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INSIGHTS

FRENCH TREATMENT OF FOREIGN TRUSTS

BRACE YOURSELF, PILOTS: YOUR TAX HOME DOES NOT FLY WITH YOU

WHAT IS THE CORPORATE TRANSPARENCY ACT AND WHAT DOES IT MEAN FOR BUSINESS AND INCORPORATORS?

AND MORE

Insights Vol. 8 No. 1

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EDITORS' NOTE

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

- **French Treatment of Foreign Trusts.** The French Trust Register was introduced in December 2013 by a law enacted to stop tax fraud and serious economic and financial crimes. In October 2016, the French Constitutional Court ruled that public access to the Trust Register was unconstitutional. In the period since that decision, French authorities have issued two rulings allowing a broad class of persons to gain access to trust data. including tax officers, customs officials, professionals having compliance duties to combat money laundering and terrorist financing, journalists, and N.G.O.'s. Dimitar Hadjiveltchev, Partner, Adea Meidani, Counsel, and Loïc Soubeyran-Viotto, Associate, all of CMS Francis Lefebvre Avocats in Paris, address recent events regarding French tax treatment of foreign trusts and beneficiaries. They begin with the trust register – who must report, what must be reported and who have access – and move on to explain the myriad of taxes that may be imposed on trusts, settlors, and beneficiaries including income tax on distributions, inheritance and gift taxes, and real estate wealth tax.

- **What is the Corporate Transparency Act and What Does it Mean for Business and Incorporators?** The Corporate Transparency Act ("C.T.A.") was signed into law during the waning days of the Trump Administration. When effective, the C.T.A. will require businesses to disclose Beneficial Owner information to FinCEN at the time of company formation and when material changes are made in a subsequent year. Roxana Diaz, Corporate Administrator in the Miami Office of Corpag Registered Agents (USA), Inc., answers the eleven most important questions that affect persons incorporating a business and the professionals providing advice or assistance in the incorporation process.

- **Continued D.A.C.6 Reporting Obligations After Brexit.** At midnight on the December 31, 2020, the U.K. left the E.U., having secured a Free Trade Agreement ("F.T.A."). The farewell headline grabber in the drawn-out departure process relates to D.A.C. 6, the Mandatory Disclosure Reporting ("M.D.R.") rule that applies to Intermediaries. Beginning in 2021, the only reporting that will be required in the U.K. will involve the Category D Hallmark. It applies to fact patterns that are designed to hide ownership. Here, reporting will be required to maintain the integrity of the O.E.C.D. M.D.R. Gary Ashford, a Partner (non-lawyer) of Harbottle and Lewis L.L.P., London, explains the Category D Hallmark and the ongoing reporting requirements that apply to U.K.-based intermediaries after Brexit.

- **Brace Yourself, Pilots: Your Tax Home Does Not Fly With You.** The concept of a "tax home" is somewhat difficult to explain to persons resident outside the U.S. It has its origin in case law involving taxpayers who work at a temporary location for a finite, but long, period of time. Could the taxpayer deduct living costs incurred in the temporary location when the assignment bears a resemblance to a business trip, albeit for a much longer period of time. From there, it morphed into a requirement for U.S. expats wishing to

claim the benefit of the foreign earned income exclusion and its companion provision, the housing deduction. In the case of a pilot who flies between a rotation of airports, and in many instances, between a rotation of countries, what test is used to determine the pilot's tax home? Is it where the pilot happens to be at any time as is the rule for an itinerant worker? Is it where the pilot lives with his family? Is it the starting place for an outbound journey? Is it another place? Gianluca Mazzoni, who holds an S.J.D. '20 and L.L.M. '16 from the University of Michigan Law School, analyzes *Cutting v. Commr.*, a case involving a pilot. The article address the terms "*bona fide* resident" and "place of abode," each of which has a meaning for expats claiming the benefits mentioned above.

- **Form or Fizz? Coca-Cola Transfer Pricing Decision.** In *Coca-Cola Co. & Subsidiaries v. Commr.*, the taxpayer learned an important lesson for multinational groups using a residual profit split method to determine intercompany transfer prices. The factual underpinning of a residual profit split is critical to method selection, best method analysis, and selection of a reliable split metric when applying the method. In the case, the taxpayer relied on a favorable resolution of transfer pricing issues in an examination of earlier years and failed to confirm the continued existence of favorable facts. Michael Peggs explains all. Resolution of an examination does not provide the same certainty as an advance pricing agreement.

- **Tax 101: Taxation of Equity-Based Compensation and Cross Border Issues.** Equity-based compensation has long been a popular way to attract talent and align the interests of corporations and service providers. This type of compensation allows cash-poor companies to attract highly skilled individuals to join the company workforce or its board of directors. With mobility that existed in the pre-pandemic world, noncitizen individuals have moved to the U.S. becoming U.S. tax residents at the time of vesting or exercising conversion rights. Galia Antebi and Nina Krauthamer examine the tax rules in the U.S. Also discussed is the cross-border tax problem that arises when equity based compensation is taxed at different times in the home country and the U.S. and no effective mechanism is available to eliminate double taxation.

- **Does Powell Offer Taxpayers Meaningful Protection in Cross Border E.O.I. Requests?** In *Through the Looking-Glass*, Humpty Dumpty advises Alice that when he use a word it means just what he chooses it to mean – neither more nor less. The same may be true with regard to treaty based exchanges of information. When language in a treaty seems to prevent a treaty partner state from misusing the exchange of information provision, the affected individual may have no recourse to prevent the enforcement of an I.R.S. summons. Andreas A. Apostolides and Stanley C. Ruchelman explain that courts in the U.S. will not typically question the good faith of the foreign tax authority.

Enjoy the read!

- The Editors

FRENCH TREATMENT OF FOREIGN TRUSTS

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Tags
Beneficial Owners
Gift Tax
Income Tax
Inheritance Tax
Public Register
Real Property Wealth Tax
Tax Treatment
Trust
Trust Register
Wealth Tax

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INTRODUCTION

The centuries-old Anglo-Saxon legal concept of trusts, which allows assets to be held by trustees on behalf of beneficiaries, does not exist, *per se*, under French law.

Legal and tax treatment from the French perspective is uncertain since French law identifies one single person as the owner of property, except in the specific case of segregation between a life interest and bare legal ownership. Consequently, assessing taxes has been difficult for the French Tax Administration ("F.T.A.") when dealing with a trust where the settlor does not have the full control of assets, the trustee is managing assets on behalf of the beneficiary, and the beneficiary has an uncertain right to income and capital.

In the view of the F.T.A., legislation was needed to prevent trusts from being used as an instrument for tax avoidance purposes. The Finance Amendment Law no. 2011-900 of July 29, 2011 (the "2011 Law") was enacted to ensure that a taxpayer would be identified who would be responsible for the payment of French taxes. In order to ensure that the F.T.A. would have full knowledge of existing trusts in order to tax income and assets when and as due under the 2011 Law, reporting duties have been implemented and a French Trust Register has been created.

This article provides a general overview of the Trust Register, including access to confidential information, filing duties of the trusts, and the imposition of French tax in various circumstances.

FRENCH TRUST REGISTER

Characteristics of the French Trust Register

Implementing the Trust Register

The French Trust Register was introduced in December 2013 by a law[1] enacted to stop "tax fraud and serious economic and financial crimes." Once the law was enacted, an implementing decree was adopted by the Government on May 10, 2016,[2] making the Trust Register effective.

1 Law no. 2013-1117, December 6, 2013.

2 Decree no. 2016-567, May 10, 2016.

“[O]n October 21, 2016, the French Constitutional Court ruled that public access to the Trust Register was, unconstitutional because it infringed the fundamental right to privacy.”

Information to be Reported in the Trust Register

The Trust Register is managed by the F.T.A.[3] The Trust Register contains information provided in annual returns and returns that are due upon the happening of a specific event. It includes the following information on trusts that file returns:

- The trust’s name and address
- The date of establishment, and where appropriate, the date of termination
- The identification of the settlor, the beneficiary, and the trustee, based on the following standards:
  - If the settlor and the beneficiary are private individuals, the first name, last name, date, place of birth, and where appropriate date of death must be provided for the individual.
  - If the trustee is a private individual, the first name, last name, date of birth, and place of birth must be provided for the individual.
  - If the settlor, beneficiary, or trustee is a legal person such as a corporation, the legal name and the incorporation number must be provided for the corporation.

This information remains in the Trust Register for the duration of the trust’s existence and for ten years thereafter.

No information regarding the market value of the assets owned by the trust or the tax residence of the settlor, beneficiaries, and trustees is mentioned in the Trust Register.

Access to the Trust Register

Public access to the Trust Register originally was scheduled to begin as of July 4, 2016. Persons who were not tax residents of France were to be denied access to the Register. However, on October 21, 2016, the French Constitutional Court ruled that public access to the Trust Register was, unconstitutional because it infringed the fundamental right to privacy.[4] The data used to compile the Trust Register was supplied for tax purposes in good faith by affected persons who gave no permission for the information to be made public. In addition, the French Trust Register was deemed to be a disproportionate measure as it contained no limitations regarding access. No protection was offered regarding details of vulnerable beneficiaries such as children or elderly people.

Consequently, Article 10 of the ruling no. 2016-1635 of December 1, 2016[5] restricted access to the Trust Register to several government agencies authorized to combat money laundering and terrorist financing. Agencies that have access include Tracfin (the anti-money laundering unit), officers of the tax administration and customs officials having tax responsibilities, the Prudential Supervision and Resolution Authority (“A.C.P.R.”), and the Financial Markets Authority (“A.M.F.”).

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[3] The Public Finances Directorate General (“DGFiP”).

[4] Cons. Const. October 21, 2016, no. 2016-951 QPC.

[5] Rules which entered into effect on 3 December 2016.

Wider Access to the Trust Register and to Information on Beneficial Owners

In ruling no. 2020-115 ("the Ruling"), issued on February 12, 2020, unrestricted access to the Trust Register was given to police officers. In addition, tax and customs officials were given broader access to the Trust Register and can access it within the framework of duties other than tax collection.

The Ruling also provides restricted access to beneficial owner information to a wider range of people. As a result, any person may have access in the following set of circumstances:

- The person files a written request about a trust or any similar legal entity that holds a direct or indirect controlling interest in any company or other legal entity formed outside the European Union; control may exist through the ownership of bearer shares or arrangements of any kind, even if effected by means other than a shareholding.
- The person has a legitimate interest in the combatting money laundering or terrorist financing, such as journalists and non-governmental organizations.
- The person is a professional that is subject to compliance duties in terms of combatting money laundering or terrorist financing. Examples are banks and other financial institutions.

According to the French Tax Code ("F.T"C."), included as beneficial owners are the trustee, settlor, beneficiaries, protectors, and any other person having effective control of the trust, whatever that may mean. Information about beneficial owners include the following:

- Last name, first name, usual name, and alias
- The month and year of birth
- The country of residence
- Nationality
- A description of the beneficial interests held, which is yet to be defined

REPORTING REQUIREMENTS

Scope of Reporting Requirements

The 2011 Law introduced two mandatory reporting obligations for a trustee. One is an annual return and the other is a return triggered by the happening of an event. These returns must be filed in any of the following fact patterns that demonstrate a connection to France:

- The settlor or at least one of the beneficiaries is a French tax resident.
- Some of the assets held in trust are located in France.
- The trustee is established in France.

Amendments to the Filing Duties as From the Year 2020

The Ruling provides additional reporting duties for trustees established or located outside the European Union. The duties apply in each of the following circumstances:

- The trust purchases real estate located in France.
- The trust enters into a business relationship in France within the meaning of Article L. 561-2 of the French Monetary Code.

The French Monetary Code provides that the term "business relationship" refers to a professional or commercial relationship when the client is a professional that has a responsibility to prevent money-laundering and terrorist financing. and when the business relationship is meant to continue over a certain period of time. The contact may result from the execution of a contract or a pattern of activity that relies on the professional's participation in several transactions or a single transaction that is carried out over time.

Information provided through the annual return or a return upon the happening of an event will make its way to the Trust Register, thereby providing access to a broader class of user.

Yearly Filing

An annual return of the fair market value on January 1 of each year of the assets, rights, and capitalized income of the trust (and not only value of French real estate assets) must be filed by the trustee before June 15 of each year.

The annual return provides updated information[6] relating to the following items:

- The main characteristics of the trust, such as whether it is revocable or irrevocable
- Whether the trust is discretionary or the interests of the beneficiaries are fixed
- The governing law of the trust
- The names of the settlor, the beneficiary, and the trustee
- The allocation of the trust assets among beneficiaries

If the settlor or the beneficiaries are residents in France, all assets of the trust no matter where located must be declared. If none of the settlors or beneficiaries are residents in France, only French assets must be reported.

Filing Upon the Happening of a Specific Event

A return must be filed upon the setting up of the trust and upon any modification or termination of the trust. This return should be filed within one month following the event. Trustee should adopt internal procedures to ensure compliance with this short deadline for filing.

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[6] Art. 369 A of Annex II of the F.T.C.

The term “modification of the trust” includes, *inter alia*, any changes in (i) the terms of the trust, (ii) the way it is managed, (iii) assets owned, (iv) source of income, and (v) any other item that has an impact on the trust structure.

> *“Broadly speaking, it appears that distributions of income are taxed, but distributions of the initial capital are not taxed. However, the F.T.A. has not formally addressed the distribution of original capital. . .”*

The obligation to file a return upon the happening of an event is separate from the obligation to file the annual return.[7] The following information must be disclosed in the return triggered by an event:

- The nature and date of the event generating the reporting obligation
- A precise description of assets and rights held in trust
- If the event is the transfer of assets or rights to the trust, the full identity of the contributing
- In the event of a distribution to a beneficiary, the identity of the beneficiary[8]

Penalties

In the event of a failure to comply with the reporting obligations, penalties may be imposed. They include

- the assessed tax may be increased by 80%,[9] and the minimum penalty is €20,000, and
- a penalty of up to €20,000 per year, per return not filed.

The statute of limitations for the reporting obligations is four years following the year of the filing. The settlor is jointly and severally liable with the trustee for the payment of the penalty. The penalties provide a negative incentive for trustees to report information that has a link to France. Trustees should consider the revision of client mandates to allow for compliance.

FRENCH INCOME TAX

Distribution of Trust “Proceeds”

Distributions of proceeds to a French resident beneficiary are subject to a 30% flat-rate tax consisting of a 12.8% income tax and a 17.2% social charge. Broadly speaking, it appears that distributions of income are taxed, but distributions of the initial capital are not taxed. However, the F.T.A. has not formally addressed the distribution of original capital, and might conclude that all distributions by a French resident beneficiary should be taxed even if they represent the initial capital contribution. Official guidance would be helpful. Until guidance is issued, it may be prudent (i) for the trust to maintain separate accounts for income and capital and (ii) for distribution resolutions to specify the source of the distribution.

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[7] The inventory of assets and their respective market value only need to be reported in the annual return.

[8] Art. 369 of Annex II of the F.T.C.

[9] Art. 1729-0 A F.T.C.

Risk of Application of French C.F.C. Rules

France has enacted rules regarding Controlled Foreign Companies ("C.F'C.'s") that are owned by French resident individuals.[10] These rules apply when

- a French tax resident owns a participation of at least 10% in a foreign entity that may be a company, a trust, or any similar structure;
- the assets of that entity consist mainly of financial assets; and
- the entity benefits from a preferred tax regime. A tax regime is considered to be preferred if it leads to an actual tax burden that is less than 40% of the tax that a corporation would pay in France in the same circumstances.

When these conditions are met, the French tax resident is liable to tax with respect to all profits of the foreign entity, even if not distributed.

When a person is a beneficiary or a settlor of a foreign trust, questions arise as to the way the 10% participation condition applies and whether different results are realized when (i) the trust is revocable or irrevocable or (ii) the interests of the beneficiaries are fixed or discretionary. The Paris Administrative Court of Appeal recently ruled that a person who is a beneficiary of an irrevocable, discretionary trust could not be considered as having a 10% participation pursuant to Article 123 *bis* of the F.T.C.[11]

FRENCH INHERITANCE AND GIFT TAXES

Prior to 2011, the F.T.A. faced difficulty in characterizing transfers made through a trust as a taxable transfers subject to inheritance tax. In certain fact patterns, the transfers of assets were exempt from inheritance tax because they could not be characterized as gifts during life or transfers at death under the rules in effect at the time including applicable case law.

The 2011 Law introduced *sui generis* transfer duties in respect of inheritance tax applicable on the death of the settlor. These *sui generis* transfer duties apply upon (i) the transfer of property, (ii) a modification of rights, or (iii) accumulated income tis allocated to capital.

Inheritance and Gift Tax Rules in France

Regarding inheritance and gift taxes, French law[12] targets assets or rights held in a trust, as well as the income that has been accumulated and allocated to capital in the trust. Subject to applicable inheritance tax treaties, French inheritance tax is imposed on

- all assets and all accumulated income when (i) the settlor is resident in France or (ii) the beneficiaries are residents in France and have been residents during six or more years over the most recent ten years; or
- only assets and accumulated income located in France when the settlor and the beneficiaries are not residents in France.

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10 Article 123 *bis* of the F.T.C.

11 Paris Administrative Court of Appeal, 24 June 2020, case no. 19 PA00458.

12 Art. 750 *ter* F.T.C.

The 2011 Law identified the death of the French resident settlor as the triggering event. The tax is triggered even if the assets are not actually distributed to beneficiaries. Moreover, where the initial French resident settlor is dead, the French resident beneficiaries become deemed settlors and when the deemed settlors die, the French resident beneficiaries at the time become deemed settlors. In this way, where the assets remain in the trust for several generations, each generation of French resident beneficiaries is subject to inheritance taxes.

Two situations must be distinguished:

- The first involves a transfer from a trust that can be treated as a gift or inheritance under French law. Most advisers are of the opinion that a gift or an inheritance occurs only when assets are distributed outright to the beneficiaries at the time of death. Here, French gift of inheritance taxes apply according to standard rules. The surviving spouse or civil union partner is exempted from death duties. A progressive scale of up to 45% applies to heirs that are descendants of the settlor.

- The second involves a transfer from a trust that cannot be treated as a gift or inheritance under French law. Under that assumption, a *sui generis* transfer tax applies in accordance with the terms of transfer provided for by the trust deed. This is addressed in the appendix to this article.

  - Where a specific share of the trust assets is due to a single designated beneficiary, the inheritance tax is levied according to the family link between the beneficiary and the dead settlor.

  - Where a specific share of the trust assets is payable to a class of persons, such as descendants of the settlor, without any possibility to allocate the assets among such descendants, the gift or inheritance tax will be calculated at the rate of 45%.

  - In all other cases, if the assets pass to a trust whose beneficiaries are unascertainable, the gift or inheritance tax will be calculated at the rate of 60%.

Consequently, it is essential for trustees to pay very close attention when drafting the trust deed specify shares of specific beneficiaries to provide results achieving the lowest possible taxation.

Avoidance of Double Taxation

In fact patterns where the imposition of French inheritance and gift taxes are subject to the France-U.S. Inheritance, Estate and Gift Tax Treaty ("the Treaty"), a question arises whether the *sui generis* transfer duties are covered by the Treaty.

In this respect, the tax authorities have confirmed that whether or not the transmission qualifies as a gift or inheritance, the existence of the trust does not affect the application of international tax treaties[13] in case of juridical double taxation (*i.e.*, the same inheritance is taxed in more than one Member State). The F.T.A. relies on the

[13] Tax treaties on inheritance or gift taxes: BOI-ENR-DMTG-30 no. 40; 16/10/2012. Moreover, the Treaty provides that the latter applies to French inheritance and gift duties and to any *substantially similar taxes* on estates, inheritances, and gifts that either country may subsequently impose.

concept of juridical double taxation to determine if the elimination of double estate taxation (Article 12 of the Treaty) can apply. As a rule, double taxation can only be eliminated when a person is taxed in respect of the same assets by more than one State.

The Treaty does not contain any specific provisions on trusts. Consequently, many advisers believe that the treaty rules on the allocation of the right to tax must apply in the same way as if the assets were held directly by the settlor. The Treaty provides that immovable and tangible assets (other than cash) should be taxed in the State where physically located. Intangible assets such as securities and cash are taxable in the State of domicile of the decedent.[14] Thus, intangible assets held within a trust should be taxable in the U.S. as long as the settlor was domiciled in the U.S. at the time of death.

FRENCH REAL ESTATE WEALTH TAX

"French wealth tax may be imposed on the settlor or the deemed settlor of the trust. Wealth tax applies only to the value of real estate held directly or indirectly."

French wealth tax may be imposed on the settlor or the deemed settlor of the trust. Wealth tax applies only to the value of real estate held directly or indirectly. Actual taxation occurs if the overall net taxable value of the real estate ultimately held by the individual exceeds €1.3 million.[15] Wealth tax is calculated by applying a progressive scale of up to 1.5%. When the settlor is a French tax resident, wealth tax applies to his real estate assets located in France or abroad, including all real estate assets held directly or indirectly through a trust.

When the settlor is not resident in France, he is liable to French wealth tax only with respect to real estate located in France. When the assets are held in France and abroad, segregation must be made between French and non-French assets.

A settlor who is liable to French wealth tax must file a French wealth tax return on a yearly basis. If the settlor does not comply with these filing duties, a specific tax equal to 1.5% is assessed on the real estate's net market value and is due by the trustee. However, there is no cumulation of the 1.5% tax and the real estate wealth tax on the same assets.

In principle, French real estate wealth tax is subject to applicable tax treaties. In practice, only a few treaties deal with wealth taxes. One such treaty is the France-U.S. Income Tax Treaty.[16] It provides that US citizens that move their residence to France would be liable to French wealth tax in respect to foreign real assets only following five years of residence in France.[17]

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[14] Art. 8 of the France-U.S. Estate, Inheritance and Gift Tax Treaty. Special rules apply to U.S. citizens domiciled in France.

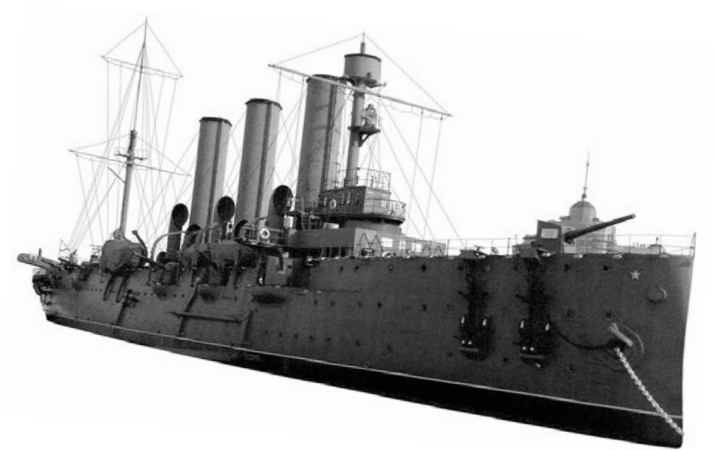
[15] Art. 964 F.T.C.

[16] See paragraph 1(b)(iv) of Article 2 (Taxes Covered) of the France-U.S. Income Tax Treaty.

[17] See paragraph 6 of Article 23 (Capital) of the France-U.S. Income Tax Treaty.

CONCLUSION

For years, French law contained no provision to integrate the concept of a trust into its tax laws. Whether income, inheritance, or wealth taxes, the identities of the settlor and the beneficiaries were held in confidence. This changed beginning in 2011 when France enacted the Trust Resister. In the intervening 10 years, much has happened. Information must be reported, nongovernment persons have access to information, inheritance and gift taxes can be imposed each time property passes from one generation to the next, and wealth taxes were imposed. Clearly, major changes have occurred over a relatively short period of time.



APPENDIX

Summary
Trust Inheritance Taxation According to French Law

<table>
<tr><th colspan="2">Legal Classification</th><th>Taxation Rate</th><th>Trustees' Liability for Tax Payment</th></tr>
<tr><td colspan="2">I. Legal classification of gift or inheritance</td><td>Tax rate according to the family ties between the settlor and the beneficiary.</td><td>Not Liable</td></tr>
<tr><td rowspan="3">II. Sui Generis Levy: Applicable when the transfer cannot qualify as gift, or inheritance, or when the assets remain in the Trust after the death of the settlor(s).</td><td>a) Transfer of a defined share of assets, rights, or income capitalized in the trust to a defined beneficiary</td><td>Tax rate according to the family ties between the settlor and the beneficiary.</td><td>Not Liable</td></tr>
<tr><td>b) Global transfer of a defined share of assets, rights, or income to the trust to several descendants</td><td>45%</td><td>Liable</td></tr>
<tr><td>c) Other cases</td><td>60%</td><td>Liable</td></tr>
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WHAT IS THE CORPORATE TRANSPARENCY ACT AND WHAT DOES IT MEAN FOR BUSINESS AND INCORPORATORS?

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Beneficial Owner
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INTRODUCTION

Businesses and incorporators will be faced with the Corporate Transparency Act (“C.T.A.”), which is contained within the National Defense Authorization Act and is designed to take actions against illegal activities conducted through anonymous shell companies by requiring the reporting of the identity of the Beneficial Owners of companies, subject to certain exceptions. This article answers the eleven most important questions that affect clients that are incorporating a business and the professionals providing advice or assistance in the incorporation process.

1. What information must be reported?

Under the C.T.A., businesses will need to disclose the “Beneficial Owner” information to the Financial Crime Enforcement Network (“FinCEN”) at the time of the formation of the company and with the annual filings to report ownership changes made during the prior year.

2. What information is required to be reported and when?

The information that must be reported regards the Beneficial Owner of the company. A “Beneficial Owner” is a natural person who

- exercises substantial control over a company,
- owns 25% or more of the equity interests of a company, or
- receives substantial economic benefits from the assets of a company.

3. Where a discretionary trust meets the ownership threshold for a company, how will the ownership of the company’s shares be attributed among the beneficiaries?

While no guidance yet exists on the attribution of shares from a discretionary trust to discretionary beneficiaries, the simplest and most effective approach is for the trustee to report on each living beneficiary, including newborn grandchildren. This alternative would match recent experience with K.Y.C. reporting applicable to bank accounts owned by trusts, where information on each beneficiary is provided. However, it would provide a glut of useless information. Other possibilities exist. One example is to look at past distribution patterns. Another might be to look at the intestacy laws that apply in the country of domicile when all beneficiaries are family members. A third is to look at a nonbinding letter of wishes drafted by the settlor. The common problem with such other methods is that all such methods can be gamed by the settlor.

4. What information must be reported at the time of formation?

At the time of formation, the company must file a list of its Beneficial Owners with FinCEN. The list must include the same information that financial institutions are required to collect under FinCEN's Customer Due Diligence rule. This is for each Beneficial Owner:

- The full legal name
- Date of birth
- Current residential or business address
- Current identification number, such as a driver's license or passport number

The applicant is also required to provide his or her information, even if he or she is not a Beneficial Owner. This means that lawyers, accountants, and others who form reporting companies for clients will be required to report their personal information. To protect themselves, and avoid legal problems in the future, applicants will want to know their clients before forming companies on their behalf.

5. Is information available to the public?

No. FinCEN is a bureau of the U.S. Department of the Treasury. FinCEN's mission is to safeguard the financial system from illicit use and combat money laundering and promote national security through the collection, analysis, and dissemination of financial intelligence and strategic use of financial authorities. Federal, state, local and tribal law enforcement would have access to the information for use in authorized investigations as would financial institutions (with customer consent) that have legally mandated anti-money laundering obligations.

6. What information must be reported annually?

An Annual Report must be filled with FinCEN. The company must report a current list of its Beneficial Owners as well as a list of any changes in the beneficial ownership that occurred during the previous year.

7. Are obligations imposed on States?

Yes. It would be mandatory for the States to inform any applicant seeking to form a company of the obligations to report the information regarding the Beneficial Owners.

8. Who must report?

The type of entities required to report are corporations, limited liability companies, or other similar entities that are

- created by the filing of a document with a secretary of state or a similar office under the law of a state of Indian Tribe, or
- formed under the law of a foreign country and registered to do business in the United States by the filing of a document with a secretary of state or a similar office under the laws of a state or Indian Tribe.

9. What companies are exempted from reporting?

In several fact patters, companies are exempted from reporting information. The most significant exception is for active businesses. A company will not be required to report the information stated in the C.T.A. if the entity

- employs more than 20 employees on a full-time basis in the United States,
- filed in the previous year Federal income tax returns in the United States demonstrating more than $5 million in gross receipts or sales in the aggregate, including the receipts or sales of (i) other entities owned by the entity and (ii) other entities through which the entity operates, and
- has an operating presence at a physical office within the United States.

While this exception may not exclude small businesses, it will exclude many active businesses from the requirement to report Beneficial Owners to FinCEN on an annual basis. Among the other types of entities that are exempt from reporting are

- public companies under the Securities Exchange Act of 1934;
- churches, charities, nonprofit entities, and any other entity that qualifies for tax-exempt status under sections 501(a), 527, or 4947(a)(1) of the Internal Revenue Code; and
- other companies that already have certain reporting obligations to regulatory bodies. Examples include, insurance companies, banks, Federal or State regulated credit unions, investment companies under the Investment Company Act of 1940, registered public accounting firms, and public utilities.

Although exempt from fling the Beneficial Owners information, an exempt entity must file a written certification with FinCEN identifying the specific applicable exemption, while providing the applicant's information at the same time. Existing entities that qualify for an exemption have two years from the date of issuance of the final regulations to file the required certification with FinCEN stating that it is exempt.

10. When will the C.T.A. become available?

The C.T.A. will not become effective until US Treasury issues regulations, which may not happen until late this year. This will give the business community time to study the C.T.A., consult with their lawyers, and determine how best to comply.

11. What is the penalty for failing to report the information?

It is unlawful under the C.T.A. to

- knowingly file false Beneficial Owner information to FinCEN, or
- willfully fail to provide complete or updated Beneficial Owner information to FinCEN.

Violations are subject to a civil penalty of not more than $10,000 and criminal penalties under title 18 of the U.S. Code, which can include fines and imprisonment for not more than 3 years. Negligent violations are not penalized. Moreover, a waiver process is provided for violations that are due to reasonable cause and not due to willful neglect, which is modeled on the Internal Revenue Service waiver process for

companies' SS-4 filings. Penalties are also provided for unauthorized disclosures or misuse of beneficial owner.[1]

CONCLUSION

For many years, European bankers and their colleagues in the offshore community have complained that the U.S. is the last holdout among countries when it comes to collecting ownership information for corporations. Whether these statements are accurate is open to debate, as the U.S. uses the banking system to identify owners of companies with accounts in the U.S. Once the C.T.A. reporting system comes online, the U.S. will collect information that will be submitted to FinCEN. However, because information submitted to FinCEN is not disseminated publicly, one might expect the complaints of naysayers to continue, but in modified form.

"For many years, European bankers and their colleagues in the offshore community have complained that the U.S. is the last holdout among countries when it comes to collecting ownership information for corporations."

[1] "FACT Sheet: A Brief Summary of The Corporate Transparency Act (Title LXIV of the NDAA, H.R. 6395)," December 17, 2020.

CONTINUED D.A.C.6 REPORTING OBLIGATIONS AFTER BREXIT

Author
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Tags
Category D
DAC6
Hallmark
Mandatory Disclosure Reporting

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INTRODUCTION

At midnight on the December 31, 2020, the U.K. left the E.U., having secured a Free Trade Agreement ("F.T.A."). This occurred in the context of four years of political discussion, several Parliaments, two Prime Ministers and what amounted to two Withdrawal Agreements (but eventually only one F.T.A.). There is no doubt that Brexit has significant implications on the U.K. International V.A.T. rules. Prior to the U.K. exit, V.A.T. was essentially an E.U. administered tax by virtue of the V.A.T. Directive, and continues for the 27 Member States remaining in the E.U. However, the headline grabber relates to the E.U. Directive of Administrative Cooperation ("D.A.C.") known as D.A.C. 6.

E.U. DIRECTIVE OF ADMINISTRATIVE COOPERATION ("D.A.C.")

Rules Through December 31, 2020

The E.U. D.A.C. is one of the key tools E.U. membership countries use to exchange information automatically. Over the years, six different directives have been issued by the European Commission. All of them relate to mandatory exchanges of information designed to shine a light on aggressive tax planning.

- The first D.A.C. (2011/16/E.U.) was introduced in 2013 and provided for automatic exchange of investment interest information by financial institutions where a resident of one Member State held an investment account in another. This D.A.C., now referred to as D.A.C.1, was updated in 2015 to allow for the automatic exchange of information of employment income, directors fees, pensions, life insurance products and immovable property.
- D.A.C.2 (2014/107/E.U.) was introduced in 2016 to effectively implement the O.E.C.D. Standard for Automatic Exchange of financial account Information in Tax Matters, commonly known as the Common Reporting Standard ("C.R.S.").
- D.A.C.3 (2015/2376/E.U.) introduced the automatic exchange of advance cross border tax rulings and advance transfer pricing arrangements in 2017.
- D.A.C.4 (2016/881/E.U.) was also introduced in 2017. It introduced automatic exchanges of country-by-country reporting, the method by which headcount, assets, and income must be reported by large corporate groups.

- D.A.C.5 (2016/2258/E.U.) brought in the mechanism to hold and exchange information regarding beneficial ownership of vehicles used in cross border tax plans. In the U.K. there are registers on both corporate and trust beneficial ownership.

- D.A.C.6 (2018/822/E.U.) implements B.E.P.S. Action12, relating to Mandatory Disclosure Reporting ("M.D.R.") by Intermediaries.[1] The implementation of D.A.C.6 has been postponed a number of times because of COVID19. The current U.K. reporting deadlines are as follows.

  - For reportable arrangements where the first step was implemented between June 25, 2018, and June 30 ,2020, the deadline February 28, 2021.

  - For arrangements made available or implemented between July 1, 2020, and December 31, 2020, the deadline is January 30, 2021.

  - For arrangements which become reportable after January 1, 2021, the deadline is 30 days from the triggering event. E.U. intermediaries are required to identify and report upon cross-border arrangements which fall within Hallmarks A to E., some of which are reportable only where obtaining a tax advantage is the main purpose for entering an arrangement.

INFORMATION REPORTING UNDER D.A.C.

Under D.A.C.6, an arrangement will be reportable if it meets at least one of several hallmarks. The hallmarks are delineated by category. Some hallmarks within the various categories must meet a main benefit test; others not. Briefly, the categories of hallmarks that trigger D.A.C.6 reporting are as follows:

Category A

- *Confidentiality* – Arrangements where the participant or taxpayer enters into a confidentiality agreement that prevents disclosure to other intermediaries or tax authorities of information describing how the arrangement could result in a tax advantage. This hallmark is subject to the main benefit test.

- *Premium Fee Arrangements* – Arrangements where the intermediary fee is based on the tax saved or a similar advantage gained. This hallmark is subject to the main benefit test.

- *Standardized Documentation* – Arrangements involving standardized documentation without substantial customization. This hallmark is subject to the main benefit test.

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[1] See Ashford, Gary, "U.K. Mandatory Disclosure Regime (DAC6)," *Insights* 7, no. 3 (2020): p.11.

Category B

- *Loss Buying – Arrangements* involving buying a loss-making company to reduce the tax liability. This hallmark is subject to main the benefit test.

- *Conversion of Income to Capital* – Arrangements which have the effect of converting income into capital gains or another type of income that is taxable at lower rates. This hallmark is subject to the main benefit test.

- *Circular Transactions* – Arrangements involving circular transactions with little or no commercial function. This hallmark is subject to the main benefit test.

Category C

- *Cross Border Arrangements with Abusive Facts* - Transactions between associated enterprises where any of the following facts exist:

    - The recipient has no tax residence. Here, the hallmark is not subject to main benefit test.

    - The country of tax residence has a zero or close to zero corporation tax rate. The hallmark is subject to main benefit test.

    - The country is included in the O.E.C.D. list as being a non-cooperative jurisdiction. The hallmark is not subject to main benefit test.

    - The payment is exempt from tax in the hands of the recipient in the jurisdiction of receipt. The hallmark is subject to main benefit test.

    - The payment benefits from a preferential tax regime in the jurisdiction of receipt. The hallmark is subject to main benefit test.

- *Double Deduction Arrangements* – Arrangements involving deductions in more than one jurisdiction. The hallmark is not subject to the main benefit test.

- *Double Reliefs from Double Taxation* – Arrangements involving the claiming of relief from double taxation on the same item in more than one jurisdiction. The hallmark is not subject to the main benefit test.

- *Inconsistent Values for Same Transaction* – Arrangements involving the transfer of assets where there is a material difference in the amount treated as payable in consideration for the assets in the jurisdictions involved. The hallmark is not subject to the main benefit test.

Category D

- *Transactions to Evade Reporting* – Arrangements which have the effect of undermining the rules on beneficial ownership or any other equivalent agreement on automatic exchange of financial account information or arrangements structured to take advantage of the absence of such automatic exchanges of information. The hallmark is not subject to main benefit test.

- *Hidden Ownership* – Arrangements involving a nontransparent legal or beneficial ownership chain with the use of persons, legal arrangements, or structures that

- do not carry on a substantive economic activity supported by adequate staff, equipment, assets, and premises; and
- are incorporated, managed, resident, controlled or established in any jurisdiction other than the jurisdiction of residence of one or more of the beneficial owners of the assets held by such persons, legal arrangements, or structures.

This hallmark is not subject to the main benefit test.

Category E

- *Abusive Transfer Pricing* – Arrangements concerning transfer pricing, including the use of unilateral safe harbors in one of the jurisdictions, or the transfer of hard-to-value intangible assets when no reliable comparable transactions exist, and the projection of future cash flows or income are highly uncertain. This hallmark is not subject to the main benefit test.

CHANGE IN U.K. RULES AS OF JANUARY 1, 2021

Brave New World

On December 29, 2020, H.M.R.C. announced that reporting under D.A.C.6 will be limited to Hallmark D. That hallmark involves fact patterns that are patently designed to hide ownership. Under the F.T.A., the U.K. undertook an obligation to avoid weakening or reducing the level of protection below the level provided for by the standards and rules which have been agreed in the O.E.C.D. in relation to the exchange of information concerning potential cross-border tax planning arrangements. The standard referred to is the O.E.C.D.'s model M.D.R.

While the U.K. has not implemented the O.E.C.D. M.D.R. in domestic legislation, existing rules that were designed to transpose D.A.C.6 into U.K. domestic law were in existence on December 31, 2020. Those rules will be revised so that they are limited to reporting Category D transactions. In principle, by retaining Category D reporting, the U.K. will meet the requirements of the F.T.A.

H.M.R.C. has announced that it will announce a period for consultation on draft legislation designed to implement the O.E.C.D. M.D.R.

Continued Reporting Under Category D Hallmark

Hallmark D is not linked to the main benefit test. If arrangements come within the Hallmark D, they are reportable regardless, regardless of the importance to the arrangement.

As mentioned above, the O.E.C.D. standard for M.D.R. must be part of the anticipated U.K. legislation. The O.E.C.D. introduced guidance on March 9, 2018, in relation to mandatory reporting. The M.D.R. effectively requires the reporting of two arrangements. One relates to the avoidance of C.R.S. reporting. The other relates to opaque structures.

C.R.S. Avoidance Arrangements

Here, reporting involves the automatic exchange of financial account information to countries having a contact with participants. This includes C.R.S. reporting, but potentially could go further into other automatic exchange of information ("A.E.O.I.") agreements regarding financial accounts.

According to the O.E.C.D. guidance,[2] arrangements that come within the scope of continued reporting include the following:

- The use of an account, product or investment that is not, or that purports not to be, a financial account, but has features that are substantially similar to those of a financial account.
- The transfer of financial accounts or assets to, or the use of entities based in, jurisdictions that are not bound by the automatic exchange of financial account information with the State of residence of the relevant taxpayer.
- The reclassification of income and capital into products or payments that are not subject to the automatic exchange o financial account information.
- The transfer or conversion of a financial institution or a financial account or the assets therein into a financial institution or a financial account or assets that are not subject to reporting under the automatic exchange of financial account information.
- The use of legal entities, arrangements or structures that eliminate or purport to eliminate reporting of one or more account holders or controlling persons under the A.E.O.I.
- Arrangements that undermine, or exploit weaknesses in, the due diligence procedures used by financial institutions to comply with their obligations to report financial account information, including the use of jurisdictions with inadequate or weak regimes of enforcement of anti-money-laundering legislation or with weak transparency requirements for legal persons or legal arrangements.[3]

The M.D.R. Report states that the test of a reportable arrangement is whether it is reasonable to conclude that the arrangement is a C.R.S. avoidance arrangement. Presumably, this will be based on reasonable conclusions in light of all the facts and circumstances. Of course, the standard likely is to be judged by compliance officers and regulators. Hence, it may be more accurate to describe the standard as whether it is reasonable from the viewpoint of a compliance officer or regulator to conclude that the arrangement is designed to have, or is marketed as having, the effect of circumventing C.R.S. legislation? If yes, the transaction is reportable.

"The M.D.R. Report states that the test of a reportable arrangement is whether it is reasonable to conclude that the arrangement is a C.R.S. avoidance arrangement."

Note, however, that the M.D.R. Report states the following regarding conversion of accounts:

> The simple fact that an Arrangement has the effect of non-reporting is not sufficient for it to be considered to have the effect of circumventing

[2] O.E.C.D. Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures (2018) ("O.E.C.D. M.D.R. Report").

[3] M.D.R. Report, p.14.

> CRS Legislation. This will only be the case where it is reasonable to conclude that the Arrangement undermines the intended policy of the CRS Legislation. The mandatory disclosure rules are not intended to second guess clear policy choices that were made in the design of the CRS. For instance, real estate is an asset class that is not within the intended scope of the CRS. As a result, an Arrangement to withdraw funds from a reportable Depository Account to purchase an apartment will not constitute a CRS Avoidance Arrangement despite the fact that the Arrangement results in non-reporting of the funds that are used for the purchase. Similarly, the CRS expressly provides for categories of Excluded Accounts and Non-Reporting Financial Institutions that are excluded from reporting to minimize compliance burdens and because, on balance, they do not pose a substantial risk of non-compliance. Accordingly, a transfer of funds from a reportable Depository Account into a pension product that qualifies as an Excluded Account, will, in normal circumstances, not be considered to have the effect of circumventing CRS Legislation.[4]

The same provision of the M.D.R. Report proceeds with illustrations of reportable conversion transactions. They tend to focus on marketing and moving from the C.R.S. reporting system to the F.A.T.C.A. reporting system where full U.B.O. reporting does not occur.

> However, the marketing of a scheme that makes use of such an exclusion in ways that undermine the policy rationale for providing that exclusion would be considered a CRS Avoidance Arrangement. An Arrangement does not have the effect of circumventing CRS Legislation if the Financial Account(s) information is exchanged under a FATCA Model 1A Intergovernmental Agreement with the jurisdiction(s) of tax residence of the Reportable Taxpayer. For example, if a Reportable Taxpayer that is tax resident in jurisdiction X transfers a Financial Account to the United States, that transfer would not have the effect of circumventing CRS Legislation, provided the account information is exchanged by the Competent Authority of the United States with jurisdiction X.[5]

In terms of the test of reasonableness, the M.D.R. Report states:

> The test of "reasonable to conclude" is to be determined from an objective standpoint by reference to all the facts and circumstances and without reference to the subjective intention of the persons involved. Thus, the test will be satisfied where a reasonable person in the position of a professional adviser with a full understanding of the terms and consequences of the Arrangement and the circumstances in which it is designed, marketed and used, would come to this conclusion.[6]

In practice, the standard likely is to be judged by compliance officers and regulators. Hence, it may be more accurate to describe the standard as whether it is reasonable

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[4] Paragraph 1.1.5, M.D.R. Report, p. 25.

[5] *Id.*

[6] Paragraph 1.1.6, M.D.R. Report, p. 25.

from the viewpoint of a compliance officer or regulator to conclude that the arrangement is designed to have, or is marketed as having, the effect of circumventing C.R.S. legislation? If yes, it would be prudent for a professional adviser assess the transaction as reportable.

Finally, the M.D.R. Report states that for reporting to be required, an "intent" standard must be met by the intermediary.

> The fact that an Arrangement is a CRS Avoidance Arrangement will not, on its own, make that Arrangement subject to disclosure by the Intermediary under these model rules. For this to be the case, there must also be an Intermediary operating within the reporting jurisdiction that is either responsible for the design or marketing of that Arrangement or that provides Relevant Services and can reasonably be expected to know that the Arrangement is a CRS Avoidance Arrangement. The test of what an Intermediary "can reasonably be expected to know" is to be determined from an objective standpoint by reference to all the facts and circumstances and without reference to the subjective intention of the persons involved. Thus, the test will be satisfied where a reasonable person in the position of a professional adviser would be aware of this information. * * * [7]

Opaque Offshore Structures

The second reporting category is for arrangements involving a passive offshore vehicle that is held through an Opaque Structure. The M.D.R. Report describes a passive offshore vehicle as a Legal Person or Legal Arrangement that does not carry on a substantive economic activity supported by adequate staff, equipment, assets, and premises in the jurisdiction where it is established or is tax resident.[8] An opaque structure is a structure that meets three tests:

- It is reasonable to conclude that the structure (i) is designed to allow, (ii) is marketed as allowing, or (iii) has the effect of allowing a natural person to be a beneficial owner of a passive offshore vehicle.
- It is reasonable to conclude that the structure (i) does not allow for the accurate determination of such beneficial ownership or (ii) creates the appearance that such person is not a beneficial owner.
- It is reasonable to conclude the obfuscation of beneficial ownership is achieved through (i) the use of nominee shareholders with undisclosed nominators, (ii) the use of means of indirect control beyond formal ownership, (iii) the use of arrangements that provide a beneficial owner to have access to assets without being identified as a beneficial owner, (iv) the absence of any requirement or mechanism to obtain basic information as to the identity of beneficial owners, as defined in the latest Financial Action Task Force recommendations, or (v) the absence of any requirement or mechanism for a trustee to obtain information on the beneficial ownership of trust income and assets.

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[7] Paragraph 1.1.7 of the M.D.R. Report, p. 25.

[8] Paragraph 1.2.

REPORTING BY U.K. INTERMEDIARIES WHEN CATEGORY D HALLMARK EXISTS

For outside advisers categorized as intermediaries to a cross border arrangement possibly containing a Category D Hallmark, the reporting obligations of D.A.C.6 remain applicable. Consequently, an outside adviser must go through the normal routine applicable under D.A.C.6.

> ***"Under D.A.C. 6, an intermediary is any person that designs, markets, organizes or makes available for implementation, or manages the implementation of a reportable cross border arrangement."***

Adviser as an Intermediary

Under D.A.C. 6, an intermediary is any person that designs, markets, organizes or makes available for implementation, or manages the implementation of a reportable cross border arrangement.

Covered by the above definition is any person that knows or can reasonably be expected to know that it has undertaken the performance of the foregoing services, knows or could be reasonably expected to know that they have undertaken to aid, assist, or provide advice with respect to the design, marketing, organizing, or managing the implementation of a reportable cross border arrangement. This latter group of intermediaries is sometimes referred to as service providers.

Lack of Knowledge as a Defense

In the event of noncompliance with reporting obligations, a claim of reasonable lack of knowledge is a defense for service providers. Access to the defense is lost when a service provider deliberately structures matters to avoid having knowledge even though standards of performance generally knowledge of the customer. If access to the defense is denied, civil and criminal penalties may be imposed by H.M.R.C.

Reporting Based on U.K. Nexus

Reporting is required if the taxpayer involved in the cross border transaction has a U.K. nexus and for that reason is relevant U.K. taxpayer. This occurs in any of the following circumstances:

- The U.K. is the jurisdiction where the relevant taxpayer is resident for tax purposes.
- The U.K. is the jurisdiction where the relevant taxpayer maintains a permanent establishment benefiting from the arrangement.
- The U.K. is the jurisdiction where the relevant taxpayer receives income or generates profits, even though the relevant taxpayer is neither a resident for tax purposes in an E.U. member State nor maintains a permanent establishment in an E.U. Member State.
- The U.K. is the jurisdiction where the relevant taxpayer carries on an activity, although the relevant taxpayer is neither a resident of the U.K. for U.K. tax purposes nor maintains a permanent establishment in the U.K.

The U.K. leaving the E.U. on December 31, 2020 will open up a number of potential challenges for clients and advisers.

CONCLUSION

Many advisers in the U.K. and other jurisdictions are delighted that the U.K. has significantly limited the scope of the reporting under D.A.C.6. Beginning this year, such reporting is limited to transactions covered the Category D hallmark – C.R.S. avoidance transactions and opaque overseas structures. U.K. advisers and advisers in third country advisers where the U.K. is the only connection to Europe should be able to benefit from limited D.A.C.6 coverage. The reduction is not a total reduction. In line with broader international obligations the U.K. will likely continue to hold beneficial ownership registers for corporations and trusts, and will be a leading participant on O.E.C.D. initiatives and those of the Financial Action Task Force.

BRACE YOURSELF, PILOTS: YOUR TAX HOME DOES NOT FLY WITH YOU

Author
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Tags
Abode
Bona Fide Resident
Foreign Earned Income
Form 2555
Tax Home

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INTRODUCTION

The Internal Revenue Code (the "Code") provides a foreign earned income and housing cost exclusion to qualified individuals.[1] These benefits are subject to certain ceilings on each of the benefits.[2]

Generally, a U.S. taxpayer can elect to exclude foreign earned income ("F.E.I.") from gross income in two circumstances. The first is that the taxpayer is an individual whose tax home is in a foreign country or countries. The second is that the taxpayer is either (i) a *bona fide* resident of a foreign country or countries for an uninterrupted period that includes an entire tax year or (ii) physically present in a foreign country or countries for at least 330 full days during any period of 12 consecutive months.[3] An individual is not considered to have a tax home in a foreign country for any period in which the individual's abode is in the U.S.[4]

In *Cutting v. Commr.*,[5] the Tax Court addressed the meaning of tax home under Code §911, focusing on the facts that must exist for an individual to be a qualified individual. While only a Memorandum Opinion of the Tax Court,[6] its importance is enhanced because the I.R.S. Large Business and International division ("L.B.&I.") added the foreign earned income exclusion ("F.E.I.E.") to the list of its compliance campaigns,[7] targeting taxpayers who have claimed the benefits of the F.E.I.E. without meeting the L.B.&I. view of the statutory requirements. Taxpayers and their tax advisors should consider this decision in determining the steps required to be compliant with the F.E.I.E.

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1 Code §911(a).

2 As to the earned income exclusion, see Code §911(b)(2); as to the housing cost exclusion, see Code §911(c)(2) (c)(2). In 2021, the maximum amount of the foreign earned income exclusion is $108,700 and the maximum amount of the housing cost exclusion is $17,392 (16% of the maximum exclusion of foreign earned income).

3 Code §911(d)(1).

4 Code §911(d)(3).

5 *Cutting v. Commr.,* T.C., Memo. 2020-158.

6 A Memorandum Opinion is issued when the law is settled or the decision is factually driven.

7 For more information, see the I.R.S. website here.

FACTS

Mr. Cutting is a U.S. citizen who was employed by Omni Air International ("O.A.I."), a domestic company headquartered in Tulsa, Oklahoma. He worked as a pilot, primarily transporting military personnel and cargo on international routes. In 2005, the same year he began working for O.A.I., he married a woman who lived in Thailand and began to spend most of his days off in Thailand with his wife and stepdaughter. He regularly entered Thailand on a temporary transit and nonimmigrant visa that was granted automatically each time he entered Thailand. It expired after 30 days and on at least two occasions he attempted to extend his visas. Each time, the Thai Government denied his requests. As a temporary visitor to Thailand, he was not allowed to own or lease any real property.

As a U.S. taxpayer, Mr. Cutting filed Form 1040, *U.S. Individual Income Tax Return*, for each of 2012, 2013, and 2014, listing his filing status as "single" for each year and listing his father's address in Campbell, California, as his mailing address. He also attached Forms 2555, *Foreign Earned Income*., reporting his entire salary from O.A.I. as F.E.I. and claiming the maximum F.E.I.E. allowed for each year. The I.R.S., relying on information submitted by Mr. Cutting, such as his California State income tax returns, and the fact that he used his father's address as his employment address of record and mailing address, disallowed the exclusion in its entirety for each year at issue. Mr. Cutting disagreed and filed a petition with the Tax Court.

"Code §61(a) broadly defines gross income as 'all income from whatever source derived' except as otherwise provided. One such exception is the F.E.I.E., which allows a qualified individual to exclude F.E.I. from gross income subject to some limitations which are set out in Code §911(b)(2)."

ANALYSIS

It is a well-settled rule that U.S. citizens are subject to U.S. income taxation on worldwide gross income unless a specific exclusion applies.[8] Code §61(a) broadly defines gross income as "all income from whatever source derived" except as otherwise provided.[9] One such exception is the F.E.I.E., which allows a qualified individual to exclude F.E.I. from gross income subject to some limitations which are set out in Code §911(b)(2). Code §911(b)(1)(A) defines F.E.I. as "the amount received by such individual from sources within a foreign country or countries which constitute earned income attributable to service performed by such individual."[10]

Tax Home Abroad

To be entitled to the F.E.I.E., a taxpayer must satisfy a two-part test.

- The first part of the test has both a positive and a negative aspect. The positive aspect is that the taxpayer must affirmatively show that he or she has a tax home in a foreign country. The negative aspect is that the taxpayer must show that he or she has not retained an abode within the U.S.

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[8] *Cook v. Tait,* 265 U.S. 47, 56 (1924); *Specking v. Commr.,* 117 T.C. 95, 101102 (2001); *Haessly v. Commr.,* 68 F. App'x 44 (9th Cir. 2003); *Huff v. Commr.,* 135 T.C. 222, 230 (2010).

[9] Code §61(a).

[10] Code §911(b)(1)(A).

- The second part of the test is satisfied by showing that the taxpayer is either: (i) a "*bona fide* resident" of one or more foreign countries,[11] or (ii) physically present in such country or countries during at least 330 days in a 12-month period.

Code §911(d)(3), which defines tax home as applied to the F.E.I.E., incorporates the travel business expense provision of Code §162(a)(2). It provides as follows:

> The term tax home means with respect to any taxpayer such taxpayer's home for purposes of section Code §162(a)(2) (relating to traveling expenses while away from home).

Thus, under Code §162(a)(2), a taxpayer's home is generally considered to be the location of taxpayer's regular or principal place of business.[12]

In this case, the court considered whether Mr. Cutting had a tax home in Thailand. Mr. Cutting argued that because he was a pilot flying international routes all over the world, he had no regular or principal place of business, and hence, his tax home

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[11] Code §911(d)(1)(A). *Prima facie*, the *bona fide* residence test applies only to U.S. citizens. However, resident aliens of the United States who are citizens of foreign countries that have an income tax treaty with the United States may qualify for the §911 exclusions under the *bona fide* residence test by application of the non-discrimination article found in most of the bilateral income tax treaties to which the United States is a party. See also Rev. Rul. 91-58, 1991-2 C.B. 340 which held that nationals of the United Kingdom who are residents of the United States within the meaning of Code §7701(b) may qualify for the exclusions and deduction provided by §911 by establishing to the satisfaction of the Secretary that they have been *bona fide* residents of a foreign country or countries under the residency rules of Treas. Reg. §1.871-2(b) for a period that includes an entire taxable year. The conclusions reached in Rev. Rul. 91-58 are also applicable to citizens of all countries which had an income tax treaty with the United States in effect as of the date of the ruling (11/4/1991).

[12] Treas. Reg. §1.911-2(b) provides as follows:

> For purposes of paragraph (a)(i) of this section, the term "tax home" has the same meaning which it has for purposes of section 162(a)(2) (relating to travel expenses away from home). *Thus, under section 911, an individual's tax home is considered to be located at his regular or principal (if more than one regular) place of business* or, if the individual has no regular or principal place of business because of the nature of the business, then at his regular place of abode in real and substantial sense * * * .

However, court decisions are split on the meaning of the term home in Code §162(a)(2). Some courts have adopted the I.R.S. view that a taxpayer's home for Code §162(a)(2) purposes is the location of the taxpayer's regular or principal place of business. See *e.g.*, *Markey v. Commr.,* 490 F2d 1249 (6th Cir. 1974); *Daly v. Commr.,* 72 T.C. 190 (1979); Rev. Rul. 75-432, 1975-2 CB 60. Other courts have taken the view that a taxpayer's home for Code §162(a)(2) purposes is the taxpayer's place of abode. See, *e.g.*, *Wallace v. Commr.*, 144 F2d 407 (9th Cir. 1944).

should be determined by reference to his regular place of abode,[13] which he argued was in Thailand.

Mr. Cutting's Facts

The Tax Court noted how it consistently rejected this argument in the past by citing several cases, such as *Wojciechowski v. Commr., Sislik v. Commr.,* and *Swicegood v. Commr.,* where the Tax Court consistently held that the principal place of business for a pilot or other individuals in similar profession is his or her base/duty station.[14] In particular, the Tax Court noted how Mr. Cutting's employment arrangement with O.A.I. was similar to the employment arrangements in *Sislik* and *Swicegood*. In each case, a U.S. commercial airline pilot flew international routes, designated his home base at a domestic airport (John F. Kennedy Airport ("J.F.K.")), and chose to live abroad for personal reasons. Despite the fact that not all of the flights originated from or terminated at J.F.K., the Tax Court still held that the base station was the principal place of employment for each airline pilot. Hence, each pilot's tax home was J.F.K. near New York City, where each pilot was responsible to report, not the foreign country in which each chose to spend personal time.

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[13] *Bujol v. Commr.,* T.C. Memo. 1987-230, provides in pertinent part as follows:

> Abode has been variously defined as one's home, habitation, residence, domicile, or place of dwelling. Black's Law Dictionary 7 (5th ed. 1979). While an exact definition of abode depends upon the context in which the word is used, it clearly does not mean one's principal place of business. Thus, "abode" has a domestic rather than vocational meaning, and stands in contrast to "tax home" as defined for purposes of section 162(a)(2) * * * .

Harrington v. Commr., 93 T.C. 297 (1989), provides in pertinent part as follows:

> In prior section 911 cases, we have examined and contrasted the taxpayer's domestic ties (*i.e.* his familial, economic, and personal ties) to the United States with his ties to the foreign country in which he claims a tax home in order to determine whether his abode was in the United States during any particular period. * * * Even though a taxpayer may have some limited ties to a foreign country, if his ties to the United States remain strong, we have held that his abode remained within the United States, especially where his ties to the foreign country were transitory or limited.

See also *Qunell v. Commr.*, T.C. Summary 2016-86. For a discussion of these cases, see Rusudan Shervashidze & Philip R. Hirschfeld, "Tax Home v. Abode – Are They the Same for Code §911 Purposes?" Vol. 4 *Insights* No. 4, at p. 47.

[14] *Sislik v. Commr.*, T.C. Memo, 1989-495; *Swicegood v. Commr.,* T.C. Memo. 1989-467 (citing *Folkman v. U.S.*, 615 F.2d 493, 496 (9th Cir. 1980); *Wojciechowski v. Commr.,* T.C. Memo. 1991-239; *Dougherty v. Commr.,* T.C. Memo. 1991-442. In *Folkman v. United States,* the 9th Circuit considered the situation of a taxpayer who was employed as an airline pilot out of San Francisco and was also a member of the Air National Guard in Nevada. As a membership condition, the Nevada Air National Guard required its members to reside in the Reno, Nevada area. On the basis that the airline employment constituted the taxpayer's primary source of income and that most of his workdays were spent in San Francisco, the court determined that the taxpayer's tax home was in San Francisco irrespective of the fact that his employment in Nevada required the taxpayer to establish residence in that state.

Mr. Cutting's employment with O.A.I. was governed by a collective bargaining agreement ("C.B.A.") between O.A.I. and the International Brotherhood of Teamsters. While O.A.I. did not require that Mr. Cutting live in the U.S., the C.B.A. required him to a have a "home base," *i.e.* a primary residence as listed on O.A.I.'s personnel and benefit records and to designate a gateway travel airport in the U.S. Mr. Cutting chose San Jose, California, to be his home base and designated San Jose Airport ("S.J.C.") as his gateway travel airport because his parents and brother lived in the area. Those selections came with substantive rights and obligations under the terms of the C.B.A., the Tax Court said. Specifically, under the C.B.A., O.A.I. was responsible for providing "deadhead" travel for Mr. Cutting from S.J.C. to a domestic duty assignment or to a domestic airport of departure for an international assignment and from the domestic airport where the duty period ends to S.J.C. On the other hand, Mr. Cutting was responsible for getting to S.J.C. to start his duty assignments and for returning from S.J.C. to wherever he wished to spend personal time when he was finished. In addition, the C.B.A. required Mr. Cutting to have a certain amount of training per year done in the U.S. Mr. Cutting also spent time each year on reserve for work. During short-call reserve, he had two hours to report for duty, if called. During long-call reserve, he had at least 12 hours to report for duty.

"Based on the above reasons, the Tax Court held that Mr. Cutting's principal place of business, and thus his tax home, was in San Jose, his home base and the location of his gateway travel airport, S.J.C."

Based on the above reasons, the Tax Court held that Mr. Cutting's principal place of business, and thus his tax home, was in San Jose, his home base and the location of his gateway travel airport, S.J.C. Accordingly, he was not a qualified individual and was not entitled to exclude any income under Code §911.

Bona Fide Residence Abroad Not Established

Having determined that Mr. Cutting's tax home was not in Thailand, the Tax Court stated that it did not need to apply the *bona fide* residence or physical presence test to determine that Mr. Cutting was not entitled to the F.E.I.E.

Nonetheless, the Tax Court addressed whether Mr. Cutting was a *bona fide* resident of Thailand during each year in issue. The statute itself does not define the term "*bona fide* resident." The Tax Court in *Nelson v. Commr.*,[15] has described it as an elusive expression and one so peculiarly related to the facts in any given case that each new case must be decided on the basis of its own unique attendant circumstances. Moreover, the Ninth Circuit in *Weible v. U.S.,*[16] in highlighting the differences between "domicile" and "residence," aptly characterized it when it said the following:

> Residence * * * has an evasive way about it, with as many colors as Joseph's coat. It reflects the context in which it is found, whereas "domicile" controls the context. Residence is physical, whereas domicile is generally a compound of physical presence plus an intention to make a certain definite place one's permanent abode, though, to be sure, domicile often hangs on the slender thread of intent alone, as for instance where one is a wanderer over the earth. Residence is not an immutable condition of domicile.

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15 *Nelson v. Commr.*, 30 T.C. 1151, 1153 (1958).

16 *Weible v. United States*, 244 F.2d 158, 163 (9th Cir. 1957).

Per the regulations issued under Code §911, the Tax Court looked to the principles of Code §871,[17] to the extent practical, when determining whether an individual is a *bona fide* resident of a foreign country. Consequently, to determine whether Mr. Cutting was a *bona fide* resident of Thailand, the Tax Court applied the 11 factors set forth by the Seventh Circuit Court of Appeals in *Sochurek v. Commr*.:

- The individual's intent
- The establishment of his or her home temporarily in the foreign country for an indefinite period
- The extent of the individual's assimilation into the life and society of the foreign country
- The physical presence in the foreign country consistent with his or her employment
- The nature, extent and reasons for temporary absences from his or her temporary foreign home
- The payment of income taxes to the foreign country
- The status as resident contrasted to that of transient or sojourner
- The way the employer treated the individual's income for income tax purposes

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[17] Treas. Reg. §1.871-2(b) provides the following in pertinent part as to the hallmarks of residence:

> An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but, if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned. An alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States within the meaning of this section, in the absence of exceptional circumstances.

In addition, Treas. Reg. §1.871-5 provides the following in pertinent part:

> An alien who has acquired residence in the United States retains his status as a resident until he abandons the same and actually departs from the United States. An intention to change his residence does not change his status as a resident alien to that of a nonresident alien. Thus, an alien who has acquired a residence in the United States is taxable as a resident for the remainder of his stay in the United States.

- Whether the individual's spouse and children also resided in the foreign country
- The nature and duration of his employment, and in particular, whether the assignment abroad could be promptly accomplished within a definite or specified time
- The existence of a good faith element in making the trip abroad or whether it is for purpose of tax evasion[18]

As with all facts and circumstances determinations, no one factor is determinative by itself. In addition, not all of the above factors need be present for a taxpayer to establish *bona fide* residence in a foreign country. However, courts typically consider and weigh the appropriate factors in each situation. Here, six factors weighed against Mr. Cutting claim of *bona fide* residence in Thailand, two factors weighed in favor of Mr. Cutting, and two factors were neutral. According to the Tax Court, the most significant factors preventing Mr. Cutting from being a *bona fide* Thai resident were

- Mr. Cutting relied on temporary transit and nonimmigrant visas and did not pursue residency,
- Mr. Cutting provided a statement to the Thai Government that he was not a resident of Thailand,
- Mr. Cutting did not pay any income taxes to Thailand,
- Mr. Cutting was not a tenant under the terms of his wife's lease, and
- Mr. Cutting's testimony contradicted his Forms 1040 in several aspects.

Regarding the last point, the inconsistencies were as follows:

- Mr. Cutting testified that he was married and lived with his wife and stepdaughter in Thailand, but filed his Forms 1040 as "single" for each year in issue and indicated on his Forms 2555 that he did not live with any family members abroad, by checking "No" on line 12a.
- He stated on each Form 2555 that he was subject to taxes to Thailand, by checking "Yes" on line 13b, but stipulated that he did not pay any income taxes to Thailand during any of the years in issue.
- He indicated on each Form 2555 that he submitted a statement to the Thai Government that he was "not a resident of that country," by checking "Yes" on line 13a. Instructions to Form 2555 provide that if a taxpayer submits a statement of nonresidence to the authorities of a foreign country in which income is earned and the authorities hold that the taxpayer is not subject to income tax laws by reason of nonresidence as to that country, the taxpayer is not considered a *bona fide* resident of that country.
- Mr. Cutting stated on his Forms 2555 that his visa did not limit the length of his stay or employment in Thailand, by checking "No" on line 15c, but testified that he relied solely on temporary transit and nonimmigrant visas that expired after 30 days.

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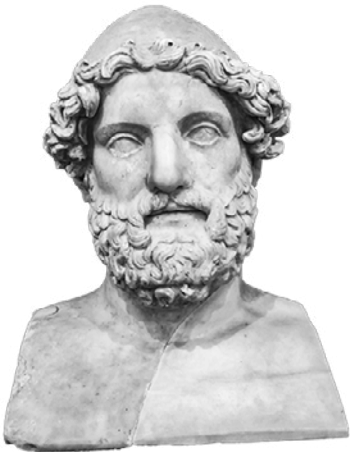
[18] *Sochurek v. Commr.*, 300 F.2d 34, 37 (7th Cir. 1962).

Based on the above factors, the Tax Court held that Mr. Cutting was not a *bona fide* resident of Thailand during the years in issue. Therefore, he was not a qualified individual as defined by Code §911(d)(1) because his tax home was in San Jose and because he did not show that he satisfied the *bona fide* residence test. Accordingly, Mr. Cutting was not entitled to exclude any of his income as an O.A.I. pilot under the F.E.I.E. for the years in issue.

The Tax Court pointed out in a footnote that, even if Mr. Cutting was not a *bona fide* resident of Thailand, he could still be a qualified individual if he were physically present in Thailand and elsewhere outside the U.S. for a certain number of days. However, Mr. Cutting did not assert in his returns, petition, or on brief that he satisfied the physical presence test. Indeed, he did not provide any information with respect to the physical presence test on any Form 2555.

LESSONS TO BE LEARNED



The decision in the *Cutting* case teaches a useful lesson about what it takes to be a qualified individual. *Prima facie*, it might seem that U.S. airline pilots flying international flights who are obligated by the terms of the employment agreement to designate a domestic airport as their home base and choose to live abroad for personal reasons are ineligible to claim Code §911 exclusion. However, it has been shown that the question of *bona fide* residence raises a highly fact-specific issue, which requires case-by-case determination. In at least two cases, taxpayers were successful in arguing that they were *bona fide* residents of a foreign country.[19]

In *Schoneberger v. Commr.,*[20] the Tax Court held that a U.S. airline pilot was a *bona fide* resident of France, despite the fact that he was based in New York for employment purposes, he did not pay any French income taxes, and his stay in France was limited by French immigration laws. The Tax Court held that the taxpayer adequately demonstrated "strong proof" of *bona fide* residency in France. According to the Tax Court, the most significant factors which weighed in favor of taxpayer were the following:

- The taxpayer's efforts to become assimilated into the French environment.
- Most of the taxpayer's off-duty hours were spent in France.
- The taxpayer's intent to remain in France for an extended period, evidenced by his rental of an apartment in Paris.
- The taxpayer studied the French language, had French as well as American friends, and dated a French woman whom he thought he might marry and who wanted to remain in France.
- The taxpayer participated in activities with the family of the French woman, which were an important aspect of French social life.

The Tax Court did not draw negative inferences from the fact that taxpayer did not join any French civic or social organizations, as he never belonged to such

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[19] See also *Cobb v. Commr.,* 62 T.C.M. (CCH) 408, T.C. Memo. 1991-736, Court Opinion and *Jones v. Commr.,* 927 F. 2d 849 (5th Cir. 1991).

[20] *Schoneberger v. Commr.*, 74 T.C. 1016, 1024 (1980).

organizations in the U.S. The Tax Court also placed little weight on the nominal restrictions as to the taxpayer's residency status under French immigration laws.

In *Linde v. Commr.*,[21] a helicopter pilot did not have his abode in the U.S. even though he maintained a marital home in Alabama, to which he returned when his overseas assignment was completed. The taxpayer was a U.S. Army veteran working as a helicopter pilot for a government contractor in Iraq. Evidence indicated that he desired to remain in Iraq indefinitely, and to that end made efforts to create a domestic and personal life in that country. In those facts, the Tax Court held that the ties to Iraq were stronger than the ties to the U.S. during the years in issue. As he did not have an abode in the U.S., his tax home could be in Iraq. The Tax Court further held that the taxpayer met the *bona fide* residence test for the years in issue and was a qualified individual within the meaning of Code §911(d)(1).

CONCLUSION

Based on the above cases, Mr. Cutting should have established a more substantial relationship with Thailand by proactively seeking to obtain a residency visa instead of exclusively relying on 30-day transit visas. Such residency visa would have allowed him to lease or own interests in real property in Thailand and would have showed that his intent was to make a home in Thailand for an indefinite period of time. He should also have presented evidence of his assimilation into the Thai community, social and cultural activities, such as learning the Thai language, enrolling into Thai civic or social organizations, renting an apartment in Thailand, obtaining a Thai driver's license, opening a checking or savings account in Thailand and acquiring Thai credit cards. He also could have reviewed the entries on Form 2555 to ensure that they were consistent with his lifestyle.

"Simply living or working abroad does not mean that a taxpayer's tax home or abode is in a foreign country."

As more evidence is submitted, the easier it is for taxpayers to objectively demonstrate that their familial, economic and personal ties are stronger to the foreign country than to the U.S.[22] Simply living or working abroad does not mean that a taxpayer's tax home or abode is in a foreign country. Taxpayers wishing to take advantage of the F.E.I.E. should seek professional advice to ensure they can comfortably rely on the F.E.I.E. based on the way their lives are lead.

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[21] *Linde v. Commr.*, T.C. Memo 2017-180.

[22] Some insight into issues pertinent to Code §911 that the I.R.S. may raise on examination is provided by the F.E.I.E. – Audit Techniques L.B.&I. Process Unit that it has made public. See in particular the list of items the I.R.S. will request and review for purposes of establishing whether the taxpayer had a tax home in a foreign country and determining the location of the taxpayer's abode – *i.e.*, where the familial, economic, and personal ties were strongest, at pp. 18 – 19. International Practice and Process Units ("I.P.U.'s") are prepared to provide I.R.S. staff with explanations of general tax concepts and specific transactions. They are not official pronouncements on law or practice and cannot be relied on or cited as authority. However, I.P.U's provide insight on how I.R.S. examiners will audit taxpayers who made a F.E.I.E election. If a taxpayer is being audited by the I.R.S., tax advisors may be able to anticipate the I.R.S.'s next steps or question an approach that does not follow the guidance in an I.P.U.

FORM OR FIZZ? COCA-COLA TRANSFER PRICING DECISION

Author
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Tags
10-50-50
Coca Cola
C.P.M.
C.U.T.
C.U.P.
Intangible Property
Transfer Pricing

The 2020 decision of the Tax Court in The Coca-Cola Company and Subsidiaries[1] ("Coca-Cola") $3 billion transfer pricing case may cause Coca-Cola to petition the appropriate U.S. Court of Appeals for the same reason it petitioned the Tax Court. A large amount of tax is at stake over a number of open tax years. But in comparison to other transfer pricing cases, this may be one of the only reasons this controversy went to trial and may yet again proceed to trial. The Tax Court's decision highlights several themes in transfer pricing best practice and global policy development.

BACKGROUND

During the years in issue, Coca Cola products were produced by independent bottlers around the world using trademarks, product names, logos, patents, secret formulas, and proprietary manufacturing processes licensed by Coca-Cola to seven controlled companies or Supply Points. The Supply Points produced beverage concentrate for sale to bottlers, and granted bottlers the right to use the Coca-Cola trademarks, product names, and logos to package beverages. Supply Points were allocated advertising, marketing and head office costs by Coca-Cola, but did not develop or execute territorial marketing or advertising. The task of local market advertising and consumer marketing and maintaining relations with bottlers fell to approximately 60 Service Companies ("ServCos"). As advertising and marketing is an important, concerted worldwide undertaking for Coca-Cola, external ad firms and marketing firms were engaged, in some cases by the ServCos.

The issue in dispute was the pricing of the licensed rights between Coca-Cola and the Supply Points. A secondary issue was whether dividends paid to Coca-Cola by the Supply Points should be regarded as payment for the licensed rights, thereby reducing the I.R.S. income reallocation to Coca-Cola.

THE VALUE OF CERTAINTY

Coca-Cola settled an I.R.S. transfer pricing examination of its 1987-1995 tax years using a residual profit split agreed with the I.R.S. The closing agreement for the examination of the 1987-1995 tax years stipulated an allocated 50% of Supply Point residual profit in excess of 10% of gross sales to Coca-Cola in satisfaction of the company's Code §482 requirement. This arrangement came to be known as the 10-50-50 method, and was used to allocate income between Coca-Cola and the Supply Points in tax years subsequent to 1995. The closing agreement allowed the Supply Points to meet their licensing payment requirements by repatriating funds in a variety of forms, including the payment of dividends from Supply Points to Coca-Cola.

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[1] *Coca-Cola Co. & Subsidiaries v. Commr.,* 155 T.C. __, No. 10, (2020).

The 10-50-50 method was agreed after a lengthy I.R.S. examination and represented what appeared to Coca-Cola to be a reliable authority on which to base its transfer pricing position for future tax years. The closing agreement did not make the 10-50-50 method binding on the I.R.S. or Coca-Cola for tax years after 1995, lacking the certainty otherwise obtainable under a unilateral A.P.A. Coca-Cola nonetheless placed a high future certainty value on the I.R.S. position without contemplating the future income effect of the compliance mechanism that performs annual tests of the key assumptions underlying a typical unilateral A.P.A. A.P.A.'s and Competent Authority agreements did vary the 10-50-50 method to resolve select controversies, but the perceived wisdom of the 1995 closing agreement endured. It is unclear why variation of the 10-50-50 method by Competent Authority was not a clearer signal to Coca-Cola or a question dealt with in more depth in the Tax Court decision.

Coca-Cola argued that the I.R.S. abandoned the 10-50-50 method in the 2007-2009 tax years, but was unsuccessful in its argument as the Tax Court found there was no agreed method to abandon.

WRITTEN AGREEMENTS

The inter-company agreements that could be located served as the court's basis for understanding the intent of Coca-Cola and the Supply Points, the rights and obligations of the parties, and the terms used in the controlled transaction. First impressions were not entirely favorable, as the court characterized the agreements as terse and incomplete.

The court's review of the agreements pointed out several gaps that would otherwise be absent in an agreement between independent parties, but focused on the rights and obligations of the Supply Points concerning the use and development of licensed intangible property. The court's analysis noted the inclusion of Coca-Cola in bottler agreements when ordinary sublicensing arrangements would render this unnecessary, but most importantly traced the history of cancellation and assignment of Supply Point licensing agreements through company reorganizations. This reorganization history demonstrated that Supply Point agreements were terminated without remuneration to the exiting Supply Point.

The nil terminal value of the rights granted to the Supply Points undermined Coca-Cola's argument that the Supply Points had accumulated the right to earn high returns from valuable intangible property by funding marketing and advertising activity. Ordinarily, an arm's length party with a defensible claim to intangible property rights and resulting expected returns would be paid a positive amount to give up such rights. The consolidation of Supply Point operations around the world over time provided a narrative of Supply Points with limited intangible property rights at arm's length.

The other series of company agreements that were examined by the court were those between Coca-Cola and its subsidiaries concerning the allocation of U.S. headquarters expenses or "*pro-rata*." Though the court suggested that the terms of the *pro-rata* allocations were often unclear, together with the evidence from the licensing agreements, the allocations of advertising and marketing expenses under the *pro-rata* agreements were used by the I.R.S. to argue that allocations of expense

to the Supply Points did not result in the right to earn high returns to licensed intangible property. This line of argument was accepted by the court, following the intangible asset ownership conditions of Treas. Reg. §1.482-4(f).

The Coca-Cola agreements largely stood on their own and were used extensively to evaluate the issue in dispute. This stands in contrast to other transfer pricing cases where fact witnesses were required to complete the court's understanding of the interpretation by the parties of key inter-company agreements and the division of duties, risks, and rights in intangible assets that followed from that interpretation.

"The factual underpinning of a residual profit split is critical to method selection, best method analysis, and selection of a reliable split metric when applying the method."

IMPRACTICALITY OF A RESIDUAL PROFIT SPLIT

Coca-Cola used the residual profit split method and other transfer pricing methods to support its position at trial, but relied principally on the 10-50-50 method or residual profit split method to determine income in its 2007-2009 tax years.

The factual underpinning of a residual profit split is critical to method selection, best method analysis, and selection of a reliable split metric when applying the method. The court's decision describes a consolidation of Supply Point operations over time, a variability in *pro-rata* allocations, and some fluidity in operational managerial responsibilities between Coca-Cola and its Supply Points over time. All of these factors point at minimum to a reconsideration of the validity of the assumptions underlying the 10-50-50 method in each tax year. From the court's decision, it seemed that the force of attraction to the method owing to the assumed precedent value of the 1987-1995 closing agreement dominated the annual requirement to select and apply the best method.

The residual profit split method is a two-sided method often employed when reliable data and uncomplicated fact patterns concerning intangible property rights are not present. The I.R.S. position adopted by the court suggests that an objective annual review of the facts and available comparable data might have resulted in a Coca-Cola income result much closer to its own. Once the assumption of Supply Point ownership of valuable intangible assets could be relaxed based on factual evidence, the way was open to apply a one-sided method such as the C.P.M.

C.U.T.'S BOTH WAYS

The court's decision marks the departure from the methodological dominance of the comparable uncontrolled transaction or C.U.T. method that has served taxpayers well in past cases tried before the Tax Court.[2] The court's thorough best method analysis and evaluation of comparability factors allowed a robust application of the C.P.M. or comparable profits method to define the I.R.S. income adjustment sustained by the court.

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[2] The persuasive nature of a CUT is discussed in M. Peggs, "Amazon Makes the C.U.T. – an Important Taxpayer Win, a Reminder to Consider Transactional Evidence," Volume 4, Number 5 *Insights* p.45 (2017).

Coca-Cola did introduce an expert report that used an application of the C.U.T. to support the company position. The expert's C.U.T. analysis was found by the court to rest on shaky factual foundations and to resemble a "Rube Goldberg machine."[3] An unkind C.U.T.

CORROBORATION BY A SECONDARY METHOD

For any economist that finds graphs to be persuasive visual support for ordinarily not-so-visual or exciting modes of communication, the Coca-Cola decision includes a handy rejoinder to attorney colleagues' variously-deployed graph and economist jokes. This section is presented without a graph. Consider how much better it could be with a graph as you read the next paragraph.

To motivate the I.R.S. reason for investigating the 10-50-50 method, the expert hired by the I.R.S. considered the question of the profitability of a sample consisting of large, public manufacturers of food and beverages, Coca-Cola, and the seven Supply Points. He then produced a striking histogram, plotting the 2007-2009 return on assets in 5% bins on the Y axis at left, and the number of companies in each of the defined bins on the X axis. Coca-Cola and all but one supply point (Egypt) were found in bins considerably above the sample mean (the Y-axis reading at the point the histogram extends furthest to the right). How considerably? Between 90% and 205% in ROA terms. This served as a convincing reason for further investigation of the reason for relatively high profitability, as opposed to investigation of the similarity of royalty rates.

Graphical inspiration received, a line of inquiry about factors effecting profitability and measurement of profitability began. Ordinarily this might be an analysis performed as part of the application of a secondary method (a best method criterion under Treas. Reg. §1.482-1(c)), but with the 10-50-50 method having been agreed only as a way of settling a dispute, the C.P.M. became the primary transfer pricing method the court relied on to decide the case.

EVIDENTIARY VALUE OF INTERNAL AND OTHER TRANSACTIONS

Coca-Cola differs from many multinational companies in that its final product is manufactured by bottlers around the world that are third parties. Moreover, these bottlers are in many cases public companies owing to the large capital requirements of bottling plants and distribution infrastructure. Many bottlers have raised capital on public securities markets and therefore report their financial results publicly.

While it is unclear whether Coca-Cola documented its reasons for not applying a transfer pricing method using bottlers financial data, the I.R.S. seized on the

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[3] Wikipedia explains a Rube Goldberg machine in the following language:

> A Rube Goldberg machine, named after American cartoonist Rube Goldberg, is a machine intentionally designed to perform a simple task in an indirect and overly complicated way. Usually, these machines consist of a series of simple unrelated devices; the action of each triggers the initiation of the next, eventually resulting in achieving a stated goal.

availability of bottler data and apply the C.P.M. A considerable portion of the dispute between Coca-Cola and the I.R.S. concerned comparability of the independent bottlers and the Supply Points. After a detailed presentation of arguments from each side, the court acknowledged several shortcomings of the C.P.M. using bottler data and allowed in most cases that identified differences between the controlled transaction terms and the attributes of the independent bottlers were not sufficiently significant to disqualify the C.P.M. In respect of certain differences where estimation of partial effects was not possible or reliable, the court reasoned that any resulting bias owing to a lack of comparability would serve to benefit Coca-Cola and therefore not overstate the proposed I.R.S. income adjustment.

WHEN AN INTANGIBLE ASSET IS NOT A VALUABLE INTANGIBLE ASSET

Many modern transfer pricing controversies concern the attribution of returns to valuable intangible assets as distinct from returns to more ubiquitous intangible assets used in business operations. A considerable share of the current policy development effort of the O.E.C.D. in respect of the digital economy is occupied with a similar question, and is seeking a relatively more mix-in-the-pan method of resolution than the Tax Court appeal and trial process conducted to decide the Coca-Cola issues. This article may inadvertently contribute to the debate by encouraging, of all things, a graphical approach.

Though exhaustive, the court's decision applies the regulations to the facts of the Coca-Cola controlled transactions and arrives at its conclusion in a principled manner. A combination of critical factors led to the court to side with the I.R.S., and hold that the Supply Points used intangible assets in their businesses, but were not entitled to a return to valuable intangible property at arm's length as a result of legal ownership or exercise of Supply Point control over the intangible property.

"This article may inadvertently contribute to the debate by encouraging, of all things, a graphical approach."

While many O.E.C.D. member market jurisdictions seek to argue for the equivalent of Coca-Cola's position and the attribution of profit resulting from intangible assets in name only using profit split methods, an objective view of value capture as was argued by the I.R.S. provides an instructive view of future talks between treaty partners.

TAX 101:

TAXATION OF EQUITY-BASED COMPENSATION AND CROSS BORDER ISSUES

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Tags
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Stock Options

Equity-based compensation has long been a popular way to attract talent and align the interests of corporations and service providers. Offering this type of compensation allows cash-poor companies, and especially tech companies, to attract highly skilled individuals to join their workforce and board of directors. And with global expansions and (pre-pandemic) ease of travel, employees and executive's mobility is on the rise. This results in non-U.S. citizens moving to the U.S. and becoming, even if only temporarily, U.S. tax residents at the time that their equity-based grants, made years before they moved, vest or are ripe for exercise. Further, U.S. citizens living away from the U.S. are granted equity-based compensation in local non-U.S. companies, and such grants may give rise to tax in the U.S. at a different time than for local purposes. This Tax 101 article will examine how the different types of equity-based compensation are taxed in the U.S. and discuss some cross-border issues relating to such compensation.

STATUTORY FRAMEWORK

Individuals and entities that perform service are taxed in the U.S. on the U.S. source portion of the compensation received whether the compensation is paid in cash or in property. U.S. citizens and U.S. residents would also be taxed on any foreign source compensation income. For individuals, who are mostly taxed on a cash basis, cash and non-cash compensation is included in tax when it is received or is considered to be received (constructive receipt). Compensation income is generally sourced based on where services were physically performed. Typically, the source of multi-year compensation is apportioned between the U.S. and a foreign country based on the relative days worked in each place. For a U.S. citizen and U.S. resident the distinction between compensation income from services performed outside the U.S. (foreign sourced income) and compensation for services performed within the U.S. (U.S. sourced income) is relevant for purposes of determining eligibility for foreign tax credits should foreign taxes be imposed on such compensation income. For a non-U.S. citizen who may have compensation income from U.S. source, the income is taxed in the U.S. as effectively connected income at graduated rates on a net basis (subject to modification by treaty).

When property received as compensation is subject to substantial risk of forfeiture, U.S. taxation is generally deferred. Code §83[1] applies to transfers of property in connection with performance of services. The general rule provides for deferred

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[1] All references are to the Internal Revenue Code of 1986, as amended.

taxation until the property received is not subject to a substantial risk of forfeiture.[2] When company shares are received as compensation for services performed and to be performed, they are typically not received free and clear but rather subject to a vesting schedule and other conditions. In such circumstances, U.S. tax will not be imposed at the grant of such property. Once the restrictions are removed, U.S. taxation is imposed. At such time, the excess of the fair market value ("F.M.V.") of the property (measured at such time and without regard to the restrictions imposed, except for restrictions that will never lapse) over the amount paid for the property, if any, is subject to tax as compensation income (ordinary income rates).[3]

Code §83(b) allows for an election to include in gross income the F.M.V. of the property received at the time it is received, notwithstanding that it is still subject to substantial risk of forfeiture. This allows electing taxpayers to close the compensation element in relation to the stock received at such time and allows the subsequent appreciation to go untaxed until such time as the stock is sold; at which time, the gain will be considered capital gain. The election, which must be made within 30 days of the grant, requires the taking of a chance. The forfeiture provision may actually occur and the transferred property, for which income tax was paid, may never become vested, or the F.M.V. of such property may decrease by the time it is vested. If this happened, no deduction or credit is allowed (other than a capital loss for amounts paid to acquire the property). An election cannot be revoked except with the express consent of the I.R.S.[4] However, if the price required to be paid for the property is close to the F.M.V., or if the F.M.V. is insignificant at the time of the grant, little to no tax will be due as a result of the election, reducing the risk associated with the election and making it an important planning tool.

Code §83 addresses the tax consequences of the transfer of property in a compensatory setting. It requires a transfer of property, meaning that the grant must be of a property, not a promise to pay or transfer property, and the recipient must be considered the beneficial owners of the property. Code §409A addresses the tax consequences of nonqualified deferred compensation. This may include contractual promises to transfer property in the future, which would not be immediately subject to Code §83.[5] If Code §409A applies to a compensation plan and the plan does not meet the requirements of the provision, the compensation is taxed when there is no substantial risk of forfeiture. The income is ordinary income and an additional 20% is imposed. Underpayment penalty interest may also apply, and every year between vesting and exercise, the unrealized appreciation may be subject to tax. Code §409A is complex and is not the focus of this article. It is addressed here in general terms only.

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[2] To be taxed under Code §83, property received must be either transferrable or not subject to substantial forfeiture. However, property is considered transferrable only if the transferee's rights in the property are not subject to a substantial risk of forfeiture. Therefore, in most cases the transferability factor is not an independent one.

[3] The regulations provide for various ways of valuing stock. Obtaining a letter from the Company stating the value of its stock should generally be acceptable.

[4] Revocation was allowed by the I.R.S. when there was a mistake of fact as to the value of the property transferred and the employer and employee agreed to rescind the underlying transaction in the year it occurred.

[5] A plan that only allow for short term deferral of no more than 2½ months after the end of the year in which it vests, are exempts from the treatment of "deferred compensation."

TYPES OF EQUITY-BASED COMPENSATION

Generally, the most common equity-based compensation plans include the grant of one or more of (i) stock, including restricted stock, (ii) stock options, (iii) stock appreciation rights ("S.A.R."), and (iv) restricted stock units ("R.S.U.").

The grant of company stock as compensation is fairly straightforward. Stock is ordinarily granted subject to transferability restrictions and a vesting schedule so as to tie an individual to the company for a certain number of years. Once the stock vests, it is often freely transferrable (unless security law restrictions apply). The recipient may be asked to pay for the stock or not, depending on the plan terms. If payment is required, the payment is made at the grant.

Stock options on the other hand, provide the holder the option – but not obligation – to purchase a set number of the underlying stock at a set price (generally, the F.M.V. at the time of the grant) at some time in the future. If the F.M.V. of the underlying stock is higher than the set purchase price (known as the strike price or exercise price), the holder will ordinarily choose to exercise the option. Unless the plan provides for a "cashless exercise" actual payment for the underlying stock is generally required at the exercise.[6]

Stock option plans may be statutory ("qualified")[7] or non-statutory ("nonqualified"). When non-qualified options are granted, the recipient will have a taxable event upon exercise. When qualified options are granted, notwithstanding the compensatory element, for policy reasons, taxation is deferred. When stock options are granted by a foreign company, in most likelihood the plan under which the options are granted will not meet the restrictive statutory rules of the Code and be treated as non-qualified.[8]

Like stock options, S.A.R. also benefit the recipient by the increase in stock price. But unlike a stock option, a S.A.R. typically does not result in ownership of the underlying stock and a net amount (after reduction of the exercise price) equal to the appreciation in the stock value is paid. S.A.R. may be settled in company stock.

Lastly, R.S.U.'s award the holder with a payment, in cash or company stock, equal to the value of a specified number of company shares. In contrast to the grant of stock or restricted stock, until an R.S.U. is settled, it is merely a promise, a contract for future payment.

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6 It is common however for an employer to facilitate the exercise by either allowing a cashless exercise where the holder exercises and immediately sells sufficient stock to pay the exercise price or by providing a net-share settlement that allows the holder to receive shares with value equal to the intrinsic value and without the need to exercise and sell.

7 Special rules apply to options granted under Code §422 (Incentive Stock Options) and new Code §83(i) (Qualified Equity Grants).

8 While U.S. based stock option plans may also be non-qualified, a U.S. plan will provide on its terms if it meets the statutory requirements. Unfortunately, most non-U.S. plans will not address U.S. tax matters and thus will be silent. Reviewing plans for compatibility with statutory requirements is a significant effort and considering the restrictive rules, foreign plans are typically assumed to be non-qualified.

U.S. TAXATION OF RESTRICTED STOCK

As mentioned above, the transfer of property for services is taxed under Code §83. As a result, no U.S. tax applies until the restrictions are substantially removed. At such time, the spread between the F.M.V. of the stock (measured at such future time) and the basis in the stock (the price paid for the stock at the grant, if any) will be subject to tax as compensation income.

A recipient of restricted stock has the choice to include the compensation income in the gross income for the taxable year of the grant by making an election under Code §83(b). If this election is made, the F.M.V. of the stock received at the time of the grant (determined without regard to any restrictions, except those that never lapse) in excess of the amount paid for the stock, if any, is included in gross income. The election must be made within 30 days and no late election relief is available. When the amount required to be paid equals or is close to the F.M.V. at the grant, an election is ideal as no tax, or almost no tax, is imposed. The benefits of the election are that subsequent appreciation in value are not taxed until the stock is disposed, and when taxed, are taxed as capital gain. On the other hand, if the stock is granted for free, but is subject to significant restrictions, including the compensation income in gross income without disposition or certainty that in the future the stock will be worth more may be a significant burden and may result in no election being made.

Because the income, when included, is compensation income, if a non-U.S. citizen performed services in the U.S. for some time between the grant and the vesting, some of the income will be U.S. source and be subject to U.S. taxation even though the individual was not a U.S. tax resident when the stock was granted or may no longer be a U.S. tax resident at the time the stock vested. Additionally, if such individual's country of residence taxes the income while the individual is temporarily in the U.S., or simply at a different time (for example, upon the grant), double taxation may arise.

Restricted stock is not "deferred compensation" in the context of Code §409A.[9]

Lastly, when restricted stock in a foreign corporation is granted to a U.S. citizen or U.S. resident, the stock must be reported on Form 8938, *Statement of Specified Foreign Financial Assets*, and of Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations,* if the stock received meet the filing requirements. Additional compliance matters may be applicable.

U.S. TAXATION OF NON-QUALIFIED STOCK OPTIONS

When a stock option is granted no property is actually transferred (unless the option is actively traded on a securities market). Therefore, Code §83 does not apply to the grant of the option.[10] Therefore, neither the grant nor the vesting (removal of risk of forfeiture) is a taxable event. Instead, options are taxed when exercised, *i.e.*, when stock is purchased for a price lower than its F.M.V., the spread is subject to tax as

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[9] Treas. Reg. §1.409A-1(b)(4)(B).

[10] Code §83(e)(3) specifically excludes the applicability of the section with respect to transfers of options without readily ascertainable fair market value.

compensation income.[11] While the F.M.V. of the stock may significantly appreciate over the period between the grant and the exercise, there is no election available to choose to include the F.M.V. of the underlying stock in income at the grant and close the compensatory element at such time. The compensatory element remains open until the option was exercised. At such point, if the purchased stock is subject to further restrictions, Code §83 will apply.

An exception applies if the option granted has a "readily ascertainable F.M.V." In such cases, which are very limited, the grant of the option is the grant of a property and thus subject to Code §83. In these limited cases, the grant of the option would be immediately taxed (unless subject to substantial risk of forfeiture). An option can be granted with a readily ascertainable F.M.V. only when the underlying stock is publicly traded and the option itself is actively traded as well. Additionally, if the granted option includes additional restrictions the I.R.S. is likely to argue the options are not identical and that the granted option does not have the same "ascertainable F.M.V." as that of the traded option.

"Stock options are a form of deferred compensation and must fit within an exception to avoid being subject to Code §409A. An option issued at a discount is subject to Code §409A. Therefore, in the U.S., most companies will issue options with strike price not lower than the F.M.V. of the underlying stock at the date of the grant."

Stock options are a form of deferred compensation and must fit within an exception to avoid being subject to Code §409A. An option issued at a discount is subject to Code §409A. Therefore, in the U.S., most companies will issue options with strike price not lower than the F.M.V. of the underlying stock at the date of the grant. However, foreign issuers may be unaware of the perils of Code §409A and may issue options at a discount. For the U.S. citizen holders this may trigger adverse tax results, including income inclusion at the time the option vests irrespective of exercise, and annually thereafter.[12] A non-U.S. individual moving to the U.S. should review his deferred compensation arrangements to determine if any action should be taken prior to becoming a U.S. tax resident subject to Code §409A.[13]

Again, because the income included at exercise is compensation income, if any portion of it is U.S. source, non-U.S. individuals would be subject to U.S. tax. Because the source rules generally apportion the income among the working days between the grant day and the vesting day, not the exercise date, but the taxable event occurs at the exercise date, a non-U.S. individual may find that 100% of the income is subject to U.S. taxation notwithstanding such individual may have already left the U.S. Because the timing of taxation of stock options among different countries may be different, double taxation is a risk for U.S. citizens as well. For U.S. citizens, U.S. tax applies whether the income is U.S. source or foreign source. But a citizen living in a different country may have a second tax imposed on the same option, at a different point in time. Depending on the source of the income, foreign tax credit may or may not be available to offset all or some of the U.S. tax.[14]

Lastly, the holder of an option to purchase stock in a foreign corporation should report the option on Form 8938, *Statement of Specified Foreign Financial Assets*.

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[11] However, when an option is granted in non-compensatory context, such as in connection with an investment in a company or when an option is bought on an established securities market, the exercise of the option is not a taxable event.

[12] All taxes paid under Code §409A are added to the basis in the option so that when the option is exercised previously taxed amount will not be taxed again.

[13] However, non-U.S. individuals may be eligible for a one-year grace period in which they can make necessary amendments or elections.

[14] The Code allows individuals to utilize unused foreign tax credits by carrying it back one year and carrying it forward 10 years.

U.S. TAXATION OF S.A.R. AND R.S.U.

As mentioned above, the grant of S.A.R. is merely a grant of a contractual right. Therefore Code §83 (and the election thereunder) does not apply until, and to the extent, that the S.A.R. is settled using stock. Upon exercise, when the S.A.R. is settled, compensation income is included in the holder's gross income.

Similar to the grant of a S.A.R., the grant of an R.S.U. is not subject to Code §83. Therefore, despite the similar name, R.S.U., unlike restricted stock, is not eligible for a Code §83(b) election. Tax will be imposed at the time the R.S.U, is exercised, and at such time, if stock is received, Code §83 may be applicable.

Both S.A.R.'s and R.S.U.'s are forms of deferred compensation that may trigger the applicability of Code §409A and must be reviewed for compliance or the applicability of an exception.

The holder of S.A.R. or R.S.U. in a foreign corporation should report it on Form 8938, *Statement of Specified Foreign Financial Assets*.

CONCLUSION

When equity-based compensation is received, tax could apply at three different points in time (at grant, at vesting, or upon exercise) When more than one country is involved, tax could apply at different points of time. Occasionally, and especially when a foreign issuer is involved, equity-based compensation may be denominated as one form of compensation (*e.g.*, "an option") but resemble more a different type (*e.g.*, "restricted stock"). The difference in treatment may affect the taxation of the compensation in the U.S. and the ability to make a Code §83(b) election. Recipients should make sure that the form fits their tax goals. For example, when a foreign company grants a U.S. service provider stock options with a *de minimis* strike price, it may be more appropriate to treat the grant as a grant of stock and consider the making of a Code §83(b) election if the "options" are not vested; The holder will be well served if the grant letter states the U.S. treatment explicitly to avoid an alternative treatment by the U.S. taxing authorities.

Whether treated the same under the laws of the two jurisdictions or differently, cross-border equity-based compensation may be subject to double taxation and should be reviewed carefully, and to the extent possible, make appropriate elections in an attempt align the recognition of income in both jurisdictions.

DOES *POWELL* OFFER TAXPAYERS MEANINGFUL PROTECTION IN CROSS BORDER E.O.I. REQUESTS?

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Tags
Code §6103
Code §7402(b)
Code §7602
Code §7604
Code §7605
Code §7609
Exchange of Information
Pub. L. No. 116-25
Tax Treaty
U.S. v. Arthur Young & Co.
U.S. v. Powell
U.S. v. Stuart

INTRODUCTION[1]

In *Through the Looking-Glass*, by Lewis Carroll, Humpty Dumpty makes the following point when speaking to Alice:

> When I use a word . . . it means just what I choose it to mean – neither more nor less.[2]

This article addresses the reasons why it is nearly impossible for a U.S. taxpayer to prevent the enforcement of a summons issued by the I.R.S. pursuant to a request for information initiated by a foreign tax authority. It makes no difference whether the foreign tax authority acts in good faith, misrepresents facts, or is motivated by a purpose unrelated to the computation and collection of the appropriate amount of tax. The safeguards designed to prevent the inappropriate use of information in the foreign country making the request simply provide no relief in the U.S. to the person that is the subject of the information exchange. Under the standards adopted in U.S. cases, the language in which those safeguards are couched has no relevance to a U.S. Federal District Court hearing the petition of an aggrieved taxpayer if the acts are perpetrated by a foreign government.

RIGHTS OF TAXPAYERS

The Fourth Amendment to the Constitution provides as follows:

> The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized.

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1 The article serves as a companion piece to an article in the last edition of *Insights*, W. Heyvaert and V.S. Mohammad, "Exchanges of Information in Tax Matters and Fundamental Rights of Taxpayers – E.C.J. Delivers Landmark Ruling in the Aftermath of Berlioz," *Insights* 7, no. 6 (2020): p. 4. The article addressed a landmark European exchange of information case considered by the C.J.E.U. in Joined Cases C-245/19 and C-246/19. There, the C.J.E.U. held that if a taxpayer whose information is requested in an E.U.-to-E.U. cross-border request has indirect remedies available in the country making the request, the Member State fulfilling the information request can deny the taxpayer and third parties the right to a direct judicial remedy preventing the exchange of information from taking place.

2 In *Through the Looking-Glass*, by Lewis Carroll (1871), Humpty Dumpty speaks these words to Alice.

In a similar vein, exchange of information provisions in most income tax treaties provide an obligation on the requesting party to keep the information secret and to disclose the information only to persons concerned with the tax assessment and collection process. For example, Article 26 (Exchange of Information) of the O.E.C.D. Model Tax Convention on Income and on Capital (”O.E.C.D. Model”) provides as follows:

> 1. The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant[3] for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Articles 1 and 2.
>
> 2. Any information received under paragraph 1 by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, the determination of appeals in relation to the taxes referred to in paragraph 1, or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions. Notwithstanding the foregoing, information received by a Contracting State may be used for other purposes when such information may be used for such other purposes under the laws of both States and the competent authority of the supplying State authorises such use.

If these were the only relevant provisions applicable to an exchange of information and they were applied as written, one could assume that an intervening party to a summons is entitled to a fair hearing of all the facts. As often stated, it is dangerous to assume, especially when the I.R.S. power to obtain taxpayer information is broad.

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[3] Paragraph (5) of the accompanying Commentary elucidates that “[t]he standard of ‘foreseeable relevance’ is intended to provide for exchange of information in tax matters to the widest possible extent [while clarifying] that Contracting States are not at liberty to engage in ‘fishing expeditions’ . . . .” The Commentary adds, “the standard requires that at the time a request is made there is a reasonable possibility that the requested information will be relevant; whether . . . [it] actually proves to be . . . is immaterial.” As an example, paragraphs 5.2 and 8.1 indicate that if a taxpayer is not individually identified by name or address, a request may be a fishing expedition. However, even the Commentary acknowledges such distinction may be ethereal, where it provides Competent Authorities may comply in any event, even if not obligated to do so.

AUTHORITY OF THE I.R.S. TO COLLECT INFORMATION IN THE CONDUCT OF AN EXAMINATION

When it comes to setting forth the I.R.S.'s power to obtain information pertaining to taxpayers' income taxes, Code §7602(a) paints with a broad bush:

> For the purpose of ascertaining the correctness of any return, making a return where no return was filed, determining the tax liability of any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the [I.R.S.] is authorized --
>
> (1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;
>
> (2) To summon the person liable for tax * * * , or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable * * * , or any other person the Secretary may deem proper, to appear * * * at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and
>
> (3) Take such testimony * * * as may be relevant or material to such inquiry.

In short, the I.R.S. may summon any person and request any information in the context of an investigation or audit, including information in the possession of a third party. In addition, the Code provides that the I.R.S. may appeal to Federal courts to compel attendance, testimony, or production and enforce its summons through appropriate process.

U.S. V. POWELL – IMPOSITION OF STANDARDS FOR THE ISSUANCE OF A SUMMONS

In *U.S. v. Powell*,[4] the Supreme Court examined whether the I.R.S. was required to meet any special showing to compel documents or testimony under Code §7602. The Court looked to prior case law involving the Department of Labor and Federal Trade Commission. In the non-tax case of *Morton Salt*,[5] issued 15 years prior to *Powell*, Justice Jackson stated the following:

> We must not disguise the fact that sometimes, especially early in the history of the federal administrative tribunal, the courts were persuaded to engraft judicial limitations upon the administrative process. The courts could not go fishing, and so it followed neither could anyone else. Administrative investigations fell before the colorful and

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[4] 379 U.S. 48 (1964).

[5] 338 U.S. 632 (1950).

> nostalgic slogan "no fishing expeditions." It must not be forgotten that the administrative process and its agencies are relative newcomers to the field of law and that it has taken and will continue to take experience and trial and error to fit this process into our system of judicature. More recent views have been more tolerant of it than those which underlay many older decisions. . . .
>
> The only power that is involved here is the power to get information from those who best can give it and who are most interested in not doing so. Because judicial power is reluctant if not unable to summon evidence until it is shown to be relevant to issues in litigation, it does not follow that an administrative agency charged with seeing the laws are enforced may not have and exercise powers of original inquiry. It has a power of inquisition, if one chooses to call it that, which is not derived from the judicial function. It is more analogous to the Grand Jury, which does not depend on a case or controversy for power to get evidence but can investigate merely on suspicion that the law is being violated, or even just because it wants assurance that it is not. When investigative and accusatory duties are delegated by statute to an administrative body, it, too, may take steps to inform itself as to whether there is probable violation of law.

In *Powell*, the Supreme Court determined that for the I.R.S. had to show four requirements were met before it could issue a valid summons under Code §7602:

- The investigation must be conducted for a legitimate purpose.
- The inquiry may be relevant to that purpose.
- The information sought is not within the I.R.S.'s possession.
- The administrative steps required by the Code have all been met.

At the time the Court heard the case, there existed a circuit split between the U.S. Courts of Appeals as to whether, once seeking in court the "appropriate process" under Code §7602, the I.R.S. was required to meet some more demanding standard, like the probable-cause standard Justice Jackson discussed in *Morton Salt*, which was adopted in the First Circuit – but no other circuit. In short, the requirement posed by the vast majority of circuits was so minimal as almost not to be a standard at all: they referred to it as a "might" standard – *i.e.*, the requested information "might" be relevant to some internal revenue rule.[6]

In the end, the Supreme Court reached a decision in the government's favor – the Court adopted the four elements listed above, and reasoned that the First Circuit, with its more demanding requirements on the government, misread Code §7605(b), which did not import additional requirements to Code §7602.[7] Under the four-prong test of *Powell*, the I.R.S. need only demonstrate a "realistic expectation rather than

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[6] See *Foster v. U.S.*, 265 F.2d 183 (2d Cir. 1959); similar approaches were taken in the Third, Fifth, Seventh and Ninth Circuits.

[7] The original version of Code §7605(b) dated to the 1921 Tax Code, in the early years of the income tax system when the nation's wealthy and powerful first complained to Congress of "petty annoyances" created by repeat visits of undisciplined lower-echelon revenue agents.

an idle hope" that in the course of enforcing the summons, something relevant to income taxes will be discovered.[8]

Once the I.R.S. makes this initial showing – by submitting a simple affidavit sworn by the investigating agent attesting that each of the requirements is met[9] – the burden shifts to the taxpayer, who must show bad faith on the part of the I.R.S. in order to have the summons dismissed.

One consequence of *Powell* is that if an I.R.S. summons is challenged, the court may simply require the I.R.S. to narrow the scope of the summons.[10] This can be a lengthy game of snakes and ladders if the I.R.S. does not carefully follow its own administrative requirements.[11] If the taxpayer loses at the level of the trial court, the summons will be enforced unless the trial court issues a stay of enforcement pending appeal. In the event the trial court fails to issue a stay of enforcement, an application for a stay may be submitted to the relevant U.S. Circuit Court of Appeals.[12]

"One consequence of Powell is that if an I.R.S. summons is challenged, the court may simply require the I.R.S. to narrow the scope of the summons."

Powell has been described as a low bar for the I.R.S. to overcome. It is even lower when a summons is issued in the context of an exchange of information under an income tax treaty.

EXCHANGE-OF-INFORMATION REQUESTS

Tax treaties contain exchange-of-information ("E.O.I.") provisions which are intended to facilitate sharing of information by revenue agencies. For example, Article 27 of the France-U.S. Income Tax Treaty, provides that the competent authorities of the U.S. and France may exchange information that is relevant to carrying out the provisions of the treaty. In pertinent part, the treaty provides as follows:

1. The competent authorities of the Contracting States shall exchange such information as may be relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States, insofar as taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Articles 1 (Personal Scope) and 2 (Taxes Covered).

2. Any information received under this Article by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection or administration of, the enforcement or prosecution

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[8] *U.S. v. Goldman*, 637 F.2d 664, 677 (9th Cir. 1980).

[9] *U.S. v. Clarke*, 573 U.S. 248 (2014), citing the U.S. Supreme Court's 1989 decision in *Stuart*, discussed below.

[10] Ninth Circuit examples include *Goldman*, cited *supra*, and *U.S. v. Kersting*, 891 F.2d 1407, 1412 (9th Cir. 1989), *cert den*. 498 U.S. 812 (1990).

[11] See for example *Larson v. United States*, 1992 WL 104791 (D. Montana 1992).

[12] See 15A Fed. Prac. & Proc. Juris § 3954 (5th ed.) (Motion for a Stay or Injunction). Also see *Methvin v. United States*, 1999 WL 458976 (1999).

in respect of, the determination of appeals in relation to the taxes referred to in paragraph 1 , or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

3. In no case shall the provisions of paragraphs 1 and 2 be construed so as to impose on a Contracting State the obligation:

   a. to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

   b. to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

   c. to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy (“ordre public”) * * *[13]

The Treasury Technical Explanation to the 2009 protocol,[14] which modified the language of the information exchange provisions, provides the following explanation:

> New paragraph 1 authorizes the competent authorities to exchange information as may be relevant for carrying out the provisions of the Convention or to the administration or enforcement of the domestic laws concerning taxes imposed by the Contracting States, insofar as the taxation under those domestic laws is not contrary to the Convention. New paragraph 1 uses the phrase “may be relevant”, which is used in the U.S. Model, to clarify that the rule incorporates the standard in Code section 7602 which authorizes the Internal Revenue Service to examine “any books, papers, records, or other data which may be relevant or material.” (Emphasis added.) In *United States v. Arthur Young & Co.,* 465 U.S. 805, 814 (1984), the Supreme Court stated that “the language ‘may be’ reflects Congress’s express intention to allow the Internal Revenue Service to obtain ‘items of even potential relevance to an ongoing investigation, without reference to its admissibility.’” (Emphasis in original.) However, the language “may be” would not support a request in which a Contracting State simply asked for information regarding all bank accounts maintained by residents of that Contracting State in the other Contracting State, or even all accounts maintained by its residents with respect to a particular bank.[15]

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[13] The treaty language in the text is not unique to the France-U.S. Income Tax Treaty. The 2016 U.S. Model Treaty includes a comparable provision.

[14] Signed by the U.S. and France on January 13, 2009 and entered into force on 12/23/2009. The relevant provision is Article XI of the protocol.

[15] This was prior to the entry into the Intergovernmental Agreement between the U.S. and France in 2013 related to F.A.T.C.A.

> The authority to exchange information granted by paragraph 1 is not restricted by Article 1 (Personal Scope) or Article 2 (Taxes Covered), and thus need not relate solely to persons or taxes otherwise covered by the Convention. For purposes of Article 27, the taxes covered by the Convention constitute a broader category of taxes than those referred to in Article 2 (Taxes Covered). Exchange of information is authorized with respect to taxes of every kind imposed by a Contracting State at the national level. Accordingly, information may be exchanged with respect to U.S. estate and gift taxes, excise taxes or, with respect to France, value added taxes. In this regard, paragraph 1 is broader than paragraph 1 of Article 27 of the 2004 Convention. Article 27 does not apply to taxes imposed by political subdivisions or local authorities of the Contracting States.

This raises the following question. If a treaty partner jurisdiction makes an E.O.I. request to the I.R.S. and the request is challenged in U.S. Federal District Court by the subject individual, should the court look to the purpose of the treaty partner tax administration or the purpose of the I.R.S. when applying the *Powell* standards? Under the cases, the answer is simple – all that matters under *Powell* is the good faith purpose of the I.R.S. in responding to the request. The good faith of the treaty partner is irrelevant.

"If a treaty partner jurisdiction makes an E.O.I. request to the I.R.S. and the request is challenged in U.S. Federal District Court by the subject individual, should the court look to the purpose of the treaty partner tax administration or the purpose of the I.R.S. when applying the Powell standards?"

STANDARD ADOPTED IN *U.S. v. STUART*

The seminal case in this area is *U.S. v. Stuart*;[16] concerning a request for bank statements under the Canada-U.S. Income Tax Treaty. In *Stuart*, the I.R.S. served a summons on a bank regarding information related the subject individual's U.S. account. The taxpayer challenged the request in U.S. Federal District Court based on the contention that the Canadian Revenue Agency investigation had proceeded to a stage that was analogous to a U.S. Department of Justice criminal investigation. By analogy to the rule of Code §7602(c), which prohibited issuances of civil summonses in such situations, the taxpayer moved to quash the summons.[17] The Supreme Court found that Code §7602(c) was inapplicable in the cross-border context, stating as follows:

> The concerns that prompted Congress to enact Code §7602(c) – particularly that of preventing the IRS from encroaching upon the rights of potential criminal defendants – are not present when the I.R.S. issues summonses at the request of foreign governments conducting investigations into possible violations of their own tax laws. This is especially so where none of the countries, including Canada, with whom the United States has tax treaties providing for exchanges of information employ grand juries and criminal discovery procedures differ considerably among those countries.

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[16] 489 U.S. 353 (1989).

[17] Introduced by the Tax Equity and Fiscal Responsibility Act of 1982, this rule has since been relocated to Code §7602(d) and provides that "[n]o summons may be issued under this title, and the Secretary may not begin any action under [Code §]7604 to enforce any summons, with respect to any person if a Justice Department referral is in effect with respect to such person."

In U.S. Federal District Court, the holding in *Stuart* is routinely cited by U.S. government attorneys for the proposition that treaty E.O.I. requests are presumptively valid under *Powell*, at least with respect to the legitimate purpose prong. Here are several examples.

Mazurek v. U.S.[18] involved a taxpayer's motion to quash a summons to provide information requested by the French revenue agency. The matter was referred to a magistrate judge who, after hearing from both parties, issued a Report and Recommendation. In it, the magistrate judge concluded that discovery and a full evidentiary hearing were not necessary, and the summons should be enforced based on the evidence in the pleadings. The district court adopted the recommendation, and the decision was affirmed by the Fifth Circuit Court of Appeal.[19] In its opinion, the appellate court reasoned as follows:

> . . . the information [Mr. Mazurek] sought to procure through discovery and to present during an evidentiary hearing relates to the propriety of the FTA's investigation under French civil tax law. His document requests reflect this same focus. Producing evidence that may demonstrate the bad faith of a French tax agency purely as a matter of French civil tax law is irrelevant to the only good faith issue under *Powell*, *i.e.*, the good faith of the IRS in honoring the French request. And, Mazurek does not seek to discover, or allege that he needs to discover, information that would impugn the good faith of the IRS in issuing the summons or enforcing it in compliance with the FTA's request.[20]

Lidas, Inc. v. U.S.[21] involves a request by the French government for information regarding U.S. bank accounts of certain individuals and a corporation. The individuals contended that they were not residents of France and challenged the enforcement

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[18] 271 F.3d 226 (5th Cir 2001).

[19] The Fifth Circuit Court of Appeals noted the taxpayer's "arguments and requests for information inappropriately focused on the legitimacy and bad faith of the FTA in requesting the summons rather than on the good faith of the I.R.S. in seeking to comply with that request under the Treaty." 271 F.3d 226, 229 (5th Cir. 2001). It's worth noting that the District Court in *Mazurek* initially granted a temporary stay in response to the I.R.S.'s information request pending re a determination of the taxpayer's residency by a French tribunal; thereafter once the foreign tribunal determined that French residency existed the stay was vacated. 2001-1 U.S.T.C. ¶50,304 (E.D. La. 2001); 2001-1 U.S.T.C. ¶50,415 (E.D. La. 2001).

[20] In a purely domestic context, courts have considered the I.R.S.'s good faith in a variety of contexts, and precedents for quashing summons based on the I.R.S.'s improper purpose may continue to be grounds for relief; see for example *United States v. Coinbase, Inc*., 120 A.F.T.R. 2d 2017-5239 (2017), in which the Court granted one John Doe defendant the right to be substituted for two others, based on an argument that the I.R.S.'s request for extensive information on owners of cryptocurrency was akin to requesting bank records for every single U.S. customer from every single U.S. bank branch based on an argument that "tax liabilities are under reported in general, and such records might turn up tax liabilities[,]" and hence an abuse of the court's process.

[21] 238 F.3d 1076 (9th Cir. 2001).

of the summons through the filing of a motion to quash. In affirming the grant of summary judgment in favor of the U.S. Government., the court stated the following:

> The [Individuals] also contend that the district court erred in granting summary judgment in favor of the United States enforcing the summons. To obtain enforcement of an administrative summons issued pursuant to 26 U.S.C. section 7602(2) (sic), the IRS need only demonstrate "good faith" in issuing the summons. The IRS's *prima facie* showing of good faith is based on the four-part test formulated in *United States v. Powell*, 379 U.S. 48 (1964). The IRS must show that: (1) the investigation will be conducted for a legitimate purpose; (2) the inquiry will be relevant to such purpose; (3) the information sought is not already within the Commissioner's possession; and (4) the administrative steps required by the Internal Revenue Code have been followed. See id. at 57-58.
>
> The same test applies where the IRS issues a summons at the request of a tax treaty partner. See *United States v. Stuart*, 489 U.S. 353 (1989). In such case, the IRS need not establish the good faith of the requesting nation. "So long as the IRS itself acts in good faith [under *Powell*] . . . and complies [pg. 2001-805] with applicable statutes, it is entitled to enforcement of its summons." *Id.* at 370.
>
> Once the IRS establishes a *prima facie* case for enforcement of its summons under *Powell*, the burden shifts to the taxpayer, who "may challenge the summons on any appropriate ground," including failure to meet the *Powell* requirements. See *Powell*, 379 U.S. at 58. Nevertheless, the taxpayer bears a "heavy burden" to rebut the presumption of good faith. *United States v. Jose,* 131 F.3d 1325, 1328 (9th Cir. 1997) (*en banc*).

"While refusing to grant a stay pending its resolution of the matter, the Court entertained the case on the basis that if the taxpayer prevailed, the I.R.S. would ask S.A.T. to return the materials and destroy any copies."

Villareal v. U.S.[22] involves a taxpayer who alleged that the treaty request for records from a third-party bank was made for the improper purpose of harassment. The taxpayer provided an affidavit stating S.A.T. could not obtain the information under Mexican law. While refusing to grant a stay pending its resolution of the matter, the Court entertained the case on the basis that if the taxpayer prevailed, the I.R.S. would ask S.A.T. to return the materials and destroy any copies. Citing *Stuart*, the Tenth Circuit ultimately determined that the Mexican authority's good faith was irrelevant to the matter, and only the I.R.S.'s good faith in issuing the summons was in issue.

In a wholly domestic context, some Circuit Courts of Appeals will permit a taxpayer to examine I.R.S. officials regarding their reasons for issuing a summons, assuming sufficient facts are alleged up front in the form of a signed affidavit. This approach is irrelevant in the cross-border context.

THIRD PARTY SUMMONS

Assume the I.R.S. requests information and the taxpayer refuses. Suppose the I.R.S. then seeks the information from third parties in whose possession such

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[22] 524 Fed. Appx. 419 (10th Cir. 2013).

information may naturally exist – perhaps the taxpayer's bank. Code §7609(a) poses three distinct procedural hoops that must be overcome in such cases:

- Within three days of the service of process to the third party, and in all events no later than the 23rd day before the date fixed in the summons on which records in the third party's possession are to be examined or provided, the I.R.S. must notify the taxpayer identified in the summons of the third-party request.
- The notice to the taxpayer must meet the requirements of Code §7603, which includes the situation where the I.R.S. serves the notice via certified or registered mail to the taxpayer's last known address on record.
- The notice must be accompanied by a copy of the summons and contain an explanation of the right to bring a proceeding to quash.

If the taxpayer intervenes under Code §7609 to quash, a case must be brought in the U.S. Federal District Court where the taxpayer resides (if an individual) or is registered for business (if a corporation or L.L.C.). This can be a lengthy game of snakes and ladders if one or both sides are not fully compliant with the requirements of the Code and the Service's own administrative requirements. If the I.R.S. fails to give the taxpayer proper notice and the third-party fails to stop and ask whether the information may legitimately be given, how will the taxpayer prevent irreparable damage? There is a Circuit split on the question of whether third-party notice requirements of Code §7609 must be strictly construed under *Powell*.[23] In addition, the Taxpayer First Act of 2019[24] amended Code §7602(c) to provide that, if the I.R.S. issues third-party summons on or after August 17, 2019, it must give notice in writing to the affected taxpayer.

WHERE INFORMATION IS MISUSED BY THE FOREIGN TAX AUTHORITY

In light of the holding in *Stuart*, what remedy is realistically available to a person whose information has been obtained by the I.R.S. under the exercise of its summons power, transferred to the tax authority of a treaty partner country, and used for an improper purpose? The answer is that limited retroactive relief may be obtained in the form of damages.

In *Aloe Vera of America, Inc. v. United States*, the taxpayer sought civil damages under Code §6103 for an allegedly unauthorized disclosure of certain confidential return information to the National Tax Administration ("N.T.A.") in Japan. Paragraph 1 of Article 26 of the relevant income tax treaty provided standard limitations on the disclosure of information by the treaty partner country making the request. In pertinent part, it provided as follows:

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[23] See *Jewell v. United States*, 749 F.3d 1295 (10th Cir. 2014), discussing four other circuit's approach to Code §7609, treating at as a "soft" requirement under *Powell*, prong 4, and reasons for which the Tenth Circuit considered it necessary for the I.R.S. to fully observe the administrative requirements of this provision.

[24] Pub. L. No. 116-25.

> Any information so exchanged shall be treated as secret and shall not be disclosed to any persons other than those (including a court or administrative body) concerned with assessment, collection, enforcement, or prosecution in respect of the taxes which are the subject of this Convention.

The taxpayer argued that the I.R.S. knew or should have known that Japan's N.T.A. routinely failed to abide by secrecy provisions when it requested information under an E.O.I. provision of income tax treaties. The taxpayers requested actual and proximate damages for the N.T.A.'s inappropriate use in the vicinity of $52 million,[25] based on the harmful effects of the N.T.A.'s negative press conference. The I.R.S. claimed that, under the convention, the duty to maintain secrecy applied solely to the N.T.A., but the court concluded that Code §6103 protections were applicable, nevertheless. Unfortunately for the taxpayer, the court awarded only statutory damages of $1,000 to each of three plaintiffs, holding that actual and punitive damages requested were inapplicable where the taxpayers failed to show that the N.T.A. commenced its simultaneous examination because of the information provided by the I.R.S.[26]

"Unfortunately for the taxpayer, the court awarded only statutory damages of $1,000 to each of three plaintiffs, holding that actual and punitive damages requested were inapplicable. . ."

[25] The taxpayers cited *Jones v. U.S.,* 9 F. Supp. 2d 1119 (D. Neb. 1998), which awarded $4,500,000 in damages to a taxpayer whose information was provided by the I.R.S. to an informant, who then publicly disclosed the information received.

[26] The case wound its way up and down through the Federal courts for nearly 20 years. The initial case was prompted by an I.R.S. audit of the taxpayers' tax liabilities in May of 1995 after an I.R.S. examiner recommended disallowing certain deductions for commissions paid on sales of Aloe Vera gel exceeding $32 million. Thereafter, the I.R.S. proposed a joint examination to N.T.A., and both agencies ultimately assessed deficiencies, including penalties and interest. The N.T.A. was notorious for leaking information to shame large or famous tax evaders. When a Japanese subsidiary's tax information was leaked, the taxpayers brought a suit for damages based on a disclosure of a baseless estimate by the I.R.S. agent. In District Court, the taxpayers asserted that the U.S. disclosed information to the N.T.A. which it knew or should have known the N.T.A. would not keep confidential. The initial decision was *Aloe Vera of Am., Inc. v. U.S.*, 128 F. Supp. 2d 1235 (D. Ariz. 2000). After three successive amendments to the taxpayers' complaint, the District Court determined in 2007 that the plaintiffs had failed to establish the existence of a genuine issue of material fact; see 2007 U.S. Dist. LEXIS 8103 (D. Ariz. 2007). On appeal, the Ninth Circuit Court of Appeals remanded for a determination of subject matter jurisdiction based on the statute of limitations. See 580 F.3d 867 (9th Cir. 2009). Subsequently, the District Court found it had jurisdiction over some claims but reaffirmed its partial award of summary judgment to the I.R.S. on other claims for reasons stated in the prior ruling. See 730 F. Supp. 2d 1020 (D. Ariz. 2010). On a second-round appeal, the Ninth Circuit affirmed in part and reversed in part, holding genuine issues of material fact existed, as discussed in 699 F.3d 1153 (9th Cir. 2012). On remand the District Court denied a motion for partial summary judgment, at 2013 U.S. Dist. LEXIS 179559 (D. Ariz. 2013). During the litigation, the U.S. waived sovereign immunity specifically with respect to the statements its agents had made to the N.T.A., and after a final bench trial, the District Court found that "considering all of the evidence, . . . [the N.T.A.] leaked information to the Japanese media," and awarded statutory damages but not actual or punitive damages requested by the taxpayers. See *Aloe Vera of Am., Inc. v. U.S.,* No. CV-99-01794-PHX-JAT, at *11 (D. Ariz. 2015); *aff'd in part, rev'd and rem'd in part, by unpub op.*, No. 15-15672 (9th Cir. 2017), *amended by unpub. op. denying pet. for reh'g and reh'g en banc*, No. 15-15672 (9th Cir. 2017).

CONCLUSION

When a U.S. person files an action to quash an I.R.S. summons that has been issued in response to an E.O.I. request, answer of the I.R.S. is predictable. It takes the form of a motion to dismiss based on the argument that *Powell*'s requirements are automatically met. While legal arguments and case citations are cited by the attorneys for the U.S. Government, should keep in mind that if the proffered argument is based on the protections granted in the E.O.I. article of a treaty, it should expect a decision based on the words uttered by Humpty Dumpty to Alice. The mandatory purpose for exchanging information and the recipient's obligation to keep the information secret are words that impose no burden on the tax authority making the request. Under the cases, those words likely mean that the foreign government wants the information and is obligated to use the information as it pleases. And, if upon obtaining the information from the I.R.S., the treaty partner revenue agency leaks protected return information to the public, in the best-case scenario the U.S. taxpayer's recourse may be limited to nominal damages plus attorney fees.[27]

Similar to E.U. taxpayers addressed by Messrs. Heyvaert and Mohammed in their article in the last edition of *Insights* and cited at n.1, the taxpayer's only effective route may be to take the matter up directly with the courts of the foreign jurisdiction originating the request, where prospects for meaningful relief may be slim.

[27] Recent U.S. Supreme Court opinions on First and Second Amendment cases such as *Uzuegbunam v. Preczewski* have addressed taxpayer's entitlement to bring suit for nominal damages, though Justice Kavanaugh speculated during oral argument that claims for nominal damages may be driven by attorney fee awards. An example can be found in Adam Liptak, Citing Taylor Swift, Supreme Court Seems Set to Back Nominal Damages Suits, Jan. 12, 2021.

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