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INSIGHTS

THE COMMON REPORTING STANDARD – A GLOBAL F.A.T.C.A?

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EDITORS' NOTE

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

- **The Common Reporting Standard – A Global F.A.T.C.A.?** The Common Reporting Standard for the automatic exchange of information by financial institutions is now in effect for the 56 jurisdictions that are Early Adopters. How will the C.R.S. work and who will be affected? How does it interact with F.A.T.C.A. I.G.A.'s? Richard Addlestone of Solomon Harris, Grand Cayman answers these and other questions.

- **The Meanderings of the Taxation of U.K. Real Estate: Where Are We Going?** For those who are considering the acquisition of U.K. real property for personal use, an unhappy surprise awaits. The U.K. government is actively waging a tax campaign against structures commonly used for these acquisitions and referred to derisively as "Enveloped Dwellings." Increased stamp duty on land transactions, annual tax on Enveloped Dwellings and related capital gains charges, and extended scope of inheritance tax take the sizzle out of high-value purchases. Naomi Lawton of Memery Crystal L.L.P., London ruminates on this puzzling development.

- **Taxpayers Take Note: I.R.S. Publishes Audit Guides for International Examiners.** U.S.-based companies facing an I.R.S. examination of international operations may secretly wish to obtain an advance look at how I.R.S. examiners plan to carry out the examination. After all, what better way to prepare for a test than to get the questions in advance? Surprise – the division conducting examinations has published its training guides for examiners. Several will be explained in this edition of *Insights*:

  - **I.R.S. Releases Subpart F Sales and Manufacturing Rules.** Beate Erwin, Kenneth Lobo, and Stanley C. Ruchelman explain how the branch rule works when a C.F.C. operates a manufacturing or selling branch in another country. While the concept is easy to explain, the computations are somewhat confusing. The article explains all.

  - **Deemed Annual Royalty Income under Code §367(d).** Christine Long delves into the world of I.P. contributions to foreign subsidiaries. She explains how Code §367(d) works and how the regulations have been revised recently to attack goodwill and going concern contributions.

  - **What the I.R.S. Looks for When Deciding If a U.S. Shareholder Has an Interest in a C.F.C.** Rusudan Shervashidze and Stanley C. Ruchelman explain the tests the I.R.S. applies to determine whether a foreign corporation is a C.F.C. and a U.S. person is a "U.S. Shareholder" potentially subject to tax under Subpart F. They explain the tax forms that examiners are encouraged to look for and the telltale signs of direct, indirect, and constructive ownership of shares by U.S. persons.

  - **License of Intangible Property from U.S. Parent to a Foreign Subsidiary.** Christine Long explains how I.R.S. examiners are encouraged to determine whether foreign subsidiaries are paying fair compensation for using I.P. owned by U.S. parent companies.

- **Monetary Penalties for Failure to File Form 5471.** The I.R.S. has initiated increased enforcement efforts to ensure compliance with information reporting obligations. Such efforts include increased assessment of penalties. Galia Antebi explains.

- **P.A.T.H. Act Leads to Widespread Tax Changes.** Everyone likes Christmas presents and the P.A.T.H. Act delivers. It provides favorable tax treatment in the form of (i) F.I.R.P.T.A. exemptions for foreign pensions funds, (ii) increased ownership thresholds before F.I.R.P.T.A. tax is imposed on C.I.V. investment in R.E.I.T.'s, (iii) increased ownership thresholds before F.I.R.P.T.A. tax is imposed on foreign investment in domestically-controlled R.E.I.T.'s, (iv) a reduction in the time that must elapse in order to avoid corporate level tax on built-in gain when an S-election is made by a corporation after the close of the year of its formation, and (v) a permanent exemption from Subpart F income for active financing income of C.F.C.'s. However, not all taxpayers benefitted from the Act. The P.A.T.H. Act increases F.I.R.P.T.A. withholding tax to 15%, adopts new partnership tax examination rules, and tightens rules regarding I.T.I.N.'s. Elizabeth Zanet, Christine Long, Rusudan Shervashidze, and Philip R. Hirschfeld explain these and certain other legislative changes.

- **I.R.S. Adopts O.E.C.D. Standard in New CbC Reporting Regulations.** Newly proposed CbC regulations that closely follow the O.E.C.D. B.E.P.S. report have been adopted by the I.R.S. Sheryl Shah and Stanley C. Ruchelman explain the I.R.S.'s reasons and request for input regarding national security exemptions not otherwise considered by the O.E.C.D.

- **Corporate Matters: If I Can Make It There I Can Make It…** In this month's "Corporate Matters," Simon Prisk addresses typical start-up legal needs of foreign clients expanding retail business to the U.S.

- **F.A.T.C.A. 24/7.** Galia Antebi, Rusudan Shervashidze, and Philip R. Hirschfeld look at recent developments in F.A.T.C.A. They address the D.O.J.'s Swiss bank deferred prosecution program; new instructions for Form 8966, *F.A.T.C.A. Report*; six new YouTube videos regarding the Online Registration System; extension of time to file *F.A.T.C.A. Reports*; upgrade to F.F.I. lists, the current I.G.A. partner countries, and more.

- **Updates & Tidbits.** Elizabeth V. Zanet, Kenneth Lobo, and Galia Antebi discuss recent events, including a Beanie Baby billionaire's light sentence; a tax reform report by the European Parliament addressing tax rulings, a common consolidated corporate tax base, a crackdown on tax havens, whistle-blower protection, public access to CbC reports, and a lower threshold to approve E.U. tax legislation; a House Ways and Means Committee action in regard to B.E.P.S., E.U. investigations on State Aid, patent box regimes, and inversions; identity theft risk in I.R.S. proposed regulations regarding charitable deductions; and allowance of accounting non-conformity for foreign-based groups that do not adopt L.I.F.O. accounting when that method is adopted by a U.S. member.

We hope you enjoy this issue.

- The Editors

THE COMMON REPORTING STANDARD – A GLOBAL F.A.T.C.A.?

Author
Richard Addlestone

Tags
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Transparency

STANDARD FOR AUTOMATIC EXCHANGE OF FINANCIAL ACCOUNT INFORMATION IN TAX MATTERS

The Standard for Automatic Exchange of Financial Account Information in Tax Matters (also known as the "Common Reporting Standard" or "C.R.S.")[1] is a global system of automatic exchange of information for tax purposes ("A.E.O.I."). As of January 1, 2016, financial institutions ("F.I.'s") in jurisdictions that have signed up as members of the Early Adopters Group ("E.A.G.")[2] of the C.R.S. are obligated to gather identification and residence information from new account holders to pass it to their jurisdictions' reporting authority in order to enable reporting of the accounts. By 2018, the 96 jurisdictions[3] that have adopted the C.R.S. will be exchanging information on those account holders identified as reportable between their respective reporting authorities. F.I.'s and tax authorities still need to work through all the details, but below is a brief introduction to the system, how it is expected to work, and some potential pitfalls.

What Countries Does It Affect and When?

Those jurisdictions that have adopted the C.R.S. include most of the world's major economies and financial centers, with the notable exception of the U.S. The earliest date for information exchange under the C.R.S. will be 2017[4] (for information gathered in 2016) for the 56 jurisdictions that make up the E.A.G. The remaining 40 jurisdictions are committed to commence exchange by 2018. The process starts with F.I.'s collecting information on new account holders and then expands to include information on relevant existing account holders. The system was developed by the Organization for Economic Co-operation and Development ("O.E.C.D.") and the Global Forum on Transparency and Exchange of Information for Tax Purposes ("Global Forum") to combat tax evasion in response to a request by the G-20. The aim was to build on the systems and agreements put in place to comply with the Foreign Account Tax Compliance Act ("F.A.T.C.A.") and to create a comprehensive global standard for A.E.O.I.

Richard Addlestone is a partner in the corporate department of the Cayman Islands law firm Solomon Harris. He principally advises managers, investors, lenders, and other financial institutions in relation to the formation, transactions, reorganization, financing, regulation, and voluntary winding down of alternative investment funds.

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1 "Standard for Automatic Exchange of Financial Information in Tax Matters." O.E.C.D. Automatic Exchange Portal - Common Reporting Standard (C.R.S.). July 21, 2014.

2 "Joint Statement by the Early Adopters Group." O.E.C.D. October 1, 2014.; "CRS by Jurisdiction." O.E.C.D.: C.R.S. Implementation and Assistance.

3 "A.E.O.I.: Status of Commitments." O.E.C.D. Global Forum on Transparency and Exchange of Information for Tax Purposes.

4 "C.R.S. by Jurisdiction." O.E.C.D.: C.R.S. Implementation and Assistance.

The U.S. is already receiving information on U.S. persons ahead of these C.R.S. deadlines. The first information exchange under its own A.E.O.I. system took place at the end of September 2015.[5] Under the U.S. system – operating under F.A.T.C.A. – the U.S. Internal Revenue Service ("I.R.S.") is provided with information on financial accounts of U.S. persons, either from F.I.'s directly or from the relevant tax authority of those foreign tax jurisdictions that have appropriate Intergovernmental Agreements ("I.G.A.'s") with the U.S. The U.S. has committed to implement a level of reciprocity under the Model 1 I.G.A.'s rather than signing up to participate in the C.R.S., but political stalemate has prevented the legislative changes necessary to make that work in practice. Among other consequences, if a jurisdiction participating in the C.R.S. deems the U.S. as non-participating, then most U.S. trusts, as well as F.I.'s that are investment entities (*e.g.*, a managed investment entity like a mutual fund), with accounts in the participating jurisdiction will have to provide information on their controlling persons, which otherwise is only required for more limited types of F.I.'s in participating jurisdictions.

How Does It Work?

The C.R.S. sets out the information that reporting authorities in participating jurisdictions should gather from F.I.'s located in those jurisdictions and that should be automatically exchanged on an annual basis with other participating jurisdictions. This information broadly consists of details of financial assets that are held by the F.I.'s on behalf of taxpayers that are resident in other participating jurisdictions, provided that the reporting authority has in place an agreement for the exchange of tax information. F.I.'s report to the reporting authority in the participating jurisdiction in which they are located. The consequences of non-compliance are left to the participating jurisdictions to specify in domestic legislation.

The Documentation

The system is made up of components. First, there is the 'Model' Competent Authority Agreement ("C.A.A.")[6] (a bilateral and reciprocal agreement based on the F.A.T.C.A. Model 1 I.G.A.), which provides the international legal framework[7] for A.E.O.I. under the C.R.S. The Common Reporting and Due Diligence Standard[8] sets out the reporting and due diligence requirements, and is known as the Common Reporting Standard or "C.R.S." This can cause confusion because the acronym C.R.S. is also commonly used to refer to the Common Reporting Standard as a whole. Finally, there is a "User Guide"[9] for the C.R.S. XML Schema and Commentaries.[10] The Schema may need to change in the future as the system evolves. To overcome the potential legal difficulties this would create, in December 2015, the O.E.C.D. agreed on a plan to work out a system for adopting future changes (see below).

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5 The first information exchange under reciprocal I.G.A.'s, took place by the September 30, 2015 deadline.

6 "Commentaries on the Common Reporting Standard." O.E.C.D.

7 "The C.R.S. Multilateral Competent Authority Agreement." O.E.C.D.: International Framework for the CRS.

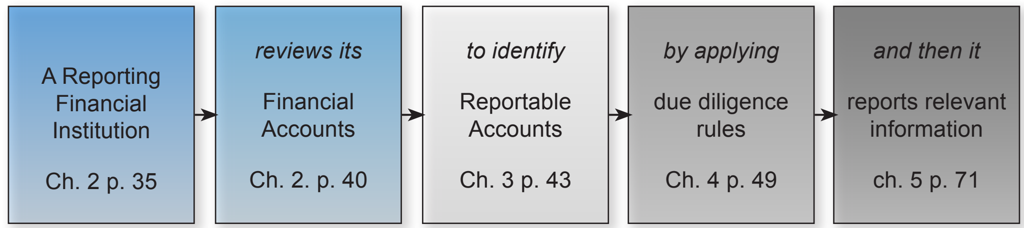
8 "Commentaries on the Common Reporting Standard." O.E.C.D.

9 "Common Reporting Standard User Guide and Schema." O.E.C.D.

10 "Commentaries on the Common Reporting Standard." O.E.C.D.

What Is Required of F.I.'s?

The A.E.O.I. process for the C.R.S. is set out in the component documents above, but the O.E.C.D. has also prepared the C.R.S. *Implementation Handbook*[11] (the "Handbook"), which explains the basics simply and clearly in "Part II: Overview of the C.R.S. and Due Diligence Rules."[12] Put simply, F.I.'s in jurisdictions that participate in the C.R.S. will need to follow the steps in the diagram below.



Guidance on exactly how to implement these steps may be found at each chapter of the Handbook referenced in the diagram above, with step-by-step flow charts on identifying Reporting Financial Institutions, Financial Accounts, and Reportable Accounts as well as the various due diligence rules to be applied depending on the nature of the account as new or pre-existing (open before January 1, 2016) and the nature of the holder as an entity or individual.

F.I.'s should advise clients and account holders that they must provide their details to the F.I. and that data will be made available to tax authorities in the client's jurisdiction of residence. While there is considerable overlap between F.A.T.C.A. and the C.R.S., information, systems, and processes that F.I.'s have established to comply with F.A.T.C.A. will need to be adapted if they are to be used for the C.R.S. The C.R.S. covers more accounts and entities than F.A.T.C.A., and there is some flexibility on which accounts are included (*e.g.*, individual jurisdictions can define which accounts are low-risk) so there is a real possibility of jurisdictional variations for reporting. Also, jurisdictions are free to decide the format by which F.I.'s will report information. Although the Handbook suggests jurisdictions use the C.R.S. Schema (which is virtually identical to the F.A.T.C.A. XML Schema) to avoid the need for significant additional investment on the part of governments or F.I.'s, it is not mandatory and F.I.'s will need to confirm the approach taken by the appropriate jurisdiction.

> ***"F.I.'s should advise clients and account holders that they must provide their details to the F.I. and that data will be made available to tax authorities in the client's jurisdiction of residence."***

Timetable

F.I.'s in E.A.G. countries will have prepared their I.T. and administrative systems to deal with the requirements for new account-opening procedures from January 1, 2016. For E.A.G. jurisdictions, the timetable is as follows:

1. F.I.'s will be required to have account-opening procedures in place to record tax residence for all new accounts opened from January 1, 2016.

2. Pre-existing accounts are those already open on December 31, 2015.

3. Due diligence identifying high-value, pre-existing individual accounts must be

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[11] "The C.R.S. Implementation Handbook," O.E.C.D.

[12] *Id.*, p. 34.

complete by December 31, 2016.

4. Due diligence for low-value, pre-existing individual accounts and entity accounts must be complete by December 31, 2017.

5. First reporting of information gathered in 2016 is expected in 2017.

As an example of the preparations being made in E.A.G. countries, in the author's jurisdiction of the Cayman Islands (which is a founding member of the E.A.G.) the Cayman Islands Department of International Tax Co-operation of the regulatory authority, the Cayman Islands Monetary Authority, has introduced regulations[13] and set up an A.E.O.I. Portal[14] to allow F.I.'s to monitor progress.

For jurisdictions that are not in the E.A.G., the timetable for collecting the same information is extended through 2017, with reporting scheduled to commence in 2018.

What Is the Domestic Legal Basis of the C.R.S.?

To create any global standard, the information gathering and exchange mechanisms need to be incorporated into the legal system of each participating country. This means that the jurisdictions that have signed up to participate in the C.R.S. have been bringing in new or adapting existing legislation to ensure that F.I.'s report the required information on the relevant financial assets that are held. The four core requirements for governments to implement the C.R.S. are as follows:

1. Translating the reporting and due diligence rules into domestic law, including rules to ensure their effective implementation (including penalties and sanctions)

2. Selecting a legal basis for the automatic exchange of information

3. Putting in place I.T. and administrative infrastructure and resources

4. Protecting confidentiality and safeguarding data

The approach to protecting the confidentiality and integrity of the data being exchanged may differ for each jurisdiction. There is non-mandatory guidance offered by the O.E.C.D. in its guide *Keeping it Safe*[15] from July 2012. In it, the O.E.C.D. sets out best practices and gives practical guidance (including a checklist) on what steps jurisdictions should take to protect the confidentiality of tax information. This protection is important, as jurisdictions can withhold information based on the fact that they consider it will not be safe in the destination jurisdiction.

What Is the International Legal Basis?

To reduce the number of F.I.'s providing information to the I.R.S. directly, the U.S.

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13 "The Tax Information Authority (International Tax Compliance) (Common Reporting Standard) Regulations, 2015." Cayman Islands Department for International Tax Cooperation. October 16, 2015.

14 "AEOI News & Updates." Cayman Islands Department for International Tax Cooperation.

15 "Keeping It Safe: The O.E.C.D. Guide on the Protection of Confidentiality of Information Exchanged for Tax Purposes." O.E.C.D.

developed Model I.G.A.'s, which allowed governments to collect information from the F.I.'s that is then provided to the U.S. in bulk. The C.R.S. provides for an alternative to multiple bilateral tax information exchange agreements. The O.E.C.D. and Global Forum drafted a Multilateral Convention on Mutual Administrative Assistance in Tax Matters ("M.A.C.") that jurisdictions may sign. This provides a legal gateway for the exchange of tax information between all countries and jurisdictions that have signed up for the C.R.S. As of October 29, 2014, 51 jurisdictions signed the Model C.A.A. for A.E.O.I. based on Article 6 of the M.A.C. – there are now 89 jurisdictions covered by the M.A.C. and 74 by the Model C.A.A.[16] To help F.I.'s understand how far along a jurisdiction is in the implementation of the C.R.S., the O.E.C.D.'s A.E.O.I. Portal has an overview of the current state of implementation for all committed G-20/O.E.C.D. member countries, which is contained in a single table.[17]

Future Changes to the C.R.S. XML Schema

On December 1, 2015, the O.E.C.D. agreed[18] to plan to consider, review, and adopt future changes to the C.R.S. XML Schema that would allow it to evolve over time. This came after the European Commission asked for the inclusion of three additional fields and a value in the C.R.S. XML Schema, which highlighted the potential legal issues involved in making such a change (*e.g.*, changes to the C.A.A.). The plan is for a substantive review of the experiences of tax authorities during the first exchange and use of the C.R.S. information in 2017 and 2018 (as well as the early exchanges of information under the F.A.T.C.A. I.G.A.'s) in order to see what other technical changes to the C.R.S. XML Schema might be needed.

"The C.R.S. asks for different data and will affect significantly more accounts than F.A.T.C.A., as it has no universal minimum level of pre-existing individual account holding below which due diligence by F.I.'s is not required."

So, Is It Really Any Different from F.A.T.C.A.?

The C.R.S. was designed to build on the agreements and systems put in place by governments and F.I.'s to comply with F.A.T.C.A. The goal was to create an effective new international standard at a minimal cost to F.I.'s and governments.

However, F.A.T.C.A. is U.S.-specific and its I.G.A.'s were unsuitable for a global standard, so changes were made.[19] The use of citizenship as an indication of tax residence and references to U.S. domestic law were changed, as were approaches that were more suited to the bilateral context of F.A.T.C.A. I.G.A.'s rather than the multilateral context of the C.R.S. The use of F.A.T.C.A. regulation definitions in the C.R.S. should help those working with both systems, but not all definitions are the same. This will create practical problems and operational challenges for F.I.'s. These include identifying which entities need further investigation for the C.R.S. and reporting entities with controlling persons that have a different tax residency than the entity.

The C.R.S. asks for different data and will affect significantly more accounts than F.A.T.C.A., as it has no universal minimum level of pre-existing individual account

16 "Statement of Outcomes." O.E.C.D.: Global Forum on Transparency and Exchange of Information for Tax Purposes. October 30, 2015.

17 "C.R.S. by Jurisdiction." O.E.C.D.: C.R.S. Implementation and Assistance.

18 "Statement of Outcomes by Working Party No. 10 on the EU Proposal on the Addition of Fields to the CRS XML Schema." O.E.C.D. December 1, 2015.

19 The Handbook offers detailed comparisons at p. 84, "Part III: The Standard compared with F.A.T.C.A. Model 1 I.G.A.," and p. 22, ¶36, "Differences to F.A.T.C.A."

holding below which due diligence by F.I.'s is not required. Regarding non-compliance, the F.A.T.C.A. threat of withholding from a non-compliant F.I.'s own money does not apply, but each participating jurisdiction will legislate its own non-compliance penalties.

The C.R.S. covers accounts held by individuals and entities, including trusts and foundations, and the information it covers includes balances, interest, dividends, and sales proceeds from financial assets. Some C.R.S. due diligence procedures will require manual checks to confirm information with paper-based documentary evidence. Without an agreed, standard form of self-certification, each jurisdiction is free to ask F.I.'s for more information than the minimum, causing duplication in the preparation of information on account holders in order to meet the information and presentation requirements of different jurisdictions.

Further Help from the O.E.C.D. and Global Forum

To back up the formal documentation of the C.R.S., the O.E.C.D. recently launched a new A.E.O.I. Portal[20] to give tax administrations and F.I.'s the information and legal, administrative, and I.T. tools that may be needed. It has published detailed F.A.Q.'s[21] and a second edition of its *Offshore Voluntary Disclosure Programmes*[22] with updated guidance on the design and implementation of voluntary disclosure programs based on the practical experience of 47 countries, including the views of private client advisers. The Global Forum has also been monitoring how jurisdictions that have signed up for the C.R.S. are implementing the commitments they have undertaken.

Beneficial Ownership Registers and the C.R.S.

There has been much discussion of beneficial ownership public registers, and it is significant that the Global Forum will include in its next round of peer reviews the examination of a jurisdiction's ability to provide beneficial ownership information.[23] This is not something that arises from the C.R.S. In fact, the C.R.S. does not actually refer at all to beneficial ownership, but rather to controlling persons. There is nothing in the C.R.S. that requires the setting up of a register, public or otherwise, for any of the information collected by F.I.'s and passed to the relevant reporting authority.

The driver for establishing beneficial ownership registers comes from the G-20 High-Level Principles on Beneficial Ownership Transparency,[24] which includes the provision that

20 "A.E.O.I. Portal." O.E.C.D.

21 "C.R.S.-related F.A.Q.'s." O.E.C.D.

22 "Update on Voluntary Disclosure Programmes: A Pathway to Tax Compliance." O.E.C.D. August 1, 2015.

23 "Statement of Outcomes." O.E.C.D.: Global Forum on Transparency and Exchange of Information for Tax Purposes. October 30, 2015.; "Global Forum on Tax Transparency Pushes Forward International Co-operation against Tax Evasion." O.E.C.D. Newsroom. October 30, 2015.

24 "G20 High-Level Principles on Beneficial Ownership Transparency." G-20.: 2014.; "Update to Article 26 of the O.E.C.D. Model Tax Convention and Its Commentary." O.E.C.D. July 17, 2012.

> [c]ountries should ensure that competent authorities (including law enforcement and prosecutorial authorities, supervisory authorities, tax authorities[,] and financial intelligence units) have timely access to adequate, accurate[,] and current information regarding the beneficial ownership of legal persons. Countries could implement this, for example, through central registries of beneficial ownership of legal persons or other appropriate mechanisms.

"A global system of A.E.O.I. to attempt to defeat tax evasion is an ambitious idea, which goes far beyond F.A.T.C.A."

The Global Forum is the premier international body for ensuring the implementation of the internationally agreed upon standards of transparency and exchange of information in tax matters. Through an in-depth peer review process, it monitors its members to ensure that they fully comply with the standard of transparency and exchange of information to which they have committed. This monitoring covers C.R.S. compliance as well as other commitments, such as those under a Tax Information Exchange Agreement ("T.I.E.A."). Under T.I.E.A.'s, there is an exchange of information on request ("E.O.I.R.") mechanism. At a meeting[25] held at the end of October 2015, the Global Forum created a new framework for the second round of Phase 2 peer reviews on exchange of information. The new 2016 terms of reference[26] include a requirement that

> [j]urisdictions should ensure that ownership and identity information, including information on legal and beneficial owners, for all relevant entities and arrangements is available to their competent authorities.

The U.K. and the E.U. have chosen to meet their commitment to ensure "timely access to adequate, accurate[,] and current information regarding the beneficial ownership of legal persons" by implementing public registers. Other countries, such as the Cayman Islands, meet the same obligation by ensuring their regulatory bodies have the information available from the formation of the relevant entities, and valid requests for such information can be, and are, responded to in a timely fashion. The C.R.S. will not require any change to this commitment or the way it is met by participating jurisdictions. It will, in fact, require assessment of slightly different criteria to identify controlling persons for some entities.

CONCLUSION

A global system of A.E.O.I. to attempt to defeat tax evasion is an ambitious idea, which goes far beyond F.A.T.C.A. It remains to be seen whether, and how, the dual F.A.T.C.A. and C.R.S. systems for A.E.O.I. will continue on their parallel paths. It will be interesting to see whether or not the two systems will gradually converge, and how the fact that the U.S. is not a participating C.R.S. country and isn't legally able to require U.S.-based F.I.'s to collect the relevant information on account holders will play out in practice.

With 96 jurisdictions committed to A.E.O.I. through the C.R.S. system, it is a certainty

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25 "Statement of Outcomes." O.E.C.D.: Global Forum on Transparency and Exchange of Information for Tax Purposes. October 30, 2015.; "Global Forum on Tax Transparency Pushes Forward International Co-operation against Tax Evasion." O.E.C.D. Newsroom. October 30, 2015.

26 "Tax Transparency 2015: Report on Progress." O.E.C.D.: Global Forum on Transparency and Exchange of Information for Tax Purposes. 2015, p. 33.

that F.I.'s will be asking their clients for more information in order to establish the clients' residence and then report their account information to the tax authority of their residence (through the F.I.'s tax authority). This will happen in every jurisdiction where the client has a reportable account and, as what is asked may differ slightly from jurisdiction to jurisdiction, it will be difficult to apply a "one size fits all" approach to due diligence/"know your client" requirements. These are early days for the C.R.S., but like F.A.T.C.A., it is here to stay in one form or another, and it is already operating in E.A.G. jurisdictions. Even though the U.S. is not a participating jurisdiction, the C.R.S. will still have an impact on some F.I.'s located there and it must still be taken it into account.

THE MEANDERINGS OF THE TAXATION OF U.K. REAL ESTATE: WHERE ARE WE GOING?

Author
Naomi Lawton

Tags
Capital Gains
Real Estate
Tax Policy
U.K.

Naomi Lawton is a senior associate in the tax department of Memery Crystal LLP. Ms. Lawton advises businesses and individuals on a wide range of direct and indirect tax issues, both in the U.K. and internationally, and has advised on business structures, corporate acquisitions, disposals and reconstructions, real estate, and employment issues.

INTRODUCTION

A striking feature of the U.K. tax landscape has been the recent introduction of significant changes to the taxation of real estate. Residential property in particular (as opposed to non-residential or "mixed" property – see further below) has borne the brunt of the attack.

Where governments make choices about who, what, and how much to tax, tax policy becomes an emotive issue, never more so than now. It is the area of a government's political strategy that has the most direct and immediate effect on a citizen's pockets. These decisions tend to have a rather focusing effect – an effect that is compounded in this case because the tax in question is on an Englishman's home (or a Welshman's, etc. – you get my drift), which is his castle, as the adage goes. It also affects the desirability of local real estate to foreign investors, whether considering it for personal use or as investment real property.

THE FISCAL SIGNIFICANCE OF PROPERTY

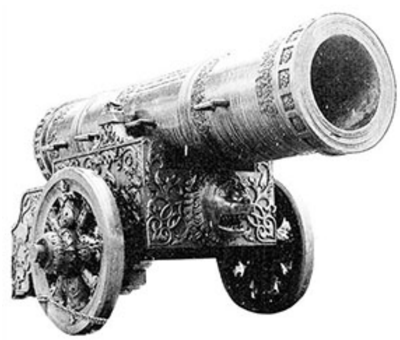
The U.K. housing market is one of the key barometers of the country's economic health. Over the long term, capital growth in real estate can be counted upon to outstrip many other forms of investment. Land is one of the few commodities that is genuinely finite in nature. We cannot produce more of it, and in the U.K., it is in relatively short supply. We Brits have enjoyed an enduring love affair with property ownership, in particular since the 1980's and the introduction of the "right to buy."

One feature that has become increasingly significant for governments seeking to raise funds in the current climate is that real estate is immoveable. This is hugely significant in a world that has seen exponential growth in international mobility, both in terms of persons and assets.

The global environment is increasingly mobile, yet taxing rights are fundamentally territorial in nature. Governments therefore compete with each other to attract mobile capital with occasionally aggressive competitive tax regimes and beneficial economic environments. The initiatives of supranational organizations, such as the E.U. and O.E.C.D., that look to provide for a fair allocation of taxing rights are increasingly important. However, the internal infrastructure and processes of these organizations are necessarily cumbersome, and the results, although astonishing under the circumstances, lag behind the changing economic landscape. In the interim, each government does what it can to tax what it perceives to be its fair share of the global tax base.

In this context, real estate is the dream asset – it is by its very nature immoveable. If an investor wants U.K. real estate, he or she will have to succumb to the U.K. tax authorities. It is perhaps not surprising that the U.K. government wants to cash in on gains arising from this immovable asset.

THE GROWING TAX ARSENAL



What follows in this section is a gallop through some of the recent changes to the taxation of U.K. property, in chronological order (according to the date of entry into force of each). Although not exhaustive, the discussion addresses some of the more significant measures.

March 2012: S.D.L.T. on Enveloped Dwellings

The first of the recent fiscal assaults began in March 2012 with the higher rate of stamp duty land tax ("S.D.L.T.") for "enveloped" dwellings. Very broadly, S.D.L.T. is the tax that is paid by a purchaser on the acquisition of interests in property. It is payable at various rates on the "chargeable consideration" (generally equal to the purchase price).

At the time of the reform, the U.K. Conservative-Liberal Democrat coalition government was (and it appears the Conservative Party government still is) concerned with dissuading the acquisition and holding of real property by non-natural persons. In significant part, this was because the stamp taxes attributable to a transfer of shares in a company holding property (for example) are likely to be considerably less than the S.D.L.T. attracted by a transfer of the underlying property itself.

The effect of the changes was to increase the rate of S.D.L.T. to a flat 15% on the acquisition of residential property by a non-natural person. By comparison, the rates of S.D.L.T. for residential property at the time ranged from 0% to 7%. In the context of commercial or "mixed" property, the rate was (and still is) a flat 4%.[1] At the time that the changes were introduced, the provisions applied only to purchases where the chargeable consideration exceeded £2 million. The government could therefore assure its public that the measure would affect only the very wealthy.

Inevitably, however, the enemy settled in and spread out – mission creep. The threshold has now been significantly reduced so that the inflated rate applies to non-natural persons acquiring residential property with a value of £500,000 and over. In many parts of the U.K., £500,000 is a depressingly insignificant trigger point. Although there are a series of exemptions to the increased S.D.L.T. charge for acquisitions by non-natural persons, they are often complex and in some cases produce anomalous results.

APRIL 2013: A.T.E.D. AND A.T.E.D.-RELATED CAPITAL GAINS

A further attack came in April 2013 with the introduction of the Annual Tax on

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1 These rates are quite high when compared to the acquisition of a comparable residential property in New York City. There, the city imposes a comparable tax of 1% of the value of the property (1.45% if the value exceeds $500,000), and the state imposes one tax on the seller of $2 for each $500 or fractional part thereof (essentially a tax of 0.4% of value) and a second tax on the purchaser of 1% when the value of the residential property exceeds $1 million.

Enveloped Dwellings ("A.T.E.D."). Again, the intention was to dissuade individuals from holding high-value residential property within a corporate structure. The effect of the A.T.E.D. is to impose an annual charge on enveloped dwellings, the quantum of which is linked to the value of the property. As above, although initially the charge applied only to properties worth in excess of £2 million, this threshold was soon reduced, and with effect from April 2016, it will be £500,000.

Although the introduction of the A.T.E.D. was intended to dissuade certain behaviors, the measure proved to be a far greater revenue generator than the government had anticipated. This seems extraordinary, given that the compelling but non-verified, anecdotal evidence indicates that the vast number of non-U.K. companies holding residential property knew nothing about the charge and non-deliberate non-compliance has been widespread. If government statistics are to be believed, the well of potential tax collections runs quite deep once the A.T.E.D. requirements are more widely known.

"The effect of the A.T.E.D. is to impose an annual charge on enveloped dwellings, the quantum of which is linked to the value of the property."

Alongside the A.T.E.D., its brother was introduced – the A.T.E.D.-related capital gains charge. This is an extended capital gains tax on disposals of high-value residential property made on or after April 6, 2013 where the property is held in a corporate wrapper and is within the A.T.E.D.

December 2014: Overhaul of S.D.L.T. for Residential Property

In December 2014, the government announced a further package of reforms to the S.D.L.T. for residential property. The measures included some welcome simplifications (the end of the "slab" system of taxation, which resulted in unnecessary market distortions, was to be replaced by a progressive "slice" system), but also some less-welcome and eye-watering tax hikes, including a new top rate of 12% for acquisitions by individuals (the rate applicable to acquisitions by companies remains 15%). Again, the measures applied (and continue to apply) only to residential property.

April 2015: Capital Gains Tax on Residential Property for Non-U.K. Residents

In April 2015, the U.K. government introduced capital gains tax ("C.G.T.") for non-residents in respect of gains realized on U.K. residential property. This measure in particular represented a very significant shift in U.K. tax policy. Until then it had been a significant (and relatively unusual) feature of the U.K. tax system that it did not seek to impose capital gains tax in respect of U.K. property on non-U.K. tax residents. This had undoubtedly contributed to the popularity of the U.K. real estate market with offshore investors. However, the prevailing political climate meant that the economic clout of foreign investors (inevitably also non-voters) was easily eclipsed by political expedience.

April 2016: Additional 3% S.D.L.T. Rate for Second Homes

The most recently announced development (November 2015) has been the rather extraordinary and generally unforeseen announcement that the U.K. government would introduce an additional 3% S.D.L.T. surcharge on the purchase of additional residential properties (such as second homes and buy-to-let properties) for considerations exceeding £40,000, with effect from April 2016.

The announcement has been met with predictable outrage from the long-suffering property industry, together with a series of specific criticisms (not least in relation to the very rushed nature of the consultation), which has required a significantly shortened consultation period and a delay in the usual timetable for publishing the draft legislation.

Clearly the intention of the measure is to curb the rise of holiday home and buy-to-let properties. The proliferation of these properties is perceived to have caused damage to the local communities of certain areas. However, the measure goes much farther and has some rather surprising consequences. In particular, the government has confirmed that it is intended that the surcharge will apply to purchases by non-U.K. residents of a first home in the U.K. where that nonresident owns other homes worldwide. This is a pretty bold move in terms of the territoriality of a domestic tax measure. How the government intends to police this provision is unclear.

The government has also stated that married couples will be treated as a "unit" for the purposes of the legislation. Commentators have argued that this effectively penalizes married couples over cohabiting couples, since married couples will be treated as acquiring a second home and taxed accordingly, while unmarried couples may simply acquire a property each. The measure may also deter parents co-purchasing property with their children. This is an odd result for a Conservative Party measure and one which has inflamed the suggestion that the ill-thought-out consequences of some of the recent measures demonstrates a lack of coherent policy in this area. Certainly, the piecemeal and fragmented approach of recent announcements is unfortunate. Many of the measures have been forward-looking in any event, and it is not clear why the measures could not have been announced together.

"Clearly the intention of the measure is to curb the rise of holiday home and buy-to-let properties. The proliferation of these properties is perceived to have caused damage to the local communities of certain areas."

Predictably, there is some vigorous lobbying underway. It remains to be seen what form the draft legislation will be in when it is published in due course.

April 2017: Extension of I.H.T. to Indirectly Held U.K. Residential Property

Finally, as part of the 2015 Summer Budget, the government announced a number of significant reforms to inheritance tax ("I.H.T.") and the concept of domicile. Broadly, I.H.T. is a charge to tax primarily on an individual's estate on death. The rate is 0% on the nil rate band, 20% for any taxable lifetime gifts, and 40% on death. An individual who is domiciled in the U.K. is subject to I.H.T. on his or her worldwide estate. An individual who is not domiciled in the U.K. is subject to I.H.T. only in respect of his or her U.K. estate. Under current rules, U.K. property does not include shares in a foreign registered company, even where that company's only asset is U.K. land. However, with effect from 2017, "U.K. property" will include U.K. residential property, even where it is indirectly held through a foreign-registered and -resident company.

As was true for the extension of C.G.T. to non-residents, the change represents a very fundamental policy shift in the U.K.'s approach to the taxation of certain foreign nationals. Historically, the U.K. has provided an extremely hospitable economic climate to the foreign investor. The sands now appear to be shifting but only in respect of residential property, at least for the current time.

Residential vs. Non-residential: Why?

As is abundantly clear, a key feature of a number of the more penal tax developments is that they apply only to "residential" property. The economic consequences of finding that a property is residential in nature are therefore very significant. Not only will it dramatically affect the rates of S.D.L.T., it can also affect the incidence of the A.T.E.D., C.G.T., and I.H.T. Clearly, this puts huge pressure on the distinction.

So what does the term "residential property" mean? The definition largely turns on whether or not the land includes buildings suitable for use as a "dwelling." Specifically, property is regarded as residential if it comprises land and/or buildings

- used as a dwelling,
- suitable for use as a dwelling, or
- in the process of being constructed or adapted for use as a dwelling.

Note that for S.D.L.T. purposes, the higher rates apply only where the land transaction is comprised "entirely" of residential property. Where the property is mixed use (that is, it includes residential and non-residential property), the lower non-residential S.D.L.T. rates will apply.

However, the fact that part of what is otherwise a dwelling is used for business purposes does not necessarily result in a finding that the property is not residential. The key question is whether the building is suitable for use as a dwelling. The distinction is not always an easy one to make. By way of example, a five-bedroom farm house with 20 acres used for commercial agricultural purposes would be mixed use and would qualify for the lower rates. On the other hand, the same house with 20 acres of parkland and the neighbor's chickens on the field at the bottom of the drive might not.

Inevitably, a number of so-called "tax planning" schemes (some more accurately described as fairytales) seek to exploit this distinction. Some of the schemes are eye-wateringly creative and undoubtedly ineffective. We can expect increasing H.M.R.C. scrutiny in this area.

What is not clear is why the U.K. government has chosen to impose such different fiscal treatment on the basis of a distinction that is in some cases both arbitrary and esoteric, and more importantly, difficult to predict. What is it about residential property that justifies this disadvantageous treatment? Many other jurisdictions do not make the distinction at all in terms of tax treatment.

THE LAFFER CURVE

Tax specialists are sometimes reputed to be inaccessible and nerdy. (I believe my U.S. friends refer to this as "dweeb-like.") This is plainly an absurd proposition, and one which I am loathe to promote by including abstract references to academic constructs without practical purpose. Instead, I will refer simply to the Laffer Curve.

The Laffer Curve demonstrates, in diagrammatic form, the behavioral economics principle that increasing the rate of tax does not continue to result in higher tax yield; indeed, the converse is true. Although increases in rates of tax at certain levels may increase total tax take, at some point, an increase in the rate will dis-incenti*vize* the activity producing the asset. At one end of the spectrum (the beginning of the curve), the tax rate is zero, as is tax take. There may be plenty of economic activity, but no tax is levied on it. On the other side of the curve (the end), the tax rate is 100%, and the tax take is also zero. The tax rate has extinguished economic activity. This is referred to, at times, as making others pay their "fair share" of tax.

The peak of the curve is the holy grail of good tax policy. It represents the maximum level at which a government can tax any particular activity before dis-incenti*vizi*ng it to levels at which tax yields decrease. In other words, it is important to tax (in this case) property investors until Lord Healy's pips squeak, but not to continue to do so to the point of a thermonuclear explosion.

Clearly, the U.K. government feels that the U.K. real estate sector is sufficiently robust to withstand the recent fiscal assaults. In other words, it believes that the Laffer Curve applicable to residential property is still in its ascendancy. However, at some point, the zenith will be reached. What then? And who will benefit at that time? Most likely, it will be the ultra, ultra-wealthy, as only they will be immune from the tax increase.

THE REAL, IMPRECISE, AND IMPERFECT WORLD

However, economics is not the only driving force behind tax policy. Tax policy does not operate in an academic vacuum. Rather, it is formed in a rather more real, imprecise, and imperfect world, in which rather more real, imprecise, and imperfect politicians (with varying degrees of intellect, personality, and competing motives) jostle for power and position, and the maximum length of fiscal foresight tends to be pretty much around the five-year mark.

In this rather more real, imprecise, and imperfect world, tax policy makers must make decisions about who, what, and how much to tax in response to any number of domestic and global economic, social, and natural events. They must then defend these positions to the media, the lobbyists, and the ever-powerful court of public opinion. Budget Day announcements undoubtedly often owe more to extravagant political posturing than to the Laffer Curve.

As mentioned above, one of the more frequent criticisms of the recent changes has been their fragmented and piecemeal development. Where is the reasoned and coherent tax policy? However, it may be that in this rather more real, imprecise, and imperfect world, it is unrealistic and even undesirable for governments to impose rigid long-term fiscal policies. Instead, it may be that an iterative approach is the ideal. It allows policymakers to respond to the changing economic and social factors and the vagaries of the tax take. Which is not to say that policymakers should abandon efforts to design and pursue a careful and coherent tax policy, but neither should they be restricted from reacting appropriately to necessity and expedience.

The U.K. enjoys a hugely successful property industry. Under the circumstances, perhaps it is not surprising that the U.K. government has sought to exploit that fact.

WHERE TO NOW?

How is the market to make sense of it all? Clearly, the taxation of real estate in the U.K. is a fast-moving and increasingly specialized area. The intricacies of many of the relevant taxes proliferate, and their interactions can be difficult to quantify in advance. Who should invest, in what form, from what jurisdiction, and in accordance with what terms? How should the property be used? The tax practitioner may find that it is best to be agile in planning, including flexibility in that investment structures so that they may be modified on the fly in response to changes of policy.

It remains to be seen whether some of recent residential property developments will be extended to commercial and mixed property. It is also possible – maybe even likely – that the government will seek to tinker with the definition of residential property or remove it entirely.

Meanwhile, it is perhaps not surprising that we are seeing an increased appetite for investment in commercial property.

TAXPAYERS TAKE NOTE: I.R.S. PUBLISHES AUDIT GUIDES FOR INTERNATIONAL EXAMINERS

Author
Stanley C. Ruchelman

Tags
Branch Rule
Code §367(d)
Form 5471
Intangible Property
International Practice Units
LB&I
Penalties
Subpart F

The Large Business & International ("LB&I") Division of the I.R.S. is responsible for examining tax returns reporting international transactions. It is in the process of revising the method by which returns are chosen for examination and the the process by which those examinations are conducted. As part of the announced changes, it has published the guidance given to international examiners developing issues as part of an examination.

Historically, wide latitude was given to field examiners to identify and develop issues in the course of an examination. With budget cuts in the I.R.S., there is an emphasis on analyzing how the examination process can be conducted more efficiently. The decision reached is to identify returns and issues through a centrally controlled process. Once an examination begins, LB&I will control the process that will be followed by the examiners.

The goal is to expand the examination base to cover companies with assets between $100 million and $1 billion. According to the I.R.S., taxpayers within this group are "underserved" by the I.R.S. To standardize the process, examiners are being retrained and guidance on specific issues has been prepared in the form of the International Practice Units ("I.P.U.'s"). By the latter part of 2015, 128 I.P.U.'s were prepared and 65 of those I.P.U.'s were published. The I.R.S. believes that this will facilitate the completion of audits because taxpayers and their advisers will not be surprised by detailed document requests designed to generate facts upon which a reasoned decision can be made regarding an adjustment.

In this edition of *Insights*, we address the following International Practice Units:

- Application of the branch rule of Subpart F, which treats branches as if they are subsidiaries where manufacturing operations are separated from sales operations and foreign tax savings are derived
- Application of deemed royalty provisions under Code §367(d) when intangible property is contributed to a foreign subsidiary in a tax-free transaction
- Methods to identify companies that are controlled foreign corporations and U.S. persons that are U.S. Shareholders subject to tax under Subpart F
- Determining whether foreign subsidiaries that use intangible property owned by related parties in the U.S. make arm's length payments in consideration for that use
- Penalties that will be imposed when a U.S. taxpayer fails to prepare a Form 5471 in connection with a foreign subsidiary

We trust it will help the reader when an international examiner begins an examination of international issues.

INTERNATIONAL PRACTICE UNIT:
I.R.S. RELEASES SUBPART F SALES AND MANUFACTURING RULES

Authors
Beate Erwin
Kenneth Lobo
Stanley C. Ruchelman

Tags
C.F.C.
Branch Rule
F.B.C. Sales Income
International Practice Units
LB&I
Subpart F

Over the summer, the I.R.S. released two International Practice Units ("I.P.U.'s") providing guidance regarding the use of branches to avoid foreign base company sales income ("F.B.C. Sales Income"), a category of "Subpart F" income. I.P.U.'s provide insight on how I.R.S. examiners will audit U.S. multinationals and global supply chains. If a client is being audited by the I.R.S., tax practitioners may be able to anticipate the I.R.S.'s next steps or question an approach that does not follow the guidance in an I.P.U.

CONTROLLED FOREIGN CORPORATION RULES

A U.S. shareholder of a controlled foreign corporation ("C.F.C.") must include in gross income a *pro rata* share of the C.F.C.'s Subpart F income.[1]

A foreign (non-U.S.) corporation is a C.F.C. if more than 50% of the total combined voting power of all classes of stock entitled to vote, or if the total value of the stock of such corporation, is owned directly or indirectly by U.S. shareholders on any day during the corporation's taxable year. Such indirect ownership may exist through a corporation, partnership, or trust owned by the U.S. shareholder or constructively through a related party.[2] Thus, a corporation is a C.F.C. if it meets either the total combined voting power test or the total value of the stock test.

A "U.S. shareholder" is a U.S. person who owns directly, indirectly, or constructively (applying 10% or more of the combined voting power of all classes of stock of such corporation entitled to vote).[3] Once a practitioner identifies a C.F.C., he or she must identify whether that C.F.C. earns Subpart F income. If it does, then the Subpart F income will be included in the income of the C.F.C.'s shareholders.

F.B.C. SALES INCOME – LEGAL BACKGROUND

The F.B.C. Sales Income provision is designed to deny tax deferral where a sales subsidiary is separated from the manufacturing activities and organized in another country in order to have the sales income subjected to a lower tax rate when customers are located in a third country. It is one of the most important categories of Foreign Base Company Income ("F.B.C.I.") to an international manufacturing and sales operation.

Under Code §954(d), F.B.C. Sales Income is income that meets the following three conditions:

1 Code §951.
2 Code §§958(a), 958(b), 957(a).
3 Code §§951(b), 958(b), 958(a).

> "The F.B.C. Sales Income provision is designed to deny tax deferral where a sales subsidiary is separated from the manufacturing activities & organized in another country in order to have the sales income subjected to a lower tax rate when customers are located in a third country."

1. The income is derived in connection with the purchase of personal property from a related person and the sale to any person, or the purchase of property from any person and the sale to a related person.

2. The property is manufactured, produced, grown, or extracted outside of the C.F.C.'s country of incorporation.

3. The property is sold for use, consumption, or disposition outside of the C.F.C.'s country of incorporation.

In addition, F.B.C. Sales Income also comprises commissions and fees earned by a C.F.C. from the sale of, or fees earned from the purchase of, property that is produced and sold for use outside of the C.F.C.'s country of incorporation, when the underlying sale or purchase is made on behalf of a related party.[4]

In other words, F.B.C. Sales Income arises only where

- the C.F.C. is involved in a purchase and sale of property where a related person is involved, and
- the property is both manufactured and sold for use outside the C.F.C.'s country of incorporation.

Thus, F.B.C. Sales Income does not include income derived from a C.F.C. partaking in the following activities:

- Buying from and reselling to unrelated persons (*i.e.*, it acts as an independent distributor)
- Buying and reselling property manufactured, produced, grown, or extracted in its country of incorporation, regardless of whether a related party is involved
- Buying and reselling property for use, consumption, or disposition within its country of incorporation, regardless of whether a related party is involved
- Manufacturing the property that it sells (the "manufacturing exception")[5]

THE MANUFACTURING BRANCH RULE

Legal Background

Under certain circumstances, Code §954(d)(2) prevents a C.F.C. from using a manufacturing branch to circumvent the F.B.C. Sales Income test. If the use of a manufacturing branch located outside of the C.F.C.'s country of incorporation "has substantially the same tax effect" ("S.S.T.E.") as if the branch were a wholly-owned subsidiary corporation, the income attributable to the manufacturing activity is treated as derived by a corporation separate from the C.F.C.[6]

Sale by C.F.C. to Unrelated Parties of Products Manufactured by Branch

A manufacturing branch will be considered to have S.S.T.E. as a wholly-owned subsidiary corporation if income allocated to the rest of the C.F.C. is taxed at an effective

[4] Code §954(d)(1).

[5] Treas. Reg. §1.954-3(a)(4).

[6] Treas. Reg. §1.954-3(b).

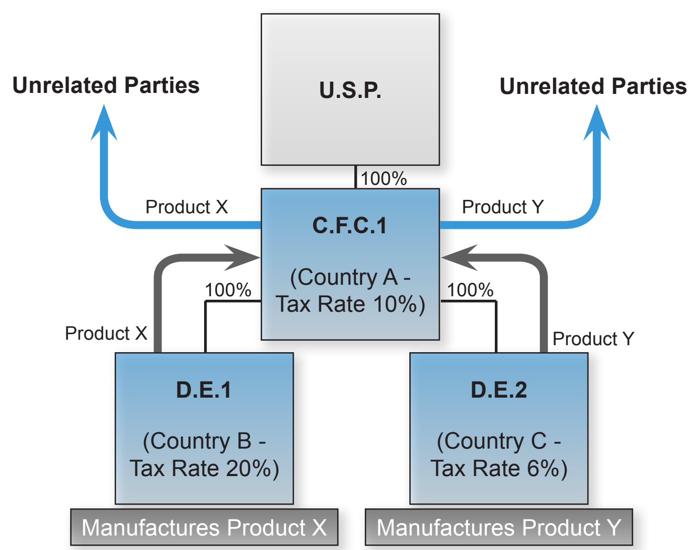
rate of tax ("E.R.T.") that is less than 90% of, and at least 5 percentage points lower than, the rate of tax that would apply to such income if, under the laws where the branch is located, all the income of the C.F.C. were allocated to the branch and treated in that country as being attributable to a permanent establishment. This is known as the manufacturing branch tax rate disparity ("T.R.D.") test.[7] If the E.R.T. under the hypothetical facts meets the percentage differential mentioned above – meaning the E.R.T. in the country of manufacture is greater than the E.R.T. actually paid by the rest of the C.F.C. – the branch is treated for Subpart F purposes as if it were a wholly-owned subsidiary of the C.F.C. (*i.e.*, a "related person" for purposes of applying the foreign base company sales provisions). The remainder of the C.F.C. will be treated as selling on behalf of the manufacturing branch and the C.F.C. will have F.B.C. Sales Income

The I.P.U. explicitly states that it addresses cases targeted by Code §954(d)(2) where a U.S. shareholder of a C.F.C. attempts to avoid the F.B.C. Sales Income rules by shifting the sales income to a lower-tax country through the use of a branch – which is disregarded for U.S. tax purposes – instead of a separate C.F.C.

Limitations Acknowledged

According to the I.P.U., if income is F.B.C. Sales Income without regard to the branch rules, or if the income would not be F.B.C. Sales Income if derived by a separate C.F.C., the branch rules are not invoked.[8] Hence, the I.R.S. auditor is advised to first apply the F.B.C. Sales Income rules without treating the branch as a separate corporation, and should not apply the branch rules where the income would not be F.B.C. Sales Income if the branch were a separate C.F.C.

TRANSACTION AND FACT PATTERN[9]



7 Treas. Reg. §1.954-3(b)(1)(ii)(b).

8 So-called priority of application and comparison with ordinary treatment rules under Treas. Reg. §1.954-3(b)(2)(ii)(f), and Treas. Reg. §1.954-3(b)(2)(ii)(e), respectively.

9 See AM2015-002 for information on the computation of the E.R.T.

- C.F.C.1 is incorporated in Country A, where the tax rate is 10%.
- D.E.1 is a hybrid entity (incorporated in Country B, where the tax rate is 20%, and disregarded for U.S. tax purposes).[10]
- D.E.2 is a hybrid entity (incorporated in Country C, where the tax rate is 6%, and disregarded for U.S. tax purposes).[11]
- D.E.1 manufactures Product X (from raw materials purchased from unrelated suppliers), and C.F.C.1 sells Product X to unrelated customers outside Country A.
- D.E.2 manufactures Product Y (from raw materials purchased from unrelated suppliers) and C.F.C.1 sells Product Y to unrelated customers outside Country A.

“Note that the E.R.T. for financial statement purposes is not the same as the actual or hypothetical E.R.T. for purposes of the manufacturing branch rule covered in this unit.”

For purposes of this example, it is assumed that the applicable tax rate correlates to the E.R.T. It is noted that in an actual exam fact pattern, the statutory rate will rarely equal the E.R.T. due to variations among tax jurisdictions in exclusions, deductions, credits, and other tax attributes.[12]

According to the I.P.U., the below action steps should be followed by the examiner.

E.R.T. of the Company

The examiner should review the company’s audited financial statements to determine the E.R.T. of the worldwide group for the years at issue and compare it to other companies in the same industry. The examiner should look for the total permanently reinvested offshore income (“P.R.I.”). Note that the E.R.T. for financial statement purposes is not the same as the actual or hypothetical E.R.T. for purposes of the manufacturing branch rule covered in this unit.

The examiner should determine the tax rates for the C.F.C. and each of its branches, including disregarded entities.

Under the facts outlined above, the following can be determined:

- The tax rate in Country A (10%) is lower than the Country B rate (20%), so profits on Product X moved to Country A are taxed at a rate that is 10 percentage points lower than the Country B rate.
- The tax rate in Country C (6%) is lower than the Country A rate (10%), so profits on Product Y moved to Country C are taxed at a rate that is 4 percentage points lower than the Country A rate.

E.R.T. Impact of Adjustment

Assuming (i) the earnings and profits are P.R.I. under APB 23 (now codified as ASC 740-30), and (ii) the income of the C.F.C.’s is not subject to taxation under Subpart F, the corporate group is able to reduce its worldwide E.R.T. by shifting profits outside

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[10] A disregarded entity is treated as a branch for U.S. tax purposes.

[11] Treas. Reg. §1.954-3(b).

[12] See AM2015-002 for information on the computation of the E.R.T.

the U.S. (or from a higher-tax foreign jurisdiction to a lower-tax foreign jurisdiction). This reduction in worldwide E.R.T. is important for financial reporting purposes.

An inclusion of Subpart F income may increase the financial income tax expense of U.S.P., resulting in higher E.R.T. However, Foreign Tax Credits ("F.T.C.'s") may offset the increase in E.R.T. if the F.T.C.'s are unrecognized deferred tax assets (*e.g.*, a valuation allowance prevents excess F.T.C. carryovers from being recognized in financial statements as a deferred tax asset).

ISSUES TO PURSUE

According to the I.P.U., the following issues should be pursued by the examiner:

1. Should D.E.1 and the remainder of C.F.C.1 be treated as separate corporations under the branch rules?
2. Does C.F.C.1 have F.B.C. Sales Income as a result of its sales of Product X?
3. Should D.E.2 and the remainder of C.F.C.1 be treated as separate corporations under the branch rules?
4. Does C.F.C.1 have F.B.C. Sales Income as a result of its sales of Product Y?[13]

For all issues, the examiners are advised to determine whether F.B.C. Sales Income rules are applicable, *i.e.*, whether C.F.C.1 derives income from the purchase and sale of personal property, where the property is manufactured, and where it is sold for use/consumption.

Examiner's Resources – Taxpayer's Focus of Documentation

The I.P.U. advises examiners to review the following documentation:

- Branch decision trees
- Consolidating financial statements
- Form 5471 for C.F.C.1
- Forms 8858 for D.E.1 and D.E.2
- Transfer pricing studies, if any, prepared for foreign country reporting
- Subpart F functional analysis (or similar documentation), if any
- Global tax and legal organizational charts

In preparation for a potential I.R.S. audit, taxpayers may want to review the above documents in order to present coherent and favorable responses to specific questions.

[13] Note that because the D.E.'s manufacture the goods from which income is derived, the sales income would not be F.B.C. Sales Income (even if they and the remainder of C.F.C.1 were treated as separate corporations).

EXAMINATION PROCESS FOR EACH ISSUE

Issue 1: Should D.E.1 and the Remainder of C.F.C.1 Be Treated as Separate Corporations under the Branch Rules?

This examination program is split into various steps. The examiner is advised by the I.P.U. to apply these steps as follows:

Step 1: Review Potential Issues

The examiner is guided through the steps to determine the T.R.D., the T.R.D. Gross Income, actual tax with respect to that income, the hypothetical tax base, and the hypothetical tax with respect to that base. The goal is to compare the actual tax paid by the branch with the tax that would have been paid if C.F.C.1 manufactured and sold the inventory to unrelated parties from a base in its home country.

These steps are as follows:

1. Determine T.R.D. Gross income, which, in the case of a manufacturing branch in Country B with sales in the remainder of the C.F.C., is the C.F.C.'s gross income derived in connection with the sale of the property in question. This step identifies the income that has been shifted from the country in which manufacturing operations occur (Country B) to the country of the sales base (Country A), as reported by that sales base.

2. Determine the actual tax with respect to the T.R.D. Gross Income (if necessary, this is determined separately from taxes on other income of the C.F.C.). This step identifies the tax imposed by the country in which the sales operations are located (Country A) on the shifted income.

3. Determine the hypothetical tax base in Country B, which is T.R.D. Gross Income reduced by any exclusions and deductions that would be permitted in the manufacturing country (Country B) if the income were derived from sources in Country B through a permanent establishment. This step looks at the shifted income from the viewpoint of the country in which manufacturing occurs. It identifies the income that has been shifted from that country (Country B) to the country in which sales are conducted (Country A), as reported in that country.

4. Multiply the hypothetical tax base in Country B by the applicable marginal tax rate(s) in the manufacturing jurisdiction (Country B determines the hypothetical tax). This step identifies the amount of tax that has been shifted away from the country where manufacturing occurs.

5. Divide the actual tax by the hypothetical tax base in Country B to compute the actual E.R.T., then divide the hypothetical tax by the hypothetical tax base to compute the hypothetical E.R.T. Compare these E.R.T.'s. This step compares the E.R.T. using the income that would have been taxed by the country of manufacture in the absence of a shifting of sales operations. The E.R.T.'s are computed and the comparison is performed.

> ***"The examiner is guided through the steps to determine the T.R.D., the T.R.D. Gross Income, actual tax with respect to that income, the hypothetical tax base, and the hypothetical tax with respect to that base."***

Step 2: Additional Factual Development

The I.P.U. advises the examiner to apply the rules to the facts in issue. In the fact pattern described in the above diagram, the examiner should determine whether the actual E.R.T. in Country A compared to the hypothetical E.R.T. in Country B is less than 90% of, and at least 5 percentage points below, the hypothetical E.R.T. based on Country B tax law. Because this is the case in the example, there is T.R.D. and D.E.1 and the remainder of C.F.C.1 are treated as separate corporations for purposes of determining C.F.C.1's F.B.C. Sales Income

Observations

For the second step above ("*Additional Factual Development*"), the examiner is directed to use the following resources:

- Income Tax Returns filed by C.F.C.1 and D.E.1 in Country A and B
- Transaction contracts/agreements
- Product flows and transaction flowcharts
- Diagrams, analysis, or presentations regarding supply chain (including any supply chain agreements)
- Copies of the tax package, organizer, or similar information from the C.F.C. in order to prepare Forms 5471 and 8858

The taxpayer should be prepared in advance to provide information substantiating the E.R.T. (including credits, deductions, etc.) from the documents listed above.

Issue 2: Does C.F.C.1 Have F.B.C. Sales Income as a Result of Its Sales of Product X?

This examination program is split into various steps. The examiner is advised by the I.P.U. to apply these steps as follows:

Step 1: Review Potential Issues

The I.P.U. advises the examiner to determine whether the necessary facts exist to create F.B.C. Sales Income These facts are as follows:

- A C.F.C. buys/sells personal property from/to (or on behalf of) a related person.
- The property is manufactured, produced, constructed, grown, or extracted outside the C.F.C.'s country of incorporation.
- The property is purchased/sold for use, consumption, or disposition outside the C.F.C.'s country of incorporation.

The income from the sale of property by the C.F.C. is F.B.C. Sales Income unless an exception applies. The U.S. shareholder(s) of the C.F.C. may have a Subpart F inclusion.

Step 2: Additional Factual Development

The I.P.U. advises the examiner to verify whether the sale of Product X by C.F.C.1 falls within the definition of F.B.C. Sales Income (*i.e.*, whether C.F.C.1 sells, on behalf of a related party, property manufactured outside Country A for use outside Country A). In the fact pattern described in the above diagram, C.F.C.1 sold Product X (manufactured outside Country A) for use outside Country A and a T.R.D. exists based on the comparable analysis described above. Consequently, C.F.C.1 is viewed under the branch rule as if it were selling on behalf of D.E.1, a separate, related corporation. C.F.C.1's income from the sale of Product X outside Country A is F.B.C. Sales Income, resulting in a Subpart F inclusion for U.S.P.

Note that D.E.1 would not have F.B.C. Sales Income if it sold Product X itself, even to a related party, because D.E.1 manufactures Product X and therefore the manufacturing exception applies.

Observations

For the second step above ("Additional Factual Development"), it is suggested that the examiner request schedules of sales by destination and copies of local country Value Added Tax ("V.A.T.") returns to verify the place of manufacture, sale, use, or consumption.

A taxpayer in comparable circumstances to C.F.C.1 and D.E.1 may want to consider having D.E.1 sell the products it manufactures, thereby benefitting from the C.F.C. manufacturing exception. The key here is the Country B tax rate that is imposed on the total profits.

"it is prudent for the taxpayer to gather all relevant documentation in order to put forward the best possible argument."

Issue 3: Should D.E.2 and the Remainder of C.F.C.1 Be Treated as Separate Corporations under the Branch Rules?

Here, the analysis is the same as in the first issue. However, factual development in this transaction indicates that the actual E.R.T. with respect to the hypothetical tax base is not less than 90% of, and at least 5 percentage points below, the hypothetical E.R.T. with respect to that base (*i.e.*, there is no T.R.D.). As a result, D.E.2 and the remainder of C.F.C.1 are not treated as separate corporations for purposes of determining C.F.C.1's F.B.C. Sales Income

Observations

As previously stated, it is prudent for the taxpayer to gather all relevant documentation in order to put forward the best possible argument that T.R.D. does not exist. Here the facts were favorable, based on the assumption that the E.R.T. for D.E.2 in the place of manufacture was not significantly greater than the E.R.T, for the balance of the C.F.C.

Issue 4: Does C.F.C.1 Have F.B.C. Sales Income as a Result of Its Sales of Product Y?

Again, based on the facts in the diagram, C.F.C.1 and D.E.2 are not treated as separate corporations because no T.R.D. exists in the facts. C.F.C.1 and D.E.2 are treated under the branch rule as a single economic unit. There is no deemed related party transaction. The income from the sale of Product Y by C.F.C.1 does not qualify as F.B.C. Sales Income Even if the raw materials used to manufacture

Product Y were purchased from related parties, C.F.C.1 would not be deemed to derive F.B.C. Sales Income under the C.F.C. manufacturing exception.[14]

Observations

It is noted in the I.P.U. that if the income from the sale of Product X by C.F.C.1 causes C.F.C.1 to meet the "full inclusion" rule, then all the income of C.F.C.1 would be deemed F.B.C. Sales Income, *i.e.*, F.B.C. Sales Income would even include income from the sale of Product Y, which, on a stand-alone basis, would not be F.B.C. Sales Income The full inclusion rule applies when more than 70% of the gross income of a C.F.C. is considered to be Subpart F income. Where such a fact pattern exists, all other income is tainted. In this case, the taxpayer may want to consider having D.E.2 owned by a sister C.F.C. to C.F.C.1.[15]

BRANCH SALES TO UNRELATED PARTIES OF PRODUCTS MANUFACTURED BY C.F.C.

Legal Background

In a second case study to be discussed, although the fact pattern changes materially, the rules outlined above continue to apply. In this case study, the branch sells the products that are manufactured by the C.F.C., *i.e.*, the roles are reversed for the C.F.C. (which is now manufacturing instead of selling as in the first case study) and the branches (which now sell instead of manufacture).

As with a manufacturing branch, the mere existence of a sales branch outside the C.F.C.'s country of incorporation does not necessarily result in F.B.C.S.I to the C.F.C. The T.R.D. test must be applied in order to determine whether the use of the branch has S.S.T.E. as if it were a separate corporation. The T.R.D. test compares the hypothetical E.R.T. with respect to the hypothetical net sales income computed under the laws of the manufacturing jurisdiction, under the assumption that the income is fully taxable in that country, to the actual E.R.T. with respect to the sales income. If there is T.R.D., the use of the branch is said to have S.S.T.E. as if it were a separate corporation, and the branch and the remainder of the C.F.C. will be treated as separate corporations for purposes of determining the C.F.C.'s F.B.C. Sales Income

A T.R.D. will exist if the actual E.R.T. imposed on the income of the sales branch is less than 90% of, and at least 5 percentage points below, the hypothetical E.R.T. that would apply if the actual income of the branch were allocated to the C.F.C. conducting manufacturing operations, and the entire income were taxed in the country of residence of the C.F.C.[16]

If a C.F.C. has more than one sales branch outside the country in which the corporation is organized, the regulations apply the T.R.D. test to the income of each sales branch. In applying the test, the regulations assume that the purchasing or selling branch being tested is the only branch of the C.F.C. and that all of the other sales branches are separate corporations.

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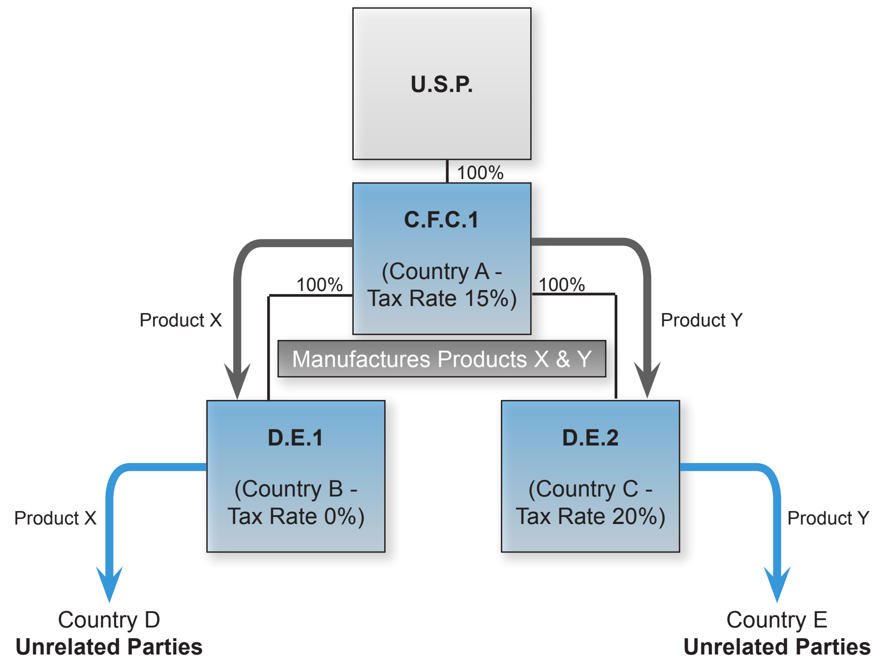
[14] Treas. Reg. §1.954-3(a)(4).

[15] Code §954(b)(3)(B).

[16] Treas. Reg. §1.954-3(b)(1)(i)(c).

TRANSACTION AND FACT PATTERN[17]



- C.F.C.1 is incorporated in Country A, where the tax rate is 15%.
- D.E.1 is a hybrid entity (incorporated in Country B, where the tax rate is 0%, and disregarded for U.S. tax purposes).
- D.E.2 is a hybrid entity (incorporated in Country C, where the tax rate is 20%, and disregarded for U.S. tax purposes).
- C.F.C.1 manufactures Products X and Y from raw materials purchased from unrelated suppliers (D.E.1 and D.E.2 do not perform any manufacturing activities).
- D.E.1 sells Product X to unrelated third parties in Country D (*i.e.*, D.E.1 is a selling branch of C.F.C.1).
- D.E.2 sells Product Y to unrelated third parties in Country E (*i.e.*, D.E.2 is a selling branch of C.F.C.1).

It is noted that if C.F.C.1 derived income from its own sales of Products X and Y to D.E.1 or D.E.2, such income would not be F.B.C. Sales Income because C.F.C.1 would qualify for the "C.F.C. manufacturing exception." This is true even if the use of D.E.1 or D.E.2 has S.S.T.E. as if they are separate corporations.

For purposes of the example, it is assumed that the applicable tax rate correlates to the E.R.T.

According to the I.P.U., the following action steps should be followed by the examiner.

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17 I.P.U. DPL/9412.01_08(2015), updated as of August 3, 2015.

E.R.T. of the Company

As in the prior example related to a manufacturing branch, the I.P.U. directs the examiner to review the audited financial statements to determine the E.R.T. of the worldwide group and its P.R.I.

The examiner should determine the tax rates for the C.F.C. and each of its branches, including disregarded entities.

The examiner is reminded that the statutory rate will rarely equal the E.R.T. due to variations among tax jurisdictions in exclusions, deductions, credits, and other tax attributes.

Under the facts of the example, the following can be determined:

- The tax rate in Country A (15%) is lower than the U.S. rate (35%), so profits moved to Country A are taxed at a rate that is 20 percentage points lower than the U.S. rate.
- The tax rate in Country B (0%) is lower than the Country A rate (15%), so profits on Product X moved to Country B are taxed at a rate that is 15 percentage points lower than the Country A rate.

This illustrates why the I.R.S. places emphasis on identifying possible F.B.C. Sales Income – so that the 20% tax savings under the structure above may be recaptured.

E.R.T. Impact of Adjustment

Again, if the earnings are P.R.I. under ASC 740-30 and the sales do not generate F.B.C. Sales Income that is taxed under Subpart F, the corporate group can shift profits outside the U.S. (or from a higher-tax foreign jurisdiction to a lower-tax foreign jurisdiction). This reduction in worldwide E.R.T. is important for financial reporting purposes.

An inclusion of Subpart F income may increase the financial income tax expense of U.S.P., resulting in higher E.R.T. However, F.T.C.'s may offset the increase in E.R.T. if the F.T.C.'s are unrecognized deferred tax assets.

ISSUES TO PURSUE

According to the I.P.U., the same issues should be pursued by the examiner as were identified in the prior case study:

1. Should D.E.1 and the remainder C.F.C.1 be treated as separate corporations under the branch rules?
2. Does C.F.C.1 have F.B.C. Sales Income as a result of its sales of Product X?
3. Should D.E.2 and the remainder of C.F.C.1 be treated as separate corporations under the branch rules?
4. Does C.F.C.1 have F.B.C. Sales Income as a result of its sales of Product Y?

For all issues, the examiners are advised to determine whether F.B.C. Sales Income rules are applicable, and if they are, whether C.F.C.1 derives income from D.E.1's sales of Products X to unrelated parties. The I.P.U. directs the examiner to identify where the property is manufactured and where it is sold for use/consumption. In addition, the examiner needs to determine whether C.F.C.1 sells by or through D.E.1 or D.E.2.

Examiner's Resources – Taxpayer's Focus of Documentation

The examiners' resources are the same as in the prior example. They include the following:

- Branch decision trees
- Consolidating financial statements
- Form 5471 for C.F.C.1
- Forms 8858 for D.E.1 and D.E.2
- Transfer pricing studies, if any, prepared for foreign country reporting
- Subpart F functional analysis (or similar documentation), if any
- Global tax and legal organizational charts

Observations

Again, the foregoing forms and documents should be reviewed in advance by taxpayers in order to prepare responses for potential audit questions.

EXAMINATION PROCESS FOR EACH ISSUE

Issue 1: Should D.E.1 and the Remainder C.F.C.1 Be Treated as Separate Corporations under the Branch Rules?

This examination program is split into various steps. The examiner is advised by the I.P.U. to apply these steps as follows:

Step 1: Review Potential Issues

As in the prior case study, the examiner is guided through the steps to determine the T.R.D., the T.R.D. Gross Income, actual tax with respect to that income, the hypothetical tax base, and the hypothetical tax with respect to that base. The goal is to compare the actual tax paid by the branch with the tax that would have been paid if C.F.C.1 manufactured and sold the inventory to unrelated parties from a base in the home country.

The steps are as follows:

1. Determine T.R.D. Gross income, which, in the case of a sales branch, is the branch's gross income derived in connection with the sale of the property manufactured by C.F.C.1. This step identifies the income that has been shifted from the country in which manufacturing operations occur to the country of the sales base, as reported by that sales base.

> ***"As in the prior case study, the examiner is guided through the steps to determine the T.R.D., the T.R.D. Gross Income, actual tax with respect to that income, the hypothetical tax base, and the hypothetical tax with respect to that base."***

2. Determine the actual tax with respect to the T.R.D. Gross Income (if necessary, this is determined separately from taxes on other income of the sales branch). This step identifies the tax imposed on the shifted income by the country in which the sales base is located.

3. Determine the hypothetical tax base (i) which is the T.R.D. Gross Income of the branch, (ii) which is allocated to C.F.C.1 in the computation and treated as permanent establishment income in that country, and (iii) is then reduced by any exclusions and deductions that would be permitted in the manufacturing country. This step looks at the shifted income from the viewpoint of the country in which manufacturing occurs. It identifies the income that has been shifted from that country to the country of the sales base, as reported by that sales base.

4. Multiply the hypothetical tax base by the applicable marginal tax rate(s) in the manufacturing jurisdiction to determine the hypothetical tax. This step identifies the amount of tax that has been shifted away from the country where manufacturing occurs.

5. Divide the actual tax of the branch by the hypothetical tax base in the country of manufacture in order to compute the actual E.R.T., and then divide the hypothetical tax by the hypothetical tax base to compute the hypothetical E.R.T. Compare these E.R.T.'s. This step compares the E.R.T. using the income that would have been taxed by the country of manufacture in the absence of a sales base. The E.R.T.'s are computed and the comparison is performed.

Step 2: Additional Factual Development

The I.P.U. advises the examiner to apply the rules to the facts in issue. In this case study, this means that the examiner must determine whether computing the E.R.T. using the actual tax in Country B (where the sales base is located) and the adjusted income in Country A (where the manufacturing base is located) produces an E.R.T. that is less than 90% of, and at least 5 percentage points below, the E.R.T. that would have been incurred under the assumption that the sales were not shifted to Country A. If so, there is T.R.D., and D.E.1 and the remainder of C.F.C.1 are treated as separate corporations for purposes of determining C.F.C.1's F.B.C. Sales Income

Step 3: Develop Arguments

The examiner is directed to look at the following items in carrying out this step:

- Income tax returns filed by C.F.C.1 and by D.E.1
- Transaction contracts/agreements
- Product flows and transaction flowcharts
- Diagrams, analysis, or presentations regarding supply chain (including any supply chain agreements)
- Tax package or organizer used by the C.F.C. to provide information used to prepare Form 5471 and Form 8858

Issue 2: Does C.F.C.1 Have F.B.C. Sales Income as a Result of Its Sales of Product X?

The factual development in this transaction indicates that D.E.1 sells Product X on behalf of C.F.C.1 outside Country B. Although D.E.1 sells to unrelated parties, it does so on behalf of a related party. Consequently, D.E.1's income from the sale of Product X outside Country B is F.B.C. Sales Income, resulting in a Subpart F inclusion to the U.S. parent. The 20-point tax saving from the structure is eliminated.

Issue 3: Should D.E.2 and the Remainder of C.F.C.1 Be Treated as Separate Corporations under the Branch Rules?

This issue replicates the steps that were performed regarding D.E.1. Here, the E.R.T. in Country C is 20%, which exceeds the E.R.T. in Country A. Consequently, if the methodology of computing the tax base in Country C is comparable to the tax methodology used in Country A – meaning that income and expense recognition rules are comparable in both countries – the actual E.R.T. with respect to the hypothetical tax base is not less than 90% of, and at least 5 percentage points below, the hypothetical E.R.T. with respect to that base. There is no T.R.D. As a result, D.E.2 and the remainder of C.F.C.1 are not treated as separate corporations for purposes of determining C.F.C.1's F.B.C. Sales Income.

"The I.P.U.'s may serve taxpayers twofold: first, as guidance for taxpayers on documentation to have in place for future I.R.S. audits and second, as tool for identifying reorganization potentials of their structures."

Issue 4: Does C.F.C.1 Have F.B.C. Sales Income as a Result of Its Sales of Product Y?

The factual development in this transaction indicates that C.F.C.1 and D.E.2 are viewed as a single economic unit. D.E.2 and the remainder of C.F.C.1 are not treated as separate corporations. Consequently, C.F.C.1 would not have F.B.C. Sales Income from D.E.2's sales of Product Y because it qualifies for the C.F.C. manufacturing exception from F.B.C. Sales Income.[18]

CONCLUSION

The two I.P.U.'s issued in the summer outline the examination process that will be followed by a U.S.-based group that manufactures inventory through a C.F.C. having manufacturing operations in one country and sales operation in another country. F.B.C. Sales Income may be generated when the inventory is intended to be sold for consumption or use in a third country. The branch rule may apply when manufacturing operations are conducted by a branch of the C.F.C. and sales operations are conducted by the main office of the C.F.C. in its country of incorporation, or when the main office manufactures and a branch carries out sales operations. If the bifurcation between manufacturing and sales results in a tax saving overseas, the branch rule may apply in appropriate circumstances. The I.P.U.'s may serve taxpayers twofold: first, as guidance for taxpayers on documentation to have in place for future I.R.S. audits and second, as tool for identifying reorganization potentials of their structures. This may require the D.E. make a substantial contribution to manufacturing of personal property it sells (which itself causes the D.E. to be viewed as the manufacturer under the contract manufacturer provision in the regulations)[19] or separating product lines between sister C.F.C.'s to avoid the full inclusion rule for the sale of products by a C.F.C. that would otherwise not result in F.B.C. Sales Income on a stand-alone basis.

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18 Treas. Reg.1.954-3(a)(4).

19 Treas. Reg. 1.954-3(a)(4)(iv).

INTERNATIONAL PRACTICE UNIT: DEEMED ANNUAL ROYALTY INCOME UNDER CODE §367(D)

Author
Christine Long

Tags
Code §367(d)
Code §936(h)(3)(B)
Deemed Royalty
Foreign Goodwill
Going Concern
Intangible Property
International Practice Units
LB&I

INTRODUCTION

The I.R.S.'s Large Business and International ("LB&I") Division issued a new International Practice Unit on November 4, 2015 called the "Deemed Annual Royalty Income Under I.R.C. 367(d)." This Practice Unit is concerned with how U.S. taxpayers attempt to reduce or eliminate Federal tax consequences under Internal Revenue Code[1] §367(d) when (i) ownership of valuable intangible property ("I.P.") is transferred to a related corporation outside the U.S. pursuant to an exchange under Code §§351 or 361 and (ii) the related person is resident in a low-tax jurisdiction.

Generally, Code §§351 and 361 apply nonrecognition treatment to the transfer of property solely in exchange for stock in the corporation either (i) as a contribution in which the transferor retains control or (ii) pursuant to a plan of reorganization. However, the Code §§351 or 361 exchange will become taxable under Code §367(d) when a U.S. person or entity transfers any I.P. to a foreign corporation. A contingent sale of the I.P. is deemed to occur when the deemed contingent gain payments are treated as a royalty. Typically, this triggers ordinary income for the U.S. entity. Some U.S. taxpayers attempt to avoid this tax or reduce the amount of the deemed royalty by asserting that most of the transferred intangibles are foreign goodwill and going concern values, which are not covered by Code §367(d). This Practice Unit focuses on how to identify the exploitation of Code §367(d) and the issues that arise in an examination.

BACKGROUND

As a way to reduce the effective tax rate, a U.S. entity may transfer I.P. offshore to another foreign corporation through a nonrecognition transfer pursuant to Code §§351 or 361. Under Code §351, no gain or loss is recognized when property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation if immediately after the exchange the group of transferors are in control of the recipient corporation. Under Code §361, no gain or loss is recognized by a corporation that is a party to a reorganization when it exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation that is a party to the reorganization. Under Code §367(d), however, these nonrecognition transactions are subject to income tax.

Code §367(d) provides that when a U.S. person transfers any I.P. to a foreign corporation pursuant to Code §§351 or 361, the U.S. transferor is treated as if it sold the I.P. in exchange for a continuing stream of annual payments. Sales of I.P. for

[1] All section references are to the Internal Revenue Code of 1986, as amended, (the "Code") and the regulations promulgated thereunder.

contingent consideration based on productivity or use are generally treated as giving rise to royalty payments, subject to recovery of basis over the course of the payment stream. The deemed royalty is characterized as ordinary income over the useful life of the property, not to exceed 20 years. The annual royalty payment will increase taxable income and the effective tax rate of the U.S. transferor annually. If, within the intangible's useful life, the foreign corporation subsequently disposes of the property to an unrelated party, the U.S. transferor must recognize all inherent gain equal to the difference between the fair market value of the property and its adjusted basis. Code §482 and the accompanying I.R.S. regulations establish the arm's length and commensurate with income standards that are used to determine the amount of the deemed royalty.[2]

Code §936(h)(3)(B) defines the term "I.P." to mean any

- patent, invention, formula, process, design, pattern, or know-how;
- copyright, literary, musical, or artistic composition;
- trademark, trade name, or brand name;
- franchise, license, or contract;
- method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
- any similar item, which has substantial value independent of the services of any individual.

Code §367(d) does not apply to the transfer of foreign goodwill or going concern ("F.G.W.G.C.") value because Treas. Reg. §1.367(d)-1T(b) provides there is no tax on the transfer of F.G.W.G.C. to a foreign corporation in a Code §§351 or 361 transaction.[3] Foreign goodwill is defined in Treas. Reg. §1.367(d)-1(T)(d)(5)(iii) as the residual value of a foreign business operation conducted outside the U.S. after all other tangible and intangible assets have been identified. This Practice Unit points out that the identification of transferred tangible and intangible assets is critical in analyzing I.P. transfers and cautions that if a substantial portion of the total transfer value is F.G.W.G.C., the transaction should be evaluated carefully and may require specialized resources.[4]

TRANSACTION AND FACT PATTERN

The Practice Unit provides an example of when a U.S. taxpayer's transfer of I.P. to a foreign corporation is treated as a deemed annual royalty income inclusion under Code §367(d) in order to demonstrate how an I.R.S. examiner should perform an audit.

The Practice Unit's fact pattern consists of a U.S. person ("U.S.P.") that is a multinational technology company. U.S.P. incorporates a controlled foreign corporation

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[2] "Deemed Annual Royalty Income Under IRC 367(d)," LB&I International Practice Service Transaction Unit, 11/4/2015, p.3.

[3] *Id.*

[4] *Id.*, p. 4.

("C.F.C. 1") in a low-tax foreign country. U.S.P. transfers valuable I.P., including assets to operate the business, to C.F.C. 1 in exchange for stock in a Code §351 transaction. C.F.C. 1 was previously a foreign branch of U.S.P. that operated with minimal profits in the prior two years. U.S.P. also transferred a significant number of interrelated license agreements to C.F.C. 1 with an average term of 12 years. U.S.P. valued each license agreement separately (not in the aggregate) in its study.

U.S.P. reported on its tax return that a large percentage of the transferred I.P. consisted of F.G.W.G.C. U.S.P. does not receive a royalty from C.F.C. 1. U.S.P. reported the transaction as a Code §367(d) transaction. U.S.P. incorporated its foreign branch and contributed all of the branch assets and additional I.P. to C.F.C. 1 in exchange for stock as part of a Code §351 transaction. Former U.S.P. engineers became employees of C.F.C. 1. These engineers brought significant technical knowhow and reference materials, including manuals and software that were developed by them while being employed by U.S.P. The study provided by U.S.P. identified that a large percentage of the transferred I.P. consisted of F.G.W.G.C. and separately valued the license agreements. In the study, U.S.P. stated that the useful life of the licenses and knowhow is five years. The contracts and other interrelated licenses that U.S.P. transferred to C.F.C. 1 have significant synergistic value.[5]

ISSUES & AUDIT PROCEDURES

The Practice Unit identifies three potential issues that examiners should focus on when a U.S. taxpayer transfers I.P. to a foreign corporation pursuant to Code §§351 or 361 and the income is deemed to be an annual royalty under Code §367(d):

1. Has all the Code §936(h)(3)(B) I.P. transferred from U.S.P. to C.F.C. 1 pursuant to Code §351 been properly identified for purposes of applying Code §367(d)?

2. Did U.S.P. properly value foreign goodwill or going concern pursuant to Treas. Reg. §§1.367(d)-1T(b)?

3. Did U.S.P. properly value the Code §936(h)(3)(B) intangible assets for purposes of computing the Code §367(d) deemed royalty?[6]

The Practice Unit provides a step-by-step approach for conducting an audit of each issue. The first step, which applies to all three issues, is to ensure that the transferred I.P. has been properly identified, for purposes of Code §367(d), by establishing the facts and supporting documentation. The examiner must confirm that U.S.P. actually transferred I.P. to C.F.C. 1 in exchange for stock pursuant to Code §351. In addition, the examiner must confirm that U.S.P. reported this transfer as a Code §367(d) transaction. The examiner must also confirm that the U.S.P. incorporated its foreign branch and contributed all of the branch assets and additional I.P. in exchange for stock pursuant to Code §351. Then, the examiner is instructed to determine whether this is in fact a Code §367(d) transaction, and if so, verify if former U.S.P. engineers became employees of the C.F.C. The Practice Unit suggests referring to the following I.R.S. forms:

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5 *Id.*, p. 5-6.

6 *Id.*, p. 8.

- Form 926, *Filing Requirement for U.S. Transferors of Property to a Foreign Corporation*, Part III, Intangible and Part IV, line 17a
- Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, Schedule O and Section E
- Form 1120, *U.S. Corporation Income Tax Return*, Disclosures Pursuant to Code §6038B[7]

The Practice Unit also suggests that examiners request or consider the following documents from the U.S.P. or C.F.C. 1 in order to effectively investigate the taxpayers' transactions:

- Transfer pricing documentation and background documentation
- Pre- and post-transfer organizational charts
- Contracts containing critical facts of the I.P. transfer and reorganization
- I.P. valuation

"The Practice Unit warns that most I.P. transfers have a substantial residual value amount that is classified as foreign goodwill or going concern."

When the documentation is provided, the Practice Unit directs the examiner to

- analyze disclosures made on the tax return pursuant to Code §351 and §367(d) as well as Form 926,
- identify interrelated intangibles from the taxpayer's valuation and transfer pricing studies,
- request the transaction steps,
- verify intangibles transferred from legal documents and contracts, and
- determine if a referral for an economist or engineer is necessary.[8]

Identification of All I.P. Transferred for Purposes of Applying Code §367(d)

In order to address the issue of whether all intangible assets transferred from U.S.P. to C.F.C. 1 have been properly identified for purposes of applying Code §367(d), the Practice Unit emphasizes that the intangibles must clearly be identified. Examiners are aware that taxpayers may transfer intangibles beyond those reported on the return or claimed in the valuation study. The examiner must personally identify and verify all the significant intangibles.

Intangibles that satisfy the definition of Code §936(h)(3)(B) are compensable even though the I.R.S. and some taxpayers may disagree as to whether a particular intangible asset meets this definition. The Practice Unit defines "I.P." under the Code §936(h)(3)(B) definition set forth above. Even if the I.P. at issue may not be specifically named on the list of Code §936(h)(3)(B), it should be included if it is considered to be similar to the items specifically listed. The Practice Unit warns that most I.P. transfers have a substantial residual value amount that is classified as F.G.W.G.C.[9]

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7 *Id.*, p. 9.

8 *Id.*, p. 10.

9 *Id.*, p. 10-11.

The examiner is directed to perform a functional analysis of the I.P. that was transferred in order to clearly identify all the intangibles and determine their values. To assist with analyzing the transfer, the Practice Unit refers to T.A.M. 200907024; Treas. Reg. §1.367(a)-1T(d)(5)(iii); *Hospital Corp. of America v. Commr*, 81 T.C. 520 (1983); and *International Multifoods v. Commr*, 108 T.C. 25 (1997).

The following are the preliminary questions for the examiner to consider:

- Does the valuation date match the transfer date?
- How was the I.P. valued?
- Does the taxpayer's return position include little or no value for I.P. transferred relative to the business enterprise?
- Did the taxpayer identify the transfer as a non-taxable outbound transfer of foreign goodwill and going concern?
- Was the I.P., in fact, transferred via Code §§351 or 361?[10]

After all of the facts are established and the intangibles are properly characterized, the examiner is ready to move to the next issue.

Determining Value of F.G.W.G.C.

In addressing the issue of whether the U.S.P. valued the F.G.W.G.C. properly under Treas. Reg. §1.367(d)-1T(b), the examiners are aware that taxpayers may characterize their transferred I.P. as F.G.W.G.C. in order to avoid tax under Code §367(d). The examiner must determine whether the F.G.W.G.C. value exists, and if so, the examiner must determine its correct value. There is also the issue of whether the goodwill is actually foreign or domestic. If it is domestic, and therefore improperly characterized as foreign, tax is triggered.[11]

"There is also the issue of whether the goodwill is actually foreign or domestic. If it is domestic, and therefore improperly characterized as foreign, tax is triggered."

The Practice Unit explains the crux of the issue as follows:

> When a taxpayer transfers its intangibles offshore through IRC 351 and IRC 361 and categorizes substantially all of it as FGWGC, it:
>
> - Minimizes the value of compensable intangibles under IRC 367(d)so that the federal tax impact from the transfer is reduced (also referred to as 'toll charge');
> - Maximizes the value of foreign goodwill and going concern value because foreign goodwill and going concern value is not compensable (a 'carve out') under IRC 367(d) and is not subject to U.S. taxation.
>
> Treas. Reg. 1.367(d)-1T(d)(5)(iii) provides foreign goodwill is the residual value of a foreign business operation conducted outside the United States after all other tangible and intangible assets have been identified. Often the identification of only some of the transferred assets will result in a large residual value. [The examiner]

10 *Id.*, p. 14.

11 *Id.*, p. 15.

must determine whether this residual value is in fact foreign goodwill or going concern.[12]

Foreign going concern value may exist even if foreign goodwill does not exist. The Practice Unit explains that case law suggests that going concern value is the additional element of value that attaches to property by reason of its existence as an integral part of a going concern. The idea is that even without goodwill, the value of a going concern exists when there is excess earning capacity and the ability of a business to continue to function and generate income without interruption as a consequence of the change in ownership.[13]

"The examiner is instructed to scrutinize any U.S. person who asserts that a large percentage of the transferred I.P. consisted of F.G.W.G.C."

The I.R.S. is concerned about identifying goodwill and going concern intangibles because U.S. some taxpayers attempt to reduce the amount of the deemed royalty under Code §367(d) by claiming that a significant amount of the intangible value is attributable to F.G.W.G.C.[14] The examiner is instructed to scrutinize any U.S. person who asserts that a large percentage of the transferred I.P. consisted of F.G.W.G.C. In the example, U.S.P. attempted to reduce its deemed royalty by reporting a large amount of F.G.W.G.C.[15]

The Practice Unit instructs the examiner to focus on the following:

> The question is whether intangible value categorized as FGWGC by the taxpayer is really another type of IRC 936(h)(3)(B) intangible. Also, it is important to:
>
> - Consider if all tangible and intangible assets have been identified
> - Consider whether the assets are from a foreign business operation conducted outside the United States that may give rise to FGWGC.
>
> In this fact pattern, USP's branch was operating with minimal profit for two years before incorporating, so it is unlikely that the branch would have developed significant FGWGC value during that period.[16]

In assessing the goodwill or going concern assets, the Practice Unit instructs the examiner to refer to the relevant Code provisions:

- Treas. Reg. §§1.367(d)-1T(b)
- T.A.M. 200907024
- HR Rep. No. 98-432 (1984) – Committee Reports on Tax Reform Act of 1984
- S. Rep. No. 98-169 (1984) – Committee Reports on Tax Reform Act of 1984
- P.L. No. 99-514, Sec.1231(e) – 1986 Modification to Code §936

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12 *Id.*, p. 16.
13 *Id.*, p. 17.
14 *Id.*, p. 19.
15 *Id.*
16 *Id.*, p. 21.

- I.R.M. Exhibit 4.61.3-4 – Transfer Pricing Functional Analysis Questionnaire

The Practice Unit also suggests referring to the following cases:

- *Conestoga Transportation Co. v. Commr*, 17 T.C. 506, 514 (1951)
- *United States v. Cornish*, 348 F.2d 175 (9th Cir. 1965)
- *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677, 685 (5th Cir. 1971)
- *Computing & Software, Inc. v. Commr*, 64 T.C. 223, 235 (1975)
- *VGS v. Commr*, 68 T.C. 563 (1977)

Proper Valuation of I.P. When Applying Code §367(d)

According to the Practice Unit, the last issue addressed in an audit is whether U.S.P. properly valued the I.P. for purposes of computing the deemed royalty under Code §367(d). Since it is difficult to determine the synergistic value between intangibles, the Practice Unit suggests following the case law to determine the proper value of the transferred I.P. The case law[17] supports valuing interrelated assets in the aggregate so that the synergistic value of the entire collection of assets is reflected in the computation.[18] This reflects a view that the value of the whole is greater than the sum of its parts.

The Practice Unit expands on this critical issue of determining the proper value in great detail:

> As a matter of economic reality and fundamental valuation principles, USP transferring intangibles at arm's length would conclude that the assets should be valued in the aggregate in a manner that properly reflects any synergistic relationships. In a scenario where numerous assets are used as a single integrated asset, it would be inappropriate to value the assets on a separate, stand-alone basis when they have functioned in the past, and will function in the future, as a single asset. Treas. Reg. 1.482-1(f)(2)(i) recognizes such economic realities by providing that multiple transactions should be valued in the aggregate if such transactions, taken as a whole, are so interrelated that an aggregated valuation is the most reliable means of determining the arm's length consideration for the transactions.
>
> - USP may have undervalued IRC 936(h)(3)(B) intangibles by disregarding synergies between separate intangibles that increase their aggregate value. Because FGWGC is a residual, undervaluing IRC 936(h)(3)(B) intangibles overvalues FGWGC.
> - Synergies between separate IRC 936(h)(3)(B) intangibles should be considered when valuing those intangibles. Often,

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[17] See *Computing & Software, Inc. v. Commr*, 64 T.C. 223, 235 (1975) and *International Multifoods v. Commr*, 108 T.C. 25 (1997).

[18] "Deemed Annual Royalty Income Under IRC 367(d)," LB&I International Practice Service Transaction Unit, 11/4/2015, p. 22.

"I.R.S. examiners are directed to review all items involved in a transfer of I.P. to ensure that the deemed royalty provisions of Code §367(d) are properly applied."

valuing IRC 936(h)(3)(B) intangibles in the aggregate, taking synergies into account, will be the most reliable means to value them.

- USP did not identify knowhow that was transferred. The technical manuals, processes, transferred to CFC1 likely constitute valuable intangibles and CFC1 should compensate USP at an arm's length rate.
- USP may contend that the useful life of an intangible is short, and therefore, the present value period for computing the royalties is also short.[19]

In the example, the examiner must scrutinize the contracts and interrelated licenses that U.S.P. transferred to C.F.C. 1 in order to determine if they have significant synergistic value. The examiner must also confirm (i) that U.S.P.'s study separately valued the license agreements, (ii) whether the technical knowhow and reference materials were in the study, and (iii) the useful life of the technology and whether it should be 12 years, not five years as U.S.P. stated in its study.[20]

The Practice Unit concludes that the study performed by U.S.P. in the fact pattern did not value the synergistic effect of the interrelated technology license agreements because these licenses have a 12-year term, which means the useful life may be 12 years and not five years as U.S.P. stated. The examiner should coordinate with an economist or engineer to determine the proper value of the I.P. since its useful life should be adjusted. The study by U.S.P. also neglected to include the large amount of knowhow when it transferred the engineers with their technical manuals and software. Therefore, an arm's length price for this I.P. should be determined in order to properly adjust the value.[21]

Finally, once the intangible properly is identified and valued, the examiner computes the Code §367(d) annual deemed royalty, which cannot exceed 20 years. The deemed royalty amount must be determined in accordance with the arm's length and commensurate with income standards of Code §482 and the regulations thereunder.[22]

CONCLUSION

When a U.S.-based multinational group expands operations abroad, a transfer of tangible assets is accompanied by a transfer of I.P. to an attractive location abroad, typically one in which I.P. box tax rules are in existence. Financial management is often focused on the tax benefits that may be derived from the global structure; tax management is often focused on the value of F.G.W.G.C. so that the effect of Code §367(d) is reduced. In this fact pattern, it is often forgotten that I.R.S. examiners are directed to review all items involved in a transfer of I.P. to ensure that the deemed royalty provisions of Code §367(d) are properly applied.

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19 *Id.*, p. 22-23.

20 *Id.*, p. 24.

21 *Id.*, p. 25.

22 *Id.*, p. 26.

INTERNATIONAL PRACTICE UNIT: WHAT THE I.R.S. LOOKS FOR WHEN DECIDING IF A U.S. SHAREHOLDER HAS AN INTEREST IN A C.F.C.

Authors
Stanley C. Ruchelman
Rusudan Shervashidze

Tags
C.F.C.
International Practice Units
LB&I
Subpart F
U.S. Shareholder

INTRODUCTION

In the flurry of new International Practice Units published by the I.R.S. in October and November, the I.R.S. issued the "Determination of a U.S. Shareholder and C.F.C. Status" (the "Practice Unit").[1] The Practice Unit is designed to identify steps for I.R.S. examiners to use when conducting an audit to determining whether a foreign corporation owned by a U.S. taxpayer is a controlled foreign corporation ("C.F.C.") and whether the taxpayer is a "U.S. Shareholder" for purposes of Subpart F taxation. During the audit, the examiner is encouraged to inquire about ownership interests in all foreign entities owned by the taxpayer and to examine all foreign entities that wire funds to the taxpayer.

BACKGROUND

The foregoing audit steps are encouraged in order to confirm that the profits of the foreign corporation are properly deferred until dividends are received by the U.S. taxpayer. Under U.S. tax law, a U.S. person can defer paying taxes on the profits of a foreign corporation in which it owns an interest until the time that such profits are repatriated in the form of a dividend. Where the U.S. taxpayer controls the foreign corporation, or is part of a U.S. group of major shareholders that control the corporation, this rule is cut back when (i) the foreign corporation is a C.F.C., (ii) the taxpayer is a U.S. Shareholder, and (iii) the C.F.C. has certain income that is characterized as "Subpart F Income" or it makes an "investment in U.S. Property" that creates a major tax benefit. Under the Subpart F rules, the earnings of a C.F.C. that are categorized as Subpart F Income may be taxed when and as earned at the level of its U.S. Shareholders even if no dividend is distributed.

A foreign corporation is a C.F.C. if shares representing more than 50% of its voting power or value are owned by U.S. Shareholders. A U.S. Shareholder is a U.S. person that owns shares representing 10% or more of the total combined voting power of the C.F.C.[2]

The Practice Unit is designed to help the examiner determine if a taxpayer is a U.S. Shareholder in a C.F.C. for U.S. tax purposes and therefore subject to certain filing requirements under Subpart F. If a taxpayer is determined to be a U.S. Shareholder of a C.F.C., certain informational returns, such as Form 5471, must be filed. If the

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1 "Determination of a U.S. Shareholder and C.F.C. Status," LB&I International Practice Service Transaction Unit, 10/7/2015.

2 There is a lower U.S. ownership threshold for certain foreign insurance companies. However, the tax rules applicable to foreign insurance companies that are C.F.C.'s are beyond the scope of this article.

U.S. Shareholder holds shares in a foreign corporation that is not a C.F.C., the taxpayer may have other tax reporting requirements if, for example, the foreign corporation is a P.F.I.C. In both cases, a Form 8938, Statement of Specified Foreign Financial Assets, may be required if the shareholder is an individual meeting the reporting threshold.

ISSUES UNDER EXAMINATION

There are three primary audit issues identified in the Practice Unit with regard to determining the U.S. Shareholder and C.F.C. status for companies other than insurance companies:

1. Does the taxpayer directly, indirectly, or constructively through attribution own shares in a foreign corporation?
2. Is the taxpayer a U.S. Shareholder?
3. Is the foreign entity a C.F.C.?

The examiner is instructed to consider all of the facts and circumstances of how a U.S. person may effectively have control or ownership of the foreign corporation. The examiner will gather background information on the taxpayer and the foreign entity and will determine if the entity has C.F.C. status.[3] In making the decision, the examiner should consider the percentage of ownership and the citizenship and/or residency of the U.S. Shareholder and any other shareholders. Under the constructive ownership rules in which ownership of shares by one person or entity is attributed to another person a U.S. person may have an ownership interest in a foreign corporation that is greater than actual ownership. Therefore, the examiner will need to gather information on related individuals and entities in order to determine how the Subpart F rules may be applied to the taxpayer under examination.

Once the examiner decides that the shareholder possesses a sufficient interest in a foreign entity, the examiner will consider whether the entity is a corporation for U.S. tax purposes. Under the entity classification regulations,[4] certain foreign entities are always treated as corporations. These entities are known as "per se" corporations, and they tend to be entities that are authorized to issue shares that can be listed on a public exchange. Under the regulations, other foreign entities, known as "eligible entities," are allowed to elect classification (*i.e.*, corporation or partnership, if there are two owners; disregarded entity, if there is only one owner) on Form 8832, Entity Classification Election.

The Practice Unit provides a list of information return forms that may shed light on the ownership structure of a C.F.C.:

- Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations, and Instructions*
- Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*
- Form 8832, *Entity Classification Election*

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3 Code §§957, 958, 953.

4 Treas. Reg. §§301.7701-1, 301.7701-2, 301.7701-3.

- Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships, and Instructions*
- Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, and Instructions*
- Form 3520A, *Annual Return of Foreign Trust With a U.S. Owner, and Instructions*
- Form 8938, *Statement of Foreign Financial Assets*

Documents that may be requested and reviewed in order to determine the ownership of the foreign corporation include

- foreign entity stock certificates, to determine ownership or control of the entity and the percent owned by each shareholder;
- foreign entity articles of organization, to determine the type of entity and the classes of shares issued and outstanding; and
- a global organization chart, to track direct and indirect ownership of the entity's shares and constructive ownership.

If questions remain, the examiner will consider issuing the following follow-up form and documents:

- Form 4564, Information Document Request ("I.D.R.")
- Formal Document Requests
- Summons

The examiner should also consider using the following follow-up tools:

- Internet Research
- Integrated Data Retrieval System ("I.D.R.S.")
- Accurint
- FinCEN Query
- YK1 Link Analysis

"The examiner will look at the person's direct, indirect, and constructive ownership of shares in the foreign corporation....

However, only direct and indirect ownership is used to determine the amount of income actually included under Subpart F."

Determining Ownership

To determine if a U.S. person is a U.S. Shareholder of a foreign corporation, the examiner will look at the person's direct, indirect, and constructive ownership of shares in the foreign corporation. Ownership is determined under the rules applicable to each of these categories – the rules are conjunctive not disjunctive. They are applied to categorize income of a C.F.C. that may give rise to an inclusion under Subpart F. However, only direct and indirect ownership is used to determine the amount of income actually included under Subpart F.[5]

Shares owned directly by a foreign entity in a foreign corporation are considered

[5] Code §§951(a)(1), 958(a)-(b); Treas. Reg. §§1.958-1, 1.958-2.

to be owned indirectly by the shareholders, partners, or beneficiaries of that entity in proportion to the respective ownership percentages of the shareholders.[6] When computing indirect ownership, only shares held by a foreign entity are considered shares to be owned by another U.S. person. Shares held by domestic persons are not taken into account. These rules are illustrated in the following fact pattern:

> U.S. persons A and B each own directly 50% of foreign Corporation U. Corporation U owns directly 60% of foreign Corporation V.
>
> A and B are each a 30% indirect shareholder of V (50% x 60% = 30%).
>
> If Corporation U were a domestic corporation, under the indirect ownership rules, neither A nor B would have any indirect ownership in Corporation V, because attribution stops with the first U.S. person in the chain of ownership from the foreign corporation.[7]

Constructive ownership means that shares owned by one person – not necessarily at a lower level in a chain of ownership – are attributed to another person. For example, shares owned directly or indirectly by an individual's spouse, children, grandchildren, or parents are attributed to the individual who becomes the constructive owner of those shares for purposes of applying the Subpart F rules. As a result, constructive ownership rules apply for determining whether the U.S. person is a U.S. Shareholder and whether a foreign corporation is a C.F.C., but they are not considered in determining the amount of a U.S. Shareholder's Subpart F inclusion.[8] A corporation, partnership, trust, or estate that owns more than 50% of the voting shares of a corporation is considered to own 100% of the voting shares of that corporation for purposes of computing the amount reattributed to others. Stock owned by a nonresident alien individual is not treated as owned by a U.S. person.[9]

"Constructive ownership means that shares owned by one person – not necessarily at a lower level in a chain of ownership – are attributed to another person."

More than one family member can be attributed the same shares. For example, shares owned by a child can be attributed to both a parent and a grandparent. There is no attribution between siblings, and shares that have been attributed to a family member cannot be reattributed from that family member to another person. Thus, shares actually owned by grandparents can be attributed to their children. However, the same shares cannot be reattributed from the children to the grandchildren. There is no direct attribution from grandparents to grandchildren.

The Practice Unit presents the following fact pattern illustrate the determination of constructive ownership:

> A, B, C, and D are U.S. persons. A and B are married and each owns 25% of foreign Corporation X. Additionally, C, their daughter, and D, C's daughter, each own 25% of Corporation X. A and B are each considered to own 100% of Corporation X because they are attributed each other's shares, as well as the shares owned by C (their daughter) and D (their granddaughter).

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6 Code §958(a)(2).

7 Practice Unit, p. 13.

8 Code §958(b).

9 Treas. Reg. §1.958-2.

C also constructively owns 100% of Corporation X, because she is attributed shares actually owned by her parents and her daughters shares. D constructively owns 50% (only her own and [through attribution] her mother's stock).

If D were a nonresident alien, A, B, and C would only constructively own 75% of Corporation X because shares of a nonresident alien is not attributed to a U.S. person.[10]

To determine the direct ownership by the U.S. person, the examiner is instructed to review the foreign entity's share certificates. If there is more than one owner in a foreign entity, the examiner is instructed to investigate whether the U.S. person has ownership in a foreign entity (such as a foreign corporation, foreign partnership, or foreign estate) that itself owns shares in the foreign corporation. The shares owned by the foreign entity will be attributed to its shareholders in proportion to their ownership interests in the foreign entity, under the rules and the adjustment discussed above. The examiner will also consider other ways the U.S. person may have direct, indirect, or constructive ownership in a foreign entity. For example, the taxpayer may have

- nominee ownership, which exists when shares are held for the benefit of a U.S. person through a third party (*e.g.*, an agent, attorney, or a trustee) in order to provide that the U.S. person obtains an actual or constructive benefit;[11]
- signature authority, which exists when a U.S. person effectively controls the foreign entity through a power of attorney or a corporate directorship; and
- voting agreement, which exists when a U.S. person has a proxy to select a majority of the board of directors.[12]

The tools available to the examiners to make this determination include the following:

- Taxpayer interviews
- Internet research
- Organization charts
- Accurint
- FinCEN Query
- Contacting Exchange of Information ("E.O.I.") and/or the Joint International Tax Shelter Information and Collaboration Network ("J.I.T.S.I.C."), which are governmental collaborative groups to which the I.R.S. belongs on a global level

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10 Practice Unit, p. 15. See also Code §958(b).

11 Bank statements of the foreign corporation can provide evidence that may support the substantive control the taxpayer has over an entity. See *Garlock v. Commissioner*, 489 F .2d 197 (2d Cir. 1973).

12 Code §958(a); Treas. Reg. §§1.958-1, 1.951-1(g)(2).

Determining U.S. Shareholder Status

If, after reviewing all the documents, the examiner concludes that the U.S. taxpayer has direct, indirect, or constructive ownership, then the examiner is instructed to consider whether the taxpayer is a U.S. Shareholder.

For purposes of determining C.F.C. status, a U.S. Shareholder is a U.S. person owning shares of the foreign entity representing 10% or more of the total combined voting power of all classes of shares of the foreign entity that are entitled to vote for the entity's Board of Directors.[13] A U.S. person is

- a citizen of the United States,[14]
- a non-U.S. citizen who is a U.S. resident (including a lawful permanent resident or an individual who meets the substantial presence test),[15]
- a domestic partnership,[16]
- a domestic corporation,[17] or
- any estate or trust other than a foreign estate or trust.

If a U.S. person owns the requisite percentage of shares, the U.S. person has the status of a U.S. Shareholder, meaning that an inclusion in income is possible if the foreign entity is a C.F.C. and the C.F.C. derives Subpart F Income or makes an investment in U.S. property. The following actions are suggested in making such a determination:

"If, after reviewing all the documents, the examiner concludes that the U.S. taxpayer has direct, indirect, or constructive ownership, then the examiner is instructed to consider whether the taxpayer is a U.S. Shareholder."

- The examiner may request documents of how and when the taxpayer acquired ownership (*e.g.*, Form 926, *Return by U.S. Transferor of Property to a Foreign Corporation*; Articles of Organization; organization chart).
- The examiner may obtain foreign records from E.O.I. or treaty requests, or utilize the assistance of the I.R.S. Tax Attaché covering a particular country, J.I.T.S.I.C., or the Information Gathering I.P.N.
- The examiner may gather information on related parties to consider how ownership of shares may be attributed to the taxpayer.
- The examiner may use internet research to look for articles or documents associating the taxpayer to foreign entities.

Determining C.F.C. Status

Once the examiner determines that a taxpayer is a U.S. Shareholder, the examiner is instructed to examine whether the foreign entity is a C.F.C.

As mentioned above, the foreign entity must be a corporation for U.S. tax purposes in order to be treated as C.F.C. The regulations provide a list of corporations that are "per se" corporations for U.S. tax purposes. Other foreign entities can qualify as

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13 Code §957(c).

14 Code §7701(a)(30).

15 Code §7701(b)(3).

16 Code §7701(b)(7).

17 Code §951(b).

corporations under default rules if unlimited liability exists for one or more members, and if not, the entity can make a check-the-box election.

A foreign corporation is a C.F.C. for a particular year if, on any day during such year, U.S. Shareholders own shares representing more than

- 50% of the total combined voting power of all classes of shares entitled to vote, or
- 50% of the total value of the shares.[18]

"To help to make a decision, the examiner is instructed to perform internet research and conduct taxpayer interviews."

Usually, if a corporation is organized in a U.S. commonwealth territory, or possession, it will be considered a foreign corporation and may be treated as a C.F.C.

A U.S. Shareholder is subject to the current inclusion rules of Subpart F only if the foreign corporation was a C.F.C for an uninterrupted period of 30 days or more during the taxable year and the U.S. Shareholder owned shares in the foreign corporation on the last day of such taxable year.[19]

In addition to considering the mere number of votes that a U.S. Shareholder is entitled to cast, the examiner is also instructed to look the U.S. Shareholder's substantive voting power with regard to

- electing, appointing, or replacing a majority of the board of directors (or corresponding governing group under local law);
- electing exactly half of the members of the board of directors and breaking a deadlock, or exercising managerial powers during a deadlock; and/or
- electing the person who exercises the powers ordinarily exercised by the board of directors.

The examiner is instructed to investigate and determine whether any arrangements exist to shift formal voting power away from a U.S. Shareholder.[20] These arrangements will not be given effect if in reality voting power is retained. For example, if there is an agreement that a shareholder owning 50% or less of the voting power will exercise power normally possessed by a majority of shareholders, the agreement should be disregarded. If the constitutive document of an entity calls for supermajority votes on specific issues, that should not be a disguised voting arrangement as the U.S. Shareholder owns only a veto power.

To help to make a decision, the examiner is instructed to perform internet research and conduct taxpayer interviews. The examiner can also request and review the following documents:

- Organization charts
- Corporate minutes
- Foreign country Articles of Organization
- Shareholder Agreements

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[18] Code §957; Treas. Reg. §1.957-1(b).

[19] Code §§951(a)(1), 7701(a)(3).

[20] Treas. Reg. §1.957-1(b)(2).

Once the examiner determines that the taxpayer is a U.S. Shareholder and the foreign entity is a C.F.C., the Subpart F income of the C.F.C., if any, will be attributed to the U.S. Shareholder to the extent of its interest in the foreign entity.

CONCLUSION

The Practice Unit provides a roadmap for an examiner looking to determine whether an inclusion of income under Subpart F is appropriate when reviewing a tax return of a U.S. taxpayer owning shares in a foreign corporation. But, by doing so publicly, it alerts U.S. taxpayers to the level of detail involved in an examination of a tax return with foreign items. The examiner is encouraged to look at original documents, global structure charts, public sources of information, tax treaty information exchange channels, and global governmental collaborative groups to which the I.R.S. belongs in order to test the veracity of the information on a Form 5471. The I.R.S. has investigative tools at its disposal, and it will use them more and more in the course of an examination.

INTERNATIONAL PRACTICE UNIT: LICENSE OF INTANGIBLE PROPERTY FROM U.S. PARENT TO A FOREIGN SUBSIDIARY

Author
Christine Long

Tags
Arm's Length
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C.F.C.
Foreign Subsidiary
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LB&I
License
Transfer Pricing
Treas. Reg. §1.482-4

INTRODUCTION

The I.R.S.'s Large Business and International ("LB&I") Division issued a new International Practice Unit on November 4, 2015 called "License of Intangible Property from U.S. Parent to a Foreign Subsidiary" (the "Practice Unit").[1] As the name suggests, this Practice Unit focuses on the transfer of intangible property ("I.P.") exclusively by means of a license from a U.S. parent ("U.S.P.") to a related foreign entity, which may be the U.S.P.'s wholly-owned controlled foreign corporation ("C.F.C.").

The transfer pricing rules dictate that a license of I.P. from a U.S. person to a related foreign subsidiary must be at arm's length, as determined by Internal Revenue Code §482[2] and Treas. Reg. §1.482-4. The I.R.S. has decided to focus on this issue because if a foreign related entity pays its U.S.P. compensation for the use of I.P. that is less than an arm's length consideration, the U.S.P. will report income that is below the level of true taxable income.[3] Under Code §482, the I.R.S. can reallocate the income by increasing the U.S.P.'s income and decreasing the foreign entity's income. The Practice Unit is designed to target the C.F.C.'s use of the licensed I.P. and consider whether the C.F.C. paid the U.S.P. an arm's length amount to use the property.[4]

TRANSACTION AND FACT PATTERN

The Practice Unit provides an example of the I.P. license transaction involving a U.S.P. and its C.F.C. in order to present the issues and to provide a step-by-step audit approach to the examination of the license transaction.

The fact pattern established in the Practice Unit is that of a U.S.P. that was formerly only a U.S. business but has globally expanded to become a parent company of a worldwide group, which designs, develops, manufactures, sells, and distributes products worldwide. The U.S.P. conducts all research and development, owns all intellectual property, and sells and distributes products into the U.S. market. In order to expand, the U.S.P. licenses its I.P. to a C.F.C. in order for the C.F.C. to use the property to sell and distribute products into all non-U.S. markets.[5] The C.F.C. is

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1 "License of Intangible Property from U.S. Parent to a Foreign Subsidiary," LB&I, November 4, 2015.

2 All section references are to the Internal Revenue Code of 1986, as amended, (the "Code") and the regulations promulgated thereunder.

3 "License of Intangible Property from U.S. Parent to a Foreign Subsidiary," p. 3.

4 *Id.*

5 *Id.*, p. 5.

in a country with a low corporate tax rate. The overall effective tax rate in this fact pattern will be reduced improperly since income will be shifted to the low-tax foreign corporation from the U.S.[6]

It is important to note that if the C.F.C. is in a country in which a withholding tax provision of a tax treaty applies, the royalty payments received by the U.S.P. must utilize the treaty withholding rate reduction since any overpayment of withholding tax would not be categorized by the I.R.S. as a mandatory tax payment. Instead, it is viewed as a "voluntary payment" rather than a tax and would not be eligible to be claimed as a foreign tax credit.

ISSUES & AUDIT PROCEDURES

The Practice Unit has identified three potential issues that examiners should focus on when a U.S.P. licenses I.P. to a C.F.C.:

1. What I.P. rights have been licensed from the U.S.P. by the C.F.C.?
2. Did the U.S.P. receive arm's length consideration for the license of I.P. to the C.F.C.?
3. Was the consideration commensurate with income ("C.W.I.") attributable to the I.P.?[7]

The Practice Unit provides a step-by-step approach for how to conduct an audit of each issue. The first step, which applies to all three issues, is to ensure that a license of I.P. occurred by establishing the facts and supporting documentation to substantiate the license.

The Practice Unit focuses on five elements in order to establish the facts of the transaction:

1. Did the U.S.P. transfer I.P. under a licensing agreement to its C.F.C.?
2. What type of I.P. did the U.S.P. license to its C.F.C.?
3. Are the I.P. routine in nature or non-routine type I.P.?
4. What form of consideration (*e.g.*, lump sum, contingent payment, or installment payment) was received by the U.S.P.?
5. Does the Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, represent that rents, royalties, and license fees were paid by the C.F.C.?[8]

In order to examine these elements, the Practice Unit suggests referring to the following resources for guidance: transfer pricing studies, organizational charts, license agreements, intercompany agreements, invoices, taxpayer's financial statements, transfer pricing roadmaps, the taxpayer's internet site, and/or a mandatory

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[6] *Id.*, p. 6.

[7] *Id.*, p. 7.

[8] *Id.*, p. 8.

transfer pricing I.D.R. To establish the facts under the element regarding Form 5471, the Practice Unit suggests referring to schedule M, line 20.[9]

Once the facts for each case are developed, the analysis of each issue begins. The Practice Unit instructs the examiner to review potential sub-issues, perform additional factual development, and finally develop arguments for each issue concerned with the I.P. licensing.

Rights Licensed to the C.F.C.

In order to address the issue of what I.P. rights have been licensed from the U.S.P. to the C.F.C., the Practice Unit defines the terms at issue and explains the subject of the examination as outlined below:

- For purposes of section 482, an intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual:
  - Patents, inventions, formulae, processes, designs, patterns, or know-how;
  - Copyrights and literary, musical, or artistic compositions;
  - Trademarks, trade names, or brand names;
  - Franchises, licenses, or contracts;
  - Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
  - Other similar items. For purposes of section 482, an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.
- A controlled transfer of Intangible Property means any transaction or transfer of such property between two or more members of the same group of controlled taxpayers. Determine if in fact an intangible as defined in Treas. Reg. 1.482-4(b) has been transferred from the USP to the CFC under a licensing arrangement.
- Determine what rights to the intangibles were transferred? Here are examples of the type of rights that may be transferred under a licensing arrangement.
  - Exclusive v. Non Exclusive
  - Sublicensing Rights
  - Geographic Rights

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[9] *Id.*

- Manufacturing, Marketing, Distribution (Make/Sell)
- Research Rights.[10]

The Practice Unit instructs the examiner to refer to Treas. Reg. §1.482-1(i)(7), Treas. Reg. §1.482-1(i)(8), and Treas. Reg. §§1.482-4(a) and (b).

Next, the Practice Unit instructs the examiner to answer the following questions by referring to the U.S.P.'s and C.F.C.'s transfer pricing roadmaps and studies, license agreements, intercompany agreements, and/or their internet sites:

"In a controlled transfer of I.P., arm's length consideration must be determined under one of four methods listed in Treas. Reg. §1.482-4(a)."

- Is there a license of I.P. between controlled parties?
- What type of I.P. is being licensed?
- What rights to the I.P. were licensed?[11]

The examiner must consider all the facts and circumstances of each specific case in order to determine whether the U.S.P.'s I.P. has been licensed. The examiner must establish that there is a controlled transfer of I.P. under a licensing arrangement pursuant to Treas. Reg. §§1.482-1(i)(7) and (i)(8), and §§1.482-4(a) and (b). In the analysis, the examiner must determine the type of I.P., the rights associated with that I.P., and whether the U.S.P. was properly compensated for the transfer of such I.P. under the licensing arrangement.[12] If the examiner determines that there was a license of I.P. rights that required the C.F.C. to make an arm's length payment to the U.S.P., the examiner may proceed to the next issue.[13]

Arm's Length Consideration for the License

In order to address the issue of whether the U.S.P. received arm's length consideration for the I.P. license to the C.F.C., the Practice Unit establishes that in a controlled transfer of I.P., arm's length consideration must be determined under one of four methods listed in Treas. Reg. §1.482-4(a), *i.e.*, the Comparable Uncontrolled Transaction ("C.U.T.") method,[14] Comparable Profits Method ("C.P.M."),[15] Profit Split method,[16] or the Unspecified Method.[17] Each method must be applied according to the provisions of Treas. Reg. §1.482-1, including the Best Method Rule of Treas. Reg. §1.482-1(c), the comparability analysis of Treas. Reg. §1.482-1(d), and the arm's length range of Treas. Reg. §1.482-1(e). The Practice Unit further explains the issue as follows:

- If the Taxpayer applies one of the methods in Treas. Reg. 1.482-4(a), and that method achieves the most reliable measure of an arm's length result, it will be considered the best method.

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10 *Id.*, p. 9-10.

11 *Id.*, p. 11.

12 *Id.*, p. 12.

13 *Id.*, p. 13.

14 Treas. Reg. §1.482-4(c).

15 Treas. Reg. §1.482-5.

16 Treas. Reg. §1.482-6.

17 Treas. Reg. §1.482-4(d).

- If the CUT Method is selected as the best method, additional comparability analysis under Treas. Reg. 1.482-4(c)(2) needs to be considered, as well.
- If the consideration received by the USP falls within the arm's length range under the best method, no adjustment is necessary.[18]

The Practice Unit instructs the examiner to consider the amount paid by the C.F.C. to the U.S.P., as well as the following questions, in light of the company's various agreements, ledgers, financial statements, and other documents that could be useful in determining whether there was arm's length consideration:

- What was the form of the consideration?
  - Lump sum
  - Installment
  - Contingent payment *e.g.* Royalty
- What method did USP select in determining the arms length compensation to receive from CFC?
  - Comparable Uncontrolled Transaction
  - Comparable Profits Method
  - Profit Split
  - Unspecified Method
- What are the functions, risks, and assets employed respectively by the USP and CFC?
- Was the method selected the best method based on facts and circumstances?
  - Comparability
  - Completeness and Accuracy of Data
  - Reliability of Assumptions
  - Sensitivity of Results
- What was the arm's length range under the best method selected?
  - Comparables
  - Multiple Year Data
  - Interquartile Range[19]

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18 "License of Intangible Property from U.S. Parent to a Foreign Subsidiary," p. 14.

19 *Id.*, p. 15-17.

After establishing that there is a controlled transfer of I.P. by the U.S.P. to the C.F.C. under a licensing arrangement, the examiner must determine whether the U.S.P. received an arm's length consideration from the C.F.C. The arm's length consideration must be determined under one of the methods enumerated in Treas. Reg. §1.482-4(a): C.U.T., C.P.M., Profit Split, or Unspecified Method.[20] The examiner must consider all the facts and circumstances of each specific case in order to determine whether the best method was chosen. Furthermore, the examiner must ensure the U.S.P.'s comparables are truly comparable to its line of business and its controlled transfer. If the consideration received by the U.S.P. is not within the arm's length range, the examiner is instructed to adjust the income.[21]

"The arm's length consideration for the transfer of an intangible from USP to CFC must be commensurate with the income attributable to the intangible."

Consideration that is Commensurate with Income ("C.W.I.") from I.P.

In order to address the issue of whether the consideration paid by the C.F.C. was C.W.I. attributable to the I.P. licensed by the U.S.P., the Practice Unit defines the terms for purposes of an examination and explains the subject as follows:

- The arm's length consideration for the transfer of an intangible from USP to CFC must be commensurate with the income attributable to the intangible. There are exceptions to applying CWI to the compensation charged by USP if the requirements under Treas. Reg. 1.482-4(f)(2)(ii)(A),(B),(C),(D) and (E) are met.

- Typically, if USP retained a substantial interest in the licensed intangible property, the arms length consideration subject to CWI shall be in the form of a periodic (usually annual) royalty, calculated at the time of the license using forecasted profits or cost savings attributed to the licensed intangible.

- Generally, if the licensing arrangement between USP and CFC covers more than one year, it may be possible to make an adjustment to the compensation charged in each taxable year under the method chosen to ensure that it is commensurate with the income being generated from the use of the intangible by CFC.

- Such adjustment may be possible if all of the requirements for applying CWI are met and the taxpayer does not qualify for one of the exceptions.

- The questions that need to be answered by the examiner when considering CWI:

  1. Are the profits being earned by the CFC materially disproportionate (in the manner described in the section 482 regulations) to the projected profits that both parties anticipated at the time of original transfer or intangibles?

  2. Does the taxpayer meet any of the exceptions to the application of CWI?

[20] *Id.*, p. 18.

[21] *Id.*, p. 19.

If the answer to question 1 is yes and the answer to the question 2 is no, then it may be possible to make a CWI adjustment.[22]

The Practice Unit instructs the examiner to answer the following questions by referring to the transfer pricing roadmaps and studies, contracts, intercompany agreements, and annual reports of the U.S.P. and C.F.C.:

- Does the license arrangement cover more than one year?
- Was nominal or no consideration charged by USP to CFC for the licensed intangible at the inception of the license?
- Did USP retain a substantial interest in the licensed intangible?
- Does the license agreement require CFC to make periodic payments to USP for use of the intangible?
- Do any of the exceptions to CWI apply?
    - CUT with same intangible
    - CUT with Comparable Intangible or Other Method
- Written contract, defined terms and time period, no substantial changes in functions performed, and actual profits or cost savings fall within 80% to 120% of forecasts.
    - Extraordinary events that could not reasonably have been anticipated
    - No CWI adjustments made after 5 years beginning with the first year in which substantial periodic consideration was required to be paid under the license agreement[23]

If all of the requirements for applying the C.W.I. principle have been satisfied and the U.S.P. does not meet an exception, the consideration charged by the U.S.P. to the C.F.C. in each taxable year might be adjusted to ensure it is commensurate with the income attributable to such I.P. under Treas. Reg. §1.482-4(f)(2).[24]

CONCLUSION

The three issues discussed above outline the focus of an I.R.S. examination of whether a C.F.C. paid an arm's length amount to use I.P. developed and owned by its U.S.P. As U.S.-based groups expand abroad and license I.P. to foreign related entities, I.R.S. examinations should be anticipated. The Practice Unit describes how such examinations will be conducted with regard to the arm's length nature of license fees that were, or should have been, paid.

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22 *Id.*, p. 20-21.

23 *Id.*, p. 22-23.

24 *Id.*, p. 24.

INTERNATIONAL PRACTICE UNIT: MONETARY PENALTIES FOR FAILURE TO FILE FORM 5471

Author
Galia Antebi

Tags
C.F.C.
Failure to File
Form 5471
International Practice Units
LB&I
Penalties
Reasonable Cause
T.I.G.T.A.

INTRODUCTION

Background

Concern among governments regarding the level of international tax compliance has been on the rise in recent years. This has lead to the enactment of the Foreign Accounts Tax Compliance Act ("F.A.T.C.A."), the O.E.C.D. Common Reporting Standard, and the O.E.C.D. Base Erosion and Profit Shifting ("B.E.P.S.") project.

In the U.S., the I.R.S. has initiated increased enforcement efforts to ensure compliance with information reporting obligations. Such efforts include increased assessment of penalties. Form 5471 is one of the key information forms for U.S. companies operating abroad. The I.R.S. takes this form seriously, as reflected in the severity of penalties that can be imposed for compliance failures. Several years ago, the I.R.S. initiated an automated penalty process as the first measure to increase compliance. In late 2013, the Treasury Inspector General for Tax Administration ("T.I.G.T.A.") issued a report recommending tightening the penalty abatement procedures applicable to the automated penalties. The recommendation to tighten the abatement of penalties is a negative incentive to file a complete and accurate Form 5471.

The complicated and overlapping rules applicable to the preparation of Form 5471 are explained in a "how to" article published in *Insights* Vol. 1 No. 2.[1] This article addresses the penalties that can be imposed when the I.R.S. reviews a case involving a Form 5471 that has been filed late or that is filed on time but is not substantially complete. The goal is to explain the opportunity of abating penalties that may be imposed.

The Monetary Penalty and Reasonable Cause Relief – T.I.G.T.A. Report

The penalty for not filing a required Form 5471, for filing not timely, or for filing a substantially incomplete form is $10,000 per form per year (the "initial penalty"). Additional penalties for continued failure may be imposed, up to $50,000 per Form 5471 required (the "continuation penalty").

While the systematic imposition of penalties has improved compliance, the government found that many penalties were abated, perhaps inappropriately. The T.I.G.T.A. report made the following findings:

- In 43% of the cases reviewed, the penalties were inappropriately abated.
- In 45% of the inappropriately abated cases, the taxpayer claimed that the

[1] Galia Antebi and Stanley C. Ruchelman, "Tax 101 – Introductory Lessons: Form 5471 – How to Complete the Form in Light of Recent Changes," *Insights* 1, no. 2 (2014).

Form 1120 was timely filed, but did not provide any proof to support the claim.

- In 15% of those cases, the taxpayer requested relief as a first-time filer.
- In 12.5% of such cases, the taxpayer claimed an absence of knowledge regarding the form or relied on advice from a tax professional that was not knowledgeable of the filing obligation.
- In 10% of such cases, the taxpayer claimed an inability to timely file Form 1120 with an attached Form 5471 because the financial records were unobtainable or because of a financial problem.
- In 10% of such cases, the taxpayer claimed that the late filing was caused by either an unintentional taxpayer or tax preparer oversight.

"For returns filed after March 18, 2010… the S.O.L. for assessing tax for an income tax return associated with a substantially incomplete Form 5471 expires three years after the date on which a substantially complete Form 5471 is provided."

The report stated that according to I.R.S. policy, the abatement request should have been denied in all such cases. It stated that ignorance of the law, forgetting to request an extension, being a first-time filer, having difficulty obtaining financial information, or having financial problems are not grounds for relief of penalties.

THE PRACTICE UNIT

The above-mentioned T.I.G.T.A. report recommended tightening the abatement process, and the I.R.S. is now focusing on the assessment of a monetary penalty process internally and on the review of reasonable cause applications. On October 7, 2015, the I.R.S. issued the International Practice Service Process Unit – Audit (the "Practice Unit"), a guide that provides I.R.S. agents with advice on how to handle audit cases where it has been determined the taxpayer had a requirement to file a Form 5471.[2] This Practice Unit is limited to the review of cases where the requirement to file was that of Category 4 and 5 Filers, *i.e.*, those having control over foreign corporations (Category 4) and those owning at least 10% of a Controlled Foreign Corporation ("C.F.C.") on the last day of the corporation's tax year (Category 5).[3]

The Practice Unit provides that for returns filed after March 18, 2010, or returns filed prior to March 19, 2010 for which the statute of limitations ("S.O.L.") was otherwise open on that date, the S.O.L. for assessing tax for an income tax return associated with a substantially incomplete Form 5471 expires three years after the date on which a substantially complete Form 5471 is provided. The extended S.O.L. applies to any tax return or period to which the information relates, *i.e.*, it applies to all items of income and deduction reported on the income tax return to which the Form 5471 was required to be attached. In addition, related income tax returns for prior periods are not required to be under examination in order to assess penalties for those years. Therefore, the Practice Unit suggests that I.R.S. agents who find that Form 5471 was required but not filed for the exam year also review earlier years to determine whether this form was required but not filed in such years. In reviewing whether all required forms were timely and properly filed, the Practice Unit suggests reviewing and comparing different documents as part of the audit process. The goal is to ensure that the examiner has a full picture of the global structure. Thus, the

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[2] Practice Unit FEN/9433.01_06(2013)(c).

[3] Constructive ownership rules apply in determining ownership for both categories of filers.

examiner should look at all returns and forms,[4] tax organization charts, and legal entity charts for the year under audit plus the two preceding tax years, as well as forms filed with the Securities Exchange Commission.

For income tax returns filed late, the initial penalty is assessed automatically, even when a request for reasonable cause was submitted with the tax return. The assessment results in a notice stating that the taxpayer may pay the penalty or request an abatement of the penalty for late filing due to reasonable cause.[5] After review of the reasonable cause statement, the penalty is either abated or the taxpayer must pay it or petition to the Office of Appeals.

If reasonable cause is found to exist for late filing, penalties may nevertheless be assessed if Form 5471 was substantially incomplete. While the first step in the process is a review of the face of the form for completeness and consistency, the complete review must include the taxpayer's explanation as well as an assessment of the magnitude and the complexity of the error found. The information required on Form 5471 must be furnished even if that information may not affect the amount of any tax due under the Code. According to the Practice Unit, the following could be an indication that Form 5471 is not substantially complete:

- Any error on page 1 of the form is an indication that the form is not "substantially complete." This includes
  - omitting to check the box of the category of the filer or incorrectly checking this box,
  - omitting the percentage of voting stock owned or filling in an incorrect percentage,
  - not attaching all the required schedules,
  - omitting the name or address of the foreign corporation or certain information regarding its corporate formation.
- Required schedules that are missing constitute by themselves an incomplete form.
- When inconsistencies or math errors are found on the face of the form and such errors are significant in amount, the form is substantially incomplete.
- When a Form 5471 is filed with a statement saying the required information will be furnished upon request or audit, the form is substantially incomplete.
- Providing consolidated financial statements of two or more foreign corporations is a common reason for noncompliance or error in completing the form.
- Filing requirements do not apply to a foreign corporation that has been dissolved. However, I.R.S. agents are encouraged to seek that the winding up transactions are reported on the final Form 5471. To do that, the Practice

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4 *E.g.*, Form 1120, *Corporate Income Tax Return, and Form 8832, Entity Classification Election*.

5 This notice does not initiate the 90-day period for application of the continuation penalty. The I.R.S. must send taxpayers a letter notifying them of the requirement to file and that a 90-day count begins.

Unit suggests that I.R.S. agents request a copy of all exam-year general ledger transactions for such companies and look for significant transactions that may have occurred and been unreported.

- Filing requirements also apply to a dormant foreign corporation.

Providing too much of the required information can also be an indication that the form is not substantially complete. A 1997 Field Service Advice ("F.S.A.") mentioned in the Practice Unit states that Congress did not intend that providing excessive information be treated as substantial compliance. Under a strict interpretation of the regulation, over-reporting is problematic because the error itself undermines the ability of the I.R.S. to rely upon the taxpayer's reporting of related-party transactions. Nevertheless, the F.S.A. recommended that "substantial compliance" be determined by reference only to significant items. The examiner should determine if an error was significant in amount and whether the I.R.S.'s ability to gather information necessary to conduct an effective examination was impacted.

Under Chief Counsel Advice ("C.C.A.") 200429007, a facts and circumstances analysis is the preferred analysis over a strict interpretation of the regulations. This C.C.A., while only an informal guide, provides seven factors to use in such analysis. No one factor is necessarily more important than any other factor, but the factors themselves may contain evaluation characteristics which, when combined with other facts, indicate the completeness of the reporting. According to the C.C.A., the following are the facts and circumstances that should be considered:

- The magnitude of the underreporting or overreporting of the erroneous reported transaction
- Whether the reporting corporation has reportable transactions other than the erroneous reported one with the same related party and whether such other transactions were correctly reported
- The magnitude of the erroneous reported transaction in relation to all of the other correctly reported transactions
- The magnitude of the erroneous reported transaction in relation to the corporation's volume of business and overall financial situation
- The significance of the erroneous reported transaction to the corporation's business in a broad functional sense
- Whether the erroneous reported transaction occurred in the context of a significant ongoing transactional relationship with the related party
- Whether the erroneous reported transaction is reflected in the determination and computation of the reporting corporation's taxable income

"Providing too much of the required information can also be an indication that the form is not substantially complete."

Under C.C.A. 200645023, significant pieces of required information, the lack of which will be treated as "significantly incomplete," include

- balance sheets and income statements, in accordance with U.S. Generally Accepted Accounting Principles ("G.A.A.P."), and
- income statements and income tax amounts that are in both functional and U.S. currencies.

Once an agent determines that the taxpayer has failed to timely file an accurate information return, he must issue a notice letter to the taxpayer. Such notice letter will initiate the count for the application of the continuation penalty, which begins 90 days after the date of the letter and continues until a substantially complete Form 5471 is provided. Extensions on the 90-day period are not provided for in the Code and are subject to the discretion of the agent. The Practice Unit warns that the notice letter must be sent to the taxpayer, not its representative, because such action can assist the taxpayer in his or her claim in appeals or in court that the notice letter was ineffective. If in response to the notice a substantially incomplete Form 5471 is filed, the continuation penalty period is still in effect. In such circumstances, while an I.R.S. agent is not required to send a second notice letter, it is good practice for appeals and in court, as it will show that the taxpayer had knowledge that the subsequently submitted Form 5471 was substantially incomplete.

"Reasonable cause could not have existed earlier than the due date for filing or the date of the notice letter."

Reasonable Cause

As mentioned above, the Code provides that the initial penalty can be abated if the compliance failure is due to "reasonable cause" and not due to willful neglect. In order for the exception to apply, the taxpayer must file a statement in writing that provides all the facts alleged to be reasonable cause and contains a declaration that the statement was made under penalties of perjury. When a proper statement is filed, the I.R.S. will consider whether the reporting requirements should be treated as met. I.R.S. agents should look for the dates of the supporting documents and events, as reasonable cause could not have existed earlier than the due date for filing or the date of the notice letter. The Practice Unit further instructs agents to review all tax years open under the statutes and assure that such years are in compliance prior to considering reasonable cause relief.

The Practice Unit provides that the following facts may be treated under certain circumstances as reasonable cause:

- Erroneous advice or reliance
- Unable to obtain records
- Death, serious illness, or unavoidable absence

Ignorance of the law, by itself, is not reasonable cause. However, in conjunction with other factors, it might be. An honest misunderstanding of the law that is reasonable in light of all the relevant facts could suggest reasonable cause. To determine whether reasonable cause exists, the additional factors that should be considered include

- the taxpayer's education,
- past penalties,
- whether the taxpayer could not reasonably be expected to know of recent changes in the law or forms, and
- the level of complexity of a tax or compliance issue.

Generally, the most important factor in determining whether a taxpayer has reasonable cause and acted in good faith is the extent of the taxpayer's efforts to report the proper tax liability. In U.S. v. Boyle, the Supreme Court noted that reasonable cause requires the taxpayer to demonstrate that it exercised "ordinary business care and prudence" but nevertheless was "unable to file the return within the prescribed time."

Generally, reliance on the substantive advice of an informed, qualified professional is reasonable. In contract, reliance on a professional to carry out ministerial duties not requiring special expertise, such as timely filing a return, is not reasonable cause. Arguments based on distance to the place where the company's books and records are kept, language limitations, currency, and accounting practice and systems may not be reasonable cause for reporting errors because most persons required to file Form 5471 have the same circumstances. The cost of converting the financial statements to U.S. dollars and U.S. G.A.A.P. would constitute reasonable cause only if the exercise of ordinary business care and prudence would not have allowed the corporation to make the conversions because such conversion would have caused it undue hardship. While an isolated error may indicate inadvertence, not intention, a large number of incomplete Forms 5471 filed by a taxpayer do not indicate an isolated oversight but an intentional decision to file incomplete Forms 5471. Moreover, a taxpayer's strong compliance history may indicate that the failure to file complete forms is not inadvertent.

Note that the fact that a foreign jurisdiction would impose civil or criminal penalties on the taxpayer or any other person for disclosing the required information and/or refusal on the part of a foreign trustee to provide information for any other reason does not constitute a reasonable cause.

If reasonable cause is determined to exist, the extended S.O.L. only applies to items related to the missing information on Form 5471.

CONCLUSION

Filing an incomplete or inaccurate Form 5471 results in high penalties under the practice now followed by the I.R.S. Reasonable cause relief is now more tightly reviewed by the I.R.S. and strong arguments are needed, supported by documentation demonstrating ordinary business care and prudence were exercised but nevertheless a complete return could not be timely filed.

It should be noted that the automatic relief from penalties for delinquent Forms 5471, which was available to taxpayers that had no underreported tax liabilities under F.A.Q. 18 to the 2012 Offshore Voluntary Disclosure Program, was eliminated when F.A.T.C.A. became effective on July 1, 2014.

P.A.T.H. ACT LEADS TO WIDESPREAD TAX CHANGES

Authors
Philip R. Hirschfeld
Rusudan Shervashidze
Christine Long
Elizabeth Zanet

Tags
Active Financing Income
Audit
C Corporation
Extenders
F.I.R.P.T.A.
F.B.C.I.
I.T.I.N.
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R.E.I.T.
R.I.C.
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U.S.R.P.I.

In the spirit of giving of the recent holiday season, Congressional Democrats and Republicans and the President joined together to enact into law the Protecting Americans from Tax Hikes Act of 2015 (the "P.A.T.H. Act") on December 18, 2015.

The P.A.T.H. Act includes more than $85 billion in tax breaks, which will affect a wide-range of taxpayers, including foreign investors in U.S. real estate.

RELIEF FOR FOREIGN INVESTMENT IN U.S. REAL ESTATE AT THE COST OF INCREASED WITHHOLDING

U.S. tax law creates preferential tax treatment for two types of collective investment vehicles marketed to investors: (i) Real Estate Investment Trusts ("R.E.I.T.'s"), and (ii) Regulated Investment Companies ("R.I.C.'s").[1]

R.E.I.T.'s must invest in real estate and real estate mortgages, while R.I.C.'s may invest in the stock and securities of nearly any company. Unlike a corporation, which is subject to corporate-level tax, a R.E.I.T. or R.I.C. can escape paying corporate-level tax if it distributes all of its income to its shareholders as dividends. As with many tax benefits, there are conditions that must be met in order to receive the favorable tax treatment. A R.E.I.T. or R.I.C. must meet certain income and asset tests, and it must not be a closely-held entity. That is, the R.E.I.T. or R.I.C. must be an investment vehicle for many, not a disguised family holding company.

The P.A.T.H. Act makes several taxpayer-favorable changes to the tax treatment of investments in R.E.I.T.'s and R.I.C.'s., as discussed below.

The P.A.T.H. Act makes several changes to sections of the Internal Revenue Code (the "Code") known collectively as the Foreign Investment in Real Property Tax Act ("F.I.R.P.T.A."), which imposes a withholding tax on a foreign investor who sells U.S. real estate or an interest in a company whose predominant asset is U.S. real estate.

The P.A.T.H. Act eliminates tax liability under F.I.R.P.T.A. for certain investments in R.E.I.T.'s. The legislation also eliminates taxation of investments made by foreign pension plans in R.E.I.T.'s and U.S. real estate. For certain foreign collective investment vehicles investing in R.E.I.T.'s, F.I.R.P.T.A. tax liability is eliminated as well. However, the legislation includes a unfavorable change that generally increased the withholding burden on a sale of U.S. real estate from 10% to 15%.

1 R.I.C.'s are commonly called mutual funds.

Background

F.I.R.P.T.A. is set forth in Code §§897 and 1445. Code §897 imposes U.S. tax on a foreign person's sale of a U.S. real property interest ("U.S.R.P.I."), with limited exceptions. Code §1445 generally requires a person who purchases a U.S.R.P.I. from a foreign seller to withhold 10% of the amount realized on the sale. If the tax withheld exceeds the actual tax liability, the seller has two options: (i) the seller and the buyer can ask the I.R.S. for permission to lower the tax withheld to the actual tax liability, if such request is made before the sale; or (ii) the seller can file a U.S. income tax return after the sale and request a refund of the excess tax withheld over the actual tax liability. Since the income tax return cannot be filed until the following year, the seller must wait to receive the refund under the latter option.

A U.S.R.P.I. includes direct ownership of U.S. real estate, such as land or a building located in the United States, as well as stock owned in a U.S. corporation that is classified as a U.S. real property holding corporation ("U.S.R.P.H.C.").

A U.S.R.P.H.C. may include stock owned in a R.E.I.T. For a foreign investor, the purchase of stock of a publicly traded R.E.I.T. is an easy way to indirectly invest in U.S. real estate.

Dividends paid to foreign investors also pose U.S. tax issues. R.E.I.T.'s can make two types of dividends: (i) an ordinary dividend, which is a distribution of a R.E.I.T.'s income from rent, interest, and other passive investments (but not sales of assets); and (ii) a capital gain dividend, which is a distribution of proceeds from a sale of real estate. For U.S. individual investors, a capital gain dividend is preferable since it is subject to lower long-term capital gains tax rates (maximum rate of 20%) rather than the regular tax rates (maximum rate of 39.6%). However, foreign investors face a major concern with capital gains dividends due to F.I.R.P.T.A. Capital gains dividends subject the foreign investor to U.S. tax, and the added requirement to file U.S. income tax returns. Foreign corporate investors may be subject to both the regular corporate tax (maximum rate of 35%) and the 30% branch profits tax. By contrast, an ordinary dividend paid to a foreign investor is generally only subject to a 30% withholding tax (subject to reduction by tax treaty) and no obligation to file U.S. tax returns. As a result, a foreign investor generally prefers ordinary dividends over capital gains dividends.

Foreign Investors Investing in Public R.E.I.T.'s

Prior to the P.A.T.H. Act, F.I.R.P.T.A. provided for an exemption from tax for a sale of stock in a publicly traded R.E.I.T., provided that the seller owned 5% or less of the stock of the R.E.I.T. (the "5% maximum ownership restriction").

If a R.E.I.T. sold U.S. real estate and then made a capital gain distribution to its non-U.S. shareholders, the R.E.I.T. could treat the capital gain dividend as an ordinary dividend subject to 30% U.S. withholding tax (or less under an applicable income tax treaty), provided that the 5% maximum ownership restriction was met.

The P.A.T.H. Act increased the 5% maximum ownership restriction to 10%. This allows a foreign investor to increase his ownership of R.E.I.T. stock to 10% and still be exempt from F.I.R.P.T.A. on a sale of that stock.

In the case of a capital gain dividend received from a R.E.I.T. by a foreign shareholder, the P.A.T.H. Act increased the 5% maximum ownership restriction for ordinary dividend treatment to 10%.

These changes should encourage greater investment in R.E.I.T.'s. They are effective for sales or distributions made on or after December 18, 2015.

Investment in Domestically Controlled R.E.I.T.'s

If a foreign investor holds stock in a domestically-controlled R.E.I.T., the stock is not considered a U.S.R.P.I. and gain from the sale of the stock is not subject to tax under F.I.R.P.T.A. A domestically-controlled R.E.I.T. is a R.E.I.T. in which less than 50% of the stock is owned by foreign persons for the five-year period preceding the sale of the stock. This exception applies to a publicly-traded R.E.I.T., as well as a privately-held R.E.I.T. It applies with no limitation on the percentage of ownership the investor may have in the R.E.I.T. (*i.e.*, the foreign investor can even own more than 10% of the R.E.I.T.).

The P.A.T.H. Act added certain presumptions that a R.E.I.T. can make in determining whether it is domestically controlled. A helpful presumption is that if a R.E.I.T. is publicly traded, then the R.E.I.T. can presume that any shareholder who owns less than 5% is a U.S. person, unless the R.E.I.T. has actual knowledge to the contrary.

Since (i) publicly-traded R.E.I.T.'s are generally widely held (and thus may have many shareholders who own less than a 5% interest), and (ii) such stock is often held in the name of a brokerage company (such as Merrill Lynch or Goldman Sachs) that holds the stock on behalf of a customer (but does not tell the R.E.I.T. the name of the customer), then this presumption should be helpful in qualifying for the F.I.R.P.T.A. exemption.

Foreign Collective Investment Vehicles as Qualified Shareholders Investing in Any R.E.I.T.

The P.A.T.H. Act adds a new exception to tax under F.I.R.P.T.A. for an investment by a qualified shareholder in a R.E.I.T. that is either a publicly-traded R.E.I.T. or a private R.E.I.T. A qualified shareholder is a collective investment vehicle (*i.e.*, an investment fund with many investors) that can obtain tax treaty benefits for dividends under an applicable tax treaty with the United States and that is generally a publicly-traded entity on a foreign stock exchange.

A qualified shareholder is not subject to any limitation on how much R.E.I.T. stock it may own, *provided that* any investor in the qualified shareholder does not own, through application of the constructive ownership rules, more than 10% of the R.E.I.T. For example, if a qualified shareholder owns 90% of a R.E.I.T., but each investor in the qualified shareholder owns 10%, then each investor owns (by application of the constructive ownership rules) only 9% of the R.E.I.T. (*i.e.*, 10% of 90%). Thus, the qualified shareholder can receive full exemption from tax under F.I.R.P.T.A.

This is a difficult exception to meet, so it is uncertain how useful it will be.

Qualified Foreign Pension Funds Investing in Any U.S.R.P.I.

The U.S. tax law provides an exemption from tax for U.S. pension funds investing in real property, subject to certain conditions. However, there is generally no similar relief for foreign pension funds.

The P.A.T.H. Act added a new exemption to tax under F.I.R.P.T.A. for an investment by a qualified foreign pension fund, as defined below, in *any* U.S.R.P.I., not just

R.E.I.T. stock. This exemption also applies to a capital gain dividend received by a qualified foreign pension fund from a R.E.I.T.

A qualified foreign pension fund means any trust, corporation, or other organization (i) which is created or organized under the laws of a non-U.S. country, (ii) which is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees, (iii) which does not have a single participant or beneficiary with a right to more than 5% of its assets or income, (iv) which is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities, and (v) with respect to which, under the laws of the country in which it is established or operates, (a) contributions to such fund that would otherwise be subject to tax are deductible or excluded from the gross income of such fund or taxed at a reduced rate, or (b) taxation of any investment income of such fund is deferred or such income is taxed at a reduced rate.

This new exemption should be very useful to foreign pension funds and should encourage their investment in U.S. real property.

F.I.R.P.T.A. Withholding Tax Increased from 10% to 15%

There is an old expression that "no good deed goes unpunished." In the case of the changes to F.I.R.P.T.A. created by the P.A.T.H. Act, there may be some truth to that sentiment because the new law increases the 10% withholding tax rate under F.I.R.P.T.A. to 15%.

The effective date for this change was listed in Congressional summaries of the P.A.T.H. Act as applying to dispositions 60 days after the new law's date of enactment. Since the P.A.T.H. Act was enacted on December 18, 2015, the 60th day after the date of enactment would be February 16, 2016. However, P.A.T.H. Act §324(c) is worded differently and actually states that this change is effective for "dispositions after the date which is 60 days *after* date of enactment." This statutory language means that the change applies one day later than the 60th day and thus would apply to dispositions made on or after February 17, 2016. It is expected that the I.R.S. will clarify which date applies before then.

This change may be a trap for the unwary, especially since I.R.S. forms may not be updated in time to reflect this and other changes to F.I.R.P.T.A.

OTHER CHANGES TO F.I.R.P.T.A.

Interests in R.E.I.T.'s and R.I.C.'s Not Excluded from U.S.R.P.I. Definition

The so-called F.I.R.P.T.A. cleansing rule provides that the term United States real property interest or U.S.R.P.I., discussed above, does not include any interest in a corporation if as of the date of the disposition of such interest, such corporation did not hold any U.S.R.P.I.'s, and all of the U.S.R.P.I.'s held by such corporation were disposed of (within a certain period of time) in transactions in which the full amount of the gain was recognized.[2]

The P.A.T.H. Act modifies the cleansing rule by excluding stock of a corporation if such corporation, or any predecessor of such corporation, was a R.E.I.T. or a R.I.C.

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[2] Code §897(c)(1)(B).

at any time during the shorter of either (i) the period after June 18, 1980 during which the taxpayer held such stock, or (ii) the five-year period ending on the date of the disposition of such stock.

Dividends Derived from R.E.I.T.'s and R.I.C.'s Ineligible for Deduction for U.S.-Source Portion of Dividends from Certain Foreign Corporations

A corporation is allowed to deduct a portion of the dividend it receives from a domestic corporation. The deduction, known as the "dividends received deduction," depends on the percentage of ownership. A corporation can deduct

- 70% of the dividend, if it owns less than 20% of the other corporation;
- 80% of the dividend, if it owns at least 20% of the other corporation but less than 80%; or
- 100% of the dividend, if it owns more than 80% of the other corporation.[3]

"The P.A.T.H. Act made significant corrections and clarifications to the new unified system of audit rules for partnerships."

Generally, a corporation is not allowed a dividends received deduction from a foreign corporation, unless the corporation owns at least 10% of the vote or value of the foreign corporation. In that case, the foreign corporation is called a qualified 10% owned foreign corporation. The deduction allowed is computed by determining the U.S.-source portion of the dividend received from the qualified 10% owned foreign corporation.

The deduction is available only if the foreign corporation distributing the dividend has post-1986 undistributed earnings and profits ("E&P") attributable either to income that is (i) effectively connected with a U.S. trade or business, or (ii) dividends received from an 80% owned domestic corporation (with post-1986 undistributed E&P).

For the purposes of determining whether dividends from a qualified 10% foreign corporation attributable to dividends from an 80% owned domestic corporation are eligible for the dividend received deduction,[4] the P.A.T.H. Act provides that a dividend received from a R.E.I.T. or a R.I.C. is not treated as a dividend from a domestic corporation and is therefore not eligible for the dividends received deduction.

CLARIFICATIONS TO THE NEW PARTNERSHIP AUDIT RULES

As discussed in the December edition of *Insights*, the Bipartisan Budget Act of 2015 amended the existing three different regimes for auditing partnerships and replaced them with a unified system of audit rules for smaller and larger partnerships.[5] The P.A.T.H. Act made significant corrections and clarifications to the new unified system of audit rules for partnerships.

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3 Code §243.

4 See Code §245. A domestic corporation is allowed a dividends received deduction for distributions from a 10% owned foreign corporation, however, to the extent that the dividend is derived from the earnings and profits attributable to the U.S.-source portion of such dividends.

5 Philip R. Hirschfeld and Nina Krauthamer, "Congress Enacts Sweeping New Partnership Audit Rules," Insights Vol. 2 No. 10 (2015): 40.

Amendments to Chapter 63 provided for a unified system for audit, adjustments, and collections of tax for partnerships starting after 2017, unless a partnership elected to not have the rules apply.

To examine a partnership, the I.R.S. may issue a notice of administrative proceeding to the partnership or its representative. Generally, the adjustments are made at the partnership level.[6] The I.R.S. has to notify the partnership or the representative about any proposed partnership adjustment before issuing a notice of final partnership adjustment.[7] The notice must identify all the adjustments issued to the partnership and provide the information on underpayment.

The partnership may seek modification if it disagrees with the underpayment made during an administrative proceeding. The partnership is permitted to (i) take into account amounts paid with amended returns filed by partners for a reviewed year, (ii) disregard the portion allocable to a tax-exempt partner, and (iii) take into account a rate of tax lower than the highest tax rate for individuals or corporations for the reviewed year. A partnership can also seek to modify the imputed underpayment amount by demonstrating a lower tax rate.[8] The statutory language only refers to "ordinary income" without making reference to income that may have a lower tax rate, such as that of a corporation, which may be subject to a lower rate than that of an individual. The P.A.T.H. Act removed the reference to "ordinary income," thus permitting application of a lower tax rate in some cases.

"The amount of the specified passive activity loss is concomitantly decreased, and the partnership takes the decrease into account in the adjustment year with respect to the specified partners to which the decrease relates."

In addition, the P.A.T.H. Act added procedures to reduce the amount of imputed underpayment for publicly-traded partnerships. The imputed underpayment can be determined without regard to the portion of the underpayment that the partnership demonstrates is attributable to specified passive activity losses attributable to a specified partner. The amount of the specified passive activity loss is concomitantly decreased, and the partnership takes the decrease into account in the adjustment year with respect to the specified partners to which the decrease relates.

The partnership tax return can be audited within three years after

- the date the partnership tax return was filed;
- the date the return was due, if it was not filed; or
- the date an administrative adjustment request is made.

The three years can be extended if the I.R.S. issues a notice of proposed adjustment.[9] Once the proposed adjustment is issued, a partnership has 270 days in which it may seek a modification of the imputed underpayment. The partnership may request additional time. During this time, the I.R.S. is not allowed to issue a notice of final partnership adjustment. When a proposed adjustment is issued within the three-year period and results in an imputed underpayment, the final partnership notice may be issued no later than either

- the date that is 270 days after the partnership has completed its response

[6] Code §6221.

[7] Code §6231(a)(1)&(2).

[8] Code §6225(c)(4).

[9] Code §6231.

seeking a revision of an imputed underpayment; or

- if the partnership provides an incomplete or no response, no later than 270 days after the date of a notice of proposed adjustment.

The P.A.T.H. Act clarifies the conflict between Code §6231, which restricts the filing of the final partnership adjustment before 270 days after the notice of proposed adjustment has been filed, and Code §6235, which requires the I.R.S. to issue the notice of final partnership adjustment within 270 days after the proposed notice of adjustment is issued. The P.A.T.H. Act provides 330 days to the I.R.S. to issue a notice of final partnership adjustment to a partnership.

The P.A.T.H. Act also clarifies that one of the forums for judicial review is the Court of Federal Claims.

THE EXTENDERS

The P.A.T.H. Act retroactively extends approximately 50 tax provisions that are favorable to individuals and businesses. These tax "extenders" were temporary tax provisions, which were regularly extended by Congress but had expired at the end of 2014.

The following discussion is focused on the permanent extensions of certain business tax provisions, specifically the following:

- Reduction in the S corporation recognition period for built-in gains tax
- Subpart F exception for active financing income
- Qualified investment entity treatment for R.I.C.'s under F.I.R.P.T.A.

Extension of Reduction in S Corporation Recognition Period for Built-in Gains Tax

The P.A.T.H. Act retroactively extends to tax years beginning after December 31, 2014, and makes permanent the provision that an S corporation has a period of five years to recognize its net built-in gain, which is reduced from the 10-year recognition period under prior law.[10]

Background

A small business corporation may elect to be treated as an S corporation.[11] A "small business corporation" is defined in Code §1361(b) and is generally as a domestic corporation that does not have

1. more than 100 shareholders,
2. corporate shareholders (*i.e.*, its shareholders are individuals, trusts, estates, qualified pensions, or certain non-profit organizations),

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[10] Code §1374(d)(7), as amended by P.A.T.H. Act §127(a).

[11] *Technical Explanation of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029* (Rules Committee Print 114-40), JCX-114-15 (Dec. 17, 2015), p. 41.

3. non-U.S. resident shareholders, and

4. more than one class of stock.[12]

Except as discussed below, an S corporation is not subject to tax at the corporate level, unlike a C corporation, because an S corporation's income and loss passes through to its shareholders. Thus, each shareholder separately accounts for and pays tax on its share of the S corporation's income or loss.[13]

"The P.A.T.H. Act retroactively extends approximately 50 tax provisions that are favorable to individuals and businesses."

A corporate-level tax is triggered under Code §1374 on the net recognized built-in gain[14] of an S corporation at the time a C corporation elects to become an S corporation, or at the time an S corporation receives an asset with a carryover basis from a C corporation in a nontaxable transfer. The S corporation is taxed at the highest marginal corporate rate (currently 35%) on all gains that were built-in at the time of the election or asset transfer, if the gain is recognized during a recognition period.

The general recognition period under the prior law was ten years. Under the P.A.T.H. Act, the recognition period has been permanently amended to five years.

Under the prior and current law, the recognition period for converting into an S corporation begins with the first day of the first tax year for which the S election was in effect.[15] The recognition period for any asset transferred by the C corporation starts on the date the asset is acquired by the S corporation in lieu of the beginning of the first tax year for which the corporation was an S corporation.[16]

For a C corporation that converts into an S corporation, if the S corporation's taxable income is less than the amount of net recognized built-in gain in the year such built-in gain is recognized (*i.e.*, because of losses after the C corporation converts into an S corporation), no tax under Code §1374 is imposed on the excess of the built-in gain over the taxable income for that year. Under Code §1374(d)(2) however, this excess of recognized built-in gain, which was untaxed in one year, is treated as recognized built-in gain in the next tax year.[17] Furthermore, Treas. Reg. §1.1374-4(h) dictates that the built-in gain tax applies to income when a corporation sells an asset before or during the recognition period and the income from such sale is reported using the installment method of Code §453 during or after the recognition period.[18]

If the S corporation acquires an asset from a C corporation in a transaction in which the S corporation's basis in such asset is determined (in whole or in part) by reference to the basis of such asset (or other property) in the hands of a C corporation, the tax of Code §1374 applies to any net recognized built-in gain attributable to any such assets for any tax year beginning in the recognition period.[19]

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[12] Code §1361(b).

[13] Code §1366.

[14] See Code §1374(d)(5). Certain built-in income items are treated as recognized built-in gain for this purpose.

[15] Code §1374(d)(7)(A).

[16] Code §1374(d)(8)(B).

[17] *Technical Explanation*, p. 41-42.

[18] *Id.*

[19] Code §1374(d)(8)(A).

The amount of any built-in gain tax imposed under Code §1374 for any tax year of an S corporation is treated as a loss sustained by the S corporation during such tax year. The character of such loss shall be determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax.[20]

Rules for Years 2009, 2010, and 2011 (Prior to P.A.T.H. Act)

Before the P.A.T.H. Act, an S corporation with tax years beginning in 2009 and 2010 did not have tax imposed on the net recognized built-in gain under Code §1374 if the seventh tax year in the corporation's recognition period proceeded such tax year.[21]

For an S corporation with a tax year beginning in 2011, no tax was imposed on the net recognized built-in gain of an S corporation under Code §1374 if the fifth year in the corporation's recognition period proceeded such tax year.[22]

Rules for Years 2012, 2013, and 2014 (Prior to P.A.T.H. Act)

"The P.A.T.H. Act permanently and retroactively extends, to tax years beginning after December 31, 2014, the temporary exclusion for 'active financing income' from the definition of Subpart F income."

Before the P.A.T.H. Act, the recognition period of Code §1374 for tax years beginning in 2012, 2013, and 2014 implemented a five-year recognition period, instead of the general 10-year period, when determining the net recognized built-in gain.[23] The five-year recognition period began with the first day of the first tax year for which the corporation was an S corporation (or beginning with the date the S corporation acquired assets from a C corporation).[24] If (i) an S corporation disposed of assets subject to Code §1374 in a tax year beginning in 2012, 2013, or 2014 and (ii) the disposition occurred more than five years after the first day of the relevant recognition period, gain or loss on the disposition was not considered in determining the net recognized built-in gain.[25]

R.E.I.T.'s and R.I.C.'s under Code §1374

A R.E.I.T. or R.I.C., as defined above, that was formerly a C corporation (or that acquired assets from a C corporation) generally is subject to the rules of Code §1374 as if the R.E.I.T. or R.I.C. was an S corporation, unless the relevant C corporation elects "deemed sale" treatment. The regulations expressly refer to the 10-year period in Code §1374.[26] As discussed above, the P.A.T.H. Act permanently amends the recognition period for net recognized built-in gain of an S corporation to five years. The five-year recognition period also applies to R.E.I.T.'s and R.I.C.'s that do not elect the "deemed sale" treatment.[27]

Extension of Subpart F Exception for Active Financing Income

The P.A.T.H. Act permanently and retroactively extends, to tax years beginning after December 31, 2014, the temporary exclusion for "active financing income" from the

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20 Code §1366(f)(2).

21 Code §1374(d)(7)(B)(i).

22 Code §1374(d)(7)(B)(ii).

23 Code §1374(d)(7)(C).

24 *Technical Explanation*, p. 43.

25 *Id.*

26 *Id.*

27 P.A.T.H. Act §127(b).

definition of Subpart F income.[28] Active financing income includes income derived in the active conduct of a banking, financing, or similar business; as a securities dealer; or in the conduct of an insurance business.

Background

Under the Subpart F rules,[29] U.S. shareholders that own 10% or more of a controlled foreign corporation ("C.F.C.") are subject to U.S. tax on certain income earned by the C.F.C., regardless of whether such income is distributed to the shareholders. Insurance income and foreign base company income ("F.B.C.I.") were initially among the types of income subject to inclusion under the Subpart F rules, until the temporary exceptions (see below) became effective for tax years beginning in 1999 and after.[30]

Under Code §954, F.B.C.I. includes foreign personal holding company income ("F.P.H.C.I.") and foreign base company services income ("F.B.C. Services Income"). F.B.C. Services Income is income derived from services performed for or on behalf of a related person outside the country in which the C.F.C. is organized.[31]

Generally, F.P.H.C.I. consists of

- passive income such as dividends, interest, royalties, rents, and annuities;
- interests in trusts, partnerships, and real estate mortgage investment conduits ("R.E.M.I.C.'s");
- net gains from commodities or foreign currency transactions; and
- income from other similar transactions.[32]

Insurance income is treated as Subpart F income and consists of any income of a C.F.C. attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the C.F.C.'s country of organization.[33]

Active Financing Income Exception (Prior to P.A.T.H. Act)

There were temporary exceptions that prevented certain F.P.H.C.I., F.B.C. Services Income, and insurance income from being treated as Subpart F income.[34] This Subpart F exclusion applied to "active financing income," which is generally income derived in the active conduct of a banking, financing, or similar business; as a securities dealer; or in the conduct of an insurance business.[35]

Before the enactment of the P.A.T.H. Act, the temporary exceptions for active financing income applied to tax years of foreign corporations beginning after December

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28 Code §§953(e)(10) and 954(h)(9), as amended by P.A.T.H. Act §128.

29 Code §§951-64.

30 *Technical Explanation*, p. 44.

31 Code §954(e).

32 Code §954(c).

33 *Technical Explanation*, p. 44.

34 *Id.*

35 Code §954(h)(3).

31, 1998 and before January 1, 2015, and to tax years of U.S. shareholders with or within such tax years of such foreign corporation's end.[36]

In order to qualify for the active financing exceptions to Subpart F treatment, a C.F.C. is required to be predominantly engaged in the active conduct of a banking, financing, or similar business, and to conduct substantial activity with respect to such business.[37] Other exceptions apply to income derived from certain cross-border transactions as well as exceptions for certain F.P.H.C.I. derived by a securities dealer within the meaning of Code §475 and for gain from the sale of active financing assets.[38]

> ***"The P.A.T.H. Act permanently and retroactively extends, to tax years beginning after December 31, 2014, the inclusion of a R.I.C. within the definition of a qualified investment entity' under Code §897."***

Extension of Qualified Investment Entity Treatment under F.I.R.P.T.A. to R.I.C.'s

The P.A.T.H. Act permanently and retroactively extends, to tax years beginning after December 31, 2014, the inclusion of a R.I.C. within the definition of a "qualified investment entity" under Code §897.[39]

However, this provision of the P.A.T.H. Act does not apply with respect to the withholding requirement under Code §1445 for any payment made before the enactment date of December 18, 2015. Thus, a R.I.C. that withheld and remitted tax under Code §1445 on distributions made after December 31, 2014 and before December 18, 2015 is not liable to the distributee with respect to such withheld and remitted amounts.[40]

There are special U.S. tax rules that apply to a foreign person's capital gains derived from dispositions of an interest in U.S. real property.[41] Under F.I.R.P.T.A., a foreign person who sells a U.S.R.P.I., as defined above, is subject to tax at the same rates as a U.S. person. Code §1445 also imposes a withholding tax on such income.

A U.S.R.P.I. includes stock or a beneficial interest in any domestic corporation unless such corporation has not been a U.S. real property holding corporation during the testing period.[42] A U.S.R.P.I. does not include an interest in a domestically controlled qualified investment entity.[43]

A qualified investment entity includes a real estate investment trust and also includes a R.I.C. that meets certain requirements.[44] However, before the P.A.T.H. Act, the inclusion of a R.I.C. in that definition did not apply for certain purposes after December 31, 2014.[45]

A distribution from a qualified investment entity that is attributable to the sale of

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36 *Technical Explanation*, p. 46.

37 See Code §954(h)(2).

38 See Code §954(h); *Technical Explanation*, p. 45.

39 Code §897(h)(4)(A), as amended by P.A.T.H. Act §133(a).

40 P.A.T.H. Act §133(b).

41 *Technical Explanation*, p. 49.

42 See Code §897; *Technical Explanation*, p. 49.

43 *Id.*

44 Code §897(h)(4)(A).

45 Code §897(h).

a U.S.R.P.I. is also subject to tax under F.I.R.P.T.A. unless the distribution is with respect to an interest that is regularly traded on an established securities market located in the U.S. and the recipient foreign corporation or nonresident alien individual does not hold more than 5% of that class of stock or beneficial interest within the one-year period ending on the date of distribution.[46] There are additional rules that apply to certain tiers of qualified investment entities.

NEW RULES FOR INDIVIDUAL TAXPAYER IDENTIFICATION NUMBERS

The P.A.T.H. Act modifies the individual taxpayer identification number ("I.T.I.N.") application procedures and establishes new rules on the use, renewal, and expiration of I.T.I.N.'s. These new provisions are effective for I.T.I.N. requests made after December 18, 2015.

General Rules for I.T.I.N.'s

"The P.A.T.H. Act modifies the I.T.I.N. application procedures and establishes new rules on the use, renewal, and expiration of I.T.I.N.'s."

An individual who files a U.S. tax return must provide his taxpayer identification number on the return.[47] A taxpayer identification number is generally the individual's Social Security number ("S.S.N.").[48] Individuals who are not eligible to have S.S.N.'s must obtain I.T.I.N.'s in order to properly file U.S. tax returns.[49] Examples of individuals who may need an I.T.I.N. in order to file a U.S. tax return include the following:

- Nonresident aliens filing a claim for a reduced withholding rate under treaty benefits
- Nonresident aliens required to file a U.S. tax return
- U.S. resident aliens filing a U.S. tax return
- Dependents or spouses of a U.S. citizen or resident alien
- Dependents or spouses of a nonresident alien visa holder[50]

To apply for an I.T.I.N., the individual must complete a Form W-7, *Application for I.R.S. Individual Taxpayer Identification Number*, which requires a taxpayer to present original documents such as passports and birth certificates, or certified copies of such documents. Notarized or apostilled copies of such documents are not accepted by the I.R.S.[51]

The Form W-7 may be submitted by mail or in person.[52] For example, a taxpayer

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[46] Code §§857(b)(3)(F), 852(b)(3)(E), and 871(k)(2)(E) require dividend treatment, rather than capital gain treatment, for certain distributions to which F.I.R.P.T.A. does not apply by reason of this exception. See also Code §881(e)(2).

[47] *Technical Explanation*, p.124.

[48] Code §6109(a).

[49] Treas. Reg. §301.6109-1(d)(3)(i).

[50] *Technical Explanation*, p.124.

[51] See Instructions for Form W-7 (Rev. December, 2014).

[52] *Id.*

“Under the P.A.T.H. Act, any I.T.I.N. issued after December 31, 2012 will expire if it is not used on a Federal income tax return for a period of three consecutive tax years.”

may apply for an I.T.I.N. by bringing the completed documentation and forms to an I.R.S. Taxpayer Assistance Center in the United States or to an I.R.S. office abroad. An acceptance agent or certifying acceptance agent may also submit the Form W-7 application on behalf of the taxpayer along with the required documentation. A certifying acceptance agent is authorized by the I.R.S. to verify the taxpayer’s identifying documentation and must attach a certificate of accuracy to the Form W-7 application that is filed on behalf of a taxpayer.[53]

Issuance of I.T.I.N.’s under the P.A.T.H. Act

The P.A.T.H. Act established that the I.R.S. may issue I.T.I.N.’s if the applicant provides the required documentation either (i) in person to an I.R.S. employee or to a community-based certified acceptance agent (authorized by the I.R.S.),[54] or (ii) by mail. Individuals who were issued I.T.I.N.’s before 2013 must renew those I.T.I.N.’s pursuant to a staggered schedule between years 2017 and 2020.

Individuals residing outside the United States may submit in-person applications to an employee or designee of the I.R.S. at a U.S. diplomatic mission or consular post. This new provision enables the I.R.S. to establish procedures on how to accept I.T.I.N. applications by mail.[55]

The I.R.S. must maintain a program for certifying and training community-based acceptance agents. The following persons may qualify as acceptance agents:

- Financial institutions
- Colleges and universities
- Federal agencies
- State and local governments (including state agencies responsible for vital records)
- Persons that provide assistance to taxpayers in the preparation of their tax returns
- Other persons or categories of persons as authorized by regulations or in other guidance by the I.R.S.[56]

The I.R.S. may determine what documents are acceptable for establishing an individual’s identity, foreign status, and residency. However, only original documents or certified copies meeting the I.R.S. requirements will be acceptable.

The I.R.S. must also develop procedures that distinguish I.T.I.N.’s used by individuals solely for the purpose of obtaining treaty benefits to ensure they are only used for such benefits.[57]

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53 *Technical Explanation*, p.125.

54 The community-based certified acceptance agent program is intended to expand the existing I.R.S. acceptance agent program. See Rev. Proc. 2006-10, 2006-1 C.B. 293 (December 16, 2005).

55 *Technical Explanation*, p.126.

56 *Id.*

57 *Id.*

Expiration of I.T.I.N.'s under the P.A.T.H. Act

Under the P.A.T.H. Act, any I.T.I.N. issued after December 31, 2012 will expire if it is not used on a Federal income tax return for a period of three consecutive tax years (expiring on December 31 of the third consecutive year).[58]

I.T.I.N.'s issued prior to 2013 are subject to the general rule that the I.T.I.N. will expire if it is not used for a period of three consecutive years. However, regardless of whether an I.T.I.N. has been used on a Federal income tax return or not, an I.T.I.N. issued prior to 2013 will no longer be valid as of the following applicable dates:

- An I.T.I.N. issued before 2008 will expire on January 1, 2017.
- An I.T.I.N. issued in 2008 will expire on January 1, 2018.
- An I.T.I.N. issued in 2009 or 2010 will expire on January 1, 2019.
- An I.T.I.N. issued in 2011 or 2012 will expire on January 1, 2020.[59]

The Treasury Office of the Inspector General must conduct an audit of the I.T.I.N. application process beginning two years after December 18, 2015 and every two years thereafter. The I.R.S. must also conduct a study on the effectiveness of the I.T.I.N. application process before amending these new provisions.[60]

58 *Id.*

59 *Id.*, p. 126-127.

60 *Id.*, p. 127.

I.R.S. ADOPTS O.E.C.D. STANDARD IN NEW CBC REPORTING REGULATIONS

Author
Stanley C. Ruchelman
Sheryl Shah

Tags
CbC Reporting
Exchange of Financial Information
Multinational Enterprises

In December, the I.R.S. released Prop. Treas. Reg. §1.6038-4,[1] which details the country-by-country ("CbC") reporting that will be required of large U.S.-based business entities. This reporting is consistent with the model template recommended by the O.E.C.D.

The proposed regulations define the persons required to file the CbC report, companies that are to included in the report, information that must be reported, acceptable measurement methodologies to be used, and uses to which data may be put. The preamble to the proposed regulations ("preamble") includes a model reporting form.

ACTION OBJECTIVES

The aim of these proposed regulations is to facilitate enforcement of U.S. tax law. These regulations will allow for better enforcement of income tax law by providing tax agencies with greater transparency regarding the operations and tax positions taken by U.S.-based multinational groups.

The model template recommended by the O.E.C.D. will be adopted by the I.R.S. As explained in the preamble, adoption of the template promotes consistent and effective CbC reporting across different tax jurisdictions. It is anticipated that other tax jurisdictions will adopt similar information reporting requirements, based on the model template, for Multinational Enterprise ("M.N.E.") groups based in those countries.

Moreover, the model template was developed taking into account extensive consultations with stakeholders, including U.S. M.N.E. groups, in order to appropriately balance the benefit to tax administrations, which arises from the collection of information about the M.N.E. groups' global operations, against the compliance costs and burdens imposed on those M.N.E. groups. These consultations significantly affected both the scope of the information included in the model template and the flexibility afforded to M.N.E. groups in determining how to compile that information in light of their diverse internal structures and logistical capabilities. In addition, the model template reflects an agreed-upon international standard for reporting by M.N.E. groups that will promote consistency of reporting obligations across tax jurisdictions and reduce the risk that other countries will depart from the standard by imposing inconsistent and overlapping reporting obligations. Nonetheless, the preamble points out that the proposed regulations are also tailored to be consistent with the preexisting information reporting requirements applicable to U.S. persons.

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[1] REG-109822, December 23, 2015.

EXCHANGE OF INFORMATION

CbC reports may be exchanged with tax authorities in other countries pursuant to income tax conventions, other applicable conventions, and bilateral agreements relating to the exchange of information. Thus, the I.R.S. anticipates that CbC reports prepared by non-U.S.-based M.N.E. groups will be furnished to the I.R.S. In the aggregate, the reports will help the I.R.S. perform high-level transfer pricing risk identification and assessment in a manner consistent with recently announced audit plan guidelines applicable to the examination of an M.N.E. According to the I.R.S., it is essential that the reporting standards should be consistent across the world so that the same level of deference is afforded to each report when using the data for tax assessment purposes.

"In a world where Sean Penn can meet a drug lord hiding in Mexico without the knowledge of the Mexican government... legitimate doubts exist concerning the data security capabilities of any government."

The information reported in a CbC report will be treated as income tax return information and thus subject to strict confidentiality rules under Code §6103. This information will be exchanged automatically under the authority of information exchange agreements to which the U.S. is a party. Consequently, the exchanged information will be treated as confidential by both parties. All disclosures and any use of the information by the receiving jurisdiction must be in accordance with the terms of the relevant information exchange agreement.

Information exchange agreements generally prohibit the parties from using any information received for any purpose other than the administration of taxes. Accordingly, under the terms of such agreements, neither tax jurisdiction is permitted to disclose the information received or to use the information for any non-tax purpose. The competent authorities of the U.S. and other tax jurisdictions intend to limit the permissible uses of exchanged CbC reports to assessing high-level transfer pricing and other tax risks and, where appropriate, for economic and statistical analysis.

U.S.-based M.N.E. groups are concerned about the practical aspects of confidentiality. In a world where Sean Penn can meet a drug lord hiding in Mexico without the knowledge of the Mexican government and the U.S. Social Security Administration can be hacked, legitimate doubts exist concerning the data security capabilities of any government.

The preamble attempts to assuage these feelings of insecurity. It points out that, prior to entering into an information exchange agreement with another tax jurisdiction, the I.R.S. closely reviews the tax jurisdiction's legal framework for maintaining confidentiality of taxpayer information and its track record of complying with that legal framework. In order to conclude an information exchange agreement with another tax jurisdiction, the I.R.S. must be satisfied that (i) the tax jurisdiction has the necessary legal safeguards in place to protect exchanged information, (ii) such protections are enforced, and (iii) adequate penalties apply to any breach of confidentiality. Moreover, even when these conditions have been met and an information exchange agreement is in effect, the U.S. competent authority will not enter into a reciprocal automatic exchange of information relationship with a tax jurisdiction unless it has reviewed the tax jurisdiction's policies and procedures regarding confidentiality protections and has determined that an exchange relationship is appropriate.

AFFECTED PERSONS

Under the proposed regulations, a U.S. business entity that is the ultimate parent entity of a U.S. M.N.E. group is required to file the CbC reporting form for an annual accounting period only if the U.S. M.N.E. group has global revenues of more than $850 million for the preceding annual accounting period.[2]

A U.S. M.N.E. group is a group of entities that is required to prepare consolidated financial accounts pursuant U.S. G.A.A.P.[3] A parent entity of a U.S. M.N.E. group

- is a U.S. business entity that controls a group of business entities, at least one of which is organized or a tax resident outside of the U.S., which
- is required to consolidate the accounts of the M.N.E. group for financial reporting purposes under U.S. G.A.A.P., or would be required to consolidate accounts if equity interests in the U.S. business entity were publicly traded on a U.S. securities exchange.

The term "business entity" means a person as defined in Code §7701(a) that is not an individual. It also includes a permanent establishment that prepares financial statements that are separate from those of its owner for financial reporting, regulatory, tax reporting, or internal management control purposes.

A business entity is considered a resident of a tax jurisdiction if the entity is liable for taxes in that jurisdiction based on place of management or organization, or another similar criterion. A business entity will not be considered resident in a tax jurisdiction if it is liable to tax solely with respect to income from sources in such jurisdiction or from capital situated there.[4] This allows some room for creative planning to ensure tax residency in certain jurisdictions and not others.

Generally, U.S. G.A.A.P. provides that, if an entity owns a majority voting interest in another legal entity, the majority owner must combine the financial statements of the majority-owned entity with its own financial statements in consolidated financial statements. A U.S. M.N.E. group does not include business entities that are accounted for under the equity method at the level of the shareholder. Such entities do not consolidate their accounts with the equity owner even though the equity owner's proportionate share of the business income is included in the equity owner's consolidated financial statements.

In some instances, the ultimate parent entity of a U.S. M.N.E. group may be required to prepare consolidated financial statements under U.S. G.A.A.P. but not considered to be an includible corporation for purposes of filing a consolidated corporate income tax return. For example, the top tier ultimate parent entity may own 65% of the outstanding common stock of a first tier holding company that is the common parent of an affiliated group of U.S. domestic corporations that files a consolidated corporate income tax return. Indeed, the ultimate parent entity may own more than one such group.

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2 Prop. Treas. Reg. §1.6038-4(j).

3 Prop. Treas. Reg. §1.6038-4(b)(4).

4 Prop. Treas. Reg. §1.6083-4(b)(6).

The preamble identifies the top tier ultimate parent entity as the company that must prepare and file the CbC report for all companies that join in the preparation of consolidated financial statements, even though it does participate in the consolidated corporate tax return in the U.S. Where these facts occur, the ultimate parent entity would file the CbC report that covers all affiliated group entities. A subsidiary corporation that is a common parent at an intermediate level would not file the CbC report for its group.

The preamble invites taxpayer comments on whether additional guidance is needed for determining which U.S. persons must file CbC reports and which entities are considered constituent entities of the filer in the context of an ultimate parent entity of an M.N.E. group that prepares financial statements on a consolidated basis without having majority ownership of constituent members. Comments are also invited to address whether a need exists for the I.R.S. to exempt a company from the CbC filing requirement or limit the scope of reporting for reasons of national security or another important government function that is within the purview of another Federal agency. In such case, a set of procedures must be drafted for U.S. persons to claim the exemption or limitation and for establishing what circumstances, if any, that would necessitate an independent review by the I.R.S.

Finally, the preamble addresses the reporting obligation when a constituent entity is a partnership in the tax jurisdiction in which it is organized and operates in no other country through a permanent establishment. It is expected that reporting will take place at the partner level so that each partner will report its share of the partnership's items in its jurisdiction of tax residence. An open issue at present is the treatment of entities that are not treated as being fiscally transparent in the owners' jurisdictions of residence but are treated as fiscally transparent in the country of organization of the entity. Again, the I.R.S. has invited comments to identify issues that require further guidance.

CBC REPORTING REQUIREMENTS

The template on which Form XXXX, *Country-by-Country Report*, will be based is provided below.

Name of the M.N.E. Group: Fiscal year concerned:															
Tax Jurisdiction	Constituent Entities resident in the Tax Jurisdiction	Tax Jurisdiction of organization of incorporation if different from Tax Jursidiction of Residence	Main business activity(ies)												
			Research and Development	Holding of Managing intellectual property	Purchasing or Procurement	Manufacturing or Production	Sales, Marketing, or Distribution	Administrative, Management, or Support Services	Provision of Services to unrelated parties	Internal Group Finance	Regulated Financial Services	Insurance	Holding shares or other equity instruments	Dormant	Other*
	1.														
	2.														
	3.														
	1.														
	2.														
	3.														

*Please specify the nature of the activity of the constituent entity in the "Additional Information" section.

Name of the M.N.E. group: Fiscal year concerned: Currency used:											
Tax Jurisdiction	Revenues			Profit (Loss) Before Income Tax	Income Tax Paid (on cash basis)	Income Tax Accrued – Current Year	Stated Capital	Accumulated Earnings	Number of Employees	Tangible Assets other than Cash and Cash Equivalents
	Unrelated Party	Related Party	Total							

Name of the M.N.E. group: Fiscal year concerned:
Additional Information. *Please include any further brief information or explanation you consider necessary or that would facilitate the understanding of the compulsory information provided in the Country-by-Country Report.*

The CbC report is required to be filed with the ultimate U.S. parent entity's timely-filed tax return.[5]

Constituent Entity Information

The proposed regulations describe the information required to be reported for each constituent entity of the M.N.E. group.[6] A reportable constituent entity is any separate business entity, except a foreign corporation or partnership, or any permanent establishment of such foreign corporation or partnership, for which the ultimate parent entity is not required to provide information under Code §6038(a). The I.R.S. has invited comments on whether additional guidance is needed on reportable constituent entities. The information required includes the tax identification number, the tax jurisdiction of residence, the tax jurisdiction in which the entity is organized (if different from the residence jurisdiction), and the main business activity of the entity.

Financial and Employee Information

Certain information,[7] which is required for each tax jurisdiction, must be presented in the aggregate for all resident constituent entities of that jurisdiction. Constituent entities that have no tax jurisdiction of residence must report the required information on an aggregate basis for all entities that have no jurisdiction.[8]

The information required for each tax jurisdiction includes (i) all revenues generated from transactions with other constituents and from non-constituent entities, (ii) pre-tax profit or loss, (iii) taxes paid in all jurisdictions, (iv) accrued tax expenses recorded, (v) stated capital, (vi) accumulated earnings, (vii) number of full-time employees,

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5 Prop. Treas. Reg. §1.6038-4(g).

6 Prop. Treas. Reg. §1.6038-4(d)(1).

7 Prop. Treas. Reg. §1.6038-4(d)(2).

8 Prop. Treas. Reg. §1.6038-4(d)(3)(i).

and (viii) net book value of tangible assets other than cash or its equivalent. This information will sum up the activity that takes place in the jurisdiction and help a tax administration to identify any highly profitable locations where few employees are assigned and little tax is paid.

The number of full-time employees can be determined at the close of the accounting period using any reasonable basis, including any independent contractors that participate in the ordinary operating activities of the constituent entity.[9] For reporting purposes, the tax residence of an employee is determined by reference to the entity that employs the individual and not by the residence of the individual. Any reasonable basis can be used to make these determinations, provided that they are applied consistently and are justifiable.

The financial information reported may be based on records used for tax reporting purposes.[10] There is no need to reconcile the revenue, profit, and tax reported or make adjustments for differences in accounting principles applied from jurisdiction to jurisdiction. Any changes made in the source data can be explained on the reporting form.

While the I.R.S. and the Treasury have tried to adhere to the model template developed by the G-20 and O.E.C.D., they acknowledge that certain areas may require clarification for practical use and therefore invite comments on the manner in which the proposed regulations request employee and financial information.

FILING AND MAINTAINING RECORDS

The reporting form is required to be filed with the ultimate parent entity's timely-filed tax return.[11] Sufficient records must be maintained to support the information provided.[12] Constituent entities are not required to provide notice of the M.N.E. reporting requirement or that they have been included in any such report.

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9 Prop. Treas. Reg. §1.6038-4(d)(3)(iii).

10 Prop. Treas. Reg. §1.6038-4(e)(2).

11 Prop. Treas. Reg. §1.6038-4(f).

12 Prop. Treas. Reg. §1.6038-4(g).

CORPORATE MATTERS:
IF I CAN MAKE IT THERE, I CAN MAKE IT...

Author
Simon H. Prisk

Tags
Corporate Law
Cross Border Tax Planning
New York
Retail

We have recently been receiving instructions from a variety of European clients looking to open either an office or retail location in New York. Typically, this is their first foray into the United States, and clients often take the view that a product that does well at home simply cannot miss when it migrates to New York. These clients are looking for advice across a range of topics: from location and leases to signage and insurance. We thought it might be helpful to set out a brief description of what to expect when opening a retail store in New York.

LOCATION AND LEASE

The first time we meet the client is when they are in New York looking at space. The typical client has a successful product in its home county, and often, the United States is their second largest market. Many feel there is still a general reluctance to purchase through the internet from Europe and hope that a store in New York will enhance sales and brand recognition. While many of the tasks required before opening can be completed simultaneously, we advise clients to hold off on entity formation and other basic tasks until a site is identified and discussions with the owner are close to completion. The term of the lease or sublicense agreement may be relatively short – clients are generally not looking for long-term commitments, and if the arrangement is initially only for a year or two, many landlords treat the tenant almost like a "pop-up" store. In any event, a review by a real estate attorney is a must. Once the lease is close to being finalized, discussions can begin with the contractor who will fit out the store.

ENTITY FORMATION

We have discussed types of entities and jurisdiction of formation in previous articles. Typically, we form entities in Delaware and qualify them to do business in the jurisdiction where operations are taking place. This is particularly the case if the thought is to open more than one location in the United States. It may be, however, that after discussion with the client a New York corporation is formed. For reasons discussed in previous articles, we typically recommend forming a C corporation as the vehicle through which the operations in the United States are conducted. Various tax reasons and asset protection reasons drive this recommendation.

BANK ACCOUNT

The business will require a bank account, and while each bank is different, we have noticed that the procedures for foreign controlled entities opening bank accounts in New York has become somewhat more streamlined. This can depend on where the foreign owner resides, however, and some research on this point should be done early in the process. To open a bank account, the entity will need a tax identification number, commonly referred to as an E.I.N. Depending on the status of the applicant, an E.I.N. can be obtained in as little as one day, but in any event, is generally available in less than a week. An E.I.N. is also often required by vendors as part of the credit authorization process.

OTHER ADVISORS

We work with a cadre of experienced accounting firms who cater to small- and middle-market clients. Often, those clients have difficulty being serviced by front-line staff at national or super-regional accounting firms. We usually try to get an accounting firm involved early in the process, as they can help with matters such as setting up payroll and tax projections.

"Clients are generally not looking for long-term commitments, and if the arrangement is initially only for a year or two, many landlords treat the tenant almost like a "pop-up" store."

We also work with insurance brokers, as all leases will have a clause requiring the tenant to carry comprehensive liability insurance. The contract will state the minimum amount of coverage required and will request that the owner and the bank holding the mortgage, if there is one, be named as additional insured under the policy.

EMPLOYEES

Employment agreements are not generally required for employees of retail stores. If an experienced President or C.E.O. is to be hired, an agreement for that individual may be advisable. Payroll systems can be put in place with the assistance of an accountant or a payroll service.

Initially, many clients prefer to have an existing employee come to oversee the start-up operations at the new location. The visa issues raised by this must be addressed early on so appropriate filings can be made on a timely basis.

Workers Compensation Insurance will most likely need to be obtained. The penalties for non-compliance with the regulations can be onerous, both as to fines and use of management time, so attention should be paid to this matter.

INTELLECTUAL PROPERTY

The company's trademark should be registered in the United States, and the extent of required filings should be discussed with a trademark attorney. Use of trademarks should be licensed in order to protect valuable I.P. from claims in the event that U.S. operations are unsuccessful and creditors attempt to seize the mark.

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

Authors
Galia Antebi
Rusudan Shervashidze
Philip R. Hirschfeld

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

D.O.J. SWISS BANK PROGRAM CONTINUES TO COLLECT PENALTIES

The U.S. Justice Department ("D.O.J.") Swiss Bank Program was launched in 2013 and allows banks to resolve potential criminal charges by disclosing cross-border activities that helped U.S. account holders conceal assets. Under the program, in addition to paying a penalty, banks must provide detailed information on U.S.-related accounts under investigation. Banks can also mitigate their penalties by encouraging U.S. account holders to come into compliance with U.S. tax and reporting obligations. As of December 23, the D.O.J. has reached agreements with 75 Swiss banks and imposed penalties in excess of $1 billion.

The latest resolution reached under the D.O.J's Swiss Bank Program was on January 6, 2016. Under the agreement, Union Bancaire Privée, UBP SA ("UBP") will pay a penalty of over $187 million in return for the department's agreement not to prosecute UBP for tax-related criminal offenses. This is the second largest settlement under the program, surpassed only by the $211 million penalty paid by BSI SA in March 2015. According to a statement made by UBP, the penalty will be paid from its 2015 profits and will not affect it's Tier 1 ratio, the result being that the bank will remain one of the most well-capitalized banks in Switzerland.

Since the D.O.J. program began, many Swiss banks have adopted a policy of forcing U.S. clients to disclose undeclared accounts to the I.R.S. in hopes of mitigating their penalties; however, some banks have ignored the official policy and continued to assist U.S. clients in avoiding taxes. U.B.P. admitted that it assisted two such clients in closing their accounts and withdrawing gold bars valued more than $50 million, thereby eliminating the paper trail back to the U.S. undeclared funds.

In December 2015, a total of 18 banks signed an agreement under the Swiss Bank Program. This includes an agreement signed on December 15, according to which three Swiss banks collectively agreed to pay $130 million to avoid charges on aiding U.S. persons to avoid tax. The Swiss banks had aided tax avoidance by setting up overseas entities, including in Panama, to hold client funds and conceal the owners' true identities from U.S. tax authorities and allowing for untraceable withdrawals of large sums of cash or gold. The three banks that joined the program in mid-December are the Zurich-based unit of France's Crédit Agricole, the Basel-based Dreyfus Sons & Co, and Baumann & Cie, Banquiers. The Zurich-based bank, which managed about 954 U.S.-related accounts worth more than $1.8 billion, paid $99.2 million of the total $130 million penalty. On December 23, five more Swiss banks agreed to pay collectively more than $178 million. Among these five banks are Bank J. Safra Sarasin AG and Coutts & Co Ltd.

According to the D.O.J. website, there have been 76 non-prosecution agreements reached since March 2015 and more than $1 billion has been collected from the banks.

Chief Richard Weber of I.R.S. Criminal Investigation said in a December 23 announcement that "with the wealth of information gathered from the Swiss Bank Program, we have already begun to track those individuals who think they are above the law and continue to hide their money offshore." U.S. account holders at the banks that reached a resolution with the D.O.J. and who have yet to come into compliance may still be eligible to participate in the I.R.S. Offshore Voluntary Disclosure Program, but the price of such disclosure has increased.

NEW INSTRUCTIONS FOR FORM 8966, F.A.T.C.A. REPORT

At the end of 2015, the I.R.S. issued 2015 instructions for foreign financial institutions ("F.F.I.'s") filing a F.A.T.C.A. report. The updated instructions outline changes to the form, including the addition of a checkbox that allows the filer to indicate that it has no accounts to report. This box is optional for filers other than direct reporting non-financial foreign entities ("N.F.F.E.'s") and sponsoring entities filing on behalf of a sponsored direct reporting N.F.F.E. For these types of filers, the new line 1b in Part I was added; it requests a two-digit category code instead of the checkbox that previously appeared in Part II, line 5, and has now been eliminated.

F.A.T.C.A. ON YOUTUBE

The I.R.S. released six new YouTube videos educating viewers on the improvements made to the F.A.T.C.A. Online Registration System. The topics include how certain F.F.I.'s may change their F.F.I. type, how a member F.F.I. can transfer to its expanded affiliated group, and how sponsoring entities can both add several sponsored entities by uploading a single file and also manage their sponsored entities and their subsidiary branches.

EXTENSION OF TIME TO FILE F.A.T.C.A. REPORT

The I.R.S. recently updated Frequently Asked Question ("F.A.Q.") #14, which outlines the procedures for requesting an extension of time to file a Form 8966, *F.A.T.C.A. Report*. According to F.A.Q. #14, Form 8809-I must be used to request an initial or additional extension of time. The form must be filed as soon as the F.F.I. knows that an extension is necessary, but not before January 1 of the filing year. The form must be filed by the due date of Form 8966, which is generally March 31 of the year following the reporting year of the return. For example, to request an extension for filing a report for 2015 a request can first be filed on January 1, 2016.

F.A.Q. #14 also clarifies that F.F.I.'s located in a Model 1 I.G.A. jurisdiction and reporting on behalf of themselves (or on behalf of another entity located in a Model 1 jurisdiction) may not request an additional extension of time to file Form 8966 because the F.F.I.'s must file a report directly to the Model 1 jurisdiction's tax authority.

UPGRADES TO F.F.I. LIST

The F.F.I. List published by the I.R.S. on their F.A.T.C.A. Portal currently allows a person to search and download the list, either in full or in part. It also allows a person to narrow down the search by Global Intermediary Identification Number ("G.I.I.N."), name of the F.F.I., and country/jurisdiction.

The recent upgrades include enabling users to locate sponsored entities and their subsidiary branches and searching for branches by name.

The I.R.S. cautions users that two or more valid G.I.I.N.'s for the same F.F.I. may be reflected on the F.F.I. List for a short period of time because of upgrades to the F.A.T.C.A. Online Registration System, including those mentioned above and featured on YouTube.

UPDATED FORM 1040NR-EZ INSTRUCTIONS REFLECT CHANGES FOR DUAL RESIDENTS WHO MAY NOT HAVE TO FILE FORM 8938 FOR 2015

A U.S. taxpayer is required to file Form 8938, *Statement of Specific Foreign Financial Assets*, to disclose specified foreign financial assets with an aggregate value exceeding $50,000. Higher thresholds apply to U.S. taxpayers who file a joint tax return or who reside outside the U.S. Form 8938 must be attached to the taxpayer's annual income tax return. Final Regulations issued in December 2014 provided an exclusion from filing to dual residents that timely file their U.S. tax return as nonresidents, pursuant to an applicable treaty between the U.S. and their country of residence, and also claim a treaty benefit on Form 8833. On January 6, 2016, the I.R.S. released the updated instructions for Form 1040NR-EZ, *U.S. Income Tax Return for Certain Nonresident Aliens With No Dependents*, in which it addressed this exception and clarified that certain dual residents do have to report specified foreign financial assets on Form 8938 for 2015.

The updated instructions for Form 1040NR-EZ also provide guidance on how to claim treaty benefits pursuant to a competent authority determination requiring that the taxpayer attach a copy of such determination to his or her return.

SATISFYING F.A.T.C.A. REQUIREMENTS WITH FORM 1099-B

On December 2, the I.R.S. released new instructions for Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*, outlining how F.F.I.'s and U.S. payers may use this form to comply with their F.A.T.C.A. obligations. A new checkbox was added to the form to identify an F.F.I. or a U.S. payer filing the form to satisfy their F.A.T.C.A. reporting requirements. The I.R.S. announced in June that it would enable F.F.I.'s to use Form 1099 for F.A.T.C.A. reporting pursuant to the regulations, and it is now delivering on its promise.

POLAND EXPECTED TO EFFECT NEW REGULATIONS UPDATING F.A.T.C.A. REPORTING

On December 8, the Polish Ministry of Finance opened the draft regulations for consultation and requested comments by December 11. The new regulations cover updates to electronic forms and the transmission method for financial information using an electronic signature to ensure authenticity. The regulations are expected to enter into force January 1, 2016.

MOLDOVA TO RATIFY MODEL 2 I.G.A.

The Moldovan Parliament, which signed a Model 2 I.G.A. with the U.S. on November 26, 2014, has now passed a bill to ratify the I.G.A. This ratification enters the I.G.A. into force, although the U.S. treats Moldovan financial institutions as having a Model 2 I.G.A. in effect as of June 30, 2014.

INDIA UPDATES F.A.T.C.A. GUIDANCE

On December 31, 2015, India's Central Board of Direct Taxes ("C.B.D.T") issued an updated version to the guidance note on F.A.T.C.A. reporting. The guidance note provides an explanation of the reporting requirements under F.A.T.C.A. and the Common Reporting Standard ("C.R.S."). The guidance note requests feedback and suggestions from affected taxpayers for future updates.

"To date, the U.S. has signed, or reached an agreement to sign, more than 100 Model 1 I.G.A.'s."

CURRENT I.G.A. PARTNER COUNTRIES

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

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

Algeria	Gibraltar	New Zealand
Angola	Greece	Norway
Anguilla	Greenland	Panama
Antigua & Barbuda	Grenada	Peru
Australia	Guernsey	Philippines
Azerbaijan	Guyana	Poland
Bahamas	Haiti	Montserrat
Bahrain	Greece	Netherlands
Barbados	Holy See	Qatar
Belarus	Honduras	Romania
Belgium	Hungary	Saudi Arabia
Brazil	Iceland	Serbia
British Virgin Islands	India	Seychelles
Bulgaria	Indonesia	Slovak Republic

Cabo Verde
Cambodia
Canada
Cayman Islands
China
Colombia
Costa Rica
Croatia
Curaçao
Cyprus
Czech Republic
Denmark
Dominica
Dominican Republic
Estonia
Finland
France
Georgia
Germany
Ireland
Isle of Man
Israel
Italy
Jamaica
Jersey
Kazakhstan
Kosovo
Kuwait
Latvia
Liechtenstein
Lithuania
Luxembourg
Macao
Malaysia
Malta
Mauritius
Mexico
Montenegro
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.

Authors
Elizabeth V. Zanet
Kenneth Lobo
Galia Antebi

Tags
Action 13
Beanie Babies
B.E.P.S.
Conformity Rule
E.U.
L.I.F.O.
Non-Profit
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T.A.X.E. Committee
Tax Evasion
Tax Reform
Patent Box

BEANIE BABY BILLIONAIRE'S SENTENCE NOT PRECEDENT FOR OFFSHORE TAX CASES

H. Ty Warner – the founder and chief executive officer of Ty, Inc., the company that produces Beanie Babies – was sentenced to two years of probation and 500 hours of community service after pleading guilty to one count of tax evasion with respect to foreign financial accounts maintained in Switzerland.

The Seventh Circuit Court of Appeals affirmed the sentence, after the government challenged it on the grounds that the sentence was unreasonable because it did not include prison time.[1]

The sentence is considerably less than what Mr. Warner could have received since his guilty plea could have sent him to jail for almost five years under the applicable sentencing guidelines,[2] and the Federal prosecutors had asked the sentencing judge for one year and one day in jail.

Since the late 1990's – as the Beanie Babies' brand first experienced considerable sales – Mr. Warner has kept money offshore in Swiss bank accounts: first at UBS and later at a smaller, regional bank called Zuercher Kantonalbank.

In 2009, under pressure and threat of indictment, UBS revealed to the U.S. Department of Justice ("D.O.J.") that Mr. Warner was one of the wealthy U.S. citizens that it had helped hide money offshore. That same year, Mr. Warner attempted to disclose this noncompliance under the Offshore Voluntary Disclosure Program ("O.V.D.P."). At that point, he learned that he was already under investigation and therefore ineligible to enter the O.V.D.P.

As part of his guilty plea, Mr. Warner paid a civil penalty in the amount of $53.6 million for willfully failing to file foreign bank account reports ("F.B.A.R.'s"). The penalty represents 50% of the maximum balance of the unreported offshore accounts during the period of noncompliance. Mr. Warner also paid back taxes, along with interest, on the income generated from the unreported accounts.

The Seventh Circuit concluded that the below-guidelines sentence was reasonable considering (i) Mr. Warner's excellent character, as shown by his long history of charity and kindness to others, (ii) the isolated and uncharacteristic nature of his tax evasion, (iii) his attempt to enter the O.V.D.P., (iv) his guilty plea and prompt payment of liabilities, (v) his payment of an F.B.A.R. penalty in the amount of $53.6

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1 *United States v. Warner*, No. 14-1330 (7th Cir. 2015) (Doc 2015-16188).

2 18 U.S.C. §3553(a).

million, which was nearly ten times the tax loss and much higher than what would have been paid under the O.V.D.P. (*i.e.*, 50% vs. 20% through the O.V.D.P.), and (vi) the fact that the government charged him with only one count and itself sought a well-below-guidelines sentence.

The government argued that the lower court gave too much weight to Mr. Warner's charitable giving. The Seventh Circuit found that the district court had looked behind the numbers to Mr. Warner's character and found him to be a genuinely benevolent person. It stated that the lower court's analysis could be applied to a non-wealthy defendant who showed similar qualities or a wealthy defendant who gave to charity cynically in an attempt to give himself an argument at the time of sentencing.

However, some commentators, including attorneys at the D.O.J., have stated that Mr. Warner's sentence should be viewed as unique, and certainly not a trend, in large offshore tax evasion cases.

EUROPEAN PARLIAMENT APPROVED REPORT ON TAX REFORM

On November 25, 2015, the European Parliament approved a report prepared by the Special Committee on Tax Rulings (also known as the "T.A.X.E." committee) which calls for (i) a common consolidated corporate tax base ("C.C.C.T.B."), (ii) crackdown on tax havens, (iii) whistle-blower protection, (iv) public access to mandatory country-by-country tax reporting, (v) stricter transfer pricing rules, and (vi) a move to eliminate unanimity voting for European Union tax legislation.

The European Parliament also extended the T.A.X.E. committee's mandate for another six months. The committee's opposition tends to come from conservatives who see further harmonization of the European Union's tax system as a power grab.

The decision to approve the report and continue the T.A.X.E. committee's mandate may have been bolstered by a public opinion poll showing widespread public support for cracking down on tax havens.

The crackdown on tax havens includes a tax haven list, which was published by the European Commission in June 2015. The list was criticized by the Organization for Economic Cooperation and Development (the "O.E.C.D.") for including jurisdictions that were cleared by the O.E.C.D. It has been criticized by many European Parliament members for not including such states as Luxembourg, the Netherlands, and Ireland, since all three countries are currently being investigated by the European Commission for granting rulings to multinational corporations that are alleged to constitute illegal state aid to those companies.

I.R.S. FACES HOUSE CONCERNS ABOUT B.E.P.S. INITIATIVE'S IMPACT ON U.S. COMPANIES

I.R.S. officials recently responded to concerns by the House of Representatives Ways and Means Committee (the "Committee") about the I.R.S.'s role in negotiating the final recommendations of the O.E.C.D.'s B.E.P.S. initiative. As mentioned here, the I.R.S. is concerned with the ability of other countries to erode the U.S.

tax base and to abuse information regarding U.S. corporations that will be made available through the B.E.P.S. initiative. The Committee was also alarmed about current European tax investigations, which they believed purposefully targeted U.S. corporations. The Committee deemed the European tax investigation actions an "overreach."

In addition, the Committee expressed concern with country-by-country ("CbC") reporting requirements, patent box regimes, and inversions.

CbC Reporting

"The Committee was troubled that the CbC reporting requirements lack adequate privacy protection and mostly target U.S. corporations."

As mentioned here, the CbC report is part of an information exchange program that multinational entities file with their U.S. income tax return. The information would then be shared with other countries under applicable tax treaties. The Committee was troubled that the CbC reporting requirements lack adequate privacy protection and mostly target U.S. corporations.

The Committee's was concerned with small businesses that

1. lack the expertise to analyze complex permanent establishment ("P.E.") rules when multiple countries claim P.E. status, and
2. are forced to submit information to foreign countries that eventually abuse the information to wrongfully attribute that income to the foreign country rather than the U.S.

Patent Box Regimes

In general, a patent box regime provides a reduced rate of tax on revenue from intellectual property licensing. The Committee questioned whether certain European patent box regimes will incenti*vize* U.S. corporations to move operations outside the U.S., and the I.R.S. agreed that certain European patent box regimes may entice U.S. businsses to relocate.

Inversions

The Committee expressed concerned about corporate inversions, as evidenced by Pfizer's recent merger.[3] While discussions about reforming the U.S. tax code have been ongoing for years, new inversion rules are unlikely to be enacted until after the 2016 election.

European Tax Investigations

Finally, the European Commission ("E.C.") is investigating tax advance rulings of Luxembourg and other countries to determine whether rulings in those countries were justified in accordance with European Union ("E.U.") state aid rules. In October 2015, the E.C. ruled that both the Netherlands and Luxembourg provided selective advantages to Starbucks and Fiat. In response to the Committee's concerns about E.C. overreach, the I.R.S. responded that it had not anticipated the E.C. investigations and noted that the E.C. rulings might conflict with bilateral tax treaties between the U.S. and various E.U. countries.

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[3] See last month's issue of Insights.

PROPOSED REGULATIONS FOR CHARITIBLE DEDUCTIONS MAY RESULT IN IDENTITY THEFT

The I.R.S. recently released proposed regulations[4] whereby as an alternative to allowing deductions based on written acknowledgment from the donee, donors can claim charitable deductions if the non-profit organization files a return that includes the names, addresses, and tax identification numbers of donors who contribute more than $250. Critics of the proposed regulations note that the information may be subject to identity theft.

Background

In general, donors who claim a charitable contribution must substantiate it with contemporaneous written acknowledgement from the charity.[5] If the contemporaneous written acknowledgement requirement is not satisfied, a donor may still claim a charitable deduction if the non-profit organization files an information return with the I.R.S.[6] The I.R.S. never published a form that satisfies such filing requirements, and therefore, the contemporaneous documentation requirement was generally the only method by which a taxpayer could substantiate a charitable deduction. Certain donors under audit for their charitable deductions took the position that a non-profit organization's filing of an amended Form 990, *Return of Organization Exempt From Income Tax*, satisfied the information return requirement and allowed for their charitable deduction, without meeting the contemporaneous written acknowledgment requirement and although the amended Form 990 was filed years after the contribution was made. These taxpayers took the position that the filing of Form 990 negated the contemporaneous written acknowledgement requirement to substantiate the charitable deduction. In response to these arguments, the I.R.S. recently published proposed regulations that describe the alternative information return requirement in more detail and provide that the I.R.S. will issue a new form to satisfy this information return requirement. The I.R.S. further clarified that the filing of Form 990 does not satisfy the information return requirement for substantiating a charitable deduction, nor does it negate the contemporaneous written acknowledgment requirement.

Proposed Regulations

Under the proposed regulations, a donor can substantiate a charitable deduction under the alternative information return requirement only if the donee organization files the appropriate new information return with the I.R.S. The return will note the amount of the contribution and provide the name, address, and tax identification number of the donor, along with other information relating to the charitable organization.[7] The I.R.S. will retain the charity's return information in the event an audit is required. If the contribution is not listed on the report, the donor will be required to produce a contemporaneous written acknowledgement from the donee organization to claim the charitable deduction.

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4 "Substantiation Requirement for Certain Contributions; Notice of Proposed Rulemaking," 80 *Federal Register* 180 (17 September 2015), pp. 55802-55805.

5 Code §170.

6 Code §170(f)(8)(D).

7 These include listing the charity's name and address, whether the charity provided any goods and services in consideration for the contribution, the amount of cash and a description of contributed property other than cash.

Critics of the proposed regulations note the high risk of identity theft since non-profit organizations would have databases of tax identification numbers, which might not be adequately protected from hackers. Accordingly, non-profit organizations would have to allocate resources away from charitable objectives and towards electronic security. The I.R.S. will likely respond to these concerns in the coming months.

U.S. SUBSIDIARY'S REPORTING ON LAST IN, FIRST OUT ("L.I.F.O.") BASIS DOES NOT VIOLATE CONFORMITY RULE – EVEN IF PARENT REPORTS ON NON-L.I.F.O. BASIS

The I.R.S. recently held that a foreign parent's planned disclosure of a U.S. subsidiary's earnings on both a L.I.F.O. and non-L.I.F.O. basis would not violate the U.S. rule that requires L.I.F.O. to be used for both tax and financial reporting purposes.

"Critics of the proposed regulations note the high risk of identity theft since non-profit organizations would have databases of tax identification numbers, which might not be adequately protected from hackers."

Background

Under the L.I.F.O. method, the more recent costs of products purchased or produced are the first costs expensed as the cost of goods sold. Accordingly, the costs of the oldest products are reported as inventory.

As per the U.S. L.I.F.O. conformity rule, if L.I.F.O. is used on a tax return, no other method can be used to value inventory to calculate income, profit, or loss in any report or statement covering the same tax year that is provided to owners or to creditors.[8] For purposes of the conformity rule, financially related corporations must consolidate their financial statements for tax reporting purposes and be treated as a single taxpayer.[9] While L.I.F.O. is allowed as a reporting method under the U.S. Generally Accepted Accounting Principles ("G.A.A.P."), it is not allowed as a reporting standard under the International Financial Reporting Standard ("I.F.R.S."). Consequently, multinational enterprises find it onerous to abide by the conformity rule for financial reporting standards, as they must report on a non-L.I.F.O. basis in one country and report on a L.I.F.O. basis in the U.S.

An exception exists where the conformity rule is not violated if a consolidated group is using a non-L.I.F.O. method and has "substantial foreign operations."[10] A consolidated group is deemed to have "substantial foreign operations" if 30% or more of the group's total operating assets are used in foreign operations.[11] The exception holds true even if a U.S. subsidiary is required to report on a L.I.F.O. basis.

Previous Ruling

A previous I.R.S. ruling[12] held that a taxpayer violated the conformity rule by provid-

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8 Code §472(c).

9 See Code §§1504, 472(g) for definitions of common control.

10 Rev. Rul. 78-246.

11 Rev. Rul. 78-246. Note that a consolidated group can still have "substantial foreign operations" under a facts and circumstances test, even if it does not meet the 30% threshold. PLR 200703018.

12 FAA 20114702F.

ing a bank with a financial statement prepared under both G.A.A.P. and I.F.R.S. The taxpayer was a U.S. subsidiary that was recently purchased by a foreign parent. The U.S. subsidiary used L.I.F.O. for tax and financial reporting purposes but reported to its foreign parent on a non-L.I.F.O. basis.

New Ruling

In the new ruling, the I.R.S. held that the foreign parent could issue I.F.R.S.-based consolidated financial statements, including the supplemental information provided in connection with its annual earnings release, without violating the L.I.F.O. conformity requirement. In the fact pattern, the foreign parent and its group of financially related corporations were engaged in substantial foreign operations. The U.S. subsidiary reported earnings to its foreign parent in an Excel workbook that contains a tab labeled "PRIMARY," which included financial statements prepared on a U.S. G.A.A.P. and L.I.F.O. basis, and a tab labeled "SUPPLEMENTAL," which included financial statements prepared on an I.F.R.S. (non-L.I.F.O.) basis.

> ***"Note that the U.S. subsidiary's reporting of its results to its foreign parent on both a non-L.I.F.O. and L.I.F.O. basis allowed it to qualify under the conformity rule exception, as opposed to the previous ruling."***

Conclusion

Readers should note that the U.S. subsidiary's reporting of its results to its foreign parent on both a non-L.I.F.O and L.I.F.O. basis allowed it to qualify under the conformity rule exception, as opposed to the previous ruling, where the U.S. subsidiary only reported to its foreign parent on a non L.I.F.O. basis. To avoid a violation of the conformity rule, tax professionals should ensure that a foreign parent receives both L.I.F.O. and non-L.I.F.O. reports from its U.S. subsidiary.

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.

Disclaimer

Contacts

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

NEW YORK

150 EAST 58TH STREET, 22ND FLOOR, NEW YORK, NY 10155

Stanley C. Ruchelman	ruchelman@ruchelaw.com	+1 212.755.3333 x 111
Nina Krauthamer	krauthamer@ruchelaw.com	+1 212.755.3333 x 118
Simon Prisk	prisk@ruchelaw.com	+1 212.755.3333 x 114
Andrew P. Mitchel	mitchel@ruchelaw.com	+1 212.755.3333 x 122
Philip Hirschfeld	hirschfeld@ruchelaw.com	+1 212.755.3333 x 112
Galia Antebi	antebi@ruchelaw.com	+1 212.755.3333 x 113
Beate Erwin	erwin@ruchelaw.com	+1 212.755.3333 x 116
Elizabeth Zanet	zanet@ruchelaw.com	+1 212.755.3333 x 123
Rusudan Shervashidze	shervashidze@ruchelaw.com	+1 212.755.3333 x 117
Christine Long	long@ruchelaw.com	+1 212.755.3333 x 127
Sheryl Shah	shah@ruchelaw.com	+1 212.755.3333 x 126
Jennifer Lapper	lapper@ruchelaw.com	+1 212.755.3333 x 124
Francesca York	york@ruchelaw.com	+1 212.755.3333 x 125

TORONTO

130 KING STREET WEST, SUITE 2300, TORONTO, ON M5X 1C8

Kenneth Lobo	lobo@ruchelaw.com	+1 416.644.0432
Michael Peggs	peggs@ruchelaw.com	+1 212.755.3333 x 232

Editorial Staff

Jennifer Lapper .... Managing Editor, Art Director

Francesca York .... Graphics Editor, Copyeditor

PHOTOS IN THIS ISSUE WERE TAKEN BY:

Galia Antebi, Philip Hirschfeld, Jennifer Lapper, Simon Prisk, Stanley C. Ruchelman, and Francesca York.