ruchelman
corporate
international
taxation

INSIGHTS

THE MCKESSON TRANSFER PRICING CASE

U.S.-BASED PUSHBACK ON B.E.P.S.

TAX 101: TAX PLANNING AND COMPLIANCE FOR FOREIGN BUSINESSES WITH U.S. ACTIVITY

CORPORATE MATTERS: CONVERTIBLE NOTE FINANCING

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

AND MORE

Insights Vol. 1 No. 7

TABLE OF CONTENTS

EDITORS' NOTE

In this month's edition of *Insights*, we focus on a number of topics. These include:

- **The McKesson Transfer Pricing Case.** In this month's lead article, Sherif Assef of Duff & Phelps weighs the consequences of a recent Tax Court of Canada case involving risk shifting and function shifting within a multinational group when neither risks nor functions are actually shifted. Nonetheless, profits were shifted and this annoyed the C.R.A.

- **U.S.-Based Pushback on B.E.P.S.** Robert G. Rinninsland and Kenneth Lobo undertake a comprehensive assessment of the O.E.C.D.'s B.E.P.S. initiative from the U.S. perspective. Has the O.E.C.D. created a miracle in Washington by bringing both political parties, two branches of government, and U.S. industry into alignment on tax policy?

- **Tax 101: Tax Planning and Compliance for Foreign Businesses with U.S. Activity.** Stanley C. Ruchelman and Philip Hirschfeld provide an extensive overview of the U.S. tax laws applicable to foreign businesses with activity in the U.S. It is must reading for tax advisers to companies expanding group operations to the U.S.

- **Corporate Matters: Convertible Note Financing.** In the vein of his prior commentary on Angel Investing, Simon Prisk explores additional options for initial investment strategies, in the form of convertible note financing.

- **F.A.T.C.A. 24/7.** Philip Hirschfield provides a monthly update on recent F.A.T.C.A. events, including additional jurisdictions that have signed an I.G.A. and recent guidance released or updated by the I.R.S.

- **Updates and Other Tidbits**. Robert Rinninsland and his team provide updates on various topics, including tax evasion in the U.S. and abroad, corporate inversions, application of the net investment income tax, and more.

We hope you enjoy this issue.

-The Editors

THE MCKESSON TRANSFER PRICING CASE

Author
Sherif Assef

Tags
B.E.P.S.
Canada
Factoring
Related Party
Guarantee Fees
Reinsurance
Risk Shifting
Synthetic Credit Rating
Transfer Pricing

Sherif Assef is a managing director in the New York office of Duff & Phelps, where he advises clients on a variety of transfer pricing matters. Mr. Assef previously helped to build Ceteris into a world-class transfer pricing firm and was a lead economist in the financial services transfer pricing practice of Ernst & Young LLP. He holds a PhD in economics from Fordham University.

BACKGROUND

The recently decided McKesson transfer pricing case in Canada, which dealt with the intercompany sale of receivables, has broad implications for other types of financial transactions, as well as risk shifting in general among related parties.

On December 13, 2013, the Tax Court of Canada ("the Court") rendered its judgment in the case of McKesson Canada Corporation ("McKesson Canada") v. Her Majesty the Queen, 2013 TCC 404. The issue was the appeal of a transfer pricing adjustment made by the Canada Revenue Agency ("C.R.A.") to McKesson Canada's income under paragraphs 247(2)(a) and (c) of the Income Tax Act, for the tax year 2003. Specifically, the relevant intercompany payments were compensation for a Receivables Sales Agreement ("R.S.A.") and a related Servicing Agreement between McKesson Canada and its parent company, McKesson International Holdings III ("MIH"), based in Luxembourg.

Essentially, the R.S.A. was a factoring agreement. Under the R.S.A., McKesson Canada sold C$460 million of trade receivables to MIH at a discount rate of 2.206%. Further, MIH committed to purchasing additional receivables over a five-year period, up to a maximum of C$900 million. Under the Servicing Agreement, MIH paid McKesson a fixed annual fee of C$9.6 million to continue servicing the receivables. MIH was granted the right to put receivables in default back to McKesson Canada at 75% of face value; MIH had no other recourse with respect to the purchased receivables. In addition, MIH held certain rights of termination of the R.S.A., including financial default of McKesson Canada or its affiliates, loss ratio of receivables beyond a set threshold, and any event materially adversely affecting the collectability of receivables. For example, the receivables potentially could have been reduced by payment defaults by customers, prompt payment discounts, and/or set-offs from rebates, discounts, and returns.

As mentioned above, the terms of the R.S.A. included a discount rate of 2.206% for the sale of the receivables, while the C.R.A. calculated the rate to be 1.013%, leading to a transfer pricing adjustment to McKesson of approximately C$26 million arising from an imputed increase in the price of the receivables sold. The Court concluded that the C.R.A.'s arm's length range of discount rates, 0.959% to 1.17%, was indeed appropriate. McKesson Canada's appeal was rejected.[1]

ISSUES RAISED

Though the Court's decision focused on the discount rate applied in the R.S.A., wider issues were raised which could be important in other similar transactions or which could have been important in this case had they been raised by the C.R.A. Among the pertinent issues are:

- The economic substance of the parties involved;
- The business purpose of the transaction; and
- The impact of a non-arm's length relationship or transaction terms on a notional arm's length analysis.

Factoring of receivables is a means by which credit risk is transferred from the seller to the buyer. This is a common practice for a taxpayer selling products under terms that call for payment within a specified number of days. In the context of an unrelated seller and purchaser, it is expected that the purchaser will be required to manage the receivable pool to ensure payment. For that reason, factoring income is more than simply interest income for the purchaser. However, when a receivables sale takes place among related parties, questions arise as to whether the purchaser is willing and able to manage that risk – not just in terms of the needed capital, but also with regard to the capacity of the purchaser to manage the receivable pool in light of its employee headcount and the capability of the employee base.

Though the C.R.A. did not challenge the C$9.6 million Servicing Agreement between McKesson Canada and MIH, the fact that the Canadian operating company continued servicing the receivables after the sale is a red flag that should raise doubts about MIH's ability to assume and manage the related risk in the first place. The off-loading of the management function over some or all of a pool of receivables by one factor to an unrelated factor in light of an objective business reason of the seller – such as lack of capacity or the need for capital – is functionally different from a situation where the party whose sales have generated the receivable continues to service the entire receivable base after the sale, albeit for a fee. Consequently, the question remains whether the risk of collecting payment of receivables was effectively shifted from McKesson Canada to MIH. Stated differently, the question was whether McKesson Canada continued to bear a significant portion of the risk even after the transfer of receivables.

The context of the intercompany transaction raises a second issue related to the business purpose of the transaction. Given the relatively low level of risk observed

---

[1] A secondary issue was McKesson Canada's failure to pay withholding tax on the disallowed portion of the purchase price, an appeal of which was also rejected.

historically with respect to McKesson Canada's portfolio of receivables, was there a believable business reason for selling the receivables to MIH other than as a means of shifting taxable income to Luxembourg? These questions were raised in the Court's decision, though not fully explored. However, they could be raised in future litigation or audits by Canadian and other tax authorities, and this case did little to establish meaningful precedent on this point. Stated in plain English, and using a before and after analysis regarding the servicing of a receivables pool, McKesson Canada performed all the same tasks and relatively the same risks before and after the transaction, yet a portion of its income was hived off to a low tax jurisdiction. Looked at in this light, it is not clear whether McKesson Canada would have entered the same transaction with an unrelated party in the absence of a need for capital.

A common thread among transfer pricing analyses of financial transactions between related parties is the difficulty involved in attributing arm's length behavior and pricing to a situation which is inherently non-arm's length in character. In the case of the McKesson Canada transaction, for example, the Court noted that the five-year term of the R.S.A. is something that would likely not be observed among unrelated parties; factoring agreements tend to be of shorter duration. Consequently, the Court could have chosen to adjust the discount rate for a one-year term, particularly since the ruling included the observation that all relevant non-arm's length factors should be taken into account; otherwise the terms of a transaction could be open to manipulation.[2] Again, though this question was raised, the Court accepted the five-year term in the final analysis when calculating its arm's length discount rate range.

These types of issues are also raised by the Base Erosion and Profit Shifting ("B.E.P.S.") initiative of The Organization for Economic Co-operation and Development ("O.E.C.D."). In particular, the B.E.P.S. Action Plan (released July 2013) includes Action Item 9, which states that the O.E.C.D. will adopt "rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital" and that returns are aligned with value creation.[3] This is not to say that risk cannot be transferred between related parties; however, any such transfer of risk must be consistent with the economic substance of the participants; the mere transfer of risk without corresponding employee functions may not be recognized. In this case, since the servicing of the receivables was retained by McKesson Canada while a portion of the risk was shifted to MIH, it seems the structure did not adhere to this O.E.C.D. principle.

[2] The counterargument recommends a court or tax authority should respect the form of a transaction, assuming it is "commercially reasonable," and then attribute arm's length prices to the existing facts.

[3] OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing. http://dx.doi.org/10.1787/9789264202719-en

IMPLICATIONS FOR OTHER FINANCIAL TRANSACTIONS

Many of the concerns raised by the Court with respect to the sale of receivables, aside from the pricing of that sale, are echoed in analyses of and potential challenges to other types of intercompany financial transactions. This article explores three such transactions: loans, guarantees, and reinsurance.

Loans

Interest rates on related-party loans are often benchmarked by performing a credit analysis of the borrowing entity on a stand-alone basis. The resulting "synthetic" credit rating of a borrower that has not been issued a credit rating of its own by a public rating company along with the terms of the related-party loan are typically accepted as the right market benchmarks for the interest rate.

Questions of business purpose and economic substance can overshadow the traditional pricing exercise when loans are made between related parties. Even with a solid credit analysis and benchmarking of the borrower, a tax authority may suspect that the loan was put in place primarily to create interest deductions. Those suspicions can be heightened if the business purpose for the loan is not apparent. One example is a parent company that extends a loan to a subsidiary when at other times it made capital contributions to an affiliate in comparable circumstances but with no immediate need for the funds. Additional transfer pricing exposure may result from situations where the stand-alone credit quality of the borrowing entity is so low that it would not be able to borrow on its own from a third party, particularly if the intercompany loan is large. Some tax authorities might then re-characterize the transaction as an infusion of capital, not a loan, and disallow all of the interest deductions.

Non-arm's length behavior can further exacerbate the audit risk for a taxpayer. Often, intercompany loans are put in place, but interest is not actually paid by the borrower to the lender. Rather, it accrues on a cash basis and is deducted on the borrower's tax return, assuming accrued but unpaid interest expense is deducted on a current basis. This may look like a transaction that would never occur between third parties, particularly if the loan is renewed at the end of its term. Similarly, if a borrower has the right to refinance an intercompany loan and fails to do so in a falling interest rate environment, it could be taken as an indication of non-arm's length behavior and therefore jeopardize the taxpayer's characterization of the transaction.

Financial Guarantees

Financial guarantees are often provided by one party to a related party (*i.e.*, a borrower) in order to minimize external interest costs or to secure a loan that might otherwise not be offered. Typically, a bank will charge the borrower a higher interest rate without such a guarantee. In effect, the guarantor is lending its credit rating to the borrower.

Transfer pricing analysis of such guarantees is in many ways the flip side of benchmarking an intercompany loan. The difference in stand-alone credit ratings for the guarantor and the borrower implies a difference in the rates at which each party could borrow on its own. Consequently, that difference in borrowing rates is the maximum that the borrower would be willing to pay for the guarantee. For example, if a parent company can borrow at a rate of 5% and its subsidiary can borrow only at 7%, the subsidiary can save 200 basis points by obtaining a guarantee from its parent and would be willing to pay up to that much as a fee for the guarantee. In most cases, the actual guarantee fee would be some fraction of that maximum, with the exact figure dependent on the relative bargaining position of the two parties.

As with loans, economic substance arguments can be used to challenge intercompany guarantee arrangements. A number of tax authorities have disputed the payment of guarantee fees among related parties – particularly, if a parent company is guaranteeing a subsidiary – on the principle that there is implied support by a parent for its subsidiary, and thus, no explicit guarantee agreement, or fee, is needed. Whether that approach by tax authorities is justifiable is an open question in light of the financial crisis that began in 2008 and left the holders of non-guaranteed debt in a perilous situation.

"A number of tax authorities have disputed the payment of guarantee fees among related parties – particularly, if a parent company is guaranteeing a subsidiary – on the principle that there is implied support by a parent for its subsidiary."

On the other hand, under the arm's length standard, are we not required to view each party on a stand-alone basis? Under this consideration, the impact of group affiliations should not be taken into account in a transfer pricing analysis. This is especially true if a bank requires an explicit guarantee agreement to make a loan or, at least, differentiates its pricing dependent upon whether or not such a guarantee exists. However, even if the bank has no such requirement or makes no such distinction, many would still argue that the benefits of implicit support within a controlled group should be ignored for transfer pricing, and a guarantee fee should be benchmarked on an arm's length basis.

Other issues may arise with respect to pricing for a guarantee fee. If the treasury department of a multinational group maintains a policy for borrowers to always pay the full value of interest savings as a guarantee fee, this could be evidence of non-arm's length behavior because the group does not differentiate between borrowing with or without the guarantee. The borrower's total costs are the same either way.

In a competitive market, a company that is in the business of extending financial guarantees might at times be able to extract full value from its customers – say, when the demand for loans is high relative to supply of loanable funds and credit capacity. At other times, however, when economic growth and demand for funds are low, a guarantee company may prefer to put its capital to work, even at lower fees, rather than incur the higher opportunity costs. Consequently, a related-party situation where full value of the guarantee is always reflected in the fee paid would not be consistent with market behavior.[4] A rule of thumb for pricing the guarantee

4 Of course, in situations where an entity cannot borrow on its own at any interest rate and a guarantee is necessary to access capital markets rather than merely to reduce its costs, the entity might be willing to pay top-dollar guarantee fees. However, the taxpayer might be in danger of having the entire fee disallowed under audit, since no third party would provide a guarantee under such circumstances. Similarly, a performance guarantee, such as to assure a subsidiary's ability to fulfill the terms of a customer or vendor contract, could command a high fee, since the subsidiary might not be able to conduct any

fee (*e.g.*, 80% to 90% of the savings) might be preferred. Alternatively, more advanced quantitative approaches for pricing the guarantee, such as real-option theory or statistical simulation, could be applied.

Reinsurance

Reinsurance agreements with related parties are very common and always vulnerable to challenge by tax authorities because the objective of reinsurance is by definition to shift risk. Moreover, related reinsurance companies often have minimal or even no substance in terms of employees to manage the risk and make accompanying strategic decisions. They are often pure risk-holding entities and located in unregulated low-tax jurisdictions. Captive insurance and reinsurance companies are common examples of such arrangements.

The challenge in analyzing and benchmarking related-party reinsurance transactions, therefore, is that there are often no third-party arrangements against which they can be compared. Setting up a captive insurer or reinsurer whose only function is to assume risk from a parent company, with the management of such risk remaining with the parent, is by definition non-arm's length behavior and further complicates benchmarking for the resulting transactions. This difficulty is not relieved by the common practice of using an unrelated "fronting company" as an intermediary in the transaction. For example, an insurance company with a related reinsurer in a low-tax jurisdiction can enlist an unrelated insurer to write policies on behalf of its customers, then reinsure with the captive reinsurer. The unrelated insurer will only achieve a market return for its administrative role, as well as the small amount of risk it bears, but it could pay above-market premiums to the reinsurer while overcharging the primary insurance company. The result is the potential for a non-arm's length shift of income from the primary insurance company to its related reinsurer, disguised as a third-party arrangement with another insurance company.

CONCLUSION

As demonstrated by the McKesson Canada case, as well as a number of cases before it (*e.g.*, the GE Capital Canada guarantee fee case of a few years ago[5]), intercompany financial transactions are vulnerable to a variety of challenges, of which actual benchmarking for the payments may be the least worrisome to taxpayers. More daunting perils may come in the form of business purpose and economic substance tests, which could question the bases and characterizations of such transactions. Uncertainty in the transfer pricing analyses of such transactions, for taxpayers certainly but also for tax authorities, will likely persist until more specific guidance is provided.

---

business without it. Identifying comparable third-party arrangements could be difficult, however.

[5] GE Capital v. Her Majesty the Queen, 2009 TCC 563.

Such guidance may come in the form of specific recommendations from the O.E.C.D. regarding Action Item 9 of its B.E.P.S. Action Plan, expected as early as December of this year, and any ensuing changes to national transfer pricing rules. Alternatively, the U.S. Global Dealing regulations, when re-proposed, may include specific guidance on financial transactions such as guarantees. No one should hold their breath, however; these regulations were first released by the Internal Revenue Service in 1998, with not a peep of follow-up since.

U.S.-BASED PUSHBACK ON B.E.P.S.

Authors
Robert G. Rinninsland
Kenneth Lobo

Tags
Arm's Length
Base Erosion
B.E.P.S.
C.F.C.
Digital Economy
Hybrid Mismatch
M.A.P.
Return on Capital
Risk Shifting
Transfer Pricing
Tax Reform
Treaty Abuse
Value Creation

INTRODUCTION

> In addition to the aggressive actions by some foreign countries to levy more taxes on U.S. taxpayers before a consensus has been reached, the process established by the O.E.C.D. raises serious questions about the ability of the United States to fully participate in the negotiations.
>
> Ultimately, we believe that the best way for the United States to address the potential problem of B.E.P.S. is to enact comprehensive tax reforms that lower the corporate rate to a more internationally competitive level and modernize the badly outdated and uncompetitive U.S. international tax structure.

So say Representative Dave Camp (R) and Senator Orrin Hatch (R), two leading Republican voices in Congress, on the O.E.C.D.'s B.E.P.S. project.

Does this somewhat direct expression of skepticism represent nothing more than U.S. political party politicking or a unified U.S. government position that in fact might be one supported by U.S. multinational corporations? The thought of the two political parties, the Administration and U.S. industry agreeing on a major political/economic issue presents an interesting, if unlikely, scenario. This article will explore that scenario.

OVERVIEW OF B.E.P.S./WHY B.E.P.S.?/WHY NOW?

Base erosion and profit shifting ("B.E.P.S.") refers to tax planning strategies that exploit gaps and mismatches in tax rules in order to make profits "disappear" for tax purposes or to shift profits to locations where there is little or no real activity and the taxes are low. This results in little or no overall corporate tax being paid.[6]

The B.E.P.S. Action Plan sets forth 15 actions to improve, in the words of the O.E.C.D., "coherence, substance and transparency" and to address tax gaps arising from the digital economy. The Action Plan calls for a multilateral instrument that countries can use to implement the measures developed in the course of the work by the O.E.C.D. The Action Plan was released in July of 2013. In September 2013, the leaders of the G20 countries meeting in St. Petersburg endorsed the Action Plan. The O.E.C.D. is set to deliver final guidance in September on several of those items, including intangible property and documentation. From a macro-economic viewpoint, B.E.P.S. is based on the following self-serving paradigms.

The O.E.C.D. is convinced that:

- There is tax rate arbitraging being done by multinational corporations that use transfer pricing to shift income to low tax jurisdictions and expenses to high tax jurisdictions.

- There is shifting of intangible property and resulting royalties and license fee income to low tax jurisdictions. This is a primary goal of multinational corporations given the rise of information technology and other knowledge-intensive industries that exploit intangible assets currently owned by companies or potentially developed in the future.

- National governments aid and abet tax avoidance by cutting corporate tax rates (*e.g.*, E.U. countries) or creating tax regimes designed solely to attract foreign investors (*e.g.*, U.S. portfolio debt and patent box legislation in several E.U. countries). A complicating factor here is the potential reaction of emerging markets and developing countries considering their own form of international tax competition.

The specific B.E.P.S. Action Plan items operate within these paradigms to address the perceived areas of concern.

Four actions in the B.E.P.S. Action Plan (Actions 2, 3, 4, and 5) focus on ensuring that tax deductible payments by one person will result in income inclusions for the recipients so that double non-taxation is avoided.

In the area of transfer pricing, the O.E.C.D. seeks to address issues such as returns related to over-capitalization, risk, and intangible assets. It is important to note that the O.E.C.D. is considering special rules, either within or beyond the arm's length principle, to correct these issues. Five actions in the B.E.P.S. Action Plan focus on aligning taxing rights with substance in order to ensure that tangible economic substance exists for an entity, as evidenced by office space, tangible assets, and employees (Actions 6, 7, 8, 9, and 10).

[6] "BEPS - Frequently Asked Questions," O.E.C.D., http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm

The Action Plan also outlines certain procedures to improve transparency, such as:

- Improved data collection and analysis regarding the impact of B.E.P.S.;
- Taxpayers' disclosure about tax planning strategies; and
- Less burdensome and more targeted transfer pricing documentation.

Four actions in the B.E.P.S. Action Plan focus on improving transparency (actions 11, 12, 13, and 14).

U.S.-BASED CONCERNS REGARDING THE B.E.P.S. ACTION PLAN

The U.S. Government's main goal is to prevent other countries from taxing what it views as "its" tax base through B.E.P.S. While the U.S. government policy makers appear to broadly agree with the O.E.C.D. that the issues addressed by B.E.P.S. should be remedied, they seem to disagree that a multilateral framework is the best solution for addressing these problems. The following discussion reviews the B.E.P.S. Action Plans and notes U.S. pushback on certain aspects. The pushback has taken the form of proposed alternatives, comments, and an expressed view to reserve judgment on implementation to a later time. The U.S. business community likewise is concerned. This reflects recent intense scrutiny of U.S. multinational corporations' tax affairs by certain E.U. countries.

ACTION 1: Address the tax challenges of the digital economy

> Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, the characterization of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of business models in this sector.

Comments

The Digital Economy Task Force ("D.E.T.F.") was established in September of 2013 under the leadership of Thomson Reuters. The goals of the D.E.T.F. are "to educate the public and work collaboratively across stakeholder groups, including government agencies, law enforcement, corporations, academia, public and non-profit agencies, as well as key industry players." The D.E.T.F. seeks an approach that "will be a balanced view of both the advantages and disadvantages surrounding the digital economy."

There is little support among members of the D.E.T.F. for adopting a "virtual" permanent establishment. The concern is whether there will be a mistaken emphasis on attributing the revenue rather than a cogent approach to attributing the deductions to a "significant digital presence."

Tax Executive Institute ("T.E.I.") is the principal worldwide organization of in-house corporate tax executives with chapters in Europe, North America, and Asia representing over 3,000 of the largest companies in the world. T.E.I. issued comments on Action Plan 1 in April.

"Improper initiatives relative to the taxation of digital businesses could very easily result in the taxation of these enterprises multiple times with regard to the same transaction."

T.E.I. agrees that it is not correct to arbitrarily label enterprises "digital" or "non-digital" as the case may be. However, T.E.I. opposes options set forth in Section VII, including modifications to the permanent establishment exemptions, a new nexus standard based on significant digital presence, a virtual permanent establishment, and creation of a withholding tax regime on digital transactions.

These options are all generally unworkable as far as T.E.I. is concerned. They are not aligned with either G20's statement that profits should be taxed where they are located, nor other B.E.P.S. Action Plans themselves, such as Action Plan 7 on Permanent Establishments; 8, 9, and 10 on Transfer Pricing; 2 on Hybrids; 4 on Base Erosion; and 6 on Treaty abuse. T.E.I. notes that digital businesses face similar issues in moving assets across jurisdictional lines as do traditional businesses. Digital business assets constituting intangible property, technical expertise, and similar intangible assets often present more complex cross border tax issues than are encountered when more traditional tangible assets are transferred. Improper initiatives relative to the taxation of digital businesses could very easily result in the taxation of these enterprises multiple times with regard to the same transaction.

Other measures noted in the Action 1 Discussion Draft would aim to restore taxation in both the market country and the country of the ultimate multinational parent. T.E.I. notes that many of these measures are designed to address low effective tax rates which are the result of deliberate tax policies of the O.E.C.D.'s Member States. T.E.I. concludes that most of the tax issues identified by the O.E.C.D. with respect to the digital economy could be addressed by proper application of existing international tax principles.

ACTION 2: Neutralize the effects of hybrid mismatch arrangements

> Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralize the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. This may include: (i) changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payor; (iii) domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules); (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (v) where necessary, guidance on co-ordination or tie-breaker rules if

> more than one country seeks to apply such rules to a transaction or structure. Special attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention. This work will be coordinated with the work on interest expense deduction limitations, the work on CFC rules, and the work on treaty shopping.

Comment

The main debate with respect to the hybrid mismatch arrangements is whether the O.E.C.D. will adopt a top-down approach to curb some types of hybrid arrangements (which could apply to any debt instrument that is held cross-border) or instead use a bottom-up approach, which would only apply to instruments held between related parties (including parties acting in concert as well as hybrid financial instruments entered into as part of a structured arrangement).

The I.R.S. has expressed disagreement with the top down approach, contending that it would be largely unworkable, requiring testing for exceptions in all cases. It is also concerned with practical issues such as effective administration of the recommended action plan. While the goals are specific, the remedy is vague and application of vague remedies in different countries can easily result in multiple adjustments that reach conflicting results – all countries involved in the cross border transaction assert primary jurisdiction to impose tax. This should be compared to a belief that is shared by multiple countries that wide latitude must exist for application of enforcement mechanisms. The I.R.S. is attempting to have the topic of controlled foreign corporations ("C.F.C.'s") included in the draft on hybrid arrangements.

The I.R.S. also has expressed disagreement with a proposal under the hybrid discussion draft that would reduce the required ownership between companies to 10% in order for the entities to be considered to be related. Again, the I.R.S. believes that this would lead to an increased burden on effective administration. The I.R.S. will attempt to raise the threshold in future discussions. Discussions on this point have gravitated to a higher threshold, generally 25%, with perhaps 50% in certain cases.

ACTION 3: Strengthen C.F.C. rules

> Develop recommendations regarding the design of controlled foreign company rules. This work will be coordinated with other work as necessary.

Comments

The work in this area is consistent with current U.S. international tax reform proposals that generally seek to broaden the non-U.S. source income tax base of multinational corporations.

In November of 2013, the "Baucus Discussion Draft" was released by Senator Baucus under the auspices of the Senate Finance Committee. The Discussion Draft is notable in its attempt to address in an entirely U.S. context many of the same international tax issues addressed by the O.E.C.D. in B.E.P.S. Action Plans 2 (Hybrid Mismatch Arrangements), 3 (Strengthening CFC Rules), 4 (Limit Base

Erosion via Interest Deductions and Other Financial Payments), and 8, 9, and 10 (Transfer Pricing).

With respect to C.F.C. rules the Baucus Discussion Draft would replace the current U.S. deferral system with a statutory scheme referred to as "Option Y" or an alternative proposal referred to as "Option Z." Either one could replace the concept of deferring non-U.S. source income with a system under which all income of foreign subsidiaries of U.S. companies would either be taxed currently at a certain minimum rate or be permanently exempt. Both options would result in subjecting a greater portion of C.F.C. income to U.S. taxation on a current basis.

A tax reform proposal was also released by the House Ways and Means Committee's Chairman Camp in February 2014 ("the Camp Draft Plan"), which would similarly broaden the corporate tax base and prevent base erosion. However, the Camp Draft Plan would take a different approach than the Baucus Discussion Draft, by proposing an essentially territorial tax system through a 95% dividends received deduction. Like the Baucus Discussion Draft, the Camp Draft Plan would expand Subpart F income by creating a new category of Subpart F income (foreign base company intangible income). It would also impose a one-time retroactive tax on previously untaxed foreign earnings, albeit at a lower rate. Unlike the Baucus Discussion Draft, which does not commit to any particular corporate tax rate, the Camp Draft Plan would lower the corporate tax rate to 25%.

ACTION 4: Limit base erosion via interest deductions and other financial payments

> Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income and other financial payments that are economically equivalent to interest payments. The work will evaluate the effectiveness of different types of limitations. In connection with and in support of the foregoing work, transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. The work will be coordinated with the work on hybrids and CFC rules.

Comment

Action Plan 4 raises issues regarding the application of transfer pricing principles to the level of debt and the rate of interest payable. It also questions the freedom of enterprises to determine the amounts of funding that can be raised through the issuance debt and equity that appears on a balance sheet.

I.R.S. and Treasury note that it is a basic tenet of the arm's length principle endorsed by the Action Plan (at least, in principle) that the tax treatment within a country should essentially be the same whether payments are made to a foreign group entity or to a third party. I.R.S. and Treasury also believe that a natural extension of this view, market dynamics of capitalization, and interest costs should control deductions claimed for interest rather than the tax exposure faced by the lender. Under this view, the taxable status of the lender simply is not relevant.

Having said this, Action Plan 4 may align nicely with current U.S. tax laws restricting interest deductions found in the I.R.C. 163(j) earnings stripping rules, as well as legislative proposals from both Congress (Rep. Camp) and the Administration regarding thin capitalization and deferral of interest deductions attributable to un-repatriated earnings.

ACTION 5: Counter harmful tax practices more effectively, taking into account transparency and substance

> Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.

Comment

In an early statement on point (June 2013 at the O.E.C.D. International Tax Conference in Washington D.C.), Robert Stack, U.S. Treasury Deputy Assistant Secretary for International Tax Affairs, Office of Tax Policy, stated in general that the B.E.P.S. Action Plans face both technical and political challenges. From the U.S. standpoint, B.E.P.S. should focus on addressing the stripping of income from higher-tax jurisdictions into low-tax or no-tax jurisdictions rather than on a fundamental reexamination of residence and source country taxation. Mr. Stack stated that the actions of both companies and governments should be examined, and he admitted that the U.S. "check the box" regulations have weakened the U.S. C.F.C. rules.

ACTION 6: Prevent treaty abuse

> Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. The work will be coordinated with the work on hybrids.

Comment

Action 6 seeks to prevent treaty abuse and develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances

The U.S. is currently reflecting on its own limitations on benefits ("L.O.B.") article, some of which is unpopular with other countries. Some countries are requesting arbitration or a mutual agreement procedure in the event that U.S. denies treaty benefits under an L.O.B. provision. Countries are also concerned that some legitimate transactions are being caught inadvertently by the L.O.B article. The I.R.S. accepts the basic merit of these comments.

The I.R.S. disagrees with the idea that a general avoidance rule is declared if one of the main purposes of a transaction is a tax benefit. In fact, the I.R.S. indicates that the U.S. will not join any multilateral treaty that has a main purpose test. If enacted, the U.S. will reserve judgment on the model treaty due to a "main purpose test."

"The I.R.S. indicates that the U.S. will not join any multilateral treaty that has a main purpose test."

ACTION 7: Prevent the artificial avoidance of permanent establishment status

> Develop changes to the definition of permanent establishment to prevent the artificial avoidance of permanent establishment status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues.

Comment

Action Plan 7 seeks to develop changes to the definition of permanent establishment. The I.R.S. wishes to curtail some of the exceptions to permanent establishment status for preparatory and auxiliary activities so that specific kinds of activities are no longer considered auxiliary but are deemed to be core. The I.R.S. believes that the examples used by the O.E.C.D. to help identify core versus auxiliary activities primarily targets U.S. companies.

ACTIONS 8, 9, 10: Assure that transfer pricing outcomes are in line with value creation

Action 8: Intangibles

> Develop rules to prevent BEPS by moving intangibles among group members. This will involve: (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.

Comment

A working party is currently debating the second prong of Action 8, which calls on countries to ensure that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with value creation. The U.S. indicates that while it may not agree with the current proposed measures, they will be addressed at a later time.

The U.S. believes that measures to analyze difficult-to-value intangibles could instead be remedied by the Internal Revenue Code ("Code") or special legislation. However, the I.R.S. has signaled that some measure should be taken to address the situation of offshore entities owning intangible property which is subject to zero tax.

The I.R.S. proposes assessing difficult-to-value intangibles using a contingent payment regime that measures value based on actual returns. Thus, it advocates a commensurate-with-income standard where the U.S. parent transfers an intangible out of the U.S. at an extremely low price. Under that approach, a tax authority could assert that when extremely low valuation was demonstrated at the time an intangible left the country after which the value became extremely high, the earlier valuation could be adjusted retroactively to the time of export from the U.S. This is the method that applies under Code §482.

The I.R.S. also fears that B.E.P.S. is focusing on territories that have a zero-tax regime, such as Bermuda, but is ignoring low tax regimes such as Ireland. However, the I.R.S. acknowledges analyzing a low-tax jurisdiction is more difficult compared to analyzing a no-tax jurisdiction.

The I.R.S. is confident that it will succeed in recalibrating the intangibles discussion draft. Specifically, it is confident in revising the rule for identifying the member of a multinational group that should be entitled to the returns on intangible property.

Note that the I.R.S. does not favor retroactive application of whichever action plan is proposed. Those that have already valued and "exported" intellectual property would continue to be protected.

Action 9: Risks and capital

> Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation. This work will be coordinated with the work on interest expense deductions and other financial payments.

Comment

Action 9 seeks to address the problem of transferring risk among or allocating excessive capital to group members.

The I.R.S. opinion on cash is that the party having capital is entitled to an arm's length return for its use. According to the I.R.S., the debate should rather be about whether an equity return or a debt return is proper in the circumstances. The important goal according to the I.R.S. is that cash-box entities should file a return. Other countries argue that members of a multinational group are linked. For that reason, an arm's length cap is appropriate on the profits attributable to capital.

With respect to debt incurred between related parties, the I.R.S. is concerned with base erosion but maintains the view that this problem should not be addressed through B.E.P.S. Nonetheless, an arm's length rule could be applied in certain intercompany loans. For example, it could be applied when an intercompany loan carries an excessive rate of interest charged or when the amount of debt is excessive and should be recharacterized as equity. In these circumstances, a facts and circumstance test should be used to determine the allowable interest rate and the status of the instrument issued in connection with the transfer of funds. In general, the I.R.S. disapproves of a view that a transaction is illegitimate merely because there is a lack of comparable transactions among independent parties.

Action 10: Other high-risk transactions

> Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be re-characterized; (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments such as management fees and head office expenses.

Comment

B.E.P.S. Acton Plans 9 and 10 have been consolidated, with a September 2015 deadline in mind. Both task the B.E.P.S. project with changing the O.E.C.D. transfer pricing guidelines and possibly the O.E.C.D. Model Tax Convention Action 9 is directed to preventing "arbitrary profit shifting" when group members transfer risks internally or allocate excessive capital to other group members. Action 10 is directed to preventing groups from engaging in transactions that wouldn't, or would only very rarely, occur between third parties.

In July, the new head of the O.E.C.D. transfer pricing unit, Andrew Hickman, addressed a Transfer Pricing Conference sponsored by the National Association for Business Economics. He defined the foregoing Action Plan tasks in terms of analysis of risk and recharacterization. The unanswered question at this time is the extent to which taxation authorities would be required to accept the facts and circumstances presented by taxpayers so that authorities could not demand that taxpayers change their specific facts and circumstances.

At the same conference, Deputy Assistant Treasury Secretary Robert Stack stated that the U.S. would focus its efforts to ensure that (i) the current arm's length standard is clearly articulated and (ii) profits are attributable to the place of economic activities. Deputy Assistant Secretary Stack enunciated the U.S. position in the following language:

- The place of economic activities is where the assets, functions, and risks of the multinational are located;
- The U.S. must further ensure that any special measures agreed to at the O.E.C.D. are firmly anchored in these principles; and
- Legal and contractual relationships are ignored in determining intercompany prices only in unusual circumstances.

Deputy Assistant Secretary Stack reiterated the U.S. position that the arm's length standard is the best tool available to deal with the difficult issue of pricing among affiliates of a multinational group. He noted that the worldwide concern with the arm's length standard emanates in large part from worldwide dissatisfaction with the very low effective tax rates reported by major U.S. multinational companies.

Tension exists among countries as to the relative value of activities performed within their borders in the product supply chain. This creates an environment in which the blunt-instruments approach of the B.E.P.S. transfer pricing Action Plans has gained traction. Nonetheless, the U.S. intends to steadfastly avoid turning long-standing transfer pricing principles into a series of vague concepts easily manipulated by countries to serve their revenue needs at the expense of the U.S. tax base and U.S. multinational groups.

The U.S. concern with the B.E.P.S. transfer pricing Action Plans reflects current events. Within the last decade, the O.E.C.D. reaffirmed its commitment to the arm's length principle in its O.E.C.D. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, as amended on July 22, 2010. The O.E.C.D. has also expressly rejected a so-called formulary approach within the context of its transfer pricing guidance. In contrast to that position, the B.E.P.S. transfer pricing Action Plan principle challenges the arm's length principal. The B.E.P.S. Action Plan notes certain "flaws" in the arm's length principle, and contemplates "special measures, either within or beyond the arm's length principle," in order to address issues with respect to "intangible assets, risk and over-capitalization."

Needless to say, Action Plans 9 and 10 have turned the transfer pricing world on its head; at least one I.R.S. official cautions that we are on the verge of international tax chaos. The B.E.P.S. transfer pricing project team is on record that "the arm's-length principle is 'not something that is carved in stone,'" and if 'we come to the point where we recognize that there is a limit to what we can do with the arm's-length principle, we may need special measures—either inside, or even outside, the arm's-length principle—to really address these situations." In this context, it is felt that the O.E.C.D. may approve new transfer pricing rules inconsistent with the arm's length principle.

The U.S. position is that a move away from the arm's length principle would abandon a sound, tested theoretical basis including transfer pricing precedents. This would thereby substantially increase the risk of double taxation. Experience under the arm's length principle has become sufficiently broad and sophisticated to establish a substantial body of common understanding among the business community and tax administrations. This shared understanding is of great practical value in achieving the objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation. Policy makers at the I.R.S. and the Treasury Department recognize that improvements to the international transfer pricing regime can be achieved. However, prior experience with the arm's length standard should be drawn on to effect changes to it.

A former Director of the I.R.S. Office of Transfer Pricing, Samuel Maruca, was quoted recently as saying "B.E.P.S. could lead to international chaos if not managed well." The issue has apparently come to a head with respect to consideration of the Revised Discussion Draft on the Transfer Pricing Aspects of Intangibles. The O.E.C.D. position is seen by the U.S. as a departure from a traditional arm's length analysis of functions and risks and more towards a formulary approach. The O.E.C.D. position places less emphasis on ownership and contractual assumptions of risk and more emphasis on the location of individuals performing what are considered to be important functions in the concept to customer chain. This approach, combined with the new proposed country-by-country reporting template intended to act as a transfer pricing risk tool, raises the specter of a multinational equivalent of formulary apportionment so common in the U.S. among state income tax systems.

ACTION 11: Establish methodologies to collect and analyze data on B.E.P.S. and the actions to address it

> Develop recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis. This will involve developing an economic analysis of the scale and impact of BEPS (including spillover effects across countries) and actions to address it. The work will also involve assessing a range of existing data sources, identifying new types of data that should be collected, and developing methodologies based on both aggregate (e.g. FDI and balance of payments data) and micro-level data (e.g. from financial statements and tax returns), taking into consideration the need to respect taxpayer confidence.

Comment

A decision is yet to be made as to how multinational companies will share their country-by-country reporting templates with tax authorities. The working party is considering whether a U.S. multinational would give its template to the I.R.S. so the government can share it under the relevant U.S. treaty, which is subject to confidentiality rules, or follow some other process for sharing the information. The I.R.S. prefers the treaty approach but believes that the issue will not be addressed in 2014.

In general, the I.R.S. believes that most reporting requirements can be fulfilled by existing U.S. Law (Code §6038); however, it has refrained from passing judgment on this measure until it reviews the final draft of the B.E.P.S. reporting template.

ACTION 12: Require taxpayers to disclose their aggressive tax planning arrangements

> Develop recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules. The work will use a modular design allowing for maximum consistency but allowing for country specific needs and risks. One focus will be international tax schemes, where the work will explore using a wide definition of "tax benefit" in order to capture such transactions. The work will be coordinated with the work on co-operative compliance. It will also involve designing and putting in place enhanced models of information sharing for international tax schemes between tax administrations.

Comment

The information returns used in the U.S. for international tax compliance and reporting are under consideration as a template for worldwide tax transparency to track how profits are moved around the globe. Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations) gathers significant legal and commercial information with respect to C.F.C.'s that may not be generally available to tax administrations around the world. Form 5471 is being considered by the G20 nations and the O.E.C.D. as the model for the type of information that may be requested by other countries. The form requires reporting by U.S. citizens or residents, domestic corporations, domestic partnerships, and certain estates and trusts of assets held in foreign corporations in which a direct or indirect ownership percentage of at least 10% exists. The requirements affect a broad range of other individuals and businesses, including U.S. citizens or residents who are officers and directors of these corporations.

Supplementing the Form 5471 are other information gathering forms such as:

- Form 8938 (Statement of Specified Foreign Financial Assets), implementing I.R.C. §6038D;
- Form 1120, Schedule UTP (Uncertain Tax Position Statement), which addresses the likelihood that certain positions taken on the tax return are correct; and
- FINCEN Form 114, the electronic successor to Form TD F90-22.1.

Thus, the work being done in conjunction with Action Plan 12 is generally seen as consistent with U.S. concepts of ongoing informational reporting.

ACTION 13: Re-examine transfer pricing documentation

> Develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNE's provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.

Comment

The key issue with Action Plan 13 has been the country-by-country reporting aspect of transfer pricing documentation. The U.S. corporate community has argued that this should not be undertaken for various commercial/legal reasons involving risks in disclosing proprietary business information. The Treasury has resisted country-by-country reporting in the past. However, with support from the G8 and G20 leaders the exercise has become not a "whether to" but a "how to" exercise.

Under the B.E.P.S. Action Plan, the information that is gathered is only to be used by tax administrations for purposes of risk assessment and should not take the place of a transfer pricing analysis. The I.R.S. is confident in its ability to conduct robust transfer pricing audits under the new Transfer Pricing Roadmap procedures, announced in February 2014. Accordingly, the I.R.S. and Treasury see Action Plan 13 as a secondary source of information. This is apparently consistent with the views of the O.E.C.D. working party dealing with Action Plan 13.

Action Plan 13 has been the subject of comments regarding several practical information reporting issues raised by industry. Examples include:

- Appropriate depreciation methods;
- Reporting for groups within a country on an aggregate basis rather than a separate legal entity basis;
- Reporting of inter-group transactions in the master file only;
- Disclosure of share capital and accumulated earnings; and
- Taxes being reported when and as paid, rather than accrued.

Many fear that Action Plan 13 may be become bogged down in detail of financial reporting, trying to balance the risk of inappropriate or illegal access to company proprietary information.

ACTION 14: Make dispute resolution mechanisms more effective

> Develop solutions to address obstacles that prevent countries from solving treaty-related disputes under MAP, including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases.

Comment

Action Plan 14 is the O.E.C.D.'s idea of a taxpayer-friendly initiative, which it feels should be welcomed by taxpayers. The Action Plan focuses on:

- Access to Mutual Agreement Procedure ("M.A.P.");
- Arbitration;
- Multilateral M.A.P.'s & Advance Pricing Agreements ("A.P.A.'s");
- Adjustment issues, including timing for corresponding adjustments, self-initiated adjustments, and secondary adjustments;
- Interest and Penalties;
- Hybrid Entities;
- Legal status of a mutual agreement;

This approach generally aligns with the I.R.S. approach as set forth in Notice 2013-78, issued in November 2013, which proposed updated guidance related to requesting U.S. Competent Authority with a view to "improve clarity, readability, and organization." The Notice also intended to reflect I.R.S. structural changes that have occurred since 2006.

On behalf of the U.S. corporate community, T.E.I. commented on Notice 2013-78 in March of 2014. Comments made by T.E.I. were that:

- Opening the Competent Authority process to taxpayer initiated adjustments was welcomed;

- Competent Authority-initiated M.A.P. cases and the required inclusion of M.A.P. issues that are not a part of the taxpayer's request for assistance elicited concerns and questions;

- Provision of all information to both Competent Authorities is overreaching, particularly where the information may not be relevant to a given Competent Authority; and

- The interplay between the foreign tax credit rules, that mandate the exhaustion of all remedies under the laws of the foreign country before a foreign tax is creditable, and the denial of U.S. Competent Authority assistance in an M.A.P. case raise fears that a U.S.-based group will be required to challenge a foreign-initiated adjustment in instances where the I.R.S. will not provide assistance through an M.A.P. case.

ACTION 15: Develop a multilateral instrument

> Analyze the tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. On the basis of this analysis, interested Parties will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution.

Comment

Deputy Assistant Secretary Robert Stack has expressed concerns regarding the implementation of this B.E.P.S. Action Plan in the United States. Action Plan 15 was criticized in connection with its call for the development of a multilateral instrument. It was characterized as an idea that is not well-defined in terms of its process and substance with little opportunity of implementation.

CONCLUSION

B.E.P.S. Action items 1, 2, 5, 6, 8, 13 and 15 currently have a September 2014 target delivery date. The O.E.C.D. expects to present final reports at the G20 Finance Ministers Meeting. Draft reports for many of these action items were released in February and March, and related comments have been collected. The O.E.C.D. has admitted that it is working at a frantic pace to deliver the final reports by the target date in order to pre-empt the development of unilateral B.E.P.S. legislation and regulation in O.E.C.D. and G20 member nations.

In light of the quickly approaching target delivery dates, U.S. lawmakers and regulators have publicly expressed doubt about the progress and effectiveness of the project. The statements noted at the beginning of this article were joint statements released by Senate Finance Committee Ranking Minority Member Orrin Hatch and House of Representatives Ways and Means Committee Chairman Dave Camp in late June 2014. They focused on the time frame and progress of the implementation of the B.E.P.S. Action Plan as well as concerns that the plan is being used by other member nations to increase the taxes collected on U.S.

corporations. According to Messrs. Hatch and Camp, the September 2014 deadline for implementation of the seven early action items is extremely ambitious, which limits the ability to review, analyze and comment on the rules being proposed. Accordingly, Messrs. Hatch and Camp believe the process raises serious questions about the ability of the United States to fully participate in the negotiations. Nevertheless, comprehensive U.S. Federal income tax reform has been suggested to lower the corporate income tax rate to a level which is internationally competitive and to modernize the U.S. international tax system.

Deputy Assistant Secretary Stack has expressed general concern regarding the implementation of the B.E.P.S. Action Plans in the United States.

Congress, the Administration, and the corporate community share several basic views regarding B.E.P.S.:

- There are areas of international tax law that are the province of the U.S. and should be managed without the layering on top of a newly created set of rules and principles;

- The basic tenet of transfer pricing, the arm's length standard, should remain a cornerstone of international tax; and

- U.S. international tax reform is urgently needed to compliment B.E.P.S. Action Plans and to protect U.S. economic interests.

As with many overriding issues and ideas, the devil is in the details. Action other than rhetoric seems to be missing. The only thing that is certain is that the saga will continue.

TAX 101:
TAX PLANNING AND COMPLIANCE FOR FOREIGN BUSINESSES WITH U.S. ACTIVITY

Authors
Stanley C. Ruchelman
Philip Hirschfeld

Tags
871, 881, 1441, 1442.
1120-F, 5472, 1042-S
8288, 8804, 8805
Allocation of Expenses
Arm's Length
Effectively Connected Income
F.D.A.P.
F.I.R.P.T.A.
Foreign Investor
Income Tax Treaties
Limitation on Benefits
Permanent Establishments
Portfolio Debt
Transfer Pricing
U.S.R.P.H.C.
W-8-BEN-EW-8IMY, W-8-EXP

I. INTRODUCTION

The U.S. tax laws affecting foreign businesses with activity in the U.S. contain some of the more complex provisions of the Internal Revenue Code. Examples include:

- Effectively connected income,[7]
- Allocation of expenses to that income,[8]
- Income tax treaties,
- Arm's length transfer pricing rules,[9]
- Permanent establishments under income tax treaties,[10]
- Limitation on benefits provisions in income tax treaties that are designed to prevent "treaty shopping,"[11]
- State tax apportionment,
- F.I.R.P.T.A. withholding tax for transactions categorized as real property transfers,[12]
- Fixed and determinable annual and periodical income,[13] and

---

7 Section 864(c) of the Internal Revenue Code of 1986 as amended from time to time and currently in effect (the "Code").
8 Reg. §§1.861-8 through 1.861-17.
9 Code §482.
10 For example, Article 5 (Permanent Establishment) of the U.K.-U.S. Income Tax Treaty.
11 For example, Article 24 (Limitation on Benefits) of the Luxembourg-U.S. Income Tax Treaty.
12 Code §1445.

- Interest on items of portfolio debt.[14]

One can imagine that it is no easy task to identify income that is subject to tax, to identify the tax regime applicable to the income, and to quantify gross income, net income, and income subject to withholding tax. Nonetheless, the I.R.S. has identified withholding tax obligations of U.S. payers as a Tier I audit issue.

Following closely with the technical obligations are the reporting obligations to ensure that the proper amounts of income, in some cases expense, and in all cases tax are reported on the income tax return filed by the foreign business. These reporting obligations can be imposed on:

- The foreign investor itself, if it engages in a transaction directly in the U.S. that produces effectively connected taxable income or loss;[15]
- The U.S. subsidiaries of the foreign investor, if they engage in transactions with affiliates controlled by the same investor;[16]
- A person who acquires real property from a foreign corporation, even when the acquisition would otherwise be free of tax under general concepts of domestic tax law;[17]
- General partners of partnerships that report effectively connected income as part of the distributable share of a foreign partner;[18] and
- Payors of income, other than effectively connected income, deemed to be from U.S. sources.[19]

This paper explains when the technical provisions listed above are likely to be applicable to a specific fact pattern and addresses the reporting obligations in each of those circumstances.

II. DIRECT OPERATIONS

A foreign company that is engaged in a trade or business in the U.S. faces exposure to U.S. tax on several levels. It is subject to (i) Federal income tax or alternative minimum tax; (ii) Federal branch profits tax on the dividend equivalent

---

13 Code §§871, 881, 1441, and 1442.
14 Code §§871(h)(2) and 881(c)(2).
15 Form 1120-F (U.S. Income Tax Return of a Foreign Corporation), Section II.
16 Form 5472 (Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business).
17 Form 8288-B (Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests).
18 Form 8804 (Annual Return for Partnership Withholding Tax (Section 1446)), Form 8804-C (Certificate of Partner-Level Items to Reduce Section 1446 Withholding), and Form 8805 (Foreign Partner's Information Statement of Section 1446 Withholding Tax).
19 Form 1042-S (Foreign Person's U.S. Source Income Subject to Withholding).

amount arising from taxable income; and (iii) State income tax. There also may be U.S. tax exposure imposed on the employees physically present in the U.S.

A. Trade or Business

While it is easy to identify the tax exposure, it is not always easy to determine when the threshold has been crossed for the imposition of tax or how the tax will be computed. For a foreign corporation to be engaged in a trade or business in the U.S., it must engage in a course of activity within the United States that is considerable, continuous, and regular.[20] Whether the threshold has been crossed is a question of fact. The threshold of the I.R.S. is generally somewhat lower than that of the Courts, which look at activity in the U.S. exclusively. The I.R.S. contends that sporadic activity in the U.S., of a kind that comprises a business outside the U.S., comprises a trade or business in the U.S.

The activity may be carried on by the foreign corporation itself or by its agents.[21] Consequently, a foreign corporation that is a member of a partnership which is engaged in a U.S. trade or business is deemed to be engaged in the trade or business conducted by the partnership.[22] However, a foreign corporation is not engaged in a trade or business in the U.S. if it engages a subcontractor to provide services and that subcontractor acts in the course of its own business.[23]

The activity within the U.S. must be income-producing or capable of producing income or sales for it to comprise a U.S. trade or business.[24] With limited exceptions, a foreign corporation that is not engaged in a trade or business within the U.S. during a taxable year cannot have income, gain, or loss that is treated as effectively connected income.[25] Two exceptions relate to dispositions of assets used in a trade or business in prior years and to deferred payment transactions.[26] In these instances, income is treated as effectively connected with a business

---

[20] *InverWorld Inc. v. Commr*., T.C. Memo 1996-301; *InverWorld Inc. v. Commr*., T.C. Memo 1997-226; Lewenhaupt v. Commr., 20 T.C. 151 (1953), affd. per curiam 221 F.2d 227 (9th Cir. 1955); and *European Naval Stores Co., S.A. v. Commr*., 11 T.C. 127 (1948).

[21] *Adda v. Commr*., 10 T.C. 273 (1948), affd. per curiam 171 F.2d 457 (4th Cir. 1948), cert. denied 336 U.S. 952.

[22] Code §875(1); *Donroy, Ltd. v. U.S*., 301 F.2d 200 (9th Cir. 1962); and *Unger v. Commr.* T. C. Memo. 1990-15, affd. 936 F.2d 1316 (D.C. Cir. 1991); Rev. Rul. 90-80, 1990-2 C.B. 170.

[23] *Miller v. Commr*., T.C. Memo 1997-134, involving a U.S. subcontractor who performed some of the work on a project for a foreign related company. Compare *InverWorld Inc. v. Commr*., T.C. Memo. 1996-301, where virtually all of the activities that generated income were conducted in the U.S. by a related party acting as agent.

[24] *Linen Thread Co., Ltd. v. Commr*., 4 T.C. 802 (1945), affd. 152 F.2d 625 (2d Cir. 1945); *Lewenhaupt v. Commr*., 20 T.C. 151 (1953), affd. per curiam 221 F.2d 227 (9th Cir. 1955); *Spermacet Whaling & Shipping Co. v. Commr*., 30 T.C. 618 (1958), affd. 281 F.2d 646 (6th Cir. 1960); *Continental Trading, Inc. v. Commr*., T.C. Memo. 1957-164, affd. 265 F.2d 40 (9th Cir. 1959), cert. denied 361 U.S. 827.

[25] Code §864(c)(1)(B).

[26] Code §864(c)(6)&(7).

conducted in an earlier year.[27] In addition, a foreign corporation can elect to treat real property income as connected with a U.S. trade or business.[28]

B. Effectively Connected Gross Income

To compute the taxable effectively connected income of a foreign corporation engaged in a U.S. trade or business, the first step is to identify the gross income that gives rise to effectively connected net income. Generally, effectively connected gross income must arise from U.S. sources as computed under the concepts of U.S. law.[29] Moreover, the gross income must be attributable to the conduct of a trade or business in the U.S. In only limited circumstances, will foreign-source income be deemed to be effectively connected income and then only if a U.S. office exists and personnel assigned to that office materially participate in arranging the income. The limited circumstances involve foreign-source rent or royalty income of a licensing company; dividends or interest derived in the active conduct of banking, financing, or similar business by an investment company; and sales of inventory for use and consumption outside the U.S.[30]

In broad terms, the three most common forms of gross income for a foreign corporation engaged in a U.S. trade or business are (i) services income, (ii) income from the sale of inventory, and (iii) rental income.

For services income, the place where services are performed controls the source of the resulting service fee income.[31] Fees for services performed in the U.S. are taxable; fees for services performed outside the U.S. are not taxable. The identity of the customer is irrelevant in determining the source of the income.

Where an organization provides services in return for a fee, many different people in many different locations may provide services. Where this occurs, all the service providers must be identified, and the relative contributions of each must be evaluated.[32] Only the portion of the fee considered to be U.S.-source income will be treated as effectively connected income. No hard and fast guidelines exist to make the required determinations. The hours spent by all personnel involved can be tracked and values can be assigned. A ratio may then be developed which compares the aggregate value of all hours in the U.S. with the aggregate value of all hours for the project. The ratio, expressed as a percentage, can be applied to the total service fee to determine the percentage taxed in the U.S.

Income from the purchase and sale of inventory – not the manufacture and sale of inventory – (or property described in Code §1221(a)(1)) is generally sourced by reference to the place where title passes. Title passes at the place where risk of loss passes. In the U.S., risk of loss is determined under the Uniform Commercial Code and generally means the place where the seller has successfully fulfilled his

---

27 Code §864(b).
28 Code §882(d).
29 See Code §861 for the general source rule of U.S. tax law.
30 Code §864(c).
31 Code §861(a)(3).
32 Reg. §1.954-4.

obligation and merely awaits payment.[33] However, a sale of inventory through an office or a fixed place of business may be sourced in the country where the office or fixed place of business is located. For foreign residents, if the sale is attributable to an office or fixed place of business in the U.S., the income is considered to be U.S.-source income.[34] This rule applies to all sales of personal property by nonresidents, including inventory, with the exception that a sale of inventory property for use, disposition, or consumption outside U.S. will be considered to generate foreign-source income if a foreign office or fixed place of business materially participates in the sale.

Where a foreign business manufactures property outside the U.S. and sells that property inside the U.S., only a portion of the income will be deemed to be U.S.-source effectively connected income. That portion is determined under a formula.[35] Where an independent factory or production price can be established by regular sales to unrelated third parties under *ex-factory* terms, the manufacturing profit is determined by reference to the *ex-factory* price. That income is sourced at the location of the factory.[36] The balance of the income from manufacturing activities is sourced at the place where the sale occurs.

Alternatively, one may elect to apportion the income between U.S. and foreign sources. Under this method, one-half of the taxpayer's gross income will be considered income attributable to production activity. Only the taxpayer's production assets are taken into account. Assets of contract manufacturers are not relevant.[37] Production assets include only tangible and intangible assets directly used by the taxpayer to produce inventory. If assets are not directly used to produce inventory, they are excluded. The remaining one-half of such gross income will be considered income attributable to sales activity.[38]

The source of rental income is dependent on the place where the property is located.[39] Thus, for example, if rental real property is located within the U.S., the rental income is treated as an item of domestic-source income.

When a foreign corporation is engaged in a U.S. trade or business, items of passive income such as interest income and gains may be treated as effectively connected income if the passive income is attributable to the trade or business.[40] This will occur if income is derived from assets used or held for use in the conduct of a U.S. trade or business.[41] For financial institutions, investment companies, and licensing companies, it may occur where the activities of a U.S. business constitute material factors in the realization of the income.[42]

"Where a foreign business manufactures property outside the U.S. and sells that property inside the U.S., only a portion of the income will be deemed to be U.S.-source effectively connected income…The source of rental income is dependent on the place where the property is located."

---

33 Code §§865(b) and 861(a)(6).
34 Code §865(e)(2)(A).
35 Code §863(b)(2).
36 Reg. §1.863-3(b)(2).
37 Reg. §1.863-3(c)(1)(i)(A).
38 Reg. §1.863-3(b)(1).
39 Code §861(a)(4).
40 Code §864(c)(2).
41 Code §864(c)(2)(A).
42 Code §864(c)(2)(B).

An asset is treated as held for use in the conduct of a trade or business if the asset is held for the principal purpose of promoting the present conduct of the trade or business in the U.S.[43] However, dividend-paying stock acquired and held to assure a constant source of supply for the trade or business of the U.S. branch is generally not an asset held for use in the conduct of a trade or businesses.[44] An asset is also viewed to be held for use in the conduct of a trade or business if it is acquired and held in the ordinary course of the trade or business conducted in the United States.[45] Here, the example is an interest-bearing account or note receivable issued by a customer of the branch's trade or business. Finally, an asset may be viewed to be held for use in the conduct of a trade or business where a direct relationship exists between the asset and the trade or business.[46] This will exist if (i) the asset was acquired with funds of the business, (ii) the income from the asset is retained or reinvested in the business, and (iii) U.S. personnel exercise significant management and control over the asset.

C. Deductible Expenses

The expenses that may be taken into account in computing the net taxable income are the expenses incurred in the U.S. to generate effectively connected income and a portion of any expense incurred outside the U.S. to the extent related, directly or indirectly, to the generation of U.S. fee income. The computation is made under concepts which appear in Reg. §§1.861-8 through 17. In making the computation, the accounts of the U.S. branch are likely the easiest to analyze. However, each expense of the foreign company, no matter where incurred, must be evaluated, account by account, to determine whether the expense is of a kind that is deductible in the U.S. If deductible in principle, each item must be analyzed to determine that the deduction does not exceed limitations of U.S. tax law. To illustrate, foreign law may contain liberal depreciation rules such as bonus depreciation, flexible depreciation, or accelerated depreciation. The depreciation computed under those methods must be adjusted to reflect U.S. depreciation rules.

Once expenses are identified as deductible for U.S. income tax purposes, they are generally placed into three pools. The first pool consists of expenses that relate entirely to U.S.-source fee income. These expenses are deductible in full. The second pool consists of expenses that relate entirely to foreign-source fee income. These expenses are entirely nondeductible. The final pool consists of expenses related in part to U.S.-source fee income and in part to foreign-source fee income. These must be apportioned under a reasonable method applied consistently from year to year and which makes sense in the circumstances.

In computing deductible expenses, the I.R.S. will attempt to ensure that expenses have actually been incurred, that they are of a kind that is deductible under U.S. concepts, that limitations of U.S. law are appropriately applied, and that expenses related to foreign operations which do not produce effectively connected income are not deducted on the U.S. tax return. If a deductible item is paid to a related

---

[43] Reg. §1.864-4(c)(2)(ii)(a).
[44] Reg. §1.864-4(c)(2)(iii)(a).
[45] Reg. §1.864-4(c)(ii)(b).
[46] Reg. §1.864-4(c)(ii)(c).

> *"One particular item that poses computational problems for a U.S. branch of a foreign operating company is the deduction for interest expense. For foreign companies, interest expense is not computed under a straightforward method."*

party outside the U.S., an examiner will attempt to confirm that the expenditure does not exceed an arm's length amount within the meaning of U.S. tax law.

It is not unusual for an examiner to contend that expenses incurred in the U.S. are related to foreign-source income not taxed by the U.S. Those expenses are not deductible. An example would be advertising expenses incurred in connection with an overall marketing approach to a brand name owned by the foreign entity. The examiner may contend that the advertising promotes foreign as well as U.S. sales and therefore cannot be deducted in full even though incurred by the U.S. branch.

One particular item that poses computational problems for a U.S. branch of a foreign operating company is the deduction for interest expense. For foreign companies, interest expense is not computed under a straightforward method. Rather, a formula that appears in regulations must be used.[47] The amount of interest expense allocable to effectively connected income of a foreign corporation is the sum of (i) the interest paid or accrued on liabilities booked in the U.S., as adjusted under a three-step process described below, and (ii) the directly allocated interest. Direct allocation of interest that can be directly allocated under the Reg. §1.861-10T rules is mandatory.[48] However, the I.R.S. has noted that certain U.S. income tax treaties provide for other interest allocation methods. If that type of treaty is applicable, the methods prescribed under the specific treaty may be used instead of the three-step method in Treas. Reg. §1.882-5.[49]

The first step of the formula is to determine the amount of assets owned by the foreign company that produce effectively connected income that is taxable in the U.S. Once that is determined, the portion of the assets that are deemed to have been acquired by the proceeds of debt must be identified. Under the premise that capital is fungible, the entity's worldwide debt-equity ratio is determined, and that ratio is multiplied against assets that produce income taxable in the U.S. This is the hypothetical amount of debt attributed to the U.S. branch. The amount treated as debt may have no resemblance to the debt reported on the U.S. balance sheet.

When the hypothetical debt is computed, the interest expense related to that debt must be identified. This is computed by reference to the actual effective rate of interest of the U.S. business (viz., book interest expense divided by average book liabilities). The rate is multiplied against the debt computed in the preceding steps. If the interest expense deduction for income tax purposes exceeds the actual interest expense reported on the books of the U.S. business, the excess is subject to 30% branch profits tax on excess interest expense.[50] The treatment of excess interest paid by a U.S. branch reverses unintended tax benefits that arise from the computation of deductible interest under the regulations. The excess is treated as if it were interest paid to the foreign corporation on a notional obligation of a wholly-owned domestic corporation on the last day of the foreign corporation's tax year.[51]

---

47 Reg. §1.882-5.
48 Id.
49 Preamble to T.D. 9281, 2006-2 C.B. 517; see also Notice 2005-53, 2005-2 C.B. 263.
50 Code §884(f)(1)(B). *Taiyo Hawaii Company, Ltd. v. Commr*., 108 T.C. 590 (1997).
51 Code §884(f)(1)(B); Reg. § 1.884-4(a)(2).

As a result, the excess is subject to the equivalent of a 30% withholding tax, absent an applicable exemption provided by domestic law or a reduction or elimination of tax for qualified treaty residents as provided by treaty. Any tax due is reported on the foreign corporation's U.S. income tax return for the year and is subject to the payment of estimated tax as provided in Code §6651.[52]

Other limitations on the deduction for interest expense are discussed below.

D. Income Taxes

Regular income tax is imposed on the net effectively connected income, after allowance of deductions.[53] The tax is imposed at various rates as follows: (i) 15% up to $50,000; (ii) 25% from $50,000 up to $75,000; (iii) 34% from $75,000 up to $10,000,000; and (iv) 35% thereafter. The benefit of the lower rates of tax is recaptured for companies having income over $100,000 and over $15 million. In addition, an alternative minimum tax of 20% of the alternative minimum taxable income is imposed if that tax is greater than the net income tax imposed at regular rates.[54]

In addition to the regular income tax or the alternative minimum tax, a foreign corporation that is engaged in a trade or business in the U.S. is subject to the 30% branch profits tax on the dividend equivalent amount.[55] This tax is the functional equivalent of a dividend withholding tax imposed when a U.S. corporation pays a dividend to its foreign shareholder.

E. Branch Profits Tax on Dividend Equivalent Amount

The dividend equivalent amount is the foreign corporation's effectively connected earnings and profits determined without reduction for dividends paid during the year. The earnings are reduced by reinvestment in a U.S. trade or business and are increased by reductions of investments that were used in prior years to shelter the dividend equivalent amount. By tracking U.S. asset investment and disinvestment, the branch profits tax broadly equates to a dividend withholding tax. If U.S. asset investment increases, profits have been retained in the U.S. and no equivalent of a dividend has been effectively distributed to foreign shareholders.

Several traps for the unwary exist with regard to the branch profits tax on the dividend equivalent amount. Previously deferred branch profits tax on effectively connected earnings and profits may be triggered when the business of a U.S. branch is terminated or when the business is contributed to a U.S. corporation.

In principle, a foreign corporation is not subject to the branch profits tax for the taxable year in which it completely terminates all of its U.S. trade or business.[56] This treatment equates to the treatment of a complete liquidation of a U.S. subsidiary by a foreign corporation. In that set of circumstances, a foreign

---

[52] Reg. §1.884-4(a)(2)(iv).
[53] Code §§882 and 11.
[54] Code §55.
[55] Code §884.
[56] Reg. §1.884-2T(a)(1).

corporation is not subject to dividend withholding tax when a liquidating dividend is received. Similarly, the non-previously taxed, accumulated effectively connected earnings and profits, as of the close of the taxable year of complete termination, are extinguished for purposes of the branch profits tax.

However, this favorable treatment applies only when a complete termination of the business exists. If a complete termination does not exist, the branch profits tax may be imposed on the non-previously taxed, accumulated effectively connected earnings and profits at such time as the net equity of the U.S. branch is reduced.

For there to be a complete termination, several tests must be met.[57] First, the foreign corporation must have no U.S. assets or its shareholders must adopt an irrevocable resolution to completely liquidate and dissolve the corporation and, before the close of the immediately succeeding taxable year, all assets in the U.S. must be distributed, used to pay creditors, or removed from the country. Second, for three years following the close of the year of complete termination, none of the U.S. assets of the terminated business, or property attributable to the sale of the business or to the U.S. earnings in the year of complete termination, can be used by the foreign corporation or by an affiliate in the conduct of a trade or business in the U.S. Third, the foreign corporation must not have any income that is, or is treated as, effectively connected with the conduct of a trade or business in the U.S. during the three-year period. Finally, the foreign corporation must extend the period of limitations on the assessment of the branch profits tax for the year of complete termination for not less than six taxable years.

When a business carried on by a U.S. branch is incorporated, the transfer of assets to a U.S. corporation is not treated as a termination of a business. Rather, the incorporation is treated as a reduction of net equity. Consequently, deferred branch profits tax will be triggered because net assets will be reduced.

This treatment is subject to an exception. The foreign corporation and its wholly-owned U.S. subsidiary elect for the transferee to step into its shoes with regard to the non-previously taxed, accumulated effectively connected earnings and profits.[58] This means that the U.S. corporation will be treated as if it has carryover earnings and profits. Moreover, dividend distributions to the foreign corporation from the earnings will qualify for treaty benefits only when the limitation on benefits provision of the treaty and its counterpart in the branch profits tax regulations are satisfied. Moreover, the foreign corporation must agree to terminate deferral of the branch profits tax in the event the shares of the U.S. transferee are sold or otherwise disposed of other than in an F-reorganization or a complete liquidation of the transferee, which is covered by Code §332.[59]

The final trap for the unwary relates to the benefit of net operating loss carryovers. The branch profits tax on dividend equivalent amounts is based on the annual earnings for a particular year. Consequently, it is not reduced by a loss carryover from earlier years. This parallels dividend treatment in the U.S. in that a distribution to shareholders will be treated as a dividend if paid from accumulated earnings and

---

[57] Reg. §1.884-2T(a)(2).
[58] Reg. §1.884-2T(d)(1)-(4).
[59] Reg. §1.884-2T(d)(5).

profits or, if none exist, current year earnings and profits.[60] Consequently, the branch profits tax on the dividend equivalent amount can be looked at as a trap for the unwary.

F. Permanent Establishment – A Treaty Concept

A full discussion of treaty benefits regarding withholding tax and the limitation on benefits provisions of U.S. income tax treaties appears below in Section VI.B. However, there is a concept in income tax treaties that is applicable to effectively connected income and for that reason is discussed here. It is the concept of a "permanent establishment."

Virtually all treaties raise the level of presence that must exist in a nation state before that state can impose tax on "business profits," the treaty term that is used to describe effectively connected income. Business profits derived by a resident of one of the countries (the "resident state") can be taxed in the other country (the "host state") only if a permanent establishment exists in the host state. In broad terms, a permanent establishment is a fixed place of business through which business is conducted in whole or in part in the host state. It typically includes a place of management, a branch, an office, a factory, a workshop, and a mine, oil or gas well, quarry, or other place of extraction of natural resources. Also included are agents, other than independent agents described below, that have and habitually exercise an authority to conclude contracts that are binding on the enterprise. Think in terms of salesmen employed by a U.S. subsidiary that visit actual or potential customers for the purpose of soliciting sales of goods and discussing the terms of the sale.

Certain items are typically excluded from being a permanent establishment. These include:

- The use of facilities in the host state solely to store, display, or deliver merchandise belonging to a corporation organized in the resident state;
- The maintenance of a stock of goods in the host state belonging to an enterprise solely for the purpose of storage, display, or delivery or solely for the purpose of processing by another entity in the host state;
- The maintenance of a fixed place of business in the host state solely for the purpose of purchasing goods or merchandise, collecting information, or other activities that have a preparatory or auxiliary character for the corporation organized in the resident state; and
- The presence of an independent agent in the host state, provided that the agent is acting in the ordinary course of its business as an independent agent. To come within this exception, the agent must be both legally and economically independent and must be acting in the ordinary course of its business in carrying out activities on behalf of the enterprise. This provision

[60] Code §316(a).

is not infrequently abused by small- or medium-sized foreign companies that wish to avoid the compliance requirements of U.S. tax law that are applicable to intercompany transactions. Here, the arrangement entails the funding of an exclusive sales agency owned by the principal sales manager in the U.S. but entirely funded by the foreign supplier.

III. TRANSACTIONS BETWEEN U.S. SUBSIDIARY AND FOREIGN AFFILIATE

U.S. tax law imposes several distinct obligations on U.S. companies that are owned substantially by foreign persons or that are controlled by foreign persons. In some instances, the obligations may limit or defer deductions. In other instances, the obligation mandates reporting so that an examiner can be prepared to question certain intercompany transactions under Code §482.[61] In either event, the preparation of the tax return for the affiliate must take these provisions into account.

A. Reporting Transactions

When a U.S. company that has substantial foreign ownership enters into a transaction with a foreign affiliate, an obligation exists to report the amount of the transaction to the I.R.S. The obligation is imposed by reason of Code §6038. The stated reason is to allow the I.R.S. to determine the true taxable income of the 25% foreign-owned corporation under U.S. law. Reporting is made on Form 5472.

The reporting obligation is set forth in Reg. §1.6038A-2. Each reporting corporation is required to make a separate annual information return on Form 5472 with respect to each related party with which it engaged in a reportable transaction during the taxable year. The information must be furnished even if the particular item does not affect the amount of any tax that may be due.

Key terms that are defined in the regulations are “reporting corporation,” “related party,” and “reportable transaction.”

The term “reporting corporation” is defined in Reg. §1.6038A-1(c). In general, it means either a domestic corporation that is 25% foreign-owned or a foreign corporation that is engaged in a trade or business in the U.S.[62] After November 4, 1990, a foreign corporation engaged in a trade or business within the United States at any time during a taxable year is a reporting corporation.[63]

For a corporation to be 25% foreign-owned, it must have at least one direct or indirect 25% foreign shareholder at some point during the taxable year.[64] The ownership threshold is met if a foreign person owns at least 25% of either (i) the total voting power of all classes of voting stock of the reporting corporation or (ii) the

61 A full discussion of Code §482 is beyond the scope of this paper.
62 Reg. §1.6038A-1(c)(1).
63 Code §6038C.
64 Reg. §1.6038A-1(c)(2).

total value of all classes of stock of the reporting corporation.[65] These tests are applied on the basis of facts and circumstances and principles similar to Reg. §1.957-1(b)(2). These principles are designed to prevent a foreign corporation from avoiding the status of a controlled foreign corporation ("C.F.C.") by adopting a capital structure in which the class of shares retaining voting power is separated from the class of shares with value.[66] As a result, attempts to separate voting power from value will be closely examined to determine if a separation in form is also a separation in fact.

In determining whether a corporation is 25% foreign-owned, the rules of constructive ownership in Code §318 continue to be applied in modified form.[67] The modifications appear in Code §6038(c)(5), which relates to the reporting of certain information by U.S. persons that control foreign corporations on Form 5471. The threshold for attribution to a shareholder from a corporation is reduced to 10% from 50%. (The ownership threshold has not been reduced for attribution from a shareholder to a corporation.) Also, the rules attributing ownership to a corporation, partnership, or trust from a shareholder, partner, or beneficiary will not be applied if the effect is to cause a U.S. person to be deemed to own shares actually owned by a non-U.S. person.

If no single foreign person owns, or is considered to own through attribution, the required 25% of the voting power or value of the corporation, the corporation is not a reporting corporation even if foreign persons own 25% or more of the voting power or value of the corporation.

The term "related party" includes a 25% foreign shareholder of the reporting corporation, determined after application of the attribution rules. It also includes a person who is related, within the meaning of Code §267(b) or §707(b), to the reporting corporation or to a 25% foreign shareholder. Finally, it includes a person that is related to the reporting corporation within the meaning of Code §482, *i.e.*, under common control with the related person.[68]

In determining whether a reporting corporation has engaged in a transaction with a related person, all transactions of the partnership may be attributed to a partner that is a reporting corporation on a pro rata basis, determined by reference to relative

---

65 Reg. §1.6038A-1(c)(3).

66 The 1986 Tax Reform Act introduced a test based on value to the then-existing test based solely on voting power for purposes of determining whether a foreign corporation is a C.F.C. This put an end to many schemes that allocated shares with voting power to foreign persons and shares with value to U.S. persons. In the period since the enactment of the 1986 Tax Reform Act, §1.957-1(b)(2) has been applied to circumstances where a foreign corporation is owned in small part by one foreign entity and in equal and principal shares by a U.S. person and by a foreign person that, itself, is not owned in substantial part by a U.S. person. If the first-mentioned foreign entity informally agrees to vote its shares with the U.S. person, the U.S. person is deemed to possess the requisite voting power even though it may not possess shares having the requisite value. As a result, the foreign corporation may be deemed to be a C.F.C.

67 Reg. §1.6038A-1(e)(1).

68 Reg. §1.6038A-1(d).

partnership interests.[69] The rule applies if the reporting corporation directly or indirectly owns a capital or profits interest which by itself, or when added to the partnership interests owned by related parties, comprises 25% or more of the total interests in the partnership. The effect of this rule is to cause the reporting corporation to treat the partnership transactions as its own for purposes of the reporting, records maintenance, monetary penalty, agent for service of process, and production of records rules of the regulations.

"A transaction is reportable even if monetary consideration is not required or is only part of the contemplated consideration."

A reportable transaction is any transaction with a foreign related person involving any of the following items:[70]

- Sales and purchases of stock in trade (inventory);
- Sales and purchases of tangible property other than stock in trade;
- Rents and royalties paid or received other than those relating to intangible property;
- Sales, purchases, and amounts paid or received as consideration for the use of intangible property, including copyrights, designs, formulas, inventions, models, patents, processes, trademarks, and similar rights;
- Consideration paid or received for technical, managerial, engineering, construction, scientific, or similar services;
- Commissions paid or received;
- Amounts loaned or borrowed, excluding open accounts arising from sales and purchases made and collected in full in the ordinary course of business;
- Interest paid or received;
- Premiums paid or received for insurance and reinsurance; and
- Any other transaction not specifically mentioned above to the extent that such amounts are taken into account for the determination and computation of the taxable income of the reporting company.

A transaction is reportable even if monetary consideration is not required or is only part of the contemplated consideration.[71] Thus, for example, the provision of managerial services by a foreign related party for a start-up or troubled operation in the U.S. is a reportable transaction even if the services are provided without a fee. This, of course, is difficult for outside accountants to track.

The Form 5472 requires the reporting corporation to identify itself by providing its name, address, and U.S. taxpayer identification number. Similar information is

---

[69] Reg. §1.6038A-1(e)(2).
[70] Reg. §1.6038A-2(a)(2) and (b)(3).
[71] Reg. §1.6038A-2(a)(2) and (b)(4).

provided for each 25% foreign shareholder, again determined after attribution rules are applied. Finally, information must be provided with regard to each related party, whether foreign or domestic, with which the reporting corporation has engaged in a reportable transaction.[72]

Three principal exceptions are provided to the filing requirement.[73] First, no reporting is required if a reporting corporation has no transactions during the year with any related parties. This exception does not relieve the reporting corporation of its obligations to maintain records or to serve as agent of process for a foreign related party. Second, if the reporting corporation is a foreign corporation for which all reportable transactions are with one or more related domestic corporations that are not members of the same affiliated group, the foreign corporation is excused from listing those transactions. Finally, no reporting is required with regard to a reportable transaction with a related corporation if a U.S. person controls the reporting corporation and files Form 5471 that fully describes the reportable transaction.

The Form 5472 is to be filed with the reporting corporation's income tax return.[74] If the income tax return is not timely filed, the Form 5472 is to be filed separately by the due date of the income tax return, as properly extended.

B. Limitation on Interest Expense Deductions

U.S. tax law contains several limitations on the deduction of interest expense.

The simplest limitation applies to accrued but unpaid interest. A U.S. company is not entitled to a current interest expense deduction for accrued but unpaid interest owed to a related foreign entity unless an amount attributable to such item is currently includible in the income of the related foreign entity.[75] This provision is designed to recognize the U.S. tax benefit only when the offshore creditor is clearly subject to tax in its jurisdiction of residence. A similar limitation denies an interest expense deduction for original issue discount ("O.I.D.") on loans from related foreign persons.[76] Loans that do not provide for current payment of adequate interest are deemed to contain adequate O.I.D.

The limitations become more complex with the application of the earnings stripping rules.[77] Under the earnings stripping limitation, no deduction is allowed for disqualified interest (*i.e.*, interest paid to a related person that is not subject to U.S. tax on receipt). The interest expense deduction is capped under the earnings stripping rules so that a U.S. borrower cannot claim a tax benefit for excess interest expense. Disqualified interest may be carried forward and deducted in a subsequent year if sufficient excess limitation exists in the subsequent year.

[72] Reg. §1.6038A-2(b)(2).
[73] Reg. §1.6038A-2(f).
[74] Reg. §1.6038A-2(d).
[75] Code§267(a)(3).
[76] Code §163(e)(3).
[77] Code § 163(j).

The scope of the earnings stripping provision is broad. It contains no grandfather provision. Thus, interest on all related-party loans is covered. The earnings stripping rules could apply to defer the benefit of the interest expense deduction even if the interest is paid to unrelated holders of debt issued by a domestic corporation, if two conditions are met. The first is that no U.S. withholding tax is imposed on the gross amount of the interest paid. The second is that the loan from the unrelated party is "guaranteed" by a related foreign person. For purposes of the limitation, a guarantee is any arrangement in which a person directly or indirectly assures, on a conditional or unconditional basis, the payment of another's obligation. Thus, any form of credit support received from a foreign parent in connection with a borrowing may result in the application of the earnings stripping rules to a particular borrowing.

The limitation applies if a corporation has "excess interest expense" and, at the end of its year or at other designated times, has a debt-equity ratio of greater than 1.5 to 1. The excess interest expense is not currently deductible.

Excess interest expense is the excess of “net interest expense” over the sum of 50% of the adjusted taxable income plus the excess limitation carryforward from the preceding three years. Net interest expense is the excess of interest expense over interest income. This computation is made by taking into account all interest income and interest expense of the corporation. The identity of the creditor is irrelevant. Adjusted taxable income means taxable income computed by adding back net interest expense, net operating loss carryovers, depreciation, amortization, and depletion. Excess limitation means the excess of 50% of adjusted taxable income over the net interest expense in any particular year.

IV. REAL PROPERTY TRANSACTIONS

A. In General

The United States taxes a foreign party's disposition of U.S. real estate or shares in a U.S. Real Property Holding Company under a statutory provision known as the Foreign Investment in Real Property Tax Act (“F.I.R.P.T.A.”). F.I.R.P.T.A. mandates that income from the disposition of U.S. real property interests must be treated as income that is effectively connected with a U.S. trade or business.[78] This characterization removes real estate transactions from the class of capital gains, which are generally exempt for foreign parties, and brings the normal income tax rules into play. As a result, the annual net gain or loss for foreign individuals is taxed at the graduated statutory tax rates of up to 39.6%,[79] at a minimum tax rate of 26% or 28%,[80] or at the favorable tax rates for long-term capital gains, currently 20%.[81]

---

78 Code §897(a)(1).
79 Code §1.
80 Code §55(b)(1)(A)(i).
81 Code §1(h)(1)(D).

"Currently, there are seven situations in which withholding is not required."

A major departure from the Code's normal tax provisions for foreign parties is in the nonrecognition override provisions under F.I.R.P.T.A. To ensure that the taxing provisions are not avoided by simple planning mechanisms such as like-kind exchanges and corporate reorganizations, Code §897 limits the application of nonrecognition transactions when U.S. Real Property Interests ("U.S.R.P.I.'s") are involved.[82] Generally, they are permitted only when the U.S. tax on gain is fully protected, such as when one U.S.R.P.I. is exchanged for another. However, gain may be deferred if the transferee in a nonrecognition transaction is a foreign person, the transferred asset consists of shares of a domestic corporation that is a U.S. Real Property Holding Corporation ("U.S.R.P.H.C."), the transferee does not receive a step-up in basis, the shareholders of the U.S.R.P.H.C., the shareholders of the foreign entity remain substantially the same, and the shares of the foreign corporation are held for at least 12 months.[83]

B. Withholding Obligation

The substantive tax rule under F.I.R.P.T.A. is augmented by a separate withholding tax provision.[84]

The purchaser of a U.S. real property interest from a foreign person is obligated to withhold 10% of the amount realized, *i.e.*, the amount of cash and the value of other property given plus the amount of debt that is relieved. If the taxable event is in the form of a distribution of a U.S.R.P.I. by a foreign corporation, the amount to be withheld is increased to 35% of the appreciation over tax basis.[85]

C. Withholding Exemptions

Because the purchaser of the U.S.R.P.I. is personally liable for any unpaid F.I.R.P.T.A. withholding tax, an incentive exists to withhold unless a transaction is specifically exempted by the statute and regulations. Currently, there are seven situations in which withholding is not required. The transferee need not withhold if he or she is buying a property to use as a residence and the amount paid is $300,000 or less.[86] This provision is designed to relieve ordinary home buyers from the burden of withholding. The exemption applies not to the type of property but to the purpose for which it is bought. Investors must withhold even if they are buying a residential property. This provision does not excuse the seller from tax on the gain; it merely exempts the purchaser from having to withhold.

Withholding is not required from a transfer of any publicly traded class of corporate interests or any publicly traded partnership interest or trust interest.[87] Lenders foreclosing on or repossessing a U.S.R.P.I. need not withhold in certain specially protected circumstances.[88] If they notify the I.R.S. of the foreclosure or repossession, their withholding obligation is 10% of the amount realized, or 10% of

---

82 Reg. §§1.897-6T.
83 Notice 2006-46, 2006-1 C.B. 1044.
84 Code §1445.
85 Reg. §1.1445-5(d).
86 Reg. §1.1445-2(d)(1).
87 Reg. §1.1445-2(c)(2).
88 Reg. §1.1445-2(d)(3).

the excess of the amount realized over the debt, whichever is less. Thus, they must withhold only on amounts that will be paid over to the debtor.

Withholding is not required if the transferred property is not a U.S. real property interest.[89] The transferee withholding agent independently determines the status of an interest that is not an interest in a corporation or public partnership. If the transfer involves an interest in a corporation, withholding is negated by a statement from the corporation that it has not been a U.S. real property holding corporation within the five years ending on the date of the transfer. A transferee may normally rely on these statements unless it knows them to be false or is notified of that fact by an agent.

Withholding is required on a transfer of a non-publicly traded partnership interest if a substantial part of the partnership's assets consist of U.S. real property interests and 90% or more of the value of the gross assets consists of U.S. real property interests plus cash or cash equivalents.[90] Otherwise, a partnership interest is not currently subject to withholding at all.

Withholding is not required if a transferor provides the transferee with a "certificate of non-foreign status" signed under penalty of perjury.[91] Except when the transferee has actual knowledge that such a statement is false, a withholding agent may rely on the statement. A non-foreign affidavit is not sent to the I.R.S. Instead, it is retained in the transferee's records. It must be kept for five years and must be made available to the I.R.S. upon request.[92] If the buyer is a foreign person, the certificate of non-foreign status obtained when the property was purchased should be retained until the property is sold. A foreign seller asking for a withholding certificate from the I.R.S. must include documentation that all withholding on its purchase of the property was accounted for, and this certificate is that documentation.

A transferor may give the transferee a notice that a nonrecognition provision applies to excuse withholding if the entire gain will be covered by the nonrecognition provision.[93] Partial nonrecognition requires a withholding certificate from the I.R.S. The validity of the affidavit is conditioned on the transferee's mailing a copy to the I.R.S., with a cover letter identifying the transferee, within twenty days after the transfer date.

All other claims of exemption from, or reduction of, F.I.R.P.T.A. withholding are made to the I.R.S. through the mechanism of a withholding certificate application. When a withholding agent receives a withholding certificate application, it is absolutely protected from liability for any unpaid tax, provided the amount specified in the withholding certificate is withheld and the payment requirements are met.[94] In form, a withholding certificate is a letter from the I.R.S. to the applicant stating

---

89 Reg. §1.1445-2(c)(1).
90 Reg. §1.1445-11T.
91 Reg. §1.1445-2(b)(2).
92 Reg. §§1.1445-2(b)(1) and 1.1445-2(b)(3).
93 Reg. §1.1445-2(d)(2).
94 Reg. §1.1445-2(d)(7).

that statutory authority exists to excuse withholding, in whole or in part, and that it may be relied on by the withholding agent.

Because of the absolute protection, withholding certificates may be of interest in situations that do not strictly require them, such as when a nonrecognition provision is claimed. The I.R.S. prefers not to issue certificates when an exemption can be claimed and supported without one, but will issue withholding certificates for a number of reasons.

Revenue Procedure 2000-35, 2000-2 C.B. 211, governs the kinds of certificates that will be issued and the information that must be supplied to get one. The two most common are based on the transferor's tax liability being less than the required amount of withholding tax, as when a net operating loss applies, and on the transferor's agreement to pay tax in a blanket withholding situation where a number of dispositions are planned over a short period. Other categories include installment withholding and secured agreements.

A special form, Form 8288-B, is used for applications in the three most common categories – nonrecognition transfers, maximum tax, and installment sales. For applications that Form 8288-B does not cover, the procedures set forth in Revenue Procedure 2000-35 and Reg. §§1445-3 and 1445-6 should be followed.

A withholding certificate application must be signed under penalty of perjury. A representative can sign it but must submit a power of attorney specifically authorizing the signing. The application must be filed with the Philadelphia Service Center not later than the date of the transaction. Common practice is for the purchaser to establish an escrow account and to deposit the full amount of statutory withholding in the account until such time as the certificate is issued.

In general, the I.R.S. response time is currently 45 days or less for applications in the three categories of certificate for which Form 8288-B is prescribed. The I.R.S. policy is to reply to any application within 90 days of receiving an application. It will advise the applicant by the forty-fifth day after receipt if it cannot respond in this ninety-day period.

V. PARTNERSHIP WITHHOLDING TAX

Where a foreign person operates in the U.S. through a partnership or an entity treated as a partnership for U.S. income tax purposes such as an L.L.C., the general partners of the partnership have an obligation to withhold U.S. income tax on the distributive share of effectively connected income allocated to the foreign partner.[95] The general partners of the partnership – including the officers of a corporate general partner – are jointly and severally liable as withholding agents for the partnership.[96]

95 Code §1446.
96 See Reg. §§1.1446-1 through 1.1446-7.

“The fact that no distribution is made to the foreign partner is not material in abating or reducing the imposition of the withholding tax obligation. As a result, the tax invites problems for partnerships having phantom income.”

The amount of the withholding tax is the highest U.S. tax rate to which a foreign partner may be subject. At present, that rate will be 35% for a partner that is a foreign corporation and 39.6% for a partner that is a foreign individual or a foreign trust. Although labeled a withholding tax, the tax is more aptly thought of as an estimated tax payment. The reason is that the liability arises from the quarterly determination of income at the partnership level. The amounts of the installment payments are determined by applying the estimated tax principles for annualizing income.

The fact that no distribution is made to the foreign partner is not material in abating or reducing the imposition of the withholding tax obligation. As a result, the tax invites problems for partnerships having phantom income.

After the year ends, the foreign partner is required to file a tax return for the year. On that return the partner’s final tax liability is computed. A credit may be claimed by the partner for the withholding tax collected by the partnership.[97] The amount of the credit allocable to the foreign partner is treated as distributed to the partner on the earlier of (i) the day on which the tax was paid by the partnership or (ii) the last day of the partnership's tax year for which the tax was paid, thus reducing the partner's basis in the partnership.[98]

The installment payments are due by the 15th day of the fourth, sixth, ninth, and 12th months of the partnership's tax year.[99] Ordinarily, this is the 15th day of April, June, September, and December. Form 8813 is used to make the quarterly withholding payments.[100]

The partnership reports the aggregate withholding tax liability for effectively connected taxable income for the tax year on Form 8804. At that time, catch-up payments should be made. The withholding tax for each foreign partner is reported on a separate Form 8805.

VI. WITHHOLDING TAX ON NONEFFECTIVELY CONNECTED INCOME

When a U.S. person makes a payment of income to a foreign person, the payor must determine whether the income is subject to withholding tax in the U.S. and, if so, at what rate. For example, if a payment is made to an individual and no Taxpayer Identification Number is provided, the withholding agent must determine whether the proper withholding tax rate is 28% under the back-up withholding tax rules or 30% under the foreign person withholding tax rules. If the latter could apply, the withholding agent may have to determine whether the tax rate is reduced by an applicable income tax treaty or by the Code for items such as interest on items of portfolio indebtedness.

---

97 Code §33.
98 Code §1446(d)(2).
99 Reg. §1.1446-3(d)(1)(ii).
100 Reg. §1.1446-3(d)(1)(i).

A. Interest on Portfolio Debt

An exception to the withholding tax exists for interest payments considered to arise from an item of portfolio indebtedness.[101] Such interest is totally exempt from U.S. withholding tax.

With limited exception, an item of portfolio indebtedness must be in registered format. This does not mean that the exemption applies only to publicly traded securities. Rather, an obligation is in registered form if it meets certain requirements:

- The obligation must be registered as to both principal and interest, and any transfer of the obligation may be accomplished only through the surrender of the old instrument and its re-issuance to the new holder; or

- The right to the principal of, and stated interest on, the obligation may be transferred only through a book-entry system.[102]

In general, a book-entry system is a paperless record of ownership of an obligation where the transfer of ownership of an interest in the obligation is required to be reflected in a book entry, whether or not physical securities are issued. A negotiable instrument would not be in registered form. The position of the I.R.S. is that a promissory note that is "payable to the order of" is not an item of portfolio indebtedness even if the note contains terms that limit the ability to negotiate and transfer the promissory note. This position is generally viewed to be flawed.

To qualify as portfolio interest, the interest on the indebtedness may not be contingent on the business performance of the borrower or a related party.[103] Thus, the amount of the interest may not be calculated by reference to:

- Any receipts, sales, or other cash flow of the borrower or a related person;

- Any income or profits of the of the borrower or a related person;

- Any change in value of any property of the borrower or a related person; or

- Any dividends, partnership distributions, or similar payments made by the borrower or a related person.

There are a few classes of creditors who cannot benefit from the exclusion. First, portfolio interest does not include interest received by a foreign bank in connection with the extension of credit in the ordinary course of its banking business.[104] Second, interest received by a "controlled foreign corporation" (referred to as a "C.F.C.") that is related to the U.S. issuer does not qualify for the portfolio interest exemption.[105] Generally, a foreign corporation is a C.F.C. if shares representing

---

[101] Code §§871(h) and 881(c).
[102] Temp. Regs. §5f.103-1(c).
[103] Code §871(h)(4)(A).
[104] Code §881(c)(3)(A).
[105] Code §881(c)(3)(C).

more than 50% of the voting power or value, are owned by one or more U.S. persons, each of whom owns shares representing at least 10% of the voting power of the foreign corporation.[106] Third, the exemption does not apply to interest paid to a "10% shareholder."[107]

The term "10% shareholder" is defined by the Code. If the borrower is a corporation, a 10% shareholder is any person who owns shares representing 10% or more of the total combined voting power of all classes of stock entitled to vote. If the borrower is a partnership, a 10% shareholder is any person who owns 10% or more of the capital or profits interest in the partnership

A 10% shareholder need not own shares directly in the borrower. Stock ownership is determined after application of attribution rules under which stock owned by one person is attributed to another person.[108] Under the attribution rules:

- An individual is considered to own stock actually owned by his or her spouse, children, grandchildren, and parents.[109] However, stock attributed under this rule cannot be reattributed to other family members.[110] Thus, for example, stock owned by an individual cannot be reattributed to a sister in two stages, *i.e.*, from the individual to the parent and then from the parent to the sister.

- An individual is considered to own his proportional share of stock actually owned by a partnership of which he is a partner, an estate or a trust of which he is a beneficiary, and a corporation of which he is a shareholder.[111]

- A partnership or an estate is considered to own stock actually owned by its partners or beneficiaries.[112]

- A trust is considered to own the stock actually owned by its beneficiaries other than remote contingent beneficiaries whose interest in the trust is valued at 5% or less.[113]

- A corporation is considered to own a pro rata portion of stock in other corporations that is actually owned by its shareholders.[114] The portion is based on the ownership percentage maintained in the corporation that will be considered the owner under these rules.

---

106 Code §957(a).
107 Code §§871(h)(3)(B) and 881(c)(3)(B).
108 Code §871(h)(3)(C). This provision refers to the general attribution rules of the Code which appear in §318 with certain modification.
109 Code §318(a)(1).
110 Code §318(a)(5)(B).
111 Code §318(a)(2) as modified by Code §871(h)(3)(C).
112 Code §318(a)(3)(A)
113 Code §318(a)(3)(B).
114 Code §318(a)(3)(C) as modified by Code §871(h)(3)(C).

> *"It is not uncommon to encounter plans that have been designed to prevent application of the attribution rule through complex ownership arrangements designed to split-off capital investment from voting power."*

- The holder of an option is considered to own the underlying shares.[115] However, stock attributed under this rule cannot be reattributed to or from corporations, partnerships, trusts, or estates.[116]

Except as provided above and in the following sentences of this paragraph, stock attributed from one person to another generally is considered to be actually owned by that individual and may be reattributed to other persons. Notwithstanding anything previously stated, stock attributed to a corporation, partnership, estate, or trust from its shareholders, partners, or beneficiaries cannot be reattributed to other shareholders, partners, or beneficiaries. Thus, stock cannot be attributed in two stages from one shareholder to a second shareholder, *i.e.*, first from one shareholder to the corporation and second from the corporation to a second shareholder.

Similar attribution rules are to be applied if the borrower is a partnership or an L.L.C. In such case, however, the ownership standard is measured on a flow-through basis to the partners or members.

It is not uncommon to encounter plans that have been designed to prevent application of the attribution rule through complex ownership arrangements designed to split-off capital investment from voting power. These types of plans are thought to work best when the split between ownership and voting power has economic substance in the circumstances.

B. Treaty Benefits

As previously mentioned, U.S. tax law imposes a 30% tax on items of fixed and determinable annual and periodic income of a foreign corporation or a nonresident, noncitizen individual.[117] However, the rate of withholding tax may be reduced or eliminated by an income tax treaty obligation of the U.S. Reflecting the fact that an income tax treaty is a contract between two nation states in which the nation states allocate the first right to impose tax to one and ensure that the other provides a form of relief so that income is not taxed twice, each income tax treaty is a unique document. While trends exist among all treaties, each one is unique and must be checked to determine whether and to what extent they reflect the general trends. For example, direct investment dividends are taxed at 5%[118] or in some cases are completely exempt,[119] portfolio investment dividends are taxed at 15%,[120] and interest and royalties[121] are exempt from withholding tax.

---

115 Code §318(a)(4).
116 Code §871(h)(3)(C).
117 Code §§1441 and 1442.
118 See, *e.g.*, Paragraph (2)(a) of Article 10 (Dividends) of the U.K.-U.S. Income Tax Treaty.
119 See, *e.g.*, Paragraph (3) of Article 10 (Dividends) of the U.K.-U.S. Income Tax Treaty.
120 See, *e.g.*, Paragraph (2)(b) of Article 10 (Dividends) of the U.K.-U.S. Income Tax Treaty.
121 See, *e.g.*, Paragraph (1) of Article 11 (Interest) and Paragraph (1) of Article 12 (Royalties) of the U.K.-U.S. Income Tax Treaty.

The benefits provided by income tax treaties contain a safeguard intended to prevent inappropriate claims of treaty tax benefits. The provision is known as the limitation on benefits article of a treaty, and with limited exception, all treaties of the U.S. contain this type of provision. The provision reflects the policy of the U.S. Treasury Department that a treaty's benefits should be limited to qualified investors. The policy ensures that a reduction in U.S. withholding tax should be used only as a means of avoiding actual double taxation. With the exception of dividends that are exempt under a participation provision of foreign law, the United States will not reduce its withholding tax under a treaty if the treaty partner does not impose tax on the receipt of the income. The second goal is that only foreign entities with a strong connection to a treaty partner should benefit from U.S. treaty benefits. This goal is embodied in the limitations on benefits provisions that are part of the U.S. tax treaty negotiating policy.

Several broad themes exist under which a foreign corporation may qualify for treaty benefits. These may be summarized as follows, although it is emphasized that each treaty must be checked in advance because the limitation on benefits provision varies from treaty to treaty:

- Publicly traded companies qualify. Specific tests must be met regarding annual turnover of shares.

- Subsidiaries of publicly traded companies qualify.

- Companies that are primarily owned by resident individuals in that country or owned by U.S. residents or citizens (or a combination thereof) qualify if base erosion is absent. Base erosion means that the corporation is a conduit to residents of third countries so that the tax base in the treaty jurisdiction is eroded by deductible payments to persons not subject to tax in that country or the U.S. This provision is more limited in the case of countries that in the past were gateways to other countries, such as Cyprus, Barbados and The Netherlands, where U.S. ownership is generally not sufficient by itself or in conjunction with local ownership.

- In the context of treaties with European countries, a company owned by a defined class of third country persons (E.U. or N.A.F.T.A.) qualify if a treaty exists with the resident country of the owners and benefits are identical in both treaties.

If a company does not qualify for general treaty benefits, it may, nonetheless qualify with regard to specific streams of income related to an active trade or business carried on in the country of residence that is viewed to be substantial in relation to the U.S. Whether a business conducted outside the U.S. is substantial is determined either under a facts and circumstances basis or in some circumstances under a safe harbor in which the foreign business is roughly 10% of the size of the U.S. business when viewed in terms of income, assets, and payrolls.

In some circumstances, the competent authority of the U.S. will rule that treaty benefits are allowed based on facts and circumstances even if none of the tests are met. This reflects a view that if there is no harm, there is no foul and typically applies if a resident in a treaty jurisdiction forms a company in a second jurisdiction to make an investment and the relevant treaty benefits in the second jurisdiction are not more favorable than the benefits in the treaty with the country of residence of the investor.

> *"Effective July 1, 2014, the Form W-8BEN used by non-U.S. corporations has been superseded by Form W-8BEN-E in connection with the implementation of F.A.T.C.A. rules by financial institutions."*

C. Purpose of W-9 and W-8BEN

If a person makes a payment of U.S.-source interest, dividends, rents, royalties, commissions, non-employee compensation, and other forms of fixed or determinable annual or periodical income, a Form W-9 (Request for Taxpayer Identification Number and Certification) or a Form W-8BEN must be obtained from the payee. These forms provide information from which the payor can determine whether the recipient is an individual U.S. resident or a foreign person. In the former instance, the receipt of Form W-9 officially provides the payor with a taxpayer identification number ("T.I.N.") of the recipient. If a valid W-8BEN is not received, a payment to an individual U.S. resident is subject to 28% back-up withholding. Among other things, the Form W-8BEN advises the payor that the individual is exempt from back-up withholding, is otherwise subject to 30% withholding for payments to foreign persons, and may qualify for a reduced withholding tax rate under a treaty. The forms are retained by the withholding agent and not forwarded to the I.R.S. Effective July 1, 2014, the Form W-8BEN used by non-U.S. corporations has been superseded by Form W-8BEN-E in connection with the implementation of F.A.T.C.A. rules by financial institutions. This is discussed below.

If the payor receives neither a Form W-9 nor a Form W-8BEN, it must make a determination whether back-up or foreign person withholding tax is due. In making that determination, the payee is generally presumed to be a domestic person who is subject to 28% back-up withholding tax.[122] However, this presumption can be overcome in several circumstances.

The first circumstance is that the payment is made to a corporation or other entity exempt from domestic back-up withholding and all of the following facts exist: (i) the payor has actual knowledge of the payee's Employer Identification Number ("E.I.N."), a T.I.N. for entities and businesses, and the number begins with the digit "98;" (ii) communications with the payee are mailed to an address in a foreign country; (iii) the name of the payee indicates that it is on the list of foreign entities that are not eligible to check the box for partnership treatment; and (iv) the payment is made outside the U.S.[123]

The second circumstance is that the payment is generally subject to foreign person withholding tax and is made outside the U.S. to an offshore account. An offshore account is one that is maintained at an office or branch of a U.S. or foreign financial institution located outside the U.S. Payment is considered to be made outside the U.S. if the payee completes the acts necessary to effect the payment outside the U.S.[124]

The final circumstance relates to payments on publicly traded securities. Under so-called "grace period rules," a payor may treat the payee as a foreign person for up to 90 days, even if a valid Form W-8 is not held. The grace period rules apply only to (i) dividends and interest from shares of stock and debt obligations that are actively traded, (ii) dividends from a redeemable security issued by a mutual fund,

---

[122] Reg. §1.1441-1(b)(3).
[123] Reg. §1.1441-1(b)(3)(iii)(A).
[124] Reg. §1.1441-1(b)(3)(ii)(C).

(iii) dividends interest or royalties from units of beneficial interest in a unit investment trust publicly offered and registered with the S.E.C., and (iv) income related to loans of any of the foregoing securities.[125]

For the grace period rules to apply, the payor must have in its possession information indicating that the person is a foreign person. The information may be in the form of an address for the payee in a foreign country, a facsimile copy or a nonqualified electronic transmission the information required to be stated in a Form W-8BEN, or it may be a Form W-8BEN that may no longer be relied upon for a reason other than the lapse of time. The grace period begins for a newly opened account on the date amounts are first credited to an account. The grace period cannot extend beyond the close of the calendar year. It closes automatically when the amount in the account is reduced to 28% or less of all amounts credited to the account during the grace period. In general, information other than a valid Form W-8BEN or Form W-8IMY received by the payor during the grace period cannot be relied upon to reduce foreign person withholding tax. There is one exception. If the Form W-8BEN in the payor's possession is complete and valid but for the fact that it was faxed, the payor may rely on the faxed Form W-8BEN to reduce foreign person withholding tax.

Due diligence obligations are imposed on the withholding agent with regard to each Form W-8BEN received. The withholding agent is responsible for ensuring that all information relating to the type of income covered by the form is complete and appears to be accurate. In that regard, the withholding agent may rely on the information and certifications provided on the form unless actual knowledge or reason to believe otherwise exists. Such knowledge or reason to believe could take the form of information in the possession of the agent that contradicts information provided on the form.

The due diligence standard is relaxed for withholding agents acting in connection with publicly traded securities of a kind mentioned above. For these withholding agents, reason to believe that the Form W-8BEN is erroneous is limited to several circumstances. First, a withholding agent has reason to suspect the veracity of the Form W-8BEN if records in its possession indicate that the permanent address of the recipient is in the U.S. Where such records exist, the recipient must be treated as a U.S. resident unless other information in the possession of the agent supports the claim of nonresidence and that other information is less than three years old. If such other information does not exist, the recipient must be contacted and must provide documentation supporting the statements in the Form W-8BEN.

Second, a withholding agent has reason to suspect the veracity of the Form W-8BEN if the address to which payment is directed is a post office box, an in-care-of address, or a U.S. address. Third, if a Form W-8BEN requests a reduction of foreign person withholding pursuant to the terms of an income tax treaty, a withholding agent has reason to suspect the veracity of the Form W-8BEN if the address to which payment is directed is not in the country with which the treaty exists. Fourth, a withholding agent has reason to suspect the veracity of the Form W-8BEN if (i) the mailing address on the form is in the U.S. or (ii) the beneficial

---

[125] Reg. §1.1441-6(c)(2).

owner notifies you of a new address for mailing or residential purposes and the new address in the U.S., or is a post office box, or is an in-care-of address, or is not in the country with regard to which an income tax treaty benefit is claimed. In each of these circumstances, the withholding agent must obtain a certificate of residence or other documentary evidence issued by a foreign government that contains the individual's name, address, and photograph to support the veracity of the Form W-8BEN. For persons other than individuals, the withholding agent may rely on other evidence to ascertain that the recipient is not a U.S. person, such as articles of incorporation or extracts or a deed of formation.

Finally, a withholding agent has reason to suspect the veracity of the Form W-8 if the form is internally inconsistent regarding the recipient's status such as a corporation, partnership, trust, estate, or individual.

D. Form W-8 BEN

The I.R.S. has published a series of Forms that must be used by persons wishing to reduce or eliminate withholding tax on payments received from U.S. persons.

The first form is the W-8BEN (Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding), which has been discussed above. This is the form that is used by foreign individuals wishing to claim treaty benefits or an exception to the 28% back-up withholding tax for domestic individuals who fail to submit valid social security numbers to certain payors. The form requires full identification of the recipient, including a permanent address other than a post office box, the U.S. taxpayer identification number if required, and a foreign tax identifying number. In addition, the form is used to make the following certifications to the payor of the income:

- The name of the individual that is the beneficial owner (or is authorized to sign for the individual that is the beneficial owner) of all the income to which the form relates;
- The person named on the form as the beneficial owner is not a U.S. person;
- The income to which this form relates is:
    - Not effectively connected with the conduct of a trade or business in the United States,
    - Actually effectively connected but is not subject to tax under an applicable income tax treaty, or
    - A share of a partnership's effectively connected income.

If the person named as the beneficial owner is a resident of the treaty country listed on line 9 of the form (if any) within the meaning of the income tax treaty between the U.S. and that country, the form must specify the article of the income tax treaty which provides the tax benefit, the rate of withholding tax, and the reason why the recipient meets the limitation on benefits article as to the particular item of income.

The Form W-8BEN is used by the beneficial owner of the income. The term "beneficial owner" is defined by reference to the anti-conduit regulations, Reg. §1.881-3. Thus, an "intermediate entity" treated as a "conduit" in a "financing transaction" cannot provide the "financed entity" with a Form W-8BEN as to income it receives.

Where the recipient is fiscally transparent, such as a hybrid entity or a trust, the form W-8 BEN must be obtained by the entity from the beneficiaries (if a trust), or the grantor (if a grantor trust), or its members (if a hybrid entity and certain other tests are met). Those forms are attached to a W-8IMY (Certificate of Foreign Intermediary, Foreign Partnership, or Certain U.S. Branches for United States Tax Withholding).

E. Form W-8BEN-E

In 2010, Congress passed the Hiring Incentives to Restore Employment Act of 2010, P.L. 111-147 (the "H.I.R.E. Act"), which added chapter 4 of Subtitle A ("Chapter 4") to the Code. The intent of F.A.T.C.A. is to export information reporting obligations on foreign financial institutions ("F.F.I.'s") as defined. It is part of a larger scheme that forces F.F.I.'s to agree to several obligations designed to provide the U.S. with information on foreign accounts owned directly or indirectly, entirely or partly by U.S. individuals. A broader discussion of F.A.T.C.A. is beyond the scope of this article. However, the Form W-8BEN-E (Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities)) is used, *inter alia*, to identify[126] whether:

- A foreign corporation is an F.F.I. or a non-financial foreign entity ("N.F.F.E.");
- An F.F.I. is a participating F.F.I. that is registered with the I.R.S. and has undertaken an obligation to have systems in place and properly operating to report its U.S. ultimate beneficial owners and the income and asset flows allocable to those owners;
- An N.F.F.E. is active or passive;
- A passive N.F.F.E. has chosen to report on its substantial U.S. ultimate beneficial owners directly to the I.R.S. instead of reporting that information to U.S. domestic financial institutions and foreign financial institutions. If direct reporting has not been elected, the names of the substantial U.S. ultimate beneficial owners must be provided to U.S. payors and participating F.F.I.'s.

The form is also used to provide information regarding ordinary withholding tax under Code §1441 and entitlement to the benefits of an income tax treaty. In comparison to the Form W-8BEN, the Form W-8BEN-E is eight pages long.

F. Form W-8IMY

The W-8IMY (Certificate of Foreign Intermediary, Foreign Partnership, or Certain U.S. Branches for United States Tax Withholding) is the form that an intermediary

---

[126] It is also used to identify certain subclass of F.F.I. such as deemed compliant F.F.I.'s. However, the other purposes of the form are not relevant here.

submits to the payor of U.S.-source income or gain. An intermediary is any person that acts as a custodian, broker, nominee, trustee, executor, or other type of agent for another person, even if the other person in that intermediary is the beneficial owner of the amount paid. Intermediaries may be either qualified intermediaries or nonqualified intermediaries. An intermediary is a qualified intermediary if it is one of a designated group of intermediaries and has entered into an arrangement with the I.R.S. to withhold and pay-over taxes applicable to payments to members and to provide the I.R.S. with sufficient information to support the appropriate withholding tax rates. The designated group consists of foreign financial institutions or foreign clearing houses, foreign branches of U.S. financial institutions or clearing organizations, foreign corporations for purposes of presenting claims of treaty benefits on behalf of its shareholders, and other persons accepted by the I.R.S. pursuant to Rev. Proc. 2000-12.[127]

The form is also used by foreign partnerships. The partnership may be a withholding foreign partnership or a nonwithholding foreign partnership. The former has entered into a withholding agreement with the I.R.S. in which it agrees to assume primary withholding responsibility for all payments that are made to it for its partners. A withholding foreign partnership is not itself subject to withholding and indicates such status on the Form W-8IMY. If the foreign partnership is a nonwithholding foreign partnership, it must provide Forms W-8BEN or W-8BEN-E of all its partners to the payor of income to the foreign partnership. The payor can use the information to determine the appropriate amount of withholding tax that must be collected on behalf of the beneficial owners. In the context of tiered foreign partnerships, the higher tier foreign partnership is obligated to provide a Form W-8-IMY to the lower tier foreign partnership. The latter includes the form and attached certificates and documentation with its submission to the I.R.S. Note that if some of the beneficial owners claim treaty benefits and others do not, or if the rate of withholding tax differs among beneficial owners, a spread sheet must be attached to the Form W-8IMY that shows the income allocated to each beneficial owner.

Like the Form W-8BEN-E, the Form W-8-IMY has been expanded to provide F.A.T.C.A. information. It, too, is eight pages in length.

G. Form W-8ECI

The I.R.S. also released Form W-8ECI (Certificate of Foreign Person’s Claim for Exemption from Withholding on Income Effectively Connected with the Conduct of a Trade or Business in the United States) and Form W-8EXP (Certificate of Foreign Government or other Organization for United States Tax Withholding).

The W-8ECI replaces Form 4224. It specifically requests that each item of income, that is expected to be received and that will be effectively connected with the conduct of a trade or business in the U.S., must be identified. The principal users of this form will be foreign entities that own real property in the U.S. and receive

127 Rev. Proc. 2000-12, 2000-1 C.B. 387, as supplemented by Announcement 2000-50, 2000-1 C.B. 998, as modified by Rev. Proc. 2003-64, 2003-32 I.R.B. 306.

rental income and U.S. branches of foreign financial institutions that receive interest income and the like from business conducted in the U.S. by the branch.

H. Form W-8EXP

The Form W-8EXP (Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding and Reporting) is used by governments, international organizations, and central banks of issue not wholly-owned by a foreign government. It requires the governmental entity to check a box which specifies the factual reason why the entity is legally entitled to the exemption of U.S. domestic law. The form is designed to ensure that the limitations imposed by Code §892 on the exemption provided to foreign governments are complied with. Under that provision, income of foreign governments derived from commercial activities, or income received by foreign governments from controlled commercial entities, and income received by a controlled commercial entity wholly-owned by a foreign government do not qualify for exemption.

The form W-8EXP has been expanded to address limited F.A.T.C.A. concerns regarding government owned entities. The intent is to ensure that the entity identify the F.A.T.C.A. exemption on which it relies to eliminate F.A.T.C.A. obligations. It is now three pages in length.

VII. STATE TAXES

A full discussion of the application of state taxes to a foreign entity engaged in business in the U.S. is beyond the scope of this paper. Nonetheless, certain items have been problematic on a recurring basis:

- Worldwide income of a foreign entity may have to be apportioned for state income tax purposes. Beyond the fact that this represents "the tail (state tax considerations) wagging the dog (the groupwide tax director located outside the U.S.)," the tax base is not determined by reference to the effectively connected income rules that apply under Federal law.

- Items that are deductible for Federal tax purposes may not be deducted for state tax purposes. A typical example relates to royalty expense paid to a related party outside the U.S. State tax law may treat the royalty payment to a foreign licensee in a way that is similar to a royalty payment to an affiliate in Delaware.

- Income tax treaties of the U.S. do not apply to the various states, except for certain nondiscrimination provisions. Thus, a foreign entity that does not have a permanent establishment in the U.S., and for that reason is exempt from U.S. Federal tax on effectively connected income, may nonetheless be subject to state tax if the foreign entity is conducting business in a particular state.

VIII. CONCLUSION

As U.S. tax provisions applicable to foreign investment in the U.S. become more and more complex, the burdens on tax return preparers have grown concomitantly. The forms that are prepared after the close of the year do not reflect the judgments that must be made throughout the year in classifying income and expenses. This paper has attempted to bridge the gap between compliance and planning for the tax return preparer facing a daunting task.

CORPORATE MATTERS: CONVERTIBLE NOTE FINANCING

Author
Simon Prisk

Tags
Capital Markets
Seed Financing
Start-ups

We have seen an increased number of term sheets for convertible note financings lately and thought it might be helpful to discuss some of the terms and conditions of these notes. In an earlier issue of *Insights*, we discussed angel investing and the risks (and rewards) of that strategy. Convertible note financings are used for seed financing and are a very economical and efficient way for start-up companies to obtain seed capital without losing control of the early-stage company.

CONVERTIBLE NOTE

A convertible note financing is short-term debt that automatically converts into shares of preferred stock upon the closing of a Series A financing round. This method of financing is favored by company founders because it can be completed very quickly, is somewhat simple, and is relatively inexpensive in terms of legal costs. A convertible note purchase agreement and note can be a few pages long and prepared and closed in a few days.

While start-up companies can issue common stock to early investors, there are a variety of reasons why the founders may be reluctant to do so. These include the difficultly in putting a value on an early stage company and potential tax issues for founders issued stock at nominal values. Because convertible notes are debt not equity, their issuance puts off the valuation matter until the later round of financing – by which time the company may have developed to an extent where more and better information is available on which to base a valuation.

INTEREST

Typically the convertible note provides for simple interest (not compounded) on the amount of the loan in the 5% to 8% range. Most notes we have reviewed recently have included 6% interest, and that seems to be the current market rate. The interest rate on these notes is less important, as it is unusual for the notes to actually be repaid. Rather, they are converted into preferred stock upon the Series A round, and the benefit to the investor is the conversion discount negotiated when the loan was negotiated. It is unusual for these convertible notes to allow for prepayment by the company because the last thing an investor wants is, after taking considerable risk, to be repaid one year later at a 6% interest rate.

CONVERSION DISCOUNT

The conversion discount is essentially the reward to note-holders for their investment risk by allowing them to convert the amount of the loan plus interest at a discount from the purchase price paid by the Series A investors.

The current market discount rate appears to be 20%, and this rate can be negotiated with the company. It should be noted that a rate that is too high can turn off potential investors at a later time. A note can also include a conversion discount that increases over time. The logic being that the longer the note is outstanding the higher the risk that the Series A round will not take place.

WARRANTS

Investors will sometimes request the issuance of warrants in lieu of the conversion discount. Company founders involved in a seed round will resist this, as it involves increased legal fees, and it appears that the conversion discount is by far the most common way to reward investors for their risk.

VALUATION CAP

A conversion valuation cap allows investors to benefit from any significant increase in the value of the start-up company subsequent to their investment. A "cap" is not a valuation but a negotiated term of the note, and different investors in the same company may have different cap amounts.

A cap is a ceiling on the value of the start-up where the company sets a maximum dollar amount for purposes of determining the conversion price, which permits investors to convert their loan, plus interest, at a lower price than the purchase price paid by the Series A investors.

If the note includes both a discount and a cap, the agreement will usually provide for the conversion price to be the lower of (i) the price per share determined by applying the discount to the Series A price per share and (ii) the price per share determined by dividing the cap by the Series A pre-money value. The reason for this approach being the lower the conversion price, the more shares the note-holders are issued upon conversion.

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

Authors
Philip Hirschfeld
Galia Antebi

Tag
F.A.T.C.A.

FOREIGN FINANCIAL INSTITUTIONS: WHO DEALS WITH THE I.R.S. ON F.A.T.C.A.?

On August 1, the Internal Revenue Service ("I.R.S.") clarified in its F.A.T.C.A. Frequently Asked Questions ("F.A.Q.") that the I.R.S.'s main contact with a foreign financial institution ("F.F.I.") will be the "responsible officer" identified under Question 10 of the registration form (*i.e.,* Form 8957, which should be completed on the I.R.S. F.A.T.C.A. portal and not in paper form). However, the I.R.S. reiterated that the responsible officer can authorize as many as five additional points of contact to receive F.A.T.C.A.-related information regarding the F.F.I. and to take other F.A.T.C.A.-related actions on behalf of the F.F.I.

Additionally, the responsible officer will receive an automatic e-mail notification to check the F.F.I.'s F.A.T.C.A. message board when certain messages are posted. For example, when the F.F.I.'s registration status changes, the responsible officer will receive an e-mail notification. Such e-mail notifications will include the last several characters of the F.F.I.'s F.A.T.C.A. identification number so that the officer can identify which F.A.T.C.A. account is being referred to. If no e-mail notifications are received, the responsible officer must verify that the e-mail address entered in Question 10 of the registration form is correct, as well as ensure that their spam blocker is not preventing e-mail notifications from getting through. Note that the responsible officer can only list one e-mail address on Question 10 of the registration form.

I.R.S. LIST OF REGISTERED F.F.I.'S

On August 1, the I.R.S. also updated its F.A.Q. on the list of registered F.F.I.'s. ("F.F.I. List"). The I.R.S. stated that it is possible that an F.F.I. that appears in the search tool on the I.R.S.'s website will not appear in a downloaded F.F.I. List in C.S.V. format.

Because some C.S.V.-compatible spreadsheet and database applications may only display a maximum number of records, an F.F.I. that is located on the list beyond that maximum limit may not be seen. To address this problem, the I.R.S. suggests that taxpayers try to use another spreadsheet and database application or text editor to open the downloaded C.S.V. file.

F.A.T.C.A.'S IMPACT ON A QUALIFIED INTERMEDIARY OR WITHHOLDING FOREIGN PARTNERSHIP OR TRUST

The I.R.S. F.A.T.C.A. F.A.Q. has also been updated on Qualified Intermediaries, Withholding Foreign Partnerships and Withholding Foreign Trusts. Beneficial owners serving on behalf of an intermediary, partnership, or trust may find it advantageous to become a Qualified Intermediary ("Q.I."), Withholding Foreign Partnership ("W.P."), or Withholding Foreign Trust ("W.T."), since holding such status may lower the U.S. withholding taxes imposed on those beneficial owners. The I.R.S. states that although F.A.T.C.A. has affected this area and there is a new set of Q&A's addressing this, the process of becoming a Q.I., W.P., or W.T. has not been hanged by F.A.T.C.A.

Q.I., W.P., or W.T. status can only be obtained by completing and submitting a Form 14345 ("Q.I. Intermediary Application") and Form SS-4 ("Application for Employer Identification Number") directly to the Q.I. Program. Interested Q.I.'s, W.P.'s, or W.T.'s should submit the required paperwork to the Q.I. program and separately use the F.A.T.C.A. registration portal to obtain a G.I.I.N. for F.A.T.C.A. purposes. F.F.I.'s cannot become a new Q.I., W.P., or W.T. through the F.A.T.C.A. portal.

Existing Q.I.'s, W.P.'s, and W.T.'s are required to renew their Q.I. agreements through the F.A.T.C.A. registration website as part of their F.A.T.C.A. registration process. All Q.I., W.P., or W.T. agreements that would otherwise expire on December 31, 2013 were automatically extended until June 30, 2014. If renewal has not yet been sought, it should be requested as soon as possible.

OTHER JURISDICTION F.A.T.C.A. REGIMES

F.A.T.C.A. is no longer just a U.S. tax law concept. The U.K. has adopted its own F.A.T.C.A.-type legislation whose purpose is to discover the U.K. taxpayers who may be holding their money outside the U.K. The Isle of Man, which is on the U.S. list of I.G.A.'s, was the first country to sign an intergovernmental agreement with the U.K. that deals with U.K. taxes. We expect that other countries may follow the lead of the U.S. and the U.K. and may use the U.S. F.A.T.C.A. regime as a model for what they may adopt.

FURTHER I.G.A. UPDATES

While several dozen F.A.T.C.A. Inter-Governmental Agreements ("I.G.A.'s") have been signed, an I.G.A. is only the first step for each of those countries to become F.A.T.C.A. compliant. The next step is for the country to release regulations or guidance on how F.A.T.C.A. is to be applied in that country. While the F.A.T.C.A. regulations may be utilized as a model for what may be done, each country has its own unique I.G.A. and its own internal views on what should be done that will shape that guidance. It should be noted that the implementation legislation must be in line with the signed I.G.A. and may not frustrate the purpose of the I.G.A.

This last month, the British Virgin Islands released a draft of their proposed guidance notes for dealing with F.A.T.C.A. under their I.G.A. A few countries, such as the U.K., Canada, and the Cayman Islands, have come out with draft guidance notes, but this process is just beginning. Every F.F.I. in an I.G.A. country will have to keep track of this.

At this time, the countries that are Model I I.G.A. partners by execution of an agreement or concluding an agreement in principle are:

Algeria
Anguilla
Antigua & Barbuda
Australia
Azerbaijan
Bahamas
Bahrain
Barbados
Belarus
Belgium
Brazil
British Virgin Is.
Bulgaria
Cabo Verde
Canada
Cayman Islands
China
Colombia
Costa Rica
Croatia
Curacao
Cyprus
Czech Republic
Denmark
Dominica
Dominican Republic
Estonia
Finland
France
Georgia
Germany
Gibraltar
Greenland
Grenada
Guernsey
Guyana
Haiti
Honduras
Hungary
India
Indonesia
Ireland
Isle of Man
Israel
Italy
Jamaica
Jersey
Kosovo
Kuwait
Latvia
Liechtenstein
Lithuania
Luxembourg
Malaysia
Malta
Mauritius
Mexico
Montenegro
The Netherlands
New Zealand
Norway
Panama
Peru
Poland
Portugal
Romania
Qatar
Saudi Arabia
Serbia
Seychelles
Singapore
Slovak Republic
Slovenia
South Africa
South Korea
Spain
St. Kitts & Nevis
St. Lucia
St. Vincent & the Grenadines
Sweden
Thailand
Turkey
Turkmenistan
Turks & Caicos
Ukraine
United Arab Emirates
United Kingdom
Uzbekistan

The countries that are or will soon become Model II I.G.A. partners are: Armenia, Austria, Bermuda, Chile, Hong Kong, Iraq, Japan, Moldova, Nicaragua, Paraguay, San Marino, Switzerland, and Taiwan.

The list of countries having an I.G.A. keeps on growing, with the only limit being the number of countries in the world.

UPDATES AND OTHER TIDBITS

Authors
Robert Rinninsland
Cheryl Magat
Kenneth Lobo
Sofia Glotsberg

Tags
Accounting Methods
Corporate Inversions
Corporate Tax
Disregarded Entities
Insourcing
N.I.I.T.i.t
Net Investment Income
O.V.D.P.
Streamline
Transfer Pricing

KENNETH WOOD NAMED ACTING DIRECTOR OF I.R.S. TRANSFER PRICING OPERATIONS

On July 24, the I.R.S. selected Kenneth Wood, senior manager in the Advance Pricing and Mutual Agreement Program, to replace Samuel Maruca as acting director of Transfer Pricing Operations. The appointment took effect on August 3, 2014. We previously discussed I.R.S. departures, including those in the Transfer Pricing Operations, here.

To re-iterate, it is unclear what the previous departures signify—whether the Large Business & International Division is being re-organized, or whether there are more fundamental disagreements on how the Base Erosion and Profit Shifting ("B.E.P.S.") initiative affects basic tenets of international tax law as defined by the I.R.S. and Treasury. Although there is still uncertainty about the latter issue, Ken Wood's appointment seems to signify that the Transfer Pricing Operations' function will remain intact in some way.

CORPORATE INVERSIONS CONTINUE TO TRIGGER CONTROVERSY: PART I

President Obama echoed many of the comments coming from the U.S. Congress when he recently denounced corporate inversion transactions in remarks made during an address at a Los Angeles technical college. As we know, inversions are attractive for U.S. multinationals because as a result of inverting, non-U.S. profits are not subject to U.S. Subpart F taxation. Rather, they are subject only to the foreign jurisdiction's tax, which, these days, is usually lower than the U.S. tax. In addition, inversions position the multinational group to loan into the U.S. from the (now) foreign parent. Subject to some U.S. tax law restrictions, interest paid by the (now) U.S. subsidiary group is deductible for U.S. tax purposes with the (now) foreign parent booking interest at its home country's lower tax rate.

"Inverted companies" have been severely criticized by the media and politicians as tax cheats that use cross-border mergers to escape U.S. taxes while still benefiting economically from their U.S. business presence. This has been seen as nothing more than an unfair increase of the tax burden of middle-income families.

The latest legislative proposals to "combat" inversion are being developed by Rep. Sander Levin (D-Mich.). Rep. Levin's bill will focus on certain aspects of the anti-inversion section currently in the tax law, Code §7874, with a retroactive effective date of May 8th. As to the outbound transaction itself, the bill would limit continuous ownership of the newly inverted company by former shareholders or partners in the original domestic business, treating the new company as domestic for tax purposes if those owners hold more than 50% interest. A merged company would be treated as domestic if management and control of the merged company remained in the U.S. and if 25% of its employees, employee compensation, income, or assets were located or derived in the U.S.

With respect to the inbound loan to the U.S., the bill would limit deductibility of interest for U.S. tax purposes by (i) repealing any safe harbor debt-to-equity ratio (currently 1:5-1:0), (ii) reducing the permitted net interest expense to no more than 25% (from 50%) of the entity's adjusted taxable income (essentially E.B.I.T.D.A.), and (iii) limiting the carryforward of excess interest to five years from the current unlimited carryforward period.

In addition, Rep. Levin's bill will amend Code §956 to include in the Subpart F definition of earnings invested in U.S. property accumulated earnings lent by C.F.C.'s to non-C.F.C. foreign affiliates where the latter use the funds to make investments into the U.S. without incurring tax at the shareholder level. This would be done by expanding Code §956 to require that stock and debt obligations of non-C.F.C. foreign affiliates held by C.F.C.'s trigger current U.S. income taxes to U.S. shareholders.

Given the difficulty of Congress to pass legislation of any substance, and the perceived urgency of the inversion issue, Stephen Shay, a former senior U.S. Treasury Department Official, has suggested that the President could invoke Code §385, which has been in the Internal Revenue Code since 1969 and grants Treasury the regulatory authority to determine when a financial instrument can be treated as debt. To the extent pending inversion transactions anticipate net tax benefits from loans back into the U.S., Mr. Shay may have a point. Code §385 remains essentially dormant today. Regulations were drafted at one point but later withdrawn.

The issue that is faced by the President in pursuing Mr. Shay's suggestion in the current political environment would be whether this would be considered another example of "executive overreach." Query whether the perceived urgency of the inversion situation would offset this concern.

CORPORATE INVERSIONS CONTINUE TO TRIGGER CONTROVERSY: PART II

In what would be an embarrassing disclosure for persons other than opinionated politicians, it was publicized in August that the Obama Administration assisted a Michigan company in a corporate inversion as part of the auto industry bailout. In 2009, the Treasury Department authorized spending $1.7 billion to assist Delphi Automotive, a Michigan parts-maker integrated with Chrysler Corporation, to reorganize as a British company, Delphi Automotive PLC. As reported by the Wall Street Journal, executives continue to run Delphi Automotive PLC from Detroit, but it runs a plant in England, potentially reducing the company's U.S. tax liability by as much as $110 million a year. Although Rep. Sander Levin remained silent on the inversion of the Michigan company, President Obama is blaming smart accountants who apparently think too much.

The Obama Administration is now trying to rescind the tax benefits of the Delphi deal that it helped facilitate. In June, the I.R.S. told Delphi that the inversion should be disregarded for tax purposes through the application of Code §7874; a securities filing reports that the company will vigorously contest the I.R.S. position.

I SAY INSOURCING; YOU SAY OUTSOURCING - LET'S CALL THE WHOLE THING OFF

"The Bring Jobs Home Act (S. 2569) is a Democrat-sponsored proposed legislation designed to give companies a tax incentive to relocate jobs to the U.S. and a penalty for moving jobs elsewhere."

The Bring Jobs Home Act (S. 2569) is a Democrat-sponsored proposed legislation designed to give companies a tax incentive to relocate jobs to the U.S. and a penalty for moving jobs elsewhere. The measure would offer a 20% tax credit to companies that relocate jobs to the U.S., while denying deductions to companies that move jobs away from the U.S. It mimics a bill by Sen. Debbie Stabenow.

Republicans had vowed amendments on tax-related issues, including one to repeal the Affordable Care Act's excise tax on medical devices, which Senate Majority Leader Harry Reid (D-Nev.) has said he wants to protect. Republicans also called for amendments on non-tax matters, environmental, and others. Senator Reid finally avoided formal consideration of the Republican amendments to the bill but could not obtain the 60 votes necessary to end debate and bring the bill to a Senate vote. Accordingly, it appears at least for now, the bill will not get out of the Senate.

L.L.C. CAN CONDUCT BUSINESS SEPARATE FROM ITS OWNER DESPITE DISREGARDED STATUS

The I.R.S. recently indicated that a limited liability company ("L.L.C.") treated as a disregarded entity with respect to its sole member company may conduct a separate and distinct business that is eligible to elect its own method of accounting.

Code §446(d) allows a choice of an accounting method at the trade or business level. A factual determination is made to determine whether a business or trade is separate. Thus, the fact that the L.L.C. failed to make an election to be treated as a corporation (and is disregarded as an entity separate from the corporation for federal income tax purposes), does not signify that the L.L.C. cannot be a separate and distinct trade or business. This is true even if the management of both the sole member company and the L.L.C. are the same. In our view, this ruling may have wider application and taxpayer benefits than one would think. It accepts the commercial reality that different businesses do have different financial metrics by which they operate. The ruling is important from that perspective in that it does not impose an artificial barrier against aligning business financial metrics with tax reporting.

UNRESOLVED QUESTIONS ABOUT THE NET INVESTMENT INCOME TAX ("N.I.I.T.") ADDRESSED

Our firm wrote about the N.I.I.T. in *Insights, No. 1*, *Volume No. 1,* which can be read here. Our firm also presented this topic at the annual CA Professional Seminars in December 2013, in Toronto, Canada.

As 2013 was the first year that the N.I.I.T. was in effect, practitioners were unsure how to allocate expenses and calculate deductions with regard to trusts and estates that paid the N.I.I.T, specifically where income and deductions that were excluded from one tax base were not excluded from another. Practitioners that were accustomed to estimating tax payable due to the distributable net income ("D.N.I.") regime are finding that using those same procedures to calculate N.I.I.T. could lead to erroneous results.

Dual Tax Base

For a domestic trust or estate, the 3.8% tax is assessed on the lesser of undistributed net investment income or the amount of adjusted gross income ("A.G.I.") above a threshold amount, creating a dual system. Due to the dual system, there is a possibility that a trust or estate may not have taxable income, but may still have an N.I.I.T. liability. According to the I.R.S., this anomaly occurs because not all deductions a trust could use to eliminate its taxable income would be deductible under the N.I.I.T. regime. N.I.I.T. deductions are limited to specifically enumerated items.

Excess Deductions

Another anomaly occurs when a terminating trust allocates excess deductions but still has an N.I.I.T. liability. This result would ensue if a trust had non-N.I.I. expenses which were deductible in arriving at adjusted gross income, but would not be deductible against the N.I.I.T. while also having miscellaneous itemized deductions subject to the 2% floor. The N.I.I. would be higher than the A.G.I. because the non-N.I.I. expenses would not be deductible. When the 2% deductions are taken into account, both the N.I.I. and the trust's taxable income would be reduced, but the A.G.I. would not be, resulting in the possibility that the trust's N.I.I.T. and the A.G.I. would have two separate tax liabilities.

It is also possible to have an N.I.I.T. liability when it recovers a prior year deduction that is included in N.I.I. but not taken into account for taxable income purposes. This irregularity occurs if the trust/estate also has a large amount of miscellaneous itemized deductions. The 2% deductions may reduce N.I.I. and taxable income, but will not change the A.G.I. Consequently, the recovery would cause the N.I.I. to be calculated higher than the taxable income.

Allocating Expenses – Uniform Manner

The I.R.S. has signaled that trusts can allocate expenses to both N.I.I.T. and N.I.I. excluded income in any "reasonable manner." However, the I.R.S. asks practitioners to allocate expenses in the same uniform manner for regular income tax and for the N.I.I.T. The I.R.S. has indicated that practitioners cannot "re-do" their allocations for N.I.I.T. purposes. They must allocate expenses in the same manner for regular tax purposes as for N.I.I.T. purposes.

Usually, a practitioner desires to allocate expenses against the highest taxed income, but the practitioner may have high tax rate income that is excluded from net investment income. In that case, the practitioner might wish to allocate all the deductions to the N.I.I. for N.I.I.T. purposes, but not necessarily for regular tax purposes.

Material Participation

There is increased discussion as to whether a trust's income can be treated as non-passive/passive (and the N.I.I.T. can be avoided), when a trustee, acting in her fiduciary duty, has materially participated in a business. The issue is whether the material participation tests that are applied to individuals should apply for trusts and estates as well. The I.R.S. is concerned that this would make it "easier" for trusts and estates to qualify for material activity.

"Several recent court rulings have held that fiduciaries can rely on non-fiduciary activities to be active involvement in a business."

Although the I.R.S. only allows a trustee acting to carry out fiduciary duties to be deemed as material participation, several recent court rulings have held that fiduciaries can rely on non-fiduciary activities to be active involvement in a business. Therefore, it may be possible for trustees and executors to argue that he/she/it is materially participating through employees or agents, and that the trust or estate is not subject to the N.I.I.T.

Aggregation Allowed

Another divisive issue is whether a trustee can aggregate materially active house on all trusts, or whether a trustee will have to materially participate for 500 hours for each trust.

CERTIFYING THAT CONDUCT IS NON-WILLFUL IN STREAMLINED O.V.D.P MAY FACE ADDITIONAL RISKS

In general, the Offshore Voluntary Disclosure Program ("O.V.D.P") allows taxpayers to disclose overseas assets to the I.R.S. in exchange for a set penalty (currently 27.5%) and the chance to avoid criminal prosecution. In June, the agency unveiled streamlined procedures with a penalty of 0 to 5% for taxpayers who can certify that their conduct wasn't willful. Our firm reported about this change in our client advisory which can be read here.

The I.R.S. has advised that tax advisors should be wary when advising clients to certify that they were not willfully concealing funds overseas under the streamlined provision. The low penalty for non-willfulness may entice O.V.D.P participants to assert non-willfulness in all situations in a bid to obtain the low penalties. The I.R.S. has reminded practitioners of their responsibilities in this regard.

Taxpayers who enter the streamlined version of the O.V.D.P. have no relief from criminal prosecution. With the new change, a risk exists where the client may accuse the professional of counseling that the taxpayer had little risk of criminal prosecution, and nevertheless, the I.R.S. has decided to proceed with criminal prosecution against the taxpayer. Consequently, professionals should be wary of advising on “willfulness” and “non-willfulness.” Firms would be well served by developing a robust internal procedure to make determinations of willfulness versus non-willfulness for O.V.D.P. clients.

TRACKING SUBSTANTIAL PRESENCE – THERE’S AN APP FOR THAT

Recent advances in modern technology are enabling non-residents of the United States to avoid being overtaxed for their time spent abroad.

Non-residents of the United States must exercise caution when travelling to the U.S. at the risk of establishing a taxable presence in the country. Non-residents must track their stay in the United States in accordance to the I.R.S. Substantial Presence Test and, in New York, in accordance with the N.Y.S. and N.Y.C. Domiciliary and Statutory Residency Tests.

U.S. Residency

The I.R.S. establishes federal residency under the Substantial Presence Test by calculating the number of days a person has been in the U.S. and then attributing residency if the following criteria is met:

1. He or she has been present in the U.S. for at least 31 days of the current year, and

2. He or she was present in the U.S. for 183 days during a three-year period comprised of the current year and the two years directly prior, counting the days in the U.S. as follows:

    a. Each day present in the U.S. during the current year;

    b. 1/3 of the days present in the U.S. in the previous year; and

    c. 1/6 of the days present in the U.S. two years before the current year.

All individuals travelling abroad to the United States are required to file Form I-94 with the Department of Homeland Security, which enables the government to track a foreign individual’s stay in the country. Travelers are also given access to this information. By going on the website of the Department of Homeland Security, one can input their passport number, date of birth, social security number, and country of origin to view their travel history.

State Residency

In addition to the federal Substantial Presence Test, every state has its own rules for determining residency status. In New York State, for instance, to be considered a resident, one must have a domicile or a permanent place of abode in New York State.

As per the definitions set by the New York State Department of Taxation and Finance, a "domicile" is defined as:

- The place one has that is intended as a permanent home;
- The location of one's permanent home; and
- The place where one intends to return after a being away for any length of time.

A "permanent place of abode" is defined as:

- A place that one maintains, not contingent upon its usage; and
- A place that is equipped for use year-round.

Smartphone Application

Pursuant to the stringency of I.R.S. regulations for determining residency status for tax purposes, a smartphone application has been developed to enable non-U.S. residents to track their days in the U.S. The idea for the application, "Monaeo," was born in 2010 when co-developer Anupam Singhal started to file his tax returns and realized that he owed taxes to many jurisdictions and did not have an efficient way of tracking all his travels. Launched on January 12, 2012, this application provides users with a GPS-based tool to track their stay abroad down to the minute so as to avoid any unnecessary tax payments.

Potential misuse of the application can arise, however, when individuals track time spent in a location when they were not actually present there (*i.e.*, the smartphone travels but not the individual). Future versions of this application might necessitate a feature whereby the user must confirm his/her identity and location to start tracking days in the United States.

IN THE NEWS

AS SEEN IN…

Stanley C. Ruchelman's article entitled "Neutralizing the Effects of Hybrid Mismatch Arrangements: The New OECD Discussion Drafts Regarding Base Erosion and Profit Shifting" was published in the May/June 2014 edition of the *Journal of Taxation and Regulation of Financial Institutions*.

A monograph by Stanley C. Ruchelman and Rusudan Shervashidze, "Exchanges of Information: What Does the IRS Receive? With Whom Does the IRS Speak?", was recently published in the noted European international taxation review *Intertax*. The article explores the ways in which information is submitted to the I.R.S. and the available avenues for information exchange between the I.R.S. and tax authorities in other jurisdictions.

Stanley C. Ruchelman continues his participation in the Practising Law Institute's *Corporate Tax Practice Series* as author of the 2014 edition of "Outbound Acquisitions: European Holding Company Structures." The treatise includes a comprehensive assessment of various holding company regimes with contributions from 16 jurisdictions.

OUR RECENT AND UPCOMING PRESENTATIONS

On June 5, 2014, Nina Krauthamer lectured on "International Estate Planning – The Basics." The workshop took place at New York Law School and addressed 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 served 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 discussed recent court decisions from Europe, Latin America, and the United States and the impact of those decisions on tax planning and compliance efforts.

On July 1, 2014, Nina Krauthamer participated in a Strafford Webinar, "Foreign Investment in U.S. Real Property: Tax Issues." She also presented a lecture on July 8, 2014, "Understanding Foreign Investment in U.S. Real Estate," as part of the two-day BNA Bloomberg seminar on *Current U.S. Tax Planning for Foreign-Controlled (Inbound) Companies.*

On July 25, 2014, Philip Hirschfeld spoke at New York University's *Advanced International Tax Institute*. The presentation, entitled "Foreign Persons Investing in U.S. Real Estate and Other Assets: Partnership and Other Structures, Treaty Planning and Financing Strategies," focused on tax-efficient structuring for non-U.S. persons investing in U.S. income producing and personal use real estate. It also addressed foreign investors looking to acquire U.S. mortgage debt and direct investment, as well as investment made in holding entities.

On August 10, 2014, Philip Hirschfeld, participated in the panel "Planning for Foreign Persons Investing in U.S. Real Estate" at the 2014 ABA Annual Meeting in Boston. The panel focused on planning tips on how to structure an investment in U.S. real estate by a foreign investor in a tax efficient manner and foreign investors acquiring or originating U.S. mortgage debt.

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.

Disclaimers

Contacts

If you have any questions regarding this newsletter, please contact the authors or one of the following members.

NEW YORK

150 EAST 58TH STREET, NEW YORK, NY 10155

Stanley C. Ruchelman	ruchelman@ruchelaw.com	+1. 212.755.3333 x 111
Robert G. Rinninsland	rinnisland@ruchelaw.com	+1. 212.755.3333 x 121
Nina Krauthamer	krauthamer@ruchelaw.com	+1. 212.755.3333 x 118
Simon H. Prisk	prisk@ruchelaw.com	+1. 212.755.3333 x 114
Andrew P. Mitchel	mitchel@ruchelaw.com	+1. 212.755.3333 x 122
Philip Hirschfeld	hirschfeld@ruchelaw.com	+1. 212.755.3333 x 112
Galia Antebi	antebi@ruchelaw.com	+1. 212.755.3333 x 113
Alev Fanny Karaman	karaman@ruchelaw.com	+1. 212.755.3333 x 116
Rusudan Shervashidze	shervashidze@ruchelaw.com	+1. 212.755.3333 x 126
Jennifer Lapper	lapper@ruchelaw.com	+1. 212.755.3333 x 124

TORONTO

130 KING STREET WEST, SUITE 2300 P.O. BOX 233

Edward C. Northwood	northwood@ruchelaw.com	+1. 416.350.2026
Kenneth Lobo	lobo@ruchelaw.com	+1. 416.644.0432

Editors

Stanley C. Ruchelman
Jennifer Lapper
Francesca York

Design Team

Kyu Kim

*Photos used in this issue were taken by Stanley C. Ruchelman