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INSIGHTS

SPONTANEOUS EXCHANGE OF TAX RULINGS – THE SWISS ANGLE

TAX ROULETTE: BUYING A BUSINESS JET IN 2017 – WHY FOLLOWING THE PATRIOT'S EXAMPLE MAY LEAD TO A JACKPOT

A CASE OF NONACQUIESCENCE: I.R.S. OPPOSES *BARTELL* DECISION

LEGAL AND PRACTICAL STRATEGIES FOR MANAGING TAX DISPUTES IN INDIA

AND MORE

Insights Vol. 4 No. 9

TABLE OF CONTENTS

Editors' Note

Spontaneous Exchange of Tax Rulings – The Swiss Angle 4

Tax Roulette: Buying a Business Jet in 2017 – Why Following the Patriot's Example May Lead to a Jackpot 8

Legal and Practical Strategies for Managing Tax Disputes in India 15

The Economic Substance Doctrine: A U.S. Anti-Abuse Rule 22

Tax 101: Deemed Annual Royalty on Outbound Transfers of I.P. to Foreign Corporations 30

Bilateral Investment Treaties: When Double Taxation Agreements Are Not Enough ... 35

O.E.C.D. Issues Proposed Changes to Permanent Establishment Provisions Under Model Tax Convention... 38

Eaton A.P.A. Cancellations Were an Abuse of I.R.S. Discretion.................................. 49

A Case of Nonacquiescence: I.R.S. Opposes *Bartell* Decision................................... 52

About Us

EDITORS' NOTE

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

- **Spontaneous Exchange of Tax Rulings – The Swiss Angle.** Most – but not all – global tax advisers know that the tax planning universe has changed. The few holdouts hoping that the old ways may yet be available were disappointed, again, when Switzerland announced procedures for the spontaneous exchange of tax rulings. Rulings issued on and after January 1, 2010, will be exchanged beginning January 1, 2018. Michael Fischer and Marc Buchmann of Attorneys Fischer Ramp Partner AG, Zurich, explain the new procedures and how taxpayers may take steps to stop the spontaneous exchange of existing rulings.

- **Tax Roulette: Buying a Business Jet in 2017 – Why Following the Patriot's Example May Lead to a Jackpot.** The New England Patriots recently made headlines with the purchase of two private team jets. Was this plan implemented only to provide more space for beefy footballers, or did ownership identify the nifty situation that could lead to a jackpot of tax savings for high-ticket assets purchased in 2017? Beate Erwin and Stanley C. Ruchelman explain that with increased depreciation deductions this year at high tax rates and possible recapture in a future year at low tax rates, the odds are good.

- **Legal and Practical Strategies for Managing Tax Disputes in India.** Most readers of this journal are front-end tax planners, proposing plans to be implemented by clients. Regrettably, not all plans escape examination by the tax inspector, and in India, that number is on the rise. Sanjay Sanghvi of Attorneys Khaitan & Co., Mumbai explains how to prepare for a tax examination in India and provides practical insights into the examination, appeals, and judicial review processes.

- **The Economic Substance Doctrine: A U.S. Anti-Abuse Rule.** While the O.E.C.D. and the European Commission have only recently discovered the "principal purpose" test as a tool to combat aggressive tax planning, U.S. case law has enforced an economic substance rule for over 85 years and that rule was codified in 2010. Fanny Karaman, Neha Rastogi, and Stanley C. Ruchelman explain the hurdles that must be achieved in order for a plan to have economic substance.

- **Tax 101: Deemed Annual Royalty on Outbound Transfers of I.P. to Foreign Corporations.** U.S. tax law contains provisions that attempt to discourage the outbound migration of intangible assets including specific rules that target transfers affected through corporate inversions. Elizabeth V. Zanet and Stanley C. Ruchelman discuss the history and current standing of those provisions, while pointing out an alternative that is currently available to limit ongoing tax liability in the context of a start-up operation.

- **Bilateral Investment Treaties: When Double Taxation Agreements Are Not Enough.** The U.S. enters into bilateral investment treaties to protect and promote foreign investment. Unlike double taxation agreements, which relate exclusively to tax matters, they are not usually seen as a defense mechanism when dealing with foreign tax authorities. Interestingly, they are! Rusudan Shervashidze and Nina Krauthamer explain.

- **O.E.C.D. Issues Proposed Changes to Permanent Establishment Provisions Under Model Tax Convention.** Earlier this year, the O.E.C.D. proposed amendments to Article 5 (Permanent Establishment) of the Model Tax Convention and Commentary. The revisions eliminate loopholes that exist for commissionaire arrangements, artificial characterization of core activities as "preparatory," avoidance of permanent establishment status through artificial fragmentation of contracts, and the use of not-so-independent agents. Neha Rastogi, Beate Erwin, and Stanley C. Ruchelman explain the replacement provisions.

- **Eaton A.P.A. Cancellations Were an Abuse of I.R.S. Discretion.** A recent U.S. Tax Court decision involving Eaton Corporation affirmed that the I.R.S. cannot arbitrarily circumvent administrative rules that are set down in revenue procedures and relied upon by the I.R.S. and a taxpayer. As a result, the I.R.S. must reasonably exercise its discretion when seeking to terminate an advance pricing agreement with a taxpayer. Michael Peggs looks at the process of obtaining an advanced pricing agreement and comments on the court's decision.

- **A Case of Nonacquiescence: I.R.S. Opposes *Bartell* Decision.** Tax-smart investors in U.S. real estate understand that the principal method of disposing real property is to participate in a two-party swap transaction with the ultimate purchaser or a three-party deferred swap through a qualified intermediary. In *Bartell v. Commr.*, the U.S. Tax Court allowed a replacement property to be purchased by an exchange accommodation title holder with whom it was parked for 17 months prior to its transfer. However, the I.R.S. has issued a notice of nonacquiescence, advising taxpayers that it disagrees with the holding of the court. Rusudan Shervashidze and Nina Krauthamer explain the facts in Bartell, the safe harbor that was published in Rev. Proc 2000-37, and the status of the facilitator as a beneficial owner for purposes of allowing tax deferral in the swap.

We hope you enjoy this issue.

- The Editors

SPONTANEOUS EXCHANGE OF TAX RULINGS – THE SWISS ANGLE

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Tags
Exchange of Information
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Switzerland

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INTRODUCTION

For the past few years, the spontaneous exchange of information – and tax rulings in particular – has been a major focus of the O.E.C.D. With many countries, including Switzerland, now adopting implementing legislation, the initiative has reached the final phase before first actions will be taken.

For the uninitiated, the term "spontaneous" means that the tax authority discovering the information sends the information to another country's tax authority on its own volition. It is neither automatic nor requested. Spontaneous exchange is one of three types of information exchange introduced during the last year by means of the O.E.C.D. Convention on Mutual Administrative Assistance in Tax Matters ("C.M.A.A.T."). Namely, the types are (i) information exchange upon request, (ii) automatic exchange of information, and (ii) spontaneous exchange of information.[1]

Switzerland introduced the spontaneous exchange of tax rulings as of January 1, 2017, on the basis of the C.M.A.A.T. Qualifying tax rulings that were confirmed after January 1, 2010, and are still applicable on January 1, 2018, will be subject to spontaneous exchange by the tax authorities.

LEGAL BASIS

Swiss tax treaties and tax information exchange agreements ("T.I.E.A.'s") in their current form do not provide for the spontaneous exchange of information. The legal basis for spontaneous exchange of information is contained in the C.M.A.A.T. as approved in December 2015 by the Swiss legislator. As Switzerland made certain reservations to the C.M.A.A.T., the spontaneous exchange is limited to tax rulings concerning (i) income (of both individuals and corporations), (ii) capital/net wealth (again of individuals and corporations), and/or (iii) withholding tax. Tax rulings covering *inter alia* V.A.T., inheritance or gift taxes, stamp duties, or social contributions will not be exchanged spontaneously, nor on request, as they would not be covered by tax treaties[2] or T.I.E.A.'s.

In order to provide a specific legal basis allowing for spontaneous exchange of tax information, the Swiss Act on International Administrative Assistance in Tax Matters and its respective ordinance required amendments, which came into effect on January 1, 2017.

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1 See C.M.A.A.T. arts. 5, 6, and 7.

2 Switzerland has nine tax treaties covering inheritance tax, but they do not contain information exchange clauses.

TAX RULINGS

In General

Switzerland boasts a longstanding and reliable tradition of providing advance rulings to taxpayers. Although Swiss legislation does not provide a formal legal basis for the practice,[3] the binding effect of tax rulings was initially derived from constitutional law (*i.e.*, the protection of good faith) and later cemented by case law.

In accordance with Swiss jurisprudence, a tax ruling is binding under the following conditions:

- The ruling was provided by the competent authority or a confirming authority, which the taxpayer could assume is competent.
- The ruling was made with respect to a specific set of fully disclosed facts.
- The ruling was not made subject to reservations.
- The ruling was not obviously incorrect.
- Specific dispositions were made based on the ruling.
- The law did not change since the ruling was granted.

Spontaneous Exchange of Tax Rulings

For the purpose of spontaneous exchange of information, Swiss law contains a definition of tax rulings that must be exchanged spontaneously. (See below regarding the so-called *de minimis* clause.)

Pursuant to that definition, a tax ruling is "an information or confirmation concerning tax consequences on the basis of the facts outlined by the taxpayer, received from the tax authority and the taxpayer relies on the confirmation/information received."

The form in which a tax ruling was granted is irrelevant with regard to its possible exchange, meaning a ruling may be exchanged whether it was granted in writing or orally (although the latter would clearly be the exception).

Nor is the granting of a tax ruling related to a subsequent implementation of the tax ruling (*e.g.*, execution of a specific transaction). This may result in a tax ruling being exchanged although the taxpayer never implemented the envisaged structure or transaction described in the ruling.

In order to avoid the exchange of rulings, whether regarding an implemented transaction or one that never occured, the advice is generally to file a request to withdraw the tax ruling prior to December 31, 2017.

Types of Rulings to Be Exchanged

In accordance with current legislation, Swiss tax authorities will not exchange all types of tax rulings on a spontaneous basis. Those subject to spontaneous

[3] The V.A.T. Act is the only Swiss legislation that provides a specific legal basis for tax rulings.

exchange are listed in B.E.P.S. Action 5 and specified for Swiss purposes in the domestic law ordinance.

Even though Article 7 of the C.M.A.A.T. may also cover rulings relating to individuals, the Swiss provisions, as currently drafted, seem to mainly affect Swiss corporations. Under the Swiss provisions, the following types of rulings are subject to exchange:

- **Rulings Relating to Preferential Corporate Tax Regimes.** *E.g.*, rulings about holding, mixed, or domiciliary company regimes, principal companies, I.P. boxes, or finance branches are subject to exchange. Although these regimes will most likely be abolished in the course of the ongoing corporate tax reform ("C.T.R."), existing rulings will still be subject to exchange.
- **Unilateral Transfer Pricing Rulings.** *E.g.*, transfer pricing rulings granted by the Swiss tax authorities without the involvement of other concerned states are subject to exchange.
- **Rulings Reducing Taxable Profit Without Reflection in the Financial Statement.** As the Swiss tax liability of a company is tightly connected to its financial statement, divergences between the profit in accordance with the financial statement and the taxable profit are rare under current legislation. However, as, for example, C.T.R. may introduce an excess deduction for research and developement, this type of rulings may become more relevant in future.
- **Rulings on Permanent Establishments ("P.E.'s").** *E.g.*, rulings about the recognition of a P.E. or profit allocation to a P.E. are subject to exchange.
- **Rulings on Conduit Structures.** *E.g.*, rulings on hybrid structures are subject to exchange. This category applies to circumstances where the structure leads to non-taxation or under-taxation.

"Tax rulings are to be exchanged only if the rulings (i) were granted after January 1, 2010, and are still in force on January 1, 2018, or (ii) are granted after January 1, 2018."

The above types of tax rulings are to be exchanged only if the rulings (i) were granted after January 1, 2010, and are still in force on January 1, 2018, or (ii) are granted after January 1, 2018.

***De Minimis* Clause**

Tax rulings need not be exchanged if they are of minor importance to the receiving states due to the tax amounts involved or if the amounts to be paid are disproportionate to the administrative effort of the tax authorities.

PROCEDURE

The cantonal tax authorities have begun issuing information letters to taxpayers whose rulings fall under one of the above categories. In principle, taxpayers have three options to proceed prior to the end of 2017:

- If the taxpayer wishes to rely on the tax ruling after December 31, 2017, an electronic registration and description of the tax ruling is required to be submitted on a template provided by the O.E.C.D. The template, and not the tax ruling, will be exchanged with the receiving state(s).

- If the taxpayer does not intend to rely on the tax ruling after December 31, 2017, the tax ruling can be withdrawn.
- If the taxpayer wishes to rely on the tax ruling after 2017 but is of the opinion that the tax ruling is not subject to spontaneous exchange, the taxpayer is invited to make his or her case.

If the taxpayer fails to act altogether or within the requested deadline (in principle, prior to December 31, 2017, at the latest), the cantonal authorities will send the tax ruling to the Federal tax authority ("F.T.A."). The F.T.A. will then decide if the tax ruling is subject to spontaneous exchange. If so, the F.T.A. will inform the taxpayer accordingly. At that point, the taxpayer has the option to appeal. In a case where advance notification may jeopardise the purpose or success of an exchange, the F.T.A. may inform the taxpayer after the information has been delivered. Legal appeals can be filed once the information is delivered.

The templates will be exchanged by category to states entitled to receive the information, provided that the receiving state has implemented rules for the spontaneous exchanges of tax information. In all of the above tax ruling categories, the state where the direct controlling and top holding company (*i.e.*, headquarters) has its tax residence will receive the information. In the case of a P.E., the state where the P.E. is located will receive the information too.

For tax rulings confirmed after January 1, 2018, the taxpayer is requested to complete the O.E.C.D. template within 60 days following the confirmation of the tax ruling.

CONCLUSION – TO KEEP OR WITHDRAW?

It is sensible for Swiss taxpayers, and international companies in particular, to analyse any Swiss tax rulings and assess whether the rulings are subject to spontaneous exchange. In cases where information exchange is likely to result in adverse foreign tax consequences, it may be sensible to opt for a withdrawal of the tax ruling.

Additionally, since spontaneous exchange of information is intended to be reciprocal, Switzerland is expected to receive information from other states regarding tax rulings issued to Swiss taxpayers. Therefore, it is also advisable for Swiss taxpayers to review tax rulings granted by other states.

Considering the wealth of information that will become available as a result of spontaneous exchange, it is expected that the number of information exchanges upon request will increase.

TAX ROULETTE: BUYING A BUSINESS JET IN 2017 – WHY FOLLOWING THE PATRIOT'S EXAMPLE MAY LEAD TO A JACKPOT

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Tags
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Five-time Super Bowl champions the New England Patriots have earned a new title: the first team in NFL history to buy their own fleet of planes. The aircraft – two Boeing 767s – were purchased from American Airlines and retrofitted with all first-class seats,[1] to provide the team a more comfortable mode of transport to and from out-of-town games. While the decision to own a plane is unique for an NFL team, it is not unheard of in other major U.S. sports franchises. NBA and NHL teams in Dallas and Detroit have all turned to private aircraft for team travel,[2] and other teams may be wise to follow suit. Earlier this year, American Airlines announced that it will be dropping charter services for six NFL teams during the 2017-2018 season. A spokeswoman for the airline attributed the decision to a desire to "ensure we have the right aircraft available for our passenger operation."[3] Nonetheless, these teams will be seeking alternative transportation, and a number of political and economic factors indicate that 2017 may be the right time to purchase a private jet for business use.

The current availability of tax benefits like a 50% bonus depreciation allowance and Code §179 expensing election, along with the potential for a large-scale overhaul of the U.S. tax code, could lead to a "perfect storm" of tax savings for aircraft purchasers in 2017.[4] If the Trump administration is able to push the president's tax reform plan through Congress, the combination of significant tax savings in the current year and lower tax rates in future tax years could enhance the benefits of buying a business-use aircraft this year, before the changes take place.

BUSINESS EXPENSE DEDUCTION

Apart from the obvious convenience and the potential adjustments to accommodate needs specific to athletes (think of the size of the average athlete compared to a plane seat in the coach section), ownership of a plane may come with some additional tax benefits. Standard benefits include tax deductions for business expenses such as food, beverages, medical supplies, and other items consumed during business flights and flights to a game. These are tax deductible whether the plane is chartered or owned. However, plane owners should also be able to deduct expenses for ordinary maintenance, hangar costs, pilots, insurance, and Federal Aviation Administration compliance.

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1 "Patriots Become First NFL Team to Have Own Planes," *ESPN*, August 9, 2017.

2 "Patriots Become First NFL Team to Own Team Jet for Travel," *New York Daily News*, August 8, 2017.

3 "American Airlines Drops Charter Flights for Six NFL Teams Including Dolphins and Steelers," *Forbes*, April 15, 2017.

4 The following assumes that the aircraft is placed into service in the year of acquisition (*i.e.*, 2017).

DEPRECIATION DEDUCTION

One of the biggest aircraft expenses – and thus tax deductions – is depreciation. Since the useful life of a business jet extends over many years, the I.R.S. will not allow a full write-off of the purchase price in the year of acquisition. However, a write-off exceeding actual depreciation in the market may be granted. The standard straight-line schedule – that is, the Alternative Depreciation System ("A.D.S.") under Code §168(g) – requires an annual deduction of equal amount over an extended period of time. However, many businesses can write off an aircraft in only five to seven years using a schedule published by the I.R.S. under the Modified Accelerated Cost Recovery System ("M.A.C.R.S.").[5] In many cases, this accelerated, front-loaded schedule allows a taxpayer to write off more than half of the aircraft's adjusted basis – generally the purchase price – in the first two years. In addition, costs for upgrading the plane (*e.g.*, the Patriot's retrofitting of the seats) should qualify as capital improvements that are eligible for a depreciation deduction.

"The current availability of tax benefits . . . along with the potential for a large-scale overhaul of the U.S. tax code, could lead to a 'perfect storm' of tax savings for aircraft purchasers in 2017."

BONUS DEPRECIATION

In order to "accelerate purchases of equipment, promote capital investment, modernization, and growth, and . . . help to spur an economic recovery,"[6] Congress has provided an additional first-year depreciation allowance ("Bonus Depreciation") for certain property placed in service during the calendar years 2008 through 2019.[7] For 2008 through 2017, Bonus Depreciation is usually 50% of the adjusted basis of "qualified property."[8] The allowance is reduced to 40% for items placed in service during 2018 and 30% for items placed in service during 2019 and, under certain circumstances, 2020.[9] Under current law, the allowance disappears at the end of 2019.[10] Only new planes – unlike the ones acquired by the Patriots – predominantly

5 Code §168; Treas. Reg. 1.168(a)-1 et seq.

6 HR Rep. No 251, 107th Cong., 1st Sess. 20 (2001).

7 Code §168(k)(1). Bonus Depreciation provisions initially applied to an earlier period, which has expired, and Congress has repeatedly deferred the sunset date of the current bonus. See, *e.g.*, Pub. L. No. 114-113, Div. Q, §143, 129 Stat. 2242 (2015); Pub. L. No. 111-312, §401(a), 124 Stat. 3296 (2010); Pub. L. No. 111-240, §2022, 124 Stat. 2504 (2010); Pub. L. No. 111-5, §1201, 123 Stat. 115 (2009); Pub. L. No. 110-185, §103, 122 Stat. 613 (2008). In many instances, the allowance expired a year or more before Congress restored it retroactively. See Rev. Proc. 2016-48, 2016-37 IRB 348, §4 (guidance on issues arising from retroactive restoration of allowance for 2015).

8 Code §168(k)(1)(A). Note that Bonus Depreciation is not allowed in determining earnings and profits.

9 Code §168(k)(6).

10 The phaseout rules generally provide an extra year of Bonus Depreciation for qualifying aircraft. *E.g.*, 30% Bonus Depreciation is available if a written binding contract is signed before the end of 2019 and the aircraft is put in service in 2020. A contract is binding if it is enforceable under state law and does not include any liquidated damage clause that amounts to less than 5% of the aircraft or equipment sales price. Additional requirements are set forth for non-commercial aircraft (such as (i) a non-refundable deposit greater than 10% of the aircraft price and capped at $100,000, (ii) a purchase price of more than $200,000, and (iii) a production period for the aircraft that exceeds four months).

used within the U.S. qualify for this rule.[11] Depreciation is not increased but accelerated under this provision. This is a cash-flow benefit in the form of reduced tax payments in early years of ownership but not necessarily a financial statement benefit. A deferred tax liability arises immediately in the form of reduced depreciation for income tax purpose in later years, which leads to increased tax payments for those years. Increased tax payments in future years are booked as a liability for the year in which accelerated depreciation is claimed. This is discussed in greater detail below.

CODE §179 DEDUCTION

To eliminate the burden of maintaining depreciation accounts for items of personal property with relatively small value, the statute permits taxpayers to elect to expense limited amounts of depreciable personal property.[12] Eligible property is generally depreciable personal property that is acquired by purchase for use in the active conduct of a trade or business. If certain requirements are met (see the limitation described below), the acquisition of an aircraft may qualify for the Code §179 deduction. Unlike the Bonus Depreciation, the Code §179 deduction is also applicable to the purchase of used aircraft. This deduction is subject to an annual dollar limitation, reduced by a phaseout amount. Both the dollar limitation and the phaseout amount have varied over the years in response to shifting political and economic pressures.

In the Protecting Americans from Tax Hikes ("P.A.T.H.") Act of 2015,[13] the dollar limitation was permanently set at $500,000 and the phaseout amount was set at $2 million, both indexed for inflation and possible adjustment.[14] Until made permanent, these amounts are the same as the ones temporarily allowed from 2010. For 2017, the inflation-adjusted dollar limitation is $510,000 and the phaseout amount is $2.03 million.[15] The phaseout provision provides that the dollar limitation for any taxable year is reduced, dollar for dollar but not below zero, to the extent that the cost of the qualifying Code §179 property placed in service during such taxable year exceeds the phaseout amount.[16] The operation of this limitation is illustrated below.

Example 1

In 2017, Taxpayer A purchases a plane for $350,000 and puts it in service the same year. No other qualifying purchases are made in this year. Taxpayer A may elect to deduct the entire $350,000 in the current year.

Example 2

The facts are the same as in Example 1 except that Taxpayer A purchases

[11] In determining whether an aircraft has been predominantly used within the U.S., the I.R.S. applies a test under which an N-registered aircraft (*i.e.*, an aircraft registered in the U.S.) is required to make, on average, a flight to or from the U.S. at least once every two weeks over the course of a year.

[12] Code §179(a).

[13] P.L. 114-113, §124(a)(1) and (2), Div. Q.

[14] Code §§179(b)(1), 179(b)(2).

[15] Rev. Proc. 2016-55, 2016-45 I.R.B. 707.

[16] Code §179(b)(2).

an additional $2.5 million of qualifying property. Therefore, the deductible amount is zero ($510,000 limitation reduced by $850,000, excess of the cost of qualifying property, $2.85 million, over the $2.03 million phaseout amount in 2017).

The amount eligible for the expense election cannot exceed the taxable income from any active trade or business of the taxpayer for the taxable year. In other words, a loss cannot be generated by means of this deduction. However, unused amounts can be carried forward.[17] If a taxpayer qualifies for M.A.C.R.S., Bonus Depreciation, and the Code §179 deduction, the latter is to be applied first, followed by Bonus Depreciation and finally M.A.C.R.S. In applying the latter two, the basis must be adjusted appropriately each time expensing and depreciation deductions are claimed. See Example 4, below.

M.A.C.R.S., BONUS DEPRECIATION, AND THE CODE §179 DEDUCTION LIMITATIONS

The 50% Bonus Depreciation deduction and the Code §179 deduction are subject to the "more than 50%" M.A.C.R.S. rules. If a taxpayer is under the more-than-50% threshold (explained below), it may not deduct Bonus Depreciation or utilize the Code §179 deduction and is subject to the considerably slower depreciation schedule under A.D.S.[18]

In 1984, Code §280F was enacted to prohibit taxpayers from using the beneficial M.A.C.R.S. to depreciate assets that frequently are used for business and personal use. These types of assets are called "Listed Property," a term that encompasses certain motor vehicles, photographic equipment, computer equipment, and aircraft. Code §280F shares the same policy as the hobby loss rules where taxpayers claim deductions for businesses that do not generate net operating income and reflect activities customarily found in hobbies, such as farming or horse raising. Under Code §280F, Listed Property must be predominantly (*i.e.*, more than 50%) used for a qualified business in order to qualify for M.A.C.R.S. depreciation. If the qualified business use falls below the threshold, the taxpayer must utilize A.D.S., which provides for longer recovery periods.

Language intended to limit potential abuse in this context comes with one specific exception: If aircraft is used at least 25% for qualified business purposes, leasing or compensatory flights of a 5% or more owner can be treated as qualified business use.[19] This is a huge exception for business aircraft owners. If the aircraft ownership is structured carefully, the owner is able to include certain personal flights in the calculation to reach the "more than 50%" threshold that triggers the ability to use M.A.C.R.S., Bonus Depreciation, and the Code §179 deduction for aircraft.

The following examples illustrate the availability of benefits with and without the exception.

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17 Code §179(b)(3).

18 Code §280F(b)(1).

19 Code §280F(d)(6)(C)(ii). The exception also covers leasing to a 5% or more owner of the aircraft company and compensation for any other person under certain circumstances.

Example 3

Taxpayer A is the sole member of Aero L.L.C. Aero L.L.C. purchases a plane for $1,000,000 in October 2016. Taxpayer A determines that in 2016 the use of the plane is divided as follows: 37% business flights, 28% personal non-entertainment flights, 25% personal entertainment flights, and 10% maintenance flights. Without the exception, 37% of the flights would be categorized as qualified business use. Consequently, Taxpayer A would not be eligible for Bonus Depreciation or the Code §179 deduction in 2016. Thus, Taxpayer A's allowable depreciation in 2016 would be $83,333 (*i.e.*, $1 million depreciated over a period of six years under A.D.S. applying the half-year convention = $1 million / 6 x 0.5).

Example 4

The facts are the same as in Example 3. However, because of the exception for aircraft, Taxpayer A is allowed to count both personal non-entertainment flights (28%) and business flights (37%) as qualified business use, thereby comfortably satisfying the more than 50% M.A.C.R.S. threshold. As a result, the taxpayer may also take advantage of both accelerated first-year deductions, which results in an allowable deduction of $578,750 in 2016 on that same $1,000,000 plane (*i.e.*, $500,000 from the Code §179 deduction, $75,000 from the 50% Bonus Depreciation, and $3,750 from 5% M.A.C.R.S. depreciation in first year of a five-year period). This is nearly 58% of the total cost – a huge difference.

It should be noted that any excess depreciation taken under M.A.C.R.S. must be recaptured in income. A similar recapture rule applies to Bonus Depreciation and Code §179 deduction.

RECAP UPON THE SALE OF THE AIRCRAFT

Typically, accelerated depreciation deductions come at a price. As mentioned above, depreciation is a timing deduction that allocates the cost of a wasting asset to each year of its useful life. Nonetheless, it is a zero-sum computation over the useful life of the asset. As a result, if a greater amount is allocated to an early year of useful life, a reduced amount must be allocated to a later year. Consequently, accelerated depreciation merely results in a deferral of tax. However, many entrepreneurs look at deferral as the equivalent of absolute savings in tax – as if the day of retribution never arrives.

In any event, in the later years of useful life the tax is increased because depreciation is pushed to earlier years, and upon the sale of the aircraft, tax benefits generated by the depreciation deduction, Bonus Depreciation, and the Code §179 result in increased recognition of gain. The I.R.S. computes any taxable gains or losses on the sale by subtracting the aircraft's "adjusted basis" from the sales price. Generally, the starting point for the adjusted basis is the purchase price. However, the aircraft's adjusted basis will be reduced each year by the amount of depreciation taken as a deduction, as illustrated below.

Example 5

A used plane is sold for $710,000. It was originally purchased for $1,000,000

and depreciation deductions since acquisition amount to $762,500. Hence, the adjusted basis is $237,500. The gain on the sale is $472,500 (*i.e.*, $710,000 less $237,500).

The gain on the sale is entirely related to the depreciation recapture. Accordingly, it will be treated as ordinary income, subject to income tax at a rate of up to 43.4%[20] for individuals (*e.g.*, if owned via an L.L.C.). To the extent the gain exceeds the depreciation recapture, it be treated as capital gain and taxed at 20%[21] if the asset was held for more than 12 months (long-term capital gain). Thus, the owner must be able to sell the aircraft for a price exceeding the acquisition price (*i.e.*, more than $1,000,000) after a one-year holding period.

Nonetheless, there is a happy ending for an entrepreneur. If, instead of a sale, the owner exchanges the plane for another aircraft used in his or her trade or business, the gain may be rolled over through a carryover basis in the newly acquired aircraft under certain circumstances. While a full analysis of this option is beyond the scope of this article, a common example helps to illustrate this principle. Readers who have traded-in an old car at the time of acquiring a new one from a dealer may have recognized that local sales taxes are not imposed on the credit for the trade-in. The same general principle applies to a like-kind exchange under Code §1031 for depreciable property used in a trade or business. Because that section imposes several hurdles before gain is deferred on an exchange of property, taxpayers should seek advice before making such a decision.

BENEFITS UNDER PROPOSED TAX REFORM

If a taxpayer is already on the fence about making a new aircraft purchase, upcoming changes to the Bonus Depreciation regime are a serious consideration for the timing of the investment. While the benefits of Bonus Depreciation have been set to expire each year since 2012 only to be renewed by Congress, some commentators anticipate that the phaseout under the P.A.T.H. Act will not be extended as a means of "paying for" a general reduction in tax rates. Further, there is a possibility that Congress will repeal the accelerated depreciation incentive after the 2017 tax year if the expected overhaul of the tax code is successful. Even if an overhaul does not occur, the current timeline for the expiration of these benefits places a new sense of urgency on business owners trying to decide on an aircraft purchase.

Currently, if aircraft owners in an L.L.C., partnership, or S-Corporation recognize gain from recapture of depreciation at time of sale, that gain is treated as ordinary income and is taxed at ordinary income rates (as high as 43.4%). Under President Trump's proposal, most corporate tax expenditures would be eliminated,[22] while or-

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20 *I.e.*, the progressive income tax rate of up to 39.6% plus 3.8% Net Investment Income Tax under current law.

21 This rate applies to individuals in the highest tax bracket (*i.e.*, those with taxable income exceeding $418,401 in 2017 as single filers or $470,701 for couples filing jointly).

22 An exception applies to the research and development credit and expenditures for capital investments by manufacturing companies (subject to the condition they forego the deduction for interest expense). For a breakdown of the proposal as of early 2017, see "Trump and the Republican-Led Congress Seek

> *"If a taxpayer has ever considered an aircraft purchase or postponed the decision to find the right time, this may be the best opportunity in a decade to capitalize on the tax benefits to make that purchase."*

dinary income from L.L.C.'s, Partnerships, and S-Corporations would be taxed at the new corporate rate of 15%.[23] If an aircraft owner is able to deduct depreciation on the acquisition cost of the aircraft now and use the deductions against income taxed at a 43.4% rate while being subject to a 15% tax rate on the recapture of depreciation upon the sale of the aircraft in future years, a net tax savings of 28.4% will be realized.

Compare this with the consequences of tax reform under the House Republican Tax Reform Blueprint (the "Blueprint"), a plan released in June 2016 by the G.O.P.-led House Ways and Means Committee. According to the Blueprint, the cost of capital investment would be fully and immediately deductible rather than depreciated over time. Unlike the president's proposal, the immediate expensing of capital investment would be automatic, thus a taxpayer would not be required to make an election in order to expense the cost of the capital investment. Such expensing would be available for all business investments (including tangible and intangible assets) other than land. The intended effect of immediate expensing is to transform the U.S. corporate tax system from income-based to cash-flow or consumption-based. The costs of acquisition would be 100% tax deductible in the year of acquisition. The tax rate would be reduced to 20% for corporations and 25% for L.L.C.'s, partnerships, and S-Corporations, resulting in a net effective tax rate of 20% and 25%, respectively, upon sale of the aircraft (sale price less adjusted basis of zero).

While the Blueprint offers an even greater incentive in particular for large scale capital investments, it remains to be seen whether a lower tax rate in combination with this significant acceleration of deductions could find a majority in Congress to pass the required legislation. A reduction in individual and corporate income tax rates by itself is already subject to heavy discussions. Taxpayers may choose the bird in the hand over the two in the bush.

CONCLUSION

The current tax environment provides the opportunity to purchase business-use aircraft, new or used, and deduct a significant amount of the acquisition cost in 2017. With the top tax rate at 43.4% on ordinary income for high earners, every deduction counts in reducing what could amount to a massive tax burden.

A significant future reduction in tax rates could also benefit aircraft owners if taxable income is reduced at the current higher rates and lower rates apply when the recapture of depreciation occurs upon the sale. While there are no guarantees that there will be a major overhaul to the U.S. tax code, signs point in that direction. Both the White House and House representatives have repeatedly signaled their commitment to realize this plan. If a taxpayer has ever considered an aircraft purchase or postponed the decision to find the right time, this may be the best opportunity in a decade to capitalize on the tax benefits to make that purchase.

Overhaul of International Tax Rules." A later version, released on April 26, 2017, did not bring further illumination to the president's plans.

23 Most recently, President Trump reconfirmed his plan for a 15% rate on August 30, 2017.

LEGAL AND PRACTICAL STRATEGIES FOR MANAGING TAX DISPUTES IN INDIA

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Tags
B.E.P.S.
India
Multilateral Instrument
Tax Controversy
Transfer Pricing

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In an era of globalization, where foreign entities are looking at rapid expansion and turning to newer markets such as India, entities may find themselves exposed to unexpected tax risks and disputes in jurisdictions with unfamiliar tax systems. A tax dispute can potentially have serious long-term ramifications with respect to both the profitability of the entity and the reputation of the business enterprise. In the Indian context, the last decade has seen an upsurge in tax disputes, with a number of high-profile cases currently being contested at various levels. Multinational companies such as Vodafone, Nokia, Shell, Aditya Birla, and NDTV are all cases in point.

The main causes for the rise in tax disputes are as follows:

- Recent efforts on the part of the Indian tax authorities to widen the country's tax base by emphasizing source-based taxation
- Taxpayers implementing "creative" structures to achieve a tax-effective structure or transaction
- Confusion resulting from lack of clarity on new provisions exacerbated by aggressive interpretations by both taxpayers and tax authorities
- Conflicting rulings pronounced by different appellate forums or authorities across the country contributing to delays or multiplicity of tax disputes

The following high-profile tax disputes and controversies in India have gathered attention in the recent years:

- The $11 billion *Vodafone* case wherein the question of taxability of indirect transfer of Indian assets was decided by the Supreme Court of India
- The *Nokia* case, which involved taxation of royalty payments from Nokia India to its Finnish parent company, wherein the Income Tax Department issued a notice to Nokia's subsidiary in India and froze its assets
- The *Shell India* and *Vodafone* cases involving the application of transfer pricing provisions regarding the issue of shares and the alleged under-valuation of shares to avoid tax in India[1]
- The Aditya Birla-AT&T deal involving the question of an "indirect transfer" of Indian assets and the application of the India-Mauritius Income Tax Treaty
- The recent *NDTV* case where the Income Tax Appellate Tribunal ("I.T.A.T.") collapsed the entire multi-jurisdictional corporate structure created by NDTV and taxed certain amounts received by it as unexplained income

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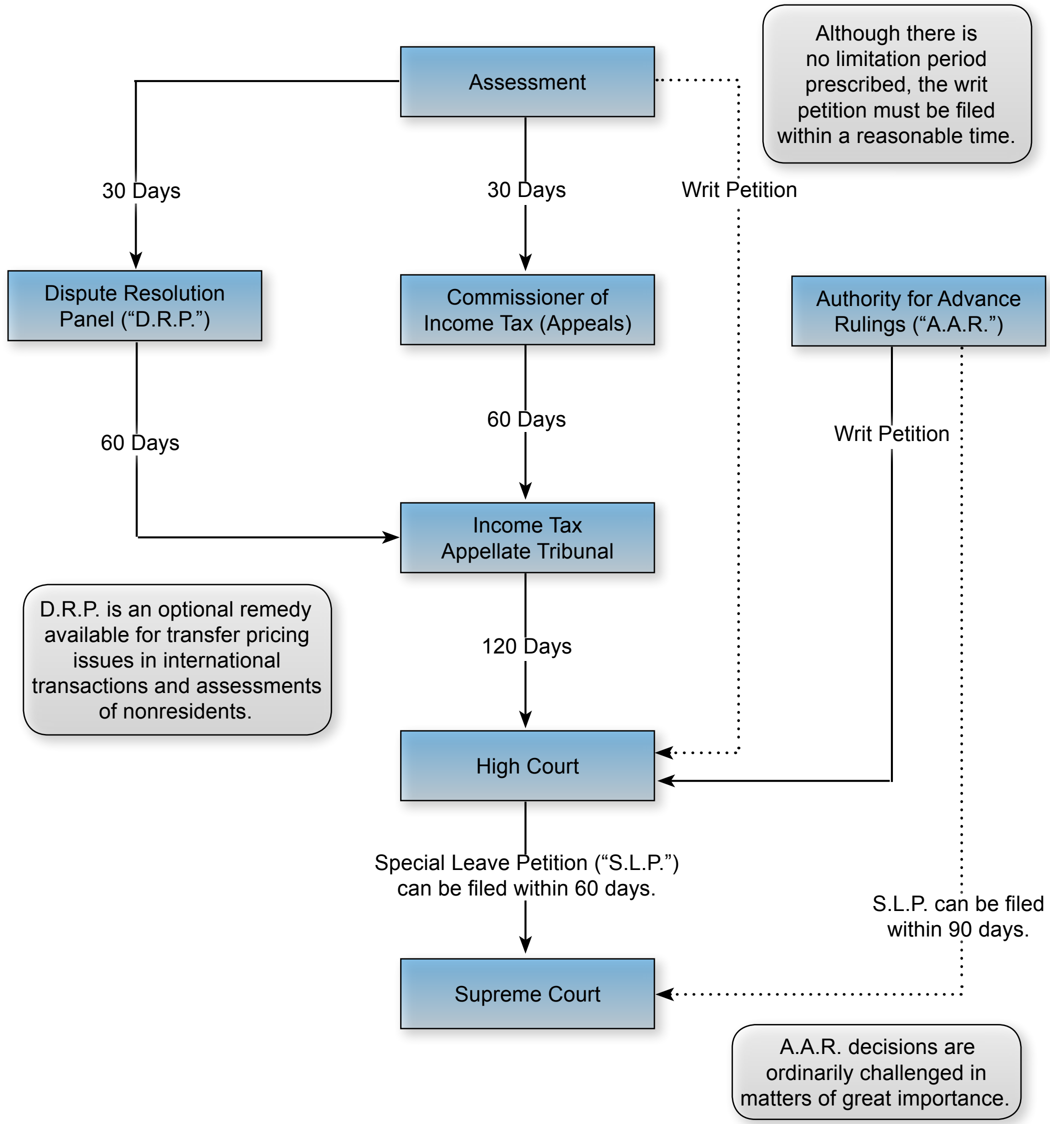
[1] This issue has been resolved following the Bombay High Court's decision in *Vodafone* and the Indian government's support for the decision.

The diagram below provides an overview of the appeals process in India and the timelines for filing such appeals or objections:



> ***"The last decade has seen an upsurge in tax disputes, with a number of high-profile cases currently being contested at various levels."***

DEVELOPING PROPER STRATEGIES FOR EFFECTIVE HANDLING OF TAX LITIGATION

The importance of enlisting sound tax counsel to develop effective legal strategies and mitigate tax disputes cannot be overemphasized. Such strategies can be beneficial both before and after a transaction is effected. Unless handled properly, litigation can be a long-drawn and expensive affair in India.

Preventing Tax Disputes

Some of the key steps that could help avoid tax litigation are set out below:

- Vet transactions from an income tax perspective to ensure compliance with all applicable laws and legal "do-ability."
- Appropriately draft legal documents and vet prospective structures from tax

perspective to avoid unnecessary litigation or disputes going forward. With the introduction of the General Anti Avoidance Rules ("G.A.A.R."), it is important that the commercial intent behind each transaction is immaculately captured in the transaction documents.

- When undertaking a transaction such as an acquisition, merger, slump sale,[2] or share sale, ensure that all relevant documents and evidence are preserved, including supporting evidence with respect to the valuation of the assets involved.
- Take a proactive approach by making the best use of the forums available for speedy dispute resolution (*e.g.* approach the Authority for Advance Ruling ("A.A.R.") for a determination on the taxability of a transaction).
- Make appropriate disclosures in tax returns at the outset to bring relevant facts and legal documents on record and lay the foundation for a strong defense of the taxpayer's position. This can also help to avoid the application of penalties, if the taxpayer's claim is not accepted in a tax assessment.
- When undertaking international transactions with related parties, a taxpayer should make a reasoned determination of how it will handle transfer pricing aspects of the transactions. Choices include (i) preparation of a competent transfer pricing study prior to undertaking the transaction, rather than as an afterthought, (ii) utilization of the Advance Pricing Agreement ("A.P.A.") mechanism, as discussed in detail below, or (iii) adherence to the prescribed safe harbor rules.
- Consider obtaining a "tax insurance policy" to safeguard against any potential future tax demands.

Handling Tax Disputes

When tax disputes arise, it is critical that the taxpayer arrange for proper and effective representation before the tax and appellate authorities and that all key facts, arguments, supporting evidence, and relevant documentation are put forth in a comprehensive manner. It should be noted that the High Courts and the Supreme Court generally decide on questions of law and not questions of fact. Further, they do not routinely permit the introduction of additional evidence. There should also be timely compliance with official procedures and follow up to push for speedy resolution of disputes.

UTILIZING FORUMS THAT FACILITATE DISPUTE RESOLUTION

Under Indian income tax laws, the following forums facilitate dispute resolution.

A.A.R.

This forum is primarily available to nonresidents and foreign companies. An advance

[2] A slump-sale involves the transfer of one or more undertakings as a result of the sale for a lump-sum consideration without values being assigned to the individual assets and liabilities.

ruling can be obtained for a completed transaction as well as for a proposed transaction, but not for a hypothetical transaction. An A.A.R. ruling is binding on the tax authorities and the applicant. Consequently, it provides certainty regarding the tax position in India for a nonresident or foreign company. However, in several instances, the High Courts and the Supreme Court have entertained challenges against advance rulings by way of a writ petition or a special leave petition ("S.L.P.") under the Constitution of India.

It may be noted that the prerequisite for filing an application before the A.A.R. is that the question raised by the applicant must not be pending before any income tax authority, appellate tribunal, or court.

The benefit of approaching the A.A.R. is that potential proceedings before a tax officer are usually put on hold from the date of the application until the date of the ruling. Consequently, the tax authorities may not assert, or demand payment of, a tax liability while A.A.R. proceedings are under way.

While the provisions prescribe a time limit of six months, within which the A.A.R. will pronounce its ruling, of late the A.A.R. has been taking between two or four years to issue its ruling. Factors contributing to this delay include a vacancy in the office of the chairman and a backlog of cases. One hopes that this situation will soon improve and the A.A.R. will revert to the prescribed timeframe.

A.P.A.'s for Transfer Pricing Matters

Globally, as well as in India, transfer pricing disputes account for a major portion of all tax litigation. With a view to reduce such litigation, the Indian government has introduced a framework for A.P.A.'s between the tax authorities and certain specified taxpayers who enter, or propose to enter, transactions with associated enterprises outside India. An A.P.A. is an agreement between a taxpayer and the tax authority on an appropriate and mutually agreed upon transfer pricing methodology for a set of transactions over a fixed period of time.

An A.P.A. will be valid for the period of years specified in the agreement, subject to an upper limit of five consecutive tax years. A rollback provision is also available, so that the A.P.A. is applicable to past years as well. The A.P.A. is binding only with respect to the specified transaction. The A.P.A. ceases to be binding if there is any change in law or facts bearing on the subject matter of the A.P.A.

An A.P.A. provides the following benefits to the taxpayer:

- Certainty with respect to the international transactions covered in the agreement
- Low annual reporting costs
- Flexibility in developing pragmatic and workable solutions for complex transfer pricing issues owing to the joint endeavors of the taxpayer and the tax authorities
- Excellent returns on the time and effort invested in negotiating the original A.P.A. when the agreement is renewed
- Reduction in risks and costs associated with transfer pricing audits and litigation over the term of the A.P.A.

As of July 31, 2017, the tax department entered into 171 A.P.A.'s, which include 12 bilateral A.P.A.'s and 159 unilateral A.P.A.'s.

Withholding Tax Authorization

An action taken with the consent of the tax authorities is generally protected from litigation going forward.

If a payor or a recipient believes that a proposed payment is not taxable in India, or is taxable at a reduced rate, the tax authorities may be approached for authorization. Where the tax authorities issue a reduced rate or zero tax withholding certificate, the payment can be effected without deducting tax or with tax deducted at a reduced rate.

This mechanism can reduce the possibility of later disputes. However, the withholding certificate is not a conclusive determination of the recipient's tax position. The tax authorities usually reserve the right to make a final determination when assessing the taxpayer's return for the relevant period.

Dispute Resolution Panel ("D.R.P.")

The D.R.P. is another mechanism formulated by the Indian government to facilitate expeditious resolution of tax disputes. The D.R.P. consists of a collegium of three commissioners of income tax who adjudicate matters concerning adjustments proposed by the tax officer in tax assessments of foreign companies and cases involving transfer pricing adjustments.

A taxpayer who objects to adjustments proposed in a tax assessment may submit those objections to the D.R.P. The D.R.P. considers the objections and, after hearing both sides, gives necessary directions to the tax officer, who is obliged to frame the tax assessment based on the directions of the D.R.P. The D.R.P. is required to provide its directions in a timely manner.

Mutual Agreement Procedure ("M.A.P.") Under Tax Treaties

This is a special mechanism for dispute resolution provided under Indian's multilateral tax treaties. The M.A.P. applies to cases where an action or a proposed action leads to double taxation of income or to tax that is not in accordance with the relevant tax treaty. On receipt of a taxpayer's application for the M.A.P., the competent authority of the taxpayer's country of residence will take up the disputed matter with the competent authority of India to discuss the issues and attempt to arrive at a resolution.

Resolution under the M.A.P. and resolution under domestic laws can be carried out simultaneously, and the taxpayer may choose to accept or decline the resolution reached by the competent authorities.

TRIGGERING LITIGATION – TAXPAYER BEWARE!

G.A.A.R.

One cannot discuss Indian income tax provisions without examining the impact that will arise from the introduction of G.A.A.R. Moving to a "substance" over "form" approach, the introduction of G.A.A.R. from April 1, 2017, is expected to change the landscape of taxation in India.

G.A.A.R. may be invoked by the tax authorities where the main purpose of an arrangement is to obtain a tax benefit. The G.A.A.R. provisions empower the tax authorities in India to declare any such arrangement as an "impermissible avoidance arrangement." On this basis, it may disregard entities in a structure, reallocate income and expenditures between parties to the arrangement, alter the tax residence of entities and the legal situs of assets, and treat debt as equity or vice versa. By doing so, the tax authorities may even deny tax benefits conferred under a tax treaty.

Accordingly, taxpayers must ensure that there is commercial substance behind every transaction or structure in order to mitigate risks. A taxpayer may also approach the A.A.R., for determining whether a particular proposed transaction would be free from attack under the G.A.A.R. provisions.

Transfer Pricing

Transfer pricing has always been a subject of heavy litigation in India – the controversies in the *Vodafone* and *Shell* cases being only recent examples.

Indian transfer pricing provisions are fast evolving as the Indian government endeavors to protect the country's tax base. Along these lines, Finance Act 2017 introduced two international practices to the Indian tax landscape: thin capitalization norms and secondary adjustments.

"Moving to a 'substance' over 'form' approach, the introduction of G.A.A.R. from April 1, 2017, is expected to change the landscape of taxation in India."

Even with risk mitigation and dispute resolution mechanisms such as A.P.A.'s and safe harbor rules, India has experienced a substantial increase in transfer pricing disputes in recent years. As India's role in the global economy and presence of the international stage continues to grow, a further increase in transfer pricing related disputes is expected.

"Indirect Transfer" Tax Provisions

The indirect transfer tax provisions were introduced in 2012 with retrospective effect, to negate the effect of the Supreme Court's ruling in *Vodafone*. Under the indirect transfer tax provisions, gains on a transfer of an interest in entity (which includes a foreign corporation) are liable to tax in India if the foreign entity derives "substantial value" from assets situated in India, subject to benefits available under tax treaty, if any.

For the purpose of determining whether a foreign entity derives substantial value in India, certain threshold limits are provided, based on the values of the asset and the foreign entity. Consequently, tax disputes are anticipated with respect to the application of the indirect transfer tax provisions to specific transactions.

Place of Effective Management

In 2016, the test for corporate residency of foreign companies moved from control and management being situated wholly in India to place of effective management ("P.O.E.M.") in India. The determination of P.O.E.M. is a factual determination, based on substance over form, taking a holistic approach on a year-to-year basis. Considering the subjective nature of the guidelines issued for determining P.O.E.M., disputes are likely to arise.

Valuation Norms

By reason of recently introduced provisions, a minimum fair market value test is to be fulfilled by the acquirer of assets situated in India, as well as the transferor of equity shares in India. The fair market value of equity shares is to be computed by a hybrid mechanism based on the asset composition of the company. For the purpose of valuing equity shares, the fair market value of any downstream investments, onshore or offshore, are also to be taken into consideration.

In addition, ambiguity exists with respect to the application of accepted valuation norms to instances such as the conversion of instruments or a bonus issue of shares. Considering the complexities that may arise in obtaining a valuation of this nature and the ambiguity surrounding the application of these provisions, taxpayers should seek sound legal advice prior to entering into any such transaction.

Implementation of B.E.P.S. Provisions

Over the past few years, India has begun adopting provisions under the O.E.C.D.'s B.E.P.S. initiative, including the equalization levy and thin capitalization norms. It is expected, that India will steadily adopt many concepts under the B.E.P.S. Action Plan, leading to further changes in the Indian tax regime.

India has already signed the O.E.C.D.'s Multilateral Instrument ("M.L.I."), in line with the B.E.P.S. Action Plan. The M.L.I. seeks to amend the existing network of more than 3,000 bilateral tax treaties between the signatory countries. With the ratification of the M.L.I. by each new country, existing tax treaties between India and the signatory jurisdiction will stand amended. The potential impact of the M.L.I. will require careful study, and advice should be sought prior to entering any transaction.

CONCLUSION

Given the adversarial nature of tax assessments and the costs involved in tax dispute resolution, it is preferable to conduct one's business so as to ensure that cause for a dispute does not arise in the first place. However, litigation may become inevitable owing to the nature of the transaction, the stakes involved, or the conflicting views of the tax authorities.

The government has the responsibility to ensure that disputes are addressed with a sense of urgency and without delayed or frivolous appeals. This may be accomplished through the creation of stringent guidelines to ensure pro-taxpayer rulings are challenged only if they are demonstrably perverse or apparently erroneous. Additionally, the government may establish a mechanism to hold tax authorities accountable for frivolous or vexatious tax demands. The merits of a case should be the guiding factor in determining if a tax dispute moves forward, not merely the quantum of tax or the stakes involved in the matter.

In this challenging, high-stakes environment, the best possible strategy for managing tax disputes involves maintaining proper and robust documentation, capturing the commercial substance of the transaction in legal documents, carefully drafting legal submissions to the judicial authorities, bringing all the relevant facts to the fore at the first possible instance, and acquiring effective and persuasive legal representation.

THE ECONOMIC SUBSTANCE DOCTRINE: A U.S. ANTI-ABUSE RULE

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Tags
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Code §7701(o)

INTRODUCTION

Major corporate transactions typically reflect at least two separate elements. One is the business arrangement agreed to by the parties. The other is tax planning that is designed to minimize taxes while allowing the business arrangement to be consummated. In order to strike the appropriate balance, advisors must consider the potential impact of the economic substance doctrine. This doctrine constitutes a major tool for the I.R.S. to counter tax abusive transactions, because a transaction that has no economic substance will not be respected for income tax purposes in the U.S.

When the tax plan follows the business plan, taxpayers have wide latitude to choose a structure that reduces or defers tax for the seller. A simple example is that a taxpayer may choose to pursue a tax-free reorganization as the form of the transaction rather than a taxable sale of assets. At times however, the tax planning may go beyond the business deal or the underlying transaction may have no purpose other than a reduction of taxes. See, for example, *ACM Partnership v. Commr.*[1] and related cases.[2] Each involved the creation of an arrangement to produce losses for a U.S. taxpayer in order for it to reduce an equivalent amount of gains from an unrelated transaction, and each was created by financial engineers at a large financial institution. In such cases, the courts and the I.R.S. have imposed limits on tax planning when a tax reduction turned out to be the sole driver for a transaction.

COMMON LAW EVOLUTION

The economic substance doctrine is a common-law creation that has been part of U.S. tax law for over 85 years.

Its origins can be traced to *Gregory v. Helvering*,[3] in which the Supreme Court recognized a taxpayer's right to minimize their tax exposure as long as Congress intended those tax benefits.[4]

> The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which

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1 TC Memo. 1997-115, affd. 157 F.3d 231 (3d Cir. 1998).

2 *ASA Inversterings Partnership v..Commr.*, T.C. Memo. 1998-305 affd, 201 F3d 505 (DC Cir. 2000); *Boca Investerings Partnership v. U.S.*, 314 F.3d 625 (D.C. Cir. 2003), revg. 167 F Supp 2d 298 (D.D.C. 2001); and *Saba Partnership v. Commr.* 273 F.3d 1135 (D.C. Cir 2001).

3 293 US 465 (1935).

4 Citing *U.S. v. Isham*, 17 Wall. 496, 506; *Bullen v. Wisconsin*, 240 U.S. 625, 630.

the law permits, cannot be doubted. * * * But the question for deter mination is whether what was done, apart from the tax motive, was the thing which the statute intended.

In the case, the taxpayer was the owner of all the stock of Corporation A, which held appreciated shares of Corporation B. The taxpayer wanted to sell the Corporation B shares at favorable capital gains tax rates. She therefore formed Corporation C, which acquired from Corporation A all the shares it owned in Corporation B in a tax-free reorganization. Corporation C was immediately liquidated and distributed the Corporation B shares to the taxpayer. Under the law in effect at the time, the liquidation of Corporation C was a tax-free event, much like the reorganization by which the Corporation B shares were acquired. All steps required by law were followed. The question was whether the reorganization should be ignored for tax purposes because the taxpayer never intended for Corporation C to continue in business. The Supreme Court answered in the negative and treated the taxpayer as if she received a taxable dividend from Corporation A, taxed as ordinary income.

"The doctrine of economic substance becomes applicable . . . where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings."

Since this case, courts have sought to differentiate legitimate tax planning (*i.e.*, that which has substance) from tax abusive structures, which are compliant with the letter of the law but contrary to its spirit. The principle has been invoked in different iterations and has evolved over the years:

- The incidence of taxation depends upon the substance of the transaction and not mere formalism.[5]
- Taxation is not so much concerned with refinements of title as it is with actual command over the property.[6]
- A mere transfer in form, without substance, may be disregarded for tax purposes.[7]
- A given result at the end of a straight path is not made a different result because reached by following a devious path.[8]
- Where a taxpayer embarks on a series of transactions that are in substance a single, unitary, or indivisible transaction, the courts have disregarded the intermediary steps and have given credence only to the completed transaction.[9]

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5 *Commr. v. Court Holding Co.*, 324 U.S. 331, 334 (1945).

6 *Corliss v. Bowers*, 281 U.S. 376, 378 (1930); see also *Commr. v. P. G. Lake, Inc.*, 356 U.S. 260 (1958); *Helvering v. Clifford*, 309 U.S. 331 (1940); *Griffiths v. Commr.*, 308 U.S. 355 (1939); *Sachs v. Commr.*, 277 F. 2d 879, 882-883 (8th Cir. 1960), affirming 32 T.C. 815 (1959).

7 *Commr. v. P. G. Lake, Inc.*, *supra*; *Commr. v. Court Holding Co.*, *supra*; *Commr. v. Sunnen*, 333 U.S. 591 (1948) *Helvering v. Clifford*, *supra*; *Corliss v. Bowers*, *supra*; *Richardson v. Smith*, 102 F. 2d 697 (2nd Cir. 1939); *Howard Cook v. Commr*, 5 T.C. 908 (1945); *J. L. McInerney v. Commr.*, 29 B.T.A. 1 (1933), affd. 82 F. 2d 665 (6th Cir. 1936).

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

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

- Transactions that are challenged as intermediary steps of an integrated transaction are disregarded when found to be so interdependent that the legal relations created by one transaction would have been fruitless without the completion of the series.[10]

- The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.

- Whether we respect a taxpayer's characterization of a transaction depends upon whether the characterization represents and is supported by a *bona fide* transaction with economic substance, compelled or encouraged by business or regulatory realities, and not shaped solely or primarily by tax avoidance features that have meaningless labels attached.[11]

At times, the economic substance doctrine has been used in conjunction with the business purpose doctrine. The latter, a subjective doctrine, entails analyzing the purpose of the transaction to determine whether the taxpayer intended the transaction to serve some useful non-tax purpose.[12]

Some degree of uncertainty arose through different applications of the economic substance doctrine by various courts. One of the most cited inconsistencies was that certain courts would examine both the economic substance and the business purpose of a transaction in order to determine a given transaction's economic substance (the "conjunctive test"), while other courts determined that the presence of either economic substance or business purpose was enough in reaching a conclusion (the "disjunctive test").

This uncertainty and lack of uniformity led to the codification of the economic substance doctrine in 2010.

CODIFICATION OF THE ECONOMIC SUBSTANCE DOCTRINE

The standards by which the economic substance doctrine is applied were clarified by the enactment of Code §7701(o). Thus, the term "economic substance doctrine"

Oil Corporation v. Commr., 32 B.T.A. 777 (1935), *certiorari* denied 306 U.S. 661 (1939); *Kuper v. Commr.*, 61 T.C. 624 (1974); *Kimbell-Diamond Milling Co. v. Commr.*, 14 T.C. 74 (1950), affirmed *per curiam* 187 F. 2d 718 (5th Cir. 1951), *certiorari* denied 342 U.S. 827 (1951).

10 *American Bantam Car Co. v. Commr.*, 11 T.C. 397, 405 (1948), affd 177 F. 2d 513 (3rd Cir, 1949), *certiorari* denied 339 U.S. 920 (1950); see *Scientific Instrument Co. v. Commr.*, 17 T.C. 1253 (1952), affd *per curiam* 202 F. 2d 155 (6th Cir., 1953).

11 *Frank Lyon Co. v. U.S.*, *supra* at 583-584; *Winn-Dixie Stores, Inc. v. Commr.*, *supra*; *Nicole Rose Corp. v. Commr.*, 117 T.C. 328 (2001), affd 320 F3d 282 (2nd Cir. 2002).

12 Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in Combination with the "Patient Protection and Affordable Care Act,"* JCX-18-10, March 21, 2010, p. 143. Herein, referred to as the "Technical Explanation to the 2010 Act."

is defined as the common law doctrine under which income tax benefits with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

In determining whether a given transaction has economic substance, Code §7701(o) continues to rely on case law. In determining whether a transaction meets the economic substance doctrine, the following points must be considered:[13]

- The economic substance doctrine must be relevant to the transaction.
- Additionally, the following conjunctive two-prong test must be met:
  - The transaction changes the taxpayer's economic position in a meaningful way (apart from Federal income tax effects) (the "economic substance test").
  - The taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into the transaction (the "business purpose test").

In determining whether the taxpayer meets the conjunctive two-prong test, the transaction's potential for profit is taken into account only if the expected pre-tax profits substantially exceed the expected net tax benefits that would be allowed if the transaction were respected (the "profit potential test").[14] For the purpose of computing profit potential, fees and other transaction expenses are to be taken into account as expenses in determining pre-tax profit. In addition, the I.R.S. is authorized to adopt regulations under which foreign taxes will be treated as expenses in determining pre-tax profit in appropriate cases. Note that factors other than profit potential may demonstrate that a transaction results in a meaningful change in the taxpayer's economic position or that the taxpayer has a substantial non-Federal tax purpose for entering into such transaction. The provision does not require or establish a specified minimum return that will satisfy the profit potential test.

Certain benefits that stem from reducing Federal taxable income can no longer be used as a business purpose. Thus, for example, reductions in state or local income taxes – which are typically counted as deductions when computing taxable income for Federal purposes – are treated in the same manner as a reduction in Federal income taxes if the transaction at issue affects the computation of taxable income for Federal tax purposes in addition to state tax purposes. In addition, entering into a transaction to achieve a financial accounting benefit will not be treated as a valid business purpose for entering into the transaction if the origin of the financial accounting benefit is a reduction of Federal income tax.

The provision does not alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice, are respected merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages.[15] Among these basic decisions are

- the choice between capitalizing a business enterprise with debt or equity,

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[13] Code §§7701(o)(1) and 7701(o)(5)(D).

[14] Code §7701(o)(2)(A).

[15] Technical Explanation to the 2010 Act, JCX-18-10, p. 152.

- the choice between foreign corporations and domestic corporations,
- the treatment of a transaction or series of transactions as a corporate organization or reorganization, and
- the ability to respect a transaction between related parties, provided that the arm's length standard of Code §482 is satisfied.

Nonetheless, Code §7701(o) does not alter a court's ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the economic substance doctrine. Thus, the court decisions, referenced above, regarding economic substance continue as valid law.

I.R.S. APPLICATION OF CODE §7701(O)

Application of the Conjunctive Test

In applying the conjunctive two-prong test, the I.R.S. will rely on relevant case law under the common-law economic substance doctrine and the business purpose doctrine.[16] In this regard, the I.R.S. will rely on pre-codification authorities and post-codification authorities.[17] The I.R.S. will not issue general administrative guidance regarding the types of transactions to which the economic substance doctrine applies or does not apply,[18] or issue private letter rulings or determination letters on whether a transaction meets the requirements of Code §7701(o).[19]

Definition of "Transaction"

As explained earlier, the economic substance doctrine applies to a transaction or a series of transactions. In Notice 2014-58, the I.R.S. refers to Treas. Reg. §1.6011-4(b)(1) to define a "transaction." Generally, the term includes all the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement. It also includes any or all of the steps that are carried out as part of a plan. Facts and circumstances determine whether a plan's steps are aggregated or disaggregated when defining a transaction.

Generally, all steps are taken into consideration (*i.e.*, an aggregated approach is applied) when all such steps are interconnected with a single objective. However, when certain steps are taken for tax purposes only, such steps may be isolated and a disaggregated approach may be applied. Notice 2014-58 provided the following disaggregated approach example:

> If transfers of multiple assets and liabilities occur and the transfer of a specific asset or assumption of a specific liability was tax-motivated and unnecessary to accomplish a non-tax objective, then the economic substance doctrine may be applied solely to the transfer or assumption of that specific asset or liability. Separable activities may

16 Notice 2010-62. Notice 2010-62 was issued by the I.R.S. to provide interim guidance regarding the codification of the economic substance doctrine and related provisions in the Health Care and Education Reconciliation Act of 2010.

17 Notice 2010-62, B.

18 *Id.*

19 Notice 2010-62, Effect on Other Documents.

> take many forms including, for example, the use of an intermediary employed for tax benefits and whose actions or involvement was unnecessary to accomplish an overarching non-tax objective. These situations are merely examples intended to illustrate the potential application of the disaggregation approach and are not exhaustive or comprehensive.

Analysis of Relevancy

In Notice 2010-62, the I.R.S. provided guidance as to how it would determine relevancy of the economic substance doctrine to a particular transaction. It stated, in relevant part, that:

The IRS will continue to analyze when the economic substance doctrine will apply in the same fashion as it did prior to the enactment of section 7701(o). If authorities, prior to the enactment of section 7701(o), provided that the economic substance doctrine was not relevant to whether certain tax benefits are allowable, the IRS will continue to take the position that the economic substance doctrine is not relevant to whether those tax benefits are allowable.

The I.R.S. will not issue private letter rulings or determination letters on the issue of relevancy. As a result, the transactions listed in the non-exhaustive list provided in the Technical Explanation to the 2010 Act constitutes the only "angel list" regarding the economic substance doctrine. Aside from that, Notice 2014-58 states that the determination of relevancy requires a factual, case-by-case analysis.

PENALTIES AND ADDITIONAL GUIDANCE

When a taxpayer enters into a transaction that does not meet the economic substance standard and the transaction reduces tax, the portion of the taxpayer's reduction in tax that is attributable to the transaction is subject to a 40% penalty. If the transaction is disclosed in the tax return, the penalty is reduced to 20%. Disclosure is effected on Form 8275, *Disclosure Statement*.[20] The penalty does not apply to any portion of an underpayment on which a fraud penalty is imposed.[21]

The penalty is a strict liability penalty (*i.e.*, the taxpayer cannot benefit from a reasonable cause exception).[22] Because there is no reasonable cause defense available to taxpayers, any proposal to impose a Code §6662(b)(6) penalty at the examination level must be reviewed and approved by the appropriate Director of Field Operations ("D.F.O.").[23]

The I.R.S. Large Business and International ("LB&I") Division has issued internal guidelines for determining when it is appropriate to apply the codified economic substance doctrine. While the Treasury Department has cautioned taxpayers not to rely too heavily on these guidelines, examiners are instructed to carry out the following

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20 Code §6662(b)(6).

21 Code §6664(b).

22 Code §6664(c)(2).

23 LB&I, *Codification of Economic Substance Doctrine and Related Penalties,* LMSB-20-0910-024, September 14, 2010. This directive is effective for transactions entered into on or after March 31, 2010.

four-step inquiry prior to asking a D.F.O. to assert the penalty:

- First, an examiner should evaluate whether the circumstances in the case are those under which application of the economic substance doctrine to a transaction is likely not appropriate.
- Second, an examiner should evaluate whether the circumstances in the case are those under which application of the doctrine to the transaction may be appropriate.
- Third, if an examiner determines that the application of the doctrine may be appropriate, the examiner must make a series of inquiries, provided in the guidance, before seeking approval to apply the doctrine.
- Fourth, if an examiner and his or her manager and territory manager determine that application of the economic substance doctrine is merited, guidance is provided on how to request D.F.O. approval.

"While the economic substance doctrine has certainly been introduced into the Code by Code §7701(o), it has not been entirely codified."

The LB&I guidelines provide examples for every step. These examples are relevant not only for purposes of the penalty regime but also with respect to I.R.S. application of the economic substance doctrine. For example, transactions to which the application of the economic substance doctrine is generally not appropriate include the following ones:

- The transaction is not promoted/developed/administered by a tax department or outside advisors.
- The transaction is not highly structured.
- The transaction contains no unnecessary steps.
- The transaction generates targeted tax incentives that are consistent with Congressional intent in providing the incentives.
- The transaction is at arm's length with unrelated third parties.
- The transaction creates a meaningful economic change on a present value basis (pre-tax).
- The taxpayer's potential for gain or loss is not artificially limited.
- The transaction does not accelerate a loss or duplicate a deduction.
- The transaction does not generate a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset).
- The taxpayer does not hold offsetting positions that largely reduce or eliminate the economic risk of the transaction.
- The transaction does not involve a tax-indifferent counterparty that recognizes substantial income.
- The transaction does not result in the separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years.

- The transaction has credible business purpose apart from federal tax benefits.
- The transaction has meaningful potential for profit apart from tax benefits.
- The transaction has significant risk of loss.
- The tax benefit is not artificially generated by the transaction.
- The transaction is not pre-packaged.
- The transaction is not outside the taxpayer's ordinary business operations.

In the LB&I guidelines, the I.R.S. refers to the four transactions that are not deemed relevant by the Technical Explanation to the 2010 Act, by stating that "it is likely not appropriate to raise the economic substance doctrine if the transaction being considered is related to" these transactions.

CONCLUSION

While the economic substance doctrine has certainly been *introduced* into the Code by Code §7701(o), it has not been entirely *codified*. It is a constantly evolving concept and one that makes abusive tax planning extremely costly through the applicable penalty regime. The likelihood of disclosure of a transaction without economic substance will likely be low for taxpayers that are neither audited under U.S. G.A.A.P. nor subject to analysis by the auditors in accordance with FIN 48, which deals with uncertain tax positions. Without the overview provided in an audit of financial statements under U.S. G.A.A.P., taxpayers may not have a system to report and disclose the transaction. In comparison, if a U.S. G.A.A.P. audit is performed and a reserve is taken with regard to an uncertain tax position, Schedule UTP must be filed with the tax return for the year in which the reserve is established and the taxpayer's assets exceed the $10 million threshold provided in the instructions.

TAX 101:
DEEMED ANNUAL ROYALTY ON OUTBOUND TRANSFERS OF I.P. TO FOREIGN CORPORATIONS

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Tags
Code §367
Intangible Assets
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For many years, the U.S. government has been concerned about U.S. businesses reducing or deferring U.S. income tax liabilities through the use of foreign corporations. Recently, the issue has come to the fore with respect to transfers of intangible property, and the government has sought to rein in these activities by tightening regulations under Code §367.

BACKGROUND

In the early 1930s, when the world and tax laws were simpler, Congress enacted Code §367 to discourage the transfer of appreciated property by U.S. persons (*e.g.*, U.S. citizens or residents, domestic partnerships, domestic corporations) to foreign corporations. The concern was that a U.S. person could transfer appreciated property to a foreign corporation formed in a low-tax jurisdiction. The transaction could be structured as a nonrecognition transaction for U.S. Federal income tax purposes (such as a tax-free contribution of capital or a tax-free outbound reorganization). The foreign corporation could subsequently sell the appreciated asset and the gain generally could escape U.S. taxation.

Somewhat later, Code §367 was used to target the reorganization of a U.S. corporation into a foreign corporation that would be based in a low-tax jurisdiction – a transaction ultimately referred to as a corporate inversion. Under an earlier version of the regulations under Code §367, outbound transfers of intangible assets, including intellectual property ("I.P."), could qualify for nonrecognition treatment in certain instances. By the 1980s, Congress became concerned that a number of U.S. businesses were developing I.P. at U.S. facilities and transferring the I.P. to foreign manufacturing subsidiaries incorporated in a low-tax jurisdiction. The ownership of the I.P. by the manufacturing subsidiary abroad enabled the U.S. company to increase the transfer price paid on purchases from that subsidiary. After all, the subsidiary owned the I.P. Consequently, by engaging in this type of practice, the U.S. company could achieve three tax planning bonanzas. First, the research and development expenses could be deducted when and as incurred.[1] Second, the operating profits derived abroad by the foreign manufacturing subsidiary could be deferred for income tax purposes[2] and permanently deferred for financial accounting purposes.[3] Third, the ownership of manufacturing I.P. abroad justified higher prices for inventory transactions, which allocated greater profit to the foreign subsidiary without resulting in higher import tariffs in some circumstances.[4] During this time, Congress

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1 Code §174.

2 HR Rep. No. 432, Pt. 2, 98th Cong., 2d Sess. (Mar. 5, 1984).

3 S.F.A.S. 109.

4 The U.S. has adopted a Generalized System of Preferences in tariffs.

addressed the concern with the enactment of Code §367(d), which introduced the deemed annual royalty regime for outbound transfers of intangible assets – those transfers are treated as transfers pursuant to a sale involving contingent payments.[5]

Despite the government's efforts, Code §367 has not deterred some U.S. businesses from inverting, as they may find that the tax cost of Code §367 is worth the benefit of removing or deferring income from the reach of relatively high U.S. Federal corporate income tax (currently, the rates are 34% and 35%), potential exposure to tax under Subpart F on profits of foreign subsidiaries that are controlled foreign corporations, and the lock-out effect under which publicly traded corporations can trigger deferred tax liabilities for financial statement purposes if they access earnings of foreign subsidiaries.[6]

As a result, Congress and the I.R.S. have continued to implement considerable disincentives for outbound transfers and inversions.

The most important was the 2004 enactment of Code §7874, which will disregard an inversion transaction under certain circumstances. Additionally, the U.S. transfer pricing regime has been used to scrutinize inversion transactions (*e.g.*, the Code §482 regulations may recharacterize the transfer of I.P. as the provisions of technical services and, thus, require the payment of compensation for the U.S. corporation, with the compensation income characterized as U.S. source income which cannot be reduced by foreign tax credits). Further, if the outbound transfer will involve debt, the limitations on interest deductions under Code §163(j) and the debt-equity rules of Code §385 should be considered. Though beyond the intended scope of this article, the foregoing Code sections and regulations should be considered when planning an outbound transfer.

THE MECHANICS OF CODE §367(A)

Code §367(a) applies to transfers by U.S. persons of property, including stock or securities, to foreign corporations in transactions otherwise qualifying for nonrecognition treatment, including contributions to controlled corporations under Code §351 and certain transfers relating to corporation reorganizations. It states, in the case of such a transfer, that the foreign corporation will not be treated as a corporation for the purposes of determining the extent to which gain must be recognized on the transfer. Since nonrecognition treatment in transactions covered by Code §367(a) hinges on the transferee being a corporation, negating the foreign corporation's existence as a corporation has the effect of denying nonrecognition treatment. Additionally, it should be noted that Code §367(a) requires the recognition of gain, but not loss, in the transaction.

The general rule of Code §367(a) has several exceptions, including an exception for property transferred to a foreign corporation for use by the foreign corporation in an active trade or business outside the U.S., often referred to as the Foreign Trade or Business Exception.[7] This exception recognizes that in a globalized economy,

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5 Code §367(d)(2).

6 See Donald J. Marples and Jane G. Gravelle, "Corporate Expatriation, Inversions, and Mergers: Tax Issues," Congressional Research Service (August 17, 2017).

7 Code §367(a)(3).

a U.S. person may have *bona fide* business reasons for forming or reorganizing a foreign corporation. Importantly, the Foreign Trade or Business Exception does not apply to transfers of intangible property, as defined in Code §936(h)(3)(B), which broadly defines the term and includes most forms of I.P.

THE DEEMED ANNUAL ROYALTY REGIME OF CODE §367(D)

Before the enactment of Code §367(d) and certain amendments that made the application of Code §367(a) based on more objective standards (*e.g.*, the tightening of the Foreign Trade or Business Exception to specifically exclude intangible property), the transfer of I.P. by a U.S. person to a foreign corporation could potentially qualify for tax-free treatment if the foreign corporation used the I.P. in an active trade or business. If the transfer could not qualify for the Foreign Trade or Business Exception, it generally would be subject to Code §367(a) and, therefore, immediate recognition of any built-in gain.

Code §367(d) introduced a deemed annual royalty regime, thus generally removing the transfer of intangible property by a U.S. person to a foreign corporation from the application of Code §367(a). Under the deemed annual royalty regime, a U.S. person that transfers any intangible property, as defined in Code §936(h)(3)(B), to a foreign corporation in an exchange under Code §351 (relating to the tax-free contribution of capital to a controlled corporation) and Code §361 (relating to nonrecognition treatment for a distributing corporation in certain reorganization transactions) is treated as having sold the property for payments that are contingent upon the property's productivity, use, or disposition and having received amounts that reasonably reflect the amounts that would have been received annually in the form of the deemed payments over the useful life of the property. In the case of a direct or indirect disposition following the transfer, the amount should reflect the amount paid at the time of the disposition.[8]

The deemed annual royalty regime requires the U.S. transferor to treat the deemed payments as "commensurate with the income attributable to the intangible."[9] This concept is derived from the U.S. transfer pricing rules on intangible assets, under which the U.S. transferor is deemed to charge the foreign transferee an arm's length amount for the foreign transferee's use of the intangible asset over the asset's useful life.

One of the few taxpayer-favorable provisions of the deemed annual royalty regime is that the earnings and profits of the transferee foreign corporation are reduced by the amount of the deemed annual royalty payments.[10]

Another favorable rule is that deemed royalty payments are considered foreign-source income, although they are treated as ordinary income, not capital gain.[11] Since they are treated as foreign-source income, the deemed royalty payments are considered foreign-source royalty income and can be used to calculate the U.S.

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8 Code §367(d)(2).

9 Code §367(d)(2) flush language.

10 Code §367(d)(2)(B).

11 Code §367(d)(2)(C).

transferor's foreign tax credit limitation.[12]

It should be noted that the subsequent sale of the I.P. by the transferee foreign corporation to an unrelated party during the I.P.'s useful life yields a harsh result for the initial U.S. transferor under Code §367(d). The regulations state that at the time of the I.P.'s sale by the transferee foreign corporation seller, the initial U.S. transferor must recognize gain, but not loss, on the sale equal to the difference between the I.P.'s fair market value at the time of the sale and the initial U.S. transferor's original adjusted basis, without any increase for any deemed royalty payments that the initial U.S. transferor may have recognized as income during the I.P.'s useful life before the sale. Additionally, during the tax year of the sale, the initial U.S. transferor must recognize any deemed royalty income attributable to the part of the tax year before the date of the sale. However, if the transfer is to a related U.S. person or a related foreign person, the application of the deemed royalty regime continues unaffected.[13]

"Deemed royalty payments are considered foreign-source royalty income and can be used to calculate the U.S. transferor's foreign tax credit limitation."

SPECIAL ELECTION TO TREAT AN OUTBOUND TRANSFERS AS A SALE

In very limited circumstances, a U.S. person may elect to treat the transfer of intangible assets, including in some instances I.P., as a sale rather than deemed royalty income.

The circumstance most relevant in the I.P. context is the outbound transfer of intangible property to a newly formed foreign corporation in which the intangible property constitutes a significant portion of the foreign corporation's assets, as follows:

The U.S. transferor transfers the intangible property to the foreign corporation within three months of the organization of that corporation and as part of the original plan of capitalization of that corporation.

Immediately after the transfer, the U.S. transferor owns at least 40% but not more than 60% of the total voting power and value of the stock of the transferee foreign corporation. This is intended to avoid any tax consequences arising from an inversion transaction.

Immediately after the transfer, at least 40% of the total voting power and the total value of the stock of the transferee foreign corporation is owned by unrelated foreign persons.

The intangible property constitutes at least 50% of the fair market value of the property transferred to the foreign corporation by the U.S. transferor.[14]

Where a deemed sale election is made, the fair market value of transferred property is the single payment arm's-length price that would be paid for the property by an unrelated purchaser determined in accordance with the principles of Code §482. The allocation of a portion of the purchase price to intangible property agreed to by the parties to the transaction will not necessarily be controlling for this purpose.[15]

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12 *Id.*

13 Treas. Reg. §1.367(d)-1T(f).

14 Treas. Reg. §1.367(d)-1T(g)(2)(iii).

15 Treas. Reg. §1.367(d)-1T(g)(5).

As an alternative to a contribution of I.P. in return for shares, a U.S. taxpayer may make an actual sale or license of intangible property by a U.S. person to a foreign corporation. In that case, the rules of Code §367 are inapplicable. If an adjustment under Code §482 is required with respect to an actual sale or license of intangible property, Code §367(d) will not apply to the required adjustment. Rather, the sale price will be adjusted upward.[16] On the other hand, a purported sale or license of intangible property may be disregarded, and treated as a transfer subject to Code §367(d), if the purported sale or license is made to a foreign corporation in which the transferor holds (or is acquiring) an interest and the terms of the purported sale or license differ so greatly from the economic substance of the transaction or the terms that would be obtained between unrelated persons that the purported sale or license is a sham.[17] The terms of a purported sale or license will be determined by reference not only to the nominal terms of the agreement but also to the actual practice of the parties. Contractual terms that exist on paper, but are not followed, will be ignored. Note that a sale or license of intangible property will not be disregarded solely because other property of an integrated business is simultaneously transferred to the foreign corporation by the U.S. transferor in a transaction described in Code §367(a)(1).

CONCLUSION

While the toll-charge of Code §367(a) may be a burden, Code §367(d) can be an even harsher response to the concern over U.S. businesses shifting income and gain outside the U.S. tax jurisdiction. This reflects the fact that intangible assets are relatively easy to move from one jurisdiction to another and are increasingly the key income-generating assets of many businesses. The only exceptions to the application of Code §367(d) are a deemed sale of property in controlled circumstances (as discussed above) or a true sale that is honored in the way the taxpayer and its foreign subsidiary carry out the written terms.

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16 Treas. Reg. §1.367(d)-1T(g)(4)(i).

17 Treas. Reg. §1.367(d)-1T(g)(4)(ii).

BILATERAL INVESTMENT TREATIES: WHEN DOUBLE TAXATION AGREEMENTS ARE NOT ENOUGH

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Tags
Investment Treaties
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The U.S. enters into bilateral investment treaties ("B.I.T.'s") to protect and promote foreign investment. Unlike double taxation agreements ("D.T.A.'s"), which relate exclusively to tax matters, they are not usually seen as a defense mechanism when dealing with foreign tax authorities. Interestingly, they are!

Over the last few years B.I.T.'s have become useful tools for investors dealing with what appear to be unresolvable tax issues with foreign governments. This article will explore similarities and differences between B.I.T.'s and D.T.A.'s, and will discuss the recent *Georgian Manganese* case, where the taxpayer chose to rely on the B.I.T. instead of the D.T.A.

BACKGROUND

The U.S. has concluded 47 B.I.T.'s, not including investment provisions and other investment-related instruments, with foreign jurisidictions. Of these countries, nearly half do not have D.T.A.'s in place. They are Albania, Argentina, Bahrain, Bolivia, Cameroon, Democratic Republic of Congo, Croatia, Ecuador, El Salvador, Granada, Haiti, Honduras, Jordan, Mongolia, Mozambique, Nicaragua, Panama, Rwanda, Senegal, Trinidad and Tobago, and Uruguay.

B.I.T.'s and D.T.A.'s are drafted and negotiated by different institutions. A B.I.T. is negotiated by the national investment agency or the Ministry of Trade, while a D.T.A. is negotiated by the Ministry of Finance. Although they represent two different agreements negotiated by two different institutions, there is a great deal of similarity between the two. Both provide certainty when making an investment, provide dispute resolution mechanisms, and assist with growth and investments in the partner countries.

In addition, B.I.T.'s provide many advantages that are not present in D.T.A.'s:

- B.I.T.'s do not require that litigation commence in the local courts. Investors can choose to arbitrate claims in the International Centre for Settlement of Investment Disputes ("I.C.S.I.D.") (Convention Arbitration), the Additional Facility of I.C.S.I.D. (if Convention Arbitration is not available) or any other arbitration institution or rules agreed upon by both parties to the dispute, or they can choose ad hoc arbitration using the Arbitration Rules of the United Nations Commission on International Trade Law ("U.N.C.I.T.R.A.L.").
- B.I.T.'s provide that the host country will not treat a partner jurisdiction investment, or activities associated therewith, less favorably than an investment, or associated activities, of its own nationals or companies, or nationals or companies of any third country. This usually provides a favorable commitment from the host country.

- B.I.T.'s include a commitment to permit all transfers related to an investment to be made freely and without delay into and out of the host country.

Historically, B.I.T.'s have been chosen over the D.T.A.'s due to the availability of international arbitration without going through the local court system.

Notably, B.I.T.'s do not impose tax reductions or exemptions, or impose measures to reduce double taxation. For those benefits, taxpayers should continue to rely on D.T.A.'s.

GEORGIA AMERICAN ALLOYS, INC.

Earlier this year a U.S. private company, Georgia American Alloys, Inc., ("G.A.A.") filed a request with the Department of Treasury for assistance in a dispute with the Government of Georgia pursuant to Article XIII of the U.S.-Georgia B.I.T. G.A.A., through its subsidiaries, is engaged in production of a manganese ferroalloy and has invested a significate amount not only in its Georgian facilities but in the local community's infrastructure and services.

According to the request (the "Submission") filed on May 4, 2017, the Government of Georgia used expropriatory measures[1] when it assessed more than $82.45 million in taxes, penalties, and interest. G.G.A. alleged that the amount would entirely deprive it of its investments in Georgia. According to the Submission, Georgian authorities also intimidated and harassed one of the G.A.A. subsidiaries, Georgian Manganese, LLC ("G.M.") by denying fair court and audit proceedings through the lower court system.

The Submission covers following four issues:

- **Accounting of Waste.** When calculating the value of G.M.'s inventory the Government of Georgia included valueless waste products as inventory, even though the company does not have the technology to obtain an economically viable manganese containing product from these materials. G.M. has tried to commercialize the waste, but the cost exceeds the price for which waste could be sold. Furthermore, two major accounting firms, PwC and EY, both confirmed that G.M.'s accounting method complies with the Tax Code of Georgia and International Accounting Standards.

- **Transfer Pricing.** The Government of Georgia claimed that the exported product was improperly valued. It is not clear how the Government of Georgia priced the products, as it has not produced its calculation method. However, G.M. obtained an opinion from the outside auditors, EY and PwC, that verified the pricing of its products and confirmed it is consistent with the arm's length principal defined in the O.E.C.D. guidelines governing intercompany transactions.

- **Employee Meals.** G.M. provided food (so-called subsidized employee meals) to its employees, for which it recorded its costs and paid taxes thereon based on the market price of the meals. The general standard is market price plus a 10% mark up. However, the Government of Georgia assessed

[1] Expropriation occurs when state measures have the effect of substantially depriving an investor of the value of its investment.

taxes on the meals at the market price plus a 70% mark up. According to the Submission, G.M.'s valuation meets the general standard.

- **Additional Taxes, Penalties and Interest.** In addition to the taxes described above, the Government of Georgia assessed additional taxes, penalties, and interest, which G.A.A. contested.

Interestingly, in this case, G.A.A. did not choose the B.I.T. because of the possibility to arbitrate the case without going to the court. Rather, G.A.A. relied on the B.I.T. with Georgia because the D.T.A. did not provide a feasible defense to the fines imposed to by the Government of Georgia.

Soon after the Submission was filed, Georgia's Kutaisi Court of Appeals overturned the lower court's decision and ordered the Georgian Revenue Service to reopen the case to calculate the correct payment due.

CONCLUSION

In recent years, Georgia has become a popular frontier for foreign businesses. The Kutaisi Court of Appeals decision may be a signal that the court was mindful of the impact its decision could have on future investments in Georgia.

While D.T.A.'s are the traditional way that multinational taxpayers resolve tax disputes, the use of B.I.T.'s provides an interesting alternative. B.I.T.'s are, perhaps, the only method of resolving financial disputes (including confiscatory tax assessments) in those jurisdictions that do not have D.T.A.'s with the U.S. However, *Georgian Manganese* serves as a reminder that their use should not be overlooked in jurisdictions where multiple treaty options are available.

O.E.C.D. ISSUES PROPOSED CHANGES TO PERMANENT ESTABLISHMENT PROVISIONS UNDER MODEL TAX CONVENTION

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Tags
Action 7
B.E.P.S.
P.E.
O.E.C.D.

On July 11, 2017, the O.E.C.D. Committee on Fiscal Affairs released the draft contents of the 2017 update to the O.E.C.D. Model Tax Convention (the "O.E.C.D. M.C.") and the Commentary prepared by the Committee's Working Party 1 (the "Draft Contents"). This article discusses, in detail, the proposed amendments to Article 5 (Permanent Establishment)[1] in the 2017 update to the O.E.C.D. M.C. and Commentary, as well as the background and reasoning for the amendments in light of the Final Report on Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 ("Action 7 Final Report").

The update has not yet been approved by the Committee on Fiscal Affairs or by the O.E.C.D. Council, although significant parts of the 2017 update were previously approved as part of the B.E.P.S. package. The update will be submitted for approval by the Committee on Fiscal Affairs and the O.E.C.D. Council later this year.

The majority of the changes proposed to Article 5 are the result of the Action 7 Final Report under the B.E.P.S. Action Plan. While these amendments have been approved under the B.E.P.S. consultation process, the Draft Contents include additional changes to the O.E.C.D. M.C. and the Commentary that were open for public comment. The latter will be the subject of a separate article in the next edition of Insights.

THE "*COMMISSIONAIRE* ARRANGEMENTS" LOOPHOLE

The concept of "*commissionaire*" is recognized in civil law countries and is generally defined as one who buys and sells goods in his or her own name but on behalf of the principal. *Commissionaire* arrangements are the result of tax planning arising from a distinction recognized by civil law countries between contracts entered on behalf of and contracts entered in the name of.

Contracts made in the name of and on behalf of the principal do not give rise to *commissionaire* arrangements since the principal is disclosed to the buyer, and therefore, the contract is legally binding on the principal. However, as mentioned above, contracts made in the name of the agent but on behalf of the principal (*i.e.*, an undisclosed principal) result in *commissionaire* arrangements, where the principal is not legally bound by the terms of the contract.

In an international tax context, a *commissionaire* arrangement may be defined as an arrangement through which the agent (*i.e.*, *commissionaire*) sells products in

[1] All Article references are to the O.E.C.D. Model Tax Convention on Income and on Capital, 2014, as amended, unless otherwise specified.

a country in its own name but on behalf of a foreign enterprise that is the owner of these products. Since the *commissionaire* who sells these products is not the owner, the *commissionaire* is not taxed on the profits arising from the sale and is only taxed on the remuneration received by the foreign enterprise for its services (*i.e.*, commission). At the same time, the *commissionaire* may not be treated as a permanent establishment ("P.E.") of the foreign enterprise under the present terms of paragraph 5 of Article 5 since the sale does not occur "in the name of the foreign enterprise."[2] The interpretation of this phrase has been the subject of litigation in various countries in recent years. Based on the civil law principles governing *commissionaire* arrangements, several courts have decided that because a *commissionaire* does not legally bind the foreign enterprise, the *commissionaire* does not conclude contracts in the name of the enterprise.

Taxpayers have exploited this loophole and introduced *commissionaire* arrangements to replace subsidiaries that traditionally acted as distributors, thus shifting profits out of the source country (*i.e.*, the country of sale) without a substantive change in the functions performed in that country.

The O.E.C.D. discussed such abusive arrangements in its Action 7 Final Report and addressed this issue by proposing amendments to of paragraph 5 of Article 5.

The proposed amendment to paragraph 5 of Article 5 provides that where the activities exercised by an intermediary in a country are intended to result in the regular conclusion of contracts to be performed by the foreign enterprise (regardless of whether the contract is in the name of the foreign enterprise), that enterprise will be considered to have a taxable presence in that country (*i.e.*, a P.E.) unless the intermediary is performing these activities in the course of an independent business. The proposed amendment to paragraph 5 of Article 5 is as follows:

> 5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person − other than an agent of an independent status to whom paragraph 6 applies − is acting in a Contracting State on behalf of an enterprise and has, and habitually exercises, in a Contracting State, an authority to conclude contracts, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are
>
> a) in the name of the enterprise, or
>
> b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or
>
> c) for the provision of services by that enterprise,
>
> that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that

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[2] As of the date of this article, paragraph 5 of Article 5 requires, inter-alia, the sale of goods to be on behalf of and in the name of the principal foreign enterprise for the creation of P.E. in the source country.

> person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

The Commentary on Article 5 concerning the definition of a P.E., has been amended to provide that paragraph 5 of Article 5 will apply if all the following conditions are met:

a) a person acts in a Contracting State on behalf of an enterprise;

b) in doing so, that person habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and

c) these contracts are either in the name of the enterprise or; for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or for the provision of services by that enterprise.[3]

"A person is acting in a contracting state on behalf of an enterprise when that person involves the enterprise to a particular extent in business activities in the state concerned."

However, the Commentary carves out an exception for legitimate business activities by an independent agent and provides that even if the paragraph 5 of Article 5 conditions are met, a foreign enterprise will not be deemed to have a P.E. if the activities performed by the agent on behalf of the enterprise are (i) covered by the independent agent exception of paragraph 6 of Article 5 or (ii) limited to activities mentioned in paragraph 4 of Article 5, which if exercised through a fixed place of business, would be deemed not to create a P.E.[4]

The Commentary clarifies that neither the maintenance of a fixed place of business solely for the purposes of preparatory or auxiliary activities nor a person whose activities are restricted to such purposes will cause the creation of a P.E. By way of an example, the Commentary explains that where a person acts solely as a buying agent for an enterprise and, in doing so, habitually concludes purchase contracts in the name of that enterprise, the person shall not be treated as the P.E., even if that person is not independent of the enterprise, as long as such activities are preparatory or auxiliary.[5]

Although also used in prior versions of paragraph 5 of Article 5, the Draft Contents provide the first explanation of the phrase "a person acting on behalf of an enterprise." According to the Draft Contents, a person is acting in a contracting state on behalf of an enterprise when that person involves the enterprise to a particular extent in business activities in the state concerned. However, a person cannot be said to be acting on behalf of an enterprise if the enterprise is not directly or indirectly affected by the action performed by that person.[6]

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3 Draft Contents, Commentary on Article 5, paragraph 84.

4 Draft Contents, Commentary on Article 5, paragraph 85.

5 *Id.*

6 Draft Contents, Commentary on Article 5, paragraph 86.

In addition, proposed paragraph 5 of Article 5 requires the agent to either conclude contracts or habitually play the principal role leading to the conclusion of the contracts in order to avoid P.E. status. Under the current version of this article, a P.E. is created if a person (other than an independent agent) acting on behalf of a foreign enterprise has the "authority to conclude contracts in the name of the enterprise." A prior draft of the report on B.E.P.S. Action 7, referred to "persons that habitually conclude contracts or negotiate the material elements of contracts." However, the Draft Contents – in line with the Action 7 Final Report – refers to persons that habitually conclude contracts or "habitually play the role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise."

The Commentary in the Draft Contents explains that the relevant law of the contracting state governing contracts shall determine where a contract is considered to have been concluded. Further, a contract may, under the relevant law, be concluded in a state even if that contract is signed outside that state. In addition, a person who negotiates in a state all elements and details of a contract in a way binding on the enterprise can be said to conclude the contract in that state even if that contract is signed by another person outside that state.[7]

Even if the contract is not concluded by the agent, paragraph 5 of Article 5 may still apply if the agent plays the principal role leading to the conclusion of the contracts that are routinely concluded without material modification by the enterprise. This definition aims to cover situations where the conclusion of a contract directly results from the actions performed by agent in a contracting state on behalf of the enterprise, even though, under the relevant law governing contracts, the contract is not said to be concluded by that agent in that contracting state. Thus, the guiding principle to determine who concluded the contract is to examine whose actions convinced the third party to enter into the contract.[8]

The amendment results in the application of paragraph 5 of Article 5 to contracts involving disclosed principal that create rights and obligations that are legally enforceable between the foreign enterprise – on whose behalf the agent is acting – and the third parties. The amendment also is applicable to contracts involving undisclosed principal, if those contracts create obligations that will effectively be performed by the enterprise rather than by the agent.[9] As discussed above, a typical example involves contracts that a *commissionaire* concludes with third parties under a *commissionaire* arrangement with a foreign enterprise. Although the *commissionaire* acts on behalf of the enterprise, in doing so it concludes contracts in its own name that do not create rights and obligations that are legally enforceable between the foreign enterprise and the third parties. However, the *commissionaire* arrangement results in a direct transfer to the third parties of the ownership or use of property that the enterprise owns or has the right to use.[10]

While a P.E. will result if proposed paragraph 5 of Article 5 applies to the foreign enterprise, the O.E.C.D. cautions that it does not mean that the entire profit resulting from the performance of the contract should be attributed to the P.E. The determination of the profits attributable to a P.E. resulting from the application of paragraph

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7 Draft Contents, Commentary on Article 5, paragraph 87.

8 Draft Contents, Commentary on Article 5, paragraph 88.

9 Draft Contents, Commentary on Article 5, paragraph 91.

10 Draft Contents, Commentary on Article 5, paragraph 92.

5 of Article 5 will be governed by the rules of Article 7 (Business Profits) such that the profits to be attributed to the P.E. are only those that the P.E. would have derived if it were a separate and independent enterprise performing the activities that paragraph 5 of Article 5 attributes to that P.E.[11] The actual meaning of this clarification is somewhat obscure because the *commissionaire* is performing the service of selling and, for that service, receives arm's length compensation. It is not clear whether any profit for services performed in the country is left after payment of the fee to the *commissionaire*.

ARTIFICIAL AVOIDANCE OF P.E. STATUS THROUGH EXCEPTIONS IN PARAGRAPH 4 OF ARTICLE 5

Paragraph 4 of Article 5 contains the list of preparatory and auxiliary activities that do not result in the creation of a P.E. However, since the introduction of these exceptions, there have been dramatic changes in the way businesses are looked at by tax examiners. In the current environment, activities previously regarded as preparatory or auxiliary in nature may now be treated as core business activities, and the P.E. exemption may no longer be justified.

Each Activity Listed in Paragraph 4 of Article 5 Must Be "Preparatory or Auxiliary" in Nature

To ensure that profits derived from a core business activity are taxed in the source country, the O.E.C.D. proposes to amend paragraph 4 of Article 5 to ensure it is in line with its original purpose. To accomplish this goal, the Draft Contents require that each exempt activity be preparatory or auxiliary in nature in order to qualify for the exemption.

The revised paragraph 4 of Article 5 would read as follows:

> 4. Notwithstanding the preceding provisions of this Article, the term 'permanent establishment' shall be deemed not to include:
>
> a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
>
> b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery
>
> d) he maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
>
> e) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

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11 Draft Contents, Commentary on Article 5, paragraph 101.

f) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity ~~of a preparatory or auxiliary character~~;

g) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), ~~provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character~~,

provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.

The O.E.C.D. has also provided additional guidance in the Commentary relating to paragraph 4 of Article 5 to clarify the meaning of the phrase "preparatory or auxiliary" with the help of a number of examples.

"Businesses have attempted to take advantage of the benefit under paragraph 4(f) of Article 5 by setting up several subsidiaries, each performing only one function listed in paragraph 4 of Article 5."

Fragmentation of Activities Between Closely Related Parties

Under the current O.E.C.D. M.C., a fixed place of business maintained solely for any combination of the activities mentioned in subparagraphs (a) to (e) of paragraph 4 of Article 5 does not result in the creation of a P.E., provided that the overall activity of such fixed place of business is of a preparatory or auxiliary nature.[12] Further, paragraph 27.1 of the Commentary on Article 5 provides that a single enterprise that divides a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity will not be eligible to avail the exemption under paragraph 4(f) of Article 5.

It is noteworthy that, as it stands, paragraph 27.1 limits its application to single enterprises and does not apply in cases where such operations are carried on by related parties. Thus, businesses have attempted to take advantage of the benefit under paragraph 4(f) of Article 5 by setting up several subsidiaries, each performing only one function listed in paragraph 4 of Article 5. These groups have argued that each subsidiary is merely engaged in a preparatory or auxiliary activity.

The O.E.C.D. proposes to disallow the P.E. exemption in the case of activities carried on by closely related enterprises at different places or at the same place. The O.E.C.D. proposes to insert a new paragraph 4.1 to Article 5 to address the tax abuse, and it reads as follows:

> Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and
>
> d) that place or other place constitutes a P.E. for the enterprise or the closely related enterprise under the provisions of this Article, or
>
> e) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by

[12] O.E.C.D. M.C., paragraph 4(f) of Article 5.

the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,

> provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.

This draft anti-fragmentation rule intends to deny the application of the exceptions of paragraph 4 of Article 5 where complementary business activities are carried on by closely related enterprises at the same location or by the same enterprise or closely related enterprises at different locations.

For those advisers having experienced the nuances of unitary taxation under state law in the U.S., this approach should sound familiar. Various units of an integrated operation are treated as part of a common tax base for state apportionment purposes, even if the units are placed in separate corporations.

The Commentary contains examples that explain the proposed paragraph 4.1 of Article 5.[13]

ARTIFICIAL AVOIDANCE OF P.E. STATUS THROUGH CONTRACT SPLITTING

A building site or construction or installation project only constitutes a P.E. if it lasts more than 12 months.[14] In order to circumvent this provision, contractors or subcontractors will divide contracts into several parts, each covering a period of less than 12 months and attributed to a different company within the same group.[15]

The O.E.C.D. proposes to address this abuse through the application of a new "principal purpose test," which aims at disallowing a benefit under the O.E.C.D. M.C. if obtaining that benefit is one of the principal purposes of a transaction.[16] However, the benefit may still be available if the person is able to establish that obtaining the benefit would be in accordance with the object and purpose of the relevant provisions of the O.E.C.D. M.C. The O.E.C.D. provides the following example to explain the application of the principal purpose test with respect to contract splitting:

> RCO is a company resident of State R. It has successfully submitted a bid for the construction of a power plant for SCO, an independent company resident of State S. That construction project is expected to last 22 months. During the negotiation of the contract, the project is divided into two different contracts, each lasting 11 months. The first contract is concluded with RCO and the second contract is concluded with SUBCO, a recently incorporated wholly-owned subsidiary of RCO resident of State R. At the request of SCO, which wanted to ensure that RCO would be contractually liable for the performance of the two contracts, the contractual arrangements are such that RCO

13 Draft Contents, Commentary on Article 5, paragraph 81.

14 Paragraph 3 of Article 5.

15 Commentary on Article 5, paragraph 18.

16 Draft Contents, paragraph 9 of Article 29.

is jointly and severally liable with SUBCO for the performance of SUBCO's contractual obligations under the SUBCO-SCO contract.[17]

In this example, in the absence of facts and circumstances showing otherwise, it would be reasonable to conclude that one of the principal purposes for the conclusion of the separate contract for SUBCO is for each to obtain the benefit of the rule in paragraph 3 of Article 5 of the State R-State S tax convention. Granting the benefit of that rule in these circumstances would be contrary to the object and purpose of that paragraph, as the time limitation of that paragraph would otherwise be meaningless.[18]

The example is silent on what other circumstances might lead to a different conclusion. For example, if SUBCO has a separate business history and the industry views the functions of SUBCO to be functionally independent, might that be a sufficient factor to lead to a different result? Alternatively, is the overall guarantee by RCO of SUBCO's performance sufficient to overcome business history? If only SUBCO won the bid but the performance was guaranteed by RCO, would RCO have a P.E. such that any guarantee fee received for the guarantee of performance would be considered to be business profits attributable to a P.E. in State S?

Further, the O.E.C.D. has advised that states that do not include the principal purpose test in their tax treaties should include an additional provision to address contract splitting. In order to determine the 12-month period under paragraph 3 of Article 5, the O.E.C.D. suggests that the provision may provide as follows:

a. Where an enterprise of a Contracting State carries on activities in the other Contracting State at a place that constitutes a building site or construction or installation project and these activities are carried on during one or more periods of time that, in the aggregate, exceed 30 days without exceeding twelve months, and

b. Connected activities are carried on at the same site or project during different periods of time, each exceeding 30 days, by one or more enterprises closely related to the first-mentioned enterprise,

then these different periods of time shall be added to the period of time during which the first-mentioned enterprise has carried on activities at that site or project.[19]

To determine whether the activities of the first and second enterprise are connected, the following factors may be relevant:

- Whether the contracts covering the different activities were concluded with the same person or related persons
- Whether the conclusion of additional contracts with a person is a logical consequence of a previous contract concluded with that person or related persons

[17] Draft Contents, Commentary on Article 29, paragraph 182 of Article 5, ex. J.

[18] *Id.*

[19] Commentary on Article 5, paragraph 52.

- Whether the activities would have been covered by a single contract absent tax planning considerations
- Whether the nature of the work involved under the different contracts is the same or similar
- Whether the same employees are performing the activities under the different contracts[20]

These factors provide conflicting guidance where RCO wins the contract but brings in related subsidiaries to perform separate and distinct portions of the project as subcontractors in accordance with industry standards. Some suggest this fact pattern is subject to the principal purpose test and others suggest the opposite.

OTHER CHANGES PROPOSED TO ARTICLE 5

No P.E. Where the Agent Acts Independently in the Ordinary Course of Business

In the Draft Contents, the O.E.C.D. has retained the essence of paragraph 6 of Article 5 (*i.e.*, that a foreign enterprise shall not be deemed to have a P.E. if it carries on business in a contracting state through an independent agent); however, the paragraph has been redrafted to provide greater clarity. The reworded paragraph 6 of Article 5 reads as follows:

> 6. ~~An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.~~ ***Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.***

The current version of the independent agent exemption under paragraph 6 of Article 5 uses the concept of "associated parties." However, the revised Action 7 discussion draft referred to "connected parties," and in the Action 7 Final Report, the tightened definition of independent agent uses the concept of "closely related enterprises."

The Commentary explains that a person is not considered to be an independent agent where the person acts exclusively or almost exclusively for one or more enterprises to which it is closely related. However, paragraph 6 of Article 5 will not apply automatically where a person acts for one or more enterprises that are related to each other but not the general commission agent.

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[20] Draft Contents, Commentary on paragraph 3 of Article 5, paragraph 53.

Determining independent status of an agent requires a facts and circumstances test. If the facts demonstrate that the agent carries on a business as an independent agent and acts in the ordinary course of that business, the exemption under paragraph 6 of Article 5 will be available. However, independent status is less likely if the activities of the person are performed wholly, or almost wholly, on behalf of only one enterprise, or a group of enterprises that are closely related to each other, over the lifetime of that person's business or over a long period of time.

The O.E.C.D., however, acknowledges that small and newly setup businesses may financially rely on few customers at the beginning of their operations. In that fact pattern, independent status may still be available to a person acting exclusively for one enterprise (to which it is not closely related), but only if that exclusivity lasts for a short period of time. Again, no bright-line guidance is provided to identify appropriate time periods.[21]

"A person or enterprise is said to be closely related to an enterprise if one has control of the other or both are under the control of the same person(s) or enterprise(s)."

The phrase "exclusively or almost exclusively" employed in paragraph 6 of Article 5 means that where the person's activities on behalf of enterprises to which it is not closely related do not represent a significant part of that person's business, that person will not qualify as an independent agent. For example, where the sales that an agent concludes for enterprises to which it is not closely related represent less than 10% of all the sales that it concludes as an agent acting for other enterprises, that agent should be viewed as acting "exclusively or almost exclusively" on behalf of closely related enterprises, and therefore, the P.E. status exemption will be unavailable.[22]

The Commentary is silent regarding the effect of a large contract that absorbs all of an established company's resources for a six-month period, resulting in devoting 50% of the company's revenue for a full year. It is not known how this scenario will be treated and whether the view will be consistent among taxpayers and tax authorities.

A person or enterprise is said to be closely related to an enterprise if one has control of the other or both are under the control of the same person(s) or enterprise(s). A person or enterprise will be considered to be closely related to an enterprise in any of the following circumstances:

- One directly or indirectly possesses any of the following:[23]
    - More than 50% of the beneficial interests in the other
    - More than 50% of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company
    - More than 50% of the aggregate vote and value of the company's shares or of the beneficial equity interest in the two enterprises
- Another person or enterprise directly or indirectly possesses more than 50% of the beneficial interest in the person and the enterprise or in the two enterprises.

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21 Draft Contents, Commentary on Article 5, paragraph 111.

22 Draft Contents, Commentary on Article 5, paragraph 112.

23 Draft Contents, paragraph 8 of Article 5.

A Place of Business at the Disposal of the Enterprise to Constitute a P.E.

The Commentary on Article 5 contains several other illustrative examples of the revised rules. One of such explanation is found in definition of the phrase "at the disposal of the enterprise."[24]

The Commentary, in general, provides that the place of business may exist even when no premises are available but the enterprise has a certain space at its disposal. In the draft contents, the O.E.C.D. explains whether a location may be considered to be at the disposal of an enterprise in such a way that it may constitute a "place of business" will depend on that enterprise having the effective power to use that location as well as the extent of the presence of the enterprise at that location and the activities that it performs there.[25]

Registration Under Value Added Tax or Goods and Service Tax is Irrelevant for Determining P.E. Status

The O.E.C.D. is of the view that by itself, registration under Value Added Tax ("V.A.T.") or Goods and Service Tax ("G.S.T.") by the foreign enterprise is irrelevant when determining whether a P.E. exists.[26] A comment received from the public drew attention to the fact that a foreign enterprise may appoint a third party (*e.g.*, a tax professional) or a related party (*e.g.*, a local subsidiary) for carrying out the registration and representation before the relevant authorities, and therefore, clarification was required that the appointment of the V.A.T./G.S.T. representative does not, by itself, control the issue.[27]

CONCLUSION

As previously stated, the Draft Contents have not yet been approved by the Committee on Fiscal Affairs or by the O.E.C.D. Council. As a result, they do not reflect a final opinion of the O.E.C.D. However, the proposed changes to the O.E.C.D. M.C. are in line with the Action 7 Final Report, and therefore, it is likely that they will become part of the O.E.C.D. M.C. in the ordinary course of events. When this happens, it will constitute a significant step in implementing B.E.P.S. policies and a major overhaul of the international tax landscape. Taxpayers will face challenges where current business models create new P.E.'s under the new rules, as new P.E.'s mean additional tax filing obligations and increased potential for controversy. Moreover, the B.E.P.S. recommendations relating to profit attribution to these new P.E.'s has not yet been finalized and will be an important matter for businesses in this context.[28]

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24 Commentary on Article 5, paragraph 12.

25 *Id.*

26 Commentary on Article 5, paragraph 5.

27 O.E.C.D., *Draft Contents of the 2017 Update to the O.E.C.D. Model Tax Convention, Comments Received on the 11 July Public Release*, August 11, 2017.

28 A public consultation on the additional guidance on the attribution of profits to P.E.'s and on the revised guidance on the transactional profit split method is planned for November 2017 by the O.E.C.D.

EATON A.P.A. CANCELLATIONS WERE AN ABUSE OF I.R.S. DISCRETION

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Tags
A.P.A.
Eaton
Transfer Pricing

INTRODUCTION

As the transfer pricing travails of Eaton Corporation ("Eaton") continue, a recent U.S. Tax Court decision affirmed that (i) I.R.S. administrative rules set down in revenue procedures and relied upon by the I.R.S. and a taxpayer cannot be arbitrarily circumvented and (ii) the I.R.S. must reasonably exercise its discretion.

At issue was the cancellation of two advance pricing agreements ("A.P.A.'s") and the consequent I.R.S. income adjustments made as a result of applying a different transfer pricing method. Eaton's position was that the A.P.A.'s were binding contracts and that these contracts were cancelled for reasons other than those named as cause for termination in the respective A.P.A.'s. Though the Tax Court did not agree with Eaton that an A.P.A. should be interpreted under contract law, the Tax Court carefully reviewed the circumstances of the cancellation against Rev. Proc. 96-53 and Rev. Proc. 2004-40, which govern the drafting and administration of A.P.A.'s in the relevant tax years.

BACKGROUND

An A.P.A. is an alternative to the traditional adversarial model between a taxpayer and one or more tax authorities. Its purpose is to reach an agreement concerning the transfer pricing method to be used for a number of tax years in one or more controlled transactions.

A.P.A.'s take a long time to negotiate, owing both to the fact-intensive nature of transfer pricing matters and the considerable due diligence both sides must undertake. Both sides must be prepared to compromise technical positions somewhat in order to obtain practical transfer pricing certainty. Once concluded, an A.P.A. is signed and a program of annual review is undertaken to ensure that the terms of the A.P.A. are followed. For transfer pricing positions that influence a large share of a tax provision, or a significant transfer pricing position that is complex or unique, generally accepted convention holds that is it better to spend the time and fees for two years negotiating an A.P.A. than to spend an even greater amount to produce Treas. Reg. §1.6662-6 documentation and manage examinations, appeals, competent authority intervention, and litigation.

Currently, the administrative procedures for requesting and administering an A.P.A. are set out in Rev. Proc. 2015-41. As with any agreement, the hallmarks of a successful A.P.A. are (i) negotiation in good faith, (ii) disclosure of all material or relevant facts or documents, (iii) disclosure of true facts or documents, and (iv) adherence to the terms of the agreement over the duration of the agreement's lifespan.

ANALYSIS

In the case at hand, the I.R.S. alleged "failure of a critical assumption, misrepresentation, mistake as to a material fact, failure to state a material fact, failure to file a timely annual report, or lack of good faith compliance with the terms and conditions of the A.P.A."[1] as among the "numerous reasons" for the cancellation of the Eaton A.P.A.'s. The Tax Court weighed each claim, finding in favor of Eaton in the case of all stated reasons for cancellation.

The origin of the dispute was a series of inadvertent accounting errors committed by Eaton accounting and tax personnel and discovered only after a new transfer pricing manager joined the company and looked *de novo* at the calculations and underlying information used to comply with the terms of the A.P.A.'s. Many of these errors did not result in a favorable tax outcome for Eaton, though in net terms the transfer prices were higher as a result by approximately 5% in each of the 2005 and 2006 tax years.

Eaton alerted the I.R.S. to these discrepancies, filed Forms 1120X to report the additional income, and prepared to update its annual A.P.A. reports to explain the effect of the errors. In response, the I.R.S. changed its view concerning the transfer pricing method in negotiations of a third A.P.A., advised Eaton not to file updated A.P.A. reports, and issued a letter cancelling the A.P.A.'s covering tax years 2001-2009.

The extensive information gathering and questioning that occurred during the first and second A.P.A. negotiations, as well Eaton's responsiveness and cooperation, proved to be a large part of the undoing of the I.R.S. case. Many items of information that were alleged to have been omitted or neglected by Eaton in an act of bad faith bargaining were found to have been disclosed during A.P.A. negotiations or, alternatively, could have been discovered by the I.R.S. during its many series of questions or meetings.

In its analysis, the Tax Court concentrated *inter alia* on the interpretation of the terms "material fact", "critical assumption," and "misrepresentation" in the context of the Eaton facts, finding that the conditions for the cancellation of an A.P.A., as set out in the revenue procedures, were not met. It was noted that either side could have walked away during either of the two A.P.A. negotiations if viewpoints concerning the best transfer pricing method differed significantly enough and that the I.R.S. signing of two largely similar A.P.A.'s limited its ability to argue in retrospect for a different transfer pricing method.

CONCLUSION

The *Eaton* case outcome highlights the complexities of implementing a transfer pricing method once the "transfer pricing study" is complete, especially when accounting and enterprise information systems are used to store information and generate reports to be used in tax calculations.

The 202-page Tax Court memo explains in considerable detail the data warehousing procedures used by Eaton to store report templates and files, the ledgers and

[1] *Eaton Corporation and Subsidiaries v. Commr.* T.C. Memo 2017-147, p. 112.

“mirror ledgers” used to record transfer prices for accounting purposes and eliminate intercompany transactions on consolidation, and the sources of information used to calculate ratios and cost variance factors critical to the compliance with the A.P.A. terms. It was the fact that many data sources had to connect across group companies using the intervention of controllers and tax personnel that supported the finding of “human error” or “computational error” rather than deliberate misrepresentation or deceit. Even with an audit opinion on the non-consolidated financial statements of the Eaton entities relevant to the A.P.A.’s, the calculation errors slipped by the taxpayer and the I.R.S. at successive annual reporting checkpoints.

While this decision offers some relief for companies with pending or in-force A.P.A.’s or competent authority settlements, it also illustrates the value of proper transfer pricing policy implementation and the engagement of employees and advisors outside of the tax function to make sure the system works reliably from the start. Personnel entrusted with key information or process control can change jobs unexpectedly or eventually retire. Initial engagement of all people needed to produce results representing true taxable income is critical, as is a periodic check to ensure that the system is performing as expected.

“The **Eaton** *case outcome highlights the complexities of implementing a transfer pricing method once the ‘transfer pricing study’ is complete.”*

Finally, the *Eaton* case serves as a reminder of the possible unfortunate consequences of fixing mistakes, even honest mistakes, in a climate of heightened suspicion of tax avoidance among tax authorities.

A CASE OF NONACQUIESCENCE: I.R.S. OPPOSES *BARTELL* DECISION

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Tags
Action on Decision
Bartell
Like-Kind Exchange
Nonacquiescence
Reverse Exchange

The I.R.S. has announced that it disagrees with the ruling in *Bartell v. Commr.*[1] in an Action on Decision ("A.O.D.") issued on August 14, 2017, expressing its "nonacquiescence" with the case. In Bartell, the taxpayer attempted to effect a like-kind exchange wherein the exchange facilitator held replacement property for 17 months before property was transferred to a qualified intermediary and then to the taxpayer in a so-called reverse exchange. The A.O.D. indicates that the I.R.S. will not follow the holding on a nationwide basis but will recognize the precedential impact of the opinion on cases arising within the jurisdiction of the deciding circuit to the holding.

Following an adverse Tax Court decision, the I.R.S. generally issues an A.O.D. to explain whether it agrees or disagrees with the ruling and whether it will follow the ruling in the future. An A.O.D. is formal memorandum that sets forth the tax litigation position the I.R.S. will take with regard to a court decision. It is not binding on the taxpayers and cannot be cited as president but is generally used to provide guidance to I.R.S. employees working on similar issues.

The I.R.S. issues three types of A.O.D.'s[2] that express either "acquiescence," "acquiescence in result only," or "nonacquiescence." Generally, in the first two instances, the I.R.S. acknowledges that it accepts the ruling and will follow it when dealing with the same controlling facts. However, *acquiescence* does not indicate approval or disapproval with the court's reasoning in the case, while *acquiescence in result only* indicates disagreement with some or all the court's reasoning. The I.R.S. does not agree with the holding of the case and does not intend to follow the decision although the case was not appealed.

In the *Bartell* case, it is important to point out that the Tax Court based its decision on the case law before Treas. Reg. §1.1031(k)-1 and Rev. Proc. 2000-37.[3] Neither Code §1031 nor the regulations addressed the situation in *Bartell*, wherein replacement property is "parked" with the accommodating party in a reverse exchange.

Treas. Reg. §1.1031(k)-1 allows for a "deferred exchange," which is a like-kind exchange in which, pursuant to an agreement, a taxpayer transfers property held for productive use in a trade or business or for investment ("relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment ("replacement property").[4]

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1 *Estate of Bartell v. Commr.* 147 T.C. No 5 (2016). For detailed discussion of the case please see our article "New Developments in the World of Reverse Like-Kind Exchanges."

2 I.R.B. 2012-4 (November 13, 2012).

3 At the time the *Bartell* transaction was undertaken, Treas. Reg. §1.1031(k)-1 did not cover deffered exchange transactions.

4 I.R.B. 2017-33 (August 14, 2017).

Rev. Proc. 2000-37,[5] which was issued after the exchange facilitator acquired the title to the replacement property in *Bartell*, provides a safe harbor for taxpayers seeking to park relinquished property or replacement property with an exchange accommodation titleholder ("E.A.T.") in anticipation of a like-kind exchange. If the safe harbor requirements are met (*inter alia* the E.A.T. does not hold the property for more than 180 days), the E.A.T. – and not the exchanging taxpayer – is considered the owner of the property held by the E.A.T., regardless of who has the benefits and burdens of the ownership.

In *Bartell*, the Tax Court ruled that for Code §1031 purposes an exchange facilitator may be treated as the owner of the replacement property regardless of whether it has the benefits and burdens of ownership.[6]

As stated above, the I.R.S. announced its nonacquiescence with the Bartell case. Thus, the A.O.D. addresses that for transactions outside the scope of the deferred exchange regulations, the I.R.S. will not follow the Tax Court opinion. Similarly, in determining whether a reverse exchange outside the scope of Rev. Proc. 2000-37 meets the requirements of Code §1031, the I.R.S. will not follow the principle that an exchange facilitator may be treated as the owner of property regardless of whether it possesses the benefits and burdens of ownership.[7]

[5] Rev. Proc. 2000-37, 2000-2 C.B. 308.

[6] *Supra*, note 4.

[7] *Id*.

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