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EDITORS' NOTE

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

- **India Announces Ambitious Budget for 2015-16.** Guest contributor Jairaj Purandare of JPM Avisors Pvt Ltd, in Mumbai, India, provides a comprehensive assessment of provisions for the coming fiscal year, including policy announcements and proposed amendments to the tax law.

- **Debt vs. Equity: Comparing HP Appeal Arguments to the PepsiCo Case.** Galia Antebi and Nina Krauthamer address arguments raised by the I.R.S. when a taxpayer attempts to treat debt as equity.

- **Falciani: "The Man Who Makes the Rich Tremble."** Rusudan Shervashidze and Andrew P. Mitchel address the death of bank secrecy and government secrecy in this article addressing leaks of information.

- **McDonald's Accused of Re-Routing Royalty Payments to Avoid Billions in European Taxes.** Kenneth Lobo discusses how stakeholders are aggressively attacking large corporations planning to save tax.

- **Using a §897(i) Non-Discrimination Election to Avoid F.I.R.P.T.A.** Sheryl Shah and Nina Krauthamer explain how a corporation resident in a treaty country can use an election to be treated as a domestic corporation as a tool to limit F.I.R.P.T.A. tax.

- **New Centralized Approach to International Audits.** Christine Long comments on how budget cuts are affecting the way the I.R.S. conducts audits. Examinations limited to travel & entertainment accounts may be a thing of the past.

- **Nice Work If You Can Get It: A New Yorker's Guide to Change of Domicile.** Rusudan Shervashidze and Andrew P. Mitchel discuss a recent New York estate tax case acknowledging that a change in domicile is possible when a New York resident moves abroad. The decision expands the number of days that a person can be present in New York without being resident for income tax purposes.

- **I.R.S. Defines Measure for Tax Rate Disparity Test.** Kenneth Lobo and Andrew P. Mitchel discuss how the rate disparity test works when evaluating whether a manufacturing or sales branch is to be treated as a separate entity for purposes of taxing Foreign Base Company Sales Income derived within one company.

- **Pre-Immigration Tax Planning, Part I: U.S. Tax Residence.** Stanley C. Ruchelman presents the first in a multi-part series addressing pre-immigration tax planning for an arriving resident. The key is to implement the plan before residence begins.

- **Major U.S. Drug Company Avoids Billions in Taxes on $1,000 Pill.** The U.S. is one of the few countries without a participation exemption applicable to dividends from foreign subsidiaries. Christine Long and Andrew P. Mitchel investigate one company that cannot bring its profits home to shareholders because of the tax burden. Will the law change after the next election?

- **Corporate Matters: Partnerships.** Simon Prisk and Andrew P. Mitchel explore differences between limited partnerships, limited liability partnerships, and limited liability limited partnerships. More than semantics are involved.

- **F.A.T.C.A. 24/7.** This month, Philip R. Hirschfeld and Galia Antebi address a waterfall of F.A.T.C.A. developments. Included are changes in the obligation to file Form 8938 when the taxpayer is a dual resident whose residence is allocated abroad, the common reporting standard in Europe, recent developments in International Data Exchange Services ("I.D.E.S."), which is the key for automatic transmission of date under F.A.T.C.A., guidance in the Netherlands regarding the Netherlands-U.S. I.G.A., more F.A.T.C.A. guidance in the U.K., exposure of withholding agents for failing to check G.I.I.N. of payees, and the current list of I.G.A. partner countries.

We hope you enjoy this issue.

- The Editors

INDIA ANNOUNCES AMBITIOUS BUDGET FOR 2015–16

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Tags
G.A.A.R.
India Budget 2015
Place of Effective Management
Royalties
Service Fees
Vodaphone
Wealth Tax

Jairaj Purandare is the Founder Chairman of JPM Advisors Pvt Ltd, a consulting and tax firm based in Mumbai, India. He has over three decades of experience in tax and business advisory matters, having served as Regional Managing Partner and Country Leader – Markets & Industries for PwC India, Chairman of EY India, and Country Head of Andersen India's Tax & Business Advisory practice.

The Indian Finance Minister presented the *Budget for 2015-16* and the *Finance Bill, 2015* in Parliament on February 28, 2015. These measures include, among other policy announcements, proposed amendments to the tax law.

In the run up to the budget, a revival of the Indian economy together with a plunge in crude oil prices have resulted in a conducive environment for a budget to promote economic growth. Real G.D.P. growth for fiscal year 2015-16 is expected to be about 8.5%. Consumer Price Inflation ("C.P.I.") is currently at 5.1%, while Wholesale Price Inflation ("W.P.I.") is negative. The Current Account Deficit ("C.A.D.") is expected to fall below 1.3% of G.D.P. The Finance Minister has set a target fiscal deficit of 3.9% for fiscal year 2015-16, 3.5% for fiscal year 2016-17, and 3% for fiscal year 2017-18.

Set against this background, the *Budget for 2015-16* is a realistic budget and bold on policy reforms. This budget is a growth-oriented budget with regard to every section of society and attempts to strike a balance between growth, inclusiveness, and fiscal discipline.

This article analyses some of the key proposals of the *Finance Bill, 2015*.

POLICY ANNOUNCEMENTS

- To facilitate ease of doing business in India, and with a view to integrate services of all Central Indian Government departments and ministries, 14 regulatory permissions have been integrated on a single e-biz portal.
- It is also proposed to appoint an Expert Committee to examine the possibility of replacing the current need for multiple prior permissions with a pre-existing regulatory mechanism and to prepare draft legislation to that effect.
- Suggestions regarding the Indian Financial Code ("I.F.C.") are currently being reviewed, and the Finance Minister is hopeful that the I.F.C. will soon be introduced in Parliament for consideration.
- It is proposed to introduce tax-free infrastructure bonds for projects in rail, road, and irrigation sectors.
- It is proposed to revitalize the Public Private Partnership mode of infrastructure development with sovereign risk.
- It is proposed to set up five new Ultra Mega Power Projects, of 4,000 megawatts each, in the "plug and play mode" and to consider similar plug and play projects in other infrastructure areas such as roads, ports, rail lines, airports, etc.

- In line with the Indian Government's commitment to repatriate funds legitimately belonging to the country, it is proposed to enact a comprehensive law on black money, which will specifically deal with offshore holdings.

DIRECT TAX PROPOSALS

General Anti-Avoidance Rule ("G.A.A.R.")

- Provisions in respect of G.A.A.R. were previously introduced in Indian tax law, effective April 1, 2013. Due to various uncertainties within the provisions and the possibility for abuse by tax authorities, the provisions have faced considerable criticism. A committee was therefore appointed by the Indian Government to review these provisions. Based on the recommendations of this committee in 2013, the implementation of G.A.A.R. was deferred until April 1, 2015.
- In the current budget, it is proposed that G.A.A.R. will be deferred for an additional two years, *i.e.*, G.A.A.R. will come into force prospectively beginning April 1, 2017. Investments made up to March 31, 2017 are proposed to be protected from the applicability of G.A.A.R.
- Further, in view of the fact that India is an active participant in the O.E.C.D.'s Base Erosion and Profit Shifting ("B.E.P.S.") project and the report on various measures to counter B.E.P.S. is forthcoming, it would be appropriate to implement G.A.A.R. as part of a far-reaching regime, in line with global practices, that addresses B.E.P.S. and tax avoidance.
- This proposal is a step in the right direction with regard to boosting investment in Indian. It will also provide additional time for the Income Tax department to train tax officers and announce a clear set of rules for enforcing G.A.A.R. provisions.

Direct Taxes Code ("D.T.C.")

- The D.T.C. was introduced in Parliament in 2010, to replace existing tax law. The D.T.C. contained some onerous provisions and therefore, after various representations, went through revision.
- It is now proposed to forego enactment of the D.T.C., as most of its provisions have already been included in the current law and jurisprudence under Indian tax law is well evolved.
- This proposal is a welcome step toward fostering investment into India.

Corporate Tax Rate

- The Wealth Tax Act has been abolished as of April 1, 2015. To offset the loss in revenue, the surcharge tax rate is increased by 2% for all taxpayers (other than foreign companies) whose income exceeds ₹10 million. However, the tax rate for foreign companies will remain unchanged.
- It is also proposed to reduce the corporate tax rate from the present 30% to 25% over the next four years, beginning from fiscal year 2016-17, with the objective of bringing the rate, more or less, on par with that of other major

“A company will be considered a tax resident of India if at any time during the relevant year its P.O.E.M. is in India.”

Asian economies. Consequentially, it is also proposed to remove various tax exemptions and incentives available to corporate taxpayers in a phased manner. This is intended to reduce tax litigation and disputes.

Provisions Relating to the Source Rule

- Under the current tax law, a foreign company is considered to be a tax resident in India if control and management of its affairs is wholly situated in India during the year.
- Under the existing law, it is, therefore, possible for foreign companies to avoid becoming resident in India through minor actions, such as holding a single board meeting outside of India.
- It is now proposed to amend this provision and to introduce the concept of Place of Effective Management (“P.O.E.M.”). It is proposed that a company will be considered a tax resident of India if at any time during the relevant year its P.O.E.M. is in India. This amendment is expected to target shell or conduit companies, which are incorporated outside of India but are effectively controlled from within the country.
- Furthermore, lack of clarity in the proposed definition of the P.O.E.M. is likely to give rise to significant litigation.
- This provision could act as a disincentive for foreign companies wishing to invest into India and could be a stumbling block to the Prime Minister’s flagship “Make in India” campaign. *E.g.*, a foreign company considering investment in India and holding a meeting of Board of Directors in India (prior to investing), runs the risk of having its global income subject to tax in India.

Indirect Transfers

- As a consequence of the controversy surrounding the Vodafone judgment, a retrospective amendment was made to Indian tax law in the year 2012. As per this amendment, any share or interest in an entity registered outside of India is deemed to be situated in India if the share or interest substantially derives its value, either directly or indirectly, from assets located in India, thereby making such transfers taxable in India.
- This provision contained several ambiguities and generated considerable furore among the investor community. Consequently, a committee was set up by the Indian Government to review this provision.
- It is proposed to make various amendments to the tax law after considering the recommendations of this committee. Some of the key amendments are as follows:
    - “Assets” include both tangible and intangible assets located in India;
    - “Substantial value” of Indian assets has been defined as an amount exceeding ₹100 million (U.S. $1.584 Million as of March 13, 2015) and representing at least 50% of the value of the total assets owned by the company or entity on the specified date; and
    - Taxation of gains arising on indirect transfer will be on a *pro-rata* basis.

- It is interesting to note that the provision to tax indirect transfers was introduced to the tax law retrospectively, beginning April 1, 1961. However, the proposed amendment clarifying the taxation of "indirect transfers" will come into effect prospectively, beginning April 1, 2015.

Taxability of Interest Paid by the Permanent Establishment of a Bank to a Non-Resident Outside India

- In the past, taxability of interest paid by a Permanent Establishment ("P.E.") of a bank to a head office or any other branch outside of India was the subject matter of litigation.
- Interest expense incurred by a P.E. of a banking company was not subject to withholding tax provisions in India, as per several judicial decisions; however, the interest paid was allowed as a deduction in computing the profits of the P.E. in India. Such interest was not chargeable to tax in the hands of the recipient outside India, effectively constituting a "double dip" situation.
- To remedy this situation, it is proposed that in the case of a non-resident engaged in the business of banking, any interest payable by the Indian P.E. of such non-resident to the head office or any other branch outside of India would be chargeable to tax in the hands of the recipient, because the P.E. would be deemed to be a person independent of the non-resident.
- Such interest would also be subject to withholding tax at the rates in force, and any failure to withhold would result in disallowance of the expenditure for the P.E. in India and would attract interest and penalty.

"The proposed amendment clarifying the taxation of 'indirect transfers' will come into effect prospectively, beginning April 1, 2015."

Incentives to Fund Managers of Offshore Funds

- In order to encourage fund management activities in India, a specific tax regime has been proposed.
- The regime provides that, subject to specified conditions, in the case of an eligible investment, fund management activity carried out through an eligible fund manager on Indian soil acting on behalf of such a fund, will not constitute a business connection in India.
- In view of the above, the eligible investment fund will not be considered to be a tax resident of India merely on the basis of the location of such fund manager in India.

Taxation of Alternative Investment Funds ("A.I.F.'s")

- A special tax regime is proposed to be introduced to rationalize the taxation of Category I and Category II A.I.F.'s ("Investment Fund"/"Fund"). This amendment will help garner funds from local High Net worth Individuals ("H.N.I.'s") into these Funds.
- Under this regime, all investment income earned by the Fund would be taxable in the hands of its unit holders or investors of the Fund, while the business income of such Fund will be taxed in the hands of the Fund.
- Due to these amendments, a Fund will be a "translucent structure" *viz.* partly transparent and pass-through with regard to certain income and partly opaque with regard to non-pass-through business income.

Taxation Regime for Real Estate Investment Trusts ("R.E.I.T.'s") and Infrastructure Investment Trusts ("Inv.I.T.'s")

- A special taxation regime was introduced in the previous budget in respect of two new investment vehicles, R.E.I.T.'s and Inv.I.T.'s ("business trusts").
- It is now proposed to tax the capital gains arising to a sponsor on the transfer of units in the business trust, acquired in exchange for shares in the Special Purpose Vehicle ("S.P.V."), in the same manner in which the transfer of units is taxed in the hands of other unit holders. Earlier, the tax treatment of such capital gains was akin to that of unlisted shares.
- This proposal is expected to remove the disadvantage faced by the sponsor on account of capital gains tax arising at the time of transfer of such (listed) units of the business trust, as against a situation where the sponsor had opted to exit through an Initial Public Offer ("I.P.O.").
- It is also proposed to extend the tax pass-through status to rental income received by a R.E.I.T. from assets owned directly by it. However, rental income received from assets held by the R.E.I.T. through an S.P.V. will continue to be taxed at the maximum marginal rate.

Rate of Tax on Royalties and Fees for Technical Services

- It is proposed to reduce the rate of tax on royalties and fees for technical services payable to nonresidents from the existing 25% to 10%, provided that such royalties or fees are not effectively connected with the P.E., if any, of a nonresident in India.

INDIRECT TAX PROPOSALS

Goods and Services Tax ("G.S.T.")

- It is proposed that a modern indirect tax regime is put in place by way of a unified G.S.T., which is to be rolled out by April 1, 2016.

Service Tax

- It is proposed to increase the rate of Service Tax to 14% after subsuming the Education cess and Secondary and higher education cess, which will come into effect on a date that is yet to be notified.

IN SUMMARY

Overall, the budget statement is indicative that the Indian Government is making a sincere attempt to establish a non-adversarial, stable, certain, and simplified tax regime, conducive to encouraging investment, including foreign investment. However, the *Budget for 2015-16* is only the first step in a long and arduous journey towards achieving sustainable growth. Budget proposals alone are not sufficient to address the various economic problems and need to be followed up with strong execution.

DEBT VS. EQUITY: COMPARING HP APPEAL ARGUMENTS TO THE PEPSICO CASE

Authors
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Tags
Debt
Equity
HP
PepsiCo

INTRODUCTION

Historically, the I.R.S. and taxpayers often disagreed over whether a loan between related entities should be treated as equity rather than true debt. As a result, substantial case law has built up over the years, especially involving closely-held entities. One such case is *Mixon*,[1] which was discussed in our prior publication from April 2014[2] as the leading case law providing for the 13 factors to be considered in debt-equity cases. In recent years, the I.R.S. has begun to focus on the debt-equity issue in the cross border arena, and new decisions are being issued. Two 2012 cases, in the United States Tax Court (the "Tax Court" or "Court"), went in different directions. In *PepsiCo*,[3] the taxpayer prevailed and equity treatment was upheld. In contrast, the I.R.S. prevailed in *Hewlett-Packard*,[4] where the Tax Court was convinced that the transaction should be categorized as a loan rather than equity. In this case, the court looked beyond the instrument at issue and also examined agreements between the shareholders in the transaction.

Earlier this year, Hewlett-Packard ("HP") appealed its loss in the Tax Court to the U.S. Court of Appeals for the Ninth Circuit, arguing that the lower court's finding – that the investment displayed more "qualitative and quantitative indicia of debt than equity" – was "clearly erroneous."

HP CASE – FACTS AND TAX COURT DECISION

HP purchased an interest in a Dutch corporation, Foppingadreef ("FOP"), from AIG in 1996. The investment was originally structured by AIG as an equity investment in preferred shares. The other shareholder was a Dutch bank, ABN AMRO ("ABN"). FOP's Articles of Incorporation provide that it was organized for the purpose of investing its assets in contingent interest notes ("C.I.N.'s") and other approved debt instruments. FOP invested in C.I.N.'s issued by ABN which provided for interest consisting of a fixed element and a contingent element. The terms of the preferred shares, as structured by AIG, gave HP voting rights and preferred entitlement to dividend distributions. HP's vote was slightly more than 20%. However, if FOP was in default of its obligations, including failure to pay dividends when due and payable, HP was granted a majority vote and the authority to convene a shareholders meeting at which the shareholders could (i) cause the foreign corporation to redeem or repurchase HP's shares or (ii) cause the foreign corporation to dissolve.

1 *Estate of Mixon v. U.S.*, 464 F.2d 394, 402 (5th Cir. Ala. 1972).

2 See *Insights*, Vol. 1 No. 3, "Tax 101: Financing a U.S. Subsidiary – Debt vs. Equity."

3 *PepsiCo Puerto Rico, Inc. v. Commissioner,* T.C. Memo. 2012-269 (9/20/12).

4 *Hewlett-Packard Co. v. Commissioner,* T.C. Memo 2012-135 (5/14/12).

The dividends provision in the Articles of Incorporation provided that the FOP may distribute dividends out of profits from the preceding year, with the preferred stock receiving a dividend according to a specified formula before any dividends were paid to the common stockholders. FOP's Shareholders Agreement provided that the parties shall take "all such action as may be required to give effect" to the dividend provision in the Articles of Incorporation. HP received dividends each year from 1996 to 2003 from FOP, which reflected earnings from the fixed interest portion payable on the C.I.N.'s.

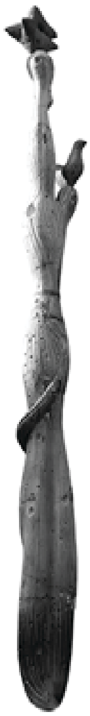
As part of the investment, and as originally agreed between ABN and AIG, HP entered into a put and call option agreement with ABN. This put option gave HP the right to compel ABN to buy its shares in FOP for fair market value on two specific dates, in January of 2003 and 2007, or upon the occurrence of particular events beyond the control of the parties. ABN had a call option on the same shares, giving it the right to purchase the shares from HP in the event of certain changes in Dutch or U.S. tax law or other financial institution regulatory regimes.

HP's investment was the result of outreach by AIG marketers, who approached HP because it was a global company with large international sales and, thus, was in an excess limitation position concerning its foreign tax credits. Prior to investing, HP calculated a pre-tax projection internal rate of return of 1.586% and an after-tax base case projection of a 9.1% internal rate of return. The worst-case scenario modeled the result of the FOP transaction with only a portion of the foreign tax credits and resulted in a 1.91% internal rate of return. Therefore, based on the creditworthiness of ABN and the very attractive after-tax return, HP made the FOP investment. Since HP treated the investment as equity, it claimed direct foreign tax credits for dividend withholding tax amounts paid to the Dutch authorities and an indirect foreign tax credit for the portion of Dutch income tax paid by FOP hoping to achieve the high after-tax rate of return calculated in its projections. The I.R.S. disallowed foreign tax credits and argued that (i) the investment is more appropriately characterized as debt rather than equity; (ii) the investment was a sham under the economic substance doctrine; and (iii) FOP should be treated as a conduit under the step-transaction doctrine and the transaction should be treated as a direct loan from HP to ABN.

"The Court reviewed the transaction documents and all relevant documents, including agreements between the parties."

The Court reviewed the transaction documents and all relevant documents, including agreements between the parties, and found that the investment is more appropriately characterized as debt. This rendered the remaining issues as moot in the Court's opinion and thus these were not discussed.[5] In the debt versus equity issue, the Court reviewed the traditional factors. It ruled that the inquiry of a court in resolving the debt-equity issue is primarily directed at ascertaining the intent of the parties and the critical factor in finding that an investment is in substance a loan is to ask whether, when the funds were advanced, the parties actually intended repayment. The Court focused on the fact that HP had a put option and ruled that when HP's FOP investment is viewed in its entirety, it becomes clear that HP never intended to absorb the risk of the FOP venture; rather, it intended to have its investment repayable in any event. The Court determined that there were essentially no actions that FOP could initiate which would undermine the put agreement, and under these circumstances, the Court interpreted the Shareholders Agreement as

[5] While the HP court decision was based on the debt-equity analysis, HP's investment was challenged by the I.R.S. under two more theories: (i) economic substance and (ii) step transaction.



obligating FOP, either jointly or secondarily, to effect the put option. Further, the court viewed the dividend provision from the Articles of Incorporation as effectively negating the board's discretion on declaring dividends and the Shareholders Agreement commitment to act to its effect as providing HP with a legal remedy against the unrelated shareholder and FOP if ABN failed to perform as required under the agreement or did not pay the interest on the C.I.N. it issued. The Court's view was that while payment of dividends was contingent on FOP's earnings, the transaction was arranged so that FOP's earnings were predetermined and that the terms of the C.I.N.'s issued by ABN, which included a fixed interest element, assured that FOP would have sufficient earnings to make the aggregate periodic payments to HP. Additionally, the Court decided that the right under the put agreement to sell the shares in January of 2003 or 2007 effectively serviced as the investment's maturity date, which is generally a debt factor. While HP had 20% of FOP's voting power, allowing it to designate one of four board members, the Court did not give this factor much weight as indicative of equity treatment. In the Court's opinion, HP did not view these rights as important, being that no evidence was submitted to demonstrate that HP's representative ever attended any board meeting. The Court focused on its belief that HP never intended to absorb the risk of the FOP venture because the Shareholders Agreement and the put option demonstrated that HP sought a definite obligation, repayable in any event, and that HP always intended a seven-year exit from the transaction based on the option to sell its shares in FOP to ABN in 2003 when the tax benefit ceased.

PEPSICO – FACTS AND TAX COURT DECISION

In *PepsiCo*, PepsiCo Global Investments ("PGI"), a Dutch affiliate of PepsiCo, Inc. ("PepsiCo"), issued "advance agreements" to several PepsiCo domestic subsidiaries in exchange for certain outstanding indebtedness belonging to PepsiCo and members of its consolidated group (the "Indebtedness"). PepsiCo intended the advance agreements to be treated as equity for U.S. tax purposes and as debt for Dutch tax purposes. In other words, the interest income on the Indebtedness would be offset, for Dutch income tax purposes, by an interest expense deduction with respect to the preferred return payable to the U.S. affiliates on the advance payments. The terms of the advance agreements were 40 years maturity with PGI being given the option to extend the maturity date for up to 15 additional years. However, PGI also had the right to prepay the principal amount and preferred return, in full or in part, at any time. The terms provided for a preferred return that accrued unconditionally at a defined rate payable on an annual basis out of "net cash flow," which was tied to income from the Indebtedness. Any accrued, but unpaid, preferred return would be capitalized and accrue compound interest. Furthermore, the holder of an advance agreement was subordinated to all other creditors.

The I.R.S. contended that the advance agreements were, in substance, debt, and that the parties' intention was demonstrated by their negotiations with the Dutch tax authorities to receive a ruling confirming the agreements be treated as debt for Dutch purposes. The I.R.S. also argued that the terms of the agreements were not relevant because of the common control of the parties. The Tax Court ruled in favor of the taxpayer, stating that the form of a transaction often informs its substance. The Court explained that the characterization of the advance agreements as debt or equity must be considered by examining the relevant terms of the instruments in light of the surrounding facts and circumstances, including but not exclusive to the

> ***"The issuance of a stock certificate indicates an equity contribution, whereas the issuance of a bond, debenture, or note indicates a* bona fide *indebtedness."***

taxpayers' correspondence with the Dutch tax authorities. It also held that while the relatedness of the parties needs to be considered as a relevant factor and closely scrutinized for substance, an otherwise legitimate transaction will not be disregarded merely because it represents a related-party agreement.

The Tax Court followed a traditional analysis of the debt-versus-equity factors and concluded that the focus of such an inquiry is generally whether there was intent to create a debt with a reasonable expectation of repayment and, if so, whether that intent comports with the economic reality of creating a debtor-creditor relationship. The Tax Court found that PGI was exposed to eastern European markets and those of other developing countries, and together with its ability to defer repaying the principal for up to 55 years, there was no expectation of repayment.

Although payment of the preferred return was linked to interest payments received on the Indebtedness and the instrument's was characterized as a debt instrument by the Dutch tax authorities, the Tax Court held that the advance payments were equity. This treatment was supported by the complete subordination of the advance agreements and the determination that an independent creditor would not have loaned funds in the amount of the advance agreements to PGI under any reasonably similar financial terms. Those factors, together with the lack of repayment expectation, led the Tax Court to the conclusion that the risk involved in making the advances revealed its equity characteristics. The Court focused on the long term nature of the investment (which under certain circumstances could become perpetual) and the fact that the right to receive payments involved the issuer's discretion.

HP'S APPEAL

Label Given to the Instrument

The issuance of a stock certificate indicates an equity contribution, whereas the issuance of a bond, debenture, or note indicates a *bona fide* indebtedness.

Further to this concept, HP claims that there is no dispute it invested in preferred stock and thus, by the terms of the relevant documents, had an equity investment in FOP. It argues that the Court's decision to minimize the value of this factor in light of its review of the overall transaction is not supported by cogent reason. HP further claims that while the name of an instrument is not controlling, there is no basis for arguing that HP's preferred stock was a "gimmick of form" or that the underlying stock certificate was not meaningful whereas HP's rights under the terms of the preferred stock are those that normally are associated with stock ownership.

In *PepsiCo*, the Court ruled this factor to be neutral because the advance agreements, at least superficially, evinced the issuance of neither stock certificates nor debt instruments.

Presence or Absence of Fixed Maturity Date

The presence of a fixed maturity date indicates a fixed obligation to repay, a characteristic of a debt obligation. The absence of the same factor, on the other hand, would indicate repayment was in some way tied to the fortunes of the business, typical of an equity advance.

HP's preferred shares did not have a fixed maturity date. HP claims that the Tax Court's conclusion that the preferred shares should be treated as having an effective fixed maturity date due to the put option is flawed, as the put agreement is an agreement between HP and ABN and not with FOP, the issuer of the stock. Thus, it claims such an agreement does not shed light on the legal rights and obligations inherent in the investment. Additionally, HP claims that even if the put option were somehow relevant to the proper characterization of HP's investment in FOP, it is not unusual for preferred stock to have a fixed maturity date.

In *PepsiCo*, the advance agreements had a 40-year maturity date, which could be unilaterally extended by additional 15 years, and to the extent that any related party were to default on any loan receivables held by PGI, the terms of the advance agreements were to be voided, rendering the instruments perpetual. The I.R.S. argued that the maturity date was fixed and that the perpetual clause was meaningless, as there was an unrealistic possibility that the terms of the advance agreement would become void as the parties were all related and thus would never cause an involved party to default on any loan receivable held by PGI. However, the court rejected the I.R.S.'s arguments and ruled that under the circumstances the uncertainty of repayment of the principal amounts of the advance agreements at maturity was too great to conclude that PGI had an unqualified obligation to pay a sum certain at a reasonable fixed maturity date. The Court based its opinion on the fact that PepsiCo was reluctant to use domestic funds to further its global expansion and there was no assurance that the international investments would succeed as those involved unestablished markets.

"If repayment is possible only out of corporate earnings, the transaction has the appearance of a contribution of equity capital; but if repayment is not dependent upon earnings, the transaction reflects a loan to the corporation."

Source of Payments

If repayment is possible only out of corporate earnings, the transaction has the appearance of a contribution of equity capital; but if repayment is not dependent upon earnings, the transaction reflects a loan to the corporation.

HP claims it is uncontested that FOP's Articles of Incorporation made preferred stock dividends payable only out of earnings and that this factor should point towards equity treatment. Furthermore, it claims that when the Court discussed this factor it strayed from the intended topic – the source of payments – and instead focused on the likelihood of repayment. HP claims that the Court erred in treating the dividend provisions as a debt-like feature simply because of the high likelihood that earnings would be available to make dividend payments.

In *PepsiCo*, the high likelihood of receiving payment also controlled the Court's decision with respect to this factor. The provisions of the advance agreements were meticulously structured to ensure that annual payments remained, effectively, discretionary. Additionally, PGI was required to make payments only to the extent "net cash flow" exceeded (i) accrued, but unpaid, operating expenses incurred and (ii) capital expenditures made or approved during the applicable year. Because board approval of expenses would result in no payments under the advance agreements, PepsiCo argued that payment likelihood was not uncertain. However, the I.R.S. argued that payments were never in doubt, as evidenced by PepsiCo's dialog with the Dutch tax authorities, which effectively obligated PGI to make payments in order to ensure debt treatment for Dutch tax purposes. The Court decided that payments on the advance agreements were largely linked to interest received on the notes from related parties and thus not speculative. Accordingly, the Court found this factor emphasized a debt characteristic.

Right to Enforce Payment

A definite obligation to repay an advance, including interest thereon, suggests a loan obligation.

HP claims that it had no right to demand the return of its investment if FOP failed to pay dividends. Instead, HP's recourse was to exercise its voting power to force FOP to redeem the preferred stock or to dissolve, a type of remedy typical to any preferred stock in support of equity treatment. HP claims that the Court's characterization of this right as an apparatus to enforce creditor rights lacks basis, as equity investors are entitled to try to protect their investment, and the mere fact that they have rights in case of failure to pay declared dividends does not make them "creditor rights."

In *PepsiCo*, the I.R.S. argued that while there was no mechanism providing the holders of the advance agreements with the right to demand immediate repayment for outstanding principal and interest in the event PGI defaulted, there was no real possibility that PGI would default because PepsiCo controlled all entities involved and would be economically disadvantaged if PGI were to default. The Court, however, rejected this claim and found that full repayment of principal and interest on the advance agreements was not unconditional due to the long-term nature of the advance agreements, which render the payments of principal speculative and the payment of the preferred return subject to business realities and uncertainties.

Participation is Management

The right of the entity advancing funds to participate in the management of the receiving entity's business demonstrates that the advance may not have been *bona fide* debt and instead was intended as an equity investment.

"A definite obligation to repay an advance, including interest thereon, suggests a loan obligation."

HP's preferred stock carried with it management participation rights representing slightly more than 20% of FOP's voting power and the right to designate one of four members of the board of directors. Moreover, the Shareholders Agreement gave HP additional voting rights in the event of certain occurrences that threatened its investment, including failure to pay dividends when declared. HP claims that that voting power was meaningful because unanimity was required for many important board resolutions and that these rights represent substantial interest in the affairs of the corporation. The Court, however, determined that this factor is to be granted no weight, as in its opinion HP did not value those rights. The determination was based on the fact that evidence was not submitted to show that HP's representative ever attended any board meetings or formally objected to ABN's impermissible FOP investments. HP claims that the Court strayed from the relevant debt-equity analysis, which required examination of the objective characteristics of an investment as ascertained at the time the investment was made. HP continues to claim that what is relevant to the inquiry is the right to participate in management, which is fixed at the outset, not the extent to which the investor actually participates in said management, which can be determined only after the fact.

In *PepsiCo*, this factor was neutral, as PepsiCo commonly controlled the entities involved.

Borrower's Ability to Obtain Outside Loans

The touchstone of economic reality is whether an outside lender would have made the payments in the same form and on the same terms.

The lower court, in HP's case, examined the expected rate of return on the FOP investment and concluded that the availability of foreign tax credits was an important consideration in the rate-of-return analysis. It found that the expected rate of return would have been relatively unattractive to a prospective lender without those credits. However, because those credits are only available to owners and not lenders, the Court found that outside lenders would not have lent funds to FOP in the same form and on the same terms. Nevertheless, the Court found this factor to be neutral in light of concerns about allowing a taxpayer's tax-advantaged instruments to elude debt characterization.

In *PepsiCo*, the Court determined that since the terms of the advance agreements could not have been replicated in any reasonably similar manner by independent debt financing, this factor highlights equity characteristics.

Subordination to Regular Corporate Creditors

Whether an advance is subordinate to obligations to other creditors bears on whether the taxpayer advancing the funds was acting as a creditor or an investor.

HP's Articles of Incorporation provided that liquidation preference and any dividend right associated with FOP stock were junior to all FOP creditors. However, the Court concluded that since FOP's activities were sufficiently limited by its organizational documents, it would never do anything that would cause FOP to have a material creditor, and thus, HP's subordinate status gives it rights indicative of creditor.

In *PepsiCo*, the advance agreements were, on their face, unequivocally subordinate to any obligation of PGI to pay unpaid principal or accrued, but unpaid, preferred return to indebtedness of PGI and the rights of all creditors. The Court found this subordination to be meaningful and indicative of equity, in spite of the fact that all outstanding debts that ranked superior were related debt.

Intent of the Parties

The inquiry of a court in resolving the debt-equity issue is primarily directed at ascertaining the intent of the parties. The focus of the debt-versus-equity inquiry narrows to whether there was with a reasonable expectation of repayment and, if so, whether that intent comports with the economic reality of creating a debtor-creditor relationship.

HP claims that where the transaction was well-planned and the parties were counseled, this inquiry is likely to accord with the labels on the documents. The Tax Court, however, found that this factor pointed toward debt because it was of the opinion that HP intended to exercise the put option in 2003. Additionally, in evaluating this factor, the conclusion of the Court repeated some of the conclusions it reached in its analysis of other factors. These included the predictability of the cash flows and HP's additional voting right, which enabled it to protect its investment if dividends were not paid. HP claims that while it bore little risk because the FOP venture itself held little risk, its intention was to make an equity investment. Therefore, the Court's focus on the riskiness of the investment rather than on the legal rights and obligations attached to the instrument is erroneous. Additionally, HP claims that while it purchased a safe investment from AIG, there remained some risk in this investment because FOP's income depended upon ABN meeting its obligations.

"It is not easy to predict the outcome of HP's appeal. While it makes very compelling arguments, the appellate court, like the Tax Court, may focus more on the expanded use of foreign tax credits by HP and less on traditional debt-equity factors."

In *PepsiCo*, the Court found that the negotiations with the Dutch tax authorities emphasized the taxpayer's expectation that the advance agreements would be characterized as equity for U.S. tax purposes and as debt for Dutch tax purposes. It further found that the terms of the advance agreements also indicated that there was no intent to create debt, as evidenced by the long-term nature of the advance agreements and the speculative investments in undeveloped foreign markets to which repayment was effectively subject. The Court further concluded that the taxpayer's actions during the years were in accordance with legitimate tax planning and supported the taxpayer's intent to create a hybrid instrument.

CONCLUSION

It is not easy to predict the outcome of HP's appeal. While it makes very compelling arguments, the appellate court, like the Tax Court, may focus more on the expanded use of foreign tax credits by HP and less on traditional debt-equity factors.

FALCIANI: “THE MAN WHO MAKES THE RICH TREMBLE”

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Tags
Bank Secrecy Laws
HSBC
Hervé Falciani
I.C.I.J.

There is no denying that HSBC Holdings plc (“HSBC”) has significantly benefited from the Swiss bank secrecy laws. A February 8, 2015 report by the International Consortium of Investigative Journalists (the “I.C.I.J.”) revealed the private banking information for a Swiss subsidiary of HSBC as of 2007. The list of clients with secret accounts includes royal families, ambassadors, terror suspects, drug cartels, arms dealers, tax evaders, and fugitive diamond merchants.

The I.C.I.J. announced that it received information on 100,000 accounts through its collaboration with the French newspaper *Le Monde*, which obtained it from a source in the French government. The information was initially provided by a former HSBC employee, a computer technician named Hervé Falciani. French newspapers have dubbed him “the Man Who Makes the Rich Tremble.”

Eight years ago Mr. Falciani provided five disks of confidential information to French Financial Minister Christine Lagade. Ms. Lagade has since provided the information to various governments worldwide. This information confirmed that the bank secrecy laws were used to avoid taxes, and on this basis, many countries have initiated tax investigations.

HSBC has admitted to its shortcoming in the course of ongoing compliance efforts and has promised to combat money laundering and tax evasion. One explanation given by HSBC was that its Swiss subsidiary had not been fully integrated into the group after it was acquired in 1999, and therefore, the levels of compliance were subsequently and sustainably “significantly lower.”

As a result of changes implemented after 2007, HSBC’s Swiss private bank has reduced its client base by almost 70%. Group Chief Executive Stuart Gulliver has spent billions of dollars on compliance and internal control, but his efforts may be too little too late in light of the Falciani leak.

The Swiss government has accused Mr. Falciani of trying to sell account information and is now seeking extradition on charges of industrial espionage and violating bank secrecy laws. In his defense, Mr. Falciani has accused the Swiss government of trying to protect its banks by prosecuting him.

The controversy comes amidst efforts by the Swiss government to change existing laws on bank secrecy. Mario Tuor, communications director for the Swiss State Secretariat for International Financial Matters, told Bloomberg BNA on February 9 that “Switzerland hopes to continue to be one of the most important financial places in the world, but with an internationally accepted framework – and part of this is dismantling the bank secrecy laws.” The Swiss plan is to adopt the O.E.C.D. regulations in Switzerland and then campaign for uniform corporate taxation, whereby companies operating internationally will be taxed in the country where value is created. Its goal is to introduce new law by 2017, in order to start participating in automatic exchange of tax information with other countries from 2018 on.

MCDONALD'S ACCUSED OF RE-ROUTING ROYALTY PAYMENTS TO AVOID BILLIONS IN EUROPEAN TAXES

Author
Kenneth Lobo

Tags
B.E.P.S.
E.U.
Luxembourg
McDonald's
Tax Avoidance

Labor unions are accusing McDonald's of avoiding €1 billion in tax by re-routing revenue through Swiss and Luxembourg units.

McDonald's apparently asked its various franchises to pay it royalty revenue for using the McDonald's brand. These deductible payments were then subject to low tax rates when the payments were re-routed to the McDonald's Luxembourg S.à.r.l. The union report found that while the Luxembourg branch registered revenues of £2.7 billion over five years, it only paid less than £12 million of tax.

McDonald's moved its corporate headquarters from the U.K. to Switzerland in 2009, indicating that the relocation was due to reducing redundancies in its European divisions. However, critics allege that this was mostly done for tax reasons, as the Swiss rate for royalty payments at that time was 9% lower than the effective U.K. tax rate.

As mentioned in previous editions, the Organisation for Economic Co-operation and Development's ("O.E.C.D.'s") Base Erosion and Profit Shifting initiative ("B.E.P.S.") seeks to force multinational companies to report on a country-by-country basis their number of employees and sources of revenue, among other information, which will then be shared with treaty countries.[1] This reporting may force multinationals like McDonald's to stop engaging in such practices unless they can prove that there is economic substance to support the business decision other than tax avoidance.

[1] See *Insights* Special Edition B.E.P.S. Retrospective: The Global Approach to Combatting Base Erosion and Profit Shifting in 2014.

USING A §897(I) NON-DISCRIMINATION ELECTION TO AVOID F.I.R.P.T.A.

Authors
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Tags
§351 Transaction
§897(i) Election
Nondiscrimination
Nonrecognition
Tax Treaties

Mistakes happen. Often nonresident alien individuals buy U.S. real property, often personal use property, in their individual names. This can be a costly mistake.[1] With certain exceptions, if such an individual were to die while owning the property, a U.S. estate tax of approximately 40% of the value of the property could be imposed.

There is one method to restructure this investment in the case of a foreign individual, or an entity owned by a foreign individual, if such a person is eligible to claim the benefit of an income tax treaty with the United States and the treaty contains a so-called "Nondiscrimination Clause." These clauses provide that a resident of a treaty state will not be treated any less favorably than a U.S. resident carrying on the same activities. This article will look at how a Nondiscrimination Clause can be used to avoid onerous F.I.R.P.T.A. provisions when a foreign person invests in U.S. real property.

The technique described in this article essentially permits a nonresident alien individual to transfer U.S. real property on a tax-free basis to a foreign entity, which will be treated as a domestic entity for income tax purposes and as a foreign (non-taxable) entity for U.S. estate tax purposes.

A nondiscrimination claim has to be argued and proven by the foreign person. To preempt such claims under F.I.R.P.T.A., Congress included a Code §897(i) provision (the "§897(i) Election") that allows foreign corporations in treaty countries to elect to be treated as domestic corporations for the purposes of F.I.R.P.T.A., provided they meet certain criteria.

THE §897(I) ELECTION

The §897(i) Election allows a foreign corporation to be treated as a domestic corporation for purposes of Code §897 (disposition of investment in U.S. real property), Code §1445 (withholding), and Code §6039C (foreign person returns). The §897(i) Election is the exclusive remedy for any person claiming discriminatory treatment with respect to the rules that apply to foreign investment in U.S. real property.[2]

There are four criteria that a corporation must meet before it is permitted to make a §897(i) Election:[3]

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1 See *Insights* Vol. 2 No. 2, "Tax 101: Understanding U.S. Taxation Of Foreign Investment In Real Property – Part III" and additional publications regarding F.I.R.P.T.A.

2 Code §897(i)(4).

3 Treas. Reg. §1.897-3(b).

“The requirement for holding a U.S.R.P.I. is satisfied when a U.S.R.P.I. is acquired simultaneously with the §897(i) Election.”

1. **The foreign corporation must hold a U.S. real property interest (“U.S.R.P.I.”).**

The requirement for holding a U.S.R.P.I. is satisfied when a U.S.R.P.I. is acquired simultaneously with the §897(i) Election. As previously discussed in the prior Tax 101 series on F.I.R.P.T.A., a U.S.R.P.I. is any interest in real property located in the U.S. or the U.S. Virgin Islands and the personal property associated with its use, or, in any domestic corporation unless the domestic corporation was at no time a U.S. real property holding corporation during when the interest was held or the five years preceding the date of disposition.[4]

This provision allows a foreign person transferring a U.S.R.P.I. to a newly formed foreign corporation qualifying for nonrecognition under Code §351[5] to avoid recognition on the gain of the transfer by making this §897(i) Election.[6]

2. **The foreign corporation must be entitled to nondiscriminatory treatment with respect to that U.S. real property interest under an applicable U.S. treaty.**

The corporation indirectly holding the U.S.R.P.I. has to be entitled to the nondiscriminatory treatment. This entails going through the applicable treaty affecting the parties and looking for an antidiscrimination clause that covers the discrepancy in taxation between a U.S. and foreign person. Although the most common place to find these clauses are the income tax treaties, the Economic Tax Act of 1981 expanded “U.S. treaty” to mean any treaty obligation of the U.S. including Nondiscrimination Clauses under treaties of friendship, commerce, and navigation as well.[7]

3. **The foreign corporation must qualify as a U.S. real property holding corporation (“U.S.R.P.H.C.”) upon making the election.**

A corporation must qualify as a U.S.R.P.H.C. upon making the election. Generally a corporation is a U.S.R.P.H.C.[8] if the fair market value of the U.S. real property interests held by the corporation on any determination date equals or exceeds 50% of the sum of its:

- U.S.R.P.I.’s,
- Foreign real property interests, and
- Certain business assets.

If a foreign corporation is not a U.S.R.P.H.C., the election will not be permissible since allowing it to make an §897(i) Election would enable it to avoid being taxed under Code §897(d).

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4 See “Definitions of Terms and Procedures Unique to FIRPTA: U.S. Real Property Interest.”

5 Code §351(a) provides that no gain or loss shall be recognized if property is exchanged solely for stock of a corporation, immediately after which the transferor is in control of that corporation.

6 P.L.R. 201032016.

7 P.L. 97-34, Code §831(d).

8 Treas. Reg. §1.897-2.

4. **<u>The foreign corporation must submit the election in proper form and in a timely manner.</u>**

To successfully make the election, the foreign corporation must show that it has met the requirements of the §897(i) Election. At this time the necessary documents, listed below, must be mailed to the I.R.S. Service Center in Ogden:

- A general statement signed by a responsible corporate officer under penalties of perjury indicating that an §897(i) Election is being made and providing:
  - The electing corporation's name, address, identifying number, and place and date of the incorporation;
  - The treaty and article number under which the electing corporation is seeking nondiscriminatory treatment;
  - Descriptions, acquisition dates, adjusted bases, and fair market values of the U.S.R.P.I.'s held directly or indirectly by the corporation; and
  - Information regarding any dispositions of interests in the foreign corporation between related persons between January 1 and June 18, 1980.
- A binding waiver of treaty benefits that may apply to any gain or loss from the disposition of any U.S.R.P.I. during the period in which the §897(i) Election is in effect. No other treaty benefits will be affected by this waiver.
- A binding agreement to pay income tax like a domestic corporation on any gain that is recognized upon the disposition of the U.S.R.P.I. or any property acquired in exchange for a U.S.R.P.I. in a transaction to which nonrecognition treatment applies under Code §897(e) during the time of the §897(i) Election.
- Unless the shareholder is a shareholder of a publicly traded corporation whose stock ownership satisfied the exception to U.S.R.P.I., on the date of the election each shareholder has to file a signed consent to the making of the election and a waiver of U.S. treaty benefits with respect to gain or loss from the disposition of any interest in the foreign corporation. Along with the shareholders' consent to the election, a list identifying and describing the interests held by each shareholder in the foreign corporation has to be submitted, as well.
- There is an alternative to filing the shareholders' consents and waivers. The electing corporation can avoid the requirement by placing a legend stating that an §897(i) Election has been made on all outstanding certificates of stock. In addition, it has to include with its election (a) a statement that it has received the signed consents and waivers from all required shareholders, (b) a list that describes the interest of the corporation held by the shareholders, and (c) an agreement that the corporation will retain in its possession all signed consents and waivers for a period of three years from the date of the election.

- The election corporation must make a statement that no interest was disposed of during the longer of the last ten years before the date of the §897(i) Election or the last ten years prior to the date on which one or more domestic shareholders or related persons are in control of the foreign corporation.[9]

The election becomes effective on the date on which it is made or on such earlier date as specified in the election. The I.R.S. will acknowledge receipt of an §897(i) Election filing within 60 days. The election applies for as long as the corporation exists.

"The election applies for as long as the corporation exists."

TAX CONSEQUENCES OF AN §897(I) ELECTION

There are several factors to consider when making an §897(i) Election.

The primary advantage of the election is that it enables a foreign corporation to benefit from certain nonrecognition provisions of the code that it would not be able to take advantage of otherwise. In addition, a §897(i) Election only causes the foreign corporation to be treated as a domestic corporation for F.I.R.P.T.A. purposes, not for estate tax purposes. This means that the corporation may still take advantage of treaty benefits in other areas. Furthermore, the election allows the foreign corporation to avoid F.I.R.P.T.A. withholding tax on the disposition of the U.S.R.P.I.

Once a foreign corporation has elected to be treated as a domestic corporation, a transfer of the real estate to the corporation will be eligible for nonrecognition under Code §351 and Code §897(e). Under Treas. Reg. 1.897-6T, the corporation must comply with certain filing requirements including the filing of a notice of nonrecognition under Treas. Reg. §1.1445-2(d)(2) within 20 days of the transfer.

Nonetheless, the disadvantages need to be weighed as well. The consent and waiver requirements mean that the direct shareholders have to shed their anonymity so that the accuracy of the documents may be verified. The major tax disadvantage is that the corporation exposes any gain in the non-U.S.R.P.I. assets to U.S. income tax because it becomes a U.S.R.P.H.C. This means that the sale of stock of a foreign corporation becomes taxable, and at its full value at the shareholder level.

CONCLUSION

An §897(i) Election enables a foreign corporation to be treated as a domestic corporation for F.I.R.P.T.A. purposes and eligible to participate in a nonrecognition transaction. This can be very useful when a foreign person wants to transfer U.S. real property to a foreign corporation and avoid U.S. estate tax. The §897(i) election is a useful "second chance" for the taxpayer eligible to claim treaty benefits.

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9 Treas. Reg. §1.897-3(c)(5), as announced to be modified by Notice 89-85, 1989-2 C.B. 403, and Notice 2006-46, 2006-1 C.B. 1044.

NEW CENTRALIZED APPROACH TO INTERNATIONAL AUDITS

Author
Christine Long

Tags
International Audits
I.R.S.
Large Business & International Division (L.B.&I.)
Risk Assessment

Federal budget cuts have resulted in a new risk-based approach to international audits by the Large Business & International ("L.B.&I.") division of the I.R.S.

On February 27, Sharon Porter, acting director of International Business Compliance within the L.B.&I., announced that the I.R.S. will "re-engineer" its approach to international audits and begin implementing a pilot program utilizing an experimental centralized method of risk assessment. The L.B.&I. has organized a group of revenue agents, international examiners, and transfer pricing specialists to assess risk for all coordinated industry case returns in order to identify possible compliance issues.

Porter explained that, since the 1960's, the I.R.S.'s audit instructions have traditionally been to "find the compliance risk in this return" within a certain amount of time. Now, it is commonplace for companies to be involved in intricate international transactions, and more data is available to be utilized in the audit process.

The new centralized approach provides the examiner with more information at the beginning of the review process, and risk is assessed at the beginning of the audit. The examiners and specialists will then review the returns. This centralized approach will more efficiently allocate the L.B.&I.'s resources.

The L.B.&I. is also employing best practice methods in its examination process, with internal reviews and compliance assurance for large cases.

An international strategy council has been formed to detect compliance risk and establish a systematic way of "identifying top strategic issues." The council is developing new efficient training programs to maximize resources and reduce the training time for examiners. Typically a new domestic agent is trained in about a year, while an international examiner has three years of training. Through best practices and transactional-based training methods, the L.B.&I. will re-focus its approach to international audits.

NICE WORK IF YOU CAN GET IT: A NEW YORKER'S GUIDE TO CHANGE OF DOMICILE

Authors
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Rusudan Shervashidze

Tags
Change of Domicile
New York
Nonresident

New York State has been known to question individuals who leave the state, easily identifiable as prior New York residents who file Form IT-203, *Nonresident and Part-Year Resident Income Tax Returns*. Often, the New York State Division of Taxation (the "Division of Tax") will argue that the taxpayer has not established sufficient evidence to relinquish New York domicile. New York places a high standard on redomiciliation: "The taxpayer must prove his subjective intent based upon the objective manifestation of that intent displayed through his conduct,"[1] and it is always challenging for the taxpayer to show subjective intent. Therefore, it was welcome news when Judge Herbert M. Friedman Jr., an Administrative Law Judge, in Albany, New York recently ruled in favor of the taxpayer Irenee D. May.

THE MATTER OF IRENEE D. MAY

Mr. May moved to New York State and acquired a home in Harrison, New York (the "Harrison House"), where he resided with his wife and two children. He worked for JP Morgan in New York City for almost 20 years. Mr. May was terminated from his job effective January 2005. Shortly after, Mr. May obtained a position in London, working for the Royal Bank of Scotland. Mr. and Mrs. May made plans for the family to move to London with their children. They rented an apartment in London for the whole family, including their nanny. The lease was for one year; the eventual goal of the family was to sell Harrison House and purchase a home in London.

Subsequently, the children were not accepted to the desired London schools; therefore, Mrs. May returned with the children to Harrison allowing them to continue attending their previous school in Greenwich, C.T. Mr. May's daughter briefly attended school in London but later returned to Harrison to live with her mother and brother.

The Harrison House was not listed for sale due to the uncertainty of the timing when the family would move to London. In late 2006, Mr. May moved to a smaller apartment in London, but it was still big enough for each family member to have their own room. Mr. May remained in London while his family lived at the Harrison House. Due to the distance and Mr. May's desire to remain permanently in London, his marriage deteriorated and eventually ended in divorce proceedings, which were finalized in 2011.

During his employment at the Royal Bank of Scotland, Mr. May was an "at will" employee without any limit on duration or term to his contract. He was not treated as an expatriate, but as a U.K.-based employee, who did not receive a housing stipend. Mr. May received payments in British pounds, which were directly deposited into his U.K. bank account.

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[1] *Matter of Simon*, Tax Appeals Tribunal, March 2, 1989.

On his N.Y. tax returns for 2006, 2007, and 2008 he filed as nonresident, maintaining that his new domicile was London. The Division of Tax claimed that Mr. May did not establish new domicile and remained a New York domiciliary, assessing income tax against him as a New York resident, plus penalties and interest.

SUBSTANCE OF THE DECISION

Judge Friedman held that Mr. May had established a change in domicile to London after carefully considering the following factors:

- Retention of the place of abode in the former domicile;
- Location of business activity;
- Family ties;
- Social and community ties; and
- Formal declarations of domicile.

"As demonstrated in the case above, there is no bright-line rule to determine an individual's domicile."

Judge Friedman clearly distinguished this case from others where a taxpayer's claim of change of domicile had been rejected. Judge Friedman emphasized the fact that Mr. May spent far more time in London than in New York: Mr. May spent approximately 25 days in New York in 2006, 27 days in 2007, and 40 days in 2008. When Mr. May traveled to the United States to join his family for holidays, it was often to the Delaware property and not New York.

Judge Friedman was convinced by the testimony of Mr. May and his former wife regarding Mr. May's intentions to make London a new permanent home for himself and his family. In addition, Judge Friedman rejected the Division of Tax's argument that establishing a change to a foreign domicile required greater proof than establishing a change of domicile to another state.

CONCLUSIONS

A taxpayer who maintains property in New York State should be careful when changing to a new domicile outside of New York. In this light, the *Matter of Irenee D. May* is a potentially significant decision that can help many taxpayers. As demonstrated in the case above, there is no bright-line rule to determine an individual's domicile. Therefore, taxpayers should plan carefully when attempting redomiciliation and pay special attention to how many days are spent in New York, as well as the ties he/she establishes in a new place.

I.R.S. DEFINES MEASURE FOR TAX RATE DISPARITY TEST

Authors
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Tags
Branch Rule
C.F.C.
Foreign Base Company Sales Income
I.R.S.
Tax Rate Disparity

In order to reduce its overall foreign tax rate, a company may attempt to separate its foreign manufacturing from its foreign sales operations. If a foreign manufacturing entity sells products at a low margin to a related foreign sales entity in a low-tax jurisdiction, less foreign taxes are paid than if the foreign manufacturing entity sold the products directly to customers. This type of transaction would generally trigger foreign base company sales income ("F.B.C.S.I.") for the sales entity, while the manufacturing entity could rely on the exception whereby income produced by certain manufacturing activities is not included in F.B.C.S.I. (the "Manufacturing Exception").[1]

If not for a "Branch Rule," one potential way to avoid F.B.C.S.I. would be to have the manufacturing entity sell products to its branch or disregarded entity in a low-tax jurisdiction; from a U.S. tax perspective, the manufacturing entity is selling directly to customers. To prevent such abuse, the Branch Rule provides that the Manufacturing Exception will not apply if the sales and manufacturing activities are located in different jurisdictions and certain thresholds are met.

The Branch Rule will apply where the activities of the branch have "substantially the same effect" as those of a wholly-owned subsidiary, as determined using a tax rate disparity test (the "Tax Rate Disparity Test").[2] If the Branch Rule applies, the entity will not be treated as a branch but rather as a wholly-owned subsidiary of the C.F.C and will itself be subject to F.B.C.S.I. rules. The I.R.S. recently issued chief counsel advice as to how the Tax Rate Disparity Test should be applied.[3]

The Tax Rate Disparity Test consists of comparing the applicable tax rate in the C.F.C.'s country of incorporation to the tax rate where the branch is located, in order to determine whether the sales income (where the branch is located) is subject to a tax rate that is less than 90% of (and at least 5% lower than) the tax rate it would have been subject to if it were located in the manufacturing location. According to the recently released chief counsel advice, the calculation should be made by dividing the actual tax and the hypothetical tax by the hypothetical tax base determined under the laws of the manufacturing jurisdiction.

If a tax rate disparity exists, the entity will not be treated as a branch, but rather as a wholly-owned subsidiary of the C.F.C., and the Manufacturing Exception will not apply. Accordingly, the sales income would be treated as part of F.B.C.S.I.

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1 Code §954(d)(1).

2 Treas. Reg. §1.954-3(a)(2)-(4).

3 I.R.S. AM 2015-002, February 9, 2015.

PRE-IMMIGRATION INCOME TAX PLANNING, PART I: U.S. TAX RESIDENCE

Author
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Tags
Closer Connection Test
Green Card Test
Pre-Immigration Planning
Substantial Presence Test
Residency Starting Date
Residence Tiebreaker Provision

INTRODUCTION

Income tax planning for an individual preparing to immigrate to the U.S. involves both understanding the jurisdictional concepts of U.S. tax law and making intelligent life decisions to take advantage of the rules. In comparison to a business investment in the U.S., which involves the use of funds to accomplish a specific goal, individuals wishing to come to the U.S. make a series of personal changes that will affect all aspects of their lives. U.S. tax planning considerations are merely one part of the puzzle that must be solved. The key to the planning often requires a timely decision to accelerate or defer income, gain, or loss, so as to avoid unnecessary exposure to tax while in the U.S. In addition, it entails knowledge of the tax cost involved in the event an individual wishes to continue to live in an accustomed life style.

This article is the first in a series that will discuss the rules affecting individuals moving across borders. The series will address important considerations before, during, and after undergoing a period of U.S. tax residence, income tax planning opportunities for persons wishing to immigrate to the U.S., and ethical considerations that may apply when providing advice to the foreign individual. Departure taxes in other countries are beyond the scope of this article.

This installment discusses the tests by which a foreign individual is deemed to be a U.S. tax resident under domestic law and provisions for determining residence under income tax treaties. Domestic law applies the "Substantial Presence Test" and the "Green Card Test." If an individual meets the conditions of either test, he or she will be considered to be a resident for income tax purposes.[1]

GREEN CARD TEST

A foreign individual becomes a resident with respect to a calendar year if he or she is a lawful permanent resident of the U.S. at any time during that calendar year.[2] A lawful permanent resident is an individual who has been lawfully granted the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws.

Resident status is deemed to continue unless it is rescinded or is administratively or judicially determined to have been abandoned. That occurs when a final administrative or judicial order of exclusion or deportation is issued with regard to the individual. For this purpose, an order that is no longer subject to appeal to a higher court of competent jurisdiction is considered a final judicial order. If a green card

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1 Code §7701(b)(1)(A).

2 Treas. Reg. §301.7701(b)-1(b)(1).

has not been rescinded or administratively determined to have been abandoned, the individual technically remains a U.S. tax resident without being a U.S. resident for immigration purposes and at least one case has affirmed this conclusion.[3] This has both income tax issues and F.B.A.R. reporting issues under the Bank Secrecy Act and the penalties for the latter may far ourweigh the tax under the former. The regulations, however, are silent regarding the effective date of a formal abandonment and if a determination of abandonment is obtained from the Department of Homeland Security, U.S. Citizenship and Immigration Services, the Form I-407 (Abandonment of Lawful Permanent Resident Status) may identify any act of abandonment in a prior year that is countersigned by a government official.

SUBSTANTIAL PRESENCE TEST

In General

Under the Substantial Presence Test, a foreign individual is treated as a U.S. resident for income tax purposes if he or she is present in the U.S. 183 days or more during a rolling three-year period. The period begins anew for each year and comprises the second preceding year, the year immediately preceding, and the current year.[4] The individual must also be present for at least 31 days in the current year.[5] If the 31-day threshold is not met for a particular year, the individual cannot be treated as a resident during the year. The 31-day test has no relevance to years other than the current year being reviewed.

An individual is treated as being present in the U.S. on any day that he or she is physically present at any time during the day. It does not matter how short a period is involved. Thus, if a person were to arrive in the U.S. on a late flight landing at 11:00 P.M. on February 1, 1998, the individual would be deemed to be present in the U.S. for all of that day.

In computing the days present in the U.S., a weighting formula is applied under which days in the current year are given greater weight than days in the earlier two years. Days in the current year are fully weighted, days in the first preceding year are afforded a one-third weight, and days in the second preceding year are afforded a one-sixth weight.

To illustrate the effect of the weighting rule, assume that an individual will be present in the United States for 122 days in 2015. Assume further, that he will also be present in the United States for 122 days in each of 2014 and 2013. To determine tax residence status for 2015, the individual will count all 122 days in the United States in that year, plus one-third of the 122 days in the United States in 2014 (40.67 days), plus one sixth of the 122 days in the United States in 2013 (20.33 days). The total of 122 + 40.67 + 20.33 equals 183 days. The individual will be a U.S. resident for 2015 because the Substantial Presence Test is met. If, in comparison, if the individual were physically present in the U.S. for 121 days each year, tax residence would not be established.

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[3] *Topsnik v. Commr.,* 143 T.C. __,No. 12 (2014).

[4] Code §7701(b)(3)(A)(ii).

[5] Code §7701(b)(3)(A)(i).

Excluded Days

In determining whether a foreign individual meets the Substantial Presence Test based on days present in the U.S., certain days are excluded and are not counted as days present in the United States. A day is excluded if the individual falls within any of the following categories:

Exempt Individual

"In determining whether a foreign individual meets the Substantial Presence Test based on days present in the U.S., certain days are excluded and are not counted as days present in the United States."

A day is exempt if the individual is an "Exempt Individual" on that day. An Exempt Individual may be a foreign government-related individual, a teacher or trainee, a student, or certain professional athletes.

1. Government Official

   A foreign government-related individual is an individual who is temporarily present in the U.S. (i) as a full-time employee of an international organization, (ii) by reason of diplomatic status, or (iii) by reason of a visa that represents full-time diplomatic or consular status. An individual who falls within any of the foregoing foreign government-related categories is considered to be temporarily present in the U.S. as long as he or she is not a lawful permanent resident under the Green Card Test. For this purpose, the length of stay in the U.S. does not matter.

2. Teacher or Trainee

   A teacher or trainee is an individual, other than a student, who is admitted temporarily to the United States as a nonimmigrant under the provisions of the Immigration and Nationality Act relating to the admission of teachers and trainees to the United States.[6] The individual must substantially comply with the requirements of the visa status held.[7] This entails avoiding activities that are prohibited by the Immigration and Nationality Act and which could result in the loss of J visa status. If substantial compliance is questioned by the I.R.S., merely showing that a visa has been issued and not revoked is not suffieicent by itself for an individual to demonstrate substantial compliance. An independent determination of facts and circumstances may be made by the I.R.S. and the burden of proof is on the individual.

   This exception is designed to attract people for training during a limited period of time so that they may return home to engage in their trade or profession. It is not designed to allow people to remain indefinitely in the U.S. Consequently, time limits are provided. An individual is not treated as an Exempt Individual under the teacher or trainee provision if he or she has been exempt as a teacher, trainee, or student for any part of two of the six preceding calendar years.[8] However, if the individual has a foreign employer and receives compensation from that employer during prior years that is exempt from U.S. tax under Code §872(b)(3), the test is relaxed. In that situation, the individual will remain exempt in the current year unless he or she has been present in the U.S. as a teacher, trainee, or student for parts of four of the six preceding calendar years.[9]

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6 See §101(a)(15) of 8 U.S.C. 1101(a)(15)(J).

7 Treas. Reg. §301.7701(b)-3(b)(6).

8 Treas. Reg. §301.7701(b)-3(b)(7)(i).

9 Treas. Reg. §301.7701(b)-3(b)(7)(ii).

Several examples in the regulations[10] illustrate the limitations on the teacher or trainee exception. In the first example, an individual is temporarily present in the U.S. during the current year as a teacher. The individual does not receive compensation in the current year from a foreign employer that is exempt. The facts state that the individual was treated as an exempt student for the prior three years. The example concludes that, although the year at issue is the first year that the individual is seeking to be exempt as a teacher, he or she will not be considered an Exempt Individual for the year. The individual was exempt as a student for at least two of the past six years.

In the second example, the individual is temporarily present in the U.S. during the current year as a teacher and receives compensation in the current year from a foreign employer that is exempt. The facts state that the individual was treated as an exempt teacher for the prior two years, but the compensation for those years was not exempt because it was not received from a foreign employer. The example concludes that the individual will not be considered an Exempt Individual for the current year because he or she was exempt as a teacher for at least two of the past six years.

The third example illustrates the rule applicable to teachers receiving exempt compensation in prior years. The facts are the same as in the second example, except that all of the individual's compensation for the two preceding years was exempt by virtue of being received from a foreign employer. This example concludes that the individual will be an Exempt Individual for the current year because he or she was not exempt as a student, teacher, or trainee for four of the six preceding calendar years.

3. <u>Student</u>

A student is any individual who is admitted temporarily to the U.S. as a nonimmigrant under the provisions of the Immigration and Nationality Act relating to the admission of students into the U.S.[11] The individual must substantially comply with the requirements of being admitted.[12] As with a trainee, this entails avoiding activities that are prohibited by the Immigration and Nationality Act and which could result in the loss of visa status. Again, an independent determination of substantial compliance may be made by the I.R.S. The regulations focus on undertaking unauthorized employment as an act that could cause a student to fail the substantial compliance test.

4. <u>Professional Athlete</u>

A professional athlete temporarily present in the U.S. to compete in a charitable sports event (i) for which all the net proceeds are contributed to an organization described in Code §503(c) and exempt from tax under Code §501(a) and (ii) for which substantially all work is performed by volunteers is an Exempt Individual.[13] Professional golfers and tennis players are likely the intended beneficiaries of this exemption.

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10 Treas. Reg. §301.7701(b)-3(b)(7)(v).

11 Treas. Reg. §301.7701(b)-3(b)(4). See, *inter alia*, §101(a)(15)(F) or (M) of 8 U.S.C. 1101(a)(15).

12 Treas. Reg. §301.7701(b)-3(b)(6).

13 Treas. Reg. §301.7701(b)-3(b)(5).

> The regulations provide a narrow reading of this exemption. Only days on which the athlete actually competes in the charitable sports event are excluded. Thus, days on which the individual is present to practice for the event, to perform promotional or other activities related to the event, or to travel between events are included for purposes of the Substantial Presence Test.

Medical Condition

An individual will not be considered present during days on which he or she intends to leave, but is unable to leave because of a medical condition or medical problem.[14] The medical condition or problem must have arisen while the individual was present in the U.S. Thus, if the condition or problem existed prior to the individual's arrival in the U.S., and the individual was aware of the condition or problem, the individual is not exempt on days during which departure from the U.S. is prevented by the condition or problem. Also, a day of presence will not be excluded if, after the medical condition or problem subsides, the individual is able to leave the U.S., but instead, remains in the U.S. beyond a reasonable period for making departure arrangements. A day will also not be excluded if the medical condition arose during a prior stay in the U.S. and the individual returns to the U.S. for treatment.

Two key elements for coverage under this provision are a demonstration that the individual intended to leave the U.S. on a particular day and a determination that the departure was prevented by the medical condition. These are factual considerations. The regulations establish the points of reference for making these determinations. The inability to depart is easily determinable; the intent to depart may be a trap for the unwary. As a general rule, an individual will be presumed to have intended to leave during a period of illness if he leaves the U.S. within a reasonable period of time after becoming physically able to leave.[15] This is the minimum period within which arrangements to leave may be made. However, if at the time an individual's medical condition or medical problem arose, the individual was present in the U.S. for a definite purpose which by its nature could not be accomplished without being viewed to be a resident under the Substantial Presence Test, the requisite intent to leave the U.S. will not exist.

Several examples in the regulations place this test in perspective.[16] In the first example, an individual is in a serious automobile accident on the way to an airport to depart the U.S on March 31. The departure ticket indicates that the individual intended to leave the U.S. on March 31, but was unable to leave as a result of the injuries suffered in the accident. He recovers from the injuries and is able to leave the U.S. on May 31. He departs from the U.S. on that date. The example concludes that the individual's presence in the U.S. during the period from April 1 through May 31 will not be counted as days of presence in the U.S. The days up to and including the date of the accident will be counted.

In the second example, the facts are the same, except that the intended date of the return flight is May 31, as evidenced by an airline ticket. The example concludes that the individual may not exclude any days of presence in the in the U.S. under the tests related to medical conditions.

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[14] Treas. Reg. §301.7701(b)-3(c)(1).

[15] Treas. Reg. §301.7701(b)-3(c)(2).

[16] Treas. Reg. §301.7701(b)-3(c)(4).

Days in Transit

A foreign individual may exclude days of presence in the U.S. if the individual is in transit between two foreign points, and is physically present in the U.S. for a period of time that is less than 24 hours.[17] An individual is considered to be in transit if he or she pursues activities that are substantially related to completing his or her travel to a foreign point of destination. For example, an individual who travels between airports in the U.S. in order to change planes en route to his or her destination will be considered to be in transit. However, if the individual attends a business meeting while present in the U.S., whether or not that meeting is within the confines of the airport, he or she will not be considered to be in transit. This provision is helpful for individuals who are strictly counting days in the U.S. and who are forced to be present in the U.S. overnight while transiting to a foreign destination.

"A foreign individual who believes that he or she is exempt on a particular day of presence in the U.S. and does not wish that day to count toward substantial presence in the U.S. must file a statement with the I.R.S. on or before the due date of a tax return."

Procedural Requirements

A foreign individual who believes that he or she is exempt on a particular day of presence in the U.S. and does not wish that day to count toward substantial presence in the U.S. must file a statement with the I.R.S. on or before the due date of a tax return.[18] Form 8843 (Statement for Exempt Individuals and Individuals With a Medical Condition), is used for this purpose. The statement must contain sufficient information describing the reasons why the day's presence should be exempted under the applicable test described above. If an individual claims that a day is exempt because of a medical condition or a problem that developed while present in the U.S., the statement must be signed by the treating physician. If a medical condition prevented an individual from leaving the U.S., the treating physician must certify that fact and that there was no indication of a pre-existing condition.

Unless the I.R.S. determines otherwise, a failure to timely file the statement will result in all days present in the U.S. being counted toward substantial presence.[19] The I.R.S. may waive the procedural requirement if the individual can show by clear and convincing evidence that he or she took (i) reasonable actions to become aware of the filing requirements and (ii) significant affirmative steps to comply with those requirements. Also, the I.R.S. may choose to ignore the requirement if in the best interest of the Federal government.[20]

Closer Connection Test

A foreign individual who meets the Substantial Presence Test may nevertheless be considered to be a nonresident with regard to the current year if he can demonstrate that closer connections are maintained to another, single, foreign country.[21]

To come within this exception, three conditions must be satisfied. First, the individual must be present in the U.S. for fewer than 183 days in the current year. Thus, this exception applies to persons who are in the U.S. for more than 183 days during the rolling three-year period, computed in light of the weighting rules discussed above, and who are present for up to 182 days in the current year.

17 Treas. Reg. §301.7701(b)-3(d).

18 Treas. Reg. §301.7701(b)-8(c).

19 Treas. Reg. §301.7701(b)-8(d)(1).

20 Treas. Reg. §301.7701(b)-8(e).

21 Treas. Reg. §301-7701(b)-2(a).

Second, the individual must maintain a "Tax Home" in a foreign country during the year. The concept of a Tax Home originated in the context of the deduction of travel expenses incurred while away from home. While there is no uniform definition in court cases, and the view of the I.R.S. is somewhat different from that of many courts, in broad terms a Tax Home is the place where a person generally should live in light of his employment responsibilities. Thus, if a person works in New York, it is reasonable for him to have a home in the New York area; living expenses incurred in New York would not be deductible. Living expenses incurred while temporarily outside New York would be deductible. However, if a person generally works in Los Angeles, but takes a short-term assignment in New York that is scheduled to last for less than one year, it would not be reasonable for him to permanently move to New York. His Tax Home would continue to be Los Angeles. Expenses incurred while in New York temporarily would be deductible. Finally, if a person merely moves from one job to another, staying at each place only temporarily, the person's Tax Home would be wherever he or she happened to be at the time.[22] The same rule applies if the individual does not work and merely lives in several places during the year. Each place at which he is present is his or her tax home for the period of presence at that place.

"If a person merely moves from one job to another, staying at each place only temporarily, the person's Tax Home would be wherever he or she happened to be at the time."

Third, the individual must have a closer connection during the year to a single foreign country in which he or she maintains a Tax Home than the connections maintained to the U.S. To meet this requirement, the individual must demonstrate that he or she has maintained more significant contacts with the foreign country than with the U.S. The regulations look to the following factors:

- The location of the individual's permanent home;
- The location of the individual's family;
- The location of personal belongings, such as automobiles, furniture, clothing, and jewelry owned by the individual and his or her family;
- The location of social, political, cultural, or religious organizations with which the individual has a current relationship;
- The location where the individual conducts his or her routine personal banking activities;
- The location where the individual conducts business activities (other than those that constitute the individual's Tax Home);
- The location of the jurisdiction in which the individual holds a driver's license;
- The location of the jurisdiction in which the individual votes;
- The country of residence designated by the individual on forms and documents; and
- The types of official forms and documents filed by the individual, such as Form 1078 (Certificate of Alien Claiming Residence in the United States), Form W-8BEN (Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding), or Form W-9 (Payer's Request for Taxpayer Identification Number).

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22 See I.R.S. Publication 17 (Your Federal Income Tax for Individuals), Chapter 26 (Car Expenses and Other Employee Business Expenses).

“Generally, the Residency Termination Date will be the last day of the calendar year.”

If an individual moves between two foreign countries during the year, he or she may demonstrate closer connections to each of the two foreign countries during the period of residency in such country.[23] To come within this rule, the individual must remain a resident for tax purposes within one of the foreign countries for the entire year or must be subject to taxation as a resident in one of the foreign countries for the period where a Tax Home is maintained and in the other foreign country for the balance of the year. An individual may not make this determination for three or more countries.

The closer connection exception is not available to a foreign individual who has personally applied, or taken other affirmative steps, to change his or her status to that of a permanent resident during the current year or has an application pending for adjustment of status during the current year.[24] Affirmative steps include the filing of the Department of Homeland Security, U.S. Citizenship and Immigration Services (“U.C.I.S.”) Form I-508 (Waiver of Immunities), Form I-485 (Application for Status as Permanent Resident), Form I-130 (Petition for Alien Relative), Form I-140 (Petition for Prospective Immigrant Employee), Department of Labor Form ETA-750, (Application for Alien Employment Certification), and Department of State Form OF-230, (Application for Immigrant Visa and Alien Registration).

A filing requirement is a condition of coming within this exception to residence under the Substantial Presence Test.[25] Form 8840 (Closer Connection Exception Statement for Aliens) is used to claim the closer connection exception.

PERIOD OF RESIDENCE

General Rule

Residence generally begins on the “Residency Starting Date” and ends on the “Residency Termination Date.” These are defined terms under the regulations.

The Residency Starting Date for an individual who meets the Substantial Presence Test is the first day during the calendar year on which the individual is present in the United States. The Residency Starting Date for an alien who meets the Green Card Test is the first day during the calendar year in which the individual is physically present in the United States as a lawful permanent resident. If both tests are met, the Residency Starting Date is the earlier of the two dates on which the tests were met.

Generally, the Residency Termination Date will be the last day of the calendar year. Thus, it is not the last day of presence in the U.S. during the calendar year. This rule, however, is subject to an exception. If the individual establishes that, for the remainder of the calendar year, (i) his or her Tax Home was in a foreign country and (ii) he or she maintained a closer connection to that foreign country than to the United States, the Residency Termination Date will be the last day of presence in the U.S. under the Substantial Presence Test and the last day of lawful permanent residence under the Green Card Test. If the individual satisfied both residence tests, it is the latter of the two dates.

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23 Treas. Reg. §301-7701(b)-2(e).

24 Treas. Reg. §301-7701(b)-2(f).

25 Treas. Reg. §301-7701(b)-2(g).

De Minimis Presence

An alien individual may be present in the United States for up to 10 days without triggering the Residency Starting Date under the Substantial Presence Test or extending the Residency Termination Date under that test.[26] To come within this "*De Minimis* Rule," the individual must establish that, during the period covering the 10 days of presence, (i) the individual's Tax Home was in a foreign country and (ii) he or she maintained a closer connection to that foreign country than to the U.S.

The regulations contain several technical rules. First, the days in the U.S. need not be consecutive, but the total cannot exceed ten days. Second, if all the days that occur during a period of continuous presence cannot be excluded, none of the days can benefit from the *De Minimis* Rule. Finally, although the days in the *De Minimis* period are not considered in determining the Residency Starting Date, the days are taken into account in computing the Substantial Presence Test.

Elective Residency Starting Date

If a foreign individual, who otherwise does not meet the Substantial Presence Test or the Green Card Test for the current year, is physically present in the United States for at least 31 consecutive days during the current year and for at least 75% of the subsequent days in balance of the year, the individual may elect to have the residency starting be the first day of that 31-day period.[27] This elective procedure applies only if the individual was not a resident in the immediately preceding year and continues to be a resident under the Substantial Presence Test in the subsequent year. This means that the election cannot be made until it is known that residence is established for the subsequent year, and an extension may be obtained. The election is important for individuals arriving in the U.S. from a jurisdiction that has a soak-up rule allocating tax residence to that country if an individual departing therefrom is not a resident of any other country.

No-Lapse Rules

The Code and regulations contain two rules designed to prevent an individual from managing his or her residence to avoid tax. The first of these no-lapse rules provides that an individual who was a U.S. resident during any part of the preceding calendar year and who is a U.S. resident for any part of the current year will be considered to be taxable as a resident at the beginning of the current year.[28] It also provides that an individual who is a U.S. resident for any part of the current year and who is also a U.S. resident for any part of the following year will be taxable as a resident through the end of the current year. It does not matter that the individual has a closer connection to a foreign country than the United States during the current year.

The second no-lapse rule coordinates taxation with the expatriation provisions of Code §877 that generally cover expatriates for years prior to the effective date of Cod §877A.[29] In brief, they extended U.S. jurisdiction to impose ordinary income tax on net income for a period of ten years for items of income actually arising from U.S.

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26 Treas. Reg. §301.7701(b)-4(c)(1).

27 Treas. Reg. §301.7701(b)-4(c)(3).

28 Treas. Reg. §301.7701(b)-4(e).

29 Code §7701(b)(10); Treas. Reg. §301.7701(b)-5(a).

sources or deemed to arise from U.S. sources. The second no-lapse rule applies to persons who have had U.S. residence in the past (the initial residency period), relinquish that residence for a period of years (the intervening period), and reestablish residence in the U.S. If the initial residency period covers at least three taxable years of at least 183 days each, and residence is reestablished before the close of the third complete calendar year following the residency terminations date, the individual will be subject to tax during the intervening period in the manner prescribed by Code §877. The special tax regime applies only if it results in the imposition of a greater tax liability than the 30% withholding tax ordinarily imposed on persons who are neither citizens nor residents of the U.S. with regard to U.S.-source income that is not effectively connected with the conduct of a trade or business in the U.S.

"The residence article of an income tax treaty generally contains a tiebreaker provision under which the dual resident individual is classified as a resident of one, and only one, country for purposes of the income tax treaty."

RESIDENCE UNDER INCOME TAX TREATIES

In General

Even though a foreign individual may be deemed to be a resident of the U.S. under domestic U.S. tax law, the individual may, nonetheless, be taxed as if he were a nonresident with regard to the U.S. if so mandated by treaty.

With limited exception, the income tax treaties of the U.S. now in effect or awaiting Senate approval contain a residence provision. Under these provisions, the standard for determining the residence of individuals and corporations is established. Residence status is important because only residents qualify for the benefits provided by the treaty.

Ordinarily, if an individual is taxed as a resident of a treaty country for purposes of the domestic tax laws of that country, the individual will be treated as a resident of that country for purposes of the income tax treaty. Where, under the domestic tax laws of each of the two treaty jurisdictions, the individual would be treated as a resident, he or she is potentially subject to double taxation of income. This type of individual is commonly referred to as a "dual resident." The residence article of an income tax treaty generally contains a tiebreaker provision under which the dual resident individual is classified as a resident of one, and only one, country for purposes of the income tax treaty.[30] In that way, the tiebreaker is one of the few provisions of an income tax treaty which overrides U.S. domestic law.[31]

Tiebreaker Provision

Under the tiebreaker provision, a series of tests is applied in a specific order to the particular facts and circumstances of the dual resident. Once the individual's residence is determined under a particular test, there is no need to proceed to another test. In general, exclusive residence is determined by applying the following tests in the following order:

- First, the individual is deemed to be a resident of the country in which a permanent home is available;

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[30] See, *e.g.*, Article 3 (Fiscal Residence) of the Israel-U.S. Income Tax Treaty; Article IV (Residence) of the Canada-U.S. Income Tax Treaty; and Article 4 (Residence) of the U.K.-U.S. Income Tax Treaty.

[31] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1528 (1984).

- If the individual has a permanent home in both countries or in neither country, he or she will be deemed to be a resident of the country with which his personal and economic relations are closer – this is known as the center of the individual's vital interests;
- If the closer economic relations cannot be determined, the individual will be a resident of the country in which he has an habitual abode; and
- If he has a habitual abode in both countries or in neither one, he will be deemed to be a resident of the country of which he is a national.

If the issue cannot be settled by the application of these tests, the competent authorities of both countries (*viz.*, the I.R.S. and its counterpart overseas) will decide by mutual agreement the country of which the individual will be considered an exclusive resident.

Use of the Tiebreaker

The tiebreaker rule is important for individuals who wish to retain a green card but who do not wish to pay U.S. tax on income derived from sources outside the U.S. The closer connection test of domestic law, discussed above, is not relevant for an individual who is a permanent resident of the U.S. If residence can be allocated exclusively to the jurisdiction that is the tax treaty partner of the U.S., the individual may be able to retain the benefits of the green card without incurring the tax detriments of U.S. tax residence.

In this regard, it should be noted that many countries defer the imposition of tax on certain types of income for newly-arrived, non-domiciled individuals. For example, investment income of a non-domiciled individual who resides in the U.K. may be deferred until the investment income or gains are remitted to the U.K. (After seven years, a fixed remittance charge is imposed for continuing this tax treatment.) The State of Israel will not impose tax on gains from the disposition of foreign assets held offshore at the time an immigrant first establishes residence. Canada allows for a step-up in basis of capital property held at the time Canadian residence is established by an individual. The income tax treaty with a country whose laws contain any of those types of provisions must be examined closely to determine the interplay between foreign tax law and the income tax treaty benefit desired. In many instances, income that is taxed only upon remittance will not qualify for the full range of treaty benefits.[32] However, each treaty is unique and the specific terms

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[32] *E.g.*, Article 1(7) (General Scope) of the U.K.-U.S. Income Tax Treaty provides as follows:

> Where under any provision of this Convention income or gains arising in one of the Contracting States are relieved from tax in that Contracting State and, under the law in force in the other Contracting State, a person, in respect of the said income or gains, is subject to tax by reference to the amount thereof which is remitted to or received in that other Contracting State and not by reference to the full amount thereof, then the relief to be allowed under this Convention in the first-mentioned Contracting State shall apply only to so much of the income or gains as is taxed in the other Contracting State.

See also Article 4(5) (Fiscal Domicile) of the Bangladesh-U.S. Income Tax Treaty; Article 4(5) (General Rules Of Taxation) of the Cyprus-U.S. Income Tax Treaty; and Article 6(6) (General Rules of Taxation) of the Israel-U.S. Income Tax Treaty.

of the applicable treaty must be examined. There may continue to be benefits for offshore investment income.

Reporting

The U.S. income tax regulations set forth certain rules of general application that must be followed in order for a dual resident to be able to take advantage of the tiebreaker tests and be treated as a resident of the other treaty country for purposes of an applicable treaty and other U.S. income tax purposes. These rules are similar to those discussed above in connection with individuals contending that they are exempt for certain days.[33] Under these rules, the individual must prepare an income tax return computing tax liability as a nonresident alien. The return is filed on Form 1040NR. Generally, the return is due on June 15 of the year following the taxable year. The due date can be extended up to six months, if timely requests are filed.

A disclosure statement is provided on Form 8833 (Treaty-Based Return Disclosure Under §§6114 or 7701(b)) attached to the Form 1040NR which:

- Contains a statement that the taxpayer is claiming a treaty benefit as a nonresident of the United States; and
- Describes the facts relied upon to support the position taken, the nature and approximate amount of income that is exempted, and the specific treaty provision for which the taxpayer is claiming a treaty benefit.

The Form 1040NR and the attached statement are filed with the Department of the Treasury, Internal Revenue Service Center, in Austin, Texas, 73301-0215.

PATH FORWARD

As part of the series addressing an overall plan to provide pre-mmigration tax planning, this article explained the standard that is applied to determine:

- Whether an individual is a tax resident of the U.S.,
- When the period of residence begins and ends,
- The interface with comparable provisions in income tax treaties, and
- Reporting obligations.

The next installment will address the tax consequences of relinquishing U.S. citizenship or becoming a former long-term resident of the U.S. Once the bookends of tax residence are explained, this series will address the planning choices that are available.

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[33] Treas. Reg. §301.7701(b)-7.

MAJOR U.S. DRUG COMPANY AVOIDS BILLIONS IN TAXES ON $1,000 PILL

Authors
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Tags
Offshore Profits
Pharmaceuticals
Tax Avoidance
Transfer Pricing

Gilead Sciences Inc. ("Gilead") has developed one of the most expensive drugs available and is avoiding billions of dollars in U.S. taxes by holding its profits outside of the U.S.

The U.S. company has produced a hepatitis C treatment that costs $1,000 per pill. The treatment, which consists of a 12-week regime of its hit drug, Sovaldi, and another pill called Harvoni, costs $94,500 and has alleviated the hepatitis infection and successfully cured most patients of hepatitis C. Since receiving approval for Sovaldi from the Food and Drug Administration in 2013, the profits poured in for Gilead.

Gilead had $10.3 billion in worldwide drug sales for 2014. The company's securities filing reports its 2014 foreign income as $8.2 billion before taxes and that it earned more in non-U.S. profits than it recorded in non-U.S. sales. In comparision, in 2013 Gilead reported only $738 million in foreign income before taxes. The securities filing also shows that 73% of Gilead's revenue came from U.S. sales in 2014, compared to only 60% from U.S. sales reported in 2013.

A representative of Gilead stated it would owe $5.5 billion in U.S. taxes if it repatriated the $15.6 billion it holds in overseas profits. According to its securities filing, the company has only paid about 5% in foreign taxes on its offshore income.

Gilead established its operations and worldwide revenue base in Ireland. Ireland's highest corporate tax rate is 12.5%, compared to the U.S. corporate tax rate of 35%. The high U.S. tax rate on corporations incenti*vize*s companies to shift their profits offshore.

Like Gilead, many multinational corporations based in the U.S. utilize the corporate tax rules to transfer their valuable intangible property to countries with low tax rates. The transfer of intangibles from a U.S. parent company to a foreign subsidiary is often structured as a taxable sale. However, the sales price is difficult to ascertain when the intangible is new to the market. Pharmaceutical and technology companies often transfer their intellectual property overseas because a new drug or technology is hard to value before it produces income.

The Federal government is concerned about the tax revenue lost from approximately $2 trillion in profits held by U.S. multinational corporations overseas.

CORPORATE MATTERS: PARTNERSHIPS

Authors
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Tags
Limited Liability Limited Partnership
Limited Liability Partnership
Limited Partnership

In previous issues, we discussed limited liability companies and the various benefits of using such entities, including pass-through taxation, asset protection, ease of formation and flexibility.[1] There are partnerships that can be used to achieve the same results that may be of particular interest to individuals from jurisdictions where the limited liability company is not recognized to the same extent as it is in the United States. These are "Limited Partnerships," "Limited Liability Partnerships" and "Limited Liability Limited Partnerships." We thought it may be helpful to outline the differences between these three types of partnerships. Research should be conducted on a state-by-state basis depending on the jurisdiction one is interested in – the following discussion focusses on Delaware.

LIMITED PARTNERSHIP

A Limited Partnership is a partnership where one or more of the owners are general partners and one or more of the owners are limited partners. The general partners have unlimited liability and are liable for all of the partnership's debts and obligations. The limited partners have limited liability – limited to the amount of capital they have invested in the partnership. General partners control the partnership and are responsible for its operation. Limited partners have no say in the operation of the partnership and are subject to losing liability protection if they are found to be participating in the management of the partnership. The Delaware Revised Uniform Limited Partnership Act ("DRLPA") provides that "a limited partner is not liable for the obligations of a limited partnership unless he or she is also a general partner or, in addition to the exercise of the rights and power of a limited partner, he or she participates in the control of the business."[2]

LIMITED LIABILITY PARTNERSHIP

A Limited Liability Partnership is a general partnership for which an election has been made to obtain limited liability for all of the general partners. Unlike a Limited Partnership, in a Limited Liability Partnership there are no limited partners and all partners can participate in the management of the partnership. As a general rule, the partners of a Delaware general partnership are liable for all of the obligations of the partnership. Once qualified as a Limited Liability Partnership, the partners are protected from this general rule and the obligations of the partnership arising subsequent to the entity's qualification as a Limited Liability Partnership are solely the

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1 See Insights, Vol. 1 No. 8 "Corporate Matters: Delaware or New York L.L.C.?," Vol. 1 No. 10 "Corporate Matters: Series Limited Liability Companies," and Vol. 2 No. 2 "Corporate Matters: Limited Liability Company Agreements."

2 6 Del. C §17-303 *et seq.*

obligations of the partnership. Note, however, that a partner may still have liability for his or her own actions.

LIMITED LIABILITY LIMITED PARTNERSHIP

"A Limited Liability Limited Partnership is a Limited Partnership with limited liability for all partners, including general partners."

A Limited Partnership may be formed as, or may become, a Limited Liability Limited Partnership by filing a statement of qualification with the Secretary of State.[3] A Limited Liability Limited Partnership is a Limited Partnership with limited liability for all partners, including general partners.

In order to become a Limited Liability Limited Partnership in Delaware, a Limited Partnership must satisfy the requirements of §§17-214 of the DRLPA, namely:

- The Limited Partnership's partnership agreement must permit the filing of a Statement of Qualification;
- The Limited Partnership must file a Statement of Qualification containing:
    - The name of the partnership,
    - The address of its registered office,
    - The name and address of its registered agent for service of process,
    - The number of partners at the time the statement is effective,
    - A statement that the partnership elects to be a Limited Liability Limited Partnership, and
    - The date or time upon which the statement is to be effective;
- The Limited Partnership must pay a filing fee; and
- The Limited Partnership must include as the last words or letters in its name "Limited Liability Limited Partnership," "L.L.L.P." or "LLLP."

The Limited Partnership's status as a Limited Liability Limited Partnership is effective upon the filing of the Statement of Qualification.

In order to retain its status as a Limited Liability Limited Partnership, the entity must file an Annual Report together with the applicable fee. Failure to file the Annual Report or pay the required filing may result in the partnership's status being revoked.

CONCLUSION

To summarize the differences between the above partnerships and how they play out in practice:

- If a general partnership is formed by two partners to conduct a business activity, both partners are liable for the debts and obligations of the partnership.
- If the two partners had instead formed a Limited Partnership, one would be the general partner (and would, therefore, be liable for the partnership's

[3] 6 Del. C §17-214 *et seq.*

debts) and the other would be the limited partner (and would have limited liability).

- If a Limited Liability Partnership is formed, neither of the partners is subject to personal liability.
- If a Limited Liability Limited Partnership were formed, neither the general partner nor the limited partner would be liable for the partnership's debts.

There may not be any reason why an existing U.S. Limited Partnership would elect to be treated as a Limited Liability Limited Partnership. If the structure is in place, either the existing general partner is a corporate entity with limited liability or the creditworthiness of the general partner is crucial to the operation of the partnership. Taking that liability away may be detrimental to the operations of the entity. Note, also, that qualifying as a Limited Liability Limited Partnership does not relieve a general partner from obligations incurred prior to such qualification. Furthermore, in the U.S. those desirous of forming an entity with pass-through tax treatment and limited liability for all parties would most likely simply form a limited liability company.

In Canada, however, U.S. limited liability companies are not recognized as partnerships for tax purposes and are, therefore, subject to double taxation. Limited Liability Limited Partnerships have not, to date, been subject to the same interpretation and, therefore, are very useful for Canadians wishing to invest in the U.S.

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Tags
Common Reporting Standard
F.A.T.C.A.
Form 8938
I.G.A.
Netherlands
U.K.

FOREIGN ACCOUNTS – UPDATE TO 2014 INSTRUCTIONS TO FORM 8938

Form 8938, *Statement of Specified Foreign Financial Assets*, requires the disclosure of certain foreign financial assets owned by U.S. citizens, resident alien individuals, and nonresidents who elect to be treated as resident alien individuals for U.S. tax purproses. (*E.g.*, a nonresident alien having a U.S. citizen spouse may elect be treated as a U.S. resident for purpose of filing a joint income tax return.) Form 8938 is attached to the individual's income tax return for the applicable year (starting with tax year 2011) and must be filed by the due date for said return, including extensions.

Updates to the 2014 instuctions for the Form 8938 reporting requirements were announced on March 10, 2015 and incorporate final Treasury Regulations under Internal Revenue Code (the "Code") §6038D, adopted in December 2014. The final regulations are effective for taxable years beginning after December 19, 2011. The update contains additional information not included in the updated instructions for Form 8938. Taxpayers and their tax return preparers must review these recent changes to the form's instructions to make sure it does not affect their filing obligations.

Dual Resident Taxpayers

A dual resident taxpayer, within the meaning of these regulations, is an individual who is considered a resident of the U.S. under the Code and applicable regulations because he or she meets the "Green Card Test" or the "Substantial Presence Test" and is also a resident of a treaty country (pursuant to the internal tax laws of that country). The updated instructions apply to dual resident taxpayers who determine their income tax liability for all or a portion of the taxable year as if they were nonresident aliens (pursuant to a provision of an income tax treaty that provides for resolution of conflicting claims of residence by the U.S. and its treaty partner).

- A dual resident alien filing as a nonresident alien at the end of his or her taxable year is not required to report specified foreign financial assets on Form 8938 for the portion of the individual's taxable year covered by the applicable Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, if the individual complies with the filing requirements, *i.e.*, generally, timely filing the applicable Form 1040NR and attaching Form 8833, *Treaty-Based Return Position Disclosure Under §6114 or 7701(b).*

- A dual resident alien filing as a resident alien at the end of his or her taxable year is also not required to report specified foreign financial assets on Form 8938 for the portion of the individual's taxable year reflected on the schedule to the applicable Form 1040, *U.S. Individual Income Tax Return*, if the individual complies with all of the filing requirements, *i.e.*, generally, timely filing the applicable Form 1040 and attaching a properly completed Form 8833.

Exclusions from the Definition of "Financial Account" Under a Model 1 or Model 2 Inter-Governmental Agreement ("I.G.A.")

For taxable years beginning on or before December 12, 2014, if the jurisdiction in which a financial account is maintained has a F.A.T.C.A. I.G.A. in effect, or is treated as having a Model 1 or Model 2 I.G.A. in effect, on or before the last day of the taxpayer's taxable year, certain financial accounts will be excluded from reporting on Form 8938. Exclusions include retirement and pension accounts, and non-retirement savings accounts, as well as accounts satisfying conditions similar to those described in the F.A.T.C.A. regulations as excluded from the definition of a financial account under Code §1.1471-5(b)(2)(i), or by virtue of the definition of a financial account pursuant to the applicable I.G.A.

Note that the above rule does not apply for taxable years beginning after December 12, 2014. With respect to such taxable years the final Code §6038D regulations provide that the above-mentioned accounts that are excluded from the definition of a financial account under the F.A.T.C.A regulations or an IG.A. must nevertheless be reported by the taxpayer on Form 8938. Such accounts are, therefore, subject to uniform reporting rules and must be reported without regard to whether the account is maintained in a jurisdiction with an I.G.A.

Joint Form 5471 or Form 8865 Filing

Form 5471 is an information return filed by certain U.S. persons with respect to an interest in a foreign corporation. Form 8865 is an information return filed by certain persons with respect to a foreign partnership. The two forms and the applicable schedules may be filed by one person for other persons who have the same filing requirements.

A U.S. person who is required to file Form 5471 or Form 8865 but is instead included as part of a joint filing must attach a statement to his or her income tax return to notify the I.R.S. that the filing requirement was, or will be, satisfied and provide the I.R.S. with identifying information for the person and return that will satisfy the filing requirements, including the I.R.S. service center with which such return was, or will be, filed. The I.R.S.'s March 10 publication clarifies that with respect to Form 8938, such a taxpayer does not have to report any asset that is reported (or deemed reported due to joint filing) on a timely filed Form 5471 or Form 8865 for the same tax year, provided that the taxpayer's Form 8938 reports the filing of the applicable form on which the asset is reported.

F.A.T.C.A. IN TANDEM WITH O.E.C.D. INFORMATION EXCHANGE EFFORTS

The common reporting standard ("C.R.S.") proposed by the O.E.C.D. is moving toward its first stage of implementation in 2016, and there is mounting pressure for the United States to join the global effort.

The O.E.C.D. is paralleling the Foreign Account Tax Compliance Act ("F.A.T.C.A.") in its growth toward automatic information exchange. The C.R.S. is an indication that the rest of the world has accepted F.A.T.C.A. and is ready to embrace its benefits and burdens. In a view to maximize efficiency, the O.E.C.D. borrows heavily from the intergovernmental approach to implementing F.A.T.C.A. The model I.G.A.'s contain language indicating intent to work together toward achieving common reporting and due diligence standards for financial institutions. The C.R.S. will result in more pressure on the United States to expand its information collection regarding financial accounts held by non-U.S. persons.

The C.R.S. is aimed at preventing the spread of different reporting standards, which would increase costs for both governments and financial institutions. In a similar fashion to I.G.A.'s, the C.R.S. generally requires that jurisdictions enact domestic implementing legislation.

The C.R.S. requires reporting on investment income, account balance and sales proceeds from financial assets, whether held by individuals or entities. Reporting financial institutions include banks, custodians, brokers, and some collective investment vehicles and insurance companies. The C.R.S. includes a look-through provision for passive entities to ensure that the individuals who control the entities are disclosed.

Enforcement

While F.A.T.C.A. incorporates a 30% withholding tax to insure compliance with U.S. law, the C.R.S. lacks such an enforcement mechanism for compliance. Therefore, the chief enforcement mechanism is an honor system, which can become problematic. Local jurisdictions will likely setup their own enforcement mechanisms, such as a withholding tax or monetary penalties that can work in tandem with C.R.S. Given the possible country-by-country discretion with regard to compliance and enforcement, a multinational body may be required to oversee and monitor each country.

INTERNATIONAL DATA EXCHANGE SERVICES – GETTING F.A.T.C.A. ACCOUNT INFORMATION TO THE I.R.S.

International Data Exchange Services ("I.D.E.S."), recently created by the Internal Revenue Service ("I.R.S."), is a secure, managed file transfer service that is available to financial institutions ("F.I.'s") and host country tax authorities ("H.C.T.A.'s") to facilitate F.A.T.C.A. reporting. This reporting is provided for under the U.S. Treasury Regulations, the F.F.I. agreements, Tax Information Exchange Agreements ("T.I.E.A.'s"), and I.G.A.'s, as well as other guidance issued by the Treasury Department and the I.R.S. The data collected through I.D.E.S. will be incorporated into I.R.S. compliance operations.

I.D.E.S. is accessible to enrolled users over the Internet via Hypertext Transfer Protocol Secure ("H.T.T.P.S.") or Secure File Transfer Protocol ("S.F.T.P."). I.D.E.S. provides for an end-to-end controlled file transfer with enhanced monitoring and security features. The system only accepts encrypted electronic submissions and will allow for the transmission of F.A.T.C.A. reporting in the approved F.A.T.C.A. XML Schema v1.1 ("F.A.T.C.A. X.M.L.").

I.R.S. Releases Revised Publication on F.A.T.C.A. Data Exchange Service

The I.R.S. has released Publication 5190 (03-2015), *Draft Foreign Account Tax Compliance Act F.A.T.C.A. I.D.E.S. User Guide*, providing guidance for F.I.'s and H.C.T.A.'s that enroll in the I.D.E.S. to transmit F.A.T.C.A. data.

Authorized I.D.E.S. Users

Authorized I.D.E.S. users include F.I.'s, direct reporting N.F.F.E.'s, and H.C.T.A.'s. Each authorized user has limited access to the system based on the data flow model described in their applicable agreement with the United States (*e.g.*, an I.G.A.) or in the Treasury regulations.

I.R.S. Revises F.A.Q. on Systems Used for F.A.T.C.A. Data

The I.R.S. has released a revised list of frequently asked questions ("F.A.Q.") on I.D.E.S. and the international compliance management model system, which are used for F.A.T.C.A. data, adding and updating several questions. Issues covered by the revised F.A.Q. include enrolling in test windows, verification of test data by authorized users prior to launching of the system, and more.

DUTCH GUIDANCE ISSUED UNDER NETHERLANDS I.G.A.

On January 22, 2015, the Dutch Ministry of Finance published the Dutch Guidance Notes for the I.G.A. between the Netherlands and the U.S. The Guidance Notes contain clarification of certain definitions and procedures to be followed by companies that are considered Dutch F.I.'s for F.A.T.C.A. purposes. The publication of the Dutch Guidance Notes follows the approval of the I.G.A. by the Dutch House of Representatives. The I.G.A. is still subject to the approval of the Dutch Senate; voting is planned to take place in the first quarter of 2015.

U.K. ISSUES F.A.T.C.A. ONLINE REGISTRATION GUIDANCE

HM Revenue & Customs ("H.M.R.C.") has issued guidance that provides details on how to use H.M.R.C. online services to register for U.S. F.A.T.C.A. purposes. While a reporting U.K. F.I. has to register with the I.R.S. to receive a F.A.T.C.A. identification number, the Global Intermediary Identification Number ("G.I.I.N."), it also has to register with H.M.R.C. to receive a U.K.-assigned F.A.T.C.A. I.D. for itself and an H.M.R.C. registration I.D. for any other F.I. it may be registering as its sponsor.

U.S. WITHHOLDING AGENTS RESPONSIBLE TO CHECK G.I.I.N.'S

"Withholding agents are advised to establish written internal procedures requiring G.I.I.N. verification and to clarify who is responsible for fulfilling this obligation."

Many U.S. withholding agents have faced the burden of receiving incomplete Form W-8's due to the complexity of the Form W-8BEN-E (completed by entities that are the beneficial owners of a payment) and Form W-8IMY (completed by entities that serve as an intermediary to the beneficial owner). This situation has led some withholding agents to assist in the completion of the forms.

While delivery of a fully completed Form W-8, containing a G.I.I.N., is often perceived as the last step in avoiding F.A.T.C.A. withholding, withholding agents are in fact required to take one more step. To ensure that no F.A.T.C.A. withholding will apply, withholding agents must check the G.I.I.N provided against the list of registered F.F.I.'s, which appears on the I.R.S. F.A.T.C.A. webpage. Unless a U.S. withholding agent confirms that the G.I.I.N. they received is on the I.R.S. list and matches up with the G.I.I.N provided on the Form W-8 received, F.A.T.C.A. withholding is still required. This obligation is aided by the F.F.I. List Search and Download Tool, which is prominently displayed on the F.A.T.C.A. webpage and is updated on a monthly basis.[1]

This list search is a list of F.I.'s registered, accepted, and assigned a G.I.I.N. in accordance with the F.A.T.C.A. regulations. A withholding agent can download the entire list of F.I.'s or search for a particular F.F.I. by its (1) legal name, (2) G.I.I.N., or (3) country.

Entry into this list reveals the massive number of G.I.I.N.'s that have already been issued. For the U.K., there are more than 22,000 G.I.I.N.'s. For the Cayman Islands, a popular locale for forming investment funds, over 28,000 G.I.I.N.'s have been issued. While some countries have very few (*e.g.*, Armenia had only 36, and there were none for Antarctica at the time of this publication), more than 150,000 G.I.I.N.'s that have been issued so far.

Withholding agents are advised to establish written internal procedures requiring G.I.I.N. verification and to clarify who is responsible for fulfilling this obligation. Such practices are helpful with regard to documenting compliance and protecting the withholding agent in the event that a good faith mistake is made in the verification process and a wrong G.I.I.N. was actually set forth on the Form W-8.

CURRENT I.G.A. PARTNER COUNTRIES

To date, the U.S. has signed, or reached an agreement to sign, more than 100 Model 1 I.G.A.'s. An I.G.A has become a global standard in government efforts to curb tax evasion and avoidance on offshore activities and encouraging transparency.

At this time, the countries that are Model 1 partners by execution of an agreement or concluding an agreement in principle are:

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[1] See IRS.gov, "Foreign Account Tax Compliance Act."

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

The countries that are Model 2 partners by execution of an agreement, or concluding an agreement in principle, are: Armenia, Austria, Bermuda, Chile, Hong Kong, Iraq, Japan, Macao, Moldova, Nicaragua, Paraguay, San Marino, Switzerland, and Taiwan.

This list will continue to grow.

IN THE NEWS

AS SEEN IN...

Kennneth Lobo's "Guidance for Canadian Snowbirds" was published the the December 2014 edition of *The Botom Line*, Canada's premier independent news source for the professional accounting community. The article focuses on the considerations and consequences of U.S. real property ownership for Canadians seeking warm-weather vacation homes, commonly referred to as "snowbirds."

OUR RECENT AND UPCOMING PRESENTATIONS

On December 19, 2014, Stanley C. Ruchelman and Kenneth Lobo presented "The Life of an Outbound Investment from the U.S. into Canada" to the B.C. chapter of the Canadian Bar Association in Vancouver, Canada. The topics addressed included entity classification, tax treatment under §367 of asset transfers, Subpart F, P.F.I.C.'s, U.S. and international attacks on excessive benefits, and permanent establishment issues.

On January 18-20, 2015, Stanley C. Ruchelman participated in the *ITSG 2015 Conference* in Calgary. Presentations included: "Double Irish Sandwich: Google Feasts, European Governments Suffer Heartburn," on international pushback on C.F.C. planning arragements; "How Much Equity is Enough Equity in a U.S. Entity?" regarding characterization of intercompany loans; and "Action 4: Limit Base Erosion - Interest Payments and Other Financial Payments," which addressed O.E.C.D. guidance for combatting B.E.P.S.

On February 19-22, 2015, Stanley C.Ruchelman joined the GGi PG Meeting International Taxation Winter Meeting in Marbella, Spain, where he presented "Follow up Work on B.E.P.S. Action 6: Preventing Treaty Abuse." The talk addressed the most recent work on B.E.P.S. Action 6, including the release of the second discussion draft for which over 750 pages of comments were submitted by interested parties.

On April 17, 2015, Stanley C. Ruchelman will participate in the panel "Exchange of Information Going Global: FATCA, OECD, EU and Beyond" as part of the *ABA/IFA Tax Planning Strategies U.S. and Europe Conference* in Munich, Germany. The discussion will outline the evolution of global exchange of tax information, beginning with the U.S. enactment of F.A.T.C.A. in 2010 and continuing on to the proliferation of similar programs across the globe. It will explore the obligations imposed on taxpayers and the overlapping nature of these separate regimes.

Copies of our presentations are available on the firm website at www.ruchelaw.com/publications, or by clicking the links above.

About Us

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

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

The tax practice is supported by our corporate group, which provides legal representation in mergers, licenses, asset acquisitions, corporate reorganizations, acquisition of real property, and estate and trust matters. The firm advises corporate tax departments on management issues arising under the Sarbanes-Oxley Act.

Our law firm has offices in New York City and Toronto, Canada. More information can be found at www.ruchelaw.com.

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