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EDITORS' NOTE

In this month's edition of *Insights*, we introduce a new feature: an article prepared by guest contributors. The inaugural contributors are Dr. Peter Altenburger and Natalie Peter, Esq. Each is a prominent Swiss tax lawyer who focuses on trustee issues and private client matters. This month's articles include:

- **Guest Contribution**: Natalie Peter and Dr. Peter Altenburger jointly comment on the effect of F.A.T.C.A. on Swiss trustees and board members of foundations. The I.G.A. Model 2 with Switzerland has limited application when the underlying trust or foundation is formed outside Switzerland but managed and controlled in Switzerland.

- **TAX 101:** Armin Gray and Fanny Karaman explain how movements in foreign currency values affect U.S. tax computations. Items discussed include the computation of basis and sales proceeds when foreign currency is purchased and sold and the character of the resulting gain or loss.

- **In-Depth Analysis**: Proposed I.R.S. regulations affecting disguised sales of partnership interests and the computation of outside basis in partnerships that have underlying debt are discussed by Robert G. Rinninsland, Kenneth Lobo and Cheryl Magat. The article addresses basic issues that are faced when property is contributed to a partnership and when an existing partner attempts to defer tax through a two-step transaction with a new partner. Key provisions in proposed regulations are explained.

- **Private Client:** Cross-border estate planning for Canadian parents of U.S. children is discussed this month by Kenneth Lobo. Items addressed include U.S. estate tax basics, the workings of the U.S. estate tax exemption amount, and several planning opportunities.

- **Corporate Matters**: An introduction to "angel" investing is discussed by Simon H. Prisk. Guidance is provided on the matters an investor should consider when evaluating an investment opportunity.

- **F.A.T.C.A. 24/7**: This month's F.A.T.C.A. developments are discussed by Armin Gray and Philip Hirschfeld, including the I.R.S. "good faith" notice for F.F.I.'s, the release of forms and guidance, and a list of new I.G.A.'s.

- **State Tax**: New York corporate tax reform is discussed by Nina Krauthamer and Galia Antebi. Matters include a new and reduced nexus standard, income computation for a non-U.S. corporation doing business in New York State, reduced tax rates, changes to apportionment rules, and more.

- **Updates and Tidbits**: We discuss events affecting the taxation of cross border investors. P.F.I.C. rules for tax exempt shareholders are relaxed, proposed tax treaties remain blocked in 2014, the Credit Suisse debacle, and an I.R.S. decision not to appeal the judgment that struck down tax return preparer regulations.

We hope you enjoy this edition.

-The Editors

SWISS TRUSTEES AND BOARD MEMBERS OF FOUNDATIONS HAVE TO PREPARE FOR F.A.T.C.A.

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Tags
F.A.T.C.A.
Switzerland
U.K.
Liechtenstein

BACKGROUND

Trusts are unknown under Swiss law and family foundations are not commonly used because their purpose is very limited by law. Consequently, many Swiss trust companies, family offices or lawyers act as trustees of non-Swiss trusts or as members of family foundations. It is not uncommon for trustees, trusts or foundations, and underlying companies to be established under the laws of different jurisdictions, and typically Liechtenstein is used.

Foreign trusts and foundations, foreign trustees and underlying holding companies that invest in the U.S. must determine their classification under the Foreign Account Tax Compliance Act ("F.A.T.C.A.") and possibly a relevant intergovernmental agreement ("I.G.A."). In the case of Switzerland, a Model 2 I.G.A. exists.

The determination must be made prior to the end of June 2014, even if no U.S. owners or beneficiaries are involved. The reason is that, by 1 July 2014, a foreign entity that is a Foreign Financial Institution ("F.F.I.") must register on the I.R.S. F.A.T.C.A. portal and receive a G.I.I.N. The I.R.S. has announced that the last date to register and receive a G.I.I.N. prior to 1 July 2014 is 5 May. Registration is required unless the F.F.I. is a certified deemed-compliant F.F.I. or a Non-Financial Foreign Entity ("N.F.F.E."). An exempt F.F.I. could be a sponsored investment entity, a sponsored closely held investment vehicle, or an owner-documented F.F.I. In each of those fact patterns, another entity is engaged to carry out the F.A.T.C.A. reporting. An N.F.F.E. is an entity that is formed outside the U.S. that is not an F.F.I.

RELEVANT JURISDICTION

On 14 February 2013, Switzerland and the U.S. signed an I.G.A. It was amended on 30 September 2013 in line with the new timetable for F.A.T.C.A. implementation. Swiss financial institutions now have to implement F.A.T.C.A. to be fully compliant as of 1 July 2014 rather than from 1 January 2014 as initially stated.

Unlike most other countries, Switzerland signed a Model 2 I.G.A., which provides for direct reporting by the Swiss financial institution to the I.R.S. For F.F.I.'s covered by a Model 1 I.G.A., reporting is to be made to the local country's competent authority, which will automatically report the information to the I.R.S. The Swiss parliament approved the Swiss Model 2 I.G.A. and also passed the

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corresponding law for the implementation of the I.G.A., which should be effective before 1 July 2014.

As a result, Swiss reporting F.F.I.'s must comply with the Swiss F.A.T.C.A. law, the Swiss Model 2 I.G.A., and F.A.T.C.A. They will be required to register as participating F.F.I.'s with the U.S., unless exempted or certified deemed-compliant.

Liechtenstein and the U.S. have in substance reached a Model 1 I.G.A. The text has not yet been released, but the U.S. Treasury treats the Model 1 I.G.A. as if it were in effect as of 2 April 2014. Thus, financial institutions in Liechtenstein are allowed to register on the F.A.T.C.A. registration website, but the last date for registration in order to timely receive a G.I.I.N. is deferred until the end of the year.

ARE TRUSTS AND FOUNDATIONS FINANCIAL INSTITUTIONS?

The definition of "financial institution" is very broad. It includes all entities that hold funds on a fiduciary basis on behalf of other persons. Passive investment companies are typically included since their only purpose is to hold funds of the shareholder and ultimate beneficial owner.

Many professional organizations, such as the American College of Trusts and Estates Counsel, have argued that foreign trusts should be treated as N.F.F.E.'s and not as F.F.I.'s. The F.A.T.C.A. regulations accept this view if the trust, foundation, or holding company does not retain managers that are entities engaged in the business of giving investment advice to customers. On the other hand, a trust, foundation, or holding company will be an F.F.I. if it retains an entity engaged in the business of giving investment advice to customers and more than 50% of the gross income of the trust, foundation, or holding company is derived from investing in stocks, bonds, partnership interests and similar assets. Charitable trusts or foundations are classified as Non-Reporting F.F.I.'s under an I.G.A.

"Many professional organizations, such as the American College of Trusts and Estates Counsel, have argued that foreign trusts should be treated as N.F.F.E.'s and not as F.F.I.'s."

In comparison to F.F.I.'s, N.F.F.E.'s are generally subject to less stringent F.A.T.C.A. compliance obligations. Consequently, foreign trusts or foundations that are not managed by entities engaged in the business of giving investment advice to customers may avoid F.F.I. classification. Nonetheless, they will be required to provide withholding agents (including U.S. banks and Reporting F.F.I.'s with information about U.S. beneficiaries having substantial interests in the trust). Trustees can pass the reporting obligation down to a wholly owned holding company if reporting is problematic for the trustee. If they hold all investments through a holding company that is categorized as a corporation for U.S. tax purposes, the holding company will be subject to F.A.T.C.A. compliance obligations as an F.F.I. in its own right, but not the trust. If disclosure of information on beneficiaries is problematic, a foreign trust or foundation that is an N.F.F.E. can avoid F.A.T.C.A. disclosure to third parties by forming its holding company in the U.S., thereby taking steps to be compliant but limiting the dissemination of confidential information so that the U.S. party receiving information is within the group. This may have suboptimal U.S. tax consequences if the investment portfolio is structured to generate items of tax-free portfolio debt for foreign investors and capital gains from publicly traded equity securities.

SWISS FINANCIAL INSTITUTIONS

Specific I.G.A.'s generally apply to entities that are resident in the foreign country or that are organized under the laws of that country. While most I.G.A.'s define a financial institution as one that is "resident" in the country signing the I.G.A., Switzerland chose the definition based on organization in Switzerland. Some advisers suggest that "organized under the laws of Switzerland" means managed and controlled in Switzerland. This substance-over-form approach could lead to a result where a Liechtenstein foundation could be viewed as a Swiss F.F.I. if it is managed and controlled by Swiss board members. Merely receiving bank statements or carrying on an accounting function for the trust or foundation is likely not sufficient for the management and control of a trust or foundation to exist in Switzerland.

"...any trust or foundation settled outside Switzerland could never be considered a Swiss Financial Institution ...the Swiss Model 2 I.G.A. would not be applicable to determine the classification of the trust or foundation."

It is the view of the authors that this interpretation is not supported by the Swiss Model 2 I.G.A. The German translation interprets the term "organized" as "established or settled under the laws of Switzerland." Accordingly, any trust or foundation settled outside Switzerland could never be considered a Swiss Financial Institution as form of organization controls over the substance of management. Thus, the Swiss Model 2 I.G.A. would not be applicable to determine the classification of the trust or foundation. The Swiss trustee on the other hand or an underlying holding company incorporated under the laws of Switzerland would fall under the Swiss Model 2 I.G.A.

Custodial or depository institutions, investment entities or specified insurance companies having their place of organization in Switzerland will be characterized as Swiss F.F.I.'s. For purposes of the Swiss Model 2 I.G.A., an investment entity is any entity that conducts as a business (or is managed by an entity that conducts as a business) one or more of the following activities or operations for or on behalf of a customer:

- Trading in money market instruments (cheques, bills, certificates of deposit, derivatives, etc.); foreign exchange; exchange, interest rate and index instruments; transferable securities; or commodity futures;
- Individual and collective portfolio management; or
- Otherwise investing, administering, or managing funds or money on behalf of other persons.

In comparison to the F.A.T.C.A. rules, the Swiss Model 2 I.G.A. provides that the term "investment entity" should be interpreted in a manner consistent with similar language set forth in the definition of "financial institution" in the Financial Action Task Force Recommendations. Although this definition is very broad, it is limited to financial services subject to the Swiss Anti-Money Laundering Law. Thus, an entity managed directly by its beneficial owners (not to exceed the number of 20) is not covered by the anti-money laundering law and therefore not subject to the Swiss Model 2 I.G.A. or F.A.T.C.A. The result, however, is similar to the F.A.T.C.A. rule described above under which a trust, foundation or holding company will not be considered to be an F.F.I. if its assets are not managed by an entity engaged in the business of giving investment advice to customers.[1]

U.K. OR LIECHTENSTEIN FINANCIAL INSTITUTIONS

The U.K. and Liechtenstein have entered into Model 1 I.G.A.'s. Each Model I I.G.A. defines a financial institution as one that is "resident" in the respective country.

The updated U.K. guidance notes of 28 February 2014 regarding the Implementation of The International Tax Compliance (United States of America) Regulations 2013 make clear that in cases where the residence of an F.F.I. is less obvious, H.M.R.C. will determine the entity's status from the tax residence of the entity. If the F.F.I. is resident for tax purposes in the U.K., H.M.R.C. will regard the F.F.I. as within the scope of the U.K. Model 1 I.G.A.

For these purposes, residence in the U.K. means the following:

- For a company – the company is incorporated in the U.K. or centrally managed and controlled in the U.K.
- For a company not resident in the U.K. – it is within the charge to corporation tax because it carries on a trade in the U.K. through a permanent establishment in the U.K.
- For a trust – all the trustees are resident in the U.K. Where some of the trustees are U.K. tax resident, the trust is treated as U.K. resident if the settlor is both resident and domiciled in the U.K. for tax purposes.

Liechtenstein has not issued any guidance at this time.

SWISS TRUSTEES OR BOARD MEMBERS OF LIECHTENSTEIN TRUSTS OR FOUNDATIONS

Swiss trustees or board members of a Liechtenstein foundation have an initial obligation to determine their own classification under F.A.T.C.A. and the applicable I.G.A. If they meet the criteria of an investment entity, they must undertake due diligence and prepare to register with the I.R.S. If the applicable I.G.A. is the Swiss Model 2 I.G.A., they must do this by the end of June 2014. If the applicable I.G.A. is the Liechtenstein Model 1 I.G.A., the target date for registration is the end of the year.

Even professional trust companies acting as trustees must register in order to comply with the respective I.G.A. In this way, they can avoid the withholding taxes

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[1] See Treas. Reg. §1.1471-5(e)(4)(v) Example 5 and 6.

that will be imposed under F.A.T.C.A. on an F.F.I. that fails to have a system in place that documents U.S. owners or account holders, if any.

Private trustee companies may be classified as N.F.F.E.'s. These trustee companies remain obligated to certify their F.A.T.C.A. status to withholding agents, but they are not subject to F.A.T.C.A. due diligence. In order be classified as an N.F.F.E., a private trust company must not meet any of the broad criteria that defines an investment entity. Consequently, they must limit their activity to fiduciary activity for the trusts and foundations they serve.

The classification of the trustee or manager as an N.F.F.E. does not result in the trust or foundation being categorized as an N.F.F.E. As outlined above, the trust or foundation could be classified as an F.F.I. if a financial institution is engaged to manage the trust or the financial assets for the trust. F.F.I. status for the trust or foundation can be avoided if investments are managed by an individual who is not employed by an investment entity.

SUMMARY

Regarding non-Swiss trusts and foundations, the Swiss Model 2 I.G.A. is not applicable because neither the trust nor the foundation is organized under the laws of Switzerland. Thus, the I.G.A. of the jurisdiction where the trust or foundation is resident would typically be applicable and should be analyzed.

If the trust or foundation is resident in Liechtenstein, the Liechtenstein Model 1 I.G.A. is applicable. A Liechtenstein trust or foundation that is professionally managed would be classified as an F.F.I. The Liechtenstein Model 1 I.G.A. provides for trustee-documented F.F.I. classification for trusts where the trustee is itself a reporting F.F.I. The trustee or manager will be required to identify any trust or foundation for which it provides fiduciary services if it has U.S. beneficiaries. For those trusts or foundations, it must submit an annual report to the I.R.S. containing information regarding, *inter alia*, income and distributions affecting the U.S. beneficiaries.

According to the guidance notes of H.M.R.C., a trust settled under U.K. law is not tax resident in the U.K. when all its trustees are outside the U.K. Consequently, if all trustees are resident in Switzerland, the U.K. trust will not be tax resident in the U.K. and the U.K. Model 1 I.G.A. would not be applicable. Additionally, the Swiss Model 2 I.G.A. will be applicable only if the trust is organized under Swiss law. Some have suggested that a substance-over-form interpretation should be applied to determine where the trust is "organized." If this view is correct, the Swiss Model 2 I.G.A. would be applicable. However, the German translation is clear that the Swiss Model 2 I.G.A. cannot apply. A trust must be settled under the laws of Switzerland to qualify for coverage by the Swiss Model 2 I.G.A. Consequently, the F.A.T.C.A. regulations, unmodified by any I.G.A., would be applicable to the trust in this fact pattern.

If a trust is settled under Swiss law or a foundation is formed under Swiss law, the Swiss Model 2 I.G.A. will be applicable. If it is professionally managed by an investment entity that is itself organized pursuant to the laws of Switzerland, the trust or foundation would qualify as a Swiss F.F.I. In this case, the trust must be registered with the I.R.S. directly under F.A.T.C.A.

TAX 101:
TRANSACTIONS IN FX: A PRIMER FOR INDIVIDUALS

Authors
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Tags
International Tax
Financial Products
Foreign Currency

In our last issue, we discussed the recent I.R.S. guidance on bitcoins which, in general, stated that transactions in bitcoins should be treated as transactions in property under the general rules of the Internal Revenue Code (the "Code") rather than the special rules applicable to foreign currency. We therefore thought it would be useful to provide a primer on common transactions involving foreign currency (sometimes hereinafter referred to as "FX") with respect to U.S. individuals.

IN GENERAL

The first thing to note about engaging in transactions involving foreign currency is that foreign currency is treated as any other asset. Think stocks, bonds, or real estate. When an individual buys foreign currency, that individual has a basis in the FX (*e.g.*, Euro) similar to any other investment. When the individual sells that foreign currency, that individual will have a realization event, in which case gain or loss may have to be recognized. Whether the character of that gain or loss is ordinary will depend on the specific transaction and the applicability of Code §988, as will be discussed in more detail below.

> **Example 1**
>
> Mr. FX Guy, a U.S. citizen individual, buys real property located in the U.K. for 100,000 British pounds (£) on January 1, 2014. In order to effectuate the purchase, Mr. FX Guy uses £100,000 that he purchased for $150,000 on January 1, 2012 when the exchange rate was $1.5 to £1. Assume on January 1, 2014, the exchange rate was $2: £1 as the British pound appreciated against the U.S. dollar. The £100,000 has a basis of $150,000. It was acquired on January 1, 2012 and disposed of on January 1, 2014. The disposition is a sale of an asset (in this case, the FX). The amount realized is the fair market value of the consideration received, or $200,000. Accordingly, the taxpayer has a gain of $50,000 attributable to the foreign currency that must be recognized. The character of the gain, and the applicability of §988, will depend on whether the transaction was a "personal transaction."

The second thing to highlight is the tax treatment of a foreign currency denominated transaction turns on the identity of the taxpayer's functional currency. When dealing with multiple currencies, a rule is required to provide the "default" currency for which transactions are entered into and gain or loss can be measured. Thus, §985(a) generally requires all U.S. Federal income tax determinations to be made in a taxpayer's functional currency. Subject to one caveat, U.S. individuals are required to use the U.S. dollar as the functional currency.[2] Additionally, U.S. individual taxpayers must measure income or loss from dealings in foreign currency in U.S. dollars, on a transaction-by-transaction basis.

To the extent a taxpayer has a “qualified business unit” (“QBU”), the taxpayer may be permitted to use a foreign currency as its functional currency. In that case, income or loss derived from a QBU is determined in a foreign currency (before translation into U.S. dollars). In general, the use of a foreign currency as the functional currency of a QBU will result in the deferral of exchange gain or loss from transactions conducted in that currency as there will not be a taxable disposition upon exchange of the FX.

QUALIFIED BUSINESS UNIT: FOR INDIVIDUALS

As noted above, a QBU may be permitted to use a foreign currency as its functional currency. A QBU that does not conduct its activities primarily in U.S. dollars may use the currency of the economic environment in which a significant part of the QBU’s activities is conducted, provided that the QBU keeps (or is presumed to keep) its books and records in such currency.[3] If a QBU has more than one currency, the QBU may choose any such currency as its functional currency.

A QBU is any separate and clearly identified unit of a trade or business of a taxpayer provided that separate books and records are maintained. The regulations specifically provide that an individual is not a QBU. However, an individual’s activities may qualify as a QBU if the activities constitute a trade or business and a separate set of books and records is maintained with respect to the activities. While not ordinarily the case, for these purposes, a trade or business is an independent economic enterprise carried on for profit, the expenses related to which are deductible under §§162 or 212.[4]

Example 1

Mr. FX Guy is an individual resident of the United States and is engaged in a trade or business wholly unrelated to any type of investment activity. Mr. FX Guy also maintains a portfolio of foreign currency-denominated investments through a foreign broker. The broker is responsible for all activities necessary to the management of Mr. FX Guy's investments and maintains separate books and records with respect to all investment activities of the taxpayer. Mr. FX Guy's investment activities qualify as a QBU to the extent the activities generate expenses that are deductible under §212.

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2 See Treas. Reg. §1.985-1(b)(1)(i).
3 Treas. Reg. §1.985-1(c).
4 See Treas. Reg. §1.989(a)-1(b), (c).

CHARACTER OF GAIN OR LOSS

Section 988(a) provides that any foreign currency gain or loss attributable to a "Section 988 transaction" is computed separately and treated as ordinary income or loss.

Thus, the first question is what types of transactions are Section 988 transactions. In general, Section 988 transactions include the following:

- Any disposition of any nonfunctional currency.
    - As previously noted, in the case of U.S. individuals, a nonfunctional currency is any currency other than the U.S. dollar.
    - The acquisition of nonfunctional currency is relevant for determining basis.
    - For these purposes, nonfunctional currency includes coin and nonfunctional currency denominated demand or time deposits or similar instruments issued by a bank or other financial institution.
- Any of the following transactions, if the amount that he taxpayer is entitled to receive (or is required to pay) is: (i) denominated in terms of a nonfunctional currency or (ii) determined by reference to the value of one or more nonfunctional currencies:
    - The acquisition of a debt instrument or becoming the obligor under a debt instrument.
    - Accruing (or otherwise taking into account) for purposes of this subtitle any item of expense or gross income or receipts which is to be paid or received after the date on which so accrued or taken into account.
    - Entering into or acquiring any forward contract, futures contract, option, or similar financial instrument.[5]

However, certain types of transactions are excluded from §988. For example, regulated futures contracts and nonequity options subject to the mark-to-market regime of §1256 are excluded unless the taxpayer elects in. In this case, the election is for all transactions involving regulated futures contracts and nonequity options.[6]

A special rule exists for a forward contract, a futures contract, or option that is held as a capital asset and that is not part of a straddle. The taxpayer may elect to treat exchange gain or loss as capital gain or loss. The election must be made, and the

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5 Code §988(c)(1); see also Treas. Reg. §1.988-1.
6 Code §988(c)(1)(D).

transaction must be identified, on the same day the transaction is entered into by the taxpayer.[7]

Example 2

On January 1, 2014, Mr. FX Guy acquires 10,000 Canadian dollars. On January 15, 2014, Mr. FX Guy converts the 10,000 Canadian dollars to U.S. dollars. The acquisition of the 10,000 Canadian dollars is a Section 988 transaction for purposes of establishing Mr. FX Guy's basis in such Canadian dollars. The conversion of the 10,000 Canadian dollars to U.S. dollars is a Section 988 transaction.

Example 3

On January 1, 2014, Mr. FX Guy purchases at original issue a 3-year bond maturing on December 31, 2017 for £100,000 at a stated redemption price of £100,000. The bond pays 10% interest per annum. The acquisition of the bond is a Section 988 transaction.

Example 4

On January 1, 2014, Mr. FX Guy purchases a one-year note at original issue for its issue price of $1,000. The note pays interest in dollars at the rate of 4% per annum. The amount of principal received by Mr. FX Guy upon maturity is equal to $1,000 plus the equivalent of the excess, if any, of: (a) the Financial Times One Hundred Stock Index (an index of stocks traded on the London Stock Exchange, hereafter referred to as the "FT100") determined and translated into dollars on the last business day prior to the maturity date, over (b) £2.150, the "stated value" of the FT100, which is equal to 110% of the average value of the index for the six months prior to the issue date, translated at the exchange rate of £1 = $1.50. The purchase of this instrument is not a Section 988 transaction because the index used to compute the principal amount received upon maturity is determined with reference to the value of stock and not nonfunctional currency.

Example 5

On January 1, 2014, Mr. FX Guy enters into an interest rate swap that provides for the payment of amounts by Mr. FX Guy to its counterparty based on 4% of a 10,000 yen principal amount in exchange for amounts based on yen LIBOR rates. The yen for yen interest rate swap is a Section 988 transaction.

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[7] Code §988(a)(1); see also Treas. Reg. §1.988-3.

Example 6

On January 1, 2014, Mr. FX Guy enters into an option contract for sale of a group of stocks traded on the Japanese Nikkei exchange. The contract is not a Section 988 transaction because the underlying property to which the option relates is a group of stocks and not nonfunctional currency.

RELIEF FOR PERSONAL TRANSACTIONS

Prior to the Tax Reform Act of 1986 ("1986 Act"), many of the rules for determining the U.S. Federal income tax consequences of foreign currency transactions were embodied in a series of court cases and revenue rulings issued by the I.R.S. The legislative history notes that there was some lack of clarity with respect to the pre-1986 law regarding the character, the timing of recognition, and the source of gain or loss due to fluctuations in the exchange rate of foreign currency. Thus, the 1986 Act provided a comprehensive set of rules for the U.S. tax treatment of transactions involving foreign currencies embodied in §988. With respect to individuals, the 1986 Act provided as follows:

> (e) Application to individuals.
>
> This Section shall apply to Section 988 transactions entered into by an individual only to the extent expenses properly allocable to such transactions meet the requirements of Sections 162 or 212 (other than that part of Section 212 dealing with expenses incurred in connection with taxes).

Accordingly, notwithstanding the 1986 Act, pre-1986 law continued to apply to personal transactions. Pre-1986 law provided that crossing in-and-out of currencies required calculation of gain and loss. For example, in Rev. Rul. 74-7, the IRS has ruled that an individual who converts U.S. dollars to a foreign currency for personal use while traveling abroad realizes exchange gain or loss on reconversion of appreciated or depreciated foreign currency and the transaction was not a "like-kind exchange." The ruling further stated that the foreign currency at issue was a capital asset and any gain or loss realized was capital in nature.

In 1997, Congress made a *de minimis* exception to this regime for "personal transactions." Current §988 now provides:

> (e) Application to individuals.
>
> (1) In general.
>
> The preceding provisions of this Section shall not apply to any Section 988 transaction entered into by an individual which is a personal transaction.
>
> (2) Exclusion for certain personal transactions.
>
> If—

(A) nonfunctional currency is disposed of by an individual in any transaction, and

(B) such transaction is a personal transaction.

so gain shall be recognized for purposes of this subtitle by reason of changes in exchange rates after such currency was acquired by such individual and before such disposition. The preceding sentence shall not apply if the gain which would otherwise be recognized on the transaction exceeds $200.

(3) Personal transactions.

For purposes of this subsection, the term "personal transaction" means any transaction entered into by an individual, except that such term shall not include any transaction to the extent that expenses properly allocable to such transaction meet the requirements of—

(A) Section 162 (other than traveling expenses described in subsection (a)(2) thereof), or

(B) Section 212 (other than that part of Section 212 dealing with expenses incurred in connection with taxes).

"Thus, if an individual acquires foreign currency and disposes of it in a personal transaction and the exchange rate changes between the acquisition and disposition of such currency, gain is not recognized if it does not exceed $200."

Thus, if an individual acquires foreign currency and disposes of it in a personal transaction and the exchange rate changes between the acquisition and disposition of such currency, gain is not recognized if it does not exceed $200. However, no change is made with respect to losses, which are limited in the case of personal transactions.[8]

As noted above, a personal transaction is any transaction other than a transaction which is a trade or business expense or a §212 expense (*i.e.*, an expense in a for profit activity).

The 1997 legislative history stated the reasons for the change as follows:

An individual who lives or travels abroad generally cannot use U.S. dollars to make all of the purchases incident to daily life. If an individual must treat foreign currency in this instance as property giving rise to U.S.-dollar income or loss every time the individual, in effect, barters the foreign currency for goods or services, the U.S. individual living in or visiting a foreign country will have a significant administrative burden that may bear little or no relation to whether U.S.-dollar measured income has increased or decreased. The Committee believes that individuals should be given relief from the requirement to keep track of exchange gains on a transaction-by-transaction basis in *de minimis* cases.

[8] See Code §165(c).

Although this exception appears to be favorable, for U.S. citizens living abroad or dealing with large sums of foreign currency, the exception is limited. Further, the non-deductibility of losses can be quite disadvantageous to the taxpayer in the case of, *e.g.,* personal mortgages.

Example 8

Assume Mr. FX Guy, a U.S. citizen, exchanges $1,500 for 1000 British pounds (£) on April 1, 2014 for use in a personal vacation in the U.K. when the exchange rate was $1.5 to £1. Assume Mr. FX Guy spent £100 on transportation cost from the airport on April 1, 2014; £200 at a local restaurant on April 5, 2014; £100 on transportation cost to the local airport on his return flight on April 8, 2014; and converted the £600 back to U.S. dollars on April 8, 2014. Assume the exchange rates were $1.5 to £1 on April 1, 2014; $1.75 to £1 on April 5, 2014; and $2 to £1 on April 8, 2014. As a technical matter, Mr. FX Guy must determine his basis in the FX and calculate gain or loss on a <u>per transaction</u> basis. In this case, basis in each £1 is $1.5; gain on each transaction is, respectively, $0; $50; $50; and $300. The first three transactions' gain will not be recognized because they do not exceed $200; the final transaction's gain must be recognized as it exceeds $200.

Example 9

Assume Mr. FX Guy, a U.S. citizen, buys a U.K. home for personal use for 1,000,000 British pounds (£) when the exchange rate was $2 to £1. Assume Mr. FX Guy financed the home with a personal mortgage for £800,000, also converted at $2 = L1. Assume no principal was repaid, and the property was sold for £2,000,000 when the exchange rate was $1.5 to £1, and £800,000 of the purchase price was used to repay the mortgage. In this case, there are two separate transactions: the sale of the real property and the repayment of the mortgage. With respect to the sale of the real property, the taxpayer has a gain of $1,000,000 [current U.S.D. value of $3,000,000 (1.5 x 2,000,000) less initial U.S.D. cost of $2,000,000] a portion of which may be excluded under the principal residence exclusion. With respect to the repayment of the mortgage, the taxpayer has a gain of $400,000, the difference between the U.S.D. value of the amount borrowed ($1,600,000) and the U.S.D. value of the repayment ($1,200,000).

COMMON INVESTMENT ACTIVITIES

As noted above, investment (for profit) activities are Section 988 transactions. Common investments include deposits, debt, equity, and derivatives.

Determining Basis

The basis of nonfunctional currency withdrawn from an account with a bank or other financial institution is determined under any reasonable method that is consistently applied from year to year by the taxpayer to all accounts denominated in a nonfunctional currency. For example, a taxpayer may use a first in first out method, a last in first out method, a pro rata method, or any other reasonable method that is consistently applied. However, a method that consistently results in units of nonfunctional currency with the highest basis being withdrawn first is not considered reasonable.[9] The simplest method is to use a formula represented as follows: (FX withdrawn / total FX in the account) x (total U.S. dollar basis). This method is blessed in an example in the regulations.

Publically Traded Stock

If stock or securities traded on an established securities market are sold for nonfunctional currency by a cash basis taxpayer, the amount realized with respect to the stock or securities (as determined on the trade date) is computed by translating the units of nonfunctional currency received into functional currency at the spot rate on the settlement date of the sale. If a cash basis taxpayer for nonfunctional currency purchases stock or securities traded on an established securities market, the basis of the stock or securities is determined by translating the units of nonfunctional currency paid into functional currency at the spot rate on the settlement date of the purchase. An accrual method taxpayer may also elect to use the same rule.[10]

Example 10

On January 1, 2013 (the trade date), Mr. FX Guy, a calendar year cash basis U.S. individual, purchases stock for 100 British pounds (£) for settlement on January 5, 2013. On January 1, 2014, the spot value of the £100 is $140. On January 5, 2013, Mr. FX Guy purchases £100 for $141, which X uses to pay for the stock. Mr. FX Guy's basis in the stock is $141, or the U.S.D. value on the settlement date.

On December 30, 2013 (the trade date), Mr. FX Guy sells the stock for £110 for settlement on January 5, 2014. On December 30, 2013, the spot value of £110 is $165. On January 5, 2014, Mr. FX Guy transfers the stock and receives £110 which, translated at the spot rate, equals $166. Mr. FX Guy's basis in the £110 received

9 Treas. Reg. §1.988-2(a)(2)(iii).
10 Treas. Reg. §1.988-2(a)(4)(iv)(A)-(C).

from the sale of the stock is $166, which is the U.S.D. value on the settlement date.

Special Rules Relating to Certificates of Deposit

As noted above, certificates of deposit can be Section 988 transactions if denominated in a foreign currency or if value is determined by reference to that foreign currency. However, there are special rules with respect to certificates of deposit. In particular, no exchange gain or loss is recognized with respect to the following transactions:

- The deposit of nonfunctional currency in a demand or time deposit or similar instrument (including a certificate of deposit) issued by a bank or other financial institution if such instrument is denominated in such currency;
- Withdrawal of nonfunctional currency from a demand or time deposit or similar instrument issued by a bank or other financial institution if such instrument is denominated in such currency;
- Receipt of nonfunctional currency from a bank or other financial institution from which the taxpayer purchased a certificate of deposit or similar instrument denominated in such currency by reason of the maturing or other termination of such instrument; and
- The transfer of nonfunctional currency from a demand or time deposit or similar instrument issued by a bank or other financial institution to another demand or time deposit or similar instrument denominated in the same nonfunctional currency issued by a bank or other financial institution.

For these purposes, the taxpayer's basis in the units of nonfunctional currency or other property received in the transaction is the adjusted basis of the units of nonfunctional currency or other property transferred.[11]

Translating Interest Income and Expense

Demand Accounts

Interest income received, with respect to a demand account with a bank or other financial institution which is denominated in (or the payments of which are determined by reference to) a nonfunctional currency, is translated into functional currency at the spot rate on the date received or accrued or pursuant to any reasonable spot rate convention consistently applied by the taxpayer to all taxable years and to all accounts denominated in nonfunctional currency in the same financial institution. For example, a taxpayer may translate interest income received with respect to a demand account on the last day of each month of the taxable year, on the last day of each quarter of the taxable year, on the last day of each half of the taxable year, or on the last day of the taxable year.[12] However, no

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11 Treas. Reg. §1.988-2(a)(1)(iii).
12 Treas. Reg. §1.988-2(b)(1).

exchange gain or loss is realized upon the receipt or accrual of interest income with respect to a demand account.

Debt Denominated or Determined by Reference to a Single Nonfunctional Currency

Interest income or expense received or paid that is not required to be accrued by a taxpayer prior to receipt or payment is translated at the spot rate on the date of receipt or payment. A taxpayer may have to accrue interest income, *e.g.*, if the instrument has original issue discount.[13] In this case, the regulations state that the taxpayer must, in general, translate accrued interest or expense at the average spot rate for the interest accrual period or, with respect to an interest accrual period that spans two taxable years, at the average spot rate for the partial period within the taxable year.[14] However, the taxpayer may elect to use a spot accrual convention, in which case income and expense are translated at the spot rate on the last day of the interest accrual period (and in the case of a partial accrual period, the spot rate on the last day of the taxable year). If the last day of the interest accrual period is within five business days of the date of receipt or payment, the regulations provide that the taxpayer may translate interest income or expense at the spot rate on the date of receipt or payment. The election is made by filing a statement with the taxpayer's first return in which the election is effective.[15]

With respect to exchange gain or loss, the taxpayer must realize exchange gain or loss with respect to accrued interest income on the date such accrued interest income is received or the instrument is disposed of. The amount of exchange gain or loss so realized with respect to accrued interest income is determined for each accrual period by:

- Translating the units of nonfunctional currency interest income received with respect to such accrual period into functional currency at the spot rate on the date the interest income is received or the instrument is disposed of (or deemed disposed of); and

- Subtracting from such amount the amount computed by translating the units of nonfunctional currency interest income accrued with respect to such income received at the average rate for the accrual period.[16]

A similar rule is provided for accrued interest expense.[17]

In general, with respect to principal, the holder of a debt instrument realizes exchange gain or loss on the date principal is received from the obligor or the instrument is disposed of. For purposes of computing exchange gain or loss, the principal amount of a debt instrument is the holder's purchase price in units of nonfunctional currency. The amount of exchange gain or loss so realized by the holder with respect to principal is determined by:

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[13] Treas. Reg. §1.988-2(b)(2)(ii)(B).
[14] Treas. Reg. §1.988-2(b)(2)(ii)(C).
[15] Treas. Reg. §1.988-2(b)(2)(iii).
[16] Treas. Reg. §1.988-2(b)(3).
[17] Treas. Reg. §1.988-2(b)(4).

- Translating the units of nonfunctional currency principal at the spot rate on the date payment is received or the instrument is disposed of (or deemed disposed of); and

- Subtracting from such amount the amount computed by translating the units of nonfunctional currency principal at the spot rate on the date the holder (or a transferor from whom the nonfunctional principal amount is carried over) acquired the instrument (is deemed to acquire the instrument).

In order to make these calculations for debt instruments issued with original issue discount, a series of ordering rules apply. In general, units of nonfunctional currency received or paid are treated: first as a receipt or payment of periodic interest, second as a receipt or payment of original issue discount to the extent accrued as of the date of the receipt or payment, and finally as a receipt or payment of principal.[18]

Example 11

Mr. FX Guy is an individual on the cash method of accounting with the dollar as his functional currency. On January 1, 2012, Mr. FX Guy converts $13,000 to 10,000 British pounds (£) at the spot rate of £1 = $1.30 and loans the £10,000 to Y for 3 years. The terms of the loan provide that Y will make interest payments of £1,000 on December 31 of 2012, 2013, and 2014, and will repay Mr. FX Guy's £10,000 principal on December 31, 2014. Assume the spot rates for the pertinent dates are as follows:

Date	Spot rate (pounds to dollars)
Jan. 1, 2012	£1 = $1.30
Dec. 31, 2012	£1 = $1.35
Dec. 31, 2013	£1 = $1.40
Dec. 31, 2014	£1 = $1.45

Mr. FX Guy will translate the £1,000 interest payments at the spot rate on the date received. Accordingly, Mr. FX Guy will have interest income of $1,350 in 2012, $1,400 in 2013, and $1,450 in 2014. Because Mr. FX Guy is a cash basis taxpayer, Mr. FX Guy does not realize exchange gain or loss on the receipt of interest income.

Mr. FX Guy will realize exchange gain upon repayment of the £10,000 principal amount determined by translating the £10,000 at

18 Treas. Reg. §1.988-2(b)(7).

the spot rate on the date it is received (£10,000 × $1.45 = $14,500) and subtracting from such amount, the amount determined by translating the £10,000 at the spot rate on the date the loan was made (£10,000 × $1.30 = $13,000). Accordingly, Mr. FX Guy will realize an exchange gain of $1,500 on the repayment of the loan on December 31, 2014.

Debt Denominated or Determined by Reference to Multiple Currencies

FX debt subject to contingencies, or determined by reference to multiple currencies, is subject to special rules.[19] In this case, a hypothetical model ("noncontingent bond method") is created that eliminates the contingencies in order to calculate interest income, gain or loss on a per annum basis (to avoid deferral). Appropriate adjustments are made in order to 'true-up' actual interest income, gain or loss. In order to facilitate this model in the case of multicurrency debt, a "predominant" currency must be determined. In general, the predominant currency of the instrument is the currency with the greatest value determined by comparing the functional currency value of the noncontingent and projected payments denominated in, or determined by reference to, each currency on the issue date, discounted to present value (in each relevant currency), and translated (if necessary) into functional currency at the spot rate on the issue date. For this purpose, the applicable discount rate may be determined using any method, consistently applied, that reasonably reflects the instrument's economic substance. The predominant currency is determined as of the issue date and does not change based on subsequent events (*e.g.*, changes in value of one or more currencies). If (i) no currency has a value greater than 50% of the total value of all payments and (ii) the difference between the discount rate in the denomination currency and the discount rate with respect to any other currency in which payments are made (or determined by reference to) pursuant to the instrument is greater than 10%, then the I.R.S. may determine the predominant currency under any reasonable method.[20]

What can be said here is that the rules are incredibly complex, and the taxpayer will need to consult their professional tax advisor to properly report income on the instrument.

Derivatives

As noted above, forward contracts, futures contracts, and option contracts on or referencing foreign currency are Section 988 transactions. With respect to determining exchange gain or loss:

- A spot contract to buy or sell nonfunctional currency is not considered a forward contract or similar transaction unless such spot contract is disposed of (or otherwise terminated) prior to making or taking delivery of the currency.[21] A spot contract is a contract to buy or sell nonfunctional

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[19] See Treas. Reg. §1.988-6.
[20] See Treas. Reg. §1.988-6(d)(1), (2).
[21] Treas. Reg. §1.988-2(d)(1).

currency on or before two business days following the date of the execution of the contract.[22]

- Exchange gain or loss is realized and recognized, in general, upon sale, exchange, or other disposition of the contract.[23]

- Further to point in the preceding sentence, <u>any</u> gain or loss determined is treated as exchange gain or loss. In addition, exchange gain or loss is determined by subtracting the amount paid (or deemed paid), if any, for or with respect to the contract (including any amount paid upon termination of the contract) from the amount received (or deemed received), if any, for or with respect to the contract (including any amount received upon termination of the contract).[24]

- Finally, if the taxpayer makes or takes delivery in connection with the derivative contract, any gain or loss is realized and recognized in the same manner as if the taxpayer sold the contract (or paid another person to assume the contract) *on the date on which he took or made delivery for its fair market value on such date*.[25]

<u>Conclusion</u>

Cross-border investments often result in significant complexity. Transactions in foreign currency are often overlooked. Taxpayers that engage in transactions involving foreign currencies should be prepared to account for significant administrative burdens.

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22 Treas. Reg. §1.988-1(b).
23 Treas. Reg. §1.988-2(d)(2), (3).
24 Treas. Reg. §1.988-2(d)(4)(i).
25 Treas. Reg. §1.988-2(d)(4)(ii).

PROPOSED PARTNERSHIP REGULATIONS WILL AFFECT PARTNERSHIP DEAL ECONOMICS

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Tags
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INTRODUCTION

In 2014-8 I.R.B., the I.R.S. proposed amendments to regulations issued under Code §707 relating to disguised sales of property to or by a partnership and under Code §752 regarding the treatment of partnership liabilities. The proposed regulations address certain deficiencies and technical ambiguities in the existing regulations and certain issues in determining partners' shares of liabilities under Code §752. The proposals are designed to limit taxpayers' ability to structure a sale of a partnership interest as a contribution of property by one partner and the receipt of a distribution by a second partner in a way that is not taxable in the year of the transaction. For a foreign investor, the proposed regulation regarding the interplay of partnership liabilities and investor basis in the partnership add another unwelcome level of complexity that must be accounted for in tax planning for an investment. The reason is that a partner's ability to deduct losses of a partnership or L.L.C. is capped at the basis maintained in the partnership interest held. Partners have basis for liabilities of the partnership. The issue is the allocation of losses among the partners or members. The proposed regulations limit ways to increase basis through planning mechanisms that have been accepted for a long period of time.

PARTNERSHIP BASICS AND RELATED ISSUES

Background

A partnership is said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses.[26]

Whether through special entity classification elections or by virtue of the business deal at hand, the use of the partnership tax structure has historically provided taxpayers with significant U.S. tax benefits. The "pass-through" tax aspects of a partnership arrangement result in the flow-through of income, deductions and credits to the owners. In each case, the item retains its character as determined at

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[26] *Commissioner v. Tower*, 326 U.S. 280 (1946).

the level of the partnership. There is no taxation at the partnership level. Consequently, there is only one layer of taxation which is assessed at the individual level. This is in contrast to a corporate entity that pays tax at the corporate level before distributing dividends to shareholders. The dividends paid to individuals and corporate investors are generally taxed a second time, albeit at a lower rate.

Additionally, partnerships offer structural flexibility allowing the partnership agreement to allocate voting and income rights in just about any manner desired, provided that (i) the gains, loses, deductions or credits are allocated to partners based on the partnership agreement and (ii) the allocation has "substantial economic effect." Thus, use of a partnership provides a wide degree of latitude for taxpayers in determining both who is taxed and how that tax will be shared. This freedom of allocation is limited by one important rule. The allocation must be made without the sole intent to reduce the individual partner's tax liabilities and must affect each partner's capital account, so that if a partner is allocated losses, its capital account must be reduced and the reduction affects capital gains allocation at the conclusion of the partnership.

"When a taxpayer contributes property to a partnership in exchange for an interest in that partnership, no gain or loss is recognized by either the partnership or its partners."

Contributions and Basis

When a taxpayer contributes property to a partnership in exchange for an interest in that partnership, no gain or loss is recognized by either the partnership or its partners.[27] This nonrecognition rule applies to both new and existing partnerships. The partnership interest must be received in exchange for "property," which is generally defined as cash, inventory, accounts receivable, patents, instalment obligations, and intangibles, such as goodwill.

Disregarding debt obligations within the partnership, the partner's outside basis in the partnership interest received in connection with the contribution of property is equal to the sum of the money and the adjusted basis of property contributed to the partnership.[28] The partnership's inside basis in the property received is equal to the basis of the contributing partner in the property (*i.e.*, the partnership has a transferred basis in the property received).[29] Any inherent gain or loss is preserved and recognized on disposition of the contributed property or disposition of the partnership interest. In addition, the contributing partner alone bears the consequence of built-in income, gain, deduction loss and credit inherent in the contributed property so that such gain is specially allocated to the contributing partner at such time when it is realized by the partnership.[30] Gain that inures after the contribution is allocated separately in the manner provided by the partnership agreement.

Gain (but not loss) may be recognized, if the contributing partner receives property other than a partnership interest (*i.e.*, boot) but only if the amount of the boot exceeds the total basis in the partnership interest.[31] Liabilities transferred with the contributed property may be boot, but only to the extent that liabilities are

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27 Treas. Reg. §1.721-1(a).
28 Code §722.
29 Code §723.
30 Code §704(c).
31 Code §752(c); Treas. Reg. §1.752-1(e).

shifted to other partners. Initially, and generally thereafter, the aggregate of the partners' outside bases should equal the partnership's inside basis in its assets.

Each partner's equity in the partnership is reflected in a capital account. Capital accounts reflect the fair market value of assets at the time of contribution and distribution. The capital accounts thus accurately show the partners' economic interests in the partnership and track the "business deal."

The partners' capital accounts can be increased or decreased with no immediate tax consequences. A revaluation of a capital account may be referred to as a "book-up" or "book-down." For example, the partners generally wish to restate their book capital accounts upon the admission of a new partner. For business purposes, this permits the partners to document their ownership in the appreciation of partnership assets that accrued prior to the new partner's admission. For tax purposes, this would permit gain or loss inherent in the property at that point to be taxed to the partner whose business deal is affected by movements in value, thus upholding the assignment of income doctrine.

The partners' book capital accounts, based on generally accepted accounting principles, will reflect book income and deductions and are used primarily for financial reporting purposes. This would be particularly relevant to publicly traded partnerships. The partners' tax capital reflects tax accounting adjustments.

As the foregoing indicates, a partner's capital account is not equal to the outside basis of the partnership interest. Once a partnership begins operations, the outside tax basis computed in the manner discussed above is increased by the distributable share of (i) taxable income, (ii) tax exempt income, and (iii) the excess of the deductions for depletion over the basis of the property subject to depletion[32] The tax basis is decreased by the partner's share of (i) distributions of cash and property, (ii) tax losses, (iii) nondeductible partnership expenditures which cannot be capitalized, and (iii) depletion.[33]

Outside tax basis rules thus function to ensure that, over the partnership's life, the partner does not withdraw more than the net investment in the partnership without a tax impact by providing that a distribution to a partner in excess of outside basis results in a gain.

Partnership Liabilities

An increase in a partner's share of partnership liabilities is considered a contribution of money, which increases the partner's outside basis in the partnership interest.[34] A decrease in a partner's share of partnership liabilities is considered to be a distribution of money[35] to the partner, which decreases the partner's outside basis (but not below zero).[36] If a decrease in the partner's share of partnership liabilities exceeds the partner's outside basis, the partner recognizes the excess as capital

32 Code §705(a)(1).
33 Code §§705(a)(2) and 733.
34 Code §752(a).
35 Code §752(b).
36 Code §§705(a) and 733.

gain from the sale or exchange of the partnership interest.[37] This typically occurs in real estate partnerships where depreciation deductions often out-pace amortization of debt principal, resulting in more debt than basis at a given time. An example is real property acquired for a note that calls for interest payments only for a period of time followed by a balloon payment of principal at certain intervals.

A partnership liability is classified as "recourse" only to the extent that a partner bears the economic risk of loss for the liability.[38] A partner's share of the recourse liabilities of a partnership equals the portion of the liability for which the partner bears the economic risk of loss.[39] In simple terms, this means the lender can look to the partner for repayment if the partnership defaults. A liability is "nonrecourse" to the extent that no partner bears the economic risk of loss for the liability.[40] The partners generally share nonrecourse liabilities in proportion to their share of partnership profits.[41] This reflects the fact that only profits can be used to repay the debt, ignoring a repayment funded through a refinancing with other lenders.

"A threshold question is whether a partnership liability actually exists"

When a partner contributes property subject to a liability to a partnership, two transactions are deemed to occur: First, the transfer partner is treated as having received a cash distribution equal to the entire liability assumed by the partnership.[42] Secondly, that partner is treated as having made a cash contribution equal to the transferor's share of the liabilities attached to the transferred property.[43] These events are treated as having occurred simultaneously, resulting in a net deemed distribution or a net deemed contribution of money. Careful tax planning is required to ensure that a partner contributing debt-encumbered property will not realize gain from a sale of a partnership interest. The tax result arising from a transfer of property that is subject to recourse debt against the transferor may differ if the property is subject to nonrecourse debt.

A threshold question is whether a partnership liability actually exists. The Treasury Regulations[44] state that an obligation is a liability only if, when, and to the extent that incurring the obligation: (i) creates or increases the basis of any of the obligor's assets (including cash), (ii) gives rise to an immediate deduction to the obligor, or (iii) gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital. This definition is consistent with Rev. Rul. 88-77, which addressed the definition of partnership liabilities in the context of a cash basis partnership, and Rev. Rul. 95-26, in which a short sale of securities created a partnership liability because it created an obligation for the seller to return the borrowed securities. Thus, the cash received in the short sale resulted in a basis increase to partnership assets.

An obligation is any fixed or contingent obligation to make payment without considering whether the obligation is otherwise taken into account for purposes of

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37 Code §§731(a)(1), 741.
38 Treas. Reg. §1.752-1(a)(1).
39 Treas. Reg. §1.752-2(a).
40 Treas. Reg. §1.752-1(a)(2).
41 Treas. Reg. §1.752-3(a).
42 Treas. Reg. §1.752-1(c).
43 Treas. Reg. §1.752-1(b).
44 Treas. Reg. §1.752-1(a)(4)(i). .

"A debt that is created for the sole purpose of generating tax savings is not genuine and must be disregarded for tax purposes. A business motive for incurring a partnership liability must exist."

the Internal Revenue Code. Examples of obligations for this purpose include debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, futures contracts, and swaps.[45]

A debt that is created for the sole purpose of generating tax savings is not genuine and must be disregarded for tax purposes. A business motive for incurring a partnership liability must exist. Similarly, a *bona fide* debt cannot be ignored.

The rules are structured to keep a close correlation between inside and outside basis. If deductions are funded by partnership debt, the outside tax basis is increased to allow the partners the benefit of the deduction. To this end, there is coordination between the rules which govern how partnership liabilities are shared and the rules governing partnership allocations.

Taxable Disguised Sales

The tax-free treatment and adjustments to the outside tax are subject to the so-called "disguised sale" rules. These rules are designed to prevent partners from re-characterizing a sale or exchange of property as a contribution to the partnership followed by a distribution by the partnership. The two-step transaction that is the target of the rules inappropriately allows a partner to avoid or defer tax on the distribution.

A disguised sale occurs when a transfer of property is made from a partner to a partnership and is then followed by a transfer of money or other consideration from the partnership to another partner, if the transfer would not have been made but for the near simultaneous transfer.[46] Although one of the most common scenarios is a property contribution by a partner to a partnership with a distribution of cash from the partnership to the contributing partner (*i.e.*, a disguised sale by the partner to the partnership), a disguised sale can take other forms such as:

- A cash contribution by a partner to a partnership with a property distribution from the partnership to the contributing partner (*i.e.*, a disguised sale by the partnership to the partner); and

- A property contribution by one partner and a cash contribution by another partner with a cash distribution from the partnership to the partner contributing property and a property distribution to the partner contributing cash (*i.e.*, a disguised sale between the partners).

There are several exceptions to the disguised sale rule, most notably the "pre-formation capital exception" and the "debt-financed exception."

The pre-formation capital exception generally excludes transfers to reimburse a partner for certain capital expenditures and costs incurred provided that: (i) the

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45 Treas. Reg. §1.752-1(a)(4)(ii).

46 See the preamble to the proposed disguised sales regulations under Code §707 in Notice of Proposed Rulemaking for REG-119305.

capital expenditures are incurred within two years preceding the contribution of the property and (ii) the capital expenditures do not exceed 20% of the fair market value of the contributed property. The 20% limit does not apply if the fair market value of the property does not exceed 120% of the tax basis of the property.

Under the debt-financed distribution exception to disguised sale treatment, a distribution of money to a partner generally is not treated as consideration to the extent the distribution is traceable to a partnership liability (incurred within 90 days of the distribution) and the amount of the distribution does not exceed the partner's allocable share of the liability incurred to fund the distribution. An anticipated reduction in a partner's share of liability will be taken into account in determining the partner's share of liability for purposes of the disguised sale rule. However, "qualified liabilities" are excluded from disguised sale treatment.

"A leveraged partnership structure allows a seller to transfer most of the economic interest in a business in exchange for cash without triggering current taxes"

PARTNERSHIP PLANNING

The above rules regarding partnership basis, assumptions of liabilities and avoidance of the disguised sales rules are key to leveraged partnerships in capital intensive industries such as oil, gas, and real estate. They also affect hedge funds that acquire businesses in highly leveraged transactions.

A leveraged partnership structure allows a seller to transfer most of the economic interest in a business in exchange for cash without triggering current taxes. The partnership is formed with a purchaser of assets who would act as a strategic business partner or a financing entity and to whom essentially all of the economics (*i.e.*, up to 90%) and effective control of a business would be allocated. The seller of the partnership assets would receive cash proceeds through a leveraged distribution by the partnership. The seller's guarantee of the debt of the partnership in an amount equal to the cash distributed to the seller establishes the seller's basis in the partnership, so that cash proceeds received reduce partnership basis, but the reduction is offset by the increase resulting from the guarantee. Alternatively, the purchaser can provide the financing (so long as the seller guarantees its repayment) or the purchaser can be a co-guarantor, so long as the seller indemnifies the purchaser for any costs it bears as guarantor. Under these arrangements, the seller's gain from the distribution is deferred until such time as (i) the seller exits the partnership, (ii) the assets of the partnership contributed by the seller are sold, (iii) the debt is repaid, or (iv) the guarantee no longer exists.

A bottom guarantee structure can reduce the seller's credit exposure. Here the partnership borrows an amount greater than needed to fund the distribution, thereby creating excess cash for deployment in the business. The seller guarantees all remaining amounts in excess of the first losses on the entire borrowing. The partnership borrows more than, say 90%, of the value of the business so that the seller will still be able to guarantee debt equal to the cash it receives, while not bearing the "first losses" on this debt. The excess cash can be utilized for normal working capital needs of the business or to fund acquisitions or capital expenditures.

The I.R.S. has taken issue with leveraged arrangements under current rules where the seller guarantees arguably were not commercial liabilities of the seller.

In Chief Counsel's Advice ("C.C.A.") 201324013, the taxpayer was an S-corporation that would have incurred significant double tax if it had sold certain property prior to the 10-year anniversary of its conversion to S-corporation status. (For 2009 through 2013, the period was materially shortened to as little as five years. That provision has not yet been extended to 2014, but may be covered by possible legislation to extend expiring tax rules.) To defer the taxable sale date, the taxpayer ("X corp") indirectly contributed the property to a leveraged partnership with the buyer, an indirect subsidiary of Y corp. The buyer contributed both cash and receivables from Y corp. The partnership then borrowed significant cash from a bank and distributed it to X corp. The bank debt was guaranteed by buyer. The partnership agreement also contained put/call provisions to facilitate an exit starting one day after the 10-year period was reached.

The commercial issue faced by X corp was the fact that the buyer guaranteed the borrowing and the bank relied on the guarantee when extending the credit. X corp issued its indemnity to the buyer for a portion of the obligation under the guarantee and argued that its outside basis was increased by the amount of the indemnity. Nonetheless, the C.C.A. concluded that X corp's indemnity should be ignored. It categorized the indemnity as nothing more than optics designed to reduce tax, finding that:

- The indemnity lacked important features typical of an indemnity in a commercially-driven transaction. A typical indemnity expressly includes features such as net worth maintenance requirements, an arms-length fee, an obligation to provide annual financial statements, and evidence that the parties engaged in genuine negotiations over the indemnity.

- The indemnity is specious because there is no practical or commercial risk of it being enforced.

- The buyer merely used the partnership as a conduit to borrow cash in order to accommodate the seller's tax structure.

Consequently, the transaction was taxable as a disguised sale. Alternatively, the C.C.A. concluded that the partnership could be ignored under the partnership anti-abuse regulations. The C.C.A. also noted that the transaction could be considered a straight sale transaction under general common law substance over form principles.

THE PROPOSED REGULATIONS: KEY PROVISIONS

The proposed regulations address (i) the disguised sale rules[47] and (ii) allocation of liabilities to partners' tax basis in the partnership[48] within the context of addressing I.R.S. concerns regarding highly leveraged partnerships, as illustrated by C.C.A. 201324013.

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[47] Treas. Reg. §§1.707-3, -4, and -5.
[48] Treas. Reg. §1.752-2.

Disguised Sales

The proposed regulations clarify three ambiguities relating to the preformation capital expenditure exception to the disguised sale rules:

- The fair market value limitation test of Treas. Reg. §1.707-4(d)(1)(ii)(B) is applied on a property-by-property basis and not on an aggregate basis.

- The term "capital expenditures" of Treas. Reg. §1.707-4(d)(3) is defined to include capital expenditures that the taxpayer previously elected to deduct but to exclude deductible expenses the taxpayer elected to capitalize.

- The exception under Treas. Reg. §1.707–5(a) would not apply to the reimbursement by the partnership to the extent a partner funds a capital expenditure through borrowing and economic responsibility for the borrowing is shifted to another partner upon the assumption of that liability by the partnership.

The existing regulations provide several exceptions to disguised sale treatment. One such exception generally provides that a distribution of money to a partner is not taken into account to the extent the distribution is traceable to a partnership borrowing and the amount of the distribution does not exceed the partner's allocable share of the liability incurred to fund the distribution. This is known as the "debt-financed distribution exception." The I.R.S. expressed the view that uncertainty exists as to whether the amount of money transferred to a partner that is traceable to a partnership liability is reduced by any portion of such amount that is also excluded from disguised sale treatment under one or more other exceptions. For example, what happens if the transfer of money is also properly treated as a reasonable guaranteed payment? Does the debt-financed distribution exception apply? The answer is yes. The proposed regulations apply the debt-financed distribution exception before other exceptions from disguised sale treatment. This is designed to prevent the application of other exceptions from minimizing the application of the debt-financed distribution exception. If there is any amount not excluded after taking the debt financed distribution exception, the amount is to be tested under a different exception.

Under the existing regulations, a partner's share of a liability assumed, or taken subject to, by a partnership is determined by taking into account certain subsequent reductions in the partner's share of the liability. Specifically, a subsequent reduction in a partner's share of a liability is taken into account if:

- At the time that the partnership incurs, assumes, or takes property subject to the liability, it is anticipated that the partner's share of the liability will be subsequently reduced; and

- The reduction is part of a plan that has as one of its principal purposes minimizing the extent to which the distribution or assumption of, or taking property subject to, the liability is treated as part of a sale (the "anticipated reduction rule").

The I.R.S. recognized that uncertainty exists as to the circumstances in which a reduction is anticipatory because it is generally anticipated that all liabilities will be repaid. Consistent with the overall approach of the existing regulations, the proposed regulations adopt the view that a reduction that is subject to the entrepreneurial risks of partnership operations (*i.e.*, that will be paid if the business succeeds) is not an anticipated reduction. However, if the a partner's share of the liability is reduced within two years of the partnership incurring, assuming, or taking project subject to the liability due to a decrease in the partner's or related person's net value, then the reduction is presumed to be anticipated. [49] The presumption may be rebutted if the facts and circumstances establish that the liability was not incurred in anticipation of the transfer, [50] and the treatment of the liability as a qualified liability under the new definition is disclosed to the I.R.S.[51]

The existing regulations provide only a limited tiered-partnership rule for cases in which a partnership succeeds to a liability of another partnership. Under those rules, if a lower-tier partnership succeeds to a liability of an upper-tier partnership, the liability in the lower-tier partnership retains the same characterization as either a qualified or a nonqualified liability that it had as a liability of the upper-tier partnership. A similar rule applies to a transfer from a lower-tier partnership to an upper-tier partnership. The proposed regulations add additional rules regarding tiered partnerships. First, the proposed regulations clarify that the debt-financed distribution exception applies in a tiered partnership setting. Second, the proposed regulations provide rules regarding the characterization of liabilities attributable to a contributed partnership interest. A partner that contributes an interest in a partnership to an upper-tier partnership must take into account its share of liabilities from the lower-tier partnership.

The lower-tier partnership is treated as an aggregate[52] for purposes of determining whether the upper-tier partnership's share of the liabilities of that lower-tier partnership is qualified liabilities. Thus, these proposed regulations provide that a contributing partner's share of liabilities from a lower-tier partnership are treated as qualified liabilities to the extent the liability would be a qualified liability had the liability been assumed, or taken subject to, by the upper-tier partnership in connection with a transfer of all of the lower-tier partnership's property to the upper-tier partnership by the lower-tier partnership.

Recourse Liabilities

As discussed above, the existing regulations[53] provide that a partner's share of a recourse partnership liability equals the portion of the liability, if any, for which the partner or related person bears the economic risk of loss. A partner generally bears the economic risk of loss for a partnership liability to the extent the partner, or a related person, would be obligated to make a payment if the partnership's assets were worthless and the liability became due and payable. Current partnership regulations assume that all partners and related persons will satisfy their payment

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49 Prop. Treas. Reg. §1.707-5(a)(3)(ii).

50 Treas. Reg. §1.707-5(a)(7)(i).

51 Disclosure is required under Treas. Treas. Reg. §1.707-8.

52 When a partnership is treated as an aggregate, all partners are considered as owning a share of all assets of the partnership; the partnership is not an entity separate and apart from its assets.

53 Treas. Reg. §1.752–2.

obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.[54]

The I.R.S. is concerned that some partners or related persons have entered into payment obligations that are not commercially reasonable exclusively to achieve an allocation of a partnership liability to such partner. Consequently, the proposed regulations adopt a rule that obligations will not be recognized for basis enhancement purposes unless the following requirements are met:

"The I.R.S. is concerned that some partners or related persons have entered into payment obligations that are not commercially reasonable exclusively to achieve an allocation of a partnership liability to such partner."

- The obligor must maintain a commercially reasonable net worth throughout the term of the payment obligation, or otherwise be subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration;
- The obligor must be required to periodically provide commercially reasonable documentation regarding the obligor's financial condition;
- The term of the obligation must not end prior to the term of the partnership liability;
- The payment obligation must not require that the primary obligor, or any other obligor with respect to the partnership liability, directly or indirectly holds money other liquid assets in an amount that exceeds its reasonable needs;
- The obligor must receive arm's length consideration for assuming the payment obligation; and
- For a guarantee or similar arrangement, the obligor must be liable up to the full amount of such obligor's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. No bottom-dollar or partial-dollar guarantees are recognized.

The I.R.S. is also concerned that some partners or related persons might attempt to use certain structures or arrangements to circumvent the rules included in the proposed regulations with respect to bottom-dollar guarantees. For example, a financial intermediary might artificially convert a single mortgage loan into senior and junior tranches using a wrap-around mortgage or other device with a principal purpose of creating tranches for partners to guarantee that result in exposure tantamount to a bottom-dollar guarantee. Accordingly, the proposed regulations revise the anti-abuse rule[55] to address the use of intermediaries, tiered-partnerships, or similar arrangements to avoid the bottom-dollar guarantee rules.

The satisfaction presumption does not apply to the payment obligations of disregarded entities. Instead, the payment obligation of a disregarded entity for which a partner is treated as bearing the economic risk of loss is taken into account only to the extent of the net value of the disregarded entity. In addition, the I.R.S. believes there are other circumstances under which this satisfaction presumption is

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[54] Treas. Reg. §1.752(b)(6).
[55] Treas. Reg. §1.752–2(j).

not appropriate. The proposed regulations expand the net value requirement to any partners and related persons that enter into an obligation with respect to a partnership liability, other than a partner who is an individual or decedent's estate.

As a result, to the extent that an obligation is taken into account under the six requirements, the allocation of a partnership liability, on the account of the obligation entered into by such a partner or related person, will be limited to the obligor's net value. The net value of the partner for these purposes consists of:

- The fair market value of all assets owned by the partners that may be subject to creditors' claims under local law (excluding the partner's interest in the partnership for which the net value is being determined and the net fair market value of any property pledged to secure a liability of the partnership); less

- All of the obligations of the partner that do not constitute payment obligations under the existing liability rules.

An obligor subject to this net value requirement must provide information to the partnership as to the obligor's net value that is appropriately allocable to the partnership's liabilities on a periodic basis.

Finally, in determining the amount of any obligation of a partner to make a payment to a creditor or a contribution to the partnership with respect to a partnership liability, the proposed regulations[56] expand the scope of the rule that reduces the partner's payment obligation by the amount of any reimbursement from others. The current regulations provide that the basis reduction rule applies when the partner would be entitled to receive from another partner, a person related to another partner, or the partnership. Under the proposed regulations, the basis reduction rule applies if there is a right to reimbursement from any person.

<u>Non-Recourse Liabilities</u>

Existing regulations[57] address the methods under which a partner's share of a nonrecourse liability of a partnership. Under one method, a partner's share of excess nonrecourse liabilities is determined in accordance with the partner's share of partnership profits. Alternatively, excess nonrecourse liabilities may be allocated among the partners in the manner that deductions attributable to those liabilities are reasonably expected to be allocated. They may also be allocated in a manner that is reasonably consistent with allocations that have substantial economic effect on some other significant partnership item attributable to the property securing the nonrecourse liability.

The I.R.S. believes that the allocation of excess nonrecourse liabilities in accordance with the latter two methods does not properly reflect a partner's share of partnership profits that are generally used to repay such liabilities because the allocation of the significant item may not necessarily reflect the overall economic

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56 Proposed Treas. Reg. §1.752–2(b)(1).
57 Treas. Reg. §1.752–3.

arrangement of the partners. Consequently, the two methods are eliminated under the proposed regulations.

Moreover, in determining a partner's interest in partnership profits, the proposed regulations look to the relative "liquidation value percentages" of the partners. For purposes of the proposed rule, the liquidation value of a partner's interest in a partnership is the amount of cash the partner would receive with respect to the interest if, immediately after formation of the partnership or the occurrence of a capital book-up event, the partnership:

- Sold all of its assets for cash equal to the fair market value of such property;
- Satisfied all of its liabilities;
- Paid an unrelated third party to assume all of its liabilities in a fully taxable transaction; and
- Liquidated.

Thus, a partner's liquidation value percentage would be equal to the partner's capital account balance maintained for tax purposes subject to recalibration upon occurrence of events that would provide for a book-up of the capital accounts. This balance is compared with all other balances to determine the percentage. Built-in gains and capital account book-ups or book-downs are taken into account.

CONCLUSION

Commentators have generally viewed the clarifications of ambiguities in the existing regulations as constructive. As to partners' shares of liabilities, however, there is great concern that the proposed regulations fundamentally change the economics of partnership transactions by altering the way economic risk of loss is determined. By limiting economic loss to "commercial" guarantees (those meeting the six requirements set forth in the proposed regulations) and ignoring "bottom-dollar" guarantees, the proposed regulations significantly impact the ability of taxpayers to (i) make tax deferred contributions of leverage property to partnerships, (ii) receive tax deferred distributions of cash from partnerships, and (iii) maintain sufficient allocations of liabilities to avoid recapture of "negative capital accounts" associated with partnership interests.

The current regulations address issues arising from allocations of non-recourse debt that provide unwarranted tax benefits from a basis bump-up. Specific aspects of the business deal, economic substance requirements for allocations, and rules that mandate the restoration of negative capital accounts or face other curative allocations of partnership level tax attributes likely address most concerns addressed in the proposed regulations.

Where a foreign person operates in the U.S. through a partnership or L.L.C., the general partners or managers have an obligation to withhold U.S. income tax on the distributive share of effectively connected income allocated to the foreign partner.[58] The fact that no distribution is made to the foreign partner is not material in reducing the imposition of the withholding tax obligation.

"Liabilities that might have increased an investor's capacity to absorb and deduct partnership losses – through an increase in basis – may turn out to be ephemeral."

The proposed regulations may exacerbate cash-flow issues where phantom income issues arise. It is anticipated that not all commercial risk legitimately assumed by an investor in a partnership transaction will meet the strict economic risk standards imposed by the proposed regulations. For the foreign investor in a leveraged investment, such as real estate, the proposed regulations add another unwelcome level of complexity onto an already complex area of the tax law that is not well understood outside the U.S. Liabilities that might have increased an investor's capacity to absorb and deduct partnership losses – through an increase in basis – may turn out to be ephemeral.

[58] I.R.C. §1446. .

CROSS-BORDER ESTATE PLANNING: CANADIAN PARENTS OF U.S. CHILDREN

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Tags
Gift and Estate Tax
U.S. and Canada

U.S. transfer taxes (U.S. gift, estate and generation skipping taxes) should be a concern to any practitioner creating an estate plan with U.S. links. The following article addresses U.S. estate tax consequences of a family comprised of Canadian citizen/resident parents with American children.

IN GENERAL

Transfer tax is imposed on the fair market value of the property transferred, reduced by any consideration received.

U.S. citizens, and non-U.S. citizen individuals that are domiciled in the U.S., are subject to the U.S. transfer tax system on global assets.

A person acquires a domicile in a place by living there, for even a brief period of time, without the presence of a definite intention to leave.

A facts and circumstances test is used to determine domicile. Factors include, *e.g.*:

1. Statements of intent (as reflected, *e.g.*, on tax returns filed, visa application, and similar evidence);
2. Time spent in U.S. versus time spent abroad;
3. Visa status (*e.g.*, green card holder);
4. Ties to the U.S. versus abroad;
5. Country of citizenship;
6. Location of employment, business, and assets;
7. Other indicators such as voting, affiliations, membership, driver license, and similar items.

Residence without the intention to remain indefinitely will not constitute a domicile, and the intention to change domicile will not effect such a change unless accompanied by actual relocation.

On the other hand, non-resident, non-citizens ("N.R.N.C.'s") (*i.e.*, nonresident aliens that are not domiciled in the U.S.), such as Canadian citizens and residents, are only subject to the U.S. transfer tax system on U.S. situs assets (see discussion below) that are given away during their lifetimes or upon their death.

Thus, the U.S. estate tax minimization planning covered in this article addresses both U.S. estate taxation as it may apply to U.S. situs assets owned by N.R.N.C.

*This article was edited by Edward C. Northwood parents, as well as the U.S. child's exposure to U.S. estate tax on the worldwide assets that are accumulated during their lifetimes (including what they may receive as inheritance from their parents).

U.S. ESTATE TAX BASICS

U.S. Citizen or Domiciliary

The U.S. estate tax base (the "gross estate") of a U.S. citizen or resident includes the value of all personally owned property as well as assets, comprising certain trusts and similar structures, that may not be effectively excluded from the estate tax base because the decedent retains an interest in the property at the time of death. If the asset is located outside the U.S., a foreign tax credit may be claimed for the amount of any estate, inheritance, legacy or succession taxes actually paid to a foreign country in respect of any property situated within that foreign country and included in the gross estate of the decedent under foreign law.

N.R.N.C.

In General

The gross estate for an N.R.N.C., on the other hand, is comprised solely of U.S. situs assets that would be included in such decedent's estate under general estate tax rules. The gross estate tax value is reduced by various deductions to arrive at a taxable estate. Examples of the main deduction items include gifts to a surviving spouse or a spousal trust (the "marital deduction"), gifts to charities, debts of the decedent, and estate administration expenses. In the case of an N.R.N.C. estate, the eligibility of the marital and charitable deductions is more restricted and other deductions are allowed only in proportion to the value of the U.S. situs assets over the value of the worldwide assets.

U.S. Situs Assets

As noted above, only assets deemed situated in the United States (*i.e.*, U.S. situs assets) are included in the N.R.N.C. decedent's gross estate and are subject to U.S. estate tax. U.S. real estate and tangible personal property located within the United States are considered U.S. situs assets for both U.S. gift and estate tax purposes.

With respect to intangible property, U.S. situs assets include stock issued by a domestic corporation and debt obligations of a U.S. person, the U.S. and any state or political subdivision thereof, or the District of Columbia. For U.S. situs purposes, it is only relevant as to where the company is organized, not where the shares are traded or located. Therefore, it is important for N.R.N.C.'s to note that shares of stock of American companies, such as Coca-Cola or Apple, are considered U.S. situs assets.

> **Example 1**: John, a Canadian citizen, resident and widower, owns shares of Facebook valued at $6,000,000. The shares are located in a brokerage account in Montreal and the title is in John's personal name. Absent any credits or deductions, John will be subject to the U.S. estate tax on his shares of Facebook at the conclusion of his lifetime.

Non-U.S. situs assets include proceeds of life insurance, bank deposits, debt obligations generating portfolio interest under Code §871(h)(1), and works of art on loan in the United States for exhibition purposes at the time of the N.R.N.C. owner's death.

The situs of a partnership remains unclear. In the absence of a Treaty provision, authorities will analyze the situs of the underlying assets of a partnership to make a determination. Additionally, the I.R.S. has held situs of a partnership to be where the business of the partnership is carried out.

Under the U.S.-Canada Treaty, there exists is a reciprocal foreign death tax credit. Thus, upon death, if a Canadian has a Canadian capital gains tax on a U.S. situs asset (due to a deemed disposition on death) and also has a U.S. estate tax on the same U.S. situs asset, the U.S. estate tax may offset the Canadian federal tax due.

> **Example 2:** Aline, a Canadian widow, passes away, holding shares of SallyCo, a company organized in the U.S. The shares (held in a brokerage account in Montreal) have appreciated in value from $1,000,000 to $2,000,000 when the Aline passes away, and thus, a capital gains "death" tax is due in Canada. Aline's worldwide estate is valued at over $6,000,000. Aline's estate will receive a credit on her Canadian capital gains tax due for the U.S. estate tax paid on the shares of SallyCo.

Since the U.S. estate tax is often higher than the Canadian capital gains tax, there may still be some U.S. estate tax due. Further, some Canadian provinces do not recognize the U.S. estate tax death credit. Therefore, there may be some "double taxation" with regard to Canadians residing in these provinces.

U.S. ESTATE TAX: EXEMPTION AMOUNT

U.S. Citizen or Domiciliary

The lifetime gift/estate tax exemption for U.S. domiciliaries/citizens ("U.S. individual(s)") is $5,000,000, indexed for inflation beginning in 2011. Thus, U.S. individuals may transfer $5,000,000+ free of U.S. gift tax during life, but the lifetime usage of the $5,000,000+ exemption will offset the $5,000,000+ available at death. Cumulative lifetime taxable gifts are added to the taxable estate in order to unify the gift and estate tax system.

For 2014, the exemption amount is $5.34 million resulting in a unified tax credit of $2,081,000.

Year	Exemption Amount	Tax Rate Range	Unified Credit
2014	$5,340,00	18-39% on first $1 million, then 40% rate on excess	$2,081,800

For 2014 and thereafter, the graduated estate tax rates on taxable estates are as follows:

From	To	Initial Tax	Rate on Excess
$0	$10,000	0	18%
$10,000	$20,000	$1,800	20%
$20,000	$40,000	$3,800	22%
$40,000	$60,000	$8,200	24%
$60,000	$80,000	$13,000	26%
$80,000	$100,000	$18,200	28%
$100,000	$150,000	$23,800	30%
$150,000	$250,000	$38,800	32%
$250,000	$500,000	$70,800	34%
$500,000	$750,000	$155,800	37%
$750,000	$1,000,000	$248,300	39%
$1,000,000	And over	$345,800	40%

N.R.N.C.

In General

N.R.N.C.'s are generally allowed a reduced estate tax exemption amount of only $60,000 for a limited unified credit of $13,000. However, this amount may be increased by an applicable tax treaty.

Treaty Benefits: U.S.-Canada Tax Treaty

The U.S.-Canada Tax Treaty (the "Treaty") provides that Canadian residents that are not U.S. citizens will, in general, be able to claim the same exemption amount ($5.34 million in 2014) that U.S. citizens and domciliaries may claim. However, the exemption is prorated based on the ratio of value of U.S. situs assets over worldwide assets.

> **Example 3:** Ruth is a Canadian citizen and resident and passes away in 2014. She owns a condo in Florida valued at $500,000 but her worldwide estate is valued under $5,340,000. Consequently, Ruth will not have a U.S. estate tax on death provided her estate files a non-resident return and makes a treaty election. The same result would occur if Ruth was a U.S. individual.

"The U.S.-Canada Tax Treaty…provides that Canadian residents that are not U.S. citizens will, in general, be able to claim the same exemption amount ($5.34 million in 2014) that U.S. citizens and domciliaries may claim."

> **Example 4:** Ruth is a Canadian citizen and resident and passes away in 2014. She owns a condo in Florida valued at $1,000,000, but her worldwide estate is valued at $10,000,000. The U.S. estate on the $1,000,000 is $345,800; however, the Treaty allows a credit of $208,180 (10% of $2,081,000).

Marital Credit

Upon death of the first spouse, there also exists a marital credit under the Treaty. This effectively *doubles* the pro-rated applicable credit amount (*i.e.*, exemption). The marital credit is available if property passes to an N.R.N.C. in a way that would have qualified for the U.S. marital deduction (either outright or in a marital trust). The marital credit is only available if the estate foregoes use of the marital deduction that passes to a Qualified Domestic Trust ("Q.D.O.T.").

> **Example 5:** The facts are the same as Example 4, but Ruth leaves everything to her spouse, a Canadian resident. Upon her death, the U.S. estate tax will be entirely eliminated, as there will be a marital credit of $137,620.

Martial Trust

As with the Canadian deemed disposition tax on death, the estate tax may be deferred until the death of the second-to-die of a married couple. The use of a spousal trust/marital trust with an "ascertainable standard" can allow the surviving spouse the ability to access income while excluding the assets of the spousal trust from his/her gross estate.

> **Example 6:** Pauline, a married Canadian citizen/resident has an estate of $9,000,000. Her spouse, Phillipe, also a Canadian citizen/resident has an estate valued at $1,000,000. Pauline also has title, in her sole name individually, to a townhouse located in Tampa, Florida, valued at $1,000,000. Upon her death, Pauline has the option of leaving the townhouse directly to Phillipe or alternatively to leave the townhouse to Phillipe through the use of a spousal trust/marital trust with an "ascertainable standard" clause. If Pauline does not use a spousal trust in her will and Phillipe receives the assets outright, Phillipe will have a gross estate of $10,000,000 and the Florida townhouse will be subject to U.S. estate tax upon his death.

PLANNING FOR CANADIAN PARENTS WITH U.S. CHILDREN

Canadian Parents

As N.R.N.C.'s, the parents will only be subject to U.S. estate tax on U.S. situs assets. Therefore, to avoid U.S. estate taxation, direct ownership of U.S. situs assets should be avoided (unless the pro-rated Treaty exemption will completely shelter such assets from estate tax). Examples of "blocker" entities include Canadian holding companies and certain irrevocable trusts.

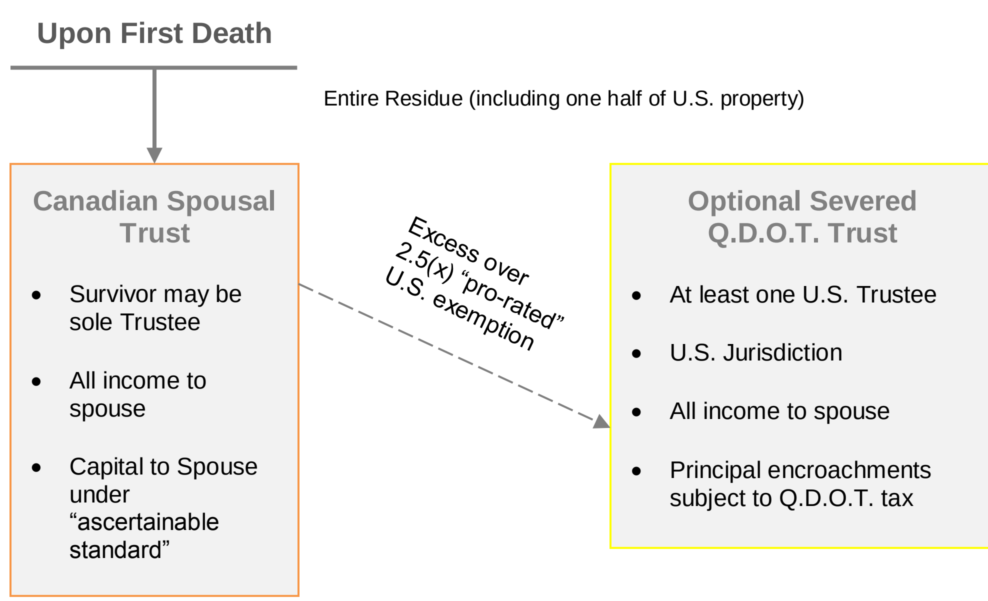
Marital Deduction

Where estate tax would exist on the death of the first spouse and the exemption, even after including the marital credit, is insufficient to preclude such tax, a marital deduction must be used. Since the surviving spouse is an N.R.N.C., the deferral can only be obtained through a Q.D.O.T. In general, for a qualified Q.D.O.T, the surviving spouse must be the only beneficiary during his/her lifetime and must receive all income of the trust. Further, there must be a U.S. trustee, and the trust must be subject to a U.S. jurisdiction. Thus, clients should realize that the use of a Q.D.O.T. may limit flexibility if employed, due to these administrative/logistical requirements.

Design

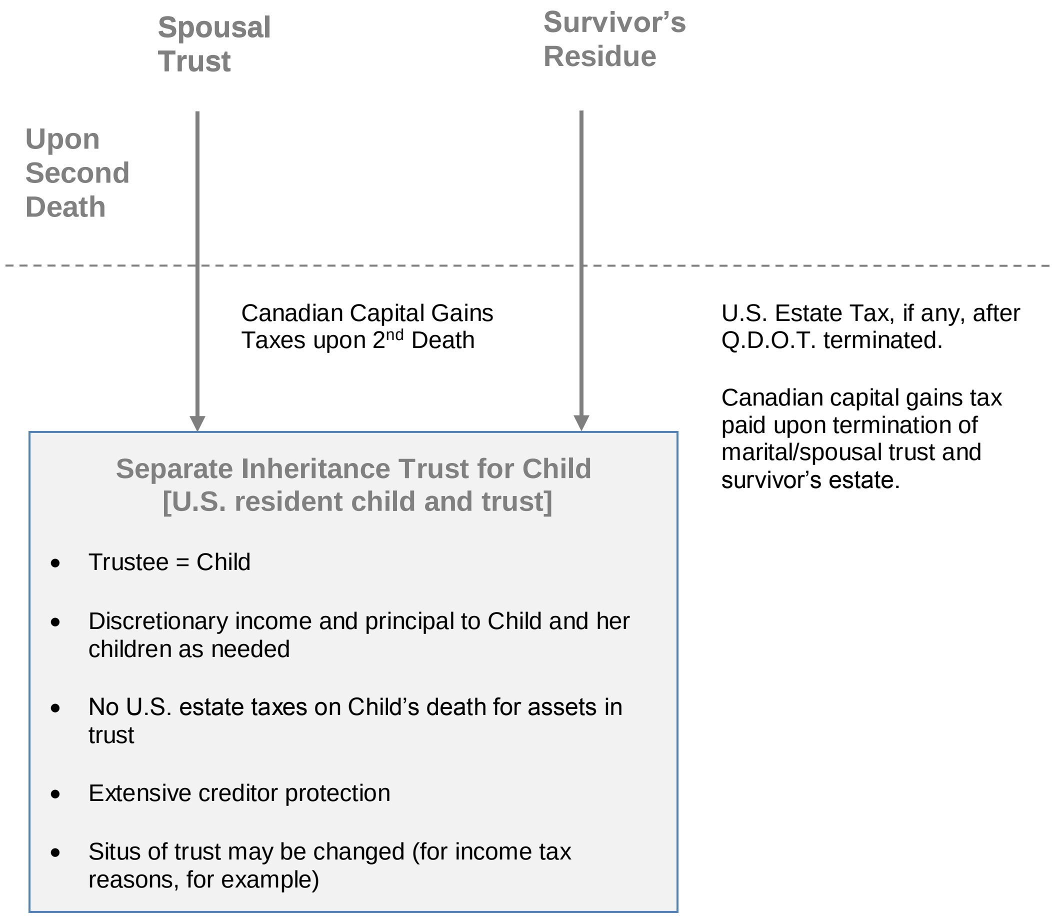
So, what should the cross-border planning process entail and what should the recommendation be? The first step is to work with the Canadian trusts and estate lawyer when he/she drafts the parents' wills. The next step is to determine whether the Canadian parents have a possible U.S. estate tax. If they do, the estate plan should apply the Treaty pro-rated unified credit while maximizing flexibility for the client through the application of marital credit in conjunction with a marital/spousal trust. While a Q.D.O.T. *could* be appropriate, the estate of the first deceased spouse would lose the marital credit. Therefore, the Q.D.O.T. should remain an option, but not a certainty, in the drafting of the will and should only be used if the first spouse to die had a worldwide estate of more than twice the amount sheltered by the two applicable credit amounts, taking into account the use of death tax credits and the allowable estate tax deduction (other than the marital deduction).

The first diagram demonstrates the estate plan of the first parent to pass away.



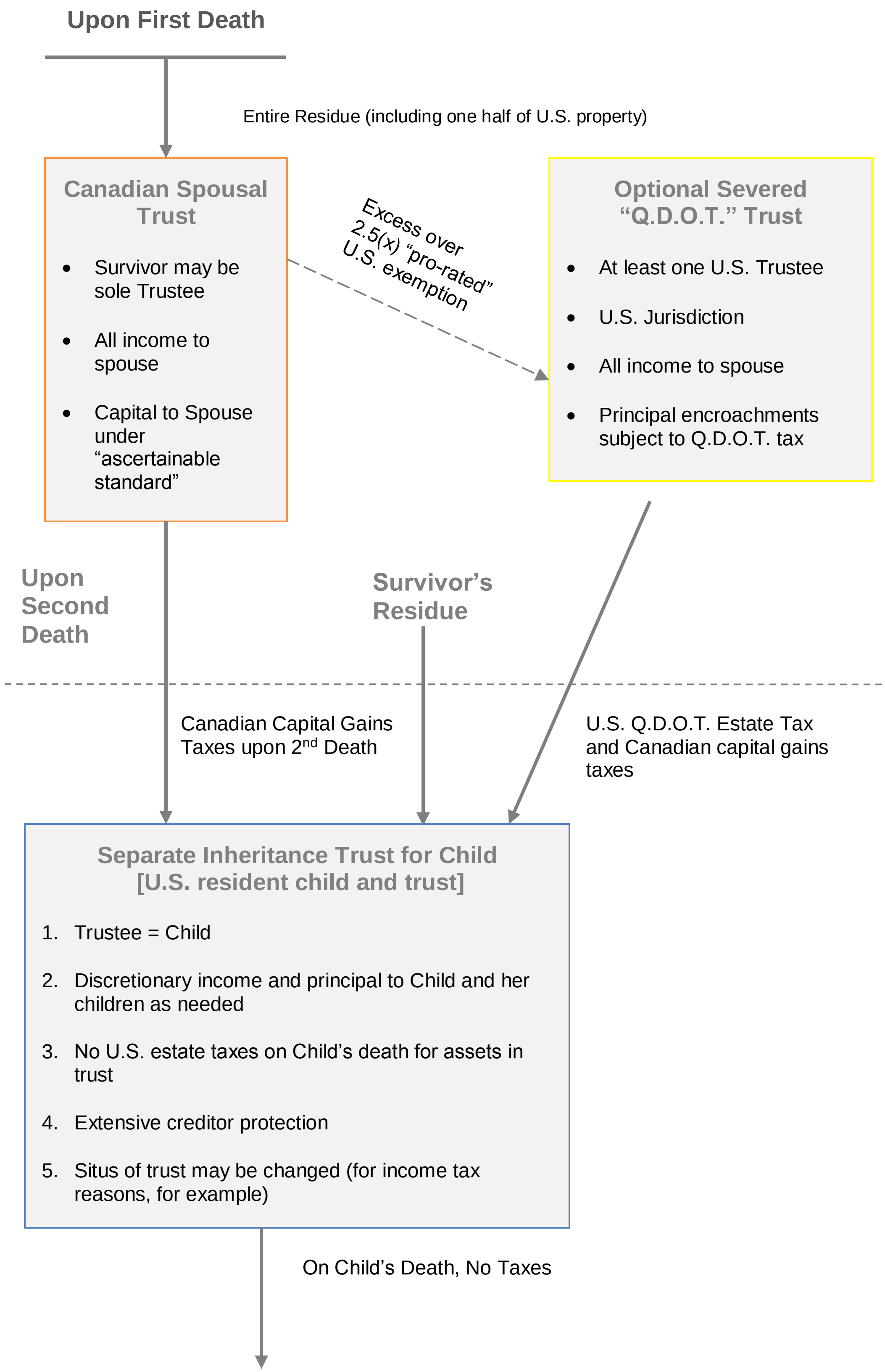
U.S. Children

Unlike the parents, the U.S. children will have their lifetime gifts and worldwide estate taxed at death (not just their U.S. situs assets). An "inheritance trust/dynasty trust" is a trust that exists for a child's lifetime, drafted so that the value of the trust is excluded from the child's estate upon his/her death. Thus, upon the death of the second spouse, the assets from the combined estate should be distributed to a separate inheritance trust for each child and descendant.



Final Diagram

The full plan is diagramed as follows:



CORPORATE MATTERS:
ANGEL INVESTING: AN INTRODUCTION

Author
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Tags
Capital Markets
Angel Investing

Bette Davis once said that growing old is not for sissies. If she were she alive today, she would no doubt be an accredited investor and may well add angel investing to the potentially long list of activities not for sissies.

Typically, angel investors provide seed capital to startup companies or entrepreneurs. When an individual or newly formed closely-held entity seeks financing for a new venture, the most common sources of financing are individuals who have a preexisting relationship with the founders of the venture. With every IPO of a former startup and the corresponding stories of amazing returns on investment for the few initial investors, angel investing activity, as a whole, and the number of people seeking out such investments has steadily increased over the last decade. The Center for Venture Research at the University of New Hampshire found that the number of active angel investors in 2012 was 268,160. A decade earlier, that number had been approximately 200,000. The dollar amount invested over the same period grew to $22.9 billion from $15.7 billion. There is potential for the numbers to grow further: The Angel Capital Association estimates that there are approximately 4 million potential accredited investors (persons with an individual or joint net worth with a spouse that exceeds $1 million - not counting the primary residence) in the United States who might be interested in startup and early stage companies.

This increase is despite the fact that approximately 80% of startups fail. Many investments made by angel investors end up worthless or sit for long periods in inert companies that buyers have little interest in.

When initially investigating a potential investment, realize that the founders, owners and managers are usually the same persons. This group should have a common goal that is shared by you, in terms of your investment outlook. The goals of the founders may quickly determine whether it is the type of venture you want to invest it. For example, what is the exit strategy of the founders – are they planning an IPO or are they working towards selling the company in five years or when a certain value is reached? Many legal, financial, and business decisions would be made in a certain way if the goal were to go public in 3 years as compared with staying private indefinitely.[59] Also realize that the time frame in this type of investment is long. According to Dow Jones VentureSource, venture capital firms, which usually

[59] Lee R. Petillon & Robert Joe Hull, *Representing Start Up Companies* (1992).

"If one is considering becoming an angel investor, the due diligence process should be taken very seriously."

invest in startups several years after angel investors, wait a median 7.35 years for a startup to achieve liquidity through an IPO and a median 5.21 years for an acquisition.

If one is considering becoming an angel investor, the due diligence process should be taken very seriously. An article by Martin C. Zwilling highlights some important considerations.[60] He refers to the confusion in the entrepreneur and investor community between viability and fundability when outlining reasons why an investor may decline to invest or hold off on investing until the company has finished a particular product or signed up a few customers. He states that non-viable businesses should not be funded, which, as he points out, is obvious, but many viable businesses are also not fundable. The reasons he gives form a useful checklist to consider when thinking of making an investment in a startup company.

1. **Business plan.** If the founders have not been able to come up with a good business plan, no matter how good the idea, they have obviously not thought through how to make the business work. Founders who start a business without a good written plan almost always fail.

2. **Experience of the team.** If the founders are not experienced in building a business, an investor may want to hold off until they can partner with someone with more expertise.

3. **Type of business.** Certain sectors have higher failure rates than others (*e.g.*, food service, retail).

4. **Opportunity for growth.** Is there a large and growing market for the product?

5. **Competitive advantage.** Can the idea be protected from others in the same business sector?

As diversification is key in angel investing and many investors cannot sufficiently diversify their portfolio alone, there has been a proliferation, over the last decade or so, of angel investing groups. The Angel Capital Association estimates that there are today approximately 300 formal and informal angel groups in the United States and Canada with about 15,000 individual members, as opposed to 50 such groups in the late nineties. The growth has been due to several factors, including the ability of a group, however informal, to generate better deals than an individual, the complexity of seed capital investing, the growth and attractiveness of venture capital investing, and the large and growing number of self-made high net worth individuals looking to mentor others.

Always have your legal adviser review any documentation surrounding an early stage investment, even if you have a preexisting relationship with the founders. Items such as restrictions on founders selling stock may be missing from standardized paperwork, so it is always advisable to have a seasoned legal advisor review the deal.

[60] See *supra* note 1.

F.A.T.C.A. 24/7

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I.R.S. RELEASES "GOOD FAITH" NOTICE

I.R.S. Notice 2014-33, issued on May 2, 2014, established a major relaxation of the F.A.T.C.A. withholding regime that will begin on July 1, 2014. While not providing for a delayed implementation, the Notice says that all affected persons may treat 2014 and 2015 as a transition period in which such parties must show a good faith effort to comply with F.A.T.C.A. As long as they act in good faith, there will be no liability for any withholding agent who did not properly withhold for F.A.T.C.A. or for any Foreign Financial Institution ("F.F.I.") that failed to properly register or fill out the appropriate forms. While the scope of actions that comprise good faith is somewhat unclear, this notice eliminates the need for withholding agents to seek perfection in F.A.T.C.A. compliance, which may have driven them to over-withhold.

The I.R.S. also said that the definition of a pre-existing account will be delayed from July 1, 2014, to January 1, 2015. As a result, new on-boarding procedures can be delayed until January 1, 2015, and U.S. withholding agents do not have to get the new forms such as the Form W-8BEN-E until the end of the year. Likewise, F.F.I.'s do not have to get those forms from their own account holders until the end of the year.

I.R.S. RELEASES VARIOUS FORMS, INSTRUCTIONS

The I.R.S. released the much anticipated Form W-8IMY on April 30. The Form W-8IMY will need to be used by qualified or non-qualified intermediaries, foreign partnerships and foreign simple or grantor trusts. The I.R.S. has still not released instructions that will supplement the newly published F.A.T.C.A. compliant forms. I.R.S. officials said that the agency is working diligently to complete instructions for the series of W-8 forms covering W-8BEN-E, W-8IMY and W-8EXP.

The I.R.S. is still in the process of amending the qualified intermediary agreements under F.A.T.C.A. The regulations issued hint at what to expect, such as changes to withholding responsibilities. Additionally, there have been numerous updates to the frequently asked questions on the I.R.S. F.A.T.C.A. website. Taxpayers need to pay particular attention to registering with the I.R.S. for F.A.T.C.A. compliance.

On May 5, the I.R.S. made available final instructions for Form 1042, reflecting important changes required by F.A.T.C.A.

NEW I.G.A.'S SIGNED OR AGREED UPON IN SUBSTANCE

Intergovernmental agreements ("I.G.A.'s") are being signed, revised, or released with all deliberate speed in anticipation of the July 1, 2014 impending withholding deadline. These include the following:

- On April 17, 2014, Mexico revised and re-issued their Mexico-USA I.G.A. of November 19, 2012.
- On April 23, 2014, Belgium signed a Model 1 I.G.A.
- On April 28, 2014, Australia followed suit.
- On April 29, 2014, the U.S. and Bulgaria reached a Model 1 I.G.A. agreement in substance.
- On May 1, 2014, Israel followed suit.
- On May 9, 2014, Hong Kong and the U.S. agreed to a Model 2 I.G.A. in substance.

RUSSIA IN LIMBO

As a recent response to the political turmoil following Crimea's decision to secede from Ukraine and join Russia, the U.S. has halted discussion with Russia on implementing the I.G.A. This will be a major blow to streamlined compliance for the hundreds of Russian banks and financial institutions with U.S. investments. Russia is considering domestic law changes that will help its financial institutions to comply with F.A.T.C.A. The Treasury noted that Russian banks may be able to sign up directly for F.A.T.C.A. as well.

AGREEMENT IN SUBSTANCE

The I.R.S. has published a list of about 30 countries that have reached agreement in substance on an I.G.A. (*e.g.*, India, Bahamas, Gibraltar, and Liechtenstein). The I.R.S. has indicated that a financial institution in that country may treat itself as if the I.G.A. has been signed, at least until the end of the year. This I.R.S. statement is beneficial since financial institutions in Model 1 I.G.A. countries are given an added six months to register on the I.R.S. electronic portal and get a G.I.I.N., which is the F.A.T.C.A. identification number issued by the I.R.S., although it would be prudent to register as soon as possible due to concern that the U.S. withholding agents may get confused by the maze of new F.A.T.C.A. forms and inadvertently withhold.

F.A.T.C.A. F.A.Q.'S UPDATED

On May 13, 2014, the I.R.S. updated their F.A.T.C.A. F.A.Q.'s by providing that trustees needing to register a trustee-documented trust should use the same procedures used by sponsors to register sponsored entities. In this regard, the F.A.Q.'s state that the I.R.S. is developing a streamlined process for sponsoring entities to register sponsored entities on the registration portal and additional information will be provided at a later date. Under a transitional rule, the temporary and proposed regulations provide that, for payments prior to January 1, 2016, a sponsored entity may provide the G.I.I.N. of its sponsoring entity on withholding certificates if it has not yet obtained a G.I.I.N. Thus, a sponsored entity does not need to provide its own G.I.I.N. until January 1, 2016 and is not required to register before that date.

NEW YORK ENACTS MAJOR CORPORATE TAXATION REFORMS

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Tags
New York State
Corporate Taxation

New York enacted major corporate tax reforms on March 31, 2014 when Governor Andrew Cuomo signed the final New York State budget legislation for Fiscal Year 2014-2015. Generally, the provisions are effective for tax years beginning on or after January 1, 2015.[61] The new law changes do not automatically affect New York City taxes; conformity by New York City will require additional legislation. Significant changes are outlined below:

NEW NEXUS STANDARD

Historically, New York State taxed out-of-state corporations that had a physical nexus with the state, although physical nexus could be indirect or attenuated. The reform abandons the concept of physical nexus and adopts a new economic standard based on an annual dollar threshold of receipts derived from the state. By doing so New York significantly expands the number of corporations that will be subject to tax in the state. Corporations will now be taxable in New York for purposes of the corporation franchise tax and the metropolitan transportation business tax ("M.T.A.") surcharge if they have $1 million or more of receipts from activity in New York. Furthermore, a corporation that is part of a combined reporting group and has receipts derived from New York of less than $1 million but more than $10,000 satisfies the threshold requirement if the New York receipts of all group members who individually exceed $10,000 equal $1 million or more in the aggregate.

FOREIGN (NON-U.S.) CORPORATIONS

Foreign (non-U.S.) corporations, referred to as alien corporations, will only be subject to New York tax if they are considered as U.S. domestic corporations under Internal Revenue Code (I.R.C.) §7701 or have effectively connected income under I.R.C. §882 for the tax year. This may have the effect of reducing the tax base of those foreign corporations that are subject to New York tax. However, the new nexus standard also applies, and thus, more foreign corporations may end up being subject to New York tax (alone or on a combined basis) in the future. Note that a

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[61] The Budget Bill is available here: http://open.nysenate.gov/legislation/bill/S6359D-2013

foreign corporation cannot claim treaty benefits to avoid U.S. tax unless the treaty specifically so provides.

BANKING CORPORATIONS

Banking corporations will no longer be subject to a separate taxing regime but will be subject to the same taxing regime as other commercial corporations.[62] Additionally, banks meeting certain requirements and general business corporations are required to be included in the same combined filing group.

NEW (OFTEN LOWER) TAX RATES: N.O.L.'S AND TAX CREDITS

The existing corporate franchise tax rate of 7.1% is reduced to 6.5% effective January 1, 2016.[63] The M.T.A. surcharge is increased to 25.6% effective for tax years beginning on or after January 1, 2015 and before January 1, 2016. Thereafter, the rate would be adjusted annually at the Commissioner's discretion depending on the state's financial need. Additionally, the M.T.A. surcharge will be assessed based on the new economic nexus standard and on the highest of the tax bases, determined before credits rather than after credits.

"The existing corporate franchise tax rate of 7.1% is reduced to 6.5% effective January 1, 2016. "

All corporations will now calculate tax on the following three tax bases (reduced from four): business income base, capital base, and fixed dollar minimum base. The new law adopts additional tax brackets and substantially increases the tax amount for some brackets.[64] The capital base tax rate will be completely phased out by 2021, with qualified New York manufacturers paying a lower tax rate during the phase-out period.[65]

Special rules apply to qualified New York manufacturers, who will have an effective net income tax rate of 0%.

Changes are made to the use and calculation of net operating losses ("N.O.L.'s") available for use for New York tax purposes. Tax credits have been enhanced.

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[62] Article 32 of the New York Tax Law was repealed under the Budget Bill.

[63] Some taxpayers, such as qualified New York manufacturers, will enjoy an even lower rate.

[64] For example, the current top bracket applies to taxpayers with receipts of over $25 million. The applicable tax amount for such taxpayers is $5,000. Under the new law, the top bracket would be for taxpayers with receipts of over $1 billion, and the tax amount would be $200,000. There are four other brackets in between.

[65] The new legislation also caps the tax paid under the capital base during the phase-out to $5 million for tax years beginning on or after January 1, 2008 and before January 1, 2011 and $1 million for taxable years beginning on or after January 1, 2011.

CHANGES TO APPORTIONMENT RULES

The New York apportionment factor is a single receipts factor with a set of complex customer-based sourcing rules. Specific provisions exist for various types of sales including other business receipts, rents and royalties, and digital products. Under the new law an annual irrevocable election can be made to use in the numerator either a fixed amount of 8% of all net income from qualified financial instruments or a customer location apportionment factor. Under the new law receipts from intangible property, such as patents and trademarks, will be apportioned to New York based on the extent of activities related to the intangible that take place in the state. Receipts from services and other business transactions will be apportioned to New York based on a customer location hierarchy, specifically starting with where the customer receiving the benefit of the transaction is located.

COMBINED REPORTING

Unitary combined reporting will be required for tax years beginning on or after January 1, 2015. Combined reporting will be required for any taxpayer that is part of an affiliated group (using a more than 50% ownership or controls test by voting power) and is engaged in a unitary business with those corporations. It should be noted that combined reporting will apply to alien corporations that satisfy state ownership and unitary thresholds and that are considered U.S. domestic entities under I.R.C. §7701 or have effectively connected income under I.R.C. §882 for the tax year. Additionally, the new law provides taxpayers an election to file a combined return with a commonly owned group of corporations.

UPDATES AND OTHER TIDBITS

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P.F.I.C.
O.V.D.P.
F.B.A.R.

PASSIVE FOREIGN INVESTMENT COMPANY: RELAXATION OF RULES APPLICABLE TO TAX-EXEMPT SHAREHOLDERS

The passive foreign investment company ("P.F.I.C.") rules can have an adverse impact on any U.S. person that may invest in a foreign company classified as a P.F.I.C. A P.F.I.C. can include an investment in an offshore investment company that owns investment assets such as stocks and securities. While ownership by a taxable U.S. investor can produce adverse tax results, ownership by a U.S. tax-exempt entity, such as a retirement plan or an individual retirement account ("I.R.A."), usually will not result in adverse tax results. This situation is helpful since many tax-exempt entities invest in offshore investment companies. The one exception is if the U.S. tax-exempt investor borrows money to make its investment in the P.F.I.C. then the U.S. tax exempt may recognize unrelated business taxable income ("U.B.T.I.") from this investment. Despite its tax-exempt status, U.B.T.I. is taxable to a U.S. tax-exempt investor under Code §511.

The P.F.I.C. rules, as do many tax rules, include extensive constructive ownership rules whose purpose is to make sure that the statutory purpose behind the rules are not undercut by use of intermediate holding companies or other means. One lurking issue was whether these constructive ownership rules could possibly apply where a beneficiary of a retirement plan or I.R.A. or a shareholder of a tax-exempt entity gets a distribution from the entity that is attributed to its investment in a P.F.I.C. The I.R.S. recently issued Notice 2014-28 that alleviated this concern. As a result, a shareholder of a tax-exempt organization or a beneficiary of a tax exempt retirement plan or I.R.A. is not subject to the P.F.I.C. rules. This notice alleviates not only possible adverse tax results, but also the need to file any relevant P.F.I.C. tax forms such as Form 8621, Information Return for a shareholder of a P.F.I.C.

TAX TREATIES STILL BEING BLOCKED

In a May 7, 2014 letter, Senator Rand Paul (R-KY) stated that he would continue to block approval of tax treaties with Luxembourg, Switzerland, Chile, and Hungary. As noted in prior publications, Rand Paul cited his objections on privacy grounds. This is particularly important, *e.g.*, with respect to the current tax treaty with Switzerland and the "tax fraud or the like" standard under Article 26 regarding exchange of information. The 2009 Protocol would make it easier for the U.S. to seek account holder information by amending Article 26 to a "may be relevant" standard which the Technical Explanation notes incorporates the standard in Code §7602.

NOT TOO BIG TO JAIL: CREDIT SUISSE

As widely reported in the press, in a video posted to the Justice Department's website, Attorney General Eric H. Holder Jr. said that no company or individual is "too big to jail." Although Holder would not name a specific target, the press linked the video to two ongoing investigations with respect to financial institutions, one relating to offshore tax evasion: Credit Suisse.[66] Still yet undeclared U.S. account holders at Credit Suisse would be wise to clean up their tax and anti-money laundering compliance obligations before the proverbial axe comes down. The Justice Department is reported to be asking for the names of "all U.S. citizens."[67]

I.R.S. WILL NOT SEEK SUPREME COURT REVIEW OF TAX RETURN PREPARER REGULATIONS

The press reported that the I.R.S. let a deadline pass to seek review by the Supreme Court of the decision that overturned, on the grounds that the I.R.S. exceeding its congressional authority, the tax return preparer regulations.[68] These regulations would have required tax return preparers to pay a fee, take continuing education courses, and pass a competency test.

I.R.S. RELEASED A REFERENCE GUIDE ON THE REPORT OF FOREIGN BANK AND FINANCIAL ACCOUNTS (F.B.A.R.)

On April 23, 2014 the I.R.S. has released a reference guide on foreign bank accounts and financial accounts (F.B.A.R.). The guide will assist U.S. persons as well as tax professionals who prepare and electronically file F.B.A.R. reports on behalf of clients in understanding the obligation relating to F.B.A.R. filing. The guide will also assist I.R.S. examiners in their efforts to consistently and fairly administer the F.B.A.R. examination and penalty programs.

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66 See, *e.g.*, Danielle Douglas, "No company is too big to jail, Holder says of Justice Dept. probes." *Washington Post*, May 5, 2014, available at: http://www.washingtonpost.com/business/economy/no-company-is-too-big-to-jail-holder-says-of-justice-dept-probes/2014/05/05/e133e49c-d45f-11e3-aae8-c2d44bd79778_story.html (last accessed May 15, 2014).

67 See, *e.g.*, Silke Koltrowitz, Ed. Ruth Pitchford, "U.S. wants Credit Suisse to plead guilty in tax dispute: report," *Reuters*, May 4, 2014, available at: http://www.reuters.com/article/2014/05/04/us-credit-suisse-idUSBREA4302A20140504 (last accessed May 15, 2014).

68 See, *e.g.*, Kathleen Pender, "IRS misses deadline to appeal tax preparer rules rejection," *San Francisco Chronicle*, May 14, 2014, available at: http://www.sfchronicle.com/business/networth/article/IRS-misses-deadline-to-appeal-tax-preparer-rules-5475521.php (last accessed May 16, 2014) See Loving, No. 13-5061 (D.C. Cir. 2/11/14), aff'g No. 1:12-cv-00385 (D.D.C. 1/18/13).

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 or accounts outside of the U.S. and the aggregate maximum value of the account(s) exceeds $10,000 at any time during the calendar year.

The guide explains who is treated as a U.S. person for purposes of the F.B.A.R. The guide provides some useful examples. One such example discusses a U.S. citizen residing outside the U.S. and electing to be treated as a tax resident of another country under a tax treaty. Nevertheless, this individual is treated as a U.S. person for purposes of the F.B.A.R. because treaties do not affect F.B.A.R. filing obligations.

The guide also explains when a U.S. person is treated as having a financial interest in or a signatory authority over an account. The guide provides examples discussing ownership on record and holding a legal title, joint ownership, and a financial interest held though ownership of entities (domestic or foreign), including trusts in which a U.S. person has an interest as a grantor or as beneficiary.

The guide also covers the recordkeeping requirements for documents relating to reportable accounts and discusses the exceptions from filing. The guide explains the civil and criminal penalties that may be assessed for noncompliance with F.B.A.R. reporting and recordkeeping requirements. Lastly, the guide includes a nine-question exercise (with answers) to test one's understanding of the general rules.

The guide can be found here:

http://www.irs.gov/pub/irs-utl/IRS_FBAR_Reference_Guide.pdf

IN THE NEWS

AS SEEN IN…

Philip Hirschfeld was recently published in the March/April 2014 edition of the *Journal of Taxation and Regulation of Financial Institutions*. His article entitled "FATCA 2013 Overview: Getting Down to the Wire" provided a retrospective of 2013 developments related to the Foreign Account Tax Compliance Act, including the issuance of final regulations, Notice 2013-43, registration of Foreign Financial Institutions, and the signing of intergovernmental agreements.

OUR RECENT AND UPCOMING PRESENTATIONS

On March 8, 2014, Stanley C. Ruchelman participated in two panels at the G.G.I. I.T. Winter Meeting in Milan, Italy. The first panel entitled "Voluntary Disclosure of Tax Evasion" discussed transparency initiatives in various countries. The second presentation entitled "Base Erosion and Profit Shifting and the O.E.C.D." provided an overview of the activities and objectives of the O.E.C.D. and addressed recent developments in the B.E.P.S. project.

On March 13, 2014, Edward C. Northwood presented a seminar entitled "Cross Border Issues in Trusts & Estate Matters," organized by the Monroe County Bar Center for Education in Rochester. The presentation focused on income and estate tax in New York State and the U.S. and summarized cross border tax planning strategies.

On March 24, 2014, Robert G. Rinninsland lectured to a group of LL.M. candidates at New York Law School. The discussion addressed transfer pricing issues arising in cross borders transactions of intellectual property.

On April 3, 2014, Galia Antebi presented a seminar entitled "Three Traps in Sending Client or Funds to the U.S." at the G.G.I. European Conference in Edinburgh. The discussion included the green card trap, foreign gifts and foreign trusts.

On April 10, 2014, Stanley C. Ruchelman participated in a panel entitled "New Information Changes and Reporting Challenges for the Swiss Financial Sector" at the 14th Annual Tax Planning Strategies – U.S. and Europe Conference in Geneva. The panel addressed the impact of O.E.C.D., G20, and F.A.T.C.A. tax regimes on the Swiss financial environment and provided practical advice on current compliance challenges.

On April 30, 2014, Philip Hirschfeld participated in a panel entitled "F.A.T.C.A. for Those on This Side of the Ocean/Border" for an A.B.A. Section of Taxation

Webinar. The discussion followed up on a January F.A.T.C.A. panel held at the A.B.A. Winter Meeting in Phoenix, with the addition of late-breaking F.A.T.C.A. developments and the participation of two members of the I.R.S. Office of Chief Counsel.

On June 5, 2014, Nina Krauthamer will lecture on "International Estate Planning – The Basics." The workshop will take place at New York Law School and address the fundamentals of estate tax planning for foreign persons, including withholding under the Foreign Investment in Real Property Tax Act ("F.I.R.P.T.A.").

On June 5, 2014, Stanley C. Ruchelman will serve as co-chair of the panel "Litigation Update" at the 7th Annual U.S. – Latin America Tax Planning Strategies conference in Miami, Florida. This panel will discuss recent court decisions from Europe, Latin America, and the United States and the impact of those decisions on tax planning and compliance efforts.

A copy of our presentations is available on our website: www.ruchelaw.com/publications or by clicking the above links.

About Us

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

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

The tax practice is supported by our corporate group, which provides legal representation in mergers, licenses, asset acquisitions, corporate reorganizations, acquisition of real property, and estate and trust matters. The firm advises corporate tax departments on management issues arising under the Sarbanes-Oxley Act. Our law firm has offices in New York City and Toronto, Canada. More information can be found at www.ruchelaw.com.

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