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# INSIGHTS

## USE IT OR LOSE IT: THE FUTURE OF SHELL ENTITIES IN THE E.U.

## THE DOOR TO A NEW WORLD: DECENTRALIZED FINANCE (DeFi)

## EXPANDED I.R.S. REPORTING OBLIGATIONS FOR DIGITAL ASSETS

## AND MORE

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**About Us**

# EDITORS' NOTE

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

- **Use it or Lose it: The Future of Shell Entities in the E.U.** Shortly before Christmas, the European Commission published a proposal for a directive laying down rules to prevent the misuse of shell entities for improper tax purposes. The "Unshell Directive" applies to any company or other "undertaking," regardless of its legal form that (i) is considered tax resident in an E.U. Member State and (ii) is eligible to receive a tax residency certificate. Targeted by the Unshell Directive are entities that have the following characteristics: (a) they lack real economic activities, (b) they are involved in certain cross-border arrangements forming a scheme to avoid and evade taxes, and (c) they allow their beneficial owners or parent company to access a tax advantage. Paul Kraan, a tax partner at Van Campen Liem in Amsterdam, explains the general exemptions, the gateway indicators, the reporting obligations, the presumptions, and potential rebuttals in this attack on certain special purpose vehicles.

- **The Door to a New World: Decentralized Finance (DeFi).** The world of crypto is fast-moving. An exciting development in this space is Decentralized Finance ("DeFi"), which entered the scene in March 2020. Its use has exploded ever since. The term refers to the offering of traditional financial services not by centralized players such as banks, insurance companies, and exchanges, but through smart contracts running on blockchains. Niklas Schmidt, a partner of the Vienna office of Wolf Theiss and leader of the firm-wide tax team, and Lioba Mueller, a *Rechtsreferendarin* at the Regional Court of Aachen and PhD student at the University of Bonn, Germany, explain the ups and downs of this relatively new financing vehicle.

- **Expanded I.R.S. Reporting Obligations for Digital Assets.** If DeFi is the *Ying* in the crypto world, new I.R.S. reporting obligations are the *Yang*. I.R.S. reporting requirements for cryptocurrency and other digital assets have been substantially expanded, and as a result, are expected to have a significant impact on the wide range of businesses and individuals to which they apply. Among other things, information reporting requirements for certain brokers now include digital assets, and digital assets valued at more than $10,000 are treated as "cash." Lawrence S. Feld, a New York attorney whose practice concentrates on Federal and State criminal and civil tax controversies, explains all.

- **The Last Days of Dummy Companies.** The use of anonymous shell companies or "dummy companies" that may be availed of to conceal the true identities of the ultimate beneficial owners is viewed by financial regulators as a tool to facilitate money laundering and the financing of terrorism. The benefit of anonymity may soon be a thing of the past in the U.S. as well as in Europe. Amendments made to Recommendation 24 by the Financial Action Task Force, proposed regulations by FinCEN to require reporting on "beneficial owners," and pronouncements on the I.R.S. website that explain the meaning of the term "responsible party" that must be reported when applying for an employer identification number in the U.S. all demand that a U.S. corporation report its controlling person. Ibn Spicer, an experienced attorney whose practice focuses on entertainment and corporate law, and who is currently enrolled in the LLM in Taxation Program of New York Law School, observes that the opportunities for hidden ownership are shrinking rapidly.

- **The Price is Right: Former I.R.S. Attorney Discusses Information Return and F.B.A.R. Penalties**. Ever wonder what happens to well-crafted reasonable cause statements attached to late-filed I.R.S. information returns, such as Forms 5471, 5472, and 3520? In a presentation before the San Francisco Tax Club, a retired long-term I.R.S. attorney named Daniel Price provided the answer: nothing happens to them. Over the years, the I.R.S. has increased the number of information returns that must be filed by taxpayers. To keep up the pace, I.R.S. delegates many tasks to lower-level employees who may not have been trained sufficiently to make discretionary judgments. Moreover, they are managed by relatively inexperienced supervisors. Stanley C. Ruchelman and Wooyoung Lee explain the problem and several suggestions offered by Mr. Price. Recent experience with F.B.A.R. penalty inconsistencies are also discussed.

- **"Manning Up": Twenty-First Century Tales of Tax Avoidance and Examination Options on the I.R.S.'s Table.** The U.S. tax system is a "self-assessment" system: upon determining how tax provisions apply to their transactions, taxpayers pay the tax they determine is due, and report the transactions to the I.R.S. in sufficient detail to permit the I.R.S. to confirm that liability was correctly calculated. Paradoxically, the tax system is so complex that it incessantly creates ambiguity and opportunity for abuse. Determining one's tax obligations is often difficult, even for taxpayers with simple profiles. In a lighthearted article, Andreas A. Apostolides looks at two recent events – the first is a letter written by Senate Finance Committee Chairman Ron Wyden to the Chairman of Bristol-Myers Squibb questioning a 10-yearold transaction and the second is a court decision striking down the I.R.S. system of listed transactions and transactions of interest, both part of the anti-tax shelter provisions of U.S. tax law.

- **New Subpart F and P.F.I.C. Regulations – *Ex Uno Plures*.** Is a partnership an entity for certain tax purposes or is it an aggregate of the partners? U.S. tax law was never consistent on this point. In 2017, a foreign taxpayer won a major victory when the U.S. Tax Court held that a partnership is an entity when determining the tax exposure of a foreign partner selling its partnership interest or having its interest redeemed. Almost immediately, Congress changed the law. From that moment, the I.R.S. reviewed the way partnerships and their partners are treated for purposes of the Subpart F, G.I.L.T.I., and P.F.I.C. provisions of U.S. tax law. Regulations were revised, the Schedule K-1 reporting form was modified with the addition of Schedule K-2 and Schedule K-3, and elections once made by domestic partnerships and binding on all members were now to be made by individual partners. Stanley C. Ruchelman and Wooyoung Lee explain these and other changes in the treatment of partnerships for the international provisions of U.S. tax law.

We hope you enjoy this issue.

- The Editors

# USE IT OR LOSE IT: THE FUTURE OF SHELL ENTITIES IN THE E.U.

**Author**
Paul Kraan

**Tags**
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Paul Kraan is a tax partner at Van Campen Liem in Amsterdam, specializing in international tax planning and structuring, advising corporations, funds, and high-net worth individuals on Dutch tax aspects of their investments. Paul studied law and economics at the University of Amsterdam. He is a member of the board of the Netherlands Association of Tax Attorneys ("N.V.A.B.").
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## INTRODUCTION

Shortly before Christmas,[1] the European Commission published a proposal for a Directive (the "Directive") laying down rules to prevent the misuse of shell entities for improper tax purposes and amending Directive 2011/16/E.U. – the directive on administrative cooperation (the "D.A.C.").

Given that the proposed rules are intended to enhance and complete two previous iterations of the anti-tax avoidance directive (the "A.T.A.D."), the proposed Directive is commonly referred to as "A.T.A.D. 3." In the view of the Commission, this extension of the A.T.A.D. is required to create a fair and effective taxation system in the E.U. However, the main purpose of the draft is to prevent the misuse of shell entities, and for that reason, it is commonly known as the "Unshell Directive."

Prior to the release of the Directive, on May 18, 2021, the European Commission published its 'Communication on Business Taxation for the 21st Century' (the "Communication") with the stated aim of setting out a long-term vision to provide a fair and sustainable business environment and E.U. tax system as well the E.U. Tax Policy Agenda, announcing actions that could potentially be taken to increase transparency and substance requirements for corporations used in implementing tax plans.

At that moment, it was clear that one of the most relevant proposals on the Commission's Agenda was the initiative regarding the fight against the perceived misuse of shell companies, which are companies with not more than minimal substance and without real economic activity. According to the Commission, initiative is necessary given the extent to which shell entities continue to be used, despite the measures taken at the E.U. level over recent years, including the two earlier iterations of the A.T.A.D. and various extensions of the D.A.C. Before launching the Unshell directive, the European Commission initiated a Public Consultation entitled "Fighting the Use of Shell Entities and Arrangements for Tax Purposes,' which takes the form of a questionnaire.

Within that context, less than four months after closing its Public Consultation, the Commission published a concrete proposal for a Directive. The purpose of A.T.A.D. 3 is to increase the level of scrutiny for shell companies within the E.U. in order to prevent them from being used for purposes of tax evasion and avoidance.

If adopted by the Council, the Directive would introduce certain reporting requirements for E.U. resident companies that generate largely passive income streams that are highly mobile and that lack adequate substance. Failure to submit a full or correct report will subject the company to severe penalties.

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[1] December 22, 2021.

In a nutshell, A.T.A.D. 3 lays down certain gateway indicators to determine which entities must report on their substance. In case such reporting indicates that the company is a shell entity which lacks adequate substance, the benefits of tax treaties and E.U. Directives may be denied, potentially resulting in an increased withholding tax burden and other tax disadvantages.

This article describes the relevant mechanism embodied in A.T.A.D. 3 and analyzes its potential impact.

## OVERVIEW

### Scope

The proposed Directive will apply to any company that is considered tax resident in a Member State of the E.U. and is eligible to receive a tax residency certificate, regardless of its legal form. For simplicity, use of the term "company" will include a company within the meaning of the proposed directive. The proposed Directive targets entities that have the following characteristics:

- They lack real economic activities.
- They are involved in certain cross-border arrangements forming a scheme to avoid and evade taxes.
- They allow their beneficial owners or parent company to access a tax advantage.

### General Exemptions

In its Communication, the European Commission recognized that valid reasons may exist for the use of shell companies. Based on this notion, entities established to perform certain specific functions are explicitly carved out from the scope of the Directive. Included are

- certain regulated financial companies, such as investment funds;
- companies with transferable securities listed on a regulated market; and
- companies having at least five full-time equivalent employees or members of staff exclusively carrying out the activities which generate the relevant income.

Moreover, general exemptions apply to holding companies based in the same country as their beneficial owners or shareholder(s) – or the ultimate parent entity.

According to the impact assessment carried out within the context of this initiative, it is expected that less than 0.3% of all E.U. companies will fall within scope of the Directive.

### Gateway Indicators

A.T.A.D. 3 provides three gateway indicators in the prior two years that are used to determine whether a company may be at-risk of being a shell company. If all gateway indicators are present, the entity is considered to be at-risk of being a shell company.

Generally, a company is considered to be at risk where

- more than 75% of its revenue is characterized as mobile or passive income, referred to a relevant income;
- the company is mainly engaged in cross-border activity, meaning that more than 60% of its relevant assets are located abroad or at least 60% of its relevant income is earned or paid out via cross-border transactions; and
- the company has outsourced the administration of its day-to-day operations and decision-making on significant functions, while its own resources to perform core management activities are inadequate at best, and for that reason, are outsourced.

Where the three gateway indicators are present, a company faces a choice of two next steps:

- It becomes an at-risk company that is subject to further reporting requirements to determine whether it meets certain minimum substance requirements. If substance is not present, the company is a shell company. The scope of the reporting is addressed below.
- It may request an exemption from the reporting obligation if it can provide sufficient evidence that its existence does not reduce the tax liability of its beneficial owner or the group of companies to which it belongs. If the exemption is granted, it is not a shell company.

*"The third test can be met in only two fact patterns."*

**Reporting Obligations**

Where a company is considered to be at risk and the exemption is not applicable, the company must indicate whether it has adequate substance. For this purpose, adequate substance exists based on the cumulative presence of the following three factors:

- It has its own premises, meaning that it possesses an office space or the exclusive use of an office space,
- It has its own bank account located in the E.U. that has regular activity in the form of receipts and disbursements.
- It has qualified local management or employees.

The third test can be met in only two fact patterns. The first is that the company has at least one statutory director who is a resident in the jurisdiction of residence of the company or is a resident of a neighboring jurisdiction and his or her home is in relatively close proximity to the office of the company. Here, the term "director" is used in an operational sense rather than in the sense of being a representative of the shareholder group. The director must be qualified to carry out the responsibilities of his or her office and must be authorized to make relevant management decisions. Moreover, the director must exercise responsibility actively, independently, and on a regular basis. In addition, the duties of the local director must be performed on the basis of exclusivity, meaning that he or she cannot be an employee of an unrelated third party, such as a fiduciary trust company, and cannot function as a director of any other unrelated entity at the same time.

The second fact pattern is that the majority of the company's employees are resident in the jurisdiction of residence of the company or are resident of a neighboring jurisdiction and live in relatively close proximity to the office of the company. An example is a frontier worker living in one Member State and commuting to an office in another Member State. The local employees must be qualified to carry out the activities that generate the relevant income.

If a company fails to meet any of the three substance indicators, it will be presumed to be a shell company for A.T.A.D. 3 purposes.

A company that is at risk of being a shell company must make a determination as to its substance and declare its status in its annual tax return.  This entails a determination of whether the presumption can be rebutted.

## REBUTTAL AND EXEMPTION

### Rebuttal of Presumption

In principle, the above criteria only lead to the presumption of having inadequate substance. This implies that a company may still rebut the presumption by substantiating the business rationale of its activities within the relevant Member State. However, within the context of the rebuttal process, the burden of proof will be on the company, meaning that the right to rebut is subject to further evaluation by the tax authorities at the time of an examination.

Where a company that is deemed to be a shell company decides to rebut the presumption, it must produce concrete evidence of activities it performs. It must provide information with respect to the commercial reasons behind its existence, the human resources available to the company, and any other element that verifies the economic nexus between the company and the Member State of residence, typically where management decisions are taken in relation to the activities that generate value.

Moreover, within the context of a rebuttal, the taxpayer must be able to demonstrate that it has actually performed the business activities that generate the relevant income (or – in the absence of income – relate to the assets) and continuously had control over the related risk that it born.

If the tax authorities in the relevant E.U. Member State are satisfied, they must certify the outcome of the rebuttal for the relevant tax year. Provided the legal and factual circumstances remain unchanged, the validity of such certificate may be extended for another five years. Once the maximum period of six tax years has expired, the process would start all over again.

### Exemption for Lack of Tax Motives

While a company that meets the three gateway indicators is generally considered to be at risk, it may request an exemption from the reporting obligation if it can provide sufficient evidence that its existence does not reduce the tax liability of its beneficial owner or its group of companies. If granted, the exemption applies for one year and can be extended up to five years.

As part of a request for exemption, a company must provide evidence of comparable tax treatment in two fact patterns. The first is the combined tax due for the company, its owner, and the group resulting from the actual fact pattern. The second is the combined hypothetical tax that would have been due for the owner and group if the transaction were carried on without the participation of the company. To meet the burden of proof, the combined hypothetical tax in the latter fact pattern must not be greater than the actual tax in the actual fact pattern.

As is the case for the procedure regarding the rebuttal of presumption, if the tax authorities in the relevant E.U. Member State are satisfied that the existence of the company does not create any tax benefits, they may grant an exemption for the relevant year. Again, provided the legal and factual circumstances do not change, the validity of the exemption can be extended for another five years.

## CONSEQUENCES OF FAILING THE TEST

If, on the basis of its self-assessed reporting or a failed rebuttal process, a company that is resident in a particular E.U. Member State is presumed to be a shell company, several adverse tax consequences will follow:

- Other Member States are to disregard the application of tax treaties, the Parent-Subsidiary Directive, and the Interest and Royalties Directive in relation to transactions with the shell company.
- If the shell company has a shareholder established in an E.U. Member State, the shell company should be treated as if tax transparent so its income will be taxed by the Member State of residence of the owner, as if the income accrued to the owner directly with a foreign credit for any taxes paid by the shell company.
- The tax authorities of the E.U. Member State where the shell company is resident cannot issue a certificate of tax residence for the company or may issue a conditional tax residence certificate stipulating that the shell company is not entitled to the benefits of an income tax treaty or any E.U. Directive.

Since the Member State of residence of the shell company may issue only a tax residence certificate including a warning that the company is a shell, the introduction of A.T.A.D. 3 may have an effect on the shell company's transactions with third countries. However, as regards the allocation of taxing rights between source countries and home countries, for the time being A.T.A.D. 3 should have an effect on transactions only between E.U. Member States. Nonetheless, it is anticipated that the Commission contemplates extending the Unshell Directive to cover transactions with third countries.

## CERTAIN FORMAL ASPECTS

### Penalties

The draft Directive provides that Member States may impose penalties for failure to comply with the reporting obligations arising from A.T.A.D. 3.  Such penalties must be effective, proportionate, and dissuasive. It is anticipated that the penalties for failing to report or for filing incorrect reports will not exceed 5% of annual revenues.

**Tax Audits**

In addition to domestic sanctions, the draft Directive provides that a Member State may also request another Member State to initiate a tax audit if there is suspicion that a company resident in that other Member State is not complying with the provisions of A.T.A.D. 3.

***"It follows from the above description of the mechanics that A.T.A.D. 3 creates a filter system for shell companies throughout the E.U."***

**Exchange of Information**

The proposed Directive aims to amend the D.A.C. so that information gathered pursuant to A.T.A.D. 3 will be exchanged between the Member States automatically. Consequently, a robust exchange of information program will exist and will include information on taxpayers that have rebutted the presumption or applied for exemption. Consistent with earlier amendments of the D.A.C., the information that is reported by taxpayers in accordance with A.T.A.D. 3 will be stored in a central databank accessible to all Member States.

**Implementation**

If A.T.A.D. 3 is adopted by the Council, E.U. Member States will be required to implement the Directive by June 30, 2023, for the new rules to apply with effect from January 1, 2024.

To some extent, A.T.A.D. 3 has retroactive effect from January 1, 2022, because of the two-year look-back rule that applies to Gateway Indicators. This suggests that presumed shell companies may want to implement appropriate actions in 2023 in order to be in position to prevent application of the Gateway Indicators in a 2024 filing.

## OBSERVATIONS

It follows from the above description of the mechanics that A.T.A.D. 3 creates a filter system for shell companies throughout the E.U.  The trigger for the filter system is that that any entities resident for tax purposes in the E.U. that qualifies for a residence certificate issued by an E.U. Member State, is covered by A.T.A.D. 3., no matter the form taken by the entity.

All these entities enter a funnel, with the first stop being exemption. Where an intermediate vehicle is used within a regulatory framework or in a truly active manner, it is removed from the filter system. Those entities that are not removed, enter the second step of the filter, which concerns the three cumulative gateways. In principle, any company that meets all three gateways has an obligation to report on substance. It then moves to the next step, which is to rebut the presumption of being a low substance conduit vehicle by proving additional evidence. That evidence will be entity specific, requiring bespoke solutions. Those entities having proper rebuttals are removed from immediate effect of shell company classification, but their information is maintained in a central database.

In principle, each entity based in the E.U. falls within scope of the Directive. However, this element of overkill is addressed through the filter system. Nonetheless, one of the main concerns is that not all special purpose entities having a business purpose for its insertion into a particular business transaction will be able to adequately rebut the presumption that would result from the three gateway indicators. Though it would seem that A.T.A.D.3 is not intended to hit special purpose entities that have been set up for completely valid reasons, such as asset protection or simply because legal separation is required by a bank, it would be useful if concrete examples would be provided by the Commission or within the context of implementation into domestic law.

From the outset, it would appear that A.T.A.D. 3 is aimed to tackle the typical type of shell entities managed by fiduciary trust companies. The European Commission indicates that pure holding companies established in the same country as their operating subsidiaries and beneficial owners are unlikely to be affected by the Directive, since these are normally not set up to derive an abusive tax benefits. Nevertheless, it cannot be ruled out that tax authorities may apply a broader interpretation of the Unshell Directive.

It is noteworthy that A.T.A.D. 3 is not yet a fait accompli. The European Parliament and the Member States must still respond to the draft. Even if the draft Directive were to be adopted in its current form, Member States must still transpose it into national law, which provides an opportunity to add some couleur locale where possible. This means that the political game is only just beginning. The general expectation is that the proposal will not be adopted without changes.

This raises the question parts of the proposed filtering system can be revised during the remaining steps of the process. In principle, several provisions can still be revised, such as the exemption categories and the criteria for the three gates. These are all political decisions which eventually will have an impact on the entities that will be caught up in the A.T.A.D. 3 funnel.

It is also conceivable that the various minimum substance requirements may be adjusted. For over a decade, the Netherlands has applied a system which is comparable to A.T.A.D. 3 to service entities functioning as a conduit for interest and royalty payments. The relevant legislation contains a more extensive list of substance requirements, including the criteria listed in the proposed Directive as well as others.

For the Netherlands, the open issue is whether the government will replace its own criteria with the requirements of A.T.A.D. 3 or attempt to operate with two sets, each used for its own purposes. It is conceivable that within the context of the decision-making process at E.U. level, the Netherlands would make a case for its extensive set of criteria to be implemented within the framework of A.T.A.D. 3. Even though the number of criteria would increase, the focus on the three substance criteria laid down in the draft Directive – office space, bank account and location of management or key personnel – would be expanded to address other aspects. That might open the door for somewhat more nuanced approach to substance.

Finally, it will be interesting to see how the same-country approach in the Directive will develop. If a country-by-country approach would become the guiding principle, a group of companies could have many entities with different economic activities in one single Member State without having to worry about the fact that an entity which has a pure holding function is set up with somewhat leaner in terms of substance. If by contrast an entity-by-entity approach would eventually prevail, such holding company may well qualify as a shell entity, even though it has access to an organization with extensive substance in the country where it is based. In sum, the same country approach clearly has the benefit that it immediately recognizes the fact that there may well be commercial or legal reasons to use multiple entities in one and the same country, without the need to go through a cumbersome rebuttal process.

Even though the political game of playing with the various elements of A.T.A.D. 3 has not yet begun, the general expectation is that the proposed Directive will eventually make it across the finish line. That said, even though tackling tax avoidance continues to be high on the E.U.'s agenda, at this moment the proposed timing seems somewhat optimistic, particularly now that the E.U. clearly has other geopolitical issues to face.

As mentioned, the draft assumes the Member States will implement the Directive in their national legislation prior to July 1, 2023, with January 1, 2024, as the intended date of entry into force. It remains to be seen whether this timeline will be met. If a corporate group believes it will be adopted at some point, management may find it prudent to adopt indicia of substance in all group members sooner rather than later.

# THE DOOR TO A NEW WORLD: DECENTRALIZED FINANCE (DEFI)

**Authors**
Niklas Schmidt
Lioba Mueller

**Tags**
Bitcoin
Blockchain
Crypto
Decentralized
DeFi
Ether
Fiat
Investing
Stablecoin
T.V.L.

Niklas Schmidt is a partner of the Vienna office of Wolf Theiss, where he leads the firm-wide tax team. He is a prolific writer and speaker on tax topics with a focus on crypto assets.

Lioba Mueller, is a *Rechts-referendarin* at the Regional Court of Aachen and a PhD student at the University of Bonn, Germany. Previously, she was an intern at Ruchelman P.L.L.C.

> *"If crypto succeeds, it's not because it empowers better people. It's because it empowers better institutions."*
>
> – Vitalik Buterin, co-founder of Ethereum

## WHAT IS DEFI ABOUT?

The world of crypto is fast-moving. An exciting development in this space is Decentralized Finance ("DeFi"), which entered the scene in March 2020, and its use has exploded ever since. The term refers to the offering of traditional financial services not by centralized players such as banks, insurance companies, and exchanges, but through smart contracts running on blockchains. In other words, central intermediaries are being replaced by an immutable computer code. If users indeed choose to go "bankless", this could disrupt the world of finance as it is currently known.

## WHAT ARE THE PROS AND CONS OF DEFI?

The advantages of DeFi include the following:

- Access to financial services around the clock and from anywhere in the world (no old-fashioned bank opening hours)
- Access to financial services without having to fulfill K.Y.C./A.M.L. requirements (no filling in paper forms and disclosing personal circumstances)
- Access to financial services offered in a non-discriminatory manner (nobody is excluded from using DeFi services, so that even previously "unbanked individuals" can open a bank account)
- Access to financial services without having to trust a counterparty (no risks resulting from mismanagement of a bank's assets or fraudulent actions on the part of its employees)

The disadvantages of DeFi include the following:

- Risks of bugs in smart contracts (which can lead to a loss of assets deployed if the bugs are found by hackers)
- Certain technical skills are required of users (currently, a lack of user friendliness exists for DeFi)

## WHAT VOLUME HAS DEFI REACHED?

As of early March 2022, the DeFi ecosystem had a volume of approximately U.S. $209 billion.[1] This figure refers to the value of assets locked in smart contracts (total value locked, or "T.V.L."). While this is literally nothing compared to traditional finance, the growth rate of T.V.L. is exponential. Exponential growth of that magnitude is a typical sign of disruptive tech.

## ON WHICH BLOCKCHAINS DOES DEFI RUN?

Blockchains are a kind of infrastructure used to run smart contracts. In the realm of DeFi, smart contracts mostly run on Ethereum (54% of T.V.L.), followed by Terra (11% of T.V.L.), BNB Chain (6% of T.V.L.), Avalanche (5% of T.V.L.) and Fantom (5% of T.V.L.). While the future is probably "multi-chain" (rather than "one chain to rule them all"), Ethereum will likely continue to capture a large part of market share, in particular due to network effects. One of the buzzwords of DeFi is "money lego", meaning that various DeFi applications can be put together like LEGO bricks. Composability in turn requires DeFi apps to reside on the same blockchain, making it advantageous to be on the Ethereum blockchain. However, while blockchains were traditionally unconnected islands, they are becoming more and more interconnected through so-called bridges.

## WHAT ARE STABLECOINS?

Crypto assets are extremely volatile. Although the top two – Bitcoin with a market share of 41% and Ether with a market share of 17% – are considered "conservative" assets, even they have often experienced double-digit drawdowns within a 24-hour timeframe.[2] Taking the volatility into account, it makes no sense to invest crypto assets in DeFi protocols with a view to generating say an annual 10% yield, if there is a risk that the capital invested will depreciate by 10% within the next day. Enter stablecoins: these are crypto assets without volatility, pegged to a fiat currency such as the U.S. Dollar. These are ideal assets for the usage in DeFi.

There exist three different types of stablecoins:

- Fiat collateralized stablecoins, such as Tether ("USDT"), TrueUSD ("TUSD"), Binance USD ("BUSD"), USD Coin ("USDC"), Pax Dollar ("USDP"), and Gemini Dollar ("GUSD")
- Crypto collateralized stablecoins, such as Dai ("DAI"), mStable USD ("MUSD"), Magic Internet Money ("MIM"), and Frax ("FRAX")
- Not-collateralized stablecoins, such as Ampleforth ("AMPL")

Fiat collateralized stable coins are easy to understand but rely on a hopefully trustworthy intermediary who holds the collateral (U.S. Dollars) and issues stable coins against the collateral deposited. The most important representative by far of this category is Tether ("USDT"). Crypto collateralized stablecoins are more complex to understand but get rid of intermediaries and are thus truly decentralized. In stress

1 See https://defillama.com.

2 Investors in crypto need nerves of steel, or they die a premature death.

situations, crypto collateralized stablecoins might not be able to hold the peg at all times. Not-collateralized stablecoins are an interesting monetary experiment utilizing an elastic money supply.

## WHAT CATEGORIES OF DEFI EXIST?

DeFi is slowly but surely replicating all services being offered in traditional finance. Currently, the five most important categories of DeFi comprise the following:

- Decentralized savings deposits and loans
- Decentralized insurance
- Decentralized derivatives
- Decentralized investment funds
- Decentralized exchanges

The following discussion provides examples for each category.

### Decentralized Savings Deposits and Loans

Compound[3] is an example of a decentralized marketplace for capital. Lenders can lend crypto assets, thereby earning interest, and borrowers can borrow crypto assets, thereby paying interest. Lending and borrowing does not take place between individual users. Rather, lenders lend directly to the platform and borrowers borrow directly from the platform. Thus, this is not peer-to-peer, but peer-to-protocol lending and borrowing. The protocol functions like a bank, earning interest spread.

On Compound, possible crypto assets for lending and borrowing include the stablecoins Tether ("USDT"), TrueUSD ("TUSD"), USD Coin ("USDC"), Pax Dollar ("USDP"), and Dai ("DAI"), but also volatile crypto assets such as Ether ("ETH") and Wrapped Bitcoin ("WBTC"). The applicable interest rates depend on the crypto asset concerned and are algorithmically determined by supply and demand, with rates changing constantly. Interest rates are stated as Annual Percentage Yields ("APY"), and interest is settled every block, which is every 15 seconds. At the time of writing, yields on stable coins were between 1.61% and 2.99% – which is a far cry from the typical yields on bank accounts. Lending and borrowing are extremely flexible, there exist no maturities: deposits can be withdrawn, and loans can be repaid at any time.

In order to borrow crypto assets, collateral exceeding the loan amount must be provided, *e.g.*, to the extent of 150%. This over-collateralization is a necessary consequence of the pseudonymous nature of the blockchain and the resulting lack of a possibility to determine a borrower's creditworthiness.

Compound has several competitors: noteworthy other names include AAVE,[4] which offers a slightly larger menu of crypto assets that can be deposited and borrowed, and Anchor,[5] which offers only one single stablecoin and at the time of writing had a

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[3] See https://app.compound.finance.

[4] See https://app.aave.com/#/markets.

[5] See https://app.anchorprotocol.com/earn.

whopping deposit interest rate of 19.46% p.a. Notional[6] allows for fixed-rate borrowing and BarnBridge[7] offers fixed-rate deposits.

## Decentralized Insurance

DeFi is based on crypto assets locked in smart contracts. In the event of programming errors in the smart contract, there is a risk of losing the capital invested. It is possible to insure against this risk, for example, with the application Nexus Mutual,[8] a kind of mutual insurance company. As of early March 2022, 115 different insurance contracts are being offered that provide protection against bugs in a protocol or against risks with centralized exchanges or custodial wallets. Premiums start at 2.6% p.a. for low-risk projects. For example, to insure 100,000 Dai ("DAI") invested in AAVE over a period of one year, a payment of exactly 2,600 Dai was required as a form of insurance premium. Interestingly, on Nexus Mutual, insurance coverage can be obtained without crypto assets locked in the insured smart contract; this is of course different with traditional insurance. In addition to policyholders, there are also investors who provide risk capital to the protocol and receive compensation in return, in the form of premiums. If the insured event occurs, the protocol makes the insurance payment from these funds provided.

Nexus Mutual has a number of competitors: Unslashed[9] is a decentralized insurance platform on Ethereum that offers 25 different insurance products. InsurAce[10] is a similar solution that offers protection for 114 DeFi applications on 16 different blockchains. Armor[11] is a kind of insurance broker on Ethereum: instead of having to procure decentralized insurance protection for various DeFi applications on different blockchains individually and to constantly adjust the policies, Armor can be used to dynamically adjust the insurance protection as an investor moves across different platforms.

## Decentralized Derivatives

Mirror Protocol[12] is a platform for decentralized derivatives on which synthetic assets can be created and traded. Shares such as Alphabet, Apple, Airbnb, Advanced Micro Devices, Amazon.com, Alibaba, Coinbase, Facebook, Goldman Sachs, Robinhood, Johnson & Johnson, Coca-Cola, Microsoft, Netflix, NVIDIA, PayPal, Starbucks, Square, Tesla and Twitter can be purchased in the form of an ERC-20 token. An ERC-20 token is an asset on the Ethereum blockchain which can be sent and received. The above-mentioned tokens can be traded 24/7 and can be held directly in a crypto wallet without having to trust an intermediary like a bank. A competitor of Mirror Protocol is UMA,[13] which offers similar functionality.

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6 See https://notional.finance.

7 See https://app.barnbridge.com.

8 See https://app.nexusmutual.io/cover.

9 See https://app.unslashed.finance/cover.

10 See https://app.insurace.io/Insurance/BuyCovers.

11 See https://armor.fi/protect.

12 See https://mirrorprotocol.app/#/trade.

13 See https://umaproject.org.

### Decentralized Investment Funds

Set Protocol[14] is a DeFi application on Ethereum through which one can buy or sell Sets. A Set is a decentralized investment fund whose composition of crypto assets is managed automatically. The Sets are designed in the form of an ERC-20 token and embody the underlying crypto assets. Sets can be held directly in a wallet without an intermediary. Investors are not subject to any minimum investment amounts.

Index Coop[15] is a decentralized provider of various crypto indices. Important indices are, for example, the DeFi Pulse Index or the Metaverse Index. These indices enable an efficient investment in a basket of tokens.

Enzyme Finance[16] is a decentralized asset management platform. Asset managers can set up investment funds quickly and easily based on their investment strategies. They can also determine a specific fee structure. There is full transparency regarding the development in value of the funds and the crypto assets they hold. There exist currently around 100 funds to choose from.

### Decentralized Exchanges

One of the most important categories of DeFi is the decentralized exchange ("DEX"). With a DEX, there is no central operator, such as Coinbase or Kraken, who holds the crypto assets in question and who must therefore be trusted as there is counterparty risk. Instead, smart contracts are used: if you send a certain amount of Ether to an Ether/USDC smart contract, you automatically get back the equivalent in USDC, and vice versa. Nobody holds your crypto assets, and accordingly, no one can run away with your crypto assets. On a DEX, anyone can list a new trading pair, while on a traditional exchange, a listing is subject to a decision by the exchange, sometimes only possible upon payment of a listing fee, and can also be revoked. Also, trading fees on a DEX accrue to the liquidity providers, while on a traditional exchange, they accrue to the operator alone. In addition, KYC/AML provisions are not applied on DEXes, while these may be applicable on a traditional exchange. Initially, tokens were listed on traditional exchanges and then gradually on DEXes. Now, the reverse is true. Projects list their tokens on a DEX, which is easier and cheaper, and if they are successful, the tokens eventually come to the traditional exchanges. Historically, the first example of a DEX was Uniswap.[17] Beginning early in March 2022, U.S. $7.5 billion of liquidity was available there in a wide variety of trading pairs. Other well-known examples of DEXes are Curve (U.S. $19.9 billion T.V.L.)[18] and SushiSwap (U.S. $3.9 billion T.V.L.).[19]

## WHAT ABOUT REGULATORS?

Apps in the field of DeFi will often engage in regulated activities, such as deposit-taking, lending, or insurance businesses, without complying with the current need

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14 See https://www.tokensets.com/explore.

15 See https://app.indexcoop.com.

16 See https://app.enzyme.finance.

17 See https://uniswap.org.

18 See https://curve.fi.

19 See https://app.sushi.com/en/swap.

for obtaining a license. The question arises as to whether such noncompliant apps could simply be switched-off by a regulator or whether they are so far decentralized that regulators are powerless to intervene. Here it is necessary to distinguish

- the underlying smart contract runs on a blockchain that normally cannot be stopped; and
- the corresponding website of the DeFi application, which is the frontend, can be shut-down. Ultimately, however, this will not be a successful move: because the website is an interface, anyone can build a new interface that accesses the same unstoppable smart contract in the background, often by simply copying the publicly available code.

***"DeFi is one of the most interesting applications of blockchains and smart contracts. We have opened the door to DeFi for you, now it is up to you to enter."***

## WHAT COMES NEXT?

DeFi is one of the most interesting applications of blockchains and smart contracts.[20] We have opened the door to DeFi for you, now it is up to you to enter.[21]

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[20] Other interesting applications are Non-Fungible Tokens ("N.F.T.'s") and Decentralized Autonomous Organizations ("D.A.O.'s").

[21] For more information please see this webinar.

# EXPANDED I.R.S. REPORTING OBLIGATIONS FOR DIGITAL ASSETS

**Author**
Lawrence S. Feld

**Tags**
Broker Reports Crypto
Crypto
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Digital Assets
I.R.S. Reporting Crypto
Virtual Currency
Voluntary Disclosure

Lawrence S. Feld concentrates his practice in federal and state criminal and civil tax controversies and white collar criminal defense. Mr. Feld is a co-author of Tax Fraud and Evasion, a com-prehensive two volume treatise on criminal and civil tax fraud and money laundering, which is published by Thomson Reuters. He is an adjunct professor at New York Law School where he teaches an advanced seminar on criminal tax enforcement.

## INTRODUCTION

Advances in digital and distributed ledger technology for financial services in recent years have resulted in dramatic growth in markets for digital assets. This transformation has profound implications for consumers, investors, and businesses in a broad spectrum of areas of vital interest to the United States and the global community. These areas include data privacy and security; financial stability and systemic risk; crime; national security; the ability to exercise human rights; financial inclusion and equity; and energy demand and climate change. In November 2021, non-state issued digital assets had a combined market capitalization of $3 trillion, an extraordinary increase from an estimated $14 billion in November 2016. Surveys indicate that approximately 16% of adult Americans – about 40 million people – have invested in, traded, or used cryptocurrencies. More than 100 nations are exploring or, in some cases, introducing Central Bank Digital Currencies ("CBDCs"), a digital form of sovereign currency.

### Expansion of I.R.S. Reporting Obligations

I.R.S. reporting requirements for cryptocurrency and other digital assets have been substantially expanded, and as a result, are expected to have a significant impact on the wide range of businesses and individuals to which they apply. Two of these new reporting obligations were enacted as part of the Infrastructure and Jobs Act, signed by President Biden on November 15, 2021. First, the information reporting requirements for certain brokers have been extended to digital assets. Second, digital assets valued at more than $10,000 are now treated as "cash'' under IRC § 6050I and must be reported to the I.R.S. when received by any person engaged in a trade or business, in the course of that trade or business.

The third disclosure obligation relates to the I.R.S. Voluntary Disclosure Practice.

On February 15, 2022 the I.R.S. announced that Form 14457, *Voluntary Disclosure Practice Preclearance Request and Application*, has been revised to include an expanded section on reporting cryptocurrency.

### Executive Order

On March 9, 2022, President Biden signed the "Executive Order on Ensuring Responsible Development of Digital Assets." Section 1 of the Order explains the government's policy with respect to digital assets as follows:

> While many activities involving digital assets are within the scope of existing domestic laws and regulations, an area where the United States has been a global leader, growing development and adoption of digital assets and related innovations, as well as inconsistent

> controls to defend against certain key risks, necessitate an evolution and alignment of the United States Government approach to digital assets. The United States has an interest in responsible financial innovation, expanding access to safe and affordable financial services, and reducing the cost of domestic and cross-border funds transfers and payments, including through the continued modernization of public payment systems. We must take strong steps to reduce the risks that digital assets could pose to consumers, investors, and business protections; financial stability and financial system integrity; combating and preventing crime and illicit finance; national security; the ability to exercise human rights; financial inclusion and equity; and climate change and pollution.

The new I.R.S. disclosure obligations may be viewed as important beginning steps in effectuating the policy objectives of the United States with respect to digital assets.

This article provides an introductory explanation of these new disclosure duties and discusses some of the many intriguing questions presented by these reporting requirements.

## DIGITAL ASSETS

The Internal Revenue Code now defines "digital asset" as follows:

> Except as otherwise provided by the Secretary, the term 'digital asset' means any digital representation of value which is recorded on a cryptographically secure distributed ledger or any similar technology as specified by the Secretary.[1]

The I.R.S. is drafting regulations that will explain and amplify the statutory definition. The effective date of the new definition is January 1, 2023.[2]

It is useful to compare this definition of "digital asset" with the definition contained in the Executive Order. Section 9 of the Order states as follows:

> (a) The term 'blockchain' refers to distributed ledger technologies where data is shared across a network that creates a digital ledger of verified transactions or information among network participants and the data are typically linked using cryptography to maintain the integrity of the ledger and execute other functions, including transfer of ownership or value.
>
> (b) The term 'central bank digital currency' or 'CBDC.' refers to a form of digital money or monetary value, denominated in the national unit of account, that is a direct liability of the central bank.

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1 Code §6045(g)(3)(D). References to the Secretary that appear in the Code relate to the Secretary of the Treasury or a delegate, which typically means the I.R.S.

2 Code §6045(g)(C)(iii).

(c) The term ‘cryptocurrencies’ refers to a digital asset, which may be a medium of exchange, for which generation or ownership records are supported through a distributed ledger technology that relies on cryptography, such as a blockchain.

(d) The term ‘digital assets’ refers to all CBDCs, regardless of the technology used, and to other representations of value, financial assets and instruments, or claims that are used to make payments or investments, or to transmit or exchange funds or the equivalent thereof, that are issued or represented in digital form through the use of distributed ledger technology. For example, digital assets include cryptocurrencies, stablecoins, and CBDC. Regardless of the label used, a digital asset may be, among other things, a security, a commodity, a derivative, or other financial product. Digital assets may be exchanged across digital asset trading platforms, including centralized and decentralized finance platforms, or through peer-to-peer technologies.

(e) The term ‘stablecoins’ refers to a category of cryptocurrencies with mechanisms that are aimed at maintaining a stable value, such as by pegging the value of the coin to a specific currency, asset, or pool of assets or by algorithmically controlling supply in response to changes in demand in order to stabilize value.

## TAX CONSEQUENCES OF VIRTUAL CURRENCY

In I.R.S. Notice 2014-21, the I.R.S. announced the position that virtual currency, including cryptocurrency, is treated as property for Federal income tax purposes. The Notice provides examples of how well-established tax principles applying to transactions involving property apply to virtual currency. Virtual currency is defined by the I.R.S. as a digital representation of value, other than a representation of the U.S. dollar or foreign currency, that functions as a unit of account, a store of value, and medium of exchange. Cryptocurrency is a type of virtual currency that uses cryptography to secure transactions that are recorded on a distributed ledger, such as a blockchain.[3]

The I.R.S. expanded its guidance on virtual currency with the issuance of Frequently Asked Questions on Virtual Currency Transactions,[4] which includes useful information for individuals who hold cryptocurrency as a capital asset and are not engaged in the trade or business of buying and selling cryptocurrency.

I.R.S. Form 1040 now asks the following question: “At any time during 2021, did you receive, sell, exchange or otherwise dispose of any financial interest in virtual currency?” The taxpayer must answer this question. A willfully false response to this question on a tax return filed with the I.R.S. is a felony.[5]

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3 See here for more information.

4 See here.

5 Code §7206(1).

## BROKERS

Code §6045 establishes reporting obligations for persons doing business as a broker. Section 6045 requires brokers that are dealers/middlemen in "covered security" transactions to issue a Form-1099-B to both the brokers' customers and the I.R.S., identifying the sales of securities through the broker, the customer's adjusted basis in the security, and the proceeds of the transaction. The amended statute expands the definition of a broker and expands the definition of a "covered security" to include digital assets. As a result, the Form 1099-B reporting obligation extends to digital asset transactions conducted through brokers.

The term "broker" has been expanded to include:

> [A]ny person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another.[6]

This definition clearly applies to cryptocurrency exchanges, which are digital platforms that allow users to trade cryptocurrency and other digital assets for other digital assets as well as fiat currencies such as the U.S. dollar or foreign currency. Questions have been raised as to whether this new definition of a "broker" extends to other participants in the development of digital assets, such as miners, providers of digital wallets and developers of new digital assets. The scope of the term "digital assets" is uncertain. The regulations may amplify these definitions and there may be additional legislation that clarifies these new reporting obligations.

As a result of the new reporting obligations of brokers, the underreporting of cryptocurrency gains is expected to diminish. The Joint Committee on Taxation estimates that these new reporting requirements will raise more than $27 billion over ten years.[7]

## TRADES AND BUSINESSES THAT RECEIVE DIGITAL ASSETS

Code §6050I, enacted in 1984, requires that any person who is engaged in a trade or business and who, in the course of that trade or business, receives more than $10,000 in cash in one transaction (or two or more related transactions) must file a return reporting certain required information. The return is Form 8300, and it currently requires information concerning

- the identity of the individual from whom the cash was received,
- the person on whose behalf the transaction was conducted,
- a description of the transaction and method of payment, and
- the business that received the cash.

Cash for purposes of the statute now includes any digital asset as defined in Section 6045(g)(3)(D).

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6 Code §6045(c)(1)(D).

7 Report, Joint Committee on Taxation, JCX-33-21 (Aug. 2, 2021).

According to the Form 8300 Reference Guide,[8] the information contained in the form assists law enforcement in its anti-money laundering efforts. Compliance by businesses with this reporting obligation provides authorities with an audit trail to investigate possible tax evasion, drug dealing, terrorist financing and other criminal activities. The willful failure to file I.R.S./FinCen Form 8300 by a recipient is punishable by up to five years in prison, and a maximum fine of $250,000 for an individual and $500,000 for a corporation.[9] A recipient who willfully files a materially false or incomplete Form 8300 is punishable by up to three years in prison and a maximum fine of $250,000 for an individual and $500,000 for a corporation.[10] Civil penalties for knowing violations Code §6050I can be severe.[11] The I.R.S. adjusts the penalty amounts annually for inflation.

***"A voluntary disclosure does not guarantee immunity from prosecution. Rather, it will be considered along with all other facts and circumstances in deciding whether to recommend prosecution to the Department of Justice."***

## I.R.S. CRIMINAL INVESTIGATION (I.R.S.–CI) VOLUNTARY DISCLOSURE PRACTICE

I.R.S.-CI Voluntary Disclosure Practice refers to the long-standing practice of I.R.S.-CI that provides taxpayers with potential criminal exposure for the willful failure to comply with tax or tax related obligations a means to come into compliance with the law and potentially avoid criminal prosecution. A voluntary disclosure does not guarantee immunity from prosecution. Rather, it will be considered along with all other facts and circumstances in deciding whether to recommend prosecution to the Department of Justice. A voluntary disclosure requires the applicant to be timely, truthful, and complete in making the disclosure. During the voluntary disclosure process, the applicant also must

- cooperate with the I.R.S. in determining the tax liability and compliance reporting requirements;
- cooperate with the I.R.S. in investigating any enablers who aided in the noncompliance or were in any way involved in the noncompliance;
- submit all required returns, information returns and reports for the disclosure period; and
- make good-faith arrangements to fully pay the tax, interest, and penalties determined by the I.R.S. to be applicable.

Taxpayers who did not commit any tax or tax related crimes and wish to correct mistakes or file delinquent returns have other options available to comply with their tax and reporting obligations.

The starting point for making a voluntary disclosure is the submission of Form 14457, *Voluntary Disclosure Practice Preclearance Request and Application*. On February 15, 2022, the I.R.S. announced that Form 14457 had been revised, including an expanded section on reporting virtual currency. The previous version of Form 14457 provided checkboxes for applicants to disclose cryptocurrency noncompliance that they wanted to report. Disclosing cryptocurrency under the old form did not always apply well to virtual currency holdings.

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8 See here.

9 Code §7203.

10 Code §7206(1).

11 Code §§6721 and 6722.

The revised Form 14457 has a separate section for reporting virtual currency holdings. The taxpayer is required to disclose all domestic and foreign noncompliant virtual currency owned or controlled by the taxpayer or which the taxpayer beneficially owned directly or indirectly during the disclosure period. For each virtual currency holding the taxpayer must report the following information:

- The name of the virtual currency
- The acquisition and disposition dates
- The identifying number or other designation for the holding
- The account holders

The instructions for line 13 in revised Form 14457 note the following about virtual currencies:

> Virtual Currency is a dynamic area, and for purposes of this form encompasses assets beyond what many would define as virtual currencies.

The instructions also explain that the listings of virtual currency for the disclosure period must include assets acquired or disposed of during the disclosure period and include those held through entities.

The applicant is further instructed that if a "mixer" or "tumbler" were used in connection with any virtual currency transaction, the taxpayer is required to identify the "mixer" or "tumbler" used and the reason for its use. A "mixer" or "tumbler" is a service offered by certain providers that is employed to conceal or disguise the source of funds used in a transaction. They are frequently used to hide an illegal source of income or assets. The I.R.S. Voluntary Disclosure Practice is not available to taxpayers with illegal source income determined under applicable Federal law. Consequently, the involvement of a mixer or tumbler is a "red flag'' that the taxpayer may not qualify for a voluntary disclosure.

## CONCLUSION

Technological advances in the digital asset sector and the transactions which they affect are occurring at a rapidly growing pace. Recent developments in I.R.S. reporting obligations for digital assets are part of a new effort in this dynamically evolving area to safeguard the revenue system on which our nation depends. The stakes are high for the I.R.S. and the risks may be higher for those who fail to comply with the new rules.

# THE LAST DAYS OF DUMMY COMPANIES

**Author**
Ibn Spicer

**Tags**
C.T.A.
F.A.T.F.
FinCen
Recommendation 24
Responsible Party
Ultimate Beneficial Owner

Ibn Spicer is an experienced attorney whose practice focuses on entertainment and corporate law. Currently he is enrolled in the LLM in Taxation Program of New York Law School, and as part of his studies, is an extern at Ruchelman P.L.L.C.

## INTRODUCTION

The use of anonymous shell companies or "dummy companies" that may be availed of to conceal the true identities of the ultimate beneficial owners is viewed by financial regulators as a tool to facilitate money laundering and the financing of terrorism. Their existence may soon become a thing of the past. The globalization of world trade and finance has meant that law enforcement agencies and other competent authorities must be able to identify the responsible individuals whenever dummy corporations are used in criminal activity, be it terrorism, drug trafficking, arms dealing, or corruption of government officials. Recently international governmental authorities have promoted the concept of beneficial ownership transparency as a major component in combatting bad actors that hide behind shells.

## F.A.T.F. RECOMMENDATON 24

Following enactment of Corporate Transparency Act ("C.T.A.") and the proposed regulations published by the Financial Crimes Enforcement Network of the I.R.S. ("FinCEN") seeking to implement identification rules for determining beneficial ownership information ("B.O.I."), the Financial Action Task Force ("F.A.T.F.") adopted amendments to its Recommendation 24 on beneficial ownership earlier this month. The revisions are designed to help address the lack of beneficial ownership information that is vital for money laundering investigations.

### In General

The F.A.T.F. is the intergovernmental policymaking body whose purpose is to establish international standards, and to develop and promote policies designed to combat fraud, money laundering, and the financing of terrorism. The F.A.T.F. works to generate the political will necessary to bring about national legislative and regulatory reforms to combat these international corrupt and criminal acts. There are currently 37 member countries in the F.A.T.F., including the United States, and two regional organizations – the European Commission and the Gulf Cooperation Council. The F.A.T.F. sets the global anti-money laundering standards through its 40 recommendations. More than 200 countries and jurisdictions are committed to implementing those regulations, and failure to adhere to them can have serious consequences. Countries that are black-listed or grey-listed may have challenges in accessing the global financial system.

Recommendation 24 states that countries should ensure that competent authorities such as law enforcement, financial intelligence units, and tax agencies have access to adequate, accurate, and up-to-date information on the true owners of companies operating in their country.

According to the F.A.T.F., the amendments to Recommendation 24 are in response to evolving money laundering risks and widely publicized failures to prevent misuse of legal entities. The amendments seek to strengthen the international standards on beneficial ownership of legal entities to ensure greater transparency about their ultimate ownership and control and to mitigate the risks of their misuse. One of the concrete goals in this regard is to create an up-to-date, efficient beneficial ownership register that would be accessible to competent authorities.

**Amendments**

Specifically, the F.A.T.F. recommended the following action steps.

Countries should

- require companies to obtain and maintain adequate, accurate and up-to-date information on their own beneficial ownership;
- make such information available to competent authorities in a timely manner; and
- require beneficial ownership information to be held by a public authority or body functioning as beneficial ownership register or may use an alternative mechanism that provides competent authorities efficient and timely access to accurate information.

In implementing the action steps, countries should apply any supplementary measures that are deemed necessary to ensure the determination of beneficial ownership of a company. One example is the maintenance of a beneficial ownership information database using information obtained by regulated financial institutions and professionals or held by regulators or stock exchanges.

The amendments include measures to prevent legal entities from misusing bearer shares and nominee arrangements by prohibiting the issuance of new bearer shares and bearer share warrants and the conversion or immobilization of the existing ones, while setting out stronger transparency requirements for nominee arrangements.

**Centralized Registers**

The amended Recommendation 24 says countries should create a centralized register of the beneficial owners of companies using a public authority, but it falls short of an explicit mandate.  Instead, countries may consider alternative mechanisms if those provide efficient access by competent authorities. One would be hard-pressed to come up with an effective alternative to a centralized register. the use of a wide variety of mechanisms among participating countries could impair the effectiveness of the global database of beneficial ownership information.

**Risk-Based Approach for Selection of Legal Entities Subject to Reporting**

Both domestic legal entities and foreign entities with sufficient links to a country should be included in assessing whether registration is required. The risk-based approach recommendation to determine which legal entities should be required to report beneficial ownership information will allow countries the flexibility to exempt certain entities from any reporting requirements.

**Public Procurement**

The revisions also require public authorities to collect beneficial ownership information of legal entities for purposes of public procurement. Since the U.S. federal government is the largest purchaser of goods and services in the world, this could potentially be one of the largest sources of beneficial ownership information.

**Prohibiting New Bearer Shares**

Bearer shares and nominee shareholder arrangements are some of the instruments used to move, hide, and launder illicitly acquired assets. Bearer shares are company shares that exist in certificate form. Whoever is in physical possession of the bearer shares is deemed to be the owner. Since the transfer of shares requires only delivery of the certificate from one individual to another, they permit anonymous transfers of control and create a serious impediment to investigations of financial crime.

The revised Recommendation 24 states that countries should prohibit the issuance of new bearer shares, as their ownership is essentially unverifiable. However, the revisions do not explicitly require the official identification of holders of existing bearer shares.

A nominee shareholder refers to the holder of shares on behalf of another person, or a beneficial owner, or the original holder of shares. The revisions call for stronger transparency requirements for nominee arrangements.

## BENEFICIAL OWNER FOR C.T.A. PURPOSES

While there is no single beneficial ownership definition in F.A.T.F. Recommendation 24, the C.T.A. defines a "beneficial owner" as a natural person who

- exercises substantial control over a company,
- owns at least 25% of a company's ownership interests, or
- receives substantial economic benefits from a company's assets.

The proposed regulations from FinCEN clarify elements inherent in "substantial control." See Proposed 31 CFR 1010.380(d)(1).

The beneficial owner is the individual that exercises substantial control and receives substantial economic benefits from a company's assets. The proposed FinCEN regulations define "substantial control" using three specific indicators:

- Senior officer of a reporting company
- Authority over any officer or dominant majority of the board of directors of a reporting company
- Substantial influence over the management of any principal assets, significant contracts, major expenditures, and investments and compensation schemes for senior officers

Additionally, the proposed regulations include a "catch-all" provision to make clear that substantial control can take additional forms not specifically listed in the regulations and to prevent individuals from evading identification by hiding behind formalisms.

## RESPONSIBLE PARTY FOR E.I.N. PURPOSES

The increased governmental effort to mandate corporate transparency can also be found in the changes made by the I.R.S. in connection with the term "responsible party" for purposes of obtaining an Employer Identification Number ("E.I.N."). In comparison to the meaning of the term "substantial control," the I.R.S. form adopts the term "responsible party." The terms are not identical, but they appear to be defined in similar ways.

### Definition in Instructions

According to the instructions for the current revision of Form SS-4, *Application for Employer Identification Number (EIN)*, the I.R.S. defines the term "responsible party" as follows:

> **Responsible party defined.**
>
> The "responsible party" is the person who ultimately owns or controls the entity or who exercises ultimate effective control over the entity. The person identified as the responsible party should have a level of control over, or entitlement to, the funds or assets in the entity that, as a practical matter, enables the person, directly or indirectly, to control, manage, or direct the entity and the disposition of its funds and assets. **Unless the applicant is a government entity, the responsible party must be an individual (that is, a natural person), not an entity.**
>
> - For entities with shares or interests traded on a public exchange, or which are registered with the Securities and Exchange Commission, "responsible party" is (a) the principal officer, if the business is a corporation, (b) a general partner, if a partnership. The general requirement that the responsible party be an individual applies to these entities. For example, if a corporation is the general partner of a publicly traded partnership for which Form SS-4 is filed, then the responsible party of the partnership is the principal officer of the corporation.

*"The increased governmental effort to mandate corporate transparency can also be found in the changes made by the I.R.S. in connection with the term 'responsible party' for purposes of obtaining an Employer Identification Number."*

### Definition on I.R.S. Website

However, the I.R.S. website[1] provides an enhanced definition of the term "responsible party" which approaches the definition of the term "beneficial owner" for purposes of the C.T.A. by emphasizing that a nominee cannot be a responsible party.

> **Nominees**
>
> A "nominee" is someone who is given limited authority to act on behalf of an entity, usually for a limited period of time, and usually during the formation of the entity. The "principal officer, general partner," etc., as defined by the IRS, is the true "responsible party" for the entity, instead of a nominee. The "responsible party" is the individual or entity that controls, manages, or directs the entity and the disposition of the entity's funds and assets, unlike a nominee,

[1] See here.

who is given little or no authority over the entity's assets.

The Internal Revenue Service has become aware that nominee individuals are being listed as principal officers, general partners, grantors, owners, and trustors in the Employer Identification Number (EIN) application process. A nominee is not one of these people. Rather, nominees are temporarily authorized to act on behalf of entities during the formation process. The use of nominees in the EIN application process prevents the IRS from gathering appropriate information on entity ownership, and has been found to facilitate tax non-compliance by entities and their owners.

The IRS does not authorize the use of nominees to obtain EINs. All EIN applications (mail, fax, electronic) must disclose the name and Taxpayer Identification Number (SSN, ITIN, or EIN) of the true principal officer, general partner, grantor, owner or trustor. This individual or entity, which the IRS will call the "responsible party," controls, manages, or directs the applicant entity and the disposition of its funds and assets.

To properly submit a Form SS-4, the form and authorization should include the name, Taxpayer Identification Number and signature of the responsible party. Third party designees filing online applications are reminded of their obligation to retain a complete signed copy of the paper Form SS-4 and signed authorization statement for each entity application filed with the IRS. Nominees do not have the authority to authorize third party designees to file Forms SS-4, and should not be listed on the Form SS-4.

## CONCLUSION

Overall, the amendments made to Recommendation 24 significantly strengthen the F.A.T.F. standards, and in so doing, enables competent authorities in countries and territories to tackle money laundering and terrorist financing around the world. As the U.S. faces new national security threats and increased focus on Russian ownership of shell companies, and the real property and other assets owned by overseas entities, there is renewed political urgency to act against anonymous ownership of companies. The likelihood of success for the F.A.T.F. recommendations will depend on how effectively and timely they are implemented. The details, the method of enforcement, are all hugely important, and are yet to be worked out.

In the U.S., significant steps have been taken towards implementation through the proposed FinCEN regulations on beneficial owner and the I.R.S. website advising that the responsible party for E.I.N. purposes will be the same person who is considered the beneficial owner for C.T.A. purposes. The definitions and specific indicators of substantial control under the proposed FinCEN regulations means that a person who exercises substantial control and receives substantial economic benefits from a company's assets is likely the proper person to be the responsible party for purposes of obtaining an E.I.N. Nominees are not welcome.

# THE PRICE IS RIGHT: FORMER I.R.S. ATTORNEY DISCUSSES INFORMATION RETURN AND F.B.A.R. PENALTIES

**Authors**
Stanley C. Ruchelman
Wooyoung Lee

**Tags**
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Form 5472
Form 3520
Information Returns
Penalties

## INTRODUCTION

If a statement was filed and no one reads it, was it filed at all? That is the uncomfortable question many taxpayers will be asking after Daniel Price, a long-time I.R.S. attorney, admitted that the I.R.S. does not read reasonable-cause statements attached to late-filed international information returns.[1]

Many I.R.S. penalties are assessable penalties. This generally means that the I.R.S. is not required to provide the taxpayer with an opportunity to contest the penalty before the I.R.S. levies it. A taxpayer who believes that the penalty is incorrect must file a suit to claim a refund. Assessable penalties include those for failure to file certain information returns, including Forms 5471, *U.S. Persons With Foreign Corporations)*, 5472, *Foreign Corporations With a U.S. Trade or Business*, and 3520, *Foreign Trusts and Gifts*. Penalties start at $10,000 or more and increase with continued noncompliance. Taxpayers who file returns late but have reasonable cause for doing so can attach statements explaining their situation. This can result in a waiver of the penalty.

Mr. Price, who was speaking at an event held by the San Francisco Tax Club, confirmed what many practitioners have suspected. Lengthy delays and vague or even incorrect form responses are common complaints of tax advisers having a cross-border practice. Such experiences are particularly concerning because the taxpayer's route to appeal may be described as "pay first, argue later" rather than appeal first, hopefully not pay at all. If the I.R.S. takes too long in addressing an appeal, the taxpayer must fight the penalty after its assessment and after having to make payment.

### Need for Speed

Over the years, the I.R.S. has increased the number of information returns that must be filed by taxpayers. With more obligations come a greater need for enforcement, and it is this area that has given way to resource constraints. Originally, the I.R.S. would only discover missing information returns during audits, leading to a manual assessment of penalties. But beginning in the last decade, the I.R.S. switched many of these penalties to systemic assessment driven by computers. This means that a return filed late will lead to an automatic penalty assessment against the taxpayer. Reasonable-cause statements are supposed to be insurance against a more penalty-friendly system. They benefit both taxpayers and the I.R.S. Taxpayers are benefitted by presenting their case before the tax is assessed. The I.R.S. is benefitted because a harsh penalty system that kicks-in automatically may ultimately reduce

[1] "Ex-Official Confirms IRS Ignores Some Reasonable Cause Statements," *Tax Notes*, February 7, 2022.

voluntary compliance for those honest taxpayers who erred and wish to comply on a go-forward basis.

To keep up the pace, I.R.S. has also delegated many tasks to lower-level employees who are not suited to the task of making discretionary judgments. In theory, there is protection against this. Code §6751(b)(1) requires that an immediate supervisor approve the penalty determination in writing for certain penalties. But according to Mr. Price, the supervisory roles are themselves often delegated down, which makes supervisory approval meaningless.

That many penalties are wrongly assessed is supported by data. The Taxpayer Advocate Service ("T.A.S."), an I.R.S. office that represents taxpayer interests, released a report arguing that systemic assessment of penalties related to Forms 5471 and 5472 is inefficient and legally unsound.[2] In 2018 (the most recent year for which there is data in the report), over half of systemically assessed penalties for Forms 5471 and 5472 were abated. In terms of dollars, this represented almost three fourths (71%) of penalties. Manually assessed penalties for the same year and same forms faced abatement rates of 24% and 8%, respectively.

Beyond efficiency concerns, the T.A.S. believes that the I.R.S. does not even have authority to systemically assess penalties for Forms 5471 and 5472. One view is that Subchapter B ("Assessable Penalties") of Chapter 68 lists all penalties that may be systemically assessed, and Code §§6038 and 6038A (which are responsible for penalties related to Forms 5471 and 5472) are not located there. The I.R.S. believes that assessable penalties are not limited to Subchapter B. Instead, all penalties that are not subject to deficiency procedures (which allow a taxpayer to contest a penalty before assessment) are assessable by default. Code §6201 of the Code provides authority for the I.R.S. to assess assessable penalties.

As for the high abatement rates, the I.R.S. recognizes such rates are "relatively high" and wants to "explore whether there are more efficient methods." In fairness, abatement rates decreased by 17% by number of penalties and 15% by dollar figure from 2014 to 2018. But it is unclear whether this is because of more efficient penalty assessment, less generous abatement, or normal variance.

Given the I.R.S.'s noncommittal response to the T.A.S. report, taxpayers may have to avail themselves of other means. Mr. Price had several suggestions that might give taxpayers more transparency into their individual cases. A managerial conference might get a taxpayer into direct contact with the people evaluating the case. Freedom of Information Act requests may allow a taxpayer to determine whether there was proper, written supervision. Beyond the statements, Form 843 (Claim for Refund and Request for Abatement) may provide a faster route to reclaiming money.

## F.B.A.R. PENALTIES

Reasonable-cause statements were not the only penalty-related subject of Mr. Price's talk. Federal courts have found themselves split over the proper way to calculate penalties for non-willful F.B.A.R. reports of FinCEN Form 114, *Report of Foreign Bank and Financial Accounts* violations. U.S. taxpayers who hold foreign

[2] "The IRS's Assessment of International Penalties Under IRC §§ 6038 and 6038A Is Not Supported by Statute, and Systemic Assessments Burden Both Taxpayers and the IRS," Taxpayer Advocate Service, 2020.

bank and other financial accounts with an aggregate value above $10,000 at any point in a given year must report the accounts on a single, yearly form called the F.B.A.R. The source of the confusion is Code §5321, which limits the penalty for a non-willful "violation of any provision of section 5314" to $10,000. Code §5314 lays out F.B.A.R. requirements. Unhelpfully, the term "violation" is not defined. Under one interpretation, a violation is a failure to file the form. Another holds that each unreported account on the same form is a separate violation.

The different theories can lead to drastically different penalty figures. Alexandru Bittner, a Romanian and American businessman, was not aware of his F.B.A.R. obligations and failed to report his foreign accounts from 2007 to 2011.[3] At trial, the district court applied the per-form standard and set his penalties at $50,000: $10,000 for each annual form. The I.R.S. disagreed and persuaded the Fifth Circuit that penalties should apply per account, leading to a penalty in the amount of $2.72 million.

That decision put the Fifth Circuit at odds with the Ninth Circuit. In *Boyd*, the court dealt with a taxpayer who failed to report 13 foreign accounts during a single year.[4]Using the per-form standard, the Ninth Circuit reversed the district court's decision and capped the penalty at $10,000. *Boyd* relied on *Shultz*,[5] in which the Supreme Court noted that penalties under the Banking Secrecy Act (the legislation that, among other things, created F.B.A.R. obligations) attach to the regulations, not the statute. Treas. Reg. §1010.350(a) requires taxpayers to report accounts on an F.B.A.R. forms, while Treas. Reg. §1010.350(c) creates a deadline for doing so. The taxpayer missed the deadline but still reported her accounts accurately. The court thus found only one violation and one penalty.[6]

*Bittner* ignored *Shultz*, as *Shultz* was about constitutionality and not interpretation of the penalty provisions. The Fifth Circuit instead noted that the provision on non-willful violations, unlike other parts of Code §5321, do not refer to a "violation of a regulation." The court accordingly focused on the statute, rather than the regulations. The court found a distinction between substantive obligation – reporting the accounts – and procedural requirements – the form used for reporting. The statute centered on the former, while the regulations fleshed out the latter.

The court also drew a comparison with willful penalties. The provision on willful penalties refers to accounts, suggesting that penalties should generally be tied to noncompliance of each account. But given the non-willful penalties provision does not mention refer to accounts, one might question why this was not a definition by omission, which was questioned by the district court and Ninth Circuit. The Fifth Circuit used that logic to conclude that non-willful violations do not attach to regulations. The court's answer was that the cap on willful penalties depends partly on the balance of unreported accounts, while the cap on non-willful penalties is a flat $10,000. The court further observed that the reasonable-cause exception, which can excuse non-willful F.B.A.R. penalties, specifically requires that account

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3 *U.S. v. Bittner*, 991 F.3d 1077.

4 *U.S. v. Boyd*, 19 F.4th 734.

5 *The Calif. Bankers Assn. v. Shultz*, 416 U.S. 21 (1974).

6 This suggests that even the Ninth Circuit would approve of a penalty greater than $10,000 for one form if the form was both filed late and with incorrect information, as, incidentally, Mr. Bittner initially did.

balances be accurately reported. It would be inconsistent to tie the penalty to the form but the exception to the account.

Some taxpayers were relieved when Mr. Price confirmed that the I.R.S. is following the per-form theory in the Ninth Circuit.[7] However, there is no guarantee that this situation will last. The two opinions are incompatible and create uncertainty, not least given the potentially huge disparity in results. The circuit split surely invites resolution of the conflict, perhaps by the Supreme Court.

In the meantime, Mr. Price suggests that those in the Ninth Circuit facing penalties for non-willful F.B.A.R. violations take advantage of *Boyd* by citing the case or requesting the involvement of the Office of Chief Counsel, as attorneys would be more reluctant to ignore precedent than lower-level employees. It is not a guarantee of success, but the potential payoff is worth the effort.

## CONCLUSION

A similar calculus applies to the reasonable cause statements attached to information returns. Even if the I.R.S. has been ignoring them, there is still value in the taxpayer following procedure by filing the statement. The statement can provide a paper trail. It can serve as evidence of a consistent story, should a dispute get dragged out. And it might even be read.

7 "IRS Following *Boyd* FBAR Interpretation in Ninth Circuit Only," Tax Notes, February 7, 2022.

# "MANNING UP": TWENTY-FIRST CENTURY TALES OF TAX AVOIDANCE AND EXAMINATION OPTIONS ON THE I.R.S.'S TABLE

**Author**
Andreas A. Apostolides

**Tags**
Bristol-Myers Squibb
Circular 230
Listed Transaction
Mann Construction
Tax Shelter

## INTRODUCTION

> *"Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."*
>
> – Justice Learned Hand, *Helvering v. Gregory* (1934)[1]
>
> *"If tax compliance were an industry, it would be one of the largest in the United States."*
>
> – Nina E. Olson, National Taxpayer Advocate (2013) [2]

The U.S. tax system is a "self-assessment" model: upon determining how tax provisions apply to their transactions, taxpayers pay any tax due, and report the transactions to the I.R.S. in sufficient detail to permit the I.R.S. to confirm that liability was correctly calculated.[3]

Paradoxically, the tax system is so complex that it incessantly creates ambiguity and opportunity for abuse. Determining one's tax obligations is often difficult, even for taxpayers with simple profiles. When enterprising taxpayers with complicated facts are tempted to test the boundaries, the I.R.S. must devote significant resources to establishing and policing those boundaries.

The term "tax shelter" is defined in the Code as a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax.[4]

In this article we look at two very different taxpayers, and their participation in tax shelters – as well as reasons for which each became in recent weeks the focus of the tax press and/or the public at large.

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1 69 F.2d 809 (2d Cir. 1934), at 810, quoting *U.S. v. Isha*m, 17 Wall 496.

2 "Tax code 'is 10 times the size of the Bible'," StarTribune.

3 See *Beard v. Commr.*, 82 T.C. 766 (1984), affd. 793 F.2d 139 (6th Cir. 1986).

4 Code §6662(d)(2)(c)(ii). The purpose is to clarify situations in which a taxpayer may obtain relief from a 20% penalty for understating taxes because the position was either disclosed or there was substantial authority for the position; participation in a "tax shelter" prevents such relief from being applicable.

## BRISTOL-MYERS SQUIBB

Bristol-Myers Squibb (also referred to as "B.M.S.") is a New Jersey-based pharmaceutical company ranked #75 on the Fortune 500 list in 2021.[5] Formed by the 1989 merger of Bristol-Myers and Squibb, two major New York pharmaceutical companies, the company is a global manufacturer of drugs used to fight cancer, HIV/AIDs, and cardiovascular disease, among other disorders.[6]

In 2012, a wholly owned U.S. subsidiary of B.M.S. transferred appreciated intangible property – apparently, patents to leading pharmaceutical drugs – in exchange for shares of a foreign unlimited liability company treated as a partnership for U.S. Federal income tax purposes.[7] The stated purpose of the transaction was to "better align the geographical and operational focus" of the B.M.S. global affiliated group. The net effect of amortization claimed by the partnership, some of which was allocated back to the U.S., was to reduce B.M.S.'s U.S. tax bill by approximately $1.4B.

As part of entering into this transaction, an outside adviser was retained to value the contributed assets using a discounted cash flow analysis; the produced valuation report allocated fair market value almost entirely to each patent's "on-patent" period, *i.e.*, the remaining period of validity; the report assumed precipitous decline in each patent's value upon expiration; the adviser also valued the contribution as a percentage of the total assets of the foreign partnership, including certain high-basis, high-value property contributed by a related foreign partner.

Meanwhile, the property contributed by the related foreign partner was non-depreciable or otherwise had a tax basis roughly corresponding to its fair market value.

B.M.S. received two opinions supporting the claimed tax benefits, including one from PricewaterhouseCoopers ("PwC") and the white shoe law firm of White & Case LLP.

### The Field Advice

In a letter providing advice for audit agents around the country (the "F.A.A." or "Field Advice"),[8] the I.R.S. Office of Chief Counsel analyzed the transaction in detail. It noted that Code §704(c), a rule also mentioned in the 2015 notice which allocates taxable appreciation in contributed property to be allocated back to the contributing partner, was applicable.

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5 In 2021, Bristol-Myers Squibb had revenues of $42.5B, revenue growth of 62.6% from the preceding year. See here.

6 For a list of select medicines, see here. Bristol-Myers supplied penicillin to Allied Forces in World War II. Squibb, a pharmaceutical company founded in 1858 in Brooklyn, New York, supplied Union troops in the American Civil War, and started publishing Squibb's Ephemeris of Materia Medica after failing to convince the American Medical Association to incorporate higher purity standards. See here.

7 Field Attorney Advice ("F.A.A.") 20204201F (April 22, 2020) (the "F.A.A." or "Field Advice").

8 See *supra* note.

As outlined in the Advice, Code §704(c), aided by a special partnership anti-abuse rule,[9] permitted the I.R.S. to place the foreign partnership on a so-called curative accounting method. The method would prevent the U.S. affiliate from benefiting from Irish patent amortization while causing all the U.S. patents' gain to be allocated to the tax-indifferent foreign partner. To do so, the I.R.S. invoked an anti-abuse rule specific to Code §704(c) matters.

Unlike the general partnership anti-abuse rule,[10] which requires a "principal purpose" to be tax benefits in order for the I.R.S. to recharacterize a transaction, the Code §704(c) anti-abuse rule, enacted in 1993, requires the I.R.S. simply to show that the taxpayer operated "with a view to" tax benefits, a much lower bar.[11] The I.R.S. determined it was met. It is not precisely clear where the B.M.S. matter ended up afterwards, and it is quite possible that B.M.S. settled with the I.R.S. for less than the full amount of asserted tax due.

After the government improperly leaked a not fully redacted Field Advice through the Tax Notes research portal, however, the New York Times obtained a copy and exposed the transaction and its participants.[12] Almost a year later, in 2022, Senate Finance Committee Chairman Ron Wyden[13] sought additional information on the transaction from B.M.S.'s Chairman.[14] Noting that the offshoring reduced B.M.S.'s effective tax rate from 24.7% to minus 7%, he inquired into its economic substance and whether or not B.M.S. was contesting the I.R.S.'s decision. He also asked whether B.M.S.'s auditors had reviewed the transactions.

One additional aspect noted in Senator Wyden's letter was that hundreds of pages of legal advice failed to refer even once to Code §704(c), a glaring omission. A failure by "sophisticated outside advisors" to address key issues "raise[d] serious questions as to whether such an omission was deliberate. Other observers have been more understanding of B.M.S. and critical of the Senator.[15]

9 Treas. Reg. §1.704-3(a)(10).

10 Treas. Reg. §1.702-2(b). This general rule allows the I.R.S. to recharacterize transactions with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability "in a manner that is inconsistent with the intent of subchapter K."

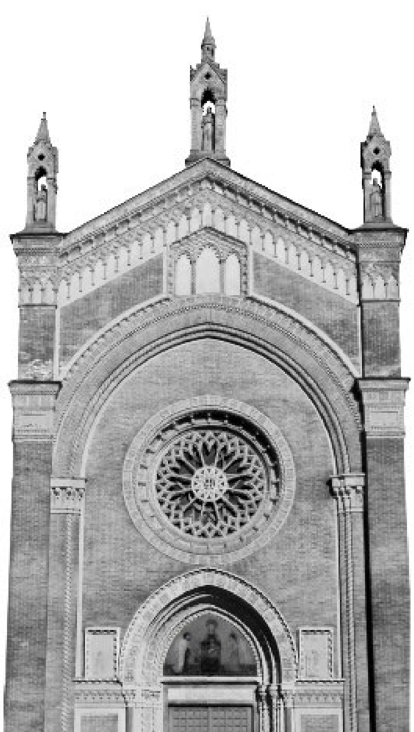
11 Another author has suggested Code §197 would not permit B.M.S.'s I.P. offshoring from giving rise to amortization in any event; see Karen C. Burke, "Transfers of Zero-Basis Intangibles to a Partnership," Tax Notes, Jan. 18, 2022. However quick and dirty, the I.R.S.'s approach was less technically demanding and got to the point faster.

12 "An Accidental Disclosure Exposes a $1B Tax Fight With Bristol Myers", April 1, 2021, and available here.

13 Senator (D-OR) from 1996.

14 Letter from Ron Wyden, Chairman: Committee on Finance, to Giovani Caforio, Chairman of the Board and C.E.O., Bristol Myers Squibb, Jan. 18, 2022.

15 For example, an article by the Wall Street Journal's editorial board pointed out the murkiness of the law and alleged the Senator's letter was a witch hunt for purely political purposes. "Democrats Find a Pharma Scapegoat: Tax sleuth Ron Wyden discovers a 10-year-old, legal deduction," WSJ.com, Jan. 26, 2022.



## *MANN CONSTRUCTION V. UNITED STATES*

***"A listed transaction is a variety of reportable transactions which is the same or substantially similar to one of the types of transactions that the I.R.S. has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction."***

The second transaction examined involves Mann Construction, an owner-managed construction business focusing on warehouses and retail outlet malls in the Midwest since 1975, and operated out of Harrison, a town with population of 2,150.[16] According to the company website, they have designed several Dollar stores and a drive-thru banking facility in Harrison, Michigan.[17] They have 2 reviews and a 4-star rating on Google.[18]

Between 2013 and 2017, Mann established an employee-benefit trust paying premiums on cash-value life insurance for the benefit Brook Wood and Lee Coughlin, its founders and sole shareholders. In the I.R.S.'s view, such a trust generates excess deductions to the company and is also designed to transfer a significant part of the insurance policy value to the insured's beneficiary tax-free. The arrangement was flagged by the I.R.S. as a "listed transaction" in Notice 2007-83.[19]

A listed transaction is a variety of reportable transactions which is the same or substantially similar to one of the types of transactions that the I.R.S. has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction.[20] Each taxpayer engaging in a listed transaction must report the transaction during each year of participation using Form 8886, *Reportable Transaction Disclosure Statement*, which is attached to the return for the year in question.[21] The instructions to the form clearly indicate that the mere reporting on the form does not mean that the tax benefits will be automatically disallowed. In *Mann*, all the taxpayers failed to file the form. In consequence, upon auditing the company's 2013 tax return, the I.R.S. imposed penalties both on the company and its shareholders.

Paying the penalties to the I.R.S., the taxpayers first sought administrative refunds, and failing that, recovery in Federal court by challenging the penalties on four grounds:

1. The 2007 notice failed to comply with notice-and-comment procedures under the Administrative Procedure Act.
2. The notice constituted unauthorized agency action.
3. The notice was arbitrary and capricious.
4. Even if the notice were valid, the arrangement was not within its scope.

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16 It is near the junction of U.S. 127 and M-61, though according to Wikipedia U.S. 127 actually bypasses the city. Harrison is bordered by Budd Lake on the east; the biggest local events are the Clare County Fair and the Frostbite Open Golf Tournament on Budd Lake. See here.

17 See here.

18 One of the reviewers assures us that "They do good work."

19 See also Notice 2009-59, defining "listed transactions" for purposes of Code §6707A, cross-referencing Notice 2007-83 at §2(33).

20 Treas. Reg. §1.6011-4(b)(2).

21 In addition, in the first year in which the taxpayer participates in a reportable transaction, a copy of the form must also be mailed to the Office of Tax Shelter Analysis ("O.T.S.A.").

The I.R.S. agreed that it had not followed the notice-and-comment procedures required by the Administrative Procedure Act ("A.P.A.").

## **Background: Growing Inroads by the A.P.A.?**

In fact, until 2019 the I.R.S. and Treasury generally have proceeded for decades with a view that tax regulations were outside the A.P.A.'s ambit (a kind of tax exceptionalism). Typically, this involved issuance of temporary regulations without notice and comment, followed by final regulations many years later. A chip in this edifice was created by the 2011 Supreme Court case of *Mayo Foundation for Medical Education and Research et al. v. United States*,[22] which upheld certain wage withholding rules under the Federal Insurance Contributions Act.

In a first, *Mayo* cited non-tax administrative law cases normally discussed only when analyzing A.P.A. issues, not tax issues. A second case swiftly followed in *United States v. Home Concrete & Supply, LLC*,[23] this time rejecting a Treasury regulation running counter to courts' interpretations of a long-standing tax rule, the six-year extended statute of limitations applicable to certain understatements under Code §6501(e).

Under the A.P.A., it may be permissible for an administrative agency to introduce rules without notice-and-comment, provided it can show good cause. In *Mann*, the I.R.S. simply asserted that it was not required to do so. Unlike the 2011 and 2012 opinions, the court this time fully unfurled an A.P.A.-type analysis, to conclude that the I.R.S.'s obligation to identify reportable transactions under Code §6707A, enacted by Congress in 2004,[24] could not be met through mere issuance of interpretive guidance like the notice. The I.R.S. retorted that its failure to follow notice-and-comment was because in A.P.A. terms, Notice 2007-83 was an "interpretive rule" rather than a "legislative rule;" or, even if the notice were acknowledged to be a legislative rule, the I.R.S. was exempted from complying with A.P.A.-type rules by Congress. This was an odd argument to make, particularly given the fact that in 2019 the Treasury Department specifically issued a policy statement committing to notice-and-comment rulemaking.[25]

The Sixth Circuit evaluated Notice 2007-83 and found it wanting. The argument of tax exceptionalism was dismissed out of hand.

Moreover, the Sixth Circuit read Code §6707A, which requires taxpayers to file information with respect to reportable transactions, side by side with Code §6011(a), to conclude that listed transactions could not be reportable transactions unless so designated in Treasury Regulations. When the I.R.S. pointed out that Code §6707A(c) specifically should be read alongside Treas. Reg. §1.6011-4(b)(2), which defines a listed transaction, specifically including one designated in a published notice, the Court went even further:

> [T]he agency's reference to its apparent rules of process, without more, does not show that *Congress* exempted Notice 2007-83 from

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22 562 U.S. 44 (2011).

23 566 U.S. 478 (2012).

24 Enacted by the American Jobs Creation Act of 2004, Pub. L. No. 108-357.

25 Department of the Treasury, "Policy Statement on the Tax Regulatory Process," March 5, 2019, which can be downloaded here.

> notice-and-comment rulemaking. The question is whether Congress amended the APA's prerequisites, not whether the IRS did. While the cross-reference is probative of whether Congress was aware of the IRS's transaction-listing procedures, it does not alone suffice to show an express exemption from the APA procedures. Even on its own terms, moreover, the argument falls short. Section 6707A deals with penalties for not reporting certain transactions to the IRS. The statute's key feature is to describe the "type[s]" of "transaction[s]" subject to penalties for non-reporting, namely the ones "determined" by "the Secretary" "because" they have a "potential for tax avoidance or evasion." 26 U.S.C. § 6707A(c)(1). The statute thus addresses a "which transactions" question, not a "what process" question. That does not suffice to create an express modification of the APA's background assumption that rulemaking will go through the notice-and-comment requirements.

Thus, in literally a few brief strokes of the pen, decades of I.R.S. regulatory practice appeared to go up in a puff of smoke.

If the result in *Mann* is upheld, the I.R.S. will face predictable difficulty, particularly in dealing with out-of-the-way areas of the law, done by smaller taxpayers, where audit resources may already be limited. Whether that difficulty will have a long shelf life is unclear. When the taxpayer in *Grecian Magnesite*[26] won a stunning victory over Rev. Rul. 91-32 in the U.S. Tax Court, the ink was hardly dry before Congress revised the law to reverse the outcome of the case by adopting Code §864(c)(8) and §1446(f) on a prospective basis. The court held that gain from the sale or redemption of a foreign taxpayer's interest in a U.S. partnership was not effectively connected income.

***"Thus, in literally a few brief strokes of the pen, decades of I.R.S. regulatory practice appeared to go up in a puff of smoke."***

## CONCLUSION

The two taxpayers we looked at, like their transactions, lie at polar opposite ends of the spectrum. What can one learn from them, or from the difference in result when each was attacked by the I.R.S.? While politically small businesses may not be as attractive targets as large corporate multinationals are for politicians like Senator Wyden, individual tax evasion may reach as high $50 billion a year, suggesting that the cost of auditing and litigating against the latter group is worth the expected return.[27] In short, their stories speak volumes not only about the challenges facing the I.R.S. today and the contours of its future evolution, but also about the state of the nation.

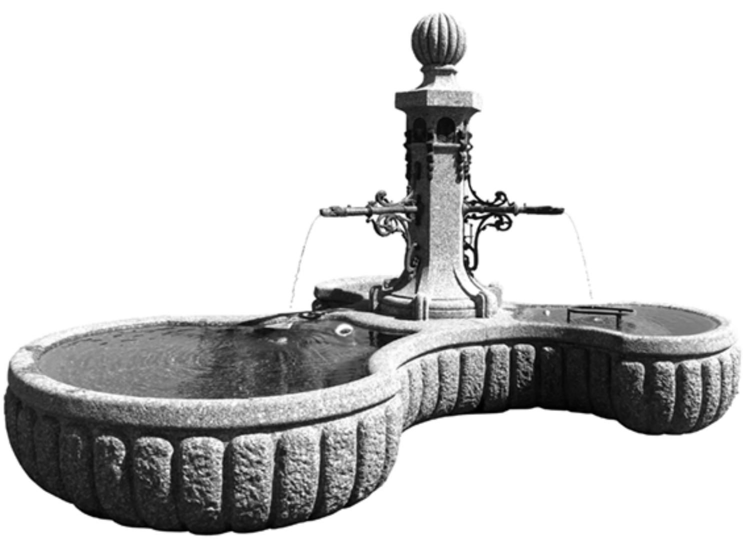
The Sixth Circuit's opinion in *Mann* – particularly if upheld by the Supreme Court – may result in a perception by the I.R.S. of diminishing returns in pursuing smaller

26 *Grecian Magnesite Mining, Industrial & Shipping Co., SA, v. Commr.*, 149 T.C. 63 (2017), affd. 926 F/3d 819 (D.C. Cir. 2019).

27 See a slightly dated report by Joseph Guttentag and Reuven Avi-Yonah, "Closing the International Tax Gap" cited in Congressional Research Service, "Tax Havens: International Tax Avoidance and Evasion", updated Jan. 6, 2022 ("C.R.S. Report"), at n.125. The $50 billion can be fruitfully compared to $50 billion that Kimberly Clausing and Reuven Avi-Yonah estimated in 2008 as the potential revenue gain from moving to a formulary apportionment system for on worldwide income for U.S. corporate taxpayers; see the C.R.S. Report at n.94. While not an "apples-to-apples" comparison, it is instructive.

businesses and individuals participating in the traditional tax shelters. In the short run, it may cause a reallocation of audit resources. In the long run, the more realistic thing is to recognize that the I.R.S. never loses. As Will Rogers said, "the only difference between death and taxes is that death doesn't get worse every time Congress meets."

Thus, assuming for the moment that the 2019 Policy Paper was issued in error, the the I.R.S. may "Mann-up" and request what it needs from Congress, similar to what happened when its position in Rev. Rul. 91-32 was overruled by the Tax Court in *Grecian Magnesite*. In short, the most likely outcome is that the I.R.S. will zealously and successfully petition Congress for a permanent fix, explicitly granting an exception from clunky A.P.A. procedures.



# NEW SUBPART F AND P.F.I.C. REGULATIONS – *EX UNO PLURES*

**Authors**
Stanley C. Ruchelman
Wooyoung Lee

**Tags**
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951A
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Flow-through entities raise the question of when the entity stands in its own name versus being a collection of its owners. This is commonly referred to the entity versus aggregate approach to partnerships, that was at the heart of the *Grecian Magnesite* case,[1] applying entity treatment for sales and other dispositions of partnership interests, and the adoption of Code §864(c)(8) and §1446(f), prospectively applying aggregate treatment for those transactions. The Internal Revenue Code allows entity treatment in certain situations and aggregate in others. Four years ago, the I.R.S. issued regulations on the proper approach for certain purposes of Code §951A, related to Global Intangible Low-Taxed Income ("G.I.L.T.I.).

The I.R.S. initially contemplated a hybrid approach for U.S. partnerships that were shareholders in controlled foreign corporation ("C .F.C.'s"). U.S. partners who also owned shares of the C.F.C. directly would follow the aggregate approach and compute their G.I.L.T.I. share directly. For all other partners, the partnership would calculate its G.I.L.T.I. share, and the partners would report a distributive share of the partnership's G.I.L.T.I. inclusion.

The final G.I.L.T.I. regulations scrapped this complex method and adopted the aggregate approach for all partners for purposes of Code §951A. The I.R.S. has now set its sights on similar questions in different areas. On January 25, 2022, the I.R.S. released final regulations for C.F.C.'s under Subpart F and proposed regulations on Passive Foreign Investment Companies ("P.F.I.C.'s"). As with the G.I.L.T.I. regulations, the new Subpart F and P.F.I.C. regulations reflect aggregate treatment for partnerships.

## SUBPART F

### Background

Under Code §951, U.S. Shareholders in a C.F.C. must include in income their respective shares of the C.F.C.'s Subpart F Income. A foreign corporation is a C.F.C. if shares representing more than 50% of the total value of all shares of stock outstanding or more than 50% of the total voting power of all shares of stock of the foreign corporation entitled to vote are owned directly, indirectly, or by attribution from others, by one or more persons who are "U.S. Shareholders."[2] A U.S. Shareholder is a U.S. Person who owns directly, indirectly, or by attribution from others, shares representing at least 10% of the total value of all shares of stock outstanding or at least 10% of the total voting power of all shares of stock of the foreign corporation

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1 *Grecian Magnesite Mining, Industrial & Shipping Co., SA, v. Commr.,* 149 T.C. 63 (2017), *affd*. 926 F/3d 819 (D.C. Cir. 2019).

2 Code §957(a).

  

entitled to vote.[3] A "U.S. Person" includes a citizen, a tax resident, a domestic corporation, and domestic partnership, and a domestic trust or estate.[4]

Entity treatment was the proper method prior to the new regulations. A domestic partnership or S-Corporation that owned shares in a C.F.C. would calculate its Subpart F inclusion and add it to the distributive shares of its owners.

## Proposed Regulations

The initial set of proposed regulations, which were released in 2019, used a hybrid treatment: there would be entity treatment with regard to foreign owners but aggregate treatment with regard to domestic owners. But as with the G.I.L.T.I. regulations, the final regulations choose a simpler approach of aggregate for all.[5] In addition to partnerships and S-Corporations, aggregate treatment applies to domestic grantor trusts but not to domestic non-grantor trusts or domestic estates.

The new regulations[6] eliminate Subpart F Income inclusions for many partners and S-Corporation shareholders. Previously, Subpart F Income inclusion was determined at the entity level, meaning that each partner included his or her share of the partnership's Subpart F Income. Now, a partner who owns less than 10% of a partnership that owns 100% of a C.F.C. will no longer have Subpart F Income with respect to that C.F.C. The partnership does not have Subpart F Income that the partner must take into account, and the partner is not a U.S. shareholder in his or her own right because less than 10% of the C.F.C. is deemed held by the partner.

More broadly, the regulations apply aggregate treatment for purposes of Code §§951 and 951A and any provision that refers to them. In the proposed regulations, this created a bit of ambiguity. Code §951(a)(1)(B) requires the inclusion of sums calculated under Code §956, but Code §956 does not refer to Code §§951 or 951A. Code §956 governs a C.F.C.'s investment in U.S. property. The final regulations explicitly add Code §956(a) to the scope of the new regulations.

Entity treatment still applies for certain aspects. Whether a foreign corporation is a C.F.C. is still determined at the entity level. A foreign corporation that is owned solely by a domestic partnership is still a C.F.C. This is true even if none of the partners are U.S. shareholders of a C.F.C. under aggregate analysis. If the partnership then sells C.F.C. stock and recognizes gain, the gain is still subject to dividend treatment under Code §1248, determined at the entity level. Entity treatment also applies in identifying controlling domestic shareholders of a C.F.C. Finally, entity treatment still seems applicable with regard to Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*. A domestic partnership or S-Corporation that is a U.S. shareholder of a C.F.C. can relieve its partners or shareholders of the duty to file Form 5471 by filing the form itself. The new regulations do not mention any changes to this requirement.

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3 Code §951(b).

4 Code §7701(a)(30).

5 T.D. 9960.

6 Treas. Reg. §1.958-1(d).

## Examples in Regulations

The final regulations contain three examples[7] that illustrate the treatment of a U.S. partnership and its members when applying Subpart F and G.I.L.T.I.

*Example (1)*

(A) *Facts*. USP, a domestic corporation, and Individual A, a United States citizen unrelated to USP, own 95% and 5%, respectively, of PRS, a domestic partnership. PRS owns 100% of the single class of stock of FC, a foreign corporation.

***"The final regulations contain three examples that illustrate the treatment of a U.S. partnership and its members when applying Subpart F and G.I.L.T.I."***

(B) *Analysis*

(1) *United States shareholder and CFC determinations*. Under paragraphs (d)(2)(i) and (ii) of this section, respectively, the determination of whether PRS, USP, and Individual A (each a United States person) are United States shareholders of FC, and whether FC is a controlled foreign corporation, is made without regard to paragraph (d)(1) of this section. PRS, a United States person, owns 100% of the total combined voting power or value of the FC stock within the meaning of section 958(a). Accordingly, PRS is a United States shareholder under section 951(b), and FC is a controlled foreign corporation under section 957(a). USP is also a United States shareholder of FC because it owns 95% of the total combined voting power or value of the FC stock under sections 958(b) and 318(a)(2)(A). Individual A, however, is not a United States shareholder of FC because Individual A owns only 5% of the total combined voting power or value of the FC stock under sections 958(b) and 318(a)(2)(A).

(2) *Application of sections 951 and 951A*. Under paragraph (d)(1) of this section, for purposes of sections 951 and 951A, PRS is not treated as owning (within the meaning of section 958(a)) the FC stock; instead, for purposes of determining the persons that own the FC stock within the meaning of section 958(a), the FC stock is treated as if it were owned by a foreign partnership under paragraph (b) of this section. Therefore, for purposes of sections 951 and 951A, USP is treated as owning 95% of the FC stock under section 958(a), and Individual A is treated as owning 5% of the FC stock under section 958(a). USP is a United States shareholder of FC, and therefore USP determines its income inclusions under sections 951 and 951A directly with respect to FC based on its ownership of FC stock under section 958(a). However, because Individual A is not a United States shareholder of FC, Individual A does not have an income inclusion under section 951 with respect to FC or a *pro rata* share of any amount of FC for purposes of section 951A. This is the case even though PRS is a United States shareholder of FC.

*Example (2)*

(A) *Facts*. USP, a domestic corporation, and Individual A, a United States citizen, own 90% and 10%, respectively, of PRS1, a domestic partnership. PRS1 and Individual B, a nonresident alien individual, own 90% and 10%, respectively, of PRS2, a domestic partnership. PRS2 owns 100% of the single class of stock of FC, a foreign corporation. USP, Individual A, and Individual B are unrelated to each other.

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7 Treas. Reg. 1.958-1(d)(3) *Examples*.

(B) *Analysis*.

(1) *United States shareholder and CFC determinations*. Under paragraphs (d)(2)(i) and (ii) of this section, the determination of whether PRS1, PRS2, USP, and Individual A (each a United States person) are United States shareholders of FC, and whether FC is a controlled foreign corporation, is made without regard to paragraph (d)(1) of this section. PRS2 owns 100% of the total combined voting power or value of the FC stock within the meaning of section 958(a). Accordingly, PRS2 is a United States shareholder under section 951(b), and FC is a controlled foreign corporation under section 957(a). Under sections 958(b) and 318(a)(2)(A), PRS1 is treated as owning 90% of the FC stock owned by PRS2. Accordingly, PRS1 is also a United States shareholder under section 951(b). Further, under section 958(b)(2), PRS1 is treated as owning 100% of the FC stock for purposes of determining the FC stock treated as owned by USP and Individual A under section 318(a)(2)(A). Therefore, USP is treated as owning 90% of the FC stock under section 958(b) (100% x 100% x 90%), and Individual A is treated as owning 10% of the FC stock under section 958(b) (100% x 100% x 10%). Accordingly, both USP and Individual A are also United States shareholders of FC under section 951(b).

(2) *Application of sections 951 and 951A*. Under paragraph (d)(1) of this section, for purposes of sections 951 and 951A, PRS1 and PRS2 are not treated as owning (within the meaning of section 958(a)) the FC stock; instead, for purposes of determining the persons that own the FC stock within the meaning of section 958(a), as the FC stock is treated as if it were owned by foreign partnerships under paragraph (b) of this section. Therefore, for purposes of determining the amount included in gross income under sections 951 and 951A, under section 958(a) USP is treated as owning 81% (100% x 90% x 90%) of the FC stock, and Individual A is treated as owning 9% (100% x 90% x 10%) of the FC stock. Because USP and Individual A are both United States shareholders of FC, USP and Individual A determine their respective inclusions under sections 951 and 951A directly with respect to FC based on their ownership of FC stock under section 958(a). This is the case even though PRS2 is a United States shareholder of FC.

<u>*Example (3)*</u>

(A) *Facts*. Individual A, a United States citizen, Individual B, a United States citizen unrelated to Individual A, and Individual C, a foreign person unrelated to both Individuals A and B, own 10%, 5%, and 85%, respectively, of PRS, a domestic partnership. PRS owns 100% of the single class of stock of FC, a foreign corporation. FC holds an account receivable from PRS that constitutes an obligation of a United States person within the meaning of section 956(c)(1)(C) and §1.956-2(a)(1)(iii).

(B) *Analysis*.

(1) *United States shareholder and CFC determinations*. Under paragraphs (d)(2)(i) and (ii) of this section, respectively, the determination of whether PRS, Individual A, and Individual B (each a United States person) are United States shareholders of FC, and whether FC is a controlled foreign corporation, is made without regard to paragraph (d)(1) of this section. PRS, a United States person, owns 100% of the total combined voting power or value of the FC stock within the meaning of section 958(a). Accordingly, PRS is a United States shareholder under section 951(b), and FC is a controlled foreign corporation under section 957(a). Individual A is also a United States shareholder of FC because it owns 10% of the total combined voting

power or value of the FC stock under sections 958(b) and 318(a)(2)(A). Individual B, however, is not a United States shareholder of FC because Individual B owns only 5% of the total combined voting power or value of the FC stock under sections 958(b) and 318(a)(2)(A).

(2) *Application of section 956(a).* Under paragraph (d)(1) of this section, for purposes of section 956(a), PRS is not treated as owning (within the meaning of section 958(a)) the FC stock; instead, for purposes of determining the persons that own the FC stock within the meaning of section 958(a), as the FC stock is treated as if it were owned by a foreign partnership under paragraph (b) of this section. Therefore, for purposes of section 956(a), under section 958(a) Individual A is treated as owning 10% of the FC stock, and Individual B is treated as owning 5% of the FC stock. Individual A is a United States shareholder of FC, and therefore Individual A determines the amount it must include in gross income under section 951(a)(1)(B) by reason of the PRS obligation held by FC based on its ownership of FC stock under section 958(a) as determined under paragraph (d)(1) of this section. However, because Individual B is not a United States shareholder of FC, Individual B does not have an amount to include in income under sections 956(a) and 951(a)(1)(B).

(3) *Application of section 956(c) and (d).* Under paragraph (d)(2)(iii) of this section, for purposes of section 956(c) and (d), the determination of whether FC holds United States property is made without regard to paragraph (d)(1) of this section. Therefore, PRS is treated as owning stock of FC within the meaning of section 958(a) for purposes of determining the amount of United States property held by FC arising from its account receivable from PRS.

## P.F.I.C.'S

The P.F.I.C. rules are designed to prevent a U.S. person from avoiding tax by deferring receipt of income from a P.F.I.C., thereby allowing profits to be reinvested on a pre-tax basis. By default, Code §1291 mandates ordinary-income treatment when a P.F.I.C. shareholder receives an excess distribution, which includes not only distributions from the P.F.I.C., but gain on disposition of the P.F.I.C. shares of stock. The excess distribution is allocated to each day in the holding period, all income allocated to a prior P.F.I.C. year is taxed at the highest rate prescribed for ordinary income in such year. The tax for each such prior P.F.I.C. year is deemed to be paid late, and late payment interest is calculated for such year. The entire benefit of deferral and often much more is paid the U.S. Fisc as tax on the excess distribution, a much more painful result than a current inclusion in income under Subpart F.

Where a P.F.I.C. is owned by a partnership, the proposed regulations apply aggregate treatment to the excess distribution regime.[8] Mechanically, the proposed regulations exclude domestic partnerships and S-Corporations from the definition of P.F.I.C. shareholder for certain purposes.

As an alternative to the excess distribution regime, P.F.I.C. shareholders can make one of two elections. A shareholder can elect to treat a P.F.I.C. as a Qualifying Electing Fund ("Q.E.F."). A shareholder of a Q.E.F. must include his or her share of the Q.E.F.'s income in gross income on an annual basis. If a shareholder has marketable P.F.I.C. stock, the shareholder can instead make a mark-to-market ("M.T.M.")

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[8] REG-118250-20.

election, which requires the shareholder to include the year-to-year change in the value of the stock in gross income. These elections are made shareholder and once made affect only that shareholder. Consequently, a P.F.I.C. can be a Q.E.F. with respect to one of its shareholders while remaining a P.F.I.C. for some or all other shareholders. Additionally, if the shareholder makes the election after the first year in which P.F.I.C. stock is acquired – or if the individual is an arriving resident in the U.S. and not a citizen, in the year residence begins – the P.F.I.C. stock is considered tainted and will be subject to both the excess distribution regime and the rules of the shareholder's elected regime as to future capital gains. Removing the taint requires a purging election, or a deemed sale or dividend.

*"As with old rules for G.I.L.T.I. and Subpart F, Q.E.F. and M.T.M. elections were previously made at the entity level. This will change under the proposed regulations. "*

As with old rules for G.I.L.T.I. and Subpart F, Q.E.F. and M.T.M. elections were previously made at the entity level. This will change under the proposed regulations. When effective, they will require that each partner or S-Corporation shareholder make the election and notify the entity upon doing so. Purging elections are also to be done at the owner's level. Allowing the entity's individual owners to make the election puts decision-making in the hands of those who are ultimately affected by such elections. This aligns with the I.R.S.'s goal of consistency but is likely to greatly increase the volume of reporting and coordination between partners/shareholders and partnerships/S-Corporations. The problem is exacerbated for funds and their investors, as each investor wishing to make an election would have to file an election that the fund previously could have filed once for all of its investors. In a nod to administrability concerns, the I.R.S. is floating the idea of allowing partnerships and S-Corporations to also make Q.E.F. or M.T.M. elections. Additionally, the proposed regulations would maintain existing Q.E.F. or M.T.M. elections but conform to the new approach by treating the election as though it were made by the partners or S-Corporation shareholders. The objective is to mitigate the number of elections that will have to be made.

There are similar concerns over information reporting. Shareholders of a P.F.I.C. must file Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*. Currently, if a partnership or S-Corporation owns shares of stock in a P.F.I.C., the entity can file the form and relieve its owners of this obligation. This is similar to the requirements regarding Form 5471, discussed above. However, in comparison to Form 5471, the proposed regulations shift this duty to the partners or S-Corporation shareholders. The owners would receive the necessary information on the new Schedule K-3 prepared by the entity. As with the elections, aggregate treatment will result in massive growth in reporting obligations. With the number of forms growing, the likelihood of errors will increase exponentially, likely leading to the assessment of penalties for late or inaccurate filing.

As discussed above, the new Subpart F regulations mean that many partners or S-Corporation shareholders will no longer have Subpart F inclusions. As mentioned above, their relief might be fleeting. Under the C.F.C.-P.F.I.C. overlap rule, a U.S. person who holds shares in a company that is both a C.F.C. and a P.F.I.C. is not subject to P.F.I.C. rules while the person is a U.S. Shareholder of the C.F.C. But if C.F.C. status is eliminated, P.F.I.C. rules will apply in their place. Not surprisingly, the proposed regulations confirm that the overlap rule is analyzed at the level of the partner or shareholder.

## CONCLUSION

After adoption of the earlier G.I.L.T.I. regulations, it was no surprise that the I.R.S. extended aggregate treatment to Subpart F and P.F.I.C.'s. Consistency was the Service's stated goal. But this may lead to more onerous filing and reporting requirements for taxpayers. That result is likely to be confirmed when the I.R.S. publishes final P.F.I.C. regulations. Next on the I.R.S.'s aggregate-vs-entity agenda is previously taxed earnings and profits, which will be the subject of a new set of proposed regulations. In sum, not only will there be a long and bumpy transition to aggregate filing that will be accompanied by errors, compliance costs will skyrocket. Less-for-more truly is the mantra of our age.

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## Location

Architects and Designers Building | 150 East 58th Street, 22nd Floor | New York, New York 10155

## Contacts

If you have any questions regarding this publication, please contact the authors or one of the following members.



| | | |
|---|---|---|
| Galia Antebi | antebi@ruchelaw.com | +1 212.755.3333 x 113 |
| Andreas Apostolides | apostolides@ruchelaw.com | +1 212.755.3333 x 127 |
| Nina Krauthamer | krauthamer@ruchelaw.com | +1 212.755.3333 x 118 |
| Wooyoung Lee | lee@ruchelaw.com | +1 212.755.3333 x 121 |
| Michael Peggs | peggs@ruchelaw.com | +1 212.755.3333 x 232 |
| Simon H. Prisk | prisk@ruchelaw.com | +1 212.755.3333 x 114 |
| Neha Rastogi | rastogi@ruchelaw.com | +1 212.755.3333 x 131 |
| Stanley C. Ruchelman | ruchelman@ruchelaw.com | +1 212.755.3333 x 111 |



## Editorial Staff


Stanley C. Ruchelman .................. Editor in Chief

Claire Melchert .............................. Copyeditor

Francesca York ............................. Graphic Designer

WITH PHOTOS BY:

Galia Antebi, Jennifer Lapper, Simon Prisk, Stanley C. Ruchelman, and Francesca York.