UPDATES AND OTHER TIDBITS

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CORRECTION TO THE PROPOSED 2013 DIVIDEND EQUIVALENT REGULATIONS

On December 5, 2013, proposed and final Treasury Regulations were published, relating to U.S. source dividend equivalent payments made to nonresident individuals and foreign corporations.[18] On February 24, 2014, a correction to the proposed regulations was published, which tackles errors contained in the 2013 proposed regulations. The corrections mainly clarify the 2013 proposed regulations and prevent any potential misleading caused by their formulation. In addition, on March 4, 2014, the I.R.S. released Notice 2014-14, which states that it will amend forthcoming regulations to provide that specified equity-linked instruments ("E.L.I.'s") will be limited to those issued on or after 90 days following publication of the final regulations. This will allow additional time for financial markets to implement necessary changes.

UNITED STATES AND HONG KONG SIGN T.I.E.A.

On March 25, 2014, H.K. and U.S. governments signed a Tax Information Exchange Agreement ("T.I.E.A.") confirming their commitment to enter into an I.G.A., subject to ongoing discussions. The T.I.E.A. will apply to profits tax, salaries tax, and property tax in H.K. and will cover federal taxes on income, estate and gift taxes, and excise taxes in the U.S.

E.U. ORDERS TAX INFORMATION FROM LUXEMBOURG DETAILING PATENT BOX AND CORPORATE SCHEMES

On March 24, 2014, the European Commission demanded that Luxembourg provide information on its corporate tax arrangements with more than 100 companies, including some leading U.S. multinationals, or face legal action with the European Court of Justice. This comes after Luxembourg previously declined to provide the Commission with the information, which relates to agreements made by

[18] See our article "Dividend Equivalents: Past, Present and Future" in *Insights* Vol. 1, No.1.

rulings of the Luxembourg tax authorities in 2011 and 2012, claiming it was protected by rules on “fiscal secrecy.” Under these agreements, authorities settled (typically in confidence) the manner in which they intended to apply tax rules to a company's activities and often provided informal tax-breaks to favored multinationals. The Commission also requested details regarding “patent box” schemes that allow companies to receive tax reductions of 80% on income from intellectual property including patents, trademarks, and models as a means of support in technology. In 2013, the Commission concluded that the patent box plan in the U.K. violated E.U. Code of Conduct rules against unfair taxation; however, the U.K. was able to defer a decision to allow E.U. finance ministers to further study the issue. If the Commission finds evidence that tax breaks constituted illegal state aid, it can demand that the funds be repaid.

SENATE RELEASES REPORT, HOLDS HEARING ON CATERPILLAR TAX STRATEGY

On April 1, 2014, executives from construction equipment manufacturer Caterpillar Inc. (“Caterpillar”) voluntarily agreed to testify before the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations (“P.S.I.”) to discuss the company's offshore tax strategies. P.S.I. also released a subcommittee report detailing Caterpillar's tax strategies and international business operations.

The hearing and report relates to the year 2009, when a former Caterpillar employee, Daniel Schlicksup, sued the company, alleging that he faced reprisal from management after he raised ethical objections to Caterpillar's tax practices. (Mr. Schlicksup claimed that the tax strategy lacked economic substance and had no business purpose other than tax avoidance.) He accused the company of using a “Swiss structure” to shift profits to offshore companies and avoid more than $2 billion in U.S. federal corporate taxes. The structure involved many shell corporations with no business operations, through which management of profitable business was technically shifted to Switzerland while actually remaining in the United States. The details of the report provide that in 1999, Caterpillar used a new a series of complex transactions to designate a new Swiss affiliate, Caterpillar SARL (“CSARL”), as its “global parts purchased” and licensed CSARL to sell third-party-manufactured parts to Caterpillar's non-U.S. dealers. This strategy effectively removed Caterpillar from the legal title chain for non-U.S. parts. Caterpillar then received royalty payments, resulting in 15% or less of the profits from the sale of replacement parts, while the remaining 85% of the profits was attributed to CSARL. Furthermore, Caterpillar was able to negotiate a deal with Swiss officials in which its effective tax rate in Switzerland was between 4% and 6%, lower than Switzerland's general federal corporate tax rate of 8.5%. Schlicksup also alleged the use of a “Bermuda structure” and a “Luxembourg structure” by which shell companies returned profits to the U.S. without paying taxes in 2005. The suit was settled in 2012.

During the hearing, Caterpillar executives defended the tax strategy and even received support from Republican senators, who claimed that Caterpillar was not the problem but the result of a "broken tax code." Among developed countries, the U.S. has the highest corporate tax rate and is one of the few remaining jurisdictions with a version of a territorial tax system. PwC, who was paid to $55 million to develop the tax strategy and served as both tax consultant and auditor to

Caterpillar at the time, was also questioned at the Senate hearing. It stood by its structure and claims it maintained independence at all times.

The Senate report makes four recommendations:

- The I.R.S. should clarify regulations on transfer pricing transactions to analyze whether the transactions have economic substance;
- I.R.S. transfer pricing regulations should require the U.S. parent corporation to identify and value the functions of related parties participating in a transfer pricing agreement and provide justification for the profit allocation in accordance with which of the parties performed the functions that contributed to specified profits;
- The Treasury and the I.R.S. should participate in O.E.C.D. efforts to develop improved international principles for taxing multinational companies; and
- Public accounting firms should be prohibited from providing auditing and tax consulting services to the same corporation simultaneously.

I.R.S. RELEASES VIRTUAL CURRENCY GUIDANCE

The I.R.S. released Notice 2014-21 ("Notice") on March 25, 2014, guidance in the form of F.A.Q.'s providing basic information on the U.S. federal tax implications of transactions involving virtual currency. The Notice states that transactions involving virtual currencies, such as Bitcoin, may create a tax liability on a per transaction basis, causing a potential administrative nightmare.

The I.R.S. describes virtual currency as "a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value." It may function like "real" currency and is customarily used and accepted as a medium of exchange in the issuing country. However, virtual currency does not have legal tender status in any jurisdiction.

The Notice provides that virtual currency is treated as *property* for U.S. federal tax purposes, and therefore, general tax principles which apply to property transactions also apply to those transactions that involve virtual currency.[19] Therefore:

- It is not treated as foreign currency, and there is no exchange gain or loss.[20]
- For a sale or exchange, the amount of gain or loss must be calculated. Thus, a determination of basis is required and amount realized. In addition, the character of gain or loss attributed to the sale or exchange of virtual

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[19] Notice 2014-21, FAQ No.1.
[20] *Id*., FAQ No.2.

currency is dependent upon whether the currency is a capital asset in the hands of the taxpayer.[21]

- Employee wages paid with virtual currency are taxable to the employee, must be reported on a Form W-2, and are subject to withholding and payroll taxes.[22] Backup withholding is obligatory in the case where there is no T.I.N. or if the payor receives notification from the I.R.S. that backup withholding is required.[23]

- Payments made to independent contractors and other service providers with virtual currency are also taxable under the self-employment tax rules;[24] generally, a Form 1099-MISC is issued by the payor, and the payment must be reported to the I.R.S. for amounts greater than $600.[25]

- Any payments made using virtual currency are subject to information reporting to the same extent as any other payments made in property.[26]

Finally, if taxpayers do not comply with tax laws, taxpayers may be subject to penalties. For instance, if there is a failure to timely or correctly report virtual currency transactions when required to do so, the taxpayer may be subject to penalties under Code §§6721 and 6722. Penalty relief may be available to taxpayers and persons required to file an information return who are able to establish that the underpayment or failure to file returns is due to reasonable cause.[27]

21 *Id.,* FAQ No. 7.
22 *Id*., FAQ No.11.
23 *Id*., FAQ No.14.
24 *Id.,* FAQ No. 10.
25 *Id*., FAQ No. 13.
26 *Id*., FAQ No. 12.
27 *Id*., FAQ No. 16.