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INSIGHTS

U.K. ADOPTS PUBLIC REGISTER OF PEOPLE WITH SIGNIFICANT CONTROL OVER U.K. CORPORATIONS

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EDITORS' NOTE

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

- **U.K. Adopts Public Register of People with Significant Control Over U.K. Corporations.** Think you can hide behind a corporate shell in order to avoid notoriety? Think again if you own a company or L.L.P. formed in the U.K. These entities are now being required to maintain a statutory register setting out the individuals who are considered "persons with significant control," and beginning in July, the registers are to be made available to the public. Naomi Lawson and Melanie Jory of Memery Crystal, London, explain of this new, transparency-seeking legislation and provide commentary on the multitude of potentially adverse consequences.

- **Inversions Under Siege: New Treasury Regulations Issued.** On April 4, 2016, the Treasury Department issued a third round of new rules under Code §7874 aimed at halting the wave of inversions. Already, at least one inversion transaction, involving pharmaceutical giants Pfizer and Allergan, has been scuttled. Beyond that, the new rules resuscitate regulations issued under Code §385. Philip R. Hirschfeld explains.

- **Country-by-Country Reporting – Where Are We Going?** B.E.P.S. Action 13 addresses country-by-country reporting among tax authorities as a means of ferreting out mismatches between functions and profits. Now, CbC reporting is morphing in Europe to a public disclosure tool to bring N.G.O.'s into the process. Your tax savings through planning becomes a global problem for the N.G.O.'s to redress through public outcry. Michael Peggs and Kenneth Lobo tell all.

- **Transfer Pricing Positions of Consolidated Groups: After *Guidant*.** Michael Peggs and Kenneth Lobo comment on the I.R.S. victory in the *Guidant* case where the I.R.S. applied the "one size fits all" approach to group-wide transactions. Their conclusion is that today's I.R.S. victory may be tomorrow's lost revenue where a taxpayer seeks competent authority relief for transfer pricing adjustments initiated abroad.

- **What Is a Corporate Business Purpose for a Tax-Free Corporate Division?** As *Insights* continues to look at various provisions of the Internal Revenue Code applicable to corporate reorganizations and divisions, Elizabeth V. Zanet and Beate Erwin delve deeper into the requirements to address an eternal question relating to a tax-free spin-off.

- **Outbound Transfers of Stock in Code §351 "Tax-Free" Exchanges.** The U.S. has extensive rules regarding tax-free reorganizations in a domestic context. When the transaction involves cross-border exchanges, these rules are supplemented by Code §367(a). Rusudan Shervashidze and Andrew P. Mitchel explain how the rules work when shares of a U.S. corporation are transferred to a foreign corporation in a §351 exchange.

- **Final Regulations Limit Importation of Built-In Losses.** In the heyday of tax shelters, transactions involving transfers of low value assets with high tax bases were elevated to an art form. The fervor effectively ended when the

American Jobs Creation Act of 2004 enacted anti-loss importation provisions under Code §§334(b)(1)(B) and 362(e)(1). In March, the I.R.S. issued final regulations to stop base erosion through shifting of loss property into the U.S. Christine Long and Beate Erwin explain all.

- **Foreign Owned, Single-Member L.L.C.'s: Proposed Regulations Imminent?** The offshore community often accuses the I.R.S. of having insufficient U.B.O. reporting for offshore companies forming single-member L.L.C.'s that serve as U.S. fronts for global business. The L.L.C. conducts business, but the I.R.S. treats the taxpayer as foreign. If no effectively connected income is generated, no U.S. tax returns are filed. The I.R.S. announced that information reporting will be required, much like partnership reporting by U.S. partnerships not having U.S. members or U.S. effectively connected income. Galia Antebi and Rusudan Shervashidze explain.

- **B.E.P.S. Around The World.** Under political pressure from N.G.O. watchdogs, governments are striving to demonstrate their support for the B.E.P.S. Action Plan on a national level. Kenneth Lobo and Stanley C. Ruchelman look at implementation issues around the world. Included are issues in Germany related to exchanges of information, treatment of C.I.V.'s for income tax treaty purposes, and U.K. tax penalties for aggressive tax planning.

- **F.A.T.C.A. 24/7.** This month, Galia Antebi and Philip R. Hirschfeld discuss (i) the growing list of countries with which the I.R.S. will exchange F.A.T.C.A. information, (ii) the litigation in Canada attempting to block F.A.T.C.A. exchanges with U.S., (iii) recent developments in acceptably encryption for F.A.T.C.A. exchanges, (iv) additional competent authority agreements, and (iv) an updated list of I.G.A. partner countries.

- **Updates & Tidbits.** In this month's update, Sheryl Shah and Stanley C. Ruchelman look at the following recent developments: (i) one-time payments for off-the-shelf software are not considered to be royalties in India, (ii) offshore voluntary disclosure in Greece, (iii) the movement of Slovak companies to other jurisdictions, and (iv) the effect of the Panama Papers on CbC reporting in Europe.

We hope you enjoy this issue.

- The Editors

U.K. ADOPTS PUBLIC REGISTER OF PEOPLE WITH SIGNIFICANT CONTROL OVER U.K. CORPORATIONS

Authors
Naomi Lawton
Melanie Jory

Tags
Mossack Fonseca
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INTRODUCTION

With effect from April 6, 2016, U.K. companies and L.L.P.'s are required to maintain a statutory register setting out the individuals who are considered "persons with significant control" ("P.S.C.'s"). The requirement was introduced by the Small Business, Enterprise and Employment Act 2015 and is designed to create more transparency around the ownership of companies.[1]

With effect from June 30, 2016, U.K. companies and L.L.P.'s will be subject to a further requirement to register that information with Companies House. The P.S.C. information will be available to the public.

POLITICAL CONTEXT

International pressure for transparency has been a recurring theme in recent years, as transparency has become increasingly high on many political agendas. Its proponents have included the G-20, the Financial Action Task Form ("F.A.T.F."), and the International Monetary Fund ("I.M.F."), and it was also the focus of E.U. anti-money laundering directives.

The immediate genesis of this particular measure began life in 2013, as a personal commitment by the U.K.'s prime minister, David Cameron, to introduce a public register of beneficial ownership. It was certainly a brave move, and businesses were alarmed. It was also unexpected, given that Prime Minister Cameron had previously decided to withdraw a proposal for public registers from the Lough Erne G-8 agenda – in part on the basis that other G-8 countries were unlikely to endorse the proposal.

As part of the consultation process that followed, a number of bodies, including the Law Society, voiced concerns. Inevitably, many of the concerns were based on issues of personal privacy. Policy initiatives preserving personal privacy are increasingly maligned, but few would suggest that public policy requires us to make available on Google the contents of our bank accounts or other statements of personal wealth. Yet, as significant wealth is held through the medium of companies, commentators have argued that this is exactly the effect of a public register of beneficial ownership of shares. The U.K. takes for granted its (relative) political stability and assurance of personal security. However, this position is not mirrored in all jurisdictions.

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.

Melanie Jory is a senior associate in the corporate department of the Firm, where she specializes in corporate transactions, including flotations and fundraisings on A.I.M. and the Official List. Ms. Jory has experience acting for companies, nominated advisers, and brokers, and has been involved in a number of acquisitions and disposals of public and private companies.

[1] The authors would like to acknowledge the contribution of Alice Foster, trainee solicitor at Memery Crystal LLP. Ms. Foster will qualify into the corporate department of the Firm in September 2016.

There was also particular concern that the U.K. would be the first jurisdiction to create and maintain a central public register of beneficial ownership. Investment might therefore be diverted from the U.K. to other jurisdictions. Although many jurisdictions have paid lip service to the concept of transparency and there are a number of supranational efforts to introduce further disclosure, this is generally limited to disclosure between government agencies (in particular, tax collection agencies). Although a number of jurisdictions offer information to the public in relation to the share registers of companies, the U.K. is the first to extend the breadth of transparency to include ultimate beneficial ownership, as opposed to nominee ownership.

PERSON OF SIGNIFICANT OF CONTROL DEFINED

The legislation is complex, but essentially, a P.S.C. is someone who meets one or more of the following conditions:

- Directly or indirectly owns more than 25% of the share capital
- Directly or indirectly controls more than 25% of the voting rights
- Directly or indirectly holds the right to appoint or remove a majority of the board of company directors
- Exercises, or holds the right to exercise, significant influence or control over a company
- Exercises, or holds the right to exercise, significant influence or control over activities of a trust or firm which itself meets one or more of the first four conditions

The legislation contains detailed provisions relating to the interpretation of these conditions and includes anti-avoidance provisions.

In the vast majority of cases, it will be easy to determine whether any particular individual is a P.S.C. – it will be a straightforward binary analysis. However, in the context of more complex structures, the determination will be much more difficult. For example, convoluted cross-border investment structures comprising share capital of different classes, shareholder agreements, and investment agreements will require a lengthy, cumbersome, and undoubtedly expensive analysis. The legislation is designed to identify ultimate beneficial ownership – these are individuals, not companies or other legal entitles. Therefore, there are provisions to "look-through" intermediate entities.

The government has recognized that the exercise will be difficult in certain circumstances, and has published extensive draft guidance. Nonetheless, it advises also that it is likely that companies will require expert advice in difficult cases, particularly given that failure to comply with the legislation can result in fines and imprisonment.

EXEMPTIONS TO MANDATORY DISCLOSURE

Given that the obligations created by the legislation are onerous, the availability of exemptions was fiercely debated at the consultation stage.

Listed companies

A significant number of companies will benefit from the exemption available to listed companies. Broadly, and on the basis that their significant shareholdings are already in the public domain, the following companies are not required to complete and maintain a P.S.C. register:

- Companies that are subject to D.T.R. 5 (Disclosure and Transparency Rules), which includes companies on the Main Market, A.I.M., and I.S.D.X. Growth Market
- Companies that are admitted to trading on a regulated market in an E.E.A. state (other than the U.K.)
- Companies listed on certain markets in Israel, Japan, Switzerland, and the United States

However, these exemptions do not simply flow through to any U.K. subsidiaries. Further, the exemption from these rules for A.I.M. and I.S.D.X. Growth Market companies is likely to fall away in July 2017, when the fourth E.U. anti-money laundering directive comes into force.

Protection Regime

The legislation also provides for a "protection regime," which allows a company to apply to Companies House on behalf of the P.S.C., requesting that Companies House refrain from publicly disclosing information about the P.S.C. if the company reasonably believes that the disclosure will expose the P.S.C. to the risk of violence or intimidation. Thus, there is still a requirement to disclose *vis a vis* Companies House; however, there is no further obligation on the company to make this information publicly available. The draft guidance states that applications will be assessed on a case-by-case basis, and there is no set list of circumstances in which protection will be granted.

INFORMATION THAT MUST BE DISCLOSED ON THE P.S.C. REGISTER

For individuals on the P.S.C. register, certain personal information will need to be disclosed, including name, service address, nationality, date of birth, and usual residential address. The P.S.C. register will also include details of the nature of the control exercised by the P.S.C.

U.K. companies and L.L.P.'s will have to file the information on their P.S.C. registers with an Annual Return (to be renamed as a Compliance Statement). The information must be filed with Companies House at least once every 12 months, from June 30, 2016, and the P.S.C. register must also be made available for inspection at the entity's registered office from April 6, 2016.

TERRITORIAL AMBIT AND ENFORCEMENT

The legislation applies to companies and other bodies corporate incorporated under the U.K. Companies Act and to L.L.P.'s formed under the Limited Liability

Partnerships Act 2000. It does not apply to the overseas subsidiaries of U.K. companies, for example.

The legislation requires an affected company to take reasonable steps to find out if it has any registrable P.S.C.'s and, if so, to identify them. The company must then record the requisite details in its P.S.C. register. Failure to maintain a register or take reasonable steps to find and identify P.S.C.'s will make the company liable to a fine and its director(s) liable to a fine and imprisonment. However, many individuals may be P.S.C.'s in relation to U.K. companies without having ever set foot in the U.K. This raises the following questions of fairness:

- How can a company elicit the required information?
- What are reasonable steps in these circumstances?

The legislation contemplates that the company will submit a notice to the potential P.S.C. requesting the information. It is a criminal offense for a person to fail to comply with a notice sent by a company. Further, the legislation allows the company to impose restrictions on shares or rights held by an individual if he or she does not comply with the terms of a notice.

"Effectively, the register relies on self-reporting only. There are no procedures in place for systematic and objective verification."

But, what if the company receives plainly inaccurate information? Is it under an obligation to investigate further? What steps are "reasonable" steps? And, more importantly, what steps are *not* "reasonable" steps? If a shareholder sent back a return stating that his full name was Mickey Mouse and his address was on Pluto, presumably it would be difficult for the company to claim that it had taken reasonable steps. But where does the boundary lie? What degree of investigation is required?

The government's draft guidance states the following:

> 2.3.1 You must take reasonable steps to determine whether any individual or any legal entity meets the conditions for being a P.S.C. or registrable [relevant legal entity] in relation to your company, and if so, who that person or registrable [relevant legal entity] is. It may be that, having taken these steps, you cannot identify the person or confirm their details, but failure to take reasonable steps is a criminal offence.

The draft guidance does therefore anticipate the possibility that it may not be feasible to identify the control by the company. However, it offers little else by way of guidance.

Further, there is no system for the verification of information. This was one of the objections voiced by a number of commentators during the consultation process. Effectively, the register relies on self-reporting only. There are no procedures in place for systematic and objective verification, which leads to the following two questions:

- Are there enough regulations to ensure that the data reported is reliable?
- Is a system that elicits and stores inaccurate information worse than no system at all?

When this objection was raised during consultation, the response was that if an entry was incorrect, public scrutiny would identify and report it. This seems weak at best and, given that the consequent penalties are criminal in nature, arguably wholly inadequate. Commentators have questioned the propriety of having the accuracy and verification of U.K. government regulation dependent on the N.G.O. community's agenda – a largely unregulated but politically powerful sector.

RECENT (IRONIC) DEVELOPMENTS

Transparency has moved further up the current political agenda with the recent unprecedented leak from Panamanian law firm Mossack Fonseca. The sheer scale of the leak has been dramatic, as has the number of high-ranking government officials that have been implicated. Ironically, given that he has been the prime protagonist in the development of the world's first publicly-available register of beneficial ownership of companies, Prime Minister Cameron has suffered in particular as a result of disclosures about the nature and background of his family's wealth.

As a result of the leak, tax and law enforcement agencies in the U.K., Germany, France, Italy, and Spain have agreed to additional data-sharing arrangements and are now seeking to establish cross-border company register information. However, although this is demonstrative of the continued drive for transparency, this information sharing is still at government level only and, therefore, can be clearly distinguished from the substantive content of the U.K.'s P.S.C. register. The U.K. remains the only jurisdiction to have implemented this type of legislation.

Some will be irritated by the continued assumption by the media (the good and the bad) that "offshore" jurisdictions are all created equal. For a start, the term "offshore" means different things to different people. In this context, "offshore" is widely used as a pejorative shorthand to suggest tax evasion, organized crime, terrorism, arms trade, or drug dealing.

The evidence suggests otherwise. A recent academic study, "Global Shell Games,"[2] looked at compliance with F.A.T.F. guidelines. In summary, the authors posed as consultants wishing to form a shell company. They sent emails asking over 3,500 different incorporation agents in 182 jurisdictions to form companies for them. Overall, 48% of the agents who replied failed to ask for proper identification. Almost half of these did not want any documentation at all.

The authors compiled a table of compliance, ranking jurisdictions in terms of their compliance. It makes for interesting reading. The following is an extract from the authors' conclusions:

> One of the biggest surprises of the project was the relative performance of rich, developed states compared with poorer, developing countries and tax havens.… The overwhelming policy consensus, strongly articulated in G20 communiqués and by many NGOs, is that tax havens provide strict secrecy and lax regulation, especially when it comes to shell companies. This consensus is wrong. The Dodgy Shopping Count for tax havens is 25.2, which is in fact much higher than the score for rich, developed countries at 7.8 – meaning

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2 Michael G Findley, Daniel L Nielson and JC Sharman, *Global Shell Games: Experiments in Transnational Relations, Crime and Terrorism*, (Cambridge: Cambridge University Press: 2014).

it is more than three times harder to obtain an untraceable shell company in tax havens than in developed countries. Some of the top-ranked countries in the world are tax havens such as Jersey, the Cayman Islands and the Bahamas, while some developed countries like the United Kingdom, Australia, Canada and the United States rank near the bottom of the list. It is easier to obtain an untraceable shell company from incorporation services (though not law firms) in the United States than in any other country save Kenya.

THE ROAD AHEAD

Perhaps the most controversial aspect of the new provisions has been the requirement not just to collate information on the ultimate beneficial ownership of companies, but to make it publicly accessible. Recent developments notwithstanding, no other jurisdictions have made firm commitments to introduce equivalent measures.

No doubt the rest of the world will be watching the U.K. with interest over the coming months. The measures will undoubtedly add to the burden of doing business through a U.K. company – in some cases, considerably. Whether the benefits of that burden will be worthwhile remains to be seen. If the data is inaccurate, what will have been achieved but another layer of costly administration and a deterrent to doing business through U.K. entities? Anecdotal evidence suggests that reputable tax advisers try not to associate with criminals, and it seems likely that criminals are not much interested in accurate self-certification for government authorities.

"Transparency has moved further up the current political agenda with the recent unprecedented leak from Panamanian law firm Mossack Fonseca. . . . Cameron has suffered in particular as a result of disclosures about the nature and background of his family's wealth."

As a final point, the lack of certainty surrounding a company's "reasonable" attempts to obtain information is of particular concern, particularly given that failure to make such efforts carries criminal penalties. In a sense, the requirement to maintain the P.S.C. register is simply an expansion of F.A.T.C.A. and the C.R.S. from financial institutions to everyday companies with an added twist: a failure to comply with an undefined standard of reasonableness elicits criminal penalties for non-performance. In the world of F.A.T.C.A., noncompliance is burdened only with withholding tax.

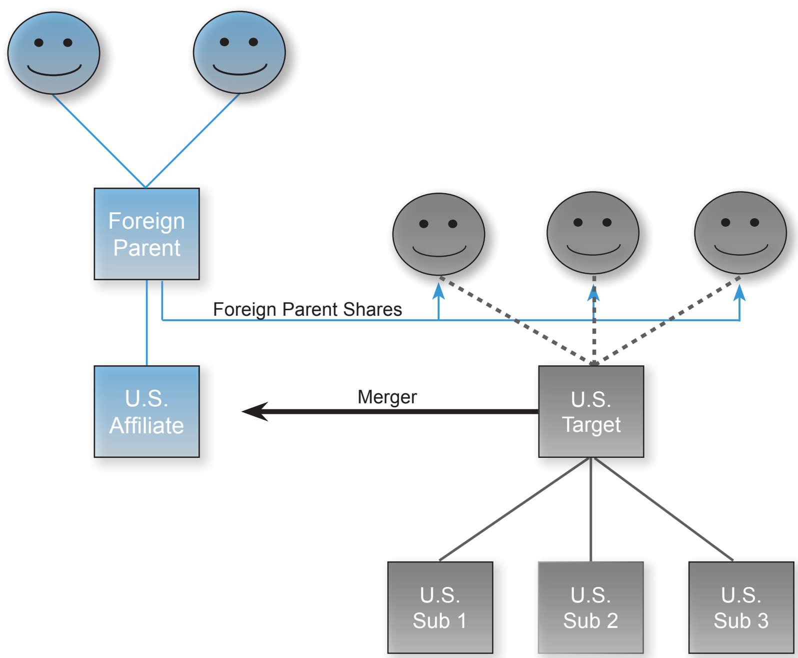
INVERSIONS UNDER SIEGE: NEW TREASURY REGULATIONS ISSUED

Author
Philip R. Hirschfeld

Tags
Code §956
Code §367
Code §304
Code §7874
Code §385
Code §163(j)
Debt-Equity Classification
Earnings Stripping
Interest Deductions
Inversions

IN GENERAL

On April 4, 2016, the Treasury Department issued a third round of new rules under Code §7874 aimed at halting the wave of inversions that have allowed U.S.-owned multinational groups to restructure their global organization in order to lower U.S. taxes.[1] In an inversion, a U.S. parent corporation of a multinational group is replaced with a foreign parent corporation; the inversion is often structured as a merger of the U.S. parent into an affiliate of the foreign parent corporation with the shareholders of the U.S. parent getting stock of the foreign parent in that merger.



Notice 2014-52, issued on September 22, 2014, and Notice 2015-79, issued on November 19, 2015, created rules under §7874[2] aimed at stopping inversions. Those earlier efforts did not totally stop inversions, as illustrated by the recently-announced $160 billion Pfizer-Allergan merger that was set to close later this year. In this latest

1 On the day of the release, Treasury Secretary Jacob J. Lew announced, “Today, we are taking further action to make it more difficult to invert.” U.S. Department of the Treasury, “Remarks by Treasury Secretary Jacob J. Lew on a Press Conference Call Regarding Announcement on Corporate Tax Inversions,” press release, April 4, 2016.

2 References to a section are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

action, the Treasury issued regulations under these two notices and also made some changes aimed at bolstering their impact.[3] This recent action also expanded upon the earlier efforts, and within 24 hours of its release, Pfizer and Allergan announced their merger was scuttled due to these new rules.[4]

A major change adopted to halt inversions was the addition of a rule that disregards certain stock that is attributable to prior acquisitions of other U.S. companies (the "Multiple Domestic Entity Acquisition Rule") in computing whether a current transaction is subject to §7874.[5] The Multiple Domestic Entity Acquisition Rule will thwart efforts to increase the value of the foreign corporation (such as Allergan) by acquisitions of other companies made within three years of the signing of an agreement to participate in an inversion transaction. In a potential merger of a U.S. corporation (such as Pfizer) into a foreign corporation (such as Allergan), this new rule requires the enhanced value of the foreign corporation arising from these prior acquisitions to be removed from the calculation of the percentage interest acquired by the former shareholders of the U.S. corporation in the combined company. The result of this new rule is to increase the percentage ownership interest of the shareholders of the target, which makes the transaction more likely to be subject to §7874. In addition, the Treasury added the "Multiple-Step Acquisition Rule" aimed at halting multiple-step transactions that were designed to circumvent the inversion rules.[6]

Apart from these inversion rules, the Treasury also took extra steps that can have an impact on *any* international tax planning where related-party debt is involved.[7] In an unexpected move, the Treasury ignored Code §163(j), the earnings stripping provision,[8] and issued proposed regulations under Code §385.[9] While Code §385 directly addresses debt-equity classification issues, this section was dormant for decades with no regulations issued under it apart from a set of regulations that were withdrawn in 1983.[10] The proposed regulations target debt issued as a dividend to a foreign shareholder as well as related-party debt that was not issued to finance an acquisition. The Code §385 proposed regulations permit the I.R.S. to bifurcate a debt instrument into part debt and part equity, and add certain documentation requirements for large corporate groups. These proposed regulations can apply to any transaction and are not limited to inversions.

"Within 24 hours of [the Treasury] release, Pfizer and Allergan announced their merger was scuttled due to these new rules."

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3 Treas. Reg. §§1.304-7T, 1.367(a)-3T(c)(3)(iii)(C), 1.367(b)-4T, 1.956-2T(a)(4), 1.7701(l)-4T(h), 1.7874-1T(h)(2), 1.7874-2T(l)(2), 1.7874-3T(f)(2), 1.7874-4T(k)(1), 1.7874-6T(h), 1.7874-7T(h), 1.7874-8T(i),1.7874-9T(g), 1.7874-10T(i), 1.7874-11T(f), and 1.7874-12T(b).

4 Jonathan D. Rockoff, Liz Hoffman, and Richard Rubin, "Pfizer Drops Allergan Takeover," *Wall Street Journal*, April 6, 2016, A1.

5 Treas. Reg. §1.7874-8T.

6 Treas. Reg. §1.7874-2T(e).

7 This will be the subject of a future *Insights* article.

8 Earnings stripping occurs when a foreign shareholder of a U.S. corporation lends money to the U.S. corporation and the interest paid to the shareholder is not subject to 30% U.S. withholding tax. The goal is to create an interest deduction for the U.S. corporation and allow U.S. earnings to totally escape U.S. taxation. Code §163(j) is targeted toward earnings stripping, and if it is applicable, no deduction will be allowed to the U.S. corporation for interest paid on that loan.

9 Prop. Treas. Reg. §§1.385-1, 2, 3 & 4.

10 T.D. 7920, 1983-2 C.B. 69.

CODE §7874 FRAMEWORK TO CHALLENGE INVERSIONS

In 2004,[11] Congress enacted Code §7874 in order to halt abuses associated with inversion transactions. An inversion occurs when a U.S. corporation (or partnership) becomes a subsidiary of a foreign acquiring corporation ("F.A."),[12] and the shareholders of the U.S. corporation (or partners in the U.S. partnership) continue to own an interest in F.A. Among other post-acquisition planning techniques, the foreign subsidiaries previously owned by the U.S. parent can then be transferred to F.A., which eliminates potential U.S. tax on dividends and the impact of the controlled foreign corporation ("C.F.C.") rules.

The key factor under Code §7874 is whether F.A. will be treated as a surrogate foreign corporation, which will activate several limitations (*e.g.*, any "inversion gain" will be fully taxable from the date the acquisition begins until ten years after its completion, with only limited offset by losses and tax credits). Code §7874(a) provides that F.A. will be a surrogate foreign corporation if, pursuant to a plan or series of related transactions, the following conditions are met:

- F.A. acquires, directly or indirectly, substantially all of the properties held directly or indirectly by a domestic corporation or substantially all the properties constituting a trade or business of a domestic partnership.
- After the acquisition, at least 60% of the stock (by vote or value) of F.A. is held by former shareholders or partners of the domestic entity ("D.E.") by reason of their former ownership of D.E. (the "ownership percentage test").
- After the acquisition, F.A.'s "expanded affiliated group" ("E.A.G.") fails to meet the substantial business activities test, which works as an overall exception to Code §7874.

In determining the ownership percentage, the "ownership fraction" is referred to in the regulations and commentary. The ownership fraction has as its numerator the value (or vote) of the stock of F.A. acquired by the former shareholders of D.E. (the target U.S. corporation or partnership), and the denominator is the value (or vote) of all the stock of F.A. after the acquisition of D.E. is completed. For purposes of this computation, stock issued in a "public offering" is excluded from computation of this ownership fraction.[13] In addition, §7874(c)(4) provides that "[t]he transfer of properties or liabilities (including by contribution or distribution) shall be disregarded if such transfers are part of a plan a principal purpose of which is to avoid the purposes of [§7874.]"

Code §7874(b) further provides that if the first and second conditions above are met and at least 80% of the stock of F.A. (by vote or value) is held by former own

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11 Pub. L. 108-357, 118 Stat. 1418 (2004).

12 Prior to adoption of Code §7874, an inversion could also occur if the U.S. parent corporation reincorporated into a foreign country with all its shareholders continuing to own stock in the reincorporated company. Code §7874, as discussed above, did away with this planning technique by treating the reincorporated company as a U.S. corporation. Code §7874(b).

13 Code §7874(c)(2)(B).

ers of D.E. by reason of their historic ownership, F.A. will be treated as a domestic corporation for all Federal tax purposes.

NEWLY-ADOPTED MULTIPLE DOMESTIC ENTITY ACQUISITION RULE

Reason for Action

The Treasury wanted to close down a planning strategy, used by some foreign companies, in which multiple acquisitions of unrelated U.S. target corporations are made over time. This strategy allowed the foreign companies to avoid application of §7874, since each acquisition was analyzed on its own.[14] The major factor for determining if an inversion occurs is the ownership percentage that the shareholders of the U.S. target have in the foreign acquiring company. That ownership percentage is based on the ownership fraction noted above:[15] The numerator of this fraction is the value of the stock in the foreign company owned by the former shareholders of the U.S. target company, and the denominator is the value of all the stock in the foreign company owned by all shareholders after the acquisition.[16]

In a typical situation, the value of the stock of first U.S. target corporation to be acquired is small enough such that the shareholders of that first U.S. target do not own 60% or more of the foreign company. After that acquisition, the value of the foreign company is increased. As a result, the foreign company can acquire a larger U.S. target company, in a separate undertaking at a later time, without causing Code §7874 to apply.

After this second acquisition, the value of the foreign company stock owned by the shareholders of the second target would be less than 60% (or 80%). However, that percentage of interest would exceed 60% (or 80%) if the first acquisition is either disregarded or collapsed together with the second acquisition. There is a regulation that can collapse the two acquisitions into a combined transaction if they are part of a *plan* to acquire both companies. However, such a plan may not exist or, if it does, finding that plan can be very difficult, so this regulation has not been as useful as initially anticipated.[17]

The Treasury has now decided that certain prior acquisitions of U.S. corporations should be backed out of the computation of the denominator of the ownership fraction. This revised computation can push an acquisition into being an inversion subject to §7874.

Action Taken

The Multiple Domestic Entity Acquisition Rule is set forth in Treas. Reg. §1.7874-8T.

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14 T.D. 9761, Explanation of Provisions, I(B)(3). (April 8, 2016).

15 Treas. Reg. §1.7874-12T(a)(17).

16 The ownership percentage also has an alternate test based on vote, as previously discussed. Since the vote test can be more easily manipulated to prevent an inversion, practitioners have put greater focus on the value test when trying to avoid an inversion. As a result, the balance of this article will only refer to the value test for ease of presentation.

17 Treas. Reg. §1.7874-2(e).

This new rule will exclude from the denominator of the ownership fraction an amount equal to the sum of the "excluded amounts" computed separately with respect to each "prior domestic entity acquisition" and each "relevant share class."[18]

A prior domestic entity acquisition is any acquisition of a domestic corporation made within the 36-month period ending on the signing date for the acquisition unless an exception applies.[19] An exception to this rule applies if the shareholders of this acquired domestic entity consequently hold less than 5% (by vote and value) of the stock of the foreign company and the fair market value of the foreign company did not exceed $50 million on the date the domestic entity was acquired.[20]

The determination of each excluded amount is done by a three step process:[21]

- First, the total number of shares of F.A. stock, outstanding after the prior domestic entity acquisition, must be calculated ("total number of prior acquisition shares").
- Second, for each relevant share class, the total number of prior acquisition shares must be adjusted to account for redemptions in the period after the completion date of the prior domestic entity acquisition, ending on the day prior to the completion date of the relevant domestic entity acquisition ("the general redemption testing period").[22]
- Third, for each relevant share class, the total number of prior acquisition shares, as adjusted, is multiplied by the fair market value of a single share of stock of the relevant share class, as of the completion date of the relevant domestic entity acquisition (the product is "an excluded amount").[23]

The total amount of stock of F.A. that is excluded from the denominator of the ownership fraction is the sum of the excluded amounts computed separately with respect to each prior domestic entity acquisition and each relevant share class.[24] This change applies to transactions undertaken after April 4, 2016.[25]

Pfizer-Allergan Deal Terminated Due to New Rules

As noted earlier, Pfizer's $160 billion deal with Irish-based Allergan was materially impacted by these new rules, and within 24 hours of the Treasury's actions, the planned merger was scuttled.

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18 Treas. Reg. §1.7874-8T(b).

19 Treas. Reg. §1.7874-8T(g)(4)(i).

20 Treas. Reg. §1.7874-8T(g)(4)(ii).

21 Treas. Reg. §1.7874-8T(c).

22 Treas. Reg. §1.7874-8T(e)(1). The number of redeemed shares is then multiplied by the redemption fraction (the product is the "allocable redeemed shares"). The numerator of the redemption fraction is generally the total number of prior acquisition shares, and the denominator is the sum of: (i) the number of outstanding shares of F.A. stock as of the end of the last day of the redemption testing period and (ii) the number of redeemed shares during the redemption testing period.

23 Treas. Reg. §1.7874- 8T(c).

24 Treas. Reg. §1.7874-8T(b).

25 Treas. Reg. §1.7874-8T(i).

Under the rules in effect before these latest changes, Pfizer's shareholders were expected to get approximately 56% of Allergan's stock as a result of the merger. This percentage would not have triggered application of the U.S. inversion rules since it is less than the 60% ownership threshold.[26] In determining the stock ownership percentage and related ownership fraction, transactions conducted by Allergan in the last three years served to increase its value. Thus, the stock ownership percentage was decreased, with respect to Pfizer shareholders, to a rate below the 60% threshold. However, the addition of the Multiple Domestic Entity Acquisition Rule changes the way ownership in the combined company would be computed by disregarding the enhanced value that Allergan achieved through those prior acquisitions.

"The Treasury was concerned that certain taxpayers were targeting foreign corporations with a value that was attributable to substantial passive assets rather than business assets."

Allergan did several major deals in the last three years, including the $66 billion merger of Allergan and Actavis Plc, the $25 billion acquisition of Forest Laboratories, and the $5 billion takeover of Warner Chilcott.[27] Application of the new rules was expected to remove these deals from the computation of Allergan's value and, thus, increase the post-merger ownership percentage of the Pfizer shareholders. That risk resulted in the decision to cancel the merger.

NEWLY ADOPTED MULTIPLE-STEP ACQUISITION RULE

Reason for Action

Treas. Reg. §1.7874-2(c)(2) provides that when a foreign corporation ("Foreign Parent") acquires stock of another foreign corporation ("Foreign Sub") and Foreign Sub owns stock of a U.S. corporation (or an interest in a U.S. partnership) then Foreign Parent is not treated as making an indirect acquisition of the assets of the U.S. corporation or partnership. This regulation is a taxpayer favorable rule that prevents Foreign Parent from getting caught under the inversion rules.

The Treasury became aware that some taxpayers have realized that they can do a multiple-step acquisition that relies on §1.7874-2(c)(2) so that the second step can avoid being subject to §7874.[28] In the first step, a foreign corporation (the "initial acquiring corporation") acquires substantially all of the properties held by a domestic entity in a transaction that does not result in the initial acquiring corporation being treated as a domestic corporation under Code §7874(b) because the ownership percentage is less than 80% (the "initial acquisition"). In the second step, pursuant to a plan that includes the initial acquisition or a series of related transactions, another foreign corporation (the "subsequent acquiring corporation") acquires substantially all of the properties of the initial acquiring corporation (the "subsequent acquisition"). In this case, the subsequent acquiring corporation is not treated as acquiring any of the assets of the domestic entity based on Treas. Reg. §1.7874-2(c)(2). It is essential to this planning that the first step does not make the initial acquiring corporation a domestic corporation, which would occur if 80% or more of its stock was acquired initially by the shareholders of the domestic corporation.

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26 Lynnley Browning & Michelle Cortez, "Pfizer-Allergan Deal May Be Imperiled by U.S. Inversion Rules," *Bloomberg*, April 5, 2016.

27 Lindsay Dunsmuir & Carl O'Donnell, "New U.S. Inversion Rules Threaten Pfizer-Allergan Deal," *Fiscal Times*, April 4, 2016.

28 T.D. 9761, Explanation of Provisions, I(A). (April 8, 2016).

Action Taken

Treas. Reg. §1.7874-2 defines when a foreign corporation becomes a surrogate foreign corporation. The Treasury has adopted temporary regulations to incorporate the Multiple-Step Acquisition Rule into the definition of a surrogate foreign corporation.[29] This change applies to transactions undertaken after April 6, 2016.[30]

ADOPTION OF REGULATIONS DESCRIBED IN NOTICE 2014-52

Notice 2014-52 (the "First Notice") described regulations that the Treasury intended to issue to address transactions that would avoid the purposes of §7874, as well as to address tax avoidance by corporate groups that have completed certain transactions described in §7874. The adopted Code §7874 regulations incorporate these rules with some modifications. Significant modifications are discussed below.

Disregarded Stock Attributable to Passive Assets

The Treasury was concerned that certain taxpayers were targeting foreign corporations with a value that was attributable to substantial passive assets rather than business assets. That type of cashbox foreign corporation would serve as the foreign acquiring corporation with the goal of removing the transaction from the application of Code §7874.[31] Since the passive assets were already held by the foreign corporation, the full value of the foreign corporation, including the value attributable to the passive assets, would be reflected in the denominator of the ownership fraction. The First Notice indicated that regulations would be issued to halt the use of foreign cashbox corporations.

Treas. Reg. §1.7874-7T incorporates this rule and identifies certain foreign corporation stock, which has substantial value and is attributable to passive assets. That stock is disregarded in determining the ownership fraction. If more than 50% of the gross value of all "foreign group property" is "foreign group nonqualified property," a portion of the stock of the foreign acquiring corporation is excluded from the denominator of the ownership fraction.[32] When triggered, this rule will skew the ownership fraction in the direction of the former shareholders of the domestic acquired corporation so that Code §7874 may apply.

One comment received by the Treasury was concern that this passive assets rule could apply to a case where the former shareholders of the U.S. target company get only a *de minimis* amount of stock in the foreign acquiring company.[33] The regulations address this point by adding a *de minimis* rule that applies if (i) the ownership percentage of the former shareholders is less than 5% measured by vote or value and (ii) the former domestic entity shareholders own less than 5% of any member of the E.A.G. headed by the foreign acquiring company.[34]

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29 Treas. Reg. §§1.7874-2T(a), (b)(7) -(13), (c)(2), (c)(4), (f)(1)(iv).

30 Treas. Reg. §1.7874-2T(l)(2).

31 Notice 2014-52, 2014-42 I.R.B. 712, § 2.01(b).

32 Treas. Reg. §1.7874-7T(b).

33 T.D. 9761, Explanation of Provisions, I(B)(2)(c)(i) (April 8, 2016).

34 Treas. Reg. §1.7874-7T(c).

This regulation generally applies to transactions undertaken after September 22, 2014.[35]

Disregarded Pre-Transaction Distributions by a Domestic Target

The so-called anti-skinnying rule of the First Notice would disregard any non-ordinary course distribution ("N.O.C.D.") made by the domestic entity during the 36-month period ending on the acquisition date.[36] This rule applies to all distributions, regardless of whether they are treated as dividends for tax purposes.[37] For example, a spin-off described in Code §355 would be a distribution subject to this rule.

Treas. Reg. §1.7874-10T incorporates this rule and, in determining the ownership fraction, disregards certain N.O.C.D.'s made by a domestic entity in the 36-month period before the inversion.[38] This means that former shareholders (or former partners) of the domestic entity (or former domestic entity partners) are treated as receiving additional stock of the foreign acquiring corporation when the domestic entity has made one or more N.O.C.D.'s.

For this purpose, an N.O.C.D. is any distribution within a look-back year in excess of the N.O.C.D. threshold for that look-back year.[39] A look-back year is generally each 12-month period within the 36-month period ending on the completion date.[40] The distribution history period referred to below means, with respect to a look-back year, the 36-month period preceding the start of the look-back year.[41] In both instances, adjustments are made for corporations with a shorter period of existence.

The N.O.C.D. threshold is generally equal to 110% of the distributions made within the distribution history period, multiplied by a fraction in which the numerator is the number of days in the look-back year and the denominator is the total number of days in the distribution history period.[42]

The regulations incorporate comments regarding the effect of post-distributions fluctuation in value.

> Accordingly, post-distribution fluctuations in the value of the stock or interests of the domestic entity, as applicable, or the value of the distributed property (for example, in the case of a spin-off), do not affect the amount of...stock that is deemed received.[43]

This regulation generally applies to transactions undertaken after September 22, 2014.[44]

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35 Treas. Reg. §1.7874-7T(h). Because it is a temporary regulation, this regulation expires in three years (*i.e.*, April 4, 2019). Treas. Reg. §1.7874-7T(i).

36 Notice 2014-52, 2014-42 I.R.B. 712, §2.02(b).

37 *Id.*

38 Treas. Reg. §1.7874-10T(a).

39 Treas. Reg. §1.7874-10T(h)(6).

40 Treas. Reg. §1.7874-10T(h)(5).

41 Treas. Reg. §1.7874-10T(h)(2).

42 Treas. Reg. §1.7874-10T(h)(7).

43 T.D. 9761, Explanation of Provisions, I(B)(5)(b)(i) (April 8, 2016).

44 Treas. Reg. §1.7874-10T(i).

Subsequent Transfers of Foreign Acquiring Corporation Stock

In determining the ownership percentage, Code §7874(c)(2)(A) and Treas. Reg. §1.7874-1 provide that certain stock held by members of the E.A.G. that includes the foreign acquiring company will not be taken into account in either the numerator or the denominator of the ownership fraction.[45]

To insure that these rules are not used as a device to avoid an inversion, Treas. Reg. §1.7874-5T, issued in 2012, indicates that stock that was acquired with the intent to carry out an inversion will not lose that status if it is subsequently transferred. As a result, the transferred stock will be included in the determination of the ownership percentage.

In the First Notice, the Treasury said it will supplement these rules by issuance of an additional rule applicable to stock of the foreign acquiring corporation that is (i) received by a former owner of the U.S. target company and (ii) later transferred in a transaction related to the inversion. That stock will be included in both the numerator and the denominator of the fraction, subject to two exceptions involving U.S.-parented groups and foreign-parented groups.[46]

Treas. Reg. §1.7874-6T incorporates these rules, but makes one helpful change by providing that the U.S.-parented group exception applies even if the common parent of the E.A.G. changes after the transaction.[47] The U.S.-parented group exception applies if (i) before and after the acquisition, the transferring corporation (or its successor) is a member of a U.S.-parented group; and (ii) after the acquisition, the person that holds the transferred stock, the transferor of such stock, and the foreign company that acquired the U.S. target company are all members of a U.S.-parented group headed by any of the following corporations: the original U.S. parent, another U.S. member of that group, or a new U.S. company formed in the overall transaction.[48]

The Treasury declined to accept a request for a change to the definition of a foreign-parented group to permit a restructuring. The foreign-parented group exception applies if (i) before the acquisition, the transferring corporation and the domestic entity are members of the same foreign-parented group and (ii) after the acquisition, the transferring corporation is a member of the E.A.G. or would be a member of the E.A.G. absent the subsequent transfer of any stock of the foreign acquiring corporation by a member of the foreign-parented group in an acquisition-related transaction.[49]

This regulation generally applies to domestic entity acquisitions completed on or after September 22, 2014.[50]

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45 However, such ownership will be taken into account in the denominator (but not the numerator) if the stock was acquired in an internal group restructuring, which can help to reduce the ownership percentage. Treas. Reg. §1.7874-1(c)(2).

46 Notice 2014-42, §2.03.

47 T.D. 9761, Explanation of Provisions, II(C)(3)(a) (April 8, 2016).

48 Treas. Reg. §1.7874-6T(c)(1).

49 Treas. Reg. §1.7874-6T(c)(2).

50 Treas. Reg. §1.7874-6T(h).

Application of Code §956

Code §956 provides that a U.S. shareholder of a C.F.C. recognizes income if the C.F.C. makes an investment in U.S. property. The Treasury expressed concern that an inverted domestic corporation could divert earnings from the U.S. group by having its foreign subsidiaries make loans to, or acquire stock of, a foreign affiliate outside the U.S.-parented chain. To prevent this money from bypassing the U.S. shareholder's tax return, the First Notice said that regulations will be adopted to require income inclusion under Code §956 in these situations.

Treas. Reg. §1.956-2T(a)(4)(i) incorporates this anti-hopscotch rule. If an expatriated foreign subsidiary (*viz.*, a C.F.C. subsidiary of a domestic corporation that was acquired in an inversion) acquires an obligation or stock of a non-C.F.C. related foreign corporation during the applicable period, the obligation or stock is treated as U.S. property under Code §956. The applicable period[51] is the ten-year period beginning on the date of acquisition of the domestic corporation.

The Treasury expanded the foregoing concept by including in the scope of the rule any obligation or stock of the related foreign corporation acquired in a "transaction related to the inversion transaction."[52] As a result, an obligation or stock acquired *before* the applicable period is covered by this rule if made in contemplation of the inversion.[53]

"An obligation or stock acquired before the applicable period is covered by this rule if made in contemplation of the inversion."

Consistent with the First Notice, the regulation provides that if the expatriated foreign subsidiary is a guarantor or pledger of debt of the non-C.F.C. related foreign person, then the C.F.C. is treated as holding an obligation of the non-C.F.C. person.[54] As a result, income recognition may then occur for the domestic corporation.

This regulation generally applies to obligations or stock acquired after September 22, 2014.[55]

Preventing De-Control of C.F.C. Stock

U.S. companies that are targets of inversions usually have many foreign corporate subsidiaries that are C.F.C.'s. The First Notice described certain specified transactions that may be undertaken, after the inversion, to de-control an expatriated foreign subsidiary so that it no longer is a C.F.C. The First Notice also indicated that regulations will be adopted to stop any tax benefits that such de-control may afford.[56]

Treas. Reg. §1.7701(l)-4T adopts these de-control rules.[57] Under these rules, the C.F.C. status of an expatriated foreign subsidiary is preserved despite a later stock issuance by that expatriated foreign subsidiary to a related non-C.F.C. foreign person. For example, a transaction by which an expatriated foreign subsidiary issues

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51 Treas. Reg. §1.7874-12T(a)(2).

52 Treas. Reg. §1.956-2T(a)(4)(i)(C)(2).

53 T.D. 9761, Explanation of Provisions, II(A)(2)(a) (April 8, 2016).

54 Treas. Reg. §1.956-2T(c)(5).

55 Treas. Reg. §1.956-2T(i).

56 Notice 2014-52, §3.02.

57 T.D. 9761, Explanation of Provisions, II(B)(1)(b) (April 8, 2016).

stock to a related foreign person for cash will generally be re-characterized so that (i) the cash is deemed contributed by the related foreign purchaser of the stock to the U.S. inverted company and then (ii) the U.S. inverted company contributes the cash to the expatriated foreign subsidiary in exchange for a deemed issuance of stock.[58] As a result, the U.S. ownership of the expatriated foreign subsidiary is not reduced and it continues to be a C.F.C. Similar rules are adopted to prevent loss of C.F.C. status due to the transfer of stock in the expatriated foreign subsidiary to a related person.[59]

The regulation adopts two exceptions to the rules set forth in the First Notice.[60] The regulations add a new *de minimis* rule that can apply if at least 90% of the pre-transaction ownership in the expatriated foreign subsidiary is maintained, excluding the percentage of stock owned by non-C.F.C. related persons.[61] The regulations also contain a special rule that can unwind the impact of C.F.C. status if the disregarded stock in the expatriated foreign subsidiary is later transferred to an unrelated person.[62]

This regulation generally applies to specified transactions occurring on or after September 22, 2014, but only if the inversion was *completed* on or after such date.[63]

Preventing Dilution of Ownership Under Code §367 Regulations

Code §367(b) provides that a shareholder that exchanges stock of a foreign corporation for stock of another foreign corporation in certain tax-free transactions must include the Code §1248 amount in income as a deemed dividend, if the exchange results in (i) loss of C.F.C. status for the foreign corporation that issued the exchanged stock or (ii) loss of Code §1248 shareholder status for the shareholder involved in the exchange.[64] The Code §1248 amount is the portion of the C.F.C.'s non-previously taxed earnings and profits.[65] The First Notice provided that a stock dilution rule would be adopted, which would extend this deemed dividend treatment to certain nonrecognition transactions that occur after an inversion even if the transaction does not result in loss of C.F.C. status or Code §1248 shareholder status.

This stock dilution rule is adopted in Treas. Reg. §1.367(b)-4T(e)[66] with two new exceptions.[67] The first exception is built into the definition of specified exchanges and provides that this new rule does not apply if the exchanging shareholder is neither

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58 Treas. Reg. §1.7701(l)-4T(c)(2) (assuming the stock issuance is made within the 10-year period after the inversion).

59 Treas. Reg. §1.7701(l)-4T(c)(3).

60 Notice 2014-52, §3.02(e)(i)(C) adopted in Treas. Reg. §§1.7701(l)-4T(b)(2)(i), (ii). The two exceptions are for fast pay stock or a case in which a person pays full U.S. tax on the transfer of the stock.

61 Treas. Reg. §§1.7701(l)-4T(b)(2)(i), (iii).

62 Treas. Reg. §1.7701(l)-4T(d)(3).

63 Treas. Reg. §1.7701(l)-4T (h).

64 Treas. Reg. §1.367(b)-4(b).

65 Treas. Reg. §1.367(b)-2(c).

66 T.D. 9761, Explanation of Provisions, II(B)(2) (April 8, 2016).

67 T.D. 9761, Explanation of Provisions, II(B)(2)(c)(ii) (April 8, 2016).

an expatriated entity nor an expatriated foreign subsidiary.[68] The second exception is a *de minimis* rule.[69]

The temporary regulations also adopt a rule that can require income recognition for any unrealized gain if an expatriated foreign subsidiary transfers specified property to a foreign transferee corporation in a Code §351 transaction.[70]

This income recognition rule is generally applicable to exchanges completed after November 19, 2015, but only if the inversion was completed on or after September 22, 2014. However, the new Code §351 rule and certain other changes apply to transfers occurring on or after April 4, 2016.[71]

Preventing the Repatriation of Untaxed Earnings Under Code §304 Regulations

The First Notice addressed certain transactions that taxpayers are thought to engage in after an inversion in order to reduce a C.F.C.'s earnings and profits to facilitate a subsequent repatriation of cash or other property of the C.F.C. in a tax-free manner.[72] Treas. Reg. §1.304-7T addresses this concern, effective for transactions completed on or after September 22, 2014.[73]

An example in the regulations illustrates when this rule applies.[74] In the example, F.A., a foreign corporation that is not a C.F.C., owns 100% of a domestic corporation ("D.T.") that has $51 of earnings and profits. D.T. owns 100% of a C.F.C. ("F.S.1") that has $49 of earnings and profits. F.A. sells the D.T. stock to F.S.1 for $100. Code §304(a)(2) applies to the sale, so the $100 cash is treated as a distribution in redemption of D.T. stock owned by F.A. Under prior law, the $49 of F.S.1's earnings and profits would have been eliminated and the $100 cash would have been treated as a foreign-source dividend, not subject to U.S. tax. Under the temporary regulations, F.S.1's earnings and profits are not eliminated and the $100 of cash is treated as a U.S.-source dividend to the extent of D.T.'s $51 of earnings and profits.

As noted above, this new rule was adopted based on transactions undertaken following an inversion. However, this temporary regulation is not limited to transactions that are a part of an inversion transaction. As a result, it can have greater impact.

ADOPTION OF REGULATIONS DESCRIBED IN NOTICE 2015-79

Notice 2015-79 (the "Second Notice") described regulations that the Treasury intended to issue to address transactions that would avoid the purposes of Code §7874, as well as to address tax avoidance by corporate groups that have completed certain transactions described in Code §7874. The adopted Code §7874

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68 Treas. Reg. §1.367(b)-4T(e)(2).

69 Treas. Reg. §1.367(b)-4T(e)(3).

70 Treas. Reg. §1.367(b)-4T(f).

71 Treas. Reg. §1.367(b)-4T(h).

72 T.D. 9761, Explanation of Provisions, II(B)(4) (April 8, 2016).

73 Treas. Reg. §1.304-7T(e).

74 Treas. Reg. §1.304-7T(d), Ex. 1.

regulations incorporate these rules with some modification. Significant modifications are discussed below.

The "Third Country Rule"

The Second Notice addressed adoption of a Third Country Rule,[75] and it is incorporated in Treas. Reg. §1.7874-9T. The Third Country Rule involves a case in which a domestic entity is combined with an existing foreign corporation under a new foreign parent corporation that is a tax resident of a "third country."[76] The likely impact of this rule is to cause the new foreign parent company to be treated as a U.S. corporation unless the former shareholders of the domestic entity own less than 60% of the foreign parent company.

Some background is needed to understand the reason for this new rule. A foreign corporation may want to acquire a U.S. target corporation in exchange for its stock, but at the same time, the foreign corporation may want to restructure by establishing a new foreign parent holding company for the group with a tax residence that is different from that of the existing foreign corporation. In these circumstances, a new third-country parent acquires the stock of the existing foreign corporation, and the shareholders of the existing foreign corporation receive more than 20% of the stock of the new third-country parent. At the same time, the new third-country parent acquires the stock of the domestic entity, and the shareholders of the domestic entity receive less than 80% of the stock of the new third-country parent.

In the Second Notice, the I.R.S. said that such a "third-country transaction" is:

> Generally driven by tax planning including the facilitation of U.S. tax avoidance following the acquisition. For example, the third country may have a more favorable income tax treaty…with the result that U.S. withholding taxes on dividends, interest, and royalties paid by the domestic entity may be reduced or eliminated.[77]

Under this rule, if a third-country transaction occurs, this rule ignores the stock issued to the old shareholders of the existing foreign company in determining the ownership percentage of the former shareholders of the U.S. target in the new foreign parent.[78] A third-country transaction will generally occur if

- the former shareholders of the U.S. target company get 60% or more of the stock of the new foreign parent company ("share ownership test"),
- the new foreign parent company also acquired a foreign target company in the same transaction, and
- the foreign parent company is subject to tax in a country other than the country in which the foreign target company is taxed.[79]

The regulations adopt a share ownership (or continuity of interest) test rather than a

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75 Notice 2015-79, §2.02(b).

76 T.D. 9761, Explanation of Provisions, I(B)(4)(a) (April 8, 2016).

77 Notice 2015-79, §2.02(b).

78 Treas. Reg. §1,7874-9T(b).

79 Treas. Reg. §1,7874-9T(c). See also Treas. Reg. §1.7874-9T(f), Example.

test based on gross value of assets, which was set forth in the Second Notice. As a result, the new parent company will generally be classified as a domestic company if the former shareholders of the U.S. target company now own 80% or more of the shares of the new parent company.

This regulation generally applies to transactions undertaken on or after November 19, 2015. However, for transactions completed on or after November 19, 2015 but before April 4, 2016, taxpayers can elect to determine whether there has been a third-country transaction by use of the gross asset test in the Second Notice rather than the continuity of interest test in the regulations.[80]

"Nonqualified property includes cash, marketable securities as well as any other property 'acquired with a principal purpose of avoiding the purposes of Code §7874.'"

Ownership Percentage Exclusions

A key factor in determining whether an inversion occurs is the ownership percentage. This invites planning to try to either increase the denominator or decrease the numerator to lower the ownership percentage. Code §7874(c)(2)(B), the "statutory public offering rule," provides that stock issued in a public offering that is related to the acquisition of a U.S. target company (*viz.*, the funds raised in the public offering are used by the company to finance the acquisition of the U.S. target company) is excluded from the denominator.

On January 16, 2014,[81] the Treasury adopted Treas. Reg. §1.7874-4T(b), which provides that disqualified stock is not included in the denominator of the fraction, subject to a *de minimis* exception. Disqualified stock includes stock of a foreign acquiring company that is transferred for "nonqualified property" when that exchange is related to the inversion transaction. Nonqualified property[82] includes cash, marketable securities as well as any other property "acquired with a principal purpose of avoiding the purposes of Code §7874."[83]

The Second Notice expressed concern that some taxpayers "may be narrowly interpreting the definition of avoidance property."[84] To address those situations, the Second Notice indicated that the definition of avoidance property will be modified to add the words "regardless of whether the transaction involves an indirect transfer of property." This change was adopted in revised Treas. Reg. §1.7874-4T(i)(7)(4).[85]

Most importantly, the Treasury added an example to illustrate how this may apply.[86] In the new example, a foreign partnership transfers certain business assets to a new foreign corporation in exchange for 25 of its shares, and at the same time, the shareholders of U.S. target company transfer their stock in the domestic target to new foreign corporation in exchange for the remaining 75 shares of the foreign corporation. The example concludes that the 25 shares issued to the foreign partnership were issued for avoidance property and, thus, those 25 shares are disqualified stock. As a result, the former shareholders of the domestic target own 100% of the new foreign corporation, which is caught by the inversion rules and is treated as a

80 Treas. Reg. §1.7874-9T (g).

81 T.D. 9654 (Jan. 16, 2014).

82 Treas. Reg. §1.7874-4T(i)(7).

83 Treas. Reg. §1.7874-4T(i)(7)(iv) ("avoidance property").

84 Notice 2015-79, §2.03.

85 T.D. 9761, Explanation of Provisions, §II(B)(1) (April 8, 2016).

86 Treas. Reg. §1.7874-4T(j), Example 3.

U.S. corporation. This change is effective for acquisitions completed on or after November 19, 2015.[87]

Substantial Business Activities

Code §7874 does not generally apply if the E.A.G. that includes the foreign acquiring company conducts "substantial business activities" in the country where the foreign acquiring company is formed.[88] Treas. Reg. §1.7874-3, adopted on June 3, 2015,[89] sets forth rules for determining if substantial business activities are conducted. Substantial business activities will exist if at least 25% of the group's employees, assets, and income are derived in the relevant foreign country.[90]

The Second Notice indicated that this regulation will be modified so that the "subject to tax" rule will only be met if the foreign corporation is also a resident of that foreign country.[91] Treas. Reg. §1.7874-3T(b)(4) adopted this rule without making any substantive changes and is effective for acquisitions after November 19, 2015.[92]

Inversion Gain

If an inversion occurs, Code §7874(a)(1) provides that, for any taxable year during the the ten-year period after the inversion, the taxable income of the expatriated U.S. entity will not be less than the inversion gain for that year. This rule does not allow the expatriated entity to use a net operating loss carry forward to offset the inversion gain. Inversion gain includes the income or gain recognized by the expatriated entity on a direct transfer of stock or other property from the inversion transaction or a license by the expatriated entity that was entered into as part of the inversion transaction.[93]

The Second Notice indicated that the Treasury will issue regulations that will provide that income or gain attributable to "indirect" transfers of stock or property by an expatriated entity, or an "indirect" license, will also be included as part of inversion gain. The Treasury was concerned that such indirect transfers may also remove "foreign operations from U.S. taxing jurisdiction while avoiding current taxation contrary to the policy underlying [the inversion rules]."[94] For example, after an inversion, a C.F.C. owned by the expatriated U.S. entity may sell property to the foreign acquiring entity in a transaction that generates Subpart F income to the expatriated U.S. entity. This Subpart F income is not classified as inversion gain under the Code. Therefore, it may be sheltered from tax by use of a N.O.L. carry-forward unless this indirect transfer rule is adopted.

Treas. Reg. §1.7874-11T adopts rules for determining inversion gain. The definition of inversion gain includes gain attributable to the "direct or indirect transfer of stock or other properties or license of any property either as part of the [inversion

87 Treas. Reg. §1.7874-4T(k)(1).

88 Code §7874(a)(2)(B)(iii).

89 T.D. 7874 (June 3, 2014).

90 Treas. Reg. §1.7874-3(b).

91 Notice 2015-79, §2.02(a).

92 Treas. Reg. §1.7874-3T(f)(2).

93 Code §7874(d)(2).

94 Notice 2015-79, §3.01((b).

transaction], or after such acquisition if the transfer or license is to a specified related person."[95] In response to a comment,[96] Treas. Reg. §1.7874-11T(b)(1) provides that inversion gain includes amounts treated as dividends under Code §78 with respect to foreign taxes deemed to be paid by an expatriated entity under Code §902(a) or Code §960(a)(1).

This regulation generally applies to transfers or licenses of property completed on or after November 19, 2015, but only if the inversion transaction was completed on or after September 22, 2014.[97]

CONCLUSION

The latest attempt to close down inversions has seen its first success story in the termination of the pending Pfizer-Allergan merger. While they are not prone to the same public exposure, there are likely many other inversions in the planning stages that will never see the light of day as a result of these actions. As we have also mentioned, the Treasury opened up a whole new front on the battle against inversions with its release of proposed regulations under Code §385 that take aim at related-party debt.

95 Treas. Reg. §1.7874-11T(b).

96 T.D. 9761, Explanation of Provisions, §II(C)(2) (April 8, 2016).

97 Treas. Reg. §1.7874-11T (f).

COUNTRY-BY-COUNTRY REPORTING: WHERE ARE WE GOING?

Authors
Michael Peggs
Kenneth Lobo

Tags
Action 13
B.E.P.S.
CbC Reporting
Exchange of Financial Information
Tax Policy

Far from its humble beginnings as a tax form, the Country-by-Country ("CbC") report attracted further notoriety and criticism on April 12, when the European Parliament amended the E.U. single-market legislation to include reporting of activity in tax haven jurisdictions that will be identified and listed. As countries introduce legislation to require the filing of CbC reports for tax purposes and companies work toward meeting new compliance requirements, we are reminded of one of the many Yogi-isms (from baseball legend Yogi Berra): "You've got to be very careful if you don't know where you're going because you might not get there." E.U. legislation now risks derailing the consensus, fostered by the O.E.C.D.'s B.E.P.S. Project, between the world's tax authorities.

Originally intended as the remedy to the financial information shortage that tax authorities experienced while auditing multinational companies, CbC reporting was first introduced as one of three updated tiers of transfer pricing documentation in the O.E.C.D./G-20 final report on B.E.P.S. Action 13, released on October 5, 2015. A CbC report is a tax-authority-generated form that must be filed by the ultimate parent company in its country of residence, in cases where the revenue of a consolidated group exceeds the equivalent of €750 million (U.S. $850 million). The form reports, on a country-by-country basis, items such as related and unrelated party revenue, profit before income tax, income tax paid on a cash basis, income tax accrued, stated capital, accumulated earnings, number of employees, non-cash tangible assets, jurisdictions of organization and residence, and primary business activity by entity.

CbC report data is intended to be used by tax authorities for three purposes:

- To perform high-level transfer pricing risk assessments and assist with audit selection
- To detect any other potential tax issues (again, in the context of audit selection)
- To perform statistical analysis of the extent of base erosion and profit shifting activity by taxpayers and the effect that new legislation has on curtailing such activity

Initial concerns by business groups over the inappropriate use of CbC report data – for the purpose of proposing adjustments to the income of a taxpayer based on an allocation formula, such as would result from the irresponsible use of a profit split transfer pricing methodology – resulted in clear guidance from the O.E.C.D., which circumscribed tax authority usage of CbC report data.[1]

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[1] O.E.C.D., *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13-2015 Final Report*, O.E.C.D./G-20 Base Erosion and Profit Shifting Project, (Paris: O.E.C.D. Publishing, 2015), para. 59.

CbC reports are to be filed with the tax authority in the jurisdiction of the ultimate parent and exchanged with other tax authorities. The conventions for exchange of information set out in that jurisdiction's network of income tax treaties and other exchange of information agreements ("T.I.E.A.'s"). An electronic XML schema was recently released by the O.E.C.D. to enable tax authorities to exchange data in a common format. This schema follows the example of the Common Reporting Standard used in the international exchange of banking information.[2]

"At the heart of the debate between E.U. Member States and the European Parliament is the question of whether state tax authorities can be entrusted with the sovereign task of modifying taxpayer behavior."

Heralded by civil society groups and tax authorities alike as one of the great successes of the B.E.P.S. Project, the CbC report has inspired concern from the private sector. Business groups voiced concerns about potential damage from lapses in tax authority data security and misuse of CbC report information both within and outside tax authorities. Specific business groups, such as defense contractors, are seeking exemptions from certain CbC reporting requirements to guard against the exposure of information vital to national security interests. U.S. CbC reporting, proposed under Prop. Treas. Reg. §1-60384-15 on December 23, 2015, was accompanied by assurances from the Department of the Treasury that data security breaches by foreign treaty partners would result in the suspension of U.S. cooperation in the exchange of CbC report information.

The issue of public CbC reporting has been addressed by the B.E.P.S. Project and subsequent legislation enacted in O.E.C.D. Member and Observer states. China and India have been active in shaping public reporting policy, having been strong Observer State voices throughout the B.E.P.S. Project and adopters of CbC reporting for tax purposes. CbC report data was intended to be treated confidentially by tax authorities and not used for any purpose except for the administration of taxation. Nevertheless, public CbC reporting has been championed by the European Parliament, and certain E.U. Member States, and has received renewed attention following the publication of the Panama Papers by the International Consortium of Investigative Journalists.

At the heart of the debate between E.U. Member States and the European Parliament is the question of whether state tax authorities can be entrusted with the sovereign task of modifying taxpayer behavior or whether further public pressure must be applied from outside the income tax system. The legislation proposed on April 12 makes it clear that the European Parliament believes tax policy objectives cannot be achieved without resorting to the stronger disincentive of public disapproval.

Notable in the proposed legislation is the requirement that an E.U. branch or medium- or large-sized E.U. subsidiary of a non-E.U. parented company must report its activities using the CbC model; display this report on the website of the subsidiary or branch; and note, on the relevant audited financial statements, where reporting has not been completed in accordance with the legislation. Albeit reduced, responsibility for the reporting requirement falls ultimately to the "members of the administrative management and supervisory bodies"[3] or "the legal representative," leading to potential director and officer liability.

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[2] The Common Reporting Standard is discussed in the lead article in Insights Vol. 3 No. 1.

[3] European Commission, *Proposal for a Directive of the European Parliament and of the Council Amending Directive 2013/34/EU as Regards Disclosure of Income Tax Information by Certain Undertakings and Branches*, (2016), para. 10.

The amendment proposed on April 12 establishes a forthcoming list of tax havens for which reporting by jurisdiction will apply – distinct from the reporting on the aggregation of tax profile attributes of companies resident outside the E.U. Tax haven countries on the "Common Union list of certain tax jurisdictions" do not comply with the following criteria:

- Transparency and exchange of information standards, including information exchange on request and automatic exchange of financial account information
- Fair tax competition standards
- Standards set up by the G-20 and/or the O.E.C.D.
- Other relevant standards, including international standards set up by the Financial Action Task Force[4]

Companies are required to prepare and display the CbC report not later than 12 months after the balance sheet date. The effective date of the legislation depends on the date of enactment but will most likely apply to the first financial year beginning not later than one year after the E.U. directive is adopted or transposed into Member State law.

As an unintended consequence, these provisions bring about public exposure of certain portions of the CbC report, which are prepared for tax purposes and would otherwise have been guaranteed confidential treatment by tax authorities when exchanged between Competent Authorities, as set out in many tax treaties and T.I.E.A.'s. Significant controversy is expected to surround the issue of public CbC reporting, with opposition arising from the tax authorities of E.U. Member States and from the I.R.S. and Treasury – already vocal critics of the E.U. State Aid cases that have been brought against many of the largest U.S. multinationals.

For E.U. subsidiaries of U.S.-based groups, placing the reporting obligation on the local European company is an attempt to circumvent provisions in U.S. tax law that make a Federal employee's[5] unauthorized disclosure of tax return information a Federal crime.[6] When information is provided by the I.R.S. to a foreign government, there are limitations on the use to which the information can be put. The parties are prohibited from using any information received for any purpose other than the administration of taxes. Any information received from the U.S. is to be treated as secret, in the same manner as information obtained under the domestic laws of that state, and may be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment; collection; or administration of, enforcement or prosecution in respect of, or determination of appeals in relation to the taxes covered by this convention.[7]

4 *Id.*, art. 48c.

5 Code §6103(a).

6 Code §7213 makes a willful and unauthorized disclosure of tax return information a felony punishable upon conviction by a fine in any amount not exceeding $5,000, or imprisonment of not more than 5 years, or both, together with the costs of prosecution.

7 Preamble to REG–109822–15, 80 Fed. Reg. 79,795 (December 23, 2015) related to Prop. Treas. Reg. §1.6038-4.

TRANSFER PRICING POSITIONS OF CONSOLIDATED GROUPS: AFTER *GUIDANT*

Authors
Michael Peggs
Kenneth Lobo

Tags
§482 Adjustments
Comparable Price Method
Consolidated Taxable Income
Guidant LLC
Separate Taxable Income
Transfer Pricing

You may recall a particularly memorable Inspector Clouseau dialog from the 2006 remake of film *The Pink Panther*, with Steve Martin cast in the role of Inspector Jacques Clouseau. It goes like this:

> CLOUSEAU. It's amazing how he fell perfectly into the chalk outline on the floor.
>
> PONTON. I think they drew the outline after he was shot.
>
> CLOUSEAU. Ah! We must be working with some kind of mastermind!

The exchange seems fitting for a discussion of the Tax Court decision in *Guidant LLC, et al. v. Commr.*, where the court held that, at law, a single application of the comparable profits method ("C.P.M.") can be used to determine the true consolidated taxable income resulting from multiple controlled transactions of various types concluded by multiple members of a U.S. controlled group of companies.

So, was the victim (the consolidated taxpayer) fitted into a chalk outline already drawn on the floor by the I.R.S.? In this article, we ask the Clouseau-esque question: Was this outcome the the work of a mastermind?

GUIDANT CASE

The facts in *Guidant* are straightforward.[1] The taxpayer was an affiliated group that filed a consolidated tax return. Various group members consummated transactions with foreign affiliates. Instead of rendering specific adjustments to each subsidiary's separate taxable income ("S.T.I."), the I.R.S. determined the group's true consolidated taxable income ("C.T.I.") by posting one adjustment to the entire group. The I.R.S. did not make adjustments related solely to tangible, intangible, or services income – despite the fact that those items of income were obvious in the transactions. The taxpayer asserted that

- the I.R.S. adjustments were "arbitrary, capricious, and unreasonable"[2] as a matter of law because the I.R.S. did not determine the "true taxable income" of each controlled taxpayer as required by the regulations, and
- the I.R.S. did not make specific adjustments with respect to each transaction involving the use of an intangible, a purchase and sale of tangible property, or a provision of services, also as required by the regulations.

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1 *Guidant LLC f.k.a. Guidant Corporation and Subsidiaries, et al. v. Commr.*, 146 T.C. No. 5 (Feb. 29, 2016).

2 Treas. Reg. §1.482-1(f)(1)(iv).

To the first argument, the I.R.S. noted that it would be too costly for it to extract each individual member's information at the time of audit. Further, according to the I.R.S., the taxpayer was uncooperative in providing detailed information related to the S.T.I. of each group member. The court noted that the I.R.S. should determine a consolidated group's taxable income only after determining each individual member's true taxable income to ensure accuracy. However, the court noted that it would not force the I.R.S. to do so where it would "…eliminate the Commissioner's ability to make Section 482 adjustments when a taxpayer consciously withholds or fails to maintain records information necessary for S.T.I. adjustments." The court held that determining whether the I.R.S. proceeded in an "arbitrary, capricious and unreasonable" manner depends on specific facts. Here, the I.R.S. asserted that the taxpayer was uncooperative with the I.R.S., and for that reason, the approach of the examiner was reasonable. This matter was left for a trier of fact to determine at trial.

As to the second argument, the judge noted that, as a matter of law, the I.R.S. may aggregate transactions involving tangibles, intangibles, and services when doing so provides the best means of determining the true taxable income of a controlled taxpayer. The I.R.S. is allowed to make one adjustment to a consolidated group while ignoring the individual transactions within the group but only if the amount represents the true taxable income of the taxpayer. Whether the amount calculated by the I.R.S. was accurate must be determined by a trier of fact at trial. The C.P.M., as defined in Treas. Reg. §1.482–5, may be used to evaluate the arm's length price for controlled transactions of various types, including transfers of tangible and intangible property, and services. The C.P.M. is also widely used in the application of the residual profit split method to allocate income to the routine contributions of the relevant parties.[3] The C.P.M. is the workhorse of U.S. transfer pricing, much as its O.E.C.D. cousin, the T.N.M.M. (Transactional Net Margin Method), is the workhorse of controlled transaction pricing in the rest of the world.

"As a matter of law, the I.R.S. may aggregate transactions involving tangibles, intangibles, and services when doing so provides the best means of determining the true taxable income of a controlled taxpayer."

THE COMPARABLE PROFITS METHOD

While the C.P.M. is referenced in the respective Treasury regulation sections concerning the approach to pricing different types of controlled transactions, only Treas. Reg. §1.482–5 sets out the rules in detail for the proper application of this method in coordination with the more general requirements of Treas. Reg. §1.482–1(c) applying the best method rule and Treas. Reg. §1.482–1(d) addressing comparability. The C.P.M. is defined as follows:

> The comparable profits method evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability [profit level indicators] derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances.[4]

In the foregoing, the term "controlled transaction" is singular, and a standard of comparability is established with respect to the business activities and circumstances that characterize the controlled transaction. On the basis of this definition, the C.P.M. appears to be a method that is applied by transaction.

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[3] Treas. Reg. §1.482–6(c)(3).

[4] Treas. Reg. §1.482–5(a).

Under the C.P.M., the determination of an arm's length result is based on "the amount of operating profit that the tested party would have earned on related party transactions."[5] Measurement of this operating profit is to be carried out with reference to the "tested party's most narrowly identifiable business activity for which data incorporating the controlled transaction is available (relevant business activity)." Whether all members of the consolidated group may be treated as the tested party for the purpose of calculating operating profit depends in large part on the availability of reliable data and whether this calculation can be carried out using a relatively small number of reliable adjustments. If a particular application of the C.P.M. cannot meet these requirements, there is a diminished likelihood of achieving a good standard of comparability and of being able to conclude that the C.P.M. is the best method.

In practice, it would appear that the I.R.S. lacked information needed to apply the C.P.M. transactionally. While it may be the case that the lack of transactional analysis was excusable, owing to a failure on the part of the taxpayer to provide information during the course of the examination, the question remains whether the C.P.M. can be the best method as a matter of law when applied using an undifferentiated measure of operating profit earned both from related party transactions and other irrelevant business activity.

SECTION 482 ADJUSTMENTS

In general, the I.R.S. has the authority to make allocations to any case where the transfer price between a controlled party is deemed not to be at arm's length.[6] To make an adjustment, the I.R.S. neither has to show a taxpayer's intent to evade taxes nor demonstrate that there is a taxable realization event. However, once an adjustment is made, the I.R.S. must apply the arm's length standard, even if the result is favorable to the taxpayer.[7]

Once an adjustment is made, the taxpayer bears the burden of demonstrating that the I.R.S. is incorrect by establishing that the stated price is at arm's length and that the I.R.S. determination was arbitrary, capricious, or unreasonable.[8] If the taxpayer does not establish the arm's length price, a court will determine the arm's length price on its own.[9] Readers should note that the burden of proof remains with the taxpayer. Should the taxpayer not present enough evidence to demonstrate that the I.R.S. adjustment is arbitrary, capricious, or unreasonable, the I.R.S. determination will not be overturned.

The taxpayer can discharge its burden of persuasion by establishing that the I.R.S. allocation (i) is based on erroneous assumptions regarding the property and business or related persons, (ii) reflects significant errors in developing the arm's length

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5 Treas. Reg. §1.482–5(b)(1). The tested party is the participant in the controlled transaction.

6 Treas. Reg. §§1.482-1(a)(2), (f).

7 *Pikeville Coal Co. v. U.S.*, 37 Fed. Cl. 304 (Ct. Cl. 1997).

8 *Searle, G.D. & Co v. Commr.*, (1987), 88 T.C. 252. *United States Steel Corp v. Commr.*, 45 AFTR 2d 80-1081 (CA2, 1980)

9 Veritas Software Corp & Subsidiaries, et al. v. Commr., 133 T.C. 297 (2009).

price from uncontrolled transactions, or (iii) is otherwise contrary to the regulations.[10]

CONSEQUENCES

> ***"Taxpayers must be diligent in keeping records of communications with the I.R.S. to avoid being deemed 'uncooperative.' . . . Compliance with I.R.S. response deadlines for I.D.R.'s tends to support cooperation and justify possible deficiencies in the responses."***

The decision on the partial summary judgment motion in *Guidant* implies that the C.P.M. must work both for and against the I.R.S. in the case of an affiliated group filing a consolidated tax return. This approach makes it possible for U.S. consolidated groups to use the C.P.M. to both lower or raise the profit resulting from an aggregation of controlled transactions. Thinking more broadly, and especially in the event that the Tax Court finds at trial that the I.R.S. was not arbitrary and capricious when it applied the C.P.M., double taxation cases may never be the same again.

Consider a circumstance in which a foreign tax authority makes an adjustment to the transfer price used in an intangible asset transaction between a foreign subsidiary and its U.S. parent that is itself a part of a U.S. affiliated group. Suppose the foreign tax authority uses a profit split method to calculate its adjustment. Suppose further that the U.S. parent entity has considerable net operating losses. Ordinarily, the relevant profit to be divided using the profit split method is the profit earned by the transaction participants. The foreign adjustment appears to have little merit because there is no combined profit (assuming the U.S. loss exceeds the foreign profit).

On the other hand, if the profit to be divided is the C.T.I. of the U.S. affiliated group and the foreign subsidiary, the foreign adjustment may appear to have greater merit. Here, the U.S. tax base is harmed, contrary to the intent of the Court in the *Guidant* decision, because an unprofitable S.T.I. has been turned into a profitable C.T.I. Moreover, the outcome of applying the C.P.M. by using the C.T.I. in the U.S. and the profit split method abroad closely approximates the result that is reached under a formulary apportionment method – similar to California unitary taxation.[11]

While we must wait for the outcome of the trial to determine whether the fate of Treas. Reg. §1.482–5 is to fall into a chalk outline, we can learn two immediate lessons from *Guidant* at this stage.

The first is that withholding information from the I.R.S. or providing information that is insufficiently detailed during the course of a transfer pricing examination is not advisable, given that a defense based on the facts may not be possible at trial. As a result, taxpayers may become more cooperative in order to avoid an unfortunate finding at the affiliated group level. Taxpayers must be diligent in keeping records of communications with the I.R.S. to avoid being deemed "uncooperative." Should the case proceed to trial, factual determinations at trial will aid practitioners in determining when clients are being "uncooperative" when providing information to the I.R.S. Compliance with I.R.S. response deadlines for information and document requests ("I.D.R.'s") tends to support cooperation and justify possible deficiencies in the responses.

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[10] *American Terrazzo Strip Co Inc. v. Commr.*, 56 T.C. 961, acq 1973-2 CB 1 (1971); *Altama Delta Corp. v. Commr.*, 104 T.C. 424 (1995); *Veritas*, 133 T.C. 297 (2009).

[11] Formulary apportionment has been rejected by the 2015 B.E.P.S. Project reports, now being incorporated into domestic legislation and administrative practice.

The second lesson is that a clearly documented account of how the C.P.M. has been applied in a transactional manner is essential in order to be able to defend this position when settling double tax cases.

The taxpayer may argue that the I.R.S. used an incorrect comparable, or comparables, when determining the true taxable income, since it was unlikely that the comparable used was determined in accordance with the methods prescribed for all income types (tangible, intangible, and services). Since an incorrect comparable is likely unreliable, the arm's length price determined by the I.R.S. on the basis of that comparable would likely be unreliable, also. In those circumstances, factual grounds support a taxpayer contention that the I.R.S. proceeded in an arbitrary, capricious, or unreasonable manner

WHAT IS A CORPORATE BUSINESS PURPOSE FOR A TAX-FREE CORPORATE DIVISION?

Authors
Elizabeth V. Zanet
Beate Erwin

Tags
Business Purpose
Code §355
Corporate Division
Demerger
Spinoff

Since 2003, the Internal Revenue Service ("I.R.S.") has stated that it will not issue rulings on certain specific technical requirements for a tax-free corporate division under Internal Revenue Code ("Code") §355 – also known as a "spin-off" – including whether the transaction has a corporate business purpose requirement. Further, in 2013, the I.R.S. stated that it would stop issuing rulings on spin-off transactions altogether, except for transactions with one or more "significant issue." According to the I.R.S., a significant issue is an issue of law, the resolution of which is not essentially free from doubt, and that is germane to determining the tax consequences of the transaction.

More recently, in Revenue Procedure 2015-43[1] and Revenue Procedure 2016-3,[2] the I.R.S. stated the "no-ruling" areas of spin-offs. Further, in Notice 2015-59,[3] the I.R.S. discussed specific tax-free spin-off issues that it is studying and for which it is seeking public comments.

The limitations to the I.R.S.'s ruling policy for tax-free spin-offs has placed even more significance on the formal opinion of tax counsel.

CORPORATE BUSINESS PURPOSE DEFINED

A tax-free spin-off must be motivated, in whole or substantial part, by one or more "corporate business purposes."[4] A corporate business purpose is described in the Treasury Regulations as a real and substantial purpose germane to the business of the corporation.[5] The corporate business purpose may be germane to the business of the distributing corporation, the controlled corporation, or the affiliated group.[6] As discussed in more detail below, a corporate business purpose is not a shareholder's business purpose.

The corporate business purpose requirement is intended to limit tax-free treatment to transactions in which the distributions are incident to readjustments of corporate structures required for business reasons and that result only in readjustments of continuing interests in property under modified corporate forms.[7]

A classic example of a corporate business purpose is the separation of two lines of

1 Rev. Proc. 2015-43, 2015-40 I.R.B. 467, 9/14/2015.

2 Rev. Proc. 2016-3, 2016-1 IRB 126, 12/31/2015.

3 Notice 2015-59, 2015-40 IRB 459, 9/14/2015.

4 Treas. Reg. §1.355-2(b)(1).

5 Treas. Reg. §1.355-2(b)(2).

6 *Id.*

7 Treas. Reg. §1.355-2(b)(1).

businesses held by one corporation. Suppose that Corporation X is owned by two shareholders, A and B, and operates two businesses of equal value: One business is the design, manufacture, and sale of jewelry (the "Jewelry Business"), and the other business involves the ownership and active management of residential rental property (the "Real Estate Business"). The shareholders are siblings who inherited equal ownership of the corporation from their parents. Shareholder A is passionate about the Jewelry Business. She studied jewelry design and has built a reputation as an admired and sought-after jewelry designer. Shareholder B has no interest or expertise in the Jewelry Business. She prefers working with people in the Real Estate Business. She has a good track record of identifying undervalued residential buildings in up-and-coming neighborhoods, renovating them and then renting the units as luxury apartments. A and B decide to split up the businesses of the Corporation X because it is anticipated that the value of each business will be enhanced by the separation, since each shareholder will be able to devote undivided attention to the business in which she is more interested and more proficient. Further, since the siblings do not generally get along well, the separation of the businesses will help promote family harmony. Accordingly, Corporation X transfers the Jewelry Business to new Corporation Y and distributes the Corporation Y stock to A in exchange for all of A's stock in Corporation X. The spin-off has a corporate business purpose: namely, the separation of the business lines in order to improve the operations of each of the businesses.

Other examples of a corporate business purpose are (i) compliance with laws, including regulatory laws, such as a state-chartered bank required to divest itself of a subsidiary in the insurance business before it can merge with a Federally-chartered bank;[8] (ii) improving the financial position of a company, such as a spin-off in which the distribution is intended to increase the amount of commercial credit that the distributing and controlled corporation can each attract;[9] (iii) improving the public or market perception of business, such as a corporation's spin off of a baby food business from its pesticide business to attract customers who have concerns about the pesticide business.[10]

A DISTRIBUTION MUST HAVE A BUSINESS PURPOSE

The distribution of the stock of the controlled corporation required in a spin-off must have a corporate business purpose as well.[11] That is, there must be a business purpose for the transaction to take the form of a distribution. Thus, in the above example, if the corporate business purpose for separating the business lines was, instead, to protect the Jewelry Business from the liability claims of the Real Estate Business, then the distribution of the Corporation Y stock to A would not have a business purpose. This is because the protection of the Jewelry Business is achieved as soon as Corporation X transfers the Jewelry Business to Corporation Y. The distribution of the Corporation Y stock is not necessary to carry out the business purpose.

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8 *Commr. v. Morris*, 367 F.2d 794 (4tn Cir. 1966).

9 Rev. Rul. 77-22, 1977-1 CB 91.

10 Rev. Rul. 2003-110, 2003-2 CB 1083.

11 Treas. Reg. §1.355-2(b)(3).

SHAREHOLDER'S BUSINESS PURPOSE V. CORPORATE BUSINESS PURPOSE

A shareholder's business purpose is not a corporate business purpose. However, as illustrated in the example above, if the shareholder's business purpose is closely aligned with the corporate business purpose, the spin-off will be considered to have a corporate business purpose.

In another example, the I.R.S. ruled that a separation that was intended to increase the value of the stock of the distributing and controlled corporations was a corporate business purpose even though the shareholders' business purpose was certainly apparent in wanting to increase the value of their shares.[12]

"If the shareholder's business purpose is closely aligned with the corporate business purpose, the spin-off will be considered to have a corporate business purpose."

[12] Rev. Rul. 2004-23, 2004-1 CB 585.

OUTBOUND TRANSFERS OF STOCK IN CODE §351 "TAX-FREE" EXCHANGES

Authors
Rusudan Shervashidze
Andew P. Mitchel

Tags
Active Trade or Business Test
Gain Recognition Agreement
Nonrecognition
Outbound Transfer
Tax-Free Transfer

Certain transfers of appreciated property in the course of a corporate organization, reorganization, or liquidation can be made without recognition of gain to the transferor or to the corporation involved. When a transaction involves an "outbound transfer," (*i.e.*, a transfer from a U.S. person[1] to a foreign corporation) Code §367(a)(1) provides that, for purposes of determining gain, the foreign corporation is not considered a corporation. This rule means that the corporate nonrecognition rules do not apply to outbound transfers. There are, however, a number of exceptions to this general rule.[2]

Under prior law, to avoid gain recognition a taxpayer had to obtain a private letter ruling from the I.R.S. concluding that the transfer did not have the avoidance of Federal income taxes as one of its principal purposes. However, in 1984, Congress eliminated the private letter ruling requirement and created objective rules, which were based on the private letter rulings the I.R.S. had issued in the prior years.[3] Congress also added special rules for the outbound transfer of intangibles. A common theme in the rules is the prevention of tax avoidance through the transfer of appreciated assets outside the U.S.

Only when an outbound transfer meets one of the exceptions to Code §367(a)(1) can gain recognition be avoided. In this article we discuss the exceptions to gain recognition under Code §367(a) on outbound transfers of shares of stock of foreign and domestic corporations in Code §351 exchanges.

CODE §351 "TAX-FREE" EXCHANGE

In general, no gain or loss is recognized if *property* is transferred to a corporation by one or more persons *solely in exchange for stock* in such corporation and immediately after the exchange such person or persons are in *control* of the corporation.[4] "Control" is defined to mean the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.[5]

For example, if a U.S. person transfers property (such as shares of stock in a

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1 U.S. persons generally include: U.S. citizens and U.S. tax resident individuals, U.S domestic partnerships, U.S. domestic corporations, and certain trusts and estates. Code §7701(a)(30).

2 Code §367(d) involves outbound transfers of certain forms of intangible property. Those rules are not discussed in this article.

3 Deficit Reduction Act of 1984. H.R. 4170, 98th Congress, Public law 98-369.

4 Code §351.

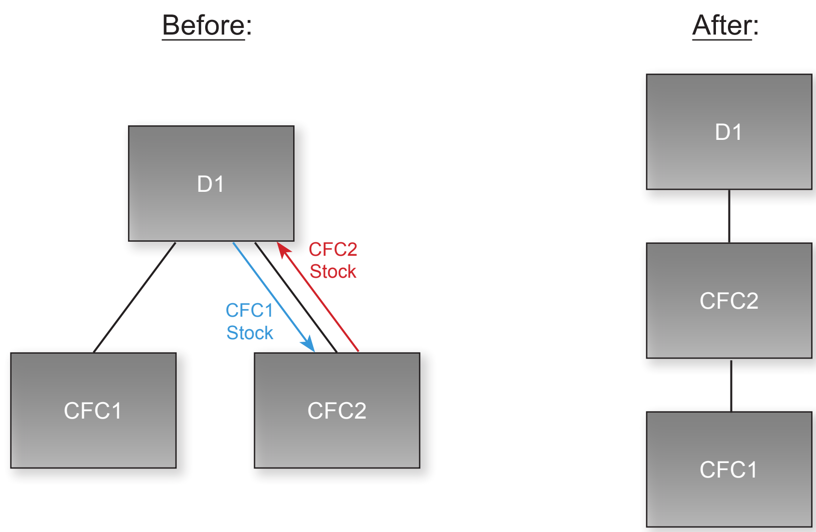
5 Code §368(c).

corporation) to a domestic corporation solely in exchange for stock in the domestic corporation, and the U.S. person controls the transferee domestic corporation after the transfer, Code §351 generally provides that no gain or loss is recognized on the transfer.

OUTBOUND §351 EXCHANGE OF SHARES OF A FOREIGN CORPORATION

Example 1

A domestic corporation ("D1") owns 100% of a controlled foreign corporation ("CFC1"). D1 also owns 100% of another controlled foreign corporation ("CFC2"). D1 transfers all of the stock of CFC1 to CFC2 solely in exchange for stock of CFC2. The exchange meets the requirements of Code §351.



Although the transfer by D1 (a U.S. person) of the shares of CFC1 to CFC2 (a foreign corporation) would generally meet the nonrecognition requirements of a Code §351 tax-free exchange, Code §367(a)(1) provides that, in general, gain will be recognized under these circumstances.

An exception from gain recognition is provided for certain transfers of shares of a foreign corporation.[6] If a U.S. person transfers stock or securities of a foreign corporation to a foreign corporation in a transaction that qualifies as a Code §351 exchange, gain is not recognized if

- the U.S. person owns less than 5% (applying attribution rules), directly or indirectly, of both the total voting power and the total value of the stock of the transferee foreign corporation immediately after the transfer; or
- the U.S. person enters into a five-year gain recognition agreement ("G.R.A.") with respect to the transferred stock or securities.[7]

[6] Code §367(a)(2) and Treas. Reg. §1.367(a)-3(b).

[7] Treas. Reg. §1.367(a)-3(b).

In Example 1, D1 owns more than 5% of the shares of CFC2. Consequently, the only way that D1 can avoid gain recognition on the outbound transfer of the shares of CFC1 is if D1 enters into a G.R.A.

Under the G.R.A., D1 must agree to recognize gain and pay tax if the shares of CFC1 are disposed of within a five-year period, or if certain other triggering events occur.[8] In connection with the filing of a G.R.A., D1 must extend the period of limitations on assessments of tax with respect to the gain realized but not recognized on the transfer of the CFC1 shares through the close of the eighth full taxable year following the taxable year during which the transfer occurs. D1 would extend the period of limitations by filing Form 8838, *Consent to Extend the Time to Assess Tax Under Section 367—Gain Recognition Agreement*.[9]

In addition, for each of the five full taxable years following the taxable year of the initial transfer, D1 must include a certification that the shares of CFC1 have not been disposed as part of its timely-filed return.[10]

Other Considerations

Although not applicable to Example 1, if D1's ownership in CFC2 is below 10% – such that as a result of the exchange D1 is no longer considered a "1248 shareholder" with respect to CFC1 – D1 would be required to include, in its income, a deemed dividend[11] of an amount essentially equal to D1's *pro rata* share of CFC1's undistributed earnings while CFC1 was owned by D1.[12]

In an earlier article we mentioned that, in the international context, it is common to restructure foreign entities in a way that can qualify as a D-reorganization through the use of the "check-the-box" rules.[13] In Example 1, if D1 had, pursuant to a plan, contributed the shares of CFC1 to CFC2, and then CFC1 had elected to be treated as a disregarded entity of CFC2, the combined steps may be treated as a D-reorganization.

If the combined steps are treated as a D-reorganization, the transaction is not treated as though D1 made an outbound transfer. Instead, it is treated as if CFC1's assets are transferred directly to CFC2 in exchange for CFC2 stock, and then as though CFC1 liquidates, distributing the CFC2 stock to D1. In this situation, D1 is treated as surrendering its stock in CFC1 for shares of stock of CFC2, but D1 is not treated as though it transferred shares of CFC1 stock to CFC2. As a result, D1 is not required to enter into a G.R.A.

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8 Treas. Reg. §1.367(a)-8.

9 *Id.*, (f)(1).

10 *Id.*, (g).

11 Treas. Reg. §1.367(b)-4(b).

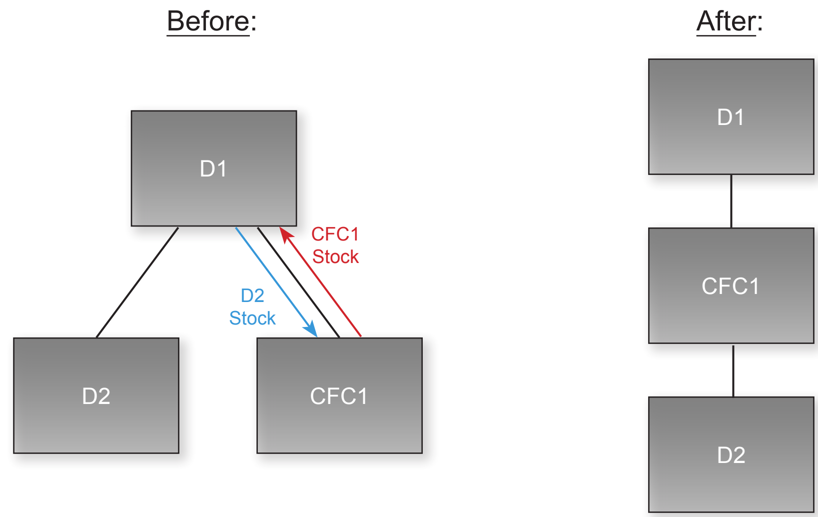
12 The amount required to be included is known as the "§1248 amount." Treas. Reg. §1.367(b)-2(c).

13 Rusudan Shervashidze and Andrew P. Mitchel, "Tax 101: Corporate Reorganizations Part II – Types C, D, E, & F," *Insights* 3 (2016).

OUTBOUND §351 EXCHANGE OF SHARES OF A DOMESTIC CORPORATION

Example 2

A domestic corporation ("D1") owns 100% of another domestic corporation ("D2"). D1 also owns 100% of a controlled foreign corporation ("CFC1"). D1 transfers all of the stock of D2 to CFC1 solely in exchange for stock of CFC1. The exchange meets the requirements of Code §351.



As described above, although the transfer by D1 (a U.S. person) of the shares of D2 to CFC1 (a foreign corporation) would generally meet the nonrecognition requirements of a Code §351 tax-free exchange, Code §367(a)(1) provides that, in general, gain will be recognized under these circumstances.

An exception from gain recognition is provided for certain transfers of shares of domestic corporations.[14] If a U.S. person transfers stock or securities of a domestic corporation to a foreign corporation in a transaction that qualifies as a Code §351 exchange, gain is not recognized if the domestic corporation complies with certain reporting requirements[15] and if each of the following four conditions is met:

- 50% or less of both the total voting power and the total value of the stock of the transferee foreign corporation is received in the transaction, in the aggregate, by U.S. transferors.
- 50% or less of each of the total voting power and the total value of the stock of the transferee foreign corporation is owned, in the aggregate, immediately after the transfer by U.S. persons that are either officers or directors of the U.S. target company or that are 5% target shareholders.
- Either
  - the U.S. person is not a 5% transferee shareholder, or

[14] Treas. Reg. §1.367(a)-3(c).

[15] Treas. Reg. §1.367(a)-3(c)(6).

- ○ the U.S. person is a 5% transferee shareholder and enters into a five-year agreement to recognize gain.

- The active trade or business test is satisfied.[16]

In Example 2, D1 is the only transferor. D1 receives 100% of the stock of CFC1 issued in the transaction. Consequently, the first requirement is not met – U.S. transferors received 100% of the stock received in the transaction and not 50% or less of the stock received in the transaction. D1 cannot avoid recognition of gain on its transfer of the shares of D2 to CFC1.

"The substantiality test essentially requires that the acquisition has to be a 'big foreign fish' swallowing a 'little U.S. fish.'"

The second requirement is also not met because D1 is a U.S. person that is a 5% (or greater) shareholder of CFC1, and D1 owns greater than 50% of the stock of CFC1.

The fourth requirement, the "active trade or business test," has three of its own separate requirements. First, the transferee foreign corporation must have been engaged in an active trade or business outside the U.S. for the entire 36-month period immediately before the transfer.[17] Second, at the time of the transfer, neither the transferors nor the transferee foreign corporation can have an intention to substantially dispose of or discontinue such trade or business.[18] Third, the fair market value of the transferee foreign corporation must be equal to, or greater than, the fair market value of the U.S. target corporation.[19]

The third requirement of the active trade or business test is referred to as the "substantiality test."[20] The substantiality test essentially requires that the acquisition has to be a "big foreign fish" swallowing a "little U.S. fish."

Caveat: Anti-Inversion Rules of Code §7874

It is important to note that when a U.S. person transfers assets of a U.S. corporation or shares of a U.S. corporation to a foreign corporation, the "anti-inversion" rules of Code §7874 can apply. These complex and potentially draconian rules can cause the foreign corporation to which the assets are transferred to be taxed as a U.S. corporation.[21]

In Example 2, if the anti-inversion rules of Code §7874 were to cause CFC1 to be taxed as a U.S. corporation, there would be no outbound transfer. The transfer of the stock of D2 to CFC1 would be considered a transfer to a U.S. corporation, and the Code §367 gain recognition rules discussed above would not be applicable.

The anti-inversion rules of Code §7874 would not apply to Example 2 because the transaction would qualify for the "internal group restructuring" exception.[22]

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16 Treas. Reg. §1.367(a)-3(c).

17 *Id.*, (3)(i)(A).

18 *Id.*, (3)(i)(B).

19 *Id.*, (3)(i)(C). The I.R.S. will entertain requests for private letter rulings relaxing the requirements of the active trade or business test if the taxpayer can demonstrate substantial compliance. Treas. Reg. §1.367(a)-3(c)(9).

20 Treas. Reg. §1.367(a)-3(c).

21 Code §7874 and the regulations issued thereunder.

22 Treas. Reg. §1.7874-1(c)(2).

FINAL REGULATIONS LIMIT IMPORTATION OF BUILT-IN LOSSES

Authors
Christine Long
Beate Erwin

Tags
Code §334(b)(1)(B)
Code §362(e)
Loss Importation

On March 28, 2016, the I.R.S. issued final regulations (T.D. 9759, or the "Final Regulations")[1] to limit built-in losses of offshore property from being imported into the U.S. through nonrecognition transactions. The Final Regulations are issued under the anti-loss importation provisions of the Internal Revenue Code ("the Code") §§334(b)(1)(B) and 362(e)(1). The regulations apply to tax-free transfers of loss property acquired by corporations in capital contributions, complete liquidations under Code §332, corporate reorganizations under Code §368, and nonrecognition exchanges under Code §351.[2] The Final Regulations apply to transactions occurring on or after March 28, 2016.

Loss importation refers to U.S. companies acquiring offshore depreciated property through tax-free transactions that result in an "importation" of a built-in loss into the U.S. Federal tax system. The imported loss can then be used by a profitable company in the U.S. to offset otherwise taxable gains. The anti-loss importation provisions of Code §§334(b)(1)(B) and 362(e)(1) were enacted under the *American Jobs Creation Act of 2004*[3] to stop the erosion of the corporate tax base through such shifting of loss property into the U.S. The Final Regulations intend to prevent U.S. companies from reallocating such losses and to establish a framework for determining the basis of the built-in loss property when it is transferred to a corporation.[4]

The Final Regulations affect corporations that transfer assets to, or receive assets from, their shareholders in exchange for the corporation's stock. The regulations require the corporations and their shareholders to separately report the fair market value and basis of the property (including stock) transferred in the nonrecognition transfer, which enables the I.R.S. to verify that taxpayers are complying with Code §§334(b)(1)(B), 362(e)(1), and 362(e)(2).[5]

The Final Regulations adopt most of the proposed anti-loss importation regulations that were published on September 9, 2013 ("2013 Proposed Regulations").[6] In addition, the Final Regulations adopt, without changes, proposed regulations issued in March 2005 that implement various statutory amendments to Code §§332 and 351. The I.R.S. invited taxpayers to comment on the 2013 Proposed Regulations,

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1 T.D. 9759, RINs 1545-BF43, 1545-BC88, 03/28/2016.

2 Limitations on the Importation of Net Built-In Losses, 81 F.R. 17066-17083 (Mar. 28, 2016) (amending 26 C.F.R. pt. 1).

3 *American Jobs Creation Act of 2004*, Public Law 108-357, 188 Stat. 1418 (2004).

4 81 F.R. 17066 (Mar. 28, 2016).

5 *Id.*

6 78 F.R. 54971 (Sept. 9, 2013).

but most of the taxpayers' suggestions were not adopted by the I.R.S. in the final version. Notably, the I.R.S. retained the look-through rules in the Final Regulations.

LOSS IMPORTATION PROPERTY

The basic importation transaction being targeted by the Final Regulations occurs when a person (the "Transferor") transfers property to a corporation (the "Acquiring Corporation") that results in an importation of loss into the Federal tax system.[7] The loss importation rule of Code §362(e)(1) provides that when property is transferred to a corporation with a built-in loss (*i.e.*, the property's adjusted basis in the hands of the corporation exceeds its fair market value), the corporation's basis in such property becomes the fair market value. The Final Regulations provide a framework for identifying "loss importation property."

Property is considered to be loss importation property if the following two conditions are met:

- The Transferor's gain or loss on the sale of an individual property immediately before the transfer would not be subject to any Federal income tax.
- The Acquiring Corporation's gain or loss on the sale of the transferred property immediately after the transfer would be subject to Federal income tax.[8]

The Final Regulations use a hypothetical sale analysis to identify loss importation property. The loss importation property is identified by treating the Transferor as a hypothetical seller of the transferred or acquired property to determine whether the hypothetical seller would take the gain or loss into account in determining its Federal income tax liability. All the relevant facts and circumstances must be considered. Examples in the Final Regulations should provide for more detailed guidance.[9]

In one example, a foreign corporation transfers property to a taxable U.S. corporation and the determination of loss importation property takes into account whether the foreign corporation would be required to include the amount of gain or loss under Code §§864 or 897 as income effectively connected with the conduct of a U.S. trade or business. The examples assume that no income tax treaty applies. However, the determination of the foreign corporation's tax on the property disposition takes into account whether the foreign corporation could eliminate U.S. tax pursuant to the business profits or gains provisions of an income tax treaty. In this case, the property would be considered loss importation property.[10] In response to comments that a number of issues could be the subject of further study, such as the effect of tax treaties, nonfunctional currency, and the application of Code §7701(g) (clarification of fair market value in the case of nonrecourse indebtedness), the preamble notes that the I.R.S. and Treasury considered these issues beyond the scope of these regulations and did not address them. The I.R.S. and Treasury are considering whether further study of these issues is to be undertaken.

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7 81 F.R. 17066 (Mar. 28, 2016); Treas. Reg. §1.362-3(a).

8 *Id.*, 17067.

9 *Id.*; Treas. Reg. §1.362-3(c); See examples, Treas. Reg. §1.362-3(f).

10 81 F.R. 17067 (Mar. 28, 2016).

> ***"Under the Code, certain entities are able to shift occurrences of Federal income tax by distributing income or gain to its owners."***

Once property has been identified as importation property, the Acquiring Corporation determines its basis in the importation property under generally applicable rules and, if that aggregate basis exceeds the aggregate value of all importation property transferred in the transaction, the transaction is a loss importation transaction subject to the anti-loss importation rules. If the aggregate basis of the importation property does not exceed such property's value, the anti-loss importation rules do not apply (see below for more detail).

Property Acquired from Grantor Trusts, Partnerships, and S-corporations

The Final Regulations apply a look-through rule when the Transferor of the property is a grantor trust, a partnership, or an S-corporation because these are treated as flow-through entities for U.S. Federal income tax purposes. In such cases, the determination of whether gain or loss from a hypothetical sale is subject to Federal income tax is made by reference to the tax treatment of the gain or loss in the hands of beneficial owners, *i.e.*, the grantors, the partners, or the S-corporation shareholders. If the organizing instrument of the grantor trust, the partnership, or the S-corporation allocates gain or loss in different amounts (*e.g.*, a partnership agreement provides for a special allocation) the determination of whether gain or loss from a hypothetical sale is subject to U.S. Federal income tax is made by reference to the person to whom, under the terms of the instrument, the gain or loss on the entity's hypothetical sale would actually be allocated. This analysis must also consider the entity's net gain or loss actually recognized in the tax period in which the transaction of property occurred.[11]

Various concerns addressed in the comments on the 2013 Proposed Regulations related to partnership issues. In particular, commenters suggested that the look-through rule should not apply to publicly-traded partnerships. However, the I.R.S. did not follow this, or any other, suggestion in the Final Regulations, which merely clarify that the partnership agreement and any applicable rules of law are taken into account in determining how to allocate an item to a partner.[12]

The I.R.S. did acknowledge a commenter's request for clarification on the interaction of the regulations proposed under Code §§362(e) and 704(c)(1)(C).[13] However, the I.R.S. stated that it will address these issues in the Final Regulations under Code §704(c)(1)(C).[14]

Anti-Avoidance Rule for Certain Entities

Under the Code, certain entities are able to shift occurrences of Federal income tax by distributing income or gain to its owners. The entities that are able to shift tax in this way include U.S. trusts, estates, regulated investment companies ("R.I.C.'s"), real estate investment trusts ("R.E.I.T.'s"), and cooperatives. The I.R.S. was concerned that the anti-loss importation provisions would be undermined if the ability of these entities to shift incidences of Federal income tax was disregarded. Conversely, the I.R.S. was also concerned that applying a look-through rule to the owners

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[11] *Id.*; Treas. Reg. §1.362-3(d)(2).

[12] *Id.*,17068-9.

[13] 79 F.R. 3041 (Jan. 16, 2014).

[14] 81 F.R. 17069 (Mar. 28, 2016).

of such entities would impose a significant administrative burden.[15] Therefore, the regulations adopt an anti-avoidance rule for such entities that transfer property pursuant to a nonrecognition transaction.

The anti-avoidance rule applies to U.S. trusts, estates, R.I.C.'s, R.E.I.T.'s, and co-operatives that transferred property directly or indirectly (including through another similar entity) in a Code §§362(a) or 362(b) transaction, in which property is acquired by the issuance of stock in the corporation or in a corporate reorganization. Such entities are subject to a look-through rule if property is directly or indirectly transferred to, or acquired by, the entity as part of a plan to avoid the anti-loss provisions. Under the look-through rule, the entity is presumed to distribute the proceeds of its hypothetical sale, and the tax treatment of the gain or loss in the distributees' hands determine whether a gain or loss was taken into account in determining Federal income tax liability. If the distributee is also one of the listed entities, the rule looks through to the ultimate owners of the entity's interests. Whether or not the property is importation property is determined by reference to the deemed distributees or, in the case of tiered entities, to the ultimate deemed distributees.[16]

Although commenters suggested modifying the treatment of certain trusts, the Final Regulations did not adopt any suggestions and fully implemented the 2013 Proposed Regulations relating to the anti-avoidance and look-through rules of these entities.[17]

"If the aggregate basis of the importation property exceeds the aggregate value of all importation property transferred, the transaction is a loss importation transaction that is subject to the anti-loss importation provisions."

Gain or Loss Affecting Certain Income Inclusions

In order to address taxpayer concerns about the treatment of property transferred by or to a controlled foreign corporation ("C.F.C."), the regulations expressly provide that gain or loss recognized on a hypothetical sale by a C.F.C. is not considered subject to Federal income tax solely by reason of an income inclusion under Code §951(a). Similarly, the regulations also provide that gain or loss recognized by a passive foreign investment company ("P.F.I.C.") is not subject to Federal income tax solely by reason of an inclusion under Code §1293(a).[18]

In response to the comments, the Final Regulations treat debt-financed property as subject to Federal income tax in proportion to the amount of such gain or loss that would be includible in the tax exempt Transferor's unrelated business taxable income ("U.B.T.I.") on a sale under Code §§511 through 514.[19] The Final Regulations provide that a transfer which includes debt-financed assets will be bifurcated

15 *Id.*,17067.

16 *Id.*; Treas. Reg. §1.362-3(d)(5).

17 81 F.R. 17069 (Mar. 28, 2016).

18 *Id.*,17067; Treas. Reg. §1.362-3(d)(3).

19 If a tax-exempt entity transfers debt-financed property (as defined in Code §514), the disposition of such property would be subject to Federal income tax. Consequently, the property could not qualify as loss importation property – even if there was only a *de minimis* amount of indebtedness and only a small portion of any gain or loss would be subject to Federal income tax. Commenters noted the "cliff effect" and resulting potential for avoidance of the anti-loss importation provisions for certain tax exempt entities. This loophole was closed by the Final Regulations.

and the rest of the property will be subject to the anti-loss importation provisions the same way that property is tentatively divided to calculate gain or loss amongst multiple property owners.[20]

LOSS IMPORTATION TRANSACTION

Once the importation property has been identified as such, the Acquiring Corporation must then determine the aggregate basis and aggregate value of all importation property acquired in the transfer, without regard to the anti-loss importation provisions of Code §362(e).[21] Note that the "value" of property is generally its fair market value without regard to any liabilities assumed in the transaction.[22]

The regulations emphasize that basis and value of importation property must be determined in the aggregate and that all importation property acquired in a transaction must be considered, regardless of the number of transferors.[23] This aggregate rule differs from the transferor-by-transferor approach of Code §362(e)(2), which focuses on whether a transferor would otherwise duplicate loss by retaining loss in stock and transferring property with a net built-in gain.[24]

If the aggregate basis of the importation property exceeds the aggregate value of all importation property transferred, the transaction is a loss importation transaction that is subject to the anti-loss importation provisions. Accordingly, the Acquiring Corporation's basis in each importation property is equal to its value immediately after the transaction. If the aggregate basis of the importation property does not exceed such property's value, the anti-loss importation provisions do not apply (but may still be subject to loss duplication rules of Code §362(e)(2)).[25]

The regulations implement special valuation rules for partnerships. Since a partner's share of partnership liabilities is generally included in its basis of its partnership interest, the property may have a built-in loss. Thus, the regulations redefine "value" for partnership interests by taking liabilities into account. The Final Regulations specifically provide that the value of a partnership interest would be the sum of cash that the Acquiring Corporation receives for such interest, increased by any liabilities of the partnership that were allocated to the Acquiring Corporation with regard to such transferred interest under Code §752.[26]

In response to comments, the Final Regulations expressly provide that, for Federal income tax purposes, the transferee's, or Acquiring Corporation's, basis is generally considered determined by reference to the Transferor's basis, notwithstanding the application of the anti-loss importation or anti-duplication provisions to a transaction.

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20 81 F.R. 17070 (Mar. 28, 2016); Treas. Reg. §1.362-3(d)(4); see also Treas. Reg. §1.362-3(e).

21 *Id.*, 17068; Treas. Regs. §§1.362-3(b) and 1.362-3(c)(3).

22 Treas. Reg. §1.362-3(c)(4)(i).

23 Treas. Reg. §1.362-3(c)(3).

24 81 F.R. 17068 (Mar. 28, 2016); Treas. Regs. §1.362-3(b) and (c)(3).

25 Treas. Reg. §1.362-4(3); 81 F.R. 17068 (Mar. 28, 2016); Treas. Regs. §1.362-3(b) and (c)(3).

26 *Id.*; Treas. Reg. §1.362-3(c)(4).

However, solely for the purposes of determining the adjustment to the basis of partnership property under Code §755, a determination of basis under the anti-loss importation provisions is treated as not made by reference to the Transferor's basis.[27]

FILING REQUIREMENTS

The Final Regulations modify the information reporting requirements for corporate nonrecognition transactions to assist with the I.R.S.'s administration of the anti-loss importation provisions and the anti-duplication provisions of Code §362(e)(2). Taxpayers, both entities and individual shareholders, are required to separately disclose the aggregate basis and value of the transferred property (including stock) in all nonrecognition transactions under Code §332 liquidations and Code §§362(a) or 362(b).[28]

CONCLUSION

While the Final Regulations aim to prevent companies from importing losses from offshore property into the U.S. through nonrecognition transfers as well as limit erosion of the U.S. corporate tax base, they also provide planning opportunities. They permit U.S. acquirors to step up the basis of built-in gain importation property in addition to stepping down the basis of built-in loss importation property. As reflected in the comments and the preamble, however, the Final Regulations leave various issues open with respect to, *inter alia*, certain entities and look-through rules as well as treaty implications. Furthermore, these anti-loss importation regulations impose a substantial burden and compliance cost on taxpayers by requiring the separate reporting of the basis and value of the property acquired through such corporate nonrecognition transfers. Tax advice should be sought by U.S. acquirors prior to such envisaged transfers to evaluate the impact of anti-loss importation rules in advance and identify planning opportunities accordingly.

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27 81 F.R. 17070; Treas. Reg. §1.362-3(b)(4).

28 81 F.R. 17068.

FOREIGN OWNED, SINGLE-MEMBER L.L.C.'S: PROPOSED REGULATIONS IMMINENT?

Authors
Galia Antebi
Rusudan Shervashidze

Tags
Disregarded Entities
Foreign Ownership
L.L.C.
Reporting Requirements
Transparency

According to a statement made by Treasury Deputy Assistant Secretary for International Tax Affairs Robert Stack, the I.R.S. will soon publish proposed regulations that will treat foreign owned, single-member limited liability companies ("L.L.C.'s") as corporations for U.S. reporting purposes. The proposed regulations are the first step in an initiative, under the Treasury's 2015-2016 Priority Guidance Plan, to write regulations and other guidance to treat disregarded entities as corporations for purposes of reporting and record-keeping under Code §6038A and related provisions.

BACKGROUND

L.L.C.'s are formed under state laws, which generally do not require that the state have the knowledge of the L.L.C.'s owners in order for the company to be formed. Under current Federal tax law, a single-member L.L.C. is not recognized as an entity separate from its owner, unless the owner elects to treat the entity as a corporation by filing Form 8832. Most states treat L.L.C.'s in a similar manner.

Because a single-member L.L.C. is a disregarded entity, no reporting obligations apply to the entity itself. The L.L.C.'s income and assets are treated as being owned by the single member and are subject to the reporting obligations applicable to that member. Therefore, unless there is sufficient nexus to the U.S. – through business activities or offices – the L.L.C. is not subject to reporting or tax in the U.S., and in certain circumstances, the entity will not even have a U.S. tax identification number.

Taking advantage of this treatment, a common practice involves incorporating a company offshore in a location where there is no tax, such as the Bahamas, and having the foreign corporation form a U.S. L.L.C. The L.L.C. will typically have the same name as the offshore company, so that it appears to be one and the same. To the unwary, assets owned by the U.S. L.L.C. – both in and outside the U.S. – appear to be owned by a U.S. entity. However, because U.S. tax rules treat the foreign company as the owner, no reporting is due in the U.S., and no income is taxed in the U.S. – unless it is from U.S. sources. This abusive structure results in, for example, a Bahamian company that has the guise of as a U.S. entity but is free from U.S. tax and free from the inconvenience of U.S. reporting obligations. According to Mr. Stack, these entities "can pose a tax transparency risk" and can "be used to dodge non-U.S. taxes, or to shield the true beneficial owners of a foreign bank account."

FORTHCOMING REGULATIONS

Once finalized, the new regulations will shut down this use of an L.L.C. in international structures. The regulations will allow the I.R.S. to require information returns from foreign owned, single-member L.L.C.'s, which at the very least, will be required to provide a tax identification number. Thus, the entities will be forced to disclose their owners. It is anticipated that the information reporting requirements will be similar to those included in Schedule K of a corporate tax return (Form 1120), which generally reports ownership of other entities, including foreign or domestic partnerships and certain distributions made by the company.

The proposed regulations are part of a broader attempt to change the framework of reporting to enable the I.R.S. to obtain information on the beneficial ownership of certain single-member L.L.C.'s. The the need to improve beneficial ownership reporting was apparent in a November 2013 peer review by the O.E.C.D.'s Global Forum on Transparency and Exchange of Information for Tax Purposes, according to which F.A.T.F. (Financial Action Task Force) rated the U.S. as non-compliant with respect to beneficial ownership recommendations.

Because the income tax treatment of single-member L.L.C.'s is not expected to change, it is anticipated that these regulations will help prevent non-U.S. tax avoidance by allowing the I.R.S. to respond to requests about the entities from other tax authorities under U.S. tax treaties and tax information exchange agreements

Authors
Kenneth Lobo
Stanley C. Ruchelman

Tags
Action 5
Action 6
Action 13
B.E.P.S.
CbC Reporting

IMPLEMENTATION OF B.E.P.S. ACTION PLAN CAUSES FEDERAL FRICTION IN GERMANY

German state tax authorities disagree with German Federal tax authorities as to whether the sharing of German tax information under B.E.P.S. Action 5 will render governments liable for the violation of German privacy laws.

B.E.P.S. Action 5 – Exchange of Information Framework

The goal of the B.E.P.S. Action Plan is to develop a single global standard for automatic exchanges of information and to stop corporations from shifting profits to jurisdictions with little or no tax. The end result is to ensure taxation in the jurisdiction where profit-generating economic activities are performed and value is created.

Action Item 5 generally recommends the compulsory spontaneous exchange of information with regard to tax rulings related to preferential tax regimes. We previously discussed Action Item 5, noting that:

> [Action Item 5] will introduce an obligation for an individual country to spontaneously exchange information that could be relevant to another country, even when the information has not been requested by the second country. In addition, the Forum on Harmful Tax Practice is authorized to prepare a report on preferential regimes for public dissemination – *viz.*, name and shame.[1]

German State Tax Agencies Believe Tax Information Exchange Will Create Legal Liability

While the German Federal finance ministry agreed to implement Action Item 5, German state tax authorities are uncertain whether the exchange of information will violate German privacy laws. State tax authorities continue to collect tax information, but before entering into the exchange, the authorities want to clarify that the delivery of such information will not violate German domestic privacy laws

Much of the concern was created by a German tax court ruling, which held that a mere agreement at the European level to create a data exchange framework was not sufficient to force such an exchange on the state level. Further, state tax authorities believe that that the Federal government must enact E.U. Council Directives on the matter to prevent liability when German state tax authorities exchange information.

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1 Stanley C. Ruchelman and Rusudan Shervashidze, "Action Item 5: Countering Harmful Tax Practices More Effectively," *Insights* 9 (2014).

B.E.P.S. ACTION 6 COULD DENY TREATY BENEFITS TO CERTAIN INVESTMENT VEHICLES

Following the release of Action Item 6, the finance industry warned the O.E.C.D. that certain collective investment vehicles ("C.I.V.'s") could be denied treaty benefits due to the "active trade or business test" under the Limitation on Benefits provision. The O.E.C.D. believes that the Action 6 language adequately addresses C.I.V.'s but that commentary is needed to prevent non-C.I.V. funds from being wrongfully denied treaty benefits because of the structure adopted for investments.

B.E.P.S. Action 6

Action Item 6 addresses the abuse of treaties in general, as well as the specific issue of treaty shopping, which it notes as one of the most important sources of B.E.P.S. As we've mentioned previously, "Among other measures, the report recommends inclusion of a Limitation on Benefits ('L.O.B.') provision and a general anti-avoidance rule called the Principal Purpose Test ('P.P.T.') to be included in the O.E.C.D."[2]

"The O.E.C.D. believes that the Action 6 language adequately addresses C.I.V.'s but that commentary is needed to prevent non-C.I.V. funds from being wrongfully denied treaty benefits."

A taxpayer will be entitled to treaty benefits under Action Item 6 if it qualifies as:

> A resident of Contracting State that is engaged in the active conduct of a trade or business, but only to the extent that the income is derived in connection with that business or is incidental to that business:
>
> - An entity generally will be considered to be engaged in the active conduct of a business only if persons through whom the entity is acting, such as officers or employees of a company conduct substantial managerial and operational activities. * * *
> - The business of the person claiming the benefit must be substantial in relation to the business in the payor's state of residence, which is to be determined on a facts and circumstances basis. Where this provision applies, the resident is entitled to the benefit even if not a qualified person.[3]

C.I.V. & Non-C.I.V. Funds

According to the O.E.C.D., investors tend to pool their funds in a C.I.V. with other investors, as it is more economically efficient. C.I.V.'s may take several legal forms, depending on the country in which they are established (*e.g.*, companies, trusts, and contractual arrangements).[4]

Practitioners are concerned that C.I.V.'s would not be entitled to treaty benefits as the making or managing of investments by a C.I.V. would not satisfy the active trade or business test under the L.O.B. provision. According to finance managers, many funds are not listed; they often pool capital from investors across a number

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2 Philip R. Hirschfeld and Stanley C. Ruchelman, "Action Item 6: Attacking Treaty Shopping," *Insights* 9 (2014).

3 *Id.*

4 O.E.C.D., "The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles," (April 23, 2010).

“The U.K. government recently released guidance about large businesses that engage in aggressive tax planning and a potential punitive measure that would force such businesses to publicly publish their ‘aggressive’ tax strategies.”

of countries, and they are readily marketed outside their home countries. However, the O.E.C.D. believes that the active trade or business test, as listed, will adequately identify those C.I.V.'s that have the economic substance to qualify for treaty benefits and those that do not.

The O.E.C.D. acknowledges that non-C.I.V. funds, such as pension funds, sovereign wealth funds, and charities may be adversely affected by Action Item 6. These institutions could lose the ability to recover withholding tax by not being entitled to treaty benefits. The O.E.C.D. is currently seeking comments on the matter, to prevent such non-C.I.V. funds from being denied treaty benefits merely because the structures of such funds do not satisfy the active trade or business test.

U.K. TO BATTLE AGGRESSIVE TAX PLANNING

The U.K. government recently released guidance about large businesses that engage in aggressive tax planning and a potential punitive measure that would force such businesses to publicly publish their “aggressive” tax strategies.[5]

The proposed “Special Measure” would take into account not only those businesses administered by the U.K. Large Business Directorate but also “any large business,” so long as it is listed under the country-by-country framework, as described by Action Item 13. The U.K. Special Measure would complement the country-by-country framework, not substitute it.

Before punitive action is taken, the U.K. government would issue a warning notice and offer the offending business a one-year improvement period to resolve outstanding issues. Triggering factors for the warning could include discovery that the business is “non-compliant” with the view of H.M.R.C. on certain transactions or when the business has submitted erroneous returns resulting from a tax avoidance plan. The specific definition of these terms is listed in the legislation.

Once targeted by the government, the offending business must publicly list its approach towards U.K. tax planning and its approach towards negotiating with U.K. tax authorities. H.M.R.C. notes that companies subject to the “Special Measure” regime are most likely already listed under the U.K. government's “high risk management system.”

CONCLUSION

The above three items – privacy concerns in Germany, entitlement of C.I.V.'s to treaty benefits, and sanctions for corporations pursuing aggressive tax plans – demonstrate that while countries are fully in favor of B.E.P.S. on a national level, issues remain with actual implementation. Under political pressure from N.G.O. watchdogs and minority parties in parliament, governments may continue to create more and more programs to publicly shame multinationals that pursue aggressive tax plans, even if such programs are redundant with respect to the B.E.P.S Action Plan. In sum, the breadth of implementing the B.E.P.S. Action Plan in Europe may result in the creation of a B.E.P.S. compliance industry whose sole purpose is to navigate B.E.P.S. compliance mechanisms. The presence of the compliance officer at all businesses having cross-border operations may be a ubiquitous reality, much like the communist party officer during the Soviet era.

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5 “Special Measures Guidance: Introduction,” HM Customs & Revenue, published March 31, 2016.

Authors
Galia Antebi
Philip R. Hirschfeld

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

U.S. APPROVES THREE MORE COUNTRIES FOR EXCHANGE OF INFORMATION

The latest step in F.A.T.C.A. implementation is an expansion of the list of countries with which automatic exchange of information is deemed to be appropriate, with respect to bank interest paid to nonresident aliens. The addition of three new countries is provided under of Revenue Procedure 2016-18. The statement includes a complete, updated list of countries, which now stands at 37. The three countries that have been added are Azerbaijan, Jamaica, and the Slovak Republic.

The rule allowing the I.R.S. to report certain deposit interest paid to nonresident alien individuals applies to interest paid on or after January 1, 2013.

ATTEMPTS TO BLOCK F.A.T.C.A. – CANADIAN UPDATE

Many readers may remember that before Canada first exchanged F.A.T.C.A.-related information with the U.S., two U.S.-born Canadians filed suit against the Canadian government asserting that the Inter-Governmental Agreement ("I.G.A.") between the two countries violates Canadian constitutional rights and cedes Canadian sovereignty. At the time, the Canadian government supported F.A.T.C.A. and rejected these assertions in court. The Federal Court of Canada ruled against the allegations and subsequently rejected an application for an injunction to block the first transfer of F.A.T.C.A.-related information pending a hearing of the constitutional allegations. To date, the hearing has yet to be scheduled, but the first bilateral transfer of about 155,000 information slips did occur on September 30, 2015, as anticipated.[1]

Before coming to power in late 2015, Liberal Party leaders, including current prime minister Justin Trudeau, voiced concerns regarding F.A.T.C.A. According to Canadian publications,[2] the prime minister described the concept of reporting to a foreign government on Canadian citizens' actions as "troublesome," and called the prior administration's efforts to protect Canadians' privacy "inadequate."

In spite of these concerns, and much to the litigants' discontent, the current administration has stated it will continue to comply with F.A.T.C.A. as required under the

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1 Galia Antebi and Philip R. Hirschfeld. "The Transparent World: Exchange of Information Has Begun & Pacts to Assist Implementation Have Been Signed," *Insights* 9, (2014).

2 Thompson, Elizabeth. "Revenue Canada Quietly Handed 155,000 Canadian Banking Records to IRS." iPolitics. March 16, 2016.

I.G.A. Canada will continue to provide the I.R.S. with F.A.T.C.A.-related information regarding U.S. citizens living within its borders. However, national revenue minister Diane Lebouthillier said that the government takes the issue of privacy very seriously and will ensure that all such exchanges are subject to strict confidentiality rules that protect Canadians' interests.

It seems that the litigants will be forced to continue their efforts to collect donations to fund the lawsuit as they wait for the hearing to be scheduled. In the hearing, the group representing the litigants, the Alliance for the Defense of Canadian Sovereignty ("A.D.C.S."), is expected to argue that "threats of economic sanction from the U.S. is not sufficient justification to take away constitutional rights of Canadian," according to A.D.C.S. chairman Stephen Kish.

CHANGES TO ENCRYPTION MODE FOR F.A.T.C.A. EXCHANGE

The I.R.S.'s International Data Exchange Service, or "I.D.E.S.," will not accept data packets encrypted using the Electronic Code Book ("E.C.B.") mode of operation after July 8, 2016. Instead, starting July 9, all users must transmit data packets encrypted using the Cipher Block Chaining ("C.B.C.") mode. The reason for the update is that the C.B.C. is a more complex algorithm and therefore a more secure method of encrypting data. C.B.C. encryption can be implemented in code or by the user's software of choice.

MORE COMPETENT AUTHORITY AGREEMENTS ADDED

The U.S. continues to sign more competent authority agreements relating to F.A.T.C.A. enforcement.

On June 30, 2014, Israel and the U.S. signed a Model 1 reciprocal I.G.A. On April 6, 2016, the U.S. and Israel competent authorities signed an arrangement under the I.G.A. to implement compliance under F.A.T.C.A.

On December 16, 2014, Curaçao and the U.S. signed a Model 1 reciprocal I.G.A. On April 6, 2016, the U.S. and Curaçao competent authorities signed an arrangement under the I.G.A. to implement compliance under F.A.T.C.A.

On November 19, 2015, St. Lucia and the U.S. signed a Model 1 reciprocal I.G.A. On April 6, 2016 the U.S. and St. Lucia competent authorities signed an arrangement under the I.G.A. to implement compliance under F.A.T.C.A.

CURRENT I.G.A. PARTNER COUNTRIES

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

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

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

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.

"The U.S. continues to sign more competent authority agreements relating to F.A.T.C.A. enforcement."

Authors
Sheryl Shah
Stanley C. Ruchelman

Tags
CbC
Greece
India
Offshore Accounts
Panama
Royalties
Slovakia
Tax Evasion
Tax Treaties

ONE-TIME SOFTWARE PAYMENTS NOT ROYALTIES IN INDIA

The Mumbai Income Tax Appellate Tribunal ruled that a sale of "off-the-shelf" software packed in shrink wrap and embodied in a disc, thumb drive, or other comparable delivery mode is a sale of goods rather than a license to use copyright.

In a case put before the tribunal, Capgemini Business Services (India) Ltd. purchased software from QAD Singapore Pvt. Ltd., which it treated the payment as an expense, and claimed a deduction in 2007. The Indian tax authority allowed the deduction but argued this payment was made for the use of the copyright and was therefore subject to withholding tax. The tribunal applied the more favorable definition of royalty found in the India-Singapore tax treaty and treated the software like a literary work, with the one-time payment being for its sale. The tribunal found that under the India-Singapore tax treaty a payment made by an Indian entity for an off-the-shelf sale by a Singapore-based company cannot be considered a royalty, and therefore, such a payment is not subject to withholding tax in India.

This favorable ruling is not likely to be the last time the issue is raised in a court proceeding in India. The Delhi High Court recently ruled on a copyright matter involving the India-U.S. Income Tax Treaty, and the Korean company Samsung Electronics Co. Ltd. has petitioned the Supreme Court to rule on how and where cross-border software sales involving an Indian business should be taxed.

GREECE PROMISES PARTIAL AMNESTY ON OFFSHORE CASH

In an effort to fix the banking system and increase tax revenue, Greece is asking its citizens to repatriate funds hidden overseas in exchange for partial amnesty and other incentives.

Tax evasion and trade are alleged to reduce Greece's national tax revenue by an estimated €15 to €20 billion per year, according to the Deputy Finance Minister. Seeking to rectify this situation, the country has imposed fines on purported tax evaders on the "Lagarde List" – a spreadsheet containing Greek account holders with HSBC's Geneva branch, which the government received from current head of the I.M.F., then Finance Minister of France, Christine Lagarde in 2010. The amnesty plan would not forgive everything but would incenti*vize* citizens to participate.

SLOVAK COMPANIES MOVING TO TAX HAVENS

Research shows that more than 4,700 Slovakian companies have moved to more tax-friendly jurisdictions in 2015. Among the favored tax havens are the Netherlands, for its lack of dividend tax; Cyprus because it is not subject to double taxation in the E.U., the Seychelles because it offers absolute ownership anonymity and a zero tax rate; and the U.S. because it provides a high rate of ownership anonymity, low sovereign risk, and low state tax for individuals in Florida and Texas. Federal tax is not reduced by a move to any particular state in the U.S.

Although tax is clearly a consideration, it is not the only driver for Slovakian companies deciding to leave the country. Benefits such as a stable legal system, corporate flexibility, intellectual property protection, and an efficient banking system are also drivers in determining whether and where to move.

CBC REPORTING AFFECTED BY THE PANAMA PAPERS

Once again, questions are being raised about tax reporting and information sharing, as a recent leak of documents from Panamanian law firm Mossack Fonseca reveals data on the offshore assets and financial dealings of wealthy and powerful people worldwide, including heads of state, sports stars, and celebrities. Mossack Fonseca has more than 40 offices globally and specializes in commercial law, trust services, investment advising, and international structuring. Individuals already linked to the leak include football player Lionel Messi, golf legend Nick Faldo, actor Jackie Chan, the children of Pakistani Prime Minister Nawaz Sharif, the president of the U.A.E., and Icelandic Prime Minister David Gunnlaugsson.

Over the past year, confidential files were leaked to the press, who began reporting on the information this month on a global basis. The files revealed possible underhanded tax planning, money laundering, and filing of false financial statements by the rich, the famous, and the politically influential. Leading banks have worked with the firm, presumably believing that politically exposed persons were investing their own money.

In light of the leak, members of the European Parliament have complained that the CbC reporting plan is too weak as drafted. According to these members, the threshold for reporting should be lowered so as to include more companies and the results should be published. Professional groups will have to identify members and clients that have been involved with Mossack Fonseca and work to isolate fallout from the matter. Some advisers fear that the good old days of moving money are officially over.

The source obtained terabytes of information, which it offered to the Munich-based newspaper *Sueddeutsche Zeitung* through an encrypted channel in exchange for security measures but no compensation. The German newspaper then verified the authenticity of the data by comparing it to legal records available.

The question that remains is the identity of the source. Mossack Fonseca is claiming it is the victim of a hack by foreign servers. At this point in time, it seems that the leak, which affects 214,488 companies and 14,153 clients, could have come from any source anywhere in the world. It is not likely to be the work of random criminals because there have been no reported blackmail attempts. According to Gerard Ryle, the director if the I.C.I.J., the source "claimed to be concerned about what he or she saw in the documents." One alternative theory coming from the Kremlin is that a security agency opposed to Russian President Vladimir Putin – a supposed holder of over $2 billion in offshore assets – hacked the files for political reasons and delivered the entire data dumped to the newspaper to cover its tracks.

"In light of the leak, members of the European Parliament have complained that the CbC reporting plan is too weak as drafted. According to these members, the threshold for reporting should be lowered so as to include more companies and the results should be published."

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

Sofia Goltsberg .... Copyeditor

PHOTOS IN THIS ISSUE WERE TAKEN BY:

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