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INSIGHTS

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EDITORS' NOTE

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

- **Five Reasons Why the Legal Professional Privilege of Belgian Lawyers is Incompatible With the Mandatory Reporting Under D.A.C.6.** D.A.C.6 in the E.U. requires Member States to impose a disclosure obligation on intermediaries who advise on, or are involved in, implementing aggressive cross-border arrangements. This poses a conundrum for tax lawyers involved in a transaction because, whatever they do, rights of taxpayers and duties of attorneys to maintain client confidences may be ignored, or significantly cut back. In Belgium, the approach is to ignore Belgian case law that recognizes the obligations of lawyers to keep confidences and forces attorneys to violate various obligations to clients. Not surprisingly, the Belgian Bar Councils and the Belgian Association of Tax Lawyers have challenged the restrictive interpretation of the L.P.P. before national and European courts. Werner Heyvaert, a partner at the Brussels office of AKD Benelux Lawyers, and Vicky Sheikh Mohammad, an associate at the Brussels Office of AKD Benelux Lawyers, explain the five reasons why Belgian implementation of D.A.C.6 is flawed. The case is currently under consideration by the C.J.E.U.

- **How New York Courts Provide Broad Support to Parties Engaged in International Arbitration and Litigation.** Why is an international tax journal addressing the broad scope of remedies available to parties in foreign litigation or arbitration? The reason is simple. Clients enter transactions, transactions blow-up, and parties sue or can be sued. Even if the parties, the contract, or the dispute at issue have little or no connection to New York, potential documents, assets, or witnesses may be located within the State. If so, New York courts can provide tools (i) to obtain broad information vital to a pending foreign proceeding, (ii) to attach assets to secure an ultimate recovery or incentivize settlement, or (iii) to enforce final judgments or awards, including seizure of assets and other post-judgment remedies. These are important tools to a litigator. Dan J. Schulman, a commercial litigator based in New York, explains all. He has over 35 years of experience managing complex commercial litigations, arbitrations, and appeals in New York, and shares the tools that are available to parties in a litigation.

- **Israel Tax Authority Proposes Changes for Individuals With Cross-border Connections.** In an age of spectacular liquidity events for Israeli start-up companies, the Israel Tax Authority has proposed significant revisions to the tax law designed to bring more income and gains into the Israeli tax net. In part, this reflects a global trend among governments and to close a perceived tax gap among the wealthy, especially those having one foot at home and a second foot abroad. In Israel, the proposals directed at individuals include (i) adoption of objective rules for determining tax residence with greater certainty, (ii) tightening of exit tax rules to ensure collection of deferred amounts, (iii) expansion of C.F.C. rules to cover more foreign companies, (iv) elimination of foreign tax credit carryovers for unused foreign tax credits, and (v) changes to basis step-up rules for property inherited from foreign decedents. Daniel Paserman, a partner in the Tel Aviv office of Gornitzky, attorneys, and the head of the firm's tax practice, and Inbar Barak-Bilu, a partner in the Tel Aviv Office of Gornitzky, attorneys, caution that the proposals are groundbreaking and are likely to have an influence on persons considering a move to or from Israel.

- **Toulouse or not Toulouse? N.I.I.T.-Picking the Reach of the U.S. Foreign Tax Credit.** When is a tax that is based on income not an income tax? When are treaty provisions that provide for relief from double taxation properly ignored? The answer in the U.S. is when the tax is the Net Investment Income Tax, generally referred to as N.I.I.T. In the *Toulouse* case, the U.S. Tax Court refused to allow a U.S. citizen resident abroad to claim a foreign tax credit when it came to the N.I.I.T. In addition to the technical issue, the case is interesting because it illustrates the choice of procedures to be followed when challenging an I.R.S. increase in tax for reasons unrelated to the computation of income or the availability of a credit. One is the Collection Appeals Program ("C.A.P.") and the other is the Collection Due Process program ("C.D.P."). Here, the taxpayer chose the C.D.P., as it allowed the taxpayer an opportunity to challenge an adverse position of the I.R.S. by filing a petition in the U.S. Tax Court. Andreas Apostolides and Wooyoung Lee explain the rationale of the court in denying double tax relief. In particular, it points out that taxpayers who seek treaty relief in matters other than withholding tax rates do so at their peril.

- **Trusts Under Attack – the Legislative Landscape.** Bad ideas travel globally, especially if the source of information is a progressive crusader. Reducing perceived wealth disparity in the U.S. has become a major political goal of the Biden Administration and the Democratic Party. That goal, together with the goal of increased transparency concerning ownership, have resulted in a number of legislative proposals, which, if enacted will fundamentally alter tax planning regimes for the wealthy. In her article, Nina Krauthamer explores some of these recommendations and their effect.

- **Rescission – Undoing a Transaction That Seemed Like a Good Idea at the Time.** How many times have we watched a movie, read a book, or listened to a colleague talk about an action that appeared to be a no-risk proposition, only to turn into a nightmare? At some point, the general lament is uttered: "It seemed like a good idea at the time, but . . ." Tax plans can be like that, too. A company identifies an acquisition target, proposes a merger with a supplier, or considers an internal restructure. Teams of lawyers, accountants, and operations personnel perform appropriate due diligence. The deal closes. At some point, blemishes, problems, errors float to the surface. The same lament is uttered: "It seemed like a good idea at the time, but . . ." While the laments are the same, the suffering for a tax planning mistake need not linger forever. If the parties to a transaction act quickly, the doctrine of rescission may apply, allowing the parties to treat the event as if it never occurred. Stanley C. Ruchelman and Neha Rastogi explain the early cases and discuss a published ruling and several private letter rulings in which the principal concern of the I.R.S. is that the transaction and its rescission occur in the same taxable year.

- **The "Value Creation" Question has Escaped the New Pillar 1 Mousetrap.** In every decade, a phrase or a term pops up that is widely used, although its meaning may vary from person to person. Examples in past decades include "groovy," "viral," "neat," and "heavy." In his article, Michael Peggs identifies "value creation" as a phrase that has gone "viral" among the O.E.C.D., the G-20, and tax authorities. The "neat" aspect is that, over the centuries, the term has meant different things to different commentators. Nonetheless, it remains the central foundational feature of controlling policy for global policy wonks. It could mean that while everyone appears to be marching in unison, they are really marching in different directions, much to the chagrin of multinational enterprises. "Heavy!"

We hope you enjoy this issue.

- The Editors

FIVE REASONS WHY THE LEGAL PROFESSIONAL PRIVILEGE OF BELGIAN LAWYERS IS INCOMPATIBLE WITH THE MANDATORY REPORTING UNDER D.A.C.6

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Tags
Attorney Client Privilege
Belgium
Charter of Fundamental Rights
D.A.C.6
Legal Professional Privilege
L.P.P.

INTRODUCTION

The European Union's Council Directive 2018/822 of May 25, 2018 (better known as "D.A.C.6") requires Member States to impose a disclosure obligation on intermediaries who advise on, or are involved in, implementing aggressive cross-border arrangements.[1] The conundrum faced by some intermediaries is that they are bound by legal professional privilege ("L.P.P."), and therefore, are not allowed to share privileged information.[2] This is typically the case for persons who are engaged in the active practice of law. As a solution, the Directive allows Member States to exempt such "privileged intermediaries" from their reporting obligation where the reporting would breach L.P.P. under national law.[3] While most European legislators used this option to exempt lawyers from their reporting obligation, the rules in each Member State have unique twists and turns.[4]

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1 Council Directive (E.U.) 2018/822/E.U. of 25 May 2018 as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements, OJ L 139/1 (hereinafter: the "Directive"). The acronym "D.A.C." stands for "Directive on Administrative Cooperation."

2 The protection of L.P.P. is a common legal tradition of all E.U. Member States, even though legal basis, type, and scope may differ. What is identical, however, is that the protection is not absolute. Encroachment may be permissible (i) where defense rights are not at stake (see Section 6 E.C.H.R.) and (ii) the encroachment is in accordance with the law and is necessary in a democratic society because it is (a) in the interests of national security, public safety or the economic well-being of the country, (b) for the prevention of disorder or crime, (c) for the protection of health or morals, or (d) for the protection of the rights and freedoms of others (proportionality principle, see Section 8 E.C.H.R.).

3 See Directive, Section 8ab(5), which provides as follows

> Each Member State may take the necessary measures to give intermediaries the right to a waiver from filing information on a reportable cross-border arrangement where the reporting obligation would breach the legal professional privilege under the national law of that Member State. In such circumstances, each Member State shall take the necessary measures to require intermediaries to notify, without delay, any other intermediary or, if there is no such intermediary, the relevant taxpayer of their reporting obligations * * *.

4 For a comparative view of D.A.C.6's implementation in different Members States, see, K. Resenig, "European Union - The Current State of DAC-6 Implementation in the European Union," Vol. 60, n° 12 *European Taxation*, pp. 527-535 (2020).

In this article, the authors identify five inconsistencies between the reporting obligation imposed by the Belgian Implementation Law of the Directive[5] and the L.P.P. of Belgian lawyers.[6]

INCONSISTENCIES OF THE BELGIAN IMPLEMENTATION LAW WITH THE L.P.P. OF BELGIAN LAWYERS

Belgium made use of the option offered by the Directive to exempt privileged intermediaries by implementing Section 326/7 in the Belgian Income Tax Code ("B.I.T.C."), which states as follows:

> Section 326/7.
>
> § 1. Where an intermediary is bound by a L.P.P., he must:
>
> 1° [if there is one or multiple other intermediaries involved,] inform him or them, in writing and in a motivated manner, that he [read: the privileged intermediary] cannot comply with the reporting obligation, whereupon the reporting obligation automatically shifts to the other intermediary or intermediaries;
>
> 2° in the absence of another intermediary, inform [directly] the taxpayer or taxpayers, in writing and in a motivated manner, that the reporting obligation shifts to him or them. The exemption from the reporting obligation [for the privileged intermediary] is effective only from the moment [such] intermediary has fulfilled the obligation referred to in paragraph 1 [*i.e.*, inform in writing and in a motivated manner any other intermediary or the taxpayer].
>
> § 2 The taxpayer may, by written authorisation, allow the [privileged] intermediary to [nevertheless] fulfil the reporting obligation […]. If the taxpayer does not give any authorisation, the reporting

[5] Law of 20 December 2019, *Belgian State Gazette*, 30 December 2019 (hereinafter: "Belgian Implementation Law"); for further details, see Belgian Circular Letter, "*F.A.Q.: DAC 6 - Déclaration des dispositifs transfrontières*," available in French and Dutch at www.myminfin.be; See also, W. Heyvaert and V. Sheikh Mohammad, "European Union's New Reporting Obligations for Tax Intermediaries: Key Features of the Belgian Administrative Guidance - D.A.C.6," Vol. 8, No 2 *Insights*, pp. 3-10; D.-E. Philippe and E. Yuksel, "Mandatory Disclosure of Aggressive Cross-Border Tax Planning Arrangements: Implementation of DAC 6 in Belgium," Vol. 60, No 4 *European Taxation*, pp. 121-128 (2020); J. Malherbe, "*La déclaration obligatoire des dispositifs transfrontières – Directive DAC 6 du 25 mai 2018 et loi du 20 décembre 2019*," 1-2 *Revue Générale du Contentieux Fiscal,* pp. 29-40 (2020).

[6] The L.P.P. of Belgian lawyers is an essential feature of the profession and the obligation to comply with it is formally set out in the professional rules of conduct (see Section 1.2.(b) of the French and German Code (O.B.F.G./Avocats.be); Section I.1.1. and Title I.3, of the Flemish Code (OVB)). Violation of the L.P.P. is criminally sanctioned under Section 458 of the Belgian Criminal Code; for an overview of the regulation of the legal profession in Belgium, see here.

obligation remains with the taxpayer, and the [privileged] intermediary shall provide to the taxpayer the information necessary to comply with the reporting obligation […].

§ 3 [The reporting exemption for privileged intermediaries] does not apply for marketable devices, that give rise to a periodic reporting […]" [Unofficial translation.]

The foregoing provision of the B.I.T.C. is incompatible with the L.P.P. of Belgian lawyers for several reasons.

- The provision mandates disclosure of protected confidential communication.
- The provision fails to recognize that the scope and obligations of the L.P.P. for lawyers is broader than for other professions.
- Allowing a client to waive rights under the L.P.P. is invalid (even if the attorney agrees to the waiver).
- The reporting obligation for marketable arrangements is overly broad.
- The assertion that the L.P.P. does not apply to tax advice is without merit.

Each is discussed below.

The Provision Mandates Disclosure of Protected Confidential Communication

Belgium exempts lawyers from their reporting obligation *provided* they inform another intermediary or, if there is no other intermediary, the relevant taxpayer of its reporting obligations.[7] In other words, lawyers are exempt from their "duty to report" only after they accomplish a "duty to inform." However, the mere circumstance that a lawyer shares privileged information with someone other than the client (here, another intermediary, say an accountant or consultant or a bank) breaches the Belgian L.P.P. At a minimum, the mere fact that a client has chosen a specific lawyer is privileged. Moreover, the privilege not only covers advice given to the client by the lawyer, but also covers information received by the lawyer from the client. In sum, the exemption for Belgian lawyers is flawed, as it is incompatible with the L.P.P.[8]

The Provision Fails to Recognize that the Scope and Obligations of the L.P.P. for Lawyers is Broader Than for Other Professions

Belgium does not make any distinction between the various types of privileged intermediaries. This shortcoming goes against long-established case-law of the Belgian Constitutional Court ("*Cour Constitution-nelle/Grondwettelijk Hof*"), which sets apart the L.P.P. of lawyers from that of other professions:

> [Lawyers] are subject to strict ethical rules * * *. It follows from the special status of lawyers, established by the Belgian Judicial Code

[7] B.I.T.C., Section 326/7, § 1 (which is in line with Section 8ab(5) of the Directive).

[8] This mechanism also goes against primary E.U. law, see Belgian Association of Tax Lawyers, Issues Related to the European Directive 2018/822 (D.A.C.6) and its Transposition into National Law, spec. pp. 11-12.

> and by the regulations adopted by the [Bar Associations] that lawyers in Belgium are distinct from other independent legal professions. [Unofficial translation.][9]

For the Belgian Constitutional Court, the lawyer's L.P.P. is the cornerstone that guarantees the right of a legal defense against challenges by the government.[10] The protection against self-incrimination depends on the confidential bond between the lawyer and the client and the confidentiality of their written and oral conversations.

Allowing a Client to Waive Rights Under the L.P.P. is Invalid (Even if the Attorney Agrees to the Waiver)

Belgium allows a taxpayer to waive the L.P.P. and to authorize the lawyer to comply with his or her reporting duty.[11] However, the waiver is incompatible with the public policy (*ordre public/openbare orde*) that exists in the L.P.P. covering Belgian lawyers. Under Belgian law, when a statutory provision reflects public policy, one cannot derogate from it unilaterally or by mutual agreement. If it were otherwise, government pressure imposed on the taxpayer could easily jeopardize a taxpayer's right of defense, including the presumption of innocence.

"Under Belgian law, when a statutory provision reflects public policy, one cannot derogate from it unilaterally or by mutual agreement.'"

For more than a century, the Belgian Court of Cassation explicitly acknowledges the L.P.P.'s public policy nature:[12]

> Legal professional privilege relates to public order and protects a specific interest, which is to ensure the practicability of certain professions necessary for the proper functioning of [a democratic] society, the exercise of which necessarily implies a guarantee for the confidant that the trust in the person to whom he confides is not betrayed. [Unofficial translation.]

The Reporting Obligation for Marketable Arrangements is Overly Broad

Belgian lawyers cannot invoke their L.P.P. rights where the reporting obligation relates to a marketable arrangement.[13] In contrast with a bespoke arrangement, the Belgian Implementation Law defines a "marketable arrangement" as "a cross-border arrangement that is designed, marketed, ready for implementation or made available for implementation without a need to be substantially customised."[14]

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9 Belgian Constitutional Court, No. 126/2005 of 13 July 2005, available on www.const-court.be, see spec. points B.6.1.-B.6.3.

10 Belgian Constitutional Court, No 127/2013 of 26 September 2013, available on www.const-court.be, spec. points B.29.2, B.29.3 and 30.

11 B.I.T.C., Section 326/7, § 2.

12 Belgian Court of Cassation, 20 February 1905, *Pasicrisie (Pas.),* I, 1905, p. 141; For a more recent case, see Belgian Court of Cassation, 19 January 2001, *Journal des tribunaux (J.T.),* 2002, p. 9; The Belgian Constitutional Court also acknowledges the public policy nature of the L.P.P., Belgian Constitutional Court, 3 May 2000, *Jurisprudence Liège Mons Bruxelles (J.L.M.B.).,* 2000, p. 868; Belgian Constitutional Court, 24 March 2004, *Jurisprudence Liège Mons Bruxelles (J.L.M.B.).,* 2004, p. 2080.

13 B.I.T.C., Section 326/7, §3.

14 B.I.T.C., Section 326/1, 6°, unofficial translation.

The rationale for this provision is that the Directive orders Member States to require intermediaries to report on a quarterly basis each marketable arrangement in which the intermediary participated. Since the first intermediary is the only one who has the knowledge and ability to make a quarterly report of marketable arrangements, he cannot pass this reporting obligation to another intermediary or to the taxpayer. Moreover, he or she cannot invoke any rights related to the L.P.P. for lawyers.

This looks quite similar to the German "*kurieren am Symptom*." Since no effective solution can be found for the quarterly reporting of marketable arrangements, the first intermediary must breach his L.P.P. But why should the first intermediary not be able to provide the taxpayer with the information required to file the quarterly report? This mechanism works well for the first report and should work equally well for the quarterly reports.

When a lawyer advises a client (such as a bank or an insurance company) on a marketable arrangement, the client is rarely the end-user since he in turn sells the arrangement to the actual end-user. Such clients are sufficiently equipped to make the quarterly reporting themselves and may even be in a better position than the lawyer who merely provides legal or tax advice on the marketable arrangement.

The Assertion that the L.P.P. Does Not Apply to Tax Advice is Without Merit

the Explanatory Memorandum of the Belgian Implementation Law suggests that a lawyer's tax planning advice would not be covered by the L.P.P., as the privilege only covers the legal defense or representation in court and/or the determination of the legal position of a taxpayer.[15]

> The * * * implementation of cross-border arrangements * * * is not immediately related to any secret entrusted to an intermediary by his client but is more a matter of assistance or advice provided by the intermediary to the client. The protection of the trust that a client puts in an intermediary as a result of the exercise of his professional activity can only concern the assistance or advice provided by the intermediary to the client insofar as it relates to the determination of the legal position of a taxpayer or the defense of the taxpayer in a judicial action, which can also be found in the Law of September 18, 2017 on the prevention of money laundering and terrorist financing and the limitation of the use of cash. In particular, this refers to purely legal advice, excluding tax planning of a potentially aggressive nature. It is only for these activities that a statutory exemption from the reporting obligation may apply for the intermediary. On the other hand, an adviser who limits himself to the above-mentioned legal advice and who has at no time directly or through other persons provided help, assistance or advice concerning the design, marketing or organization of a reportable cross-border scheme or concerning its provision for implementation or the management of its implementation, will not be considered an intermediary, as defined in the Directive, and will therefore not be subject to the reporting obligation.

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15 Belgian Parliamentary Documents, House of Representatives, 2019-2020, n° 55-791/001, pp. 18-22, spec. p. 19 (hereinafter: "Explanatory Memorandum"); To be read in parallel with the Law of 18 September on the prevention of money laundering and terrorist financing and the limitation of the use of cash, Belgian State Gazette, 16 October 2017, spec. art. 53.

> This view is therefore consistent with Section 53 of the Law of September 18, 2017, as it implicitly recognizes that, in the context of the determination of the legal position and legal defense/representation, the L.P.P. applies. In this context, a statutory exemption from the reporting obligation for the intermediary can indeed be granted within the limits of the aforementioned regulation. [Unofficial translation.]

This reasoning of the Belgian legislator disregards the case-law of the Belgian Constitutional Court, which takes the opposite view:[16]

> [I]nformation known to the lawyer in the course of the exercise of the essential activities of his profession * * *, namely the assistance and defense of the client in court, and legal advice, even outside of any legal proceedings, are covered by the L.P.P., and may not be brought to the attention of the authorities. [Unofficial translation.]

In the Explanatory Memorandum, the Belgian legislator ventures into a hazardous comparison with the reporting obligation in money laundering cases and to the fact that the L.P.P. is subordinated to a higher value ("*motif d'intérêt supérieur/reden van hoger belang*").

No one disputes that even fundamental rights are subject to exceptions and must give way to an overriding interest. In this instance, however, the Belgian legislator is comparing apples to oranges. The mandatory reporting in money laundering cases relates to criminal offenses that the client is suspected of, whereas D.A.C.6 concerns legitimate cross-border arrangements that are neither fraudulent nor even abusive.

Moreover, when lawyers suspect a client of money laundering, they report it to the President of the Bar Association, not to the Belgian Financial Information Processing Unit ("C.T.I.F./C.F.I.") and definitely not to the Public Prosecutor. For D.A.C.6, the Belgian legislator does not mention any overriding interest that would be proportionate to the objective to be achieved and justify lifting the L.P.P.

LEGAL CHALLENGE TO B.I.T.C. SECTION 326/7

At the time this article was written, the Belgian Bar Councils (the Flemish (O.V.B.) and the French and German (O.B.F.G.) Bars) and the Belgian Association of Tax Lawyers have challenged the restrictive interpretation of the L.P.P. in the Belgian Implementation Law before national and European courts. The identity of the appellants is no coincidence since the L.P.P. is a concept of great importance to all members of the legal profession.

On August 31, 2020, they lodged claims for the suspension and annulment of the Flemish Decree implementing the Directive before the Belgian Constitutional Court. On December 21, 2020, the Belgian Constitutional Court requested a preliminary

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16 Belgian Constitutional Court, Case No. 10/2008 of 23 January 2008, available on www.const-court.be, spec. point B.9.6; The Belgian Constitutional Court also rules that the L.P.P. is a general principle of law that can only be overridden by an urgent reason of general interest and the lifting of it must be strictly proportionate to that general interest (see Case No 127/2013 of 26 September 2013, spec. point B.31.2).

ruling from the European Court of Justice on the Belgian implementation of D.A.C.6. The request for a preliminary ruling concerns the compatibility of the Directive with Section 7 (right to respect private life) and Section 47 (right to a fair trial) of the Charter of Fundamental Rights of the E.U. insofar as it requires legal counsel to notify other intermediaries of a need to report under D.A.C.6.

The Court's ruling is highly expected, as it will be important not only for Belgium, but also for all other Member States.

CONCLUSION

The important take-aways for the reader may be summarized as follows:

- The Belgian L.P.P. covers the mere fact that a taxpayer/client has chosen a specific lawyer to provide him with legal or tax advice. The L.P.P. covers both advice given to the client by the lawyer and information received by the lawyer from the client. Requiring a lawyer to inform another intermediary of confidential information received from a client as a condition to applying the L.P.P. is simply a gutless a breach of the L.P.P. by the government.
- •The Belgian L.P.P. reflects time honored public policy. A taxpayer cannot be forced to waive the privilege unilaterally or mutually, by reason of an agreement with his or her lawyer, and even if the taxpayer would be allowed to do so or do so on a voluntary basis, his or her consent would not be valid and would not be a sufficient legal basis for the lawyer to breach the L.P.P.
- The Belgian L.P.P. should apply to marketable arrangements, unless reasonable justification exists in a fact pattern for their exclusion, *quod non*.
- The Belgian L.P.P. applies equally when a lawyer gives tax advice to a client. The L.P.P. is not limited to legal defense or representation in court and/or the determination of the legal position of a taxpayer. The asserted comparison to anti-money laundering legislation is flawed because (i) the reporting obligation under D.A.C.6 relates to legitimate acts that are neither fraudulent nor abusive, and are not directed to facts constituting a criminal offense, (ii) no "filter" exists between the lawyer and the authorities as exists in anti-money laundering cases, where the President of the Bar serves as an intermediary, and (iii) the lifting of the L.P.P. is not proportional to any overriding interest.

HOW NEW YORK COURTS PROVIDE BROAD SUPPORT TO PARTIES ENGAGED IN INTERNATIONAL ARBITRATION AND LITIGATION

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INTRODUCTION

The State and Federal courts of New York provide critical means of obtaining a wide range of discovery in, as well as enforcement of, foreign or international arbitral and judicial proceedings. Even if the parties, the contract, or the dispute at issue have little or no connection to New York, but potential documents, assets, or witnesses are located within the State, New York courts can provide tools (i) to obtain broad information vital to a pending foreign proceeding, (ii) to attach assets to secure an ultimate recovery or incentivize settlement, or (iii) to enforce final judgments or awards, including seizure of assets and other post-judgment remedies.

OBTAINING DISCOVERY IN NEW YORK FEDERAL COURTS THROUGH 28 U.S.C. §1782

U.S. Federal law provides a means by which parties to foreign arbitrations and litigations can obtain discovery in the United States. Specifically, Title 28, Section 1782 of the United States Code ("28 U.S.C. §1782" or "Section 1782") is designated "Assistance to foreign and international tribunals and to litigants before such tribunals." This statute specifically provides that a U.S. district court having jurisdiction over a person or entity within that district can order that person or entity to provide testimony or produce documents or other items "for use in a proceeding in a foreign or international tribunal." Section 1782(a). Such an order from a U.S. district court can be made pursuant to a letter rogatory or request from the foreign tribunal. It can also be based "upon the application of any interested person." Such an order can adopt the "practice and procedure" of the foreign tribunal for the discovery sought, or it can be governed by the Federal Rules of Civil Procedure applicable to U.S. litigants. In other words, Section 1782 can give parties to foreign litigations and arbitrations access to the liberal methods and broad scope of discovery available in U.S. proceedings.

As articulated by the U.S. Court of Appeals for the Second Circuit, the Federal appellate court in New York, the "twin aims" of the statute are "providing efficient means of assistance to participants in international litigation in our Federal courts and encouraging foreign countries by example to provide similar means of assistance to our courts."[1] Consistent with these goals, there are three requirements to obtaining discovery through application of this statute:

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1 *In re Application of Al-Attabi.*

- The person from whom discovery is sought resides (or is found) in the district of the district court to which the application is made.
- The discovery is for use in a foreign proceeding before a foreign [or international] tribunal.
- The application is made by a foreign or international tribunal or any interested person.[2]

Each of these three requirements can be addressed briefly.

First, the scope of "discovery" and "evidence" to be sought is broad, encompassing both testimony in a deposition or documents or other items having any potential relevance to the proceeding. The statute also allows for such testimony or documents to be sought from either a party or a non-party to the proceeding. In fact, there is no requirement that the testimony or documents being sought even be discoverable or admissible in the foreign tribunal – it need only be discoverable under the expansive U.S. standards of discovery. However, there is a territorial limitation. The person or entity from whom the discovery is sought must reside in or be found in the district for which the district court has jurisdiction. This simply means that, for example, if the person resides in or the entity has an office in Manhattan, the application must be made to the U.S. District Court for the Southern District of New York, not any other Federal court.

Second, the discovery sought must be "for use in a foreign proceeding," and both "use" and "foreign proceeding" are broadly defined. As for "use," this is not a requirement that the discovery is necessary for the requesting party to prevail; no such necessity need be demonstrated. "The plain meaning of the phrase 'for use in a proceeding' indicates something that will be employed with some advantage or serve some use in the proceeding — not necessarily something without which the applicant could not prevail."[3] The discovery must merely serve some purpose at some stage in a foreign proceeding. And the "foreign proceeding" can be a foreign litigation, a foreign arbitration, a foreign appeal, or even a proceeding that has not even been initiated yet, but which is within "reasonable contemplation" of the requesting party.

Third, the request must be made by a foreign tribunal *or* by "any interested person." A request from an "interested person" (such as one of the parties) will likely take less time and allow for the requesting party to seek a broader scope of discovery than would be requested in a letter of request or letters rogatory issued by a foreign court.[4] But either option will satisfy this requirement.

If these three broad requirements are met, the U.S. district court has wide discretion to order discovery. Section 1782 "entrusts to the district courts many decisions about the manner in which discovery under the statute is produced, handled, and

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2 *Mangouras v. Squire Patton Boggs.*

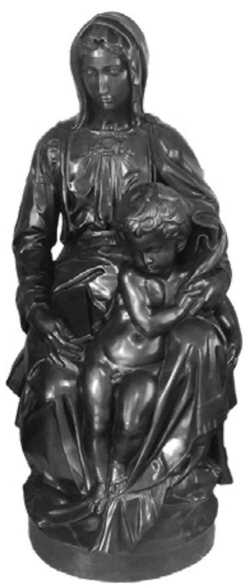
3 *Mees v. Buiter.*

4 Note that both the United States and the United Kingdom have ratified the 1970 Hague Convention on the Taking of Evidence Abroad in Civil and Commercial Matters, the 1965 Hague Service Convention, and the 1961 Hague Apostille Convention, all facilitating the requests for and use of legal evidence across national jurisdictions.

used."[5] In the exercise of such discretion, there are several factors for which the district court can take account. The U.S. Supreme Court (in *Intel Corp. v. Advanced Micro Devices, Inc.*) has identified four such factors:

- Whether the person from whom discovery is sought is a participant in the foreign proceeding, in which case the need for §1782(a) aid generally is not as apparent.
- The nature of the foreign tribunal, the character of the proceedings underway abroad, and the receptivity of the foreign government or the court or agency abroad to U.S. Federal-court judicial assistance.
- Whether the request conceals an attempt to circumvent foreign proof-gathering restrictions or other policies of a foreign country or the United States.
- Whether the request is unduly intrusive or burdensome.

In addition, "a district court [can] condition relief upon that [requesting] person's reciprocal exchange of information," but it is not required to do so.[6]



However, the question of whether the sought-after evidence is *admissible* in the foreign proceeding is *not* a valid consideration when determining whether to order discovery pursuant to Section 1782. The Second Circuit has consistently held "that §1782 [does] not require that the discovery material be admissible in the foreign proceeding, on the ground that, '[a]s in *Intel*, there is no statutory basis for [such a] requirement.'"[7]

OBTAINING ATTACHMENT OF ASSETS IN NEW YORK STATE AND FEDERAL COURTS

One highly useful tool available under New York State and Federal law before reaching a final judgment or final determination in arbitration is attachment of assets located in New York. This tool can ensure that sufficient assets are available to provide a full recovery should the party obtain a successful decision, and the act of freezing such assets may prompt the parties to consider settlement or another resolution of the matter.

There are four types of attachment of New York assets that are relevant here:

- Attachment prior to reaching a decision in a U.S. or foreign arbitration.
- Attachment while a motion is pending in a New York court to recognize an arbitration award (U.S. or foreign) or a foreign judgment.
- Attachment before a judgment has been reached in a litigation commenced in New York.
- Attachment pursuant to U.S. Federal maritime/admiralty law ("Rule B") prior to a final decision or judgment.

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5 *In re Accent Delight Int'l Ltd.*

6 *Sampedro v. Silver Point Capital.*

7 *Mees v. Buiter.*

Although the first three are remedies provided under New York State law, a Federal court in New York can and will invoke any or all of those three state-law remedies, so long as diversity of citizenship exists between the parties.

For the **first** type of attachment, pursuant to New York Civil Practice Law and Rules ("N.Y. C.P.L.R.") 7502 provides that a participant in a U.S. or foreign arbitration can seek an order from a New York court to attach assets in New York before a decision is reached in the arbitration. It must be an arbitration that is currently pending or will be commenced within 30 days. The arbitration can be taking place in the U.S., the U.K., or nearly anywhere else worldwide. The relevant New York court "may entertain an application for an order of attachment or for a preliminary injunction in connection with an arbitration that is pending or that is to be commenced inside or outside this state, whether or not it is subject to the United Nations convention on the recognition and enforcement of foreign arbitral awards . . . ."[8]

The basis for an application must be "upon the ground that the [arbitration] award to which the applicant may be entitled may be rendered ineffectual without such provisional relief."[9] Examples of an appropriate ground include

- a risk that the other party may become insolvent before an award is reached and satisfied,
- the other party is a nonresident of New York or a foreign corporation not qualified to do business in New York, or
- the other party, "with intent to defraud his creditors or frustrate the enforcement of a judgment [or award] that might be rendered in [the other party's] favor, has assigned, disposed of, encumbered or secreted property, or removed it from the state or is about to do any of these acts * * * ."[10]

If any of those grounds exists, an order of attachment can be granted both before any arbitration award is reached, as well as before any foreign arbitration award is domesticated as a New York judgment.

Procedurally, a party to a foreign arbitration can apply to a New York court having jurisdiction over the assets in issue, though an *ex parte* motion or a motion on notice.[11] The application or motion can seek to attach any tangible or intangible property held by the opposing party or by a third party on behalf of the opposing party.[12] However, the application requires the applicant to "give an undertaking, in a total amount fixed by the court."[13] This means the applicant must post a bond or make a cash deposit, typically 5-7% of the value of the assets to be attached, although the amount is wholly subject to the discretion of the court. The undertaking can be waived by contract, so an arbitration agreement that does so would eliminate that requirement.

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8 N.Y. C.P.L.R. §7502(c).

9 *Id.*

10 N.Y. C.P.L.R. §6201.

11 N.Y. C.P.L.R. §§6210-6211.

12 N.Y. C.P.L.R. §6202.

13 N.Y. C.P.L.R. §6211(b).

“Significantly, there is one form of property that cannot be subject to attachment under Admiralty Rule B. This property is ‘E.F.T. funds,’ meaning funds that are in the hands of an intermediary bank processing them as a result of an electronic funds transfer. . .”

When faced with an application, the court will consider various factors, including

- the possibility of irreparable harm, as described above,
- the likelihood of success on the merits for the applicant, and
- a balance of the equities in favor of the applicant.[14]

These are the same three elements used when ruling on motions seeking temporary restraining orders or preliminary injunctions, which are discussed below.

For the **second and third** types of attachment, Article 62 of the N.Y. C.P.L.R. can be invoked to seek attachment of assets in New York (a) while a motion is pending in a New York court to recognize a foreign arbitration award or foreign judgment or (b) while an action is pending in New York but has not yet reached a judgment. An applicant would use the same procedures outlined above, and the court will apply similar standards in determining whether to issue an order, namely, looking for irreparable harm in the absence of attachment, the likelihood of success on the merits, and a balance of equities.[15]

For the **fourth** type of attachment, it is Federal admiralty law, specifically “Admiralty Rule B,” that provides a basis for attaching property in New York. It allows for attachment of such property having a value up to the value of the claim in the foreign arbitration or foreign litigation. To seek such relief in the relevant U.S. District Court in New York, the applicant must demonstrate that (i) it has a valid claim under admiralty law against the other party and (ii) the other party does not reside and cannot be found in the district. If those elements are met, the Federal court can grant an order of attachment, and will, again, look for irreparable harm, the likelihood of success on the merits, and a balance of the equities.

Significantly, there is one form of property that *cannot* be subject to attachment under Admiralty Rule B. This property is “E.F.T. funds,” meaning funds that are in the hands of an intermediary bank processing them as a result of an electronic funds transfer – as opposed to funds simply sitting in the other party’s account at the other party’s bank.

Each of these forms of attachment of New York assets is potentially available in New York courts to a party to a foreign arbitration or foreign litigation.

OBTAINING A PRELIMINARY INJUNCTION OR TEMPORARY RESTRAINING ORDER IN NEW YORK COURTS

In addition to attachment, a party to a foreign arbitration or foreign litigation could seek other preliminary, prejudgment relief in the form of a preliminary injunction or a temporary restraining order. Pursuant to N.Y. C.P.L.R. §6301

> [a] preliminary injunction may be granted in any action where it appears that the defendant threatens or is about to do, or is doing or procuring or suffering to be done, an act in violation of the plaintiff’s

[14] N.Y. C.P.L.R. §§6212(a), 6201, 7502.

[15] N.Y. C.P.L.R. §§6212(a), 6201.

> rights respecting the subject of the action, and tending to render the judgment ineffectual, or in any action where the plaintiff has demanded and would be entitled to a judgment restraining the defendant from the commission or continuance of an act, which, if committed or continued during the pendency of the action, would produce injury to the plaintiff. A temporary restraining order may be granted pending a hearing for a preliminary injunction where it appears that immediate and irreparable injury, loss, or damage will result unless the defendant is restrained before the hearing can be had.

A preliminary injunction can be granted only upon a motion on notice to the other side in which the applicant shows that

> * * * the defendant threatens or is about to do, or is doing or procuring or suffering to be done, an act in violation of the plaintiff's rights respecting the subject of the action and tending to render the judgment ineffectual; or that the plaintiff has demanded and would be entitled to a judgment restraining the defendant from the commission or continuance of an act, which, if committed or continued during the pendency of the action, would produce injury to the plaintiff.[16]

It requires an undertaking to be given, as described above. In addition to this showing of irreparable harm, the applicant must also show a likelihood of success on the merits and a balance of equities in the applicant's favor.

A temporary restraining order ("T.R.O.") is typically sought based upon an *ex parte* motion in which the applicant "shall show that immediate and irreparable injury, loss or damages will result unless the [other party] is restrained before a hearing can be had."[17] It also requires an undertaking to be given, as described above. If a T.R.O. is granted, the court "shall set the hearing for the preliminary injunction at the earliest possible time." If this is in New York state court, it will be scheduled within a "reasonable" time after the grant of the T.R.O. If in New York Federal court, it will be scheduled within 10 days of the grant of the T.R.O.

Each of these tools is potentially available in New York courts to a party to a foreign arbitration or foreign litigation.

RECOGNITION OF FOREIGN JUDGMENTS AND ARBITRAL AWARDS IN NEW YORK COURTS

Generally, once a party reaches a final judgment in a foreign litigation or a final award in a foreign arbitration, New York courts will readily recognize and enforce the judgment or award. The rules for recognition are quite liberal in both New York state and Federal courts, and, when recognized, a foreign judgment or arbitration award is treated identically to any judgment originating from such courts.

First, regarding foreign judgments, New York courts will presumptively recognize monetary judgments deriving from other countries having legal systems similar to that of the United States. New York state courts will follow the Uniform Recognition

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16 N.Y. C.P.L.R. §§6311-6312.

17 N.Y. C.P.L.R. §6313.

of Foreign Country Money Judgements, codified in Article 53 of the N.Y. C.P.L.R., and New York Federal courts will invoke comity to provide recognition in a similar manner. More specifically, except as provided in N.Y. C.P.L.R. §5304

> [a] court of this state shall recognize a foreign country judgment to which this article applies as conclusive between the parties to the extent that it grants or denies recovery of a sum of money.[18]

To do so, a party to a foreign judgment can file an action on the judgment or a motion for summary judgment in lieu of a complaint. If such recognition is sought in an action already pending in New York, the issue can be raised by counterclaim, crossclaim, or affirmative defense.

Thus, Per Article 53, the foreign monetary judgment will be recognized in New York state court, or in New York Federal court applying comity or applying state law when there is diversity of citizenship, unless an exception from N.Y. C.P.L.R. §5304 applies. Per the terms of N.Y. C.P.L.R. §§5303 and 5304, there is no requirement of reciprocity in foreign recognition of judgments from U.S. courts. There is no requirement that the country in which a court rendered the judgment at issue is a country officially recognized by the United States, such as Taiwan is not. A New York court could recognize a foreign judgment even if that judgment is on appeal in the foreign forum. Also, the application of comity and the liberal standards of recognition can often lead to recognition of foreign nonmonetary judgments to enforce legal concepts such as collateral estoppel and *res judicata*.

N.Y. C.P.L.R. §5304 provides several exceptions to recognition of foreign judgments. It sets forth three mandatory grounds for non-recognition, based on complete lack of due process or jurisdiction, as follows:

> A court of this state may not recognize a foreign country judgment if:
>
> 1. the judgment was rendered under a judicial system that does not provide impartial tribunals or procedures compatible with the requirements of due process of law;
>
> 2. the foreign court did not have personal jurisdiction over the defendant; or
>
> 3. the foreign court did not have jurisdiction over the subject matter.[19]

The statute also provides nine discretionary grounds for nonrecognition of a foreign judgment, based largely on procedural irregularities or conflicts with due process or U.S. public policy, as follows:

> A court of this state need not recognize a foreign country judgment if
>
> 1. the defendant in the proceeding in the foreign court did not receive notice of the proceeding in sufficient time to enable the defendant to defend;

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18 N.Y. C.P.L.R. §5303.

19 N.Y. C.P.L.R. §5304(a).

2. the judgment was obtained by fraud that deprived the losing party of an adequate opportunity to present its case;

3. the judgment or cause of action on which the judgment is bases is repugnant to the public policy of this state or of the United States;

4. the judgment conflicts with another final and conclusive judgment;

5. the proceeding in the foreign court was contrary to an agreement between the parties under which the dispute in question was to be determined otherwise than by a proceeding in that court;

6. in the case of jurisdiction based only on personal service, the foreign court was a seriously inconvenient forum for the trial of the action;

7. the judgment was rendered in circumstances that raise substantial doubt about the integrity of the rendering courts with respect to the judgment;

8. the specific proceeding in the foreign court leading to the judgment was not compatible with the requirements of due process of law; or

9. the cause of action resulted in a defamation judgment obtained in a jurisdiction outside the United States, unless the court before which the matter is brought sitting in this state first determines that the defamation law applied in the foreign court's adjudication provided at least as much protection for freedom of speech and press in that case as would be provided by both the United States and New York constitutions.[20]

"The use of the N.Y. Convention is subject to some restrictions. The United States limits the application of the N.Y. Convention to commercial matters."

A New York court confronting one of these discretionary grounds for recognition could choose (i) to refuse to recognize the judgment, (ii) to simply stay the motion seeking recognition pending further inquiry or analysis, or (iii) to recognize the judgment despite this issue. Importantly, the party resisting recognition of a foreign judgment in New York bears the burden of establishing that one of these grounds for nonrecognition exists, without which the judgment will be recognized.[21]

Second, regarding foreign arbitration awards, New York courts will presumptively recognize and enforce arbitration awards issued in many foreign or international forums under either New York state law or pursuant to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (known as the "N.Y. Convention") adopted by the U.S., U.K., and 148 other countries.

The use of the N.Y. Convention is subject to some restrictions. The United States limits the application of the N.Y. Convention to commercial matters. Further, there

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[20] N.Y. C.P.L.R. §5304(b). This ninth ground could prevent the recognition of certain libel or defamation judgments issued by courts in the U.K.

[21] N.Y. C.P.L.R. §5304(c).

are seven grounds set forth in the N.Y. Convention for non-recognition of a foreign arbitral award, even if it is from a commercial matter. Those grounds, per Article V(1)-(2), are

> [1] The parties to the agreement [to arbitrate] were, under the law applicable to them, under some incapacity, or the said agreement is not valid under the law to which the parties have subjected it or, failing any indication thereon, under the law of the country were the award was made; or
>
> [2] The party against whom the award is invoked was not given proper notice of the appointment of the arbitrator or of the arbitration proceedings or was otherwise unable to present his case; or
>
> [3] The award deals with a difference not contemplated by or not falling within the terms of the submission to arbitration, or it contains decisions on matters beyond the scope of the submission to arbitration, provided that, if the decisions on matters submitted to arbitration can be separated from those not so submitted, that part of the award which contains decisions on matters submitted to arbitration may be recognized and enforced; or
>
> [4] The composition of the arbitral authority or the arbitral procedure was not in accordance with the agreement of the parties, or, failing such agreement, was not in accordance with the law of the country where the arbitration took place; or . . .
>
> [5] The award has not yet become binding on the parties, or has been set aside by a competent authority of the country in which, or under the law of which, that award was made.
>
> [6] The subject matter of the difference is not capable of settlement by arbitration under the law of that country [*i.e.*, the country where recognition and enforcement is sought]; or
>
> [7] The recognition or enforcement of the award would be contrary to the public policy of that country.

If the limitations of the N.Y. Convention pose an issue, Article 75 of the N.Y. C.P.L.R. provides even broader authority to recognize and enforce foreign arbitral awards. Indeed, any arbitration agreement

> * * * is enforceable without regard to the justiciable character of the controversy and confers jurisdiction on the courts of the state [and on New York Federal courts applying state law] to enforce it and to enter judgment on an award. In determining any matter arising under this article, the court shall not consider whether the claim with respect to which arbitration is sought is tenable, or otherwise pass upon the merits of the dispute.[22]

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[22] N.Y. C.P.L.R. §7501.

New York courts thus routinely recognize and enforce virtually all arbitration awards. In fact, per N.Y. C.P.L.R. §7510

> * * * [t]he court shall confirm an [arbitration] award upon application of a party made within one year after its delivery to him, unless the award is vacated or modified upon a ground specified in section 7511.

An award may be vacated if the rights of a party were prejudiced in some way or the arbitration agreement was invalid or breached or it may be modified if there was a miscalculation or an error in form, outside of the merits.[23] In any event, the party opposing the recognition of the foreign arbitral award again bears the burden of demonstrating a basis for non-recognition, or it will be confirmed, per the presumption in N.Y. C.P.L.R. §7510.

Once an arbitration award is recognized by a New York state or Federal court, it becomes a judgment of that court.[24] "A judgment shall be entered upon the confirmation of an award." As such, it is then entitled to identical treatment and enforcement, including in other U.S. states, as an original judgment originating from that court.

Third, once a foreign judgment or foreign arbitral award is recognized by a New York court, there is a myriad of tools available for post-judgment enforcement in New York.

As noted above, attachment of funds and assets in New York can be sought via an *ex parte* motion while seeking the New York court's recognition of a foreign arbitration award or foreign judgment. In fact, "when a judgment debtor is subject to a New York court's personal jurisdiction, that court has jurisdiction to order the judgment debtor to bring property into the state" under that authority.[25]

Additional discovery can be obtained post-judgement or post-award, in order to gather information about funds and other assets that may be needed to satisfy the judgment or award. New York courts will generally allow wide latitude to find such information. A judgment creditor or an award creditor can seek documents, answers to interrogatories or requests for admission, and even deposition testimony from the judgement debtor, from garnishees, and from third parties potentially having relevant knowledge, all to access such information and learn the best avenues to pursue for collection. Such discovery can be sought from a bank used by the judgment debtor to obtain credit. Also available is information provided to the bank by the judgment debtor that details his income, investments, property, other assets, debts, and liabilities.

Discovery can be used to obtain account statements from financial services companies or fund managers to track where funds may have been transferred. Discovery can also be used to gather information from or about spouses, family members, business partners, etc., to whom assets may have been transferred to hide them from the judgment creditor. Often at this point there are many questions in need of answers, and post-judgment or post-award discovery can provide some of those answers to ensure full recovery.

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23 N.Y. C.P.L.R. §§7511(b)-(c).

24 N.Y. C.P.L.R. §7514.

25 *Koehler v. Bank of Bermuda Ltd.*

In addition to obtaining information about assets and attaching assets, a judgment or award creditor potentially can seek a restraining notice issued to the judgment debtor and third parties. Once a foreign judgment or arbitral award has been recognized in a New York court, it becomes a judgment of that court, and, per N.Y. C.P.L.R. §5222(a), an attorney for the judgment creditor (or a clerk of the court) can issue a restraining notice to enforce that judgment. Such a notice will bar the judgment debtor or third parties, such as banks, broker/dealers, suppliers, vendors, business partners, etc., from "any sale, assignment, transfer or interference with any property" to which the notice applies.[26]

Other tools available in New York courts include (i) orders of seizure or levy on tangible property, such a real property, and intangibles, such as shares of stock and other investment holdings; (ii) income executions or garnishment; (iii) installment payment orders; (iv) receivership, if deemed necessary to prevent dissolution of assets; and (v) enforcement by contempt, meaning the judgment debtor is held in contempt of court as a result of failing to comply with the court's directives and is thereby subject to further orders and restrictions.

CONCLUSION

There are a wide range of methods and processes readily available in New York state and Federal courts to gather information in, secure resources for, and enforce decisions of foreign or international arbitrations and litigations. Parties to such proceedings should take full advantage of these many tools available to reach a positive resolution and maximize recovery.

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26 N.Y. C.P.L.R. §5222(b).

ISRAEL TAX AUTHORITY PROPOSES CHANGES FOR INDIVIDUALS WITH CROSS-BORDER CONNECTIONS

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Tags
Basis Step-Up
C.F.C.
Exit Tax
Foreign Tax Credit
Israel
L.L.C.
New Residents
Residence

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INTRODUCTION

The Israel Tax Authority (the "I.T.A.") has proposed major international tax reform (the "Reform") that may have a great influence on the residence of individuals and companies having economic operations in Israel or personal ties to Israel. The reform may influence foreign-resident individuals considering a move to Israel and Israeli resident individuals considering a departure from Israel. This article summarizes the main points relating to individuals

CHANGE IN DETERMINATION OF TAX RESIDENCY OF INDIVIDUALS

As of today, an individual is considered to be an Israeli tax resident if the individual's "center of vital interests" is in Israel. This is a facts-and-circumstances test that examines the individual's family, economic, and social ties. In addition, there are two rebuttable presumptions based on the number of days the individual spends in Israel. Under the presumptions, an individual is considered a resident when

- more than 183 days of presence in Israel exists in a tax year, or
- 30 days or more of presence in Israel exists in a tax year and the total number of days of presence in Israel in the three most recent tax years amount to at least 425 days.

The presumptions can be rebutted, by both the individual and the I.T.A., and the party that wishes to rebut the presumption has the burden of proof as to the country in which the individual's center of vital interests is located.

The Reform introduces the concept of irrebuttable presumptions in order to determine the tax residence of individuals who are present in Israel. Under the Reform, an individual will be considered an Israeli tax resident in any of the following fact patterns:

- The individual stays in Israel for more than 183 days in each of two consecutive tax years.
- The individual stays in Israel for more than 100 days in the current tax year and more than 450 days over the course of the three most recent tax years. This presumption will not apply if the individual stays 183 days or more in a country with which Israel has an income tax treaty in effect (a "Treaty Country") and the individual obtains a certificate of residency from the tax authority of that country.

- The individual stays in Israel for more than 100 days in the current tax year and the individual's spouse is an Israeli tax resident or the individual with whom a mutual household is maintained is an Israeli tax resident.

At the same time, the Reform introduces conclusive presumptions determining that an individual is a foreign tax resident. Consequently, an individual will be considered to be a foreign tax resident in either of the following fact patterns:

- The individual spends less than 30 days per tax year in Israel during each of the four most recent tax years. In such instance, the individual will be considered a foreign tax resident from the first day of the four-year period. This presumption applies only if not more than 15 days are spent in Israel during the first month of the first tax year in the measuring period or during the last month of the last tax year in the measuring period.

- The individual spends less than 30 days per tax year in Israel during each of the three most recent tax years. In such instance, the individual will be a foreign tax resident from the first day of the second tax year. This presumption applies only if not more than 15 days are spent in Israel during the first month of the first tax year in the measuring period or during the last month of the last tax year in the measuring period.

- An individual and spouse spend less than 60 days per tax year in Israel during each of the four most recent tax years. In such instance, they will be foreign tax residents from the first day of the four-year period. This presumption will apply only if not more than 30 days are spent in Israel by the couple during the first two months of the first tax year or during the last two months of the last tax year in the measuring period.

- An individual and spouse spend less than 60 days per tax year in Israel during each of the three most recent tax years. In such instance, they will be foreign tax residents from the first day of the second tax year. This presumption will apply only if not more than 30 days are spent by the couple in Israel during the first two months of the first tax year or during the last two months of the last tax year.

- An individual and spouse spend less than 100 days per tax year in Israel during each of the four most recent tax years. In such instance, they will be foreign tax residents from the first day of the four-year period, provided they spend more than 183 days in a Treaty Country and obtain a certificate of residency from the tax authority of that country. This presumption will apply only if not more than 50 days are spent by the couple in Israel during the first 100 days of the first tax year or the last 100 days of the last tax year.

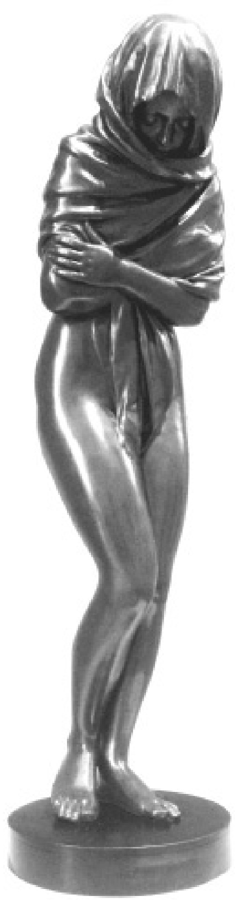
- An individual and spouse spend less than 100 days per tax year in Israel, during each of the three most recent tax years. In such instance, they will be foreign tax residents from the first day of the second tax year, provided they spend more than 183 days in a Treaty Country and obtain a certificate of residency from the tax authority of that country. This presumption will apply only if not more than 50 days are spent by the couple in Israel during the first 100 days of the first tax year or the last 100 days of the last tax year.

The Reform retains the center of vital interests test for cases where the conclusive presumptions are not applicable.

TAX BENEFITS TO NEW ISRAELI RESIDENTS AND RETURNING RESIDENTS

Since 2007, an individual who has become an Israeli tax resident, whether for the first time or after spending considerable time outside Israel as a foreign tax resident, is entitled to material tax and reporting benefits. New Israeli residents and returning residents are entitled to tax and reporting exemptions with respect to foreign income and assets for a period of 10 years, commencing on the date they became Israeli tax residents. The Reform is expected to abolish the exemption from reporting with respect to foreign income and assets, thereby eliminating a contentious issue with the O.E.C.D. and the E.U., but to date, there is no suggestion of any changes to the substantial tax exemption.

EXIT TAX



Israeli tax law imposes an exit tax on an individual who ceases to be a tax resident, which means that the assets of an Israeli who terminates his residency are considered to have been sold on the day prior to the day of departure. Current law allows the postponement of the tax payment until the date of an actual sale. The Reform provides additional reporting obligations on assets and the posting of guarantees by individuals who wish to postpone the tax payment to the sale event. It also cancels the option to postpone the tax payment in certain circumstances. The proposals are as follows.

If the value of the assets subject to exit tax as of the date of departure is less than NIS 3 million (approximately €840,000 as of November 30, 2021), the taxpayer may elect to postpone the tax payment to the realization date. However, the taxpayer must file a financial report for the year of departure that includes all assets owned and the unrealized gain as of the date of departure.

If the value of the assets subject to exit tax as of the date of departure exceeds NIS 3 million, the assets owned will be allocated to several categories, each having its own rule:

- The first category is readily marketable securities. Assets in this category will be treated as if sold on the departure date and will be taxed and reported accordingly.
- The second category is real estate located outside of Israel. Assets in this category may be treated in one of two ways, at the election of the taxpayer. The first calls for the immediate payment of exit tax and the second allows for postponed payment. Should the individual choose to postpone the payment, reporting obligations will be imposed to ensure proper reporting of the gain when due. In addition, if the tax is estimated to exceed NIS 1.5 million (approximately €420,000 as of November 30, 2021), an interest in the property may be required to be registered in favor of an Israeli nominee.
- The third category is other assets. Assets in this category may be treated in one of two ways at the election of the taxpayer. The first calls for the immediate payment of exit tax and the second allows for postponed payment. Should the individual choose to postpone the payment, title to the assets may be required to be held by an Israeli nominee.

The Reform also includes additional provisions to prevent tax avoidance. For example, the exit tax may be imposed on dividend income distributed by a foreign company to an individual after that individual's departure. The tax would continue to be imposed until the postponed exit tax is fully paid. Another recommendation is to impose taxes on assets that are sold during a specified period commencing from the day the individual ceases to be an Israeli resident. That period under consideration is four years. The tax would be calculated as though the individual remained an Israeli tax resident.

CONTROLLED FOREIGN CORPORATION ("C.F.C.")

Under current law, C.F.C. rules provide that passive income of a foreign corporation controlled by Israeli residents result in a deemed dividend distributed to the Israeli shareholders in certain circumstances. The Reform will expand the definition of passive income to include income derived from interest, insurance, or royalties received from related parties in specified circumstances. In addition, the Reform proposes to increase the tax base by reducing the passive income threshold to one third of the total income or profits of the foreign company from the current threshold, which is of one third of total income or profits.

The reform would apply the C.F.C. rules on a broader basis for a corporation resident in a country on the black and grey lists of the E.U. (except where the country has an income tax treaty in effect with Israel) or a resident of a country that does not have an agreement with Israel that allows the exchange of information. Under the Reform, the C.F.C. rules would apply once Israeli share ownership reaches 30%, rather than 50% under current law. In addition, the C.F.C. rules would be applied to all passive income of a C.F.C., no matter the percentage which passive income bears to total income or profits.

Also, as part of the Reform, the holdings of new residents and returning residents will be considered holdings of Israeli residents that are taken into account when determining whether a foreign corporation is a C.F.C. Under current law, those holdings are not considered to be owned by Israeli residents for when determining whether a foreign company is a C.F.C. This provision would apply only with respect to assets purchased after the arrival in Israel.

FOREIGN TAX CREDIT

The Reform proposes reducing the current number of foreign tax credit baskets to five. They would be baskets for

- passive income,
- active income,
- capital gains,
- C.F.C.'s, and
- professional foreign corporations ("P.F.C.'s").

In addition, the rules under which credits are provided would be tightened for taxes paid to countries included in the black or grey lists of the E.U. Also under consideration is the elimination of the five-year carryforward for unused foreign tax credits that exists under current law, except is specified circumstances.

TREATMENT OF L.L.C.'S

The I.T.A.'s current approach to U.S. L.L.C.'s treats an Israeli member of a U.S. L.L.C. as the owner of the LLC's taxable income only for the purpose of claiming foreign tax credits in Israel for the U.S. taxes paid at the member level. The I.T.A.'s approach explicitly states that an L.L.C. will not be regarded as a pass-through entity for all tax purposes. Consequently, the losses of an L.L.C. cannot be claimed by an Israeli resident as an offset to taxable income.

The Reform proposes to revise the I.T.A.'s approach so that losses derived by an Israeli resident from an L.L.C. formed under U.S. tax law will be available to offset income of that Israeli resident derived from U.S. sources and U.S. situs assets, provided the losses are available in the U.S. to reduce U.S. taxable income. This treatment will be elective and once elected will be irrevocable.

TAXATION OF EXERCISE OF OPTIONS AND WORK INCOME THAT ARE PARTIALLY VESTED WHILE THE INDIVIDUAL IS A FOREIGN TAX RESIDENT

According to the I.T.A.'s approach, an employee's income is calculated on a cash basis so that on the date the employee receives the income, the tax treatment is determined according to the employee's residence on that date. This rule applies also with respect to options granted or vested while the employee is a foreign tax resident. In order to encourage overseas Israelis to return to Israel, the I.T.A. is considering the adoption of a rule under which the employee will be exempt from tax in Israel in respect of the portion that was vested abroad, even if the income was received after the return of the employee to Israel.

BASIS STEP-UP FOR INHERITED PROPERTY

As of today, the I.T.A. allows a step-up in the basis of foreign assets received by an Israeli tax resident as a gift or inheritance made by a foreign tax resident. The I.T.A. is considering modifying the step-up rule. While no decision has yet been taken, several options are on the table. The first is to abolish the existing mechanism regarding foreign assets entering the Israeli tax net. Under this approach the pre-transfer appreciation in an asset received from a nonresident would be taxed in Israel at the time of sale by an Israeli donee or legatee according to the original cost basis. The second is a mechanism to tax overseas legatees when they receive a bequest from an Israeli decedent. This may be analogized to an inheritance or estate tax.

REPORTING OBLIGATIONS

The I.T.A. is considering the adoption of a mandatory information report that would be filed annually by an Israeli shareholder who holds, directly or indirectly, more than 50% of the controlling shares of a foreign corporation. The profit and loss statement of the foreign corporation and its P&L would be attached to the report. Also to be attached would be the names and other information of directors, management members, and shareholders. Finally, the I.T.A. is considering the imposition of a reporting obligation on resident individuals who receive a payment or a gift from abroad in an amount above NIS 500,000 (approximately €140,000 as November 30, 2021).

CONCLUSION

"Whether it is B.E.P.S., Pandora Papers, E.U. blacklists, or the Biden Administration tax proposals, governments and tax authorities are examining new ways to fund operating costs of government and to raise the level of examination for the wealthy, especially those with one foot at home and another abroad."

Whether it is B.E.P.S., Pandora Papers, E.U. blacklists, or the Biden Administration tax proposals, governments and tax authorities are examining new ways to fund operating costs of government and to raise the level of examination for the wealthy, especially those with one foot at home and another abroad. The Reform under consideration by the I.T.A. is in line with the current trend.

TOULOUSE OR NOT TOULOUSE? N.I.I.T.-PICKING THE REACH OF THE U.S. FOREIGN TAX CREDIT

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Tags
Foreign Tax Credit
Net Investment Income Tax
Toulouse v. Commr.

> "There are three things that matter in [tax legislation]: location, location, location."
>
> – *adapted from the famous quote, apocryphally attributed to Lord Harold Samuel, about real estate.*

While a picture is worth a thousand words, the placement of just a few words in the Internal Revenue Code can sometimes cost taxpayers thousands of dollars in extra tax, particularly where foreign tax credits are involved. In *Toulouse v. Commr.*,[1] the U.S. Tax Court held that the foreign tax credit, which arises under §§27 and 901 of Chapter 1 of the Internal Revenue Code, as amended ("the Code"), cannot be used to offset a taxpayer's net investment income tax ("N.I.I.T."), a *sub rosa* tax increase of 3.8% that is applied to the taxpayer's net investment income in excess of certain thresholds defined in Code §1411. The N.I.I.T. appears in Chapter 2A of the Code.

While not surprising to some observers, and clearly consistent with the I.R.S.'s own published regulations, the case confirmed that taxpayers with assets and activities in more than one country can find themselves in a tricky situation with regard to the N.I.I.T., similar to parallel tax regimes sometimes set up by certain other countries, for which those countries argue that foreign tax credits are not available. Unfortunately, tax treaties' continuing ability to provide double tax relief in such circumstances is limited.

THE CASE

Catherine Toulouse was an American citizen living abroad. She correctly realized that she owed N.I.I.T. and reported it on her tax return. Ms. Toulouse also had unused foreign tax credits from taxes paid to France and Italy. She offset the N.I.I.T. with a portion of her otherwise unused foreign tax credits and paid nothing. The case centered around her claim of foreign tax credits to reduce the payment of the N.I.I.T.

Ms. Toulouse timely filed her 2013 Form 1040, U.S. *Individual Income Tax Return*, and proceeded to claim credits for income taxes paid to Italy and France against N.I.I.T. reported on her Form 8960, *Net Investment Income Tax — Individuals, Estates, and Trusts*, which she duly attached together with Form 8833, *Treaty-Based Return Position Disclosure under Section 6114 or 7701(b).* Because Ms. Toulouse recognized that the I.R.S. would disagree with a claim running flatly contrary to published regulations, she attached a Form 8275, *Disclosure Statement*, flagging to the I.R.S.'s attention that she was taking a position on her tax return contrary to published guidance. The benefit of attaching the form is to secure relief from

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[1] 157 T.C. __, No. 4 (August 16, 2021).

accuracy-related penalties, assuming sufficient justification exists for claiming the position in the first place.[2]

The I.R.S. disagreed with the taxpayer's position and responded by mailing her a series of notices under its broad authority to assess and collect additional tax owing because of mathematical errors in the return.[3] Normally, a taxpayer's ability to challenge the I.R.S.'s assertion of additions to tax in Tax Court commences with the mailing of a statutory notice of deficiency by the I.R.S. In this case, the I.R.S.'s initial notices were not based on the issuance of a notice of deficiency.

C.A.P. VS. C.D.P.

The notice of deficiency is a prerequisite to a taxpayer challenging the I.R.S.'s assertion of additional tax due in Tax Court without having to pay the tax first.[4] In Ms. Toulouse's case the I.R.S. only issued the taxpayer with a notice of a mathematical error. As a result, the immediate avenue of relief for the taxpayer involved the I.R.S.'s internal process. There are two I.R.S. internal appeal processes worth noting in this regard, which work according to different rules and carry important implications for the taxpayer's ability to challenge the I.R.S.'s ultimate determination. One is the Collection Appeals Program ("C.A.P.") and the other is the Collection Due Process program ("C.D.P.").

C.A.P. is typically available in a broader set of circumstances than a C.D.P. hearing, both before and after the I.R.S. files a Notice of Federal Tax Lien, or levies (*i.e.*, seizes) taxpayer property. C.A.P. is also available if the I.R.S. terminates, or proposes to terminate, an installment Agreement.[5] By contrast, C.D.P. is available only if the taxpayer receives a specific notice that is accompanied by imposition of a Federal tax lien, or the I.R.S. levies on the taxpayer's property. And while the C.A.P. program may cover a broader range of collection actions, only the latter procedure — the C.D.P. hearing — permits a taxpayer to resort to Tax Court after an unfavorable final determination by the I.R.S. Generally, the C.A.P. route forecloses ability to take advantage of a C.D.P. hearing.[6]

The C.D.P. hearing can be requested only within a statutory 30-day window after a notice for a right to a hearing has been received or after receiving a C.D.P. levy notice on forms such as Letter 1058 or Letter LT11. The request is made on Form 12153, *Request for a Collection Due Process or Equivalent Hearing*.[7]

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2 Generally, where a taxpayer adopts a return position contrary to published regulations, as opposed to other published guidance, the I.R.S. requires the position to be disclosed on Form 8275-R, *Regulation Disclosure Statement*. By so doing, a taxpayer meets one of the requirements to have a no-fault penalty abated.

3 See Code §6213(b)(1).

4 Code §6213(a).

5 See Pub. 1660.

6 However, if the underlying liability is not addressed by the C.A.P. appeal, it is possible that a C.D.P. hearing may still be requested under Code §6330(c)(2)(B). See *Mason v. Commr.*, 132 T.C. 301 (2009).

7 A C.A.P. hearing is requested on Form 9423, *Collection Appeal Request*.

Ms. Toulouse took advantage of the C.D.P. procedure to challenge the I.R.S.'s initial "mathematical" correction to her tax return. When that proved unsuccessful, filed a timely petition to the Tax Court.

N.I.I.T. – DEFINITION AND GENESIS IN LAW

N.I.I.T. arises under Code §1411 – as a standalone Code section in Chapter 2A, titled "Unearned Income Medicare Contribution" which contains no other sections. Enacted by the Health Care and Education Reconciliation Act of 2010,[8] the tax applies to "net investment income," defined statutorily as the excess (if any) of

- gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business which is not a passive activity or financial instrument or commodity trading business;
- other gross income derived from a passive activity or financial instrument or commodity trading business; and
- net gain to the extent taken into account in computing taxable income attributable to the disposition of property other than property held in a trade or business which is not a passive activity or financial instrument or commodity trading business;

— *less* —

- (the deductions allowed by this subtitle properly allocable to such gross income or net gain).[9]

The words "this subtitle" above refers to subtitle A of the Internal Revenue Code applicable to income taxes and includes Code §§1 through 1564. The N.I.I.T. relies on a common architecture applicable to income taxes including self-employment income (Chapter 2), Unearned Income Medicare Contribution (N.I.I.T.), Withholding Tax on Nonresident Aliens and Foreign Corporations (Chapter 3), F.A.T.C.A. penalties (Chapter 4), repealed excise taxes formerly applicable to certain outbound transfers (Chapter 5),[10] and consolidated return regulations under Chapter 6.[11]

Notwithstanding the comparisons to non-income taxes in the Code, many of the terms to which N.I.I.T. refers (net income, adjusted gross income, and deductions,

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[8] Pub. L. No. 111-152.

[9] See Treas. Reg. §1.1411-1(d)(8), defining net investment income as defined in Code §1411(c) and Treas. Reg. §1.1411-4, as adjusted in Treas. Reg. §1.1411-10(c). Initially, proposed regulations defined it as a positive amount only but this view was not carried through in the 2012 final regulations. Treas. Reg. §1.1411-4(f)(1).

[10] Former Code §§1491 through 1494. With respect to foreign trusts, the Taxpayer Relief Act of 1997, Pub. L. No. 94-455, replaced Chapter 5's former 35% excise tax with a new gain recognition regime under Code §684, located in Chapter 1.

[11] Subtitle A contains all the income taxes in the Code, and most of the 6 chapters share a common concern with clear reflection of income. For example, Code §1502 provides that the Secretary may issue regulations governing the taxable income of affiliated corporations filing a consolidated income tax return, "in such a manner as clearly to reflect the income-tax liability [of the affiliated group]."

among others) are terms used in common with the income tax; at a high level, in addition to the familiar concept of a net income base (gross income less deductions), N.I.I.T. shares other basic features with Chapter 1 tax, such as exclusions from income[12] and progressivity. For example, similar to regular taxable income, net investment income has a concept of "excluded income," defined by Treas. Reg. §1.1411-1(d)(f) as any income excluded under Chapter 1, in addition to additional items that are excluded under Treas. Reg. §§1.1411-4 and 1.1411-10, and any other items specifically excluded by Code §1411, the regulations thereunder, or the Internal Revenue Bulletin. In addition, because net investment income is traditionally earned by higher-income taxpayers who earn a higher proportion of their income from investments in stocks and bonds rather than from wages, the tax is progressive.

"It does not appear illogical to argue that the 3.8% surtax is fundamentally an income tax unlike its sister 0.9% Medicare tax. Hence, the question of whether N.I.I.T. is a covered tax for treaty purposes is more nuanced than either taxpayer or the I.R.S. may have intimated . . ."

While progressive, the 3.8% tax applies in a manner quite different from the Chapter 1 income tax: it is imposed only to the extent of the lesser of the taxpayer's net investment income, or the extent to which modified adjusted gross income exceeds applicable thresholds.[13] This may explain why some commentators refer to the 3.8% tax as a surtax.[14] Part of the ambiguity as to what the 3.8% tax is best characterized as may relate to the absence of helpful legislative history. The provision was added to a House version of a 2010 revenue bill during the legislative wrangling over Republican attempts to repeal the Affordable Care Act, and reflected in a version of that bill reported out as part of the reconciliation process.[15] This was after rumors in 2009 that a new Code §1411 was under consideration after an increase to the Code §1 rate tables was legislatively defeated.

The first public mention of N.I.I.T. was an Obama-era presidential proposal which referred to a 2.9% tax on interest, dividends, annuities and most investment income — together with the additional 0.9% Medicare tax; the two provisions are in some respects mirror images since they apply above similar thresholds and are designed such that the Medicare tax applies to wages (which are excluded income for N.I.I.T. purposes) and N.I.I.T. is defined to apply to most passive income streams. Chapter 2A's official name (Unearned Income Medicare Contribution) to which the Tax Court gives significant weight in its analysis in the *Toulouse* opinion, to which we turn next, suggests that the tax was meant to supplement Medicare tax; on the other hand, the Joint Committee on Taxation clarified that N.I.I.T. revenue would go to the Treasury's General Fund rather than the Medicare Trust Fund.

It does not appear illogical to argue that the 3.8% surtax is fundamentally an income tax unlike its sister 0.9% Medicare tax. Hence, the question of whether N.I.I.T. is a covered tax for treaty purposes is more nuanced than either taxpayer or the I.R.S. may have intimated in the recent case, to which we turn next.

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12 Notable exclusions include wages, unemployment compensation, Alaska Permanent Fund Dividends, alimony, and Social Security Benefits

13 These thresholds are $250,000 for married taxpayers filing a joint return, $125,000 for married taxpayers filing separate returns, and $200,000 for single taxpayers. The fact that such thresholds are not indexed to inflation would tend to make the N.I.I.T. *less* progressive over time.

14 See M.B. Kofsky & Bryan P. Schmutz, "What a Long Strange Trip it's Been for the 3.8% Net Investment Income Tax."

15 H. Rep. No. 111-448.

PLACEMENT IN THE CODE VERSUS CHARACTER AS A TAX ON NET INCOME

While the statutory text providing for the N.I.I.T. is silent as to the question of foreign tax credits, the I.R.S. has clearly provided that such credits may not be claimed to reduce N.I.I.T in its published regulations:[16]

> Amounts that may be credited against only the tax imposed by chapter 1 of the Code may not be credited against the section 1411 tax imposed by chapter 2A of the Code unless specifically provided in the Code. For example, the foreign income, war profits, and excess profits taxes that are allowed as a foreign tax credit by section 27(a), section 642(a), and section 901, respectively, are not allowed as a credit against the section 1411 tax.

Before getting to the regulation's language, however, the Tax Court first looked to the Code. The statutory source of the foreign tax credit is Code §27, which demarcates the credit's limits by incorporating Code §901. Code §901 allows the credit to be used against "tax imposed by this chapter [1]." The N.I.I.T., on the other hand, is part of chapter 2A. The Tax Court came to the straightforward conclusion that the foreign tax credit was inapplicable to N.I.I.T. Ms. Toulouse might have found a glimmer of hope in the Treasury Regulations. Treas. Reg. §1.411-1(a) allows all Code provisions that are applicable to determining a taxpayer's taxable income for chapter 1 purposes to "also apply in determining the tax imposed by §1411." The court was not swayed. The regulation crucially defined taxable income as under Code §63(a). Code §63 defines taxable income as gross income less deductions and does not mention tax credits. Since Code §63 does not cover tax credits, the court concluded, neither does Code §1411.

As if to banish any further doubt, the court pointed out that the language of Treas. Reg. §1.1411-1(e), quoted above, specifically disallowed taking the foreign tax credit against the N.I.I.T. The regulation provides that credits that can only be taken against a Chapter 1 tax (*e.g.*, the foreign tax credit) require a specific statutory authorization to also be creditable against the Code §1411 tax. The regulation further specifies that the "foreign tax credit… [is] not allowed as a credit against the [Code] §1411 tax."

In the end, the court ended up restating the I.R.S.'s view, consistent with the 2013 final regulations, which places decisive significance on the express language of the foreign tax credit provisions itself, limiting relief to taxes under Chapter 1. In the preamble to the 2013 regulations, the I.R.S. stated that:

> The Treasury Department and the IRS also received comments asking whether United States income tax treaties may provide an independent basis to credit foreign income taxes against the section 1411 tax. The Treasury Department and the IRS do not believe that these regulations are an appropriate vehicle for guidance with respect to specific treaties. An analysis of each United States income tax treaty would be required to determine whether the United States would have an obligation under that treaty to provide a credit against

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16 Treas. Reg. §1.1411-1(e).

> the section 1411 tax for foreign income taxes paid to the other country. If, however, a United States income tax treaty contains language similar to that in paragraph 2 of Article 23 (Relief from Double Taxation) of the 2006 United States Model Income Tax Convention, which refers to the limitations of United States law (which include sections 27(a) and 901), ***then such treaty would not provide an independent basis for a credit against the section 1411 tax***. (emphasis supplied).[17]

Clearly aware of the unfriendly nature of the domestic legislation, Ms. Toulouse urged the court to look to the treaties instead. In her brief, she appears to have placed emphasis on the treaties' principle of eliminating double taxation. The court acknowledged that treaties should be interpreted liberally to give effect to their goals but warned that plain meaning would take precedence. This proved fatal for the taxpayer's case. The income tax treaties with France and Italy restricted the credit to the extent allowed by U.S. law, which led the court back to the analysis of the Code.

Next, Ms. Toulouse turned to congressional intent, an area which offers taxpayers less than firm ground. She claimed that legislative history gave no indication that Congress did not want the credit to be applicable or, more broadly, wanted to override the principle of eliminating double taxation. Relying on dictionary definitions, the taxpayer argued that any limits had to be specified and affirmed as such by Congress. She concluded that the placement of the N.I.I.T. in chapter 2A instead of chapter 1 was a coincidence. The court disagreed. The credit was not something that existed by default, requiring only affirmative disallowance to be inapplicable. Rather, the treaties themselves delineated the credit's limits (*i.e.*, U.S. law). The court added that the treaties were not meant to nor attempted to completely eliminate double taxation. The court supported its argument with some textual evidence, including that Code §1411 is the only section of Chapter 2A, which itself was a fairly new chapter when the N.I.I.T. was introduced. Creating a new chapter in the Code is never a coincidence.[18]

While Ms. Toulouse attempted to portray the treaties as an independent source of authorization for the foreign tax credit, unfettered by the details of domestic statute, she claimed that there would be no point in tax treaties if a credit requires a Code provision to be valid. It is possible that the taxpayer may have had greater success if her brief focused on the N.I.I.T.'s basic character as a tax on net income. The resolution of the case thus turned on whether placement in Chapter 2A is properly considered a "limitation" of U.S. law, similar to Code §904's income basket limitation and other key components of the U.S. domestic foreign tax credit regime.[19]

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17 T.D. 9644 (April 1, 2014).

18 According to the court's view, the technical explanation to the treaties also confirmed that credits were subject to the "limitations" of U.S. law.

19 Another element in tension with the I.R.S.'s approach to N.I.I.T. is the fact that deductions for foreign taxes are permitted, and a specific allocation mechanism is provided to ensure that taxpayers do not deduct foreign taxes against both the tax under Chapter 1 and the tax under Chapter 2A. See Treas. Reg. §1.1411-4(f)(3)(iii). This clause was added in a correction to the 2013 final regulations in 73 Fed. Reg. 72,394, which came with no explanation or preambulatory language of its own but accompanied by a note titled "Need for Correction" and stating that "[a]s published, the final regulations (TD 9644) contain errors that may prove to be misleading and are in need of clarification."

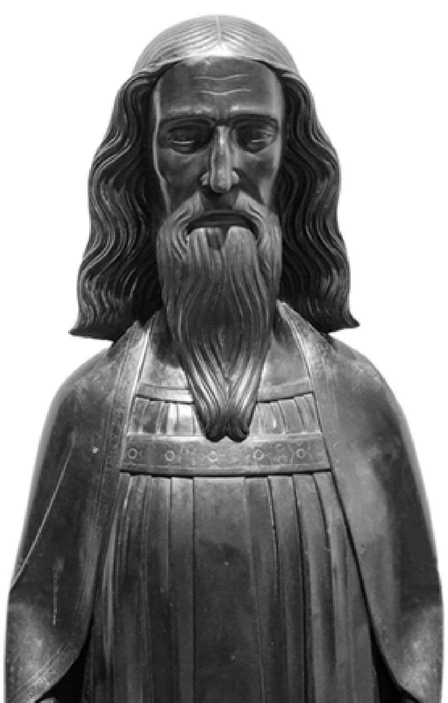
While the words chosen by Congress and the I.R.S., together with the placement of N.I.I.T. within the broader Code, are clearly important, the possibility that Chapter 2A's N.I.I.T. should be a covered tax under relevant treaty provisions because it is substantially similar to an income tax, or whether the above preambulatory text provides sufficient grounds to support the I.R.S.'s approach in Treas. Reg. §1.1411-1(e), are matters that were simply not addressed.[20]

In the end, the court focused on the difference between not providing for a credit versus expressly disallowing a credit and concluding that the plain language in Treas. Reg. §1.1411-1(e) ended the analysis. While the court may be right about the significance of the N.I.I.T.'s placement within the Code, Ms. Toulouse lost when the court decided that whether Treas. Reg. §1.1411-1(e) constituted a limitation under U.S. law was the key issue, rather than whether N.I.I.T. was fundamentally an income tax under Subtitle A and therefore should be characterized as a covered tax for treaty purposes.

As a final note, commentators have observed that, in 2013, the year in which Ms. Toulouse's contested tax arose, the I.R.S. placed the line for reporting N.I.I.T. on Forms 1040 and 1041 (income tax returns for individuals and estates and trusts, respectively) below the line for claiming foreign tax credits, consistent with its view that the two cannot offset.[21] The 2020 Form 1040 and the instructions make this clearer still by moving N.I.I.T. to Schedule 2, together with Medicare tax. Because the Tax Court and I.R.S. both gave short shrift to the taxpayer's attempt to modify Form 8960 by adding additional lines, permitting her to offset tax that was "blocked" on Form 1040. While the Tax Court appears unimpressed by this amendment of the form, the notice that she provided to the I.R.S. of her return position by attaching Form 8275 likely prevented her from suffering additional penalties.

IMPLICATIONS

As *Toulouse* illustrates, in the case of the N.I.I.T., policy rationale will usually take a back seat to statutory mechanics. It is notable that Chapter 2 and 21 taxes have specific provisions that relieve tax liability to the extent provided for in social security totalization agreements ("S.S.T.A.'s"). The N.I.I.T. lacks this. Beyond that, however, the statute and regulations do not provide many clues. A much more ambiguous question than the one at the heart of *Toulouse*, and consequently one carrying greater hope for the taxpayer, is whether N.I.I.T.'s fundamental character as an income tax could mean that the I.R.S.'s position is incorrect. However, as noted by some,



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[20] The court simply references Articles 2(2) and 2(3) of the France-U.S. and Italy-U.S. Income Tax Treaties without analyzing the issue.

[21] On the 2013 Form 1040, N.I.I.T. (referenced as "Taxes from . . . [b] Form 8960") is on Line 60, whereas foreign tax credits are stated on Line 47. This is different from the 2020 income tax return which has been reduced to 38 lines, where "Other Taxes" on Schedule 2 (including Medicare and N.I.I.T.) feed into "other taxes" on line 23.

a statutory amendment by Congress may be required before F.T.C.'s can properly be claimed; or, in the alternative to specifically tag N.I.I.T. as a social security tax, permitting relief under S.S.T.A.'s.[22]

And, similar to certain "parallel" tax regimes set up by certain other countries for which foreign tax credits are unavailable, the N.I.I.T. creates problems for double tax relief under existing treaty architecture. The problem of such exceptional mini tax regimes is that the protections which income tax treaties were designed to provide are steadily eroded in a manner that the treaty drafters sought to account for when providing that their treaties should apply to "substantially similar" taxes.[23]

In the case of the N.I.I.T., a combination of ambiguity and prudence should push taxpayers in a cautious direction. Like with the foreign tax credit itself, the weight of words may prove most relevant, meaning that taxpayers are advised to await for further action by Congress before taking a position against the I.R.S.'s expressed view.

"In the case of the N.I.I.T., a combination of ambiguity and prudence should push taxpayers in a cautious direction."

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22 As the Treasury's May 2021 Green Book specifically suggests the N.I.I.T. revenue could be directed to the Hospital Insurance Trust Fund similar to F.I.C.A. and S.E.C.A. revenues; see "General Explanation of the Administration's Fiscal Year 2022 Revenue Proposals," at p. 72; presumably accompanied with changes to the self-employment tax regime, this might permit crediting of foreign taxes against N.I.I.T. under S.S.T.A. provisions.

23 For example, Italy imposes "substitutive tax" of 26% on certain foreign source financial income of Italian long-term residents, including dividends, interest, and capital gains earned outside a trade or business, and refuses to accord a credit or deduction for income taxes paid in the foreign country (*e.g.*, the U.S.), based on the view that the substitutive tax is neither an income tax, nor a substantially similar tax, to which the treaty can apply.

TRUSTS UNDER ATTACK – THE LEGISLATIVE LANDSCAPE

Authors
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Tags
Biden Tax Proposals
Corporate Transparency
Pandora Papers
Trusts

Reducing perceived wealth disparity in the United States has become a major political goal of the Biden Administration and the Democratic Party. That goal, together with the goal of increased transparency concerning ownership, have resulted in a number of legislative proposals, which, if enacted will fundamentally alter tax planning regimes for the wealthy. This article explores some of these recommendations and their effects.

PANDORA PAPERS/ENABLERS ACT

In an unprecedented leak, The Washington Post and the International Consortium of Investigative Journalists ("I.C.I.J.") gained access to more than 11.9 million confidential documents maintained by trust and corporate services providers around the world. The records, known as the Pandora Papers, revealed that that foreign political and corporate leaders or their family members moved money and other assets from long-established tax havens to U.S. trust companies. The investigation identified 206 U.S.-based trusts linked to 41 countries.[1]

The response was immediate. In the United States, a bipartisan bill was introduced in the House of Representatives on October 6, 2021. Named the "Establishing New Authorities for Business Laundering and Enabling Risks to Security (ENABLERS) Act," the Enablers Act, would amend the 51-year-old Bank Secrecy Act by requiring the Treasury Department to create basic due diligence rules for American "gatekeepers" who facilitate the flow of foreign assets into the United States. Gatekeepers include art dealers, investment advisors, real estate professionals, lawyers, accountants, trust or company service providers, public relations professionals, dealers of luxury vehicles, money service businesses and other similar professions.

The U.S. Treasury Department would be authorized to create basic due diligence rules on source of funds. A basic due diligence program could be as simple a requirement as asking if suspicious funds are the proceeds of a crime. The new rules would be effective for 2023 and affected reporting persons would have until June 30, 2024 to have required programs in place.

The "temporary" exemption in place since 2002 for real estate professionals and sellers of luxury cars, ships, and aircraft from anti-money laundering programs would be removed and the U.S. Treasury Department would be required to create anti-money laundering rules for these industries. Attorneys who use a paid service provider to set up companies (and therefore avoid becoming financial institutions) would be exempt from the anti-money laundering rules.

1 See, generally, the International Consortium of Investigative Journalists website, icji.org.

Title insurers in a handful of large American cities are required to collect beneficial ownership information (actual ownership) for residential real estate purchase in all cash (*i.e.*, non-mortgage) transactions. This would be expanded nationwide and would also apply to commercial real estate, within 90 days of enactment.

THE CORPORATE TRANSPARENCY ACT

On January 1, 2021, Congress passed the Corporate Transparency Act ("C.T.A.") as part of the overall 2021 National Defense Authorization Act and under the scope of the Anti-Money Laundering Act of 2020 ("A.M.L.A."). The C.T.A. requires (i) the establishment of new federal beneficial ownership reporting requirements for certain U.S. domiciled or active entities, including foreign entities that operate in the U.S., and (ii) FinCEN's maintenance of a federal database for the beneficial ownership information collected. Noncompliance with the C.T.A. can result in significant civil and criminal penalties.

The C.T.A. defines "beneficial owner" to mean, with respect to an entity, an individual who, directly or indirectly, through any contract, arrangement, understanding, relationships, or otherwise, exercises "substantial control" over the entity or owns or controls not less than 25% of the "ownership interests" of the entity. Reported information will include full legal name, date of birth, current residential or business street address, and a unique identifying number from an acceptable identity document or a unique identity number generated by FinCEN.

The C.T.A. requires the Secretary of the Treasury to promulgate regulations under the C.T.A. not later than one year after the enactment of the C.T.A. (*i.e.*, not later than January 1, 2022). For any reporting company that has been formed or registered before the effective date of the Treasury regulations, such reporting company is required to submit to FinCEN the required beneficial ownership report not later than two years after the effective date of such Treasury regulations. For any reporting company formed or registered after the effective date of the Treasury regulations prescribed under the C.T.A., such reporting company is required to submit to FinCEN the required beneficial ownership report at the time of formation or registration.

Law enforcement for foreign countries (*e.g.*, Interpol, Europol) may get access to the information. In addition, information may be provided to Federal government agencies, including those with law enforcement, national security, intelligence and applicable financial regulatory missions (*e.g.*, Justice Department, F.B.I., Treasury Department (for tax administration purposes), Federal Reserve Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency), State, local or tribal law enforcement agencies with an appropriate court order, and certain financial institutions.

The term "reporting company" under the C.T.A. means, subject to certain exclusions, "a corporation, limited liability company, or other similar entity" that is (i) created by the filing of a document with the secretary of state or similar office under the laws of a state or Indian tribe or (ii) formed under the law of a foreign country and registered to do business in the United States by the filing of a document with the secretary of state or similar office under the laws of a state or Indian tribe. A trust (other than certain business trusts) does not appear to be considered a reporting company at this time. There are other exclusions, including an exclusion for an entity that (i) employs more than 20 employees on a full-time basis in the United States, (ii) 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 (a) other entities owned by the entity and (b) other entities through which the entity operates, and (iii) has an operating presence at a physical office in the United States.

Many trusts (foreign and domestic) own assets through single-member LLCs, treated as disregarded for tax purposes. Those LLCs will be subject to this new law. A trust would not appear to be subject to the new law, although there is discussion among experts whether forthcoming regulations will expand the scope of the new law to include trusts.[2] Many other countries require trusts to report information about trusts (including beneficial ownership) to a centralized registry.

PROPOSED TAX LEGISLATION

In an effort to provide funding for an expansive Democratic agenda, several tax proposals would have the effect of increasing taxes on wealthier individuals and trusts. These proposals are constantly changing, but may include the following, and may, in certain instances, be applicable this year.

"In an effort to provide funding for an expansive Democratic agenda, several tax proposals would have the effect of increasing taxes on wealthier individuals and trusts."

Tax Increases

Rates (Original Proposal)

The top individual income tax rate for taxable incomes will be increased from 37% to 39.6%. A 3% surtax will be imposed on those individuals with a modified adjusted gross income in excess of $5 million, and in excess of $100,000 for estates and trusts. The 3.8% Net Investment Income Tax would be expanded to apply to all income not subject to the 3.8% Medicare tax on wages and self-employment income. The maximum tax on long-term capital gains and dividends would increase to 25% for taxpayers having taxable income over $1 million. This could result in a possible 31.8% tax including the 3.8% net investment income tax and the 3% surtax, if applicable, and over 40% for residents in high tax states (such as New York, New Jersey and California).

These significantly higher taxes could impact decisions to accumulate income in many dynasty trusts, particularly those established by foreign individuals as exempt from generation skipping transfer tax.

Revised House Proposal

A new 5% surcharge would be imposed on individuals with a modified adjusted income in excess of $10 million and an additional 3% surcharge for modified adjusted gross income over $25 million. Modified adjusted gross income is calculated before charitable and mortgage interest deductions. For estates and trusts, the same rates apply at modified adjusted gross income over $200,000 and $500,000, respectively. This could result in a rate of tax on capital gains of 28.8% to 31.8%. The 3.8% Net Investment Income Tax would be expanded to apply to all income not subject to the 3.8% Medicare tax on wages and self-employment income, and for taxpayers with taxable income of $400,000 or more ($500,000 for taxpayers filing jointly), income derived in the ordinary course of business, or active business income, will be subject to the 3.8% tax.

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[2] See "Foreign Money Secretly Floods U.S. Tax Havens. Some of It is Tainted," *The Washington Post*, October 4, 2021.

Lower Estate Tax Exemption

The exemption for estate, gift, and generation skipping transfer ("G.S..T.") tax of $11.7 million will revert back to $5 million (as indexed for inflation, approximately $6.02 million indexed for inflation in 2022, as of January 1, 2022.

Revised Plan: Not included.

Changes to Grantor Trust Rules

Assets held by grantor trusts (for income tax purposes) will be included in the estate of the grantor at death. Distributions from grantor trusts to beneficiaries during the grantor's lifetime (and trust terminations during lifetime) will be treated as gifts from the grantor. These proposals, if enacted, could largely eliminate the utility of grantor retained annuity trusts ("G.R.A.T.'s"), spousal limited access trusts ("S.L.A.T.'s"), qualified real property trusts ("Q.P.R.T.'s") and insurance trusts as tax efficient estate planning techniques to remove property and appreciation on such property from a grantor's estate. Sales or exchanges of property between a grantor trust and its grantor would be taxable, eliminating the ability to remove the appreciation on assets from a grantor's estate through income tax-free sales by a grantor to a grantor trust.

Revised Plan: Not included.

Valuation Rules

One proposal includes a change to the rules applicable to valuation of entity interests owned at death or transferred by gift. There would be no valuation discounts for estate and gift tax purposes on nonbusiness assets (cash, stock, debt, annuities, and real property, (other than certain real property used in a real property trade or business, which includes development, management, leasing, construction, or management businesses) held in entities. This would eliminate most valuation discounts for entities, other than assets used in an active business.

Revised Plan: Not included.

FURTHER THOUGHTS

It is clear that profound changes are coming to increase tax on wealthy individuals. There has been considerable pushback on a number of these proposals. Most recently, discussion regarding a possible wealth tax on wealthy individuals has re-emerged, but it appears to have been shut down by moderate Democrats. Proposals change frequently, and it is difficult to predict what changes may ultimately be enacted.

RESCISSION – UNDOING A TRANSACTION THAT SEEMED LIKE A GOOD IDEA AT THE TIME

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Tags
Penn v. Robertson
Rescission
Rev. Rul. 80-58
Status quo ante

INTRODUCTION

How many times have we watched a movie, read a book, or listened to a colleague talk about an action that appeared to be a no-risk proposition, only to turn into a nightmare? At some point, the general lament is uttered: "It seemed like a good idea at the time, but . . ."

Tax plans can be like that, too. A company identifies an acquisition target, proposes a merger with a supplier, or considers an internal restructure. Teams of lawyers, accountants, and operations personnel perform appropriate due diligence. The deal closes. At some point, blemishes, problems, errors float to the surface. The same lament is uttered: "It seemed like a good idea at the time, but . . ."

However, in comparison to the personal nightmare which may have ramifications for a long period of time, an opportunity to undo what was done exists in the business world. Moreover, it exists in the tax world if parties acts quickly. The magic elixir is embodied in the doctrine of rescission. Where it applies, the parties can separate from each other and the transaction is treated as if it never occurred.

DOCTRINE OF RECISSION

<u>Annulling the Transaction</u>

The term "rescission" refers to the cancellation or voiding of a contract and the return of the parties to the positions they would have been in had the contract not been made. Rescission is neither a rewriting of the contract nor a correction of an error in an ongoing contract. A rescission is simply a remedy that allows the parties to ignore the existence of the transaction and to be placed in *status quo ante*, again, as if the transaction never took place.[1] The conditions for a successful application of the doctrine of rescission have been clearly described in Revenue Ruling 80-58.

In the ruling, the I.R.S. addressed two situations in Rev. Rul. 80-58. The distinguishing feature between the two situations was the year in which the act of rescission took place. In the first, the transaction and its revision occurred during one tax year. In the second, the transaction occurred in one year, but the rescission occurred in the next. The first transaction could be rescinded. The second could not.

The I.R.S. observed the following with regard to the rescission doctrine:

> The legal concept of rescission refers to the abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting

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1 *A.W. Shaw*, 13 B.T.A. 716 (1928).

> parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made. A rescission may be effected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of rescission.

Timely Action Required

The transaction and its recission must take place in the same year. The reason is explained in *Penn v. Robertson*.[2]

In *Penn*, the taxpayer was a participant in an employees' stock benefit fund created by the directors of the company without the approval of the shareholders. The taxpayer was credited with earnings from the fund for years 1930 and 1931, but the plan was rescinded in 1931 for lack of compliance with corporate governance rules. The court held that although the plan was rescinded for 1930, the annual accounting period principle required the determination of income at the close of the taxable year without regard to subsequent events. Consequently, the rescission in 1931 was disregarded for purposes of determining 1930 taxable income. On the other hand, the rescission for amounts received in 1931 was valid and no income resulted from events in 1931 or the cancellation, itself.

As to the attempt in 1931 to rescind income received in 1930, the court stated:

> A cardinal principle of federal income taxation requires annual returns and accounting; and this principle requires the determination of income at the close of the taxable year without regard to the effect of subsequent events. Thus, in determining whether the credits made on the note in 1930 constituted income for that year, it is necessary to disregard the rescission in 1931; and we must determine the question in the light of conditions that existed at the end of 1930.

As to the attempt in 1931 to rescind income received in that year, the court stated:

> But we agree with the district judge that the rescission in 1931 before the close of the calendar year, extinguished what otherwise would have been taxable income to Penn for that year. The Collector contends that the rescission was not a genuine rescission but really a re-sale of the stock. But this is refuted by the record, the stipulation of counsel and the findings of the district judge. We have no doubt that the parties intended a genuine rescission. Certainly what was done was entirely consistent therewith.

A similar conclusion was reached in *Davis v. U.S.*,[3] where the court explained the purpose of the recission doctrine in denying a post-verdict motion filed by the government:

> * * * [A] taxpayer who by mistake consummates a transaction in a manner that is not in accord with his actual intent may, in the same tax year, with the consent of the other parties, reform the transaction

[2] 115 F.2d 167 (4th Cir. 1940).

[3] 378 F. Supp. 579 (N.D. Tex. 1974).

> so as to carry out his real intent, and that such reformation will determine the [F]federal tax consequences.

These principles were adopted in Rev. Rul. 80-58 which stated the following as to the effect of a recission made within the same year in which the original transaction was entered:

> In Situation 1 [involving a sale and its rescission in the same year] the rescission of the sale during 1978 placed A and B at the end of the taxable year in the same positions as they were prior to the sale. Thus, in light of the *Penn* case, the original sale is to be disregarded for federal income tax purposes because the rescission extinguished any taxable income for that year with regard to that transaction. See Rev. Rul. 74-501, 1974-2 C.B. 98, which holds that there is no adjustment to the basis of the old stock where a shareholder exercised stock rights and paid the subscription price for the new stock, which subscription price was later returned to the shareholder in the same taxable year in which the rights were issued because the market price of the stock had depreciated to a price below the subscription offer.

The same principle was enunciated in Rev. Rul. 80-58.

> The annual accounting concept requires that one must look at the transaction on an annual basis using the facts as they exist at the end of the year. That is, each taxable year is a separate unit for tax accounting purposes. See *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281 (1944), Ct. D. 1603, 1944 C.B. 526.

"Generally, the intent that motivates the application of the doctrine of recession is not determinative of its application."

TRANSACTIONS THAT BENEFITTED FROM THE RESCISSION DOCTRINE

Generally, the intent that motivates the application of the doctrine of recession is not determinative of its application. Several cases and private letter rulings illustrate that the scope of the rescission doctrine is broad, so long as the parties act to rescind in the same tax period in which the original transaction was consummated and the parties are put back in the original position that existed prior to the transaction.

<u>Rescission on Account of a Mistake of Fact</u>

<u>Davis v. U.S., supra.</u>

In *Davis*, the taxpayer owned shares of corporate stock in a privately held group of companies. He contemplated transferring the shares to his children, but was initially undecided whether to effect the transfer by gift or by sale. Ultimately, he decided to make a gift. At that point, the Vice President and Treasurer of the group owned by Mr. Davis was authorized to implement the transaction. This authorization was consistent the authority held by the Vice President to administer the consummation of business transactions such as the transfer of shares. The Vice President structured the transactions as sales rather than as gifts. This resulted in the potential recognition of capital gain by the taxpayer. The tax exposure was discovered several months after the gifts were made. Within the same taxable year as the original sale, the original transactions were restructured to be gifts.

The I.R.S. asserted that the original transaction cast as a sale was binding on the taxpayer. Ultimately, the I.R.S. contended that the transaction was part gift and part sale because the children agreed to pay the resulting gift tax imposed on the taxpayer.

The matter gave rise to a series of cases in Tax Court and in District Court regarding different aspects of the case. The matter in District Court addressed the following question:

> [W]ere [the taxpayers] entitled to judgment as a matter of law on the ground that regardless of the intent of the taxpayers at the time of the transfers of the Cummins stock in April, 1964, they could subsequently, in the same tax year, with the consent of the transferees, and in the absence of fraud, change the transaction to a gift and pay gift tax rather than income tax thereon. *Buff v. Commissioner*, (1972), and cases cited therein[?] (Footnotes omitted.)

The jury found the answer to be yes, and the court confirmed the verdict in ruling on post-verdict motions that were submitted.

> The Court is of the opinion that the plaintiffs are entitled to judgment (1) as a matter of law on the theory above discussed in connection with the motion for instructed verdict, and also (2) on the verdict of the jury considered along with the facts established as a matter of law by stipulation or otherwise. The following cases support the principle that a taxpayer who by mistake consummates a transaction in a manner that is not in accord with his actual intent may, in the same tax year, with the consent of the other parties, reform the transaction so as to carry out his real intent, and that such reformation will determine the federal tax consequences. *United States v. Merrill*, 9 Cir., 211 F. 2d 297, 304 * * *. (Footnotes omitted.)

U.S. v. Merrill[4]

Merrill involves the payment of an executor's fee received by an individual from the estate of his deceased wife in a state that was a community property jurisdiction. The wife's estate included property that was properly categorized as community property, meaning that he had an existing interest in one-half of the property. The executor's fee allowed by the probate court was $20,000, of which $12,500 was paid in one year and balance – $7,500 – was paid in the following year. The estate tax return was examined before the end of the following year and the examiner disallowed a claim against the estate for the portion of the executor's fee in excess of $10,000, the amount charged to the portion of the community property attributable to the deceased wife.

Consistent with that disallowance, the taxpayer did not report the $7,500 as income in the year of receipt. The I.R.S. contended that, because the $7,500 was received as a claim of right to income, the taxpayer could not disavow that he was taxable

4 211 F. 2d 297 (9th Cir. 1954).

to that income. In rejecting the position of the I.R.S., that an erroneous inclusion of income cannot be reversed if discovered in the year of receipt, the court stated the following:

> [W]ith respect to the $7500 in executor's fees which were mistakenly paid out of the wife's share of the community property in 1940. For as to that part of the fee, the mistake was discovered in the same year as the sum was received (1940) and appropriate adjustments were made in his own books and those of his wife's estate in that year in recognition of the mistake. We think the $7500 receipt in 1940 was thereby placed outside the operation of the "claim of right" rule. * * * We are not aware that the rule has ever been applied where, as here, in the same year that the funds are mistakenly received, the taxpayer discovers and admits the mistake, renounces his claim to the funds, and recognizes his obligation to repay them. *Cf. Carey Van Fleet*, 2 B.T.A. 825; *Curran Realty Co. v. Commissioner*, 15 T.C. 341. We think there is no warrant for extending the harsh claim of right doctrine to such a situation. In such case the Internal Revenue Bureau is not faced with the problem of deciding the merits of the claim to the funds received, for the question has been resolved by the interested parties. No question is here raised as to the *bona fide*s of appellee's 1940 bookkeeping entries relative to the mistaken payments. Good faith is indicated by the fact that the taxpayer's $7500 obligation to the estate was not only recognized by him in 1940 but was paid in cash in 1943.

Rescission on Account of Change in Circumstances

P.L.R. 200613027 – Undoing a Check-the-Box Election[5]

In P.L.R. 200613027, an L.L.C. that was treated as a partnership for U.S. income tax purposes converted into a corporation under relevant state law. Where permitted under state law, a conversion is effected simply by amending the certificate of formation. For tax purposes, a conversion is treated as a deemed transfer of assets to a corporation that is tax free under Code §351 because the deemed transferors control the corporation. The conversion was effected pursuant to a contract previously entered into with its two shareholders in anticipation of making an I.P.O. of the stock.

Shortly after the conversions, certain precipitous and unexpected deterioration in market conditions caused the I.P.O. to be canceled. No plan existed to attempt another public offering in the near future. In the circumstances, the two shareholders and the corporation proposed that the corporation convert back into an L.L.C. taxable as a partnership before the end of the year that included the original conversion,

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[5] Pursuant to Code §6110(k)(3), a private letter ruling may not be used or cited as precedent by any person other than the taxpayer to whom issued. Nonetheless, it demonstrates the thinking of the National Office of the I.R.S. as of the date issued and may be used as authority to abate the imposition of a penalty. Practically speaking, private letter rulings can serve as guides to National Office interpretations, and I.R.S. employees consider them in issuing letter rulings to similarly situated taxpayers. Saltzman & Book, IRS Practice and Procedure (Thomson Reuters/Tax & Accounting, Rev. 2nd ed. 2002, with updates through October 2021) (online version accessed on Checkpoint [November 15, 2021]) at paragraph 305, n. 458.

so that it and the owners together again would be subject to only a single level of federal income taxation.

Without application of the rescission doctrine, the return to L.L.C. status would typically be a taxable event at the corporate level and again at the shareholder level. Consequently, the corporation requested a ruling from the I.R.S. allowing the conversion to be rescinded for tax purposes.

"In order to obtain a favorable ruling from the I.R.S., the corporation and its shareholders were required to make the following representations intended to confirm the facts that existed prior to the original transaction, the facts that existed during the period of existence of the corporation, and the facts that would exist after the rescission."

In order to obtain a favorable ruling from the I.R.S., the corporation and its shareholders were required to make the following representations intended to confirm the facts that existed prior to the original transaction, the facts that existed during the period of existence of the corporation, and the facts that would exist after the rescission. The scope of the representations illustrate the I.R.S. view of the term *status quo ante*.

- Prior to the incorporation transaction, the L.L.C. was treated as a partnership for Federal income tax purposes.
- The L.L.C. had no current intention or plan to make an election pursuant to §301.7701-3 of the Income Tax Regulations to be classified as an association after converting back into an L.L.C.
- Other than certain redemptions made to certain members of the L.L.C.'s management team as a result of the death or separation from service and a distribution prior to the conversion date which appeared to have been made pursuant to the L.L.C. agreement, no distributions were made by the corporation to its equity holders since the date of the conversion.
- Since the date of the conversion, the corporation took no actions nor did it engage in any transactions with its two owners that were inconsistent with the actions and transactions the Taxpayer would have undertaken had it remained a partnership for Federal income tax purposes at all relevant times, except that profit distributions were not made. Those distributions were scheduled to be made after the rescission was implemented.
- Once the rescission transaction would be implemented, the L.L.C. intended to file its Federal income tax return as if it were a partnership during all of calendar year. In addition, each of its two owners planned to include in income an allocable share of the L.L.C.'s income, deduction, gain, and loss for the period beginning with conversion and ending with the rescission.
- Each member of the management team that received a distribution agreed to report the amounts received as if received from an L.L.C. taxable as a partnership during the entire taxable year.
- Upon the effective date of the rescission, the same operating agreement that was in existence prior to the conversion will continue to be in effect after the rescission, even if the agreement needed to be re-executed.
- The rescission agreement was intended to restore the legal and financial arrangements between the owners and the L.L.C. that would have existed in the absence of the conversion.

- The effect of the rescission agreement was to cause the legal and financial arrangements between the owners and the L.L.C. to be identical in all material respects to arrangements that would have existed had the conversion not occurred.
- Neither the owners nor the L.L.C. took or intended to take any material position inconsistent with the position that would have existed had the conversion not occurred.

Once the representations were made, the I.R.S. ruled that, pursuant to Rev. Rul. 80-58, the conversion of the L.L.C. into a corporation giving rise to a tax-free transaction under Code §351 could be rescinded with the following consequences:

- The entity was treated as a partnership at all times during calendar year.
- The owners of the entity were treated as partners of the entity during the entire taxable year.
- The conversion of the entity from a corporation into a limited liability company taxable as a partnership pursuant to the rescission was not treated as a liquidation of the corporation for purposes of determining the taxable income of the entity and its owners.

P.L.R. 200701019 – Undoing a Corporate Merger

P.L.R. 200701019 involves the rescission of a corporate merger in the following fact pattern.

Parent Corp acquired all the outstanding common stock of Target Corp for cash. The only asset of Target Corp was the outstanding common stock of Subsidiary Corp. Subsidiary Corp did not own any equity interest in any other entity. As part of the acquisition, Parent Corp retired some amounts of Subsidiary Corp's debt in exchange for a note from Subsidiary Corp in the same amount. To maximize operational efficiencies and reduce state franchise tax exposure, immediately after Parent Corp acquired all of Target Corp's outstanding stock, Target Corp was merged into Parent Corp with Parent Corp surviving. The transaction was characterized as a complete liquidation of Target Corp for U.S. income tax purposes.

As result of the merger, Parent Corp became the sole shareholder of Subsidiary Corp. From the date of the merger (and before the rescission), Parent Corp loaned money to Subsidiary Corp for use in Subsidiary Corp's ongoing business.

Shortly after the merger and prior to the end of the taxable year of the merger, Parent Corp experienced an unexpected downturn in its business and realized it would need to dispose of one or more business lines to raise capital. Parent Corp realized that its decision to liquidate Target Corp rather than preserve its adjusted tax basis in Target Corp's stock had not been prudent. Therefore, Parent Corp formed New Target Corp under the laws of the same state in which old Target Corp had been incorporated. The bylaws of New Target Corp were identical to the bylaws of Target Corp. Parent Corp was the sole shareholder of New Target Corp. Parent Corp contributed all the outstanding stock of Subsidiary Corp to the capital of new Target Corp in exchange for all the common stock of new Target Corp.

Again, the I.R.S. required certain representations to ensure that all parties were put back to the same positions that existed before the acquisition of Target Corp was effected and merged into Parent Corp. The representations were detailed as the original transaction and following transactions were more than a simple share acquisition or conversion.

- The retirement of Subsidiary Corp's debt in exchange for a note from Subsidiary Corp in the same amount would have been carried out notwithstanding the merger.
- No actual or constructive transfers of money or property occurred between Subsidiary Corp and Parent Corp or its subsidiaries prior to the rescission transaction other than the contribution of Subsidiary Corp shares to New Target Corp.
- No material changes in the legal or financial arrangements between Subsidiary Corp and Parent Corp or its subsidiaries prior to the date of the rescission transaction.
- After the rescission transaction the legal and financial arrangements among Parent Corp, New Target Corp, and Subsidiary Corp would be identical in all material respects to the legal and financial arrangements among those corporations prior to the merger.
- The merger and the rescission transaction took place in the same taxable year.

The I.R.S. ruled the rescission doctrine applied to the unwinding of the merger of Subsidiary Corp into Parent Corp, based on the above facts and representations. Consequently:

- Target Corp was not treated as having merged into Parent Corp.
- Target Corp and Parent Corp were treated as two separate corporations at all times during the tax year.
- Parent Corp was treated as having been the shareholder of Target Corp at all times during the tax year.
- The merger of the Target Corp into the Parent Corp was not treated as a liquidation of the Target Corp for purposes of determining Parent Corp's or Target Corp's taxable income.

Rescission to Reverse Unexpected Adverse Tax Consequences

P.L.R. 9829044

In P.L.R. 9829044, the I.R.S. considered whether the legal doctrine of rescission applied to reverse the termination of the status of a U.S. domestic corporation as an S-Corporation ("S Corp"). An S-Corp is a domestic corporation that computes income as if it were an individual, and to the extent provided by law, its shareholders are taxed on the income automatically.

In the ruling, the shareholders of an S-Corp transferred their stock in the S-Corp to another corporation ("S-Corp II") that was owned by the same shareholders of the S-Corp. The purpose of the transaction was to streamline the business operations of the two corporation and reduce administrative expenses. A parent S-Corporation – here, S-Corp II – may elect to treat one or more of its eligible subsidiaries as a qualified subchapter S-Corporation subsidiary ("QSub").The QSub election results in a deemed liquidation of the subsidiary into the parent. Following the deemed liquidation, the QSub is not treated as a separate corporation and all of the subsidiary's assets, liabilities, and items of income, deduction, and credit are treated as those of the parent.

"At least two conditions must be satisfied for the remedy of rescission to apply to disregard a transaction for Federal income tax purposes."

At some point during the same taxable year, the outside accountants of the S-Corp discovered that shareholder basis in the S-Corp stock was overstated. As a result, a substantial amount of losses reported by the S-Corp would be suspended until the basis was increased. Unfortunately, once S-Corp became a QSub of S-Corp II, the suspended losses were eliminated. To remedy the problem, the transfer of shares in S-Corp to S-Corp II was rescinded and a ruling request was submitted to the I.R.S. to determine whether the rescission would be respected for income tax purposes.

The I.R.S. required the shareholders of S-Corp and S-Corp II to make the following factual representations:

- There were no actual or constructive distributions of money or property from S-Corp to S-Corp II while the latter corporation owned the former.
- There were no actual or constructive contributions of money or property from S-Corp II to S-Corp while the former corporation owned the latter.
- There were no material changes in the legal or financial arrangements between S-Corp and S-Corp II or between one or more of the shareholders and the corporation while latter corporation owned the former.
- After the rescission was implemented, the legal and financial arrangements among all of the parties were identical in all material respects to such arrangements prior to the initial transaction.
- No consideration was paid to any of the shareholders in order to induce shareholder consent to the original transaction or its rescission.

The I.R.S. looked to Rev. Rul. 80-58 for guidance in determining whether the rescission would be respected. At least two conditions must be satisfied for the remedy of rescission to apply to disregard a transaction for Federal income tax purposes. First, the parties to the transaction must return to the *status quo ante*. This means that they must be restored to the relative positions they would have occupied had no contract been made. Second, this restoration must be achieved within the taxable year of the transaction. These are factual questions and in light of the facts recited and the factual representations made, those facts existed. The rescission was not a taxable event in the circumstances.

P.L.R. 200911004

P.L.R. 200911004 involves a relatively straightforward merger and rescission completed within the same taxable year involving Acquiring Corp and Target Corp. As a prelude to the merger, Acquiring Corp acquired convertible preferred shares of

Target Corp from existing shareholders, paying cash for the shares. Thereafter, a merger agreement was entered into between Acquiring Corp and Target Corp.

Within several months, Acquiring Corp realized that the merger could yield adverse tax consequences that potentially would be devastating to the viability of Acquiring Corp as an ongoing entity. The ruling did not elaborate on the adverse consequences. Consequently, Acquiring Corp, Target Corp, and certain shareholders of Target Corp undertook steps to rescind the merger and to implement a taxable sale of Target Corp common stock to Acquiring Corp.

Again, the I.R.S. required the following representations from Acquiring Corp:

- At the time of completion of the rescission transaction, the legal and financial arrangements among Acquiring Corp, Target Corp, and their respective shareholders were identical in all material respects to all such arrangements prior to the merger.
- Neither Acquiring Corp nor Target Corp would take any material position for U.S. Federal income tax purposes inconsistent with the position it would have taken had the merger not occurred.
- There was no plan or intention to liquidate Target Corp with or into Acquiring Corp.

The I.R.S. ruled the rescission doctrine applied to the unwinding of the merger of Target Corp into Parent Corp, based on the above facts and representations. Consequently:

- Target Corp was not treated as having merged into Acquiring Corp.
- Target Corp and Acquiring Corp were treated as two separate corporations at all times during the relevant taxable year.
- Acquiring Corp was treated as having acquired all of the Target common stock that was not part of the rescission pursuant to the Agreement as of the date of the rescission.

I.R.S. ADOPTION OF NO-RULING POLICY

In 2010, guidance on the scope and application of the rescission doctrine was placed on the I.R.S. priority guidance plan. Then, in 2012, the I.R.S. announced that it was no longer issuing private letter rulings regarding rescissions.[6] At about the same time, the guidance project was dropped. However, the no-ruling policy remained in effect. The no-ruling policy was included in Rev. Proc. 2014-3 (Section 3.02(8)), the annual announcement of those domestic provisions of the Code in which the I.R.S. will not issue letter rulings or determination letters.

Although the I.R.S. will not issue a ruling on the application of the rescission doctrine to a particular fact patter, Rev. Rul. 80-58 remains official guidance of the I.R.S. and was recently followed in a private letter ruling issued by the I.R.S. In P.L.R. 202123001, a taxpayer requested an extension of time to change its entity classification within the 60-month period succeeding the effective date of a prior

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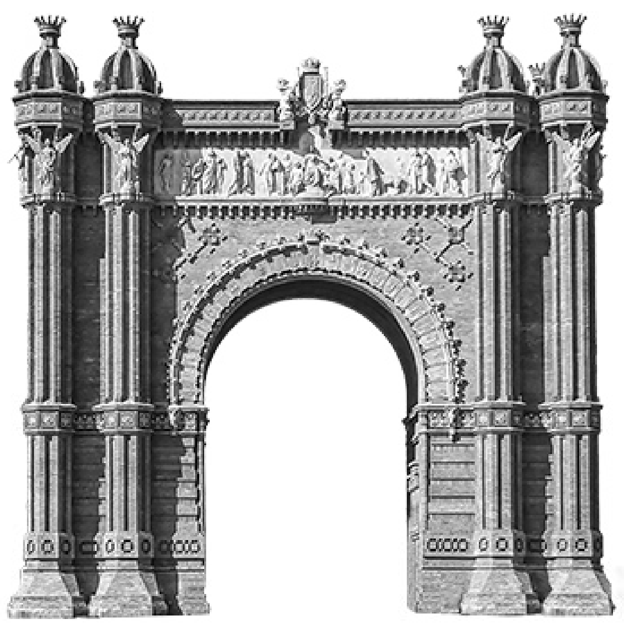
6 In Section 5.02 of Rev. Proc. 2012-3.

election. Ordinarily, an election cannot be reversed within the 60-month period. In denying the application, the I.R.S. analogized the taxpayer's request to the doctrine of rescission, and Rev. Rul. 80-58 was cited as appropriate authority to state that the conditions for a rescission to be recognized for U.S. income tax purposes were not met.

> Further, though X's request is made in the form of a late election, in substance X is seeking a ruling permitting the rescission of the deemed transaction that occurred in a prior year. Using an overlapping election to rescind a transaction is different than making a second election and is not provided for in the regulations under § 301.7701-3. Moreover, rescissions, in general, raise other considerations. See, *e.g.*, Rev. Rul. 80-58, 1980-1 C.B. 181 (the annual accounting period principle precludes rescission of a transaction completed in a prior year).



THE "VALUE CREATION" QUESTION HAS ESCAPED THE NEW PILLAR 1 MOUSETRAP

Author
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Tags
Digital Economy
Pillar 1
Transfer Pricing

Ho lwana badula-mmoho

(Sesotho proverb, loosely meaning "Those who stay together often quarrel".)

When a Mosotho or a Sesotho speaker says "stay together," they usually mean "live together." By this terminology, the Inclusive Framework of 137 countries that agreed in October to adopt the two-Pillar approach to taxing the digital economy has also agreed to cohabit the role of global tax administration. The final details of the new arrangement have yet to be concluded, but one of the policy imperatives that led the world's tax authorities to this point has yet to be addressed by the Pillar 1 approach. Among other reforms, Pillar 1 replaces the arm's length standard with a formula-driven profit allocation mechanism for multinational companies with worldwide sales greater than €20 billion.

The path that led to the adoption of the new Pillar 1 taxing right began with the O.E.C.D./G-20 finance ministers committing to a plan calling for the allocation of profits to jurisdictions where value is created.[1] Since that decision was reached, much has been written about the vague and undefined nature of "value creation" as a foundational element of international tax policy on transfer pricing.[2] This has not stopped the term from being codified in certain O.E.C.D. transfer pricing compliance requirements.[3] Most important, for companies that are not required to conform to the formula-driven approach of Pillar 1, "value creation" remains the central foundational feature of the controlling policy idea.

This unresolved point all but guarantees an ongoing quarrel over transfer pricing policy for the portion of global companies that are not part of the group of large multinational companies that will be governed by Pillar 1. This group consists of most of the world's multinational companies by count, not by revenue. They will face conflicting definitions of the term "value creation" that almost certainly exist among those tax administrations that have chosen to stay together.

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1 OECD, Action Plan on Base Erosion and Profit Shifting, OECD Publishing, p.20 (2013).

2 See for example, M.P. Devereux & J. Vella, *Value Creation as the Fundamental Principle of the International Corporate Tax System*, Eur. Tax Policy Forum Policy Paper, (31 July, 2018), J. Schwarz, *Value Creation: Old wine in new bottles or new wine in old bottles?,* Kluwer International Tax Blog (21 May, 2018), Allison Christians, *Taxing According to Value Creation*, 90 Tax Notes International, (June 18, 2018).

3 OECD (2014), Guidance on Transfer Pricing Documentation and Country-by-Country Reporting, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing.

Having lived with this practical uncertainty in a professional capacity for some time, I was intrigued to read the opening chapters of Mark Carney's *Value(s)* that adopted a definition of the troublesome term and helpfully described its origin in rough terms. At about the same time, I happened upon a paper by a staunch proponent of the arm's length principle and a number of co-authors[4] that proposes to solve the "value creation" problem by swinging a wedge pulled from the cooperative game theory golf bag to split profit as an outcome rather than quantify value creation, thereby promising the all-but-certain popular demise of the arm's length principle in favor of just about anything else. As long as the term "value creation" is central to multilateral guidance, it will continue to be used variously in its current undefined form by tax authorities and multinational companies to justify their transfer pricing positions, and quarrel will continue to be the norm.

Faced with these competing reading options, I decided to revisit the scribblers of political economy that first used the "value creation" term that has now taken its place in policy through generations of teachers and students to see if a practical meaning could be found. I immediately encountered what we now know to be a garden variety cognitive bias in economics, namely that your view on certain issues depends on your membership (whether known or not) in a school of thought.[5] We can add this cognitive bias to the list of past discoveries reported in *Insights*.[6]

It is also worth noting that the definition of "value creation" assumed by the O.E.C.D. members, many of whom trace the origins of their political economy to the traditions of modern Western civilization, may be predisposed to conflict with the fundamental views of the rest or the world (the O.E.C.D. non-member states that are part of the Inclusive Framework) that may understand "value creation" differently.

> *Sefate se tsejwa ka ditholwana*
>
> (Sesotho proverb, loosely meaning "A tree is known by its fruit.")

If the "value creation" policy concept is the proverbial fruit, then the O.E.C.D.-member drafters that employed the term are most likely to be found sitting in the shade of a tree of either the classical or neoclassical species.

Classical theories of value developed from the time of Aristotle held that the idea of value creation coincides with need for a supply or a commodity and the utility from consuming the supply or the disutility from being without it. A thing was valuable if it was viewed as such in the societal context, if it advanced the national interest, or if it glorified a higher power.

Labor theories of value later refined and expanded by Smith, Ricardo, and Marx began with agricultural production and concentrated on the labor required to produce a good. Value creation occurred through the use of labor. With industrialization, labor remained the key source of value creation as labor was used to produce machines. Labor inputs were used to create surplus, creating a link at the time between labor and profit. Certain sources of profit such as usury and profit from exchange or trade

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4 Shapley, "Value: A Fair Solution to the Value Creation Puzzle in Transfer Pricing?" in *TaxNotes*.

5 See, for example, Javdani, Mohsen and Chang, Ha-Joon, "Who Said or What Said? Estimating Ideological Bias in Views Among Economists," (September 1, 2019). Available at SSRN.

6 See, generally, Volume 5, Number 5 of *Insights* (June 2018).

were not counted as value creation, owing to moral or societal constructs of the time, or due to the fundamental controlling assumption that labor was the genesis of all value.

The Aristotelian concept of utility was later further developed and elevated to define the neoclassical definition of value creation in response to Ricardo and Marx. Value creation became synonymous with consumer utility, or the value placed on a good in an exchange and has been taught in economics and business programs in the tradition of Marshall, Walras, and Pareto for the last century. Trading off utilities and prices at the margin, and using aggregating principles to explain company, industry and macro activity we observe and expect is representative of the current mainstream.

Thinking of an international tax structure from a bygone era that uses an entity resident in a low-tax jurisdiction to hold intangible property and do nothing else offends both the classical and neoclassical definitions, as both the production and market locations associated with value creation are located elsewhere. Thought of this way, either Western view of value creation achieves the O.E.C.D./G-20 goal of frustrating the allocation of profit to tax havens.

The "value creation" policy concept however appears ill-equipped to go further and answer any other questions concerning profit allocation. Pillar 1 resolves the issue by stipulating an answer. If nothing else has been gained from transfer pricing policy reform efforts, tax authority positions may now at least be classified as classical, neoclassical, or other.

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