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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-profi organizations would have databases of tax identificatio 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.

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.

"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."

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