles for their customers.

This is particularly interesting for fintech companies. If a consumer grants a third party permission to analyze their personal payment data, that firm can collect payment data from the bank and provide specific reports. Fintech companies could combine the reports in an app that connects with a bank account, categorizing all receipts and expenses.

A mortgage service provider may not need paystubs if it can directly access salary details of a prospective customer.

In addition, a consumer may be able receive tailored marketing messages based on a payment profile. An example is a digital message from an insurance company advertising lower rates than currently paid for existing insurance.

While many see account information services as a miracle for companies engaged in marketing activities, these services can also help consumers gain insight into spending patterns in order to make better financial decisions through a digital budget planner. The former may be viewed as bad from a consumer protection viewpoint, and the latter may be viewed as good from an empowerment viewpoint. This type of data is easier to obtain using account information services, as opposed to personally reviewing and analyzing payment details.

Personal Data Protection Matters

With the newly created possibilities to access account data, privacy issues are of the utmost importance. Parliament has taken time to address account holder privacy and the processing of financial and personal data. Clearly, the gathering of payment data and personal data is a sensitive matter. Therefore, one of the most important provisions in P.S.D. II is that without explicit consent of the customer, no payment service provider may obtain access to the customer's personal data. This applies to all parties that have access to financial data of consumers, including banks, payment initiation service providers, and account information providers.

"Dutch banks are asked to provide their customers with a list of the payment services providers to which they have given explicit consent to access payment and account data."

Consent must be given explicitly. Customers must have the right to easily withdraw consent at any time. Although no standardized form has been provided to obtain consent, the form used by parties having access to financial data must be request consent clearly and unambiguously. Tacit consent or pre-ticked boxes will not qualify as explicit consent.[5] Consent must be given for each payment service, and if consent is given for a specific purpose, such consent is not deemed to apply to other parts of the contractual relationship between the payment service provider and the consumer. To illustrate, if a consumer has given explicit consent to a payment initiation service provider, this will effectively lead to a payment order to the bank. This consent cannot be revoked. However, if a consumer has given their consent for repeated payments to the same beneficiary, the consumer must have the right to contact the payment initiation service provider to withdraw that consent.

Consumers are not obligated to make use of payment initiation services. However, if those services are the only form of payment for online stores, they will not be able to buy products from those online stores.

[5] These provisions are consistent with the E.U.'s General Data Privacy Regulation ("G.D.P.R."), which came into effect last year. For more on the global scope of the G.D.P.R., see "G.D.P.R. Is Imminent – Is Your U.S. Business Prepared?" *Insights* 5, no. 4 (2018).

Dutch banks are asked to provide their customers with a list of the payment services providers to which they have given explicit consent to access payment and account data.

Regulatory Supervision

Several regulatory bodies in the Netherlands are empowered to oversee P.S.D. II matters. These include the D.N.B., which oversees the provision of financial services; the Authority for the Financial Markets, which oversees the stock exchanges; the Dutch Data Protection Authority; and the Dutch Authority for Consumers and Markets.

CONCLUSION

Europe is moving towards greater regulation and oversight of financial services providers. W.T.T. 2018 and P.S.D. II are two examples. The former establishes standards for the provision of trust services and the latter introduces, though authorized, access to financial information of consumers. From a policy standpoint, both initiatives raise the standard of professionalism for gatekeepers to corporate structures and providers of financial services.

STRATEGIES FOR FOREIGN INVESTMENT IN INDIAN START-UPS

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Tags
India
Start-Ups

Foreign investment in Indian start-ups offers significant opportunities for investors who understand their options. This is especially true for investment in technology start-ups developing artificial intelligence and consumer facing apps. Various investment avenues available to nonresidents are outlined in the paragraphs below.

INVESTMENT ENVIRONMENT

Indian start-ups have begun attracting nonresident high net worth individuals and family offices in significant numbers. These groups represent a large portion of the $38.3 billion garnered by Indian start-ups in over 1,000 deals during 2018.

In particular, wealthy business families have been promising supporters of Indian start-ups. These families often come with significant expertise in the industries where they invest and are more flexible in their exit strategies than venture capitalists, funds, and other investors. This has often resulted in nonresident individuals and families owning prominent and profitable Indian start-ups that were considered risky in their early stages.

PURCHASING SHARES AND DEBT

Nonresidents can invest directly in start-ups by subscribing to shares (equity or compulsorily convertible preference shares) or debt issued by the start-up. During the tenure of these investments, nonresident investors would continue to receive income in the form of dividends or interest to the extent of free cash.

Dividends paid by Indian companies are subjected to Dividend Distribution Tax ("D.D.T.") at the company level under Section 115-O of the Indian Income Tax Act, 1961("I.T.A.") and are tax-free in the hands of shareholders. Since individual investors do not directly incur the tax, it may be difficult for an individual to claim foreign tax credit relief in the home country for D.D.T. imposed on dividends without further analysis of the D.D.T. under home country tax concepts. Interest would be taxed under Indian tax law at the individual rate applicable to nonresidents, subject to relevant tax treaty relief.

Upon the sale of these shares or controlling rights, nonresidents would be liable to pay capital gains tax under domestic law, subject to any relevant tax treaty benefits. Under domestic law, the capital gains tax rate is dependent on the holding period. Where the holding period is more than 36 months (assuming the shares of the Indian start-up are unlisted), gains are taxed as long-term capital gains at the rate of 10% (plus applicable surcharge and cess) without the benefit of foreign currency conversion or cost indexing under Section 112(1)(c) of the I.T.A. Capital receipts would be received by nonresident H.N.W.I.'s (net of tax). Further, nonresidents

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would be required to obtain a permanent account number (“P.A.N.”) from the Indian tax authorities and file an Indian income tax return with respect to the transaction.

CAPITAL CONTRIBUTIONS IN LIMITED LIABILITY PARTNERSHIPS

Nonresidents can also invest in Indian limited liability partnerships (“L.L.P.’s”) by way of capital contributions.

Income earned by an Indian L.L.P. would be taxed in hands of L.L.P. at a rate of 30% (plus applicable surcharge and cess). Any distributions to nonresident partners would be tax-free.

In the case of a change in shareholding, there may be no exit tax in the hands of the outgoing partner.

INVESTING THROUGH FUNDS

Nonresidents can incorporate alternate investment funds (“A.I.F.’s”) registered with the Securities Exchange Board of India (“S.E.B.I.”) (in the form of a company, trust, L.L.P., or body corporate) for the purpose of investing in eligible start-ups.

A.I.F.’s can take several forms:

- Category I, Subcategory I A.I.F.’s enjoy passthru status. That is, any income earned by these funds is tax-exempt in the hands of the fund under Section 10(23FB) of the I.T.A. and taxable in the hands of the nonresident investor under Section 115U of the I.T.A. Neither D.D.T. nor withholding tax would be applicable on the distribution of income to the nonresident investor.
- Other A.I.F.’s registered as Category I & II (also known as “Investment Funds”) enjoy passthru status for income other than business income. That is, business income would be taxable in hands of the A.I.F. under Section 115UB of the I.T.A. and the distribution would be tax-free in the hands of the nonresident investor. All other income (other than business income) would be exempt for the A.I.F. under Section 10(23FBA) of the I.T.A. and, hence, taxable in the hands of the nonresident investor. No D.D.T. would be applicable on the distribution of income to the nonresident investor.
- Income from Category III A.I.F.’s does not enjoy passthru status. Income would be taxed at the rates applicable to the entity. For instance, if an A.I.F. is incorporated in the form of a business trust, its taxation would be governed by the income tax provisions applicable to business trusts. D.D.T. or withholding tax, as per the I.T.A., would be applicable on the distribution of income to nonresident investors.

In all these forms, the investor can exit at any time by transferring its interest in the A.I.F. and paying tax on the capital gains on the sale, subject to relevant tax treaty relief. Nonresident investors are entitled to claim tax benefits under a relevant tax treaty during the investment tenure and on exit, if the treatment is more favorable than the I.T.A. provisions.

INVESTING THROUGH BUSINESS TRUSTS

Nonresident individuals can set up business trusts that, in turn, invest in eligible start-up companies.

On the tax front, any interest and dividend income is exempt under Section 10(23FC) of the I.T.A. in the hands of the trust but is taxable in the hands of the investor as per applicable tax rates. Capital gains, business income, or other income is taxed in the hands of the trust in accordance with Section 115UA of the I.T.A. and, hence, is tax-free on distribution to the nonresident investor.

Upon a transfer of units in the business trust, the nonresident would be liable for tax on the capital gains, subject to the relevant tax treaty relief.

CONCLUSION

Investment in Indian start-ups is a high-risk, high-reward activity. The space offers a potential win-win for foreign investors looking to multiply investments with high rates of return and for the country as a whole, with Indian start-ups providing jobs, digitalization, and innovations that contribute to a vibrant economy and produce a positive social impact.

As an investor, there is always a question of whether to become involved in day-to-day management of the business or to let the concept owner take the lead. In either case, the ease of entry and exit, clear Indian tax laws, and availability of tax treaty benefits make investing in Indian start-ups a promising and lucrative opportunity for nonresidents.

F.B.A.R.'S – WHAT YOU NEED TO KNOW

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Tags
Compliance
F.B.A.R.

April 15 is almost here, and while most people know this date as the filing deadline for individual tax returns, it also important to another filing requirement: the Report of Foreign Bank and Financial Accounts ("F.B.A.R."). Although the form (currently Financial Crimes Enforcement Network (FinCen) Form 114) has been around since the 1970's, many people still are unaware of its existence and those that are aware may be confused about the requirements. A recent Federal case illustrates the perils of failing to file a required F.B.A.R. report.

THE RULES

At first glance, the F.B.A.R. instructions seem relatively simple: A U.S. person must file an F.B.A.R. if that person has a financial interest in or signature authority over any financial account(s) outside of the U.S. and the aggregate maximum value of the account(s) exceeds $10,000 at any time during the calendar year. But they also spark certain questions:

- Who is a U.S. person?
- What is a financial account?
- What is a financial interest or signature authority?
- If a filing obligation is not fulfilled, what are the consequences?

Some of these answers are straightforward.

For F.B.A.R. purposes, a U.S. person is (i) a U.S. citizen or resident, (ii) an entity created or organized under the laws of the U.S., (iii) a trust formed under the laws of the U.S., or (iv) an estate formed under the laws of the U.S.

A financial account includes bank accounts, securities accounts, commodity futures, option accounts, insurance policies with a cash value, mutual funds, and any other accounts maintained in a foreign financial institution or by a person performing the services of a financial institution.

However, when delving into the specifics of these rules, there are also some ambiguities.

Recently, the U.S. District Court of Maryland ruled in *U.S. v. Horowitz*[1] on three issues regarding the F.B.A.R. filing obligation. These answers will come in handy when determining whether an F.B.A.R. filing obligation exists.

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1 *U.S. v. Horowitz*, 2019 U.S. Dist. LEXIS 9484 (D. Md. 2019)

THE CASE

"The statute of limitations for assessing civil penalties for an F.B.A.R. violation is six years, and the clock begins to run on the date the F.B.AR. is due."

Mr. and Mrs. Horowitz (referred to as "H" and "W" respectively) were U.S. citizens who lived in Saudi Arabia from 1984-1992 and 1994-2001. H established an account at Foreign Commerce Bank, a Swiss bank, in 1988. In 1994, when H returned to Saudi Arabia, he traveled to Switzerland to close the account and to open an account at UBS. Both H and W jointly owned the UBS account, and the account opening documents listed an address for them in Saudi Arabia.

During the years 2001-2008, H and W moved back to the U.S. During this time, they did not make any deposits or withdrawals, but H called UBS every year or two to monitor the account.

After reading some troubling news articles about UBS, H traveled to Switzerland to close the account and open a new one at Finter, another Swiss bank. By this time, the balance on the account was almost $2 million. H brought his spouse's passport with him, but Finter would not allow him to open a joint account without her present. H filled out a list of authorized signatories and powers of attorney when he opened the account and designated his spouse as the person to whom he gave an "unlimited power of attorney." However, the form lacked W's signature, which would enable her to communicate with the bank. In October 2009, H and W traveled to Switzerland to add W to the account, as a joint owner.

During these years, H and W retained an accountant to prepare their joint tax returns. H communicated with the accountant and provided an annual summary of tax-pertinent information, but he never mentioned the Swiss accounts. Once each tax return was prepared, H and W signed the joint return. Over this period, they never answered "Yes" on Schedule B of Form 1040 to identify their ownership of a foreign account, and they never filed an F.B.A.R. to disclose either the UBS or the Finter account.

Finally, in 2010, they disclosed the funds for the first time. In June 2014, the government assessed penalties of $247,030 against each of them for their alleged willful failure to disclose the UBS account for the 2007 tax year and penalties of $247,030 against each of them for their alleged willful failure to disclose the Finter account for the 2008 tax year.

In 2016, the government took action to collect the penalties. In response, H and W moved to have the case dismissed, arguing that the government removed the assessed penalties in 2014 and that the collection process was untimely.

<u>Does Removing Penalties from the I.R.S. Module Actually Bar the Assessment of Penalties Under the Statute of Limitations?</u>

The statute of limitations for assessing civil penalties for an F.B.A.R. violation is six years, and the clock begins to run on the date the F.B.AR. is due.[2]

The parties agreed that in 2014 the government assessed the penalty within the statute of limitations and that the statute ran out on December 31, 2015. The question presented to the court was whether certain I.R.S. actions negated the penalties assessed in 2014.

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[2] 31 U.S.C. §§5314, 5321(b)(1).

The government conceded that around October 24, 2014, an I.R.S. agent removed the penalty input dates from the database. This action appears to be in response to a request to remove or reverse the assessed penalties. However, the government disagreed that these actions amounted to an actual removal of the penalties themselves.

In its ruling, the court pointed out that the defendant bears the burden of proof. Here, H and W failed to show that, even if the I.R.S. agent reversed the penalty, she had the authority to do so. When the actual penalty was assessed, the agent was required to obtain a manager's signature before inputting the data. Therefore, the court reasoned that treating the penalties as removed without the manager's signature was incongruous with the initial signature requirement.

The government also noted the absence of other required approvals. Under Federal regulations, the Department of Justice must approve the settlement of a claim that exceeds $100,000. Further, the penalty section of the Internal Revenue Manual advises I.R.S. employees that post-assessed F.B.A.R. penalties in excess of $100,000[3] cannot comprise the penalty by Appeals without the approval of the D.O.J.

What Constitutes a Financial Interest in a Foreign Account?

In its argument, the government relied on the definition of "financial interest" found in the 2011 Treasury regulations:

> A United States person has a financial interest in each bank . . . account in a foreign country for which the owner of record or holder of legal title is—(i) A person acting as an agent, nominee, attorney or in some other capacity on behalf of the United States person with respect to the account.[4]

The government also relied on the 2011 definition of "signature or other authority," arguing that it is the authority of an individual (alone or in conjunction with another) to control the disposition of money, funds, or other assets held in a financial account by direct communication (whether in writing or otherwise) to the person with whom the financial account is maintained.[5]

W pointed out that while those regulations were promulgated in 2011, she relied on the 2008 F.B.A.R. instructions, which are more limited in scope and in part provide as follows:

> A United States person has a financial interest in . . . [a] financial account in a foreign country for which the owner of record or holder of legal title is . . . a person acting as an agent, nominee, attorney, or in some other capacity on behalf of the U.S. person.
>
> And, [possessing the authority to] control the disposition of money or other property in it by delivery of a document containing his or her signature . . . to the bank . . . with whom the account is maintained. Other authority exists in a person who can exercise comparable power over an account by communication with the bank or

3 31 U.S.C. §3711(a).

4 31 C.F.R. §1010.350(e)(2)(i).

5 31 C.F.R. §1010.350(f)(1).

> other person with whom the account is maintained, either directly or through an agent, nominee, attorney or in some other capacity on behalf of the U.S. person, either orally or by some other means.[6]

The court did not address which definition applied but ruled that, even under the broad definition provided by the government, W did not have authority over the Finter account in 2008 and that her husband could not be seen as acting on her behalf.

In its discussion, the court pointed out the following facts. Finter would not allow H to open the account in both of their names. H was able to withdraw funds from their joint account and deposit it into the Finter account with his name only. Without a signature specimen, W could not write to, or otherwise, directly communicate with, the bank "to control the disposition of money, funds or other assets" in the Finter account.[7]

"Form 1040, Schedule B, asks whether a foreign bank account exists and not whether it is taxable."

Therefore, W could not exercise signature authority over the Finter account, and by taking money that was in W's name and placing it in an account that was not in her name, H could not, in any light, be seen as acting on her behalf.

<u>What Facts Amount to "Willful Blindness"?</u>

If a taxpayer fails to file a timely F.B.A.R., the Secretary of the Treasury may impose a financial penalty.[8] If the failure is not "willful," the amount is capped at $10,000.[9] However, if the failure is a willful violation, the amount is greater of (i) $100,000 or (ii) 50% of the balance in the account at the time of the violation.[10]

According to H and W, they conversed with other expatriates living in Saudi Arabia and were led to believe that they were not required to pay U.S. tax on the income they earned in the country if the funds remained overseas. H stated that he did not think he needed to file the F.B.A.R., while W stated that she did not even know what an F.B.A.R. was at that time. Further, she pointed out that she never participated in filing the income tax returns and that her husband handled all of the taxes. According to the pair, their accountant neither asked about overseas bank accounts nor explained the F.B.A.R. or the question on Form 1040, Schedule B, that addresses foreign accounts. H and W insisted that neither of them had actual knowledge of the F.B.A.R. requirement and therefore penalties for willful violations were not appropriate.

The government countered by pointing out that despite H and W's testimony, the simple instructions in Part III of Form 1040, Schedule B, state that "you must complete this part if you (a) had over $1,500 of taxable interest or ordinary dividends, or (b) had a foreign account." According to the government, H and W met both of the requirements. Interestingly, the government pointed out Form 1040, Schedule B, asks whether a foreign bank account exists and not whether it is taxable.

The court discussed various cases and concluded that H and W declared, under

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6 Form TD F 90-22.1 (Rev. 10-2008).

7 31 C.F.R. §1010.350(f)(1).

8 31 U.S.C. §5321(a)(5)(A).

9 31 U.S.C. §5321(a)(5)(B)(i).

10 31 U.S.C. §5321(a)(5)(C)(i).

penalty of perjury, that they had examined the returns and accompanying schedules and statements and that, to the best of their knowledge, the return was true, accurate, and complete. The tax return included a question about whether they had foreign accounts, followed by a cross-reference to exceptions and filing requirements for the F.B.A.R. Further, the court reiterated that a taxpayer who signs a tax return will not be able to claim innocence because they did not actually read the return. Their signatures were *prima facie* evidence that they, by application of reasonable care or diligence, knew the contents of the return, including the question about foreign accounts and the cross-reference to filing requirements, which put them "on inquiry notice of the F.B.A.R. requirement."[11]

In response to the claim that other expatriates advised H and W that they did not need to pay taxes on the interest in the foreign accounts, the court noted that these expatriates' credentials were not before the court nor was there any information from which to assess whether it was reasonable for them to accept this information as legally correct. And, in any event, these views would not override the clear instructions on Schedule B, which, as noted, requires a "Yes" answer if the taxpayer has an interest in a foreign account, regardless of whether the funds within it constituted taxable income.

Moreover, the fact that the H and W discussed the tax liabilities on these foreign accounts demonstrated their awareness that the income could be taxable. The failure to have the same conversation with their accountant easily showed "a conscious effort to avoid learning about reporting requirements." Based on these facts, the court ruled that willful blindness can be inferred.

THE CONCLUSION

To reiterate, a U.S. person must file the F.B.A.R. if that person has a financial interest in or signature authority over any financial account(s) outside of the U.S. and the aggregate maximum value of the account(s) exceeds $10,000 at any time during the calendar year. Question 7a of Form 1040 Schedule B specifically asks whether the taxpayer has a financial interest in or signature authority over a foreign financial account and whether the taxpayer was required to make an F.B.A.R. filing.

The recent Horowitz case is helpful when we look at the application of this rule. The case stands out for three reasons: First, the removal of penalties from I.R.S. database does not negate the actual penalties without additional approvals. Further, it is notable that, even under the broad definition used by the government, the court did not find that a spouse has control over a foreign account opened by her husband and funded from a joint account if she is not empowered to communicate directly with the bank. Finally, and most crucially for many taxpayers, marking "No" on Form 1040, Schedule B, can negate non-willfulness, as the taxpayer is expected to know what is in the tax return.

[11] *Williams II*, 489 Fed App'x at 659.

THE I.R.S. APPROACH TO DEPENDENT AGENT STATUS

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Tags
Dependent Agent
I.P.U.
Permanent Establishment

When foreign corporations have certain activities in the U.S., the question often arises as to whether a taxable presence exists in the U.S. for Federal income tax purposes. Under U.S. Federal tax law, a foreign corporate taxpayer with direct activities or operations in the U.S. is subject to U.S. corporate income tax and branch profits tax if it has a U.S. trade or business generating effectively connected income.[1] Recently, the I.R.S. Large Business and International division published an international practice unit ("I.P.U.") addressing the creation of a P.E. through the activities of a "dependent agent."

In general, the permanent establishment ("P.E.") article of a treaty between the foreign taxpayer's jurisdiction and the U.S. will govern U.S. tax treatment of the foreign taxpayer's U.S. activities, if the taxpayer is eligible and elects for treaty benefits.[2] Often, the treaty definition of a P.E. is, in effect, less stringent in that it allows for the exemption from a taxable presence when under U.S. domestic laws, a taxable presence would have been determined. In other words, the treaty is more generous than the U.S. definition of a U.S. trade or business and foreign taxpayers are able to generate income from U.S. activities – within certain limitations – without being deemed to create a taxable presence. For example, treaties in their current form exclude certain preparatory and auxiliary activities from the definition of a P.E. while expressly including certain activities of a dependent agent. In recent years, however, the scope of the P.E. exceptions has been tightened in order to limit base erosion.[3]

The recent I.P.U. bases its discussions on the U.S.-U.K. Income Tax Treaty (the "U.K. Treaty") and provides valuable information as to how the I.R.S. will audit tax returns in order to detect the presence of a U.S. dependent agent concluding contracts on the taxpayer's behalf in the U.S.

It is worthwhile noting that the I.P.U. assumes that the taxpayer is otherwise eligible for U.K. Treaty benefits and emphasizes that its discussion is based on the U.K. Treaty. It is thus important to bear in mind that all income tax treaties are different and that the results may vary depending on the provisions of a particular treaty.

The relevant P.E. definition under Article 5 of the U.K. Treaty reads as follows:

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1 In comparison, certain passive income derived by foreign corporations from U.S. sources is subject to U.S. taxation by means of withholding, *e.g.*, so-called fixed or determinable, annual or periodic ("F.D.A.P.") income.

2 Such as residency for treaty purposes and meeting one of the tests under the limitation of benefits article.

3 See, *e.g.*, "Permanent Establishments Become More Permanent: The Dwindling Preparatory and Auxiliary Activities Exception," *Insights* 6, no. 3 (2019) and "O.E.C.D. Receives Public Comments on Proposed Changes to the Model Tax Convention," *Insights* 4, no. 10 (2017).

ARTICLE 5

Permanent Establishment

. . .

5. Notwithstanding the provisions of paragraphs 1 and 2 of this Article, where a person – other than an agent of an independent status to whom paragraph 6 of this Article applies – is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority to conclude contracts that are binding on the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities that the person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 of this Article that, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

CLUES TO THE EXISTENCE OF A DEPENDENT AGENT P.E.

The I.P.U. provides guidance to I.R.S. agents (which is similarly helpful for taxpayers) as to how to determine the potential presence of a dependent agent based on available information, including documentation provided by the taxpayer. For illustrative purposes, the I.P.U. is based on the following fact pattern:

- A U.K. company active in the hotel business has an international presence through owned and franchised hotels.
- The U.K. company is the sole owner of a U.S. subsidiary that owns and operates hotels in the U.S.
- The U.S. subsidiary acts as the U.K. company's U.S. headquarters.
- The U.K. company and the U.S. subsidiary entered into an intercompany agreement pursuant to which the subsidiary negotiates franchise contracts with U.S. hotels on behalf of the parent company.

The I.P.U. advises agents to look at four main sources of information:

- Information submitted by the taxpayer (such as Forms 1120-F, *U.S. Income Tax Return of a Foreign Corporation*; Forms 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*; Forms 8833, *Treaty-Based Return position Disclosure under Section 6114 or 7701(b)*; or financial statements, indicating the use of a U.S. agent or commissions paid to an agent[4])
- Information received from the taxpayer upon I.R.S. request (such as the companies' financial statements, organizational charts, and copies of invoices issued by the U.S. subsidiary to U.S. customers that relate to certain types of income)

[4] Part E of Form 1120-F; Part IV line 21 of Form 5472.

- Internal I.R.S. research tools (including the Information Document Retrieval System ("I.D.R.S."), Yk1 Readiness ("YK1"), the LB&I Imaging Network ("L.I.N."), and the Office of Governmental Liaison)
    - The I.D.R.S. is a system enabling certain I.R.S. employees to have instant visual access to certain taxpayer accounts.[5]
    - YK1 is a research, analysis, and statistics development application that can display visual connections between entities that may engage in abusive tax avoidance transactions. It focuses on partnerships, S-corporations, and trusts. The links between the entities is generally based on K-1 relationships, parent-subsidiary relationships, or spousal relationships. The information the application uses to link entities and individuals are corporate, partnership, S-corporation, trust, and individual income tax returns.
    - L.I.N. turns certain paper or electronically filed tax returns into PDF format for easier access.[6]
    - Finally, Governmental Liaison is an I.R.S. office that partners with state tax agencies and Federal and local government agencies to improve voluntary compliance and make tax administration more efficient.[7]
- Readily available information on the internet

If the agent concludes that no agent relationship exists, the I.P.U. cautions I.R.S. agents to still look for withholdable F.D.A.P. payments and make certain that the appropriate transfer pricing rules are applied.

ANALYZING THE PRESENCE OF A DEPENDENT AGENT P.E.

To determine the presence of a dependent agent P.E., the I.P.U. proceeds with four successive steps:

1. Determine whether the contracts concluded by the potential agent related to the foreign taxpayer's essential business operations.
2. Determine whether the potential agent habitually exercises its authority to conclude contracts on behalf of the foreign taxpayer.
3. Determine whether the contracts concluded by the potential agent bind the foreign taxpayer.
4. Determine whether the potential agent is a dependent agent of the foreign taxpayer.

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5 IRS, "Section 14 - Integrated Data Retrieval System (IDRS)."

6 Treasury Inspector General for Tax Administration, "Successfully Processing Large Corporate Tax Returns Electronically Was a Major Accomplishment, but Eliminating More Compliant Returns from the Audit Stream Is a Work in Progress," (May 19, 2011).

7 "Information for Governmental Liaisons," I.R.S., last reviewed Aug. 17, 2018.

Step 1: Relation to Foreign Principal's Essential Business Operations

The I.P.U. reiterates what the technical explanations to Article 5(5) already provide: The contracts referred to by the U.K. Treaty are those relating to the essential business operations of the enterprise rather than ancillary activities.

What is somewhat surprising here is that the I.P.U. includes an example that is based on the Commentary on Article 5(5) of the 2014 version of the O.E.C.D. Model Tax Convention (the "Model Convention"). As explained in the preamble to the Technical Explanation of the U.K. Treaty, both the U.S. Model Treaty and the 2000 Model Convention have been taken into account in negotiating the U.K. Treaty. Yet, the I.P.U. refers to the 2014 Model Convention and not to the 2000 one. Even more interesting is the fact that the I.P.U. does not use the most recent version of the Model Convention, which was released in 2017 and incorporates changes under the O.E.C.D.'s B.E.P.S. initiative, in particular Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status).[8]

"The authority to enter into binding contracts on behalf of the foreign taxpayer does not in and of itself create a dependent agent P.E."

The example essentially states that the mere fact of having the authority to enter into binding contracts on behalf of the foreign taxpayer does not in and of itself create a dependent agent P.E. The authority to conclude the contracts must relate to the essential business operations of the foreign taxpayer. As a result, the authority to conclude service contracts for the foreign taxpayer's business equipment used in the agent's U.S. office does not create a dependent agent P.E.

The I.P.U. then explains that even if the contracts are related to foreign taxpayer's business operations, agents should investigate further and determine whether the contracts relate to a core external activity of the foreign taxpayer, as opposed to essential business operations. This determination can be made by looking at the foreign taxpayer's financial statements or sample contracts entered into by the agent on behalf of the foreign taxpayer, or by conducting internet research.

If the contracts are not related to the foreign taxpayer's essential business operations, a P.E. may still exist under a different provision, such as "carrying on a business in the U.S."

Step 2: Habitual Exercise of Authority to Conclude Contracts on Behalf of Foreign Principal

The I.P.U. advises that this determination must be based on the "commercial realties" of each case. The nature of the contracts and the business of the foreign taxpayer must be taken into account. For this purpose, I.R.S. agents are advised to review some contracts to assess the potential agent's authority to conclude contracts in the context of the industry and commercial realities of the particular case. This assessment is made by (i) comparing the number of contracts the potential agent signed on behalf of the foreign principal with the number signed by the foreign principal's agents in other countries, (ii) determining how many contracts the potential agent entered into compared to prior years, and (iii) communicating with other I.R.S. teams working in the industry to determine industry norms.

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8 The 2017 Model Convention was approved by the O.E.C.D. Committee on Fiscal Affairs on September 28, 2017, and by the O.E.C.D. Council on November 23, 2017.

Again, the I.R.S. defers to the Commentary on the 2014 Model Convention.[9] Interestingly, the I.P.U. also cites Treas. Reg. §1.864-7(d)(1)(ii) but omits part of the regulation. The regulation reads as follows; the emphasized part is not included in the I.P.U.:

> An agent shall be considered regularly to exercise authority to negotiate and conclude contracts or regularly to fill orders on behalf of his foreign principal only if the authority is exercised, or the orders are filled, with some frequency over a continuous period of time. **<u>This determination shall be made on the basis of the facts and circumstances in each case, taking into account the nature of the business of the principal; but, in all cases, the frequency and continuity tests are to be applied conjunctively. Regularity shall not be evidenced by occasional or incidental activity.</u>** An agent shall not be considered regularly to negotiate and conclude contracts on behalf of his foreign principal if the agent's authority to negotiate and conclude contracts is limited only to unusual cases or such authority must be separately secured by the agent from his principal with respect to each transaction effected. [Emphasis added.]

This raises the question of whether the I.R.S. will not apply the frequency and continuity tests conjunctively in the future. The view expressed by the I.R.S. in past rulings, however, was contrary to this interpretation and in line with the definition of a U.S. trade or business developed under case law.[10] Under this concept, a U.S. trade or business requires activities that are continuous, regular, and considerable – whereas occasional and incidental activities are not deemed sufficient to create a taxable presence.[11]

<u>Step 3: Binding Force of Contracts on Foreign Principal</u>

This step evolves around the question of whether the agent has authority to enter into the contracts. This determination is highly factual, and a substantive approach is encouraged. Thus, the mere fact that a person outside the U.S. signs the contract does not automatically mean that the potential agent is not a P.E. if the responsibilities of the person signing are mostly clerical.

Agents are advised to look at the following or proceed with the following:

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[9] Again, it does not use the most recent version. Contrary to the latest version of the U.S. Model Treaty, which was issued in 2016 and did not include Technical Explanations, the 2017 Model Convention was released with changes to the Commentary.

[10] See *Pinchot v. Commr.*, 113 F.2d 718, 719 (2d Cir. 1940); *de Amodio v. Commr.*, 34 T.C. 894, 906 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962); *Spermacet Whaling & Shipping Co. v. Commr.*, 30 T.C. 618, 634 (1958), aff'd, 281 F.2d 646 (6th Cir. 1960).

[11] Note in this context that the performance of services is held to a much lower standard whereby even a single occurrence may create a taxable presence for a foreign taxpayer in the U.S. See, *e.g.*, Rev. Rul. 70-543, 1970-2 CB 172, Rev. Rul. 85-4, 1985-1 CB 294, Treas. Reg. §1.864-2(a). An exception only applies to employees and independent contractors under certain conditions which, given a dollar amount threshold of $3,000 has a very limited scope. Code §§861(a)(3) and 864(b)(1).

- Sample contracts
- Employee interviews
- The agreement between the potential agent and the foreign principal
- Whether the foreign principal needs to have final approval of the contract and, if so, whether the foreign principal actually amends or cancels certain contracts

If necessary, I.R.S. agents are advised to travel and even interview customers. The appropriate procedures, including securing of travel funds or legal counsel, are outlined.

Step 4: Dependent Agent Status

Once the presence of an agent has been determined, the dependent or independent nature of the agent must be investigated. The I.P.U. provides a list of factors indicating dependency:

"I.R.S. agents are advised to travel and even interview customers."

- **Significant Control and Detailed Instructions:** I.R.S. agents are instructed to base this determination on employee interviews, the agreement between the agent and the foreign principal, or any other contracts between the parties (in the example, the franchise contract). The I.P.U. provides a list of questions to be answered in conducting this determination.
- **Absence of Business Risk:** The mere reimbursement of expenses, if aligned with industry practices, is not determinative. If the agent's income is indexed on the income generated by the contracts, this indicates the presence of a business risk. In determining the presence of a business risk, I.R.S. agents are instructed to review several documents, including the financial statements, tax filings, and any agreements the foreign principal entered with other worldwide affiliates that are similar to the one between the agent and the foreign principal.
- **Economic Control Over the Agent Due to the Exclusive Nature of the Agent-Foreign Principal Relationship:** Among the documents that should be reviewed are tax planning documents, such as slide decks, internal correspondence, tax research, memos, or opinions.

If strong indicators for a dependent agent P.E. exist but the I.R.S. agent cannot reach a conclusion, the I.P.U. advises the applicable treaty's exchange of information and administrative assistance article be used to request information from the foreign principal's home jurisdiction.

CONCLUSION

What is of particular interest for foreign taxpayers with operations in the U.S. is that the I.P.U. does not shy away from incurring expenses but instead seems to encourage I.R.S. agents to investigate on an international scale. In any event, in a post-B.E.P.S. world foreign taxpayers are advised to closely monitor activities by agents operating on their behalf to mitigate exposure to creating a taxable presence in the U.S.

MORE PERMANENT ESTABLISHMENTS: THE DWINDLING PREPARATORY AND AUXILIARY ACTIVITIES EXCEPTION

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Nothing is certain in this world, except death and taxes – and even taxes are subject to change. The ever-expanding definition of a permanent establishment ("P.E.") and ever diminishing exceptions to a P.E. under the O.E.C.D.'s B.E.P.S. Project has made one thing clear – the restrictions local jurisdictions put on activities by foreign taxpayers to trigger taxation are tightening. The dwindling preparatory and auxiliary activities exception is a prime example.

Under U.S. domestic law, a foreign enterprise is subject to taxation in the U.S. if its activities constitute a U.S. trade or business ("U.S.T.B.") and the income is effectively connected with the U.S.T.B.[1] However, if the foreign enterprise is resident in a country that has an income tax treaty with the U.S., an exception may apply. If the activities of the foreign enterprise, as defined in the applicable income tax treaty, do not rise to a certain level, the foreign enterprise will not be taxable in the U.S. More specifically, as long as the foreign enterprise is not deemed to create a P.E. in the U.S., it will not be subject to U.S. taxation on income related to its U.S.T.B.

This article discusses the meaning of a P.E. in general and a particular exception to the creation of a P.E. that is invariably found in the tax treaties signed by the U.S. As will be shown, the "safe harbor" activities that have so far been treated as *de minimis*, and thus not sufficient to create a P.E., are dwindling.

PERMANENT ESTABLISHMENT DEFINED

In broad terms, the profits of an enterprise of one country are taxable only in that country (*i.e.*, the home country or country of residence) unless it carries on a business in the U.S. through a P.E.[2] Therefore, the definition of a P.E. is crucial for identifying which country has a primary right to taxation.

In most cases, U.S. income tax treaties define a P.E. to include a fixed place of business in the U.S. through which the foreign enterprise carries on its business either wholly or partly. This includes, *inter alia*, the following examples:

- A place of management
- A branch
- An office

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[1] Code §864(c)(1)(A). Special rules apply to certain passive U.S. source income derived by foreign persons. The latter is typically subject to U.S. withholding tax unless it is reduced (up to zero) under an applicable income tax treaty.

[2] U.S. Department of the Treasury, *U.S. Model Income Tax Convention*, (Feb. 17, 2016), art. 7.

- A factory
- A workshop

However, a foreign enterprise will not be deemed to have a U.S. P.E. if its activities in the U.S. are limited to certain activities that are of a preparatory or auxiliary nature. For example, the U.S.-U.K. Income Tax Treaty provides that a P.E. will not include the following preparatory and auxiliary activities:[3]

- The use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise
- The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery
- The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise
- The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise
- The maintenance of a fixed pace of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character
- The maintenance of a fixed place of business solely for any combination of these activities noted, provided that the overall activity of the fixed place of business resulting from the combination is of a preparatory or auxiliary character

Thus, any fixed place of business in the U.S. – like a branch, factory, or warehouse – that carries out exclusively the above mentioned preparatory or auxiliary activities in the U.S. is not a P.E. of the foreign enterprise. For example, an office solely for the purpose of advertising, supplying information or scientific research, or servicing a patent or a know-how contract is not a P.E. if such activities have a preparatory or auxiliary character.

It should be noted that the nature of the activity itself, and not the type of fixed place of business that carries out the activity, must be examined to determine whether the activity is preparatory or auxiliary in nature. Thus, the activity may be carried out by a wholly-owned subsidiary of a foreign enterprise with multiple offices in the U.S., but it may still not be regarded as a fixed place of business if it is merely conducting preparatory or auxiliary activities. Further, a person acting on behalf of an enterprise and concluding contracts in the U.S. that relate to the preparatory or auxiliary activities does not create a P.E. of the foreign enterprise in the U.S.[4]

PREPARATORY AND AUXILIARY EXCEPTION

The rationale behind the preparatory and auxiliary exception is that, although the fixed place of business may contribute to the productivity of the foreign enterprise,

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[3] U.S. Department of the Treasury, *U.S.-U.K. Income Tax Treaty*, (Jul. 24, 2001), art. 5(4).

[4] *Id.*

the services it performs are so remote from the actual realization of profits that it is difficult to allocate any profit to that fixed place of business.[5]

In order to distinguish preparatory or auxiliary activities from those that are not, the decisive criterion is whether the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Further, a fixed place of business does not exercise a preparatory or auxiliary activity if its general purpose is identical to the general purpose of the whole enterprise.[6] For example, where the servicing of patents and know-how is the main purpose of an enterprise, a fixed place of business of such enterprise exercising such an activity cannot be excluded from the definition of a P.E.

"Although the fixed place of business may contribute to the productivity of the foreign enterprise, the services it performs are so remote from the actual realization of profits that it is difficult to allocate any profit to that fixed place of business."

Generally, a preparatory activity is carried on in contemplation of executing essential and significant activities of the enterprise as a whole. Since a preparatory activity precedes another activity, it will often be carried on during a relatively short period of time. This, however, is not always the case, as it is possible to carry on an activity at a given place for a substantial period of time in preparation for activities that take place somewhere else.[7] For example, where a construction enterprise trains its employees at one place before they are sent to remote work sites located in other countries, the training at the first location constitutes a preparatory activity for that enterprise. Overall, the duration of preparatory activities is determined by the nature of the core activities of the enterprise.

An activity that has an auxiliary character, on the other hand, generally is carried on to support, without being part of, essential and significant activities of the enterprise as a whole.[8] For example, a foreign enterprise of Country X maintains a fixed place of business in Country Y solely for the delivery of spare parts to customers for machinery sold to those customers. The fixed place of business will be treated as being engaged in an auxiliary activity since it supports the main business of selling machinery. In contrast, the exception will not apply where the enterprise maintains the fixed place of business not only for the delivery of spare parts but also for the maintenance and repairs of the machinery. These functions constitute after-sale services to the customers that are essential and significant for the trading business.

International Practice Unit on Preparatory and Auxiliary Exception to P.E. Status

On January 29, 2019, the I.R.S. released an international practice unit ("I.P.U."), titled *Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status*, that provides guidelines on whether an activity has a preparatory or auxiliary character.

The I.P.U. examines whether a U.K.-resident enterprise ("U.K. Co.") that engages in multiple business ventures which send employees to conduct advertising and marketing activities in the U.S. has a fixed place of business in the U.S. It suggests

5 O.E.C.D., *Commentary on Article 5 of the 2017 Model Tax Convention on Income and on Capital*, (Dec. 18, 2017), para. 58.

6 O.E.C.D., *Commentary on Article 5 of the 2017 Model Tax Convention on Income and on Capita*l, (Dec. 18, 2017), para. 59.

7 O.E.C.D., *Commentary on Article 5 of the 2017 Model Tax Convention on Income and on Capita*l, (Dec. 18, 2017), para. 60.

8 *Id.*

that the facts and circumstances of the case must be examined by reviewing the following information:

- U.K. Co.'s financial statements, interviews with professionals, and internet research to determine if U.K. Co.'s advertising department engages in advertising for enterprises other than U.K. Co (in which case it is unlikely that the activities are of a preliminary or auxiliary nature)
- Whether U.K. Co. earns a considerable profit in comparison to its other businesses such that advertising or marketing activities may be considered more than preparatory or auxiliary
- U.K. Co.'s financial statements to determine if U.K. Co. earns a profit from its advertising and marketing activities in the U.S.
- U.K. Co.'s financial statements and the internet to determine U.K. Co.'s core business(es) and whether marketing merely facilitates or increases other business profits
- Whether (based on financial statements, internet research, and employee interviews) U.K. Co. conducts any other activities through the U.S. that in combination or alone (either through its employees carrying on business in the U.S. or through a dependent agent on behalf of U.K. Co.) may cause U.K. Co. to have a P.E.

The I.P.U. places emphasis not only on the nature of the activities of the employees but also on the manner in which U.K. Co. describes and reports such activities on its website and financial statements. Since the I.P.U. is used by the I.R.S.'s Large Business and International division as a tool to analyze whether a P.E. exists in the U.S., taxpayers should ensure that their actions are consistent with the guidance in order to utilize the preparatory and auxiliary exception.

Revenue Ruling 72-418

On several occasions, the I.R.S. has ruled on the issue of whether a P.E. exists in the U.S. In Rev. Rul. 72-418, the I.R.S. held that a German bank conducting informational, advertising, and investigative activities through a representative's office in the U.S. did not have a P.E. in the U.S.; the U.S. office performed the following activities:

- Investigated and obtained information regarding U.S. commercial and financial matters of interest for German customers.
- Assisted bank customers with information and letters of introduction to U.S. banks.
- Established and maintained contracts with other banks, financial institutions, business corporations, and government agencies.
- Furnished information regarding German commercial and financial matters to the same institutions.
- Advertised for the bank throughout the U.S. in newspapers, periodicals, and by personal contacts.
- Communicated with the U.S. debtors of the bank "on rare occasions."

The I.R.S. observed that the above activities were preparatory in nature and the representative office did not engage in any core banking functions in the U.S. These core functions may include buying, selling, paying, or collecting bills of exchange; issuing letters of credit or receiving money for transmission or transmitting money by draft, check, cable, or otherwise; making loans; receiving deposits or exercising fiduciary powers; keeping or maintaining any books of account for the bank except a record of its own expenses; concluding any contracts on behalf of the bank; or soliciting on behalf of the business.

LIMITING EXCEPTIONS TO A P.E.

Undoubtedly, the preparatory and auxiliary exception is an attractive one. However, the B.E.P.S. initiative has tightened this exception and made it even harder to claim. As was pointed out by the O.E.C.D., one of the major goals of the B.E.P.S. Project is to ensure that taxpayers do not exploit this exception.[9] In this context, it was noted that activities that were previously considered preparatory or auxiliary may now be core business activities, especially in the digital economy. Accordingly, Article 5(4) of the O.E.C.D. Model Tax Convention on Income and on Capital was amended to include that the maintenance of a fixed place of business solely for an activity or any combination of activities (enumerated above) will be treated as preparatory or auxiliary in nature only if the overall activity of the fixed place of business is of a preparatory or auxiliary character.

For example, an online seller of a variety of goods is a resident in Country R. It maintains warehouses in Country S for the purpose of storing and delivering goods sold online to customers of Country S. The business model of the online seller relies on the proximity to customers and the need for quick delivery. Therefore, the use of warehouses that are closer to customers is an essential requirement for the success of the online seller. Therefore, the storage and delivery activities will not likely constitute preparatory or auxiliary activities. Rather, the warehouses likely will be treated as the P.E. of the online seller in Country S under the new definition. If seen on a standalone basis, the warehouse used to store and deliver the goods would squarely fall within the exception to a P.E. under the old provision since the storage and delivery activities would be treated as auxiliary activities.

Further, paragraph 4.1 was inserted to Article 5 of the O.E.C.D. Model Tax Convention to introduce an anti-fragmentation rule. This rule prevents enterprises from avoiding P.E. status by fragmenting their core business activities into several small operations and allocating the operations among closely related parties such that, if seen independently, each was engaged in a preparatory or auxiliary activity and could therefore claim the preparatory or auxiliary exception to P.E. status.

ATTRIBUTION OF PROFITS UNDER THE ANTI-FRAGMENTATION RULE

On March 22, 2018, the O.E.C.D. released the final report entitled *Additional Guidance on the Attribution of Profits to a Permanent Establishment under the B.E.P.S. Action 7 Report (Preventing the Artificial Avoidance of Permanent Establishment*

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9 O.E.C.D., *Action 1: Addressing the Tax Challenges of the Digital Economy*, (Oct. 5, 2015), p. 144.

Status). This guidance addresses how much profit should be allocated to a P.E. once it has been determined that it exists. The guidance suggests that, after it has been established that a P.E. exists due to activities specified in Article 5(4) of the O.E.C.D. Model Tax Convention, the profits to be attributed to the P.E. are those that would have been derived if it were a separate and independent enterprise performing the activities that caused it to be a P.E.

Regarding the anti-fragmentation rule in Article 5(4.1), the guidance states that the rule applies in two types of cases[10] discussed below.

Where There Is an Existing P.E. in the Source Country

A P.E. exists where a foreign enterprise or a closely related enterprise already has a P.E. in the source country and the activities in question constitute complementary functions of a cohesive business operation. A P.E.'s profits arising from such activities are derived from the combined complimentary activities, considering the profits each one would have derived if it were a separate and independent enterprise performing its corresponding activities.

For example,[11] R.C.O., a bank resident of State X, has a number of branches in State Y that constitute P.E.'s. It also has a separate office in state y where a few employees verify information provided by clients that have made loan applications at these different branches. The results of these verifications are forwarded to the headquarters of R.C.O. in State X where other employees analyze the information and provide reports to the branches where the decisions to grant the loans are made. In this case, the exceptions of Article 5(4) will not apply to the office because another place (*i.e.*, any of the other branches where the loan applications are made) constitutes a P.E. of R.C.O. in State Y and the business activities carried on by R.C.O. at the office and at the relevant branch constitute complementary functions that are part of a cohesive business operation (*i.e.*, providing loans to clients in State Y).

Where There Is No Existing P.E. in the Source Country

The second situation is where there is no pre-existing P.E. in the source country. In such a case, a determination has to be made whether the combination of activities in the source country by the foreign enterprise and closely-related foreign enterprises results in a cohesive business operation that is not merely preparatory or auxiliary in nature and therefore results in a P.E. If this occurs, the profits attributable to each P.E. are those that would have been derived from the profits made by each activity of the cohesive business operation as carried on by the P.E. if it were a separate and independent enterprise performing the corresponding activities.

For example,[12] Company X is a resident of Country C. It is engaged in the business of selling goods online directly to customers in different countries including Country Y. Company X has a leased warehouse in Country Y. The employees of the warehouse are responsible for the shipment of the goods from the suppliers, stocking

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[10] O.E.C.D., Additional Guidance on the Attribution of Profits to a Permanent Establishment under the B.E.P.S. Action 7 Report, (Mar. 22, 2018), paras. 8 and 9.

[11] O.E.C.D., Commentary on Article 5 of the 2017 Model Tax Convention on Income and on Capital, (Dec. 18, 2017), para. 81.

[12] O.E.C.D., Additional Guidance on the Attribution of Profits to a Permanent Establishment under the B.E.P.S. Action 7 Report, (Mar. 22, 2018), para. 11.

the goods, and delivering the goods using the services of an independent delivery service provider. Company X also has an office in Country Y which is responsible for collecting information from the customers in Country Y. The business activities carried on by Company X at the warehouse and the office likely constitute complementary functions that are part of a cohesive business operation. Therefore, both the warehouse and office are treated as the P.E. of Company X in Country Y. The profits attributable to the warehouse are those that it would have derived if it were a separate and independent enterprise performing the same storage and delivery activities. Similarly, the profits attributable to the office are those that it would have derived if it were a separate and independent enterprise performing the same information gathering activities.

> ***"Multinational businesses are no longer able to fragment their core activities to benefit from the preparatory and auxiliary exception. . . . The exception will apply only when activities are preparatory or auxiliary in relation to the business as a whole."***

CONCLUSION

The O.E.C.D. has taken firm steps to limit the preparatory and auxiliary exception to P.E. status. Multinational businesses are no longer able to fragment their core activities to benefit from the preparatory and auxiliary exception. Following recent O.E.C.D. guidance, the exception will apply only when activities are preparatory or auxiliary in relation to the business as a whole.

Now is the time for corporations with worldwide operations to revisit their business structures and run a P.E. risk analysis. If enterprises have split their operations into separate businesses, like procurement, storage, delivery, advertising, and distribution, it is likely that activities which enjoyed the preparatory and auxiliary exception under the old provisions will no longer be recognized as such but will rather create a P.E. in the foreign country.

DEMOCRATS TURN TO TAX REFORM TO REDUCE WEALTH DISPARITY

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Tags
Wealth Tax
Estate Tax
Income Tax Marginal Rates

The U.S. Federal deficit is expected to reach $1 trillion in 2019. Meanwhile, a hedge fund billionaire recently purchased a New York City condominium for $238 million, and it is estimated that the top 0.1% possess almost the same amount of wealth as the bottom 90% of all households.

When it comes to tax policy, Democrats have traditionally focused on tax relief, including a negative income tax, for poor and working-class families.[1] Several recent pronouncements and extensive press coverage indicate a new approach, designed to tax the wealthiest individuals at significant rates of tax.

Three progressive Democrats have made the news in recent days – Senators Sanders and Warren and Representative Ocasio-Cortez. These proposals, if enacted, would raise the marginal income tax rates and capital gains rates, increase the estate tax rates, lower the lifetime exemption, and add a wealth tax.

THE SANDERS PROPOSALS

2017 Proposal

Senator Bernie Sanders (D-V.T.) presented a white paper on "Options to Finance Medicare for All" in 2017. In that paper, Sanders suggested the following:

- Impose higher marginal income tax rates:[2]
  - 40% on income between $250,000 and $500,000
  - 45% on income between $500,000 and $2 million
  - 50% on income between $2 million and $10 million (In 2014, only 136,000 households, the top 0.1% of taxpayers, had income between $2 million and $10 million.)
  - 52% on income above $10 million (In 2014, only 16,700 households, just 0.02% of taxpayers, had income exceeding $10 million.)
- Eliminate special reduced rates for capital gains and qualified dividends.

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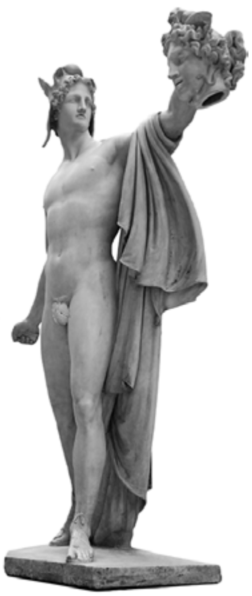
1 Senator Kamala Harris (D-C.A.) has, for example, proposed the Lift the Middle Class Tax Act. The proposal would provide a refundable tax credit of $6,000 for married couples earning up to $60,000 a year. Single filers making up to $30,000 and single parents earning up to $80,000 would get a credit of $3,000. The credit would then start to phase out. Couples and single parents with earnings of more than $100,000 and single filers making more than $50,000 would no longer be eligible.

2 The current highest Federal rate is 37%.



- Introduce higher graduated estate tax rates to replace the current 40% flat tax:
  - 45% for the value of an estate between $3.5 million and $10 million
  - 50% for the value of an estate between $10 million and $50 million
  - 55% for the value of an estate in excess of $50 million
  - An additional 10% surtax would apply to estate value in excess of $500 million ($1 billion for married couples)
- Eliminate common estate planning techniques, such as G.R.A.T.'s (grantor retained annuity trusts) and dynasty trusts:
  - A G.R.A.T. is an irrevocable trust that pays an annual annuity to the grantor (creator) of the trust. If the grantor dies during the term of the trust, the assets are included in the grantor's estate. If not, the assets pass to the beneficiaries with no gift tax other than the gift tax paid at inception. If the assets have appreciated in excess of the I.R.S. assumed rates of return (which is often the case with successful startup companies), that "excess" appreciation will pass to beneficiaries free from estate or gift taxes.
  - Dynasty trusts are long-term trusts designed to reduce estate, gift, and generation-skipping taxes at each generational level, thereby allowing accumulations of wealth for generations.
- Impose a wealth tax on the top 0.1%:
  - An annual 1% Federal wealth tax would apply to the wealthiest 0.1% of U.S. households.
  - The tax would apply to the net worth exceeding $21 million for a household (essentially those individuals that would be subject to the current U.S. estate tax). A household with $21.5 million would pay 1% of $500,000, or $5,000.

2019 Proposal

Senator Sanders recently announced that he would introduce a bill "For the 99.8%" Family farmers would be offered a special exclusion from estate tax of up to $3 million, and the conservation easement would increase to $2 million. The bill would also include the following proposals:

- Impose higher marginal income tax rates:
  - Reduce the amount exempted from estate tax to $3.5 million (the exemption in effect in 2009 and a reduction from the current $11.4 million), which would affect 0.2% of all Americans.
  - Increase the estate tax rate to 45% for estates between $3.5 million and $10 million.
  - Increase the estate tax rates on bigger estates, so that estates worth between $10 million and $50 million would be taxed at 50%, estates of

more than $50 million would be taxed at 55%, and estates in excess of $1 billion would be taxed at 77% (the top rate for 1941-1976).

- End tax breaks for dynasty trusts.
- Strengthen the "generation-skipping tax," by applying it (with no exclusion) to any trust established to last more than 50 years.
- Limit the use of G.R.A.T.'s and "intentionally defective grantor trusts," both techniques commonly used to reduce gift taxes on transfers to beneficiaries.
- Close the valuation discount "loophole."

THE WARREN PROPOSAL

Senator Elizabeth Warren (D-M.A.) is preparing to propose a new "ultra-millionaire" wealth tax on those with a net worth over $50 million. The proposal would create an **annual 2% wealth tax** on those with a **net worth above $50 million** and impose an **additional 1% on net worth above $1 billion**.

Senator Warren's proposal has come under attack from other Democrats and Independents. Former Mayor Mike Bloomberg has asserted that the tax would violate the U.S. Constitution (as a prohibited "direct tax"), a view share by a number of conservative legal scholars but disputed by other legal authorities (discussed below) and compared this type of tax with Venezuelan socialism.

A Hill-HarrisX survey found that 74% of registered voters back an annual 2% tax on people with assets over $50 million and a 3% tax on people with assets in excess of $1 billion. The poll showed support for the idea among people of all ages and races and from both political parties.

THE OCASIO-CORTEZ PROPOSAL

Freshman Representative Alexandria Ocasio-Cortez (D-N.Y.) has proposed a 70% marginal tax rate on income of $10 million to fund a "New Green Deal" to combat climate change and economic inequality.

A recent Hill-HarrisX survey of 1,001 registered voters found that 59% supported Ocasio-Cortez's proposal. A recent Fox News poll found that 70% of registered voters backed hiking taxes for families making more than $10 million a year.

THE REPUBLICAN PROPOSAL

In contrast, Senators Mitch McConnell (R-K.Y.) and two other senators, Chuck Grassley (R-I.A.) and John Thune (R-S.D.), are sponsoring a bill that would repeal the Federal estate tax.

Is a Wealth Tax Constitutional?

Article I Section 8 of the U.S. Constitution provides that "Congress shall have power to lay and collect taxes, duties, imposts and excises." Article I Section 9 provides that "no capitation, or other direct, tax shall be laid, unless in proportion to the census or enumeration herein before directed to be taken."

The definition of "direct tax" is not readily apparent. A direct tax is a tax on real or personal property imposed solely by reason of its being owned by the taxpayer. In contrast, indirect taxes are levied upon the happening of an event, such as the transmission of property. Income tax is clearly a direct tax, but it is specifically permitted by the 16th Amendment. Estate taxes have been permitted since this amendment was enacted in 1916. Those taxes were not perceived by the Supreme Court as indirect taxes, but taxes for the privilege of transferring property.[3]

Some legal scholars believe that there may be early Supreme Court precedent in *Hylton v U.S.* (1796) that suggests that "direct" taxes should be narrowly construed, identifying "capitation" taxes (imposed equally on every individual) and taxes on land as types of direct taxes. Those scholars also believe that the Supreme Court case of *Pollack v Farmers' Loan and Trust Company* (1895), striking down an income tax (pre-16th Amendment), was incorrectly decided. They conclude that a wealth tax does not seem to be a direct tax either as a functional or a categorical matter.[4]

"Passage of any of these proposals will await the 2020 elections."

The legality of an annual wealth tax may be enhanced (in this author's opinion), if it were characterized as a non-refundable prepayment of estate tax, fully creditable against future estate tax, with possible indexing for inflation.

Effect on Foreign Persons

Nonresident alien individuals (whose estates may be liable for U.S. estate tax on U.S.-situs assets) never benefited from the enhanced lifetime exemption. Those estates are offered only an exemption amount of $60,000. Only the Republican proposal to eliminate the U.S. estate tax would offer some relief.

It is not clear whether the wealth tax proposals would apply to nonresident aliens with respect to U.S. situs assets. It should be noted that the net investment income tax (the additional 3.8% tax on certain investment income) specifically excludes amounts paid to nonresident aliens. This suggests that there could be a similar exemption to wealth tax for nonresident aliens. It is not clear whether the Sanders proposal to end dynasty trusts would apply to trusts established by nonresident alien grantors.

There has been no discussion, as yet, about increasing the statutory 30% withholding tax on payments of taxable U.S.-source income to foreign persons or for eliminating the many exemptions from U.S. tax (*e.g.*, qualified interest and capital gains).

CONCLUSION

Democratic proposals for income and wealth redistribution, while popular among the Democratic base, are controversial. Passage of any of these proposals will await the 2020 elections and would only appear possible with a Democratic sweep of both houses of Congress and possibly the Presidency as well.

All of these proposals address the burgeoning Federal tax deficit. This, coupled with the growing U.S. perception that disparities between rich and poor are widening, makes the passage of some, if not all, of these proposals a possibility in the future.

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3 *New York Trust Company v. Eisner*, 1921, 256 U.S. 345.

4 Walter Dellinger, et. al., "We Need a National Debate on a Federal Tax on Wealth," *Indiana Law Journal*.

WHO'S GOT THE B.E.A.T.? SPECIAL TREATMENT FOR CERTAIN EXPENSES AND INDUSTRIES

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Tags
Base Erosion
B.E.A.T.
Code §59A
Code §163(j)
T.C.J.A.

Code §59A was enacted to impose tax on U.S. corporations with substantial gross receipts when base erosion payments to related entities significantly reduced regular corporate income tax imposed at 21%. The tax is known as the base erosion and anti-abuse tax (the "B.E.A.T."). In late December, the I.R.S. proposed regulations that will provide guidance for affected taxpayers.

This is the second of a two-part series that explains how the proposed regulations identify taxpayers affected by the B.E.A.T. and how the rules are apply to those taxpayers. It focuses on the details affecting certain expenses and certain industries. For a practical outline of effected entities and payments, see "Who's Got the B.E.A.T.? A Playbook for Determining Applicable Taxpayers and Payments."

BASE EROSION TAX BENEFITS

In General

Generally, a base erosion tax benefit is the amount of any deduction relating to a base erosion payment that is allowed under the Code for the taxable year.[1] If full 30% withholding tax is collected by the U.S. entity on payments to related parties outside the U.S., the base erosion payment has a base erosion tax benefit of zero for purposes of calculating a taxpayer's modified taxable income. If an income tax treaty reduces the amount of withholding imposed on the base erosion payment, the base erosion payment is treated as a base erosion tax benefit to the extent of that reduction. Rules similar to those in Code §163(j)(5)(B) as in effect prior to the T.C.J.A. are applied in making the computation.

Coordination with Code §163(j) Limitation

Code §163(j) applies to limit the amount of a taxpayer's business interest expense that is deductible in the taxable year. The proposed B.E.A.T. regulations coordinate with Code §163(j) to determine how much of a taxpayer's interest expense deduction is limited under the B.E.A.T. and how much is limited under Code §163(j).[2] Under these rules, the interest expense disallowed under Code §163(j) is allocated first to interest expense on loans from unrelated parties. Any disallowed interest expense remaining is allocated to loans from related parties. Interest paid or accrued to related parties that is not disallowed under Code §163(j) is taken into account when applying Code §59A. If some related-party lenders are U.S. persons and others are foreign, the interest expense payments are divided between U.S. and non-U.S. persons on a proportional basis. In a similar way, any disallowed business

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[1] Prop. Treas. Reg. §1.59A-3(c).

[2] Prop. Treas. Reg. §1.59A-3(c)(4).

interest expense carryforward is treated first as business interest paid to unrelated parties. The remainder is treated as business interest expense paid to related parties. Again, where lenders are a mix of U.S. and non-U.S. persons, apportionment is required.

MODIFIED TAXABLE INCOME

Method of Computation

For any taxable year, Code §59A imposes a tax on each applicable taxpayer equal to the base erosion minimum tax amount for that year. The base erosion minimum tax amount is determined based on an applicable taxpayer's modified taxable income for the taxable year. The computation of modified taxable income and the computation of the base erosion minimum tax amount are made on a taxpayer-by-taxpayer basis.

The computation of modified taxable income is made on an add-back basis. The computation starts with taxable income (or taxable loss) of the taxpayer, as computed for regular tax purposes, and adds (i) the gross amount of base erosion tax benefits for the taxable year and (ii) the base erosion percentage of any net operating loss ("N.O.L.") deduction under Code §172 for the taxable year.

If a taxpayer has an excess of deductions allowed by Chapter 1 over gross income, computed without regard to the N.O.L. deduction, the taxpayer has negative taxable income for the taxable year. Generally, the proposed regulations provide that a negative amount is the starting point for computing modified taxable income when there is no N.O.L. deduction from net operating loss carryovers and carrybacks.

If an N.O.L. deduction is carried to the taxable year and that N.O.L. deduction exceeds the amount of positive taxable income, the excess amount of the N.O.L. deduction does not reduce taxable income below zero for determining the starting point for computing modified taxable income.

Base Erosion Percentage of N.O.L. Deductions

Code §59A(c)(1)(B) provides that modified taxable income includes the base erosion percentage of any N.O.L. deduction allowed under Code §172 for the taxable year. The proposed regulations apply the base erosion percentage of the year in which the loss arose, or a vintage year, because the base erosion percentage of the vintage year reflects the portion of base eroding payments reflected in the net operating loss carryover.[3] In addition, because the vintage-year base erosion percentage is a fixed percentage, taxpayers will have greater certainty as to the amount of the future add-back to modified taxable income (as compared to using the utilization-year base erosion percentage).

Based on this approach, the proposed regulations also provide that in the case of net operating losses that arose in taxable years beginning before January 1, 2018, and that are deducted as carryovers in taxable years beginning after December 31, 2017, the base erosion percentage is zero because Code §59A applies only to base erosion payments that are paid or accrued in taxable years beginning after December 31, 2017.

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[3] Prop. Treas. Reg. §1.59A-4(b)(2)(ii).

Base Erosion Minimum Tax Amount

An applicable taxpayer computes its base erosion minimum tax amount ("B.E.M.T.A.") for the taxable year to determine its liability under Code §59A(a).[4] The taxpayer's B.E.M.T.A. is the amount by which (i) the applicable tax rate for the taxable year ("B.E.A.T. rate") multiplied by the taxpayer's modified taxable income for the taxable year exceeds (ii) the taxpayer's adjusted regular tax liability for that year.

In determining the taxpayer's adjusted regular tax liability for the taxable year, credits (including the foreign tax credit) are generally subtracted from the regular tax liability amount. To prevent an inappropriate understatement of a taxpayer's adjusted regular tax liability – thereby leading to excessive B.E.M.T.A., credits for overpayment of taxes and for taxes withheld at source are not subtracted from the taxpayer's regular tax liability because these credits relate to Federal income tax paid for the current or previous year.

"The base erosion percentage threshold for certain banks and registered securities dealers is lowered from 3% or more to 2% or more."

Application of Code §59A to Partnerships

A partnership is not an "applicable taxpayer." Only a corporation can be an applicable taxpayer. However, a partnership is treated as an aggregate of the partners in determining whether payments to or payments from a partnership are base erosion payments. Consequently, when determining whether a corporate partner that is an applicable taxpayer has made a base erosion payment, amounts paid or accrued by a partnership of which it is a member are treated as if they were paid by each partner to the extent an item of expense is allocated to the partner under Code §704.

Partners with certain small ownership interests are excluded from this aggregate approach for purposes of determining base erosion tax benefits from the partnership. This small ownership interest exclusion generally applies to partnership interests that represent less than 10% of the capital and profits of the partnership and less than ten percent of each item of income, gain, loss, deduction, and credit; and that have a fair market value of less than $25 million.[5]

Rules Relating to Banks and Dealers

Code §59A modifies two general rules in the case of certain banks or registered securities dealers:

- The base erosion percentage threshold for certain banks and registered securities dealers is lowered from 3% or more to 2% or more.
- The B.E.A.T. rate is one point higher for those banks or registered securities dealers.

The statutory definition of the term "bank" is not modified by the proposed regulations. Consequently, the definition in Code §581 applies. Therefore, an entity that is a bank or trust company incorporated and doing business under the laws of U.S. or any state and the District of Columbia is a bank. A foreign corporation licensed to conduct a banking business in the U.S. and subject to U.S. tax on effectively connected income is not.

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[4] Prop. Treas. Reg. §1.59A-5(b).

[5] Prop. Treas. Reg. §1.59A-7(b)(4).

The term “registered securities dealer” is limited to a dealer as defined in section 3(a)(5) of the Securities Exchange Act of 1934 that is registered, or required to be registered, under section 15 of the Securities Exchange Act of 1934.

The proposed regulations also confirm that the operative rules that lower the base erosion percentage threshold and increase the B.E.A.T. rate apply only to a taxpayer that is a member of an affiliated group, as defined in Code §1504(a)(1). They do not apply if the taxpayer is not affiliated with another includible corporation or is not itself an includible.

The lower threshold applies if any member of the aggregate group is a member of an affiliated group that includes a bank or registered securities dealer, as defined. A limited exception applies where the bank or registered securities dealer’s activities are *de minimis* within the affiliated group

Rules Relating to Insurance Companies

The definition of a “base erosion payment” includes any premiums or other consideration paid or accrued to a foreign related party for any reinsurance. Gross income for a life insurance company is defined in Code §803 to include the gross amount of premiums and other consideration on insurance and annuity contracts, less return premiums and premiums and other consideration arising out of indemnity reinsurance. For an insurance company other than a life insurance company, Code §832(b) provides that gross income generally includes underwriting income, which is comprised of premiums earned during the taxable year, less losses and expenses incurred.

This poses a practical problem as certain reinsurance agreements provide that amounts paid to and from a reinsurer are settled on a net basis or netted under the terms of the agreement. A similar practice applies to other commercial agreements where reciprocal payments may be settled on a net basis or netted under the terms of those agreements. The proposed regulations do not provide a rule permitting netting in any of these circumstances.

ANTI-ABUSE AND RECHARACTERIZATION RULES

Certain transactions with a principal purpose of avoiding Code §59A will be disregarded or deemed to result in a base erosion payment. This proposed anti-abuse rule addresses the following types of transactions:

- Transactions involving an intermediary acting as a conduit to avoid a base erosion payment
- Transactions entered into to reduce the base erosion percentage
- Transactions among related parties designed to avoid application of rules regarding banks and registered securities dealers[6]

Consolidated Groups as Taxpayers

Affiliated groups of domestic corporations electing to file a consolidated income tax return generally compute income tax liability on a “single-entity” basis. Following

6 Prop. Treas. Reg. §1.59A-9(b).

that path, the tax under Code §59A is determined at the consolidated group level. This is designed to eliminate distortions based on the location of deductions within the group.

<u>Coordinating Consolidated Group Rules for Code §§59A(c)(3) and 163(j)</u>

As with individual subsidiaries operating in the U.S., the proposed regulations coordinate the application of Code §§59A and 163(j) when U.S. operations are conducted by an affiliated group in the U.S. Where both sections apply to interest expense, the taxpayer is required to treat all disallowed business interest as allocable first to interest paid or accrued to persons who are not related parties and then to related parties.

The proposed regulations mandate that an affiliated group must identify which interest deductions are allocable to domestic related party payments, foreign related party payments, and unrelated party payments on a consolidated basis.[7]

CODE §6038A REPORTING & RECORDKEEPING REQUIREMENTS

Code §6038A imposes reporting and recordkeeping requirements on domestic corporations that are 25% foreign-owned. Code §6038C imposes the same reporting and recordkeeping requirements on certain foreign corporations engaged in a U.S. trade or business. These corporations are collectively known as "reporting corporations."

Reporting corporations are required to file an annual return on Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Under Sections 6038A and 6038C of the Internal Revenue Code)*, with respect to each related party with which the reporting corporation has had any "reportable transactions."[8] Reporting corporations are also subject to specific requirements under Code §§6038A and 6038C to maintain and make available the permanent books of account or records that are sufficient to establish the accuracy of the Federal income tax return, including information, documents, or records to the extent they may be relevant to determine the correct U.S. tax treatment of transactions with related parties.[9]

Code §6038A(b)(2) was added under T.C.J.A. and applies to taxable years beginning after December 31, 2017. It authorizes regulations requiring information from a reporting corporation that is also a Code §59A "applicable taxpayer" for purposes of administering Code §59A.

To facilitate I.R.S. screening for noncompliance with Code §59A at the return filing stage, the I.R.S. is authorized to require by form or instructions the following information reporting:

- Relationships with related parties in regard to which a Form 5472
- Transactions within certain categories on a more detailed basis

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7 Prop. Treas. Reg. §1.59A-3(c)(4).

8 Treas. Reg. §1.6038A-2.

9 Treas. Reg. §1.6038A-3.

- The manner used to determine the amount of particular reportable transactions and items
- A summary of reportable transactions and items with all foreign related parties on a schedule attached to Form 5472

CONCLUSION

The B.E.A.T. rules add significant complexity to foreign-owned U.S. corporations. This series of articles is intended to explain the scope of obligations imposed on affected corporations. For those corporate executives tasked with responsibility for preparing U.S. tax returns, the I.R.S. has posted draft forms.

About Us

Ruchelman P.L.L.C. is a boutique law firm based in New York City. It was founded in 1989 by an alumnus of a legacy firm that is now Deloitte's.

Our firm provides a wide range of tax planning and commercial legal services to clients across the Americas, Asia, Europe, and the Middle East. Clients include global investors, multinational corporations expanding into the U.S., and U.S. businesses with international operations. Our core practice focuses on cross-border transactions.

We maintain offices in New York and Toronto. The practice of the Toronto Office is limited to U.S. law and focuses on cross-border transfer pricing issues.

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Insights, the monthly tax journal of Ruchelman P.L.L.C., provides in-depth reporting on the evolving landscape of U.S. and international taxation. It offers complex analysis of current issues, legislative updates, and practical introductions to the tax law from leading tax professionals in their respective countries.

Special features include an annual examination of the use of holding companies in European tax planning and a look at the year in review.

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