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INSIGHTS

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EDITORS' NOTE

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

- **India Budget 2019-20.** The first budget of the Modi 2.0 government was announced during the summer with a goal of bringing India to a growth trajectory. To that end, the Taxation Laws (Amendment) Ordinance, 2019, was introduced on September 20, 2019, to incorporate the proposed changes into law. Included are incentives for International Financial Services Centres, tax relief for start-ups, a boost for electric vehicles, and faceless tax examinations intended to ensure that tax examinations are carried out in a uniform way. Although anticipated by some, an inheritance tax was not introduced. Jairaj Purandare, the Founder and Chairman of JMP Advisors Pvt Ltd, Mumbai, explains the new provisions.

- **Israeli C.F.C. Rules Apply to Foreign Real Estate Companies Controlled by Israeli Shareholders.** Controlled foreign corporation ("C.F.C.") laws are all the rage with parliaments around the world. Israel is no exception. Israeli shareholders controlling offshore companies that derive low-tax passive income and gains can be taxed in Israel even though no dividend is received. A recent decision by the Israeli Supreme Court addresses a fundamental question in this area. Is passive income determined on a groupwide basis or on a company-by-company basis? The answer affects Israeli residents owning a chain of C.F.C.'s when an intermediary company in the chain sells shares of an operating subsidiary. Daniel Paserman, who leads the tax group at Gornitzky & Co., Tel-Aviv, explains the holding in *Tax Assessor for Large Enterprises v. Rosebud*. Israeli residents may not like the answer.

- **Do You Have to Withhold 30% on Payments to a Non-U.S. Independent Contractor?** A common theme when a business engages the services of an individual is whether the individual is an independent contractor or an employee. The stakes become higher when the individual and the business are not resident in the same country. Galia Antebi address the applicable rules and special I.R.S. procedures for businesses located in the U.S. engaging service providers based in other countries to work in whole or in part in the U.S. Even when a tax treaty exempts the payment from income tax, businesses should be prepared to collect potentially refundable 30% withholding tax in the absence of an advance notice to the I.R.S.

- **Preferred Yet Neglected — A Plea for Guidance on Redemptions of C.F.C. Preferred Stock in the Wake of U.S. Tax Reform.** Most tax advisers in the U.S. view Code §1248 as a supporting part of U.S. C.F.C. rules. Under the provision, capital gain derived by a 10% shareholder of a C.F.C. from the sale or disposition of shares of the C.F.C. may be converted into dividend income to the extent of some or all of the accumulated earnings of the C.F.C. Prior to the Tax Cuts and Jobs Act of 2017, Code §1248 applied to all 10% U.S. Shareholders of a C.F.C. However, that is no longer the case. Whether the delinking was intentional is not clear. What is clear is that some U.S. Shareholders are not subject to Code §1248, and the tax consequences may be sub-optimal for the U.S. Shareholder. Neha Rastogi, Andreas A. Apostolides, and Stanley C. Ruchelman explain the pitfalls that may occur.

- **U.S. Tax Litigation Update — The President's Tax Returns and the New S.A.L.T. Cap.** Politics on the national and local levels in the U.S. have become a form of blood sport with no holds barred and no code of conduct that is equivalent to the Marquess of Queensberry rules that controlled the sport of boxing in England from 1867 onward. This is evidenced by various political battles between President Trump and the Democrats in the House of Representatives and in state government. Those battles have moved to Federal court. Issues involve the disclosure by government of the president's tax returns, the $10,000 cap imposed on deductions claimed for state and local income and real property taxes, and state proposed workarounds to ignore the cap. Nina Krauthamer looks at all the head-spinning activity currently taking place. Yes, bare-knuckle boxing as practiced by politicians in the U.S. is alive and well.

- **U.S. Taxation of Cloud Transactions and Digital Content Transfers: Corporate Matters: F.I.R.R.M.A. Proposed Regulations Expand C.F.I.U.S. Oversite on Foreign Investment.** C.F.I.U.S. is an interagency committee authorized to review certain transactions involving foreign investment in the U.S. Its mandate is to determine the effect of such transactions on the national security of the U.S. and, where appropriate, to deny approval to the transaction. F.I.R.R.M.A. was enacted in 2018 to expand the scope of transactions that are subject to C.F.I.U.S. review. Recently, the Treasury Department proposed regulations to implement the changes under F.I.R.R.M.A. Simon H. Prisk discusses the way in which the jurisdiction of C.F.I.U.S. has been expanded.

- **20-Year-Old Regulations Finally Move with the Times.** The I.R.S. recently proposed revisions to the regulations applicable to the classification of cloud computing transactions. The existing regulations were adopted in 1998 and have not kept pace with computer-based transactions, which are an ever-growing and evolving area. To put things in perspective, when the current regulations were adopted, a typical internet connection could download 1GB in approximately 48 hours. Now, it takes less than 15 minutes. Hannah Daniels and Galia Antebi explain the three broad proposals intended to bring the regulations up to date. Oh, how times have changed!

- **Cryptocurrencies — Latest Developments on Either Side of the Atlantic and Beyond.** The issues raised by virtual currency and the underlying blockchain technology affect tax law, transfer pricing, regulatory rules, civil law accounting rules, and valuation. The issues in all these areas share one common goal: protection of users and investors through the prevention of fraud and abuse. Beate Erwin explains recent guidance by the Financial Action Task Force in this area and the likely effect of the guidance on national laws around the world.

We hope you enjoy this issue.

- The Editors

INDIA BUDGET 2019-20

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INTRODUCTION

Budget 2019-20, presented on July 5, 2019, was a budget of many firsts. It was the first budget of the Modi 2.0 government and the first time that a female, full-time Finance Minister ("F.M.") presented the budget. The F.M. has commenced the process of bringing India back to a growth trajectory and is steering it towards becoming a $5 trillion economy by 2025. To this end, the F.M. has laid down a roadmap for growth along with financial inclusion.

On the tax front, some welcome measures include incentives for International Financial Services Centres ("I.F.S.C."), tax relief for start-ups, a boost for electric vehicles, and faceless tax scrutiny proceedings. Although it was expected in certain quarters, an inheritance tax has not been introduced.

Budget 2019-20 has now been introduced in the Income-Tax Act, 1961 (the "Act") in order to be afforded legal authority.

Subsequently, the F.M. held two press conferences, on August 23, 2019, and on September 20, 2019, to announce various tax revisions. Thereafter, the Taxation Laws (Amendment) Ordinance, 2019 (the "Ordinance") was introduced on September 20, 2019, to incorporate into law the announcements made at the press conferences. These amendments are effective from April 1, 2019.

DIRECT TAX

The direct tax amendments discussed below are effective from Financial Year ("F.Y.") 2019-20 (*i.e.*, April 1, 2019, to March 31, 2020) unless otherwise specifically stated.

Tax Rates

The basic tax rate for foreign companies remains at 40%. For domestic companies, however, the benefit of a lower corporate tax rate, of 25%, has been extended to companies with turnover or gross receipts not exceeding I.N.R. 4 billion (approximately $57 million as of September 24, 2019).

Further, as per the Ordinance, domestic companies that do not avail themselves of specified tax incentives or deductions, now have an option to pay income tax at the base rate of 22%. This amendment will be applicable to all domestic companies, which include Indian as well as foreign owned companies, irrespective of their size and turnover and whether they are listed or unlisted.

Further, new domestic manufacturing companies incorporated on or after October 1, 2019, and commencing manufacturing by March 31, 2023, would have an option to pay income tax at a lower base rate of 15%.

The surcharge has been reduced to a flat rate of 10% for companies opting for the lower 15% or 22% tax rate, and the provisions of Minimum Alternate Tax ("M.A.T") will not be applicable to such companies. For all other companies that do not opt for the lower 15% or 22% tax rate, the rate of M.A.T has been reduced from 18% to 15%.

The table below shows the new effective tax regime for domestic companies:

	Certain Existing Manufacturing Companies	Existing Companies	New Manufacturing Companies	Companies Not Opting for 22% Tax Rate	
				Turnover or Gross Receipts ≤ I.N.R. 4 Billion for F.Y. 2017-18	*Turnover or Gross Receipts > I.N.R. 4 Billion for F.Y. 2017-18*
Base Tax Rate	25%#	22%	15%	25%	30%
Surcharge	0%* 7% 12%	10%	10%	0%* 7% 12%	0%* 7% 12%
Health and Education Cess	4%	4%	4%	4%	4%
Effective Tax Rate*	**26%** **27.82%** **29.12%**	**25.17%**	**17.16%**	**26%** **27.82%** **29.12%**	**31.2%** **33.38%** **34.94%**
M.A.T.	**15%**	**–**	**–**	**15%**	**15%**

Subject to certain conditions

* No surcharge is applicable where aggregate income is less than I.N.R. 10 million. The surcharge is applicable at 7% if the aggregate income is between I.N.R. 10 million and I.N.R. 100 million or at 12% if the aggregate income exceeds I.N.R. 100 million.

For Individuals, Hindu Undivided Families ("H.U.F.'s"), Associations of Persons ("A.O.P.'s"), Bodies of Individuals ("B.O.I.'s") and Artificial Juridical Persons ("A.J.P.'s"), a higher surcharge on aggregate income exceeding I.N.R. 20 million (approximately $280,000) was proposed in the Budget. Accordingly, the maximum tax rates for F.Y. 2019-20 are given below:

Aggregate Income	Existing Surcharge Rate	Proposed Surcharge Rate	Effective Tax Rate
> I.N.R. 20 million < 50 million	15%	25%	39%
> I.N.R. 50 million	15%	37%	42.74%

However, after the announcement made by the F.M. at a press conference on August 23, 2019, and as per the Ordinance, the enhanced surcharge for the above taxpayers has been withdrawn with respect to long-term and short-term capital gains arising on the transfer of listed equity shares, units of equity oriented mutual funds, and units of business trusts.

Additionally, in the case of an A.O.P. categorized as a Foreign Portfolio Investor ("F.P.I."), the enhanced surcharge has been withdrawn with respect to all capital gains. Therefore, income from other sources such as interest arising to F.P.I.'s will continue to be subject to the enhanced surcharge. For all the above mentioned domestic and foreign investors (other than F.P.I.'s), the increased surcharge would continue to apply to capital gains arising on debt instruments and income under categories other than capital gains.

The revised Individual, H.U.F., A.O.P., B.O.I., and A.J.P. surcharge rates are below:

Aggregate Income	Surcharge on Capital Gains**	Surcharge on Other Income
Income including capital gains > I.N.R. 5 million < I.N.R. 10 million	10%	10%
Income including capital gains > I.N.R. 10 million < I.N.R. 20 million	15%	15%
Income from capital gains > I.N.R. 20 million	15%	N.A.
Income excluding capital gains > I.N.R. 20 million < I.N.R. 50 million	15%	25%
Income excluding capital gains > I.N.R. 50 million	15%	37%

** Capital gains on the transfer of listed equity shares, units of equity oriented mutual funds, and units of business trusts where Securities Transaction Tax has been paid and all capital gains in the case of A.O.P.'s and B.O.I.'s (including F.P.I.'s)

Gift from an Indian Resident to a Nonresident

Currently, a nonresident is taxed only in respect of income that (i) accrues or arises in India, (ii) is deemed to accrue or arise in India, (iii) is received in India, or (iv) is deemed to be received in India. The Act has been amended to widen the scope of income that is deemed to accrue or arise in India so that it includes a sum of money given without the receipt of consideration (gratuitously) by a resident to a nonresident. Excluded are gifts from a specified relative or under a will.

In the case of a nonresident seeking relief under an applicable Double Taxation Avoidance Agreement ("D.T.A.A."), the relevant article of the D.T.A.A. shall continue to apply for such gifts as well.

The above amendment is effective as of July 5, 2019.

Transfer Pricing – Secondary Adjustment

In the case of a transfer pricing adjustment prior to the budget announcement, a secondary adjustment applied if the amount of the primary adjustment exceeded I.N.R.

10 million (approximately $140,000) **and** the primary adjustment had been made for F.Y. 2016-17 or following years. Both conditions were required to be fulfilled. Under the budget, that is no longer required. The conditions are alternate conditions. As a result, the triggering amount no longer is relevant for original adjustments made for F.Y. 2016-17 and following years.

This amendment is effective as of April 1, 2017.

"100% of the profits of a unit in an I.F.S.C. will be allowed as a deduction for any ten consecutive F.Y.'s out of the first 15 F.Y.'s."

Currently, the excess funds in the hands of a party benefitting from a non-arm's length transaction must be repatriated to India within 90 days of the day on which the adjustment becomes final. Failure to comply will result in an interest charge at a specified rate for each outstanding year, as if the benefitting party borrowed the excess money from the party that was injured by the non-arm's length transaction. Under the budget, the benefitting party is given the option of paying a one-time additional income tax of 18% in in lieu of repatriating the excess money to India. No further credit or deduction will be allowed to the taxpayer on the amount paid by way of such additional income tax.

This amendment is effective as of September 1, 2019.

I.F.S.C.

Extension of Profit Linked Deduction

In order to maximize the benefit of the profit linked deduction to a unit located in an I.F.S.C., the Act has been amended to provide that the I.F.S.C. units will be able to defer the deduction to profitable years. Consequently, the budget provides that 100% of the profits of a unit in an I.F.S.C. will be allowed as a deduction for any ten consecutive F.Y.'s out of the first 15 F.Y.'s. The deduction will be allowed from the F.Y. in which the required permission was obtained under the relevant law.

In previous years, the 100% of the profits of an I.F.S.C. were exempt for the first five F.Y.'s, and for the next five F.Y.'s, the deduction was reduced to 50% of the profits.

Capital Gains Exemption for Category III Alternative Investment Fund ("A.I.F.")

In order to promote development of world-class financial infrastructure in India and to encourage investments in I.F.S.C.'s, the Act has been amended to exempt the income accruing or arising to or being received by a Category III A.I.F. on the transfer of certain capital assets on a recognized stock exchange located in any I.F.S.C. The exemption is subject to following conditions:

- The A.I.F. must be located in an I.F.S.C.
- All the units of the A.I.F. must be held by nonresidents other than a sponsor or manager.

Exemption from Dividend Distribution Tax

Under the current regime of dividend distribution taxation for a unit in an I.F.S.C, distributed income is exempt when the dividend is distributed out of current income. With a view to facilitate the distribution of dividends by companies operating in I.F.S.C.'s, an amendment has been introduced to extend the exemption so that it covers distributions of accumulated income derived from operations in an I.F.S.C. in the period beginning April 1, 2017.

The above amendment is effective as of September 1, 2019.

Interest Payment on Loans Taken from Nonresidents

With intent to facilitate external borrowing by units located in an I.F.S.C., the Budget has amended that the interest earned by a nonresident on debt issued by a unit located in an I.F.S.C. will be exempt from Indian withholding tax. The exemption is effective for interest paid on or after September 1, 2019.

Start-Ups

Relaxation in Condition for Allowability Setoff and Carryforward Loss

Presently, the benefit of setoff and carryforward of losses is available to an eligible start-up company when the holders of at least 51% of the shares at the end of the F.Y. in which the loss is incurred continue to own at least that percentage in the carryforward F.Y.

The Finance Act relaxed the condition for eligible start-ups to claim setoff and carryforward of losses. It provides that the benefit of the carryforward of losses will be available to eligible start-ups, as long as all original shareholders continue to be shareholders at the end of the F.Y. to which the loss is carried.

Measures to Ease Compliance for Start-Ups

In order to provide a hassle-free tax environment for start-ups, the C.B.D.T. has issued various circulars and clarifications from time to time that provide the following:

- Procedures to be followed for ongoing tax scrutiny of start-ups
- A specified time limit to complete tax scrutiny of start-ups
- A less aggressive approach toward ongoing Angel Tax litigation for recognized start-ups before the first and second level appellate authorities relating to the issue of shares for a consideration exceeding the fair market value of the shares
- No communication from the tax authorities with respect to outstanding Angel Tax demands if an elligible valuation report was submitted by a start-up
- The creation of a start-up cell to address grievances and tax-related issues

Tax on Buyback of Shares Applicable to Listed Companies

Prior to Budget 2019-20, only an unlisted company is subject to a buyback tax of 20% on distributed income upon buyback/repurchase of its shares. The income received upon buyback is exempt from further tax in the hands of the shareholders. The budget has introduced a provision to levy buyback tax on shares bought back/repurchased by listed companies as well. The provision is effective as of July 5, 2019. The buyback tax will be required to be paid by the listed company at 20% of the gain, which is the amount of the consideration paid buyback/repurchase over the amount that was received by the company upon the issuance of the shares. The shareholders involved in the buyback/repurchase of listed companies are exempt from further tax in the transaction.

At the press conference on September 20, 2019, the F.M. announced that the tax on the buyback of shares would not be applicable to listed companies that publicly announced a buyback prior to July 5, 2019.

Measures for Resolution of Distressed Companies

In order to ease the restructuring and rehabilitation of companies seeking insolvency resolution, a company taking over the business of the rehabilitated company is allowed to carry forward and set off loss of the rehabilitated company even where the plan of resolution results in a change in shareholding exceeding 49%. This benefit is applicable to companies whose resolution plan has been approved under the Insolvency and Bankruptcy Code, 2016.

The Act has been amended to extend these benefits to a company and all its direct and indirect subsidiaries where the board of directors and shareholding are changed pursuant to an order issued by the National Company Law Tribunal in cases involving the oppression of minority shareholders and mismanagement.

Withholding on Cash Withdrawals from Banks

In order to discourage cash transactions and move towards a cashless economy, the budget provided a new provision to charge a withholding tax of 2% on cash withdrawals in excess of I.N.R. 10 million (approximately $140,000) in the aggregate during the year from one or more accounts maintained by the recipient with a banking company, a co-operative bank, or a post office. The charge does not apply to certain specified recipients that handle substantial amounts of cash as a part their business operations.

The above amendment is effective as of September 1, 2019.

INDIRECT TAXES

The Budget 2019-20 encourages the government's Make-in-India policy by increasing customs duty on a slew of items that compete with goods manufactured in India. Covered by the new customs duty are, *inter alia*, gold and precious metals, automobile parts, electronics and electrical equipment, paper and paper products, and published books

Budget 2019-20 calls for the formation of a three-member National Appellate Authority for Advance Ruling ("N.A.A.A.") under the G.S.T. law in order to facilitate dispute resolution and determine legal precedents. A resolution and amnesty scheme is introduced to resolve and settle the huge backlog of pending litigation under Central Excise, Service Tax, and other related indirect tax law disputes.

CONCLUSION

Apart from tax amendments, Budget 2019-20 has key policy announcements in various sectors including infrastructure, banking and finance, and micro-, small-, and medium-enterprises. Budget 2019-20 places emphasis on making the best use of technology, providing an impetus for foreign investment, simplifying procedures, reviving the rural economy, promoting ease of living, and reducing red tape.

ISRAELI C.F.C. RULES APPLY TO FOREIGN REAL ESTATE COMPANIES CONTROLLED BY ISRAELI SHAREHOLDERS

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Tags
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Real Estate

INTRODUCTION

Recently, the Supreme Court published its judgment in the matter of *Tax Assessor for Large Enterprises v. Rosebud*, which deals with the interpretation of the provisions of Section 75B of the Israeli Income Tax Ordinance (the "Ordinance") regarding a controlled foreign corporation ("C.F.C."). In the judgment, the Supreme Court overturned a decision by the district court, in a move that is likely to have implications for the activities of Israeli taxpayers outside of Israel, through foreign companies in their control and, in particular, for companies that invest in real estate outside of Israel.

LEGISLATIVE BACKGROUND

In January 2003, a comprehensive reform of the Israeli tax laws was introduced. The reform, *inter alia*, adopted a global personal tax system to replace the territorial tax system previously in effect. According to the new global personal tax system, an Israeli resident for tax purposes is subject to tax in Israel on worldwide income. In addition, the tax legislation set forth a number of anti-avoidance provisions, which were intended to prevent taxpayers from taking advantage of the personal nature of the new law by setting up foreign companies based in low-tax jurisdictions. The main anti-avoidance provision took the form of the C.F.C. regime set forth in Section 75B of the Ordinance. The provision affects a C.F.C., as defined, and an Israeli resident who is a controlling shareholder of that C.F.C. Where the C.F.C. earns passive income in any year and fails to distribute that income to its shareholders, an Israeli resident that is a controlling shareholder will be considered to have received his or her *pro rata* share of the profits as a deemed dividend.

Adv. Daniel Paserman (LL.M, C.P.A.), TEP, is head of tax at Gornitzky & Co. in Tel-Aviv, Israel. Daniel is involved in tax litigation and intricate corporate tax planning – both domestic and cross-border. He also advises new immigrants and returning residents to Israel on taxation and tax exemption issues concerning their global assets and business activities.

A C.F.C. is a private company that is a foreign resident for tax purposes and is controlled by Israeli residents, where most of its income or profits is derived from passive income and where the rate of tax in the foreign country does not exceed 15%. Passive income includes interest income, income from linkage differentials, dividends, royalties, rent, and proceeds from the sale of an asset, provided that such income does not qualify as business income.

ROSEBUD RULING

In the case at hand, Rosebud (an Israeli subsidiary of a publicly-traded Israeli company) indirectly held a number of companies in Luxembourg through a Dutch company. The Luxembourg entities held other foreign companies that each held a separate parcel of real estate. This structure, in which each company is a special purpose vehicle that holds only a single asset, is a common structure in the real estate sector. This structure has many business advantages that do not arise from tax considerations, including (i) limitation of liability, (ii) financial benefits, and (iii) the possibility of selling assets separately – whether directly or through the sale of shares.

In Rosebud, assets and shares were sold. Rosebud claimed that the provisions of Section 75B of the Ordinance did not apply, because the matter concerned business income, which is not passive income. Thus, the question arose as to whether the sale by a company of its sole asset or the sale of shares of a company constitutes a capital event that generates a passive profit for purposes of Section 75B. Rosebud argued that its activity should be examined as a whole and that the group's operations, which include the development, management, appreciation, rental, and disposal of real estate assets, amount to business activity. Therefore, selling a particular asset out of a wide portfolio should be classified as business income rather than capital gain. In sum, the taxpayer argued that business income is not subject to the C.F.C. provisions and it is of no consequence that, in each transaction, only the sole asset of a company was sold by the company or the shares of a single company were sold by its shareholder.

The Israel Tax Authority, on the other hand, claimed that it is necessary to examine each corporation (asset) separately, without looking at the group of companies as a whole. This has been the position of the Israel Tax Authority since the C.F.C. legislation was introduced, in 2003.

The district court allowed the company's position and ruled that the group's operations should be examined as one business. Consequently, the Israel Tax Authority filed an appeal with the Supreme Court.

The Supreme Court, in an extremely short judgment, ruled that the district court had departed from the fundamental principle of corporate taxation in Israel, whereby each company is a separate tax unit. Thus, the Supreme Court classified the income as passive and ruled that the C.F.C. provisions apply.

CONCLUSION

Beyond the ruling, the Court did not go into an in-depth analysis of the issue, because the Luxembourg companies were insolvent and no further tax revenue would be raised. Although the rationale of the decision is sparse, the ruling is important, as a C.F.C. must be examined based on its own facts, not those of other members under common control.

With respect to Israeli investments in U.S. real estate, it is worth reiterating that the Israeli C.F.C. rules do not apply to a foreign company that is subject to a tax rate of more than 15%. It should be noted that dividends derived from income on which a foreign tax exceeding 15% was paid are also not be subject to the C.F.C. rules, provided that the company receiving the dividend holds at least a 5% interest in the publicly traded company distributing the dividends or at least a 10% interest in a private company. In this respect, if the investment in the U.S. is executed through a C-corporation that is liable for U.S. corporate tax at the standard rate of 21%, the Israeli C.F.C. rules are not expected to apply.

DO YOU HAVE TO WITHHOLD 30% ON PAYMENTS TO A NON-U.S. INDEPENDENT CONTRACTOR?

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Tags
Independent Contractor
Withholding Tax

BACKGROUND

In the global village where we live, U.S. companies are not limited to U.S. individuals when searching for the right service provider. U.S. companies often hire non-U.S. individuals for the job. These individuals include non-U.S. citizens living outside the U.S., who generally don't need to be present in the U.S. to provide services, and non-U.S. citizens who are temporarily present in the U.S. on an appropriate visa.

Generally, temporary immigrants will be considered U.S. tax residents under the substantial presence rule if present in the U.S. for a sufficient number of days. However, in certain fact patterns, a special rule may exempt days of presence in the U.S. from being counted towards residence status. An example is an individual present in the U.S. under an F-1 (student) visa who is working during a period of optional practical training.

In connection with income from the performance of services, non-U.S. individuals are subject to U.S. tax only on U.S.-source income. With limited exceptions, compensation income is sourced to the location where the services are performed. As a result, no U.S. withholding tax would apply to compensation payment for an individual who is an independent contractor and the following conditions are met:

- The individual is not a U.S. tax resident.[1]
- The services are not performed while present in the U.S., in whole or in part.

Once services are performed in the U.S., even in part, the payment is considered to be a U.S.-source payment to a greater or lesser extent based on the quantum of services performed and the place or places where performed. Factors that are not relevant to the source of the income include the individual's place of residence, the place where the contract for service was entered, and the place of payment. When services are performed from both within and without the U.S., the payment must be allocated between the U.S. and the foreign country, generally on the basis of the time spent in each place for performance of services.

When a non-U.S. person performs personal services in the U.S. they are generally treated as engaged in a trade or business in the U.S. and tax is due on the U.S.-source portion of the compensation. When an employee-employer relationship exists, the tax is taken care of through graduated withholding in a similar manner to the way wages are withheld on for U.S. citizens and residents.[2] But when an

1 Generally, a U.S. resident includes a U.S. citizen and a non-U.S. citizen who holds a green card or meets the substantial presence test. The determination of U.S. tax residency will not be discussed further in this article.

2 Note that while the tax liability is taken care of via withholding, the non-U.S.

employment relationship is not established, and the relationship is that of an independent service provider, how is the U.S. tax liability settled? Is the independent contractor responsible for their own tax payment or is the principal company obligated to withhold 30% of the gross amount paid under the general statutory rule applicable to a non-U.S. person receiving fixed, determinable, annual, and periodic income ("F.D.A.P. payments")?

INDEPENDENT COMPENSATION INCOME IS SUBJECT TO 30% GROSS WITHHOLDING

As mentioned above, when a non-U.S. person provides services while in the U.S., the amount of the compensation payment allocated to the days spent in the U.S. will be U.S.-source income. A payment from U.S. sources made to a non-U.S. person is subject to withholding if it is an F.D.A.P. payment. F.D.A.P. payments include compensation payments in a non-employment setting. The withholding obligation is imposed on the "withholding agent" (generally, any person with control over the payment amount) who is personally liable for the tax, independently of the tax liability of the non-U.S. individual receiving the payment.

Stated differently, if the U.S. business fails to withhold and the service provider fails to satisfy the relevant U.S. tax liability, the U.S. business will be liable (alongside the non-U.S. individual) for the tax, including interest and penalty. The tax obligation of the withholding agent is 30% of the amount paid. Whichever way imposed, the tax due will be collected only once, but it is generally easier for the I.R.S. to go after the withholding agent in the U.S. rather than the non-U.S. individual based abroad. Lastly, even if the service provider satisfies its U.S. tax liability, the U.S. business is personally liable for any interest and penalties for failure to withhold from the time withholding is due until the non-U.S. individual reports the income on a U.S. tax return and pays the tax.

"If the U.S. business fails to withhold and the service provider fails to satisfy the relevant U.S. tax liability, the U.S. business will be liable."

Consequently, unless an exception applies, a U.S. business hiring a non-U.S. individual as a service provider must withhold 30% on compensation payments made for services performed in the U.S. Looked at it this way, collection of the tax – and reduction of the gross amount paid to the non-U.S. individual – benefits the U.S. business.

WHAT AMOUNT IS SUBJECT TO WITHHOLDING?

A U.S. business payor making a compensation payment to a non-U.S. independent contractor must withhold an amount sufficient to ensure that at least 30% of the amount subsequently determined to be U.S.-source income is withheld. This may be difficult to determine, especially because at the time of payment many of the facts leading to this determination may still be unknown. This, of course, can lead to overwithholding.

Payment for reimbursement of travel and lodging expenses of a non-U.S. individual providing independent services are not subject to withholding if the payments are treated as made under an accountable plan. In general, this a plan that

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individual is considered to be engaged in a U.S. trade or business and is thus required to file a U.S. tax return on Form 1040NR, *U.S. Nonresident Alien Income Tax Return*.

- establishes the business purpose and connection of the expenses,
- substantiates the expenses claimed within a reasonable period of time, and
- requires the independent contractor to return to the payor within a reasonable period of time any advanced amounts that are above the substantiated business expenses.

CAN COMPENSATION INCOME BE EXEMPT FROM WITHHOLDING?

Treaties may exempt independent personal services payments from withholding under a special provision for independent personal services or, if such a provision is not available, by treating such income as business income, which is taxed under the business profits article of the treaty. Generally, to be eligible for treaty benefits under the relevant provision of a treaty, the service provider cannot have an office or a fixed base in the U.S. available for the performance of services or be present in the U.S. for a specified number of days. To avoid withholding based on a treaty benefit the U.S. business payor must receive from the independent contractor Form 8233, *Exemption From Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual*, in advance of making the payment. Once the form is received, the U.S. business must review it to determine if the benefit is warranted under the relevant facts, then sign it and submit a copy of it to the I.R.S. within five days of receipt. The U.S. business must then wait at least ten days to see if the I.R.S. has any objections.

The table below summarizes the treatment under some treaties with respect to compensation income earned by an independent contractor.

U.S. Tax Treaty	Independent Personal Services	Business Profits
Canada	N/A	Exempt from tax unless the individual has a permanent establishment ("P.E.") in the U.S. and the compensation income is attributable to such P.E.
China	Exempt from tax unless the compensation income is attributable to the individual's fixed base ("F.B.")[3] in the U.S. which is regularly available to them for the purpose of performing their services4, or the services are performed in the U.S. and the individual is present in the U.S. for 183 days or more in the taxable year.	N/A

[3] Fixed base is not defined but the meaning is understood to be similar to P.E.

[4] If this condition is met, services that are performed outside the U.S. may still be subject to U.S. tax if they are attributable to the individual's U.S. F.B. Compare

U.S. Tax Treaty	Independent Personal Services	Business Profits
France	Exempt from tax unless the services are performed in the U.S. and the compensation income is attributable to the individual's F.B. in the U.S. that is regularly available to the individual for the purpose of performing their services	N/A
Germany	N/A	Exempt from tax unless the individual has a P.E. in the U.S. and the compensation income is attributable to such P.E.
Italy	Exempt from tax unless the services are performed in the U.S. and the compensation income is attributable to a U.S. F.B. that is regularly available to the individual for the purpose of performing their service	N/A
Israel	Exempt from tax unless the services are performed in the U.S. and the individual is present in the U.S. for 183 days or more in the taxable year	N/A
Japan	N/A	Exempt from tax unless the individual has a P.E. in the U.S. and the compensation income is attributable to such P.E.
Thailand	Exempt from tax unless[5] • the compensation income is attributable to the individual's F.B. in the U.S. which is regularly available to him for the purpose of performing their services,[6] • the services are performed in the U.S. and the individual is present in the U.S. for 90 days or more in the taxable year, or • the compensation income exceeds $10,000 for the taxable year.	N/A

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this to the U.S. Model Treaty and other treaties that still include a separate provision for Independent Personal Services, where the services must be performed in the U.S. to be subject to U.S. tax. Additionally, if this condition is met, it is understood that the principles of the Business Profits provision would apply in computing the individual's income (*i.e.*, U.S. tax would apply on a net basis).

5 It is understood that the principles of the Business Profits provision would apply in computing the individual's income if it is taxable pursuant to this provision (*i.e.*, U.S. tax would apply on a net basis).

6 If this condition is met, services that are performed outside the U.S. may still

U.S. Tax Treaty	Independent Personal Services	Business Profits
U.K.	N/A	Exempt from tax unless the individual has a permanent establishment P.E. in the U.S. and the compensation income is attributable to such P.E.

*Note that compensation income of entertainers and sportsmen (artists and athletes) may benefit from a separate provision of tax treaties and are not addressed in this article.

Often, the facts required for the treaty provision to apply (as seen is some examples in the table above) cannot be determined at the time of the payment, and possibly until after the close of the tax year. Therefore, in many cases, even if a Form 8233 is submitted, the U.S. business payor should not accept the form and withhold 30% of a payment made.[7]

Additionally, under a special arrangement up to a maximum of $5,000 of the final payment of compensation during a tax year may be exempt from withholding if the individual obtains an exemption letter from the I.R.S. This would require submitting a statement that meets certain information requirements relating to the individual's effectively connected income ("E.C.I.") earned during the year, tax withheld, any other tax liabilities, and other relevant matters. This statement must be signed under penalty of perjury by the individual and all withholding agents who made or are expected to make compensation payments to the individual during the taxable year.

TAX LIABILITY OF THE SERVICE PROVIDER

Because the performance of services in the U.S. is generally treated as a U.S. trade or business, the income generated is generally E.C.I. and business expenses are allowed as a deduction. Therefore, the 30% tax on the gross amount paid often is greater than the net tax due on the tax return of the non-U.S. individual. Additionally, if withholding was imposed (as it should) the non-U.S. independent contractor should file a U.S. tax return on Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, and claim a refund for any overwithholding. This entails obtaining a taxpayer identification number ("I.T.I.N.") by filing a Form W-7, *Application for IRS Individual Taxpayer Identification Number*, which can take up to seven weeks if completed correctly and all supporting documents required have been submitted or up to 11 weeks if submitted during peak processing times.

REPORTING OBLIGATIONS FOR U.S. BUSINESSES

Payments potentially subject to withholding must be reported by the U.S. business making the payment on Form 1042-S, even if some or none of the payment is

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be subject to U.S. tax if they are attributable to a U.S. F.B.; For example, if a Thai independent contractor has a U.S. office regularly available to him for the performance of his services, and the services he performs require him to visit Canada, it is possible that the income from the services performed in Canada may be attributable to his U.S. office and subject to U.S. tax.

7 Form W-8ECI, *Certificate of Foreign Person's Claim That Income Is Effectively Connected with the Conduct of a Trade or Business in the United States*, should not be used for compensation income.

actually subject to withholding. An example of a fact pattern resulting in some withholding involves an individual who provides services in the U.S. and outside the U.S. An example of a fact pattern resulting in no withholding involves a complete exemption by virtue of an applicable treaty. Additionally, all amounts of tax actually withheld during a taxable year must be reported by the withholding agent on Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*.

Both Form 1042 and 1042-S must be submitted by the U.S. business by March 15 of the following year, and a copy must also be sent to the payee, who may rely on it to demonstrate the amount of tax withheld should a refund be claimed on an income tax return.

INDEPENDENT CONTRACTOR

Different responsibilities and liabilities would apply to the U.S. business if it was viewed to be an employer. Determining the character of the relationship as either (i) a principal and its independent contractor or (ii) an employer and its employee is important.

An independent contractor relationship is often desired by a U.S. business because it results in much lower costs for the U.S. business when the facts support that relationship. It also benefits the non-U.S. individual who hopes to avoid interfacing with a U.S. bureaucracy. In all cases, it is the facts and circumstances that control the determination, not the title that appears on the contract or a statement that appears towards the end of many contracts.

The Code defines an employee under common law rules. Under common law rules, an employer-employee relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, both as to the result to be accomplished by the work, and as to the details and means by which that result is accomplished. The fact that the employer does not actually direct or control the manner in which the services are performed is immaterial. The fact the business has the right to do so controls. However, if an individual is subject to the control or direction of another merely with regard to the intended result of the work and not as to the means and methods for accomplishing the result, the individual is treated as an independent contractor.

Factors that may be considered in this determination, but are not conclusive, include whether the individual is furnished with tools and with a place to work on the premises of the person receiving the services.

If a U.S. business unreasonably treats an employee as an independent contractor, the U.S. business is liable for employment taxes for that worker.

CONCLUSION

U.S.-source compensation payments made by a U.S. business to a non-U.S. individual who is an independent contractor and who is not treated as a U.S. tax resident for the taxable year will generally be subject to 30% gross withholding.

While the ultimate U.S. tax liability of the non-U.S. service provider may very well be lower, gross withholding tax should be collected by the U.S. business and paid over to the I.R.S. unless the U.S. business payor can confidently determine that a lesser amount is subject to withholding or that treaty benefits can be extended to the non-U.S. service provider. Otherwise, the tax liability becomes that of the payor.

Thus, a U.S. business must balance the detriment to the service provider with the business risk resulting from the under-withholding tax.

"U.S.-source compensation payments made by a U.S. business to a non-U.S. individual who is an independent contractor and who is not treated as a U.S. tax resident for the taxable year will generally be subject to 30% gross withholding."

PREFERRED YET NEGLECTED — A PLEA FOR GUIDANCE ON REDEMPTIONS OF C.F.C. PREFERRED STOCK IN THE WAKE OF U.S. TAX REFORM

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Tags
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C.F.C.
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Redemption

Neglected preferred stock! Yes, this article begins with an oxymoron. But as you read on, you will realize that Congress and the I.R.S. are capable of doing ANYTHING. If they can disturb the balance in the tax universe by introducing the Transition Tax and G.I.L.T.I., they can most certainly neglect one of the most desired investment instruments — preferred stock.

This article discusses the U.S. Federal income tax consequences of a redemption of non-voting preferred stock of a controlled foreign corporation ("C.F.C.") with an emphasis on the non-application of Code §1248, the redemption's effect on the C.F.C.'s earnings and profits("E&P"), and the lack of I.R.S. guidance on the subject.

REDEMPTION OF DOMESTIC STOCK

The U.S. Federal income tax treatment of a redemption of the stock of a corporation depends on whether the redemption is treated as a distribution in exchange for the stock or as a dividend.[1] Where the redemption qualifies for exchange treatment under Code §302(a), the amount of gain or loss realized by the shareholder is determined by removing the shareholder's adjusted basis in the redeemed shares from the sum of cash plus the fair market value of property other than cash received in the redemption. On the other hand, if the redemption does not qualify under Code §302(a), the distribution is treated as dividend to the extent of the company's E&P. To the extent the amount of the distribution exceeds E&P, the balance of the distribution is treated as the recovery of the shareholder's adjusted basis in the stock.[2] The portion of the distribution that exceeds the adjusted basis of the stock is treated as a capital gain.[3]

Typically, a payment in redemption of stock is accorded capital gains treatment if any of four tests identified in Code §302(b) is met. For purposes of applying these tests, explained further below, it is important to keep in mind that courts and the I.R.S. will apply the step transaction doctrine and Code §318 attribution principles.4

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1 Code §302(a).

2 Code §301(c)(2).

3 Code §301(c)(3)(A). If the amount of the distribution does not exceed the adjusted basis of the stock redeemed, the regulations require that "proper adjustment" is made to the basis of the shareholder's remaining shares (Treas. Reg. §1.302-2(c)).

4 See, *e.g.*, *Merrill Lynch v. C.I.R.*, 120 T.C. 12 (2003), aff'd, 386 F.3d 464 (2d Cir. 2004), remanded, 131 T.C. 293 (2008), applying a "firm and fixed plan" standard to integrate cross-chain sales with a planned sale of a target affiliate to a third party. For a discussion of Code §318 in the Code §302(b) context, see *U.S. v. Davis*, 397 U.S. 301, reh'g denied, 397 U.S. 1071 (1970). The Court strenuously overrode the taxpayer's claim that Code §318 attribution should

Test 1: The Redemption Is "Not Essentially Equivalent to a Dividend"[5]

The Supreme Court has indicated that a redemption will be essentially equivalent to a dividend unless a "meaningful reduction" of the shareholder's ownership position has occurred.[6] Typically, this entails a significant reduction in the right to participate in the equity growth of the corporation and the management of the corporation as a result of the redemption. Neither of these conditions exists with respect to a non-voting preferred stock.[7] Therefore, a redemption of the non-voting preferred stock will be treated as an exchange for the stock and thereby the distribution will be taxed as capital gain.

Test 2: The Redemption Is Substantially Disproportionate Within the Shareholder Group[8]

An ordinary dividend does not disturb relative interests of shareholders in the assets and earning capacity of the corporation, whereas a non-*pro rata* redemption reduces the interest of some, but not all, shareholders. Consequently, Code §302(b)(2) treats a "substantially disproportionate" redemption as a distribution of cash or other property in exchange for the stock tendered by some, but not all, of the shareholders.

In order for the transaction to qualify as an exchange by a participating shareholder, the redemption must meet three requirements demonstrating a meaningful reduction in control, voting rights, and profits interest. In particular, immediately after the redemption has occurred, the tested shareholder must own

- less than 50% of the total combined voting power of all classes of voting stock,
- less than 80% of the percentage of voting stock held immediately before the distribution, and
- less than 80% of the percentage of common stock (both voting and non-voting) owned immediately beforehand.

If a shareholder owns both voting and non-voting stock, a redemption of only the non-voting preferred stock will not qualify as a "substantially disproportionate"

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not be applied to the before and after snapshot approach of Code §302(b)(1), stating that to do so would nullify Congress's explicit directive.

5 Code §302(b)(1).

6 *U.S. v. Davis*, 397 U.S. 301. The Supreme Court (Justice Marshall opinion) analyzed the "not essentially equivalent" rule, observing the "morass" of decisions created under prior law, and remarking that the Code §302(b)(1) rule only made its way back into the Senate Finance version of the 1954 tax bill, with the Senate drafters specifically citing redemptions of preferred stock "which might be called by the corporation without the shareholder having any control over when the redemption may take place," as the extenuating rationale for maintaining this awkward language (citing S. Rep. No. 1622, 83d Cong., 2d Sess., at 44). In his heated dissent, Justice Douglas argued in favor of extending prior law, observing dryly that to apply the Court's narrow reading meant "that in the case of closely-held or one-man corporations a redemption of stock is 'always' equivalent to a dividend. I would leave such revision to Congress."

7 Treas. Reg. §1.302-2(a).

8 Code §302(b)(2).

redemption because the redemption will not reduce the shareholder's proportionate ownership of the voting stock and, thereby, the ability to control corporate affairs.[9] Thus, a redemption of only non-voting preferred stock will not meet the substantially disproportionate redemption test.

Test 3: A Complete Termination of the Tested Shareholder's Ownership Interests in the Redeeming Corporation[10]

This test is relatively straightforward. If a person is no longer a shareholder, the distribution reduces control, voting rights, and profits interest in a meaningful way.

Test 4: A Redemption in Partial Liquidation of the Company[11]

Without going into detail, this test is one with relatively limited application involving shareholders that are not corporations, such individuals and trusts. It also requires a termination of a significant business line as part of a corporate contraction.

In view of the above discussion, a C.F.C.'s redemption of its non-voting preferred stock will be able to qualify for exchange treatment only under the "not essentially dividend" test of Code §302(b)(1).

REDEMPTION OF C.F.C. STOCK

While Code §302 is a general provision applicable to redemptions of stock, the tax effect of a sale or exchange of the stock of a C.F.C. — including a redemption — is governed by the special provisions of Code §1248. Briefly, Code §1248 treats gain arising from the sale or exchange of C.F.C. stock, which otherwise would be treated as a capital gain, as ordinary dividends to the extent of the C.F.C.'s E&P that have not been previously taxed in the U.S. Code §1248 was enacted to ensure that U.S. multinationals did not repatriate deferred foreign earnings at favorable long-term capital gains rates in effect at the time by having their C.F.C.'s redeem stock or engage in either redemptions of their stock or taxable liquidations (allowing immediate basis offset under Code §302(b) or Code §331(a)).[12]

Based on prior law, Code §1248 thus provides a parity of tax treatment for U.S. shareholders who sell C.F.C. stock in the following two fact patterns:

- In the first, the C.F.C. is a corporation that distributes dividends regularly, providing its U.S. shareholders with a stream of potentially taxable dividends, as provided under U.S. tax law in effect at the time. When the stock of the C.F.C. is sold, the gain reflects solely the increase in value of the business of the C.F.C.
- In the second fact pattern, the C.F.C. is a corporation that accumulates its profits and pays no dividends. When the stock of the C.F.C. is sold, the

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[9] Treas. Reg. §1.302-3(a).

[10] Code §302(b)(3).

[11] Code §302(b)(4).

[12] S. Rep. No. 1881, 87th Cong., 2d Sess., reprinted at 1962-3 C.B. 703, 813. For a detailed analysis of Code §1248, read "Is the 100% Dividend Received Deduction Under Code §245A About as Useful as a Chocolate Teapot?" published in *Insights* Volume 6 Number 6.

> gain reflects both the increase in the value of the C.F.C.'s business and the retained cash earnings. In a system where long-term capital gains are taxed at a more favorable tax rate, as was the case in 1962 when Code §1248 was enacted, the second fact pattern resulted in more favorable tax treatment

For purposes of Code §1248, a person is treated as having sold or exchanged any stock of a C.F.C. (and is therefore within the ambit of the rule's deemed dividend treatment) if such person is treated (within the provision of Subtitle A — which includes Code §302) as realizing gain from the sale or exchange of such stock.[13] In other words, if a distribution received in redemption of the C.F.C.'s stock would be treated as an exchange under Code §302, Code §1248 overrides Code §302's treatment by characterizing the gain as if it were a dividend to the extent attributable to the C.F.C.'s accumulated E&P.[14] However, if the redemption distribution fails to meet any of the four exchange tests under Code §302, the entire distribution is governed under Code §301 rather than Code §1248.[15]

Code §1248(a) provides:

> (a) General rule. If
>
> > (1) **a United States person** ["U.S. Person"] sells or exchanges stock in a foreign corporation, and
> >
> > (2) such person owns, within the meaning of §958(a), or is considered as owning by applying the rules of ownership of §958(b), **10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation** at any time during the 5-year period ending on the date of the sale or exchange when such foreign corporation was a controlled foreign corporation (as defined in §957),
>
> then the gain recognized on the sale or exchange of such stock shall be included in the gross income of such person as a dividend, to the extent of the earnings and profits of the foreign corporation attributable (under regulations prescribed by the Secretary) to such stock which were accumulated in taxable years of such foreign corporation beginning after December 31, 1962, and during the period or periods the stock sold or exchanged was held by such person while such foreign corporation was a controlled foreign corporation. For purposes of this section, a United States person shall be treated as having sold or exchanged any stock if, under any provision of this subtitle, such person is treated as realizing gain from the sale or exchange of such stock. [emphasis added]

As the foregoing statutory language indicates, the tax treatment provided under Code §1248 continues to be applicable only to a U.S. Person who owns 10% or

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13 Code §1248(a), last line.

14 Treas. Reg. §1.1248-1(b). See discussion below of previously taxed C.F.C. E&P.

15 Code §302(d). Therefore, the full amount of the redemption distribution is treated as a dividend, rather than the amount of gain.

“Code §1248 refers to a U.S. Person owning 10% or more of the C.F.C.’s voting stock . . . rather than to a U.S. Shareholder.”

more of a C.F.C.’s voting stock and not to a U.S. Person who owns 10% or more of the value of all classes of stock of the C.F.C.

In 2017, the Tax Cuts and Jobs Act (“T.C.J.A.”) expanded the definition of a U.S. shareholder for the purposes of Subpart F, G.I.L.T.I., and the other international tax provisions to include persons owning 10% or more of the total value of stock.[16] This expanded definition (termed a “U.S. Shareholder”), created a disconnect between the trigger for Code §1248 treatment (10% of vote) and the trigger for tax under the international tax provisions.

Code §1248 refers to a U.S. Person owning 10% or more of the C.F.C.’s voting stock (“Section 1248 shareholder”),[17] rather than to a U.S. Shareholder, which includes both a person who owns 10% or more of the total combined voting power of all classes of stock entitled to vote of a C.F.C. and a person who owns 10% or more of the total value of shares of all classes of stock of such foreign corporation.[18]

It is not clear whether the T.C.J.A.’s failure to amend Code §1248 to eliminate this baseless distinction between a Section 1248 shareholder and a U.S. Shareholder, with all its ensuing consequences for C.F.C. preferred stock redemption was a mere legislative oversight.[19] In any event, the law stands as enacted, and in the absence of a legislative fix, tax advisers are once again entrusted with the task of maneuvering through this thicket of disparate Code provisions to advise clients on an issue.

INTERACTION OF REDEMPTION RULES, CODE §1248, AND U.S. TAX REFORM

A U.S. Person owning non-voting preferred stock in a C.F.C. may be in a neglected position should those shares represent 10% or more of the value of all shares of the corporation. Even if the U.S. Person is a U.S. Shareholder under Code §951(b) by virtue of owning 10% or more of the total value of all classes of the stock of the C.F.C. and therefore subject to all other C.F.C. provisions of the Code, Code §1248 will not apply because of the absence of the voting rights. This may yield unexpected results when various Code provisions interact.

To illustrate, assume a U.S. corporation owns shares representing 10% or more of a C.F.C.’s voting rights. If those shares are sold at a gain, a portion of the gain will be treated as dividend income under Code §1248. Presumably, the amount treated as a dividend would qualify for the 100% dividend received reduction (the “D.R.D.”) under Code §245A, subject to certain conditions.[20] However, if the shareholder owns only non-voting preferred stock, Code §1248 does not apply.[21] The entire

16 T.C.J.A. §14214(a).

17 Code §1248(a). The separate term Section 1248 shareholder is only used by the I.R.S. in formal guidance in the Treasury Regulations enacting Code §367 (*cf.* Treas. Reg. §1.367(b)-1(c)(2)(iv)(A)).

18 Code §951(b).

19 Also of note, the definition of U.S. Person is somewhat restricted for purposes of Subpart F, by providing special treatment for certain *bona fide* residents of Puerto Rico, Guam, American Samoa, and the Northern Mariana Islands.

20 Code §1248(j).

21 *Larry D. Barnette, et al. v. C.I.R.*, T.C. Memo 1992-371.

gain continues to be treated as capital gain and the D.R.D. under Code §245A is not available. The entire amount of the capital gain will be subject to corporate tax in the U.S. at 21%.

The D.R.D. under Code §245A is not available to non-corporate shareholders of a foreign corporation. However, the source rules for gains differ from the source rules for dividends. If the gain is taxable by the foreign country in which the C.F.C. is located and Code §1248 is not applicable, the entire gain recognized by the individual will be domestic-source gain in the absence of a favorable resourcing provision in an applicable income tax treaty. This is a significant problem for U.S. investors in Indian companies, for example, where Indian capital gains tax is imposed on the sale of an Indian company by a U.S. resident and the same gain is then liable to be taxed a second time in the U.S. without ability to claim the benefit of any foreign tax credits.[22]

REDEMPTION OF NON-VOTING STOCK: EFFECT ON E&P AND P.T.I. ACCOUNT

The Code and final regulations do not provide any guidance on the effect of a redemption of non-voting preferred stock of a C.F.C. on its E&P and on the redeemed shareholder's previously taxed E&P account ("P.T.I. Account"). While we expect to delve further into the intricacies of Code §959 in a future version of Insights, it is worth mentioning for now that the regulations under Prop. Treas. Reg. §1.959-3, released in 2006, (the "2006 Proposed Regulations") shed some light on the topic.[23] However, no final regulations have been issued to date. In addition, in early 2019, the I.R.S. indicated it intends to withdraw the 2006 Proposed Regulations.[24] Nonetheless, the 2006 Proposed Regulations remain helpful in understanding how future regulations might look at the issue if no material change is made to the underlying concepts.

The 2006 Proposed Regulations provide that the effect of a redemption on the shareholder's P.T.I. Account and on the E&P of the redeeming C.F.C. both depend on whether the distribution is treated as a payment in exchange for stock or as a distribution of property treated as a dividend under Code §301. Bringing us back to where we began, a redemption of the non-voting preferred stock of a C.F.C. (where the redeemed shareholder owns only non-voting preferred stock) is treated as a payment in exchange for the stock.

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22 In this case, Article 12 (Gains) allows India to impose the tax. Article 25 (Relief from Double Taxation) provides for a credit in the U.S. that is subject to the limitations of U.S. tax law. One such limitation is that credit is given only to reduce U.S. tax imposed on foreign-source income. Under Code §865(a)(1), such gain is treated as domestic gain for a U.S.-resident individual. Hence, the foreign tax credit limitation may be zero, and the foreign tax credit would provide no meaningful benefit. The only relief available is to claim a deduction under Code §164. Note, the $10,000 ceiling on the deduction of state, local, and foreign taxes does not apply to a foreign tax paid or accrued in carrying on a trade or business or an activity described in Code §212 (Code §164(b)(6)).

23 REG-121509-00, 71 F.R. 51155 (August 29, 2006).

24 See Notice 2019-1, I.R.B. 2019-01, at §2. The justification for this intended withdrawal was that the previously taxed E&P rules should be modified to account for the multiple new separate categories of previously taxed E&P under U.S. tax reform, including the Transition Tax and G.I.L.T.I.

Redemption Treated as Payment in Exchange for the Stock

Since a redemption of the U.S. Person's non-voting preferred stock in a C.F.C. will typically be treated as a payment in exchange for stock under Code §302(b)(1), we take a moment here to examine the effect of that redemption on the C.F.C.'s E&P and the shareholder's P.T.I. Account.

Effect on Redeeming C.F.C.'s E&P

The 2006 Proposed Regulations provide that if the redemption distribution is treated as a payment in exchange for stock under Code §302(a), the amount of the distribution chargeable to the corporation's E&P is determined under the general rules of Code §312(a), meaning that the C.F.C.'s E&P (including both previously taxed and non-previously taxed E&P) is reduced by the amount of the following:[25]

- Cash distributed in redemption
- The adjusted basis of the property distributed (Also, in the case of a distribution of an appreciated property, Code §312(b) first increases E&P by the unrealized appreciation and then reduces E&P by the amount of the fair market value.[26])
- The principal amount of the obligation distributed by the corporation

Once the amount of the distribution is determined, the pool of previously taxed E&P of the C.F.C. is reduced first. Any distribution in excess of the pool of previously taxed E&P reduces the pool of non-previously taxed E&P. These adjustments will be similar in principle to how Code §312 E&P is adjusted when the redeeming corporation is a domestic corporation.

Effect on Redeemed Shareholder's P.T.I. Account

Upon a redemption treated as an exchange, the P.T.I. Accounts related to the redeemed shares cease to exist, and any remaining P.T.I. balance in those accounts is reclassified as non-previously taxed E&P of the C.F.C.

CONCLUSION

When the T.C.J.A. failed to amend Code §1248 in a way that conforms to the definition of a U.S. Shareholder of a C.F.C. and the new rules enacted around the latter definition, a disconnect was created that has led to anomalous results when a U.S. Person's non-voting preferred shares in a C.F.C. are sold or otherwise redeemed.

While a shareholder owning 10% or more of the value in the C.F.C. will be subject to a number of provisions, like Subpart F, G.I.L.T.I., and C.F.C. reporting requirements (among others), the shareholder will face excessive taxation at the time the shares are sold or redeemed. The reclassification of the U.S. Person's P.T.I. Accounts to

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[25] Prop. Treas. Reg §1.959-3(h)(2) subjects the reduction in the C.F.C.'s E&P to two ceilings.

[26] Code §312(b)(2). The interaction of the positive and negative adjustments causes a net reduction to E&P equal to the distributing corporation's basis in the property so distributed.

non-previously taxed E&P, as indicated above, is just one more discrepancy that will result from these split definitions.

For a corporation, the excessive tax arises from the loss of the D.R.D. For individuals, the excessive tax arises from potential loss of benefit under the foreign tax credit.

"A shareholder owning 10% or more of the value in the C.F.C. . . . will face excessive taxation at the time the shares are sold or redeemed."

U.S. TAX LITIGATION UPDATE — THE PRESIDENT'S TAX RETURNS AND THE NEW S.A.L.T. CAP

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Tags
Disclosure
S.A.L.T.
Tax Returns

TRUMP TAX RETURNS

The political battle between the Democrats in the House of Representatives and President Trump concerning the release of tax returns has moved to the courts.

President Trump has sued to block the Democrat-led U.S. House Ways and Means Committee from obtaining his tax records from New York State under the T.R.U.S.T. Act, in the latest attempt to keep his personal financial information out of public view.[1] N.Y.'s T.R.U.S.T. Act compels the state's tax department to comply with the Ways and Means Committee's records requests. The president is suing as a private citizen claiming the right to privacy that is enjoyed by citizens of the U.S.

The lawsuit comes three weeks after the Committee, led by a Massachusetts Democrat, sued to force the U.S. Treasury Department and I.R.S. to hand over Trump's tax records from the past six years. That suit was filed after Treasury Secretary Steven Mnuchin rebuffed earlier requests for the information.

In an August 20, 2019, filing with the U.S. District Court for the District of Columbia, lawyers for House Ways and Means Democrats asked Judge Trevor McFadden to grant a motion for summary judgment. House lawyers said in the filing that there is no genuine dispute as to the facts of the case and that they are entitled to a judgment as a matter of law.[2]

Obtaining President Trump's New York State tax returns would expose his business relationships in years prior to his election to the Office of President, as the New York State tax return would contain Federal tax information. There is currently no requirement that this information be disclosed, but all elected presidents since Richard Nixon have routinely done so. It should be remembered that many presidents reported significant income only after their terms in office were completed. President Trump differs from his counterparts in that regard.

On July 30, 2019, a Joint Status Report was filed, in summary, stating:

> Following yesterday's hearing and this Court's minute order, the parties have met and conferred in good faith 'to determine whether they can reach an agreement regarding how best to proceed in light of [the court's] three goals' of (1) 'ensuring that Mr. Trump's claims do not become moot before they can be litigated,' (2) 'treading as lightly as possible, if at all, on separation of powers and Speech or Debate

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1 *Trump v. Committee on Ways and Means*, U.S. House of Representatives, 19-cv-2173, U.S. District Court, District of Columbia (Washington), July 23, 2019.

2 As reported by *Reuters*, August 20, 2019.

> Clause concerns,' and (3) 'adjudicating the issues in this dispute only when it is actually ripe and has a fuller record than presently exists.' . . . Notwithstanding their best efforts, the parties are unable to reach agreement.

On another front, the State of California has passed a law requiring any candidate for president to disclose previously filed tax returns as a condition of appearing on California's primary ballot.[3]

The president sued the California secretary of state on August 6, 2019, in the U.S. District Court of the Eastern District of California, asking for Declaratory and Injunctive relief.[4] The suit states that California's Presidential Tax Transparency and Accountability Act is unconstitutional and that the Constitution sets the qualifications for president, vice president, the Senate, and the House of Representatives. The suit also states that according to the Constitution, states are limited in placing restrictions on candidates and that states are barred from passing laws in order to "retaliate" against a person, which the president contends is the purpose of California's law.[5]

S.A.L.T. DEDUCTION

New York, Connecticut, and New Jersey (the "Plaintiff States"), as well as the town of Scarsdale, N.Y., sued the I.R.S. and Treasury Department on July 17, 2019, over final rules meant to curb state workarounds to the $10,000 cap on state and local tax ("S.A.L.T.") deductions.[6] The June final rules[7] prohibit workarounds that states, including New York and New Jersey, established to combat the cap by allowing state tax credits for donations to newly created "charitable funds" aimed at a variety of state programs.

Change of Law

According to the Plaintiff States' complaint:

> Congress has historically provided a federal individual income tax deduction for state and local taxes, including an unrestricted deduction for all state and local income and property taxes (the 'SALT deduction'). On December 22, 2017, Congress made a radical break with that precedent, capping the SALT deduction at $10,000

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3 On July 30, 2019, California Governor Gavin Newsom signed into law the Presidential Tax Transparency and Accountability Act, also known as SB27. The law requires all candidates for president to disclose their previous five years of tax returns as a condition of appearing on a primary ballot.

4 Case 2:19-at-00705 Document 1 Filed 08/06/19.

5 On September 19, 2019, it was reported that U.S. District Judge Morrison England Jr. issued a temporary injunction from the bench, saying he will make a final ruling in the coming days but that Trump and other candidates could face "irreparable harm without temporary relief."

6 *N.J. v. Mnuchin*, S.D.N.Y., No. 1:19-cv-06642, complaint filed 7/17/19 and *Village of Scarsdale, N.Y. v. I.R.S.*, S.D.N.Y., No. 7:19-cv-06654, complaint filed 7/17/19.

7 T.D. 9864.

for individuals and married taxpayers filing jointly, and at $5,000 for married taxpayers filing separately.

This S.A.L.T. cap disproportionately harms taxpayers in the Plaintiff States and harms the states directly. The cap puts pressure on the Plaintiff States in a number of ways – making it more difficult as a practical matter for them to impose state taxes, depressing home equity value, reducing state tax revenue, and more. It also forces states to be accountable when authorizing cash expenditures when the Federal deduction for state income taxes is capped.

The S.A.L.T. limitation also has a spillover effect. The *Chronicle of Philanthropy* on July 22, 2019, reports that the proportion of individuals who claimed charitable deductions fell to 8.5% in 2018 from 24% in 2017. This is due to the fact that with the elimination of the S.A.L.T. deduction, fewer people are itemizing their deductions and are not claiming a charitable deduction.

Additionally, wealthy taxpayers relocating to so-called sunshine states with low or no state taxes has become popular, reflecting an easy means of self help. Exit taxes at the state level have issues under the Federal Constitution.

Evolution of State Countermeasures

To ease the burden on state taxpayers, the Plaintiff States amended their respective tax laws to enable taxpayers to make contributions to state- or locality-affiliated charitable funds in return for state or local tax credits. Under the programs, taxpayers receive a state or local tax credit for their contributions, thereby reducing their state tax liability. Under longstanding judicial and I.R.S. precedent, taxpayers may also deduct charitable contributions made pursuant to these programs in full from their Federal individual income taxes. Furthermore, because the programs do not provide dollar-for-dollar tax credits, they generate a net increase in revenue for state and local governments.

For years, states have maintained similar charitable tax credit programs. At least 33 states have created more than 100 such programs, and the I.R.S. has always permitted taxpayers to claim the full Federal charitable deduction for donations made pursuant to these programs. Of course, it is one thing for a state to provide a charitable deduction to finance designated eleemosynary activity. It may be another thing when the sole purpose of the "charity" is to get around a cap on a Federal tax deduction, as often stated by governors of the Plaintiff States.

In their complaint, the Plaintiff States say the final rules from the I.R.S. violate the Administrative Procedure Act, which provides rules on how executive agencies issue regulations, and the Regulatory Flexibility Act, which requires agencies to assess how regulations impact small government jurisdictions and other small entities.

Significantly, the Plaintiff Sates claim that the rules erroneously treat a S.A.L.T. credit as a quid pro quo, or direct exchange, when the taxpayer receives it in return for having made a charitable contribution. Tax credits are not actually "a thing of value" in gross income under the tax code and so cannot be treated as a return benefit. The Plaintiff States also argue that the new rules arbitrarily distinguish between tax benefits that come as deductions and benefits that come as credits and between donors who do and do not receive tax credits worth over 15% of the underlying donation.

Other Responses

Rep. Bill Pascrell (D-N.J.) and Sen. Bob Menendez (D-N.J.) introduced a bill in February to repeal the S.A.L.T. deduction cap and raise the top individual tax rate from 37% to its pre-tax law level of 39.6%. Reps. Sean Casten (D-I.L.) and Lauren Underwood (D-I.L.) wrote a bill that would not fully repeal the cap but would increase it to $15,000 for single filers and $30,000 for married couples.[8]

CONCLUSION

Politics on the national and local level in the U.S. have become a form of blood sport with no holds barred. Seeking publication of confidential tax returns, limiting tax deductions on the Federal level for state income taxes, and adopting workarounds as charitable activity are only the latest iterations.

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8 As reported by Naoi Jagoda, *The Hill*, 5/24/19.

CORPORATE MATTERS:

F.I.R.R.M.A. PROPOSED REGULATIONS EXPAND C.F.I.U.S. OVERSITE ON FOREIGN INVESTMENT

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Tags
Corporate Law
F.I.R.R.M.A.
Foreign Investment

INTRODUCTION

On August 13, 2018, the Foreign Investment Risk Review Modernization Act of 2018 ("F.I.R.R.M.A.") was signed into law after receiving broad bipartisan support in Congress. F.I.R.R.M.A. strengthens and modernizes the Committee on Foreign Investment in the United States ("C.F.I.U.S.") review process and marks the most sweeping changes to C.F.I.U.S. in over a decade. C.F.I.U.S. operates pursuant to Section 721 of the Defense Production Act of 1950. It is an interagency committee authorized to review certain transactions involving foreign investment in the U.S. ("covered transactions"). Its mandate is to determine the effect of such transactions on the national security of the U.S. and, where appropriate, to deny approval to the transaction. F.I.R.R.M.A. addresses national security concerns arising from certain foreign non-controlling investments and real estate transactions that previously fell outside C.F.I.U.S.'s jurisdiction.

At the time of adoption of F.I.R.R.M.A., C.F.I.U.S. was directed to consider the following matters in making its determinations:

- Does a foreign person engaging in a covered transaction with a U.S. business have a history of complying with U.S. laws?
- How likely is it that a covered transaction will expose personally identifiable information, genetic information, or other sensitive data of U.S. citizens to a foreign government or foreign person that may exploit that information in a manner that threatens national security?
- How likely is it that a covered transaction will exacerbate or create new cybersecurity vulnerabilities in the U.S. or is likely to result in a foreign government gaining a significant new capability to engage in malicious cyber-enabled activities against the U.S., including such activities designed to affect the outcome of any election for Federal office?

Given the timing of the enactment of F.I.R.R.M.A., it is likely that ongoing concerns about Chinese investment in the U.S. and the activities of Russia around the election played a significant part in its drafting.

More than one year after its enactment., the Department of the Treasury has now issued proposed regulations that would comprehensively implement F.I.R.R.M.A. The public has been given until October 17, 2019, to provide the Treasury Department with comments on the proposed regulations. The comment period concludes on October 17, 2019.

The F.I.R.R.M.A. statutory provisions and the regulations issued by the Department of the Treasury are laid out below.

EXTENDED C.F.I.U.S. JURISDICTION

C.F.I.U.S.'s jurisdiction to approve or disapprove a transaction is no longer limited to transactions that could result in foreign control of certain U.S. businesses. Under F.I.R.R.M.A., its jurisdiction covers certain foreign investments where the investment fails to provide the investor with control. In addition, F.I.R.R.M.A. expands the term "covered transactions" to include the following categories:

- Real estate transactions
- Non-controlling "other investments" that change a foreign person's rights
- Evasion

"C.F.I.U.S. is now able to review certain non-controlling investments by a foreign person in an unaffiliated U.S. business."

Consequently, C.F.I.U.S. is now able to review certain non-controlling investments by a foreign person in an unaffiliated U.S. business depending on the circumstances.

Factors to be Considered

Factors to be considered with regard to a non-controlling other investment include any of the following:

- Does the U.S. business own, manufacture, supply, or service critical infrastructure?
- Does the U.S. business produce or develop critical technologies?
- Does the U.S. business maintain or collect personal data of U.S. citizens that may be exploited in a way that threatens U.S. national security?

Other Investments

Other investments include any direct or indirect investment that would not otherwise qualify as a covered transaction but allows the foreign person to have certain rights and powers outlined below:

- Access to any material nonpublic technical information in possession of the U.S. business
- Membership or observer rights on the board of directors or equivalent governing body or the right to nominate a person to the board
- Involvement, other than voting of shares, in any substantive decision-making rights regarding the use and safekeeping of sensitive personal data of U.S. citizens, use development or management of critical infrastructure, or critical technology

Non-controlling transactions become covered transactions only when they involve U.S. critical infrastructure, critical technology, or personal data and at least one of the listed factors is present.

CRITICAL INFRASTRUCTURE

Critical infrastructure refers to systems and assets, whether physical or virtual, so vital to the U.S. that its incapacity or destruction would have a debilitating impact on national security. The term "critical technologies" includes, *inter alia*, the following items:

- Defense articles or defense services that appear on the U.S. Munitions List of the International Traffic in Arms Regulations
- Items that appear on the Commerce Control List of the Export Administration Regulations that are controlled by multilateral regimes (for reasons such as national security, chemical or biological weapons proliferation, nuclear non-proliferation, or missile technology) or for reasons relating to regional stability or surreptitious listening
- Nuclear equipment, facilities, materials, software, and technology subject to export regulations by the Department of Energy or Nuclear Regulatory Commission.
- Select agents and toxins
- Emerging and foundational technologies

Carve-Out for Investment in Certain Funds

A carve-out from the expanded definition of covered transactions is provided for investment in funds when certain requirements are met regarding control issues. A fund that affords a foreign person membership as a limited partner or equivalent on an advisory board will not be considered an other investment that triggers expanded C.F.I.U.S. review jurisdiction when all the following requirements are met:

- The fund is managed exclusively by a general partner, managing member, or equivalent that is not a foreign person.
- Neither the advisory board nor the foreign person has the ability to control investment decisions or other decisions related to entities in which the fund is invested, including veto rights.
- The foreign person cannot unilaterally control the hiring, dismissal, or compensation of the general partner.
- The foreign person does not have access to material nonpublic technical information as a result of its participation in the advisory board.

Real Estate

Under F.I.R.R.M.A., certain real estate transactions require C.F.I.U.S. approval. The real estate transactions covered under F.I.R.R.M.A. include those in which a foreign person leases or purchases private or public real estate either at an air or maritime port or in close proximity to a U.S. military base or other sensitive U.S. government facility. An exception is provided for real estate transactions related to single-family housing units or real estate in urbanized areas.

Change in Rights

A covered transaction now includes a foreign person whose rights have changed with respect to a U.S. business, if the change results in foreign control of the U.S. business or it meets the criteria of an "other investment" as defined above.

Evasion

Any transaction or arrangement that is designed or intended to evade or circumvent the jurisdiction of C.F.I.U.S. is subject to C.F.I.U.S. scrutiny.

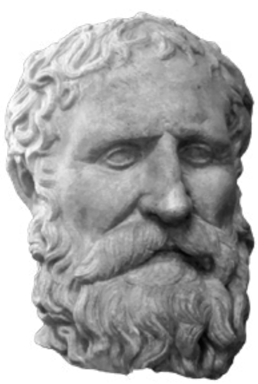
F.I.R.R.M.A. PILOT PROGRAM

In General

F.I.R.R.M.A. authorizes C.F.I.U.S. to conduct pilot programs to implement the F.I.R.R.M.A. provisions. In October 2018, interim regulations were issued to conduct a pilot program, which authorizes C.F.I.U.S. to review non-controlling foreign investments in U.S. businesses involved in critical technologies related to specific industries. The pilot program went into effect on November 10, 2018.

Investment Policy

In a set of Q&A's published in connection with the pilot program, the Treasury Department emphasized that the program does not single out any specific country. Rather, C.F.I.U.S.'s authorities may be applied to address the national security risks posed by foreign investment in the U.S. regardless of the place where an investment originates.



In addition, the Treasury Department reiterated that the U.S. welcomes foreign investment in the technology industry and maintains a strong commitment to the rule of law and the protection of intellectual property. Neither F.I.R.R.M.A. nor the pilot program changes this investment environment. C.F.I.U.S. will continue to assess, on a case-by-case basis through its current process and the pilot program, whether the facts and circumstances of a particular transaction (regardless of industry) pose a risk to U.S. national security.

The pilot program was adopted to enable C.F.I.U.S. to understand and examine, in a comprehensive manner, the nature of foreign direct investment as it relates to critical technologies and the select pilot program industries. The pilot program addresses ongoing risks to U.S. national security arising from the rapid pace of technological change in certain U.S. industries and the nature of some foreign investments aimed at affecting certain decisions regarding, or to obtain certain information relating to, critical technologies.

The pilot program will end no later than the date on which the regulations fully implementing F.I.R.R.M.A. become effective and in no event later than March 5, 2020, the date that is 570 days after the enactment of F.I.R.R.M.A.

Mandatory Reporting

Foreign investors are now required to file mandatory declarations for transactions that fall within the scope of the pilot program. The mandatory declarations are abbreviated notices that generally do not exceed five pages in length. The pilot program covers 27 specific industries, identified by their respective North American Industry Classification System code.

Pursuant to the pilot program, parties must determine whether a proposed foreign investment in a U.S. business triggers the mandatory declaration and, if so, decide whether the covered U.S. business is involved with critical technology related to the 27 industries covered under the pilot program. The 27 identified industries range from manufacturing operations for aircraft and space vehicles to high technology businesses focused on computer storage devices and semiconductor machinery. This includes the defense manufacturing industry with specific concern for military armored vehicles.

The pilot program was the first regulation implemented by the Treasury Department pursuant to F.I.R.R.M.A. The pilot program does not apply to non-controlling investments in critical infrastructure and sensitive personal data of U.S. persons, nor to real estate investments.

PROPOSED TREASURY REGULATIONS

The proposed regulations continue a largely voluntary reporting process, which involves filing a notice or submitting a short-form declaration notifying C.F.I.U.S. of a covered investment in order to receive a potential "safe harbor" letter. Once the letter is issued, C.F.I.U.S. generally does not initiate a review of a transaction except in certain limited circumstances.

Mandatory Filing

In certain circumstances, filing a declaration is mandatory. The regulations explain that a mandatory filing obligation exists for certain for specified covered transactions where a foreign government has a "substantial interest" in the investment.

Additionally, F.I.R.R.M.A. authorizes C.F.I.U.S. to mandate declarations for covered transactions involving certain U.S. businesses that produce, design, test, manufacture, fabricate, or develop one or more critical technologies.

The new provisions on covered investments only apply to investments in U.S. businesses involved in specified ways with critical technologies, critical infrastructure, or sensitive personal data – referred to as "T.I.D. U.S. businesses" for technology, infrastructure, and data.

Critical Technologies

The proposed regulations authorize C.F.I.U.S. to review transactions related to U.S. businesses that design, test, manufacture, fabricate, or develop one or more critical technologies.

The definition of critical technologies includes certain items subject to export controls and other existing regulatory schemes, as well as emerging and foundational technologies controlled pursuant to the Export Control Reform Act of 2018.

Critical Infrastructure

C.F.I.U.S. may review transactions related to U.S. businesses that perform specified functions, such as owning, operating, manufacturing, supplying, or servicing, with respect to critical infrastructure across subsectors including telecommunications, utilities, energy, and transportation. These functions are identified in Appendix I to this article.

Sensitive Personal Data

C.F.I.U.S. may review transactions related to U.S. businesses that maintain or collect sensitive personal data of U.S. citizens that may be exploited in a manner that threatens national security. Sensitive personal data is defined to include ten categories of data maintained or collected by U.S. businesses that meet any of the following criteria:

- The U.S. business targets or tailors products or services to sensitive populations, including U.S. military members and employees of Federal agencies involved in national security.
- It collects or maintains such data on at least one million individuals.
- It has a demonstrated business objective to maintain or collect such data on greater than one million individuals and such data is an integrated part of the U.S. business's primary products or services.

The categories of data include types of financial, geolocation, and health data, among others. Genetic information is also included in the definition regardless of whether it meets the criteria listed above

"Investments from all foreign persons remain subject to C.F.I.U.S.'s jurisdiction over transactions that could result in foreign control of a U.S. business."

Foreign Person and Excepted Investor

The proposed regulations create an exception from covered investments for certain foreign persons that are "excepted investors" based on their (i) ties to certain countries identified as "excepted foreign states" and (ii) compliance with certain laws, orders, and regulations.

Note that the proposed regulations do not except any person from control transactions previously subject to C.F.I.U.S. jurisdiction. Investments from all foreign persons remain subject to C.F.I.U.S.'s jurisdiction over transactions that could result in foreign control of a U.S. business.

Proposed Regulations Covering Real Estate Transactions

Types of Transactions Covered

The proposed regulations regarding real estate transactions cover the purchase or lease by, or a concession to, a foreign person of certain real estate in the U.S. that affords the foreign person three or more of the following property rights:

- The right to physically access the property
- The right to exclude physical access to another
- The right to improve or develop the property
- The right to affix structures or objects on the property

Voluntary Process

There is no mandatory filing requirement for real estate transactions. Parties may file a notice or submit a short-form declaration notifying C.F.I.U.S. of a covered real estate transaction in order to potentially qualify for a safe harbor letter that prevents

C.F.I.U.S. from initiating a review of the transaction except in certain limited circumstances.

Covered Sites

Coverage is focused on transactions in or around specific airports, maritime ports, and military installations. The relevant military installations are listed by name and location in Appendix II to this article. The relevant airports and maritime ports are on lists published by the Department of Transportation.

Locations Around Covered Sites

If real estate is located in or around a covered site, the following characteristics of the real property are relevant:

- Whether the real estate is, is within, or will function as part of an air or maritime port
- Whether the real estate is within close proximity (*i.e.*, one mile) of certain specified U.S. military installations
- Whether the real estate is within the extended range (between one and 100 miles) of certain military installations
- Whether the real estate is within certain geographic areas associated with missile fields and offshore ranges

Foreign Person and Excepted Real Estate Investor

The regulations create exceptions from coverage applicable for real estate transactions by certain foreign persons defined as "excepted real estate investors" based on their (i) ties to certain countries identified as "excepted real estate foreign states" and (ii) compliance with certain laws, orders, and regulations.

Urbanized Areas and Urban Clusters

The proposed regulations create exceptions from coverage for real estate transactions in an urbanized area or urban cluster, as defined by the Census Bureau. However, the exception does not apply to urbanized areas and clusters relating to relevant ports and those in close proximity to certain military installations.

Other Excepted Real Estate Transactions

The proposed regulations provide exceptions from coverage for certain real estate transactions:

- The purchase, lease, or concession of a single housing unit, as defined by the Census Bureau
- Transactions involving certain commercial office space in a multi-unit commercial office building

Interaction with Other C.F.I.U.S. Regulations

It should be noted that real estate transactions that are also subject to C.F.I.U.S.'s existing and proposed regulations regarding control transactions and non-controlling investments involving U.S. businesses are to be analyzed under those other regulations.

CONCLUSION

As previously mentioned, the comment period concludes on October 17, 2019. It is anticipated that final regulations will be issued soon after the close of the comment period. The target date for final regulations is not later than March 5, 2020, the date that is 570 days after the enactment of F.I.R.R.M.A.

U.S. TAXATION OF CLOUD TRANSACTIONS AND DIGITAL CONTENT TRANSFERS: 20-YEAR-OLD REGULATIONS FINALLY MOVE WITH THE TIMES

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BACKGROUND

Recently, the I.R.S. released proposed regulations for the classification of cloud computing transactions and proposed amendments to the existing computer software regulations of Treas. Reg. §1.861-18 (the "-18 Regulations").

Until now, when attempting to classify computer-based transactions, taxpayers only had the guidance of the -18 Regulations, which were proposed in 1996 and adopted in 1998 with minimal change. These rules have not kept pace with computer-based transactions, which are an ever-growing and evolving area. To put things in perspective, when the -18 Regulations were adopted, a typical internet connection could download 1GB in approximately 48 hours. Now, it takes less than 15 minutes. Oh, how times have changed.

The -18 Regulations, in their current state, provide rules for classifying transactions that involve "computer programs."[1] They apply to transfers of computer programs as well as to services relating to the development or modification of computer programs. As such, this does not have direct application to many of the internet-based transactions in which taxpayers engage daily (*e.g.*, streaming a movie on Netflix or storing data in Dropbox).

The proposed rulemaking addresses three aspects:

- It proposes amendments to the -18 Regulations that will extend the scope of the regulations to apply to transfers of digital content, which goes beyond computer programs.
- It proposes a new source rule for income from certain transactions covered under the -18 Regulations.
- It proposes to add Treas. Reg. §1.861-19 to address the classification of cloud computing transactions.

In the absence of I.R.S. guidance, and since the -18 Regulations did not apply, cloud computing transactions had previously been analyzed based on traditional characterization principles. With no transfer of property rights, cloud computing transactions have generally been treated as service transactions. The proposed regulations are consistent with such practical treatment, and thus, no economic impact is projected.

While the proposed regulations provide clarity as to the classification of cloud computing transactions as service transactions, they do not address the source rule for

[1] Computer programs are defined as a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result.

services in the cloud. Therefore, the existing uncertainty as to where income will be sourced continues. In the context of cloud computing, services can be deemed to take place where servers are located, where company personnel are located, or maybe where customers are located (or any combination of the above). Regrettably, the new proposed rulemaking does not offer clarity on that point.

PROPOSED CHANGES TO THE -18 REGULATIONS

Transfer of Digital Content

As mentioned above, the -18 Regulations currently apply only to transactions involving computer programs. The proposed amendment would replace all references to "computer programs" with "digital content" and thus broaden the scope of the existing regulations to apply to all transfers of "digital content." Digital content is generally defined as any content in digital format that is protected by copyright law and digital content that is not so protected solely due to the passage of time. The manner in which the content is transferred is immaterial to this determination.

As a result of the proposed amendment, transactions involving computer programs or content in digital format would generally be treated as one of the following:

- A sale transaction (which could be a sale of a copyrighted right or a sale of a copyrighted article)
- A licensing transaction (which could be a lease of a copyright right or a lease of a copyrighted article)
- The provision of services
- The provision of know-how

Under the -18 Regulations, when a transfer is involved and when most of the substantial copyrighted rights are transferred, the transaction is a sale of a copyright right. If most of the substantial rights are not transferred, the transfer is a lease. When no copyrighted right is transferred, the transfer is of a copyrighted article, and if the benefits and burdens of ownership are shifted, the transfer is a sale. Otherwise, the transfer is a lease. Generally, the copyrighted rights include three rights:

- The right to make copies
- The right to prepare a derivative
- The right to publicly preform or display

The proposed amendment clarifies that the mere transfer of the right to publicly perform or display digital content for the purpose of advertising the sale of the digital content, without transfers of other rights, does not constitute a transfer of a copyrighted right.

In the facts described in Example 19, one of the three new examples from the proposed regulations, the following transaction (which was probably written with Kindle in mind) describes a digital content transfer and would be classified as a sale of a copyrighted article under the existing -18 Regulations:

> “When a copyrighted article is sold through an electronic medium, the sale will be deemed to occur at the location of download or installation onto the end-user’s device.”

> Corp A operates a website that offers electronic books for download onto end-users’ computers or other electronic devices. The books offered by Corp A are protected by copyright law. Under the agreements between content owners and Corp A, Corp A receives from the content owners a digital master copy of each book, which Corp A downloads onto its server, in addition to the non-exclusive right to distribute for sale to the public an unlimited number of copies in return for paying each content owner a specified amount for each copy sold. Corp A may not transfer any of the distribution rights it receives from the content owners. The term of each agreement Corp A has with a content owner is shorter than the remaining life of the copyright. Corp A charges each end-user a fixed fee for each book purchased. When purchasing a book on Corp A’s website, the end-user must acknowledge the terms of a license agreement with the content owner that states that the end-user may view the electronic book but may not reproduce or distribute copies of it. In addition, the agreement provides that the end-user may download the book onto a limited number of its devices. Once the end-user downloads the book from Corp A’s server onto a device, the end-user may access and view the book from that device, which does not need to be connected to the internet in order for the end-user to view the book. The end-user owes no additional payment to Corp A for the ability to view the book in the future.[2]

A Customer-Based Source Rule

The amendment to the -18 Regulations includes a new source rule. It is proposed that when a copyrighted article[3] is sold through an electronic medium, the sale will be deemed to occur at the location of download or installation onto the end-user’s device. If this information is not available, the rule deems the location of the customer based on the taxpayer’s recorded sales data for business or financial reporting purposes.

This rule will create more effectively connected income (“E.C.I.”) for foreign taxpayers selling into the U.S. and who, until now, were confident they would not have E.C.I. as long as title did not pass in the U.S. and the income was not attributed to a U.S. fixed place of business or a permanent establishment. It is interesting to consider how this rule correlates to independent digital tax initiatives around the world, specifically France. These initiatives look to impose tax on revenues from digital services based on the location of the user and have been criticized for targeting U.S. multinationals. Now, the U.S. is itself imposing tax based on the location of the customer.

CLOUD COMPUTING TRANSACTIONS

New Prop. Treas. Reg. §1.861-19 governs the classification of “cloud transactions.” A cloud transaction is defined as a transaction through which a person obtains a non-*de minimis*, on-demand, network access to computer hardware, digital content, or other similar resources.

2 Prop. Treas. Reg. §1.861-18.

3 When no copyrighted right is transferred, the transfer is of a copyrighted article.

Under the proposed regulations, a cloud transaction can only be classified as either the provision of services or as lease of the resource to which access was granted (the "property"). A transaction may have the characteristics of both a lease and a service but should not be classified as two separate transactions when both aspects are part of an integrated transaction. When an arrangement involves multiple transactions, each should be viewed as a separate transaction and be analyzed independently, provided that it is not *de minimis*. The analysis of each separate transaction in the arrangement should be made under the appropriate set of rules, including the -18 Regulations and general tax law principles.

A cloud computing transaction would be treated as a provision of services under the proposed regulations when the factors relevant to the transaction, of the nine factors listed in the proposed regulations, are met.

This list of factors is non-exhaustive, and some may be irrelevant to a given transaction. The relevance of any factor depends on the factual situation. The list includes the following factors:

- The customer is not in physical possession of the property.
- The customer does not control the property, beyond the customer's network access and use of the property.
- The provider has the right to determine the specific property used in the cloud transaction and replace such property with comparable property.
- The property is a component of an integrated operation in which the provider has other responsibilities, including ensuring the property is maintained and updated.
- The customer does not have a significant economic or possessory interest in the property.
- The provider bears any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract.
- The provider uses the property concurrently to provide significant services to entities unrelated to the customer.
- The provider's fee is primarily based on a measure of work performed or the level of the customer's use rather than the mere passage of time.
- The total contract price substantially exceeds the rental value of the property for the contract period.[4]

The proposed regulations demonstrate in several elaborate examples the analysis of the listed factors.

Example 6 addresses a transaction that has more than one component; however, the second component is *de minimis* and thus does not require a separate analysis. The facts describe a cloud computing transaction (*i.e.*, on-demand network access to the computer hardware of a provider) that is treated as the provision of services. In the facts of the example:

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[4] Prop. Treas. Reg. §1.861-19.

> Corp A provides Corp B word processing, spreadsheet, and presentation software and allows employees of Corp B to access the software over the internet through a web browser or an application ("app"). In order to access the software from a mobile device, Corp B's employees usually download Corp A's app onto their devices. To access the full functionality of the app, the device must be connected to the internet. Only a limited number of features on the app are available without an internet connection. Corp B has no ability to alter the software code. The software is hosted on servers owned by Corp A and located at Corp A's facilities and is used concurrently by other Corp A customers. Corp A is solely responsible for maintaining and repairing the servers and software, and ensuring continued functionality and compatibility with Corp B's employees' devices and providing updates and fixes to the software (including the app) for the duration of the contract with Corp B. Corp B pays a monthly fee based on the number of employees with access to the software. Upon termination of the arrangement, Corp A activates an electronic lock preventing Corp B's employees from further utilizing the app, and Corp B's employees are no longer able to access the software via a web browser.[5]

Because (i) Corp B is not in physical possession of the property (the word processing, spreadsheet, presentation software, and servers), (ii) Corp B does not control the word processing, spreadsheet, presentation software, or servers, and (iii) the word processing, spreadsheet, presentation software, and servers are a component of an integrated operation in which the provider has other responsibilities, including sole responsibility for maintenance, repairs, software updates, and ensuring continued functionality and compatibility with Corp B's devices. Additionally, because (i) Corp A uses the servers concurrently to provide services to other customers and (ii) Corp A's fees are based not only on the passage of time but also on the level of use in connection to the number of employees with access to the software, (iii) the transaction is a service transaction. While the employees of Corp B download an app onto their devices, the app's main functions are only accessible when connected to Corp A's servers through the internet, and therefore, the download component of the transaction is considered *de minimis* and part of an integrated transaction that does not need to be separately analyzed.

No example is given in the proposed regulation to demonstrate when a cloud transaction is treated as a lease of property. It seems that in most cases, cloud computing transactions are anticipated to result in a provision of services categorization. Because services are sourced where the services are performed, this may create U.S.-source income where there was none before. Although one must wonder whether services would be deemed to take place where the servers are located (easily placed outside the U.S.), where company personnel is located (movable), or where customers are located (or any combination of the above).

CONCLUSION

The proposed regulations offer purported clarity. They formally apply the -18 Regulations to transfers of digital content. They propose a new source rule for transfers

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5 *Id.*

of copyrighted articles that will deem the customer’s location as the source. They generally provide that most cloud computing transactions are service transactions.

Yet, questions remain. Where are services deemed performed? Will the location of the servers be a factor? Or will European countries newest digital tax legislation influence the analysis and deem at least some of the services to be performed where the customers are located? How does the work location of company employees affect cloud transactions?

CRYPTOCURRENCIES — LATEST DEVELOPMENTS ON EITHER SIDE OF THE ATLANTIC AND BEYOND

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Tags
Compliance
Cryptocurrency
F.A.T.F.

BACKGROUND

> What is needed is an electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party. Transactions that are computationally impractical to reverse would protect sellers from fraud. . . . The system is secure as long as honest nodes collectively control more CPU power than any co-operating group of attacker nodes.[1]

This is how the developer(s), person(s) known under the pseudonym of Satoshi Nakamoto, described the aspirations that were embedded into the creation of cryptocurrency. The issues raised by virtual currency and, in the majority of cases, the underlying blockchain technology are manifold, including tax law, transfer pricing, regulatory rules, civil law accounting rules, and valuation. Notwithstanding their diversity, all legal, regulatory, and administrative areas affected by crypto-related technology share one common goal: protection of users and investors through the prevention of fraud and abuse. No matter which area is addressed, protection mostly involves application of rules designed for assets and related business models pre-dating the new technology. Because loopholes exist, cryptocurrency has become a refuge for tech-savvy criminals that have evaded regulators by choosing particular jurisdictions having little, no, or lenient regulatory oversight. This article provides an overview of recent initiatives globally and in the U.S. that are designed to counteract the dark side of crypto-related technology.

NEW ANTI-MONEY LAUNDERING RULES

In the common view of regulators, a balance must be drawn between personal and financial privacy and prevention of money laundering. The Financial Action Task Force ("F.A.T.F.") has taken the lead in this area. Established in 1989, F.A.T.F. is an intergovernmental organization consisting currently of 37 member countries[2] and two regional organizations.[3] It was created to set international anti-money laundering standards. Since July 1, 2019, F.A.T.F. is headed by a representative from China, who succeeded a representative from the U.S.[4] Some commentators call F.A.T.F. the "United Nations for fighting financial crimes." Since its inception, F.A.T.F. has

1 Satoshi Nakamoto, "Bitcoin: A Peer-to-Peer Electronic Cash System," Nakamoto Institute, October 31, 2008.

2 For a full list see F.A.T.F. Members and Observers.

3 The European Commission and the Gulf Co-operation Council.

4 The F.A.T.F. President is a senior official appointed by the F.A.T.F. Plenary from among its members for a term of one year.

developed a series of recommendations. Before June 2019, the most recent set of recommendations was published in 2012.[5] While regulatory recommendations of F.A.T.F. are not legally binding, member states are obligated to implement F.A.T.F. regulatory recommendations into enforceable local law. Including fully accredited members, over 200 jurisdictions are committed to carry out F.A.T.F. recommendations through a global network of F.A.T.F.-style regional bodies according to F.A.T.F.[6]

F.A.T.F. put forth highly anticipated new guidance in June of this year (the "Guidance"). It clarified 40 recommendations for national regulators overseeing virtual asset ("V.A.") and virtual asset service provider ("V.A.S.P.") activities.[7] Notably, it introduced a so-called travel rule calling for countries to require V.A.S.P.'s to comply with the same anti-money laundering and anti-terrorism standards generally applied to traditional financial institutions.

CRYPTOCURRENCY AND PRIVACY – THE ISSUE

Compared with traditional markets trading in stock and bonds, the cryptocurrency market is small and immature. However, the criminals trying to profit from it are among the most sophisticated in the world – reaping rewards at an estimated $4.26 billion from cryptocurrency exchanges, investors, and users just in the first six months of 2019.[8] Of great appeal to criminals is the capacity for anonymous, peer-to-peer value transfer of cryptocurrency. Technically, most cryptocurrency systems are pseudonymous, *i.e.*, users are identified publicly but only by a string of random numbers and letters. Since every transaction is recorded on a public ledger, criminals resort to a range of tactics, including using multiple addresses and exchanges, to cover their tracks.

In regulated jurisdictions like the U.S., Japan, and the E.U., exchanges that constitute bridges between the traditional financial system and the world of cryptocurrency include requirements to verify the identities users as part of a process commonly referred to as know your customer ("K.Y.C."). In other jurisdictions, exchanges may have less stringent policies in place that make it possible to move money or cash out without identification of their users. These may be referred to as T.B.E. jurisdictions, allowing exchanges to "turn a blind eye" on their customers.

RECOMMENDATION 16 – THE TRAVEL RULE

In applying Recommendation 16 under the Guidance, whenever a user of one exchange sends cryptocurrency worth more than $1,000 or €1,000 to a user of a

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5 The 2012 version of recommendations introduced Recommendation 15, "New Technologies." Inter alia, this recommendation provides that "countries and financial institutions should identify and assess the money laundering or terrorist financing risks that may arise in relation to (a) the development of new products and new business practices, including new delivery mechanisms, and (b) the use of new or developing technologies for both new and pre-existing products." At that time, Recommendation 15 did not refer to virtual currencies per se.

6 See F.A.T.F. table of regional bodies and members.

7 F.A.T.F., *Guidance for a Risk-Based Approach to Virtual Assets and Virtual Asset Service Providers*, (F.A.T.F.: Paris, 2019).

8 "Ciphertrace Q2 2019 Cryptocurrency Anti-Money Laundering Report: Thefts, Scams and Fraud May Exceed $4.26 Billion for the Year," Ciphertrace, 2019.

different exchange, the originating exchange must "immediately and securely" share identifying information about both the sender and the intended recipient with the beneficiary exchange (commonly referred to as the travel rule). That information should also be made available to "appropriate authorities upon request."

According to the F.A.T.F. Interpretive Note to Recommendation 16, originator and beneficiary information should include the following identifying information:

- Name and account number of the originator
- Originator's (physical) address, national identity number, customer identification number, or date and place of birth
- Name and account number of the beneficiary[9]

Cross-border transfers below the foregoing threshold also should include the names and account numbers of the originator and beneficiary. However, the identifying information need not be verified for accuracy in the absence of suspicion of money laundering or terrorist financing.

The rules that call upon exchanges of personal information are somewhat controversial. While some fear that restrictions affecting data privacy will tarnish the attraction of exchange traded cryptocurrencies for some customers, others see it as a chance to attract financial institutions as new investors.

Verified information exchange serves several purposes in addition to the deterrence of money laundering schemes. It removes an avenue for liquidity that might otherwise be enjoyed by individuals and organizations on global sanction lists. While this may function as a trust building measure for regulators, it adversely affects high-profit operations where yields on dark markets can be much higher for operators. However, the elimination of dark markets could, in the view of some commentators, result in an increase in prices for cryptocurrencies.

BINDING OR NOT BINDING?

As mentioned above, the Guidance does not rise to the level of law unless rules in line with the recommendations are implemented into domestic law by a country. Nonetheless, the effect of the Guidance is real. As witnessed recently at its June summit held in Osaka, Japan, the G-7 and influential members of the G-20 strongly expressed their commitment to the implementation of F.A.T.F. policy. In turn, this move pressures other countries to follow suit. Some pressure may be subtle. Other pressure is less subtle, as evidenced by a statement of U.S. Treasury Secretary Steve Mnuchin in which he called F.A.T.F.'s standards binding to all countries.[10]

Further developments point in the direction of enhanced safety standards in the crypto-related technology environment. In July, F.A.T.F. reportedly supported Japan's efforts to create an international cryptocurrency payments network. This new system would be similar to the global banking network known as S.W.I.F.T., which

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9 F.A.T.F., International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation, (F.A.T.F.: Paris, June 2019), p 79 *et seq*.

10 Steven T. Mnuchin, "Remarks of Secretary Steven T. Mnuchin FATF Plenary Session," June 21, 3019, Orlando, Florida.

employs an international messaging protocol used to prevent money laundering for bank-to-bank payments. A separate report released by Nikkei Asian Review in August indicates that 15 governments are planning to create a system for collecting and sharing personal data on cryptocurrency users.[11]

However, some commentators see the developments in a less shining light. They doubt that a government-led global cryptocurrency surveillance system currently is in the works and further doubt the effectiveness of any system that may emerge.

NOT NEW FROM A U.S. PERSPECTIVE

In some respects, the Guidance published by the F.A.T.F. is not unprecedented. Conceptually, it is the "crypto version" of a U.S. banking regulation also called the travel rule. It imposes a similar requirement on traditional financial institutions – albeit at the higher threshold of $3,000. Crypto exchanges in the U.S. are already been subject to this rule, according to recent pronouncements from the Treasury Department's Financial Crimes Enforcement Network ("FinCEN"). Plans to enforce the rule are expected to be implemented later this year. In May, FinCEN issued guidance on the application of its existing regulations to business models involving convertible virtual currencies ("C.V.C.'s").[12] For financial institutions subject to the Bank Secrecy Act ("B.S.A."), FinCEN guidance indicated that regulations relating to money services businesses apply to business models that involve money transmission in C.V.C.'s.

"Institutions that handle C.V.C.'s are on notice that the travel rule will be enforced."

The FinCEN guidance does not establish any new regulatory expectations or requirements. All rules have been in effect since 2013 and are unchanged. However, it provides important regulatory clarity that seeks to remove ambiguity ahead of enforcement actions. In particular, FinCEN reiterates that the travel rule applies to cryptocurrencies. Institutions that handle C.V.C.'s are on notice that the travel rule will be enforced.

The risk for these financial institutions is material as the list of cryptocurrency addresses on FinCEN's list of Specially Designated Nationals has grown significantly in recent months. Many of these addresses are marked as being possibly associated with the global drug trade.[13] According to the Kingpin Act,[14] U.S. companies and individuals are banned from any type of commercial relationship with addresses on the list as well as people connected to listed addresses.

In addition, the I.R.S. has begun to send letters to taxpayers with virtual currency transactions that may have failed to report income and gain from cryptocurrency transactions or did not report their transactions properly. In this context, I.R.S. Commissioner Chuck Rettig confirmed that the I.R.S. is determined to monitor compliance through tax examinations of identified traders on cryptocurrency exchanges. According to Mr. Rettig, the I.R.S. is expanding its examination efforts through

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11 "New Global Cryptocurrency System Set to Fight Money Laundering," *Nikkei Asian Review*, August 9, 2019.

12 FinCEN, Application of FinCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies, (FinCEN, 2019).

13 See the Office of Foreign Assets Control's sanctions list.

14 Foreign Narcotics Kingpin Designation Act, P.L. 106-20, enacted December 3, 1999.

increased use of data analytics to enforce U.S. tax law on trading profits and gains.[15] While this is in line with a Virtual Currency Compliance campaign announced by the I.R.S. on July 2, 2018, taxpayers and practitioners are still awaiting further guidance on interpretation of tax rules beyond the only explicit statement in this respect so far, I.R.S. Notice 2014-21. The latter states that virtual currency is property for Federal tax purposes.

CONCLUSION

According to a public statement released in conjunction with the Guidance, F.A.T.F. will conduct a 12-month review of implementation efforts of its member countries. It is expected that member countries will revise national laws and regulations to align with the Guidance. It remains to be seen whether this ambitious initiative will be implemented by countries, and if so, the speed of the implementation. Exchanges are still early in the process of identifying systems and technologies to securely handle sensitive data in a way that complies with a range of local privacy rules. F.A.T.F. seems to be juggling many balls at the same time when it comes to those involved in cryptocurrency trading.

In the U.S., taxpayers should be aware that once the I.R.S. begins a "campaign" directed to certain income or activity, its agents use the campaigns as a roadmap to conduct examinations. A campaign on virtual currencies was announced in 2018. It is anticipated that I.R.S. examiners will focus on virtual currency transactions when examining tax returns identified as potential campaign targets. The stakes for the I.R.S. are expected to be high, matching profits reportedly by those having taken long or short positions relating to cryptocurrency.

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15 I.R.S., "IRS Has Begun Sending Letters to Virtual Currency Owners Advising Them to Pay Back Taxes, File Amended Returns; Part of Agency's Larger Efforts," news release, July 26, 2019.

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Ruchelman P.L.L.C. is a boutique law firm based in New York City. It was founded in 1989 by an alumnus of a legacy firm that is now Deloitte's.

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