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TAX EVASION INDIAN STYLE: CRIMINAL OR CIVIL OFFENSE?

Judicial authorities in India are recommending that the country adopt a similar position as the United States with respect to offshore bank accounts. While investigating the "black money" held in undeclared Swiss bank accounts by 628 wealthy Indians, two of the judges recommended that tax evasion should constitute a criminal offense and not simply a civil one.

The scandal has been at the forefront of both political discussion and legal debate since there is a fine line that is being straddled between disclosing and punishing these tax evaders versus violating the confidentiality clause from the Indian-Swiss tax treaty. According to the treaty, these account names can only be revealed once charges identifying the specific individual have been filed.

In India, "black money" has always been an obstacle to tax collection. Black money constitutes undeclared income that has been "hidden," profits from the undervaluation of exports, and earnings from fake invoices or unaccounted-for goods. Black money not only affects the national treasury, but has fueled corruption, too. According to the judges, classifying tax evasion as a criminal offense, and dealing with these lawbreakers more strictly should serve as a deterrent.

HAND IT OVER, MICROSOFT?

In conjunction with its audit of Microsoft's cost-sharing transfer pricing methods for the 2004-2006 tax years, the I.R.S. has filed a petition for enforcement of an issued summons for 50 types of documents, including those relating to marketing, R&D, financial projections, revenue targets, employees, studies, and surveys.

Microsoft's business is split into three regions: (i) Europe, Middle-East and Asia; (ii) Asia-Pacific; and (iii) the U.S., Canada and Latin America. The I.R.S. is investigating the cost-sharing arrangements in the latter two regions, with affiliates in Bermuda and Puerto Rico, respectively.

The cost-sharing arrangement with the Puerto Rican affiliate divided rights to technology intangibles, such as software code, from rights to non-technology intangibles, such as brands, trademarks, and customer or partner relationships in the Americas. Microsoft retained the rights to the non-technology intangibles and treated the Puerto Rican affiliate as the economic owner of the technology intangibles. It paid the affiliate a portion of its revenues from its American retail business based on the relative share of profit that it allocated to its technology *vis-à-vis* the non-technology intangibles.

The cost-sharing arrangement with the Bermuda affiliate treated it as the economic owner of all intangibles supporting that business. However, the compensation due from the affiliate to Microsoft was based on the assumption, consistent with the Puerto Rican cost-sharing arrangement, that Microsoft had owned only a fraction of the covered non-technology intangibles.

This division of intangibles rights, the IRS noted, didn't occur in the other cost-sharing arrangements. Thus, it argued, there was a material, unjustified discrepancy in the amount the regions paid for the transfer and use of property rights needed to run the businesses. To the extent this discrepancy was a result of the forecast and projection methods used, the I.R.S. requested what it felt to be all relevant documentation regarding these forecast and projection methods.

The I.R.S. issued the summons in October. Microsoft had until November to comply, but objected, saying that the summons was "impermissibly vague, overbroad and burdensome." As such, Microsoft alleged that the summons constituted an abuse of process and violation of its right to privilege. Accordingly, it decided to instead review each item before handing it over in order to ensure that privilege wasn't broken.

Besides the possible multi-billion dollar penalty that may be imposed upon Microsoft, this case presents another all-encompassing and potentially game-changing issue.

This matter has attracted a lot of attention because the I.R.S. has outsourced the case to a private law firm, Quinn Emanuel Urquhart & Sullivan L.L.P. This groundbreaking move not only evidences the I.R.S.'s determined resolve to pursue such matters, but has also cost the taxpayers USD$2,185,000 in legal bills. It should come as no surprise that Microsoft has filed a Freedom of Information Act request that would not only reveal the intentions of the I.R.S. towards Microsoft, but also shed light on how far the I.R.S. is willing to go to crack down on tax evaders. The only question that remains is whether hiring a private entity to carry out a traditionally government role blurs the line between private and public functions.

TAX REVENUES REBOUND IN THE O.E.C.D.

Reflecting the worldwide economic recovery from the global recession, a December 2014 O.E.C.D. report indicates that tax burdens relative to gross domestic product and related tax revenue collections have generally been increasing over the past few years, reaching pre-global crisis levels.

With an average tax burden increase of 0.4% compared to 2013, tax burdens across countries have ranged from as high as 48.6% to as low as 19.7%, with some countries showing a slower growth rate than others.

The O.E.C.D. attributed most of this tax revenue growth to personal and corporate income taxes and discretionary tax changes such as V.A.T. rate increases as well as some tax base broadening. Directly aligned with increases in levels of income, these personal, corporate, and V.A.T. taxes rapidly raised revenues during the recent periods of economic growth. An interesting by-product of the report was confirmation that broadening the tax base and offering tax credits led to a greater increase in revenue than reducing rates and offering exemptions.

RETRAINING DOMESTIC EXAMINERS

In an effort to better prepare their auditors and enable them to accurately identify applicable risks, the I.R.S. has decided to re-train their domestic examiners by teaching them how to examine international issues, as well.

An initial 50 PowerPoint training documents will be made public. These documents are part of the materials used by the examiners that will train them in unfamiliar areas.

A shortage of resources means that not all cases will be held on equal footing. A risk-based approach will be used when examining cases, which will allow the I.R.S. to prioritize those matters posing the most exposure. Rather than the quantitative amount of tax revenue involved, matters will be given weight based on the significance of the issue involved.

YOU'VE SENT MAIL

While investigating online narcotics trafficking, the I.R.S. stumbled upon information revealing that U.S. taxpayers were using Sovereign Management & Legal Ltd. to help maintain and conceal their foreign assets. Based on this information, a U.S. district court authorized the I.R.S. to serve eight shipping and financial service providers with open-ended, non-specific "John Doe" summonses to identify the U.S. taxpayers that have used Sovereign's services.

The eight service providers served are Federal Express Corporation, DHL Express, United Parcel Service Inc., Western Union Financial Services Inc., the Federal Reserve Bank of New York, Clearing House Payments Company LLC and HSBC Bank USA National Association. They have been asked to produce records identifying U.S. taxpayers who used Sovereign to establish, maintain, operate, or control any foreign account or entity.

The information was uncovered through a tax voluntary disclosure where one taxpayer disclosed that Sovereign helped set up and maintain a foreign entity to hold assets and conceal ownership by using FedEx, UPS, and DHL to correspond with the U.S. taxpayer, Western Union to transmit funds, Federal Reserve Bank NY and Clearing House to wire foreign transactions, and HSBC to maintain corresponding bank accounts offshore.

Besides broadening the scope of the case, these "John Doe" summonses not only show the I.R.S.'s commitment to tracking down taxpayers avoiding U.S. tax obligations, but exemplify the types of results that can be derived through interagency cooperation.

CHANGE IN HEDGE COUNTERPARTY MEANS TERMINATION FOR HEDGE

The S.E.C. recently indicated that should there be a change in the counterparty where a derivative is hedged (called a "novation"), the hedge must be ended and a new one begun. This is true even if the counterparty is economically insignificant.

“The fact that a new hedge must begin even if the change is economically insignificant should cause practitioners to be wary when changing counterparties in a hedge transaction.”

Accounting Standards Codification (A.S.C.) 805 also states that if critical terms of the hedge relationship change from the terms initially agreed upon, the entities must designate a new hedging relationship. However, there are some exceptions to this rule, such as if the counterparty merges into another entity which assumes its rights and obligations or if the reporting entity previously documented that the derivative will be novated to a new counterparty at the outset of the hedging relationship. The fact that a new hedge must begin even if the change is economically insignificant should cause practitioners to be wary when changing counterparties in a hedge transaction. The issue from the income tax perspective is whether and to what extent the new A.S.C. 805 rules align financial reporting to income tax reporting under the so-called “Cottage Savings” doctrine embodied in *Cottage Savings Association v. Commissioner*.[1] Here the Court ruled in pertinent part, that, under I.R.C. §1001(a), an exchange of property gives rise to realization (a “disposition of property”) only if the exchanged properties are “materially different” and that material difference is not defined by an economic substitute test (whether various parties would consider their differences to be “material”), but rather on whether respective possessors enjoy legal entitlements that are different in kind or extent.

S.E.C. OFFICIAL SUGGESTS ALLOWING U.S. FILERS TO DO SUPPLEMENTAL I.F.R.S.-BASED REPORTING

The S.E.C. is currently studying the idea of allowing U.S. public companies to present financial statements prepared under international accounting rules as a supplement to their required filings under U.S. G.A.A.P.

The S.E.C. argues that this alternative may be used rather than a full adoption of international financial reporting standards (“I.F.R.S.”) for the S.E.C.’s financial reporting system. Full adoption of I.F.R.S. standards is unpopular with U.S. entities due to cost/benefit concerns. S.E.C. officials mused about other alternatives such as an “optional use” clause where entities would voluntarily provide supplemental I.F.R.S. financial information. It should be noted that full adoption of I.F.R.S. remains an option available to the S.E.C.

The primary motive of the S.E.C. is to reduce uncertainty with respect to the I.F.R.S.’s future in the U.S. However, critics point out that few companies would want to enact an I.F.R.S. supplemental reporting route and inquire as to whether the I.F.R.S.-based information filed with the I.R.S. would be subject to audit.

CHANGES TO CORPORATE INVERSION RULES CAN ONLY BE ACCOMPLISHED BY CONGRESS

I.R.S. Commissioner John Koskinen recently noted that despite Treasury action, only Congress can change the current corporate inversion rules. Koskinen also pointed out that there are limits to what the I.R.S. can accomplish without the support of Congress, and refused to indicate a timeline by which the I.R.S. would issue guidance on the subject.

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1 499 U.S. 554 (1991)

DUAL RESIDENT TAXPAYERS MAY APPLY FOR TREATY RELIEF ON REPORTING FOREIGN FINANCIAL ASSETS

The I.R.S. published final rules relating to foreign financial assets under Code §6038D for taxable years beginning after March 18, 2010. Under Code §6038D, where individuals have a certain interest in specific assets they must attach a statement to their income tax return providing the required information to the I.R.S. The most pertinent change is an exemption for individuals who are dual resident taxpayers that apply for treaty benefits under a treaty tie-breaking provision.

The I.R.S. also indicated that it is still considering how to treat virtual currency under Code §6038D—an issue which we highlighted in *Insights* previously.[2]

BUDGET TIGHTENS FOR I.R.S. IN 2015 AND INCLUDES NEW DIRECTIVES

The year-end spending package for 2015 is to cut funding for the I.R.S. to its lowest level since before year 2008. The I.R.S. would receive $10.9 billion, which is $345.6 million less than in 2014. At the same time, the government is putting the agency under closer supervision with regards to its administration.

The spending measure specifically directs the I.R.S. on how to handle many issues. In response, I.R.S. Commissioner John Koskinen stated in an interview on December 9 that in order to meet their demands, the agency needed more money.

The legislation includes:

- The disallowance of funds to be used to "target groups for regulatory scrutiny based on ideological beliefs.";
- Direction to improve telephone service and the allocation of funding for toll-free help line services;
- Direction to the I.R.S. to ensure that taxpayers seeking refundable tax credits are asked the same questions regardless of what form is used and who prepared it;
- Direction for the I.R.S. to increase its scrutiny of questionable practices by payroll service providers, to update Congress on its efforts to decrease the time required to wait for the disposition of refund fraud claims, and to examine the impact of closing Taxpayer Assistance Centers and, accordingly, report to Congress on how it will alleviate the difficulties rural taxpayers face when seeking I.R.S. guidance and assistance in filing tax returns; and
- Direction for the agency to brief Congress quarterly on its progress toward completing a five-year memorandum of understanding with Free File Alliance, the non-profit coalition of tax software providers that help taxpayers file their returns for free. The current memorandum of understanding expires in October 2015.

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[2] See: *Insights*, Vol. 1 No. 3, "The O.E.C.D.'s Approach to B.E.P.S. Concerns Raised by the Digital Economy."

> *"Taxpayers that participate in international boycotts may be subject to penalties resulting in a reduction of their foreign tax credit, the benefits of foreign sales corporations, and the deferral available to U.S. shareholders of controlled foreign corporations."*

DEPARTMENT OF TREASURY UPDATES BOYCOTT LIST

The U.S. Department of Treasury maintains anti-boycott laws and regulations. These rules impose reporting requirements on and deny certain tax benefits to taxpayers that cooperate with unsanctioned boycotts, and apply to U.S. taxpayers and their related companies, regardless of whether a transaction involves any U.S. goods or services. The Treasury also maintains a periodically-updated list of countries that require or may require participation in, or cooperation with, an international boycott.[3]

A boycott involves entering into certain agreements as a condition of doing business in a certain country. The agreement requires a taxpayer to abstain from doing business in or hiring employees from another country or with other persons that do business in or hire employees from the other country. Taxpayers are required to report their operations in boycotting countries. Those taxpayers that participate in international boycotts may be subject to penalties resulting in a reduction of their foreign tax credit, the benefits of foreign sales corporations, and the deferral available to U.S. shareholders of controlled foreign corporations.

The countries on the list remain unchanged from the list published on August 27, and are as follows: Iraq, Kuwait, Lebanon, Libya, Qatar, Saudi Arabia, Syria, United Arab Emirates, and Yemen.

The updated boycott list was published in the Federal Register on December 9.[4]

TAX EQUIVALENCY PAYMENTS BY A CONDOMINIUM ARE DEDUCTIBLE AS REAL PROPERTY TAXES

In a recent private ruling, the I.R.S. determined that tax equivalency payments, or payments in lieu of taxes ("P.I.L.O.T."), made by a condominium developer to its landlord that is a governmental fund, may be deducted as real property taxes under §164 of the Code. Furthermore, when the developer sells the condominium units, every unit buyer should be able to deduct a proportionate share of the P.I.L.O.T. as real property taxes.

Under §164 of the Code, a taxpayer can deduct state, local, and foreign real property taxes that are paid or accrued within a taxable year. Treasury Regulation §1.164-3(b) defines real property taxes as taxes imposed on interests in real property that are levied for the general public welfare. Assessments for local benefits are not treated as real property taxes.[5] Whether a particular charge is a "tax" under §164 of the Code depends on its true nature as determined under federal law, not by local law. A charge will constitute a tax if it is an enforced contribution, exacted pursuant to legislative authority in the exercise of taxing power, and imposed and collected for the purpose of raising revenues to be used for public or governmental purposes.[6]

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3 Within the meaning of section 999(b)(3) of the Internal Revenue Code of 1986.

4 See 166 DTR G-6, 8/27/14.

5 Treas. Reg. §§1.164-2(g) and 1.164-4.

6 See Rev. Rul. 71-49, 1971-1 C.B. 103; Rev. Rul. 61-152, 1961-2 C.B. 42.

The I.R.S. concluded that the P.I.L.O.T. obligations are deductible as real property taxes because they satisfy the three requirements established in Revenue Ruling 71-49, 1971-1 C.B. 103: the payments are (i) imposed at the same general rate at which real property taxes are imposed; (ii) imposed under the enabling legislation as implemented by the condominium lease; and (iii) may only be used for public purposes.