UPDATES & OTHER TIDBITS

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"ON PAPER" RESIDENTS WITH NO SUFFICIENT NEXUS TO SWITZERLAND NOT ELIGIBLE FOR TREATY BENEFITS

A recent decision, involving Starr International Company ("Starr"), provides insight into what a court may view as relevant in deciding a treaty shopping case.[1] The taxpayer, Starr, was located in Bermuda until approximately 2004, when it relocated to Ireland. Its ultimate (indirect) beneficial owner was a New York charitable foundation. In 2006 – roughly a year after relocating to Ireland – Starr relocated to Switzerland, claiming that Ireland was not amenable to its charitable objectives and its assets were not sufficiently shielded from litigation in Ireland.

Starr was the largest shareholder of A.I.G., a U.S. corporation from which it regularly received dividends. In 2007, Starr filed a request for treaty benefits under paragraph 6 of Article 22 of the U.S.-Swiss Double Taxation Treaty, to obtain the benefit of a lower dividend tax rate. However, the I.R.S. rejected the application on the grounds that Starr had engaged in treaty shopping since the primary purpose of its relocation to Switzerland was to obtain treaty benefits.

Starr argued against the ruling, noting that Article 22(6) was meant to provide relief to any company resident in the one of the contracting states and not engaged in treaty shopping and that treaty shopping always involves a third-country resident (*i.e.*, a resident of a country not party to the relevant tax treaty). Because Starr was domiciled in Switzerland and its beneficial and voting ownership was (largely) either Swiss or American, it argued that it could not have been engaged in treaty shopping and therefore should be eligible to treaty benefits.

The District Court of the District of Columbia rejected Starr's position that treaty shopping involves a third-country resident on the basis of the limitation of benefits ("L.O.B.") provision in the 1996 income tax treaty between the U.S. and Switzerland. Further, the court held that "on-paper residency" does not necessarily entitle a taxpayer to treaty benefits. Rather, the Technical Explanation of Article 22 authorizes a tax authority to deny benefits, under substance-over-form principles, "to an individual or entity that does not have a genuine connection to the jurisdiction, even when it resides there on paper." Thus, if an on-paper resident has "a sufficient nexus to the Contracting State," it may be called a *bona fide* resident and eligible to treaty benefits. Additionally, the District Court held that the I.R.S. "reasonably applied" the Administrative Procedure Act's ("A.P.A.") "arbitrary and capricious" standard in denying discretionary treaty benefits to Starr.

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[1] *Starr Int'l Co. v. U.S.*, No. 14-cv-01593 (C.R.C.).

TECHNOLOGY AND TAXATION

Changes in technology have spurred new ways of collecting information and taxes, and new taxpayer fears that their information may be compromised. In large part, the fears result from the enactment by many countries of new documentation requirements, including country-by-country reporting of tax data, to comply with new rules issued by the O.E.C.D. as part of the B.E.P.S. Project.

Brazil is a leader in the digital revolution. Brazil has been implementing a multilayered tax digitization project (known as SPED) since 2006, with a goal of having all phases operational by 2017. According to a 2016 report by Ernst & Young LLP, Brazil requires corporations to e-file accounting and tax books and records. A corporation's tax obligation is determined by the Brazilian tax authorities based on these digital reports. Corporate income tax and V.A.T. information can be exchanged among Federal tax authorities. Sellers must send e-invoices to the government for validation before shipping goods, and purchasers must check the e-invoices with the government before receiving goods. It has also been reported that Brazilian tax authorities use social media in its review of individual taxpayers.

The increased integration of technology in the tax system will accelerate. This will continue to change the way information is reported and tax is collected. The ultimate goal of this digitalization is to receive information in real time.

I.R.S. WILL RULE ON TAX-FREE STOCK DISTRIBUTIONS UNDER PILOT PROGRAM

Under Code §355, a distributing corporation may distribute stock and securities of a controlled corporation tax free, if certain requirements are met. In 2013, the I.R.S. announced that it would no longer rule on the tax consequences of several types of corporate transactions, including Code §355 distributions.

Under recently issued Revenue Procedure 2017-52, 2017-41 I.R.B., the I.R.S. introduced a pilot program expanding the scope of letter rulings to Code §355 stock and security distributions and provided the procedures to request such rulings. The pilot program widens the scope of available letter rulings for an 18-month period.

Revenue Procedure 2017-52 will apply to all ruling requests postmarked after September 21, 2017, and will expire on March 21, 2019, after which time the I.R.S. will evaluate the program's effectiveness and whether it should be continued.

THE STATE OF CORPORATE INVERSIONS

In 2016, the U.S. Treasury Department under President Obama introduced "anti-inversion" regulations under Code §7874 of the Code to discourage companies from expatriating by changing their corporate structures as a means to reduce their U.S. tax liabilities. The rule applies when former shareholders of an acquired U.S. company own 60% or more of the new foreign parent stock. If the shareholders own more than 60% but less than 80% of the new foreign parent, the availability of certain tax attributes is limited. Should the ownership meet or cross the 80% limit, the foreign acquiring company is treated like a domestic corporation for U.S. Federal income tax purposes.

The tax regulations appear to have had some effect in halting inversions. Pfizer Inc. and Allergan Plc aborted a $160 billion merger. Hewlett Packard Enterprise Co. and U.K.-based Micro Focus International Plc completed a spinoff and subsequent merger, and at least one commentator has suggested that the transaction may run afoul of the new anti-inversion rules. A Huntsman Corp. subsidiary, Venator Materials Plc, filed an initial public offering, effecting a "natural" inversion. Subsequently, Huntsman Corp. announced a merger with Swiss Clariant AG, pursuant to which Clariant shareholders would own 52% of the resulting company headquartered in Switzerland.

"By proposing favorable tax treatment for repatriation of existing earnings that are locked in abroad and the adoption of a territorial tax system moving forward, the carrot will be emphasized instead of the stick."

President Trump campaigned on a promise to clamp down on the practice of corporate inversions. However, the Code §7874 rules are subject to the president's April executive order, which directed the Treasury to scrutinize "significant" tax regulations issued since January 1, 2016, for possible changes or repeal. The American Institute of CPAs has asked Treasury Secretary Steven Mnuchin to take an especially close look at the Code §7874 Regulations, and the U.S. Chamber of Commerce has asked the Treasury to throw out the rules altogether.

As mentioned elsewhere in this edition of *Insights*, the current administration is urging Congress to take a different approach to the underlying economic problem that makes inversions attractive to management. By proposing favorable tax treatment for repatriation of existing earnings that are locked in abroad and the adoption of a territorial tax system moving forward, the carrot will be emphasized instead of the stick. The open question is whether these steps will put an end to the emigration of U.S. corporations.