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INSIGHTS

EUROPEAN COMMISSION ROCKING THE BOAT AT ARM'S LENGTH

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EDITORS' NOTE

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

- **European Commission Rocking the Boat at Arm's Length.** This month, transfer pricing economists Theo Elshof, Olaf Smits, and Mark van Mil of Quantera Global, Amsterdam, explore the European Commission's definition of the term "arm's length" in recent State Aid cases. Tax advisers with experience in transfer pricing matters will be surprised to find that reliance on practices of global competitors in the same or similar industry is not relevant when the matter relates to tax rulings comprising State Aid.

- **Goods and Services Tax: A Game Changer.** The passage of the Constitution Act, 2016, has brought India one step closer to adopting a national G.S.T. as its new indirect tax structure. The G.S.T. will replace central and state levies with a goal of eliminating multiple taxation of the same transaction. Sakate Khaitan of Khaitan Legal Associates, Mumbai, explains the rates, the coordination among jurisdictions, and the anticipated effect on business. A paradigm shift in the Indian economy is anticipated at both the micro and the macro levels.

- **§385 Regulations Adopted with Helpful Changes, but Significant Impact Remains.** On October 13, 2016, the Treasury Department released final and temporary regulations under Code §385 relating to the tax classification of debt. The new rules were proposed initially in April and were followed by a torrent of comments from Congress, business organizations, and professional groups. In the final portion of his trilogy on debt-equity regulations, Philip R. Hirschfeld explains the helpful provisions that appear in the final regulations and cautions that not all controversial proposals were modified.

- **French v. U.S. Share-Based Compensation Plans: A Comparative Anaysis.** Share-based compensation incentives are commonly used by corporations worldwide. Employees defer income or realize income immediately at a low value, and the employer accepts a deferred or reduced deduction for compensation expense. Three or four key moments in the life of a stock-based compensation plan can be identified as taxable events: (i) the grant of share-based compensation, (ii) the exercise of an option, (iii) the "vesting" of the underlying shares, and (iv) their subsequent sale. Fanny Karaman and Stanley C. Ruchelman explore tax treatment in France and the U.S. in the context of a French employee who participates in a French plan and is then assigned to the U.S.

- ***In the Matter of GKK 2 Herald LLC* – Effects on the Step Transaction Doctrine.** Clients that invest in U.S. real property have discovered that income tax planning for the structure is only once piece of the planning puzzle. A second piece relates to the imposition of transfer taxes on the sale. If the property is in New York City, planning must consider the real property transfer tax rules of both New York State and New York City. Both jurisdictions impose tax. Rusudan Shervashidze looks at recent cases in the State of New York Division of Tax Appeals Tribunal and the New York City Appeals Tribunal involving the same plan, implemented by the same taxpayer, regarding the same parcel of real property. For New York State purposes, the plan was successful. However, for New York City purposes, the plan was overturned. The statutes at the state and city level are almost identical.

- **I.R.S. Adds New Theory Why Merger Termination Fees Are Capital Rather Than Deductible Costs.** The I.R.S. and taxpayers have long argued whether fees paid by one party to another in a failed merger are capital costs or deductible costs. The consequences of capitalization may be severe, as sufficiently large capitalized costs may never be fully offset by future income. Recently, the I.R.S. enunciated a new theory in support of its capitalization position. Kenneth Lobo and Nina Krauthamer look at two recent internal memoranda indicating the I.R.S. will continue to characterize most merger termination costs as capital rather than deductible costs.

- **Corporate Matters: Should a Liquidated Damages Clause Be Included in a Contract?** A liquidated damage clause in a contract is an attempt by the parties to estimate damages in the event of non-performance or breach of the contract. It represents a way to compensate the aggrieved party for an act of the other party to the agreement. To be enforceable, the amount of the liquidated damages must not be a penalty. Simon H. Prisk explains when these clauses should be used, whether a clause may have a problem regarding its enforcement, and what standards are used for making that determination.

- **Updates & Other Tidbits.** This month, Sultan Arab, Nina Krauthamer, and Galia Antebi look briefly at several timely issues, including (i) a Swiss court order granting UBS the right to appeal an administrative order to disclose French client information to French tax authorities, (ii) the expansion of I.R.S. offshore tax avoidance investigations to banks in countries other than Switzerland, and (iii) a continuing controversy over the Common Consolidated Corporate Tax Base, known as the C.C.C.T.B., proposed by the European Commission.

We hope you enjoy this issue.

- The Editors

EUROPEAN COMMISSION ROCKING THE BOAT AT ARM'S LENGTH

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Tags
Apple
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INTRODUCTION

Many may recall the British parliamentary committee that interviewed top managers of the M.N.E.'s Google, Amazon, and Starbucks in 2012. Margaret Hodge, chairman of the committee at the time, together with other members, grilled the top managers over the tax avoidance schemes of their respective companies. The findings of the committee set things into motion and sparked the O.E.C.D. to initiate the B.E.P.S. Project. Its results were published in the autumn of 2015. Soon after, the European Commission (the "Commission") rolled up its sleeves and adopted the Anti-Tax Avoidance Package ("A.T.A.P."). Even before the introduction of the A.T.A.P., the Commission started using another approach to combat the tax avoidance schemes of M.N.E.'s: the State Aid argument. By now, various M.N.E.'s have been accused of receiving State Aid through publications that – to put it mildly – prompted some strong responses.

Because the Commission's decisions seem to be based on certain new transfer pricing rules for checking the fulfilment of the requirements of State Aid, we ¬¬– as transfer pricing specialists – would like to share with you our current understanding and views on what we can derive from two specific cases: Starbucks and Apple. We will elaborate on these cases and discuss similarities and differences in the approach taken by the Commission and the O.E.C.D.

We will first describe briefly the legal framework of State Aid and our findings on the Commission's general approach to combatting the tax avoidance schemes of M.N.E.'s. Thereafter, we will expound on the Starbucks and Apple cases. We will describe the key facts of each case followed by the Commission's approach and our comments. Before arriving at our conclusion, we will comment on the O.E.C.D.'s interpretation of the arm's length principle ("A.L.P.") versus the Commission's interpretation of the A.L.P. We will conclude by making some final remarks about the Commission's approach in both cases.

LEGAL FRAMEWORK OF STATE AID

Pursuant to Article 107 T.F.E.U., the "Commission Notice on the Notion of State Aid" and the case law of the European Court of Justice, the six constituent elements of the notion of State Aid are as follows:

1. The existence of an undertaking
2. The immutability of the measure to the Member State
3. Its financing through Member State resources

4. The granting of an advantage

5. The selectivity of the measure

6. Its effect on competition and trade between Member States

Each of the constituent elements has always been assessed separately, from one to six, both by the Commission in its decisional practice and by the European Court of Justice in its own cases. In practice, the most disputed elements are economic advantage and selectivity. On the other hand, if the six requirements are met, Article 107 T.F.E.U. stipulates certain exemptions that allow Member States to achieve certain policy objectives. However, these exemptions do not apply to the Apple and Starbucks cases.

THE COMMISSION'S APPROACH

After the publication of the O.E.C.D.'s findings about the 15 B.E.P.S. action items, the Commission pursued its crackdown on tax avoidance schemes by M.N.E.'s. The Commission's insistence on adopting uniform legislative measures in respect of the implementation of Country-by-Country Reporting and the introduction of the A.T.A.P. underlines its goal. Although it is difficult to fully grasp the approach of the Commission in its State Aid decisions, the Commission appears to have chosen favorable Advanced Pricing Agreements ("A.P.A.'s") as the vehicle to set its own approach. This approach focuses on "the market prices that a stand-alone company would pay under normal business circumstances" as a new A.L.P. definition used by the Commission in State Aid cases. The Commission seems to reject the A.L.P. of the O.E.C.D. by arguing that the O.E.C.D.'s A.L.P. only applies to M.N.E.'s. As a result, stand-alone companies, which always have to pay market prices for their individual transactions, are not covered by this A.L.P. Subsequently, a comparison is made between the scrutinized company and a stand-alone company.

The general approach of the Commission's assessment regarding State Aid may be described as follows:

- The basis for a State Aid analysis is the local regulations (tax law and guidance) of the Member State, the so-called reference system.
- The Commission considers that the O.E.C.D.'s A.L.P. is only applicable for M.N.E.'s and does not apply to independent stand-alone companies. Therefore, this principle must be replaced with the Commission's own principle: the market conditions of a stand-alone company under similar business circumstances. As such, the Commission applies its own definition of the A.L.P. when performing its State Aid analyses.
- Based on this set of principles, the State Aid analysis is performed.

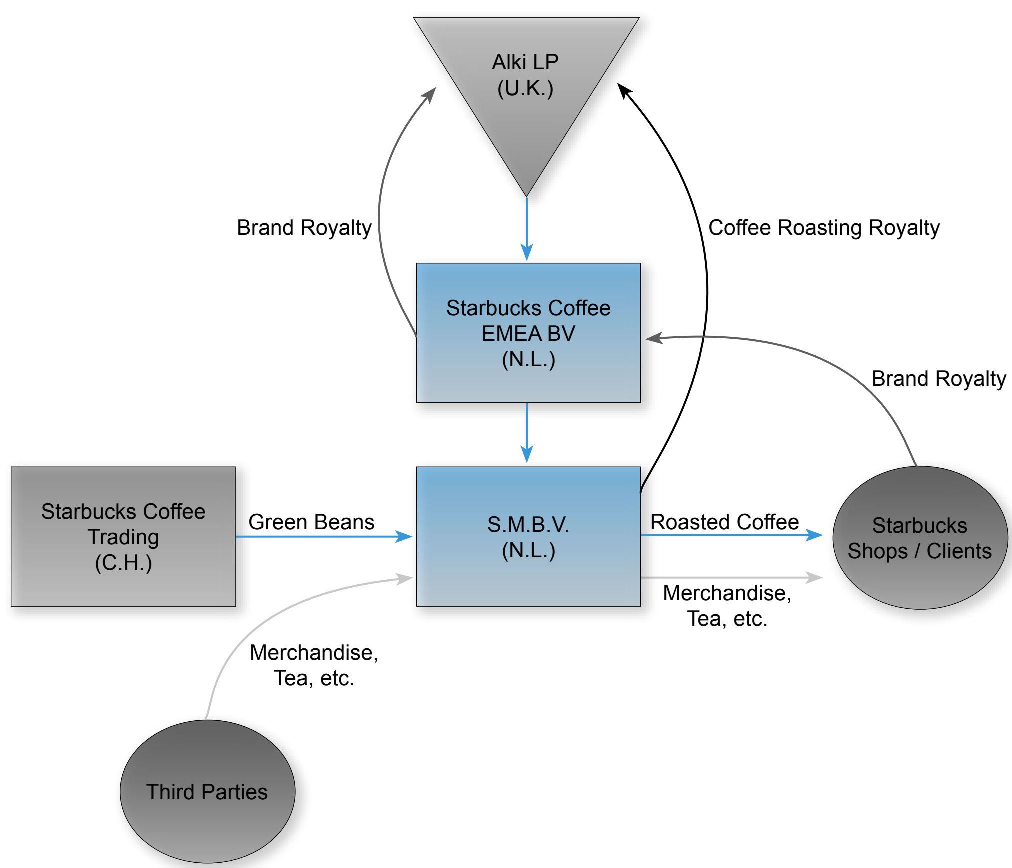
The State Aid instrument grants the Commission the authority to influence the corporate income tax paragraph within the E.U. The Commission uses that grant of authority to set aside the O.E.C.D. guidance provided in the B.E.P.S. reports and the A.L.P., and replaces that guidance with its own version (the "E.U. A.L.P."). The Commission has explicitly stated that the E.U. A.L.P. is not based on Article 9 of the O.E.C.D. Model Convention, as is the A.L.P. supported by the O.E.C.D. In other words, according to the Commission, the battle against State Aid overrides the standard of Article 9.

HOW DOES THE COMMISSION APPROACH WORK OUT IN THE CASES OF STARBUCKS AND APPLE?

The Starbucks Case

Facts

Starbucks started its activities as a coffee-roasting facility in the Netherlands in 2002, through its subsidiary Starbucks Manufacturing BV ("S.M.B.V."). The main activities of S.M.B.V. are the roasting of green coffee beans and the packaging, storage, and sale of roasted beans to Starbucks shops across Europe. S.M.B.V. purchased green coffee beans from a Swiss associated company and paid a royalty to a U.K.-based group company ("Alki LP") for licensing intellectual property rights, which are necessary for the production process and the supply to shop operators. The picture below provides a simplified overview of the transactions relevant to the Dutch A.P.A.



In 2008, an A.P.A. was granted by the Dutch tax authorities to S.M.B.V. for the arm's length remuneration of its main activity as a coffee roasting facility. The Commission concluded that the A.P.A. violated Article 107 T.F.E.U.

“The Commission defines its own principle – the E.U. A.L.P. – from the perspective of a stand-alone company, which always pays market prices for all its individual transactions.”

The Commission’s Decision

In the case of Starbucks, the report of the Commission began with an analysis of the Dutch system of corporate tax and the A.L.P. that is incorporated in Article 8(b) of the Dutch Corporate Income Tax Act (“C.I.T.A.”). In its analysis, the Commission appears to have accepted the Dutch system of corporate tax as the reference system but not the incorporated A.L.P. of the O.E.C.D. The Commission defines its own principle – the E.U. A.L.P. – from the perspective of a stand-alone company, which always pays market prices for all its individual transactions. Therefore, the E.U. A.L.P. criteria can be described as “the market prices a stand-alone company pays under similar business circumstances.” The Commission determined the market prices through the use of information requested from Starbucks’ competitors.

Based on the E.U. A.L.P., the Commission rejected the use of the transactional net margin method (“T.N.M.M.”) to determine an A.L.P., since this O.E.C.D. method can only be applied by M.N.E.’s and not by stand-alone companies that must always pay market prices. Instead, the Commission separately scrutinized all identified intercompany transactions and endeavoured to identify and apply market prices. Available market information was gathered, and competitors of Starbucks were requested to provide relevant information to determine market prices. Without going into specific details, the conclusion of the Commission was that the intercompany transactions of S.M.B.V. did not meet the E.U. A.L.P. applicable to State Aid cases.

The Commission concluded that State Aid was granted to Starbucks for the following reasons. First, the intercompany prices and recent price increases for the green beans from the associated Swiss entity could not be explained when compared to market prices. Second, a stand-alone company would not have paid any royalty to Alki LP since the latter company had virtually no business substance when measured by people and facilities. In that respect, the Commission noted that a license agreement is not an ordinary transaction for a coffee roaster.

Apparently, the granted State Aid was calculated by multiplying the differences in the pricing of green beans and the royalty payment with the Dutch tax rate. As a result, the Commission reasoned that the ruling constituted a form of State Aid that amounted to €20 to €30 million.

Our Remarks

The rejection of the O.E.C.D.’s A.L.P. in State Aid cases raises questions about the formal positioning of the E.U. A.L.P. and its effects on daily discussions between M.N.E.’s and national tax authorities.

Such questions should be handled with great care. The O.E.C.D.’s A.L.P. has been developed over a period of more than 50 years and through the recent work of the O.E.C.D. on B.E.P.S. Thus, it is more than suitable to face challenges and offer solutions to M.N.E.’s and tax authorities. The basis of the O.E.C.D.’s A.L.P. is a thorough understanding of the relevant facts to determine and test the comparability of the conditions of intercompany transactions with transactions between comparable third parties. Therefore, there is no need for another A.L.P. We even regard the creation of the Commission’s own E.U. A.L.P. as a missed opportunity to utilize the full potential of the O.E.C.D. guidance on transfer pricing.

The Commission is not primarily a tax body. Its goal is to ensure a level playing field within the European Single Market, and its officials are sensitive to *sub rosa* government actions that distort trade. In comparison, the standard of the O.E.C.D. reflects the life experience of government officials who have devoted their careers to matters related to tax policy. It should not be unexpected that tax professionals are sympathetic to tax concepts and trade administrators are sympathetic to trade law. Seen in this light, the Starbucks case indicates that winning arguments in one forum – where all M.N.E.'s can obtain comparable tax rulings – turn out to be losers in the other forum – where the business model of the smaller company sets the standard to be followed by M.N.E.'s.

Ultimately, the problem encountered by Starbucks reflects a bureaucratic disjuncture: Which of two competing competencies will control? Still to be heard are anti-trust administrators who may have a third view when an entire industry carries on business in a uniform way.

A disturbing aspect of the Commission's approach in determining market prices is the active participation of competitors in determining an acceptable business model to be imposed on Starbucks. For Starbucks, information from competitors would normally not be available. In O.E.C.D. Transfer Pricing Guidelines parlance, the use of information that is not available to taxpayers is called secret comparables. The Commission's approach leads, from a pure transfer pricing perspective, to all kinds of concerns about the comparability, intercompany effects, and lack of a more detailed understanding of the facts presented by these competitors. As a result, it is hard to determine a correct market price. Furthermore, the comparables, in this case, were not only secret but also tainted – because the comparable information was introduced by competitors responding to a request that would affect Starbucks. Therefore, the O.E.C.D. has stipulated in its Transfer Pricing Guidelines to take caution with the use of secret comparables.

"Ultimately, the problem encountered by Starbucks reflects a bureaucratic disjuncture: Which of two competing competencies will control?"

The Apple Case

Facts

Apple has two subsidiaries in Ireland, namely Apple Sales International and Apple Operations Europe. Both manufacture Apple products in Europe and hold the right to use Apple's intellectual property, for which they contribute considerable amounts for research and development ("R&D") to their U.S. parent company. The sales structure was set up in such a way that customers were contractually buying products from Apple Sales International. The Irish tax authorities granted a similar A.P.A. to both entities. The A.P.A. endorsed a split of the profits for tax purposes in Ireland between the head offices and Irish branches. The vast majority of the profits was allocated to the head offices, which did not have any employees or own premises. The head offices only held occasional board meetings. Moreover, only the Irish branches were subject to tax in Ireland. The head offices were not located in Ireland and, hence, not subjected to tax in Ireland.

The Commission's Approach

Until now, the Commission published only a summary of its reasoning to conclude that the Irish tax rulings amount to State Aid. The full reasoning is not expected to become public before 2017.

In the Apple case, two entities were under scrutiny. The Commission started by analysing the Irish system and determined that the two entities made use of sliding scale pricing. The two head offices seemed to exist on paper only, and as a result, it was unclear where they actually were located. Additionally, the head offices lacked any relevant substance. Consequently, the Commission reasoned that the A.P.A.'s provide an economic benefit to the two entities, because the branches in Ireland never would have paid that amount of profit to a third party, given the lack of relevant substance in the head offices. Finally, the Commission based the amount of State Aid on the Irish corporate income tax rate on the profits allocated by the branches to the residual Irish entities minus the minor functions, which can be allocated to the head offices.

What the Commission refused to accept is the concept that actual services were provided by affiliates in the U.S., or elsewhere, so that at the level of the Irish branches the expenses reflected value provided by the affiliates. Looked at in this manner, the issue was not an Irish issue but an issue at the level of the head offices and, in that jurisdiction, the methodology was accepted pursuant to a qualified joint cost sharing agreement.

Before issuing its decision, the Commission stated that the amount of State Aid could be lowered if more profit was allocated to the sales entities or more costs for the R&D activities were allocated in the U.S. It seems that an "always-somewhere principle" was used by the Commission, entailing that the profits should always be taxed somewhere and, if not, they will be allocated to the jurisdiction that provides the greatest tax within the E.U.

Our Remarks

To date, a complete assessment of the Apple case cannot be made because too many questions remain unanswered in the absence of a published report. Where are the head offices located? If in the U.S., a trade or business should exist. If none existed, an unacceptable tax gap has likely occurred because neither Ireland nor the U.S. levied tax. But is the existence of a tax gap sufficient justification to conclude that Ireland has granted State Aid to Apple? If the head offices are not located in the U.S., on what basis did the Commission determine that State Aid existed in Ireland?

At this point, it is not clear whether the Commission's decision is aligned with the O.E.C.D. guidelines on profit attribution with regard to allocations between head offices and branches, and how this interacts with the analysis of State Aid. Furthermore, the suggestion of the Commission to make use of an always-somewhere principle suggests that the Commission is mostly concerned that the profits are taxed and less concerned with where the profits are taxed and whether double taxation exists.

Finally, the Commission again seems to have use its own A.L.P., as it did in the Starbucks case. Remarkably, it did not scrutinize all the other intercompany transactions – like the royalties received or the lack of payments to other group companies in Europe or the U.S.

THE O.E.C.D. V. THE COMMISSION

Back in 2013, the O.E.C.D. was requested by the G-20 to start the B.E.P.S. Project. This request came after the U.K. hearings to which we referred at the beginning of this article. While the O.E.C.D. was working hard at developing its 15 B.E.P.S.

action items, the Commission did not want to wait for the outcomes and implementation. Therefore, the Commission adopted the A.T.A.P. The A.T.A.P. is meant as a B.E.P.S.-plus package and, therefore, goes even further than the outcomes of the B.E.P.S. Project.

The O.E.C.D., as the guardian of the A.L.P., seems to struggle with the recent State Aid cases of the Commission. In a recent news article, Pascal Saint-Amans, the director of the Centre for Tax Policy and Administration of the O.E.C.D., mentioned that the bulk of Apple's profits belongs in the U.S., as the profits should be aligned to R&D. Although the O.E.C.D. only provided high-level input on the recent cases, it seems that the O.E.C.D. does not agree with the new E.U. A.L.P. introduced in the State Aid cases, and it has pointed out that the functions, assets, and risks of an entity should be remunerated according to the A.L.P. established by the O.E.C.D.

"By defining a separate E.U. A.L.P. and going its own way, the Commission creates undesired confusion."

FINAL REMARKS AND CONCLUSION

We would like to add a few general comments to the Commission's approach. First, the Commission states that, as a condition for the State Aid to exist, the targeted company should be evaluated on a stand-alone basis. By doing so, the Commission ignores, or even disqualifies, the T.N.M.M. and would throw taxpayers back to the time when searches were required for exact comparables to measure the arm's length price. Thus, it regards all facts it deems to be relevant and not just specific transactions. Consequently, a similar discussion would ensue based on transfer pricing rules.

Second, the Commission focuses solely on the economic advantage criterion and disregards the criterion of selectivity. It states that the granted rulings are selective, because the economic advantage can be provided only to M.N.E.'s and not to stand-alone companies. In this way, the Commission deems the selectivity requirement fulfilled if the economic advantage requirement is met, and as a result, these two criteria are merged. The reason why the Commission has merged these two criteria is evident: It has always been difficult to prove the selectivity of rulings because they are available to everyone that applies. The current approach of the Commission has created significant uncertainty for M.N.E.'s worldwide. This has led to concerns that investments in the E.U. will be withheld.

Finally, the Commission's use of its State Aid instrument as grounds for a new definition of an A.L.P. could be viewed as a politically driven act. The Commission is seemingly grabbing the power to control direct taxes. To date, this power remains with the sovereign members of the E.U. The transfer of sovereignty regarding direct taxes has been consistently opposed by the Member States. The Commission would do well to remember that the *raison d'être* of the State Aid tool is to prevent Member States from providing special advantages to domestic companies. The use of an A.P.A. is an excellent instrument for M.N.E.'s and tax authorities to safeguard arm's length remunerations and positions, based on robust transfer pricing documentation and professional judgments. By defining a separate E.U. A.L.P. and going its own way, the Commission creates undesired confusion in this field.

In conclusion, an old saying with roots in team play comes to mind: It is better to row together than each rock the boat separately. It is not clear that the Commission understands the true meaning of this saying.

GOODS AND SERVICES TAX: A GAME CHANGER[1]

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With the passage of the Constitution ("One Hundred and First") Act, 2016, India is now one step closer to adopting a goods and services tax ("G.S.T.") as its new indirect tax structure. Although this is only the first step in the legislative process of transition of the indirect taxes in India to the G.S.T. regime, it is a major leap towards the final implementation of G.S.T. in India.

G.S.T. has been defined as "any tax on supply of goods, or services or both except taxes on the supply of the alcoholic liquor for human consumption." In essence, G.S.T. is a comprehensive single tax that is levied on the supply of goods and services in the country. It is a value added tax that is levied throughout the supply chain with permissible credits for tax paid on inputs acquired.

Once implemented, G.S.T. is expected to provide relief to businesses by adopting a more comprehensive and wider coverage of input tax set-off and service tax set-off. Additionally, G.S.T. will subsume a majority of the central and state levies within its fold, eventually phasing out the different taxes and levies and bringing them under the umbrella of G.S.T. The existing indirect tax laws have not been able to completely remove the cascading burden of taxes already paid at earlier stages. In addition to this, there are several levies by the central government and the states on the manufacture and sale of goods and the provision of services for which no set-off for input tax credit is available. G.S.T. is expected to mitigate these indirect tax inefficiencies currently prevalent under the existing framework.

G.S.T. is not merely a tax change, but is also expected to have a multifaceted impact on business. Given its omnipresence in almost every business transaction, any change in the indirect tax regime will impact almost every level of the value chain. The implementation of G.S.T. is expected to create a paradigm shift in the Indian economy at both the micro level and the macro level. At a macro level, G.S.T. will promote transparency, cost-effectiveness, and lead to a shift from unorganized to organized trade in India. At a micro level, G.S.T. will, *inter alia*, impact an organization's supply chain, procurement, logistics, finance, taxation, and pricing policies. The basic premise behind G.S.T. is to create a single, cooperative, and undivided Indian market, thereby making the economy stronger and more powerful.

BRASS TACKS

As mentioned above, G.S.T. will subsume central and state levies within its fold. To this end, G.S.T. will have three charging components: central G.S.T. ("C.G.S.T.") and state G.S.T. ("S.G.S.T."), levied together on intrastate supplies of goods and services, and integrated G.S.T. ("I.G.S.T.") on interstate supplies of goods and

[1] The following was originally published in *India Unleashed* by Khaitan Legal Associates and has been modified in a manner consistent with our format.

services. The rates would be prescribed keeping in mind revenue consideration and acceptability. While the G.S.T. model will be implemented through multiple statutes, the basic features of indirect tax law, including, *inter alia*, charge ability, the definition of taxable events and taxable persons, the measure of levy, and the basis of classification, would remain uniform across these statutes.

C.G.S.T. and S.G.S.T. will be applicable to all transactions of goods and services made for consideration except those specifically exempted or outside the purview of G.S.T. (*e.g.*, "alcoholic liquor for human consumption and petroleum products") and transactions which are below a prescribed threshold.

Every person who is engaged in an interstate transaction will have to be registered under G.S.T., irrespective of the turnover limits. Interstate transactions shall be subject to I.G.S.T., which shall be collected by the central government. The input tax paid, which may include I.G.S.T., C.G.S.T., and S.G.S.T., on goods or services acquired by a person can be utilized against the payment of I.G.S.T., C.G.S.T., and S.G.S.T., in that order. Thus, the biggest transition which G.S.T. seeks to bring is the free set-off provision and utilization of inputs available.

G.S.T. RATE STRUCTURE

With the government's intention to enforce G.S.T. from April 1, 2017, the rate of tax is likely to be decided in the upcoming winter session of the Parliament. The G.S.T. rate is to be recommended by the G.S.T. Council depending on various factors, such as economic conditions, revenue buoyancy, and revenue neutral state. The G.S.T. Council is also empowered to propose a "floor rate with band" to provide flexibility to states to levy tax at rates higher than the floor rate, but within the band.

"Every person who is engaged in an interstate transaction will have to be registered under G.S.T., irrespective of the turnover limits."

COMPENSATION TO STATES

Setting aside value added tax and merging it with G.S.T. may reduce the revenue generated by states. To provide some relief, for the first five years of G.S.T.'s implementation, the central government will compensate the loss of revenue (if any) which the states may incur due to such implementation.

IMPACT ON BUSINESS

In general, G.S.T. is expected to provide a welcome relief to businesses by providing a wider coverage of input tax set-off by subsuming several central and state levies. Further, by providing a continuous chain of set-off from the manufacturer to the retailer, the tax burden of goods and services on the end-consumer is expected to reduce. This reduced tax burden will also reduce the price of exports, thereby increasing the competitiveness of Indian goods and services in international markets.

Below are some impacts that organizations will need to consider under the proposed G.S.T. regime.

Finance and Working Capital

Organizations may need to rework their budgets and working capital expectations based on the G.S.T. tax rate applicable to them in order to appropriately meet working capital requirements.

Increased Compliance

With state-wide registration required wherever an organization has an establishment, along with increased filings on a monthly basis, it is expected that compliance requirements will increase under the G.S.T. regime.

Supply Chain Management

Most goods have a multi-layered value chain structure with several layers between the manufacturer and the ultimate customers. Typically the value chain would comprise of Manufacturer → Warehouse → Wholesaler → Retailer → Customer. In this value chain, historically, warehousing was a layer largely meant to facilitate interstate branch transfers to avoid the incidence of central sales tax.

Under the G.S.T. regime, seamless input tax credit will be available on interstate transactions, thereby dispensing with the requirement of maintaining warehouses in every state. Multi-state organizations would now have the option to replace many of their small warehouses in multiple states with larger and strategically located mother warehouses in selected states. This is expected to reduce distribution costs, which can be expected to be passed on to the end consumer.

Information Technology

One of the most crucial areas in the transition process will be the technology and enterprise resource planning ("E.R.P.") alignment from the current regime to the G.S.T. regime. Accounting software will need to be aligned to the provisions of the G.S.T. law. Computer systems will have to be updated to include the new tax codes. In addition to this, new modules will need to be developed to enable generation of G.S.T.-compliant output reports and invoices.

Business Realignment

Under the G.S.T. regime, the prices of goods and services are expected to change. As mentioned above, there will be a tax credit at each level in the supply chain. Businesses may need to realign their current business models under the G.S.T. regime in order to stay competitive in the market. To this end, procurement, logistics, distribution, and pricing policies may need to be revisited. Further, businesses may also re-negotiate contracts with vendors, and, *inter alia*, decide the extent to which G.S.T. levies are to be absorbed or passed on to the consumer.

POTENTIAL HURDLES

Like all significant changes in law, G.S.T. is expected to have its set of teething issues during the transition process before the benefits, to their fullest extent, can be enjoyed by industry and consumers.

Technology Infrastructure

At present, the technology infrastructure prevalent across states operate on different platforms and differ in technical complexity. G.S.T. will require a single seamless integrated platform that can efficiently manage the requirements of tax payers across 29 states and seven union territories. The government will have to ensure that this infrastructure is in place before G.S.T. goes live.

Non-G.S.T. Items

At present, alcoholic liquor for human consumption and petroleum products are excluded from the G.S.T. basket. The government will have to be careful that frequent changes are not made to the G.S.T. basket, so as to ensure that G.S.T. will remain the tax of convenience it is desired to be rather than becoming a tax of validation.

Administrative Realignment

The G.S.T. regime contemplates the integration of and information-sharing between the C.G.S.T. and the S.G.S.T. arms. If history is any yardstick, implementation of systems which could enable harmonization and seamless flow of data between inter-governmental bodies could be both time-consuming and arduous.

Division of Tax Collections Between States

The G.S.T. regime will result in states losing their individual identities, as they will only partake in a share of the total levies collected. In order for G.S.T. to succeed, it is essential that a just and equitable formula be sought for distribution of the receipts between the states and the central government.

Different Taxing Powers

The key taxing powers are not merged under the G.S.T. regime and therefore continue to remain either with the central or state government. As a consequence, the non-G.S.T. central and state levies will continue as they are.

CONCLUSION

While the government's initiative to make G.S.T. a reality has been received with overwhelming support and favor, the roadmap to its success is not straightforward and cannot be taken for granted.

In general, G.S.T. is expected to be a boon for commerce and industry due to the expected cost reductions and lower tax rates. The ripple effect of these benefits is also expected to reach the end consumer. Further, G.S.T. will also provide an opportunity to less developed states to compete in the national market on an equal footing, thereby boosting their individual economies and the Indian economy at large. Lastly, the uniform tax rate will also improve the ease of doing business in India, which has been the mantra of the Indian prime minister.

That said, the G.S.T. regime may not be tax-favorable for all industries. For example, the cost of insurance products is expected to rise, which, if passed on to the end consumer, will negatively impact insurance penetration in the country. Further, with the dual charging components, the compliance burden on businesses is expected to increase.

Despite the setbacks, industry is optimistic that G.S.T. will live up to the expectations. The National Council of Applied Economic Research projects that the introduction of G.S.T. would lead to a G.D.P. growth in the range of 0.9% to 1.7%, and export growth between 3.2% and 6.3%.[2] Thus, G.S.T. will not just restructure indirect taxation in India, but will seminally influence the way businesses function.

While the government has its work cut out to ensure that G.S.T. is the game changer it is touted to be, its successful implementation could be a major step towards making India the economic powerhouse it is destined to become.

"G.S.T. is expected to be a boon for commerce and industry due to the expected cost reductions and lower tax rates. The ripple effect of these benefits is also expected to reach the end consumer."

[2] Report of the Select Committee on the Constitution 122nd Amendment Bill, 2014, dated July 22, 2015.

§385 REGULATIONS ADOPTED WITH HELPFUL CHANGES, BUT SIGNIFICANT IMPACT REMAINS

Author
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Tags
Code §163(j)
Code §385
Code §482
Code §7874
Earnings Stripping
Interest Deductions
Inversions
Related-Party Debt

OVERVIEW

On April 4, 2016, the U.S. Treasury Department surprised the tax community by issuing comprehensive and detailed proposed regulations under Code §385 that address whether a debt instrument will be treated as true debt for U.S. income tax purposes or recharacterized, in whole or in part, as equity.[1] As discussed in an earlier article in *Insights*,[2] these regulations contained: (i) new documentation requirements that must be met to support debt tax treatment, (ii) a debt recharacterization rule that will treat debt as equity when issued in a certain manner (such as when the debt constitutes property that is issued as a dividend to a shareholder) or when caught by an anti-abuse rule applicable to dividends funded by a borrowing of cash from the shareholder or a related party and certain other situations, and (iii) a bifurcation rule giving the I.R.S. authority to split a debt instrument into part equity and part debt as of the date of issuance.

In an unprecedented reaction, the proposed regulations received widespread criticism from members of Congress, the business community, bar and accounting groups, and practitioners. As discussed in an earlier follow-up article in *Insights*,[3] the comments raised policy and technical issues. Some commentators and members of Congress called for a complete withdrawal of the regulations. Other commentators called for major revisions to narrow the impact on transactions that are primarily motivated by business or acceptable Treasury procedures rather than tax savings.

On October 13, 2016, the Treasury Department released final and temporary regulations under Code §385 relating to the tax classification of debt.[4] The final and temporary regulations make several helpful changes to the proposed regulations including the following:

- Elimination of the bifurcation rule[5]

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

2 Philip Hirschfeld, "Related-Party Debt: Proposed Code §385 Regulations Raise Major New Hurdles," *Insights* 5 (2016).

3 Philip Hirschfeld, "Uproar Over Proposed §385 Regulations: Will Treasury Delay Adoption?," *Insights* 8 (2016).

4 T.D. 9790 adopting Treas. Reg. §§1.385-1, 2, 3, and 4, and Treas. Reg. §§1.385-3T and 4T.

5 The bifurcation rule was found in Prop. Treas. Reg. §1.385-1(d). The proposed regulations contained few guiding principles on how such a bifurcation would be determined. While the final regulations omitted the bifurcation rule, the "Treasury and the IRS continue to study the comments received [on the bifurcation rule]" (T.D. 9790, Background III(D)). Thus, the bifurcation rule may resurface in the future.

- Adoption of a provision narrowing the scope of the regulations so that they will not impact non-U.S. issuers of debt,[6] S Corporations, non-controlled real estate investment trusts ("R.E.I.T.'s"), or regulated investment companies ("R.I.C.'s")[7]

- Adoption of a grandfathering rule preventing the application of the documentation rules for debt issued before January 1, 2018

- Adoption of expanded exceptions to the debt recharacterization rule for distributions of earnings and profits ("E&P"), equity contributions, and certain other transactions

- Adoption of an exception that removes from coverage short-term cash pooling arrangements and debt instruments issued by regulated financial groups and insurance companies

- Expansion of the $50 million threshold (so that it covers all corporations) and a limitation that prevents recharacterization on a cascading basis

- Revision of the effective date and transition rules

However, the basic structure of the regulations remains unchanged, including documentation rules – albeit with relaxed due dates – and the anti-abuse funding rule previously mentioned.[8]

In final form, these regulations will have a major impact on the way debt is structured to ensure classification as true debt for tax purposes. Challenges to the validity of these regulations are anticipated.

SUMMARY OF THE REGULATIONS

The final and temporary regulations under Code §385[9] may cause related-party debt to be recharacterized as equity in two instances:[10]

- First, debt instruments may be treated as stock if issued in certain disfavored transactions, such as when a debt instrument issued by the taxpayer is distributed to its shareholder as a dividend.[11]

- Second, timely compliance with documentation requirements is required for related-party debt to be treated as true debt for tax purposes.[12]

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6 A covered member included a foreign corporation under the Prop. Treas. Reg. §1.385-1(c)(2)(ii). The final regulations reserved on treating a foreign corporation as a covered member (Treas. Reg. §1.385-1(c)(2)(ii)).

7 Treas. Reg. §1.385-1(c)(4).

8 Treas. Reg. §§1.385-2(b)(1) and 3(b)(1). The debt recharacterization regulations, however, provide a sole exception so that for purposes of the consolidated return rules, recharacterization will not apply (Treas. Reg. §1.385-3(d)(7)).

9 References to a section designate a section of the Internal Revenue Code of 1986, as amended, (the "Code") unless otherwise indicated.

10 Prop. Treas. Reg. §§1.385-1, 2, 3, and 4.

11 Treas. Reg. §1.385-3.

12 Treas. Reg. §1.385-2.

Debt Subject to New Rules

These rules apply to debt issued between members of an expanded group ("E.G."). An E.G. is an affiliated group of corporations within the meaning of Code §1504 (which generally requires 80% ownership) with significant modification:[13]

- The E.G. includes foreign and tax-exempt corporations. For example, an E.G. will exist if a foreign corporation owns 80% or more of a U.S. corporation.[14]
- The E.G. definition is satisfied by ownership of stock representing 80% or more of either vote *or* value, rather than vote *and* value.[15] The final regulations rely on the constructive ownership rules of Code §318(a) when determining whether the ownership test is met.[16]
- Debt between members of a U.S. consolidated corporate group is not subject to these rules since all the members of that group are treated as one corporation.[17]

In response to comments made to the proposed regulations, the final regulations exempt S Corporations, R.I.C.'s, and R.E.I.T.'s from being members of an E.G. This exemption does not apply when the R.I.C. or R.E.I.T. is controlled by members of the E.G.[18] The Treasury Department rejected requests to exempt tax-exempt entities and insurance companies from membership in an E.G.[19]

While a foreign corporation can be a part of an E.G., the final regulations exempt a foreign corporation from being a "covered member" of the E.G.[20] Consequently, debt issued by the foreign corporation is not subject to the documentation and recharacterization rules.

Debt Recharacterization Rule

The debt recharacterization rule reclassifies debt issued between members of an E.G. if issued in any of the following three fact patterns ("Targeted Transactions"):

- A debt instrument issued by an E.G. member is distributed to a shareholder who is part of that E.G. It does not matter whether the instrument is treated as a dividend because there is sufficient E&P or a return of capital.
- An E.G. member acquires stock of another member in exchange for the

13 Treas. Reg. §1.385-1(c)(4)(i). An affiliated group of corporations generally files a consolidated Federal income tax return.

14 *Id.*

15 Treas. Reg. §1.385-1(c)(4)(i)(A).

16 Treas. Reg. §1.385-1(c)(4)(iii). While the proposed regulations modified the indirect ownership test of Code §1504(a)(1)(B)(i) by adding a "directly or indirectly" test, the final regulations retained and expanded that concept by adding the directly or indirectly test to the application of Code §1504(a)(1)(B)(i) (Treas. Reg. §1.385-1(c)(4)(i)).

17 Treas. Reg. §1.385-4T(b).

18 Treas. Reg. §1.385-1(c)(4).

19 T.D. 9790, Summary of Comments and Explanation of Revisions, III(B)(2)(a).

20 Treas. Reg. §1.385-1(c)(2)(ii).

issuance of a note to the selling member, other than in an exempt exchange.

- A debt instrument is transferred in exchange for property of another E.G. member in the context of certain tax-free asset reorganizations when and to the extent that
  - a shareholder that is a member of the E.G. before the reorganization receives the debt instrument,
  - the receipt of the debt instrument is part of the plan of reorganization.[21]

The Treasury Department rejected most requests to modify the second and third prong of the definition of Targeted Transactions. However, it expanded an exception for an acquisition of *newly issued* stock from a majority-owned subsidiary to apply to acquisitions of *existing* stock from a majority-owned subsidiary.[22]

"The final regulations adopt an anti-abuse rule called the 'funding rule' to combat cases where companies engage in two transactions that together have the same effect as a direct issuance of debt in a Targeted Transaction."

The final regulations adopt an anti-abuse rule called the "funding rule" to combat cases where companies engage in two transactions that together have the same effect as a direct issuance of debt in a Targeted Transaction. To illustrate, the shareholder lends funds to a subsidiary that is an E.G. member, and the E.G. member distributes a dividend to the shareholder in the same amount. Before the loan, the shareholder held cash, and after the dividend, the shareholder held the same amount of cash and a note of the subsidiary. If the roundtrip of the cash is ignored, the only transaction left is the creation of a note distributed to the shareholder. When integrated, this two-step transaction produces the same result as a simple distribution of a note.

The funding rule in the regulations addresses two-step transactions by recharacterizing the debt as equity. Under the funding rule, debt is subject to recharacterization if the debt instrument is considered to be a "principal purpose debt instrument."[23] A principal purpose debt instrument is a debt instrument issued by "the funded member" with a principal purpose of funding one of the following distributions or acquisitions ("Targeted Funding Transactions"):

- A distribution of cash or property by the funded member to another E.G. member
- An acquisition by the funded member of stock of another E.G. member for cash or property other than in an exempt exchange (as defined above)
- An acquisition of assets of one E.G. member by another, if the E.G. lends funds to the acquirer that are used as part of the consideration to acquire the assets of the transferor in a reorganization involving stock and boot[24] when the integrated transaction concludes with a distribution of the stock and boot to the common parent[25]

The principal purpose of the debt issuance is determined based on facts and

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21 Treas. Reg. §1.385-3(b)(2). As discussed in the prior article in *Insights*, there are certain limitations or exceptions to this rule.

22 *Id.*; T.D. 9790, Background V(C)(3)(c).

23 Treas. Reg. §1.385-3(b)(3)(i). As discussed in a prior article in *Insights*, there are certain limitations or exceptions to this rule.

24 In other words, "boot" within the meaning of Code §356.

25 Treas. Reg. §1.385-3(b)(3)(ii).

circumstances.[26] However, the funding rule contains a "nonrebuttable" presumption that an instrument is a principal purpose debt instrument if the debt is issued at any time during the 72-month period beginning 36 months before and ending 36 months after the issuing member makes a distribution or acquisition that is considered a Targeted Funding Transaction (the "72-Month Testing Period").[27] For example, if a foreign parent corporation lends $1,000 to its wholly-owned subsidiary in the U.S. and 30 months later the U.S. subsidiary distributes $1,000 cash back to the foreign parent (but not as part of a pre-arranged plan), the nonrebuttable presumption applies and the debt instrument is characterized as equity.

The nonrebuttable presumption has been retained in the final regulations in much the same manner as it existed under the proposed regulations but with broadened exceptions discussed below.

Documentation Rules

There are four parts to the documentation rules that impose a new set of requirements to support true debt status for U.S. tax purposes:

- The first requirement relates to the need for there to be a binding obligation to repay the funds advanced. This rule requires evidence in the form of a timely-prepared written document executed by the parties.[28]
- The second requirement is for the loan documentation to delineate the creditor's rights to enforce the debtor's obligation to repay.[29] Typical creditor rights include the right to trigger a default, the right to accelerate payments, and the superior right over shareholders to share in the assets of the issuer if the issuer is dissolved or liquidated.
- The third requirement is a reasonable expectation of repayment by the issuer of the loan.[30] This rule requires that the taxpayer prepare and maintain supporting documentation such as cash flow projections, financial statements, business forecasts, asset appraisals, and the determination of debt to equity and other relevant financial ratios of the issuer. Credit-worthiness is determined under an objective standard. When a disregarded entity having limited liability (such as a wholly-owned U.S. L.L.C.) is the borrower, credit-worthiness is based on the assets of the disregarded entity.
- The final requirement is evidence of a genuine debtor-creditor relationship.[31] This means that payment of interest and principal is made when and as provided in the loan documentation, and such payment must be demonstrated. Examples of proof of payment include wire transfer records and account statements.

The final regulations retained these four requirements, which were set forth in the proposed regulations, but added some changes discussed below to ease compliance

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26 Treas. Reg. §1.385-3(b)(3)(iv)(A).

27 Treas. Reg. §1.385-3(b)(3)(iv)(B)(1).

28 Treas. Reg. §1.385-2(b)(2)(i).

29 Treas. Reg. §1.385-2(b)(2)(ii).

30 Treas. Reg. §1.385-2(b)(2)(iii).

31 Treas. Reg. §1.385-2(b)(2)(iv).

and exempt certain debt instruments from their application.

BENEFICIAL CHANGES TO THE DEBT RECHARACTERIZATION RULE

While retaining the debt recharacterization rule largely in its proposed form, the final and temporary regulations made a few helpful changes to address comments that were received.

Expanded E&P Exception

As noted above, the funding rule is triggered if there is (i) an issuance of a debt instrument and (ii) a Targeted Funding Transaction (*e.g.*, a distribution made by the issuing company), made during the 72-Month Testing Period. The proposed regulations contained an exception where the Targeted Funding Transaction was a distribution of *current* E&P,[32] meaning the earnings generated during the year in which the loan is made. The proposed regulations reduced the amount of tainted distribution made by the amount of the current E&P. This reduced or eliminated the Targeted Funding Transaction.

The Treasury Department received comments that the E&P exception should apply to both *current* and *accumulated* E&P.[33] The final regulations adopted this recommendation but with a limitation. Under the final regulations, *current* E&P and *accumulated* E&P are to be considered if the accumulated E&P was accumulated in taxable years ending after April 4, 2016.[34] Thus, the Treasury Department decided to limit E&P to "the period of a corporation's membership in a particular expanded group."[35]

Expanded Access to $50 Million Threshold Exception

The proposed regulations contained a $50 million threshold exception so that the debt recharacterization rule would not apply if a taxpayer's related-party debt does not exceed $50 million. Commentators highlighted the cliff effect of the provision. If a taxpayer issued $1 of debt in excess of the $50 million threshold, the benefit of

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32 Prop. Treas. Reg. §1.385-3(c)(1). The technical approach taken in the regulations is to reduce the amount of distributions made by the amount of the current E&P. To illustrate how the proposed regulations worked, a U.S. company borrows $100 million from its foreign parent and issues its note to the foreign parent for $100 million. The following year, the U.S. company makes a $10 million cash distribution to its foreign parent. The $10 million distribution is treated like a taxable dividend since the U.S. company has $4 million of current E&P and $5 million of accumulated E&P. Since $4 million of the distribution is from current E&P, only the remaining distribution of $6 million is a Targeted Funding Transaction triggering the funding rule and recharacterization of $6 million of the debt as equity.

33 T.D. 9790, Summary of Comments and Explanation of Revisions, V(E)(3)(a).

34 Treas. Reg. §1.385-3(c)(3)(i). Thus, for the prior example, the full amount of the $10 million distribution would be excluded assuming that the accumulated E&P was attributable to taxable years ending after April 4, 2016. If the accumulated E&P is partially for prior years, the prior year accumulated E&P cannot be used for this exclusion to apply.

35 T.D. 9790, Summary of Comments and Explanation of Revisions, V(E)(3)(a).

this rule would be lost, entirely.[36] The final regulations eliminate this cliff effect[37] so that all taxpayers can exclude the first $50 million of debt that would otherwise be recharacterized.[38]

Exclusion of Qualified Short-Term Debt Instruments

The proposed regulations contained an exception that excluded debt issued in the ordinary course of the issuer's business. The Treasury Department received comments that the ordinary course exception was very narrow and the regulations should be revised so that these rules should not apply to non-tax motivated cash management techniques, such as cash pooling or revolving credit arrangements, nor to ordinary course short-term lending outside a formal cash management arrangement.[39]

In response to these comments, the final regulations include an exception for qualified short-term debt instruments.[40] The definition of a qualified short-term debt instrument is set forth in the temporary regulations[41] and is subject to further change.

The definition of a qualified short-term debt instrument is long and complex and likely best understood by those involved in the treasury function of the E.G. A debt instrument is a qualified short-term debt instrument if the debt instrument is (i) a short-term funding arrangement that meets one of two alternative tests (the specified current assets test or the 270-day test),[42] (ii) an ordinary course loan,[43] (iii) an interest-free loan,[44] or (iv) a deposit with a qualified cash pool header.[45]

"The final regulations include an exception for qualified short-term debt instruments."

To satisfy the specified current assets test, two requirements must be satisfied:

> First, the rate of interest charged with respect to the debt instrument is less than or equal to an arm's length interest rate, as determined under section 482 and the regulations thereunder, that would be charged with respect to a comparable debt instrument with a term that does not exceed the longer of 90 days and the issuer's normal operating cycle.[46]
>
> Second, . . . immediately after the covered debt instrument is issued, the issuer's outstanding balance under covered debt instruments issued to members of the issuer's expanded group that satisfy any of (i) the interest rate requirement of the specified current assets test, (ii) the 270-day test . . . , (iii) the ordinary course loan exception, or

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36 Prop. Treas. Reg. §1.385-3(c)(4).

37 T.D. 9790, Summary of Comments and Explanation of Revisions, V(E)(4).

38 Treas. Reg. §1.385-3(c)(4).

39 T.D. 9790, Summary of Comments and Explanation of Revisions, V(D)(8)(c).

40 Treas. Reg. §1.385-3(b)(3)(i).

41 Treas. Reg. §1.385-3T(b)(3)(vii).

42 *Id.*, (A).

43 *Id.*, (B).

44 *Id.*, (C).

45 *Id.*, (D).

46 *Id.*, (A)(1)(ii).

(iv) the interest-free loan exception, does not exceed the amount expected to be necessary to finance short-term financing needs during the issuer's normal operating cycle.[47]

For a debt instrument to satisfy the 270-day test, three conditions must be met:[48]

- First, the debt instrument must (i) have a term of 270 days or less, or be an advance under a revolving credit agreement or similar arrangement, and (ii) bear a rate of interest that is less than or equal to an arm's length interest rate, as determined under Code §482, that would be charged with respect to a comparable debt instrument with a term that does not exceed 270 days.
- Second, the issuer must be a net borrower from the lender for not more than 270 days during the taxable year of the issuer, and in the case of a covered debt instrument outstanding during consecutive taxable years, the issuer may be a net borrower from the lender for not more than 270 consecutive days.
- Third, a debt instrument will satisfy the 270-day test only if the issuer is a net borrower under all covered debt instruments issued to any lender that is a member of the issuer's E.G. that otherwise would satisfy the 270-day test, other than ordinary course loans and interest-free loans, for 270 or fewer days during a taxable year.

The temporary regulations generally broaden the ordinary course exception in the proposed regulations to provide that a debt instrument constitutes a qualified short-term debt instrument if issued as consideration for the acquisition of property other than money, in the ordinary course of the issuer's trade or business. In contrast to the proposed regulations, the temporary regulations provide that, to constitute an ordinary course loan, an obligation must be reasonably expected to be repaid within 120 days of issuance.[49]

Exclusion of Debt Instruments Issued by Regulated Financial Groups and Insurance Entities

The final regulations add an exception to the debt recharacterization rule so that a covered debt instrument does not include a debt instrument issued by either a regulated financial company or a regulated insurance company.[50] The rationale for this exclusion is that abuse is not viewed as being likely since these entities are subject to a specified degree of regulatory oversight regarding their capital structures.[51]

Limiting Certain Cascading Recharacterization

Several comments requested that the final and temporary regulations should include rules to address cascading recharacterizations. These are situations in which the recharacterization of one covered debt instrument could lead to deemed transactions that result in the recharacterization of one or more other covered debt instruments

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47 *Id.*, (A)(1)(iii).

48 *Id.*, (A)(2).

49 *Id.*, (B).

50 Treas. Reg. §1.385-3(g)(3)(i).

51 T.D. 9790, Summary of Comments and Explanation of Revisions, V(G)(1), (2).

in the same E.G.[52] The final regulations narrow the application of the funding rule by preventing the cascading consequences of recharacterizing a debt instrument as stock in certain circumstances. The final regulations provide that once a covered debt instrument is recharacterized as stock under the funding rule, the distribution or acquisition that caused that recharacterization cannot cause a recharacterization of another covered debt instrument after the first instrument is repaid.[53]

Credit for Certain Capital Contributions

Numerous comments requested that capital contributions to a member should be netted against distributions or acquisitions by the member for purposes of applying the debt recharacterization and funding rules. The commentators reasoned that, to the extent of capital contributions, a distribution does not reduce a member's net equity.[54]

The Treasury Department agreed that it is appropriate to treat distributions or acquisitions as funded by new equity before related-party borrowings.[55] The final and temporary regulations provide that a distribution or acquisition that may trigger application of this rule is reduced by the aggregate fair market value of the stock issued by the covered member in one or more qualified contributions (the "Qualified Contribution" reduction).[56] A Qualified Contribution is a contribution of property (other than excluded property) to the covered member by any member of the covered member's E.G. in exchange for stock of the covered member during the qualified period. The qualified period generally means the period beginning 36 months before the date of the distribution or acquisition, and ending 36 months after the date of the distribution or acquisition.

Exception for Equity Compensation

Some comments requested an exception to the extent that the acquiring entity makes an actual payment for the stock of the issuing corporation that is conveyed to a person as consideration for services.[57] The final regulations adopt this approach by adding an exception for the acquisition of stock delivered to employees, directors, and independent contractors as consideration for services rendered.[58]

Expansion of the 90-Day Transition Rule for Recharacterization

The proposed regulations provided for a 90-day delay in implementation for debt instruments issued on or after April 4, 2016, but prior to publication of the final regulations in the Federal Register.[59] The final regulations expand this delayed implementation to any debt instrument issued on or after the date that is 90 days after publication of the final regulations in the Federal Register. This 90-day delayed

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52 *Id.*, V(B)(4).

53 Treas. Reg. §1.385-3(b)(6).

54 T.D. 9790, Summary of Comments and Explanation of Revisions, V(E)(3)(b).

55 *Id.*

56 Treas. Reg. §1.385-3(c)(3)(ii).

57 T.D. 9790, Summary of Comments and Explanation of Revisions, V(E)(2)(b).

58 Treas. Reg. §1,385-3(c)(2)(ii).

59 Prop. Treas. Reg. §1.385-3(j).

date is January 11, 2017.[60]

BENEFICIAL CHANGES TO THE DOCUMENTATION RULES

While retaining the documentation rule largely in its proposed form, the final and temporary regulations make a few helpful changes.

Delayed Implementation

Under the final regulations, the documentation rules only apply to debt instruments issued on or after January 1, 2018.[61] This change will allow taxpayers more time to properly implement procedures to comply with the new documentation rules.

Extension of Period Required for Compliance

The proposed regulations generally required documentation to be prepared not later than 30 calendar days after the date the instrument becomes a related-party debt instrument.

The final regulations eliminate the 30-day timely preparation requirement and instead treat documentation and financial analysis as having been timely prepared if it is in existence at the time the issuer's Federal income tax return is filed (taking into account all applicable extensions).[62] At a minimum, a taxpayer will have until the filing date of the tax return of the taxable year that includes January 1, 2018, to complete the documentation requirements.

Limited Rebuttable Presumption

The proposed regulations provided that compliance with the documentation rules is required for true debt status. If any debt instrument is not timely documented, it would be treated as equity regardless of any argument in support of debt treatment.[63]

The final regulations add a rebuttable presumption, rather than a mandatory recharacterization. However, the rebuttable presumption applies only if an E.G. is highly compliant with the documentation rules.[64] Consequently, the relaxed standard applies in a narrow class of situations.

To demonstrate that a high degree of compliance exists, a taxpayer must meet one of two tests:

- Under the first test,[65] a taxpayer must demonstrate that covered instruments representing at least 90% of the aggregate issue price of all covered instruments within an E.G. are in compliance with the documentation rules.

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60 Treas. Reg. §1.385-3(j).

61 Treas. Reg. §1.385-2(d)(2)(iii).

62 Treas. Reg. §1.385-2(c)(4).

63 Prop. Treas. Reg. §1.385-2(b).

64 Treas. Reg. §1.385-2(b)(2)(i).

65 *Id.*, (B)(1).

- Under the second test,[66] a taxpayer must demonstrate either that
  - no covered instrument with an issue price of more than $100 million and less than 5% of the covered instruments outstanding failed to comply with the documentation rules, or
  - no covered instrument with an issue price of more than $25 million and less than 10% of the covered instruments outstanding failed to comply with the documentation rules.

"The rebuttable presumption applies only if an E.G. is highly compliant with the documentation rules. Consequently, the relaxed standard applies in a narrow class of situations."

An anti-stuffing rule applies to these requirements so that a debt instrument will not be counted in applying these requirements if it was entered into with a principal purpose of satisfying these rules.[67]

If a taxpayer is eligible for rebuttable presumption treatment, then the debt will continue to be treated as debt for tax purposes if the taxpayer clearly establishes that there are sufficient common law factors present to treat the instrument as indebtedness, including that the issuer intended to create indebtedness when the instrument was issued.[68]

Master Agreements Allowed for Revolving Credit Agreements, Cash Pooling, and Similar Arrangements

The Treasury Department received comments requesting relief in the case of revolving credit agreements or cash pooling and similar arrangements. The concern expressed was that a technical application of these rules could lead to a burdensome need to prepare documentation for each advance under the lending arrangement.

In response, a special rule is added to cover

- a revolving credit agreement,
- a cash pool agreement,
- an omnibus or umbrella agreement that governs open account obligations or any other identified set of payables or receivables, or
- a master agreement that sets forth general terms of an instrument with an associated schedule or ticket that sets forth the specific terms of an instrument.[69]

The documentation requirements regarding a separate note or written obligation to repay the loan and documentation of creditor's rights in each written agreement are deemed satisfied if the material documentation associated with the instrument, including all relevant documents, is prepared and maintained in accordance with the requirements of the regulations.[70] A single master agreement can satisfy the two requirements.

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[66] *Id.*, (B)(2).

[67] Treas. Reg. §1.385-2(b)(2)(i)(B)(4).

[68] Treas. Reg. §1.385-2(b)(2)(i)(A).

[69] Treas. Reg. §1.385-2(c)(3)(i)(A).

[70] *Id.*, (2).

With respect to the requirement of a reasonable expectation of repayment, the written documentation need only be prepared once every year for all advances in the year, rather than multiple times, once each for all advances. This documentation should demonstrate that the issuer's financial conditions support a reasonable expectation that the issuer would be able to pay interest and principal in respect of the maximum principal amount outstanding under the terms of the revolving agreement.[71]

Partnership Debt Exclusion

The Treasury Department decided that the documentation rules should not apply to partnership debt.[72] However, the Treasury Department indicated that it remains concerned about partnership debt so that an anti-abuse rule can bring partnership debt into coverage under the documentation rules if the partnership is used with a principal purpose of avoiding the application of the documentation rules for corporations.[73]

Treatment of Disregarded Entities

The final regulations provide that if debt issued by a disregarded entity does not satisfy the documentation rules, the debt is recharacterized as equity of the corporation that is the sole member.[74] This approach reflects comments that the debt recharacterization rules should not cause a disregarded entity to be treated as a partnership.[75] Consequently, if equity treatment is mandated, the equity is in the sole member, not its disregarded subsidiary.

CONCLUSION

Despite numerous comments made to the Treasury Department for major modification or deferral of adoption of these rules, the final and temporary regulations under Code §385 retain the basic approach of the proposed regulations, with some modifications to restrict the impact of the rules to large corporations. The Treasury Department cautions that the final regulations provide an additional level of tests that must be met in addition to the tests under case law.[76] They supplement the rules under existing law rather than replace those rules. As a result, the common-law concerns about what debt-to-equity ratio is acceptable, as well as the reasonableness of other terms of the debt (such as fixed maturity date and interest rate), remain.

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71 Treas. Reg. §1.385-2(c)(3)(i)(A)(3).

72 T.D. 9790, Summary of Comments and Explanation of Revisions, IV(B)(1)(a).

73 Treas. Reg. §1.385-2(f).

74 Treas. Reg. §1.385-2(e)(4).

75 T.D. 9790, Background IV(A)(4).

76 Treas. Reg. §1.385-1(b). For a discussion of these common-law principles, see Hirschfeld, "Related-Party Debt: Proposed Code §385 Regulations Raise Major New Hurdles."

FRENCH V. U.S. SHARE-BASED COMPENSATION PLANS: A COMPARATIVE ANALYSIS

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Tags
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U.S.

INTRODUCTION

While the terms of plans vary from country to country, share-based compensation incentives are commonly used by corporations worldwide. Employees defer income or realize income immediately at a low value and the employer accepts a deferred or reduced deduction for compensation expense. While the goals of these plans share common themes, the tax rules that make a particular plan attractive differ from country to country. Both sides to the arrangement are "invested" in operational success that leads to a liquidity event in the form of a public offering or a strategic sale.

FACTUAL CONTEXT

This article is drafted with the following situation in mind. A hypothetical French-resident employee participates in a French share-based compensation plan granted by a start-up operation. At the time of grant, neither the employer nor the employee envisions an expansion to the U.S. After several years pass, the employer forms a U.S. distribution subsidiary and sends the individual abroad to head the U.S. operation.

While the employer is concerned primarily with the success of the expansion, both the employer and the employee should be concerned with the U.S. tax treatment of the employee at the time of the liquidity event, which is the goal of the share-based scheme. The employee is concerned with avoiding excessive taxation on a global basis. The employer is concerned that the expense arising from the stock-based compensation scheme is fully deductible in the U.S. or France.

At this point, French and U.S. tax counsel are generally retained by the employer. The employee should make certain that the scope of the assistance encompasses a tax analysis of the employee's situation. If not, the employee should retain separate counsel to understand the tax consequences of his or her French share-based compensation plan for both French and U.S. tax purposes.

While a French share-based compensation plan qualifies for the relevant French beneficial income tax regime prior to moving to the U.S., it generally does not qualify for beneficial treatment on the U.S. side. Thus, French plans generally constitute nonqualified share-based compensation plans for U.S. tax purposes.

The balance of the article aims at highlighting the beneficial share-based compensation regimes for French tax purposes and providing an analysis of the U.S. tax treatment of nonqualifying share-based compensation plans.

THE MAJOR FRENCH SHARE-BASED COMPENSATION REGIMES

Three main share-based compensation regimes exist under French corporate and tax laws:

- Free share plans (“*plan d’attribution gratuite d’actions*”)
- B.S.P.C.E.’s (“*bons de souscription de parts de createurs d’entreprises*”)
- Stock option plans (“*options sur titres*”)

The first two regimes are commonly used in the start-up world, and so, those plans comprise the focus of this article.

Free Share Plans

Under current French law, free shares can be granted to certain employees and officers in a tax efficient way when the following requirements are met:[1]

- The issuing entity is formed as one of the following types of entities: a *Société Anonyme* (“S.A.”),[2] a *Société en commandite par actions* (“S.C.A.”),[3] or a *Société paactions simplifiée* (“S.A.S.”).[4]
- No free shares are distributed to employees or officers holding 10% or more of the share capital of the company.
- The distributed free shares do not exceed 10% of the share capital.
- The distribution of shares is authorized by the shareholders.
- The shares are issued to employees of the issuing entity or a related entity.

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1 Article L.225-197-1 to L. 225-197-6 of the French Commercial Code.

2 An S.A. is a joint stock corporation that is the equivalent of a corporation in the U.S. The formation of an S.A. requires at least two shareholders. The minimum capital contribution upon formation is €37,000. At least 50% must be contributed upon formation, and the balance must be contributed within five years. Strict corporate governance rules apply (Articles L225 *et seq*. of the French Commercial Code).

3 An S.C.A. is formed by at least one general shareholder and three limited shareholders. The general shareholders are jointly and severally liable for the debts of the company, and their shares are not freely transferable. In comparison, the limited shareholders have the same status as shareholders in an S.A. Their liability is limited to the amount of their contributions, and their shares are transferable under the same conditions as those applicable to shareholders in an S.A. The minimum capital contribution for privately held S.C.A.’s is €37,000, of which 50% must be paid upon formation and the balance within five years. Despite these heavy regulations, S.C.A.’s can be attractive because they offer flexibility in defining the duties of corporate officers.

4 An S.A.S. can be formed by one or more shareholders. Every shareholder has limited liability. There is no minimum capital contribution requirement. This type of entity is attractive because of the absence of mandatory corporate governance rules. Shareholders can almost freely draft the bylaws (Articles L227-1 to L 227-20 and L244-1 to L244-4 of the French Commercial Code).

- The shares are definitively attributed to the beneficiaries no earlier than one year after their grant (the "Definitive Attribution Period"), and the rights to the underlying shares are not disposed of prior to their definitive attribution.

- The Definitive Attribution Period and the "Mandatory Holding Period"[5] are at least two years in the aggregate.

"If the beneficiary of the free share plan is not a French resident at the time the underlying shares are sold, French withholding tax applies to the Acquisition Gain at the highest marginal rate of 20%."

While free shares must generally be attributed to an employee free of any payment, a symbolic purchase price can be attributed to shares granted under foreign plans.

Beneficiaries of newly issued plans[6] are subject to French income tax and social charges as follows:

- Compensation income is recognized in an amount that is equal to the difference between the fair market value at the time of definitive attribution and the amount paid for the shares (the "Acquisition Gain"). If no amount is paid, the fair market value is the measure of compensation.

- Once the amount of the Acquisition Gain is determined, tax is deferred until the shares are sold. If the shares are held for specified periods, generally applicable only for capital gains tax purposes, the taxable Acquisition Gain can be reduced by up to 65% generally and 85% in some instances. Social charges will be levied at a 15.5% rate on the full amount of the Acquisition Gain without the reductions in tax base allowed for income tax purposes.

- Capital gain realized upon sale is recognized up to the amount realized at the time of disposition, decreased by the fair market value at the time of definitive acquisition. Again, the tax base is reduced if certain holding period requirements are met. Social charges will be levied at a 15.5% rate on the full amount of the gain realized upon sale, of which 5.1% is tax deductible in the subsequent year.

- If the beneficiary of the free share plan is not a French resident at the time the underlying shares are sold, French withholding tax applies to the Acquisition Gain at the highest marginal rate of 20%.[7] No French withholding tax generally applies on the capital gain realized upon sale.

B.S.P.C.E.

Under current French law, B.S.P.C.E.'s grant their beneficiaries the right to subscribe to a certain amount of the issuing entity's shares at a strike price that is fixed at the time of grant. The B.S.P.C.E.'s constitute a sort of voucher, which gives the beneficiaries the rights to the underlying shares. The underlying shares are then issued upon the exercise and payment of the strike price by the beneficiary. The plan must stipulate a period within which the beneficiaries must exercise their rights.

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[5] A plan may provide that the shares must be held by the beneficiary for a specific period after the shares have been definitively attributed to the beneficiary (the "Mandatory Holding Period"). A plan may also provide that, for certain employees or officers, the shares, or a certain amount of the shares, cannot be disposed of prior to the end of employment.

[6] *I.e.*, plans issued as of August 8, 2015.

[7] Article 182A *ter* of the French Tax Code.

Under article 163 *bis* G of the French Tax Code, an entity can issue B.S.P.C.E.'s if all the following conditions are met at the time of issuance:

- The entity is an S.A., S.C.A., S.A.S., or "European Corporation."[8]
- The entity is subject to French corporate income tax.
- The entity is either privately held or listed on an E.U., Norwegian, Icelandic, or Liechtenstein regulated market. If so listed, the entity's listed capital cannot exceed €150 million or its equivalent.
- The entity was officially formed within the preceding 15 years and is not the result of a corporate reorganization.At least 25% of the share capital is continuously and directly held by individuals, or by companies in which individuals directly hold at least 75% of the share capital.

B.S.P.C.E.'s can be attributed to employees and certain corporate officers. They are issued on a per name basis and are not transferrable.

French income tax is imposed at the time of a subsequent sale of the shares acquired upon exercise of the B.S.P.C.E. The taxable amount is the difference between the acquisition price and the sales proceeds. It is prudent to provide for an exercise price that equals at least the fair market value of the stock at the time of grant.

If these requirements are met, the taxable amount is subject to French income tax at a rate of 19% upon subsequent sale if the individual has been employed by the company for at least three years or 30% if the individual has been employed by the company for less than three years. If the requirements are not met, the gain realized upon a subsequent sale is subject to French income tax at ordinary rates. In addition, all employment-related social charges and contributions are imposed. Thus, the share-based compensation plan is effectively deprived of its benefits.

When the employee later departs France, the taxable amount is divided into the following categories:

- Acquisition Gain – which, for this purpose, equals the value of the shares on the date of exercise (the "Exercise Value") less the amount paid for the shares upon exercise – is treated as employment income for income tax treaty purposes.
- Sale Gain – which equals the proceeds received upon sale less the Exercise Value – is treated either as a capital gain or as "other income," depending on the applicable treaty.[9]

If the beneficiary is not a French resident at the time of subsequent sale, French withholding tax applies at the highest marginal rate of 20%.

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8 A European Corporation is a legal entity that can exercise activities in various E.U. Member States. It is governed by the European Council Regulation No. 2157/2001 of October 8, 2011 and by every Member State's internal legislation. In France, articles L229-1 to L229-15 apply to European Corporations. A European Corporation generally has the legal form of an S.A.

9 BOI-RSA-ES-20-4- no 470 and 480.

U.S. STOCK OPTION AND STOCK PURCHASE REGIMES

U.S. tax law provides three separate tax regimes for share-based compensation:

- Nonqualified stock option ("N.S.O.")[10]
- Incentive stock option ("I.S.O.")[11]
- Employee stock purchase plan ("E.S.P.P.")[12]

I.S.O.'s and E.S.P.P.'s provide for favorable tax treatment. N.S.O.'s are treated as a form of deferred compensation and, by and large, do not provide for favorable tax treatment. The French share-based compensation plans described above generally fail one or more requirements to qualify for favorable U.S. tax treatment. Thus, only N.S.O.'s are analyzed in this article.

Application of Code §83 to N.S.O.'s and Restricted Property

Code §83 deals with property transferred in connection with the performance of services (see below regarding potential application of Code §409A). Absent a substantial risk of forfeiture or non-transferability, Code §83 will apply to N.S.O.'s either at grant or upon exercise, as follows:[13]

- If the option has a readily ascertainable fair market value at the time of grant, Code §83 applies to the grant of the N.S.O. As a result, that readily ascertainable value, less any amount paid by the N.S.O. recipient, is taxed as compensation income in the year of grant.
- Absent a readily ascertainable market value at the time of grant, Code §83 applies upon exercise of the option. In this case, the taxable amount equals the fair market value at the date of exercise less the price paid by the recipient for the option and the shares. In addition, if the strike price is below fair market value on the date of issuance, Code §409A may provide for taxation prior to the date of exercise (see below). Any tax paid under Code § 409A will increase the cost basis in the shares.

For the purpose of Code §83, options have a readily ascertainable value when they are publicly traded. Otherwise, the value must be measurable with reasonable accuracy.[14] In any event, an option will not be considered as having a readily ascertainable value unless all the following requirements are met:[15]

- The option is transferable by the beneficiary.
- The option is exercisable immediately in full.

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10 Internal Revenue Code of 1986, as amended, (the "Code") §§409A, 457A and 83. For purposes of this article, the provisions of Code §457A are not discussed.

11 Code §§421 and 422.

12 Code §§421 and 423.

13 Code §83(e)(3).

14 Treas. Reg. §1.83-(7)(b)(2).

15 *Id.*

- The option or the underlying shares are not subject to any restrictions or conditions that have a significant effect on the option's fair market value, other than a lien or other condition to secure the purchase price.

- The fair market value of the option privilege is readily ascertainable.

If the stock increases in value after the shares have been acquired, the sale will be treated as a capital gain. Should the shares be held for longer than 12 months, favorable tax rates for long-term capital gains (up to 20%) will apply, and possibly net investment income tax (3.8%). State and local tax in the place of residence will be imposed, as well.

As a result, if the N.S.O. is taxed upon grant, any subsequent increase in value can benefit from long-term capital gains tax rates upon subsequent sale if the holding period requirement is met. The compensation aspect is limited to the date of grant. If, however, the N.S.O. is taxed upon exercise, the potential increase in value of the underlying stock, from the date of grant until the date of exercise, is subject to income tax at ordinary rates. Only the increase in value from the date of exercise can potentially benefit from long-term capital gains tax treatment upon subsequent sale.

However, if a substantial risk of forfeiture exists upon grant or exercise, or if the option is not transferable, the taxable event will be deferred until the earlier of the following two events: the lapse of the substantial risk of forfeiture or the date of sale. Any tax computed under Code §409A is deferred until the date on which the substantial risk of forfeiture is terminated.

"Should the shares be held for longer than 12 months, favorable tax rates for long-term capital gains (up to 20%) will apply, and possibly net investment income tax (3.8%)."

Discounted Stock Options and the Code §409A Anti-Deferral Regime

Code §409A accelerates the time when the holder of an N.S.O. must recognize income. Its breadth is wide. In general, it applies to N.S.O.'s if the exercise price is lower than the fair market value of the stock at the time of grant.[16] For this purpose, restrictions that will lapse over time are ignored in measuring value. The delta is immediately taxable when the options vest. This may be on the date of issuance or on the date when a substantial risk of forfeiture lapses. A substantial risk of forfeiture exists when a person's right to compensation is conditioned upon the future performance of substantial services by any individual or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial.[17]

In addition to income tax on the deferred compensation amount, the taxpayer must also pay (i) interest, at the underpayment rate plus 1%, on the tax due as of the first day compensation should have been included in income and (ii) 20% of the deferred compensation amount.

A limited exception applies to the application of the Code §409A anti-deferral provisions. If an N.S.O. complies with the requirements of this exception, it is deemed not to provide for the deferral of compensation. For this purpose, all the following requirements must be met:

- The N.S.O. is an option to purchase "Service Recipient Stock" (defined below)

16 Treas. Reg. §1.409A-1(b)((5)(i)(A).

17 Code §409A(d)((4); Treas. Reg. §1.409A-1(d).

from an eligible issuer.[18] An eligible issuer is the corporation for which services are performed at the date of grant or a corporation in the same group.[19]

- The exercise price is not less than the fair market value of the underlying stock on the date the option is granted.[20]
- The number of shares subject to the option is fixed on the original date of grant.[21]
- The transfer or exercise of the option is subject to tax pursuant to Code §83 and Treas. Reg. §1.83-7.[22]
- The option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of the following:
  - The exercise or disposition of the option
  - The time the stock acquired pursuant to the exercise of the option first becomes substantially vested[23]

Service Recipient Stock is stock that constitutes common stock as of the date of grant. Excluded from this treatment are shares of stock that meet one of the following conditions:

- The stock contains a preference as to distributions other than distributions of Service Recipient Stock and distributions in liquidation of the issuer.
- The stock is subject to a mandatory repurchase obligation other than a right of first refusal, and the repurchase price is based on a measure other than the fair market value, disregarding lapsed

The regulations under Code §409A provide for several exceptions in the case of non-U.S. plans. One of these exceptions applies to individuals that were not U.S. residents at the time of grant but later became U.S. residents. If, in this scenario, the deferred compensation was not U.S.-source income and was earned and vested prior to the individual becoming a U.S. resident, that deferred compensation is exempt from the application of Code §409A.[24]

CONCLUSION – APPLICATION OF TAX RULES TO THE TRANSFERRED EMPLOYEE

Employing the foregoing analysis, three or four key moments in the life of a stock-based compensation plan can be identified as taxable events under both the French

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18 Treas. Reg. §1.409A-1(b)(5)(i)(A); Treas. Reg. §1.409A-1(b)(5)(iii)(A); Treas. Reg. §1.409A-1(b)(5)(iii)(E).

19 Treas. Reg. §1.409A-1(b)(5)(iii)(E)(1).

20 Treas. Reg. §1.409A-1(b)(5)(i)(A)(1).

21 *Id.*

22 Treas. Reg. §1.409A-1(b)(5)(i)(A)(2).

23 As defined in Code §1.83-3(b).

24 Treas. Reg. §10409A-1(b)(8)(ii).

qualified plan and U.S. nonqualified plan approaches:

- The grant of share-based compensation
- The exercise of an option
- The "vesting" of the underlying shares
- Subsequent sale of the underlying shares

On both sides of the Atlantic, the nature of the taxable income can vary. It may constitute ordinary income or fall within a more favorable tax regime with beneficial tax rates such as those for long-term capital gains. Generally, B.S.P.C.E.'s comply with the requirements of Code §409A or fall within the exception provided for foreign plans under the regulations and are thus subject to Code §83, only. Since free shares are not options *per se* and constitute restricted property, they are generally subject to the provisions of Code §83, only.

In addition, while French tax laws allow for beneficial tax base reductions for free shares, the benefit depends upon the holding period of the underlying shares and is not available once in the U.S. Thus, having anticipated a beneficial tax regime at grant, the beneficiary of the plan can see his or her tax burden increase unexpectedly upon a move to the U.S.

The table below summarizes the main characteristics of the applicable regimes on both sides of the ocean.

	FRANCE		U.S. (As Relevant)	
	Free Shares	**B.S.P.C.E.**	**Code §83**	**Code §409A**
Taxable Events	1. Vesting of Underlying Shares (date of definitive attribution of ownership to beneficiary) 2. Sale of Shares	Sale of Underlying Shares	1. Grant, Exercise of Option, or Lapse of Substantial Risk of Forfeiture 2. Sale of Shares	1. Grant or Lapse of Substantial Risk of Forfeiture 2. Subsequent Sale of Underlying Shares
Date Tax is Due	Year of Sale of Underlying Shares	Date of Taxable Event	Date of Taxable Event	Date of Taxable Event
General Tax Regime	1. Compensation Income (benefitting from holding period reductions) 2. Capital Gains Treatment (benefitting from holding period reductions)	Income Subject to 19% or 30% Tax Rate (19% if beneficiary has been employed for at least 3 years or 30% if employed for a shorter period)	1. Compensation Income 2. Long-Term Capital Gains Treatment (if held as a capital asset for a sufficient period)	1. Ordinary Income Tax Rates (20% surcharge and interest on deferred compensation amount may apply) 2. 20% Long-Term Capital Gains Tax (if held as a capital asset for a sufficient period)

IN THE MATTER OF GKK 2 HERALD LLC – EFFECTS OF THE STEP TRANSACTION DOCTRINE

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Tags
Controlling Interest
Mere Change in Form
Real Estate Transfer Tax
Real Property Transfer Tax

INTRODUCTION

In pre-17th century England, a transfer of land was not required to be recorded. Furthermore, a transfer was conducted by the landowner, who would take a handful of soil and then physically hand it to the purchaser. This ceremony was referred to as a "livery of seisin."

The practice of transferring one's property is very different in today's world. It is no longer required for the individuals involved to be present on the property to accomplish the transfer. The entire transaction can take place without ever setting foot on the property and is instead carried out by signing the appropriate documents at an attorney's office.

Within the last few centuries, the transfer of property has evolved into a complicated multistep transaction where various types of ownership can be transferred not only from an individual, but from various entities that may hold an interest in the property. In addition to signing various documents to record the transfer, Federal, state, and local governments also impose tax on the transfer.

The complicated nature of the various taxes imposed on a transfer of property is best illustrated by the recent case litigated in the State of New York Division of Tax Appeals Tribunal and the New York City Appeals Tribunal.

IN THE MATTER OF GKK 2 HERALD LLC

Facts

On April 9, 2007, GKK 2 Herald LLC, a Delaware limited liability company (the "Petitioner") and SLG 2 Herald LLC ("S.L.G.") acquired real property located at 2 Herald Square, New York, N.Y. (the "Property") as tenants in common ("T.I.C."). On the same date, the Petitioner and S.L.G. entered into a Tenants in Common Agreement (the "T.I.C. Agreement"), which governed their respective rights and obligations as owners of the Property. The Petitioner acquired a 45% undivided interest, while S.L.G. acquired a 55% undivided interest.

On December 14, 2010, the Petitioner and S.L.G. formed a third Delaware limited liability company, 2 Herald Owner LLC ("Herald"). On December 22, 2010, the Petitioner and S.L.G. entered into a Tenants in Common Contribution Agreement (the "T.I.C. Contribution Agreement") under which both the Petitioner and S.L.G. agreed to contribute their respective undivided interests as T.I.C. in the Property. The T.I.C. Contribution Agreement contained a number of provisions describing the Petitioner's rights and obligations in connection with the contribution of its T.I.C. interest in the Property. Among other things, the T.I.C. Contribution Agreement released the

Petitioner from all obligations under a mortgage loan secured by Herald's interest in the Property and received back its collateral, while S.L.G. received no such release.[1]

In addition, on December 22, 2010, the Petitioner and S.L.G. executed the Limited Liability Company Agreement of Herald (the "Herald L.L.C. Agreement"). The T.I.C. Contribution Agreement provided that the Petitioner and S.L.G. intended to form Herald and would enter into an L.L.C. agreement under which the Petitioner would have a 45% membership interest in Herald and S.L.G. would have a 55% membership interest in Herald. However, the Herald L.L.C. Agreement did not specify the Petitioner's or S.L.G.'s membership interests. The Herald L.L.C. Agreement merely provided that the available cashflow of Herald should be distributed from time to time as the members jointly determined in their sole discretion, and that profits and losses should be allocated jointly to the members. There were no other provisions in the Herald L.L.C. Agreement regarding the interests of the Petitioner and S.L.G. in Herald. Furthermore, on the same day, December 22, 2010, the Petitioner and S.L.G. entered into a Membership Interest Purchase Agreement (the "Purchase Agreement"), under which the Petitioner agreed to sell, and S.L.G. agreed to purchase, the Petitioner's membership interest in Herald. The Petitioner and S.L.G. timely filed state and city tax returns but asserted the "mere change in form" exception and did not pay either New York State real estate transfer tax ("R.E.T.T.") or New York City real property transfer tax ("R.P.T.T.").

On December 21, 2012, the New York City Department of Finance (the "Department") issued a Notice of Determination asserting New York City R.P.T.T. Additionally, on April 1, 2013, the New York State Division of Taxation (the "Division") issued a Notice of Determination to the Petitioner for New York State R.E.T.T.

"New York State imposes R.E.T.T. on each conveyance of real property or interest therein."

State of New York Division of Tax Appeals

New York State imposes R.E.T.T. on each conveyance of real property or interest therein.[2] This includes the transfer or transfers of any interest in real property by any method, including but not limited to "sale, exchange, assignment . . . or transfer or acquisition of a controlling interest in any entity with an interest in real property."[3] The term "controlling interest" means 50% or more of the capital, profits, or beneficial interest in such partnership, association, trust, or other entity."[4] There is an exception that can eliminate the transfer tax if the transfer is a mere change of identity or form of ownership or organization where there is no change in the beneficial ownership of the property.[5]

Interestingly, the Division conceded that, as standalone transactions, the Petitioner's contribution of its 45% T.I.C. interest and S.L.G.'s contribution of its 55% T.I.C. interest to Herald in exchange for an interest in Herald are each exempt from R.E.T.T. as mere changes in the form of ownership. Accordingly, under the Division's own regulations, the conveyance by T.I.C. of their interests in real property to a partnership or a corporation, the partnership or corporation's resulting interests being the same *pro rata* shares as the T.I.C. held prior to the conveyance, is not taxable as there is

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1 *In the Matter of GKK 2 Herald LLC*, TAT(E) 13-25(RP).

2 N.Y.S. Tax Law §1402(a).

3 N.Y.S. Tax Law §1402(e).

4 N.Y.S. Tax Law §1401(b).

5 N.Y.S. Tax Law §1405(b)(6).

no change in beneficial ownership.[6]

The Division unsuccessfully tried to aggregate three nontaxable transactions in order to impose R.E.T.T. on the transfer of a minority interest:

- The transaction between S.L.G. and Herald (which effectuated a mere change in form of ownership)
- The transaction between the Petitioner and Herald (which effectuated a mere change in form of ownership)
- The transaction whereby the Petitioner transferred its 45% interest in Herald to S.L.G.[7]

To overcome the controlling interest limitation, the Division argued that under the New York codes, rules, and regulations (the "N.Y.C.R.R."), multiple "transfers or acquisitions" of interests in real property can be added together to determine if a transfer or acquisition of a controlling interest has occurred.[8] According to the Division, the transfer of the Petitioner's interest in Herald to S.L.G., when combined with S.L.G.'s 55% interest in Herald, resulted in S.L.G.'s "acquisition" of a "controlling interest" in Herald.[9] The N.Y.C.R.R. language provides that

> [w]here there is a transfer or acquisition of an interest in an entity that has an interest in real property, on or after July 1, 1989, and subsequently there is a transfer or acquisition of an additional interest or interests in the same entity, the transfers or acquisitions will be added together to determine if a transfer or acquisition of a controlling interest has occurred. Where there is a transfer or acquisition or a controlling interest in an entity on or after July 1, 1989, and the real estate transfer tax is paid on that transfer or acquisition and there is a subsequent transfer or acquisition of an additional interest in the same entity, it is considered that a second transfer or acquisition of a controlling interest has occurred which is subject to the real estate transfer tax. No transfer or acquisition of an interest in an entity that has an interest in real property will be added to another transfer or acquisition of an interest in the same entity if they occur more than three years apart.[10]

The New York State Division of Tax Appeals (the "N.Y.S. Tribunal") disagreed with the Department's argument and pointed out that the initial transaction, in which the Petitioner and S.L.G. transferred T.I.C. interests to Herald, was a mere change in the form of ownership and not a transfer or acquisition. The Petitioner and S.L.G. both held the same beneficial ownership in the property before and after the "mere change" transaction with Herald, as their resulting interests in Herald were the "same *pro rata* shares as the T.I.C. held prior to conveyance." Furthermore, the N.Y.S. Tribunal stated that the transaction between S.L.G. and Herald was not a transfer or acquisition of an interest in an entity with an interest in real property and

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6 20 N.Y.C.R.R. 575.10(a).

7 *In the Matter of GKK Herald LLC*, Tax Appeals Tribunal, (May 26, 2016).

8 20 NYCRR 575.6(d).

9 *In the Matter of GKK Herald LLC*, Tax Appeals Tribunal, (May 26, 2016).

10 20 NYCRR 575.6(d).

that transaction cannot, under the plain language of the statute and regulations, be aggregated with the Petitioner's subsequent transfer of a noncontrolling interest.[11]

As for the second part of the regulation, the N.Y.S. Tribunal pointed out that the plain language required three things:

- There is a transfer or acquisition of a controlling interest in an entity with an interest in real property.
- R.E.T.T. is paid on that transfer or acquisition.
- The transaction is followed by a subsequent transfer or acquisition of an additional interest in the same entity within three years.[12]

The initial transfer between S.L.G. and Herald was not a transfer or acquisition of a controlling interest, but merely a change in form of ownership, and as such, no R.E.T.T. was paid. The N.Y.S. Tribunal rejected the Division's argument that the subsequent transfer of the Petitioner's 45% interest to S.L.G. should be considered a second transfer or acquisition of a controlling interest that is subject to R.E.T.T. because this argument is inconsistent with the regulation and ignores the plain language requiring that R.E.T.T. must have been paid on the initial transaction for aggregation to apply. There is no dispute that R.E.T.T. did not apply to the initial transaction between S.L.G. and Herald, wherein S.L.G. exchanged its 55% T.I.C. interest in the Property for a *pro rata* 55% interest in Herald. As such, the regulation relied upon by the Division is inapplicable.

New York City Tax Appeals Tribunal

New York City approached the case in a different way and sought to impose R.P.T.T. by applying the step transaction doctrine to the transfers. R.P.T.T. applies on each deed at the time of delivery by a grantor to a grantee when the consideration for the real property and any improvement thereon exceeds $25,000.[13] Furthermore, R.P.T.T. is imposed on each instrument or transaction, at the time of the transfer, whereby any economic interest in real property is transferred by a grantor to a grantee where the consideration exceeds $25,000.[14]

For the purposes of R.P.T.T., an "economic interest in real property" includes

- the ownership of shares of stock in a corporation that owns real property;
- the ownership of an interest or interests in a partnership, association, or other unincorporated entity that owns real property; and
- the ownership of a beneficial interest or interests in a trust that owns real property.[15]

The definition of "controlling interest" is similar to the state definition. Here, a controlling interest includes 50% or more of the "capital, profits or beneficial interest" in

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11 *In the Matter of GKK Herald LLC*, Tax Appeals Tribunal, (May 26, 2016).

12 20 NYCRR 575.6(d).

13 N.Y.C. Admin. Code §11-2102.

14 N.Y.C. Admin. Code §11-2102.b(l).

15 N.Y.C. Admin. Code §11-2101.6.

a "partnership, association, trust or other entity."[16] Thus, R.P.T.T. applies to a transfer of an economic interest in an entity that owns real property in the city only if the economic interest represents a controlling (*i.e.*, 50% or more) interest in the entity.

The New York City Administrative Code provides exemptions from R.P.T.T. for a number of persons and transactions, including an exemption commonly referred to as the "mere change exemption."[17] The R.P.T.T. rules provide that

> [f]or purposes of determining whether and to what extent the mere change of identity or form of ownership or organization exemption applies, the determination of the beneficial interest of the real property or economic interest therein prior to a transaction and the extent to which the beneficial interest therein remains the same following the transaction will be based on the facts and circumstances.[18]

Step Doctrine

The step transaction doctrine is a widely recognized, judicially-created concept applied in tax cases whereby a court, after reviewing the facts and circumstances surrounding a series of related actions or events, can determine that they should be treated as components of a single, integrated transaction and taxed accordingly.[19] The step transaction doctrine is generally viewed as involving two tests:[20]

- *End Result Test*: If it is evident that the various steps were undertaken to achieve a specific ultimate result, they will be taxed as a single transaction.
- *Interdependence Test*: Separate steps will be consolidated where it is clear that no single step would have been undertaken except as part of the whole transaction.[21]

The Department asserted that the events that took place on December 22, 2010 were steps in a single transaction whereby the Petitioner sold its 45% T.I.C. interest in the Property to S.L.G. Further, the Department asserted that the transaction was not exempt from R.P.T.T., either as a mere change in form of ownership or as a transfer of a noncontrolling economic interest. Unlike the N.Y.S. Tribunal, in the state case both the Administrative Law Judge ("A.L.J.") and the New York City Tribunal (the "N.Y.C. Tribunal") agreed with the Department.

When the R.P.T.T. rules were published in their proposed form, they contained a provision stipulating that if a transaction purporting to qualify for the mere change exemption is preceded or followed by one or more transactions that are all part of a single plan, then all of the transactions pursuant to the plan would be taken into account in determining the extent to which the mere change exemption would apply.[22] This provision was not included in the final R.P.T.T. rules, therefore the Petitioner

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16 N.Y.C. Admin. Code §11-2101.8.

17 N.Y.S. Tax Law §1401(b), N.Y.C. Admin. Code §11-2106(8)(b).

18 19 RCNY §23-05(b)(8)(iv).

19 *Id.*

20 *King Enterprises v. the United States*, 418 F.2d 511, 516 (1969).

21 *In the Matter of GKK 2 Herald LLC*, TAT(E) 13-25(RP).

22 *Id.*

argued that the removal of the provision from the final R.P.T.T. rules evidenced an intent to not apply the step transaction doctrine. However, the N.Y.C. Tribunal found that there was no evidence of such intent.

According to the N.Y.C. Tribunal, the final R.P.T.T. rules contain a provision that is broad enough to allow the application of the step transaction doctrine in examining the facts and circumstances of a transaction in determining the extent to which the mere change exemption applies. Specifically, the R.P.T.T. rules provide that

> [f]or purposes of determining whether and to what extent the mere change of identity or form of ownership or organization exemption applies, the determination of the beneficial ownership of the real property or economic interest therein prior to a transaction and the extent to which the beneficial interest therein remains the same following the transaction will be based on the facts and circumstances.[23]

The N.Y.C. Tribunal concluded that it is appropriate to apply the step transaction doctrine, even in the absence of any rules or regulations authorizing such application.

According to the N.Y.C. Tribunal's decision, it is clear that the actions taken on December 22, 2010 were wholly-interrelated components of a single transaction, whereby the Petitioner conveyed its T.I.C. interest in the Property to Herald in exchange for cash and relief from liability under the mortgage loan. All of the essential documents were executed on that same date. At the beginning of that day, the Petitioner held a 45% T.I.C. interest in the Property, while at the end of that day, the Petitioner had no interest in the Property either directly or through an interest in Herald. Instead, the Petitioner had received $25,312,500 in cash, had been relieved of any liability for the mortgage loan, and had received the return of a letter of credit provided as collateral for the mortgage loan.

"The N.Y.C. Tribunal concluded that it is appropriate to apply the step transaction doctrine, even in the absence of any rules or regulations authorizing such application."

The N.Y.C. Tribunal agreed with the A.L.J.'s conclusion that the End Result Test was satisfied, because the intended result of the actions taken was the sale by the Petitioner of its T.I.C. interest to S.L.G. Furthermore, the N.Y.C. Tribunal also found that the Interdependence Test was in fact the easier test to apply in this case, because the recitals in the T.I.C. Contribution Agreement, the Herald L.L.C. Agreement, and the Purchase Agreement describe each of the interrelated steps.

The Supreme Court has ruled that under the step transaction doctrine, "interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction."[24] Under the Interdependence Test, the court examines the steps taken to determine whether any of the steps would have been undertaken except as part of the whole.

Here, all of the steps were completed within one day. Moreover, the Herald L.L.C. Agreement did not identify the interests of the Petitioner and S.L.G. but merely stated that they would share profits, losses, and cashflow "jointly" or as they would "jointly determine." The N.Y.C. Tribunal interpreted this as lacking the intent to create a long-lasting joint venture.

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[23] 19 RCNY §23-05(b)(8)(iv).

[24] *Commr. of Internal Revenue v. Clark*, 489 US 726, 738 (1989).

The N.Y.C. Tribunal also distinguished this case from Example C in the R.P.T.T. rules.[25] In the example, the issue presented is whether a transfer results from the conversion of a partnership to an L.L.C. that could be aggregated with the subsequent sale of a 49% interest in the L.L.C. The example expressly states that “the conversion will not be considered a transfer of real property or an economic interest in real property.” Therefore, there is no transfer, exempt or otherwise, prior to the sale of the 49% interest that could be aggregated with it.

Had the conversion constituted a transfer, even one qualifying under the mere change exemption, the subsequent sale of a 49% interest might have been aggregated with that initial transaction and, therefore, be taxable as a sale of a controlling economic interest in the entity.[26] However, according to the N.Y.C. Tribunal, Example C has no relevance to the transaction in this case.

CONCLUSION

In the Matter of GKK 2 Herald LLC clearly shows two different stances being taken on the same facts. In the state case, the Division did not challenge the initial transfer,[27] while in the city case, the Department clearly identified the steps taken during the transfers as part of an overall plan.

For taxpayers, the takeaway from these decisions should be to tread with caution when planning. The New York City decision places an additional burden on taxpayers with a less than 50% interest in a partnership, association, trust, or other entity. To overcome the application of the step transaction doctrine, taxpayers must plan carefully to ensure that the transfer clearly represents a mere change of form.

25 19 RCNY §23-05(b)(8)(ii).

26 *In the Matter of GKK 2 Herald LLC*, TAT(E) 13-25(RP).

27 It should be noted that the Division has filed an exception that is pending in the New York State Tax Appeals Tribunal.

I.R.S. ADDS NEW THEORY WHY MERGER TERMINATION FEES ARE CAPITAL RATHER THAN DEDUCTIBLE COSTS

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Capital
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The I.R.S. and taxpayers have long argued whether fees paid by one party to another in a failed merger are capital costs or deductible costs. For some taxpayers, the consequences may be severe, as sufficiently large capitalized costs paid in failed mergers may never be fully offset by future income. In two recent internal memoranda, the I.R.S. added another theory in support of its capitalization position.

DEDUCTIBLE COSTS V. CAPITAL COSTS

Under the Internal Revenue Code (the "Code"), all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" are allowed as deductions.[1] To qualify for a deduction, an item must

- be paid or incurred during the taxable year,
- be for carrying on any trade or business,
- be an expense,
- be a necessary expense, or
- be an ordinary expense.[2]

A taxpayer is required to capitalize amounts paid to facilitate a transaction that provides the taxpayer with significant long-term benefits.[3] Unlike deductions, corporate capital losses from capital assets are allowed only to the extent of capital gains from capital assets. Stock is generally considered a capital asset.[4] There is a carryover permitted in the event of excess capital losses.[5] Accordingly, it is possible that a corporation may find itself in the undesirable position of never offsetting the entire capital loss unless it triggers a sufficiently large capital gain.

In a merger, whether a cost should be capitalized or deductible depends on the facts of each transaction. Often, an acquiring corporation ("Acquirer") and a target corporation ("Target") enter into an agreement where one party must pay the other a "termination fee" should one party disavow the merger. The balance of this article will be narrowly focused on these termination fees, and not on any other merger-related costs.

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1 Code §162(a).

2 *Comm'r v. Lincoln Sav. & Loan Association*, 403 U.S. 345, 352, 91 S. Ct. 1893.

3 Treas. Reg. §1.263(a)-5.

4 *Appalachian Electric Power Co. v. U.S.* (1958 Ct. Cl), 1 AFTR 2d 628.

5 Code §§1211 and 1212.

REGULATIONS AND PAST RULINGS

Past revenue rulings have held that where an Acquirer and a Target have incurred costs in attempting a merger, those costs should be deductible as a loss.[6] However, the regulations indicate that under certain circumstances, merger termination fees must be capitalized. For example, if termination fees are paid to facilitate a second transaction, those fees must be capitalized but only if the second alternative transaction is mutually exclusive to the first transaction.[7] In other words, if Acquirer could purchase both Target 1 and Target 2, but decides only to purchase one of the corporations, those costs are likely deductible.[8] The costs would be capitalized if Acquirer could not purchase both Target 1 and Target 2, since those transactions would then be "mutually exclusive."[9]

"The I.R.S. did not reference the Treasury Regulations when making its determination. Instead, it based its analysis on Code §1234A and the legislative history."

CODE §1234A

Code §1234A requires a capital gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right with respect to property that is (or on acquisition would be) a capital asset in the hands of a taxpayer to be treated as a gain or loss from the sale of a capital asset. Code §1234A was added so that a contract to deliver a capital asset would be treated for tax purposes as equivalent to the capital asset itself.[10] Code §1234A was enacted in 1981 as part of a comprehensive tax package designed to prevent tax avoidance "straddle" transactions. The provision was originally included to prevent derivatve traders from obtaining both a capital gain and an ordinary loss on the same transaction.

RECENT I.R.S. DECISIONS

The facts of the recent I.R.S. memorandum, Legal Advice Issued by Field Attorneys: Break Fee, are as follows:[11]

- Acquirer and Target entered into a merger agreement whereby Acquirer was obliged to pay a termination fee to Target should it withdraw from the merger.
- Upon receiving a notice from the U.S. Treasury Department that would adversely affect the potential tax benefits from the merger, Acquirer withdrew its offer.
- According to the I.R.S., since stock is a capital asset, "rights" relating to that capital asset must also be capital in nature. Thus, the I.R.S. held that the termination fee was a capital cost and therefore non-deductible.

Readers should note that the I.R.S. did not reference the Treasury Regulations

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6 Rev. Rul. 73-580, 67-125, 79-2.

7 Treas. Reg. §1.263(a)-5(c)(8).

8 Treas. Reg. §1.263(a)-5(l), Example 14.

9 Treas. Reg. §1.263(a)-5(l), Example 13.

10 S. Rep. No. 97-144, at 170-171; see also H.R. Rep. No. 97-201, at 213.

11 "Legal Advice Issued by Field Attorneys: Break Fee," May 3, 2016, Office of Chief Counsel, Internal Revenue Service, FAA 20163701F.

when making its determination. Instead, it based its analysis on Code §1234A and the legislative history of the statute determining whether an asset was considered a capital asset. It determined that any rights or obligations arising from a transaction involving a capital asset should be capitalized.

In a second recent legal memorandum, the I.R.S. was asked to address whether a taxpayer who investigates a stock acquisition and receives a termination fee is entitled to a deduction for those costs.[12] The I.R.S. held that because the contract provided the potential Acquirer with a "bundle of rights" relating to the acquisition of a capital asset (*i.e.*, Target's stock), under Code §1234A, those rights would likewise be considered capital assets. Accordingly, both the merger termination and investigation fees were considered capital costs. The I.R.S. supported its decision by noting that the legislature indicated an intent to provide certainty concerning the modification of property rights when drafting the Code sections relating to lapsed rights and capital assets. It was noted that this ruling was contrary to an earlier private letter ruling, P.L.R. 200823012, which held without explanation that the receipt of a termination fee under similar facts was ordinary.

CONCLUSION

Whether a merger-related cost is deductible depends on the facts and circumstances of each merger. However, the I.R.S. seems to be exploring a theory that would characterize the vast majority of (if not all) merger termination costs as capital rather than deductible costs. In some cases, if the termination costs are sufficiently large, a correspondingly large capital loss may practically never be offset by future income.

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[12] Andrew M. Irving to David Q. Cao, February 9, 2016, Office of Chief Counsel, Internal Revenue Service, Receipt of Merger Termination Fee, 201642035.

Author
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Tags
Contract Law
Corporate Law
Liquidated Damages

CORPORATE MATTERS: SHOULD A LIQUIDATED DAMAGES CLAUSE BE INCLUDED IN A CONTRACT?

WHAT ARE LIQUIDATED DAMAGES?

Liquidated damages are an amount of predetermined damages stipulated in a contract that can be recovered following the occurrence of an event set forth in the contract. A liquidated damage clause in a contract is an attempt by the parties to estimate damages in the event of non-performance or breach of the contract. The clause is typically used in circumstances where damages are hard to quantify, and it will be enforced by the courts where it is found that the harm caused by the breach is not only difficult to estimate, but also where the amount of liquidated damages is reasonable compensation in the circumstances and not disproportionate to the actual or anticipated damage. The intent of a liquidated damages clause is simply to measure damages that are hard to prove once incurred.

SHOULD YOU INCLUDE THE CLAUSE IN A CONTRACT?

Liquated damages clauses, if correctly drafted, can be an effective way of keeping parties to a contract out of court following a breach. Clients commonly like to include arbitration clauses in contracts to keep disputes out of court. Their rationale is that if there is a dispute, arbitration is quicker and less expensive; procedural steps and timelines can also be included in the contract.

Clients of this mind often also like liquidated damages clauses. The contract can state that if “X” event occurs, the parties agree that “Y” amount shall be paid as liquidated damages. If there is a breach, the amount of damages is set and the non-defaulting party does not have to go through the time-consuming and potentially expensive process of proving actual damages.

The amount of liquidated damages stated in the contract is supposed to be the parties’ best estimate as of the date of the contract of the amount of damages that would result from a breach. Clients appreciate this level of certainty. The alternative is leaving the amount of damages up to a court to decide, which, aside from the cost, has a high level of unpredictability.

ENFORCEABILITY

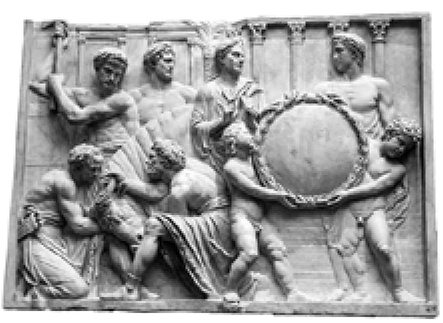
Care must be taken in drafting the clause, however, as the courts have held such clauses to be invalid when they end up imposing penalties rather than reasonable damages. A penalty is usually disproportionate to the actual harm. Where damages are easy to estimate, it may not be appropriate to use a liquidated damages clause. Generally, for a liquidated damages clause to be enforceable, the damages should be either uncertain or difficult to quantify at the time the contract was entered into.

Furthermore, simply stating in the contract that the damages are liquidated and not a penalty will not necessarily make it so.[1] If the liquidated damages are found to be disproportionate, they can be declared a penalty rather than damages and the clause rendered invalid. If this happens, recovery will be limited to the actual damage that resulted from the breach.

Relevant factors to be considered in determining what is reasonable under the circumstances may include the following:

- What the parties knew about what might occur in the event of a breach
- The extent to which the amount of damages is described and justified in the contract
- The relative bargaining power of the parties
- What the parties were thinking at the time the contract was entered into
- Whether the clause was simply included in the "boilerplate" clauses or actively negotiated by the parties

Liquidated damages clauses give the parties to a contract some certainty and provide a form of self-insurance in the event of a breach. Each party knows the cost of breaching the contract and can weigh that against the cost of performance.



[1] Restatement (Second) of Contracts, §356 cmt.c (1981).

UPDATES & OTHER TIDBITS

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Tags
C.C.C.T.B.
European Commission
France
Information Disclosure
I.R.S.
Israel
Singapore
Swiss Banks
Tax Compliance
UBS

SWISS COURT ORDER: UBS CAN FIGHT FRENCH REQUEST TO DISCLOSE CLIENT INFORMATION

In an unusual decision made on October 26, 2016, the Swiss Federal Administrative Court allowed UBS Group AG to be added as a party to a French administrative request for aid from Switzerland, thus giving the bank the right to appeal requests for customer information. Under the administrative aid request procedure, the French tax authorities must make a request to the Swiss authorities for data from UBS. The Swiss authorities then determine the relevance of the data, and if it is found relevant, make the final demand for the data from UBS.

Following this unusual ruling, UBS may appeal the decision for each final client data request to the Swiss administrative court. This is a victory for the bank in its attempts to fend off efforts by the French tax authorities to obtain customer data. The court stated that the decision was justified due to the unusually high burden that would be imposed on the bank by the French authorities' request for customer information on over 10,000 clients, which would imply that the bank had systematically helped French residents evade taxes. The court added that the data collected could be used against UBS in criminal proceedings in France.

I.R.S. OFFSHORE TAX AVOIDANCE INVESTIGATIONS MOVE BEYOND SWITZERLAND

The criminal investigation arm of the I.R.S. ("I.R.S.-C.I.") continues to track down U.S. tax evaders, division chief Richard Weber said on October 27 at an anti-money laundering conference sponsored by the New York State Society of Certified Public Accountants.[1] He stated, "In fiscal year 2017, I.R.S.-C.I. will continue to rigorously pursue U.S. citizens seeking to evade income taxes by placing assets in other countries . . . we're actually looking at a bunch of other countries where money has been flowing from Switzerland." I.R.S.-C.I. has worked closely with the Department of Justice ("D.O.J.") since it announced its Swiss Bank Program in August 2013 to identify U.S. taxpayers engaging in tax evasion. The program put pressure on banks to turn over information on their U.S. clients. In exchange, those clients paid penalties but avoided prosecution.

Anecdotal evidence suggests that those other countries may include Israel, where

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1 Allyson Versprille, "IRS Expands Offshore Tax Avoidance Efforts Past Switzerland," Bloomberg BNA, October 28, 2016.

several banks are currently under investigation by the D.O.J., and parts of Asia.[2]

In February, the D.O.J. filed an action in Federal court to compel UBS AG's branch in Miami to produce bank records of a Singapore account supposedly owned by a taxpayer living in China who was under IRS audit. In June, the D.O.J. announced that it was voluntarily dismissing its summons enforcement action against UBS as the bank had complied with an I.R.S. summons for the bank records.[3]

Weber also stated that I.R.S.-C.I. will make futher significant announcements within the next year.

LEADING EUROPEAN TAX STAKEHOLDERS CRITICIZE CHALLENGE SCOPE OF E.U. COMMON CORPORATE BASE PLANS

The European Commission's proposal for a Common Consolidated Corporate Tax Base ("C.C.C.T.B.") for multinationals to calculate taxable corporate profit, which was relaunched in 2016, is again under attack.

The C.C.C.T.B. is a single set of rules used to calculate a company's taxable profits in the E.U. With the C.C.C.T.B., cross-border companies will only have to comply with one single E.U. system for computing taxable income, rather than many different national rulebooks. Companies can file one tax return for all E.U. activities and offset losses in one Member State against profits in another. The consolidated taxable profits will be shared between the Member States in which the group is active, using an apportionment formula. Each Member State will then tax its share of the profits at its own national tax rate.[4]

The C.C.C.T.B. will be implemented in two steps. In the first step, the common base should be implemented with consolidation shortly thereafter. The C.C.C.T.B. will be mandatory for large multinationals to cover those with the greatest capacity to tax plan. The system will remain optional for those not captured by the mandatory scope, namely small- and medium-sized enterprises ("S.M.E.'s").

Some critics have stated that the C.C.C.T.B. should be expanded to include S.M.E.'s with total revenue of less than €750 million ($819 million) to make the system effective. Others are concerned that the proposal for consolidation of profits between member states will be left behind now that the C.C.C.T.B. is mandatory for large companies. Still others argue that the decision to put the consolidation part of the C.C.C.T.B. off until a second stage will not solve the problem of transfer pricing and corporate tax dodging. Under this view, the proposal is a mixed bag of a few fixes to the current tax system accompanied by the introduction of new loopholes.

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2 "DoJ Is Following The Money Trail Disclosed By Swiss Bank's to Singapore and Israel," The Tax Times, October 10, 2016.

3 "After UBS Produces Singapore-Based Documents, Justice Department Dismisses Summons Case," U.S. Department of Justice, June 22, 2016.

4 Joe Kirwin, "Critics Challenge Scope of EU Common Corporate Base Plans," Bloomberg BNA Tax and Accounting Center, October 26, 2016.

According to the European Commission, the C.C.C.T.B. will give multinational companies the opportunity to use one set of tax rules throughout the E.U. This will help reduce transfer pricing disputes. This view is not widely held by tax practitioners.

One commentator stated that the C.C.C.T.B. will force companies to deal with more accounting rules. Nonetheless, others pointed out that potential cost savings in compliance could be substantial, perhaps as much as 50%.[5]

"With the C.C.C.T.B., cross-border companies will only have to comply with one single E.U. system for computing taxable income, rather than many different national rulebooks."

[5] "Common Consolidated Corporate Tax Base (CCCTB)," European Commission Taxation and Customs Union, November 18, 2016.

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