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INSIGHTS

THE U.K. GROWTH PLAN 2022

LUXEMBOURG AMENDS LAW ON FINANCIAL COLLATERAL ARRANGEMENTS

TAX CASES AFFECTING REMOTE WORKERS AND THEIR EMPLOYERS

AND MORE

Insights Vol. 9 No. 5

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EDITORS' NOTE

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

- **The U.K. Growth Plan 2022.** Three weeks after Liz Truss became Prime Minister of the U.K., the Chancellor of the Exchequer, Kwasi Kwarteng, announced the new Government's Growth Plan. Billed as a "Mini Budget," it became a far greater set of announcements than expected. Among other items, tax rates are slashed at the corporate and individual levels, allowances for businesses are increased, and investment zone benefits enhanced. Kevin Offer, a Partner at Hardwick and Morris L.L.P., London summarizes the provisions.

- **Luxembourg Amends Law on Financial Collateral Arrangements.** Luxembourg is the second largest investment fund center in the world after the U.S. Assets under management exceed U.S. $5.0 trillion. This largely is due to the advanced investment fund legislation and favorable legal framework for investors regarding pledged collateral. Earlier this year, the law was amended to reflect current market concepts. To illustrate, an enforcement event is now defined as an event of default or any other event that triggers an enforcement action as agreed between the parties. If an enforcement event occurs and the collateral consists of financial instruments that are traded on an exchange or market, the holder of the pledgee may, without prior notice (i) assign or cause the pledged collateral to be assigned on that exchange or market or (ii) appropriate the pledged financial instruments or have them appropriated by a third party, at market price. Also, execution on the pledge can be instituted when and as the parties have agreed in the pledge. A final legal determination against the pledgor is no longer a prerequisite for execution against the collateral. These and other aspects of the amended law are explained by Anton Baturin and Graham Wilson, members of Wilson Associates L.L.C., an international business law firm in Luxembourg.

- **Tax Cases Affecting Remote Workers and Their Employers.** The legacy of the pandemic has demonstrated that an employee does not need to be in the office in order to work efficiently. Employees have adjusted to working remotely. In North America, remote working may mean a location in the suburbs surrounding the location of a business office, or perhaps a nearby state. In Europe, remote working may mean relocation to a different country. This raises questions for the employer regarding to the establishment of a P.E. in the country where the employee resides. Sunita Doobay, a partner of Blaney McMurtry, L.L.P., Toronto, discusses two recent tax rulings in Denmark and Spain and one tax case in Finland that address the issue. While all acknowledge that facts control the decision, tax administrations do not exercise judgement consistently.

- **Planning to Realize Capital Loss Upon Liquidation? Better Hurry Up As Change is in the Air.** In general, a corporation can set off losses recognized on the sale or exchange of capital assets when determining net capital gain that is subject to U.S. tax. Where the losses arise from a liquidation of a subsidiary, not all losses realized are available to offset gains. Those related to a liquidation covered by Code §331 provide a tax benefit, while liquidations involving a subsidiary defined in Code §332 provide no benefit. While the rule under Code §332 appears to be automatic, case law in the U.S. allows a corporation to restructure its investment in a subsidiary corporation in order to break the parent-subsidiary arrangement. In essence, the choice of which section applies is elective, simply by changing facts. Daniela Shani explains U.S. case law that provide favorable tax treatment, but cautions that the Biden Administration may intend to override case law with a legislative amendment in order to pay for proposed benefits.

- **Tax 101: U.S. Tax Compliance for Dual Citizen Young Adults.** It is not uncommon for a young adult who was born in the U.S. to noncitizen parents living temporarily in the U.S. to live abroad. Although he or she may never have returned to the U.S., the young individual is a U.S. citizen, and that status brings with it U.S. tax obligations. In their article, Nina Krauthamer, Wooyoung Lee, and Stanley C. Ruchelman address the tax obligations in the context of Ms. A, a typical young adult, born in the U.S., but living abroad. She may have a bank account in a foreign county, but ordinarily will not have her own source of income. At some point, Ms. A may receive gifts and bequests from her foreign parents or grandparents. At this point in her life, Ms. A's U.S. tax compliance obligations become complex. Just how complex is explained by the authors.

- **Medtronic Part Deux: The Best Method is Yet to Come?** Bad blood exists between the I.R.S. and Medtronic Inc. when it comes to transfer pricing matters. Regarding the tax years 2005 and 2006, the I.R.S. challenged a transfer pricing methodology it approved in an M.O.U. settlement with Medtronic involving the same transactions and issues in the context of an earlier year. The I.R.S. lost in an earlier case, appealed to the 8th Circuit Court of Appeals, which sent the matter back to the Tax Court to address several factual issues. In a recent decision, the Tax Court modified its earlier finding by adjusting the comparable uncontrolled transaction ("C.U.T.") in a subjective way to obtain a result that seemed to be fair in the view of the court. Michael Peggs suggests that the second trial did not produce practical guidance that was any better than the very limited guidance in the original decision.

- **Updates & Other Tidbits.** Two recent items of interest are addressed this month in Updates & Other Tidbits. The first is *Franklin v. U.S.,* where the Fifth Circuit upheld the forfeiture of a U.S. passport in the context of a U.S. citizen who was seriously in tax debt to the I.R.S. Code §7345, allows the I.R.S. to effect the revocation of a U.S. citizen's passport where a taxpayer owes more than $50,000 in tax, penalties, and interest. The taxpayer argued that international travel is a fundamental right of citizenship that was violated by the I.R.S. when it triggered forfeiture of his passport. The court disagreed, holding that a citizen has a fundamental right to travel within the U.S., but not internationally. The second item is an I.R.S. announcement that information on bank account interest will be exchanged automatically with Turkey when a Form W-8BEN (*Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals)*) has been provided by the account holder and indicates that he or she is a resident of that country. Wooyoung Lee addresses the case, explains the I.R.S. announcement, and lists all countries that receive information concerning interest received from U.S. bank accounts.

We hope you enjoy this issue.

- The Editors

THE U.K. GROWTH PLAN 2022

Author
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Tags
Additional Rate of Income Tax
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C.S.O.P.
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O.T.S.
S.E.I.S.
S.D.L.T.
Tax on Dividend

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INTRODUCTION

A mere three weeks after Liz Truss became Prime Minister of the U.K., the Chancellor of the Exchequer, Kwasi Kwarteng, stood up on the morning of September 23, 2022 to announce the new Government's Growth Plan. Billed as a "Mini Budget," it became a far greater set of announcements than expected, and even caused gasps of shock among the M.P.'s within the Conservative Party. The announcements amount to £45 billion of tax cuts resulting in the biggest such package since 1972, larger than the cuts announced by Nigel Lawson in 1988. These cuts follow on from the announcement for help with energy bills for two years which are budgeted to cost £60 billion in the next six months. All of these cuts and costs are to be financed initially by borrowing and are intended to stimulate economic growth leading to higher tax collections.

With such large tax cuts announced and further reforms promised, it was perhaps surprising that the Chancellor announced that he will close the Office of Tax Simplification ("O.T.S."). The O.T.S. is an independent adviser to the government and answerable to the Treasury. It was created to provide the Chancellor with advice on tax reforms that principally would assist individuals and small businesses. However, Kwasi Kwarteng said he wanted to "mainstream" the O.T.S.'s work across the Treasury and H.M.R.C. He went on to say

> [F]or the tax system to favour growth, it needs to be much simpler * * * instead of a single arm's-length body which is separate from the Treasury and H.M.R.C., we need to embed tax simplification into the heart of government.

Some may argue that an independent adviser would assist the Chancellor, but it seems that, with the abolition of the O.T.S. and the announcements made without any report from the Office for Budget Responsibility, outside influence is not something Liz Truss and her cabinet will be seeking.

The various tax changes are summarized below.

U.K. CORPORATION TAX

The main rate of corporation tax will not increase to 25% in April 2023 as originally planned and will remain at 19%. This reverses one of the announcements made by the previous Chancellor, Rishi Sunak, in 2021. The tax rate that will apply to profits caught under the diverted profits tax legislation will remain at 25%, maintaining the 6% differential with the main corporation tax rate. The previously announced increase in the diverted profits tax rate to 31% is also, therefore, cancelled.

The corporation tax surcharge that is applied to banking profits will also remain unchanged at 8%. This will mean a combined rate of tax on profits paid by banks and building societies of 27%. However, the level at which the bank surcharge takes effect will be increased to £100 million.

As the next Finance Bill Is likely to be in July 2023, the changes are expected to be introduced provisionally through the Provisional Collection of Taxes Act 1968.

ALLOWANCES FOR BUSINESSES

The Annual Investment Allowance ("A.I.A.") provides a 100% deduction in relation to qualifying expenditure on plant and machinery. This was temporarily increased to £1 million and was planned to be reduced to £200,000 from April 1, 2023. The temporary increase in the limit will now be permanent.

Making the A.I.A. increase permanent will allow businesses to plan expenditure more efficiently by preventing the rate of A.I.A. from affecting the timing of investment. The permanent increase will also assist those businesses investing heavily over a number of years.

Due to the elimination of the planned increase in Corporation Tax that was scheduled to be effective from April 1, 2023, the government announced that some amendments will be made to the enhanced allowances available to businesses, commonly known as the "super-deduction." The amendments will ensure that enhanced relief will operate as originally intended. No details have been provided on these amendments, but announcements worded in this way usually lead to the introduction of anti-avoidance provisions to counteract perceived abuse.

INVESTMENT ZONES

The Chancellor announced that investment zones would be created as quickly as possible. Businesses within investment zones will be able to benefit for a period of ten years from tax and other reliefs including

- 100% first year enhanced capital allowance relief for plant and machinery used within designated areas;
- accelerated Enhanced Structures and Buildings Allowance relief of 20% per year;
- 100% relief from business rates on newly occupied business premises and some existing businesses expanding into an Investment Zone;
- no stamp duty land tax on newly occupied commercial land and buildings and for land or buildings for new residential development;
- a zero rate for Employer National Insurance contributions for new employees working in the zone for at least 60% of their time, restricted to earnings up to £50,270 per year; and
- reduced regulation over planning applications.

ENTERPRISE INCENTIVES

A number of measures will be brought with effect from April 6, 2023, to help businesses raise investment capital and attract talent.

C.S.O.P.

A Company Share Option Plan ("C.S.O.P.") allows companies to grant options to employees in a tax efficient way. Companies can currently grant qualifying C.S.O.P. options over shares worth up to £30,000 to each eligible employee. This limit will be doubled to £60,000 from April 2023. As the limit has not been increased since the introduction of C.S.O.P.'s in 1995 this increase has been long-overdue and should help companies looking to incentivise employees.

In addition to the increase in the limit, the government has announced that some conditions that attach to the options will be removed from April 6, 2023.

S.E.I.S.

Seed Enterprise Investment Schemes ("S.E.I.S.") allow companies to raise up to £150,000 by way of an issue of shares that provide income tax relief to investors of up to 30% of the amount invested and the possibility to roll over capital gains up to the amount of the investment. This limit will be increased to £250,000 to allow qualifying companies to increase the amount that can be raised. There is also an annual limit on how much an individual can invest in S.E.I.S. shares. This limit has also been doubled to £200,000.

Currently, only companies with gross assets below £200,000 at the date of investment can raise funds under S.E.I.S. This limit will be increased to £350,000.

The two-year qualifying rule limiting the benefit to companies that have been trading for not more than two years will be increased to three years.

PERSONAL TAX CUTS

The Chancellor announced a number of cuts to personal tax rates:

- **Basic Rate of Income Tax.** The basic rate of income tax that applies to taxable income from £12,571 to £50,270 will be reduced from 20% to 19% with effect from April 6, 2023. This brings forward by one year the announcement made by the previous Chancellor. To avoid an impact on charities who benefit from the Gift Aid tax rebates, the reduction of the basic rate to 19% will be phased in over a four-year period to support charities.

- **Additional Rate of Income Tax.** The additional rate of income tax – meaning the top rate – currently applies to income of more than £150,000 per year. This top rate of tax would be abolished with effect from April 6, 2023. In addition, an allowance against savings income of £500 with be extended to top rate taxpayers.

- **Tax on Dividends.** The 1.25% increase in tax rates applying to dividend income that came into effect from April 6, 2022 will also be reversed from April 6, 2023.

The reversal of the increase in dividend tax rates, together with the abolition of the additional rate, creates an opportunity for tax planning. A dividend received by an individual with total gross income exceeding £150,000 will pay 6.85% less tax if the dividend is received after April 5, 2023. For these individuals, a brief deferral of dividends is beneficial. An individual making a contribution to a U.K. pension fund will receive tax relief at a rate of 45% if the contribution is made not later than April 5, 2023. A contribution after that date will receive tax relief of 40%. An acceleration of pension fund contributions will provide a greater immediate tax benefit.

The full detail of the changes are yet to be known and careful planning will be required to ensure no anti-avoidance measures apply.

NATIONAL INSURANCE

The Chancellor confirmed the reversal of the 1.25% increase in National Insurance (social security) contributions with effect from November 6, 2022 which had been announced a couple of days earlier. This was a temporary measure for the current tax year before it was replaced with the Health & Social Care Levy from April 6, 2023, which also has been reversed.

This is the third change in National Insurance this year and will present another challenge for payroll processors as employees look to see the reduction in their pay packets.

Individuals who are self-employed pay National Insurance with their income tax payments so will see a change in the rates they pay for the current tax year to 9.73% and 2.73%.

Employers will also benefit from the same reduction in employers' contributions. An employer may therefore wish to consider delaying bonuses or pay rises until after November 6 to reduce the cost to the business and increase net pay for employees.

Employers are also liable to pay National Insurance contributions on certain benefits provided to employees. For the current tax year only, a new rate of 14.53% is to be introduced to allow for the change in rates. This new rate will also apply to any Settlement Agreements.

"The obligation for determining whether I.R. 35 will apply will therefore revert back to the individual contractor."

OFF-PAYROLL WORKING

The off-payroll working rules known as "I.R. 35" have been the source of a number of problems for contractors who have been caught by (i) a general lack of understanding of how the rules are applied and (ii) pressure from customers and some advisers. The rules apply where services are provided by an individual through a personal service company ("P.S.C."). In such circumstances, tax and National Insurance apply to the payments to the P.S.C. if the engagement was more in the nature of an employment rather than self-employment. This was a measure to counteract widespread noncompliance, as the responsibility for determining whether I.R. 35 applies was moved to the end-client in almost all cases. The client paying the P.S.C. is required to operate P.A.Y.E. and N.I.C.

The Chancellor announced the I.R. 35 position will be reversed from April 2023. The obligation for determining whether I.R. 35 will apply will therefore revert back to the individual contractor. While a large number of people are celebrating the abolition of I.R. 35 in the press and social media, I.R. 35 this the benefit of the rules change will extend only to the end-client. The rules remain in place for the P.W.C., and H.M.R.C. can be expected to apply the I.R. 35 rules where appropriate. It is easy to see that H.M.R.C. may challenge any contractor who currently suffers deductions from payments made by their customers, it the contractor fails to collect P.A.Y.E. and N.I.C. from April next year.

Even though responsibility for determining whether I.R. 35 applies will rest with the contractor, the customer should not forget the impact of the Criminal Finances Act 2017. This act introduced a corporate criminal offence for failing to prevent the facilitation of tax evasion by an employee or associate. A contractor providing services for or on behalf of the end customer falls within the definition of an associate. Consequently, it will be important for a business to have procedures in place to ensure that its contractors are complying with their tax obligations. Failure to do so may lead to an unlimited fine and a public record of conviction.

BANKERS' BONUSES

The Chancellor made much of the announcement to abolish E.U. rules that limit bonuses for senior bankers to 100% of their fixed pay, or 200% with shareholder approval. The government are of the view that eliminating the ceiling on bonuses will encourage talent to move to the U.K., by effectively remove the bank's obligation to pay higher base salaries.

STAMP DUTY LAND TAX

Stamp Duty Land Tax ("S.D.L.T.") applies on the purchase of real estate in the U.K. In a bid to encourage home ownership and residential home-building. The S.D.L.T. threshold for purchases of residential property in England and Northern Ireland has been increased to £250,000 for all buyers, and to £425,000 for first-time buyers. The threshold for the value of properties qualifying for the enhanced nil rate band for first-time buyers will be increased to £625,000. These measures came into effect from September 23, 2022. The measures do not apply in Scotland or Wales which have their own land transfer taxes.

The higher rates that apply to purchases of additional properties and purchases by non-residents remain unchanged.

TAX FEE SHOPPING

A V.A.T.-free shopping scheme will be introduced for tourists and other non-U.K. visitors to the U.K. This will allow a V.A.T. refund on goods bought in and then exported from the U.K. in personal baggage. The scheme will, effectively, replace a previous scheme which provided V.A.T. refunds to non-E.U. tourists. That scheme ceased once the U.K. left the European Union.

ALCOHOL DUTIES

Lastly, the new alcohol duty rules are to be deferred to allow businesses more time to make arrangements. In addition, some of the rules have been simplified. These measures will be welcomed by suppliers and customers.

CONCLUSIONS

It seems clear that the Government are keen to pursue a trickle-down approach with the biggest tax cuts going to large businesses and wealthy individuals. Whether those who benefit most will pass down those benefits through increased spending, investing, and employing, remains to be seen. What is clear, however, is that the markets, public, and analysts have largely responded negatively to the announcements. The prospect has been raised of sterling dropping to parity with the US dollar which may come during the Conservative Party's annual conference.

"It is known that Liz Truss is a great admirer of Margaret Thatcher and sees these policies as a return to Thatcherism."

It is known that Liz Truss is a great admirer of Margaret Thatcher and sees these policies as a return to Thatcherism. However, Margaret Thatcher did raise taxes initially and only made cuts when it was perceived the economy was in good shape. That would not seem the case at present with Liz Truss and her Chancellor funding the announcements through borrowing. With interest rates increasing that may prove to be unsustainable with much of the benefit received by the majority being more than wiped out by rising prices and interest payments. The growth plan would therefore seem to be a gamble and only time will tell whether it was work the risk.

LUXEMBOURG AMENDS LAW ON FINANCIAL COLLATERAL ARRANGEMENTS

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INTRODUCTION

Luxembourg is the second largest investment fund center in the world after the U.S. Assets under management ("A.U.M.") in Luxembourg exceed U.S. $5.0 trillion. Luxembourg's success as a financial center largely is due to its advanced investment fund legislation and the legal framework in respect of financial transactions and collateral arrangements. The relevant legislation is the Collateral Arrangements Law of August 5, 2005 ("the Collateral Arrangements Law"). Earlier this year, it was amended by the law of July 20, 2025 ("the Amendment") intended to update the Collateral Arrangements Law to reflect current developments in market practices. This article explains the changes made by the Amendment.

DIRECTIVE 2002/47/EC

The Collateral Arrangements Law was initially adopted in Luxembourg to transpose Directive 2002/47/EC of the European Parliament and of the Council of June 6, 2002 ("Directive"). The aim of the Directive was to create a harmonized E.U.-wide legal framework for the receipt and enforcement of financial collateral typically provided by a borrower to support a financial transaction, whether the borrowing reflected customary banking and lending or more complex structured products trading).In this way, it would provide additional security to lenders, reduce credit losses, and encourage cross-border business within the E.U. The importance of the Directive can hardly be overestimated in times of financial crises.

The Directive set the framework for cross-border use of financial collateral. It abolished formal requirements to register the collateral, and in their place, provided minimum evidentiary requirements, such as a written pledge. This enabled enforcement of a pledge by sale or appropriation of the pledged collateral outside of insolvency proceedings. This gave the holder of the financial collateral an easier path to ensure satisfaction of the underlying obligation. In addition, the Directive required Member States to recognize close-out netting arrangements. In sum, the Directive provided contractual flexibility and legal certainty to the parties.

In comparison to E.U. Regulations, E.U. Directives do not have a direct binding effect in the E.U. Member States. They are pieces of legislation that set out goals that all E.U. countries must achieve. It is up to the individual Member States to adopt their own laws to reach these goals. The Directive provided Member States with a broad range of options regarding implementation and allowed Member States to adapt the Directive to local legal frameworks.

THE COLLATERAL ARRANGEMENTS LAW

The Collateral Arrangements Law, as further amended, is a perfect example of how the Luxembourg parliament created a competitive market within the E.U. by transposing a Directive to provide a flexible framework for the enforcement of claims against pledged collateral posted by borrowers. To illustrate, the terms for the provision of a collateral can allow for control arrangements, not only possession. Collateral substitution not prejudicing security interest is also possible.

The main pillars of the legal framework created by the Collateral Arrangements Law are as follows:

- **No registration formalities.** Financial collateral arrangements and netting agreements are recognized commercial transactions not requiring any registration. Evidence of the arrangement in writing or by any other legally equivalent manner is considered sufficient for the collateral to be valid.
- **Control arrangements.** The provision of collateral will be recognized if it is delivered, transferred, held, registered, or otherwise designated to be in the possession or under the control of the collateral taker or of a person acting on its behalf.
- **Security trustee.** The Collateral Arrangements Law expressly recognizes that a security arrangement exists by allowing the provision of the collateral to be in favor of a person acting for the account of the beneficiaries of the collateral, a fiduciary, or a trustee. Usually, it is assumed that the creditor also received the collateral and acts as the pledgee. The Collateral Arrangements Law specifically allows for the collateral to be held by a fiduciary or a security trustee without any need of parallel debt arrangements with the collateral agent.
- **Enforcement of pledge without prior notice.** In the event of a triggering default, the pledgee may enforce the pledge without prior notice, unless otherwise provided.
- **Range of enforcement procedures.** The main procedures are (i) out-of-court appropriation at the price determined by the valuation method agreed between the parties (normally, an independent auditor is appointed for this purpose) and (ii) a private sale to a third party in a commercially reasonable manner. Other methods include public auction under simplified procedures discussed below and court order. Specific rules apply to publicly traded financial instruments and insurance contracts, also discussed below.
- **No effect of insolvency.** Provisions of Luxembourg or foreign law governing reorganization measures, winding-up procedures, attachments, liquidations, or similar procedures do not constitute an obstacle to the enforcement and performance of pledge agreements.

THE AMENDMENT

The Amendment leaves the main provisions remain intact, but several important revisions:

- It confirms the contractual flexibility of the parties and the possibility to enforce a collateral arrangement, even if the secured obligation has not become due and payable.
- It updates and modernizes enforcement procedures.
- It introduces a new public auction regime for the enforcement of the financial collateral arrangement.

These amendments aim to strengthen Luxembourg as a creditor-friendly jurisdiction that provides flexibility for structuring financial transactions.

ENFORCEMENT EVENT

“These amendments aim to strengthen Luxembourg as a creditor-friendly jurisdiction that provides flexibility for structuring financial transactions.”

The definition of the “enforcement event” in the Collateral Arrangements Law did not clearly address whether a financial collateral arrangement could be enforced only when the secured obligation becomes due. The Amendment clarifies the definition of an enforcement event by providing that it is an event of default or any other event whatsoever as agreed between the parties that triggers an enforcement action. This affirms the concept of contractual freedom between the parties. They may agree that an enforcement event may occur even if the secured obligation has not become due and payable. Consequently, an enforcement event includes a breach of a financial covenant, warranty, or representation. Where the relevant financial obligations are not due at the time creditor action is taken, the proceeds will be applied to satisfy the relevant financial obligations, unless otherwise agreed.

INTRODUCTION OF CURRENT MARKET CONCEPTS

The Amendment replaces outdated references to a stock exchange with the term “trading venue,” including any regulated market, Multilateral Trading Facility (“M.T.F.”), or Organized Trading Facility (“O.T.F.”).

The Amendment provides that if an enforcement event occurs and the collateral consists of financial instruments admitted to trading, the pledgee may, without prior notice (i) assign or cause the pledged collateral to be assigned on a trading venue to which it is admitted to trading or (ii) appropriate the pledged financial instruments or have them appropriated by a third party, at market price (if such instruments are admitted to trading on a trading venue), unless otherwise provided for in the pledge. These enforcement methods complement other methods provided for in the Collateral Arrangements Law.

The definition of a “financial sector professional” as a recipient of title to collateral transferred on a fiduciary basis now includes any payment institution or any electronic money institution.

The introduction of modern concepts is a good example of how the legal framework has adapted to the fast-evolving market in order to follow current practices and I.T. development.

EXPANDED SCOPE OF COVERED COLLATERAL OVER UNITS AND SHARES OF (U.C.I.'S) AND INSURANCE CONTRACTS

The enforcement procedure has been modernized to reflect current practices. The Amendment confirms that an enforcement action may be taken units and shares of undertakings for collective investments ("U.C.I.'s") and insurance contracts serving as collateral.

The pledgee may appropriate the units or shares of a U.C.I. at the market price where such units and shares are admitted to trading or at the price of the last published net asset value ("N.A.V."), provided that the last publication of the N.A.V. does not exceed one year. Previously, an appropriation was possible only in cases where N.A.V. was published on a regular basis.

Also, the pledgee is now able to request the redemption of the pledged units or shares of a U.C.I. at the redemption price in accordance with the constituent documents of the U.C.I.

Finally, the Amendment expressly confirms the possibility for the pledgee to exercise all rights arising under the pledged insurance contract. Consequently, in the case of a life insurance contract or a capital redemption operation, the pledgee may exercise the right to surrender or request the insurance undertaking to pay any sums due pursuant to the insurance contract.

PUBLIC AUCTIONS

Under the Collateral Arrangements Law, public auctions were carried out at the Luxembourg Stock Exchange. The procedure was slow and inflexible. Now, a creditor may choose and appoint an auctioneer among bailiffs (*huissiers*) or notaries sworn in under the law of the Grand Duchy of Luxembourg. The auctioneer will determine the modalities and criteria of the auction procedure. This new regime is in line with the standard auction procedures in Luxembourg.

CONCLUSION

With the Amendment in place the Collateral Arrangements Law has been modernized to meet trading platforms of the 21st Century, adding to the attraction of Luxembourg as a preferred location for investment funds.

TAX CASES AFFECTING REMOTE WORKERS AND THEIR EMPLOYERS

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Tags
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Digital Nomad Visas
Fixed Place of Business
Home Office
Permanent Establishment
Product Information
Remote Worker

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INTRODUCTION

The legacy of the pandemic has demonstrated that an employee does not need to be in the office in order to work efficiently. Employees have adjusted to working remotely. In North America, remote working may mean a location in the suburbs surrounding the location of a business office, or perhaps a nearby state. In Europe, remote working may mean relocation to a different country. To illustrate, an article appearing in *The Guardian*[1] addresses how individuals have been encouraged to relocate to work remotely by the issuances of "digital nomad visas" offered by countries such as Croatia, Estonia, Iceland, and Greece. These visas typically require the applicant to meet minimum income levels, while others may require a minimum level of cash in the bank, as well.

While these programs focus on visa entitlement for foreign programmers and digital engineers, they do not always address the risk of tax for a foreign employer when the individual works exclusively for one company or one group of companies. An employer needs to be aware of the jurisdiction in which each of its remote employees is situated to ensure that the presence of the employee and the activity conducted in the country does not trigger a permanent establishment ("P.E.") for the employer and resulting income tax exposure.

This article addresses several recent cases in Europe and pronouncements by the Canada Revenue Agency ("C.R.A.") in Canada.

DENMARK

In Denmark, the *Skatterådet*, or Tax Council, of the *Skattestyrelsen*, or the Danish Tax Agency, issues binding rulings on tax matters of general public importance. On April 26, 2022, the *Skatterådet*, ruled that the presence of a remote employee of *Spörger*, a German company, resulted in the establishment of a P.E. in Denmark, thereby subjecting *Spörger* to Danish tax on the profits attributable to the P.E.[2]

The facts in the ruling were as follows. *Spörger* employed a sales employee who resided in Denmark (the "Employee") and who did not wish to move to Germany. The Employee was employed as an area sales manager and tasked to handle certain sales in relation to Africa, Belgium, Germany, the Netherlands, the Baltics and the Nordics. *Spörger* did not obtain any commercial advantage from the Employee

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1 Burgen, Stephen. "Spain Plans 'Digital Nomad' Visa Scheme to Attract Remote Workers." *The Guardian*. Guardian News and Media, September 25, 2022.

2 SKM number SKM2022.250.SR. related to case number 21-0722131, reported here.

performing tasks from Denmark—the Employee's performance of work from Denmark was solely due to personal circumstances.

The Employee reported to *Spörger* management Germany. Denmark had a modest demand for *Spörger* products. To illustrate, the turnover on the Danish market for each of the years in the period 2019-2020, was between 0.05% and 0.16% of *Spørger's* total annual turnover. The Employee's work did not include contact with Danish customers, but only contact with Danish dealers and other business partners. However, where the sale of products took place through individual orders, the Employee could confirm orders from customers where the selling price was within a determined price range.

Regarding the Employee's place of work, § 2(1) of the employment contract stated: "The employee's place of work is with the customers and at his private address (home workplace)." The tasks assigned to the employee involved significant travel outside of Denmark and was estimated to have constituted between 50% to 60% of his total working time for the company. When the Employee was not travelling, the Employee's activities on behalf of *Spörger* was carried out from his residence in Denmark. The Employee's work that related to sales into the Danish market constituted a maximum of 5% of the Employee's total work effort.

The *Skatterådet* looked to the definition of a P.E. in the income tax treaty between Denmark and Germany ("DG Treaty") to rule that a P.E. of *Spörger* existed in Den-mark.

Paragraph 1 of Article 5 (Permanent Establishment) defines a P.E. to be "a fixed place of business through which a company's business is wholly or partly carried on." The provision is standard and the *Skatterådet* explained the three conditions for a fixed place of business to exist:

- There must be a place of business, which covers all premises, fittings or installations that are actually used to carry out the company's business.
- The place of business must be fixed, which means that a connection is required between the place of business and a specific geographical location, and must not be of a temporary nature.
- The foreign enterprise must wholly or partially carry on its business through the fixed place of business.

Even if all three conditions are met, a P.E. will not exist if he activity carried out could be characterized as being of a preparatory or auxiliary nature. See paragraph 4(e) of Article 5 of the DG Treaty.

In determining that a P.E. existed, the *Skatterådet* determined that *Spörger* gained an advantage from the work being carried out in Denmark. The activity that was carried on by the employee from his home in Denmark constituted a surrogate for activity that would have been carried in an office in Denmark. It did not matter that the Employee's work related to the Danish market constituted not more than 5% of his annual time at work when 40-50% of his time at work for each year was carried out from Denmark. The important factors were as follows:

- The Employee had access to his own workspace at his place of residence in Denmark, making his residence a place of business.

- The Employee’s employment was not time limited.
- The Employee’s work for *Spörger* was continuous and of a long-term nature.

The Employee was tasked with developing and building relationships with dealers in Africa, Belgium, Germany, the Netherlands, the Baltics and the Nordic countries. The Nordic market includes Denmark. Hence, the location of the Employee in Denmark apparently had value for *Spörger*, because Denmark near the Spörger’s customers. The work in Denmark is thus not only due to private circumstances.

The tasks the Employee performed from home in Denmark were closely related to the sales activities in connection with customer visits in Denmark and abroad, and was part of the company’s core activity. This was also evidenced by the Employee’s title as area sales manager. This indicated that the employee’s work was of a significant nature, and included more than tasks of a preparatory or auxiliary nature.

FINLAND

On December 3, 2021, the Finnish Supreme Administrative Court held that the activities of three employees of a Swedish company who carried on product promotion activity in Finland did not constitute a P.E. under the income tax treaty in effect among the Nordic countries.[3]

The Swedish company, C AB (the “Company”) was part of an Australian group, which researched, manufactured, marketed and sold biopharmaceutical products. The Company was responsible, among other things, for product sales and marketing in the Nordic countries and maintained three employees in Finland (the “Finland Employees”). The Finland Employees were tasked with presenting the company’s products to doctors and other medical experts in Finland. The Finland Employees did not have the right to take legal action on behalf of the company, receive orders, or negotiate the sales price specified for the company’s products or other contract terms. The company did not have offices in Finland. Rather, the Finland Employees worked from their homes.

The *Verohallinto*, the Finnish Tax Administration, contended that the activity of the three employees in Finland constituted a P.E. of the Company. In the view of the *Verohallinto*, the activity of the three employees in Finland was tied to the sales activity carried on in Sweden. A deficiency it tax was asserted, and the deficiency was affirmed by a lower-level administrative court. That determination was reversed by the Supreme Administrative Court.

The Supreme Administrative Court established that, to evaluate whether an activity is auxiliary or preparatory in nature, attention should be focused on the kind of activity that is practiced in Finland. Activities that are part of the Company’s core business cannot be considered auxiliary or preparatory. Core business activities are considered to be activities that form a significant and determining part of the Company’s business. In the facts presented, the three employees were not involved in sales. Consequently, the Company cannot be considered to have a fixed place of business in Finland. The activity of visiting doctors and other medical experts to build product awareness are preparatory in nature. The Company’s core business is not product presentation and the facts do not show that the product presentation

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[3] ECLI identifier: ECLI:FI:KHO:2021:171. Reported unofficially here.

accrued income directly in Finland. The Company's activities in Finland support the operations of the main facility in Sweden.

SPAIN

In January of 2022, the Spanish Tax Authorities ("STA") held that the presence of an employee of a U.K.-based company was insufficient to establish a permanent establishment for the company and that the employee was not a dependent agent of the employee.

The consultant (the "Employer") resided in the U.K. and employed an English national (the "Employee"). Prior to COVID-19, the Employee was based in London, where he materially participated in activity that generated profits for the business and participated in top management. The Employee was not granted the authority to sign contracts in the name of the Employer or on behalf of the employer. Nor did he ever sign contracts even in the absence of authority.

The Employee owned a house in Spain, where he spent weekends and holidays. The Employee was in Spain in March 2020 when the COVID-19 lockdown in place was announced. When travel restrictions eased, the Employee remained in Spain for personal reasons. Because he was physically present in Spain for more than 183 days during 2020, he became a Spanish resident.

During 2020, he continued to work for the Employer while living in Spain. The Employer did not bear any additional expenses in relation to accommodation nor did the Employer grant any remuneration for carrying out his work in Spain. By the end of 2020, the Employee requested a formal assignment to Spain, which was turned down. The Employee resigned in February 2021.

A ruling was requested by the Employer from the Spanish Tax Authority ("S.T.A.") the Employer did not maintain a P.E. in Spain in 2020 by reason of the presence or the activities of the Employee.

The S.T.A. considered two possibilities under which the Employer might have established a permanent establishment in Spain. One related to the existence of a fixed place of business in Spain from which business activity was carried out. The other related to the existence of a dependent agent in Spain having the power to bind the Employer. The S.T.A. ruled that no P.E. existed.[4]

Fixed Place of Business

The S.T.A. turned to the O.E.C.D. Secretariat Report, "Updated guidance on tax treaties and the impact of the COVID-19 pandemic,"[5] in particular to paragraphs 14 to 19 related to employees working in home offices.

> **Home office**
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> 14. Whilst noting that the issue of whether a PE exists is a test based on facts and circumstances, in general, a place must have a certain

[4] The ruling is Consultation number V00gg-22 issued by the State Secretary of Finance, General Directorate of Taxes, and is dated January 18, 2022. It appears here.

[5] Available here.

degree of permanency and be at the disposal of an enterprise in order for that place to be considered a fixed place of business through which the business of that enterprise is wholly or partly carried on.

15. Paragraph 18 of the Commentary on Article 5 of the OECD Model explains that even though part of the business of an enterprise may be carried on at a location such as an individual's home office, that should not lead to the conclusion that that location is at the disposal of that enterprise simply because that location is used by an individual (*e.g.* an employee) who works for the enterprise. The carrying on of intermittent business activities at the home of an employee does not make that home a place at the disposal of the enterprise. A home office may be a PE for an enterprise if it is used on a continuous basis for carrying on business of that enterprise and the enterprise generally has required the individual to use that location to carry on the enterprise's business.

16. During the COVID-19 pandemic, individuals who stay at home to work remotely are typically doing so as a result of public health measures: it is an extraordinary event not an enterprise's requirement. Therefore, considering the extraordinary nature of the COVID-19 pandemic, teleworking from home (*i.e.* the home office) because of an extraordinary event or public health measures imposed or recommended by government would not create a PE for the business/ employer, either because such activity lacks a sufficient degree of permanency or continuity or because the home office is not at the disposal of the enterprise. In addition, it still provides an office which in the absence of public health measures is available to the relevant employee. This applies whether the temporary work location is the individual's home or a temporary dwelling in a jurisdiction that is not their primary place of residence.

17. If an individual continues to work from home after the cessation of the public health measures imposed or recommended by government, the home office may be considered to have certain degree of permanence. However, that change alone will not necessarily result in the home office giving rise to a fixed place of business PE. A further examination of the facts and circumstances will be required to determine whether the home office is now at the disposal of the enterprise following this permanent change to the individual's working arrangements.

18. Paragraphs 18 and 19 of the Commentary on Article 5 of the OECD Model indicate that whether the individual is required by the enterprise to work from home or not is an important factor in this determination. Paragraph 18 explains that where a home office is used on a continuous basis for carrying on business activities for an enterprise and it is clear from the facts and circumstances that the enterprise has required the individual to use that location (*e.g.* by not providing an office to an employee in circumstances where the nature of the employment clearly requires an office), the home office may be considered to be at the disposal of the enterprise. As an

> example, paragraph 19 notes that where a cross-border worker performs most of their work from their home situated in one jurisdiction rather than from the office made available to them in the other jurisdiction, one should not consider that the home is at the disposal of the enterprise because the enterprise did not require that the home be used for its business activities.
>
> 19. In conclusion, individuals teleworking from home (*i.e.* the home office) as a public health measure imposed or recommended by at least one of the governments of the jurisdictions involved to prevent the spread of the COVID-19 virus would not create a fixed place of business PE for the business/employer.

On the basis of the above, the S.T.A. determined that in 2019, no P.E. existed. However, the Employee remained in Spain throughout 2020. Consequently, the S.T.A. examined whether the Employee's home became available to the Employer for the conduct of its business. Ultimately, the S.T.A. ruled that the Employee's residence was not made available to the Employer as a place of business, based on the following facts:

- The Employee decided unilaterally to continue in Spain.
- The Employer maintained a place available to the Employee in the U.K. where the Employee could carry his work on a face-to-face basis with colleagues in the U.K.
- The Employer did not bear any expenses of the premises in Spain, nor did the Employee receive special pay to carry out work from in Spain; in other words, the Employee never received customary expat stipends.

"Ultimately, the S.T.A. ruled that the Employee's residence was not made available to the Employer as a place of business. . ."

Dependent Agent

The S.T.A. concluded that during the months that the public health measure lasted, factors listed in paragraphs 20 and 21 of the O.E.C.D. updated guidance suggested that the Employee did not "habitually" conclude contracts on behalf of the Employer.

> 21. An employee's or agent's activity in a jurisdiction is unlikely to be regarded as habitual if they are only working at home in that jurisdiction because of an extraordinary event or public health measures imposed or recommended by government. Paragraph 6 of the 2014 Commentary on Article 5 explains that a PE should be considered to exist only where the relevant activities have a certain degree of permanency and are not purely temporary or transitory. Paragraph 33.1 of the Commentary on Article 5 of the 2014 OECD Model provides that the requirement that an agent must "habitually" exercise an authority to conclude contracts means that the presence which an enterprise maintains in a jurisdiction should be more than merely transitory if the enterprise is to be regarded as maintaining a PE, and thus a taxable presence, in that jurisdiction. Similarly, paragraph 98 of the 2017 OECD Commentary on Article 5 explains that the presence which an enterprise maintains in a jurisdiction should be more than merely transitory if the enterprise is to be regarded as maintaining a PE in that jurisdiction under Article 5(5).

22. A different approach may be appropriate, however, if the employee was habitually concluding contracts on behalf of enterprise in their home jurisdiction before the COVID-19 pandemic.

Although the Employee had been in Spain for more than six months in 2020, the data provided was not conclusive on whether the activities carried out by the Employee could be identified as activities of an agent, since it was not indicated that they acted as such. Consequently, the exceptional and temporary change of place where the Employee carried out his employment due to the COVID-19 pandemic did not create a new permanent establishment for the Employer. In reaching its decision, the S.T.A. pointed out that, in last analysis, the existence of a dependent agent who habitually exercises an authority to conclude contracts is a question of fact. If other facts existed, the answer might be different.

CANADA

In Canada, a nonresident is deemed to carry on a Canadian business where the nonresident solicits orders or offers anything for sale in Canada through an agent or servant, whether the contract or transaction is to be completed inside or outside of Canada or partly in or partly outside of Canada.[6] The rule is statutory, and overrides common law decisions reaching an opposite conclusion that no trade or business is carried if no contract is concluded in Canada.

Article 12(1) of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* ("the M.L.I.")[7] adopts the policy of the Canadian statutory rule. It provides as follows:

Article 12 – Artificial Avoidance of Permanent Establishment Status through Commissionnaire Arrangements and Similar Strategies

1. Notwithstanding the provisions of a Covered Tax Agreement that define the term "permanent establishment", but subject to paragraph 2, where a person is acting in a Contracting Jurisdiction to a Covered Tax Agreement on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are:

    a. in the name of the enterprise; or

    b. for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use; or

    c. for the provision of services by that enterprise,

    that enterprise shall be deemed to have a permanent establishment in that Contracting Jurisdiction in respect of any activities which that

[6] Subsection 253(b) of the Income Tax Act.

[7] Available here.

person undertakes for the enterprise unless these activities, if they were exercised by the enterprise through a fixed place of business of that enterprise situated in that Contracting Jurisdiction, would not cause that fixed place of business to be deemed to constitute a permanent establishment under the definition of permanent establishment included in the Covered Tax Agreement (as it may be modified by this Convention).

2. Paragraph 1 shall not apply where the person acting in a Contracting Jurisdiction to a Covered Tax Agreement on behalf of an enterprise of the other Contracting Jurisdiction carries on business in the first-mentioned Contracting Jurisdiction as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.

Canada surprisingly has opted out of Article 12 of the M.L.I. entirely and has also opted out entirely of Article 13, which targets commissionaire arrangements, Article 14, which targets the splitting up of contracts, and Article 15, which targets independent agents acting almost exclusively for one or more enterprises to which the agent is closely related.

Canada's tax treaties are based on the O.E.C.D. Model Tax Convention on Income and on Capital and provide that a permanent establishment will not be created where the activities of an employee are merely preparatory or auxiliary.

In 2006, the Canada Revenue Agency released Ruling 2006-0173601R3.[8] In the ruling, a foreign bank requested a determination on whether it would be deemed to have a permanent establishment in Canada in the following fact pattern:

- It would maintain a staff of three Canadian resident employees.
- The employees would work in a rented office.
- The purpose of the office would be to promote the Foreign Bank's services to selected Canadian industries and potential Canadian customers, to support the Foreign Bank's customers in Canada, and to liaise with the Foreign Bank head office in the Foreign Treaty Country.
- The Canadian resident employees would have no authority to conclude contracts on behalf of the Foreign Bank relating to its core business operations.
- All services offered by the Foreign Bank to Canadian customers such as traditional financings, term loans, participation in syndicated financings and mezzanine financings would be carried on through offices of the Foreign Bank outside of Canada.

The C.R.A. concluded that the Canadian employees did not generate a permanent establishment for the Foreign Bank because the Canadian employees' activities

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8 The ruling appears here.

were considered to be activities of a preparatory or auxiliary character for the purposes of the Treaty.

In *Knights of Columbus v. The Queen*,[9] the Tax Court of Canada held that the field agents' premises in Canada did not constitute a permanent establishment for the Knights of Columbus, a U.S. corporation. The Court rejected the Minister of National Revenue's assertion that even though the agents were present in Canada, their homes constituted a fixed place of business for the Knights of Columbus.[10] The houses were not available at the disposal of the Knights of Columbus.

While the case remains good law as to its facts, a different conclusion might be reached in different facts. The Knights of Columbus might be viewed as having the agents' premises at its disposal, for example, if the Knights of Columbus paid for all expenses in connection with the premises, required that the agents have a room in the house maintained exclusively as a home office containing specific office equipment and sufficient size to meet with clients. In such circumstances the premises might be viewed as being at the disposal of the Knights of Columbus even if it did not hold a key to the home of its field agents.

"While the case remains good law as to its facts, a different conclusion might be reached in different facts."

[9] 2008 TCC 307.

[10] See paragraph 78 of the opinion.

PLANNING TO REALIZE CAPITAL LOSS UPON LIQUIDATION? BETTER HURRY UP AS CHANGE IS IN THE AIR

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Tags
Capital Loss
Complete Liquidation
Granite Trust
Section 331
Section 332
Section 351

INTRODUCTION

Incurring economic losses is rarely a good thing. On the other hand, harvesting a capital loss in the same tax period an unrelated capital gain is recognized has its advantages – the loss may be utilized as a deduction to reduce tax liability arising from the capital gain.[1] While this statement is generally true for all types of losses, this article will focus on capital losses incurred by a corporation from the divestiture of subsidiary stock.

In general, a corporation can deduct losses recognized on the sale or exchange of capital assets.[2] Those losses may be used only to reduce capital gains such as those recognized from the sale of subsidiary stock.[3] Consequently, a corporation that suffers a book loss due to a drop in the value of subsidiary stock may recognize the loss by selling the shares of the subsidiary. Where the sale of the subsidiary is not possible because of the absence of a buyer, the shareholder may realize the loss pursuant to the complete liquidation of the subsidiary where the tax consequences of the liquidation are governed by Code §331.

Regrettably, not every liquidation has its tax consequences governed by Code §331. Where 80% or more of the stock of the liquidating corporation is owned by a single corporate shareholder, the tax consequences of a complete liquidation are governed by Code §332. Under Code §332, no gain or loss is recognized in connection with the complete liquidation of the subsidiary. However, corporate shareholders have been taking the position that certain steps may be taken to intentionally shut down Code §332 and bring back Code §331 into play.

Over the years, courts have allowed intentional avoidance of Code §332, rejecting counter arguments by the I.R.S. However, legislation proposed in late 2021 suggests that Congress may now look to put an end to this planning opportunity in order to raise revenue.

THE ELECTIVE FEATURE OF CODE §332

Code §331 Liquidation or Code §332 Liquidation?

From a corporate law standpoint, a complete liquidation of a corporation usually involves winding down of the business of the liquidating corporation, making

1 Provided certain conditions are met. See Code §1211 and the regulations promulgated thereunder.

2 Code §1211(a).

3 Code §1221 allows the loss to offset the gain, provided the stock is not held by the taxpayer primarily for the sale in the ordinary course of trade or business.

payments to creditors, and distributing remaining assets to shareholders. From a tax perspective, however, the last step of a complete liquidation – the distribution of remaining assets – is not treated as an ordinary dividend distribution. Instead, Code §331 generally provides that the amounts received by a shareholder as part of a distribution that is part of a complete liquidation of a corporation is treated as full payment in exchange for the relinquishment of stock. In other words, Code §331 creates a fiction, under which the liquidation is treated as the transfer of the shares of the liquidating corporation by its shareholders to the liquidating corporation in exchange for the liquidating corporation's assets. An exchange of property (including shares) generally results in a recognition of gain or loss under Code §1001(c). Therefore, under Code §§331 and 1001, the deemed exchange of shares of the liquidating corporation triggers recognition of gain or loss.[4]

In contrast to Code §331, Code §332 provides that no gain or loss is recognized by a corporation that is a shareholder upon complete liquidation of a subsidiary, provided that certain conditions are met.[5] While this is a desirable outcome when a built-in gain exists in the shares, nonrecognition treatment produces an unfavorable result when a built-in loss exists in the shares. If no loss is recognized for tax purposes, no loss may be utilized to offset taxable capital gains.

Code §332 is not drafted as an elective provision. Therefore, a simple read of the section would suggest that a taxpayer is not entitled to choose whether the section applies. However, Code §332 applies to a liquidation only if several conditions are met. If any of the conditions are not met, Code §331 governs the tax treatment of the liquidation.

The first condition requires that 80% or more of the voting power and value of all shares of stock of the liquidating corporation must be owned by the corporate parent receiving the property. Moreover, the required level of ownership must exist at all times, beginning on the date of the adoption of the plan of liquidation until all property is received.[6] This 80% ownership requirement is in fact the differentiating factor between Code §332 and Code §331, since all the other conditions that apply to Code §332 apply also to Code §331.[7]

Since the 80%-ownership requirement can be controlled by a shareholder, a sole corporate parent can prevent Code §332 from applying by disposing enough shares of the liquidating subsidiary prior to the adoption of the plan of liquidation. Once there are at least two shareholders and the parent corporation holds less than 80% of the liquidating corporation, the two shareholders may adopt a plan of liquidation. That liquidation would be outside the realm of Code §332 and, instead, would trigger loss recognition under Code §331.[8]

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4 Note that gain or loss may be recognized by the shareholder upon the deemed sale of the subsidiary shares and potentially by the liquidating subsidiary upon the deemed sale of its property to the shareholder.

5 See Code §332(b) and the regulations promulgated thereunder for the conditions of Code §332(a).

6 Code §§332(b)(1) and 1504(a)(2).

7 The other conditions for Code §332 to apply are outside the scope of this article.

8 Provided the underlying conditions for Code §331 are met.

The Granite Trust Case

In *Granite Trust Co. v. U.S.*,[9] the I.R.S. was unsuccessful in challenging the effect of a disposition of shares in a wholly owned subsidiary immediately before the adoption of a plan of liquidation.

The taxpayer owned 100% of a subsidiary corporation. Over the course of several years, the value of the subsidiary's shares dropped significantly. Wishing to assure recognition of the loss on a purported liquidation of the subsidiary and to avoid nonrecognition treatment, the taxpayer sold or otherwise transferred enough shares to reduce its ownership in the subsidiary corporation to less than 80%. The transferee was a friendly party in relation to the taxpayer and was well aware of the subsidiary's situation and the taxpayer's intention to have the subsidiary liquidated. It is fair to say that the transferee acted as an accommodation party for the taxpayer, enabling the taxpayer to recognize a capital loss.

The I.R.S. challenged the application of the predecessor of Code §331. It argued that the sale of shares should be ignored in light of the step transaction doctrine. Under that doctrine, a series of transactions may be collapsed into mere steps of a single integrated transaction for income tax purposes because each individual step is meaningless or unnecessary to achieve the end-result.[10] Here, the I.R.S. argued that the end result was the complete liquidation of a wholly owned subsidiary of the taxpayer. The disposition of shares that preceded the adoption of the plan of liquidation had no purpose other than to move the governing tax law provision from the predecessor of Code §332 to the predecessor of Code §331. Consequently, it should be ignored. In addition, the I.R.S. argued that the sale should be ignored because it was transitory and meaningless, within the meaning of *Gregory v. Helvering*.[11]

The court rejected the I.R.S. challenge, finding that the taxpayer's loss was properly recognized. The court expressed the view that the rigid requirements of the predecessor of Code §332 suggested that it is not an "end-result provision" but rather one which prescribes specific conditions for the application of a nonrecognition provision of the Code. The Court relied on the decision in *Commr. v. Day & Zimmerman, Inc.*,[12] where a shareholder sold a sufficient number of shares to avoid the same nonrecognition provision. Despite the tax motive for the transaction, the sale was upheld as *bona fide*.[13]

In addition, the court reviewed the legislative history of Code §332 in 1954 to show that Congress was aware of the possibility that taxpayers could take preliminary steps to avoid the provision by reducing the stock ownership to less than 80%.[14]

9 238 F.2d 670 (1956).

10 See, for example, *King Enterprises, Inc. v. U.S.,* 418 F.2d 511, 516 (Cl. Ct. 1969).

11 293 U.S. 465 (1935).

12 151 F.2d 517 (3rd Cir., 1945).

13 In *Day & Zimmerman*, the Court found that there was no agreement between the seller and purchaser for the seller to retain any interest in the transferred stock.

14 In 1954, Code §112(b)(6) was reenacted as Code §332. According to the Report of the Senate Finance Committee (report No. 2543), Congress was aware of the 3rd Circuit's ruling in *Day & Zimmerman* and of the elective nature of Code §332 and did not change the provision to disallow it. It follows that Congress took into account that taxpayers may, by taking appropriate steps, render Code §332 inapplicable as they choose.

Nonetheless, no anti-abuse provision was adopted mandating the disregard of a sale that immediately preceded a liquidation. Therefore, the step transaction doctrine was found to be inapplicable in the context of a liquidation.

As to the second argument of the I.R.S., that the transferee's ownership was transitory, the court found the sale of shares to be genuine. The transferee acquired all the rights of a minority shareholder in the subsidiary. Provided the transaction was truly consummated as it was purported to be, the accompanying intent of the taxpayer to minimize taxes was irrelevant.

The Court's decision in *Granite Trust* effectively made Code §332 an elective provision in most circumstances.[15] Code §331 applies as long as the share transfer transaction provides the transferee with all the benefits and burdens of ownership.

The decision has been followed by several other circuit courts of appeal[16] and by the I.R.S.[17] With limited exception, Code §332 has been interpreted and implemented as an elective provision for many years. A parent corporation owning 80% or more of the shares of a subsidiary may decide to defer gain when liquidating a subsidiary that is profitable or recognize loss by disposing more than 20% of the shares in an unprofitable subsidiary prior to adopting a plan of liquidation.

A *GRANITE TRUST* TRANSACTION BETWEEN RELATED PARTIES

The Granite Trust Case Has Been Taken One Step Further

In *Granite Trust*, the taxpayer sold the shares in its subsidiary to an unrelated party. Even though the purchaser accommodated the taxpayer, it neither owned shares in the taxpayer or its affiliates, nor was owned by the taxpayer or affiliates. In the

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15 For example, where the transferee is a member of the same consolidated group – see further detail below.

16 See, for example, *Riggs, Inc. v. Commr.,* 64 T.C. 474, 489 (1975). See also *Avco Mfg Corp. v. Commr*., 25 T.C. 975 (1956); Note, however, that under certain circumstances the step transaction doctrine will be applied to treat the transaction as a liquidation of the subsidiary under §332. For example, in *Associated Wholesale Grocers, Inc. v. U.S.,* 927 F.2d 1517 (10th Cir. 1991), the court disallowed a claimed capital loss on the sale of a subsidiary's stock, in a cash merger of the subsidiary into an unrelated corporation, where the parent corporation used most of the proceeds of the merger to repurchase about 97% of the subsidiary's assets.

17 See, for example, Technical Tax Memorandum ("T.A.M.") 8428006; Field Service Advice ("F.S.A.") 200148004; The elective nature of Code §332 is also reflected in Rev. Rul. 75-521, where a 50% shareholder took preliminary steps to increase its stock ownership to 80% in order to achieve tax-free liquidation under Code §332. However, in 2014 the I.R.S. announced it will no longer issue private letter rulings ("P.L.R.'s") to taxpayers in connection with the intentional avoidance of Code §332. See Rev. Proc. 2014-3. Note that an I.R.S. written determination in the form of a P.L.R., a T.A.M. or an F.S.A. may not be cited as precedential authority by any person other than the taxpayer involved. Code §6110(k)(3). However, those determinations tend to demonstrate the view of the I.R.S. at the time issue and may be cited as authority for the limited purpose of avoiding certain penalties.

absence of a friendly third-party buyer, a transaction between the shareholder and a related party[18] may be considered.

As mentioned in n. 17, F.S.A. 200148004 concludes that a transfer to a related party immediately prior to a liquidation will be recognized as valid as long as it is a *bona fide* transfer reflecting a permanent realignment of ownership interests. Put differently, if the transferor has not retained any interest in the stock transferred and the transferee continues to hold the subsidiary's stock after the transfer has been completed, the I.R.S. will not disregard the transfer of shares.

The I.R.S. further provided in FSA 200148004 that, in lieu of actually liquidating the subsidiary, U.S. shareholders of an eligible entity[19] may instead elect to treat the entity as a partnership for U.S. Federal tax purposes. Under the Check-the-Box regulations, an eligible entity that has two or more members and is treated as an association taxable as a corporation may elect to be classified as a partnership for U.S. Federal tax purposes. As a result of making an election, the eligible entity is deemed to distribute all of its assets and liabilities to its shareholders in liquidation and immediately thereafter the shareholders are deemed to contribute all of the distributed assets and liabilities to a newly formed partnership.[20] Since an election made under the Check-the-Box Regulations is treated as a deemed liquidation, a taxpayer can trigger the recognition of a loss under Code §331 by making Check-the-Box election without having the subsidiary undergo an actual liquidation.

"As a result of making an election, the eligible entity is deemed to distribute all of its assets and liabilities to its shareholders in liquidation and immediately thereafter the shareholders are deemed to contribute all of the distributed assets and liabilities to a newly formed partnership."

As a technical matter, using a Check-the-Box election as an alternative to a Code §331 liquidation is available for subsidiaries that are eligible entities. In the domestic context, only L.L.C.'s and partnerships that previously elected to be treated as corporations for U.S. income tax purposes can make an "Uncheck-the-Box" election, and can do so only at times permitted by the regulations.[21] It is not available for an entity formed under the domestic corporation law of any state of the U.S. or the District of Columbia. In comparison, a Check-the-Box election can be used for foreign eligible entities that defaulted into association status because no member is personally liable for the obligations of the entity or that were partnerships or partnership-equivalent entities for U.S. income tax purposes that elected association status for U.S. tax purposes because at least one member is personally liable for the obligations of the entity.

Tax Implications to be Considered

Some important tax consequences should be considered when consummating a *Granite Trust* transaction between related parties:

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[18] The term "related party" is defined in Code §267(b). However, different definitions may apply for different purposes.

[19] An "eligible entity" is defined under Treas. Reg. §301.7701-3(a) as an entity that is not classified as a corporation under Treas. Reg. §301.7701-2(b), meaning that it does not include an association having two or more members.

[20] Treas. Reg. §301.7701-3(g)(1)(ii).

[21] Under Treas. Reg. §301.7701-3(c)(1)(iv), once an election is made that is effective on any date other than the date of formation, it cannot be changed for 60 months except where a substantial change has taken place in the ownership of the company.

- The stock ownership requirement triggering the application of Code §332 to a liquidation of a subsidiary looks to stock that is directly owned and stock that is indirectly owned through a member of the same consolidated group.[22] Where both shareholders of a corporation about to undergo a liquidation are members of the same consolidated group, each shareholder is deemed to own all shares owned by all other group members for purposes of applying Code §332(b)(1).[23] Consequently, a sale that is the precursor to a *Granite Trust* liquidation does not reduce the selling shareholder's interest to below 80% once the indirect ownership rules are taken into account. This rule strongly suggests that a precursor sale must take place with purchasers that are not members of the same consolidated group.

- Even where the seller and purchaser are not members of the same consolidated group, they may be members of same controlled group.[24] Where a member of a controlled group sells shares to another member at an arm's length price which triggers a loss, Code §267(f) applies, preventing the selling member from claiming a loss in the taxable year of the sale. The loss is deferred until the purchasing member of the group sells the asset to an unrelated purchaser that is not a member of the group.[25] Therefore, although pursuing a Granite Trust liquidation between members of the same controlled group is possible, the shareholder must take into account that the loss attributed to the shares sold immediately before the liquidation, will be deferred.

- If, instead of selling the shares of one subsidiary to another, the common shareholder contributes the shares to another member of a consolidated group, the transaction may qualify as a Code §351 transaction. Under Code §351, no gain or loss is recognized on the transfer of shares. Therefore, the common parent would not be able to utilize the loss realized on the transfer. As mentioned above regarding the liquidation of the loss corporation, where the transferor and transferee are members of the same consolidated group, Code §332 would continue to apply because the common shareholder would be deemed to own all shares owned by all other group members. Hence, the balance of the loss would not be recognized for U.S. income tax purposes. However, where the transferee is a not a member of the same consolidated group, as would be the case where the transferee is a foreign corporation, Code §331 is expected to apply and the parent corporation is expected to recognize loss on the shares of the liquidating subsidiary. Note that the entirety of the loss will not be recognized. The deduction is limited to the portion of the loss attributed to the shares of the subsidiary that remained in the shareholder's possession after the initial transfer of shares to the related party.

- As to the remainder of the shares of the subsidiary, the related-party transferee will not be able to recognize any loss on those shares. Loss is measured by the excess of the adjusted basis over the amount realized.[26] Since the transferee's basis in the shares received will be equal to the shares' fair

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22 See Code §§332(b)(1) and 1504(a)(2) and Treas. Reg. §1-1502-34.

23 Treas. Reg. §1.1502-34.

24 "Controlled Group" is defined in Code §267(f)(1).

25 Code §267(f)(2).

26 See Code §1001(a).

market value as of the day of their receipt,[27] the adjusted basis is not expected to exceed the amount realized upon liquidation of the subsidiary.

The loss that is attributed to the transferred shares will not be completely lost. The high basis that the transferor had in the transferred shares, will be transferred to new shares in the transferee corporation that the transferor will receive as a result of the Code §351 transaction.[28] At such time as the transferee corporation is sold by the transferor, the high basis will be taken into account and could result in a loss.

- Finally, when structuring a *Granite Trust* liquidation between related parties care must be taken to confirm that the transaction does not fall within the four walls of a reorganization under Code §368. If the transaction is recharacterized by the I.R.S. as a reorganization under Code §368,[29] nonrecognition treatment will follow. Once more, the *Granite Trust* liquidation will be ineffective. No loss will be recognized and no deduction will be allowed.

"For over 60 years, Granite Trust liquidations have been allowed, and corporations have been able to avoid nonrecognition treatment for losses when a liquidation would otherwise be governed by Code §332 if carried out in a straightforward way."

ALL GOOD THINGS MUST COME TO AN END

As mentioned throughout this article, Code §267 governs the tax treatment of losses from transactions involving related parties and provides rules that either disallow or defer such losses. Under current law, the rules of Code §267 do not apply to losses recognized under Code §331.[30] Therefore, a shareholder that has recognized a loss pursuant to a *Granite Trust* liquidation enjoys the full benefit of the loss.

In late 2021, the House of Representatives voted to approve a bill, referred to as "Build Back Better Bill," that proposed certain tax increases for corporations and upper-income individuals. As part of the House Bill, a new Code §267(h) was introduced. Proposed Code §267(h) would have deferred the loss realized on a complete liquidation under Code §331, until all members of the controlled group that receive property pursuant to the liquidation dispose all property received in subsequent transactions with unrelated persons.[31] Specifically, proposed Code §267(h) would apply to any corporation that is a member of a controlled group, within the meaning of Code §267(f), that realizes losses with respect to stock of a subsidiary pursuant to a specified controlled group liquidation. This would include distributions in complete liquidation under Code §331.

The House never voted for the final adoption of the Build Back Better Bill and the initiative to add new Code §267(h) was paused. However, it is not uncommon for unenacted revenue raising provisions to be reproposed in future tax legislation as a "pay-for" to offset revenue loss provisions. Like Lazarus in the bible, Code §267(h) may come back again and again until it is finally enacted.

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27 See Code §362(e)(2).

28 See Code §358(a).

29 For example, by using the Step Transaction Doctrine as described in Rev. Rul. 2004-83.

30 However, as mentioned above, the rules of Code §267(f) may apply to losses recognized on a sale to a related party that precedes a Code §331 liquidation.

31 See Section 138142 of the Build Back Better bill.

CONCLUSION

For over 60 years, *Granite Trust* liquidations have been allowed, and corporations have been able to avoid nonrecognition treatment for losses when a liquidation would otherwise be governed by Code §332 if carried out in a straightforward way. To date, the I.R.S. follows court decisions that favor a two-step liquidation. The first step is a sale of shares that generate a loss while reducing ownership to below the 80% level.[32] The second step is to pursue a wind-up of the company's business and a complete liquidation.

In 2021, the House of Representatives voted to approve a provision to eliminate this planning device. Although not enacted in 2021, revenue raising provisions often are reproposed to offset revenue losses in future legislations. Only time will tell whether that will happen here.

32 However, if the shares are not sold but transferred under a Code §351 transaction, the loss attributed to the transferred shares will be deferred, as explained above.

TAX 101:

U.S. TAX COMPLIANCE FOR DUAL CITIZEN YOUNG ADULTS

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Tags
Expatriation
F.B.A.R.
FinCEN Form 114
Foreign Earned Income
Foreign Housing
Form 1040
Form 1116
Form 2555
Form 3520
Form 4868
Form 5471
Form 8621
Form 8854
Form 8865
Form 8938
Form 926

INTRODUCTION

It is not uncommon for a young adult who was born in the U.S. to noncitizen parents living temporarily in the U.S. to live abroad. Although he or she may never have returned to the U.S., the young individual is a U.S. citizen, and that status brings with it U.S. tax obligations. In many cases, the young adults may not have had income or personal property, and therefore may not have had reason to file a U.S. tax return. As those young adults graduate from university and enters the workforce, or become the recipients of gifts and bequests, the matter of U.S. tax filing obligations becomes more significant.

Consider Ms. A, a typical young adult, born in the U.S. but living abroad. She may have a bank account in a foreign county, but ordinarily will not have her own source of income. At some point, Ms. A may receive gifts and bequests from her foreign parents or grandparents. At this point in her life, Ms. A's U.S. tax compliance obligations become complex. Because of her fact pattern, she faces many complex filing obligations simply because she resides abroad and almost all of her employment income, investment gains, and family gifts may need to be reported to the I.R.S. Moreover, compliance failures can generate stiff penalties. Ms. A's family may wonder whether she should relinquish her U.S. citizenship. Taking that action triggers further tax obligations and is not a straightforward solution in many instances.

This article discusses the U.S. tax obligations of Ms. A, and suggests two paths forward to exit the U.S. tax system, based on her age.

U.S. INCOME TAX

The most significant filing will be Form 1040 (*U.S. Individual Income Tax Return*). All U.S. citizens are required to report worldwide income and pay income tax to the I.R.S. regardless of where they live. While the due date of this return generally is April 15 of the following year, if Ms. A resides outside the U.S., and works or attends university on a full-time basis outside the U.S., she may qualify for an automatic two-month extension to file a tax return. This automatic extension of the filing date does not extend the time for payment of tax. Interest will be due for amounts not paid by April 15.

If an individual who lives outside the U.S. is not able to file a return by the end of the two-month extended period, she may file for an automatic four-month extension by filing Form 4868 (*Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*) by June 15 following the close of the taxable year. If timely filed, the tax return is due not later than October 15. In addition to the extension to October 15, taxpayers who are based outside the U.S. can request a discretionary two-month additional extension of time to file tax returns to December 15. It is customary for the I.R.S. to grant the extension. If for any reason the I.R.S. denies the request, it nonetheless extends the due date of the return until 10 days from the date of the denial.

The young adult may be required to make estimated tax payments during the course of the year on Form 1040-ES. Estimated tax rules apply a "pay-as-you-go" system for tax and is the method used to pay tax on income that is not subject to U.S. withholding, meaning income other than salaries. This includes income from self-employment, interest, dividends, rent, gains from the sale of assets, prizes, and awards. If the taxpayer does not pay enough estimated tax throughout the year, the I.R.S. will impose a penalty based on interest rates set by the I.R.S. for the late payment.

FOREIGN INCOME AND TAXES

If another country imposes tax on Ms. A's income, the U.S. will allow her to claim a foreign tax credit for the taxes paid to that other country. Foreign tax credit computations are made on Form 1116 (*Foreign Tax Credit (Individual, Estate, or Trust)*). Note that the income that is taxed by the foreign country must be considered foreign-source income under U.S. tax concepts in order for the credit to provide a benefit. Changes to I.R.S. regulations applicable to foreign tax credits require a jurisdictional nexus between the income and the foreign tax. Even if the nexus exists, U.S. law generally does not allow the foreign tax credit to offset U.S. tax on U.S. source income.

If Ms. A resides and works abroad, a foreign earned income exclusion and a deduction or an exemption for foreign housing amounts may be available to her when computing her taxable income. Form 2555 (*Foreign Earned Income*) is used for this purpose. If certain requirements are met, an individual may exclude up to $112,000 of foreign-earned income in 2022. In addition, up to $15,680 may be excluded or deducted in 2022 for the foreign housing amount. The maximum amount of those foreign benefits is adjusted annually to reflect inflation.

To claim the foreign-earned income exclusion, the foreign housing exclusion, or the foreign housing deduction, Ms. A must meet all three of the following requirements:

- Her tax home must be in a foreign country. A tax home is the general area of a person's main place of business, employment, or post of duty, regardless of where she maintains a family home. If a person does not have a regular or main place of business because of the nature of her work, her tax home may be the place where she regularly lives. If she has neither a regular or main place of business nor a place where she regularly lives, she is considered to be an itinerant and her tax home is wherever she works at any particular time.

- She must have foreign earned income.

- She must be either (i) a U.S. citizen who is a *bona fide* resident of a foreign country or countries for an uninterrupted period that includes an entire tax year, generally January 1 through December 31, or (ii) a U.S. citizen who is physically present in a foreign country for at least 330 full days during any period of 12 consecutive months.

FOREIGN BANK ACCOUNTS

If Ms. A opens a U.S. bank or brokerage account, Form W-9 is required to be filed in addition to any forms that are required under the Common Reporting Standard because of her tax residence. The form provides the bank or brokerage firm with, among other things, the person's Social Security Number ("S.S.N."). A U.S. citizen who does not have a S.S.N. can apply for one on Form SS-5.

If Ms. A opens a foreign bank or brokerage account, two reporting forms must be completed and timely filed, identifying both U.S. citizenship and tax residence outside the U.S.

The F.B.A.R. form (FinCEN Form 114 (*Report of Foreign Bank and Financial Accounts*)) is used to report a U.S. citizen's financial interest in or signature authority over one or more foreign financial accounts when the aggregate value of all foreign financial accounts exceeds $10,000 at any time during the calendar year. The F.B.A.R. is filed with the Financial Crimes Enforcement Network ("FinCEN"), a bureau of the U.S. Treasury Department.

Ms. A is considered to have a financial interest in a foreign financial account in any of the following circumstances:

- She is the owner of record or holder of legal title over a foreign financial account.
- She owns directly or indirectly more than 50% of the total value of shares of stock or more than 50% of the voting power of all shares of stock of a corporation that is the owner of record or holder of legal title over a foreign financial account.
- She owns directly or indirectly an interest in a partnership that is the owner of record or holder of legal title over a foreign financial account and she is entitled to more than 50% of the partnership's profits or holds more than 50% of the partnership capital.
- She is a beneficiary of a trust that is the owner of record or holder of legal title over a foreign financial account and holds a present beneficial interest that is greater than 50% in the assets or income of the trust for the calendar year where the trust.
- She (a) owns more than 50% or the income interests, equity, or voting power of an entity that is not a corporation or (b) is the grantor of a grantor trust under U.S. tax law where the entity or the trust is the owner of record or holder of legal title over a foreign financial account.

A U.S. person has signatory authority over a foreign financial account where, alone or in conjunction with others, she has the authority to control the disposition of assets held in a foreign financial account by direct communication to the bank or other financial institution that maintains the financial account.

The F.B.A.R. must be filed electronically by April 15 following the close of a calendar year. If an extension of time is obtained regarding the filing of a U.S. income tax return, the filing date is extended to October 15. The fact that the filing date for the income tax return is extended to December 15, does not extend the due date of the

F.B.A.R. Penalties may be imposed for a failure to comply, which can be severe if willful. Civil penalties for a nonwillful failure to report do not exceed $10,000 per non violation in the absence of reasonable cause. The ceiling is adjusted each year for inflation. In 2022, the ceiling is $12,921. Currently, a split of opinion exists among the Circuit Courts of Appeal as to whether the nonwillful penalty is imposed separately for each account that is unreported or once for each F.B.A.R. form that is not timely filed. Civil penalties for a willful failure to report do not exceed the greater of $100,000 per willful violation or 50% of the highest balance in the unreported account in the absence of reasonable cause. The dollar denominated ceiling is adjusted each year for inflation. In 2022, the ceiling is $129,210.

In the above discussion, it is implicitly assumed that Ms. A never owned or had a financial interest in a financial account having a balance of $10,000 or its equivalent in foreign currency in any year prior to turning 18 years of age. If one or more accounts having a balance of $10,000 or the equivalent in foreign currency existed, the F.B.A.R. obligation existed during minority according to the FinCEN *BSA Electronic Filing Requirements For Report of Foreign Bank and Financial Accounts (FinCEN Form 114), Release Date January 2017 (v1.4)*,[1] which provides as follows regarding minors at page 6:

> **Responsibility for Child's FBAR**
>
> Generally, a child is responsible for filing his or her own FBAR report. If a child cannot file his or her own FBAR for any reason, such as age, the child's parent, guardian, or other legally responsible person must file it for the child.
>
> **Signing the child's FBAR.** If the child cannot sign his or her FBAR, a parent or guardian must electronically sign the child's FBAR. In item 45 Filer Title enter "Parent/Guardian filing for child."

Form 8938 (*Statement of Specified Foreign Financial Assets*) is a form that is included in an annual income tax return to report specified foreign financial assets when the total value of all the specified foreign financial assets in which a U.S. citizen has an interest meets or exceeds a specified reporting threshold. For an unmarried individual such as Ms. A who resides outside the U.S., reporting is required if the total value of specified foreign financial assets is more than $200,000 on the last day of the tax year or more than $300,000 at any time during the tax year. If Ms. A were to reside in the U.S.in the future, reporting will required if the total value of specified foreign financial assets is more than $50,000 on the last day of the tax year or more than $75,000 at any time during the tax year. The dollar thresholds for reporting will be increased once Mrs. A becomes married. If she continues to live outside the U.S. and files a joint income tax return with her husband, the thresholds will be more than $400,000 on the last day of the tax year or more than $600,000 at any time during the tax year. If Ms. and her husband move to the U.S. and file a joint income tax return, the thresholds will be more than $100,000 on the last day of the tax year or more than $150,000 at any time during the tax year.

Ms. A will be considered to reside outside the U.S. if she is entitled to claim the benefit of the foreign earned income exclusion under the standards discussed above. Thus, she must be a *bona fide* resident of a foreign country or countries for an

[1] See here.

uninterrupted period that includes an entire tax year, or she must be physically present in a foreign country for at least 330 full days during any period of 12 consecutive months.

Specified foreign financial assets include the following assets:

- Financial accounts maintained at a foreign financial institution
- Stock or securities issued by a non-U.S. entity
- Any interest in a foreign entity
- Any financial instrument or contract that has an issuer or counterparty that is not a U.S. person
- A beneficial interest in a trust unless the beneficiary neither knows nor has reason to know that she is a beneficiary
- An interest in a foreign pension plan

> ***"If Ms. A does not file Form 8938 or fails to report a specified foreign financial asset, the statute of limitations for the tax year may remain open for all or a part of the entire income tax return until three years after the date on which a complete Form 8938 is filed."***

If a financial asset is denominated in foreign currency, the maximum value of the asset must be determined in that currency and converted to U.S. dollars, using the currency exchange rate for the last day of the tax year. Assets need not be reported on Form 8938 if reported on certain other forms (*e.g.*, Form 3520, discussed below).

If Ms. A does not file Form 8938 or fails to report a specified foreign financial asset, the statute of limitations for the tax year may remain open for all or a part of the entire income tax return until three years after the date on which a complete Form 8938 is filed. If Ms. A does not include in gross income any amount relating to one or more specified foreign financial assets, and the amount omitted is more than $5,000, any tax she owe for the tax year can be assessed at any time within six years after she files a return.

FOREIGN TRUST DISTRIBUTIONS AND GIFTS

Form 3520 (*Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*) is used by a U.S. person to report the receipt of certain large gifts from a foreign person and the receipt of distributions from a foreign trust.

In order for a gift from a foreign individual to be reportable by Ms. A, the gift must exceed $100,000. To determine if Ms. A received gifts in excess of $100,000 from a particular foreign individual, she must aggregate gifts from foreign persons that she knows or has reason to know are related to each other, such as husband and wife donors or father and grandfather donors. Once the $100,000 threshold is met, the donee describes each gift in excess of $5,000 but does not have to identify the donor on the form.

Form 3520 is due on the due date, including extensions, of Ms. A's income tax return and must be sent to the Internal Revenue Service Center, P.O. Box 409101, Ogden, UT 84409. If Ms. A fails to report the receipt of a gift generally, she may become subject to a penalty equal to 5% of the amount of the gift for each month of failure to report, up to a maximum of 25%. The I.R.S. actively pursues the penalty, which may be abated if reasonable cause exists.

INTERESTS IN FOREIGN ENTITIES

Foreign Corporations in General

Form 5471 (*Information Return of U.S. Persons With Respect to Certain Foreign Corporations*) must be filed with a Form 1040 if Ms. A were to become a 10% shareholder (measured by vote or value) in certain foreign corporations. Her ownership may be direct or indirect and requires application of a number of constructive ownership rules.

For most purposes, there is no constructive ownership attributed to a U.S. citizen from a family member who is neither a U.S. citizen nor a U.S. tax resident. However, shares in a foreign corporation that are actually owned by a foreign family member can be attributed to Ms. A for the limited purpose of imposing an obligation to file Schedule O (*Organization or Reorganization of Foreign Corporation, and Acquisitions and Dispositions of its Stock*) of Form 5471. In such case, a penalty of $10,000 may be imposed for the failure to report constructive ownership in Schedule O regarding each corporation that is actually owned by a foreign family member.

The Tax Cut & Jobs Act of 2017 repealed a provision in U.S. tax law that allowed U.S. taxpayers to benefit from nonrecognition of gain when assets transferred to a foreign corporation are to be used in the trade or business of that corporation. With limited exceptions, such transfers are now taxable. Form 926 (*Return by a U.S. Transferor of Property to a Foreign Corporation*) is the form designated to report gain from a transfer of assets to a foreign corporation. If a taxpayer fails to fully report a transfer of property to a foreign corporation, a penalty is imposed equal to 10% of the fair market value of the property at the time of the transfer. The penalty is limited to $100,000 unless the failure to comply is due to intentional disregard.

Foreign Corporations that are P.F.I.C.'s

Ownership of a "P.F.I.C." (passive foreign investment company) by Ms. A may cause her to be required to file Form 8621 (*Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*). A P.F.I.C. is a foreign corporation that meets one of two tests:

- At least 50% of the average value of its assets, as measured on the last day of each quarter, are of a kind that produce passive income
- At least 75% of its income for a taxable year consists of passive income

European collective investment vehicles and unit trusts are typically considered to be P.F.I.C.'s. Also, a start-up service business that is funded with cash and that has little in the way of capital assets may trip into P.F.I.C. status unless it is reasonable to believe that it will not be a P.F.I.C. in its second and third years of existence and is actually not a P.F.I.C. in those years.

A U.S. person that is a direct or indirect shareholder of a P.F.I.C. must file Form 8621 for each tax year reporting:

- Receipt of direct or indirect distributions from a P.F.I.C.
- Recognition of gain on a direct or indirect disposition of P.F.I.C. stock

- Information with respect to a Q.E.F. election or a mark-to-market election
- A required annual report of deferred income and gains

<u>Foreign Partnerships and Eligible Entities</u>

Investment in a foreign partnership by Ms. A may require her to file Form 8865 (Return of U.S. Persons With Respect to Certain Foreign Partnerships), similar to the reporting obligations described above. Reporting may be required in several different fact patterns, including the acquisition, ownership, or disposition of substantial interests in a foreign partnership and the disposition by the foreign partnership of appreciated property that was previously contributed by a U.S. person.

Note that foreign law does not control whether an entity is considered to be a partnership. A private limited company generally thought of a corporation for purposes of foreign company law and foreign tax law, may default into partnership status for U.S. tax purposes or may have elected partnership status for U.S. tax purposes at the insistence of a U.S. investor. An example of the former is an unlimited liability corporation formed under the laws of certain provinces in Canada.

RELINQUISHING U.S. CITIZENSHIP

Some foreign young adults with limited ties to the U.S. have considered relinquishing their U.S. citizenship to avoid U.S. tax compliance and future U.S. estate and gift taxation. As a practical matter, young adults who reside abroad and are U.S. citizens, such as Ms. A, can work or study in the U.S should they desire to do so without any limitation under U.S. immigration law. However, once citizenship is renounced, a visa will be required if they choose to re-enter the U.S for work or study purposes.

"... young adults who reside abroad and are U.S. citizens, such as Ms. A, can work or study in the U.S should they desire to do so without any limitation under U.S. immigration law."

To renounce citizenship, Ms. A must voluntarily and with intent to relinquish her U.S. citizenship appear before a U.S. consular or diplomatic officer in a foreign country and sign an oath of renunciation. A person contemplating expatriation should review the website of the U.S. embassy or consulate in the jurisdiction where expatriation is intended, as procedures vary to some extent among the embassies and consulates.

Citizenship should not be relinquished until Ms. A can certify that she has satisfied her U.S. tax obligations for the five (tax) years prior to the year of expatriation. In addition, she must file Form 8854 (*Initial and Annual Expatriation Statement*) with the I.R.S for the tax year of expatriation.

An expatriating individual who is considered a "covered expatriate" may be required to pay a capital gains tax (known as a "mark-to-market exit tax") on the amount of net gain realized upon a deemed sale or exchange of the individual's property on the day immediately preceding the date of expatriation. However, the first $767,000 of gain is excluded when computing the exit tax.

Under U.S. tax law, gift and estate taxes are generally imposed on the individual making the gift or the estate of the decedent. These taxes are not imposed on the recipient of the gift or bequest. A covered expatriate owning no U.S. situs property is not subject to gift and estate taxes upon the making of a gift during lifetime or leaving a bequest at the conclusion of life. The rules are modified when the maker of the gift or the decedent is a covered expatriate. A U.S. person receiving gifts from a covered expatriate or receiving a bequest from the estate of a covered expatriate is subject to a special inheritance tax imposed at the highest rate of gift or estate tax under U.S. law (currently 40%). When computing the tax, a U.S. recipient may claim a benefit equal to the annual exclusion provided by U.S. tax law for gifts made by a U.S. donor (currently, $15,000) for amounts received from each covered expatriate.

Ms. A would be a covered expatriate in any of the following fact patterns:

- She has an average net income tax liability of more than a specified amount for the five years preceding expatriation. In 2022, the amount is $178,000 and is adjusted each year for inflation.
- She has a net worth of at least $2.0 million on the date of departure. This amount is not adjusted for inflation.
- She fails to certify under penalties of perjury that she is in compliance with all U.S. tax obligations for the five years preceding expatriation. The instructions for Form 8854 states that the scope of the certification extends to obligations regarding income tax, employment tax, gift tax, and information returns, including obligations to file proper forms and to pay all relevant tax liabilities, interest, and penalties.

There are exceptions for certain dual citizen individuals or minors, although the tax compliance certification must be satisfied in all cases.

Dual Citizen at Birth – Renunciation Prior to 18½ Years of Age

One exception applies to a minor who was a dual citizen at birth. To meet this exception, the following conditions must be met:

- The individual was born a citizen of the U.S. and another country.
- Renunciation occurs before the age of 18½ years.
- The individual has not resided in the U.S. for more than 10 taxable years before the date of relinquishment.

There may be a timing problem in attempting to qualify for this exception. Embassies and consulates are unlikely to entertain a request to relinquish citizenship if the individual is less than 18 years old. That leaves a six-month window for a would-be covered expatriate to relinquish citizenship under this exception. U.S. diplomatic missions face severe backlogs, and it may be difficult to complete the renunciation within the six-month time frame. For example, the U.S. embassy in France notes that the current wait time for a renunciation interview is 12-18 months. The embassy in Denmark has a waiting period of over a year (the earliest appointment now being in mid-2023 .

Dual Citizen at Birth – Renunciation at or After 18½ Years of Age

A second exception applies to an individual who relinquishes citizenship at the age of 18½ years or older. To meet this exception, three conditions must be met:

- The individual was born a citizen of the U.S. and another country.
- The individual continues to be a citizen of, and is taxed as a resident of, the other country as of the expatriation date.

- The individual has not resided in the U.S. for more than 10 taxable years during the 15-taxable-year period ending with the taxable year during which the expatriation date occurs.

This second exception does not apply if the individual is no longer a resident in the country of birth. That individual must re-establish tax residence in the birth country before applying for expatriation. While there may be many ways to demonstrate tax residence, clearly the most obvious way of establishing residence involves filing a tax return for a complete taxable year in the birth country. Also, filing a final year tax return in the third country may be helpful.

CONCLUSION

Coming of age brings with it certain responsibilities for a dual citizen individual. One of those responsibilities stems from the realization that U.S. income tax returns must be filed. In the case of Ms. A, an individual born in the U.S. to non-U.S. parents temporarily present in the U.S., the tax filing obligations can be daunting and compliance failures can be heavily penalized. While one solution is renunciation of citizenship, the path to exiting the U.S. tax system has its complexities and accompanying penalties when not done correctly. For those individuals finding themselves in the circumstances of Ms. A, finding a competent U.S. tax adviser is a necessary step before taking any action.

MEDTRONIC PART DEUX: THE BEST METHOD IS YET TO COME?

Author
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Tags
C.U.T.
C.P.M.
Eaton
Intangible Assets
Medtronic
Sundstrand
Transfer Pricing

INTRODUCTION

The purpose of the most recent decision in the *Medtronic* saga[1] extends and refines the prior analysis of one of five connected controlled transactions within Medtronic's controlled group of multinational medical device producers and suppliers. The transactions may be described as follows:

1. Medtronic licensed patented and unpatented intangible property related to the design and production of sophisticated medical devices to a controlled Puerto Rican subsidiary ("MPROC"), which served as the manufacturer. The intangible property related to (i) implantable pacemakers, cardioverter defibrillators, cardiac resynchronization devices, neurostimulation devices, and (ii) connective leads.

2. Medtronic licensed its trademark intangible assets to MPROC.

3. Medtronic sold manufactured product components and sub-assemblies to MPROC.

4. MPROC sold finished medical devices to a U.S. group company for resale worldwide.

5. Medtronic licensed the same intangible assets related to products (i) and (ii) described above to a controlled Swiss manufacturer that began device and leads production operations after MPROC. The Swiss affiliate paid royalties at the same rates as MPROC to Medtronic.[2]

The first two transactions – license of manufacturing intangible property and license of trademarks – were the main subject of a period of examination controversy that concluded with the I.R.S. adjusting the royalty income of the U.S. Medtronic licensor for tax years 2005 and 2006. The adjustments included additional income necessary for the royalty to be arm's length as determined under the comparable profits method ("C.P.M.") analyses performed by the I.R.S.

Medtronic's 2005 and 2006 position originated in an M.O.U. settlement with the I.R.S. involving the same transactions and issues, but in respect of Medtronic's

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1. *Medtronic, Inc. & Consol. Subs. v. Commr.,* T.C. Memo. 2022-84 ("Medtronic III"), on remand from 900 F.3d 610 (8th Cir. 2018) ("Medtronic II"), vacating and remanding T.C. Memo. 2016-112("Medtronic I").

2. It was agreed by the parties that the Swiss royalty rate(s) would be adjusted to equal the MPROC royalty rate(s) determined by the court. No detailed facts of this transaction or of any transfer pricing analysis were presented.

2002 tax year. That settlement was based on an agreed division of profit between the U.S. and MPROC but not on a specific transfer pricing method. The settlement outcome nonetheless informed the transfer pricing position of Medtronic for the tax years 2005 and 2006. Medtronic applied the comparable uncontrolled transaction ("C.U.T.") method to determine its 2005 and 2006 non-trademark income using a licensing agreement between Medtronic and Pacesetter, a Siemens group company active in the cardiac rhythm disease management business, concluded for the purpose of settling a medical device patent litigation matter between the two competing companies in the early 1990's. Medtronic continued to rely on its C.U.T. method application to argue that the M.O.U. outcome was arm's length and petitioned the Tax Court to vacate the proposed I.R.S. income adjustments for 2005 and 2006.

The value of the second transaction was resolved easily by the Tax Court using expert evidence of trademark royalty rates. The decision noted there was an error in the calculation of the intercompany inventory sales revenue that would be corrected during the proceedings.[3] Though the focus of the controversy became the non-trademark licensing transaction, all five transactions excepting the Swiss licensing transaction were referenced by Medtronic and the I.R.S. in making arguments about the division of profit between Medtronic and MPROC.

2016 TAX COURT DECISION

In 2016, the Tax Court decided for the most part for Medtronic, though several adjustments were made to the non-trademark royalty rates (one rate for devices, a different rate for leads) to improve the comparability of the terms and circumstances of the independent Pacesetter agreement primarily relied on by Medtronic with the terms and circumstances of the licensing agreement between Medtronic and MPROC. Much of the 2016 Tax Court decision dealt with the facts of the transactions and the Medtronic burden of demonstrating that the I.R.S. position was arbitrary, capricious, or unreasonable. The I.R.S. was also found to have abused its authority in making the allocation.

On the question of whether the allocations used by Medtronic satisfied the arm's length method, the Tax Court reasoned that three adjustments were required to meet the comparability standard. These adjustments related to (i) the supply of non-patented design and production know-how, (ii) profit potential, and (iii) the licensed property (cardiac product intangibles as distinct from neurology product intangibles). After adjusting for differences, the Tax Court concluded that the adjusted C.U.T. was the best method. The outcome of the first decision raised the devices royalty rate by 15% and the leads rate by 7%. These rates, the court noted, were not significantly different from those agreed between Medtronic and the I.R.S. in the 2002 M.O.U.

The I.R.S. argued exclusively for its comparable profits method ("C.P.M.") approach and against the Medtronic C.U.T. method during the examination of tax years 2005 and 2006, during Medtronic's appeal to I.R.S. Appeals Office, and during the Tax Court proceedings that culminated in the 2016 decision. The I.R.S. provided the court with no expert testimony to assist it in estimating an adjustment to the Medtronic

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3 This sales revenue was critical to the final determination of the arm's length amount of the royalty because the royalty was a function of the sales revenue and an acceptable royalty rate.

royalty rate to remedy several identified comparability shortcomings identified in the Medtronic C.U.T. analysis.[4]

The I.R.S. appealed the 2016 Tax Court decision, arguing that (i) the decision did not adequately dispose of the question of whether Medtronic's C.U.T. was the best method, and (ii) the Tax Court did not make sufficient findings of fact to conclude that Medtronic's C.U.T. met the comparability standards of Treas. Reg. §1.482-4(c)(2). The I.R.S. was successful on appeal to the 8th Circuit Court of Appeals, and the case was remanded to the Tax Court to make the required findings of fact and determine the best method.

THE TASKS BEFORE THE COURT

As an initial matter, the Tax Court listed the tasks assigned by the 8th Circuit:

- Determine whether the Pacesetter agreement is a C.U.T.
- Determine whether the Tax Court made appropriate adjustments to the Pacesetter agreement, if it were a C.U.T.
- Determine whether the circumstances between Pacesetter and Medtronic were comparable to the licensing agreement between Medtronic and MPROC and whether the Pacesetter agreement was an agreement created in the ordinary course of business
- Determine the degree of comparability of the Pacesetter agreement's contractual terms and those of the MPROC licensing agreement
- Determine how the different intangibles in the two agreements affected the comparability of the Pacesetter agreement and the MPROC licensing agreement
- Compare and contrast the results under the C.U.T. method using the Pacesetter agreement with or without adjustments with those under the C.P.M., and determine which of the two methods is the best method

"The I.R.S. did not present an adjusted C.P.M. in the second Tax Court trial, though the Tax Court commented that such an analysis would have been considered if presented."

As an introduction to these tasks and its analysis, the Tax Court provided some general commentary to place its assigned tasks in the context of the transfer pricing regulations and the case law.

The Tax Court cited *Sundstrand*[5] to establish its role in determining whether the I.R.S. position underlying a notice of deficiency was arbitrary, capricious, or unreasonable. When these conditions are met, the next step is for the taxpayer to show that the allocations of income or expense among the related parties that satisfy the arm's-length standard.[6] The decision explains the role of the court when the

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4 The I.R.S. did not present an adjusted C.P.M. in the second Tax Court trial, though the Tax Court commented that such an analysis would have been considered if presented.

5 *Sundstrand Corp. v. Commr.,* 96 T.C. 226, 353 (1991) (citing G.D. *Searle & Co. v. Commr.,* 88 T.C. 252, 358 (1987), and citing *Eli Lilly & Co. v. Commr.,* 84 T.C. 996, 1131 (1985), *aff'd*. on this issue, *rev'd* in part and *rem'd*, 856 F.2d 855 (7th Cir. 1988)).

6 *Eli Lilly & Co. v. Commr.,* 856 F.2d 855, 860 (and the cases cited therein).

position of the I.R.S. is viewed to be unreasonable but the taxpayer does not meet its burden of demonstrating the proper method to be used:

> If neither party has proposed a method that constitutes "the best method," the Court must determine from the record the proper allocation of income. *Sundstrand Corp.*, 96 T.C. at 354. After hearing expert witnesses during further trial and reviewing the parties' positions, we conclude that there are some benefits to the CUT, and the Pacesetter agreement is an appropriate comparable as a starting point. We are concerned that there is only one comparable, that adjustments need to be made, and that if too many adjustments are made, the Pacesetter agreement might cease to be useful even as a starting point.[7]

Consistent with the decision in *Medtronic I*, the Tax Court found that the Pacesetter agreement by itself, without any adjustment for comparability, was not a C.U.T. The Tax Court rethought the appropriateness of the adjustments it made in the first trial, and on remand, made different adjustments. Ultimately choosing the application of an alternate, unspecified method but with Pacesetter as its cornerstone despite its stated misgivings. The Tax Court made findings of fact and reached conclusions on the questions posed in tasks 3-5. This set the court up to answer question 6 concerning the best method.

BEST METHOD, IDEAL METHOD, OR THE METHOD THAT GETS THE RIGHT ANSWER?

Given the recent decision reads as a retelling of fact mixed with functional, financial, and legal analysis, a grounding in the basic principles of the transfer pricing regulations is a logical place to explain the reasoning of the court. The regulations implement the goal of Code §482, "to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses" by determining the true taxable income of a controlled taxpayer.[8] When determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is the arm's length standard.[9] Evaluation of whether a controlled transaction produces an arm's length result is made pursuant to a method selected under the best method rule described in Treas. Reg. §1.482-1(c).[10]

The best method rule is a familiar standard used to evaluate all transfer pricing positions in practice. It is fundamental to all transfer pricing analysis, and has been mimicked as the "most appropriate method" in the most recent multilateral guidance from the O.E.C.D. The regulations define the best method to be the transfer pricing method that provides the most reliable measure of an arm's length result under the facts and circumstances of the taxpayer.[11] The best method rule is applied by evaluating five criteria:

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7 *Medtronic III* at p. 49.

8 Treas. Reg. §1.482-1(a)(1).

9 Treas. Reg. §1.482-1(b)(1).

10 *Id.*

11 Treas. Reg. §1.482-1(c)(1).

- The degree of comparability between the controlled transaction or taxpayers and the uncontrolled comparables, after making adjustments for differences
- The completeness and accuracy of data
- The reliability of assumptions
- The sensitivity of results to deficiencies in data and assumptions
- Confirmation of results by application of another method[12]

In *Medtronic I* and *Medtronic III*, the Tax Court decided that the C.P.M. applied by the I.R.S. did not meet any of the criteria of the best method rule, and accordingly, was not the best method. Medtronic's C.U.T. method was the only other candidate specified method, making the Court's analysis an assessment of reliability of the taxpayer's adjusted C.U.T. method under the best method rule as distinct from a determination of which method, adjusted C.U.T. or C.P.M., was relatively more reliable. The outcome of this analysis would have been the Court's reply to the sixth task from the Eighth Circuit. The recent decision applied the best method criteria to Medtronic's adjusted C.U.T. as summarized below:

The Degree of Comparability Between the Controlled Transaction or Taxpayers and the Uncontrolled Comparables, After Making Adjustments FOR Differences

The Court found that the MPROC and Pacesetter agreements were not comparable. Medtronic did not perform research and development functions in connection with the intangible property licensed to Pacesetter, but performed this function in connection with intangible property licensed to MPROC.

A significant effort was spent by the court to address a perceived difference in profit potential for the parties in the MPROC and Pacesetter licensing transactions. The intangible property regulations are clear that profit potential should be measured from reasonable expectations generated at the point of negotiation, rather than a look-back analysis a profit outcome from a point in the future.[13] Consequently, profit potential is defined in terms of the net present value of the stream of reasonably anticipated profits. The I.R.S. and the Court seemingly referenced only actual profits or sales as opposed to forecasted or expected profitability when assessing comparability of the profit potential under the MPROC and Pacesetter nontrademark licensing arrangements. In other words, the prescience of the taxpayer was assumed.

The court also noted that the intangible property licensed to MPROC consisted of 1,800 patents and know-how, while only 342 Medtronic patents were licensed to Pacesetter.

The terms of the MPROC and Pacesetter agreements were found to be sufficiently comparable, and the fact that the Pacesetter agreement arose out of litigation settlement was not found to constitute a sufficiently different economic condition for the purpose of determining comparability. No changes in technology or in industry conditions were found between the MPROC and Pacesetter agreements.

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[12] Treas. Reg. §1.482-1(c).

[13] Treas. Reg. §1.482-4(c)(2)(iii)(B)(ii).

“Medtronic applied an unspecified method in addition to its adjusted C.U.T. Its wholesale royalty rate result using a 35/65 residual profit split as a final step in a multi-step calculation was 2.6% higher (35.7%) than its high value of the adjusted C.U.T. range (33.1%).”

Medtronic made adjustments to its C.U.T. to quantify the difference in royalty rate that resulted from profit potential, the supply of know-how, different license portfolios (and numbers of patents), differences in the licensing terms among cardio and neuro products, and the Pacesetter cross-license. While little detail of the adjustments is discussed in *Medtronic III*, no material difference goes unadjusted under the proposed adjusted C.U.T. method.

Completeness and Accuracy of Data

No mention of shortcomings was made as to data quantity, completeness, or quality used in applying the adjusted C.U.T. in *Medtronic III*.

Reliability of Assumptions

None of Medtronic’s assumptions underlying its C.U.T. adjustment calculations were directly faulted. All I.R.S. criticisms were appropriately weighed and dismissed by the Tax Court.

Sensitivity of Results to Deficiencies in Data and Assumptions

While there were ranges of estimates used to adjust the C.U.T. method outcome to account for noted differences, the usual criticism of breadth of ranges appears somewhat unfounded in the Tax Court’s decision, given the ranges suggested from other method applications and from C.U.T. analysis examined in *Medtronic I* that were similarly broad.

Confirmation of Results by Another Method

This criterion is not a mandatory item but was noted as a means of demonstrating the reliable nature of one method by using a secondary method. Medtronic applied an unspecified method in addition to its adjusted C.U.T. Its wholesale royalty rate result using a 35/65 residual profit split as a final step in a multi-step calculation was 2.6% higher (35.7%) than its high value of the adjusted C.U.T. range (33.1%).

If two or more methods produce inconsistent results (as the C.P.M. and the adjusted C.U.T. did), the best method rule will be applied to select the method that provides the most reliable measure of an arm’s length result.[14] The similarity of the unspecified method and adjusted C.U.T. outcomes points to the adjusted C.U.T. being highly reliable.

Despite the reporting of the outcome of the best method rule when applied to Medtronic’s adjusted C.U.T., the Tax Court concluded that Medtronic’s adjusted C.U.T. was not the best method. It proceeded to amend Medtronic’s unspecified method in a way that can only be described as bizarre as the foundation for its opinion.

The Tax Court analysis seems to search for the ideal method or an absolute standard, contrary to the best method rule set out in the regulations. Several mentions of the division of profit between MPROC and Medtronic resulting from different method applications suggest the court prioritized an arbitrary, but somehow intuitively appealing, profit split to determine the method applications that produced reasonable outcomes and other method applications that fell short. The court stated its “goal

[14] Treas. Reg. §1.482-1(c)(2)(iii).

was to find the right answer,"[15] but this goal is stated neither by the regulations nor the 8th Circuit in its instructions on remand. More importantly, the court's reasoning for identifying the best method and comparability subfactor determinations adopted a standard that evaluates results as "too high," "too low," or "too many." In other words, the court adopted a standard under which the ends justified the means, which differs from the norm under which the means justify the ends. The court knew where it wanted to end up, and simply looked for a method that was consistent with its destination.

An old saying of trial lawyers is that bad facts make bad law and *Medtronic III* is rife with bad facts:

- A wide margin existed between the positions of the I.R.S. and the taxpayer.
- The dispute between the parties was endless. The dispute involved the tax years 2005 and 2006 and *Medtronic III* was decided in 2022.
- The amounts in question were high.
- The precedential value of the final determination could be enormous.
- The presence of an unusual fact subsequent to the initial decision in *Medtronic I* – the taxpayer sought a refund as a result of the overturn of the M.O.U. outcome.

The recently decided controversy in *Eaton*[16] over the I.R.S. cancelling an APA (not immediately relevant, but these were disputes of the same nature in many ways) may have encouraged the court to fashion a compromise decision that intends to disappoint both sides while limiting the scope for appeal.

UNIQUE UNSPECIFIED METHOD USE

The use of an unspecified method is without I.R.S. field guidance and will likely lead to future controversy in examinations if the court's approach is adopted by field examiners. Relying on an unspecified method to support a transfer pricing position prior to examination is a risky course of action for a taxpayer. Calculating a tax provision that employs an unspecified method involving an affiliate based in a treaty partner jurisdiction through the Competent Authority process would involve a series of novel and uncertain steps.

Will unspecified methods be used to impose reasoned settlements in exams, cases before the Tax Court, and Competent Authority proceedings? It is possible we will see greater use of unspecified methods as parties grow weary from the volume of factual documentation required even before addressing the substantive questions

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15 T .C. Memo. 2022-84, p. 71.

16 *Eaton Corp. & Subsidiaries v. Commr.,* T.C. Memo. 2017-147, supplemented by 153 T.C. 119 (2019) and an earlier decision, 140 T.C. 410 (2013), *aff'd* and *rev'd* in part 6th Cir. (Docket No. 21-1569/2674, 8/25/2022) reported unofficially at 30 A.F.T.R. 2d 2022-5746. Eaton involved the unsuccessful attempt by the I.R.S. to cancel an advance pricing agreement with the taxpayer based on certain errors that were self-corrected by the taxpayer and in which substantial transfer pricing penalties of 40% of the asserted increase in tax were unsuccessfully asserted in the post decision computation of tax by the parties.

“Arbitration emerges again as a strong dispute resolution candidate mechanism given the practical alternatives.”

of method selection, especially as tax authorities continue to take “method-agnostic” examination positions that propose income adjustments solely using a functional analysis, rely on unsupported normative arguments, or argue for largely unsupported profit-split positions.

As was true of *Medtronic I*, all cases are fact-specific, and not all fact patterns or method selection questions will lend themselves to the use of an unspecified method.

THE “NO-RECIPE RECIPE”

In retrospect, the question that remains after reading the decision in *Medtronic III* is whether the court adopted an unspecified method to resolve a transfer pricing dispute, or did it simply adjust a C.U.T. in a subjective way to obtain a result that seemed to be fair? In the view of the author, the method used by the court was in substance an adjusted C.U.T., a specified method. The profit split method uses more than one method, strictly speaking, to arrive at an income allocation and remains squarely in the category of specified methods.

Nonetheless, the problem with *Medtronic III*, is that two transfer pricing methodologies that were each deemed to be unreliable were packaged together using a no-recipe recipe as an unspecified method replete with a number of largely unsupported adjustment factors to reach a conclusion. The second trial did not produce practical guidance that was any better than the very limited guidance that emerged from the first.

If not appealed, the only virtue of the decision in *Medtronic III* is that it will have the force of law strictly between the taxpayer involved and the I.R.S. In a way its importance may be similar to a written determination of the I.R.S. that is covered by Code §6110(k)(3).[17] “Unless the [I.R.S.] otherwise establishes by regulations, a written determination may not be used or cited as precedent.” Nonetheless, advisers often point out that a written determination tends to indicate the position of the national office of the I.R.S. at the time issued and can be cited as authority for purposes of eliminating a penalty for the understatement of tax.

CONCLUSION

More than anything, companies want transfer pricing certainty when calculating tax provisions and disclosing uncertain positions or transactions with B.E.P.S. hallmarks. The decision in *Medtronic III* demonstrates that this certainty may not be obtainable even at a high price. Arbitration emerges again as a strong dispute resolution candidate mechanism given the practical alternatives.

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[17] Examples of a written determination include a private letter ruling, a Technical Advice Memorandum, and Chief Counsel Advice.

UPDATES & OTHER TIDBITS

Authors
Wooyoung Lee

Tags
Automatic Exchange of Information
Constitutionality
Deposit Interest Rules
Form 1042-S
Passports
Penalties
Seriously Delinquent Tax Debt

FIFTH CIRCUIT UPHOLDS PASSPORT-REVOCATION PENALTY

In *Franklin v. U.S.,*[1] the Fifth Circuit recently upheld the constitutionality of Code §7345, a provision of the Code that was in 2015. It allows the I.R.S. to effect the revocation of a U.S. citizen's passport where the individual is in seriously delinquent tax debt.

I.R.S. Procedure

The threshold for seriously delinquent tax debt is $50,000, with adjustments for inflation. Debt includes unpaid tax liability, penalties, and interest from late payments. Certain debts, such as debt of a bankrupt taxpayer, are excluded from this definition.

When the I.R.S. determines that a person is in seriously delinquent debt, it issues a CP508C Notice to the taxpayer, with a copy to the Secretary of State. This prevents the State Department from issuing or renewing a passport to the taxpayer, although the taxpayer's passport is not automatically revoked. Before denying a new or renewed passport, the State Department will give a taxpayer 90 days to sort out the situation.

Revocation may occur if the I.R.S. goes further and recommends revocation to the State Department. Before making such a recommendation, the I.R.S. will issue a Letter 6152, (Notice of Intent to Request U.S. Department of State Revoke Your Passport), to the taxpayer, informing him or her of the possible revocation. The letter requests that the taxpayer call the I.R.S. within 30 days to resolve the situation. Recommendations of revocation are typically reserved for taxpayers who promised to pay or could have paid off the debt but did not.

Avenues of Relief

Several avenues of relief are available to such taxpayers:

- The I.R.S. may not submit a certification to the State Department if the relevant debt is the subject of a requested or pending collection due process hearing.
- The individual and the I.R.S. may enter into an installment agreement allowing for the payment of the debt over time.
- The I.R.S. may accept an offer in compromise proposed by the taxpayer for the satisfaction of the debt at a lower amount.

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[1] No. 21-11104, 2022 BL 326674.

- The U.S. Department of Justice may enter into a settlement agreement to satisfy the debt.
- Collection against a married couple filing a joint tax return may be suspended as to one of the spouses claiming innocent spouse relief under Code § 6015.
- The application of Code §7345 to the taxpayer is the subject of an ongoing challenge in U.S. District Court or the Tax Court.

Franklin involved a court challenge to the application of Code §7345 after an offer in compromise was denied.

The Case

James Franklin is a U.S. citizen who failed to report a foreign trust of which he was the beneficial owner. When the I.R.S. discovered his failure in compliance, it levied penalties in the amount of $421,766. Two years later, it began taking steps to collect those penalties.

One of the steps was to issue a certification to the State Department that the taxpayer was in seriously delinquent tax debt. Mr. Franklin, believing the I.R.S.'s assessment was procedurally improper due to lack of proper supervision within the I.R.S. of the person asserting the penalty, offered to pay the agency a compromise sum. The I.R.S. declined, and the taxpayer brought suit.

Mr. Franklin asserted two reasons in support of his request for relief. The first was that procedural deficiencies invalidated the I.R.S.'s assessment. This claim was dismissed for lack of jurisdiction by both the U.S. Federal District Court and the Fifth Circuit Court of Appeals. The Anti-Injunction Act prevents a court from having jurisdiction to prevent the I.R.S. from collecting tax except as provided by statute.[2]

The second assertion challenged the constitutionality of the statute that resulted in a violation of substantive due process. Once that issue was raised, the court was required to determine the proper level of scrutiny for evaluating the claim. The standards are strict-scrutiny, intermediate scrutiny, or rational basis scrutiny.

The court first considered whether the strict-scrutiny standard applied. This standard is reserved for situations involving fundamental rights. This standard imposes an obligation on the government to show that the law is narrowly tailored to serve a compelling state interest. The court determined that strict scrutiny was inappropriate in a matter covered by Code §7345.

While early Supreme Court cases suggested that international travel might be a fundamental right,[3] later cases distinguished international travel from interstate travel.[4] The latter was a fundamental right, while the former was only an extension of the general right to liberty. The strict-scrutiny standard was not applicable.

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[2] 26 U.S.C. § 7421(a).

[3] *Zemel v. Rusk*, 381 U.S. 1 (1965); *Aptheker v. Secretary of State*, 378 U.S. 500 (1964); *Shelton v. Tucker*, 364 U.S. 479, 488 (1960).

[4] *Califano v. Aznavorian*, 439 U.S. 170 (1978); *Haig v. Agee*, 453 U.S. 280 (1981); *Regan v. Wald*, 468 U.S. 222 (1984).

Next, the court applied an intermediate level of scrutiny. Intermediate scrutiny requires that the challenged restriction must serve important governmental objectives and must be substantially related to achievement of those objectives. Collecting taxes is an important government objective and denying passport privileges is related to that objective in two ways. First, it incentivizes paying the debt. Second, it makes it difficult for delinquent taxpayers to hide assets in foreign countries. The court also approved of the law's scope. The statute targeted serious debts, included several procedural safeguards, and allowed erroneously affected taxpayers an opportunity to seek relief in court. Congress properly fashioned an arrow, not a bazooka, for the I.R.S. to use.

Note that the court reserved on determining that the intermediate standard of review applied to the case. It could have held that the rational standard of review applied,[5] but whichever standard was applicable the decision would be the same – no fundamental right exists under the Constitution regarding international travel.

The Fifth Circuit's decision followed the Tenth Circuit's validation of Code §7345 last year.[6]

TURKEY ADDED TO AUTOMATIC EXCHANGE OF INFORMATION LIST

<u>Background</u>

Over the past decade, the U.S. Treasury Department and the I.R.S. has focused on exchange of tax information with foreign tax authorities. Typically, the I.R.S. obtains information automatically from abroad regarding foreign financial accounts maintained by U.S. persons. F.A.T.C.A. is the prime example of the I.R.S. obtaining information under automatic exchange of information arrangements. In addition, the I.R.S. has a robust program that provides information to foreign tax authorities regarding U.S. bank accounts maintained in the name of foreign individuals who are resident in specific countries. The program requires domestic banks that pay interest to individual account holders who are neither resident in nor citizens of the U.S. ("N.R.N.C. individuals") to report the transaction on Form 1042-S (*Foreign Person's U.S. Source Income Subject to Withholding*).[7] The information on the Form 1042-S is transmitted to the relevant participating country.

This rule does not apply automatically to all such payments to N.R.N.C. individuals. Instead, the I.R.S. maintains two lists of countries covered by the rules. The first list is comprised of countries with which the U.S. has an information-exchange agreement, such as through an income-tax treaty.[8] The I.R.S. also maintains a second list of countries with which it shares information automatically under a Tax Information Exchange Agreement. Information that the I.R.S. collects under these

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5 The rational-basis standard is the lowest of the three standards that must be met by the government when it defends the constitutionality of a statute. The challenge to the statute fails once the government demonstrates that the law is rationally related to a legitimate government interest.

6 *Maehr v. U.S. Dept. of State*, 5 F.4th 1100 (10th Cir. 2021).

7 Treas. Reg. §1.6049-4(b)(5).

8 Treas. Reg. §1.6049-8(a).

rules will be shared with the tax authorities of countries on this list. The presence of an N.R.N.C. individual's country of residence on either list triggers the bank's reporting requirement.

Mechanically, banks can rely on a customer's Form W-8BEN (*Beneficial Owners Certificate of Foreign Status for U.S. Tax Withholding*) to determine the customer's residence and consequently the banks' reporting obligations.

The I.R.S. updates both lists annually. The most recent change is the addition of Turkey to the list regarding automatic exchanges of information.[9] This will not affect payments during the rest of 2022, but automatic exchange of information will apply to interest payments to Turkish deposit holders made in 2023 or later. Turkey was already part of the other list, so such payments were already reportable.

All Countries on the Lists

Country	Info-Exchange Agreement	Automatic Exchange of Info
Antigua & Barbuda	Yes	No
Argentina	Yes	No
Aruba	Yes	No
Australia	No	Yes
Austria	Yes	No
Azerbaijan	Yes	Yes
Bangladesh	Yes	No
Barbados	Yes	No
Belgium	Yes	Yes
Bermuda	Yes	No
Brazil	Yes	Yes
British Virgin Islands	Yes	No
Bulgaria	Yes	No
Canada	Yes	Yes
Cayman Islands	Yes	No
Chile	Yes	No
China	Yes	No
Colombia	Yes	Yes
Costa Rica	Yes	No
Croatia	Yes	Yes
Curaçao	Yes	Yes
Cyprus	Yes	Yes
Czech Republic	Yes	Yes
Denmark	Yes	Yes
Dominica	Yes	No

9 Rev. Proc. 2022-35.

Country	Info-Exchange Agreement	Automatic Exchange of Info
Dominican Republic	Yes	Yes
Egypt	Yes	No
Estonia	Yes	Yes
Faroe Islands	Yes	No
Finland	Yes	Yes
France	Yes	Yes
Georgia	Yes	No
Germany	Yes	Yes
Gibraltar	Yes	Yes
Greece	Yes	Yes
Greenland	Yes	No
Grenada	Yes	No
Guernsey	Yes	Yes
Guyana	Yes	No
Honduras	Yes	No
Hong Kong	Yes	No
Hungary	Yes	Yes
Iceland	Yes	Yes
India	Yes	Yes
Indonesia	Yes	No
Ireland	Yes	Yes
Isle of Man	Yes	Yes
Israel	Yes	Yes
Italy	Yes	Yes
Jamaica	Yes	Yes
Japan	Yes	No
Jersey	Yes	Yes
Kazakhstan	Yes	No
Latvia	Yes	Yes
Liechtenstein	Yes	Yes
Lithuania	Yes	Yes
Luxembourg	Yes	Yes
Malta	Yes	Yes
Marshall Islands	Yes	No
Mauritius	Yes	Yes
Mexico	Yes	Yes
Moldova	Yes	No
Monaco	Yes	No

Country	Info-Exchange Agreement	Automatic Exchange of Info
Morocco	Yes	No
Netherlands	Yes	Yes
Netherlands Special Municipalities[10]	Yes	No
New Zealand	Yes	Yes
Norway	Yes	Yes
Pakistan	Yes	No
Panama	Yes	Yes
Peru	Yes	No
Philippines	Yes	No
Poland	Yes	Yes
Portugal	Yes	Yes
Romania	Yes	No
Russia	Yes	No
Saint Lucia	Yes	Yes
Singapore	Yes	Yes
Saint Maarten	Yes	No
Slovakia	Yes	Yes
Slovenia	Yes	Yes
South Africa	Yes	Yes
South Korea	No	Yes
Spain	Yes	Yes
Sri Lanka	Yes	No
Sweden	Yes	Yes
Switzerland	Yes	No
Thailand	Yes	No
Trinidad & Tobago	Yes	No
Tunisia	Yes	No
Turkey	Yes	Yes
Ukraine	Yes	No
United Kingdom	Yes	Yes
Venezuela	Yes	No

10 Bonaire, Sint Eustatius, Saba

About Us

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

Our firm provides a wide range of tax planning and commercial legal services to clients across the Americas, Asia, Europe, and the Middle East. Clients include global investors, multinational corporations expanding into the U.S., and U.S. businesses with international operations. Our core practice focuses on cross-border transactions.

About Insights

Insights, the tax journal of Ruchelman P.L.L.C., provides in-depth reporting on the evolving landscape of U.S. and international taxation. It offers complex analysis of current issues, legislative updates, and practical introductions to the tax law from leading tax professionals in their respective countries.

Special features include an annual examination of the use of holding companies in European tax planning and a look at the year in review.

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