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INSIGHTS

SPANISH TAX IMPLICATIONS OF NONRESIDENT PRIVATE INVESTMENT IN SPANISH REAL ESTATE

GLOBAL EXCHANGE OF INFORMATION: HOW DOES THE U.S. FIT INTO THE PUZZLE? MEET THE U.S. FOREIGN TRUST

EUROPEAN STATE AID AND W.T.O. SUBSIDIES

AND MORE

Insights Vol. 3 No. 9

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EDITORS' NOTE

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

- **Spanish Tax Implications of Nonresident Private Investment in Spanish Real Estate.** Spanish real estate has become an attractive investment opportunity for those in search of high-quality real property at reasonable prices. Local knowledge of taxes is key for an unsuspecting, nonresident investor to avoid various tax traps. María Manzano, a partner specializing in tax at Altalex in Madrid, Spain, explains the main Spanish tax consequences that arise during the investment cycle of nonresident private investment in Spanish real estate.

- **European State Aid and W.T.O. Subsidies.** Recent European Commission rulings have attacked tax rulings granted by Ireland and the Netherlands to Apple and Starbucks, respectively. These rulings are not meaningfully different from those granted for decades by various E.U. Member States. To the shock of these countries, the tax rulings distorted trade. At the same time, the World Trade Organization ("W.T.O.") determined that several E.U. Member States have granted actionable subsidies to Airbus in order to assist the company in a way that distorts trade among W.T.O. members. Fanny Karaman, Stanley C. Ruchelman, and Astrid Champion explain (i) the basic internal procedures within the E.U. that outlaw State Aid and (ii) the applicable provisions of the global trade agreement embodied in the W.T.O. in connection with actionable subsidies. In light of the W.T.O. ruling, the question to be answered is whether the E.U. is being disingenuous by not recovering the European subsidies given to Airbus.

- **Regulations Would Address Foreign Tax Credit Planning for E.U. State Aid Adjustments.** Now that Apple, Starbucks, and other U.S. companies face significant tax adjustments in Europe, the I.R.S. is concerned with protection of the U.S. tax base. In Notice 2016-52, the I.R.S. announced that the foreign tax credit splitter rules will be applied in future regulations to ensure that the increased taxes are not separated from the earnings and profits to which they relate. Elizabeth V. Zanet and Stanley C. Ruchelman explain these preemptive steps to prevent the creation of imaginative financial products that monetize unused foreign tax credits of target companies.

- **O.E.C.D. Reaction to Research Tax Incentives – Acceptance with a Limitation Blocking Mobility.** Notwithstanding the war on State Aid within the E.U., the O.E.C.D. issued a Working Paper recognizing that the encouragement of R&D is an essential part of the development, innovation, and growth of an economy and that carefully tying incentives to the performance of R&D locally is not abusive. Philip R. Hirschfeld and Galia Antebi explain.

- **Global Exchange of Information: How Does the U.S. Fit into the Puzzle? Meet the U.S. Foreign Trust.** In the context of a model 1 I.G.A. under F.A.T.C.A., the U.S. undertakes certain reciprocal information exchanges. But reciprocal may not mean equal. This produces interesting results when a U.S. foreign trust is formed by a foreign individual. Galia Antebi and Nina

Krauthamer compare C.R.S. reporting and F.A.T.C.A. reporting in the context of a U.S. foreign trust that invests in U.S. assets producing tax-free income for a foreign investor.

- ***Estate of Bartell* Offers Taxpayer Relief in a Reverse Deferred §1031 Exchange.** Many countries provide a tax deferral benefit for property gains through the form of a reinvestment reserve. Although U.S. tax law does not provide reserves, it does permit a taxpayer to participated in a three-party exchange of properties that may offer deferral benefits that are comparable to a reserve. Most three-party exchanges involve a sale as the first step and a reinvestment of proceeds as the second step, but in some instances, the reinvestment may occur before the sale. The I.R.S. position on these reverse exchanges is that several enumerated hurdles must be overcome before tax deferral is allowed. However, as one recent U.S. Tax Court case demonstrates, the I.R.S. view is not the last word. Rusudan Shervashidze and Nina Krauthamer explain the holding in the case, place it in context, and suggest that it may offer hope for reverse three-party exchanges that do not meet I.R.S. guidelines.

- **Corporate Matters: Domestication of Non-U.S. Entities.** Although not allowed under New York law, a non-U.S. entity may transfer its corporate charter from a foreign jurisdiction to the state of Delaware and many other states. The process allows a non-U.S. entity to become subject to all of the provisions of state corporate law, and the existence of the corporation is deemed to have commenced on the date the non-U.S. entity was first formed. When the process is completed, the corporation is legally formed under U.S. state law. Simon Prisk explains.

- **Updates & Other Tidbits.** This month, the authors look briefly at several timely issues, including (i) the filing of appeals briefs in two major cases lost by the I.R.S., *Altera* and *Xilinx*, (ii) recent competent authority activity between the U.S. and India, (iii) the future of U.K. automobile assembly plants operated by U.K. subsidiaries of Japanese automakers, and (iv) final State Department rules concerning the revocation of U.S. passports issued to individuals who have a seriously delinquent tax debt. Kenneth Lobo, Michael Peggs, Nina Krauthamer, and Sultan Arab contribute.

We hope you enjoy this issue.

- The Editors

SPANISH TAX IMPLICATIONS OF NONRESIDENT PRIVATE INVESTMENT IN SPANISH REAL ESTATE

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Tags
Foreign Investment
Real Estate
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INTRODUCTION

As global stock markets remain erratic and interest rates stay low, the Spanish real estate market has become an attractive investment opportunity for those in search of high-quality real property at reasonable prices. Major cities, such as Madrid and Barcelona, and some coastal areas have experienced growing demand translating into rising prices. While price levels remain below those in comparable cities in other countries, institutional and private investors are taking notice.

For an investor planning an intricate structure to invest in Spanish real property, it is important to recognize that Spanish tax law adopts a substance-over-form approach when it comes to taxation. Tax plans devoid of sound commercial basis and adequate substance are at risk to challenge. To illustrate, corporate structures used in Spanish real estate investments may be challenged where a corporate entity that owns the real property or that finances its acquisition

- has entered into arrangements that keep it from being tax resident for income tax treaty purposes in the country where it is formed, or
- lacks sufficient economic substance, as it may be defined for this purpose.[1]

In any event, using a corporate structure to invest in real estate may be beneficial for certain taxes and not beneficial for other taxes. This is especially true for private investors acquiring residential properties. This article provides a brief summary of the main domestic tax consequences that arise during the investment cycle of nonresident private investment in Spain.

INDIRECT AND LOCAL TAXATION

The acquisition of new residential property is subject to V.A.T. at a rate of 10% and stamp duty at a rate ranging from around 0.5% to 2.0%, depending on the region where the property is located. If the property is acquired in a resale – *viz.*, the purchaser is not the first owner – the purchase will be exempt from V.A.T. but subject to real estate transfer tax ("R.E.T.T.") at a rate generally ranging from around 8% to 10%, again depending on the region and market value of the property; a lower tax rate may apply in some circumstances.

Property tax (*Impuesto sobre Bienes Inmuebles* or "I.B.I.") is calculated annually

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1 With respect to a private real estate structure held for personal use, no economic substance should be required. However, an arm's length rental payment should be made by the individual living in the property to a corporation that owns it.

on the property's cadastral value, which is assigned by the local authority and is generally lower than the acquisition or market value. I.B.I. is generally nominal and is paid to the local town.

INCOME AND CAPITAL GAINS TAX

For periods when the property is not leased out, nonresident individuals are subject to an annual nonresident income tax at a rate of 24% on imputed income, which is generally equivalent to 1.1% (or 2.0% in some cases) of the cadastral value. If the property is leased out, nonresident income tax will apply on the gross rental income. The 24% rate is reduced to 19% for residents of other E.U. Member States, as well as residents of Iceland and Norway. Residents of these countries can also deduct expenses so as to be taxed on a net income basis.

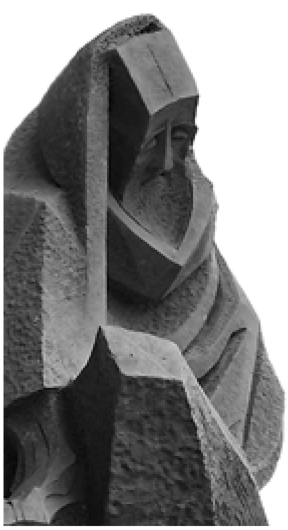
Entities that are resident in a tax haven[2] and that hold Spanish real estate are subject to a special 3% annual tax on the cadastral value of the property (or the value established for wealth tax purposes, if cadastral value is unavailable).

When properties are sold or transferred by nonresidents, a 19% tax is applied on any capital gains. In such cases, the buyer withholds 3% of the total consideration as payment on behalf of the nonresident seller. If this withholding exceeds the final tax amount owed, the nonresident can request a refund.

The withholding tax also applies to transfers of shares in companies located in a tax haven whose assets are mainly composed of Spanish real estate, whether directly or indirectly.

If the property being sold qualifies as the habitual abode of the taxpayer, the capital gain may be exempt from tax if he or she is a tax resident of Spain, another E.U. Member State, Iceland, or Norway, and if other specific requirements are satisfied. For the property to be considered the seller's habitual abode, the seller must generally have lived there for at least three years, except when marriage, divorce, or employment reasons required a change of domicile.

When urban property is sold or transferred, the increase in value of the land is subject to a tax known as *plusvalía municipal*. The amount payable depends on criteria such as the cadastral value and the number of years the property has been held. The tax is paid by the seller to the local town.



WEALTH AND INHERITANCE TAXES

Wealth tax is payable on the value of assets located in Spain, less Spanish liabilities. Nonresidents are subject to general tax rules, while residents of Spain or another E.U. Member State may be subject to the rules applicable in the region where the property is located. Madrid, for example, grants a complete rebate on wealth tax to its residents.

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2 See the list of tax haven countries or territories as established by Royal Decree 1080/1991, as amended. The list of tax haven countries in relation to Spain is published in a special edition of *Insights*, "Outbound Acquisitions: Holding Companies of Europe – A Guide for Tax Planning or a Road Map for Difficulty?" at page 114.

Wealth tax applies annually at progressive rates ranging from 0.20% to 2.75%, which is the marginal rate for net wealth exceeding €10.7 million. For E.U. residents, the applicable rules and tax rates may differ slightly depending on the region in which the property is located. The first €700,000 of net wealth (€500,000 in some regions) are generally tax exempt. Also exempt is the first €300,000 of the taxpayer's habitual abode. This amount varies depending on the region.

For wealth tax purposes, the tax base for real estate will be the greater of

- the consideration paid for the property,
- the cadastral value, and
- the value assigned by the authorities for other tax purposes.

Debt financing can reduce the net wealth base, resulting in lower effective taxation. This will be the case only if the loan proceeds are used to acquire or improve the property and not to finance other investments.

For inheritance tax purposes, the fair market value of real property on the transfer date is taxed at progressive rates of up to 34%. Effective taxation depends on several factors, including an E.U. resident's ability to apply the rules of the region where the property is located or where the deceased was resident. Again, the tax base can be reduced if a loan has been used to acquire or improve the property.

CORPORATE STRUCTURES

Aside from the benefits of increased privacy and limited liability, property ownership through a corporate structure can offer tax advantages. Those advantages are available only if the structure has appropriate substance and was established mainly for commercial purposes, not merely for tax reasons related to holding the real estate.

In terms of indirect taxation, if the property is acquired by a Spanish company during the course of conducting an appropriate business – *e.g.*, the company owning the property is engaged in real estate development activities and meets other criteria – R.E.T.T. may apply at a low rate. Alternatively, R.E.T.T. may not apply at all if the V.A.T. exemption on second or subsequent acquisitions is waived and the seller is registered for V.A.T. purposes. Such purchases would be subject to stamp duty and V.A.T. through a self-assessment mechanism, and V.A.T. may be fully or partially relieved. In comparison, R.E.T.T. leads to higher acquisition costs.

The acquisition of more than 50% of the shares in a Spanish or foreign company could be subject to indirect taxation in the form of R.E.T.T. or V.A.T., if Spanish real estate directly or indirectly comprises at least 50% of the fair market value of the target company's assets.

In relation to capital gains taxation, several double tax treaties concluded by Spain grant exclusive taxing rights to the investor's country of residence. Most of Spain's treaties follow paragraph 4 of Article 13 (Capital Gains) of the O.E.C.D. model tax convention,[3] meaning that taxation rights are generally granted to the country in

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[3] O.E.C.D., *Model Tax Convention on Income and on Capital: Condensed Version 2014*, (Paris: O.E.C.D. Publishing, 2014).

which the underlying real estate is located. In relation to wealth taxation, nonresident individuals may not be shielded from Spanish wealth tax even if the Spanish real estate is held through a Spanish or foreign corporate structure. For example, Spanish wealth tax is applicable to individuals who reside in Russia, France, Germany, or the U.K. that directly or indirectly own Spanish real property.

Entities resident in a tax haven or other low-tax jurisdiction whose assets are mostly comprised of Spanish property can be deemed tax resident in Spain. Likewise, the right to tax capital gains arising from sales of shares in real-estate-rich companies is rarely granted to the country of residence of the ultimate investor or the transferor of the Spanish or foreign shares.

"Property ownership through a corporate structure can offer tax advantages . . . if the structure has appropriate substance and was established mainly for commercial purposes."

If the property is owned through a corporate structure, and Spain retains the right to imposed wealth tax on the shares in a company that holds mainly real property, the tax basis for wealth tax purposes will either be the net equity value of the company reported on financial statements reviewed by a statutory auditor or the highest of the following three values:

- The net equity value
- The nominal value of the shares
- The value derived when the average profits or losses of the previous three years are multiplied by a factor of five

Debt obligations incurred to finance the investment typically reduce the equity amount and interest on those obligations reduce the profit and losses during the three-year period. In either event, the effective taxation under the wealth tax regime would be lowered.

For income tax purposes, E.U. residents and residents of Iceland and Norway are entitled to deduct expenses directly linked to the income generated from the real property. As mentioned above, those residents may be subject to a 19% tax rate on net income. If the property is held through a Spanish entity, taxation on net income would be at a rate of 25% and withholding tax would likely apply to distributions. Conversely, if the property is not leased out and is held by a Spanish company, the imputed taxable income in relation to individuals – generally 1.1% of the cadastral value mentioned earlier – would not apply. The *plusvalía municipal* will only apply to gain derived from the direct sale of real property. This tax does not apply to gain on the sale of shares of the company.

As mentioned above, the transfer of Spanish shares to heirs would be subject to inheritance tax at progressive rates of up to 34% of their fair market value. Again, effective taxation could be reduced by a debt obligation incurred by the Spanish company, provided that the proceeds of the debt obligation were used to finance the real estate investment. In comparison, the transfer of shares in a foreign company may escape Spanish inheritance taxation under certain circumstances.

Regarding inheritance planning, trusts are not recognized under Spanish law and Spain does not adhere to the Hague Convention of July 1, 1985 on the Law Applicable to Trusts and on Their Recognition. Consequently, the use of a trust to hold real property may cause problems from a practical legal and tax standpoint. Relatively little jurisprudence and doctrine exist regarding the taxation of trusts, resulting in uncertainty. The Spanish Tax Authorities (*Dirección General de Tributos*) have issued rulings to taxpayers indicating that trusts generally should be disregarded for Spanish tax purposes and that transactions should be treated as if taking place directly between the settlor and the beneficiaries. In any event, trusts should be analyzed on a case-by-case basis.

CONCLUSION

In light of recent increases in the value of Spanish real property, acquisition tax planning is again of interest to potential investors from outside Spain. While income taxation of gains may not be reduced through structure planning, inheritance tax and wealth tax may be reduced through the use of a foreign corporation that is based in a tax treaty jurisdiction. The corporation must have economic substance. No matter how defined, if substance does not exist, expected tax benefits may be ephemeral.

EUROPEAN STATE AID AND W.T.O. SUBSIDIES

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INTRODUCTION

Recent European Commission ("Commission") rulings involving Apple and Starbucks[1] and a World Trade Organization ("W.T.O.") ruling involving E.U. subsidies to Airbus[2] are viewed by some as evidence of a not-so *sub rosa* trade war between the U.S. and the European Union ("E.U."). The stated view in the E.U. is that these are two separate developments that should not be linked because one relates simply to fundamental harmony within the internal market of the E.U. and the other regards provisions in global trade agreements designed to settle disputes relating to export subsidies.

This article seeks to explain the basic internal procedures within the E.U. determining and outlawing State Aid. It also explains the global trade agreement embodied in the W.T.O. in connection with export subsidies and other actions designed to promote internal business in one country that harms competitors in other countries. This article concludes by evaluating the European position that State Aid within the E.U. and actionable or prohibited distortion of trade within the context of the W.T.O. are simply separate and distinct actions and that a discriminatory act under the latter cannot be compared with an illegal act under the former.

STATE AID TO STARBUCKS AND APPLE

In the past few years, the Commission has investigated many tax rulings between various companies and E.U. Member States to determine whether the agreements breached E.U. State Aid rules.

Starbucks in The Netherlands

The 2015 *Starbucks* decision addressed a Dutch advance pricing agreement obtained by the Netherlands-based entity Starbucks Manufacturing EMEA BV ("Starbucks Manufacturing"), the only wholly controlled Starbucks group entity (outside the U.S.) that roasts coffee. Starbucks Manufacturing supplied affiliates with roasted coffee. These were identified as controlled transactions for income tax purposes.

To obtain certainty regarding Dutch tax, a ruling was obtained allowing for a margin of between 9% and 12% over total production costs incurred to produce the roasted

1 Beate Erwin, "Treasury Attacks European Commission on State Aid – What Next?" *Insights* 8 (2016).

2 *Id.*; Peggy Hollinger, Shawn Donnan, and Arthur Beesley, "W.T.O. Gives Boeing Lift with Airbus Ruling," *The Financial Times*, September 22, 2016; Jason Lange, "U.S. Accuses E.U. of Grabbing Tax Revenus with Apple Decision, *Reuters*, August 31, 2016.

coffee that was sold to affiliates. Because reported profits for financial statement purposes exceeded cost plus 12%, the Dutch tax authority agreed to allow a deduction in the form of a floating royalty payment to another group entity, Alki LP.

Alki LP then reduced its income through payments to the U.S. group under a cost sharing agreement. Alki LP made buy-in payments and annual payments reimbursing the U.S. group for the development of intangible property. Under U.S. practice, Alki LP could use the intangible property without payment of a royalty to the U.S. group. The cost sharing payments simply reduced net costs incurred by the group.

In the view of the Commission, this arrangement was not available to all and distorted the internal market because of the advantage received by Starbuck Manufacturing and Alki LP.

<u>Apple in Ireland</u>

In its most recent *Apple* decision, the Commission ordered Ireland to collect a record €13 billion ($14.6 billion) in unpaid taxes from Apple, holding that certain Irish tax rulings artificially lowered the tax paid in this country since 1991.[3] Apple Ireland recorded most of the profit for Apple's European operations. In turn, Apple Ireland allocated the bulk of its profits (and hence the European profits) to a fictitious "head office" that had no substance, thus essentially allowing Apple to be taxed "nowhere."

SUBSIDIES TO AIRBUS

In its recent *Airbus* ruling, the W.T.O.'s compliance panel report (the "Panel Report") confirms its 2011 Dispute Settlement Board Report (the "D.S.B. Report").[4] As a result, and in relevant part, several measures provided to Airbus by the European Communities, France, Germany, Spain, and the U.K. were characterized as specific subsidies[5] causing serious prejudice to the interests of the U.S.

The measures at issue constituted over 300 different allegations of illegal subsidies by the European Communities and the four W.T.O. member states participating in Airbus over a period of approximately 40 years. These measures enabled Airbus to develop and produce large civil aircraft that were sold globally. The principal subsidies can be summarized as follows:

- Launch aid/member state financing provided by France, Germany, Spain, and the U.K. for the development of certain large civil aircraft projects
- Certain equity infusions provided by France and Germany to companies that were part of the Airbus group
- Certain infrastructure measures provided to Airbus (*e.g.*, the lease of land in Germany, the right to exclusive use of an extended runway at a German airport, regional grants by German authorities and government, and regional grants in Spain)

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[3] See Beate Erwin, "Apple in Europe – The Uphill Battle Continues." *Insights* 2 (2016), pp. 9-15.

[4] See organizational chart of the W.T.O. below.

[5] See below for a definition.

When compared to the aforementioned E.U. State Aid cases, the differences in the type of considered measures are substantial. The E.U. State Aid decisions fight fictitious tax arrangements allowed by certain Member States to specific taxpayers through the grant of a favorable ruling. The W.T.O. ruling condemns measures taken by a government that cause specific damage to another government.

E.U. STATE AID CONTROVERSY

One of the key concepts of the E.U. is its internal single market. The European Single Market seeks to treat the E.U. territories as one territory without any internal borders or other regulatory obstacles that may impede four fundamental principles:[6]

- The free movement of goods
- The free movement of services
- The free movement of capital
- The free movement of persons

The main objective of the European Single Market is to stimulate competition and trade, raise quality, and help cut prices.

In order to create and maintain this single market, the various E.U. Member States, relinquished national sovereignty, in part, to the E.U. This relinquishment was effected principally through the ratification of the Treaty on the Functioning of the European Union ("T.F.E.U."). While Member States relinquished the four freedoms, mentioned above, other aspects of national sovereignty were retained. Thus, the E.U., through its institutions, may only act within the limits of the grants of authority conferred to it by the Member States.

To further the achievement of the European Single Market, the E.U. State Aid rules were included in the T.F.E.U. These rules are designed to ensure fair and equal market conditions for commercial enterprises active within the various countries that comprise the European Single Market. Article 107 of the T.F.E.U. provides in relevant part that:

> Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.

The article further provides a list of deemed compatible aids and potential compatible aids.

In a 1998 Notice, the Commission further expanded the definition of State Aid.[7] It provides the following criteria upon which a measure by a Member State may be viewed to constitute State Aid:

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6 Article 26 of the T.F.E.U.

7 "Commission Notice on the Application of the State Aid Rules to Measures Relating to Direct Business Taxation," *Official Journal* C 384 (1998), pp. 3-9.

- The recipient of the measure is granted an advantage relieving it of certain charges it may otherwise incur. This advantage may reduce the taxpayer's tax burden in several ways, including
  - a tax base reduction (such as a special deduction, a special or accelerated depreciation arrangement, or the entering of reserves on the balance sheet),
  - a total or partial reduction in the amount of tax (such as an exemption or a tax credit), and
  - a deferment, cancellation, or even special rescheduling of tax debt
- The advantage must be granted either by the Member State (including its regional or local bodies) or through its resources. Whether that measure is provided for in a given Member State's tax laws or through the practice of its tax authorities is irrelevant. A loss of tax revenue is equivalent to consumption of Member State resources in the form of fiscal expenditure.
- The measure must affect competition and trade between Member States.
- The measure must be specific or selective in that it favours "certain undertakings or the production of certain goods."

"As the Commission is responsible for enforcing the E.U. State Aid rules, it may, on its own initiative, examine information regarding alleged unlawful aid from any source."

Article 108(1) of the T.F.E.U. states that "the Commission shall, in cooperation with Member States, keep under constant review all systems of aid existing in those States." Such review extends to tax measures because Article 107 applies to measures in any form whatsoever.[8] Thus, although the Member States retain sovereignty in terms of direct taxes, their direct tax systems must be compliant with the E.U. State Aid rules.[9] As the Commission is responsible for enforcing the E.U. State Aid rules, it may, on its own initiative, examine information regarding alleged unlawful aid from any source.[10]

In this area, the Commission operates in several steps. It begins by opening a preliminary investigation. If questions regarding the compatibility of the measure persist, the Commission then carries out an in-depth investigation.[11] The decision to initiate the formal investigation procedure is sent to the relevant Member State.

Pursuant to the formal investigation, a final decision is taken. There is no legal deadline to complete an in-depth investigation, and its actual length depends on many factors, including the complexity of the case, the quality of the information provided, and the level of cooperation by the Member State concerned.[12]

Three possible outcomes exist:

- The Commission reaches a favorable decision regarding the measure at issue. The measure is considered not to be aid or the aid is considered to be compatible with the internal market.

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8 *Id.*

9 *Italy v. Commission*, Case 173/73, EU:C:1974:71.

10 Council Regulation 2015/1589, Article 12.

11 "Competition: State Aid Procedures," European Commission.

12 *Id.*

- The Commission reaches a conditional decision. The measure at issue is found compatible, but its implementation is subject to conditions stated in the decision.

- The Commission reaches a negative decision. The measure is incompatible with Article 107 of the T.F.E.U. and must be withdrawn retroactively. The Commission, in principle, orders the Member State to recover the State Aid that has already been paid out to the beneficiaries.

"The main purpose of the W.T.O. is to allow 'open, fair and undistorted competition' with regard to goods, services, and intellectual property, to the extent possible."

The Commission can order the retroactive recovery of unlawful State Aid for a period of up to ten years preceding the Commission's first action taken with regard to the unlawful aid.[13] The aim of recovery is to remove the undue advantage granted to a company and to restore the market to its state before illegal State Aid was granted. A Member State is deemed to comply with the recovery decision when the aid (plus compound interest) has been fully recovered.[14] If the relevant Member State does not comply with the decision in due time, the Commission may refer it to the C.J.E.U.[15]

W.T.O. PROHIBITION REGARDING SUBSIDIES

The W.T.O. was established on January 1, 1995, as a result of the Uruguay Round of the General Agreement on Tariffs and Trades ("G.A.T.T."). It is composed of 164 member states as of July 29, 2016.[16] The main purpose of the W.T.O. is to allow "open, fair and undistorted competition" with regard to goods, services, and intellectual property, to the extent possible.[17]

The W.T.O. also provides a forum for the settlement of disputes. The W.T.O. settlement procedures are directed at government actions that distort trade. The decisions of the W.T.O. are binding on the governments that are parties to the dispute.

Typical areas of dispute include

- dumping practices, occurring when a company exports a product at a price that is lower than the price it normally charges on its own home market;

- export subsidies; and

- emergency measures that temporarily limit imports to protect domestic industries.

The following organizational chart facilitates the understanding of the W.T.O.'s work:[18]

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13 Regulation 2015/1589, Article 17.

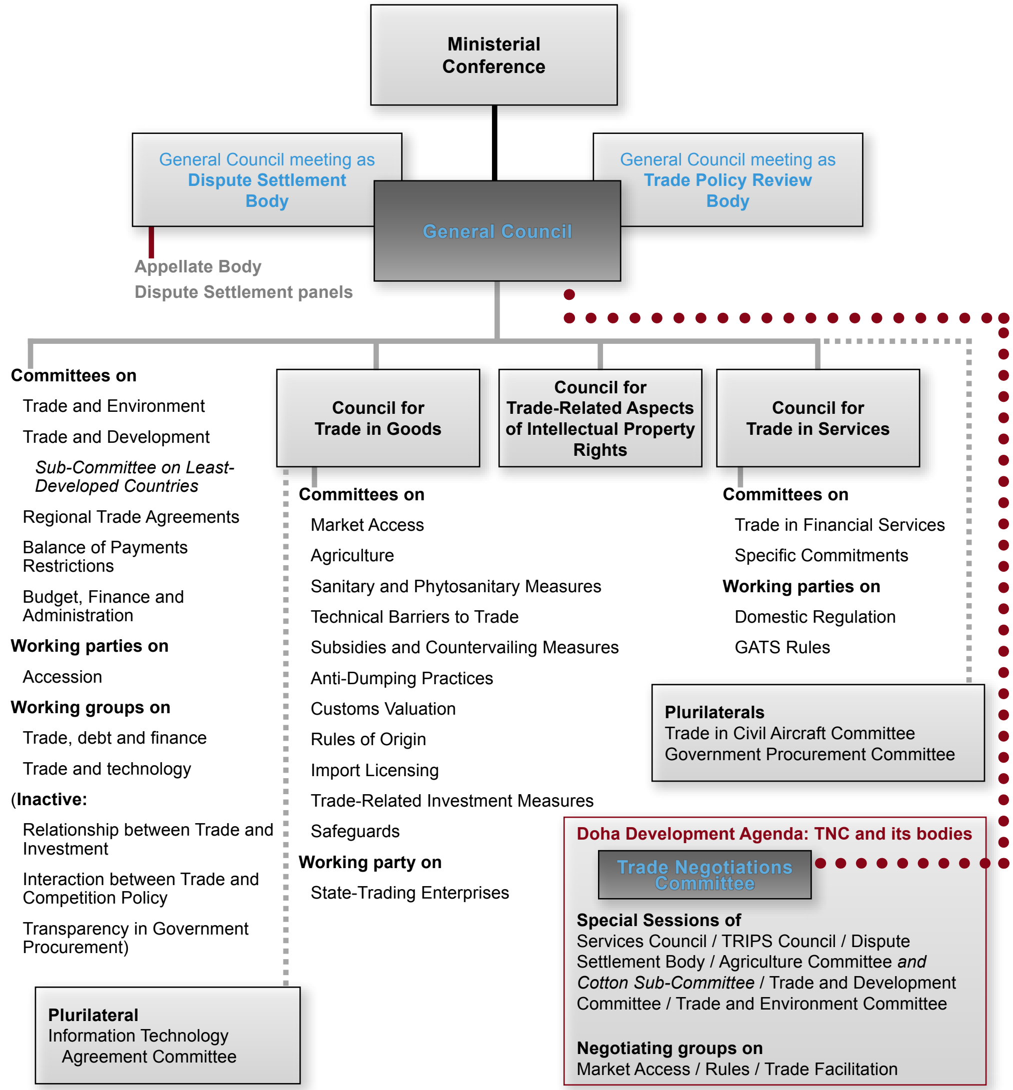
14 European Commission, "State Aid: Recovery of Illegal State Aid Gets Faster as Commission Tightens Procedures," press release, February 18, 2011.

15 Article 258 of the T.F.E.U.

16 "Understanding the WTO – Members," W.T.O.

17 *Understanding the WTO*, Fifth Edition, (Geneva: World Trade Organization Information and External Relations Division, 2015), pp. 10, 12, and 23.

18 "Understanding the WTO – Organization Chart," W.T.O.



Of the three main areas of dispute, the balance of this article focuses on the regulation of subsidies and the dispute settlement procedure.

Among the various agreements between the members of the W.T.O. is the Agreement on Subsidies and Countervailing Measures (the "S.C.M. Agreement"), which contains a definition of the term "subsidy." This definition is composed of three basic elements: (i) a financial contribution (ii) by a government or any public body within the territory of a W.T.O. member state (iii) that confers a benefit. All three of these elements must be satisfied in order for a subsidy to exist.

A financial contribution requires a charge on government funds. It can take the form of any of the following measures made directly or through payments to an intermediary:[19]

- A government practice involving a direct transfer of funds (*e.g.*, grants, loans, and equity infusion) or a potential direct transfer of funds or liabilities (*e.g.*, loan guarantees)

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[19] Article 1 of the S.C.M. Agreement and Article 16 of G.A.T.T. 1994.

- The relinquishment of government revenue or the failure to collect revenue (as would be the case with a credit or an exemption from tax generally due on domestic sales)
- The provision of goods or services other than general infrastructure by a government or the purchase of goods by a government
- Any form of income or price support that operates, directly or indirectly, to increase exports of any product from or reduce imports of any product to its territory

A subsidy is subject to the terms of the S.C.M. Agreement only if it has been specifically provided to an enterprise or industry or group of enterprises or industries so that it is not broadly available within a given economy. The basic principle is that a subsidy that distorts the allocation of resources within an economy violates the S.C.M. Agreement. In comparison, a subsidy that is widely available within an economy does not distort resources and for that reason is not subject to the S.C.M. Agreement.

Article 2 provides that the following fact patterns involve subsidies that violate the S.C.M. Agreement because benefits are directed to certain enterprises:

- Access to the subsidy is explicitly limited to certain enterprises either by law or by administrative practice.
- The law or the administrative practice for granting the subsidiary does not provide objective criteria for eligibility, or if such criteria exists, the subsidy is not automatic or the administrative practice is not strictly followed.
- There is reason to believe that the subsidy may be specific, based on other factors, such as
  - the subsidy program is used by a limited number of enterprises;
  - the subsidy program is predominantly used by a limited number of enterprises; or
  - the way in which discretion has been exercised by the granting authority.

A subsidy also is subject to the S.C.M. Agreement if it is limited to certain enterprises located within a designated geographical region, or if it targets export goods or goods using domestic inputs.

Once a subsidy subject to the S.C.M. Agreement exists, a determination must be made whether the subsidy is prohibited or actionable. Prohibited subsidies are those that promote exports and those that have local content requirements. Actionable subsidies are subsidies that cause adverse effects to the interests of another member of the W.T.O. Most subsidies fall in this category.

There are three types of adverse effects. First, there is injury to a domestic industry caused by subsidized goods that are imported into the territory of the complaining member state. Second, there is serious prejudice, which usually arises because of adverse effects of the subsidy on the market of the complaining member state or a third country. Third, there is nullification or impairment of benefits accruing under

G.A.T.T., meaning an impairment of market access is presumed to flow from a tariff reduction as a result of the subsidy.[20]

CONCLUSION

As to procedure, Commission decisions regarding illegal State Aid of an E.U. Member State differs from W.T.O. rulings as to trade disputes that impair global trade.

- The Commission's rulings on State Aid are binding on the relevant Member State, which then must recover up to ten years in back taxes and interest.
- The W.T.O.'s rulings are based on good faith participation by the W.T.O. member states. Every member will then carefully consider whether a countermeasure, such as the implementation of an import duty, would be the appropriate remedy. No retroactive effect is given to a W.T.O. ruling.

However the goals of Article 107 of the T.F.E.U. to stop actions that distort free trade and those of Article 2 of the S.C.M. Agreement appear to be identical.

PROVISONS THAT MAY CONSTITUTE STATE AID	PURPOSE OF W.T.O. AGREEMENT; ACTIONABLE & PROHIBITED ACTS
The recipient of the measure is granted an advantage relieving it of certain charges it may otherwise incur.	A benefit conferred by a government or any public body within the territory of a member in the form of a financial contribution.
This advantage may reduce the taxpayer's tax, which amounts to a loss of tax revenue.	The foregoing of or absence of collection of revenue, for instance tax incentives such as tax credits.
The measure must affect competition and trade between Member States.	Government actions contrary to open, fair and undistorted competition.
The measure must be specific or selective in that it favors certain undertaking.	Access to a subsidy that is explicitly limited to a certain enterprise.

There may be many ways to look at the foregoing similarities between the Commission actions against Apple and Starbucks, and the W.T.O. decision in the *Airbus* case. However, the quantum of similarities in the goals of E.U. principles and W.T.O. principles leads one to question the judgment of the Commission to attack Member States and U.S. companies on the basis of illegal distortion to internal trade, while at the same time turning a blind eye on subsidies granted to European enterprises in a way that distorts a global market.

20 Article 5 of the S.C.M. Agreement.

REGULATIONS WOULD ADDRESS FOREIGN TAX CREDIT PLANNING FOR E.U. STATE AID ADJUSTMENTS

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Foreign-Initiated Adjustment
Foreign Tax Credit
State Aid

INTRODUCTION

The Internal Revenue Service ("I.R.S.") recently issued a notice[1] stating that it intends to issue regulations to address two new categories of foreign tax credit splitter arrangements that may be implemented by a taxpayer as a result of foreign-initiated adjustments.

Although the notice is not expressly limited to foreign-initiated adjustments arising from European Union ("E.U.") State Aid decisions, the I.R.S. notice reflected concern that U.S.-based multinational groups might attempt to revise global structures in advance of a payment in order to maximize subsequent foreign tax credits under Code §902 at the time a dividend is received by a U.S. shareholder. As a cautionary note, the I.R.S. cautioned that the notice cannot be taken to infer that payments made pursuant to any particular foreign-initiated adjustment, including those arising under E.U. State Aid investigations by the European Commission, are creditable taxes.

FOREIGN TAX CREDIT BASICS

Under Code §901, and subject to the limitations of Code §904 discussed below, a U.S. person (*e.g.*, a U.S. citizen, a U.S. corporation) can elect to claim a credit for foreign income taxes paid or accrued to a foreign country or a U.S. possession. The foreign tax credit under Code §901 is a direct credit because the foreign income tax is paid or accrued by the U.S. person.

Under Code §902, if a U.S. corporation receives a dividend during the tax year from a foreign corporation in which it owns at least 10% of the voting stock, the U.S. corporation can elect to claim a credit for the foreign income taxes paid by the foreign corporation, which are related to earnings that generate the dividend. The U.S. corporation will be deemed to have paid the same proportion of the foreign corporation's post-1986 foreign income taxes as the amount of the dividend bears to the foreign corporation's pool of post-1986 undistributed earnings. The foreign tax credit under Code §902 is an indirect or deemed paid credit.[2]

Under Code §904, the foreign tax credit is limited so that the credit can be applied only on U.S. income tax attributable to foreign-source net taxable income of the corporate shareholder. This limitation serves the purpose of preventing a U.S.

1 Notice 2016-52, I.R.B. 2016-40.

2 Further, under Code §960, a U.S. corporation may claim a credit under Code §902 for a dividend it was deemed to have received during the tax year as a result of the gross income inclusion rules applicable to controlled foreign corporations.

person from offsetting U.S. income tax on U.S.-source income with a tax credit for foreign income taxes. Further, Code §904 separates foreign income into different categories (*i.e.*, the passive category and the general category) in order to prevent the averaging of low foreign withholding tax rates, which typically apply to passive foreign income (nil for interest and royalties and nil, 5%, or 15% for dividends), and high foreign income tax rates, which typically apply to foreign income derived from an operating business, when computing benefits under the foreign tax credit.

FOREIGN-INITIATED ADJUSTMENTS

When a foreign tax authority re-determines or adjusts foreign income taxes in a tax year after a U.S. person has claimed a foreign tax credit attributable to those foreign income taxes, the rules of Code §905(c) apply. In general, if any adjustment affects a direct tax under Code §901 (*e.g.*, a refund or reduction of a withholding tax) a U.S. person is required to file an amended return to reflect the adjustment. Adjustments to foreign income taxes imposed on subsidiaries and claimed as indirect credits under Code §902 are generally taken into account prospectively by making appropriate adjustments to the pools of post-1986 foreign incomes taxes and the pools of post-1986 undistributed earnings. When the adjustments are made the last day of the second full taxable year succeeding the accrual year, refunds cannot be made. Instead, the pool of undistributed earnings and the pool of creditable foreign tax credits are adjusted and may be used going forward.

For example, if a foreign subsidiary, which paid a dividend to its U.S. parent in Tax Year 1, is assessed a higher income tax for Tax Year 1 and pays the assessment in Tax Year 3, its U.S. corporate parent would generally not be able to file an amended return for Tax Year 1 in order to receive a higher foreign tax credit. Instead, the U.S. corporate parent would have to adjust the pools of post-1986 foreign income taxes used to calculate its indirect foreign tax credit. The pool of foreign income taxes paid or accrued by the foreign subsidiary would be increased and the pool of undistributed earnings would be decreased. Such an adjustment may affect the U.S. corporate parent's foreign tax credit in Tax Year 3, presumably increasing the foreign tax credit that attaches to each dollar of dividend received.

"When a foreign tax authority re-determines or adjusts foreign income taxes in a tax year after a U.S. person has claimed a foreign tax credit attributable to those foreign income taxes, the rules of Code §905(c) apply."

FOREIGN TAX CREDIT SPLITTER ARRANGEMENTS

Enacted in 2010, Code §909 is aimed at preventing situations in which foreign income taxes have been separated or "split" from the related income. That is, foreign tax credits have been made available to a U.S. person but the underlying income is not yet subject to U.S. Federal income tax.

Under Code §909(a), if there is a "foreign tax credit splitting event" ("F.T.C.S.E.") with respect to a foreign income tax paid or accrued by a taxpayer, such foreign income tax will not be taken into account for U.S. Federal income tax purposes before the tax year in which the related income is taken into account by the taxpayer. That is, the accelerated taxes that are split off from the deferred income are suspended until there is a matching of the foreign tax credits and the related inclusion of income.

Under Code §909(b), if there is a F.T.C.S.E. with respect to foreign income tax paid or accrued by a Code §902 corporation (defined below), that foreign income tax will not be taken into account for the purposes of Code §902 (nor for the purposes of

Code §§960 and 964(a)) before the tax year in which the related income is taken into account for U.S. Federal income tax purposes by the Code §902 corporation or a U.S. corporation that owns the Code §902 corporation in the manner described in Code §§902(a) and (b) (*i.e.*, the U.S. corporation must own at least 10% of the voting stock in the case of a first-tier foreign corporation).

For the purposes of Code §§909(a) and (b), "related income" means, with respect to any portion of the foreign income tax, the income (or earnings and profits) to which the portion of the foreign income tax relates.

"The regulations announced in the notice would add two new categories of foreign tax credit splitter arrangements."

A Code §902 corporation is (i) a first-tier foreign corporation in which a U.S. corporation owns 10% of the voting stock or (ii) a lower-tier foreign corporation in which a U.S. corporation owns at least 5% of the voting stock indirectly through a chain of foreign corporations connected through stock ownership of at least 10% of their voting stock.[3]

The Treasury regulations provide an exclusive list of four splitter arrangements that give rise to an F.T.C.S.E.: (i) reverse hybrid structures, (ii) loss-sharing, (iii) hybrid instruments, and (iv) partnership inter-branch payments.

The case of a reverse hybrid involves an entity that is treated as a corporation for U.S. Federal income tax purposes and a pass-through entity for foreign income tax purposes. An example is a foreign partnership that is tax transparent in the jurisdiction where organized but is treated as a corporation for U.S. income tax purposes because of a check-the-box election. If the reverse hybrid earns income from a foreign business, the foreign tax will be imposed on its U.S. parent corporation since it is a pass-through entity under foreign law. However, under Code §909, the foreign income taxes are not taken into account for U.S. Federal income tax purposes until the underlying income of the reverse hybrid becomes taxable in the U.S. Since it is a corporation for U.S. Federal income tax purposes, that event will occur when, for example, the reverse hybrid pays a dividend to the U.S. parent.

FOREIGN-INITIATED ADJUSTMENT SPLITTER ARRANGEMENTS

The regulations announced in the notice would add two new categories of foreign tax credit splitter arrangements, referred to as "foreign-initiated adjustment splitter arrangements." For the purposes of the new regulations, a "foreign-initiated adjustment" would be a foreign-initiated adjustment (or series of related adjustments to more than one tax year) that results in additional foreign income tax liability of greater than the foreign currency equivalent of U.S. $10 million.

The new regulations would seek to prevent the following planning. Before a payment is made pursuant to a foreign-initiated adjustment, a taxpayer attempts to change its ownership structure or cause the Code §902 corporation to make an extraordinary distribution so that the subsequent tax payment creates a high-tax pool of post-1986 undistributed earnings that can be used to generate substantial amounts of foreign taxes deemed paid, without repatriating and including in U.S. taxable income the earnings and profits to which the taxes relate.

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[3] Code §909(d)(5).

The new regulations would apply similar rules to taxpayers that take the position that taxes paid by a U.S. person pursuant to a foreign-initiated adjustment to the tax liability of a Code §902 corporation are eligible for a direct foreign tax credit under Code §901.

Splitter Arrangements Arising from the Application of Code §905(c) to Successor Entities

The new regulations would provide that a splitter arrangement arises when, as a result of a "covered transaction" (defined below), a Code §902 corporation pays "covered taxes" (defined below) during a tax year, that is, the "splitter year."

For the purposes of the notice, "covered taxes" are foreign income taxes that

- are taken into account by adjusting the payor's pools of post-1986 undistributed earnings and post-1986 foreign income taxes in the tax year under Code §905(c), and
- result from a specified foreign-initiated adjustment (*i.e.*, an adjustment resulting in foreign income taxes greater than the foreign currency equivalent of $10 million) to the amount of foreign income tax accrued with respect to one or more prior tax years, referred to as the "relation-back years."

A "covered transaction" generally would be any transaction (or series of related transactions) that meets the following conditions:

- The transaction results in covered taxes being paid by a payor that is a Code §902 corporation but is not the Code §902 corporation that would have been the payor of the covered taxes (*i.e.*, the predecessor entity) if the covered taxes had been paid or accrued in the relation-back year.
- The predecessor[4] entity was a "covered person" (essentially, a related person) with respect to the payor immediately before the transaction, or, if the payor did not exist immediately before the transaction, the predecessor entity was a covered person with respect to the payor immediately after the transaction.

Reflecting a no-harm, no-foul approach, a covered transaction would not include a transaction in which the payor (*i.e.*, the successor Code §902 corporation) also succeeds to the earnings and profits of the predecessor entity under Code §381(c)(2) (relating to carryovers of earnings and profits in certain corporate acquisitions), nor would it include a case in which the taxpayer can demonstrate by clear and convincing evidence that the transaction was not structured with a principal purpose of separating covered taxes from the post-1986 undistributed earnings of the predecessor entity that include the earnings to which the covered taxes relate.

The new regulations would provide a definition for the term "related income" applicable to this first new category of foreign tax credit splitter arrangement. Related income would equal the sum of the portions of the predecessor entity's earnings and profits for each of the relation-back years that meet all of the following conditions:

- The earnings and profits are described in Code §316(a)(2) relating to dividends made out of current earnings and profits.

[4] The term "predecessor entity" would include a successor of the predecessor entity.

- The earnings and profits are included in the foreign tax credit pool under Code §904 to which the covered tax is assigned.

- The earnings and profits are attributable to all activities that gave rise to the income (computed under foreign law) included in the foreign tax base that was adjusted pursuant to the specified foreign-initiated adjustment, regardless of which activities gave rise to the adjustment.

Splitter Arrangements Arising from Distributions Made Before the Payment of Additional Tax Pursuant to Foreign-Initiated Adjustments

The notice stated that taxpayers could achieve a similar result by using distributions to move post-1986 undistributed earnings from one Code §902 corporation to another Code §902 corporation before the first one makes a tax payment as a result of a foreign-initiated adjustment.

In the case of such a distribution, the earnings to which the tax payment relates are first taken into account by the payor but, as a result of the distributions, are then taken into account by a covered person that is a Code §902 corporation ("a section 902 covered person"), before the first Code §902 corporation pays the tax.

The regulations would provide that a splitter arrangement results when a payor that is a Code §902 corporation pays covered taxes during a tax year (*i.e.*, the splitter year) and the payor has made a "covered distribution." A "covered distribution" is any distribution, with respect to the payor's stock, to the extent such distribution

- occurred in a tax year of the payor to which the covered taxes relate or any subsequent tax year up to and including the tax year immediately before the tax year in which the covered taxes are paid,

- resulted in a distribution or allocation of the payor's post-1986 undistributed earnings (which, for this purpose, does not include earnings and profits attributable to income effectively connected with the conduct of a U.S. trade or business or otherwise subject to U.S. Federal income tax in the hands of the payor) to a section 902 covered person, and

- was made with a principal purpose of reducing the payor's post-1986 undistributed earnings that included the earnings to which the covered taxes relate in advance of the payment of covered taxes.

A distribution will be presumed to have been made with the principal purpose of reducing the payor's post-1986 undistributed earnings if the sum of all distributions that would be covered distributions (without regard to the principal purpose requirement) is greater than 50% of the sum of (i) the payor's post-1986 undistributed earnings as of the beginning of the payor's tax year in which the covered tax is paid, and (ii) the sum of all distributions that would be covered distributions without regard to the principal purpose requirement.

The presumption is rebutted only by clear and convincing evidence that the distribution was not made with the principal purpose of reducing the payor's post-1986 undistributed earnings that included the earnings to which the covered taxes relate in advance of the payment of covered taxes.

For the purpose of this second new category of foreign tax credit splitter arrangement, "related income" is determined by first determining the "initial related income," which would be the sum of the portions of the payor's earnings and profits for each relation-back years that

- are described in Code §316(a)(2) (relating to dividends made out of current earnings and profits),
- are in the foreign tax credit pool under Code §904 to which the covered tax is assigned, and
- are attributable to all activities that gave rise to the income (computed under foreign law) included in the foreign tax base that was adjusted pursuant to the specified foreign-initiated adjustment, regardless of which activities gave rise to the adjustment.

O.E.C.D. REACTION TO RESEARCH TAX INCENTIVES – ACCEPTANCE WITH A LIMITATION BLOCKING MOBILITY

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Tags
Code §42
Code §174
O.E.C.D.
Research & Development

In recent years, the European Commission (the "Commission") has been criticizing arrangements between multinational companies and countries within the E.U. offering favorable tax treatment to certain income. Such arrangements required these companies to locate some of their business in the country offering the benefits and often required the hiring of local talent. One example would be the investigatin into arrangements between Ireland and Apple Inc., a U.S. corporation.[1]

Despite such actions and recent Commission decisions, which treat such arrangements as illegal State Aid and impose harsh economic penalties on a retroactive basis, the Organization for Economic Cooperation and Development ("O.E.C.D.") issued a working paper (the "Working Paper")[2] that recognizes that the encouragement of research and development ("R&D") is an essential part of the development, innovation, and growth of an economy. In a caveated breath of fresh air, the Working Paper acknowledges and accepts the importance of taxes as it recommends that "fiscal incentives, including tax policies, . . . be directed at specific barriers, impediments or synergies to facilitate the desired level of investment in R&D and innovations."

The Working Paper lists several issues affecting the recent decrease in global R&D, including the difficulty encountered to finance the activity, especially for small start-up companies, and the leakage of knowledge garnered from R&D activity. To overcome some of these issues, the O.E.C.D. acknowledged that governments should support R&D and offer incentives.

R&D tax incentives adopted in one jurisdiction have potential spillover into other countries' tax policies; however, as the Working Paper provides, such spillover is not necessarily positive and such activities may not result in an overall increase in global innovation. It may simply shift R&D activity from one country to another country. The Working Paper expresses a concern about the mobility of intellectual property ("I.P.") and the potential tax abuse that may follow by shifting income away from the country where the I.P. was created. To prevent harmful tax practices, the Working Paper recommends adoption of a "nexus" approach to R&D tax incentives, which allows the incentives in the country where the I.P. was created and possibly not elsewhere, especially if it is moved to a low-tax or no-tax country.

Fiscal incentives can be presented in several forms, including, but not limited to, grants, guarantees, and tax incentives. Tax incentives then can also take several forms, including tax credits, accelerated depreciation, or favorable capital gain tax

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1. On August 30, 2016, the E.U. published the results of the *Apple* case and concluded that Apple must repay Ireland €13 billion.
2. Thomas Neubig, et. al., "O.E.C.D. Taxation Working Paper No. 27, Fiscal Incentives for R&D and Innovation in a Diverse World," *O.E.C.D. Taxation Working Papers* 27 (2016).

rates. The Working Paper surveyed the practice of R&D incentives around the world and found that most countries focus the tax incentives on increased expenditures on R&D and that an increasing number of countries have adopted or are considering adopting income-based R&D tax incentives in addition to their expenditure-based R&D tax incentives. Due to the mobility of I.P. and the potential abusive result to a global tax base, the Working Paper recommends adopting a "nexus" approach as a threshold for R&D tax incentives in order to "avoid harmful tax practices."

"In a caveated breath of fresh air, the Working Paper acknowledges and accepts the importance of taxes."

The Working Paper concludes that given the significant diversity of businesses and different type of R&D investments, more research is needed to determine the global effects of local R&D incentives that provide the biggest improvement in productivity.

U.S. TAX RESEARCH INCENTIVES

Absent special tax treatment, capital investment to create or purchase new tangible or intangible property produces a long-term asset so that the cost of such asset cannot be taken as an ordinary and necessary business deduction under Code §162. Rather, the cost of the asset may be depreciated under Code §167 or amortized under Code §197. The 15-year amortization of intangible property under Code §197 (a), however, is not allowed for self-created intangibles.[3]

To encourage investment in R&D, Code §174 offers two methods to obtain tax relief for R&D expenditures. One method provides a current deduction[4] and the other method provides for amortization.[5] Both forms of tax relief apply only to the extent that the amount claimed for R&D is reasonable under the circumstances.

Current Expense Deductions

Under the current expense deduction, taxpayers may treat R&D expenditures paid or incurred during the tax year in connection with their trades or businesses as expenses that are not chargeable to the capital account. This allows for current tax benefit for the amount expended.

If the current expense method is adopted by the taxpayer, it applies to all R&D expenditures of the taxpayer. Cherry picking is not allowed. Once adopted, the method must be followed in all subsequent tax years, unless the I.R.S. approves a change to a different method.

Amortization Deduction

The amortization deduction method allows the taxpayer to elect to treat qualified R&D expenditures as deferred expenses amortized ratably over a period of not less than 60 months, as selected by the taxpayer. Qualified R&D expenditures are those paid or incurred by the taxpayer in connection with a trade or business.[6]

Credit for Increasing Research Activities or Alternative Credit

Code §42 allows a credit for a portion of the costs of increasing expenses paid or

[3] Code §197(c)(2).

[4] Code §174(a).

[5] Code §174(b).

[6] *Id.*

incurred for qualified research. Code §280C allows for an alternative credit that is not as favorable. Qualified research means research for which expenses may be deducted currently under Code §174. The research must be undertaken for discovering information that is technological in nature, and its application must be intended for use in developing a new or improved business component of the taxpayer. In addition, substantially all of the activities of the R&D activity must be elements of a process of experimentation relating to a new or improved function, performance, reliability, or quality. The credit is claimed by filing Form 6765.

CONCLUSION

The O.E.C.D. has been leading the attack on tax incentives and uses of the tax system that are viewed by policy makers in Europe as abusive. While most new O.E.C.D. pronouncements have caused tax advisors to cringe, the recent O.E.C.D. Working Paper recognizes that R&D tax incentives are appropriate when tax relief is tied to the place where the R&D activity is performed. Financing R&D without activity by employees and officers is not sufficient to claim tax relief. The tax relief provided to innovation companies performing R&D activity is triggered at the time revenue is realized from the R&D. To date, the U.S. allows relief only when and as amounts are expended – either on a current basis or an amortized basis.

GLOBAL EXCHANGE OF INFORMATION: HOW DOES THE U.S. FIT INTO THE PUZZLE? MEET THE U.S. FOREIGN TRUST

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Tags
Common Reporting Standard
Information Exchange
F.A.T.C.A.
O.E.C.D.
Trusts

U.S. RECIPROCAL REPORTING UNDER F.A.T.C.A.

In 2010, the U.S. enacted the Foreign Account Tax Compliance Act ("F.A.T.C.A.") in an attempt to obtain information about foreign bank and financial accounts held by Americans. Many of these Americans had not been fully U.S. tax compliant and had failed to file information returns or pay tax on the income from these accounts. The new law placed the onus on foreign financial institutions to look for U.S. account holders and U.S. persons who controlled certain non-U.S.-owned accounts and to report specific information relating to such "U.S. accounts."

Generally, the information that the U.S. sought was (i) the names of the U.S. persons, (ii) the account balance on the last day of the year, (iii) the amounts paid during the year, (iv) the dividends and interest earned, and (v) starting in 2017, the gross proceeds from sales of property.

Motivation for foreign financial institutions to comply came in the form of a 30% F.A.T.C.A. withholding tax, applicable to U.S.-source income paid to nonparticipating institutions. However, no matter how strong the motivation was for foreign financial institutions to comply, they could not overcome the fact that reporting this type of information was against the law in most countries.

Thus, foreign governments that chose to cooperate with F.A.T.C.A. first had to enact F.A.T.C.A.-inspired laws to allow for the required disclosures of information. The first step in foreign implementation was the signing of an intergovernmental agreement ("I.G.A.") with the U.S., and to entice participation in the I.G.A. approach to F.A.T.C.A. compliance, the U.S. offered some countries reciprocal agreements.

Notably, not all countries were offered the reciprocal version. Only those with which the U.S. had an income tax treaty allowing for the exchange of information for tax purposes, or those that were a party to an agreement on exchange of information in tax matters ("T.I.E.A."), were offered a reciprocal model 1 I.G.A.

HOW RECIPROCAL ARE THOSE AGREEMENTS? DOES THE U.S. REPORT INFORMATION SIMILAR TO WHAT IT REQUESTS AND RECEIVES?

As it turns out, reciprocal does not mean equal. While the U.S. requires foreign countries to provide all of the above-mentioned information, the U.S., without changing its laws, would offer only the information it already collects, namely, U.S.-source interest income earned on individual depository accounts. With respect to non-cash accounts, the U.S. would report U.S.-source dividends and interest earned. And in any event, the U.S. would not (and will not) seek to learn or identify the residency of beneficial owners. If an entity custodial account is reported, it is the entity that will be reported.

Additionally, the I.R.S. announced that it will engage only in reciprocal exchange (as reciprocal as that may be), with foreign countries that, among other requirements, meet stringent I.R.S. information safeguard, privacy, and technical standards. The I.R.S. said that before exchanging information the U.S. will conduct a detailed review of the recipient country's laws and infrastructure concerning the use and protection of taxpayer data and cyber-security capabilities, as well as security practices and procedures.[1]

REPORTING UNDER THE COMMON REPORTING STANDARD

In 2014, the G-20 countries, inspired by F.A.T.C.A., requested that the O.E.C.D. draft standards for common reporting of information between jurisdictions. Many refer to this as the Global F.A.T.C.A. – or in short, G.A.T.C.A. – but the formal name is the Standard for Automatic Exchange of Financial Account Information in Tax Matters. In short, it is known as the Common Reporting Standard or C.R.S.

"Under C.R.S. definitions, a trust is considered resident in the country where the trustee is residing, regardless of whether the trust, itself, is considered resident in that country for income tax purposes."

C.R.S. requires financial institutions to report information similar to that requested under F.A.T.C.A., except it is not limited to U.S. persons. There is no *de minimis* rule under the C.R.S., and the categories of entities for which a look-through rule applies are broader.

As of July 26, 2016 – the last day the O.E.C.D. updated its list of participating jurisdictions – 101 countries have committed to the C.R.S.[2] Of those, 54 countries have committed to an initial exchange as early as 2017. This exchange will correspond to the prior year. The 2017 reports affecting preexisting accounts are expected to only be with respect to high value individual accounts. Entity accounts are expected to begin in 2018, with respect to 2017.

THE C.R.S. LOOK-THROUGH RULE

The C.R.S. requires financial institutions to "look through" passive nonfinancial entities in order to identify "controlling persons." The term controlling person is defined under C.R.S. in relation to the term "beneficial owner" in the Financial Action Task Force ("F.A.T.F.") recommendations. Generally, the term means the natural person(s) who exercises control over the entity, normally, the individual(s) with a controlling ownership interest. While there is no set threshold, in many structures, individuals that hold, directly or indirectly, more than 25% of the voting rights will be

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1 "IRS Announces Key Milestone in FATCA Implementation; U.S. Begins Reciprocal Automatic Exchange of Tax Information under Intergovernmental Agreements," I.R.S., last reviewed or updated September 12, 2016.

2 As of September 14, 2016, with the joining of Pakistan, 104 countries have committed to the C.R.S. O.E.C.D., "Pakistan Becomes the 104th Jurisdiction to Join the Most Powerful Multilateral Instrument Against Offshore Tax Evasion and Avoidance," news release, September 14, 2016.

treated as controlling persons. In the case of a trust, the term controlling persons is explicitly defined in the C.R.S. to mean the settlor(s), the trustee(s), the protector(s) (if any), the beneficiary(ies) or class(es) of beneficiaries, and any other natural person(s) exercising ultimate effective control over the trust. If any of the above controlling persons is an entity, the reporting financial institution must identify the controlling persons of such entity in accordance with the applicable definition.

Further, the C.R.S. views investment entities that are managed by financial institutions that are resident in countries not participating in the C.R.S. as passive nonfinancial entities. When the look-through rule applies, the financial institution applying C.R.S. must identify the controlling persons of such investment entity. With respect to trusts, these will be investment entities if their gross income is primarily attributable to investing, reinvesting, or trading in financial assets, and if they are managed by a financial institution. Generally, the only trusts that would not be investment entities are those that have an individual trustee that does not hire any entity as an investment manager, advisor, etc., but those will be subject to the general look-through rule applicable to passive nonfinancial entities.

Under C.R.S. definitions, a trust is considered resident in the country where the trustee is residing, regardless of whether the trust, itself, is considered resident in that country for income tax purposes. Thus, if the trustee is a resident of a country that does not participate in the C.R.S., the financial institution with which an account is held that is subject to C.R.S. reporting obligations will be required to look through the trust to its controlling persons. Controlling persons (*i.e.*, trust beneficiaries as well as settlors, protectors, and trustees) who are residents of C.R.S.-participating countries will be reported to their countries of residence, and any U.S. person will be reported to the U.S. under F.A.T.C.A.

Consequently, trusts that historically have been established in third-party (now participating) jurisdictions for asset protection, privacy, and other reasons may find that the new C.R.S. rules will impose a level of disclosure inconsistent with those objectives.

U.S. PARTICIPATION IN THE C.R.S.

To date, the U.S. has not signed or committed to sign on to the C.R.S. Thus, the U.S. is not part of the O.E.C.D.'s list of participating jurisdictions. However, in a footnote to that list, the O.E.C.D. stated that the U.S.:

> [H]as indicated that it is undertaking automatic information exchanges pursuant to FATCA from 2015 and has entered into intergovernmental agreements (IGAs) with other jurisdictions to do so. The Model 1A IGAs entered into by the United States acknowledge the need for the United States to achieve equivalent levels of reciprocal automatic information exchange with partner jurisdictions. They also include a political commitment to pursue the adoption of regulations and to advocate and support relevant legislation to achieve such equivalent levels of reciprocal automatic exchange.[3]

While the U.S. has committed, in its reciprocal I.G.A.'s, to adopt regulations and

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[3] O.E.C.D., *AEOI: Status of Commitments*, (2016).

advocate relevant legislation, to date, no legislative action has been taken. Under these I.G.A.'s the U.S. and partner countries agreed that prior to December 31, 2016 they would consult in good faith to amend the agreements as necessary to reflect progress on the commitment for reciprocity.[4]

WHERE DOES IT LEAVE THE U.S.? WILL U.S. TRUSTS AND FUNDS BE TREATED AS PASSIVE NONFINANCIAL ENTITIES TO WHICH THE C.R.S. LOOK-THROUGH RULE WILL APPLY?

Under the C.R.S., it is expected that each country would have a list of non-reporting financial institutions and that there will be a separate list for domestic institutions and for different participating jurisdictions. It is further expected that each country would make its lists publicly available.

Based on the footnote with respect to the U.S., which the O.E.C.D. included on the list of participating jurisdictions, it appears that each C.R.S. signatory may decide how to treat the U.S. in its local implementing legislation, and financial institutions in that country would be required to follow such a classification. Nevertheless, the O.E.C.D. has provided guidelines for including countries in the participating list. These guidelines basically limit the list to those countries that demonstrate some commitment to the C.R.S.

Luxembourg and the B.V.I., as well as one or two other jurisdictions, initially included the U.S. on their lists of participating jurisdictions, based on the U.S. commitment under F.A.T.C.A. However, shortly after publication, these jurisdictions removed the U.S. from their lists, indicating that the U.S. does not meet the requirements. It seems, therefore, that if the U.S. remains a non-signatory, it would be prudent to assume other countries may not agree to view the U.S. commitment to exchange information under F.A.T.C.A. as satisfactory under the C.R.S.

This may mean that U.S. funds and U.S. trusts that are managed by financial institutions (*i.e.*, U.S. trust companies) will be looked through outside the U.S. if they maintain accounts in a C.R.S.-participating country. This does not mean, however, that the C.R.S. rules will apply to a U.S. entity whose assets are invested in the U.S.

COULD THE U.S. BE THE ANSWER?

It is possible to establish a U.S. trust under the laws of a state such as Delaware, South Dakota, or New York with U.S. trustees, yet which is treated as a foreign trust for income tax purposes. Consequently, this "hybrid" trust will be a foreign trust for U.S. income tax purposes and a U.S. trust for C.R.S. reporting purposes (as the trustees are U.S. persons and the trust, therefore, is resident in the U.S.). This is sometimes referred to as a "U.S. foreign trust."

For a trust to be treated as a U.S. domestic trust for income tax purposes, two tests must be met: (i) a "court test," which looks for a U.S. court to have exclusive jurisdiction over the trust (generally met in the case of a trust established under the laws

[4] Model 1 I.G.A., Article 6 and Article 10(3).

of a state), and (ii) a "control test," which requires U.S. persons to hold the power to make all substantial decisions with respect to the trust. A trust will be a U.S. foreign trust for income tax purposes if, for example, a foreign individual serves as protector and has the power to control the decision to terminate the trust or to distribute trust assets.

A U.S. foreign trust for income tax purposes, is taxed in the U.S. as a nonresident, noncitizen individual that is not present in the U.S. at any time. This means that U.S.-source passive income, such as rents,[5] dividends, interests, and royalties, will be subject to 30% withholding on a gross basis. Some types of interest may be exempt from U.S. tax if the debt for which they are paid meets the requirements for treatment as "portfolio debt."[6] Publicly traded debt instruments issued by U.S. corporations and U.S. Treasury debt instruments typically meet those requirements. Also exempt are (i) bank deposit interest that is not considered to be effectively connected income;[7] (ii) short-term, original issue discount income;[8] and (iii) original issue discount of tax exempt municipal bonds.[9] Effectively connected income is subject to tax at graduated rates of up to 39.6% and the tax base can be reduced by deductions for operating expenses.[10]

Capital gains from U.S. sources generally will not be subject to U.S. tax. However, exceptions to that treatment exist for capital gains from real property[11] and gains from the sale of intangible property to the extent such gain is contingent on productivity, use, or disposition of the intangible property.[12] Real property capital gains will be treated as effectively connected income and as such the net gain will be taxed at 20% if the property is held for more than 12 months. Contingent gain from the sale of intangible property is subject to 30% withholding tax imposed on the gross amount paid. State tax may also apply to certain income allocated to state property.

Accounts maintained by a U.S. foreign trust in a foreign participating jurisdiction may result in C.R.S. look-through reporting in that jurisdiction, unless the U.S. is treated as a participating country under local C.R.S. laws. Those accounts should be avoided until further clarification.

CONCLUSION

The U.S. position on the C.R.S. is likely to be influenced by the outcome of the next election. Whatever happens, planning to use the hybrid trust structure should prove beneficial. As long as the U.S. is not part of the C.R.S., privacy is enhanced,

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5 Other than rents for which an election is made to have the rents treated as effectively connected income. See Code §871(d). Such rents are subject to graduated tax rates and deductions for operating expenses and depreciation reduce the tax base.

6 Code §871(h).

7 Code §871(i)(2)(A).

8 Code §871(g)(1)(B)(i)

9 Code §871(g)(1)(B)(ii)

10 Code §871(b)(1).

11 Code § 897.

12 Code §871(a)(1)(D).

and even if the U.S. becomes a participating C.R.S. jurisdiction, the structure can be retained as there is no other jurisdiction that offers privacy and has as stable a financial industry as the U.S. Enjoy the privacy while it lasts, and know that the U.S. will likely be the last jurisdiction to sign on – if it ever does. Even then, the U.S. is unlikely to provide information that will not be kept confidential by the receiving country.

"The U.S. position on the C.R.S. is likely to be influenced by the outcome of the next election. Whatever happens, planning to use the hybrid trust structure should prove beneficial."

ESTATE OF BARTELL OFFERS TAXPAYER RELIEF IN A REVERSE DEFERRED §1031 EXCHANGE

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Tags
Like-Kind Exchange
Deferred Exchange
Reverse Exchange
Bartell v. Commr.
Replacement Property
Relinquished Property
Accommodation Party

Over the years, the tax-free like-kind exchange provision of the Internal Revenue Code of 1986, as amended, (the "Code") §1031 has evolved from a direct two-party exchange to deferred exchanges and reverse deferred exchanges. A deferred exchange connotes a sale of property and a later purchase of replacement property. The reverse deferred exchange connotes the acquisition of replacement property followed by a sale of the relinquished property. The latest decision by the U.S. Tax Court (the "Tax Court"), in favor of the taxpayer, offers some guidance to those taxpayers that cannot structure a reverse deferred exchange within the safe harbor provided by the Internal Revenue Service ("I.R.S.").

BACKGROUND

Generally, no gain or loss is recognized on the exchange of property held for productive use in a trade or business, or for investment, if such property is exchanged solely for property of "like kind," which is to be held either for productive use in a trade or business, or for investment.[1] Code §1031 was enacted to help taxpayers reinvest or exchange trade or business property without incurring tax at the time of the exchange. If during the transfer the taxpayer received any cash or other property,[2] then the taxpayer recognized gain to the extent of cash or other property received.

Code §1031(3) imposes a timeline during which the transaction must be accomplished. Property received by the taxpayer is not treated as like-kind property if

(i) it is not identified within 45 days; and

(ii) it is not received within the earlier of 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or the due date for the transferor's tax return.[3]

Deferred Exchange

In 1991, the I.R.S. issued regulations that provided rules for a deferred like-kind exchange, where the replacement property[4] is acquired before the relinquished property[5] is transferred. The regulations addressed the following circumstances:

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1 Code §1031(a)(1).

2 *Id.*

3 Code §1031(a)(3).

4 As defined in Treas. Reg. §1.1031(k)1(a).

5 *Id.*

- Security arrangements (such as deed of trust, guarantee, or letter of credit)[6]
- Qualified escrows and qualified trusts[7]
- Qualified intermediaries[8]

Reverse Exchange

Reverse deferred exchanges were not addressed in the regulations, but taxpayers developed a system where the desired replacement property would be "parked" with an accommodation party until the time the taxpayer arranged to transfer the relinquished property to the ultimate transferee in a simultaneous or deferred exchange.

On September 15, 2000, the I.R.S. issued Rev. Proc 2000-37, in response to one taxpayer's attempt to create these complex arrangements. Rev. Proc. 2000-37 provides a safe harbor under which the I.R.S. will not challenge (i) the qualification of property as either replacement property or relinquished property for purposes of Code §1031 and the regulations thereunder, or (ii) the treatment of the exchange accommodation titleholder as the beneficial owner of such property for Federal income tax purposes, if the property is held in a Qualified Exchange Accommodation Arrangement (the "Q.E.A.A.").[9]

For purposes of this revenue procedure, property is held in the Q.E.A.A. if all of the following apply:

- Qualified indicia of ownership of the property is held by the exchange accommodation titleholder (the "E.A.T.").
- At the time the qualified property is transferred to the E.A.T., it is the taxpayer's *bona fide* intent that the property held by the E.A.T. represent either replacement property or relinquished property in an exchange that is intended to qualify for non-recognition of gain (in whole or in part) or loss under Code §1031.
- No later than five business days after the transfer of the qualified property to the E.A.T., the taxpayer and the E.A.T. enter into a Q.E.A.A., which provides that (i) the E.A.T. is holding the property for the benefit of the taxpayer in order to facilitate an exchange under Code §1031 and Rev. Proc. 2000-37, and (ii) the taxpayer and the E.A.T. holder agree to report the acquisition, holding, and disposition of the property as provided in Rev. Proc. 2000-37. The Q.E.A.A. must specify that the E.A.T. will be treated as the beneficial owner of the property for all Federal income tax purposes. Both parties must report the Federal income tax attributes of the property on their Federal income tax returns in a manner consistent with this agreement.
- No later than 45 days after the transfer of ownership of the replacement property to the E.A.T., the relinquished property is properly identified. Identification must be made in a manner consistent with the principles described in Treas. Reg. §1.1031(k)1(c).

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6 Treas. Reg. §1.1031(k)-1(g)(2).

7 Treas. Reg. §1.1031(k)-1(g)(3).

8 Treas. Reg. §1.1031(k)-1(g)(4).

9 Rev. Proc. 2000-37.

- No later than 180 days after the transfer of ownership of the property to the E.A.T. (i) the property is transferred (either directly or indirectly) through a qualified intermediary to the taxpayer as replacement property, or (ii) the property is transferred to a person who is not the taxpayer or a disqualified person as relinquished property.
- The combined time period that the relinquished property and the replacement property are held in a Q.E.A.A. does not exceed 180 days.[10]

ESTATE OF *BARTELL V. COMMR.*

Bartell Drug Co. ("Bartell") is a drugstore chain in Seattle, Washington. In 1999, Bartell entered into an agreement to purchase a replacement property ("Lynwood") from a third party in anticipation of structuring an exchange transaction under Code §1031. Bartell later assigned its rights in the purchase agreement to E.P.C., a third-party exchange facilitator, and entered into a second agreement with E.P.C. The second agreement provided that E.P.C. would purchase Lynnwood and Bartell would have a right to acquire it from E.P.C. for a stated period and price. E.P.C. purchased Lynwood on August 1, 2000. Bartell managed the construction on the property and in June 2001, when the construction was complete, Bartell leased the store from E.P.C. until title to Lynnwood was transferred from E.P.C. to Bartell on December 31, 2001.[11]

In late 2001, Bartell contracted to sell its existing property ("Everett"), to a fourth party. Bartell next entered into an exchange agreement with an intermediary, Section 1031 Services, Inc. ("S.S."), and assigned to S.S. its rights under the sale agreement and under the earlier agreement with E.P.C. S.S. sold Everett, applied the proceeds of that sale to the acquisition of Lynnwood, and had the title to Lynnwood transferred to Bartell on December 31, 2001.[12]

This reverse exchange began prior to the issuance of Rev. Proc. 200-37 and, moreover, did not satisfy the terms of the safe harbor. The I.R.S. challenged the tax-free nature of the exchange and argued that under a "benefits and burdens" analysis, Bartell was the actual owner of Lynnwood, and therefore, the transaction would not qualify for Code §1031 gain deferral. The I.R.S. noted that Bartell already owned Lynnwood at the time of the disputed exchange because Bartell (not E.P.C.) had all the benefits and burdens of ownership of the property – namely, the capacity to benefit from any appreciation in the property's value, the risk of loss from any diminution in its value, and the other burdens of ownership, such as taxes and liabilities arising from the property. Moreover, the I.R.S. contended that Bartell had possession and control over the property during the entire period E.P.C. held the title, first by virtue of the agreement giving Bartell control over the construction of the site improvements and then through a lease that E.P.C. was obligated to provide under the agreement.[13]

The taxpayer pointed out, that both the Tax Court and the Court of Appeals for the Ninth Circuit, to which an appeal in this case would ordinarily go, have expressly

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10 *Id.*

11 *Estate of Bartell v. Commr.*, 147 T.C. No. 5 (August 10, 2016).

12 *Id.*

13 *Id.*

rejected the proposition that a person who takes title to the replacement property for the purpose of effecting a Code §1031 exchange must assume the benefits and burdens of ownership in that property to satisfy the exchange requirement.

The I.R.S argued that the *Bartell* case was similar to *DeCleene v. Commr.*,[14] where the Tax Court endorsed the benefits and burdens test. The Tax Court pointed out the difference between the *DeCleene* case and the case at hand. In *Decleene*, the taxpayer failed to use a third-party exchange facilitator, acquired the replacement property outright, and held the title directly for more than a year before transferring the title to a buyer. Here, a third-party exchange facilitator was used, and under the case law, there is no specific limit on the period in which a third-party exchange facilitator may hold title to the replacement property before title to the relinquished and replacement properties are transferred in a reverse exchange.[15]

"There is no specific limit on the period in which a third-party exchange facilitator may hold title to the replacement property before title to the relinquished and replacement properties are transferred in a reverse exchange."

CONCLUSION

Taxpayers should be advised to structure a reverse exchange to comply with the requirements of the Rev. Proc. 2000-37. The purchase of replacement property in *Estate of Bartell* occurred prior to the issuance of the I.R.S. safe harbor, and that alone may limit the relevance of its holding to other taxpayers. Nevertheless, *Estate of Bartell* may offer some hope to those taxpayers who fail to meet the rigid time requirements of Rev. Proc 2000-37.

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14 *DeCleene v. Commr.*, 115 T.C. No. 34 (November 17, 2000)

15 *Estate of Bartell v. Commr.*

CORPORATE MATTERS:
DOMESTICATION OF NON-U.S. ENTITIES

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Tags
Corporate Law
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Domestication

Domestication – sometimes known as re-domiciliation, transfer, continuance, or company migration – is a process by which a non-U.S. entity transfers its domicile from a foreign jurisdiction to the U.S. while continuing the existence of the entity in its place of organization.[1]

"Foreign jurisdiction" is defined in the Delaware General Corporation Law (the "Act") as "any foreign country or other foreign jurisdiction (other that the United States, any state, the District of Columbia, or any possession or territory of the United States)." [2]

Domestication is commonly allowed in offshore financial centers, such as the British Virgin Islands and the Cayman Islands. It is also permitted by law in Delaware and many other states in the U.S. – a notable exception being New York – and the rules and procedures are somewhat similar between states. This article will focus on the laws of Delaware.

The domestication provisions of the Act would be used when, for example, a company incorporated in the British Virgin Islands wishes to become a Delaware company without having to dissolve the B.V.I. entity.

Section 388 of the Act and Section 18-212 of the Delaware Limited Liability Company Act deal with non-U.S. entities that wish to domesticate into Delaware. Non-U.S. entities looking to domesticate into Delaware should file a certificate of domestication, accompanied by a certificate of incorporation (or formation, in the case of a limited liability company), with the Delaware Secretary of State. The domestication should first be approved in the manner provided by the governing documents of the entity and by any applicable laws of the foreign jurisdiction. For a company to domesticate, it must be permitted in both in its originating jurisdiction and in the destination jurisdiction.

The certificate of domestication is quite simple, laying out the original name of the company and what the name of the company will be following the domestication (as written in the accompanying certificate of incorporation or formation), the date of formation, place of domicile immediately prior to the filing the certificate of domestication, a future effective date (if any), and the manner of approval.

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1 Domestication is also available between states within the U.S. See, for example, Delaware Code §390.

2 "Non-U.S. entity" means a corporation, limited liability company, statutory trust, business trust or association, real estate investment trust, common-law trust, or any other unincorporated business or entity, including a partnership whether general (including a limited liability partnership) or limited (including a limited liability limited partnership), formed, incorporated, created, or that otherwise came into being under the laws of any foreign jurisdiction.

Once the certificate of domestication is effective, the non-U.S. entity is subject to all of the provisions of the Act and the existence of the corporation is deemed to have commenced on the date the non-U.S. entity commenced its existence in the jurisdiction in which it was first formed or incorporated.[3]

Following domestication, the existence of the non-U.S. entity remains intact and it is not required to wind up its affairs or pay its liabilities and distribute its assets, and the domestication does not cause or constitute a dissolution of the non-U.S. entity. If, following domestication, a non-U.S. entity that has become domesticated continues its existence in the foreign jurisdiction in which it was existing immediately prior to domestication, the corporation and the non-U.S. entity shall, for all purposes of the Act, constitute a single entity incorporated and existing under the laws of the State of Delaware and the laws of the foreign jurisdiction.[4]

CONTINUATION

According to the Act, domestication "shall constitute a continuation of the existence of the domesticating non-U.S. entity in the form of a corporation of this State."[5] Further, all of the rights, privileges, and powers of the non-U.S. entity that has been domesticated, as well as all of its property (real, personal, and mixed) and all debts due to it, shall remain vested in and be the property of the corporation to which the non-U.S. entity has been domesticated (and also in the non-U.S. entity, if and for so long as the non-U.S. entity continues its existence in the foreign jurisdiction).

"Following domestication, the rights of creditors and all liens on property of the non-U.S. entity are preserved unimpaired."

CREDITORS' RIGHTS

Following domestication, the rights of creditors and all liens on property of the non-U.S. entity are preserved unimpaired. In addition, all of the non-U.S. entity's debts and liabilities will be attached to the corporation to which it has been domesticated, and may be enforced against the domesticated corporation to the same extent as if the domesticated corporation had originally incurred or contracted such debts and liabilities in its own capacity. However, the rights, privileges, powers, and interests in property of the non-U.S. entity, as well as its debts, liabilities, and duties, shall not be deemed, as a consequence of the domestication, to have been transferred to the domesticated corporation. Such duties will also remain attached to the non-U.S. entity for so long as it continues its existence.

WHY DOMESTICATE?

There are a variety of reasons why the shareholders of an entity may choose to domesticate to the U.S., including dealing with shareholders who are no longer outside of the U.S. and individuals concerned about disclosure rules of certain foreign jurisdictions. Also, the laws of the U.S. or another jurisdiction, if a Delaware entity is considering domesticating out of Delaware, might be better suited for the objectives

[3] Delaware Code §388(d).

[4] Delaware Code §388(j).

[5] *Id.*

of the company, might give it more flexibility or better tax treatment than the laws of its current domicile, or it may be a combination of these factors.

Domestication allows the corporation to retain its original date of incorporation, its existing Federal tax identification number, corporate bank accounts, licenses, and lines of credit. In addition, retaining the age of the corporation may be useful if applying for new lines of credit and/or special government exemptions. While there may be ancillary tax consequences, a domestication is a tax-free "F-reorganization" for Federal tax purposes.[6]

[6] Rev. Rul. 88-25,1988-1 C.B. 116.

UPDATES & OTHER TIDBITS

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Tags
Altera
Brexit
India
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Tax Competitiveness
Tax Compliance
Transfer Pricing
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Xilinx

ALTERA UPDATE – I.R.S. FILES APPEAL, ALTERA & XILINX RESPOND

As *Insights* previously noted, in *Altera*, the U.S. Tax Court (the "Tax Court") held that Code §482 regulations requiring parties to include stock-based compensation in a qualified cost-sharing agreement ("C.S.A.") were invalid because the regulations lack "a basis in fact" and are invalid as a matter of law.[1] Additionally, the court held that the I.R.S. position of assuming an arm's length standard without looking to the actual facts and empirical data from the taxpayer was flawed.

Earlier this year, the I.R.S. filed an appeal with the Ninth Circuit. In its motion, the I.R.S. argued that it is not required to use an empirical analysis unless such an analysis is required in the statute, and U.S. transfer pricing rules have no such requirement.[2] Since the requirement is absent in the regulations governing the taxation of C.S.A.'s, the I.R.S. interpretation of those regulations is sound so long as its process is "logical and rational."[3] The I.R.S. further argues that the Tax Court's reliance of the *Xilinx* case in making its determination in *Altera* was erroneous, since the court did not consider whether amendments effective after the *Xilinx* decision and governing later tax years rendered the *Xilinx* decision obsolete.[4] Per the I.R.S., the post-*Xilinx* amendments made an empirical analysis requirement unnecessary.

Altera responded to the I.R.S. appeal and disagreed with the I.R.S. analysis. Altera believes that the I.R.S. position that the "commensurate with income" ("C.W.I.") standard, present in the C.S.A. regulations, overrides the arm's length principle, is erroneous since such a position was not expressed when the regulation was drafted. Through a review of legislative history, Altera argues that the C.W.I. standard clarifies but does not override the arm's length standard, by stipulating that the transfer of a related-party intangible should reflect the income actually generated by the intangible. Altera finally notes that the Treasury has taken an inconsistent approach in its appeal, as it has previously stated in various tax treaties that the C.W.I. standard does not override the arm's length standard.

While the case works its way through the appeal process, the aftereffects may be severe. Should the I.R.S. prevail, this may indicate that it possesses the power to

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1 Michael Peggs, Stanley C. Ruchelman, and Beate Erwin, "Tax Court Strikes Down I.R.S. Position On Stock Based Compensation in Altera Case." *Insights* 7 (2015).

2 I.R.S. Brief, Dkt. Nos. 16-70496, 16-70497, p. 43.

3 *Id.*

4 *Id.*, p. 46.

interpret Code §482 regulations, lessening certainty and increasing the likelihood of audit controversy. Additionally, guidance on the C.W.I. standard is in short supply compared to the extensive guidance available relating to the arm's length standard. Should the I.R.S. position succeed, previously successful tax planning strategies that relied on the arm's length standard may not be as dependable when a C.W.I. standard is used instead.

U.S. & INDIA RESOLVING COMPETENT AUTHORITY DECISIONS

In January, the U.S. and India reached an agreement to create a framework to resolve transfer pricing disputes involving information technology and software development. The Treasury estimated that there were 250 pending cases to resolve. The Indian commissioner acknowledged that the cases may be resolved slowly, as the Indian competent authority division was short-staffed. Both Indian and American tax practitioners are hoping that resolving the backlog of cases in the information technology sector will eventually lead to bilateral advanced pricing agreements ("A.P.A.'s").

An A.P.A. is an agreement between the I.R.S. and a taxpayer comprising issues arising under Code §482. A bilateral A.P.A. is an A.P.A. in which the issues and methods covered by the agreement are determined by a competent authority resolution reached between the U.S. competent authority and a foreign competent authority.[5] Bilateral A.P.A.'s are advantageous to multilateral entities, as they provide certainty when developing tax plans.

Since January, cases involving information technology with similar fact patterns have been resolved. However, more complex cases remain on the docket. The I.R.S. hopes that the framework will lead to increased bilateral A.P.A.'s with India, although such agreements have not yet materialized.

JAPANESE CARMAKERS FACING UNCERTAIN FUTURE AFTER BREXIT

Honda, Toyota, and Nissan's U.K. manufacturing facilities are on shaky ground following the June Brexit referendum. Commonly known as Japan's Big Three, the giant carmakers each have plants in the U.K. that face a serious risk of closure once the U.K. leaves the European Union ("E.U.").

The fate of the plants will rest upon the final Brexit terms, since a significant portion of the cars they manufacture are exported to other E.U. Member States. According to *The Financial Times*, 75% of Toyota and Nissan cars produced in the U.K. are exported to the E.U., while Honda's U.K. plant exports 40% of its cars to the E.U.

The U.K. government has said it intends to ensure British business retains the ability to trade efficiently with E.U. Member States. However, Carlos Ghosn, Nissan's

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5 "IRS to Begin Accepting Bilateral Advance Pricing Agreement Requests for India on February 16," last reviewed or updated February 1, 2016.

President and C.E.O., expressed concern that forthcoming negotiations will result in a "hard" Brexit, wherein the U.K. will exit from the European Single Market and the company's car exports will become subject to a 10% E.U. import duty. Mr. Ghosn warned that Nissan would not commit to additional investment in the country. In response, U.K. Prime Minister Theresa May met Mr. Ghosn on October 14. She indicated that the government was committed to supporting the automotive industry and suggested that the U.K. could negotiate E.U. access for certain sectors.

"The State Department may revoke an existing U.S. passport or limit the passport so as to only allow return travel the U.S., once a certification has been received."

Nissan is not alone in voicing its concerns. Toyota has also indicated that the imposition of E.U. duties after a Brexit deal would significantly affect its car production activities in the U.K. At the September 28 Paris Motor Show, where Mr. Ghosn delivered his comments, the Society of Motor Manufacturers and Traders ("S.M.M.T.") confirmed that the U.K. car sector's biggest trading partner is the E.U. – with 57.3% of U.K.-produced cars being exported there this year alone. S.M.M.T. Chief Executive Mike Hawes noted that "the future success of this sector will hinge upon the ability of the U.K. to maintain the business and trading conditions that make the sector so competitive globally."

SERIOUSLY DELINQUENT TAX DEBTS PROMPT REVOCATION OR DENIAL OF U.S. PASSPORTS

In early September 2016, the State Department issued final rules concerning passport denial and revocation requirements for individuals who have a seriously delinquent tax debt as defined by the Fixing America's Surface Transportation ("F.A.S.T.") Act, enacted in December 2015. As described in 26 U.S.C. 7345, "[a] seriously delinquent tax debt" is generally an assessment of $50,000 or more (including an interest and penalties) for which a lien or levy has been filed.

The I.R.S. has stated it will issue a certification to the secretary of the treasury for individuals who have a seriously delinquent tax debt, as a result of which the State Department will deny a passport to those individuals. In addition, the State Department may revoke an existing U.S. passport or limit the passport so as to only allow return travel the U.S., once a certification has been received. The State Department maintains the authority to issue a passport, despite receiving a delinquency certification from the I.R.S., for "emergency and for humanitarian reasons."

Exceptions to this rule apply (i) if the debt is being paid in a timely manner pursuant to an agreement to which the individual is party under Code §6159 or §7122, or (ii) if the collection of the debt is suspended because a due process hearing under Code §6330 is requested or pending, or because an election under subsection (b) or (c) of Code §6015 is made or relief under subsection (f) of such section is requested.

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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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