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INSIGHTS

EUROPEAN REGISTRATION & FRENCH TAX LAW CREATE PITFALLS FOR U.S. TRUSTS

TAX 101: FOREIGN SETTLORS, U.S. DOMESTIC TRUSTS, AND U.S. TAXATION

CROWDFUNDING: A POPULAR WAY TO INVEST, BUT WATCH OUT FOR TAXES

A NEW WAY TO DO THE SPLITS: B.E.P.S. GUIDANCE FALLS SHORT OF ENABLING GLOBAL FORMULARY APPORTIONMENT

AND MORE

Insights Vol. 3 No. 7

TABLE OF CONTENTS

EDITORS' NOTE

In this month's edition of *Insights*, the following topics are addressed:

- **European Registration & French Tax Law Create Pitfalls for U.S. Trusts.** Events that have taken place in the E.U. during July confirm that a U.S. person who establishes a U.S. domestic or foreign trust for the benefit of a European resident, may face significant pitfalls regarding confidentiality and tax. While trusts historically constitute a testamentary dispositive tool in common law countries, the recent UBS and Panama Papers scandals have shed a harsh light on these instruments. At the level of the E.U., enhancements to existing anti-money laundering provisions have been floated. The legislation would eliminate certain exceptions to reporting. In France, adverse tax rules al-ready exist for trusts, settlors, and beneficiaries that fail to take into account fundamental differences among trust instruments. In addition, wealth tax issues and public disclosure issues must be considered. Fanny Karaman and Stanley C. Ruchelman explore these and other problem areas.

- **A New Way to Do the Splits: B.E.P.S. Guidance Falls Short of Enabling Global Formulary Apportionment.** From the moment the B.E.P.S. Project began in 2013, multinational enterprises have been concerned that tax authorities would be emboldened to apportion income resulting from the joint commercialization of intangible assets. Surprise. A July 4 publication of the O.E.C.D.'s *Revised Guidance on Pro it Splits* discussion draft does not place an over-broad profit apportionment tool in the hands of tax authorities. Michael Peggs explains why the transactional profit split method may not be appropriate in many instances.

- **I.R.S. Issues Proposed Regulations Affecting Valuation Discounts for Gift and Estate Tax Purposes.** For corporate tax purposes, the I.R.S. maintains the view that a transaction between a taxpayer and a disinterested party – meaning a person that does not have an adverse interest to a taxpayer because tax neither increases nor decreases as a result of a particular term agreed upon – is not the result of arm's length bargaining and can be disregarded where appropriate. Now, the I.R.S. proposes to expand that approach to estate plans. The proposal is embedded in regulations issued under Code §2704. As a result, commonly used tools may no longer be available to reduce gift or estate tax. Minority ownership discounts and unilateral governance rights that disappear at death are valuation planning tools that are at risk because of the common goals of the participants. Fanny Karaman, Stanley C. Ruchelman, and Kenneth Lobo explain.

- **Tax 101: Foreign Settlors, U.S. Domestic Trusts, and U.S. Taxation.** Non-U.S. tax advisers to high net worth individuals are familiar, to some degree, with U.S. tax rules involving trusts, settlors, and beneficiaries. While they may know that a grantor trust allows for income to be taxed to a grantor, they are not always conversant with the differences between U.S. income tax rules for grantors and the U.S. gift and estate tax rules that cause trust property to be included in the taxable estates of trust settlors. Fanny Karaman, Kenneth Lobo, and Stanley C. Ruchelman explore the way these rules exist side by side – highlighting the differences, in the context of a nonresident, non-citizen settlor establishing a U.S. domestic trust for the benefit of an adult U.S. child wishing to acquire an apartment in the U.S.

- **Proposed Regulations on Nondevice & Active Business Requirements Under Code §355.** Many jurisdictions have special provisions that apply when two businesses owned by a corporation or corporate group are divided and shares of group members are distributed to shareholders. Sometimes referred to as a "demerger" in Europe and other times as a "butterfly" in Canada, in the U.S. these transactions are called Code §355 spin-offs, split-ups, and split-offs. In the U.S., several hurdles must be overcome for the transaction to be free of tax at the level of the company making the distribution and the shareholder receiving the distribution. The I.R.S. recently issued proposed regulations clarifying the application of two of these hurdles: the transaction must not be a "device" to distribute earnings, and companies conducting two or more active business must be involved. The proposed regulations were motivated by a proposal by Yahoo! to distribute shares of Alibaba. Rusudan Shervashidze and Andrew P. Mitchel analyze the proposed regulations and how they will apply to circumstances involving a spin-off of a corporation operating a small business but having a large investment asset.

- **B.E.P.S. Action 7 – O.E.C.D. Calls for Improved International Coordination on the Allocation of Branch Profit.** One of three releases on July 4, the O.E.C.D.'s *Additional Guidance on the Attribution of Profits to Permanent Establishments* addresses the imponderable question – how much profit should be attributed to a P.E.? The answer will make tax advisers quite happy: It depends on the facts, and the O.E.C.D. suggests that a coordinated global approach is required to avoid double taxation. Stakeholders are invited to comment. Michael Peggs examines five examples in the additional guidance.

- **Crowdfunding: A Popular Way to Invest, but Watch Out for Taxes.** Crowdfunding is an internet-based form of raising capital for businesses and other endeavors that is popular with millennials. Millions of dollars are raised each month through crowdfunding, but it is unlikely that much thought has been given to the tax consequences for investors and the companies being funded. The ways in which crowdfunding transactions are structured vary significantly, and as a result, the tax consequences vary. In Information Letter 2016-0036, the I.R.S. explains its view of the tax consequences. The tax consequences may not be benign for the company raising the funds unless certain conditions exist. Philip R. Hirschfeld and Elizabeth V. Zanet explain the I.R.S. view.

- **$3.1 Billion Scam – Hijacked E-Mail Accounts Invite Wire Transfer Fraud.** In a public service announcement, the F.B.I. has publicized a new internet risk for business that goes beyond Russian hacking of political parties. It is a sophisticated scam targeting businesses that work with foreign suppliers and that regularly perform wire transfer payments. E-mail accounts are hacked, hijacked, and used by criminals to authorize bogus business payments. The scam has been reported by victims in all 50 states and in 100 countries. Fraudulent transfers have been sent to 79 countries, with the majority going to Asian banks in China and Hong Kong. Simon H. Prisk examines how the scam works and advises *caveat solventis*.

- **Alternative Basis Recovery Methods for Contingent Payment Sales.** Basis recovery is important when a taxpayer sells property and recognizes gain over a period of time, or when a taxpayer acquires property – other than inventory that is used in a trade or business – and wishes to depreciate or amortize the cost of the property over its useful life. When a selling price is contingent on future events, it is possible for income recognition – but not basis recovery – to be frontloaded, resulting in an expensive mismatch in the computation of income. Galia Antebi explains how matching of basis recovery and income recognition may be achieved in various fact patterns.

- **German-Trained Lawyer Could Not Deduct U.S. Educational Expenses.** Taxpayers generally may deduct all the ordinary and necessary expenses paid or incurred, during the tax year, in carrying on a trade or business. Interesting questions arise when an individual moves to a new country of residence. This was recently illustrated by a Court of Appeals decision involving a U.S. citizen who was German lawyer. He returned to the U.S. and, in order to sit for the bar, was required to take additional law school classes. Elizabeth V. Zanet explores whether U.S. law school tuition was deductible.

- **Updates & Other Tidbits.** This month, "Tidbits" explores the following developments: (i) the extension of FinCEN reporting requirements by title companies involved in all-cash real estate transactions; (ii) a European Commission decision calling for Spain to recover over €30 million from seven Spanish soccer clubs that unlawfully received State Aid; (iii) other tax breaks involving Spain that are under consideration by the E.C.J. that could affect State Aid cases against U.S.-based companies; and (iv) new rules regarding the need to refresh I.T.I.N.'s issued to nonresident, non-citizen individuals. Kenneth Lobo, Fanny Karaman, and Galia Antebi discuss these developments.

We hope you enjoy this issue.

- The Editors

EUROPEAN REGISTRATION & FRENCH TAX LAW CREATE PITFALLS FOR U.S. TRUSTS

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INTRODUCTION

Events that have taken place in the European Union during July confirm that a U.S. person who establishes a U.S. domestic or foreign trust for the benefit of a European resident, may face significant pitfalls regarding confidentiality and tax.

While trusts historically constitute a testamentary dispositive tool in common law countries, the recent UBS and Panama Papers scandals have shed a harsh light on these instruments. Add in the E.U.'s economic stagnation and the existence of terrorist threats, and it is not surprising that a massive, hasty crack-down on the use of trusts by high net worth individuals has ensued.

In an era of country-by-country reporting, the trust mechanism is no longer considered an estate planning or charitable giving tool. Rather, it is viewed as a tax evasion mechanism only available to a sophisticated elite who are either interested in concealing income and committing tax fraud, or possibly in financing terrorism. This view ignores the fact that high net worth individuals commonly use trusts to provide for future generations. Individuals who move internationally or have family members in multiple jurisdictions will undoubtedly suffer from the crack-down.

In light of the Panama Papers scandal, the European commissioner for economic and financial affairs, taxation and customs, Pierre Moscovici, has announced proposed changes to the existing ownership disclosure rules. This is not Mr. Moscovici's first foray into transparency legislation, having served as France's Minister of Economy and Finance when, in 2013, French legislation providing for a public trust registry was enacted. Now, in his role with the European Commission, Mr. Moscovici has brought forth a proposal for a Directive of the European Parliament and of the Council (the "Proposed Directive") to amend Directive (E.U.) 2015/849 On the Prevention of the Use of the Financial System for the Purposes of Money Laundering or Terrorist Financing and Directive 2009/101/E.C.

The Proposed Directive was announced at a July 5, 2016 press conference, where Mr. Moscovici emphasized the necessity for transparency and fair taxation, and pointed to increased need for scrutiny of trusts, tax advisors, and lenient countries. We have learned from experience that when a politician uses terms like "fair taxation" and "transparency," taxpayers must take heed, as those terms frequently precede a tax grab.

As referenced above, ownership disclosure rules already exist with regard to trusts in France. This article will first address the proposal for modification of the European Directive on the registration of trust beneficiaries that is currently under consideration by the European Parliament. It will also address French income, gift, inheritance, and wealth tax rules designed to ensure that no tax revenue is ever lost in France when a French individual is a settlor or beneficiary of a trust.

EUROPE'S BENEFICIAL OWNERSHIP HUNT

The Proposed Directive amends the recently enacted Fourth Anti-Money Laundering Directive[1] (the "4A.M.L.D.") and "fight[s] against tax evasion and money laundering, with the aim of ensuring both social justice and fighting organised crime and terrorism."[2] It is aligned with recent E.U. legislation and discussions with regard to transparency of information in the tax field,[3] including the B.E.P.S. Project. It aims at preventing "the large-scale concealment of funds which can hinder the effective fight against financial crime" and ensuring "corporate transparency so that true beneficial owners of companies or other legal arrangements cannot hide behind undisclosed entities."[4]

As a consequence, the Proposed Directive wishes to improve transparency with regard to ultimate beneficial ownership information, which must be available to competent tax authorities, financial institutions, and persons with a "legitimate interest." Among the entities targeted for improved disclosure are trusts and similar entities, such as foundations, *treuhands*, *fiducies*, or *fideicomisos*.

The 4A.M.L.D. already contains disclosure rules with regard to corporate entities, as well as trusts and comparable arrangements. The Proposed Directive now intends to harmonize the beneficial ownership disclosure rules applicable to corporate entities with those applicable to trusts. To that end, the explanatory memorandum to the Proposed Directive states:

> Rules regarding the registration of the beneficial ownership information of trusts by their trustees should be consistent with those in place in respect of the registration of beneficial ownership information of companies.

With this in mind, the Proposed Directive draws a distinction between "business-related trusts" and other trusts. For this purpose, business-related trusts are defined as follows:

> [T]rusts which consist of any property held by or on behalf of a person carrying on a business which consists of or includes the management of trusts, and acting as trustee of a trust in the course of that business with a view to gain profit.

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1 Directive (E.U.) 2015/849.

2 European Commission, "Remarks by Commissioner Moscovici at the Press Conference at the Launch of the New Transparency Rules to Tackle Terrorism Financing, Tax Avoidance and Money Laundering," news release, July 5, 2016.

3 See, *e.g.*, the Directive on Administrative Cooperation, accessible via "Enhanced Administrative Cooperation in the Field of (Direct) Taxation," European Commission; European Commission, *Proposal for a Council Laying Down Rules Against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market*, (Brussels: 2016); EU2016.nl, *Informal ECOFIN - Line to take NL Presidency*, (2016).

4 Directive (E.U.) 2015/849, Explanatory Memorandum.

In the case of a business-related trust, the disclosed beneficial ownership information will be made available to a range of persons that is broader than the range for other trusts. In cases related to other trusts, only persons holding a legitimate interest are to be granted access to the beneficial ownership information. A legitimate interest exists where there is a mission statement to combat money laundering, terrorist financing, and associated offenses. This can extend to governmental and nongovernmental organizations, provided that the latter demonstrates (i) previous activities relevant to the fight against money laundering and terrorist financing or associated predicate offences, or (ii) a track record of surveys and actions in that field.

While the reasons behind the trust distinction seem clear, the distinction itself could very well be fictitious in most cases. Indeed, individuals often retain professional trustees, whom they entrust with overseeing assets that are held for subsequent generations or for charitable purposes. Trusts with an institutional trustee will be considered to be business-related trusts and will fall under the broader disclosure rules. In effect, the distinction between the two types of trusts is meaningless.

Article 31 of the current 4A.M.L.D. provides that Member States must require trustees of any trust "governed under their law" to obtain and hold accurate and up-to-date information on beneficial ownership. The information to be disclosed is the following:

- The settlor
- The trustee(s)
- The protector (if any)
- The beneficiaries or class of beneficiaries
- Any other natural person exercising effective control over the trust

Article 31 further provides that when the trust "generates tax consequences," Member States must hold the above information in a central register.

The Proposed Directive attempts to clarify the phrases "governed under their law" and "generates tax consequences," and criticizes the previous lack of definition. The Proposed Directive points out that as a result, Member States may take the position that if they do not recognize trusts under their domestic laws, they are not required to monitor and register any trusts which may be administered from their territories.

To address the issue, the Proposed Directive suggests that governed under their law should be understood as the place of administration. With regard to the requirement that the trust must generate tax consequences before there is a filing requirement in a central register, the Proposed Directive points out that this limitation on the registration requirement is not compliant with another 4A.M.L.D. requirement regarding trust categorization. The 4A.M.L.D. provides that categorization of trusts is required prior to the time a business relationship is entered into with a trust. In addition, the Proposed Directive points out that existing rules create a loophole for trusts that do not pay taxes in any jurisdiction as a result of different rules regarding tax residence. These trusts would not be registered anywhere. Consequently, the Proposed Directive provides for an interconnection of national registers.

FRANCE'S ONE-SIZE-FITS-ALL TRUST ANALYSIS

Although the trust mechanism does not exist under French law, the French Tax Code defines a trust, for tax purposes, in the following terms:

> [T]he legal relationships created in a country other than France, *inter vivos* or upon death, by a person, the settlor, in order to place assets or rights under the control of a trustee for the benefit of one or more beneficiaries or to achieve a specific purpose.[5]

Under French tax law, a trust can trigger three main types of tax consequences: an income tax consequence, a gift and estate tax consequence, and a wealth tax consequence.[6] Disclosure requirements apply. In all cases, French tax law does not take into account the fundamental differences that exist between various trust instruments, such as differences between current or future, capital or income beneficiaries, fixed or discretionary entitlements, and revocable or irrevocable trusts. Instead, French tax law applies the same regime to all trusts under a one-size-fits-all approach.

U.S. Trusts and French Taxes on Distributions

French tax law provides for general tax rules, which are applicable to trusts. In certain cases, an unfavorable income tax regime applies.

General Tax Regime Applicable to Distributions

Under the general regime, trust distributions are subject to French ordinary income tax rates if the beneficiary of the distributions is a French resident for French income tax purposes.[7] The highest applicable marginal income tax rate is 45%. French law is unclear as to whether the tax applies to capital distributions or if it is limited to distributions of income. However, the approach taken by the French tax administration seems to indicate that income distributions are subject to French income tax and capital distributions are subject to French gift and estate tax.[8] Income distributions are taxed without regard to the nature of the underlying income.

Although nothing to that effect is mentioned in the French-U.S. Income Tax Treaty, an outdated French administrative notice should still be applicable to trust distributions in the French-U.S. context.[9] The notice, issued in the context of the terminated 1967 France-U.S. income tax treaty, was extended in 1999[10] to a prior version of the current income tax treaty,[11] which came into effect in 1994 and has been amended twice since then. Nonetheless, the notice has not been published in the official

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5 Article 792-0 *bis* of the French Tax Code.

6 When dealing with French tax exposure, it must always be kept in mind that substantial social charges generally apply on passive-type income.

7 Article 120, 9 of the French Tax Code.

8 BOI-ENR-DMTG-30, Oct. 16, 2012, No. 170.

9 BOI-14B-2-81, Mar. 25, 1981.

10 BOI-14B-33-99, May 6, 1999.

11 Convention with Respect to Taxes on Income and Property of 1967, U.S.-Fra., Jan. 1, 1967. TIAS 6518.

administrative regulations database, which is available online, and the continuing validity of the notice may be subject to challenge.

Under this notice, the U.S. trust mechanism is taken into account for tax purposes to a certain extent:

> ***"French tax law does not take into account the fundamental differences that exist between various trust instruments. . . . [It] applies the same regime to all trusts under a one-size-fits-all approach."***

- In the presence of a "simple trust," France treats the trust instrument as fiscally transparent. The underlying income will flow through to the beneficiaries. Thus, depending on the underlying nature of the trust income, the applicable treaty article should be referred to in order to determine the right to tax that income under the treaty.
- In the case of a "complex trust" (*i.e.*, a trust that accumulates income without distributing it automatically), France also treats the trust instrument as tax transparent. However, France grants foreign tax credits on trust distributions only to the extent that U.S. tax was incurred by the beneficiaries and not by the trust itself.
- France retains the right to analyze every trust instrument on a case-by-case basis in order to determine whether a given trust is a "grantor trust." In that case, the grantor is treated as the taxpayer and the beneficiaries are not.

Distributions of the trust assets are subject to French gift or inheritance tax upon transfer, if the trust beneficiary or the settlor is a French resident at the time of the transfer or death.[12] The applicable exemption amounts and rates generally depend on the relationship between the settlor and the beneficiary.[13] However, the highest (*i.e.*, 60%) rate applies when either (i) the trustee is subject to the laws of a non-cooperating state or (ii) the trust instrument was formed after May 11, 2011, and the settlor was a French tax resident at the time of formation.[14]

<u>*Unfavorable Income Tax Regime*</u>

French tax law provides for an unfavorable regime, which applies to French residents who directly or indirectly hold at least 10% of the shares, interest, economic rights, or voting rights in an entity (whether it be a legal entity, organization, French *fiducie*, or similar institution) that meets all of the following criteria:[15]

- It is established or formed outside of France.
- It is subject to a beneficial tax regime. (For this purpose, a tax regime is considered beneficial when the tax burden is at least 1/3 lower than the French corporate tax rate that would apply if the income were held by a French corporation.[16])
- It directly or indirectly holds securities, debt instruments, deposits, or accounts.

Should this regime apply to a trust, 125% of the income distributions would be subject

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[12] Article 750 *ter* of the French Tax Code.

[13] Article 792-0 *bis* of the French Tax Code.

[14] Article 792-0 *bis*, 2, last paragraph of the French Tax Code.

[15] Article 123 *bis* of the French Tax Code.

[16] BOI-RPPM-RCM-10-30-20-10, Sept. 12, 2012, No. 300.

to French income tax at the beneficiary level.[17] If the trust is formed in a non-cooperating country or in a country that has not entered into an administrative assistance agreement with France, the beneficiary's taxable distribution will be multiplied by 125% and by an annual interest rate published by the French administration.

This provision disregards the underlying trust instrument. The determination of who, for instance, has a 10% interest in a discretionary, irrevocable, and transgenerational trust instrument is unclear, to say the least. In this context, the applicability of Article 123 *bis* of the French Tax Code may be subject to challenge, but no tax planner likely wishes to be the first to raise that challenge.

Under U.S. tax law, the income of a U.S. trust may be taxable at the trust level, at the beneficiary level, or at the settlor level. In virtually none of these cases would the U.S. tax rate be at least 1/3 lower than the French corporate tax rate (*i.e.*, less than 22%), and the application of Article 123 *bis* in the French-U.S. context could be challenged under this approach as well.

French social charges generally apply to trust distributions under both the general and unfavorable regimes.

U.S. Trusts and French Wealth Tax

A French resident is generally subject to French wealth tax on worldwide assets if his/her worldwide estate exceeds €1.3 million on January 1, 2016.[18]

French wealth tax is computed as follows:

Net Taxable Estate	Applicable Rate
Not exceeding €800,000	0
In excess of €800,000 but less than €1,300,000	0.50%
In excess of €1,300,000 but less than €2,570,000	0.70%
In excess of €2,570,000 but less than €5,000,000	1.00%
In excess of €5,000,000 but less than €10,000,000	1.25%
In excess of €10,000,000	1.50%

Settlors must include trust assets in their taxable estates for wealth tax purposes.[19] When assets remain in a trust after the conclusion of a settlor's life and the assets are held for the benefit of beneficiaries, the beneficiaries must include the trust assets in their estates for French wealth tax purposes.

Here again, this provision applies without further analysis of the trust instrument. A

17 Article 158, 7, 2 of the French Tax Code.

18 Article 885 of the French Tax Code.

19 Article 885 G *ter* of the French Tax Code.

French-resident settlor of an irrevocable discretionary trust must still include trust assets in the tax base for purposes of the French wealth tax during the balance of the settlor's life, even though no control is retained over the assets held in trust.

"A French-resident settlor of an irrevocable discretionary trust must still include trust assets in the tax base for purposes of the French wealth tax during the balance of the settlor's life."

U.S. TRUSTS & THE FRENCH TRUST REGISTRY

French Disclosure Obligations

Disclosure obligations exist in France with regard to trusts.[20] These obligations apply in the following set of circumstances:

- If either (i) the settlor, one of the beneficiaries, or the trustee is a French resident for French tax purposes or (ii) an asset owned by the trust is located in France, the trustee must file Form 2181-Trust 1, disclosing
  - the creation of the trust instrument,
  - the names of the settlor and the beneficiaries,
  - amendments that have been made to the trust instrument,
  - the dissolution of the trust instrument if applicable, and
  - the terms of the trust instrument.
- If the settlor or one of the beneficiaries is a French resident for French tax purposes, the trustee must file Form 2181-Trust 2, disclosing the value of all the trust assets.[21]
- If neither the settlor nor any of the beneficiaries is a French resident, but some of the trust assets are located in France, the trustee must file Form 2181-Trust 2, disclosing the value of the French situs trust assets.

Failure to file the appropriate forms results in a failure-to-file penalty, which is the greater of 12.5% of the value of the trust assets and capitalized trust income, or €20,000. In addition, failure to subject trust assets to French wealth tax, or failure to file Form 2181-Trust 1 or Form 2181-Trust 2, will trigger a 1.5% tax on the worldwide trust assets, should the settlor or a beneficiary be a French tax resident. If the obligation is triggered only because French situs assets are owned by the trust, the penalty is imposed on assets located in France.[22]

French Public Trust Registry

The law requires that a public trust registry must be maintained. It must contain information regarding the name of the trustee, the name of the settlor(s), the names of the beneficiaries, and the date the trust was created. On July 5, 2016, this public registry became available online.

Initially, the only requirement to access the registry was a French tax identification number. This essentially resulted in all French taxpayers being able to access the

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[20] Article 1649 AB of the French Tax Code.

[21] This disclosure obligation is in addition to the foregoing.

[22] Article 990 J of the French Tax Code.

register. However, this open access was short lived. In a July 22, 2016, emergency hearing of the highest French administrative court, the *Conseil d'Etat* suspended access to the public registry.[23]

The petitioner in the deciding case was a 89-year-old French resident who had established U.S. trusts in order to plan for the distribution of her estate at the conclusion of her lifetime. The petitioner claimed that, by disclosing particularly private information regarding her estate plan, which included the identity of the trust beneficiaries, the public register had subjected her to pressures from her entourage regarding her succession plan and violated her constitutionally protected right to privacy. The *Conseil d'Etat* deemed the public access to constitute a potential non-apportioned violation of the right to privacy, as guaranteed by Article 2 of the Declaration of Human Rights, and referred the question to the French Constitutional Court. The latter is required to render a decision within a three-month period.

CONCLUSION

While this article focuses mainly on disclosure and tax issues under French tax law, the Proposed Directive signifies the ever-increasing complexity of compliance obligations in the European Union. Advisers to global families should plan for difficult times when drafting estate plans involving trust instruments for high net worth families.

23 Conseil d'Etat, *juge des referes*, July 22, 2016, No. 400913.

A NEW WAY TO DO THE SPLITS: B.E.P.S. GUIDANCE FALLS SHORT OF ENABLING GLOBAL FORMULARY APPORTIONMENT

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Tags
B.E.P.S.
Profit Splits
Transfer Pricing

It takes considerable training and the right physical conditioning to successfully do the splits and avoid injury or embarrassment. For those who view transfer pricing as a gymnastics sub-discipline, applying a profit split method is often an approach of last resort and is arguably as difficult to accomplish in a graceful manner as the gymnastic feat. Since the B.E.P.S. (Base Erosion and Profit Shifting) Project began in 2013, a key focus has been the revision of the O.E.C.D. guidance that multinational companies and tax authorities use to apportion income resulting from the joint commercialization of intangible assets within a multinational group. The unwelcome, and potentially widespread, *ex-post* use of profit split methods as proxy for global formulary apportionment was viewed by corporate taxpayers and commentators with the same sense of dread as a surprise gymnastics skills test.

However, it would appear that companies can relax somewhat after the July 4 publication of the O.E.C.D. *Revised Guidance on Profit Splits* discussion draft. The discussion draft links other transfer pricing developments in the B.E.P.S. Project[1] to the guidance on the application of the transactional profit split method, but it does not propose to place an over-broad profit apportionment tool in the hands of tax authorities.

Like a gymnastic maneuver, successful application of the transactional profit split method requires a full understanding of risk – in this case economically significant risk incurred by the participants in the relevant business opportunity. The transactional profit split method is one of five transfer pricing methodologies set out in Chapter II of the O.E.C.D. Guidelines. In cases where controlled taxpayers participate in highly integrated operations and contribute valuable intangible assets in respect of a joint business opportunity, the profit split method is used to split the profits or losses from the combined activity on an economically valid basis to approximate an arm's length return to the respective contributors.

Not unlike the provisions of Treas. Reg. §1.482-6, the transactional profit split may be applied using either the more direct contribution analysis or the more indirect residual analysis (*i.e.*, routine profits to the associated enterprises are determined first, and then deducted from the actual pooled profit to determine the residual profit to split). The transactional profit split method can also be used in conjunction with a valuation method to estimate the value of an intangible asset transferred from one controlled taxpayer to another.

In contrast to the Treas. Reg. §1.482-6 method, the O.E.C.D. Guidelines allow for the splitting of either anticipated or actual profit. The discussion draft adapts the

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1 See, *e.g.*, O.E.C.D., *Aligning Transfer Pricing Outcomes with Value Creation*, Actions 8-10 Final Reports, (O.E.C.D. Publishing, Paris: 2015) (the "O.E.C.D. Guidelines").

“The transactional profit split method may, therefore, not be appropriate in circumstances where . . . each party does not have the financial capacity to assume its proportional share of the risk.”

O.E.C.D. Guidelines profit split by incorporating the changes to Section D.2.6.2 of Chapter VI that discuss how to reliably estimate anticipated profit from an intangible asset. The draft properly points out that appropriate use of the transactional profit split method uses a profit split metric determined in advance of the knowledge of the actual profit to be divided between the two parties. This serves as a reminder to companies of the evidentiary value of intercompany agreements – used in this instance to demonstrate taxpayer intent and to clearly set out the way in which a split of unanticipated profit will be calculated in the future. The fact that an agreement is required to manage the uncertain outcome of a business activity where risk is shared, in and of itself, reinforces the appropriateness of a profit split method.

The use of the transactional profit split method based on the combined actual profits of the contributing parties is linked to the control exercised by those parties over the economically significant risks associated with the combined business. The transactional profit split method may, therefore, not be appropriate in circumstances where the risks of the combined business are not separately or collectively controlled by the participants, or where each party does not have the financial capacity to assume its proportional share of the risk. The evaluation of control over risk should be carried out annually, as actual profits are intended to be split each taxation year under the transactional profit split method.

This limiting control condition arises from the work completed by the B.E.P.S. Project, to date, on transfer pricing issues relating to intangible assets. Interestingly, this new limitation on attribution of profit from intangible assets to only those entities exercising control over risk and possessing sufficient financial resources to mitigate risk circumscribes the authority of tax administrations to use the transactional profit split method in a formulary way, as was feared by many B.E.P.S. Project observers.

Some useful guidance appears in the discussion draft to differentiate a reliable profit split from a less graceful version. Parties must “share the same economically significant risks”[2] associated with the combined business activity or “separately assume closely related risks”[3] associated with the same activity.

The term “economically significant risks” is explained in the revised Chapter I of the O.E.C.D. Guidelines[4] as being those factors that cause the anticipated objectives or outcomes of the business activities for the contributing parties to vary to the greatest degree. Strategic risks, marketplace risks, infrastructure risks, operational risks, financial risks, transactional risks, and hazard risks are suggested as the principal (though not the only) types of risk to consider.

There is, therefore, a less reliable profit split where

- the economically significant risks have not been specified,
- the nature of the contributions of the parties has not been accurately determined,
- an evaluation of how those contributions influence profit outcomes has not been made,

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2 O.E.C.D., *Public discussion draft, BEPS Actions 8 – 10, Revised Guidance on Profit Splits*, (O.E.C.D. Publishing, Paris: 2016), para. 16.

3 *Id.*

4 *Supra* note 1, Section D.1.2.1.1, pp. 25-28.

- the profits to be split have not been reliably identified, and
- the basis for splitting the profits has not been reliably determined.

In certain cases, tax authorities (and sometimes companies) choose to skip the difficult work of comparability analysis or comparability adjustments, and apply the profit split method. The discussion draft acknowledges a shortage of comparables may exist in practice, but it warns that a lack of comparables alone does not justify the use of the transactional profit split method. Rather than stretching to apply the transactional profit split method, the discussion draft suggests that the use of a different method (inexact comparables) and well-supported comparability adjustments may result in a pricing outcome that better approximates an arm's length result.

Similarly, the discussion draft sets out limitations, concerning integrated operations, unique and valuable contributions of intangible assets, and group synergies to the use of the transactional profit split method, in order to promote the responsible use of this transfer pricing method. The mere appearance of integrated operations is stated as an insufficient condition for the application of the profit split method. A careful functional analysis and an understanding of the company's value chain is required to establish whether it is truly the case that the functions of company participants are so integrated that an intercompany transaction cannot be reliably delineated and perhaps priced using a more reliable methodology.

Finally, the discussion draft clarifies that treatment accorded to profits resulting from group synergies should differ from the treatment of profit resulting from the commercialization of intangible assets. The benefits or cost savings connected with group synergies are termed "marginal system profits," which should not be included in the "total system profits" to be divided using the transactional profit split method.

Room for disagreement exists with regard to the definition of a unique or valuable intangible asset, the degree to which a risk is economically significant, the importance of location savings, and the way market characteristics figure into a profit split analysis between a company based in a country with a developed economy and a related party with operations in a country with an emerging economy. Nonetheless, the focus of the O.E.C.D. guidance on intangible assets has been sharpened significantly, thereby reducing uncertainty for all.

I.R.S. ISSUES PROPOSED REGULATIONS AFFECTING VALUATION DISCOUNTS FOR GIFT AND ESTATE TAX PURPOSES

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INTRODUCTION

For estate tax purposes, the taxable estate of a decedent includes the fair market value of all assets owned at the time of death, in the case of a U.S. person, or the fair market value of all U.S. situs assets, in the case of a nonresident, non-citizen individual. For gift tax purposes, the taxable basis is the fair market value of the transferred asset at the time of the gift. Value is thus the key to determining the tax base for gift and estate tax purposes. This value can be discounted when circumstances limit the full enjoyment of ownership rights to the transferred asset, such as in the case of a minority interest.

Recently proposed regulations, issued by the I.R.S., would change the way certain rules are used to reduce value in order to decrease the gift and estate tax liability in the context of a family-owned business. This article explains how the minority discount and other valuation rules are applied under current practice and the way those rules may be modified when, and if, the proposed regulations are adopted.

THE GENERAL CONTEXT OF MINORITY DISCOUNTS AMONG RELATED PARTIES

One tax planning tool used for estate, gift, and generation-skipping transfer tax purposes is to take into account an impairment to value that is suffered by the holder of a minority interest in a closely-held entity.

If the value of the business is the starting point to the value of shares or partnership interests, the shares held by the person who controls the entity are worth more than the shares held by a minority interest holder. The shares of the former have a premium, while the shares of the latter suffer a discount in value. In essence, no buyer would pay full value for a non-controlling interest in a company that is controlled by a single person or a small control group.

Similarly, shares in a holding of more than two-thirds of the voting stock will be worth proportionately more than shares in a holding of 50% of the voting stock, if only the holder of a more-than-two-thirds interest can cause a liquidation of the corporation without the approval of other shareholders.

In preparing the estate plan of a family patriarch that owns or controls a closely-held business, the planner may recommend giving minority interests to various trusts established for the benefit of the patriarch's heirs. In each case, the value of the asset given to the trust is reduced because of its minority position in the company. In practice, minority interests that do not afford the holder with a power to remove management, or to control the operation of the business, are simply worth less than the same proportional value of the business itself. The savings will be compounded at the death of the patriarch if the total number of shares given away during his lifetime precludes his estate from having the power to liquidate the company.

The I.R.S. accepts the concept of minority discounts among independent parties, but it is concerned that family members are not always in the same position as independent parties. Thus, the I.R.S. maintains that gifts from patriarchs to family members should not systematically reduce value for gift and estate tax purposes under the valuation discount rules.

CODE §§2701-2704 VALUATION RULES

Special valuation rules, applicable to transactions involving family limited partnerships and family-held corporations, were enacted in 1990 to replace an earlier provision, the former Code §2036(c), enacted in 1987. Code §§2701-2704 are intended to prevent the use of estate valuation freeze techniques, such as those described above, that are considered to be abusive. They were not, however, adopted to eliminate minority interest discounts.[1]

Originally, Code §2036(c) provided that transferred property and interests in property were included in the transferor's taxable estate if a disproportionate share of the future appreciation was transferred to the next generation while the patriarch retained rights to income or management. In comparison, Code §2701 applies special valuation rules to the initial transfer and provides for adjustments to taxable gifts upon a subsequent transfer of a retained interest or the death of the transferor.

In broad terms, Code §2701 provides that – solely for purposes of determining whether a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family is a gift – the value of certain distribution, liquidation, put, call, or conversion rights must be determined as if each right were exercised in the manner resulting in the lowest value being determined for all such rights. The effect is that for estate tax purposes, the value of the patriarch's taxable estate is increased.

Code §2703 provides that the value of any property is to be determined without regard to any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property or any restriction on the right to sell or use such property. This rule does not apply to any option, agreement, right, or restriction that meets the following criteria:

- It is a *bona fide* business arrangement.
- It is not a device to transfer property to members of the decedent's family for less than a full and adequate consideration in money or money's worth.
- It contains terms that are comparable to similar arrangements entered into by persons in an arm's length transaction.

Code §2704 is better understood in light of the case law that led, in part, to its

[1] H.R. Rep. 101-964, at 1122 (1990) (Conf. Rep.).

enactment.[2] In *Estate of Harrison v. Commr.*,[3] the decedent and his sons entered into a partnership agreement. The decedent contributed assets with a fair market value of approximately $59 million at the time of contribution, in exchange for a 1.0% general partnership interest and a 77.8% limited partnership interest. Each son contributed approximately $4 million in exchange for a 10.6% general partnership interest. The partnership agreement provided that each general partner had the right to dissolve the partnership during his lifetime. That right lapsed at death. One of the questions at issue was the valuation of the decedent's limited partnership interest for estate tax purposes. The right to dissolve the entity and receive all the assets is a valuable right. However, because it lapsed at death, the heirs could not receive that right. The estate argued that because the decedent's right to liquidate the partnership lapsed at the time of death, the value of his limited partnership interest amounted to $33 million. Pursuant to this reasoning, the court concluded in favor of the estate. In support of its decision, the court cited *U.S. v. Land*,[4] for the following proposition:

> Brief as is the instant of death, the court must pinpoint its valuation at this instant – the moment of truth, when the ownership of the decedent ends and the ownership of the successor begins. It is a fallacy, therefore, to argue value before or after death on the notion that valuation must be determined by the value either of the interest that ceases or of the interest that begins.

As a result, the value of the limited partner interest was less than its value either in the hands of the decedent immediately before death or in the hands of his two sons immediately after death.

Partly to negate the approach of the court, Code §2704 limits the application of the valuation rules with regard to certain types of intra-family transfers of interests in corporations and partnerships subject to voting or liquidation rights and restrictions that lapse. In early August, the I.R.S. proposed regulations[5] that will raise the standards which must be met for these types of restrictions to be taken into account. The proposed regulations will be effective when adopted in final form.

Treas. Reg. §25.2704-1(a)(2)(v) defines a liquidation right as the right or ability, including by reason of aggregate voting power, to compel the entity to acquire all or a portion of the holder's equity interest in the entity, whether or not its exercise would result in the complete liquidation of the entity.

Further, for purposes of Code §2704, certain restrictions are not taken into account when determining the value of the transferred interest. The scenario in which these restrictions are disregarded is the following:[6]

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2 *Id.*

3 *Estate of Harrison v. Commr.*, T.C. Memo 1987-8 (1987).

4 *U.S. v. Land*, 303 F2d 170, 171-173, (1962).

5 REG-163113-02. The amount of the transfer would be the excess of the fair market value of all interests held by the transferor, determined as if the voting or liquidation rights were non-lapsing, over the fair market value of such interests after the lapse.

6 Code §2704(b)(2).

- An interest in a corporation or partnership is transferred to, or for the benefit of, a member of the transferor's family.
- The transferor and members of the transferor's family hold control of the entity immediately before the transfer.

In that situation, the restriction must be disregarded for valuation purposes if the restriction

- effectively limits the ability of the corporation or partnership to liquidate, and
- either of the following conditions apply to the restriction:
  - The restriction lapses, in whole or in part, after the above-mentioned transfer.
  - The transferor or any member of the transferor's family, either alone or collectively, has the right to remove the restriction, in whole or in part, after such transfer.

In addition, Treas. Reg. §25.2704-1(c)(1) provides that a lapse of a liquidation right occurs at the time a presently exercisable liquidation right is restricted or eliminated. However, under the regulation, a transfer of an interest that results in the lapse of a liquidation right generally is not subject to this rule if the rights, with respect to the transferred interest, are not restricted or eliminated. The effect of this exception is that *inter vivos* transfers of a minority interest by the holder of an interest with the aggregate voting power to compel the entity to acquire the holder's interest is not treated as a lapse, even though the transfer results in the loss of the transferor's presently exercisable liquidation right.

The I.R.S. believes that the Treas. Reg. §25.2704-1(c)(1) exception should not apply when the *inter vivos* transfer resulting in the loss of the power to liquidate occurs on the decedent's deathbed.

SUMMARY OF THE PROPOSED CHANGES TO THE CODE §2704 VALUATION RULES

The proposed regulations would amend Treas. Reg. §25.2701-2 to address what constitutes "control" of an L.L.C., or another entity or arrangement that is not a corporation, partnership, or limited partnership. The proposed regulations would amend Treas. Reg. §25.2704-1 to address deathbed transfers that result in the lapse of a liquidation right and to clarify the treatment of a transfer that results in the creation of an assignee interest that is short of being a partnership interest. The proposed regulations would also amend Treas. Reg. §25.2704-2 to refine the definition of the term "applicable restriction," by eliminating the comparison to the liquidation limitations of state law. Further, the proposed regulations would add a new section, Treas. Reg. §25.2704-3, to address restrictions on the liquidation of an individual interest in an entity and the effects of insubstantial interests held by persons who are not members of the family.

The following discussion outlines the proposed regulations in light of the currently applicable provisions and planning trends, which are under attack by the I.R.S.:

- The proposed regulations acknowledge that many taxpayers utilize L.L.C.'s as the preferred business or investment form. Although Code §2704 speaks in terms of corporations and partnerships, the proposed regulations address two situations in which it is necessary to go beyond this division of entities. Hence, the entities covered by the proposed regulations would also include (i) L.L.C.'s and (ii) other entities and arrangements that are business entities within the meaning of Treas. Reg. §301.7701-2(a), whether domestic or foreign. These situations require consideration of the differences among various types of business entities under local law, which mandates the creation and governance of these entities. As a result, the proposed regulations look to the form of the entity or arrangement under local law for the purposes of determining control of any business entity or arrangement that is not a corporation and whether a restriction is imposed at the state level. The determination would be made regardless of how the entity is classified for other Federal tax purposes and whether it is disregarded, for such purposes, as an entity separate from its owner.

- The proposed regulations define control in the context of an L.L.C. or of any other entity or arrangement that is not a corporation, partnership, or limited partnership. The hurdle to be met for control to exist is the holding of (i) 50% or more of either the capital or profits interests, or (ii) any equity interest with the ability to cause the full or partial liquidation of the entity or arrangement. In general, concepts of local law – *viz.*, the law under which the entity or arrangement is created or organized – will control. Attribution rules apply, which will cause an individual, an individual's estate, and members of the individual's family to be treated as holding interests that are held indirectly through a corporation, partnership, trust, or other entity.

"The proposed regulations look to the form of the entity or arrangement under local law for the purposes of determining control of any business entity or arrangement that is not a corporation."

- The current regulations provide an exemption from the definition of an applicable restriction for a restriction on liquidation that is no more restrictive than the state law that would apply in the absence of the restriction. Consequently, only restrictions that are more restrictive than local law are not covered. Due mostly to case law and changes in state laws that are designed to assist taxpayers in meeting the standard of the regulations, the I.R.S. views the exception under current regulations to be too broad. The proposed regulations would thus eliminate the comparison to the liquidation limitations of state law so as to prevent the use of artificial restrictions for valuation discount purposes.

- An exception for restrictions imposed, or required to be imposed, by any Federal or state law in Code §2704(b)(3)(B) would be clarified by limiting the provision to laws of the U.S., the individual states, and the District of Columbia. Restrictions imposed by the law of any other jurisdiction are not covered by the exception.

- A restriction is imposed or required to be imposed by law if (i) the restriction cannot be removed or overridden and (ii) it is mandated by the applicable law and is required to be included in the governing documents. In addition, a restriction imposed by state law may constitute an applicable restriction in two situations. In each situation, although the statute itself is mandatory and cannot be overridden, another statute is available to be used for the entity's governing law, which does not require the mandatory restriction. The first situation involves a state law that is limited in its application to family-controlled entities. The second situation involves contradictory state laws allowing the mandatory restriction to be elective in practice.

“The valuation of the same property interest may differ if the transferee is a family member, rather than a charity.”

- Code §2704(b) does not apply to transfers to nonfamily members and thus has no application in valuing an interest passing to charity or to a person other than a family member. If part of an entity interest passes to family members and part to nonfamily members, and the part passing to the family members is valued under Code §2704(b), the proposed regulations treat that part as a property interest separate from that passing to nonfamily members. Consequently, the valuation of the same property interest may differ if the transferee is a family member, rather than a charity. The fair market value of the part passing to the family members is determined taking into account the special valuation assumptions of Code §2704(b), as well as any other relevant factors, such as those supporting a control premium. The fair market value of the part passing to nonfamily members is determined in a similar manner but without the special valuation assumptions of Code §2704(b).

- In the case of a family-controlled entity, certain restrictions on an owner’s right to liquidate an interest in the entity will be disregarded if (i) the restriction will lapse at any time after the transfer or (ii) the transferor, or the transferor and family members, may remove or override the restriction without regard to certain interests held by nonfamily members. This rule applies to restrictions that

    - limit the ability of the holder to liquidate the interest;

    - limit the liquidation proceeds to an amount that is less than a specified minimum value;

    - defer the payment of the liquidation proceeds for more than six months; or

    - permit the payment of the liquidation proceeds in any manner other than in cash or other property, other than certain notes.

- Treas. Reg. §25.2704-1 provides that a transfer of an interest that results in the lapse of a liquidation right is not a lapse of a liquidation right if the rights with respect to the transferred interest are not restricted or eliminated. This exception would be narrowed by the proposed regulations, in that they provide for a three-year look-back period. If the interest was transferred within the three-year period prior to the transferor’s death, the transfer would be treated as a lapse occurring on the transferor’s deathbed. The transferred interest would be included in the decedent’s gross estate (although the transferred interest would continue to be owned by the transferee), but the identity of the beneficiary of any resulting step-up in basis is unclear.

- Currently, certain taxpayers transfer their partnership interests to an assignee, rather than a partner. They claim that, because the assignee does not have the right to liquidate his or her partnership interest, the restriction is less than would be imposed upon an assignee under state law. Thus, the assignee status of the transferred interest is not an applicable restriction and a valuation discount can be claimed on the transferred interest. In order to avoid this type of scenario, the proposed I.R.S. regulations would assimilate an assignee interest to a lapsed voting or liquidation right.

CONCLUSION

It is clear that the proposed regulations will have a drastic effect on estate plans of high net worth individuals whose lives conclude after the effective date of the regulations – expected to be the date of adoption in final form. In certain cases, the proposed regulations may even have effects for the three-year period prior to the date of final adoption. Until then, a cottage industry has emerged within tax advisory firms, recommending damage control for existing plans. Many include the acceleration of a giving plan during the client's lifetime and before the effective date of the proposed rules.

TAX 101:
FOREIGN SETTLORS, U.S. DOMESTIC TRUSTS, AND U.S. TAXATION

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Tags
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INTRODUCTION

Trust instruments constitute a common estate planning tool in common law countries. While, planning for future generations within the boundaries of a single jurisdiction constitutes the historical approach, families in today's world do not necessarily live in the same country. When planning for high net worth individuals, present and future international family aspects must be considered. Otherwise, adverse tax consequences may ensue.

This article serves as a primer for the use of trusts in the context of a non-U.S. individual settlor forming a trust that has one or more U.S. beneficiaries on an exclusive or non-exclusive basis. The scenario involves (i) a non-U.S. parent who was never a U.S. citizen or resident for income tax purposes, (ii) a U.S. resident adult child that wishes to acquire a house or a condominium unit in the U.S., and (iii) a trust intended to hold the property for the child.

The U.S. tax consequences of the arrangement must be carefully considered at three points in time. The first point in time is at the funding of the trust: Is there gift tax that may be imposed? The second point in time is during the life of the trust: Is there income tax that may be imposed unexpectedly on the beneficiary, for instance in the case of rent-free use of an apartment? The third point in time is at the conclusion of the settlor's lifetime: Is there estate tax exposure because of retained strings over the trust's assets? This article takes the reader through each step. Throughout, differences are highlighted in the tax treatment of (i) a U.S. individual and a non-U.S. individual, and (ii) a U.S. domestic trust and a foreign trust.

GIFT TAX EXPOSURE ON FORMATION & FUNDING OF THE TRUST

<u>Question 1: Under the rules applicable to U.S. residents and citizens, is a gratuitous transfer of property from a settlor to a trust considered to be a gift?</u>

Yes. Unless, the trust is revocable, a gratuitous transfer of assets, from a settlor to a trust, is ordinarily treated as a gift that is subject to gift tax under the rules applicable to U.S. residents and citizens.[1]

<u>Question 2: When the donor of the gift is a nonresident, non-citizen ("N.R.N.C.") individual, do the same rules apply regarding the taxation of gifts, or is tax imposed on gifts of certain categories of assets?</u>

When the donor of the gift is an N.R.N.C. individual, the scope of gift taxation is

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[1] Treas. Reg. § 25.2511-1(c).

reduced. U.S. gift tax is imposed only with regard to real property and tangible personal property[2] having a U.S. situs. In general, gifts of intangible property ("I.P.") made by an N.C.N.R. individual are not subject to U.S. gift tax, even if the transfer is made in the U.S. Examples of I.P. include shares of stock or a debt instrument issued by a corporation.

Question 3: If the N.R.N.C. parent purchases a house in the U.S. and gives the house to a trust for the benefit of the U.S.-resident adult child, will the gift be taxable?

Yes, if the N.R.N.C. parent purchases a house in the U.S. and gives the house to a U.S.-resident adult child, the gift will be taxable. The gift relates to U.S. situs real property.

"A given result at the end of a straight path is not made a different result because it is reached by following a devious path"

Question 4: If the N.R.N.C. parent purchases a house in the U.S., transfers the house to a newly created U.S. corporation, and gives the stock of the corporation to a U.S. domestic trust established for the benefit of the U.S.-resident adult child, will the gift of stock be exempt from U.S. gift tax as I.P.?

No, the transfer likely will not be viewed to be exempt from gift tax even though it is a transfer of shares and shares are considered to be I.P. The transfer of shares is the final step in an integrated plan that begins with the transfer of real property owned by the N.R.N.C. parent. Unless the transfer of the real property to the U.S. corporation is unconnected to the transfer of shares, the substance of the gift is a transfer of real property.

For many years, U.S. courts have applied a court-made rule under which substance must control over form when determining the tax consequences of a particular transaction.[3] To that end, a given result at the end of a straight path is not made a different result because it is reached by following a devious path.[4] Consequently, where a taxpayer has embarked on a series of transactions that are, in substance, a single, unitary, or indivisible transaction, the courts have disregarded the intermediary steps and have given credence only to the completed transaction.[5]

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[2] Code §2511(a)

[3] *Gregory v. Helvering*, 293 U.S. 465 (1935). In the case, some of the assets of a corporation, which was owned wholly by the taxpayer, were transferred to a new corporation, which was owned wholly by the taxpayer and created solely for the purpose of receiving and transferring assets to the taxpayer as a liquidating dividend, and after the transfer, the new corporation was dissolved. The transfer was not a "reorganization" within statute, which provides an exemption from tax for gain arising out of a transfer of assets by one corporation to another corporation pursuant to a plan of reorganization. The Court found that the transfer was not made pursuant to a plan of reorganization. Rather, it was made pursuant to a plan having no relation to the business of either corporation.

[4] *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938).

[5] *Redwing Carriers, Inc. v. Tomlinson*, 399 F. 2d 652, 654 (5th Cir. 1968); *May Broadcasting Co. v. U.S.*, 200 F. 2d 852 (8th Cir. 1953); *Whitney Corporation v. Commr.*, 105 F. 2d 438 (8th Cir. 1939), affirming 38 B.T.A. 224 (1938); *Commr. v. Ashland Oil & R. Co.*, 99 F. 2d 588 (6th Cir. 1938), reversing *sub nom*. *Swiss Oil Corporation v. Commr.*, 32 B.T.A. 777 (1935), *certiorari* denied 306 U.S. 661

One case[6] illustrates how this rule applies when the income tax produces a lesser liability than the gift tax. An N.R.N.C. individual owned real property in Hawaii and wanted to transfer the property to a son. At the time, U.S. law allowed an N.R.N.C. individual to sell real property without incurring U.S. tax on the gain. However, gifts of U.S. real property by an N.R.N.C. individual were subject to U.S. gift tax. Clearly, a gift would produce suboptimal results. Consequently, a gift of funds was made by the N.R.N.C. individual to his son with the expectation that the funds would be used as a down payment to acquire the property in Hawaii. The gift of funds was not subject to U.S. gift tax – foreign currency was used and the transfer took place outside the U.S. A seller's mortgage note was taken back by the N.R.N.C. individual.

At a surface level, the property was transferred by sale and the gain was free of income tax. However, the I.R.S. asserted a deficiency in gift tax and the I.R.S. position was affirmed. The court found that the gift of funds was illusory, as it represented a circular flow of cash. On the other hand, even though payments of the note were forgiven periodically over time, the note was not illusory. The net effect was that the value of the property in excess of the face amount of the note was a gift of U.S. real property. It was subject to gift tax.

Question 5: If an N.R.N.C. individual makes a gift to a U.S. domestic trust by wiring funds to a U.S. bank account for the purpose of acquiring real property, is the wire subject to gift tax in the U.S.?

No, a gift effected by wire transfer to a bank account in the U.S. is a gift of I.P. and not subject to gift tax. Even if the funds in a bank account are viewed to be tangible property, which is at times stated in private letter rulings without support, the same result should apply provided the wire transfer originates from a bank located outside the U.S.

The term "I.P." is not specifically defined in the Code, but the regulations addressing the situs of property expressly define I.P. as including a debt obligation, such as a bank deposit.[7] In broad terms, property is categorized as I.P. when the value of the property is attributable to the property's intangible elements rather than to the property's tangible form.[8] A 1982 private letter ruling acknowledges that bank accounts are not tangible personal property.[9] In particular, the I.R.S. analyzed the gift tax provisions of U.S. law and stated:

> Section 2501 of the Internal Revenue Code imposes a tax on the transfer of property by gift. The gift tax applies, pursuant to section 2511 of the Code, to direct and indirect transfers.

(1939); *Kuper v. Commr.*, 61 T.C. 624 (1974); *Kimbell-Diamond Milling Co. v. Commr.*, 14 T.C. 74 (1950), affirmed *per curiam* 187 F. 2d 718 (5th Cir. 1951), *certiorari* denied 342 U.S. 827 (1951).

6 *Davies v. Commr.*, 40 T.C. 525 (1963).

7 Treas. Reg. §25.2511-3(b)(4).

8 In general, see *Curry v. McCanless*, 307 U.S. 357 (1939). See also I.R.S., *Publication 544 Sales and Other Dispositions of Assets*, (2016) p. 25.

9 P.L.R. 8210055. Note that a private letter ruling may be cited as authority only by the taxpayer to whom it is issued. Nonetheless, it demonstrates the thinking of the national office of the I.R.S. at the time of issue and may be relied on to eliminate penalties.

> In general, section 2501 does not tax the transfer of intangible property by a person who is neither a citizen nor a resident of the United States unless such person is an expatriate who lost his or her citizenship within 10 years of the date of the transfer.
>
> Section 25.2511-3(b) of the Gift Tax Regulations defines the term 'intangible property' as 'a property right issued by or enforceable against a resident of the United States or a domestic corporation (public or private), irrespective of where the written evidence of the property is physically located at the time of the transfer.'
>
> Debt obligations such as bank deposits or obligations of which the United States is the primary obligor are considered to be intangible property. See section 25.2511-3(b)(4) of the regulations.

This private letter ruling revisited a position in an earlier ruling,[10] expressly finding that the earlier ruling was incorrect. The prior ruling held that Treasury bills are tangible personal property and subject to gift tax if held in the U.S. at the time of the gift. Both rulings held that a gift made by check drawn on a foreign bank is a gift of non-U.S. property, even if it is payable by a U.S. bank.

"The I.R.S. views cash as tangible property. . . . It has expressed a view that bank account balances funded by cash are tangible property, notwithstanding the plain meaning of the regulations."

The I.R.S. views cash as tangible property. As previously mentioned, it has expressed a view that bank account balances funded by cash are tangible property, notwithstanding the plain meaning of the regulations. However, there should be no gift tax, even if the I.R.S. were to assert that view, when the bank account of the N.R.N.C. individual is maintained with a bank located outside the U.S. In a 2003 private letter ruling[11] involving generation skipping tax ("G.S.T."),[12] the issue involved, *inter alia*, a division of rights in the trust and whether the division was subject to G.S.T. The conclusion was dependent on whether the original funding of the trust was subject to gift tax. In concluding that the original funding was not subject to gift tax, the private letter ruling applied the following rationale for concluding that G.S.T. was not due under the circumstances:

> When Trust was established on D1, and when A initially funded Trust, A was a citizen of Country 1 and a permanent resident of Country 2. Consequently, for purposes of the GST tax, A was a nonresident alien, not a citizen of the United States. Trust was funded with cash transferred directly from A's accounts in Country 2 to Trust. Thus, although A, a nonresident alien, transferred cash, which is tangible personal property for purposes of §2501(a)(2), the funds were not physically situated within the United States prior to the transfer. Therefore, pursuant to §25.2511-3(b)(1), the transfer of cash was not a transfer that was subject to the gift tax under §2501(a). Consequently, generation-skipping transfers from Trust, to the extent attributable to A's transfer of cash to Trust, will not be subject to the GST tax.

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10 P.L.R. 8138103.

11 P.L.R. 200340015.

12 Under Code §2601, G.S.T. applies when a transfer from one generation (*e.g.*, parent) skips the next generation (*e.g.*, child) and is received by a lower generation (*e.g.*, grandchild).

While treating a transfer from a bank balance as tangible property appears to be inconsistent with the status of the account balance as I.P. and is inconsistent with an earlier private letter ruling treating cash as I.P.,[13] the wire transfer is not subject to gift tax if the transferor's account is maintained with a bank located outside the U.S.

Whichever approach is taken, a wire transfer of funds maintained in a foreign bank is not subject to tax under Code §2501, under the circumstances presented.

Question 6: If an N.R.N.C. individual makes a gift to a U.S. domestic trust, must the gift be reported to the I.R.S.?

Subject to two exceptions, a gift by an N.R.N.C. individual to a U.S. domestic trust must be reported to the I.R.S. Reporting is made on Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*. Failure to report the gift exposes the trust to a penalty equal to 5% of the amount of such foreign gift(s) for each month for which the failure to report continues (not exceeding a total of 25%).[14] However, no penalty is imposed if the trust can demonstrate that the failure to comply was due to reasonable cause and not willful neglect.

The reporting obligation is subject to two exceptions:

- The first applies to a gift from an N.R.N.C. individual to a trust, where the N.R.N.C. individual is treated as the owner of the trust under the U.S. grantor trust rules discussed below. In this set of circumstances, no transfer is deemed to have occurred for income tax purposes and the N.R.N.C. individual is treated as the owner of the property legally transferred to the grantor trust.

- The second applies to all gifts received from an N.R.N.C. individual during the year, where the total amount does not exceed $100,000 during that period. For this purpose, an aggregation rule applies so that gifts from the N.R.N.C. individual include gifts from other foreign persons that are related to the N.R.N.C. individual. The penalty applies if the trustee knows (or has reason to know) that the other persons are related to each other. For this purpose, related persons include family members such as brothers and sisters, half-brothers and half-sisters, spouses, parents, grandparents, great grandparents, children, grandchildren, and spouses of any of the persons mentioned above. It may also include a corporation in which the N.R.N.C. owns, directly or indirectly, more than 50%, in value, of the outstanding stock.

Question 7: If an N.R.N.C. individual arranges for a foreign corporation or a partnership to make a gift to a U.S. domestic trust acting on his or her instruction, is the transfer subject to gift tax under the same rules applicable to the N.R.N.C. individual?

No, if a U.S. person receives, directly or indirectly, a purported gift from a foreign corporation, the purported gift or bequest must be included in income as if it were a distribution from the foreign corporation.[15] If the foreign corporation is a passive

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13 P.L.R. 8120030.

14 Code §6049F.

15 Code §672(f).

foreign investment company ("P.F.I.C."), the P.F.I.C. rules of Code §1291 apply.[16] If the purported gift is made by a foreign partnership, the gift is treated as ordinary income.[17] No P.F.I.C. treatment applies when the purported gift comes from a partnership.

Under an exception in the income tax regulations, the recharacterization provisions do not apply to gratuitous transfers by foreign corporations or partnerships if the N.R.N.C. individual who beneficially owns the corporation or partnership reported the purported gift as a dividend and as a gift to the trust for purposes of the tax laws of the N.R.N.C. individual's country of residence. This suggests that better tax treatment may exist in the U.S. if the N.R.N.C. individual who owns the foreign corporation, or partnership, is resident in a jurisdiction that does not impose tax on unremitted income.

INCOME TAX EXPOSURE ON INCOME AND GAINS DERIVED BY A TRUST

Question 8: Are all trusts categorized in a similar way under U.S. tax law for the purpose of computing the tax of the trust, the grantor, and the beneficiaries?

No. The U.S. tax treatment applicable to trusts, their grantors, and their beneficiaries is dependent on the characterization of the trust as either a grantor trust or a nongrantor trust.

Question 9: How is a grantor trust taxed under U.S. tax law?

In general, if a trust is a grantor trust, neither the trust nor the U.S. beneficiaries are subject to tax on either (i) the realization of the income by the trust or (ii) the distribution of income to the beneficiaries. Instead, the income of the trust is considered to be the income of the person who settled the trust (other than a nominee grantor) and who made a gratuitous transfer of assets to the trust. For U.S. tax purposes, that person is referred to as the "grantor" of the trust, and the grantor is the taxpayer with regard to the income of the grantor trust, whether or not that income is taxed. If a distribution is made by a grantor trust to a U.S. beneficiary other than the grantor, the trust distribution is treated, in general, as a gift from the grantor to the beneficiary. Such gifts are not considered to be taxable income of the beneficiary, although reporting obligations exist for the beneficiary.

Question 10: What circumstances will cause a trust to be a grantor trust for U.S. income tax purposes?

In general, a trust is treated as a grantor trust when the person who funds the trust (*i.e.*, the grantor) retains one or more of the following interests in the trust:

- The grantor has a reversionary interest in either the corpus or the income therefrom and, as of the inception of that portion of the trust, the value of the interest exceeds 5% of the value thereof.[18]

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16 Treas. Reg. §1.672(f)-4(a)(2).

17 Treas. Reg. §1.672(f)-4(a)(1).

18 Code §673.

- The grantor has the power to control beneficial enjoyment of the income or corpus.[19]
- The grantor retains certain administrative powers, including the right to substitute property in the trust and the right to borrow from the trust on an interest-free basis.[20]
- The grantor has a power to revoke the trust so that all property reverts to the grantor.[21]
- The income of the trust is or may be distributed to, held for the future benefit of, or used to pay for life insurance on the life of the grantor, or the grantor's spouse.[22]

Question 11: Are the circumstances the same for a trust being treated as a grantor trust, when the person funding the trust is an N.R.N.C. individual?

No, the circumstances for a trust to be treated as a grantor trust are not the same when the person funding the trust is an N.R.N.C. individual. A trust will be viewed to be a grantor trust with an N.R.N.C. individual as grantor only in two circumstances:

- The foreign settlor, alone or without the approval of any person having an adverse interest, has the power to revoke the trust and be revested absolutely in the trust assets.[23] This power must exist for a total of 183 days or more during the trust's taxable year.[24]
- During the settlor's lifetime, the trust can make distributions to the settlor or the settlor's spouse, only.[25]

The higher threshold in the context of a foreign settlor is designed to prevent a double non-taxation scenario, where the assets of an irrevocable trust produce foreign income that is neither taxed in the U.S. nor in the country of residence of the settlor. This could exist if grantor trust status flowed from the retention of a minor administrative power, such as (i) the right to substitute assets of equal value or to control investment policy over the trust assets or (ii) the power to appoint additional beneficiaries or to remove beneficiaries.[26]

Question 12: How are a nongrantor U.S. domestic trust and its beneficiaries taxed?

A nongrantor trust is generally taxed like an individual. Taxable income is computed much the same way as for an individual, but with certain modifications.[27] One

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19 Code §674

20 Code §675.

21 Code §676.

22 Code §677.

23 Code §672(f)(2)(A)(i); Treas. Reg. §1.671(f)-3(a)(1).

24 Treas. Reg. §1.671(f)-3(a)(2).

25 Code §672(f)(2)(A)(ii); Treas. Reg. §1.671(f)-3(b).

26 An example appears in Rev. Rul. 69-70.

27 Code §641(b).

significant modification is that a nongrantor trust is entitled to deduct distributions paid from current year's income or required to be paid from such income to a beneficiary.[28] Distributions that are deductible for the trust generally are includible in the gross income of the beneficiaries.[29] The current year's income that is includible in the income of a beneficiary has the same character for the beneficiary as it had in the hands of the trust.[30] Thus, if the item is considered to be foreign-source income for the trust, it is foreign-source income for the beneficiary; if it is characterized as long term capital gain for the trust, it is similarly characterized for the beneficiary. In this manner, nongrantor trusts that distribute income on a current basis are treated as conduits between the trust and the beneficiary.

"When a nongrantor trust provides that the trustee may distribute income or capital, the trust is entitled to a deduction for the amount distributed, even if the distribution is allocable to capital for trust law purposes."

For U.S. income tax purposes, the amount that is deductible for the nongrantor trust and includible in the income of the beneficiaries generally is limited by the distributable net income ("D.N.I.") of the trust for the taxable year. D.N.I. generally means the taxable income of the trust, computed with adjustments.

Question 13: If a trustee designates a distribution as being made from capital, will that designation be respected for U.S. income tax purposes when the recipient is a U.S. resident or citizen?

No. The designation by the trustee is generally not given effect for income tax purposes. No matter how it is identified by the trustee, for U.S. income tax purposes, all distributions made to all beneficiaries are deemed to consist on a *pro rata* basis of all income and gains of the trust.

When a nongrantor trust provides that the trustee may distribute income or capital, the trust is entitled to a deduction for the amount distributed, even if the distribution is allocable to capital for trust law purposes. The deduction is limited to the trust's D.N.I. for the year. The recipient includes the amount received in income. As mentioned above, this amount has the same character as at the level of the trust. All distributions are deemed to come on a *pro rata* basis from all D.N.I. Thus, if the amount of the distribution exceeds D.N.I., the amount of the distribution included in income by the beneficiary is determined on a *pro rata* basis computed with reference to all amounts distributed during the year.[31]

To illustrate, assume a trust has D.N.I. of $100. It distributes $100 of income to certain beneficiaries and $300 of capital to other beneficiaries pursuant to the exercise of a discretionary grant to the trustee. If, pursuant to the exercise of the trustee's discretion, a U.S. beneficiary receives a $100 capital distribution, and foreign beneficiaries receive $100 of income distributions and $200 of capital distributions, the U.S. beneficiary is considered to have received $25 of income and $75 of capital for income tax purposes. That is because the $400 of capital and income is considered to be distributed *pro rata* to the recipients of all distributions during the year. The distribution to the U.S. beneficiary represents 25% of all amounts of income and capital distributed by the trust during the year. Consequently, 25% of the "capital distribution" is taxable for the U.S. recipient as income.

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[28] See Code §651(a) for current inclusion trusts; and Code §661(a) for other trusts.

[29] See Code §652(a) for current inclusion trusts; and Code §662(a) for other trusts

[30] Code §§652(b) and 662(b).

[31] Code §662(a)(2).

Question 14: If a U.S. domestic trust accumulates income that is distributed in subsequent years, will beneficiaries be subject to U.S. income tax when the accumulated income is distributed in a later year?

No. As a general rule, when a U.S. domestic trust accumulates income that is ultimately distributed in a later year, the beneficiaries will not be subject to U.S. income tax when the accumulated income is distributed.[32]

Question 15: If a non-grantor trust, other than a U.S. domestic trust, accumulates income that is distributed in subsequent years, will U.S. beneficiaries be subject to U.S. income tax when the accumulated income is distributed in a later year?

Yes. For U.S. beneficiaries receiving an accumulation distribution from a foreign trust, the tax rules are significantly more complex. U.S. tax law considers the beneficiaries to have "deferred" income in a foreign trust because income is earned in one year at the level of the trust, but the U.S. beneficiaries do not receive that income until it is distributed in a later year. This time gap is often referred to as a "deferral period." U.S. tax law provides that the beneficiaries must re-compute their tax for each of the years in the deferral period,[33] and the re-computation generally results in additional tax in each intervening year. That additional tax is deemed to be paid late, and it is subject to an interest charge payable to the Federal government.[34] The actual computation is significantly more complex than the foregoing description and a full description is beyond the scope of this article.

Question 16: What tests are applied for a non-grantor trust to be considered a U.S. domestic trust?

Generally, a trust is considered a U.S. domestic trust if it is subject to primary supervision by a U.S. court and all substantial decisions are made by U.S. persons.[35] Neither the residence of the trustee nor the law under which the trust is formed, by itself, controls the status of a trust as a domestic trust or a foreign trust. Consequently, a trust formed in New York can be viewed to be a foreign trust if either the court test or the control test is not met.

A trust meets the court test if a court within the U.S. is able to exercise primary supervision over its administration. Treasury regulations contain a safe harbor.[36] A trust is a domestic trust if it meets the following criteria:

- The trust instrument does not direct that the trust be administered outside the U.S.
- The trust in fact is administered exclusively in the U.S.
- The trust is not subject to an automatic migration provision, *i.e.*, a provision that provides that a U.S. court's attempt to assert jurisdiction or otherwise supervise the administration of the trust directly or indirectly would cause the

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32 Code §665(c).

33 Code §666.

34 Code §668.

35 Treas. Reg. §301.7701-7(a).

36 Treas. Reg. §301.7701-7(c)(1).

trust to migrate from the U.S. (but not if it applies only in the case of foreign invasion of the U.S. or widespread confiscation or nationalization of property in the U.S.).[37]

The control test requires that one or more U.S. persons (*e.g.*, a U.S. citizen, U.S. resident, or U.S. corporation)[38] have authority to control all substantial decisions of the trust.[39] The term "substantial decisions" means all decisions other than ministerial decisions (*e.g.*, bookkeeping, collection of rents, and the execution of investment decisions made by others[40]) that any person, whether acting in a fiduciary capacity or not, is authorized or required to make under the terms of the trust instrument or applicable law. These include decisions regarding

- whether and when to distribute income or principal;
- the amount of any distributions;
- the selection of a beneficiary;
- the power to make investment decisions;
- whether a receipt is allocable to income or principal;
- whether to terminate the trust;
- whether to compromise, arbitrate, or abandon claims of the trust;
- whether to sue on behalf of the trust or to defend suits against the trust;
- whether to remove, add, or replace a trustee; and
- whether to appoint a successor trustee or trustees.[41]

If either the court test or the control test is not met, a trust is considered a foreign trust.[42] The application of both tests depends on the terms of the trust instrument and applicable law.[43] The tests are applied daily, and a trust is a U.S. domestic trust on each day that it meets both tests.

<u>Question 17: For U.S. income tax purposes, must a U.S. domestic non-grantor trust charge rent to a beneficiary in connection with the occupancy of aa residence in the U.S.?</u>

No. A beneficiary that is allowed to reside in a residence owned by a U.S. domestic nongrantor trust on a rent-free basis does not have imputed income.[44] One U.S.

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37 Treas. Reg. §301.7701-7(c)(4).

38 Code §7701(a)(30).

39 Treas. Reg. §301.7701-7(d)(1)(ii).

40 *Id.*

41 Treas. Reg. §301.7701-7(d)(1)(ii).

42 Code §§7701(a)(30)(E) and 7701(a)(31)(B).

43 Treas. Reg. §301.7701-7(b).

44 *H.B. Plant v. Commr.*, 30 B.T.A.133 (1934), affd. 76 F.2d 8 (2d Cir. 1935), and *Alfred I. duPont Testamentary Trust v. Commr.*, 66 T.C. 1976, affd. 574 F.2d 1332 (5th Cir. 1978).

Supreme Court case[45] characterized this as an issue not to be pursued by the I.R.S.:

> It is not uncommon for parents to provide their adult children with such things as the use of cars or vacation cottages, simply on the basis of the family relationship. We assume that the focus of the Internal Revenue Service is not on such traditional familial matters.

Question 18: Would the answer differ if a nongrantor trust other than a U.S. domestic trust were to own the residence?

If the nongrantor trust is not a U.S. domestic trust (a "foreign trust"), the answer could be different. Code §643(i) provides, in pertinent part, that if a foreign trust directly or indirectly permits any U.S. person who is a beneficiary (or a person related to a beneficiary) to use the property without paying fair market compensation, the fair market value of the use of such property is to be treated as a distribution by the trust to the beneficiary. Under this rule, rent-free use of a residence (or below-market rent charged for the residence) could be treated as taxable income if and to the extent the foreign trust has D.N.I. In the context of this discussion, D.N.I. would likely arise from net income and gains from investments. It follows that if the foreign trust has neither D.N.I. for the current year nor undistributed net income ("U.N.I.") for past years, no tax can be imposed in connection with the deemed distribution. There is, however, a distribution from a foreign trust. That distribution must be reported by the U.S. beneficiary on Form 3520 with sufficient back-up information to demonstrate the absence of D.N.I. and U.N.I.

ESTATE TAX CONSEQUENCES FOR A FOREIGN SETTLOR

Question 19: If a U.S. domestic nongrantor trust were to hold the U.S. residence at the conclusion of the settlor's lifetime, will U.S. estate tax be due on the value of the property at that time?

Subject to certain exceptions discussed below, estate tax should not be due because the settlor will not own the property at the time of death. The estate of an individual decedent who is neither a citizen nor a resident of the U.S. is computed generally by taking into account only items connected with the U.S. that are owned at the time of death.[46] U.S. estate tax is generally imposed only with regard to items of U.S. situs property. As discussed above, in connection with gift tax in the context of an N.R.N.C. individual, examples of U.S. situs property include real estate located in the U.S., debt instruments and shares of stock issued by U.S. companies, and personal property located in the U.S. at the time of the decedent's death. The exception for I.P. under the gift tax regime generally does not apply to estate tax.

Question 20: In what circumstances can property, not actually owned by an N.R.N.C. individual, be included in his or her taxable estate in the U.S.?

There are several circumstances in which U.S. situs property may be included in the gross estate of an N.R.N.C. individual even though the property is owned by another.

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45 *Dickman v. Commr.*, 465 U.S. 330 (1984).

46 Code §2103.

<u>Lifetime Transfers Subject to Retained Right to Enjoy the Income or Appoint Persons Who Will Enjoy the Income</u>

U.S. situs property may be included in a U.S. taxable estate of an N.R.N.C. individual where the individual gave away property during lifetime but (i) continued to have a right to the income from the property or (ii) retained the right, either alone or in conjunction with any person, to designate the persons who can possess or enjoy the property or the income. Code §2036(b) causes shares of stock to be included in a taxable estate if the decedent transfers the stock but retains control over how the shares are voted. It does so by deeming such retention of the voting rights a retention of the enjoyment of the transferred property.

"A right to income generally would not exist if the trust agreement provides for a true exercise of discretion by an independent trustee."

Where either right exists, property transferred during life will be included in the decedent's estate unless the property was disposed of in return for adequate consideration in money or money's worth. A transfer by gift is not considered to be a transfer in return for adequate consideration in money or money's worth.

It is important to note that having a right to income is different from receiving income as a result of the exercise of discretion by an independent party. A right to income generally would not exist if the trust agreement provides for a true exercise of discretion by an independent trustee.[47] Consequently, if a trust is established for the benefit of all the family members of the settlor, including the settlor, it will not cause the trust assets to be included in the settlor's estate, so long as the trustee is independent and has the authority to determine who among the beneficiaries will benefit from the trust's income and gains.

While the foregoing rule is favorable, cases in the U.S. provide a clear warning that abuses will not be tolerated. A decedent will be viewed to have retained the right over income even though the trust agreement provides for the appearance of discretion in the trustee. U.S. courts have concluded that the presence of certain arrangements will cause the settlor to have the right to income or the power over income in the following circumstances:

- *<u>Hidden Retention</u>*: Where there is an agreement or understanding that the transferor would receive the income, the property will be included in the settlor's estate.[48] Even though the instrument of transfer might not give the transferor an interest, right, or power, a retention of that type of interest, right, or power may still be held to exist under a methodology that looks beyond the terms of the trust to extrinsic facts, such as the transferor's domination of the trustee or a "side agreement" with the trustee. Such an agreement may sometimes be inferred from the fact that the transferor actually received all or most of the income.

- *<u>Creditor Invasion</u>*: Where, under the law of creditors' rights, the settlor's creditors can reach the trust income to pay the settlor's debts, the settlor has been deemed to have the right over the income.[49] The settlor may spend borrowed money and refuse to make payments to creditors. If the creditors

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[47] *Commr. v. Irving Trust Co.*, 147 F.2d 946 (2d Cir. 1945); *Sherman v. Commr.*, 9 T.C. 594 (1947).

[48] Treas. Reg. §20.2036-1(a)(1)(ii).

[49] See in general, Rev. Rul. 77-378, 1977-2 C.B. 348.

can look to the trust for payment, the settlor is viewed to have an interest over the income of the trust.

- *Settlor as Trustee*: Where the settlor is the trustee of the discretionary trust, the settlor has retained sufficient power over the income to cause the property to be included in his or her estate.[50] A settlor of a trust has reserved a power in him- or herself, if the trust instrument confers that power on the trustee and also designates the settlor as trustee. Retention also exists in a case where the settlor names another as trustee, if the settlor has the power to remove the trustee from office and name him- or herself as successor trustee.

- *Discretion Limited by Enforceable Standard*: Where the trustee's discretion is limited by a standard that can be enforced by the settlor-beneficiary, the settlor is considered to have retained rights over the income. He can go to court to force the trustee to exercise discretion in favor of the settlor.[51]

Revocable Trusts and Trusts Over Which the Decedent Controls Enjoyment by Others

The taxable estate of an individual will include any interest in property transferred during life if enjoyment of the interest is subject, at the date of death, to change through the decedent's exercise of a power to alter, amend, revoke, or terminate.[52] At its simplest and most straightforward form, one example is a revocable trust whose assets may revert to the grantor by written notification to the trustee.

However, this provision also reaches non-beneficial powers. These include powers that affect the beneficiaries of a trust even if the power cannot be exercised in the donor's favor. Examples include a power to change the proportionate interests of a trust's remainder beneficiaries, the power to remove beneficiaries, and the power to add beneficiaries. These powers could subject an N.R.N.C. individual's U.S. situs property to estate tax, even if the settlor must act in conjunction with another person. Of course, if these powers are held solely by persons other than the decedent, property owned by a U.S. domestic nongrantor trust will not be subject to U.S. estate tax.

Question 21: If the U.S. domestic trust is a U.S. grantor trust for income tax purposes, will an N.R.N.C. grantor be subject to U.S. estate tax with regard to the real property owned by the trust at the conclusion of the grantor's lifetime?

Yes. If the U.S. domestic trust is a U.S. grantor trust for income tax purposes, an N.R.N.C. grantor will be subject to U.S. estate tax with regard to the real property owned by the trust at the conclusion of the grantor's lifetime. As mentioned previously, for the U.S. domestic trust to be a grantor trust for income tax purposes, the trust must be either revocable so that the property reverts to the settlor at the discretion of the settlor during the settlor's lifetime or the settlor and spouse are the only persons entitled to distributions during the settlor's lifetime. Each of these powers will cause the settlor to be subject to U.S. estate tax.

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[50] *U.S. v. O'Malley*, 383 U.S. 627 (1966).

[51] *Boardman Est. v. Commr.*, 20 T.C. 871 (1953).

[52] Code §2038(a)(1).

<u>Question 22: If the U.S. domestic trust is not a U.S. grantor trust for income tax purposes, could an N.R.N.C. settlor be subject to U.S. estate tax with regard to the real property owned by the trust at the conclusion of the grantor's lifetime?</u>

Yes. Even if the U.S. domestic trust is not a U.S. grantor trust for income tax purposes, an N.R.N.C. settlor could be subject to U.S. estate tax with regard to the real property owned by the trust at the conclusion of the grantor's lifetime. If the N.R.N.C. individual retains rights identified in either Code §§2036 or 2038, estate tax exposure can exist if the settlor retains powers over the enjoyment of the U.S. real property. To illustrate, a U.S. domestic trust may not be revocable and may provide that distributions can be made to persons other than the settlor and spouse during the settlor's lifetime. A U.S. domestic trust with those provisions is not a grantor trust. Nonetheless, the settlor might demand the retention of a power to appoint or remove beneficiaries or to defer the time when a beneficiary may become entitled to a share. Other settlors may wish to retain the right to receive the capital transferred to the trust, leaving the appreciation to the beneficiaries. To achieve the goal without clearly running afoul of Code §2038, the settlor lends to the trust on noncommercial terms. If the debt is not true debt, the settlor is not a lender. If not a lender, the settlor's relationship with the trust is unclear, at best.

CONCLUSION

An N.R.N.C. grantor of a U.S. domestic trust formed and funded to acquire assets held for the benefit of an adult child must carefully consider how income, gift, and estate taxes may be imposed at various times during the life of a trust. This includes the formation of the trust, the generation of income within the trust, and the demise of the settlor. Depending on the terms of the trust and the assets owned by the settlor and transferred to the trust, income tax, gift tax, and estate tax consequences must be considered, and the conclusions regarding income tax may not be consistent with the conclusions regarding gift and estate taxes. Merely because the settlor is not subject to gift tax on the formation of the trust or income tax during the lifetime of the trust, does not mean that estate tax will not be imposed at the conclusion of the settlor's life.

PROPOSED REGULATIONS ON NONDEVICE & ACTIVE BUSINESS REQUIREMENTS UNDER CODE §355

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Tags
Active Trade or Business Test
Code §355
Device
Per Se Test
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The I.R.S. recently issued proposed regulations (the "Proposed Regulations")[1] clarifying the application of the "device" prohibition and the "active business" requirement of Code §355. The Proposed Regulations will affect corporations and their shareholders that plan to distribute stock of controlled corporations in tax-free transactions under Code §355.

CORPORATE DISTRIBUTIONS

Generally, a distribution of assets from a corporation to its shareholders is a taxable event. The corporation recognizes gain to the extent the fair market value of the distributed property exceeds the corporation's adjusted basis.[2] For the shareholders, the distribution will be treated as a dividend to the extent of the corporation's earnings and profits.[3] The portion of the distribution that is not treated as a dividend is first applied against, and is used to reduce, the adjusted basis of the stock.[4] The excess amount is treated as a gain from the sale or exchange of property.[5]

Code §355 generally provides that, if certain requirements are satisfied, a distributing corporation ("Distributing") may distribute the stock, or stock and securities, of a controlled corporation ("Controlled") to its shareholders and security holders, without Distributing, its shareholders, or its security holders recognizing income, gain, or loss on the distribution. However, Code §355 does not apply to a distribution if the transaction is used principally as a device for the distribution of the earnings and profits of Distributing, Controlled, or both.[6] Numerous other requirements also must be satisfied for Code §355 to apply to a distribution. One such requirement is that Distributing and Controlled must each be engaged in the active conduct of a trade or business immediately after the distribution (the so-called active business requirement).[7]

As mentioned above, the Proposed Regulations deal with both the device prohibition and the active business requirement. For more on divisive D-reorganizations and the additional requirements under Code §355, please see our article "Tax 101: How to Structure a Corporate Division."[8]

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1 REG-134016-15, July 15, 2016.

2 Code §311(b).

3 Code §301(c)(1).

4 Code §301(c)(2).

5 Code §301(c)(3).

6 Code §355(a)(1)(B).

7 Code §355(a)(1)(C) and (b)(1)(A).

8 Elizabeth V. Zanet, "Tax 101: How to Structure a Corporate Division," *Insights*

DEVICE PROHIBITION

Generally, the determination of whether a transaction is used principally as a device will be made from all the facts and circumstances, including, but not limited to, the presence of certain device and nondevice factors.[9] The existing regulations specify three factors that are evidence of a device[10] and three factors that are evidence of a nondevice.[11]

The device factors are (i) a *pro rata* distribution, (ii) a subsequent sale or exchange of stock, and (iii) the existence of assets that are not used in a trade or business (the "nature and use of assets" factor).[12]

The nondevice factors are (i) the presence of a corporate business purpose, (ii) the fact that the stock of Distributing is publicly traded and widely held, and (iii) the fact that the distribution is made to certain domestic corporate shareholders.[13]

Although the device prohibition primarily targets the conversion of dividend income to capital gain, a device can still exist if there would be a recovery of stock basis in lieu of the receipt of dividend income, even if the shareholder's Federal income tax rates on dividend income and capital gain are the same.

The Proposed Regulations modify Treas. Reg. §1.355–2(d), which addresses transactions that are or are not a device. Specifically, the Proposed Regulations would revise (i) the nature and use of assets device factor and (ii) the corporate business purpose nondevice factor, and (iii) would add a *per se* device test.

Nature and Use of Assets

The preamble to the Proposed Regulations states that device potential will generally exist (i) if Distributing or Controlled owns a large percentage of gross assets that are not used in business operations ("Nonbusiness Assets"), as compared to the total assets, or (ii) if Distributing's and Controlled's relative percentages of these assets ("Nonbusiness Asset Percentages") differ substantially.

The Proposed Regulations would provide thresholds for determining whether the ownership of Nonbusiness Assets and/or differences in the Nonbusiness Asset Percentages for Distributing and Controlled are evidence of device. If neither Distributing nor Controlled has Nonbusiness Assets that comprise 20% or more of its total assets, the ownership of Nonbusiness Assets ordinarily would not be evidence of a device.[14]

Additionally, a difference in the Nonbusiness Asset Percentages of Distributing and Controlled ordinarily would not be evidence of a device if the difference is less than

10 (2015).

9 Treas. Reg. §1.355-2(d)(1).

10 Treas. Reg. §1.355-2(d)(2).

11 Treas. Reg. §1.355-2(d)(3).

12 Treas. Reg. §1.355-2(d)(2).

13 Treas. Reg. §1.355-2(d)(3).

14 Prop. Treas. Reg. §1.355-2(d)(2)(iv)(C)(1).

10% or if, in the case of a non-*pro rata* distribution, the difference is attributable to a need to equalize the value of the distributed stock and securities of Controlled and the consideration exchanged by the distributees.[15] Accordingly, the Proposed Regulations treat these circumstances as ordinarily not constituting evidence of a device.

Corporate Business Purpose

Under the Proposed Regulations, a corporate business purpose that relates to a separation of Nonbusiness Assets from one or more businesses, or from assets used in business operations ("Business Assets"), would not be evidence of a nondevice, unless the business purpose involves an exigency that requires an investment in, or other use of, the Nonbusiness Assets.[16] Under the Proposed Regulations, absent such an exigency, separations are treated as distributions used principally as a device.

"The Proposed Regulations add a per se device test, which provides that some nondevice factors can never overcome the device factors if the test is met."

Per Se Device Test

The Proposed Regulations add a *per se* device test, which provides that some nondevice factors can never overcome the device factors if the test is met.[17] The *per se* device test has two prongs:

- The first prong is met if Distributing or Controlled has a Nonbusiness Asset Percentage of at least 66.67%.
- The second prong is met if the Nonbusiness Asset Percentage of Distributing differs significantly from that of Controlled.

Specifically, the second prong is satisfied if any of the following three bands are met:

- Band One: One corporation's Nonbusiness Asset Percentage is 66.67% or more, but less than 80%, and the other corporation's Nonbusiness Asset Percentage is less than 30%.
- Band Two: One corporation's Nonbusiness Asset Percentage is 80% or more, but less than 90%, and the other corporation's Nonbusiness Asset Percentage is less than 40%.
- Band Three: One corporation's Nonbusiness Asset Percentage is 90% or more, and the other corporation's Nonbusiness Asset Percentage is less than 50%.

All of these bands represent cases in which the Nonbusiness Asset Percentages of Distributing and Controlled are significantly different.

Example

Distributing has Business Assets of $80 and Controlled has Business Assets of $105. Distributing also has $195 cash, which Distributing holds as a Nonbusiness Asset. Distributing contributes $5 to Controlled. Controlled retains the amount, and

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15 Prop. Treas. Reg. §1.355-2(d)(2)(iv)(C)(2).

16 Prop. Treas. Reg. §1.355-2(d)(3)(ii).

17 Prop. Treas. Reg. §1.355-2(d)(5).

the stock of Controlled is distributed *pro rata* among Distributing's shareholders. Distributing's Nonbusiness Asset Percentage is 70% (*i.e.*, $190/$270), and Controlled's Nonbusiness Asset Percentage is 4.5% (*i.e.*, $5/$110).

Analysis

The first prong would be met because Distributing has a Nonbusiness Asset Percentage of more than 66.67%. The second prong would be met because Distributing's Nonbusiness Asset Percentage is more than 66.67%, but less than 80%, and Controlled's Nonbusiness Asset Percentage is less than 30% (Band One). In this example, the distribution would, *per se*, be considered a device for the distribution of the earnings and profits of Distributing, Controlled, or both. Therefore, the distribution could not qualify for tax-free treatment under Code §355.

ACTIVE BUSINESS REQUIREMENT

Under the active business requirement, Distributing and Controlled must each be engaged in the active conduct of a trade or business immediately after the distribution.[18] To qualify, a corporation must conduct an active business throughout the five-year period ending on the date of the distribution, and within that period, it may not have directly or indirectly acquired the business in a transaction in which gain or loss was recognized.[19]

The Code does not currently provide a minimum or relative size requirement for an active business to qualify under Code §355(b). The Proposed Regulations would require the "Five-Year-Active-Business Asset Percentage" (*i.e.*, the percentage determined by dividing the fair market value of a corporation's "Five-Year-Active-Business Assets"[20] by the fair market value of its total assets with respect to the above-mentioned five-year period) of each corporation, Distributing and Controlled, to be at least 5% for the requirements of Code §355(a)(1)(C) and (b) to be satisfied with respect to a distribution.[21]

ANTI-ABUSE RULE

The Proposed Regulations also provide an anti-abuse rule.22 A transaction or series of transactions (such as a change in the form of ownership of an asset, an issuance, assumption or repayment of indebtedness, or an issuance or redemption of stock) would not be given effect if undertaken with a principal purpose of affecting (i) the Nonbusiness Asset Percentage of any corporation, in order to avoid a determination that a distribution was a device, or (ii) the Five-Year-Active-Business Asset Percentage of any corporation, in order to avoid a determination that a distribution does not meet the active business requirement. The transactions covered by the anti-abuse rule generally would not include an acquisition or disposition of assets

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18 Code §355(a)(1)(C), (b).

19 Code §355(b)(2)(B), (C), (D).

20 The Five-Year-Active-Business Assets of a corporation means its gross assets used in one or more businesses that meet the five year active business requirements of Code §355(b)(2). Prop. Treas. Reg. §1.355-9(a)(3).

21 Prop. Treas. Reg. §1-355-9(a).

22 Prop. Treas. Reg. §1-355-2(d)(2)(iv)(E).

(other than an acquisition from or disposition to a related person) or a transfer of assets between Distributing and Controlled.

MOVING FORWARD

The Proposed Regulations will become effective as of the date the final regulations are published in the Federal Register. The Proposed Regulations will not change current rules with respect to the transactions that occurred before the Proposed Regulations become final, but taxpayers should consider the proposed rules when planning a distribution intended to qualify under Code §355.

B.E.P.S. ACTION 7 – O.E.C.D. CALLS FOR IMPROVED INTERNATIONAL COORDINATION ON THE ALLOCATION OF BRANCH PROFIT

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Tags
Allocation
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P.E.
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INTRODUCTION

One of three July 4 releases, the O.E.C.D.'s *Additional Guidance on the Attribution of Profits to Permanent Establishments* is the sequel to the B.E.P.S. (Base Erosion and Profit Shifting) Project's consideration of how to prevent artificial avoidance of a permanent establishment ("P.E."). Now that the conditions for the existence of a P.E. have been reviewed and updated, the July 4 draft asks the critical questions of how much profit should be attributed to a P.E. and how this determination should be made.

THE JULY 4 DRAFT

The draft is a discussion draft in the truest sense, and it is clearly set out to elicit comments from stakeholders. Like other discussion drafts issued throughout the B.E.P.S. Project, it does not represent consensus between Member States and other participants. This means more consultation and drafting is needed to arrive at workable guidance.

If the draft asks more questions than it answers, this should really come as no surprise. Branch or P.E. profit is a slippery topic, chiefly because there is no consensus on which article of the O.E.C.D. Model Tax Convention should be referenced when determining the amount of branch profit, if any at all. To a great extent, the question of P.E. profit attribution is answered by the 2015 B.E.P.S. Action 7 Final Report, *Preventing the Artificial Avoidance of Permanent Establishment Status*, which clarifies the conditions for the existence of a P.E., and the O.E.C.D.'s 2010 *Report on the Attribution of Profits to Permanent Establishments*. The latter document establishes that O.E.C.D. transfer pricing guidance should be used to price inter-branch dealings and thereby attribute profit to a P.E. Not all countries follow this approach.

The discussion draft appears to highlight the potential for double taxation that may arise when countries (i) do not support the current version of Article 7 (as is the case for many countries that follow the U.N. Model Double Taxation Convention, such as India and China), (ii) have not concluded income tax treaties with current Article 7 language, or (iii) either reject or do not fully apply the 2010 Authorized O.E.C.D. Approach ("A.O.A.") of attributing profit to a P.E. The discussion draft calls for a more coordinated approach to the application of Article 7 and Article 9 of the O.E.C.D. Model Tax Convention, and does so by reference to five examples.

EXAMPLES

Example 1 involves a manufacturer with an associated sales agent constituting independent agent enterprise in a second country. The manufacturer has a dependent agent P.E. in the second country, where its customers are located. Critically, the manufacturer alone determines when to extend credit to customers, and it stores inventory until it ships the product to its customer in the second country. Under Article 9, the sales agent earns a sales commission and profit after deducting expenses other than advertising costs reimbursed by the manufacturer. All other profit accrues to the manufacturer. Under Article 7, the manufacturer's dependent agent P.E. has no risk, no assets, no capital, no people functions, and therefore no profit in the second country. The dependent agent P.E. recognizes all sales revenue from customers in the second country and has expenses of (i) compensation to head office for its functions and (ii) compensation to the dependent agent enterprise [in this example, the sales agent] for its sales function. This leaves the manufacturer's dependent agent P.E. with zero profit. The key question here is how and whether the finding of zero profit for the manufacturer's P.E. depends on the appropriate profit of the associated sales agent. Article 9 seems able to answer this critical question, while Article 7 and the A.O.A. are silent.

In a typical inbound case that we see in North America, a local subsidiary conducts the sales activity. Assuming that the activity causes the subsidiary to be a P.E. – the subsidiary is a dependent agent having the power to bind the foreign manufacturer – Example 1 suggests that the only profit that is taxable in North America is the profit of the subsidiary for acting as a sales agent. Even if the activity constitutes a P.E. for the foreign manufacturer, provided the manufacturer conducts no activity in North America, its manufacturing income is allocated to profits that are taxable in the home country. The sales profit is the arm's length commission of the dependent agent.

Example 2 shifts the responsibility for the credit risk management and collections function, as well as the warehousing and inventory management function, to the sales agent company. Inventory title remains with the manufacturer until the product is shipped to the customer. Under Article 9, these changes in facts give rise to a return to the manufacturer for its funding of the inventory held by the sales agent, and further increases the income and profit of the sales agent. The sales agent's commission goes up by an increase in its operating profit and an amount required to cover actual expenses taken on as a result of the shift in functions. The Article 7 analysis relies on the significant people functions concept to attribute the manufacturer's funding return to the assets physically held in the second country. The net profit result of the change in facts under the Article 7 analysis depends entirely on the funding return to the manufacturer.

Again, the North American inbound experience suggests that the calculation of a return to the P.E. might start from a distributor's return and be adjusted for different levels of receivables risk and inventory risk, leaving the residual to the manufacturer. The discussion draft's approach involves several more moving parts and analyses than North American experience might suggest, generally making for a more complicated and expensive policy to manage.

Example 3 substitutes an employee of the manufacturer for the affiliated sales agent in the second country. Article 9 does not apply to the relation between the manufacturer and its employee. Here, Article 7 deems the manufacturer's dependent agent P.E. to report a distributor's operating profit in the second country. The profit of the dependent agent P.E. in this example is roughly equivalent to the Article 9 result in Example 2.

This example is the beach-head scenario that many companies use as a second step to enter a market. After having over-extended a manufacturer's representative or other independent agent, an employee is sent to further develop the market. Usually it is the employer taxes that arise initially as a concern, as well as the employee's personal tax affairs for the time he or she spends earning income in the second country. This Article 7 result is an extreme outcome for one employee but is more practically problematic for companies that are used to having employees work remotely and/or independently across the globe.

Example 4 takes the same fact pattern but divides the credit analysis and receivables management functions between the manufacturer and the sales agent. This example illustrates the contrast between the results of an analysis of return to risk under Article 9 and Article 7. While Article 9 allocates the return to the credit and receivables risk using a contingent approach, Article 9 apportions returns by relative contributions from those people performing the risk management function. This example illustrates the difference between the current O.E.C.D. transfer pricing approach and an older approach that is geared more toward attaching returns to functions.

"This discussion draft is one of the most tentative of all the B.E.P.S. outputs, suggesting that significant work is required to arrive at consensus guidance."

Example 5 contrasts the results of an Article 7 analysis referencing the O.E.C.D. A.O.A., using a company that specializes in providing spare parts, warehousing, and inventory management services to customers in a second country and that uses a building owned by the company in the "home" country. Three variations of this fact pattern are presented: (i) the company provides warehousing services as its core business, (ii) the company performs warehousing functions but purchases spare parts for resale to aeronautical industry customers, and (iii) the company uses a third-party contractor to operate the warehouse, rather than its own people as in (ii).

The approach posited by the discussion draft in the first of these scenarios is an arm's length return for warehousing services, less expense allocations or charges for workforce cost, know-how and operation software use, warehouse operations and investment advice, property depreciation, and acquisition funding expense. The pricing solution in the other two scenarios is suggested to be an arm's length return on the capital asset, less the cost of investment advice and acquisition funding. This example will test the limits and conditions for the reliance on returns on assets and risks as compared to the returns on assets connected to significant people functions prescribed by the O.E.C.D. A.O.A.

CONCLUSION

Though it should be expected that Action 7 guidance, like other B.E.P.S. transfer pricing outputs, will proceed swiftly to conclusion, this discussion draft is one of the most tentative of all the B.E.P.S. outputs, suggesting that significant work is required to arrive at consensus guidance. If implementation of treaty amendments is recommended to better coordinate the application of P.E. and A.O.A. guidance, the proposed O.E.C.D. Multilateral Instrument mechanism and its attendant sovereignty issues will need to be considered.

CROWDFUNDING: A POPULAR WAY TO INVEST, BUT WATCH OUT FOR TAXES

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Tags
Claim of Right Doctrine
Code §61
Code §102
Code §118
Code §721
Constructive Receipt Doctrine
Crowdfunding

INTRODUCTION

Crowdfunding is a relatively recent, internet-based form of raising capital for businesses and other endeavors. While millions of dollars are raised each month through crowdfunding, it is likely that both the providers and the recipients of the amounts raised have not given much thought to the tax consequences of crowdfunding. Sometimes, the recipients of crowdfunding cash may receive a Form 1099-K, *Payment Card and Third Party Network Transactions*, and may be confused about what to do with it. The Internal Revenue Service (the "I.R.S.") recently issued Information Letter 2016-0036 (June 24, 2016) to address the tax treatment of crowdfunding. As discussed below, in the letter, the I.R.S. noted that there are many ways that crowdfunding arrangements can be characterized, depending upon the "facts and circumstances" of each case, and each case can have very different tax implications for the parties.

Crowdfunding is popular because it provides greater access to nontraditional funding sources. In the past, if a person wanted to raise capital to start a business or launch a new product, that person would market his or her business plan to a limited pool of wealthy individuals or institutions. These funding sources included banks, angel investors, and venture capital firms. Thus, the number of key investors was limited.

Crowdfunding is a method of raising capital primarily online, via social media and crowdfunding platforms, that leverages the collective network for greater reach and exposure. By opening the pool of potential investors to anyone having the use of the internet, crowdfunding opens up investing to nearly anyone while also streamlining the traditional investment model.

TYPES OF CROWDFUNDING

Crowdfunding websites, such as kickstarter.com and indiegogo.com, have increased in popularity over the last few years. On these platforms, "creators" or "initiators" of a fundraising campaign seek "contributors" or "backers" to finance their projects. Other sites, such as gofundme.com or causes.com, feature fundraising campaigns for personal or charitable endeavors. There are a variety of crowdfunding arrangements, which may be distinguished by the products or services offered and the goals of the fundraising. The three primary types of crowdfunding are donation-based, rewards-based, and equity-based crowdfunding.

Donation-Based Crowdfunding

Donation-based crowdfunding campaigns provide no financial return to the contributors. Common donation-based crowdfunding initiatives include fundraising for disaster relief, charities, nonprofits, and medical bills.

Rewards-Based Crowdfunding

Rewards-based crowdfunding involves individuals contributing to a business in exchange for a "reward." This generally entails receiving a form of the product or service that the company offers. Even though this method offers backers a reward, it is still generally considered a subset of donation-based crowdfunding since there is no financial or equity return. This approach is a popular option used by Kickstarter and Indiegogo, since it lets business owners incentivize their contributors without incurring significant extra expense or selling ownership shares in their businesses.

Equity-Based Crowdfunding

Equity-based crowdfunding allows contributors to become part-owners of a company by investing capital in exchange for equity shares. As equity owners, the contributors receive a financial return on their investment by ultimately receiving a share of the profits in the form of a dividend or distribution.

Alternative Funding: Traditional Lending Through a Non-Traditional Medium

While generally not considered to be crowdfunding, lending is always an option for raising needed capital, with the lender receiving a fixed repayment of the money that was advanced and an additional return in the nature of interest. The scope of available lenders has greatly expanded with the use of the internet.

For example, any person may advance $100,000 to a new business as a loan. Interest on the unpaid principal of the loan at a 10% rate (or $10,000) would be due every year and the unpaid principal on the loan (or $100,000) would be due five years after the loan is made. Since the money is advanced as a loan, repayment of the loan has priority over any amounts due to a shareholder or other equity investor in the company. However, unlike an equity owner in the business, such lender does not share in the financial success of the business.

TAX CONSEQUENCES

Gross Income

Kickstarter and Indiegogo mention potential taxation on their webpages, but neither provides definitive information on reporting crowdfunding income and paying taxes. Indiegogo simply notes that taxing authorities may classify funds raised on its site as taxable income of the campaign owner and any beneficiary.[1] Kickstarter states that it cannot give tax advice, but it indicates that in the United States funds raised through campaigns on Kickstarter will generally be considered income.

Internal Revenue Code ("Code") §61(a) provides the general rule that, except as otherwise provided in the Code, gross income includes all income, from whatever source derived. Gross income includes all accessions to wealth, whether realized in the form of cash, property, or other economic benefit. However, some benefits that a taxpayer receives are excludable from income, either because they do not meet

1 See, Indiegogo's "Terms of Use," available at indiegogo.com.

the definition of gross income or because the law provides a specific exclusion for certain benefits that Congress chooses not to tax.

In Information Letter 2016-0036, the I.R.S. indicated that money received is generally included in gross income by the recipient unless any of the following facts exists:

- There is an offsetting liability (such as a repayment obligation) that makes the arrangement into a loan.
- There is a capital contribution to the entity in exchange for an equity interest in the entity.[2]
- The money is a gift made out of detached generosity and without any "quid pro quo."[3]

"Crowdfunding revenues must generally be included in income to the extent they are received for services rendered or are gains from the sale of property."

The I.R.S. noted that the facts and circumstances of a particular situation must be considered to determine whether the money received in a given situation is income.

As a result, crowdfunding revenues generally are includible in income if they are not

- loans that must be repaid,
- capital contributed to an entity in exchange for an equity interest in the entity, or
- gifts made out of detached generosity and without any "quid pro quo."

In addition, crowdfunding revenues must generally be included in income to the extent they are received for services rendered or are gains from the sale of property.

Gifts

Code §102(a) excludes gifts from the definition of income, but the Code is silent as to what constitutes a gift. A gift is generally defined for U.S. Federal income taxes as an amount transferred out of "detached and disinterested generosity."[4] Gift treatment would be disallowed where the reward has a value approximately equal to or greater than the contribution in return for the payment.[5] Therefore, amounts received in a rewards-based crowdfunding campaign that promises a reward that has some value is unlikely to be considered a non-taxable gift.

Non-Shareholder Contribution to Capital

In the case of corporations, Code §118 allows certain receipts to be treated as nontaxable contributions to capital by a non-shareholder. If the creator operates the activity as a corporation and the backer receives no reward, certain requirements must be met for the contribution to be treated as a non-shareholder contribution to capital. In *Chicago, Burlington & Quincy R.R. Co.*,[6] the Supreme Court required that

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[2] While not stated in the letter, the applicable Code section providing for nonrecognition of income would be either Code §118 in the case of a corporation or Section §721 in the case of a partnership.

[3] While not stated in the letter, the applicable Code section providing for nonrecognition of income would be Code §102.

[4] *Commr. v. Duberstein*, 363 U.S. 278 (1960).

[5] *U.S. v. American Bar Endowment*, 477 U.S. 105 (1986).

[6] *Chicago, Burlington & Quincy R.R. Co. v. Chicago*, 412 U.S. 401 (1973).

the contribution meet five factors:

- It must become a permanent part of the transferee's working capital structure.
- It may not be compensation for services rendered (or presumably for products received).
- It must benefit the transferee commensurately with its value.
- It ordinarily will be used to produce additional income.
- It must be bargained for.

While a crowdfunding contribution may meet some of the criteria, the last factor may be difficult to meet. Due to the nature of a crowdfunding campaign, creators simply post a project and hope backers will choose to contribute. Kickstarter will not provide backer information to a creator until after a project is funded and contributions are received by the creator, so negotiation is not possible.

Timing of Income – Constructive Receipt & Claim of Right Doctrines

Treasury Regulation §1.451-2 contains the constructive receipt doctrine. For income that is not actually in the taxpayer's possession, this regulation provides that income is constructively received by the taxpayer in the tax year during which it is credited to its account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time. Alternatively, income is constructively received if the taxpayer could have drawn upon it during the tax year if notice of intention to withdraw had been given. Treas. Reg. §1.451-2 further provides that income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. However, a self-imposed restriction on the availability of income does not legally defer recognition of that income. Thus, for the taxpayer, the income tax result of a crowdfunding effort depends on all the facts and circumstances surrounding that effort.

Amounts received by a taxpayer under a claim of right that gives the taxpayer complete control over the amounts are also included in gross income, even though the taxpayer may have to return the income. There is no statutory provision setting forth the claim of right doctrine, which has been established by case law. In *North American Oil Co. v. Burnet*,[7] the Supreme Court laid down the foundation for this doctrine. For the income to qualify as being received, there must be a receipt of cash or property that ordinarily constitutes income rather than loans or gifts or deposits that are returnable, the taxpayer needs unlimited control on the use or disposition of the funds, and the taxpayer must hold and treat the income as its own.

Both Kickstarter and Indiegogo warn backers that the websites do not guarantee the completion of the project or the delivery of the reward. This means that once creators receive the funds, they have complete control over them, even if they do not complete the project and deliver the reward. Based on the claim of right doctrine, this income may be taxable in the year of receipt regardless of the creator's accounting method.

Creators can have a timing problem, however, if the income is taxable in one year but the related expenses, which usually would be incurred after completion of a

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7 *North American Oil Co. v. Burnet*, 286 U.S. 417 (1932).

campaign, are not deductible until the following year. This can create cash flow problems for the creator that could affect the creator's ability to complete the project. To address this issue, creators may plan to end their campaigns early in the year, so that some, if not all, of the expenses of their projects will be incurred during the same year.

CONCLUSION

The tax treatment of crowdfunding arrangements can materially affect the economics of such arrangements. Information Letter 2016-0036 highlights the need for parties to crowdfunding arrangements to carefully review the resulting tax treatment and properly document the arrangement to limit the exposure to an I.R.S. examination. While this letter is the first I.R.S. announcement on the subject, the complexity and uncertainty surrounding such arrangements will require additional I.R.S. guidance. In the meantime, parties in these arrangements may want to discuss the above-described issues with their tax advisors before they decide to invest so that the intended economic benefit is not diluted by unplanned tax consequences.

"For the taxpayer, the income tax result of a crowdfunding effort depends on all the facts and circumstances surrounding that effort."

$3.1 BILLION SCAM – HIJACKED E-MAIL ACCOUNTS INVITE WIRE TRANSFER FRAUD

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Tags
Business E-mail Compromise
E-mail Hacking
Internet Crime Complaint Center ("IC3")
Wire Fraud

The Federal Bureau of Investigation ("F.B.I.") released a public service announcement ("P.S.A.") regarding what is known as the Business E-mail Compromise ("B.E.C."), a sophisticated scam targeting businesses working with foreign suppliers and/or businesses that regularly perform wire transfer payments.[1]

The B.E.C. scam is carried out by compromising legitimate business e-mail accounts through social engineering or computer intrusion techniques in order to conduct unauthorized transfers of funds. Most victims report using wire transfers as a common method of transferring funds for business purposes, although some victims also report using checks. The digital thieves use the method most commonly associated with their victims' normal business practices.

STATISTICAL DATA

The B.E.C. scam continues to grow, evolve, and target businesses of all sizes. Since January 2015, there has been a 1,300% increase in identified exposed losses.[2]

The scam has been reported by victims in all 50 states and in 100 countries. Reports indicate that fraudulent transfers have been sent to 79 countries, with the majority going to Asian banks in China and Hong Kong.

Combined Reporting

The following B.E.C. statistics were reported to the Internet Crime Complaint Center ("IC3") and are derived from multiple sources, including IC3 victim complaints and complaints filed with international law enforcement agencies and financial institutions:

Domestic and International Victims:	22,143
Combined Exposed Dollar Loss:	$3,086,250,090

IC3 Victim Complaints

The following B.E.C. statistics are derived from victim complaints to the IC3, in the period from October 2013 to May 2016:

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1 The article reproduces much of the information printed in F.B.I. alert no. I-061416-PSA, which can be seen online here.

2 Exposed dollar loss includes actual and attempted loss in U.S. dollars.

Domestic and International Victims:	15,668
Combined Exposed Dollar Loss:	$1,053,849,635
Total U.S. Victims:	14,032
Total U.S. Exposed Dollar Loss:	$960,708,616
Total Non-U.S. Victims:	1,636
Total Non-U.S. Dollar Exposed Loss:	$93,141,019

BACKGROUND

The victims of the B.E.C. scam range from small businesses to large corporations. Victims deal in a wide variety of goods and services, indicating that a specific sector does not seem to be targeted.

It is largely unknown how victims are selected. However, it is known that the subjects monitor and study their selected victims using social engineering techniques prior to initiating the B.E.C. scam. The subjects are able to accurately identify the individuals and protocols necessary to perform wire transfers within a specific business environment. Victims may also first receive "phishing" e-mails requesting additional details regarding the business or individual being targeted (*e.g.*, name, travel dates, etc.).

Some individuals reported being a victim of various Scareware or Ransomware cyber intrusions immediately preceding a B.E.C. incident. These intrusions can initially be facilitated through a phishing scam in which a victim receives an e-mail from a seemingly legitimate source that contains a malicious link. The victim clicks on the link, which downloads malware, allowing the actor(s) unfettered access to the victim's data, including passwords or financial account information.

The B.E.C. scam is linked to other forms of fraud, including but not limited to romance, lottery, employment, and rental scams. The victims of these scams are usually U.S.-based and may be recruited as unwitting money mules.[3] The mules receive the fraudulent funds in their personal accounts and are then directed by the subject to quickly transfer the funds to another bank account, usually outside the U.S. Upon direction, mules may open bank accounts and/or shell corporations to further the fraud scheme.

SCENARIOS OF B.E.C.

Based on IC3 complaints and other complaint data,[4] there are five main scenarios by which the B.E.C. scam is perpetrated.

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3 Money mules are persons who transfer money illegally on behalf of others.

4 Multiple source complaint data, not limited to IC3, describing the B.E.C. scam is dated as far back as 2009.

Scenario 1: Business Working with a Foreign Supplier

A business, which often has a long-standing relationship with a supplier, is requested to wire funds for invoice payment to an alternate, fraudulent account. The request may be made via telephone, facsimile, or e-mail. If an e-mail is received, the subject will spoof the e-mail request so it appears very similar to a legitimate account and would take very close scrutiny to determine it was fraudulent. Likewise, if a facsimile or telephone call is received, it will closely mimic a legitimate request. This particular scenario has also been referred to as the "Bogus Invoice Scheme," the "Supplier Swindle," and the "Invoice Modification Scheme."

"The B.E.C. scam is linked to other forms of fraud, including but not limited to romance, lottery, employment, and rental scams."

Scenario 2: Business [Executive] Receiving or Initiating a Request for a Wire Transfer

The e-mail accounts of high-level business executives (*e.g.*, C.F.O., C.T.O., etc.) are compromised. The account may be spoofed or hacked. A request for a wire transfer from the compromised account is made to a second employee within the company who is normally responsible for processing these requests. In some instances, a request for a wire transfer from the compromised account is sent directly to the financial institution with instructions to urgently send funds to bank "X" for reason "Y." This particular scenario has also been referred to as "C.E.O. Fraud," the "Business Executive Scam," "Masquerading," and "Financial Industry Wire Frauds."

Scenario 3: Business Contacts Receiving Fraudulent Correspondence Through Compromised E-mail

An employee of a business has his or her personal e-mail hacked. This personal e-mail may be used for both personal and business communications. Requests for invoice payments to bank accounts controlled by a digital thief are sent from the employee's personal e-mail address to multiple vendors identified from the employee's contact list. The business may not become aware of the fraudulent requests until the business is contacted by a vendor to follow up on the status of an invoice payment.

Scenario 4: Business Executive and Attorney Impersonation

Victims report being contacted by digital thieves, who typically identify themselves as lawyers or representatives of law firms and claim to be handling confidential or time-sensitive matters. This contact may be made via either phone or e-mail. Victims may be pressured by the digital thief to act quickly or secretly in handling the transfer of funds. This type of B.E.C. scam may occur at the end of the business day or work week and be timed to coincide with the close of business of international financial institutions.

Scenario 5: Data Theft

B.E.C. victims recently reported a new scenario involving the receipt of fraudulent e-mails requesting either all Wage or Tax Statement ("W-2") forms or a company list of Personally Identifiable Information ("P.I.I."). This scenario does not always involve the request for a wire transfer. However, the business executive's e-mail is compromised (either spoofed or hacked) and the victims are targeted in a similar manner as described in Scenario 2 of the B.E.C. scam. Fraudulent requests are sent utilizing a business executive's compromised e-mail. The entity in the business organization responsible for W-2's or maintaining P.I.I., such as the human resources department, bookkeeping, or auditing section, have frequently been identified as the targeted recipient of the fraudulent request for W-2's and/or P.I.I. Some of these incidents are isolated and some occur prior to a fraudulent wire transfer request. Victims report they have fallen for this new B.E.C. scenario, even if they were able to successfully identify and avoid the traditional B.E.C. incident. The data theft scenario of the B.E.C. first appeared just prior to the 2016 tax season.

CHARACTERISTICS OF B.E.C. COMPLAINTS

The IC3 has noted the following characteristics of B.E.C. complaints:

- Targets are predominantly businesses and associated personnel using open source e-mail accounts.
- Individuals responsible for handling wire transfers within a specific business are targeted.
- Spoofed e-mails very closely mimic a legitimate e-mail request.
- Hacked e-mails often occur with a personal e-mail account.
- Fraudulent e-mail requests for a wire transfer are well worded, specific to the business being victimized, and do not raise suspicions as to the legitimacy of the request.
- The phrase "code to admin expenses" or "urgent wire transfer" was reported by victims in some of the fraudulent e-mail requests.
- The amount of the fraudulent wire transfer request is business-specific; therefore, dollar amounts requested are similar to normal business transaction amounts so as to not raise doubt.
- Fraudulent e-mails received have coincided with business travel dates for executives whose e-mails were spoofed.
- Victims report that I.P. addresses frequently trace back to free domain registrars.

"Targets are predominantly businesses and associated personnel using open source e-mail accounts."

SUGGESTIONS FOR PROTECTION AND BEST PRACTICES

Businesses with an increased awareness and understanding of the B.E.C. scam are more likely to recognize when they have been targeted by B.E.C. digital thieves, and are therefore more likely to avoid falling victim and sending fraudulent payments.

Businesses that deploy robust internal prevention techniques at all levels (especially targeting frontline employees who may be the recipients of initial phishing attempts), have proven highly successful in recognizing and deflecting B.E.C. attempts.

Some financial institutions reported holding their customer requests for international wire transfers for an additional period of time to verify the legitimacy of the request.

The following is a compilation of self-protection strategies provided in the B.E.C. P.S.A.'s from 2015.[5]

- Avoid free web-based e-mail accounts. Establish a company domain name and use it to establish company e-mail accounts in lieu of free, web-based accounts.
- Be careful about what is posted to social media and company websites, especially job duties or descriptions, hierarchal information, and out-of-office details.
- Be suspicious of requests for secrecy or pressure to take action quickly.
- Consider additional I.T. and financial security procedures, including the implementation of a two-step verification process.
    - Out of Band Communication: Establish other communication channels, such as telephone calls, to verify significant transactions. Arrange this second-factor authentication early in the relationship and outside the e-mail environment to avoid interception by a hacker.
    - Digital Signatures: Both entities on each side of a transaction should utilize digital signatures. This will not work with web-based e-mail accounts. Additionally, some countries ban or limit the use of encryption.
    - Delete Spam: Immediately report and delete unsolicited e-mail (spam) from unknown parties. Do not open spam e-mail, click on links in the e-mail, or open attachments. These often contain malware that will give subjects access to your computer system.
    - Forward v. Reply: Do not use the "reply" option to respond to any business e-mails. Instead, use the "forward" option and either type in the correct e-mail address or select it from the e-mail address book to ensure the intended recipient's correct e-mail address is used.
    - Consider Implementing Two Factor Authentication ("T.F.A.") for Corporate E-mail Accounts: T.F.A. mitigates the threat of a subject gaining access to an employee's e-mail account through a compromised password by requiring two pieces of information to login: (i) something the user knows (a password) and (ii) something the user has (such as a dynamic P.I.N. or code).
- Beware of sudden changes in business practices. For example, if a current business contact suddenly asks to be contacted via their personal e-mail address when all previous official correspondence has been through company e-mail, the request could be fraudulent. Always verify via other channels that you are still communicating with your legitimate business partner.
- Create intrusion detection system rules that flag e-mails with domain names that are similar to the company's e-mail domain. For example, where the legitimate domain name of an e-mail address is abc_company.com, the system

[5] Additional information is publicly available in the U.S. Department of Justice website, www.justice.gov, publication entitled "Best Practices for Victim Response and Reporting of Cyber Incidents."

would flag a fraudulent e-mail from abc-company.com.

- Register all company domains that are slightly different than the actual company domain.
- Verify changes in vendor payment location by adding additional T.F.A., such as having a secondary sign-off by company personnel.
- Confirm requests for transfers of funds. When using phone verification as part of the T.F.A., use previously-known numbers, not the numbers provided in the e-mail request.
- Know the habits of your customers, including the details of, reasons behind, and amount of payments.
- Carefully scrutinize all e-mail requests for transfers of funds to determine if the requests are out of the ordinary.

WHAT TO DO IF YOU ARE A VICTIM

If funds are transferred to a fraudulent account, it is important to act quickly.

- Contact your financial institution immediately upon discovering the fraudulent transfer.
- Request that your financial institution contact the corresponding financial institution where the fraudulent transfer was sent.
- Contact your local F.B.I. office if the wire is recent. The F.B.I., working with the U.S. Department of Treasury Financial Crimes Enforcement Network ("FinCEN"), might be able to help return or freeze the funds.
- File a complaint, regardless of dollar loss, with the IC3.

"Victims should always file a complaint with the IC3 regardless of the dollar loss or timing of the incident."

When contacting law enforcement or filing a complaint with the IC3, it is important to identify your incident as "B.E.C." and provide a brief description of the incident. Consider providing the following financial information:

- Originating[6] name
- Originating location
- Originating bank name
- Originating bank account number
- Recipient[7] name
- Recipient bank name
- Recipient bank account number
- Recipient bank location (if available)

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6 The term "originating" is synonymous with the term "victim."

7 The term "recipient" is synonymous with the term "beneficiary."

- Intermediary bank name (if available)
- S.W.I.F.T. number
- Date
- Amount of transaction
- Additional information, if available, including F.F.C. (for further credit) and F.A.V. (in favor of)

Victims should always file a complaint with the IC3 regardless of the dollar loss or timing of the incident, and, in addition to the financial information, provide the following descriptors:

- I.P. and/or e-mail address of fraudulent e-mail
- Date and time of incidents
- Incorrectly formatted invoices or letterheads
- Requests for secrecy or immediate action
- Unusual timing, requests, or wording of the fraudulent phone calls or e-mails
- Phone numbers of the fraudulent phone calls
- Description of any phone contact to include frequency and timing of calls
- Foreign accents of the callers
- Poorly-worded or grammatically incorrect e-mails
- Reports of any previous e-mail phishing activity

Complaints may be filed with the IC3 online at www.IC3.gov.

ALTERNATIVE BASIS RECOVERY METHODS FOR CONTINGENT PAYMENT SALES

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Tags
Adjusted Basis
Installment Sale

INTRODUCTION

Basis recovery is important when a taxpayer sells property and recognizes gain over a period of time or when a taxpayer acquires property other than inventory that is used in a trade or business and wishes to depreciate or amortize the cost of the property over its useful life.

The U.S. applies special gain recognition rules when property is sold and at least one payment is received by the seller after the close of the selling year. When this occurs, gain is recognized under the installment method of accounting unless the taxpayer elects otherwise. This means that gain is recognized as payments are received. In addition to deferred recognition of gain, the installment method requires that basis generally be recovered at the same time gain is recognized. In that way, generally, neither will be "front loaded" by allocation to early payments.

To determine the portion of each payment that is allocated to gain, each payment is multiplied by the gross profit percentage ("G.P.P."). The G.P.P. is calculated in three steps:

1. The total consideration in the transaction is identified. Typically, this equates to the total sales price.
2. The consideration is reduced by the adjusted basis at the time of sale. This results in the gain.
3. The gain is divided by the total selling price.

Once the gain element in each payment is determined, the balance of the payment is recovery of basis.

When the price is contingent, meaning the aggregate selling price cannot be determined by the close of the taxable year in which the sale occurs, special methods apply for allocating the basis to payments called for in the sales transaction. Typically, the basis is allocated in equal amounts to all years in the payment schedule. Any amount received in a year that exceeds the basis allocated to the year is gain.

When the contract has neither a determinable maximum selling price nor a method to determine the time over which payments will be received, the contract will generally be closely scrutinized by the I.R.S. If sale treatment is still allowed, basis will be recovered in equal increments over a period of 15 years.[1]

In typical situations, basis recovery for property used in a trade or business is done by depreciating the total cost of the property over its useful life (as determined for

[1] Teas. Reg. §15a.453-1(c)(4).

tax purposes). However, when the asset used in a trade or business is a copyright or another item of intangible property, the typical basis recovery rules may distort net income because income is significantly front loaded while basis recovery is deferred.

NORMAL METHODS OF RECOVERY WHERE NO DISTORTION OF BASIS RECOVERY IS EXPECTED

Installment Sale – Maximum Selling Price Known

When the maximum selling price is stated or determinable based on the contract, the taxpayer generally allocates the basis in the property to each payment under the regular installment method as if the selling price was fixed, treating the maximum contract price as the selling price.

Installment Sale – Maximum Selling Price Unknown/Fixed Payment Period Known

When the maximum selling price cannot be determined before the end of the tax year in which the sale occurs, but the period over which payments will be made is known and is fixed, the taxpayer must generally allocate the basis over the fixed number of years determined in the contract in equal annual increments. This rule applies, for example, when the selling price is expressed as a fixed percentage of gross income over a fixed period of years, or when the selling price is fixed but denominated in a currency that is not the U.S. dollar.

"When the asset used in a trade or business is a copyright or another item of intangible property, the typical basis recovery rules may distort net income."

However, if the selling price incorporates a component that is not identical for all taxable years (*e.g.*, an increasing or decreasing percentage of gross income to be payable over the term of the contract), the basis recovery must take into account that component unless it is inappropriate to presume that the payments are likely to accord with the variable component.

No loss is allowed until the last year in the fixed payment period. When no loss is allowed, the unrecovered basis is carried forward to the next year.

Depreciation of Operating Assets – Income Forecast

The income forecast method is applicable to the recovery of basis in the form of depreciation or amortization deductions rather than as an installment sale. Under Code §167(g)(6), use of the income forecast method is limited to motion picture films and videotapes, sound recordings, copyrights, books, patents, and other property as specified by I.R.S. regulations. For these items of property, the revenue stream is front loaded. Because the revenue stream is not related to the useful life, application of typical depreciation or amortization rules is expected to result in a distortion of the taxpayer's income over time. In this case, the taxpayer may elect to use the income forecast method.[2] An election to use the income forecast method is made on a timely-filed return for the first year under the contingent payment agreement in which a payment is received.

Under the income forecast method, the taxpayer may estimate the total payments that are expected to be received over a ten-year period. In each year, the taxpayer

[2] Code §167(g).

may recover a greater or lesser portion of total basis in a manner that is synchronized with fluctuations in the receipt of income. The steps that are used to compute basis recovery in any year are as follows:

1. Determine the payment received in the tax year (excluding interest).
2. Determine the total payments (excluding interest) that are forecasted to be received under the contract.
3. Divide the payment for the year by the total forecasted income that will be generated by the asset.
4. Multiply the percentage determined in the third step by the original basis.

Note that the estimate of total payments may be changed at a later date if it is found to be substantially overestimated or underestimated due to circumstances occurring in that later year. Under a lookback rule, changes in the forecast of income will affect previously-claimed depreciation deductions. This affects the computation of tax for prior years. Interest will be due on underpayments of tax in prior years. Taxpayers are entitled to interest in the event depreciation was understated. No loss is recognized until the final payment year.

THE ALTERNATIVE METHOD TO AVOID SUBSTANTIAL DISTORTION

Although the income forecast method is limited to certain specified items of intangible property, a comparable method is permitted for other assets, provided I.R.S. approval is obtained. If a taxpayer can show that the use of the regular methods described above would substantially and inappropriately defer the taxpayer's basis recovery, the taxpayer may request the I.R.S. allow the use of an alternative method which will allow for a quicker recovery of basis.[3]

The taxpayer must receive a ruling from the I.R.S. before using the alternative method. The submission of the request for a ruling must generally be made before the due date for filing the return for the year in which the first installment payment is received (including extensions).

The request for the ruling to use the alternate method must be in accordance with all applicable procedural rules and any applicable revenue procedures relating to submission of ruling requests.[4]

The taxpayer must demonstrate that the normal methods will substantially and inappropriately defer the basis recovery. To demonstrate this, the taxpayer must show that

- the proposed method is a reasonable method; and
- under that proposed method, it is reasonable to conclude that recovery of basis will be at least twice as fast as under the regular methods.

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3 Treas. Reg. §15A.453-1(c)(7)(ii).

4 Rev. Proc. 2012-9, 2012-2 IRB 261.

A taxpayer's demonstration should be based on "contemporaneous or immediate past relevant sales, profit, or other factual data subject to verification." The I.R.S. generally only accepts projections if based upon a specific event that has occurred already.

An alternative method usually applies for all years in which payments are received. However, if facts change over the life of a contingent payment obligation, an alternative method may be instituted for a later year. Similarly, in cases where one of the normal methods was initially applied but during the term of the contract circumstances show that a continued use of the applied method will substantially and inappropriately defer the recovery of the basis, the taxpayer may apply for a ruling to allow a use of the alternative method.

An alternative method may also be applied without the taxpayer's request. If the I.R.S. finds that the normal basis recovery methods will substantially and inappropriately accelerate the basis recovery, it has the authority to require the use of an alternative method. In such cases, the alternate method must be used unless the taxpayer can demonstrate that

- the alternate method is unreasonable for ratable recovery; or
- under that method, it is reasonable to conclude that basis recovery will not be at least twice as fast as under the normally applicable methods.

A taxpayer's defense against an I.R.S. alternative method may be based on "contemporaneous or immediate past relevant sales, profit, or other factual data subject to verification," and in special cases where the I.R.S.'s consent was given, on a reasonable projection based on one or more events that have already occurred.

Example

T sells the stock of the X Corporation for $1.8 million in cash and the buyer's agree to pay T an amount equal to 1% of X's net profits in each of the next ten years. T's basis in the stock is $100,000 and the contract provides for adequate stated interest.[5] The maximum amount that may be paid to T (exclusive of interest) may not exceed $10 million.

Because the contract has a maximum selling price, under the normal method of recovery, the G.P.P. is 99% (the stated maximum selling price of $10 million less adjusted basis of $100,000, divided by the contract price of $10 million). This results in a recognized gain for the year of the sale of $1,782,000 (99% of the $1.8 million down payment) and a recovery of only $18,000 out of the total $100,000 basis.

However, if the taxpayer could demonstrate that the current and recent profits of X have approximated $2 million a year, and there is no reason to anticipate a major increase in the total profits during the next ten years, the taxpayer can expect that the selling price will total $2 million (1% of $2 million equals $20,000 for a total of $200,000 over 10 years, plus the first-year payment of $1.8 million). Therefore, the taxpayer can submit a ruling requesting the use an alternative method of recovery.

In the ruling request, T may propose to use a G.P.P. of 95% based on the excess of the expected selling price of $2 million over the adjusted basis of $100,000, divided

[5] Code §1274 related to debt instruments issued for property.

by the expected total price of $2 million). Under this method, T would recover $90,000 of the total $100,000 basis in the year of sale and 5% of each payment received up to a maximum of $10,000 over the next ten years. The I.R.S. should allow this request because T's proposed alternative method allows for a reasonable basis recovery which is at least twice as fast as under the normally applied method.

Recent Private Letter Rulings

In four very similar ruling requests, the I.R.S. approved the use of an alternative recovery method. The rulings deal with a merger where shareholders of the target corporation were paid a specified sum at closing and three additional payments in subsequent years. The subsequent payments were to be valued under a formula in which an agreed amount was specified (*viz.*, $X) but was to be adjusted by fluctuations in the value of the acquiring corporation's publicly-traded shares. As the shares increased or decreased in value from the acquisition date to the payment date, the installment payments would fluctuate, as well. As matters turned out, the acquiring corporation's stock price dropped in value immediately following the merger so that by the time the first deferred payment was due, it was reasonable to anticipate that the regular applicable basis recovery method would result in substantial and inappropriate basis recovery deferral – the initial payment at the time of the merger turned out to represent a greater percentage of overall considerations than originally forecast. The taxpayers timely applied for a ruling and the I.R.S. approved.[6]

The rationale of the I.R.S. was as follows:

- Code §453(a) provides that income from an installment sale is to be taken into account under the installment method of accounting.
- Code §453(j)(2) authorizes the I.R.S. to prescribe regulations providing for ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot be readily ascertained. The transaction involving the merger was just such a transaction, as the final price was adjustable based on share value fluctuations.
- Treas. Reg. §15A.453-1(c)(7)(ii) provides that a taxpayer may use an alternative method of basis recovery if the taxpayer is able to demonstrate, prior to the due date of the return including extensions for the taxable year in which the first payment is received, that application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis.
- To demonstrate that application of the normal basis recovery rule will substantially and inappropriately defer recover of basis, the taxpayer must show (i) that the alternative method is a reasonable method of ratably recovering basis, and (ii) that, under that method, it is reasonable to conclude that over time the taxpayer likely will recover basis at a rate twice as fast as the rate at which basis would have been recovered under the otherwise applicable normal basis recovery rule.

Based on share prices at the time of the first installment, the taxpayers in the ruling expected to receive substantially reduced payments. In support of its position, the taxpayer submitted a table indicating the basis recovery calculations that were

6 See, for example, P.L.R. 201626009, 06/24/2016.

used in the year of the sale, prepared under the assumption that share price would remain stable, and comparing that recovery schedule with an adjusted schedule based on the actual downward movement in share price. The following items were taken into account in the table:

- Beginning basis
- Amounts received/estimated to be received annually
- Annual basis recovery
- Ending basis
- Amount of basis deferred annually
- Percentage of total basis used annually

"As matters turned out, the acquiring corporation's stock price dropped in value immediately following the merger. . . . It was reasonable to anticipate that the regular applicable basis recovery method would result in substantial and inappropriate basis recovery deferral."

Under the facts, the I.R.S. ruled that the taxpayer's proposed alternative basis recovery method was a reasonable method of ratably recovering basis, and that the use of the proposed alternative method of basis recovery will result in basis recovery at a rate more than twice as fast as the rate at which basis would be recovered under the normal basis recovery rules. Accordingly, the taxpayer's use of the proposed alternative method of basis recovery was approved.

GERMAN-TRAINED LAWYER COULD NOT DEDUCT U.S. EDUCATIONAL EXPENSES

Author
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Tags
Code §162
Deductions
Educational Expenses

Under Internal Revenue Code ("Code") §162(a), taxpayers generally may deduct all the ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business. Treasury Regulations address the deductibility of educational expenses and the circumstances under which educational expenses are deductible, including if the education "maintains or improves skills required by the individual in his employment or other trade or business."[1]

However, not all eduction expenses paid or incurred by a working individual are deductible. Educational expenses are considered to be nondeductible personal expenditures[2] if they are incurred (i) in order to meet the minimum educational requirements for qualification in the individual's employment or other trade or business, or (ii) for education that is part of a program of study being pursued by the individual which will lead to qualification in a new trade or business.[3] Where either fact exists, it does not matter that the education may also assist in maintaining or improving skills.

In the recent case of *O'Connor v. Commr.*,[4] the taxpayer was a U.S. citizen who had studied law in Germany. In 2007, he completed the minimum requirements to become a member of the legal profession in Germany and obtained a German law license. During that year, he was living in the U.S., and at some point during the year, he took a job as a project manager of a residential building project in Utah.

In 2009, while still living in Utah, he began studying law at a law school in California. During the tax years involved in the case – 2010 and 2011 – he was not an employee of any company, and his tax return for each of those tax years did not include a Schedule C (Profit or Loss from Business), for any business operated by him.

In 2012, he received his juris doctor degree from the California law school, and in 2014 he passed the New York State bar examination. Sometime in 2014, he was also involved in investigating a *qui tam* legal action (*i.e.*, a whistleblower action). He filed a *qui tam* complaint in September 2014.

The taxpayer was married during the tax years in question and jointly filed U.S. Federal income tax returns with his wife for those years. On their tax returns for 2010 and 2011, they deducted the expenses of his juris doctor studies. The Internal Revenue Service (the "I.R.S.") disallowed the educational expenses under Treas.

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1 Treas. Reg. §1.162-5(a)(1).

2 Treas. Reg. §1.162-5(b)(1).

3 Treas. Reg. §§ 1.162-5(b)(2),(3).

4 An unpublished order of the 10th Circuit Court of Appeals (Docket No. 15-9006, June 28, 2016), published unofficially at 117 AFTR 2d 201,. affirming T.C. Memo. 2015-155.

Reg. §1.162-5 on the grounds that expenses were not incurred to maintain or improve skills required in his employment, he had been absent from work for more than a year, and the expenses were incurred while he was not employed or actively engaged in a trade or business.

In his case before the U.S. Tax Court (the "Tax Court"), the taxpayer asserted that because he had fulfilled the requirements to practice law in Germany, he had already met the minimum requirements of the trade of a legal professional. In fact, in light of his German qualifications, he could have been licensed in New York, even without a juris doctor degree. Further, he was active in "any" trade or business, as Code §162 requires, because he worked as a project manager and was involved in the *qui tam* action.

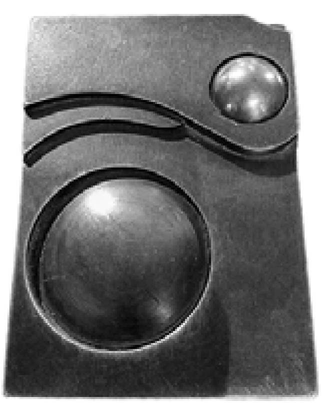
The I.R.S. asserted that he was not employed or engaged in a trade or business while attending law school (*i.e.*, during 2009 to 2012), and alternatively, that the expenses were incurred to meet the minimum educational requirements to qualify for a new trade or business.

The Tax Court determined that the disallowance should be sustained because (i) notwithstanding his German law license, he was not established in the legal profession in the U.S., and therefore his law school expenses were incurred in connection with entering into a new trade or business; and (ii) even if he were involved in project management and investigating a *qui tam* legal action in 2010 and 2011, he had not shown any connection between those activities and his U.S. legal education.

The taxpayer appealed the case to the appellate court, arguing that the Tax Court failed to consider his German law degree and improperly required a nexus between the educational expenses and his business activities.

The Court of Appeals for the Tenth Circuit disagreed and sustained the Tax Court's judgment. The court noted that a person who is admitted to practice law in one jurisdiction, but then incurs expenses to become qualified to practice in another jurisdiction, is considered to be entering a new trade or business.[5]

The taxpayer tried to argue that he was active in creating a new business model based upon his acquired knowledge of German law and German construction standards. However, the court dismissed the "new business-model" argument because it was based on facts not presented to the Tax Court.



Finally, the court stated that taxpayer's argument that the Tax Court improperly required him to show nexus between the educational expenses and his business activities made little sense. The primary requirement for deductibility under Code §162 is that the particular expense be an ordinary and necessary expense, which bears a proximate cause and a direct relationship to the taxpayer's trade or business. The taxpayer failed to meet the requirement.

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5 *Vetrick v. Commr.*, 628 F.2d 885, 886-87 (5th Cir. 1980); *Sharon v. Commr.*, 591 F.2d 1273, 1275 (9th Cir. 1978) (*per curiam*); see also *Levine v. Commr.*, 54 T.C.M. (CCH) 209 (1987); *Walker v. Commr.*, 54 T.C.M. (CCH) 169 (1987); and *Horodysky v. Commr.*, 54 T.C. 490, 492-93 (1970).

UPDATES & OTHER TIDBITS

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Tags
European Commission
FinCEN
I.T.I.N.
Real Estate
Spain
State Aid

FINCEN EXTENDS REQUIRED DISCLOSURES FOR ALL-CASH REAL ESTATE TRANSACTIONS

On July 27, 2016, the U.S. Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN") expanded the reach of previously published Geographic Targeting Orders ("G.T.O.'s").[1] These orders relate to possible money laundering in connection with purchases of U.S. real property when the purchaser uses no mortgage financing to fund the purchase.[2] The Treasury is concerned that individuals purchase U.S. real property in all-cash transactions to conceal the proceeds of unreported income and to hide the true identity of the owner.

The previous G.T.O. required U.S. title insurance companies to identify the "beneficial owners" of L.L.C.'s, partnerships, corporations, and other similar entities that purchase residential real property in certain geographical areas, in all-cash transactions in excess of specified thresholds. The new G.T.O adds other U.S. locations and sets a new expiration date of February 23, 2017.

The G.T.O. applies to both U.S. and non-U.S. entities.[3] While the G.T.O. targets all-cash purchases,[4] it does not include transactions where the purchase is made through bank financing, as the Treasury believes that enough information is disclosed in the mortgage application process. The G.T.O. also does not include transactions where a title insurance company is not involved or where the purchase is made via wire transfer.

The following table provides a listing of the applicable thresholds on a location-by-location basis:

State	Borough/County	Purchase Price
N.Y.	Manhattan	$3,000,000

1 The previous G.T.O. was effective as of March 1, 2016 and was set to expire on August 27, 2016. U.S. Department of the Treasury, FinCEN, *Geographic Targeting Order*, Jan. 13, 2016, §III(B).

2 U.S. Department of the Treasury, FinCEN, "FinCEN Takes Aim At Real Estate Secrecy in Manhattan and Miami," news release, Jan. 13, 2016.

3 U.S. Department of the Treasury, FinCEN, *Geographic Targeting Order*, July 22, 2016, §III(A)(1)(ii).

4 *Id.*, (2)(iv). An all-cash purchase includes purchases made using currency, a cashier's check, a certified check, a traveler's check, a personal check, a business check, or a money order in any form.

State	Borough/County	Purchase Price
N.Y.	Brooklyn, Queens, the Bronx, Staten Island	$1,500,000
T.X.	Bexar County	$500,000
C.A.	San Francisco County, San Diego County, San Mateo County, Santa Clara County, Los Angeles County	$2,000,000
F.L.	Broward County, Palm Beach County, Miami-Dade County	$1,000,000

When these thresholds are met, the title company must report the beneficial owner's identity if the individual owns, directly or indirectly, 25% or more of the equity interests of the purchasing entity.[5] Information about the title company, the purchasing entity, the identity of the purchaser's representative, and details about the actual transaction must also be provided.[6] This information is provided by title companies on FinCEN Form 8300, which must be filed within 30 days of the closing date of the purchase.[7]

Considering that the program was recently expanded, future expansions of the program are likely.

EUROPEAN STATE AID – SOCCER CLUBS TO PAY

On July 4, 2016, the European Commission found that seven Spanish soccer clubs (Real Madrid, FC Barcelona, Valencia, Athletic Bilbao, Elche, Hércules, and Altético Osasuna) had unlawfully received tax breaks and financial guarantees that constituted State Aid from Spain. The decision followed three separate inquiries that resulted in the Commission ordering Spain to recover over €30 million from the clubs.

The first investigation concerned tax privileges in favor of four soccer clubs which were granted a 5% reduction of their corporate tax rate for about 20 years. The unfair aid included "nonprofit" tax status.

The second inquiry concerned a land transfer between Real Madrid and the city of Madrid which was overvalued by more than €18 million. Lastly, the investigation concerned guarantees given by the state-owned Valencia Institute of Finance for loans taken by three soccer clubs which were not financially sound at the time.

Margrethe Vestager, European Commissioner for Competition, stated that these measures were taken to preserve a level playing field for the majority of professional

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5 U.S. Department of the Treasury, FinCEN, *Frequently Asked Questions*, Feb. 1, 2016, Question 2.

6 *Geographic Targeting Order*, July 22, 2016.

7 Form 8300 can be found here: https://www.irs.gov/pub/irs-pdf/f8300.pdf.

clubs who have to operate without subsidies. She further stated:

> Professional football is a commercial activity with significant money involved and public money must comply with fair competition rules. The subsidies we investigated in these cases did not.

"The European Commission found that seven Spanish soccer clubs . . . unlawfully received tax breaks and financial guarantees that constituted State Aid from Spain."

SPANISH DECISION TO PAVE THE WAY FOR HIGH-PROFILE RULINGS

The European Court of Justice ("E.C.J.") is due to rule on certain other Spanish tax break cases by the end of 2016. It is very possible that the Commission is waiting for the ruling before issuing decisions involving high-profile U.S. companies that have been the subject of State Aid investigations over the past several years. These companies include Apple, Amazon, and Starbucks.

In 2007, the Commission found that Spain was allowing tax breaks for Spanish companies investing in non-Spanish companies and opened an investigation. The inquiry concluded that these tax breaks constituted State Aid and that Spain must recover the illegal aid. The companies then appealed the Commission's ruling and the European General Court backed their arguments, concluding that the tax breaks were not "selective" and therefore were not illegal State Aid. The Commission appealed the decision in a case involving World Duty Free Group Holdings. The E.C.J. is expected to rule on this matter by the end of 2016.

Meanwhile, on July 28, 2016, Melchior Wathelet, the E.C.J. Advocate General ("A.G."), backed the Commission's appeal, arguing that the tax breaks offered by Spain to Spanish companies investing in non-Spanish companies were "selective" and therefore illegal, even if available to other companies.

While the A.G. opinion is non-binding, it is rarely not followed. The A.G.'s opinion stated as follows:

> Once a tax measure derogates from the 'normal' or reference tax regime and benefits undertakings performing the transactions in question to the detriment of others that perform similar transactions and are therefore in a comparable situation that measure is by definition discriminatory or selective unless the differentiation created by the measure is justified by the nature or general scheme of the system of which it forms a part.
>
> The fact that the conditions attached to the transactions covered by the derogatory tax measure are relatively easy to fulfill and that, for that reason, the benefits which that measure offers are available to a large number of undertakings does not call into question its selective nature but only the degree of selectivity.

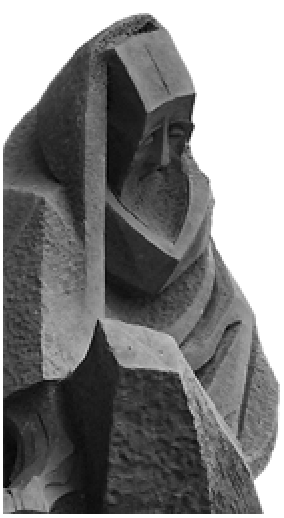
If the E.C.J. follows the A.G.'s opinion, the result may be detrimental to other companies facing State Aid inquiries, including the high profile U.S. companies Amazon, Apple, and Starbucks. Such a ruling could also offer the Commission an incentive to open new investigations for rulings that could be said to be based on State Aid.

I.R.S. ANNOUNCES LIMITED LIFE FOR I.T.I.N.'S – BUT ALLOWS FOR CONTINUED USE

In Notice 2016-48, the I.R.S. announced a procedure calling for invalidation of an Individual Taxpayer Identification Number ("I.T.I.N."). An I.T.I.N. is a nine-digit number issued by the U.S. Internal Revenue Service ("I.R.S.") to a nonresident, non-citizen ("N.R.N.C.") individual. It is used by foreign individuals who are required to have a U.S. taxpayer identification number for U.S. tax purposes but who are not eligible to get a social security number. An I.T.I.N. must be used when an N.R.N.C. individual is required to furnish a U.S. taxpayer identification number for one of several tax reasons. Examples include the following:

- An N.R.N.C. individual claims the benefit of a reduced withholding tax rate under an applicable income tax treaty.
- An N.R.N.C. individual is required to file a U.S. tax return or files a U.S. tax return in order to claim a refund.
- An N.R.N.C. individual files a document with the I.R.S. in relation to a real estate transaction that is subject to F.I.R.P.T.A. withholding tax.

Any tax adviser who has assisted an N.R.N.C. individual in obtaining an I.T.I.N. knows the difficulties encountered in the process. Although, the I.R.S. mandates the use of the I.T.I.N. in the circumstances described above and others, it recognizes that the use of the I.T.I.N. can have a legitimizing effect for an undocumented alien.



To the untrained eye, the I.T.I.N. resembles a social security number. To protect the integrity of the form, the process requires the submission of an original passport, an official copy of a passport that is certified by the issuing agency in the foreign country, or a photocopy of the passport that is certified at a U.S. embassy or consulate. If original documents are submitted, the announced policy of the I.R.S. is that the documents will be returned within 60 days. They will be mailed to the applicant's residence abroad. A prepaid Express Mail or courier envelope may be submitted for faster return delivery.

If an N.R.N.C. individual is physically present in the U.S., an in-person application may be submitted to an I.R.S. employee authorized to review and accept applications or to a community-based certified acceptance agent approved by the I.R.S. Individuals who apply in person will have their documentation returned once the in-person application is completed.

Many N.R.N.C. individuals are under the impression that, once the I.T.I.N. is obtained, the number is valid for life. Indeed, that was the original rule when the I.R.S. introduced the concept of the I.T.I.N. Then, in 2014, the I.R.S. announced that if an I.T.I.N. was not used for five consecutive years on a U.S. tax return, it would be invalidated. Nonetheless, this procedure for invalidation was never implemented because Congressional legislation, enacted in 2015, mandated automatic invalidation of an I.T.I.N.

In Notice 2016-48, the I.R.S. explained how it will apply the 2015 legislation. Regardless of when the I.T.I.N. was issued, any I.T.I.N. not used on a U.S. Federal tax return for three consecutive years will now be invalidated, unless renewed.

Furthermore, an I.T.I.N. issued prior to 2013 and used on a U.S. Federal tax return within each three-year cycle since issuance will be invalidated pursuant to the following schedule:

- If issued before 2008, it will be invalidated on January 1, 2017.
- If issued in 2008, it will be invalidated on January 1, 2018.
- If issued in 2009 or 2010, it will be invalidated on January 1, 2019.
- If issued in 2011 or 2012, it will be invalidated on January 1, 2020.

The I.R.S. intends to notify N.R.N.C. individuals by mail when invalidation will occur. The first batch of notices will focus on holders of an I.T.I.N. that has the number 78 or 79 in the fourth and fifth digits.

Having established a procedure for invalidation and the requirements for renewal, the I.R.S. made a surprising announcement: An invalidated I.T.I.N. may continue to be used on a U.S. tax return. Although, the I.R.S. cautions a delay in processing may occur and certain credits may be lost. In addition, an invalidated I.T.I.N. may continue to be used for information return purposes even after invalidation. However, if the individual is later required to file a U.S. tax return, the I.T.I.N. will have to be renewed at that time – subject, of course, to the preceding sentence. At some point, the I.R.S. will no longer accept returns using a terminated I.T.I.N.

Nonetheless, it remains curious that the I.R.S. has adopted an approach that will likely take years of education before awareness sinks in. After all, the I.R.S. could have modified Form W-8BEN to request a certification that an I.T.I.N. remained valid under the schedule outlined in Notice 2016-48. In addition, the I.R.S. could have announced the imposition of penalties for withholding agents that accept certifications with numbers having tainted fourth and fifth digits, such as 78 and 79. If the experience under F.A.T.CA. is any guide, financial institutions would have demanded new W-8BEN forms with renewed I.T.I.N.'s on an A.S.A.P. basis, thereby prompting taxpayer compliance.

"It remains curious that the I.R.S. has adopted an approach that will likely take years of education before awareness sinks in."

Two possible reasons come to mind. One view is that the more effective approach was considered but dropped after consultations with leaders in the financial services industry. An alternative view is that the I.R.S. is bound to follow the 2015 legislation. However, it has decided not to allocate a significant budget to the matter. Hence, the I.R.S. mandates renewal, but it will only enforce that renewal when a tax return is filed by an N.R.N.C. individual.

About Us

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

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

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

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

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