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INSIGHTS

THE (NON) RECOGNITION OF TRUSTS IN GERMANY

TAX COURT STRIKES DOWN I.R.S. POSITION ON STOCK-BASED COMPENSATION IN *ALTERA* CASE

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EDITORS' NOTE

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

- **The (Non) Recognition of Trusts in Germany.** Have you ever thought of using a trust to hold property for the benefit of a German resident or to hold property in Germany? Guest author Alexander Fürwentsches of Baker Tilly Roelfs, in Munich, explains the pitfalls and possible benefits.
- **Tax Court Strikes Down I.R.S. Position on Stock-Based Compensation in *Altera Case*.** Is the *Altera* case important because it struck down the I.R.S. stock based compensation regulations related to cost sharing agreements? Or is it important because of the procedural analysis that was required in order for the Tax Court to be in position to strike down a regulation? Beate Erwin, Stanley C. Ruchelman, and guest author Michael Peggs of Cadesky Tax, in Toronto, explain why the case is important for both reasons.
- **U.S. Taxation of Carried Interest.** Favorable long-term capital gains tax treatment for managers of hedge funds has been under attack by the current Administration. While the industry defended itself from outright changes to favorable tax treatment, the I.R.S. recently proposed to disallow favorable treatment where a manager's right to payments bears no entrepreneurial risk. Nina Krauthamer, Philip R. Hirschfeld, and Kenneth Lobo explain.
- **Proposed P.F.I.C. Exception Regulations Detrimental to Foreign Insurers.** In April, the I.R.S. proposed regulations that provide exceptions for P.F.I.C. treatment for offshore insurance companies, unless they are formed by hedge funds intending to defer or reduce tax. Andrew P. Mitchel and Christine Long look at comments of industry representatives.
- **Busy Month for B.E.P.S.** The busy season for B.E.P.S. opened at the end of July as O.E.C.D. Working Parties completed their assignments. Readers may wish to see how the world will look after all B.E.P.S. Actions are completed. Galia Antebi and Stanley C. Ruchelman discuss several developments.
- **Inverted Corporate Giant May Be Eligible for U.S. Government Contracts.** The politicians led us to believe that inverted corporations are not eligible for U.S. government contracts. Ingersoll-Rand has a different view. Elizabeth V. Zanet explains.
- ***Summa Holdings Inc. v. Commr.*** Many advisers believe that the interest-charge DISC is the last great international tax planning idea because a portion of the export profits are taxed at low rates for shareholders that are individuals. Some advisers believe it is even better when the benefit is channeled to a Roth I.R.A. dthat provides tax forgiveness rather than tax deferral. Galia Antebi and Rusudan Shervashidze discuss a recent case won by the I.R.S. that shows how too much of a good thing may be bad.
- **Artificial Loan Restructuring.** The I.R.S. has discovered that related taxpayers have been renegotiating existing intercompany loans to allow operating companies within the group to pay a higher rate of interest to a related party benefitting from favorable tax attributes without violating Code §482

principles. Andrew P. Mitchel and Sheryl Shah explain that the I.R.S. is taking aim at this new approach to self-help.

- **European Commission, State Aid, and Tax Transparency – More Steps in One Direction.** The EDF experience in France demonstrates that State Aid in Europe comes in many forms and can be harshly treated when discovered. Beate Erwin looks at EDF's experience and other developments in the European Commission's attack on state aid through private tax rulings.

- **I.R.S. Plan to Reject Foreign Taxpayers' Refunds Criticized by I.R.S. Advisory Committee.** The I.R.S. proposal to deny refunds of excess withholding tax when the withheld tax is stolen by the withholding agent were harshly criticized by the Information Reporting Program Advisory Committee. It seems the I.R.S. does not have the authority to pass the loss onto the party that suffered withholding. Elizabeth V. Zanet and Andrew P. Mitchel discuss the issue in detail.

- **F.A.T.C.A. 24/7.** July and August were busy months for F.A.T.C.A. developments and Galia Antebi and Philip R. Hirschfeld explain the highlights.

    - The I.R.S. notified countries with early I.G.A.'s that more favorable provisions are available, but the notice may escalate the onboarding controversy with Canada and the U.K.

    - The Common Reporting Standard is moving forward, either with or without U.S. participation and global F.I.'s must adjust reporting systems.

    - Iceland and the United Arab Emirates publish F.A.T.C.A. guidance.

    - Belarus ratified the I.G.A. with the U.S.

    - Italy published an implementation decree for exchange of information.

    - Turkey and Slovakia signed Model 1 I.G.A.'s.

    - Mauritius and Luxembourg extend local F.A.T.C.A. reporting deadlines.

    - F.A.T.C.A. partner countries listed.

- **Updates & Tidbits.** Andrew P. Mitchel and Sheryl Shah identify items of interest. The corporate tax may be lowered, expatriation numbers are down, the I.R.S. Transfer Pricing Operations Unit is here to stay, and three more banks agree to disclose activities to D.O.J.

We hope you enjoy this issue.

- The Editors

THE (NON) RECOGNITION OF TRUSTS IN GERMANY

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Germany is a civil law jurisdiction that does not recognize common law trusts. From a German perspective, it is hard to understand that ownership in strict law may rest with the trustees, while ownership in equity rests with the beneficiaries.

As there are manifold reasons for using a trust, the concept does not have one single civil law equivalent. Amongst others, one popular alternative to the common law trust is the private foundation. In Germany, a private foundation can be structured either as a corporate body with legal personality or as a separate estate without legal personality. In the latter case, ownership of the foundation's assets is held by an administrative body. This body is contractually obliged to administer the assets in accordance with the foundation's aims, thereby enabling the foundation to closely resemble the structure of a trust.

Bearing this in mind, it is not surprising that the same rules apply to the taxation of foreign trusts and foreign private foundations. But before looking on the taxation of a foreign trust in Germany, a few aspects of relevant civil and private international law should be summarized.

CIVIL LAW AND PRIVATE INTERNATIONAL LAW

Estate Planning for German Nationals

As of date of this publication, a German national cannot be a settlor of a testamentary trust because the German rules regarding conflicts of law lead to the application of German inheritance law whenever the deceased is a German national. German inheritance law, in turn, does not allow for a bequest in favor of a trust.

However, the advent of the European Succession Regulation changes the outcome.[1] If the decedent dies after August 16, 2015, the succession laws of the decedent's last habitual residence will apply. It does not matter where the habitual residence was located, and it can be inside or outside the European Union. This means that from August 17, 2015, a German national who is habitually resident in the U.S. can settle a testamentary trust, even from a German perspective, because the succession laws of the respective U.S. state will be applicable unless the testator made a testamentary choice of law in favor of German inheritance law. Inter-vivos trusts are not affected by the advent of the European Succession Regulation because a German national has always been free to settle an *inter-vivos* trust.

Transferring German Assets to a Trust

A general restriction applies to the transfer of assets to a trust: Although German

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[1] Regulation (E.U.) 650/2012.

nationals can settle foreign trusts, German situs property cannot be placed directly into trust. Germany has not ratified the Hague Trust Convention, and there are no current proposals to do so. Consequently, a foreign trust cannot directly hold German real estate or an interest in a German corporation or partnership, and the trust, as such, cannot be registered in the German land or companies register. For an individual wishing to place German assets into trust, the most straight-forward solution is for the trust to hold all the shares of an underlying foreign holding corporation that will hold the title in the German assets. Such a corporation can be registered in the land or companies register and can therefore hold the title to the German assets. From a German civil law perspective it makes no difference whether the corporation is located onshore or offshore.

"German situs property cannot be placed directly into trust. Germany has not ratified the Hague Trust Convention, and there are no current proposals to do so."

Asset Protection

Several restrictions in German private law should be considered when a trust is used for assets protection purposes.

According to German forced heirship rules, spouses and direct descendants, or in their absence, parents, have a claim for a compulsory share of a decedent's estate. If a settlor dies within ten years after settling a trust, the assets transferred into that trust will form part of the estate for forced heirship purposes. This compulsory share decreases by one-tenth for each year that passes after the settlement of the trust. The ten-year period does not start, however, if the settlor retains a usufruct right or some form of economic interest in the trust funds or if the settlor can revoke the trust at any time.

If a marriage ends in divorce, German matrimonial property law provides that the statutory regime leads to a monetary equalization of assets between the spouses, in favor of the spouse with the lower gain. Funds transferred into a trust are included in the computation of assets. In other words, transferring funds into a trust generally does not lead to a reduction in the equalization claim. Exceptions apply if the settlement of the trust occurred more than ten years prior to the divorce or if the other spouse agreed to the transfer of the funds into trust.

Generally, all gratuitous transfers, which include transfers into a trust without consideration, can be challenged by any creditor within a four-year period or within a ten-year period if the transfer is made in order to disadvantage creditors. However, it is up to the applicable jurisdiction of the foreign trust to determine whether a German judgment in favor of creditors will be enforceable against the trust when the assets are located outside of Germany.

TAXATION

Several civil law jurisdictions, such as Malta and Switzerland, that have enacted comprehensive rules on the taxation of trusts. This is not true of Germany. Singular rules can be found in the Gift and Inheritance Tax Act and in the Foreign Tax Act, which includes the German rules regarding controlled foreign corporations ("C.F.C.'s"), but there is no comprehensive tax framework on trusts. Consequently, unexpected results may occur if the settlor or beneficiary is or becomes a German tax resident.

Recognition of the Trust for Tax Purposes

Wherever special rules do not exist, German law attempts to treat trusts like comparable civil law instruments. The first question is always whether a trust should be recognized for German tax purposes. The answer depends on the facts of each individual case. If a trust is not recognized for German tax purposes, the (beneficial) ownership of the assets, for such purposes, remains with the settlor. There is no court authority specifically addressing the recognition of trusts. It is the view of the author that the principles established by the German Federal Fiscal Court, the *Bundesfinanzhof* ("BFH"), in a 2007 decision involving a Liechtenstein foundation can be equally applied to trusts. The BFH is the highest German tax court.

The principles that the BFH applied are similar to the concept of "alter ego trusts," where beneficial ownership of trust assets remains with the settlor. In the U.K., the application of this concept to facts before a court may support the contention that a particular trust is a sham. In the 2007 case, the BFH concluded that the founder retained so much control over the foundation and its assets that he could access the foundation's assets as if he were the owner. The foundation did not become the economic owner of the assets as the rights of ownership were not enforced by the legal title holder.

This conclusion was based on the following facts:

- The founder did not lose influence in the foundation (*i.e.*, he retained the right to revise or revoke the articles of the foundation);
- The foundation had a managing director who was bound by an engagement letter with the founder, obliging him to act only upon instruction by the founder and to resign upon request by the founder; and
- All rights in the foundation's assets remained with the founder as the assets could revert to the founder at his sole discretion.

Transparent Versus Opaque

For the purposes of this article, a trust that is not recognized for German tax law purposes will be called a "Transparent Trust." If the settlor has less control over the trust and its assets so that the trust is recognized for tax purposes, it will be referred to as an "Opaque Trust." An Opaque Trust is treated like a family foundation, *i.e.*, it is treated as a corporate body, which has no shareholder, and therefore is formed for a purpose and not for the benefit of any owner. There is no bright-line rule to define a trust as transparent or opaque. The determination is made on a case by case basis in light of all the facts and circumstances, which explains the uncertainty faced when working with trusts. In theory, it might be quite simple to ensure that a trust is seen as opaque. But in most cases, the settlor is not willing to give away complete control of the assets and the trust, making it difficult to determine if the level of control retained makes the trust transparent. In any event, a Transparent Trust could become an Opaque Trust if it becomes irrevocable after the settlor's death.

Settlement of a Trust

The settlement of an Opaque Trust and the transfer of assets to an Opaque Trust are subject to German Gift and Inheritance Tax ("G.I.H.T."). G.I.H.T. applies if the settlor (i) is a German tax resident or (ii) is a German national whose residency

or habitual abode was located in Germany at some point during the most recent five years before settling the trust. If the German national is a U.S. resident, the look-back period is extended from five years to ten years. The tax rate is 30% on transfers below €6 million. Above that amount, a tax rate of 50% applies. Because all gifts made within a period of ten years are aggregated, making several separate transfers to a trust will not reduce the tax rate.

To the extent a transfer of assets to a trust is permitted, the transfer of assets to a Transparent Trust does not trigger G.I.H.T because economic ownership remains with the settlor. However, when the trust transfers property to an underlying company, the risk of G.I.H.T. is quite high. Even if the trust is transparent, the foreign corporation will be opaque for G.I.H.T. purposes and that transfer is taxable.

Death of the Settlor

In the case of a Transparent Trust, the assets remain with the settlor and form part of the settlor's estate. Consequently the death of the settlor triggers G.I.H.T. if the settlor is a German tax resident. If a trust is opaque and qualified as a corporate body, it is not affected by the death of the settlor. Remember, the settlor is not considered to be the owner of an Opaque Trust and so the assets of the trust are not subject to inheritance tax.

From an estate planning perspective, it is usually preferable to structure an *inter-vivos* trust as opaque. No one can foresee the applicable tax law at the time of the settlor's death, and while transferring assets to an Opaque Trust will trigger G.I.H.T. directly, it is a foreseeable consequence that can be planned for appropriately.

Changes in the Class of Beneficiaries

Changes in the class of beneficiaries do not lead to tax consequences in Germany, regardless of the trust's status as opaque or transparent.

Trust Income

If a trust is a Transparent Trust, all its income is considered to be the income of the settlor for German tax purposes. If the settlor is a German tax resident, the worldwide income of the trust is subject to the settlor's personal income tax liability in Germany, as limited by the relevant double tax treaties. For the purpose of applying the provisions of a double tax treaty the settlor is the relevant person.

If the trust is an Opaque Trust, the trust itself will be neither a German tax-resident, nor the direct owner of German situs property. Therefore, the trust will not be subject to tax in Germany. Again, income from German situs property owned by a foreign corporation owned by the Opaque Trust will be subject to corporate income tax in Germany.

Even if the trust itself is not subject to German income tax, the Foreign Transactions Tax Code ("F.T.T.C."), *i.e.*, the German C.F.C. rules, may attribute that income to a German resident. Section 15 of the F.T.T.C. provides that earnings of a family trust are attributed to a German-resident settlor or proportionally to the German tax-resident beneficiaries if the settlor is not a German tax resident. A trust is qualified as a family trust if the settlor, persons associated with the settlor, and the descendants of each are entitled to more than half of the trust benefits. According to the German tax authorities, such entitlement need not be legally enforceable. Even if a trust is fully discretionary, it will be qualified as a family trust if more than half of the beneficiaries are family members. This rule applies even if no distributions were made in the past. The attribution of profits to a German resident leads to German income tax liability, even if there has been no distribution of cash or assets to the beneficiaries. On the other hand, a previously taxed income concept applies to income of the trust that has already been attributed to a German resident and taxed. When distributed to German resident beneficiaries, the distribution is free of German income tax, provided the distribution occurs within seven years after the attribution of income.

The general policy of profit attribution is to apply German tax rules to the trust income as if the German tax resident had received the profits directly. Nevertheless, it often leads to a heavy tax burden. One practical example arises when trust assets are invested in U.S. or other foreign investment funds. In Germany, investment funds must file certain tax information in an official Federal bulletin. The failure to file – as is the case with nearly all funds not designed for the German market – results in the application of a special tax regime calling for a minimum annual tax of 6% of the fund's net asset value. This tax applies even in years the fund has made a loss.

In 2014, the European Court of Justice ruled that this special regime does not comply with the fundamental freedoms of the European community.[2] The taxpayer must be granted the opportunity to prove the amount of the actual profit, if one was made, or existence of an operating loss. The former may reduce the tax and the latter may eliminate the tax. A letter ruling published by the Federal Ministry of Finance now allows the taxpayer to bring evidence of actual profits, but the requirements set out in the letter ruling are extensive. Even if the German tax resident is able to obtain all the information from the relevant foreign fund, a substantial compliance cost will be incurred.

"Without any further differentiation, this would mean that the same distribution is subject to G.I.H.T. and income tax at the same time, leading to a total tax burden of up to 75%."

German beneficiaries must file a separate tax declaration for the trust in which income of the trust is computed in accordance with German tax rules. Again, compliance costs are substantial.

Trust Distributions

Trust distributions made from a Transparent Trust are treated as direct payments from the settlor (*i.e.*, the economic owner) to the beneficiaries. Typically, the distributions are made without the receipt of consideration. Consequently, the distribution will be treated as a gift by the settlor. If the settlor or the beneficiary receiving the distribution is a German tax resident, the distribution is subject to G.I.H.T., which is imposed at a rate that ranges between 7% and 30% for direct relatives. The exact rate depends on the value of the distribution and any other gifts made during the previous ten years.

Trust distributions from an Opaque Trust will face a high level of uncertainty in Germany. One source of this uncertainty is a decision by the BFH made in 2013 in which the Court ruled that all payments made out of a trust are subject to G.I.H.T. But the decision seems to ignore specific provisions of German tax law. There are two different provisions applicable to distributions from a trust. The Income Tax Act provides that distributions from foreign foundations and trusts are taxed as income from capital similar to dividends. In addition, the G.I.H.T. act provides that all payments made from a foreign fund with or without legal personality during its existence

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[2] *Rita van Caster and Patrick van Caster v. Finanzamt Essen-Süd*, C-326/12.

are subject to G.I.H.T. This wording applies to trusts, but not to family foundations. Without any further differentiation, this would mean that the same distribution is subject to G.I.H.T. and income tax at the same time, leading to a total tax burden of up to 75%.

Systematically, this should be impossible. The income tax applies to income of the taxpayer. On the other hand, the G.I.H.T. applies to the enrichment resulting from a gratuitous receipt of assets. In principle, a distribution is either income or gratuitous enrichment. Nonetheless, the BFH has ruled in the past that income tax and G.I.H.T. could be applied side by side. In recent cases. the BFH has moved towards a more systematic approach, *i.e.*, levying either income tax or G.I.H.T. But there still is no settled case law in Germany.

For foreign foundations, this conflict appears to have been resolved. If a distribution from a foundation is based on its articles, such distribution is not "without consideration" and, therefore, is subject to German income tax but not G.I.H.T. Conversely, if the foundation makes a distribution that is not based on its articles or if the foundation's assets are distributed, such distributions are subject to G.I.H.T. but not income tax.

For trusts, the BFH denied this differentiation and ruled that all distributions made by a trust are subject to G.I.H.T. The language of the law allows for such an interpretation, especially since the relevant wording in the G.I.H.T. act is applicable only to trusts, not to family foundations. The author believes there is no reason to apply different rules to opaque family trusts and family foundations. Recent changes in law have eliminated loopholes that may have existed at one time and there is no longer a reason for a trust distribution to be subject to income tax and G.I.H.T.

Nonetheless, as of today, distributions made from an Opaque Trust to a German resident beneficiary are subject to both G.I.H.T. and German income tax.

Revocation of a Trust

The revocation of a Transparent Trust has no tax consequences since from a German tax perspective ownership of the trust assets remains with the settlor. Therefore, revocation does not result in a transfer of these funds.

In contrast, the revocation of an Opaque Trust will lead to a transfer of the assets held in the trust to the settlor without consideration. This triggers again – as with the settlement – G.I.H.T. at a rate of 30% on assets up to €6 million and 50% on assets above €6 million.

SUMMARY

Although trusts are unknown to German civil law and Germany has not ratified the Hague Convention on Trusts, trusts can be used for estate planning purposes, even if German tax residents are involved. However, this requires very careful planning in each individual case. Because of the high risk of double taxation of trust distributions and a resulting tax burden of up to 75%, trusts should primarily be used as savings boxes where German tax residents are involved. If a trust is settled by a non-German tax resident and structured correctly with a view to the F.T.T.C. rules, such a trust could be used to avoid German taxes, particularly if a beneficiary resides in Germany on a temporary basis.

TAX COURT STRIKES DOWN I.R.S. POSITION ON STOCK-BASED COMPENSATION IN *ALTERA* CASE

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Tags
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Chevron
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Seagate Technologies
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Xilinx

INTRODUCTION

In its *Altera* decision[1] issued on July 27, 2015, the U.S. Tax Court struck down 2003 cost-sharing regulations that require the sharing of stock-based compensation ("S.B.C.") under a cost sharing agreement ("C.S.A.") with a party under common control for purposes of Code §482. The court held that the regulations, Treas. Reg. §1.482-7(d)(2), lack "a basis in fact" and are invalid as a matter of law. This issue was the focus of an earlier Tax Court decision, *Xilinx Inc. v. Comm'r* ("*Xilinx*"),[2] involving a year when the regulations did not provide for a specific rule with respect to S.B.C.

In *Xilinx*, the court addressed the application of the 1995 cost-sharing regulations that allowed controlled entities to enter into a qualified cost-sharing agreement ("Q.C.S.A.").[3] The court held that a Q.C.S.A. need not share S.B.C. costs – meaning expenses related to employee stock options – because parties operating at arm's length would not do so. The court underscored that the arm's-length standard was of paramount importance in determining costs to be covered under a Q.C.S.A.

The I.R.S. has not yet decided whether to appeal the holding in *Altera*, according to a statement by the Acting Director of the I.R.S. Office of Transfer Pricing Operations, David Varley.[4] If the case is appealed, the matter will be heard by the Ninth Circuit Court of Appeals, the same court that decided Xilinx.

The *Altera* decision touches two areas that have been in issue for decades:

- **In the C.S.A. context, does the commensurate-with-income standard prevail over the arm's-length standard?**

  In other words, will the arm's-length standard control over a specific regulatory provision that may require taxpayers to do something that, arguably, parties at arm's length would not do? Or should in a such a scenario the commensurate-with-income standard apply, and if so, would it subject the transaction to a different set of criteria than the arm's-length standard?

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1 *Altera Corp. v. Comm'r.*, 145 T.C. __, No. 3 (July 27, 2015) ("*Altera*").

2 *Xilinx Inc. v. Comm'r.*, 125 T.C. 37 (2005), ("*Xilinx 1*"), rev'd. 567 F.3d 482 (9th Cir. 2009) ("*Xilinx 2*"), reversal withdrawn 592 F.3d 1017 (9th Cir. 2010), and aff'd. 598 F.3d 1191 (9th Cir. 2010) ("*Xilinx 3*").

3 In the following references to "C.S.A." assume that such agreements meet the Q.C.S.A. standards; the terms are thus used interchangeably.

4 See *International Taxes Weekly Newsletter*, Vol. 6, No. 31 (Aug. 4, 2015).

- **Is the standard of review of regulations process based or rule oriented?**

  The first is based on the *State Farm*[5] decision, the second relates to a two-prong test based on the *Chevron*[6] decision.

This article evaluates the impact of the *Altera* decision in light of administrative law principles applicable to the I.R.S. and economic principles applicable to controlled intercompany transactions and the requirement under U.S. tax law to conduct transactions under arm's length terms and conditions.

COST-SHARING REGULATIONS

Under the regulations, a "cost sharing arrangement" is an arrangement in which controlled participants share the costs and risks of developing identified intangibles in proportion to the reasonably anticipated benefits for each participant.[7] In broad terms, a C.S.A. must meet certain requirements for it to be a Q.C.S.A.

"A 'cost sharing arrangement' is an arrangement in which controlled participants share the costs and risks of developing identified intangibles in proportion to the reasonably anticipated benefits for each participant."

- All controlled participants must commit to, and in fact, engage in cost sharing transactions including the cost of platform transactions.
- The C.S.A. must be recorded in writing in a contract that is contemporaneous with the formation (and any revision) of the C.S.A. and must cover items such as (i) a complete list of participants, (ii) the costs to be shared, (iii) the anticipated benefits of each participant, (iv) the methodology for sharing costs and anticipating benefits, (iv) the functions and risks that each controlled participant will undertake, (v) the form of payment for platform contributions, and (vi) the duration of the agreement.

All intangible development costs must be shared if and to the extent such costs relate to intangible development activity.[8] Intangible development costs include all costs, in cash or in kind (including S.B.C.), incurred in the ordinary course of business and that are directly identified with, or are reasonably allocable to, the intangible development activity.[9] The term "stock-based compensation" means any compensation provided by a controlled participant in a C.S.A. to an employee or independent contractor in the form of equity instruments, options to acquire stock (stock options), or rights with respect to (or determined by reference to) equity instruments or stock options, including transfers of property that are taxable under Code §83 and stock options covered by Code §421.[10] The regulations go on to provide that the cost attributable to S.B.C. is equal to the amount allowable as a deduction for Federal income tax purposes.[11]

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5 *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983) ("*State Farm*").

6 *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984) ("*Chevron*").

7 Treas. Reg. §1.482-7(b).

8 Treas. Reg. §1.482-7(d)(1).

9 Treas. Reg. §1.482-7(d)(1)(iii).

10 Treas. Reg. §1.482-7(d)(3)(i).

11 Treas. Reg. §1.482-7(d)(3)(iii).

THE *ALTERA* DECISION

In *Altera*, the U.S. parent entered into a Q.C.S.A. with its Cayman Islands subsidiary, Altera International. The purpose of the C.S.A. was to pool resources in order to conduct research and development ("R&D") activities using certain pre-cost-sharing intangible property ("I.P.") for a defined period. Under the C.S.A., the U.S. parent included the cash compensation of its R&D employees, but not S.B.C., in the pool of costs to be shared. As such, the payments made by Altera International to the U.S. parent did not include the reimbursement of any portion of the U.S. parent's S.B.C. costs. The I.R.S. proposed the following adjustments to the cost sharing payments received by the U.S. parent corporation.

Year	Cost-Sharing Payment Adjustment
2004	$24,549,315
2005	$23,015,453
2006	$17,365,388
2007	$15,463,565

Notices of tax deficiency were issued based on the final 2003 C.S.A. regulations. Bringing the taxpayer into compliance with the final regulations was the sole purpose of the cost sharing adjustments contained in the notice of deficiency.

The taxpayer raised two arguments in its brief. First, it argued that the C.S.A. regulations are a legislative rule under §553(b) of the Administrative Procedures Act ("A.P.A.") and are subject to notice and comment requirements because, if valid, the regulations would have the force of law. Alternatively, the taxpayer contended that if the final rule were an interpretive rule, it would not have the force and effect of law and would not be binding on the court. The I.R.S. contended that the C.S.A. regulations have the force of law, but disagreed that it was a legislative rule, and took the position that it complied with the A.P.A. notice and comment requirements mentioned above.

In an opinion that was reviewed by the full Tax Court on cross-motions for summary judgment, the court agreed with taxpayer, Altera Corp., that the final C.S.A. regulations violated the arm's-length standard because there is no evidence unrelated parties ever share such costs. The Tax Court faulted the Treasury Department for ignoring the extensive testimony that unrelated parties do not share S.B.C. costs, and noted that, in adopting the final rules, the Treasury never responded to those comments and never explained its basis for concluding otherwise. Moreover, the Tax Court concluded that the final C.S.A. regulations were legislative rules promulgated by an administrative agency, and were the I.R.S. adjustment to be sustained, the taxpayer would have been confronted with adjustments to its U.S. taxable income amounting to $80.4 million over a period of four years.

To reach its decision, the Tax Court looked at the following factors:

- Principles of administrative law regarding the procedure for an administrative agency to follow when adopting a legislative rule;
- The submissions to the I.R.S. when the final C.S.A. regulations were issued in which the premise of the regulations was challenged on the basis that unrelated parties acting at arm's length do not conduct themselves in the manner mandated by the final C.S.A. regulations in respect of S.B.C. payments;
- The absence of any analysis by the I.R.S. that took into account the foregoing submissions, which reflect a position that when independent parties deal with each other in uncontrolled transactions to develop I.P. the circumstances are not comparable to a transaction between related parties and should therefore be ignored;
- The standard to be followed by a court when considering a challenge to the validity of an administrative rule; and
- The final holding in *Xilinx*, which was not followed by the I.R.S. in the final C.S.A. regulations.

If and when the Tax Court decision in *Altera* becomes final and is not reversed legislatively, it may have a profound effect on the way the U.S. applies rules under B.E.P.S. that pertain to hard-to-value intangibles. The analysis by the Tax Court, based on U.S. rules and standards, appears to be diametrically opposed to the *ipsa dixit* pronunciations of Action 8.

ARM'S-LENGTH STANDARD V. COMMENSURATE-WITH-INCOME STANDARD

Transfer Pricing Rules – Legal Background

Related-party transactions are subject to a special statutory rule to ensure that each related party reports the proper income or expense arising from a specific transaction. Code §482 provides as follows:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (*within the meaning of section 936 (h)(3)(B), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible*). [Emphasis added.]

The first direct predecessor of the current Code §482 dates back to the Act of 1921. The commensurate-with-income rule (also called the "Super Royalty Provision") was added by Congress decades later, in 1986. With the proliferation of international transactions in the early 1960's, Code §482 gained importance. The House of Representatives proposed the adoption of a measure to add a new subsection to Code §482, which would require taxpayers to demonstrate the use of an arm's-length standard in the pricing of intercompany transactions or else an apportionment formula based on relative economic activities would be used.[12] The House proposal was not adopted. Instead, the Conference Committee stated that Code §482 already granted enough power to the I.R.S. to allocate income and deductions to taxpayers. Nevertheless, it prompted the Treasury to develop regulations that would "provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income."[13] The Treasury followed this recommendation and issued regulations in 1968 (the "1968 Regulations"), which, in their main parts, remain in effect. The 1968 Regulations reaffirm the arm's-length standard as a fundamental principle in transfer pricing transactions.

"The arm's-length standard constitutes the baseline against which all transfer pricing between related parties is tested and judged."

Under the regulations, the failure to clearly reflect income or the presence of an arrangement for the avoidance of taxes subjects such transactions to allocations of income or expense under Code §482 and Treas. Reg. §1.482-1(a)(1). In those cases, the I.R.S. will aim at determining the "true taxable income" of the taxpayer. In the effort to determine the taxpayer's true taxable income, the regulations introduce the arm's-length standard.

The arm's-length standard constitutes the baseline against which all transfer pricing between related parties is tested and judged. The arm's-length standard requires intercompany transactions to generate results consistent with those transactions unrelated parties would have engaged in (*i.e.*, arriving at prices conforming to the market price).[14] On these premises, arm's-length behavior is determined on a case-by-case basis, turning on the facts and circumstances of each transaction. Conceptually, it assumes that "comparable" transactions between unrelated persons in "comparable" markets and circumstances actually exist.

With respect to intangible development costs, special rules under the regulations were issued in 1995. Before then, the first U.S. transfer pricing regulations, promulgated in 1968, did not provide for rules regarding C.S.A.'s. At the time the transfer pricing regulations were written, cost sharing rules were proposed but never finalized. The proposed rules were ultimately withdrawn, apparently because there was substantial disagreement regarding the proper method of handling such transactions. It was not until 1995, when Congress introduced the "commensurate-with-income" requirement to Code §482, that the cost sharing discussion was revived. Initially, this rule was construed to evidence "a rejection of the arm's-length standard in that unrelated parties typically do not deal with each other in such a matter."[15] In its *Study on Intercompany Pricing*, also known as the White Paper of 1988, the Treasury acknowledged the fact that comparables are generally unavailable in the

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[12] Martinez, Bibiana A. Cruz, "The Arm's Length Standard vs the Commensurate with Income Standard: Transfer Pricing Issues in the Valuation of Intangible Assets," 305.

[13] "Treasury Department & Internal Revenue Service, A Study of Intercompany Pricing," *supra* note 5, at 10 ("White Paper").

[14] Treas. Reg. §1.482-1(b)(1); Treas. Reg. §1.482-1(i)(9); and Treas. Reg. §1.482-1(i)(10) (describing the intercompany transaction as the "controlled" transaction and the latter transaction as an "uncontrolled" transaction).

[15] Levey, Marc M. and Stanley C. Ruchelman, "Section 482-The Super Royalty Provisions Adopt the Commensurate Standard," *The Tax Lawyer*, 41, no. 3 (1988): 611, 636.

case of intangible assets and that "regulations fail[ed] to resolve the most significant and potentially abusive fact patterns."[16] The commensurate-with-income standard was considered to create a solution to the abuses it identified for cases when comparables did not exist.[17] According to the Treasury, the periodic adjustments these methods provided for were consistent with the arm's-length standard since "unrelated parties generally provide some mechanism to adjust for change in the profitability of transferred intangibles."[18] In its proposed regulations 1992 and final regulations 1994, the Treasury moved away from B.A.L.R.M. and re-emphasized the arm's-length standard.[19] What some observed in this respect as relaxation of the commensurate-with-income standard was construed by others as its loss of relevance.

C.S.A. and S.B.C. Issue

Despite on and off discussions of the need for C.S.A. rules, specific rules were not adopted until 1995, when the I.R.S. issued Treas. Reg. §1.482-7, effective for taxable years beginning on or after January 1, 1996 (the "1995 Regulations"). The 1995 Regulations define a C.S.A. as a written agreement:

> [U]nder which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement.[20]

These rules generally provide that all intangible development costs must be shared among controlled participants in a Q.C.S.A. (the "All-Cost Rule").[21] These costs are treated as operating expenses to be included in the pool of costs to be shared. A controlled participant's share of the costs should equal its share of reasonably anticipated benefits attributable to the development of the intangible under the arrangement.[22] One issue has been whether the value of compensatory stock options should be considered part of the R&D cost pool under a Q.C.S.A.

In support of its position that such costs should be included in a C.S.A. and appropriately allocated, the Treasury issued guidance in a field service advice ("F.S.A.") in 1999.[23] On August 26, 2003, the I.R.S. issued final regulations on the stock option issue.[24] Notwithstanding voluminous comments and criticisms to the proposed

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[16] White Paper, *supra* note 5, at 34.

[17] These were the Basic Arm's Length Return Method ("B.A.L.R.M.") and the Profit Split Addition to the B.A.L.R.M.

[18] White Paper, *supra* note 5, at 71.

[19] Under the 1995 Regulations the best method rule was introduced and the concept of the arm's-length range was established. Furthermore, the 1995 Regulations created safe harbors where no adjustments are necessary, most importantly introducing the Comparable Uncontrolled Transactions ("C.U.T.") method.

[20] Treas. Reg. §1.4827-7(a)(1).

[21] Treas. Reg. §1.482-7.

[22] Treas. Reg. §1.482-7(d)(1).

[23] F.S.A. 200003010 (Oct. 18, 1999).

[24] TD 9088 (Aug. 25, 2003), corrected Nov. 10, 2003. Treas. §1.482-7 is generally effective for tax years beginning after December 31, 1995. However, the provisions newly added by TD 9088 apply to stock-based compensation granted in tax years beginning after August 25, 2003.

regulations, the final regulations incorporated only minor modifications from the proposed form, a fact that becomes the central point in *Altera*.

To reiterate the S.B.C. rules, the final regulations mandate that stock-based compensation must be taken into account in determining the operating expenses subject to a C.S.A.[25] S.B.C. includes statutory and non-statutory stock options, phantom stock, and restricted stock.[26] The determination of whether S.B.C. is related to intangible development activity through a C.S.A. is made on the grant date of the S.B.C.[27] The amount of the S.B.C. expense generally is based on the amount allowed as a deduction to the controlled participant for U.S. Federal income tax purposes.[28] Foreign controlled participants are treated as U.S. taxpayers for purposes of this determination in order to bring consistency in the computations. Alternatively, an election can be made to value publicly traded stock options in the same amount, and as of the same time, so that the publicly traded stock options are reflected as a charge against income in audited financial statements or included in a footnote in such audited financial statements.[29] Such an election is available only to taxpayers preparing financial statements in accordance with U.S. generally accepted accounting principles.

"The final regulations mandate that stock-based compensation must be taken into account in determining the operating expenses subject to a C.S.A."

The I.R.S. felt that inclusion of S.B.C. was consistent with the arm's-length standard, the legislative history of Code §482, and U.S. income tax treaties.[30] The I.R.S.'s reasoning included the following:

> Treasury and the IRS believe that if a significant element of that compensation consists of stock-based compensation, the party committing employees to the arrangement generally would not agree to do so on terms that ignore the stock-based compensation.[31]

The I.R.S. rejected the idea of adopting a safe harbor.[32] It maintained a view that no basis existed for including other forms of compensation and excluding S.B.C.[33] Commentators on the proposed regulations argued that persons dealing at arm's length in real-world transactions do not take S.B.C. into account.[34]

The amendments to the final regulations were effective for S.B.C. granted in taxable years beginning on or after August 26, 2003. The preamble to the final regulations notes that these regulations are a clarification of the arm's-length standard under Code §482. Accordingly, while rules of specific application in the final regulations are prospective from the effective date, the effective date did not change the government's basic position set out in a directive that S.B.C. must be taken into account

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25 Treas. Reg. §1.482-7(d)(2)("final rule").

26 See Former Treas. Reg. §1.4827(d)(2)(i).

27 See Former Treas. Reg. §1.4827(d)(2)(ii).

28 See Former Treas. Reg. §1.4827(d)(2)(iii)(A).

29 See Former Treas. Reg. §1.4827(d)(2)(iii)(B)(1).

30 T.D. 9088, 2003-42 IRB 841, 842.

31 T.D. 9088, 2003-42 IRB 841, 843.

32 *Id.*, at 843–844.

33 *Id.*, at 841, 842.

34 *Id.*, at 841, 842.

in some reasonable form from the January 1, 1996, the effective date of the former cost sharing final regulations.

MUST S.B.C. BE INCLUDED IN THE POOL OF COSTS UNDER A Q.C.S.A.? – CASE LAW PRIOR TO *ALTERA*

Seagate

The inclusion of S.B.C. in cost sharing payments was the subject of litigation in the *Seagate* case.[35] In the settlement of that case, the government apparently conceded the stock option issue, kindling hope among taxpayers that it had changed its overall stance on the issue. Nevertheless, in a directive to examiners, the I.R.S. reaffirmed its prior position that stock option costs are properly includible in allocating costs under a cost sharing agreement.[36]

The *Seagate* case involved a motion for summary judgment by the taxpayer, Seagate Technology Inc. ("Seagate"). It argued that arm's-length principles under Code §482 do not mandate the inclusion of S.B.C. in a Q.C.S.A. Seagate was seeking a ruling that would contradict the I.R.S.'s position in F.S.A. 200003010. In effect, Seagate argued that, by its own admission, the I.R.S. had not identified a "a single actual market participant" whose transactions supported its position on compensatory stock options. Seagate compared the case in issue to *Compaq Computer Corp. v. Comm'r.*,[37] in which the taxpayer prevailed because the I.R.S. failed to establish sufficient evidence of comparable transactions. Rather, the company argued, the evidence showed that at arm's length, unrelated parties do not include the value of in-the-money options in shared costs. To this point, Seagate put forth two examples in which Federal authorities allegedly did not take into account compensatory stock options as a cost that can be compensated in their respective contracts: (i) contracts entered by the Federal Acquisition Regulations System ("F.A.R.S."), which governed contracts with all executive agencies of the Federal government for the acquisition of goods and services, including R&D during 1991 and 1992; and (ii) service contracts the United States entered into with more than 2,000 firms in each year in the period of 1990 through 1992 for the provision of R&D, testing, and engineering services. During this period, the government executed services contracts with private firms worth $19 billion, $18 billion, and $19 billion, respectively. Seagate pointed out that:

> [E]ach of these firms agreed at arm's length to conduct research and development work for the United States despite the fact that the United States refused to pay for any value of at-the-money stock options granted to their employees.

In a December 6, 1999 response to the company's request for admissions, the I.R.S. acknowledged that it could not identify a single arm's-length C.S.A., joint venture, or other similar arrangement in which one unrelated company agreed to pay a second unrelated company for any "costs" incurred with respect to the second company's granting of in-the-money stock options to its employees.

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35 *Seagate Technology Inc. v. Comm'r.*, T.C. Memo. 2000-388 ("*Seagate*").

36 "IRS Issues Directive on Stock Options and Cost Sharing Agreements," 2002 TNT 2145, Jan. 31, 2001 (dated Jan. 25, 2001).

37 *Compaq Computer Corp. v. Comm'r.*, T.C. Memo. 1999-220 ("*Compaq*").

Seagate argued that Code §482 cost-sharing regulations preclude the I.R.S. from making allocations where a taxpayer's C.S.A. is *bona fide*. Seagate Technology was a successor in interest to Conner Peripherals Inc., which merged into a *Seagate* subsidiary. Seagate noted that I.R.S. examiners had accepted Conner Peripherals' C.S.A. with foreign subsidiaries. Those examinations resulted in four "very specific" adjustments to the pool of costs, three of which were agreed to by the taxpayer. The three agreed-upon adjustments amounted to approximately $50,000 out of a total cost-sharing pool of $180 million.

Seagate asserted that, under Treas. Reg. §1.482-2A(d)(4), *bona fide* C.S.A.'s may only be subjected to allocations provided they are appropriate to reflect each participant's arm's-length share of the costs and risks of developing the property. Rather, the I.R.S. first must establish the factual predicate that allocations are necessary to reflect an arm's-length sharing of the costs and risks. In admitting unequivocally that it had no evidence to support its positions on the cost-sharing stock option issue, the I.R.S. acknowledged that the factual predicate was not demonstrated.

In addition, Seagate pointed out that the I.R.S.'s allocations for support costs related to non-integral services. Seagate argued that under Treas. Reg. §1.482-2(b)(5)(ii), the deemed arm's-length charge for non-integral services expressly excludes expenses related to the issuance of stock. Those expenses fall under the category of costs and deductions not to be considered in determining an arm's-length charge for services. Hence, the C.S.A. regulations were inconsistent with general rules under Code §482 without any reason justifying a separate rule.

The Tax Court denied the motion for summary judgment.[38] The Tax Court held that the taxpayer failed to demonstrate the absence of a genuine issue of material fact. Under the regulations, the I.R.S. is not required to be aware of arm's-length circumstances as a prerequisite to the making of a determination allocating a cost in connection with a C.S.A. As a result, the arguments made by the taxpayer – that the I.R.S. cannot apply the C.S.A. regulations calling for S.B.C. to form part of the shared costs if it cannot identify an actual C.S.A. between independent parties that includes S.B.C. – are better considered after a full trial takes place and briefs are filed.

Xilinx

At the appellate court level, the *Xilinx 2* and *Xilinx 3* cases illustrate the controversy that results from the interplay of the commensurate-with-income standard and the arm's-length standard. An opinion was issued; it was withdrawn; the holding was reversed, and two judges expressed opposite views as to the relationship between the two provisions.

The basic facts appear in the Tax Court case, *Xilinx 1*. The taxable years in issue were 1996 through 1998. In 1995, Xilinx Inc. and its Irish subsidiary entered into a C.S.A., which provided that all right, title, and interest in new technology developed by either company would be jointly owned. Under the C.S.A., each party was required to pay a percentage of the total R&D costs in proportion to the anticipated benefits to each from the new technology that was expected to be created.

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38 Summary judgment is an appropriate means by which to decide a legal issue if the pleadings, admissions, and other materials, including affidavits, demonstrate that no genuine issue exists as to any material fact and a decision may be rendered as a matter of law.

Specifically, the agreement required the parties to share: (i) direct costs, defined as costs directly related to the R&D of new technology, including, but not limited to, salaries, bonuses and other payroll costs and benefits; (ii) indirect costs, defined as costs incurred by departments not involved in R&D that generally benefit R&D, including, but not limited to, administrative, legal, accounting and insurance costs; and (iii) costs incurred to acquire products or intellectual property rights necessary to conduct R&D. The agreement did not specifically address whether employee stock options ("E.S.O.'s") were a cost to be shared.

"The Tax Court initially found that parties dealing at arm's-length would not use stock option compensation as a cost and therefore concluded that the government's position was an invalid application of the then existing cost-sharing regulations."

In tax years 1997, 1998 and 1999, Xilinx Inc. deducted as business expenses approximately $41,000,000, $40,000,000 and $96,000,000, respectively, based on its employees' S.B.C. The I.R.S. contended that the S.B.C. costs of the U.S. parent should have been shared with its foreign subsidiary and issued notices of deficiency. The Tax Court initially found that parties dealing at arm's-length would not use stock option compensation as a cost and therefore concluded that the government's position was an invalid application of the then existing cost-sharing regulations. The Tax Court reasoned that the commensurate-with-income standard was intended to supplement and support the arm's-length standard; it was not intended to supplant the standard. Nothing in Code §482, its accompanying regulations, or its legislative history indicates that internal measures of cost and profit should be used to the exclusion of the arm's-length standard.

That decision was reversed by the Ninth Circuit Court of Appeals in *Xilinx 2*. The appellate court completely disregarded the "supplement and support" argument of the Tax Court and stated that despite the unequivocal language of Code §1.482-1(b)(1) of the regulations (whereby arm's-length standard is to be applied in every case), the All-Cost Rule under Code §1.482-7(d) is broad.

> [The All-Cost Rule is] explicitly defined to include virtually all expenses not included in the cost of goods. The plain language does not permit any exceptions…we conclude the two provisions establish distinct and irreconcilable standards for determining which costs must be shared between controlled parties in [a] CSA specifically to intangible product development.[39]

According to the appellate court in *Xilinx 2*, the two provisions could not be harmonized.

The opinion in *Xilinx 2* was withdrawn and ultimately replaced by the opinion in *Xilinx 3*. In the revised opinion, the appellate court determined that the interaction of the All-Cost Rule and the arm's-length standard was at least ambiguous, and likely in conflict. On the basis of the arguments of the parties and the briefs submitted by friends of the court – including persuasive authority from international tax treaties – the court determined that the arm's-length standard was Congress' intended touchstone for Code §482. According to the court:

> The purpose of the regulations is parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions. The regulations are not to be construed to stultify that purpose. If the standard of arm's length is trumped by 7(d)(1), the purpose of the statute is frustrated. If Xilinx cannot deduct all its stock option costs, Xilinx does not have tax parity with an independent taxpayer.

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[39] *Xilinx 2*, at 488.

Consequently, the court refused to apply a rule of construction calling for a specific provision to control in lieu of a more general provision. The court was of the view that the purpose of Code §482 would not be furthered by ignoring the almost universal way in which unrelated parties behaved when entering a C.S.A. with another party.

An interesting sidelight of Xilinx 3 is that the company's petition for a rehearing of the case included a letter signed by former senior officials of the Organization for Economic Cooperation and Development and former tax officials of Australia, France, Germany, Japan, Mexico, Switzerland, and the United Kingdom. The letter stated that the Ninth Circuit's decision in Xilinx 2 is contrary to international norms. The rehearing petition also included a letter from an Irish tax official stating that it had contacted the U.S. Competent Authority because it was "not clear how…double taxation could be avoided" under the Ninth Circuit's prior decision.

On August 16, 2010, the I.R.S. responded to the Ninth Circuit's decision with Action on Decision 2010-003, wherein the I.R.S. reiterated its claim that the All-Cost Rule under Treas. Reg. §1.482-7(d)(1) was consistent with the arm's-length standard.[40] In the I.R.S.'s view, Treas. Reg. §1.482-7(d)(1) properly adjusted the pricing of a transaction to reflect an arm's-length result by ensuring that the controlled participants bore shares of all costs associated with their anticipated benefits.

The I.R.S. nevertheless acquiesced in the result of the decision because it viewed the decision as mooted by the 2003 amendments to Treas. Reg. §1.482-7. As explained above, these amendments expressly state that stock options are costs related to the development of intangible property that controlled taxpayers must share. The amendments apply to stock options granted in tax years beginning after August 25, 2003.

STATE FARM OR *CHEVRON* STANDARD OF REVIEW IN LIGHT OF *MAYO* CASE

Altera Approach

In *Altera*, the Tax Court fully embraced the view that all tax regulations – whether issued under a specific grant of authority or under the general authority of Code §7805(a), as in the *Altera* case – are subject to the notice and comment rulemaking requirements under the A.P.A. For some, this conclusion may be surprising. However, it follows a trend in which the grant of authority given to the I.R.S. is accompanied by an expectation of responsibility that prevents the I.R.S. from being arbitrary and capricious. Based on the holding in *Altera*, Microsoft has announced that it may follow suit.[41]

The court in *Altera* ruled that all final administrative rules – *viz.*, regulations – issued under the Treasury's general rulemaking authority based on Code §7805(a) are

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40 Compare AOD 2010-003, IRB 2010-33 (Aug. 16, 2010), 2010 AOD LEXIS 6, at 7-8, with *Xilinx 2*, at 491 and *Xilinx 1*, at 54.

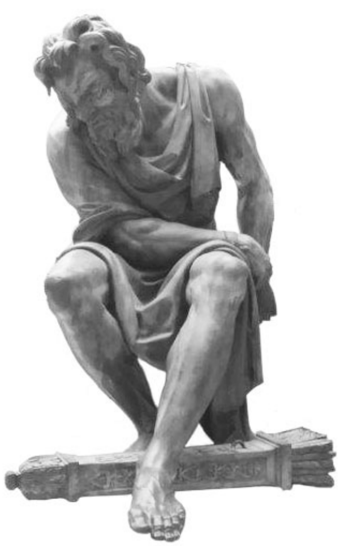
41 In defense of a summons enforcement action in Federal District Court (*U.S. v. Microsoft, W.D. Wash.*, No. 2:15-cv-00102, notice filed August 6, 2015). See *International Tax Monitor*, No. 156 (Aug. 10, 2015).

legislative rules because they are intended to have the force of law.[42] Moreover, it was clear to the Tax Court that the Treasury Department intended to exercise that power when it issued the C.S.A. regulations directed at S.B.C. Accordingly, it held that the final rule is subject to the notice and comment rulemaking process outlined in A.P.A. §533.

More than one standard of review can apply under the A.P.A. The task of the Tax Court in *Altera* is to determine the standard that is applicable. In the case, the taxpayer contended that the final rule was arbitrary and capricious under the so-called *State Farm* standard. In comparison, the I.R.S. countered that rule was valid based on the so-called *Chevron* test. In its decision, the Tax Court accepted neither position completely. It held the distinction to be irrelevant. According to the court, the *State Farm*[43] standard of review must be followed in applying the *Chevron*[44] step two test:

> * * * whether *State Farm* or *Chevron* supplies the standard of review is immaterial because *Chevron* step 2 incorporates the reasoned decision making standard of *State Farm*, see *Judulang v. Holder*, 565 U.S. at ___ n.7, 132 S. Ct. at 483 (stating that, under either standard, the 'analysis would be the same, because under *Chevron* step two, we ask whether an agency interpretation is `arbitrary or capricious in substance' (quoting *Mayo Found.*, 562 U.S. at 53)) * * * . Because the validity of the final rule turns on whether Treasury reasonably concluded that it is consistent with the arm's-length standard, the final rule must-in any event-satisfy *State Farm*'s reasoned decision making standard.[45]

Further, referring to the *State Farm* standard of review, the Tax Court held that:



> [B]y failing to engage in any fact finding, Treasury failed to 'examine the relevant data', *State Farm*, 463 U.S. at 43, and * * * failed to support its belief that unrelated parties would share stock-based compensation costs in the context of a QCSA with any evidence in the record. Accordingly, the final rule lacks a basis in fact.[46]

The Tax Court held that the final rule failed to satisfy *State Farm*'s reasoned decision-making standard and for that reason was invalid.

***State Farm* Standard**

The standard discussed in *Altera*, is one that is mandated on all Federal agencies that promulgate rules pursuant to a legislative mandate. Thus, whether the rule is a tax rule in a Treasury regulation or a Federal Communications Commission rule that applies to broadcast media, the same standard applies in determining whether the process set forth in the A.P.A. has been followed and whether the rule reflects action that is arbitrary and capricious.

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[42] *Am. Mining Cong. V. Mine Safety & Health Admin.*, 995 F.2d 1106, 1109 (D.C. Cir. 1993)

[43] *State Farm*.

[44] *Chevron*.

[45] *Altera*, at 68.

[46] *Id.*, at 71.

The Supreme Court, in a nontax context, stated that an agency's notice of rulemaking must:

> * * * articulate a satisfactory explanation for its action, including a rational connection between the facts found and the choice made * * * [and] must cogently explain why it has exercised its discretion in a given manner.

An agency rule is invalid as arbitrary and capricious if it:

> * * * entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.[47]

State Farm involved a challenge to the efforts of the newly-elected Reagan administration to deregulate the area of passive restraints for automobiles.[48] The National Highway Traffic Safety Administration ("N.H.T.S.A."), to which the Secretary has delegated his authority to promulgate safety standards, rescinded the requirement of Modified Standard 208 that new motor vehicles produced after September 1982 be equipped with passive restraints (automatic seatbelts or airbags) to protect the safety of the occupants of the vehicle in the event of a collision. The safety requirements that the N.H.T.S.A. rescinded had been established in the implementation of:

> [T]he National Traffic and Motor Vehicle Safety Act of 1966 (Act). The Act, created for the purpose of 'reduc[ing] traffic accidents and deaths and injuries to persons resulting from traffic accidents,' directs the Secretary of Transportation or his delegate to issue motor vehicle safety standards that 'shall be practicable, shall meet the need for motor vehicle safety, and shall be stated in objective terms.' In issuing these standards, the Secretary is directed to consider 'relevant available motor vehicle safety data,' whether the proposed standard 'is reasonable, practicable and appropriate' for the particular type of motor vehicle, and the 'extent to which such standards will contribute to carrying out the purposes' of the Act.[49]

The Court held that the N.H.T.S.A.'s rescission of the safety requirements was subject to review under the arbitrary or capricious standard because the safety standards had been defined by informal rulemaking.[50] The Court based its application of such review standard on analysis in an earlier case, *Overton Park*.[51] In particular, similar to *Overton Park*, the Court's analysis retained the uncertain distinction between the substance of the agency decision and its decision-making process:

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47 *State Farm*, at 43 and 48 (1983). See *Dominion Res., Inc. v. U.S.* 681 F3d 1313 (Fed. Cir. 2012) (holding paragraph in detailed Treas. Reg. under Code §263A(f) invalid because the Treasury provided "no explanation for" its inclusion of rule stated in paragraph).

48 *State Farm*, 463 U.S. 29, 36-37 (1983).

49 *Id.*, at 33-34 (alteration in original) (citations omitted) (quoting 15 U.S.C. §§1381, 1392(a), 1392(f)(1), 1392(3)-(4) (1976 & Supp. V 1981)).

50 *Id.*, at 41.

51 *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 413-416 (1971) ("*Overton Park*").

> The scope of review under the 'arbitrary and capricious' standard is narrow and a Court is not to substitute its judgment for that of the agency. Nevertheless, the agency must examine the relevant data and articulate a satisfactory explanation for its action including a '*rational connection between the facts found and the choice made*.' In reviewing that explanation, we must 'consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment.' Normally, an *agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise*. The reviewing Court should not attempt itself to make up for such deficiencies; we may not supply a reasoned basis for the agency's action that the agency itself has not given. We will, however, 'uphold a decision of less than ideal clarity if the agency's path may reasonably be discerned.'[52] [Emphasis added.]

"The scope of review under the 'arbitrary and capricious' standard is narrow and a Court is not to substitute its judgment for that of the agency. Nevertheless, the agency must examine the relevant data and articulate a satisfactory explanation for its action."

While applying this standard, the Court rejected the conclusion that the agency's rescission was unlawful:

> The failure of Congress to exercise its veto might reflect legislative deference to the agency's expertise, and does not indicate that Congress would disapprove of the agency's action in 1981. And even if Congress favored the Standard in 1977, it - like NHTSA - may well reach a different judgment, given changed circumstances four years later.[53]

I.e., in the Court's view, the agency's rescission had not exceeded the scope of its legal authority in applying the *Overton Park* terminology of review. In other words, the Court rejected a claim that rescission was barred under the first step of *Chevron*, as discussed below.

The Court then considered the adequacy of the agency's decision-making process. The Court concluded, unanimously, that the agency violated the arbitrary or capricious standard because it had failed to consider whether to mandate the exclusive use of either airbags or the continuous seatbelt. This was arbitrary or capricious. The Court held that:

> The first and most obvious reason for finding the rescission arbitrary and capricious is that NHTSA apparently gave no consideration whatever to modifying the Standard to require that airbag technology be[ing] utilized.[54]

The agency rescinded the requirement without assessing whether safety would be promoted by simply requiring all manufacturers to use the same safety technology.

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52 *State Farm*, 43 (citations omitted) (quoting *Burlington Truck Lines, Inc. v. U.S.*, 371 U.S. 156, 168 (1962); *Bowman Transp., Inc. v. Ark.-Best Freight Sys., Inc*., 419 U.S. 281, 285-86 (1974); *Overton Park*, 401 U.S. at 416, and *SEC v. Chenery Corp*, 332 U.S. 194, 196 (1947) ("*Chenery 1*"); *Camp v. Pitts*, 411 U. S. 138, 411 U. S. 142-143 (1973) (*per curiam*)).

53 *State Farm*, at 45.

54 *Id.*, at 46.

The statute, in other words, defined the factors that the agency had to consider in making its regulatory decisions. "The agency has failed to supply the requisite 'reasoned analysis' in this case."[55]

The arbitrary or capricious review standard the Court applied in *State Farm* was much more elaborate than in *Overton Park*. The *State Farm* decision retained a path to challenge an administrative regulation in terms of process but was directed at the substance of the rule. At one level, uncertainty remained about whether the standard to be applied in determining whether agency action is arbitrary or capricious is concerned only with the agency's decision-making process, yet at another level, the standard seemed to reflect the Court's view that the agency's substantive decision was erroneous because it did not address certain factors that were found to be of importance. In other words, the terminology of the Court was process, the holding suggested substance.[56]

In sum, *State Farm* retained the core view that in the first place the content of law for an agency may be defined by Congress. In the absence of clearly defined law, the agency's application of the law may be subjected to review under the arbitrary or capricious standard.[57] That standard is focused on the agency's decision-making process. *State Farm* thus stands for a process-oriented review standard of an agency's action by the courts, but appropriate process is in the eye of the beholder.

***Chevron* Standard**

In *Chevron*, the Court laid down two main principles: First, as long as there is administrative guidance on a statute, the Court is required to defer to an agency's interpretation as opposed to apply its own interpretation of the rule. Second, in reviewing the agency's guidance, the standard to be applied is whether the Court deems it a permissible interpretation of the rule.

In *Chevron*, the Court reviewed a regulation promulgated by the Environmental Protection Agency ("E.P.A.") that broadly defined a stationary source under the Clean Air Act. This narrowed the circumstances under which modifications of an existing source would trigger the stringent requirements for a new stationary source.[58] Accordingly, the Court proceeded to the second step of the analysis, the step at which deference is owed to an agency's interpretation.

In reaching its decision, the Supreme Court established a two-part test, commonly referred to as the *Chevron* two-step, to be applied when a court is reviewing an agency's statutory interpretation:[59]

> When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of

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55 *Id.*, at 56.

56 To illustrate, if the argument that was not considered by the agency was viewed by the Court to be frivolous, the likelihood of striking down the rule would be remote in the view of the authors.

57 *State Farm*, at 42-43 (majority opinion).

58 *Chevron*, at 840 (describing the netting out effect of the so-called bubble concept).

59 *Id.*, at 842-43 (omitting Fn. 10).

the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.[60] If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply [61]impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a *permissible construction of the statute*.[62] [Emphasis added.]

Thus, a reviewing court must affirm an agency's interpretation even if it is not the best interpretation of a statute or the interpretation that the court would have devised. The court must defer to the agency's interpretation even if it is not the meaning that the court would give to the statute. In addition, the court is not permitted to substitute its own judgment for that of the agency if the agency's interpretation is allowed by the statute. The Court stated that "the Court need not conclude that the agency construction was the only one it permissibly could have adopted to uphold the construction, or even the reading the Court would have reached if the question initially had arisen in a judicial proceeding."[63] In other words, the court must defer to the agency's interpretation unless that interpretation is unreasonable. In essence, this refined the holding in *State Farm*, by stating that the agency's decision will be affirmed where a decision to proceed in one of two or more ways is relatively even among the alternatives. It is only when the choice is not close that the action may be struck down as arbitrary or capricious. Egregious decision making by an administrative agency of the Federal government will not be affirmed.

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60 *Id.*, at Fn. 9:

> The judiciary is the final authority on issues of statutory construction, and must reject administrative constructions which are contrary to clear congressional intent. See, *e.g.*, *FEC v. Democratic Senatorial Campaign Committee*, 454 U.S. 27, 454 U.S. 32 (1981); *SEC v. Sloan*, 436 U.S. 103, 436 U. S. 117-118 (1978); *FMC v. Seatrain Lines, Inc.*, 411 U.S. 726, 411 U.S. 745-746 (1973); Volkswagenwerk v. FMC, 390 U. S. 261, 390 U. S. 272 (1968); *NLRB v. Brown*, 380 U.S. 278, 380 U.S. 291 (1965); *FTC v. Colgate-Palmolive Co.*, 380 U. S. 374, 380 U. S. 385 (1965); *Social Security Board v. Nierotko*, 327 U.S. 358, 327 U.S. 369 (1946); *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 285 U.S. 16 (1932); *Webster v. Luther*, 163 U.S. 331, 163 U.S. 342 (1896). If a court, employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue, that intention is the law, and must be given effect.

61 *Id.*, at 843.

62 *Id.*, at Fn. 11:

> The court need not conclude that the agency construction was the only one it permissibly could have adopted to uphold the construction, or even the reading the court would have reached if the question initially had arisen in a judicial proceeding. *FEC v. Democratic Senatorial Campaign Committee*, 454 U.S. at 454 U.S. 39; *Zenith Radio Corp. v. United States*, 437 U.S. 443, 437 U.S. 450 (1978); Train v. Natural Resources Defense Council, Inc., 421 U. S. 60, 421 U.S. 75 (1975); *Udall v. Tallman*, 380 U.S. 1, 380 U. S. 16 (1965); *Unemployment Compensation Comm'n v. Aragon*, 329 U.S. 143, 329 U.S. 153 (1946); *McLaren v. Fleischer*, 256 U.S. 477, 256 US. 480-481 (1921).

63 *Id.*, at 843 n.11.

The Court's motivation for granting deference to agencies came from the Court's view that statutory ambiguity means that Congress has delegated interpretive authority to agencies[64] and not courts.[65] The Court provided two reasons for this rule of deference: agency expertise and the superior democratic accountability of agencies when compared to courts.[66]

The second part of the Court's analysis, "whether the agency's answer is based on a permissible construction of the statute"[67] or what materials a court is required to consider in making that determination, is no easy undertaking. Part of the Court's discussion suggested that the agency's interpretation was lawful because the agency considered the proper factors – "the economic interest in permitting capital improvements to continue and the environmental interest in improving air quality" – when it established the regulation.[68]

The Court upheld the E.P.A.'s definition of the term "stationary source" and reversed the D.C. Circuit's judgment.[69] The Supreme Court concluded that:

> [T]he Administrator's interpretation represents a reasonable accommodation of manifestly competing interests and is entitled to deference: the regulatory scheme is technical and complex, the agency considered the matter in a detailed and reasoned fashion, and the decision involves reconciling conflicting policies.[70]

Chevron **in Tax Cases**

Chevron, which was not a tax case, was decided only five years after the Court's decision in *National Muffler Dealers Association v. U.S.*[71] In *National Muffler*, the Court held that tax regulations promulgated by the I.R.S. should hold up to a traditional rule as the standard of review and set out factors to determine the reasonableness of a Treasury regulation. These factors include:

> In determining whether a particular regulation carries out the congressional mandate in a proper manner, we look to see whether

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64 *Id.*, at 843-844:

> If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by Treas. Regulation. Such legislative Treas. Regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute. Sometimes legislative delegation to an agency on a particular question is implicit rather than explicit. In such a case, a Court may not substitute its own construction of the statutory provision for reasonable interpretation made by the administrator of the agency. (Footnote omitted.)

65 *Id.*, at 842, 843.

66 *Id.*, at 844-45, 865-66; and *Food and Drug Admin. v. Brown & Williamson Tobacco Corp.*, 120 S. Ct. 1291, 1300 (2000).

67 *Chevron*, at 843.

68 *Id.*, at 851.

69 *Id.*, at 866.

70 *Id.*, at 865.

71 *National Muffler Dealers Assn., Inc v. United States*, 440 U.S. 472 (1979) ("*National Muffler*").

> the regulation harmonizes with the plain language of the statute, its origin, and its purpose. A regulation may have particular force if it is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent.[72]

Under the traditional rule "Courts customarily defer to a treasury regulation that implements the congressional mandate in some reasonable manner"[73] and "should not overrule such a regulation 'except for weighty reasons'."[74]

Arguably, the traditional rule, not the *Chevron* rule, should apply to tax regulations. However, as the Seventh Circuit stated in *Bankers Life & Cas. Co. v. U.S.*:[75]

> While the two approaches articulate the level of deference differently, they both come down to one operative concept – reasonableness. Thus, *Chevron* and the traditional rule constitute two different formulations of a reasonableness test. There may be some subtle difference in the phrasing of each framework, but we should be wary of attempts to discern too many gradations of reasonableness. * * * Viewed from this perspective at least, the supposed gap between *Chevron* and the traditional rule is a distinction without a difference.

In *Mayo Found. for Med. Educ. & Research v. U.S.*,[76] the Supreme Court was asked to determine whether participants in residency programs for doctors were students undergoing training for purposes of the imposition of Social Security taxes. If so, no tax was due with regard to payments made by the hospitals to the residents. If not, tax would be imposed on the hospitals and the participants. The residents in the program received formal educational training and in addition spent the bulk of their time – 50 to 80 hours per week – caring for patients.

The statute defined "employment" as "any service...performed...by an employee for the person employing him."[77] The general rule, however, was subject to an exception that excluded payments in connection with any "service performed in the employ of...a school, college, or university...if such service is performed by a student who is enrolled and regularly attending classes at [the school]."[78]

Dating back to 1951, the Treasury Department construed the student exception to be applicable to students working for schools as an incident to and for the purpose

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[72] *National Muffler*, at 477.

[73] *Cottage Savings Ass'n v. Comm'r*, 499 U.S. 554, 560-61, 111 S.Ct. 1503, 1507-08, 113 L.Ed.2d 589 (1991) (citing *National Muffler*, 440 U.S. 472, 476-77, 99 S.Ct. 1304, 1306-07, 59 L.Ed.2d 519 (regulation may have particular force if substantially contemporaneous construction of statute by those presumed to have been aware of Congressional intent)); see also *Chevron*, 467 U.S. 837, 843, 104 S.Ct. 2778, 2781-82, 81 L.Ed.2d 694 (1984).

[74] *Bingler v. Johnson*, 394 U.S. 741, 750, 89 S.Ct. 1439, 1445, 22 L.Ed.2d 695 (1969) (citing *Comm'r v. South Texas Lumber Co.*, 333 U.S. 496, 501, 68 S.Ct. 695, 698, 92 L.Ed. 831 (1948)).

[75] *Bankers Life & Cas. Co. v. U.S.*, 142 F3d 973, 981–982 (7th Cir. 1998).

[76] *Mayo Found. for Med. Educ. & Research v. U.S.*,131 S. Ct. 704 (2011).

[77] Code §3121(b).

[78] Code §3121(b)(10).

of pursuing a course of study. In 2004, the Treasury Department issued regulations providing that the services of a full-time employee – which includes an employee normally scheduled to work 40 hours or more per week – are not incident to and for the purpose of pursuing a course of study. An example in the regulations concludes that a medical resident whose normal schedule requires him to perform services 40 or more hours per week as a resident is not a student.

The Mayo Foundation filed suit asserting that the regulation was invalid. The District Court upheld the claim[79] but the 8th Circuit Appellate Court reversed,[80] applying the holding in *Chevron*. The Supreme Court upheld the reversal,[81] stating:

"'The power of an administrative agency to administer a congressionally created...program necessarily requires the formulation of policy and the making of rules to fill any gap left, implicitly or explicitly, by Congress.'"

> The principles underlying our decision in *Chevron* apply with full force in the tax context. *Chevron* recognized that '[t]he power of an administrative agency to administer a congressionally created...program necessarily requires the formulation of policy and the making of rules to fill any gap left, implicitly or explicitly, by Congress.' * * * It acknowledged that the formulation of that policy might require "more than ordinary knowledge respecting the matters subjected to agency regulations.' * * * Filling gaps in the Internal Revenue Code plainly requires the Treasury Department to make interpretive choices for statutory implementation at least as complex as the * * * '[I]n an area as complex as the tax system, the agency Congress vests with administrative responsibility must be able to exercise its authority to meet changing conditions and new problems' * * *. We see no reason why our review of tax regulations should not be guided by agency expertise pursuant to *Chevron* to the same extent as our review of other regulations. (Citations omitted.)

In *National Cable & Telecommunications Association v. Brand X Internet Services*,[82] the Supreme Court held that a court must apply the *Chevron* rule, even if, before the agency adopted the regulation, the court construed the underlying statute in a way differing from the agency construction embodied in the regulation. According to the Supreme Court:

> A Court's prior judicial construction of a statute trumps an agency construction otherwise entitled to Chevron deference only if the prior Court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion. This principle follows from Chevron itself. Chevron established a "presumption that Congress, when it left ambiguity in a statute in a way that was intentionally meant for implementation by an agency, understood that the ambiguity would be resolved, first and foremost, by the agency, and desired the agency (rather than the Courts) to possess whatever degree of discretion the ambiguity allows." * * * [Smiley v. Citibank (South Dakota), N. A., 517 U.S. 735, 740–741

79 *Mayo Found. for Med. Educ. & Research v. U.S.*, 503 F.Supp.2d 1164, (D. Minn, 2007).

80 *Mayo Found. for Med. Educ. & Research v. U.S.*, 568 F.3d 675 (8th Cir. 2009).

81 *Mayo Found. for Med. Educ. & Research v. U.S.*, 131 S.Ct. 704 (2011).

82 *National Cable & Telecommunications Assn. v. Brand X Internet Services*, 545 U.S. 967, 981 (2005).

(1996).] Yet allowing a judicial precedent to foreclose an agency from interpreting an ambiguous statute, as the Court of Appeals assumed it could, would allow a Court's interpretation to override an agency's. Chevron's premise is that it is for agencies, not Courts, to fill statutory gaps. * * * The better rule is to hold judicial interpretations contained in precedents to the same demanding *Chevron* step one standard that applies if the Court is reviewing the agency's construction on a blank slate: Only a judicial precedent holding that the statute unambiguously forecloses the agency's interpretation, and therefore contains no gap for the agency to fill, displaces a conflicting agency construction.

Chevron – Bottom Line

The Supreme Court has provided little guidance as to how a court should evaluate whether the agency's interpretation is "permissible" or "reasonable" under *Chevron* step two. Oftentimes, in determining whether the agency's interpretation is reasonable, a court's focal point will be given to the purpose and goal of a statute. For example, in *Chevron*, the Supreme Court noted that the agency's interpretation "of the term 'source' is a permissible construction of the statute" in light of the statute's goals "to accommodate progress in reducing air pollution with economic growth."[83] Put in other words, "about all the Court can do is determine whether the agency's action is rationally related to the objectives of the statute containing the delegation."[84] This approach is followed by many courts. For example, in *Natural Resources Defense Council, Inc. v. EPA*, the D.C. Circuit noted that, under step two of *Chevron*, "the agency's interpretation must be sustained if it is reasonable in light of the language, legislative history, and policies of the statute."[85] In that case, the D.C. Circuit upheld an E.P.A. regulation concerning the Clean Water Act, noting that "[w]e are persuaded that E.P.A.'s reading of the statute, while not the only plausible one, is reasonable." First, the court determined the language of the statute to be "confusing." At step two, the court looked at the agency interpretation and compared it with the overarching goals of the statute to conclude that the agency's guidance was a permissible interpretation of the ambiguous statutory provision.

Kennecott Utah Copper Corp. v. United States Department of the Interior provides another example of this approach to *Chevron* step two.[86] The Department of the Interior promulgated regulations concerning when the statute of limitations for damages for certain oil spills would begin to run. The court determined that applying step two of *Chevron* the agency's construction was "not a reasonable interpretation of the [ambiguous] statute, viewed with an eye to its structure and purposes." The purpose of setting a limitation was to provide the industry with a certain level of comfort that it will not be brought to court for actions taken in the past. Hence, prolonging the limitation as set forth under the agency's regulations was construed as not compliant with the identified goal.

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83 *Chevron*, at 866.

84 *Mueller v. Reich*, 54 F.3d 438, 442 (7th Cir. 1995).

85 *Natural Resources Defense Council, Inc. v. EPA*, 822 F.2d 104, 111 (D.C. Cir. 1987).

86 *Kennecott Utah Copper Corp. v. United States Department of the Interior*, 88 F.3d 1191 (D.C. Cir. 1996).

One reason for the lack of clarity lies in the fact that once a reviewing court reaches the second step of the *Chevron* standard, the agency interpretation of the statute is usually sustained, often in a perfunctory way. With perhaps one exception, *AT&T Corp. v. Iowa Utilities Bd.*,[87] commentators have observed that the Supreme Court has never invalidated an agency interpretation of a statute at step two of *Chevron*.[88] The lower court's *Chevron* step two cases follow a similar, though not as overwhelming, pattern.[89] Consequently, an explanation of exactly what a court should examine at step two can rarely be found. Even if so, it is then hard to evaluate the relative importance of the various factors that courts can rely on when they uphold interpretations given the limited number of cases.

On a stand-alone basis, the *Chevron* step two test seems to constitute a rule-oriented standard of review for courts as opposed to the process-driven approach under the *State Farm* standard, *i.e.*, whether the agency gathered data relevant to the issue, sufficiently took into account comments, etc. Under the *Chevron* step two test, courts must defer to the agency's reasoning and deem the administrative guidance permissible as long as (i) a statute is ambiguous and (ii) the rule allows a statutory goal to be met. Absent further clarification, the bottom line is that the agencies succeed in cases where the *Chevron* test was applied.

The next question now is how *State Farm* and *Chevron* interact, *i.e.*, whether one can be performed without taking into consideration principles laid down for the other.

ALTERA CONCLUSION

At one level, the decision in *Altera* results from hubris on the part of the I.R.S. Perhaps, if the I.R.S. adopted a process by which it considered the interrelation of the commensurate-with-income standard and the arm's-length standard, it is possible that the Tax Court would not have reached *Chevron* step two analysis. By not providing analysis, the I.R.S. made it easy for the Tax Court to apply its own judgment to the issue. However, even if the process were followed by the I.R.S., an agency's reasoning can be defective to such an extent that the presumption of correctness in the regulation is vitiated without violating the *Chevron* standard.

As it turned out, the taxpayer's support for its position was largely empirical, and stood on the shoulders of the empirical case built in *Xilinx* for exclusion of S.B.C. from a cost pool in a cost sharing arrangement. This empirical evidence consisted of a number of joint venture and other collaboration agreements submitted by commentators to the proposed 2003 C.S.A. regulations.

These agreements included certain elements of labor compensation that parties to the agreements consented to share, but did not include S.B.C. among those expenses. Agreements from the software industry, comparable to the industry in

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87 *AT&T Corp. v. Iowa Utilities Bd.*,119 S.Ct. 721, 734-36 (1999).

88 See Bressman, Lisa Schultz, "Schechter Poultry at the Millennium: A Delegation Doctrine for the Administrative State," *Yale Law Journal*, Vol. 109 No. 6 (Apr. 2000): 1399, 1400.

89 See Kerr, Orrin S., "Shedding Light on Chevron: An Empirical Study of the Chevron Doctrine in the U.S. Courts of Appeals," *Yale Journal on Regulation*, Vol. 15, No. 1 (1998).

which *Altera* operated during the years at issue, were produced and viewed as sufficiently comparable to the Altera arrangement. These agreements proved persuasive in *Altera*, and served to amplify the effect of the failure of the Treasury to consider the submissions from commentators to the proposed 2003 C.S.A. regulations. Neither the Treasury, as part of its finalization of the 2003 regulations, nor the I.R.S. in *Altera* produced evidence of an agreement between third parties that included stock option costs. Proof of arm's-length behaviour with respect to stock option expense was therefore delivered in the form of a negative empirical result.

"The I.R.S. position is inherently simple to identify – if S.B.C. costs are an expense for financial statement purposes, S.B.C. costs should be an expense for income tax purposes that is properly part of a cost pool."

The empirical evidence was bolstered by economic analysis submitted as commentary to the proposed 2003 C.S.A. regulations. First, this evidence was used to demonstrate that unrelated parties would not share stock option compensation costs "because the value of stock-based compensation is speculative, potentially large, and completely outside of the control of the parties." Second, the notion that S.B.C. costs are are borne by a company was successfully defeated with analysis submitted in response to the proposed 2003 regulations by well-known economists William Baumol and Burton Malkiel, who concluded that "there is no net economic cost to a corporation or its shareholders from the issuance of stock-based compensation."

The Tax Court was persuaded that not only is S.B.C. not shared between cooperating independent parties, it held that stock-option expense should not be considered as an element of the comprehensive set of costs considered by the Treasury to be "relevant costs" in a Q.C.S.A.

The I.R.S. position is inherently simple to identify – if S.B.C. costs are an expense for financial statement purposes, S.B.C. costs should be an expense for income tax purposes that is properly part of a cost pool. The problem with this approach is that S.B.C. costs for financial accounting purposes measure the effect of dilution in earnings per share as a result of the of the S.B.C. arrangement. However, it is the shareholder group that bears this cost, not the corporation. It is recognized that the corporation receives a compensation deduction at the time of exercise. However, that simply flows from the character of the income reported by the employee and keeps the global income and expense system in stasis. One party performs services and reports income and the other party employs the service provider and has a deduction or an increase in the basis of an asset, whichever is appropriate.

Another troubling aspect with the I.R.S. position is that the cost of S.B.C. is not directly related to the value of the services performed. Rather, it is affected by the growth in value of the stock between the grant date and the exercise date, assuming the exercise price is equal to fair market value on the date of the grant.

To illustrate, assume that a janitor is assigned to maintain the building in which a participant to a C.S.A. conducts activities related to the C.S.A. Assume further that he benefits from an option issued many years ago when the value at grant date was \$25 and the exercise price was \$25. At exercise of the the option, the janitor will have \$75 of income per share if the value of each share at exercise date is \$100. At the same time, assume that a newly-hired divisional vice president heads the C.S.A. project for the same participant. Assume further that, because he is newly hired, the divisional vice president holds options with a grant date value of \$95 and an exercise price of \$95. At exercise of the option on the same day as the janitor, the

“The I.R.S. had only one principal argument to raise – it relied on the commensurate-with-income standard, and did not present any expert opinion.”

divisional vice president will have $5 of income per share. While the divisional vice president may hold many more shares than the janitor, on a per share bases, the janitor’s services are of significantly greater value than the services of the divisional vice president.

The result in the example is is extreme, but illustrates the weakness in the I.R.S. position and the reason why, when a C.S.A. is created between independent parties, S.B.C. costs are not taken into account. The expense does not reduce the wealth of the corporation and the S.B.C. is not linked to the value of services performed. The Federal government follows the same rule when reimbursing contractors operating under cost-plus arrangements. Because independent parties and the Federal government do not share S.B.C. costs, the I.R.S. found itself in a deep logic hole when arguing its position for partial summary judgment in *Altera*.

Not wishing to focus on (i) the absence of any reduction in a company’s wealth resulting from an S.B.C. arrangement, (ii) the disconnect between the value of services performed and the amount of the S.B.C. income and expense, and (iii) the actions of truly independent parties, the I.R.S. had only one principal argument to raise – it relied on the commensurate-with-income standard, and did not present any expert opinion that supported the position that S.B.C. must be included in the cost pool of a Q.C.S.A. to achieve an arm’s-length result.

Among litigators there is an old saying that in setting strategy for arguing a case, a litigator faces a choice of three possible actions. If the client benefits from favorable law but faces unfavorable facts, the litigator should strongly argue the importance of the law. On the other hand, if the client benefits from favorable facts but faces unfavorable law, the litigator should strongly argue the importance of the facts. Finally, if neither the law nor the facts benefit the client, the litigator should bang his fists loudly on the table when making arguments. Readers are invited to draw their own conclusion when reviewing the litigation strategy of the I.R.S. in *Altera*.

U.S. TAXATION OF CARRIED INTEREST

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Tags
Carried Interest
Long Term Capital Gain
Partnerships
Private Equity

INTRODUCTION

The taxation of so-called carried interest in the U.S. has received much attention over the last few years, particularly from the Obama Administration, which seeks to make their tax treatment harsher. This past month, Paul Ryan (R.-W.I.), Chairman of the Ways and Means Committee of the House of Representatives, indicated that he would not be discussing the issue of carried interest reform with his counterparts in the Democratic party. This makes it unlikely that the U.S. will overhaul the tax treatment of carried interest in 2016 or 2017. However, the I.R.S. has issued proposed regulations designed to curb carried interest in some situations.

TAX TREATMENT OF CARRIED INTEREST

"Carried interest" is the term of art used to describe a profts interest in an investment fund that is granted to an investment manager or sponsor for the work they perform in managing or selling the fund. The investment fund is generally created as a limited partnership or a limited liability company ("L.L.C.") that is treated as a partnership for U.S. tax purposes.

The equity in the investment fund is contributed by third-party investors ("Investors") who receive a share of the fund's profits. The manager ("Manager") generally contributes little or no equity and is only granted a profits interest. Generally, 100% of the cash flow from the fund is distributed to the Investors until they recieve a return of their invested capital along with a preferred return on that amount (such as 6% or 8%). Once the Investors recoup their capital and preferred return, the distribution of further profits is generally shared – 80% to the Investors and 20% to the Manager for its carried interest in the typical case.

A person who provides services, such as a Manager, is taxable on any payment they receive for the work they do, whether paid in cash or property. If a Manager is given a car for services rendered, then the Manager has to report the fair market value ("F.M.V.") of the car as taxable compensation income. However, under current U.S. tax rules, the I.R.S. generally treats the F.M.V. of a carried interest as zero if certain conditions are met, so the Manager pays no tax when it receives the carried interest – one of the key benefits of this ownership structure.

Another key benefit of a carried interest is that it is an ownership interest in a partnership, which is a pass-through entity for U.S. tax purposes. Future allocations of taxable income or gain from the investment fund to the Manager therefore retain their character in the hands of the Manager. Thus, if the partnership's income is comprised of a long-term capital gains from the sale of stocks or securities, the

Manager will have the advantage of paying the long-term capital gains rate (20%) when allocated that income.

An additional benefit is one of tax deferral, since capital gains are not typically taxed until a realized event. This allows the taxpayer to control the timing of when he or she is taxed.

The tax treatment of a carried interest has caused a debate within the upper echeleons of Washington. The Obama Administration seeks to amend the rules applicable to carried interest so all income allocated to the Manager is taxed as ordinary income (at a maximum rate of 39.6%). According to the administration, after the initial contribution, fund managers provide a service no different from the labor that other workers provide to their employers. Furthermore, the Obama Administration believes that taxing carried interest as ordinary income will generate $17.7 billion in additional revenue for the U.S. treasury. However, many in Congress do not share this belief, meaning that the legislation will likely be kept on hold until after the next presidential election or later.

"The proposed regulations recharacterize that income as a 'guaranteed payment' for services, which is taxed as ordinary income rather than as a carried interest."

On July 22, 2015, the I.R.S. issued Prop. Reg. §1.707-2 relating to disguised payments for services under Code §707(a)(2)(A). The proposed regulations provide guidance to partnerships and their partners regarding when an arrangement will be treated as a disguised payment for services and not as the issuance of a partnership interest.

The regulations are targeted at cases where a partner performs services for a partnership and the partner would normally get paid a fee in cash, which is taxed as ordinary income. Rather than being paid a fee for services rendered, the partner waives its right to a fee and the partnership makes a special allocation and distribution of the partnership income to that partner, which income is taxed as capital gain since it arises from the sale of stock. This technique allows the partner to get the same amount of cash as he/she would if paid a fee, but the partner is now taxed at capital gains, and not ordinary income, rates. The proposed regulations recharacterize that income as a "guaranteed payment" for services, which is taxed as ordinary income rather than as a carried interest.

The proposed regulations include six nonexclusive factors that may indicate that an arrangement constitutes a disguised payment for services. The most significant factor is the existence of significant entrepreneurial risk and arrangements that lack significant entrepreneurial risk may be treated as disguised payments for services. Additional factors include:

> (1) that the service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only a short duration; (2) that the service provider receives an allocation and distribution in a time frame comparable to the time frame that a nonpartner service provider would typically receive payment; (3) that the service provider became a partner primarily to obtain tax benefits that would not have been available if the services were rendered to the partnership in a third-party capacity; (4) that the value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution; and (5) that the arrangement provides for different allocations or distributions with respect

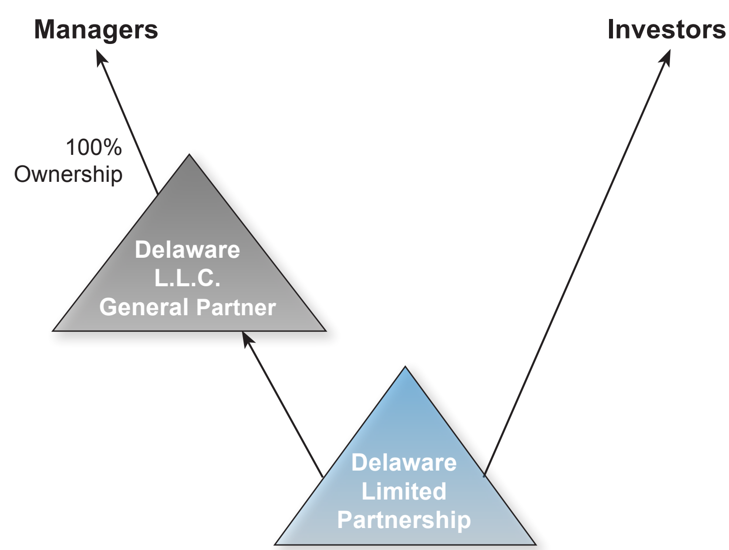
to different services received, where the services are provided by a single person or persons that are related under Code Secs. 707(b) and 267(b), and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.

While the proposed regulations do not change the treatment of traditional carried interest, the preamble to the regulations states that the I.R.S. may issue further guidance on carried interest when they finalize these regulations. That statement has caused concern as to whether the I.R.S. may change the treatment of carried interest, such as to tax the person who gets the carried interest on receipt.

TYPICAL STRUCTURE

A typical private equity fund structure is as follows:

- The fund is a limited partnership;
- Investors contribute cash to the partnership for common units in the partnership that entitle them to all cash flow until they receive distributions equal to their contributed capital and a preferred return, and after that, 80% of all future cash flow;
- The Manager creates a general partner, which receives a carried interest entitling the Manager to a 20% interest in cash flow after the Investors receive their capital and preferred return;[1] and
- The general partner also receives an annual management fee equal to a percentage of the value of the partnership's assets. Typically, this percentage is 2%.



[1] 20% is the typical amount, however, the rationale behind this amount is not well understood.

NON-U.S. MANAGERS

Managers who are non-resident, non-citizens of the U.S. ("Non-U.S. Mangers") generally pay little or no U.S. federal income tax on income from a carried interest. Foreign persons are not generally subject to U.S. tax on capital gains so long as the gain is not:

- Income effectively connected with a U.S. trade or business ("E.C.I.") that is conducted by the fund, or
- The product of a disposition of a U.S. real property interest ("U.S.R.P.I.").[2]

Thus, the tax treatment of Non-U.S. Managers depends on the income generated by the fund. If the income is capital gain and not from real estate companies, the Manager is generally exempt from U.S. tax. If the income is ordinary income from U.S. sources, there will be a withholding tax of 30% for income that is not E.C.I., such as dividends and interest. This 30% withholding rate is subject to further reduction by international tax treaties or the portfolio interest exemption.[3]

For capital gains and ordinary income that are "effectively connected" with a U.S. business, the Non-U.S. Manager is subject to the same federal income tax brackets as a U.S. person.[4] However, with proper planning, E.C.I. can be avoided.

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[2] Code §897(c), Treas. Regs. §§1.897-1 and 1.897-2.

[3] Commonly known as "F.D.A.P. Income." Code §§871(h), 882(c), 1441, and 1442.

[4] Code §871(b)(l).

PROPOSED P.F.I.C. EXCEPTION REGULATIONS DETRIMENTAL TO FOREIGN INSURERS

Authors
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Tags
Active Conduct
Code §1297
Insurance Business
Investment Activity
P.F.I.C.'s
Passive Income
Prop. Reg. §1.1297-4

The I.R.S. issued proposed regulations (REG-108214-15) for the Exception from Passive Income for Certain Foreign Insurance Companies on April 24, 2015. The goal of the proposed regulations is to prevent hedge funds from establishing foreign insurance companies to defer and reduce tax that would otherwise be due with respect to investment income. The foreign insurance companies may be passive foreign investment companies ("P.F.I.C.'s"). The I.R.S. invited the public to comment on all aspects of the proposed rules by July 23, 2015. According to the comments released, many industry professionals deem these regulations as too restrictive on insurance companies and claim the rules needlessly subject legitimate insurance businesses to the harsh tax treatment of P.F.I.C.'s.

According to the preamble, Prop. Reg. §1.1297-4 is designed to "provide guidance regarding when a foreign insurance company's income is excluded from the definition of passive income under section 1297(b)(2)(B)," which affects the U.S. shareholders of foreign corporations and policyholders.[1] The proposed regulations re-define the terms "active conduct" and "insurance business" in addition to how passive income is determined.

The main critiques reflected in the comments by insurance industry representatives are that the limited definition of "active conduct" will prevent foreign insurance companies from qualifying for the exception and that the rules disregard industry practices with respect to how investment activities and administrative services are performed by actual insurance companies. Overall, the comments express that the implementation of the proposed regulations would severely limit which foreign companies can qualify as insurance businesses and would result in harsh P.F.I.C. treatment for legitimate insurance companies.

HEDGE FUND REINSURANCE ARRANGEMENTS

The proposed regulations target hedge funds that take advantage of the P.F.I.C. exception carved out for foreign insurance companies in Code §1297(b)(2)(B) to exclude their income from passive investment treatment. Hedge funds are typically organized as flow-through entities that generate short-term capital gains, which are subject to the high ordinary income tax rates. Over the years, hedge funds have re-characterized their income from passive to active by purporting to be foreign reinsurance companies. These arrangements have allowed the investors to defer recognition of income and to characterize ordinary income as a capital gain. By entering into these reinsurance arrangements, hedge funds have been able to defer tax on what is actually investment income that should be taxed under the P.F.I.C. regime.[2]

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1 Exception From Passive Income for Certain Foreign Insurance Companies, 80 Fed. Reg. 22954 (Apr. 24, 2015) (amending 26 C.F.R. pt. 1).

2 Notice 2003-34, 2003-23 I.R.B. 990 (May 9, 2003).

According to Notice 2003-34,[3] which addresses the issue of hedge fund reinsurance agreements, a typical arrangement involves an investor or "Stakeholder, subject to U.S. income taxation, investing (directly or indirectly) in the equity of an enterprise ('F.C.'), usually a corporation organized outside the United States." The F.C. is compliant with local insurance laws, and issues "insurance or annuity contracts" or contracts to "reinsure" risks underwritten by insurance companies, but the F.C.'s insurance activities are "relatively small compared to its investment activities." Since the F.C. is regarded as an insurance company engaged in the active conduct of an insurance business, the investors do not recognize the company as a P.F.I.C. Thus, "when [a] Stakeholder disposes of its interest in F.C., it will recognize gain as a capital gain, rather than as ordinary income."[4]

The Treasury and I.R.S. are concerned about the company being characterized as an insurance company when in fact the income is passive investment income that should be taxed under the P.F.I.C. regime. Notice 2003-34 states that it will apply the P.F.I.C. rules where it determines that a foreign corporation is not an insurance company for federal tax purposes. In order to combat these offshore hedge fund reinsurance arrangements, the proposed regulations under §1.1297-4 were issued.

"INSURANCE COMPANY" UNDER THE CODE

A corporation is subject to tax as an insurance company under subchapter L[5] only if *more than half* of its business during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

The term "insurance company" was not defined in the Code until 1984. Prior to its debut in the Code, an insurance company was defined in Treas. Reg. §1.801-3(a) as a company whose *primary and predominant* business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. The prevailing regulatory definition of insurance company was enacted into the Code in 1984 in §816(a), and subsequently, Code §831(c) changed the definition of "insurance company" to any company with *more than half* of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. The two prevailing Code sections implement a stricter standard of "more than half" of the business instead of the prior regulatory law's "primary and predominant" standard.[6]

P.F.I.C. RULES UNDER CODE §1297

Code §1297 provides that a foreign corporation is a P.F.I.C. if it meets either the passive income test or the passive asset test. Under the passive income test enumerated in Code §1297(a)(1), a foreign corporation is a P.F.I.C. if 75% or more of its gross income for the taxable year is passive income. Under the passive asset test enumerated in Code §1297(a)(2), a foreign corporation is a P.F.I.C. when on average 50% or more of its assets produce passive income or are held for the production

3 *Id.*

4 *Id.*

5 Subchapter L of the Code pertains to the tax treatment of insurance companies.

6 Preamble to REG-108214-15, 80 F.R. 22954 (April 24, 2015).

“‘Passive income’ is generally defined... to mean any income of a kind that would be ‘foreign personal holding company income’...typically investment-type income not derived from the active conduct of a trade or business.”

of passive income. “Passive income” is generally defined in Code §1297(b)(1) to mean any income of a kind that would be “foreign personal holding company income” as defined in Code §954(c), which is typically investment-type income not derived from the active conduct of a trade or business. Thus, a passive asset generally generates (or is reasonably expected to generate in the reasonably foreseeable future) passive income.

INSURANCE BUSINESS EXEMPTION FROM P.F.I.C. TREATMENT

Code §1297(b)(2) provides certain exceptions to the term “passive income.” Under Code §1297(b)(2)(B), passive income does not include any income derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under subchapter L if it were a domestic corporation. However, the terms “active conduct” and “insurance business” are not defined in Code §1297, which is why the I.R.S. issued the proposed regulations in April 2015.

According to the preamble to the proposed regulations:

> [The] Treasury and the I.R.S. are proposing regulations to clarify the circumstances under which investment income earned by a foreign insurance company is derived in the active conduct of an insurance business for purposes of determining whether the income is passive income, and thus the extent to which the company’s assets are treated as passive assets for purposes of determining whether the company is a P.F.I.C.[7]

PROP. REG. §1.1297-4 EXCEPTION FROM THE DEFINITION OF PASSIVE INCOME FOR CERTAIN FOREIGN INSURANCE COMPANY INCOME

Prop. Reg. §1.1297-4(a) establishes that for purposes of Code §1297, the term “passive income” does not include income earned by a foreign corporation that would be taxed as an insurance company under subchapter L if it were a domestic corporation, but only to the extent the income is derived in the active conduct of an insurance business.

The term “active conduct” is defined in Prop. Reg. §1.1297-4(b)(1) to have the same meaning as in Treas. Reg. §1.367(a)-2T(b)(3), except that officers and employees are not considered to include the officers and employees of related entities.

The term “insurance business” is defined in Prop. Reg. §1.1297-4(b)(2) to mean the business activity of issuing insurance and annuity contracts and the reinsuring of risks underwritten by insurance companies, together with investment activities and administrative services that are required to support or are substantially related to insurance contracts issued or reinsured by the foreign insurance corporation.

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[7] *Id.*

Prop. Reg. §1.1297-4(b)(2) establishes a two-part test for determining whether an activity is an "investment activity," which reflects the passive income test and passive asset test of determining P.F.I.C. status under Code §1297:

> (i) An investment activity is any activity engaged in by the foreign corporation to produce income of a kind that would be foreign personal holding company income as defined in Code §954(c) [Prop. Reg. §1.1297-4(b)(2)(i)] [*i.e.*, generally passive income or income not derived from the active conduct of a trade or business]; and
>
> (ii) Investment activities are required to support or are substantially related to insurance and annuity contracts issued or reinsured by the foreign corporation to the extent that income from the activities is earned from assets held by the foreign corporation to meet obligations under the contracts.[8]

The proposed regulations do not address the issue of whether a company is "predominantly engaged" in the insurance business. Since the term "active conduct" of insurance companies uses the Treas. Reg. §1.367(a)-2T(b)(3) without considering officers and employees of related entities, each insurance company must have its own central managers that cannot be shared amongst its related companies. The proposed regulations also mirror the definition of investment activity with regard to the P.F.I.C. passive income and passive asset tests established in Code §1297(a).

COMMENTS

PwC's Comments

PricewaterhouseCoopers Tax Services Limited ("PwC") commented on the proposed regulations "on behalf of a group of midsize, non-publically traded insurers and reinsurers domiciled in Bermuda." A focus of this critique was how the term "active conduct" excludes officers and employees, which is very problematic for insurance businesses that share employees amongst related companies in order to operate practically and efficiently. Preventing related companies from centralizing management in this way is a disadvantage to foreign insurers not economical, and it unfairly establishes harsher treatment for foreign companies than for domestic companies. Furthermore, PwC comments that the rules should focus on the foreign insurers' "activities and contracts, rather than on the employment status of the service providers who carried out these activities."

In its comment letter to the I.R.S. regarding the proposed regulations, PwC expresses its main concerns as follows:

> In summary, PricewaterhouseCoopers Tax Services Limited believes if these regulations were adopted as proposed, excluding the activities of independent contractors and related party service providers in determining whether a foreign insurance company conducted an active insurance business would:

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[8] Prop. Reg. §1.1297-4(b)(2)(i).

1. Ignore the established business practices of the (re)insurance industry, particularly small insurance and reinsurance companies and captive (re)insurance companies;

2. Disqualify legitimate companies that otherwise meet the requirements to qualify for the exception under section 1297(b)(2)(B);

3. Force the restructuring of business operations in Bermuda and other offshore domiciles, which in turn would increase the cost of operations and the cost of insurance and reinsurance to U.S. policyholders; and

4. Apply a different standard to domestic and foreign insurers, which would be both protectionist and inconsistent with existing tax law.

Advantage Insurance's Comments

Advantage Insurance Holdings Ltd. ("Advantage Insurance"), an insurance company based in the Cayman Islands, also commented on the proposed regulations. Advantage Insurance focused on (i) holding company structures; (ii) capital requirements for the different types of insurance business; and (iii) application of percentage tests to small or specialty insurance companies. Advantage Insurance identifies itself as a "small multi-line insurance company with the majority of its operations located outside of the United States." The comment letter by the company is generally concerned with the implications of the anti-deferral regimes on small insurance companies.

Advantage Insurance suggested the following, regarding holding company structures and a safe harbor rule:

> Allow for a family of insurance and non-insurance companies under common ownership and control to be evaluated for PFIC status under a common ownership holding company structure using consolidated financial statements prepared in accordance with U.S. GAAP for the ultimate parent company. The holding company group should not be restricted or effectively prohibited from sharing employees or utilizing intracompany management agreements freely among its subsidiaries, and that activities of the holding company and other non-insurance subsidiaries incidental and supportive of the insurance business, such as administrative, financial and investment activities not be restricted for PFIC status purposes.

Advantage Insurance suggested the following regarding capital requirements for different types of insurance businesses:

> If a percentage measurement is utilized to determine if an insurance company holds capital in excess of the reasonable needs of the business, individual threshold amounts should be established for life, health, property, casualty, liability, surety, financial guarantee and other sectors of the insurance industry, with further specificity for primary insurance and reinsurance lines of business. In addition,

> “The limited definitions hurt legitimate insurance businesses by treating them as P.F.I.C.’s.”

> for an individual company writing multiple lines of business, each line should be measured with its own appropriate percentage and capital allocation. Finally, any percentage applied should take into account the total gross amount of insurance risks written, without regard to the existence or collectability of reinsurance.

Lastly, Advantage Insurance provided a recommendation for how the percentage tests of total assets should be applied considering small or specialty insurance companies:

> If any percentage thresholds are included in the new rules, either (a) apply a minimum dollar amount of capital and surplus over which the percentages apply; or (b) allow for alternate methods of excess capital determination including actuarial studies, scientific risk modeling, ratings agency evaluations, regulatory requirements and industry norms; or (c) both (a) and (b).

CONCLUSION

Overall, the comments to the proposed regulations are critical of the definitions of the terms “active conduct,” “insurance business,” and “passive income” as they relate to foreign insurance companies. The limited definitions hurt legitimate insurance businesses by treating them as P.F.I.C.’s. Furthermore, the proposed regulations fail to address a central issue of whether an insurance company is “predominantly engaged” in the insurance business. Although the I.R.S. intended to prevent hedge funds from taking advantage of the P.F.I.C. exception by operating through foreign insurance companies, the proposed regulations appear to cause unintended and detrimental tax consequences to legitimate offshore insurance businesses.

BUSY MONTH FOR B.E.P.S.

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Tags
Action 2
Action 3
Action 4
Action 12
B.E.P.S.
C.R.S.

FOUR B.E.P.S. TAX PLANNING ITEMS COMPLETED

Working Party No. 11 of the Organization for Economic Cooperation and Development ("O.E.C.D.") dealing with aggressive tax planning has completed work on four action items under the B.E.P.S. project.

Douglas Poms, Treasury acting deputy international tax counsel and a U.S. delegate to Working Party No. 11, said on July 28, 2015, that the working party finished its work on hybrid mismatch arrangements (Action 2), controlled foreign company ("C.F.C.") rules (Action 3), deductibility of interest (Action 4), and mandatory disclosure rules (Action 12). For completion of the work full consensus was required. Getting full consensus from 60 countries was a challenge, and the process affected the deliverables.

On September 23, 2015, the O.E.C.D.'s Committee on Fiscal Affairs is scheduled to adopt recommendations on the remaining B.E.P.S. items, including Actions 2, 3, 4, and 12, which will be delivered to the G-20 finance ministers meeting in Lima, Peru on October 8, 2015.

ACTION 3: C.F.C. RULES

With respect to the C.F.C. work on Action 3, Mr. Poms said that the issue of income not being taxed anywhere in the world is a big part of the B.E.P.S. problem. C.F.C. rules are a tool to make sure that certain types of income will be taxed somewhere, either in the jurisdiction where the C.F.C. is resident or in the jurisdiction where the parent is based. The U.S. had high hopes that the B.E.P.S. project would produce C.F.C. rules to address the B.E.P.S. problem. However, the work on Action 3 will not recommend a particular kind of C.F.C. rule and did not even produce a set of best practices guidelines for designing C.F.C. rules. The final report will reflect a series of optional provisions, including an excess profits approach. The excess profits approach is consistent with the 2014 budget proposal of the current Administration, which proposed imposing U.S. tax on the excess profits derived by an intangible transferred outside the U.S. if those profits are not otherwise taxed outside the U.S. at a rate of at least 10%.

Mr. Poms commented that, whereas the U.S. has strong C.F.C. rules, strong rules are missing from the tax laws of many other countries participating in the B.E.P.S. project. Some countries view C.F.C. rules as a tool that should be used sparingly, only for certain kinds of income, such as financial income, and not as a broader tool to address many B.E.P.S. issues. This may change as a result of the B.E.P.S. project.

ACTION 2: HYBRID MISMATCH

With respect to hybrid mismatch arrangements (Action 2), Mr. Poms noticed a greater degree of consensus among working party delegates. While it was not easy to agree on the specific design of the rules, the working party produced a lengthy report that includes a specific ordering rule identifying priority by which countries touched by the hybrid arrangement may impose tax under the anti-hybrid rule.

Mr. Poms expects that after countries adopt the hybrid rules, anomalies will remain that will need to be addressed. He thought the working party can be a resource in eliminating the problem of possible double taxation because two affected jurisdictions view the transaction and the rule differently.

ACTION 4: INTEREST EXPENSE

Interest expense deductions are regarded as a major contributor to the B.E.P.S. problem. Mr. Poms said that the working party was able to agree on a best practices rule regarding the amount of interest expense that should be deductible currently. The final report could be a ceiling expressed as a fixed percentage of E.B.I.T.D.A. – earnings before interest, taxes, depreciation, and amortization. This would be comparable to Code §163(j) of U.S. tax law. However, the percentage would be lower than the 50% of E.B.I.T.D.A. rule of that section, perhaps between 10% to 30% of E.B.I.T.D.A.

PATH FORWARD

The U.S. has not yet committed to the B.E.P.S. initiative. Once the B.E.P.S. project ends, the U.S. will be cautious about how much it will commit to further O.E.C.D. work. The U.S. has invested an enormous amount of resources in the B.E.P.S. project and now has other priorities to address.

CONGRESS PUSHES ON TREASURY

While the Treasury is directly involved in the B.E.P.S. project, Congress wants the Treasury to be clear on who writes tax law in the U.S., JCT Legislation Counsel Kristen Witt stated at a July 22, 2015 tax seminar held by the Practicing Law Institute. To illustrate the level of congressional pressure that is now being applied to the U.S. Treasury Department, Ms. Witt pointed to a letter dated June 9, 2015, signed by Senate Finance Committee Chairman Hatch and House Ways and Means Committee Chairman Ryan. The letter questioned the legal basis for the Treasury's involvement in the B.E.P.S. country-by-country reporting regime. Additionally, congressional leaders seem to question the benefits to the U.S. in joining the B.E.P.S. guideline drafting process. In a floor speech given on July 16, 2015, Chairman Hatch expressed his opposition to using U.S. resources as bargaining chips for international agreements that may, or may not, advance the interests of the U.S.

EUROPEAN SUPPORT

The Chairman of the European Parliament's Economic and Monetary Affairs ("ECON") Committee and his delegation expressed strong support for the B.E.P.S. project in a meeting with the Treasury in late July. ECON Chairman Gualtieri advised that economic democracies need a common alliance to address loopholes that have recently emerged. From a government viewpoint, the B.E.P.S. project is a win-win opportunity. Mr. Gualtieri repeated the O.E.C.D. mantra that the B.E.P.S. initiative is the way to avoid unilateral action, which countries may otherwise pursue to combat tax evasion. The project serves as a modern, efficient system of taxation in a multilateral framework.

Mr. Gualtieri said that automatic exchange of information and country-by-country reporting are top priorities in the European Parliament and that he is looking forward to the final B.E.P.S. report, which should include the O.E.C.D. final recommendation on country-by-country reporting.

B.E.P.S. SIDE-EFFECT: DEMAND FOR TRANSFER PRICING REPORTS INCREASES

While the B.E.P.S. reports are not final, the project has already increased controversy and litigation around the world and has been a huge game changer for economists, as transfer pricing audits tripled in the past year.

"While the B.E.P.S. reports are not final, the project has already increased controversy and litigation around the world and has been a huge game changer for economists, as transfer pricing audits tripled in the past year."

Following the introduction of the B.E.P.S. proposed actions, multinational companies must defend not only transfer pricing policies but also the economic substance of their multinational structures. Katherine Amos, vice president of transfer pricing strategy at a multinational electric equipment maker, addressed a conference by the National Association for Business Economics. She commented that real-world comparables will be required to support a transaction in which one side pays all up-front costs for an item and then makes payments to a related party for the use of that item.

Under the country-by-country reporting regime developed by the B.E.P.S. initiative, companies are expected to include a description of the top five value chains and any value chain that accounts for 5% or more of the company's revenues. Economists will be required to develop strategies used in defining value chains.

Michael Heimert, a global leader on transfer pricing services at a firm of consulting economists, predicted that the B.E.P.S. project will change the way economists address transfer pricing. After the adoption of the B.E.P.S. recommendations, economists will have to be industry specialists in order to understand certain types of transactional analogues taking place in the real world.

Robert Weissler, an economist with the I.R.S., agrees that there may be an increasing need for economists with industry-specific expertise within the I.R.S. He explained that, if the B.E.P.S. project encourages a country to claim a share of tax jurisdiction on worldwide profits, it may require a coordinated industry effort to challenge the position.

INVERTED CORPORATE GIANT MAY BE ELIGIBLE FOR U.S. GOVERNMENT CONTRACTS

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Tags
Government Contracts
Inversions

Section 835 of the Homeland Security Act of 2002, bars D.H.S. from contracting with a foreign incorporated entity that meets the definition of an inverted company. Nonetheless, it has become known that the manufacturing giant, Ingersoll-Rand Plc ("Ingersoll-Rand"), submitted a legal memorandum to the Department of Homeland Security ("D.H.S." or "Department"), which argued that the provision should not be followed.[1]

Ingersoll-Rand's memorandum apparently was submitted in March of 2013. Last year, Homeland Security Principal Deputy General Counsel, Joseph Maher, responded in a written letter stating that the Department did not disagree with the company's arguments. Presumably, this means that the company is eligible to receive U.S. government contracts. In fact, Ingersoll-Rand won a contract a few months ago with the Army Corps of Engineers, despite complaints from Democratic legislators. Presumably, other companies are entitled to comparable treatment.

Ingersoll-Rand was formed in 1905 in the United States by the merger of two rival drill manufactures. In 2002, the company moved its place of incorporation to Bermuda. In the wake of increased scrutiny of tax havens by the United States, it moved its place of incorporation again in 2009 to Ireland. The moves were said to have saved the company many millions of dollars in U.S. taxes.

INGERSOLL-RAND'S LEGAL ARGUMENTS

It is understood that the main arguments of Ingersoll-Rand were:

1. The bar against contracting with inverted companies violates the World Trade Organization's Government Procurement Agreement, an agreement signed by the United States and Ireland, which requires contracting states to not discriminate against each other's companies in government contracting;

2. Domestic companies that inverted to one foreign country and then moved to another country should not be considered to meet the definition of inverted company because they are not U.S. companies that inverted to a foreign country, but rather, foreign companies that moved to a foreign country;

3. Under § 835 of the Homeland Security Act of 2002, companies that have businesses in their new corporate homes should be allowed to bid on contracts under the exception for companies with "substantial business" in their place of incorporation.

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1 Bloomberg News stated that it had received a copy of the memorandum from Ingersoll-Rand, on the condition that it would not publish the document.

The first argument above seems to be the strongest for Ingersoll-Rand, and could be the argument that opens the door for other inverted companies to receive U.S. government contracts.

The second argument above, if acceptable to D.H.S., would create a simple road-map to skirt around the §835 bar. As long as it moved more than once, an inverted company could be eligible receive a U.S. government contract.

The third argument above reflects the fact that the definition of "inverted domestic corporation" under §835 is based on §7874 of the Internal Revenue Code (the "Code"). Under Code §7874, "substantial business activities" means that at least 25% of the expanded affiliate group's employees, employee compensation, assets, and income must be in or derived from the foreign country.[2] Though Ingersoll-Rand reportedly argued in the memorandum that it employs approximately 700 people in Ireland and has a factory in the country that manufactures one of its main products, its business activities in that country reportedly consist of only 2% of its worldwide business.

Another possible explanation for what – at least at first blush – appears to be Ingersoll-Rand's victory over §835, could be explained by the law's waiver provision. Initially, §835 provided that the prohibition against contracting with inverted companies was waived if D.H.S. determined that the waiver was required in the interest of homeland security, or to prevent the loss of jobs in the United States, or to prevent the U.S. government from incurring any additional costs that it would otherwise not incur. Later, the latter two reasons were removed from the law. Still, a waiver based upon a contract being "in the interest of homeland security" could be somewhat broadly applied. Thus, it remains to be seen whether D.H.S. approval to receive U.S. government contracts is based on the arguments set worth in its memorandum, or whether its recent award is the result of applying the law's waiver provision.

2 Treas. Regs. §1.7874-T.

SUMMA HOLDINGS, INC. V. COMM'R

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D.I.S.C.
Notice 2004-8

On June 29, 2015, the Tax Court held that payments made under an agreement to a company that was owned by Roth individual retirement accounts ("Roth I.R.A.'s.") and had elected to be treated as a Domestic International Sales Corporation ("D.I.S.C."), were not D.I.S.C. commissions but rather dividends to the shareholders of the payor corporation followed by the contributions to the Roth I.R.A.'s.

FACTS

Summa Holdings, Inc. ("Summa") was a C corporation incorporated in Delaware. A husband and wife, together with a family trust ("Benenson Trust"), owned shares of Summa. The couple's two children were the beneficiaries of the the Benenson Trust. In 2001, each of the two children established a Roth I.R.A. account and both I.R.A.'s purchased stocks in J.C. Exports Inc. ("J.C. Exports"), a Delaware corporation that made an election to be treated as D.I.S.C. Summa entered into a series of agreements with J.C. Exports under which subsidiaries of Summa paid J.C. Exports millions of dollars. J.C. Exports in turn paid most of the amounts received to the two I.R.A.'s.

Neither the parents nor the two children reported any dividends on their returns. Summa deducted the payments made to J.C. Exports on its corporate tax returns as D.I.S.C. commissions. J.C. Exports filed Form 1120-IC-DISC reflecting income received from commission sales and the dividend distribution to the I.R.A.'s.

The Internal Revenue Service ("I.R.S.") argued that the payments from Summa were not D.I.S.C. commissions but dividend distributions to the shareholders followed by contributions to the Roth I.R.A.'s. The I.R.S. issued a notice of deficiency for unreported dividends to the shareholders and for the excise tax due for the excess contribution made to the Roth I.R.A.'s.

D.I.S.C.

In 1971, Congress enacted a law to stimulate U.S. exports in the form of a tax benefit to companies that elected to be treated as D.I.S.C.'s. Under this tax regime, a D.I.S.C. was exempt from tax at the corporate level and the shareholders were taxed currently on a portion of the D.I.S.C.'s earnings in the form of distributions, whether or not they were actually distributed. The tax on the remaining portion was deferred until the actual distribution, the disposition of the D.I.S.C. shares in a taxable transaction, or the company no longer qualified as a D.I.S.C.

The European Community argued that the D.I.S.C. tax regime was in violation of the General Agreement on Tariffs and Trade, and as a result, in 1984, Congress replaced the D.I.S.C. tax regime with an Interest Charge D.I.S.C. ("I.C.-D.I.S.C.") tax regime for taxpayers having gross receipts of $10 million or less. At the same time, Congress also enacted the Foreign Sales Corporation ("F.S.C.") tax regime, which was designed to encourage U.S. exports for taxpayers having gross receipts in excess of $10 million. The F.S.C. was subsequently repealed, and the I.C.-D.I.S.C. is the only tax incentive remaining that offers tax benefits to U.S. companies with relatively small export gross receipts.

A D.I.S.C. is a company organized to conduct specific export activities. Usually, it is organized as an affiliate of a U.S. exporter for the purpose of either buying or reselling the exporter's products or acting as a commission sales agent. The U.S. exporter deducts payments made to the D.I.S.C. as commission and the D.I.S.C. is not subject to tax on its income. While the shareholders are subject to tax on the D.I.S.C. earnings and profits, they may defer the tax liability. Unlike the old D.I.S.C. regime, to the extent the shareholders defer their U.S. income tax liability, an interest charge is applicable to offset the benefit of the tax deferral. D.I.S.C. income exceeding $10 million is deemed immediately distributed and is not eligible for income tax deferral. The I.R.S. annually announces the interest rate for this purpose in a revenue ruling.

ROTH I.R.A.'S

A Roth I.R.A. is an individual retirement plan, which offers tax advantages. Unlike a traditional I.R.A., contributions made to a Roth I.R.A. are not deductible. All earnings in an I.R.A. accumulate free of U.S. tax, and while distributions from a traditional I.R.A. are taxable, qualified distributions made from a Roth I.R.A. can be made tax free. Annual contributions to Roth I.R.A.'s are limited and excess contributions are subject to excise tax.

A self-directed I.R.A. can invest in most assets other than life insurance and collectibles. Therefore, combining D.I.S.C.'s with Roth I.R.A.'s created a very powerful planning tool because dividends paid on stock held by a Roth I.R.A. were not considered contributions by the holders of the I.R.A., but rather viewed as earnings of the I.R.A. itself. This allowed taxpayers to avoid the limitations on contributions to Roth I.R.A.'s. Additionally, the I.R.A. could continue to grow the amounts received indefinitely and distribute them tax-free.

While Congress limited taxpayers' ability to hold shares of a D.I.S.C. through tax-exempt entities and avoid paying tax on deemed dividends,[1] avoiding the contribution limitation was not addressed until the I.R.S. issued Notice 2004-8,[2] in which it identified tax-avoidance type transactions in which pre-existing businesses enter into transactions with corporations owned by the taxpayer's Roth I.R.A. and where the transactions have the effect of shifting value into the Roth I.R.A. The Notice described three ways in which the I.R.S. would challenge such transactions:

(1) Apply Code §482 to allocate income from the corporation to the taxpayer, the pre-existing business, or other entities under the control of the taxpayer;

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1 Under Code §995(g) deemed dividends paid by a D.I.S.C. to a tax-exempt entity are treated as unrelated business taxable income.

2 Notice 2004-8, 2004-1 C.B. 333.

(2) Assert that under Code §408(e)(2)(A), the transaction gives rise to one or more prohibited transactions between a Roth I.R.A. and a disqualified person described in Code §4975(e)(2); and

(3) Assert that the substance of the transaction is that the amount of the value shifted from the pre-existing business to the corporation is a payment to the taxpayer, followed by a contribution by the taxpayer to the Roth I.R.A. and a contribution by the Roth I.R.A. to the corporation.[3]

"The Tax Court found that there was no business purpose or economic benefit from the transactions between Summa and J.C. Exports. Further, the court determined that the transactions were designed to shift funds into the Roth I.R.A.'s."

THE *SUMMA* CASE

The Tax Court applied the substance over form doctrine to analyze the payments made by Summa to J.C. Exports. The court looked to determine whether there was any substance to the transactions other than to transfer money to the Roth I.R.A.'s and accumulate and distribute income tax free.

The Petitioners argued the I.R.S. did not have a reason to disallow the deduction of the D.I.S.C. commissions or to reclassify the commissions as dividends because the three possible grounds for adjustment identified in Notice 2004-8 are not applicable to their facts. They relied on *Hellweg v. Comm'r*,[4] where under similar facts the Tax Court ruled in favor of the taxpayer. In *Hellweg*, the taxpayer argued that payment of D.I.S.C. dividends to a Roth I.R.A. cannot be treated as excess contributions because Congress allowed I.R.A.'s to own D.I.S.C.'s in Code §995(g), and that reclassifying the transactions under the substance over form doctrine was improper because it would result in disregarding the D.I.S.C.

The Tax Court distinguished the *Summa* case from *Hellweg* and ruled for the I.R.S. In *Hellweg*, the I.R.S. argued that the transaction lacked substance for excise tax purposes only. The Tax Court held that a transaction that is valid for income tax purposes must also be valid for excise tax purposes. The court further clarified that their "decision does not prevent the I.R.S. from recharacterizing the transaction consistently for income tax and excise tax purposes." And in fact, in *Summa*, the I.R.S. argued that the transactions were invalid for both income and excise tax purposes and that the transactions should be recharacterized to prevent tax abuse. The court also noted that the I.R.S. was not seeking to disregard the D.I.S.C. itself, but rather argued that a transaction involving a D.I.S.C. should be recharacterized.

The Tax Court found that there was no business purpose or economic benefit from the transactions between Summa and J.C. Exports. Further, the court determined that the transactions were designed to shift funds into the Roth I.R.A.'s, and therefore, it is appropriate to apply the substance over form principle and recharacterize the transaction. The court also pointed out that the reason Congress did not determine transactions between a D.I.S.C. and a Roth I.R.A. to be abusive is because the Roth I.R.A. provision was enacted ten years after Code §995(g).

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3 *Id.*

4 *Hellweg v. Comm'r*, T.C. Memo. 2011-58.

ARTIFICIAL LOAN RESTRUCTURINGS

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Tags
Loan Restructurings
Interest Deductions
Arm's Length Approach
Intercompany Financing

INTRODUCTION

The I.R.S. is currently faced with an increasing number of taxpayers who are prepaying their current intercompany loans and then entering into new loans with higher interest rates. A higher interest deduction is then available to the borrower. The I.R.S. is exploring strategies to tackle this issue.

HIGHER INTEREST DEDUCTIONS

As discussed in our previous article,[1] B.E.P.S. Action 4 stresses the need to address base erosion and profit shifting using deductible payments, such as interest, that can give rise to double non-taxation in both inbound and outbound transactions. The research shows that intragroup loans are commonly used by multinational groups to erode the taxable base in high-tax countries.

U.S. companies receive a deduction for interest payments, which reduces U.S. taxable income. If U.S. borrowers restructure their loans to increase interest expense to related foreign lenders, higher interest expense deductions to the U.S. borrower may reduce U.S. taxable income, and the interest income earned by the foreign lender may be subject to a lower rate of tax than it would be if earned in the U.S. Thus, when viewed on a worldwide basis, the multinational group may be subject to a reduced tax burden.

Although there are certain limits on interest deductions in the U.S. (such as thin capitalization and interest stripping), those limits may not apply to all U.S. borrowers. Thus, the I.R.S. may be limited to utilizing the transfer pricing rules under Code §482 when trying to combat artificial restructurings of intercompany loans.

Under Code §482, related parties must act on an arm's length basis, as though they were unrelated parties. If an unrelated borrower would not have agreed to enter into a new loan at a higher interest rate, then perhaps the increase in the interest expense should be disallowed.

Some commentators have claimed that restructuring a loan at a higher interest rate may be justified if the borrower needs more funds and the original loan does not allow for an increase. However, other commentators have suggested that a cost-benefit analysis should be performed to determine whether the borrowing entity is truly in a better position once the new loan has been made.

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1 *Insights*, Vol. 2 No. 1, "B.E.P.S. Action 4: Limit Base Erosion via Interest Payments and Other Financial Payments."

Treas. Reg. §1.482-1(d)(1) provides in part:

> Whether a controlled transaction produces an arm's length result is generally evaluated by comparing the results of that transaction to results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances.

Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant economic conditions that could affect the prices that would be charged or paid, or the profit that would be earned in each of the transactions. These factors include, among other things, "[t]he alternatives realistically available to the buyer and seller."[2]

If a U.S. borrower agrees to pay a higher interest rate to a related foreign lender, when that same U.S. borrower could have borrowed from an unrelated bank for a lower interest rate, it puts into question whether the new loan charges an arm's length interest rate.

CONCLUSION

The I.R.S. is investigating whether recent loan restructurings between related taxpayers meet the arm's length standard. If related-party loans are being restructured and interest rates are increasing, companies should carefully document the reasoning that supports the increases in the interest rates.

[2] Treas. Reg. §1.482-1(d)(3)(iv)(H).

EUROPEAN COMMISSION, STATE AID, AND TAX TRANSPARENCY – MORE STEPS IN ONE DIRECTION

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Tags
E.U. Blacklist
E.U. Commission
France
Germany
Guernsey
O.E.C.D.
State Aid
Transparency

Further to last month's article on State Aid, "Tax Rulings in the European Union – State Aid as the European Commission's Sword Leading to Transparency on Rulings,"[1] this article addresses recent developments, including the European Commission's related initiative on tax transparency:

BACKGROUND

As outlined in the preceding Insights article,[2] following its investigations into private rulings issued to Apple Inc., Fiat SpA, and Starbucks Corp. by the tax authorities of Ireland, Luxembourg, and the Netherlands, respectively, the European Commission requested data on tax rulings from 22 E.U. Member States in an effort to increase tax transparency. All these requests are based on the European Commission's authority to target measures by Member States constituting State Aid comprising, *inter alia*, the area of direct business taxation. State Aid may exist if private tax rulings issued by E.U. Member States to specific corporations provide selective advantages to a specific company or group of companies. This selective advantage given by tax authorities infringes E.U. law.

The European Commission for Competition is clear on the aim of this initiative: "If the Commission has serious doubts about the compatibility of a specific tax ruling with E.U. State Aid rules, it would open a formal investigation," the spokesman for European Commission for Competition, Ricardo Cardoso, said recently.[3] With respect to secrecy concerns addressed not only with respect to such ruling requests but also the proposal for a directive on the automatic exchange of tax rulings[4] presented as part of a transparency package in March of this year, Cardoso emphasized that such fiscal information would be subject to confidentiality as the Commission itself is "bound by rules of confidentiality."

GERMANY

While Estonia and Poland have so far not shown any intent to cooperate and have been served with injunctions by the European Commission, mandating the production of private tax rulings,[5] Germany indicated that it will furnish details of private

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1 See *Insights*, Vol. 2 No. 6, "Tax Rulings in the European Union – State Aid as the European Commission's Sword Leading to Transparency on Rulings."

2 *Id.*

3 See Bloomberg BNA, 153 DTR I-2.

4 Directive 2011/16/EU on Administrative Cooperation in the Field of Taxation.

5 See also *Insights*, "Tax Rulings in the European Union."

tax rulings entered into with a dozen corporations. It is expected that these rulings will be delivered to the European Commissioner for Competition within the next two months. Germany's decision to comply with the Commission request puts added pressure on other Member States to comply.

FRANCE

How sharp the State Aid sword is and how hard it can hit E.U.-based companies is shown by the following recent decision taken by the European Commission in July. Électricité de France ("EDF"), the main electricity provider in France, has been granted tax breaks, which the Commission determined to be incompatible with E.U. rules on State Aid. In 1997, certain accounting provisions for expenditures were reclassified as capital rather than as a current expense. This increased taxable income. Nonetheless, France did not levy all the corporation tax otherwise due and payable by EDF as a result of the reclassification. This allowed EDF to enjoy an undue economic advantage over other operators and was considered a distortion of competition. If an existing tax provision comprises State Aid, and if no exemption applies, the Member State is obliged, upon a decision of the Commission, to recover the unlawful State Aid from the beneficiary. In order to remedy this distortion, EDF must thus repay that aid.

"How sharp the State Aid sword is and how hard it can hit E.U.-based companies is shown by the following recent decision taken by the European Commission in July."

The Commission's decision was remanded by the E.U. to verify whether France's tax revenue loss was economically justified, as if it were a private investment in the company. The standard was laid down by the European courts in other decisions. On remand, the Commission concluded that justification was absent because the projections of profitability showed an inadequate return for an investor. Hence, the tax exemption granted to EDF was not deemed to be an investment made on economic grounds. Rather, the tax treatment agreed to by French tax authorities merely strengthened EDF's financial position without furthering any objective of common interest. It was therefore State Aid.

The amount in question is some €1.37 billion, of which €889 million is a tax exemption granted in 1997 and €488 million is interest. The exact amount will be calculated in cooperation with the French authorities.

E.U. DOES NOT MOVE ON TAX HAVEN "BLACKLIST" DESPITE PRESSURE FROM O.E.C.D.

Part of the European Commission's tax transparency initiative was an action plan adopted to make corporate taxation fairer, more efficient, and more transparent, presented on June 17, 2015.[6] One of the key actions in tackling corporate tax avoidance includes a list of third countries and territories currently blacklisted by Member States (the "Blacklist"). The list is available online.[7]

Criticism has been directed towards the lack of transparent and consistent methodology in establishing the Blacklist. The Commission's standard is relatively simple.

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6 *Id.*

7 See "Tax good governance in the world as seen by EU countries," European Commission.

If a country appeared on a minimum of ten E.U. Member States' national tax haven blacklists, it was placed on the Blacklist. The methodology is not consistent with the standards as set forth by the O.E.C.D. Global Forum on Transparency and Exchange of Information for Tax Purposes. The O.E.C.D. is concerned because it deems the Global Forum's standards to be incorporated into the European Commission's principles of good governance in tax matters. Apparently, 15 countries included on the Blacklist are deemed by the O.E.C.D. to be fully or largely compliant. To illustrate, Guernsey is on the Blacklist, while Luxembourg and Ireland are omitted even though they are currently under scrutiny for providing State Aid. The European Commission contends this is not a problem because the Member States apply objective criteria that result in a more accurate assessment. For example, Member States take into account a country's record on tax information exchange, tax governance, and tax laws allowing for unfair tax competition.

In early August, the Commission held meetings in Brussels to address the issue. Although the European Commission stated that it would revise the list by the end of 2015, none of the 30 countries or independent territories on the list has yet been removed.

CONCLUSION

Although the O.E.C.D.'s B.E.P.S. initiative is subject to further discussions until implementation, multinationals with European operations are already experiencing a changed landscape within the E.U. Tax results are more transparent – meaning everyone that is a stakeholder in the economy has a right to know the tax posture of all corporate taxpayers. In this environment, multinationals are advised to closely monitor the European Commission's actions with respect to private tax rulings. The result in the EDF case is not an anomaly.

I.R.S. PLAN TO REJECT FOREIGN TAXPAYERS' REFUNDS CRITICIZED BY I.R.S. ADVISORY COMMITTEE

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Tags
Foreign Taxpayers
Foreign Income
Form 1042
Form 1042-S
Tax Credit
Tax Refund
Withholding Agent
Withholding Tax

In the May 2015 issue of *Insights*, we reported that the I.R.S. announced in Notice 2015-10 (the "Notice") that it was considering issuing regulations to limit or deny withholding tax credit or refund claims when a withholding agent failed to deposit the amounts required to be withheld under Chapter 3 and Chapter 4 of the Internal Revenue Code (the "Code"), provisions that require withholding with respect to certain payments received by foreign taxpayers.[1]

Specifically, the I.R.S. stated that it intends to amend the regulations under Treas. Reg. §§1.1464-1(a) and 1.1474-5(a)(1) to provide that a credit or refund will be allowed to a claimant with respect to an overpayment *only to the extent* the relevant withholding agent has deposited, or otherwise paid to the I.R.S., the amount withheld and such amount is *greater than* the claimant's tax liability. It also intends to issue regulations under Code §33 to provide that a credit for an amount withheld is only available to a claimant *to the extent* that the withholding agent has deposited, or otherwise paid to the I.R.S. the amount withheld.

In cases in which the withholding agent deposited a portion of the tax withheld, the new regulations would provide for a *pro rata* allocation method, so that a claimant would be entitled to an amount that takes into account the amount deposited.

The I.R.S. also mentioned that, although it considered the implementation of a tracing method under which a claimant could provide that a deposit of tax made by a withholding agent was specifically made with respect to an amount withheld from him, such a method seems impractical to implement, at least at the moment.

In a letter dated June 25, 2015 (the "Letter"), the Information Reporting Program Advisory Committee ("I.R.P.A.C.")[2] discussed the reasons why the Notice's proposal does not present a workable approach to addressing the issue of fraudulent credit or refund claims.

To begin, the I.R.S. does not seem to have the authority under the Code to hold a payee liable for a withholding agent's failure to deposit taxes withheld. Instead, it is required, under Code §1462, to credit the amount of tax withheld against a payee's tax paid without regard to whether the withholding agent in fact deposited the withheld taxes.

According to I.R.P.A.C., the I.R.S. also ignores the fact that the withholding agent has no legal duty to the payee, but instead has a legal duty to the I.R.S. to deposit the withheld taxes. Thus, the proposal could leave payees with legitimate withholding tax credit or refund claims without recourse since the withholding agent would

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1 See *Insights*, Vol. 2 No. 5, "A Foreign Taxpayer's Refund or Credit Could Be Limited by Upcoming Regulations."

2 I.R.P.A.C. is an advisory committee to the I.R.S., composed of individuals from various segments of the tax professional community, with the purpose of providing a forum for discussion of tax reporting issues.

have no duty to follow the payee's instructions to deposit the withheld tax and the I.R.S. would not issue the credit or refund unless the withheld tax is deposited.

The Letter also outlines many instances in which a withholding agent may have a legitimate shortfall in its tax deposits. For example, a withholding agent may intentionally deposit less than the full amount of the taxes it withheld in a particular year if it had excessive deposits in a previous year and is expecting a corresponding credit.

PRO RATA METHOD WOULD NOT PREVENT FRAUD

According to I.R.P.A.C., the I.R.S. seems to be "conflating the legitimate problem of fraudulent refund claims with [the] collection of shortfalls in withholding deposits."

It claims that fraudulent refund claims and associated phantom deposits are unlikely to be the result of a withholding agent's deposit shortfall.

And, if a fraudulent scheme somehow targeted a legitimate withholding agent's deposits, the *pro rata* method would not prevent the fraud because the claimant would receive the refund minus the *pro rata* portion of the overall shortfall.

TRACING METHOD & THE FUNGIBILITY OF MONEY

I.R.P.A.C. agreed that the tracing method is not administratively practical given the magnitude and frequency of tax deposits received by some withholding agents.

The tracing method is further made impractical by the fungibility of money. The Letter gives the example of a withholding agent that withholds and deposits with the I.R.S. excess tax from Payee A, but later uses its own funds to refund Payee A. If the withholding agent uses tax properly withheld, but not deposited, from Payee B to reimburse itself for the tax it refunded to Payee A, then although the tax withheld from Payee B was not deposited, the tax withheld and deposited from Payee A has been effectively credited to Payee B.

EXEMPTIONS RECOMMENDED

I.R.P.A.C. recommended that, to the extent the I.R.S. believes it is still appropriate to allocate (or trace) a withholding agent's shortfall to refund claims, the following exemption categories should be included in the contemplated regulations:

1. U.S. withholding agents, qualified intermediaries and other withholding agents with significant U.S. tax nexus;
2. Withholding agents that have an established history of compliance with tax withholding, depositing and reporting obligations, and withholding agents that deposit significant dollar amounts; and
3. *De minimis* refund claims, *e.g.*, a $1,000 refund claim should not be denied or prorated if the deposited amount is $9 million.

AN UNWORKABLE APPROACH?

I.R.P.A.C. summarized the I.R.S.'s proposal as an unworkable approach with broad exceptions for fact patterns that today reflect legitimate transactions and added that the broad exceptions provide wrongdoers with a roadmap for the next fraudulent refund scheme.

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Tags
C.R.S.
F.A.T.C.A.
I.G.A.

TREASURY OFFERS MORE FAVORABLE PROCEDURES FOR NEW ACCOUNT REPORTING

The Treasury Department has notified 40 countries with early versions of an I.G.A. that more favorable terms under Article 4 or Annex I of the I.G.A. have been afforded to another Partner Jurisdiction. As a result, F.F.I.'s in those countries can use the more favorable procedures for due diligence and reporting. The countries contacted include Canada, France, Germany, Switzerland, and the U.K., as well as most other European jurisdictions and countries in other parts of the world. The Treasury's letter was sent directly to each country and was also published online.[1]

The letter was sent to enable the I.R.S. to manage the process of updating early I.G.A.'s. Under Article 7 of all I.G.A.'s, the U.S. undertakes the obligation to notify its Partner Jurisdictions of any more favorable terms under Article 4 or Annex I of an I.G.A. afforded to another Partner Jurisdiction. Once notification is given, the revision of the existing I.G.A. is automatic unless a country specifically declines in writing the application of any of the terms in the letter. To confirm whether a particular jurisdiction has declined, affected parties must contact the I.R.S. in writing within 90 days of the date of the letter.

The more favorable terms are available to banks and other F.F.I.'s in countries that have I.G.A.'s that have already entered into force and to banks in countries that have agreed in substance to an I.G.A. For countries in the latter category, such terms provide a path to compliance.

The notification provides an example of a more favorable provision in a later I.G.A. In doing so, it unilaterally implements an I.R.S.-mandated solution to an intergovernmental dispute between the I.R.S. and tax authorities in the U.K. and Canada. The dispute relates to the whether self-certification is required at the time new accounts are opened as a condition for opening such accounts.

Earlier this year, it became known that U.K. and Canadian F.A.T.C.A. implementation rules applicable to banks in those countries permitted self-certification within a reasonable time after opening an account. If proper self-certification is not obtained, the account would be reported to the I.R.S. as recalcitrant. This position is not consistent with the advice in F.A.T.C.A. FAQ 10. There, the I.R.S. states that an F.F.I. must obtain a self-certification at the time of account opening. If the F.F.I. cannot obtain a self-certification at account opening, it cannot open the account. This position causes the self-certification rules applicable to domestic financial institutions to be extended to F.F.I.'s.

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[1] U.S. Department of Treasury, "Notification of More Favorable Terms (Certain Alternative Procedures)," Jul 27, 2015.

The Treasury letter adopts a "Solomonesque" solution based on Paragraph G of Section VI of Annex I of the British Virgin Islands I.G.A. In broad terms, the approach of the B.V.I. I.G.A. is to provide a grace period of 12 months from the entry into force of the B.V.I. I.G.A. During this period, B.V.I. banks must ask new account holders to self-certify their citizenship status and confirm the "reasonableness" of the certification. The 12-month period may be terminated at an earlier point once the B.V.I. government has the ability to compel reporting by B.V.I. banks.

If during this period the account is identified as having the status of a U.S. reportable account or as an account held by a non-participating financial institution, the B.V.I. government must report the account to the U.S. within a specified period after the account is identified. The reporting deadline is the later of either the next September 30 or 90 days from identification. If banks cannot identify new accounts within one year, they will be required to close the accounts. Once the grace period has run out, due diligence and self-certification is required at the time the account is opened.

"Ninety-four countries have agreed in principle to the O.E.C.D.'s common reporting standard calling for each jurisdiction to share information on financial accounts with other countries."

The forgoing procedure is extended to all countries that have been notified. Those countries – which include Canada and the U.K. – will be presumed to accept the rules applicable to self-certification unless a written declination letter is received by the I.R.S. The open question is whether the U.K. and Canada will act to decline the terms offered in the letter, and if they do so, whether they will be able to decline only the provisions relating to the self-certification of new accounts.

The scope of the letter is not limited to the self-certification procedures. Consequently, beyond the question of how Canada and the U.K. will react to the notification, more fundamental issues relating to the effective content of an I.G.A. remain unanswered. Which terms of an actual I.G.A. have been automatically replaced in an earlier I.G.A.? What is the extent of the revision? Will advance sheets showing unofficial changes be required?

COMMON REPORTING STANDARD HURDLES BECOME NOTICEABLE TO U.S. MULTINATIONALS

Ninety-four countries have agreed in principle to the O.E.C.D.'s common reporting standard ("C.R.S.") calling for each jurisdiction to share information on financial accounts with other countries. Sixty-one countries have already signed a multilateral competent authority agreement to participate, of which 40 are early adopters that will begin implementation stages as early as January 1, 2016. Actual reporting under the C.R.S. will begin in 2017. Philip Kerfts, head of the O.E.C.D.'s International Cooperation Unit within the Center for Tax Policy and Administration, said he expects more countries to sign the multilateral pact toward the end of 2015.

While the countries that agreed to the C.R.S. have not yet begun to negotiate the bilateral agreements that the C.R.S. requires, the O.E.C.D. approach initially allows countries to view other jurisdictions as participating or not participating based on whether they have committed to the C.R.S., rather than on whether they have negotiated an agreement. According to Kerfts, a country's government will need to make a public commitment in order to be treated as participating. Ultimately, committing without implementation will not be enough. Countries must settle bilateral agreements by July 1, 2017 and begin exchanging information by 2018 in order to be considered participating.

As of now, the U.S. has not committed formally to participate in the C.R.S. If it does not, U.S. multinationals will face major challenges because participating tax agencies may report information to the I.R.S. that could be duplicative, incomplete, or incorrect. The biggest impact would be on the U.S. fund industry. If the U.S. is treated as non-participating, U.S. investment entities doing business in countries that have adopted the C.R.S. could face "look-through" treatment by jurisdictions, which means that information will be reported to the I.R.S. identifying controlling persons and possibly reporting income to those persons. This may cause duplicative or misleading reporting. This may be problematic for investment managers that are identified incorrectly as controlling persons.

While the Treasury believes that F.A.T.C.A. reporting should allow the U.S. to be viewed as participating, other governments may not agree.

In addition to the global problem stemming from participation/non-participation by the U.S., multinational companies that already comply with F.A.T.C.A. have avoided modifying information systems to gather information for compliance with the C.R.S. The information required under the C.R.S. and F.A.T.C.A. is similar, but not identical. For example, F.A.T.C.A. focuses on citizenship while the C.R.S. focuses on residence. Additionally, the C.R.S. does not have a uniform *de minimis* rule under which accounts worth not more than $50,000 are exempt. While this rule exists in connection with F.A.T.C.A. reporting, each country retains the flexibility to create its own threshold under C.R.S.

ICELAND AND UNITED ARAB EMIRATES PUBLISH F.A.T.C.A. GUIDANCE

The Icelandic Directorate of Internal Revenue issued guidance on July 10, 2015, regarding the I.G.A. signed on May 26. The guidance includes answers to frequently asked questions on the implementation of the I.G.A. and instructions on due diligence requirements.

The United Arab Emirates ("U.A.E.") Ministry of Finance issued guidance on July 15, 2015, regarding reporting obligations of U.A.E. F.F.I.'s under the I.G.A. Further, it published registration forms for U.A.E. F.F.I.'s to access the local F.A.T.C.A. portal.

BELARUS RATIFIES I.G.A. AND EXPLAINS F.A.T.C.A. REPORTING RULES

On July 22, 2015, to implement F.A.T.C.A., the Belarusian National Legal Internet Portal published a law ratifying the Model 1 I.G.A. between Belarus and the U.S., which had been signed on March 18.

Prior to such ratification, on July 15, the Belarusian Ministry of Taxes and Duties explained that under the I.G.A. Belarusian F.F.I.'s will not be required to obtain a digital certificate designed for cryptographic protection, since the Ministry is responsible for transmitting the reportable information to the I.R.S. through the International Data Exchange Service ("I.D.E.S.") and so the Ministry will obtain such certificates.

ITALY PUBLISHES IMPLEMENTATION DECREE FOR EXCHANGE OF INFORMATION

On August 6, 2015, the Italian Revenue Agency ("I.R.A.") published an implementation decree allowing reporting institutions to submit information through a third-party supplier under certain conditions. Further to the decree, the I.R.A. also issued instructions for electronically transmitting information by financial institutions covered by the I.G.A. The deadline to submit 2014 tax information is August 31, 2015.

SLOVAKIA SIGNS MODEL 1 I.G.A.

Slovakia's Ministry of Finance announced on July 31, 2015, that it has signed a Model 1 I.G.A. with the U.S. The agreement signed is reciprocal. Following the signing, the agreement was submitted to the Slovak National Council for approval and ratification.

TURKEY SIGNS MODEL 1 I.G.A.

The Turkish government announced on July 30, 2015, that it has signed a Model 1 I.G.A. with the U.S. The agreement will enter into force on the date of Turkey's written notification to the U.S. confirming that it has completed its necessary internal procedures to enact the agreement.

MAURITIUS AND LUXEMBOURG EXTEND LOCAL F.A.T.C.A. REPORTING DEADLINES

The Mauritian Revenue Authority and the Luxembourg Inland Revenues announced on July 23 and 24, 2015, respectively, that the deadline for transmitting information under F.A.T.C.A has been extended to August 31, 2015.

CURRENT I.G.A. PARTNER COUNTRIES

To date, the U.S. has signed, or reached an agreement to sign, more than 100 Model 1 and Model 2 I.G.A.'s. An I.G.A. has become the global standard in government efforts to curb tax evasion and avoidance on offshore activities and to encourage transparency.

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

- 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.

UPDATES & TIDBITS

Authors
Andrew P. Mitchel
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Tags
Corporate Tax Rate
Expatriation
Offshore Accounts
Swiss Banks
Transfer Pricing

LOWERING THE CORPORATE TAX RATE

As Democrats and Republicans attempt to revamp the U.S. tax system, retired Emerson Electric Co. executive Walter Galvin warns that, although Congress should reduce the current corporate income tax rate for the U.S. to remain competitive, it should not reduce the rate by too much. Mr. Galvin advises that the top corporate tax rate should be lowered from the current rate of 35% to 25%. However, any rate lower than 25%, he advises, will simply result in other countries lowering tax rates even further so that the U.S. rate still comes out on top.

Along with other factors, tax savings have become a predominant factor for corporate planning. Many argue that the current U.S. tax system leaves U.S. companies at a disadvantage when competing in the global market. American companies are unable to match foreign tax positions, which has led to an increase in inversions and corporate acquisitions that result in the shifting of corporate domiciliary from the U.S. to other countries. Lowering the top corporate tax rate would allow U.S.-domiciled companies to remain competitive and promote corporate decision making that is not largely based on tax planning.

Congress is considering the optimal way to revamp the tax system without affecting revenue. There have been proposals to cut back tax credits and deductions to compensate for the lower rates. In addition, the adoption of an innovation box is being considered for companies conducting research and development in the U.S.

On the whole, these proposals aim to encourage companies to remain within the U.S.

U.S. EXPATRIATION LEVELING OFF

Expatriation during the second quarter of 2015 was at its lowest since 2012, based on the published list of names of those who renounced their U.S. citizenship and long term residency.

Expatriation has been on the increase because U.S. citizens and long term residents have decided they do not want to be taxed on their worldwide income and continue filing the cumbersome U.S. tax returns.

Only 460 individuals were included on the expatriate list this quarter. This low number comes on the heels of a record high number of 1,335 for the prior quarter. This means that, despite an indication that the numbers are dropping, the total number expatriating during 2015 may still exceed the previous year.

TRANSFER PRICING IS HERE TO STAY

Dismissing rumors that the I.R.S.'s Transfer Pricing Operations ("T.P.O.") unit is set to be unwound, Acting Director David Varley affirmed that the T.P.O. is here to stay. Furthermore, he claims that the unit will have an even stronger presence in cases going forward. In fact, the Advance Pricing and Mutual Agreement unit has posted job openings for new members.

The Acting Director recommits to the goals of the unit and aims to increase efficiencies and case selection by staying focused. Whether the country-by-country reports will be used to conduct risk assessment is uncertain at the moment.

THREE MORE BANKS AGREE TO DISCLOSE ACTIVITIES TO D.O.J.

Three more Swiss banks have agreed to pay fines and disclose dealings with U.S. clients that helped such clients to evade U.S. taxes. To date, more than 100 Swiss firms have entered into agreements with the U.S. to relieve liabilities, and the ultimate penalties have depended on how successfully the banks have persuaded clients to voluntarily disclose offshore accounts.

"Three more Swiss banks have agreed to pay fines and disclose dealings with U.S. clients that helped such clients to evade U.S. taxes."

PKB Privatbank AG, Falcon Private Bank AG, and Credito Privato Commerciale S.A. will avoid prosecution by collectively paying the U.S. more than $8.4 million and making a complete disclosure of their cross-border activities. These activities include transferring assets and opening accounts for clients that had left other banks, holding accounts in the names of offshore corporations or trusts, and holding mail for clients to reduce paper trails and conceal the clients' identities.

IN THE NEWS

OUR RECENT AND UPCOMING PRESENTATIONS

On May 8, 2015, Philip R. Hirschfeld participated in a panel on “FIRPTA, Section 892 and REITS” at the *A.B.A. Annual May Meeting* in Washington D.C. The presentation focused on efficient tax structuring for a non-U.S. person’s investment in U.S. real estate and acquisition of U.S. mortgage debt by foreign investors. It addressed direct investment as well as investment in partnerships, L.L.C.’s, R.E.I.T.’s, and other investment entities holding these assets. It also addressed concerns of special investors such as foreign governments that benefit from Code §892.

In May 2015, Stanley C. Ruchelman and Beate Erwin attended the *2015 ITSG European Conference* in Madrid, Spain. Mr. Ruchelman and Ms. Erwin participated on the panel “Problems of U.S. Person Living in Europe,” which addressed banks that close accounts of U.S. persons, coming into compliance with tax return and F.BA.R. reports, and planning for expatriation. In conjuction with the conference, Mr. Ruchelman also spoke on the “Common Reporting Standard in the E.U.”

On July 23, 2015, Philip R. Hirschfeld presented on the panel “Foreign Persons Investing In U.S. Real Estate: Partnership And Other Structures, Opportunities and Traps” as part of the NYU Advanced Summer Institute in Taxation. The summer institute is offered annually by *NYU’s Advanced International Tax Institute*. Mr. Hirschfeld’s presentation focused on ways to structure a non-U.S. person’s investment in U.S. real estate in ways that minimize taxation. Investments in mortgage debt securities, partnerships, L.L.C.’s, and R.E.I.T.’s were covered.

On October 6, 2015, Stanley C. Ruchelman and Galia Antebi will speak on “Understanding U.S. Taxation of Foreign Investment in Real Property” as part of the two-day conference Current U.S. Tax Planning for Foreign-Controlled (Inbound) Companies hosted by Bloomberg BNA in New York. Thier discussion will cover legal and tax aspects of structuring U.S. real estate investments and will specifically address §871(d) net gain elections, special considerations for partnerships and withholding taxes, including the preparation of statements to reduce F.I.R.P.T.A. withholding tax, and U.S. tax aspects of cross-border M&A transactions involving U.S. R.P.I.’s.

In October 2015, Beate Erwin will attend the International Bar Association Annual Conference held in Vienna, Austria, where she will participate on the panel “Tax Structuring for Private Clients.” The panel will utilize case studies to focus on how tax issues impact structures used for private clients.

Copies of our presentations are available on the firm website at www.ruchelaw.com/publications.

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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