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INSIGHTS

ITALIAN SUPREME COURT ISSUES A LANDMARK DECISION ON THE ENTITLEMENT TO THE FOREIGN TAX CREDIT

ITALY: NEW CLARIFICATIONS CONCERNING THE TAXATION OF TRUSTS AND BENEFICIARIES

KEY FEATURES OF THE NEW-FANGLED BELGIUM-FRANCE INCOME TAX TREATY

AND MORE

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TABLE OF CONTENTS

Editors' Note

Italian Supreme Court Issues a Landmark Decision on the Entitlement to the Foreign Tax Credit 4

Italy: New Clarifications Concerning the Taxation of Trusts and Beneficiaries 11

Key Features of the New-Fangled Belgium-France Income Tax Treaty...................................... 20

Greek Tax Incentive Regimes for Newly Arrived Residents and Family Offices................... 28

Tax 101: Tricky Issues When a Non-U.S. Person Invests in an L.L.C. or Partnership Operating in the U.S................................ 36

When it Comes to Penalty Abatement, is the I.R.S. Offside? 48

Late Filed Form 3520: What Penalties to Expect and How to Respond 55

About Us

EDITORS' NOTE

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

- **Italian Supreme Court Issues a Landmark Decision on the Entitlement to the Foreign Tax Credit.** A common error among tax advisers is the expectation that tax law in a foreign country is applied in a straightforward way. For example, if a tax treaty provides that a foreign country will provide a foreign tax credit for taxes imposed by the other country, it seems clear that foreign tax will be reduced by that credit. Regrettably, this is not always the case. Francesco Capitta, who is Of Counsel to Facchini Rossi Michelutti, Studio Legale in Milan, and Andrea D'Ettorre, who is an associate at the same firm, explain that, in Italy, a decision of the Supreme Court was required in order to allow an Italian resident individual to reduce Italian tax by a foreign tax credit for U.S. income taxes withheld on U.S. source dividend income. Remarkably, there was a logical reason for the denial, but it was invalidated in the case.

- **Italy: New Clarifications Concerning the Taxation of Trusts and Beneficiaries.** Tax authorities in much of Europe look at trusts as a tax gimmick used by the wealthy as a tool to dodge taxes. However, trusts are commonly used as a tool in estate and succession planning in connection with generational transfers of family assets and businesses, the achievement of charitable purposes, and the protection of vulnerable individuals. In this context, the Italian tax authorities released Circular Letter No. 34/E in October, providing guidance on several key issues surrounding trusts. It provides many important clarifications making trusts more attractive for individuals resident in Italy and international families having one or more beneficiaries resident in Italy or wishing to relocate to Italy. Andrea Tavecchio, the Founder and Senior Partner of Tavecchio & Associati, Tax Advisers, Milan, and Riccardo Barone, a Partner at the same firm, explain how Italian tax authorities will treat various types of trusts in a logical way.

- **Key Features of the New-Fangled Belgium-France Income Tax Treaty.** After nearly two decades of negotiations, Belgium and France signed a new Income Tax Treaty in November 2021. The new treaty is in line with the latest O.E.C.D. standards, incorporates the applicable provisions of the Multilateral Instrument, and addresses salient tax issues for taxpayers engaging in cross-border transactions involving the two countries. Key aspects of the New Treaty relate to closing loopholes, expanding coverage to include wealth taxes, and retaining favorable treatment for Belgian investors in French S.C.I.'s. Werner Heyvaert, a partner at AKD Benelux Lawyers, Brussels, and Vicky Sheikh Mohammad, a tax lawyer at the same firm, explain all.

- **Greek Tax Incentive Regimes for Newly Arrived Residents and Family Offices.** The segment of European countries that have enacted favorable tax regimes to attract the wealthy are well known. Switzerland has its *forfait* regime, the U.K. has its nondom tax regime, Portugal and Italy have new resident regimes, and Malta and Cyprus have favorable regimes designed to attract new residents. To that list of countries, Greece is a new arrival, having introduced several tax incentive regimes designed to create a favorable tax

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environment for nonresident individuals transferring tax residence to Greece and the establishment and operation of family offices in Greece. Natalia Skoulidou, a partner of Iason Skouzos Law Firm, Athens, provides an overview of (i) the 5A Nondom Tax Regime, (ii) the 5B Pensioner Regime, (iii) the 5C Employee and Self-Employed Regime, and (iv) the Family Office regime.

- **Tax 101: Tricky Issues When a Non-U.S. Person Invests in an L.L.C. or Partnership Operating in the U.S.** Generally, U.S. tax law treats a partnership, including an L.L.C., as an aggregation of its partners, meaning flow-through treatment applies to the partnership's income. However, for certain purposes, a partnership is treated as a separate entity from its partners, as if it were a corporation. As a consequence, various complicated and somewhat counterintuitive tax consequences may arise from the acquisition or the disposition of interests in a U.S. partnership or L.L.C. by a foreign member. Stanley C. Ruchelman and Daniela Shani explain the way withholding taxes are computed when a foreign member sells an interest in a U.S. partnership or L.L.C. They also address U.S. tax accounting treatment for partnerships that take in additional members after operations have been conducted for several years. To say the rules are not straightforward is a massive understatement.

- **When It Comes To Penalty Abatement, Is the I.R.S. Offside?** When it comes to abatement of penalties regarding late filing of international information returns, the voluntary disclosure system adopted by the I.R.S. in its Delinquent International Information Return Submission Procedures suggests that penalties may be assessed but that there is a procedure to have them abated. In practice, penalties always seem to be assessed and the standard that must be met in order to have them abated is high. Reasonable cause from the viewpoint of a taxpayer need not be reasonable when reviewed by an I.R.S. Appeals Officer. Wooyoung Lee looks at the decided cases and the approaches taken by the I.R.S. to reduce penalties without fully abating them. He also comments on the facts of a case that has been filed in U.S. District Court challenging the apparent policy of mitigation rather than full abatement.

- **Late Filed Form 3520 – What Penalties to Expect and How to Respond.** When a U.S. person is faced with an asserted penalty for late filing of Form 3520 reporting the receipt of a foreign gift or bequest, the process to have the penalty abated is long and winding. Neha Rastogi and Stanley C. Ruchelman explain all the steps and suggest a strategy for supporting the taxpayer's contention that reasonable cause exists for the compliance shortfall. In many areas of the tax law, less is more. The authors point out that as much favorable information as possible must be given to the Appeals Officer in order to demonstrate that the shortfall in compliance was not the result of negligence or disregard of the rules by the taxpayer.

We hope you enjoy this issue.

- The Editors

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ITALIAN SUPREME COURT ISSUES A LANDMARK DECISION ON THE ENTITLEMENT TO THE FOREIGN TAX CREDIT

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Tags
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INTRODUCTION

In a recent case regarding distributions from the U.S., the Italian Supreme Court stated a general principle recognizing that, on the basis of double tax treaty provisions, Italian resident individuals are entitled to the foreign tax credit in respect of foreign taxes imposed on non-Italian source dividends.[1]

The decision is particularly relevant because it resolved a conflict between the Italian domestic rule and double tax treaty provisions. The Italian domestic rule denies the application of the foreign tax credit in a fact pattern involving foreign dividends that are subject to a reduced separate taxation in Italy, reasoning that the foreign tax credit applies solely to ordinary income subject to individual income taxes at the standard progressive rates. In comparison, the relevant tax treaty provision grants double tax relief in the form of a foreign tax credit that may be claimed by Italian resident individuals. The Italian Supreme Court ruled in favor of the clear meaning of the treaty provision.

Significant practical implications derive from this court decision as it provides grounds to Italian resident individuals to claim the refund of the income taxes paid in Italy without computing the foreign tax credit.

This article provides an overview of (i) the application of the foreign tax credit in respect of foreign source dividends received by Italian resident individuals and (ii) the main consequences that may result from the decision of the Italian Supreme Court.

TAXATION OF FOREIGN SOURCE DIVIDENDS

Under Italian domestic rules, dividends received by Italian resident individuals are not included in the ordinary income subject to individual income tax at progressive rates (up to 43%) and are instead subjected to "separate" taxation at the rate of 26%.[2]

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1 Decision of the Italian Supreme Court of Cassation No. 25698 of 1 September 2022.

2 Until December 31, 2017, a different tax treatment applied on dividends depending on whether the shareholding qualified as substantial (more than 2% of the voting rights or 5% of the equity in listed companies, or more than 20% of the voting rights or 25% of the equity in non-listed companies) or non-substantial. Dividends from substantial participations were subject to ordinary income taxation on 58.14% (49.72% until 2016) of the dividend payment. The remaining 41.86% (50.28% until 2016) was exempt. Dividends from non-substantial participations were subject to separate taxation at the reduced rate of 26% by way of final withholding tax or substitutive tax. The tax rate was originally equal to 12.5% until 2011. It was increased to 20% in the period from 2012 to June 30, 2014, and to 26% starting from July 1, 2014. As of 2018, the distinction between substantial and non-substantial participation eliminated. All dividends are subject to separate taxation at the rate

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In those cases, the recipient does not have the option to include the dividends in the ordinary income and separate taxation applies on a mandatory basis.[3]

The 26% taxation is applied either by way of withholding tax levied by an authorized financial intermediary[4] or through a substitutive tax to be paid by the recipient, if there is no financial intermediary intervening in the payment. Under the official interpretation of the Italian Revenue Agency,[5] different tax consequences result from an Italian perspective depending on whether separate taxation of foreign-sourced dividends is applied by way of withholding tax or substitutive tax.

If an authorized financial intermediary intervenes in the payment, the 26% withholding tax is applied on the amount of the dividends received net of the foreign taxes applied on those dividends. Example 1 illustrates the application of Italian tax collected by withholding.

Example 1 – Italian Withholding Tax		
A	Gross Dividend	100
B	Foreign Tax (15%)	15
C	Amount Subject to Italian W.H.T. (A – B)	85
D	Italian W.H.T. (C x 26%)	22.1
E	Foreign Tax Credit	0
F	Net Dividend (A – B – D)	62.9
G	Effective Tax Rate	37.1%

of 26%. Grandfathering rules apply in respect of dividends on substantial participations paid out of profits realized by a company up to December 31, 2017, and paid between January 1, 2018, and December 31, 2022. In particular, the taxable amount of the dividends to be included in the ordinary income subject to individual income tax is as follows: (i) 40% for dividends paid out of profits realized before 2008; (ii) 49.72% for dividends paid out of profits realized in the period from 2008 to 2016; and (iii) 58.14% for dividends paid out of profits realized in years 2016 and 2017.

3 It should be specified that the foregoing tax treatment does not apply to dividends directly or indirectly distributed by a company resident in a State with a privileged tax system. Those dividends are fully taxable in the hands of Italian resident individuals, unless previously taxed in the hands of the individuals under Italian domestic Controlled Foreign Corporation rules.

4 The category of authorized financial intermediaries includes Italian resident banks (including permanent establishments of non-Italian resident banks), Italian securities investment firms, Italian trust companies, Poste Italiane S.p.A., Italian stockbrokers and asset management companies authorized to provide individual asset management services.

5 Ruling No. 111/2020 of the Italian Revenue Agency.

If no authorized financial intermediary intervenes in the payment because, for example, the dividends are directly received by the Italian resident individual, the recipient must declare the dividends received in the individual income tax return and pay a substitutive tax at the rate of 26% on the amount of the dividends gross of foreign taxes. Example 2 illustrates the application of the Italian substitutive tax.

Example 2 – Italian Subsititutive Tax		
A	Gross Dividend	100
B	Foreign Tax (20%)	15
C	Amount Subject to Italian Substitutive Tax (= A)	100
D	Italian Substitutive Tax (C x 26%)	26
E	Foreign Tax Credit	0
F	Net Dividend (A – B – D)	59
G	Effective Tax Rate	41.0%

As shown in Example 2, when foreign dividends are subject to Italian substitutive tax, overall taxation is heavier than when Italian withholding tax is imposed on foreign dividends because the latter is collected after deduction of foreign taxes. No rational explanation exists for the difference; the two cases are identical, but for method of tax collection, and should lead to the same result. In neither case is a foreign tax credit allowed in Italy.

FOREIGN TAX CREDIT APPLIES TO ORDINARY INCOME, ONLY

According to Italian domestic rules, the foreign tax credit is granted, subject to certain conditions, exclusively with respect to foreign source income included in the taxpayer's ordinary income and is limited to the lower of the foreign tax paid or the Italian tax that relates to the foreign income. If the foreign source income is not included in the ordinary income subject to Italian individual income tax at progressive rates, the recipient is not entitled to benefit from any foreign tax credit.[6] That is the case of foreign source dividends received by individuals which, as described above, are subject to separate taxation and are not included in the ordinary income.

[6] As confirmed by the Italian Revenue Agency in Circular Letter No. 9/E of 2015, the rationale is that separate taxation is typically lower than ordinary taxation. Consequently, there is limited need for the application of methods to avoid double taxation, because the final result leads to a level taxation considered to be bearable. However, what was true when the rate for Italian taxation of dividends and certain other income of financial nature was 12.5%, is not necessarily valid when the rate of Italian tax is 26% with no relief for foreign tax.

In certain cases, the recipient may elect to treat certain financial income as ordinary income instead, which precludes application of the separate tax regime. In such a case, the recipient would be entitled to the foreign tax credit. However, this option is not applicable for foreign source dividends. Such dividends are never allowed to be included in ordinary income subject to individual income tax at progressive rates.

"The domestic foreign tax credit provision conflicts with the double tax relief provisions of the income tax treaties entered into by Italy, which generally provide double tax relief by means of a foreign tax credit."

In light of the framework described, foreign dividends suffer double taxation as they are taxed twice: first, at source, in the residence State of the foreign company and then, separately, in Italy in the hands of the recipients. The effect of double taxation is even heavier when the foreign dividends are not received through an authorized financial intermediary. As illustrated in Example 2, when the Italian substitutive tax is applied, the tax base is the amount of the gross foreign dividend computed without any reduction for foreign withholding taxes.

DOUBLE TAX RELIEF UNDER ITALIAN INCOME TAX TREATIES

The domestic foreign tax credit provision conflicts with the double tax relief provisions of the income tax treaties entered into by Italy, which generally provide double tax relief by means of a foreign tax credit.

In general, the method chosen by Italy to provide double tax relief is the ordinary credit method based on Article 23 B of the O.E.C.D. Model Tax Convention on Income and on Capital. Under the credit method, where an Italian tax resident derives income which may be taxed in the other contracting State in accordance with the provisions of the double tax treaty, Italy is obligated to allow a deduction from the tax – *viz.*, a credit – in an amount equal to the income tax paid in that other State. The credit is subject to a limitation, preventing it from exceeding the portion of Italian income tax that is attributable to the income arising in the other State. In broad terms, the Italian tax is multiplied by a fraction in which the numerator is the income that is derived from sources in the other state and the denominator is the total income of the Italian company.

Most double tax treaties entered into by Italy (87 out of 103) contain a clause allowing Italy to deny the foreign tax credit in the event that a particular item of foreign source income is taxed in Italy separately by way of a final withholding tax applied at the request of the Italian resident recipient. Examples appear in the income tax treaties with the U.S., France, Germany, Luxembourg, the Netherlands, Spain, and the U.K.[7] Consequently, if an item of foreign income is subject to separate taxation by way of withholding tax or substitutive tax on a mandatory basis rather than upon request of the Italian resident recipient, Italy should be required to allow the foreign tax credit.

In the most recent tax treaties, Italy introduced a different clause that denies the foreign tax credit where the final withholding tax is applied "also by request of" the Italian tax resident recipient. (Examples include income tax treaties between Italy and Malta, Cyprus, and Hong Kong. Other tax treaties expressly deny the foreign

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[7] See for example Art. 23, paragraph 3, third sentence, of the Italy-U.S. Income Tax Treaty, which provides that "[n]o deduction will be granted if the item of income is subjected in Italy to a final withholding tax by request of the recipient of the said income in accordance with Italian law."

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tax credit “whether at the request of the recipient or otherwise” Examples include income tax treaties between Italy and Chile, Jamaica and Colombia). Under the relevant clauses in those treaties, no foreign tax credit would be granted if foreign income is subject to separate taxation in Italy, whether the separate taxation is mandatory by law or upon request by the recipient.

In light of the above, the current Italian tax treatment of foreign source dividends can be summarized as follows:

- Foreign source dividends are subject to separate taxation in Italy either by way of withholding tax or substitutive tax.
- No foreign tax credit is allowed under Italian domestic rules because it only applies to items of income included in the ordinary income.
- An Italian resident individual who receives a dividend does not have the option to treat the dividends as ordinary income.
- Under most income tax treaties entered into by Italy, the foreign tax credit can be denied in Italy solely if the income is subject to separate taxation at the request of the recipient.
- The Italian Revenue Agency has traditionally taken the position that the Italian tax system does not allow any foreign tax credit in relation to income subjected to separate taxation.

DECISION NO. 25698/2022 OF THE ITALIAN SUPREME COURT

The recent decision of the Italian Supreme Court addressed this matter. The facts were straightforward. An Italian tax resident individual directly received distributions from a US partnership without the involvement of any authorized financial intermediary. Under Italian domestic rules, foreign entities (including partnerships) are regarded as tax opaque (*i.e.*, non-transparent) entities, regardless of the actual tax treatment in their country of residence or establishment. Consequently, from an Italian perspective, distributions from foreign entities are treated as dividends provided that certain conditions are met.[8]

In the case, the Italian recipient reported in his individual income tax return the distributions from the U.S. partnership as dividends subject to substitutive tax and used the foreign tax credit, by deducting the U.S. taxes from the Italian taxes on the U.S. income. The Italian Revenue Agency claimed that the individual omitted to pay the substitutive tax on the dividends from the U.S. partnership, arguing that no foreign tax credit was available with respect to the dividends as they were subject to “separate” taxation.

The Italian resident individual filed an appeal before the tax court of first instance, claiming that he was entitled to the foreign tax credit according to Paragraph 3 of

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[8] Distributions from shares and equity-like financial instruments issued by non-Italian entities are treated as dividend income for Italian income tax purposes provided that such remuneration: (i) is fully participating; and (ii) is not deductible from the taxable income of the issuer in its State of residence.

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Article 23 (Relief from Double Taxation) of the Italy-U.S. Income Tax Treaty. Those dividends were not subject to separate taxation at his request but were applied on a mandatory basis by operation of law.

The tax court of first instance and the tax court of second instance ruled in favor of the Italian resident individual. The Italian Revenue Agency filed an appeal before the Italian Supreme Court.

The Italian Supreme Court rejected the appeal of the Italian Revenue Agency on several grounds. First, it acknowledged that Paragraph 3 of Article 23 of the Italy-U.S. Income Tax Treaty prevails over any Italian domestic tax rules. As a result, Italy can deny the foreign tax credit only if "if the item of income is subjected in Italy to a final withholding tax by request of the recipient of the said income in accordance with Italian law." Second, it argued that the article must be construed according to its plain meaning. Consequently, when an item of foreign income, such as foreign dividends, are received by Italian resident individuals other than within the course of a business, and for that reason are subject to separate taxation on a mandatory basis the treaty limitation that prevents the individual from claiming foreign tax credits does not apply. The U.S. taxes may be claimed as a credit against the Italian income taxes due on the U.S. source income.

As support for its interpretation, the Italian Supreme Court pointed to the different wording adopted in other income tax treaties entered into by Italy. Under those treaties, Italy can deny the foreign tax credit the request of the recipient or otherwise, meaning under a provision of Italian domestic law.

Based on the above, the Italian Supreme Court ruled that the Italian resident individual was entitled to the benefit of a foreign tax credit on U.S. source dividends based on a straightforward reading of Paragraph 3 of Article 23 (Relief from Double Taxation) of the Italy-U.S. Income Tax Treaty. It clearly states that Italy can deny the foreign tax credit only if the item of income is subjected in Italy to a final withholding tax by request of the recipient in accordance with Italian law.

The principle stated by the Italian Supreme Court should apply not only to foreign dividends taxed by way of a substitutive tax paid by the individual, but also when such dividends are received through an authorized financial intermediary which applies final withholding tax.

PATH FORWARD

In light of decision No. 25698/2022 of the Italian Supreme Court, recipients of foreign source dividends should be able to claim foreign tax credit in respect of the foreign taxes applied on the dividends provided that (i) a tax treaty between Italy and the country of the company paying the dividends is applicable and (ii) according to such treaty Italy can deny the foreign tax credit solely with respect to items of income subject to withholding tax upon request of the recipient.

In moving forward, several additional considerations should be taken into account.

Italian domestic rules provide for conditions and limitations that are not envisaged in the tax treaties and the question arises as to whether those conditions and limitations apply when the foreign tax credit is granted on the basis of an applicable tax treaty.

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Moreover, from a practical perspective it is not clear what remedies are available in order to claim the foreign tax credit.

In relation to past years, for which the Italian taxes have already been paid, the only available instrument is to file a refund request with the Italian Revenue Agency, claiming a refund of the Italian taxes that would have not been paid had the foreign tax credit been applied. Under the Italian statute of limitations, refund requests must be filed within 48 months from the date of payment. In case the Italian Revenue Agency denies the refund outright or because the failure to answer a refund claim within 90 days is deemed to be a denial, it would then be necessary to appeal the denial before a tax court.

As far as dividends subject to Italian withholding tax are concerned, given that the dividends are not reported in the tax return of the recipient, it is technically not possible to claim the foreign tax credit in the tax return. Perhaps the withholding tax agent could consider adjusting the Italian withholding tax so that it is net of the foreign tax credit. However, lacking a specific rule, the withholding tax agent would likely be exposed to penalties.

If there is no authorized financial intermediary intervening in the payment, the dividends must be reported in the tax return by the Italian resident recipient and be subjected to substitutive tax. However, the tax return does not plainly allow to use the foreign tax credit against the substitutive tax on dividends.

On a go-forward basis in the absence of legislation, a prudent solution taking into account the risk of penalties is to pay the Italian taxes by way of withholding tax or substitutive tax without using the foreign tax credit and then to file a refund request to recover the higher taxes that have been paid.

The principle stated by the Italian Supreme Court is not limited to foreign source dividends. It should apply to any other items of income that are subject to separate taxation with no option covering inclusion in ordinary income. In particular, it applies to capital gains on shares in non-Italian resident companies realized by Italian resident individuals, to the extent that the applicable tax treaty allows the source country to tax the capital gain.

ITALY: NEW CLARIFICATIONS CONCERNING THE TAXATION OF TRUSTS AND BENEFICIARIES

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Italy
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Trust Beneficiaries
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INTRODUCTION

A trust is an instrument having extreme flexibility and adaptability. For those reasons, it is becoming more and more common in the field of estate and succession planning as a simple and effective solution to protect an individual's assets from uncertain events. It is customarily used in generational transfers of family assets and businesses, the achievement of charitable purposes, and the protection of vulnerable individuals.

Italy does not have proper civil rules regulating trusts, but the use of trusts has been recognized in Italy through the ratification of the Hague Convention of July 1, 1985 (enforced with the Law n. 364/89 and came into force since January 1, 1992). Nonetheless, the increasing use of trusts in Italy has raised several questions about tax treatment for trusts, settlors, and beneficiaries.

In this context, the Italian tax authorities released Circular Letter No. 34/E on October 20, 2022, providing guidance on several key issues surrounding trusts. It provides many important clarifications making trusts even more attractive for individuals resident in Italy and international families having one or more beneficiaries resident in Italy or wishing to relocate to Italy. By way of example, capital distributions involving assets located outside of Italy can be totally exempt from taxation in Italy when made by an irrevocable, discretionary trust established by a settlor resident abroad.

This article examines the principal provisions of Circular Letter No. 34/E and provides a comprehensive view of the tax treatment of trusts in Italy. Several practical examples are discussed.[1]

TAX TREATMENT OF TRUSTS, SETTLORS, AND BENEFICIARIES

The tax treatment of trusts, settlors, and beneficiaries varies depending on (i) the type of trust from an Italian tax perspective (*i.e.* opaque, transparent, or disregarded), (ii) the nature of the trust based on actual activity carried out (*i.e.* commercial or non-commercial trust), and (iii) the residence of the trust for tax purposes.

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1 The examples provided are based on the interpretation of recent clarifications provided by the Italian tax authorities. Because some points remain unclarified, the examples may need to be revised in the event additional clarifications are issued by the Italian tax authorities.

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Type of Trusts

- **Disregarded Trust.** To be treated as a disregarded trust, a trust must be (i) a revocable trust or (ii) a trust where the settlor or the beneficiaries have a power or *de facto* control or influence to manage the trust assets or dispose of either the assets held in trust or the income from such assets.

  With Circular Letter 61/E/2010, the Italian tax authority listed some cases in which a trust should be considered a disregarded entity for tax purposes:

  - Trusts where the settlor or the beneficiaries can terminate the trust at will.
  - Trusts where the settlor can, at any time appoint himself or herself as beneficiary.
  - Trusts where the trustee cannot administer the trust without the prior consent of the settlor or of the beneficiaries.
  - Trusts where the settlor has the power to revoke the trust assigning trust assets to himself or herself or to other beneficiaries.
  - Trusts where the beneficiaries have the right to receive an anticipated attribution of the trust assets during the life of the trust.
  - Trusts where the trustee must follow the directions provided by the settlor with reference to the management of the trust assets and the trust income.
  - Trusts where the settlor has the power to modify the list of beneficiaries during the life of the trust.
  - Trusts where the settlor can appoint income or assets, or provide loans, to persons appointed by the settlor.
  - Trusts where the administrative and dispositive powers of the trustee are limited, or can be affected, by the settlor or by the beneficiaries

- **Transparent Trust.** To be treated as a transparent trust, a trust must be a fixed-interest trust or another trust where the beneficiaries are identified. According to the interpretation of the tax authorities, a beneficiary is identified when he is not only named as a beneficiary, but also has an enforceable right to the payment of his share of the trust's income.

- **Opaque Trust.** To be treated as on opaque trust, a trust must be irrevocable and discretionary, meaning that the trustee has a discretionary power to appoint income and capital to beneficiaries.

Nature of Trusts

- **Commercial Trust.** To be treated as a commercial trust, the exclusive or principal object of the trust must have a commercial nature, meaning that the activity performed results in the generation of business income pursuant to Art. 55 Italian Income Tax Code, ("I.T.C.").

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- **Noncommercial Trust.** This category is a residual category. To be treated as a noncommercial trust, a trust must not be a commercial trust.

Tax Residence of Trusts

- **Resident Trust.** To be treated as a resident trust, the place of administration of the trust must be located in Italy or its principal business must be carried out in Italy.

  The Italian tax legislation provides two anti-tax avoidance presumptions for a trust to be considered fiscal resident in Italy, even if none of the listed conditions are met.

  - The first provides that a trust is presumed to be resident in Italy if (i) a trust is established in a jurisdiction not included in the white list of countries that allow exchanges of information with Italy and (ii) at least one of its settlors and one of its beneficiaries is an Italian resident person. Circular 48/E/2007 clarifies that, for the purposes of this rule, the tax residency of the settlor is tested at the time of establishment of the trust. Therefore, if at the time of formation of the trust any settlor was an Italian resident person, the anti-abuse rule applies, even though the settlor becomes nonresident at a later stage. For beneficiaries, tax residence is tested in each taxable period during the life of the trust. The taxpayer can rebut the presumption by providing evidence that the trust is considered to be nonresident in Italy according to the general rules. This means that the trust's place of effective management or place of business is located outside Italy.
  - The second addresses the addition of Italian situs real property by a resident person to a trust settled in a State that is not a white-list State. In that fact pattern, the trust is considered to be resident in Italy when, after its formation, an Italian resident person transfers to the trust full or limited ownership rights to Italian real property. Also in this case, the taxpayer can rebut the presumption by providing evidence that the trust is considered to be nonresident in Italy under general rules.

- **Nonresident Trust.** To be treated as a nonresident trust, the place of administration of the trust must be located outside of Italy and its principal business must not be carried on in Italy.

"According to Italian tax law, resident opaque trusts are treated as taxable persons for corporate income tax purposes."

DIRECT TAX PROVISIONS

Italian Resident Opaque Trusts

According to Italian tax law, resident opaque trusts are treated as taxable persons for corporate income tax purposes. Taxation of worldwide income occurs at the trust level.

Within the category of opaque trusts, a distinction must be made between opaque commercial trusts and opaque noncommercial trusts.

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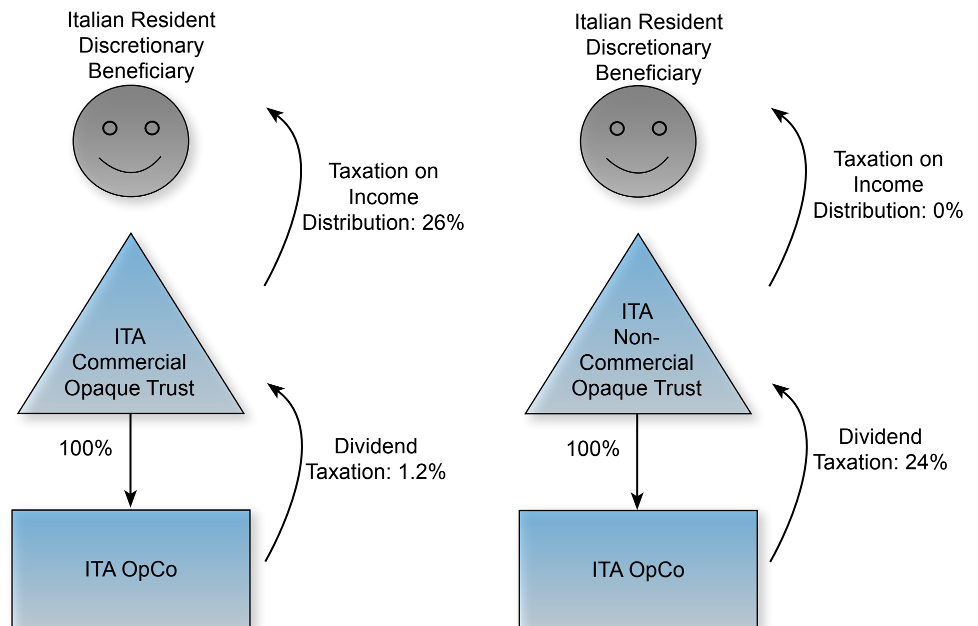
- For a commercial trust, income must be determined under the rules applicable to business income,[2] including the rules exempting capital gains[3] and dividends from tax.[4] Income is subject to corporate income tax (I.R.E.S.), levied at a rate of 24%. A subsequent income distribution to a discretionary beneficiary is subject to a withholding tax imposed at a rate of 26%. In addition, profits reserves of the commercial trust are considered to be distributed to beneficiaries before capital reserves,[5] regardless of the nature of the reserve to which the trustee has allocated the amounts distributed to the beneficiaries.

- For a noncommercial trust, income must be determined by applying the same rules which apply to individuals. By way of example, capital gains that are derived from the sale of a property held for over five years is not subject to taxation. Once income is determined, it generally is subject to I.R.E.S., levied at a rate of 24%, except for certain financial income[6] that is subject to the substitute tax, levied at a rate of 26%. Subsequent income distributions to a discretionary beneficiary are not subject to additional taxation.

The following diagram illustrates the differences in taxation of dividend income paid by an Italian operating company to an Italian resident commercial opaque trust and an Italian resident noncommercial opaque trust and distributed by the trust to a beneficiary that is an Italian resident individual.



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2 Article 81 and following provisions of the I.T.C.

3 Article 87, regulating the participation exemption regime.

4 Article 89, I.T.C. which provides for an exclusion from taxable base of 95% of the gross dividend.

5 Article 47 (1), I.T.C.

6 Dividends are not subject to 26% withholding/substitute tax but at 24% corporate income tax.

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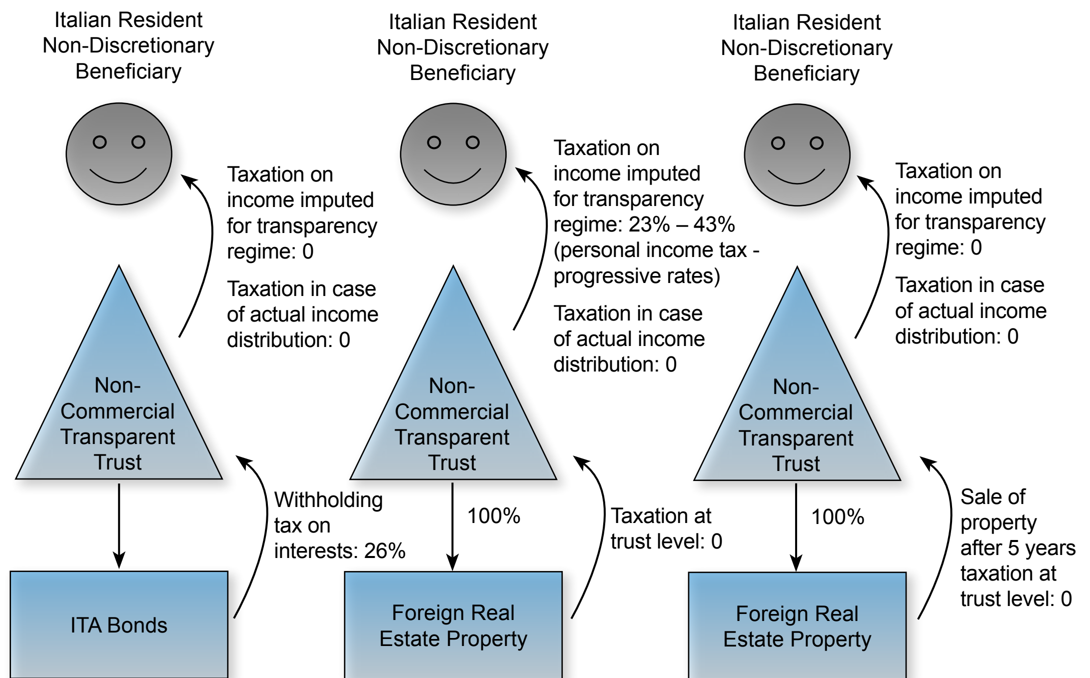
Transparent Trusts

Whether resident or nonresident, a transparent trust is not considered to be a taxable entity. As a result, the worldwide income of the trust is subject to taxation on an accrual basis at the level of Italian resident beneficiary. Where the beneficiary is an individual, the income imputed to him is added to his taxable income, and taxed at progressive tax rates that range from 23% up to 43%. Where the trust income has already been subjected to a final withholding tax or a substitute tax in Italy, no further tax is due at the level of the beneficiary. Either way, no further tax is due at the time of an actual distribution to an Italian resident beneficiary.

The following diagram illustrates taxation in three different fact patterns involving income received by a noncommercial transparent trust. In one fact pattern, the trust receives interest income derived from Italian bonds held with an Italian financial institution. In the second fact pattern, the trust receives rental income from real estate located outside of Italy. In the third fact pattern, the trust realizes a capital gain from real estate held for more than five years.



Foreign Opaque Trusts

As a general rule, foreign trusts are treated as taxable persons for corporate income tax purposes and subject to taxation in Italy in respect of income produced in Italy only. Where a trust is a foreign opaque trust, the taxation of an Italian resident beneficiary on eventual income distributions will vary depending on whether the trust is established in a low-tax jurisdiction described in Article 47-bis I.T.C.

Income distributions from a foreign opaque trust established in a low-tax jurisdiction are treated as taxable income for an Italian resident beneficiary. If the beneficiary is an individual, progressive tax rates apply, ranging from 23% to 43% on the amount received. Where the trust receives Italian source income on which Italian tax has

been paid at the trust level, no additional Italian tax is imposed on an Italian resident beneficiary when that Italian source income is distributed.

In the case of a foreign opaque trust established in a low-tax jurisdiction, where it is not feasible to differentiate contributed capital from income generated by the trust, the entire amount distributed to a Italian resident beneficiary resident is presumed to be income for Italian tax purposes. This all-or-nothing characterization may be rebutted by accurate and complete accounting records prepared by the trustee or other documentation such as bank and financial account statements. In all instances, Italian tax rules will be applied in identifying income and capital. An accounting method applied by a trustee according to the rules of its country of residence or the country of residence of the trust will not be determinative for Italian tax purposes.

In order to understand if income distributions from a foreign opaque trust is established in a low-tax jurisdiction several factors must be evaluated. The first is the nominal rate of tax imposed on the trust. An opaque trust is deemed to be established in a low tax jurisdiction where the nominal level of tax in its country of residence is less than 12%, which amounts to 50% of the Italian corporate income tax of 24%. If the trust exclusively generates income of a financial nature, the nominal rate of tax must be less than 13%, which amounts to 50% of the Italian substitute tax on financial income, currently 26%. For this comparison, special tax regimes that directly affect tax rates or that provide exemptions or reductions in the tax base affect the nominal rate in the foreign country. The comparison between the foreign nominal level of taxation and the Italian one must be made at the time the income is generated by the trust.

The second is the place of establishment. A trust is established in a low-tax jurisdiction by reference to its place of tax residence at the moment of the distribution of income to an Italian resident beneficiary (provided that the income distributed was subject to taxation, at the time of its generation, in compliance with the minimum level of taxation provided for by the aforementioned Article 47-bis of the ITC). Where a trust has more than one trustee and can be viewed to have residence in more than one jurisdiction, the state of residence is the state where the trust is actually taxed. In the event that the trust is not considered to be tax resident in any state based on relevant local criteria so that no tax is imposed on the trust or its Italian resident beneficiary, a trust is considered to be established in the state where the trust's administration activity is predominantly carried out.[7] Finally, a trust established in an E.U. or E.E.A. Member State may be considered as established in a low tax jurisdiction if it benefits from a tax exemption regime provided for offshore trusts.

If a foreign opaque trust is considered to be established in a jurisdiction other than a low tax jurisdiction, Italy will impose tax only on income generated in Italy. Distributions of income to a discretionary beneficiary residing in Italy are not taxed.

Disregarded Trusts

If a trust is a disregarded trust, its income is imputed directly to the settlor or a beneficiary based which party has de jure power or *de facto* power to (i) control or influence the management of trust assets or (ii) dispose of trust assets or income. In other words, the trust is deemed not to exist for Italian tax purposes.

[7] These trusts are referred to as resident but not domiciled trusts.

INDIRECT TAX PROVISIONS

Time of Payment of Inheritance and Gift Tax

Prior to the release of Circular Letter 34/E, the position of the Italian tax authorities was that a settlor's transfer of assets to a trust ("*atto dispositivo*") constituted an immediate gratuitous transfer subject to inheritance and gift tax ("I.H.G.T."). The Italian Supreme Court expressed a different view in several recent cases. It adopted a clear rule that the transfer of assets in favor of a trustee is a temporary transfer. The effective transfer by the settlor occurs at a later stage, at the time of distribution of assets to beneficiaries.

The Italian tax authorities have now aligned their position to the approach of the case law. The addition of assets into trusts represents a non-taxable event for I.H.G.T. purposes. Consequently, I.H.G.T. will be applied only upon the enrichment of the beneficiary which occurs (a) upon distribution of the capital to the beneficiaries or earlier (b) in case of beneficiaries acquiring a vested interest over the trust's assets.

Distributions of income are not instead subject to I.H.G.T. but rather to income tax, in the manner described above.

"Distributions of income are not instead subject to I.H.G.T. but rather to income tax . . ."

In applying its new position, the Italian tax authorities have adopted a grandfather rule. For settlements effected in earlier years where I.H.G.T. was paid at the time of contribution of assets to a trust, Circular 34/E provides that that no additional I.H.G.T. will be due upon capital distribution to the beneficiaries. The grandfather rule applies only where assets that have been transferred to the trust and the beneficiaries have not changed. Where the final transfer of assets is made to a different beneficiary or relates to assets or rights other than those transferred and taxed at the moment of the contribution of assets to the trust, I.H.G.T. previously paid at the time of contribution can be credited against the I.H.G.T. due when assets are transferred to beneficiaries. Alternatively, taxpayers may claim a refund of I.H.G.T. provided that the three-year statute of limitations from the date of payment has not elapsed.

Tax Rates and Tax Base

I.H.G.T. is levied on the worldwide assets transferred by an Italian resident transferor. It is also imposed on the transfer of Italian-situs assets transferred by a nonresident transferor. I.H.G.T. tax rates range from 4% to 8% subject to exemptions of up to €1.0 million depending on the degree of kinship between the transferor and the transferee. The degree of kinship, the computation of the tax base, and the rate of I.H.G.T. applicable to a transfer is determined at the moment of the transfer of assets to a beneficiary. The resident or nonresident status of the settlor is determined at the time assets are contributed to the trust. Finally, assets held in a disregarded trust are subject to I.H.G.T. at the time of the death of the settlor.

Examples of Application

The following examples illustrate the way I.H.G.T. will now be applied.

Example 1

A trust was established by a nonresident with regard to Italy many years ago by means of a contribution of foreign financial assets into a foreign resident trust. The

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trust is not a disregarded from an Italian tax perspective. Mr. X is a beneficiary. At the time the trust was funded, Mr. X was a tax resident in a country other than Italy. At some point thereafter, Mr. became a tax resident of Italy. He is subject to the ordinary regime for residents. After his relocation to Italy, Mr. X receives a capital distribution from the trust.

The capital distribution is not subject to Italian I.H.G.T., and as a capital distribution, it is not subject to any income tax. The residency of the trust in a white list jurisdiction or a low tax jurisdiction has no effect on Mr. X's Italian tax position with regard to the capital distribution, with one possible exception. If the trust is an opaque trust resident in a low tax jurisdiction the trustee's accounting records, supported by bank account statements and financial account statements must clearly document that the distribution is a capital distribution legally and in substance. That determination is made according to Italian tax rules applicable to trusts.

Example 2

Ms. Y is a tax resident of a country other than Italy. She establishes a revocable trust to which she contributes Italian real property. After five years, Ms. Y meets an untimely death. At the conclusion of her life, Ms. Y continued to be a tax resident of the same country.

No I.H.G.T. is due at the moment of contribution of the Italian real property to the revocable trust. However, at the conclusion of her life, the Italian real estate property is subject to Italian I.H.G.T.

TAX REPORTING OBLIGATIONS AND WEALTH TAXES

The Italian tax authorities clarified that the current legislation concerning tax reporting obligations applies to individuals who qualify as "beneficial owners" of assets held in trust. It does not matter that the legislation makes no explicit reference to trusts. The reporting obligations may be summarized as follows:

- Italian tax reporting obligations that are typically made on Form RW of the Italian tax return are not extended to the trustee or the protector. In addition, the obligation is not extended to the settlor, provided the trust is not deemed to be disregarded for Italian tax purposes.
- Regarding Italian resident noncommercial opaque trusts, the Italian tax reporting obligations fall upon the trust, itself.
- Italian tax resident beneficiaries of nondiscretionary trusts are required to fulfil the Italian tax reporting obligations disclosing the value of the foreign investments and financial assets held by the trust, as well as their share in the trust's assets.
- Regarding foreign opaque trusts, resident beneficiaries are required to comply with Italian tax reporting obligations, provided that (i) the beneficiaries are identified, or can be easily identified, pursuant to the trust deed and to the related documentation and (ii) such beneficiaries have available information; for example, where the trustee communicates a trust decision to attribute the income or capital of the trust fund to a resident beneficiary.

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- No tax reporting obligations arise for second degree beneficiaries, meaning individuals who only have a right to income or assets of the trust after the primary beneficiaries ceases to hold such interest; note that a different conclusion is possible if the relevant provisions of the trust provides that a purported second degree beneficiary has at least a potential right to receive a distribution from the trust during the lifetime of the primary beneficiaries.

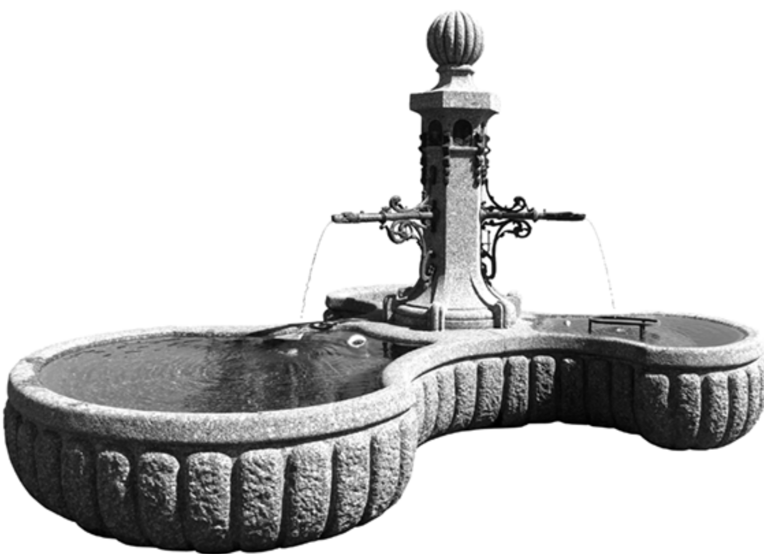
WEALTH TAX

Beginning with the 2020 tax period, noncommercial trusts that are resident in Italy are subject to wealth taxes on real property and financial assets held abroad (respectively, "I.V.I.E." and "I.V.A.F.E.").

In very general terms, wealth taxes apply to noncommercial trusts at the following rates:

- Financial assets held abroad are subject to an annual tax at the rate of 0.2%.[8] The tax is capped at €14,000. The tax base is the fair market value for listed assets and nominal value for unlisted assets.
- Real estate located abroad are subject to an annual tax at the rate of 0.76%. The tax base is the original purchase price, except for real estate located in an E.U. or E.E.A. Member State. If exchange of information programs are in place with an E.U. or E.E.A. Member State, the tax base is the value resulting from foreign cadastral registers or other deemed value relevant to foreign income, wealth or transfer taxes.

Lastly, Italian tax resident beneficiaries of a trust that is not a disregarded trust are not subject to Italian wealth taxes.



[8] For bank accounts, I.V.A.F.E. applies at a fixed amount of €100.

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KEY FEATURES OF THE NEW-FANGLED BELGIUM-FRANCE INCOME TAX TREATY

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Tags
Belgium
Corporate Tax
Foreign Tax Credit
France
International Tax
Société Civile Immobilière
Tax Treaty

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INTRODUCTION

After nearly two decades of negotiations, Belgium and France signed a new Income Tax Treaty on November 9, 2021 (the "New Treaty"). The New Treaty is in line with the latest O.E.C.D. standards, incorporates the applicable provisions of the Multilateral Instrument (the "M.L.I."), and addresses salient tax issues for taxpayers engaging in cross border transactions involving Belgium and France.

The New Treaty will enter into force when both Belgium and France complete the ratification procedure. In Belgium, the consent of the Federal Parliament and five Regional Parliaments is required. In practice, the New Treaty should not enter into force before January 2023. Until then, the Belgium-France Income Tax Treaty of March 10, 1964 (the "Current Treaty") will remain applicable.

TAXES COVERED

In contrast with the Current Treaty that only applies to income taxes, the New Treaty will cover wealth taxes in addition to income taxes. This larger scope will impact application of (i) the French real estate wealth tax, (ii) the Belgian "Cayman Tax," which imposes Belgian income tax on profits derived through certain low-tax offshore structures, and (iii) the Belgian securities accounts tax, which imposes a tax of 0.15% on securities accounts having an average value in excess of €1.0 million.

RESIDENT STATUS

Under the Current Treaty, a legal entity qualifies as "resident" depending on the location of its effective place of management, without any requirement to be subject-to-tax in Belgium or France. This changes under the New Treaty, which is in line with the latest O.E.C.D. standards. Now, a resident is defined as "any person who, under the laws of [Belgium or France], is liable to tax therein by reason of the person's domicile, residence, place of management or any other criterion of a similar nature." Consequently, a juridical or natural person who is not subject-to-tax in Belgium or France is no longer eligible for Treaty protection.

The new subject-to-tax requirement should exclude most, but not all, investment funds:

- Collective investment undertakings and pension funds may claim benefits under Article 10 (Dividends) and Article 11 (Interest) of the New Treaty even if not "resident" under the standard definition.

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- French translucent entities, such as *sociétés civiles immobilières* ("S.C.I.'s"),[1] will be eligible for Treaty protection provided certain conditions are met. The New Treaty treats partnerships, group of persons, or similar entities as "residents" where the entity (a) has its effective place of management in France, (b) is subject to tax in France, and (c) all of its shareholders, partners, or members are personally subject to tax based on their respective shares in the profits of the entity.

PERMANENT ESTABLISHMENTS

Article 5 of the New Treaty adopts the M.L.I. definition of the term "Permanent Establishment" ("P.E."), thereby enabling French and Belgian tax authorities to challenge artificial arrangements designed to avoid the existence of a P.E. status.

First, the New Treaty broadens the circumstances in which a dependent agent will constitute a P.E. In addition to the existing rule where a dependent agent "acts and habitually concludes contracts on behalf of an enterprise," a P.E. will exist where a person "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise."

Second, the New Treaty narrows the circumstances in which an agent will be viewed to be an independent agent. Any person who "acts almost exclusively on behalf of one or more enterprises to which that person is closely related" will be deemed not to be an independent agent as to those enterprises. A person is deemed to be "closely related" to an enterprise if one controls the other or both are under the control of the same persons or enterprises. The determination is made based on all the relevant facts and circumstances. Control will typically exist where one of the parties holds a direct or indirect beneficial ownership interest in the other in excess of 50%.

Third, the New Treaty includes an anti-fragmentation rule that applies when determining whether an activity has a "preparatory or auxiliary character" and, for that reason, is not considered to be a P.E. Activity that ordinarily would not constitute a P.E. under Paragraph 4 may be considered to be a P.E. under new Paragraph 4.1 which provides the following limitation:

> Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and
>
> a. that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or
>
> b. the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,

[1] S.C.I.'s are corporations that have legal personality under French corporate law, but can elect to be treated as flow-through entities for French corporate tax purposes.

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> provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.

In a deviation from the M.L.I., which provides that a building site or a construction and/or installation project must exist for 12 months in order to be treated as a P.E., the New Treaty provides that a P.E. will exist if the site or project exists for nine months. Under the Current Treaty, the period is six months.

REAL ESTATE INCOME

Under the Current Treaty, income derived from immovable property is taxed only in the country where the property is located. This rule is consistent with the traditional O.E.C.D. approach and remains unchanged in the New Treaty.

What is changed by the New Treaty is the treatment of real estate income derived by a Belgian corporation that invests in an S.C.I. or other entity that has legal personality but is treated as tax transparent in France.

"Given the tax transparency of S.C.I.'s, French tax authorities take the position that an S.C.I.'s real estate income should be treated as real estate income derived by shareholders."

Given the tax transparency of S.C.I.'s, French tax authorities take the position that an S.C.I.'s real estate income should be treated as real estate income derived by shareholders. Under this view, the income should be taxable in France under Article 6 (Immovable Property) of the Current Treaty because France is the State where the property is located. In contrast, Belgian tax authorities take the position that, because an S.C.I. has legal personality, income derived by individual shareholders should be characterized as dividends and taxed in Belgium. Not surprisingly, the disparity in views has given rise to tax disputes between the tax authorities of the two States.

The New Treaty addresses the dispute in Article 6 (Immovable Property) and Article 22 (Elimination of Double Taxation). The New Treaty provides that any income distributed by an S.C.I. will be characterized in accordance with Belgian domestic law.

Where the shareholder of an S.C.I. is a Belgian corporation, the income will be taxed in Belgium. The New Treaty allows the Participation Exemption to apply. This is a major development as Belgian tax authorities have argued that the Participation Exemption is not automatically applied.

Generally, corporations with legal personality but that are transparent for corporate tax purposes do not satisfy the qualitative (or subject-to-tax) test. The New Treaty confirms that the subject-to-tax test will not be applied at the level of the S.C.I., provided the Belgian corporate shareholder is taxed in France on the profits of the S.C.I. in proportion to the rights it holds. Other conditions for the Belgian Participation Exemptions remain applicable. In other words, the Belgian corporation must have a minimum shareholding of 10% or a minimum investment of €2.5 million and the shares must be held for an uninterrupted period of at least one year at the time dividends are received. In addition, the Participation Exemption is subject to the condition that the Belgian corporation is taxed in France on the profits of the S.C.I. in proportion to the rights it holds.

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In a nutshell, Belgian corporations receiving dividends from French S.C.I.'s will be eligible for the Belgian Participation Exemption under the New Treaty, without assessing the "subject-to-tax" test at the level of the S.C.I.

DIVIDEND WITHHOLDING TAXES

Article 10 (Dividends) of the Current Treaty limits dividend withholding tax on dividends to a rate of 10% provided the beneficiary is a qualifying parent corporation and meets a minimum ownership percentage or a minimum value for the requisite period of time. If those conditions are not met, the withholding tax is imposed at the rate of 15%.

This will change in the New Treaty. Paragraph 2 of Article 10 of the New Treaty provides a full exemption from dividend withholding tax where the following conditions are met:

- The shareholder holds a direct participation of at least 10% in the share capital of the corporation issuing the dividend throughout a period of 365 days that ends on the day of payment of the dividend.
- The recipient is the beneficial owner of the dividends. Any change of ownership directly resulting from a corporate reorganization of the shareholder or the subsidiary, such as a merger or division, does not affect the calculation of the 365 days holding period.

In all other cases, the New Treaty reduces the dividend withholding taxes to 12.8%, provided the recipient is the beneficial owner of the dividend.

The beneficial owner concept is not defined in Belgian law or in treaties concluded by Belgium. The Commentary to Article 10 of the 2017 O.E.C.D. Model Convention defines a beneficial owner as "the person who has the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person."

Paragraph 6 of Article 10 of the New Treaty grants withholding tax relief for dividends paid out of income or gains derived from immovable property by an investment vehicle that (a) distributes most of this income annually, and (b) whose income or gains from such immovable property are exempt from tax. The reduction in withholding tax to 12.8% applies if the beneficial owner of the dividends directly or indirectly holds an interest representing less than 10% of the capital of the investment vehicle. Where the beneficial owner of the dividends directly or indirectly holds an interest of 10% or more of the investment vehicle, the dividends may be taxed at the domestic withholding tax rate of the source country.

In the absence of an applicable treaty, dividends paid by a Belgian resident corporation to a nonresident shareholder are subject to a 30% withholding tax. The tax is eliminated if the nonresident shareholder is entitled to the benefits of the Parent-Subsidiary Directive or is resident in a jurisdiction with which Belgium has an income tax treaty in force. Other exemptions and reduced rates are available under Belgian domestic law.

INTEREST WITHHOLDING TAXES

Article 11 (Interest) of the Current Treaty reduces withholding taxes on interest payments to 15%. Article 11 of the New Treaty provides for a full exemption. The exemption applies only when the recipient is the beneficial owner of the interest income.

In the absence of treaty relief, interest paid by a Belgian resident corporation or P.E. to a nonresident lender not entitled to the benefits of the Interest and Royalties Directive ("I.R.D.") is subject to a 30% withholding tax. The tax is eliminated if the I.R.D. is applicable to the interest payment.

Under Belgium's implementation of the I.R.D., and provided certain formalities are fulfilled, interest paid to an E.U. resident corporation is exempt from withholding tax where the recipient is (i) a corporation that holds directly or indirectly at least 25% of the capital of the borrower or (ii) is an associated corporation in relation to the borrower. For these purposes, two corporations are associated if at least 25% of the capital of each of the two corporations is owned directly or indirectly by the same E.U. resident corporation. The formalities are that corporations must have a legal form listed in the annex to the I.R.D. and be subject to corporate income tax.

CAPITAL GAINS TAXATION

Capital Gains on Substantial Holdings by French Individuals

At the present time, Belgium does not have any wealth tax and only exceptionally applies capital gains tax on the sale of shares, which makes it attractive as a place for wealthy investors to reside. For example, the French actor Gérard Depardieu caused a media storm in 2012 after stating that he would move his residence to a small municipality in Belgium, close to the French border, shortly after a so-called "super-tax" on earnings above €1.0 million was introduced in 2012 when François Hollande became President of the French Republic. Even if the French "super-tax" was short-lived as it was repealed in 2015 by François Hollande under public pressure, Belgium became an attractive location for French nationals having sizeable investment portfolios.

For at least two reasons, the attraction of Belgium may come to an end if capital gains tax is the driver for relocation. First, the Belgian Finance Minister has recently announced the intention of the Government to tax capital gain on shares realized by Belgian individuals at a rate of 15%.[2] Second, Paragraphs 2 and 3 of the New Treaty allows France to tax the gains of Belgian residents if the following conditions are met:

- The Belgian resident was previously a French resident for at least six years during the ten-year period preceding the establishment of tax residence in Belgium.
- The capital gain relates to the disposition of shares representing more than 25% of a French corporation.

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[2] For further details about the reform, click here for the French text and here for the Dutch text.

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- The tax is imposed only on shares owned on the date the individual establishes Belgian residence.
- The gain is realized within the first seven years after the departure from France.

If an individual who would otherwise be subject to the capital gains tax contributes shares in a French corporation to a Belgian holding corporation, French tax can be imposed on the Belgian holding corporation.

Capital Gains on the Shares of a French Real Estate Corporation

Under the Current Treaty, Belgian residents realizing a capital gain from the sale of shares in a French real estate corporation are exempt from taxation in France and Belgium. The Current Treaty allocates the taxing rights to Belgium, but in most instances, capital gains realized on the shares of a French real estate corporation are exempt from Belgian tax under domestic law.

French tax authorities challenged the double no-tax result, and in 2020, the French Council of State affirmed the position of the tax authorities. The New Treaty adopts the views of the French tax authorities. Paragraph 2 of Article 13 of the New Treaty provides as follows:

> Gains from the alienation of shares or other rights in a company, trust or comparable institution, the assets of which derive more than 50% of their value directly or indirectly from immovable property referred to in Article 6 and situated in a Contracting State, not being property used by such company for the conduct of its business activities, or of rights relating to such property, may be taxed in that State if, under the laws of that State, such gains are subject to the same tax regime as gains from the alienation of immovable property. For the purposes of this provision, no account shall be taken of gains derived from the alienation of shares quoted on a regulated stock exchange in the European Economic Area.

Consequently, when the New Treaty is effective, a Belgian resident individual realizing a capital gain upon the sale of the shares or parts of a French S.C.I. will be subject to a 19% nonresident personal income tax in France and the 7.5% French solidarity tax. If the Belgian resident is a corporation, the 25% French nonresident corporate income tax will be imposed.

FOREIGN TAX CREDIT ON FRENCH-SOURCE DIVIDENDS

Belgian Corporate Shareholders

As previously mentioned, Paragraph 2(c) of Article 22 of the New Treaty confirms that French-source dividends will be exempt from Belgian corporate income tax under the conditions and within the limits provided for in Belgian domestic law.

If the Belgian corporate shareholder is not eligible for the Belgian Participation Exemption, the French tax levied on the dividend income may be claimed as a credit against the Belgian tax liability, which is quite unique in the history of Belgian income tax treaties.

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Belgian Individual Shareholders

In principle, French-source dividends paid to Belgian individuals are subject to a 12.8% dividend withholding tax in France and a 30% income tax in Belgium. To avoid double taxation, the Current Treaty requires Belgium to grant a foreign tax credit equal to at least 15% of the net dividend, after deduction of the French withholding tax. However, in 1988, Belgium abolished the foreign tax credit under its domestic law, subject to certain exceptions. As a result, the Belgian tax authorities refused to allow the foreign tax credit. This position was challenged in court and the Belgian Court of Cassation ruled in favor of taxpayers in three separate cases decided in 2017, 2020 and 2021. Each time, the court explained that international law trumps national law. Consequently, the absence of a national tax rule cannot be used to deny the application of a treaty provision.

After years of litigation, the Belgian tax authorities issued their Circular Letter of May 28, 2021 (the "Circular Letter"), allowing a foreign tax credit on French-source dividends, as mentioned in the Treaty. While Belgian individuals have enthusiastically welcomed the Circular Letter, it will be reversed by reason of Paragraph 2(e) of the New Treaty, which makes the foreign tax credit allowed in the New Treaty to be subject to the provisions of Belgian law, stating as follows:

> Subject to the provisions of Belgian law regarding the deduction from Belgian tax of taxes paid abroad, where a resident of Belgium derives items of his aggregate income for Belgian tax purposes which are interest or royalties, the French tax charged on that income shall be allowed as a credit against Belgian tax relating to such income.

As a result, the total tax burden on Belgian individuals receiving French-source dividends will be increased from 25.88% to 38.96% as indicated in the following table.

NUMERICAL EXAMPLE UNDER THE CURRENT TREATY

Gross Distributed Dividend	€100
– French Dividend W.H.T. of 12.8%	*– €12.8*
Net Dividend Taxable in Belgium	€87.2
– Belgian Dividend W.H.T. of 30%	*– €26.16*
Net Intermediary Dividend	€61.04
+ Belgian Foreign Tax Credit of 15%	*+ €13.08*
Net Dividend	**€74.12**
Total Tax Burden	**25.88%**

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NUMERICAL EXAMPLE UNDER THE NEW TREATY

Gross Distributed Dividend	€100
– French Dividend W.H.T. of 12.8%	*– €12.8*
Net Dividend Taxable in Belgium	€87.2
– Belgian Dividend W.H.T. of 30%	*– €26.16*
Net Dividend	**€61.04**
Total Tax Burden	**38.96%**

This suggests that Belgian resident individuals may wish to accelerate the distribution of dividends from French companies to a date that is prior to the effective date of the New Treaty, wherever possible.

GREEK TAX INCENTIVE REGIMES FOR NEWLY ARRIVED RESIDENTS AND FAMILY OFFICES

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Tags
Family Office
Greece
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Non-Domiciled Taxation
Pensioners

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INTRODUCTION

The segment of European countries that have enacted favorable tax regimes designed to attract the wealthy are well known. Switzerland has its *forfait* regime, the U.K. has its Nondom Tax Regime, Portugal and Italy have new resident regimes, and Malta and Cyprus have favorable regimes designed to attract new residents. To that list of countries, Greece is a new arrival, having introduced several tax incentive regimes designed to create a favorable tax environment for nonresident individuals transferring tax residence to Greece and the establishment and operation of family offices in Greece. This article provides an overview of the most important Greek incentive provisions, which are (i) the 5A Nondom Tax Regime, (ii) the 5B Pensioners Regime, (iii) the 5C Employee and Self-Employed Regime, and (iv) the Family Office regime.

THE 5A NONDOM TAX REGIME

Tax Benefits

The Nondom Tax Regime provides an alternative taxation method for foreign source income generated by individuals who transfer their tax residence to Greece. The main features of the regime include the following benefits:

- A flat tax of €100,000 per year which satisfies total tax liability for foreign source income, including capital gains, regardless of the amount or classification of such income.
- The elimination of any requirement to declare foreign source income in Greece. Instead, a tax assessment reflecting a liability of a flat amount is issued by the tax authorities as of the last working day of June.
- The flat tax must be paid in one installment, typically on or before the last working day of July. A special rule applies for the first year of residence. Under that rule, the individual must pay the flat tax within 30 days from the date of notice that the individual qualifies for taxation under the Nondom Tax Regime. Should an applicant fail to pay the flat tax by the last day of the tax year, coverage in the Nondom Tax Regime is cancelled with immediate effect.
- The Nondom Tax Regime covers a maximum of 15 tax years, beginning with the year of application.
- The Nondom Tax Regime may be extended to close relatives, such as a spouse, ancestors, and descendants. The tax for each of those individuals who is covered by the regime is €20,000 per year, with the exception of

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underage children. The Greek inheritance and gift tax rules do not apply for relatives covered by the regime.

- An exemption from Greek inheritance or gift tax is granted covering all property located abroad.
- Because the Nondom Tax Regime is viewed to favorable, no foreign tax credit is available for any foreign tax paid on foreign source income covered by the regime.
- The Nondom Tax Regime does not have an impact on any Greek source income, which must be declared and taxed according to the general tax rules applicable in Greece.
- An individual covered by the Nondom Tax Regime may import funds from abroad without having to justify the source.
- An individual covered by the Nondom Tax Regime is expected to qualify as a Greek tax resident for income tax treaty purposes and qualifies for the issuance of a Tax Residence Certificate upon request.
- If in any year, an individual fails to qualify for the Nondom Tax Regime, the individual is taxed on worldwide income according to the general tax rules applicable in Greece. Failure to qualify could result from the failure to pay the flat tax, withdrawal from the program, or the running of the 15-year period of coverage. It is expected that the individual will move his or her tax residence abroad before becoming at risk to Greek tax on worldwide income.

Qualification for the Nondom Tax Regime

Two main conditions must be met for coverage by the Nondom Tax Regime:

- The applicant must not have been a Greek tax resident for seven out of the eight years prior to the transfer of tax residence to Greece.
- An investment of at least €500,000 in real estate properties or undertakings or transferable securities or shares in legal entities in Greece must be made either by the qualifying individual or through close relatives, such as a spouse, an ancestor, or a descendant, or a majority-owned legal. The investment generally must be completed within three years from the date of application and must be retained for the full duration of the regime. However, it does not apply for an individual who has obtained a specific type of residence permit related to investment activity in Greece.

There is no requirement in the law under which an individual must be present in Greece for a minimum period of time in order to qualify as a Greek tax resident under the Nondom Tax Regime. Given that the undertaking of significant investments in Greece demonstrates the intent of to render Greece as the center of vital interests, a leased or owned main residence in Greece must be declared.

Application Procedure

The procedure for obtaining tax residence under the Nondom Tax Regime involves the following steps:

- Applications with the competent tax authority must be made by March 31 of the respective tax year. Applications filed after that date will be deferred to the following tax year.
- Requests for extension of the application to relatives must be made by the same date.
- Decisions by the applicable authority are made within 60 days.
- Supporting documentation must be provided on a timely basis within the foregoing 60-day deadline.
- Evidence of completion of the investment must be filed within six months following actual completion.

THE 5B FOREIGN PENSIONERS TAX REGIME

The Foreign Pensioners Regime provides for an alternative taxation method for individuals who earn foreign source pension income and transfer their tax residence to Greece.

Tax Benefits

The main features of the Foreign Pensioners Tax Regime include the following benefits:

- Total foreign source income of the individual is subject to a flat tax rate of 7% per year, unless the income is exempt from tax based on an applicable income tax treaty. The reduced tax rate is not limited to pension income.
- The total foreign source income is exempt from the special solidarity contribution.
- Total foreign source income for tax year, together with income from sources in Greece, must be reported on an income tax return that is due non later than June 30 of the following tax year.
- Payment of the tax must be made in one installment, typically on or before the last working day of July of the following year. Should an applicant fail to pay the tax by the last day of the tax year, coverage in the Foreign Pensioner's Tax Regime is cancelled with immediate effect.
- The Foreign Pensioner's Tax Regime covers a maximum of 15 tax years, beginning with the year of application.
- The Foreign Pensioner's Tax Regime does not provide an exemption from Greek inheritance tax or gift tax for any property located abroad.
- A foreign tax credit is available for any foreign income tax paid on foreign source income covered by the Foreign Pensioner's Tax Regime. As mentioned above, if an income tax treaty applies to foreign source income, it must allocate taxing rights to both states.
- Any income that is derived from source in Greece is taxed in Greece under general tax rules.

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- An individual covered by the Foreign Pensioner's Tax Regime is expected to qualify as a Greek tax resident for income tax treaty purposes and qualifies for the issuance of a Tax Residence Certificate upon request.

- There is no option for extending coverage under the Foreign Pensioner's Tax Regime to the close relatives of the qualifying individual. Inclusion of the qualifying individual in the regime does not have an impact on the tax residency status of relatives.

- If in any year, an individual fails to qualify for the Foreign Pensioner's Tax Regime, the individual is taxed on worldwide income according to the general tax rules applicable in Greece.. Failure to qualify could arise from the failure to timely pay the 7% tax, a voluntary withdrawal from the Foreign Pensioner's Tax, or the running of the 15-year period of coverage.

Qualification for the Foreign Pensioner's Tax Regime

Three main conditions must be met for coverage by the Foreign Pensioner's Tax:

- Foreign source pension income must be received. Evidence of pension income is provided by any document certifying that an individual receives a pension that is paid by (i) a foreign social security institution, (ii) a governmental authority, (iii) an occupational pension fund, (iv) an insurance indemnity paid in a lump sum or in annual payments by a private insurance company in the context of a group pension plan.

- The applicant must not have been a Greek tax resident for five out of the six years prior to the transfer of tax residence to Greece.

- Prior to applying for the Foreign Pensioner's Tax Regime, the applicant must have been resident in a State with which Greece has a valid agreement on administrative cooperation in the field of taxation.

"Three main conditions must be met for coverage by the Foreign Pensioner's Tax."

There is no requirement in the law under which an individual must be present in Greece for a minimum period of time in order to qualify as a Greek tax resident under the Foreign Pensioner's Tax Regime. Hence, no undertaking is required as to the intent to spend a set number of days. Nonetheless, if an individual retains contacts with another jurisdiction it is likely prudent to be present in Greece for sufficient time each year and to maintain sufficient contacts in Greece to fend off an assertion of residence in the other State.

Application Procedure

The procedure for obtaining tax residence under the Nondom Tax Regime involves the following steps:

- Applications with the competent tax authority must be made by March 31 of the respective tax year. Applications filed after that date will be deferred to the following tax year.

- Requests for extension of the application to relatives must be made by the same date.

- Decisions by the applicable authority are made within 60 days.

THE 5C EMPLOYEE AND SELF-EMPLOYED TAX REGIME

The Employee and Self-Employed Regime provides for an alternative taxation method for taxing Greek-sourced income from salaried employment and business activity by individuals who transfer tax residence to Greece.

Tax Benefits

The main features of the Employee and Self-Employed Regime include the following benefits:

- Exemptions from income tax and special solidarity contribution are provided annually for 50% of Greek source income deriving from salaried employment or business activity. The remaining 50% of this income is taxed in accordance with the general tax rules applicable in Greece, together with any other Greek or foreign source income.
- Total foreign source income for tax year, together with income from sources in Greece, must be reported on an income tax return that is due not later than June 30 of the following tax year.
- The Employee and Self-Employed Tax Regime does not provide an exemption from Greek inheritance tax or gift tax for any property located abroad.
- An individual covered by the Employee and Self-Employed Tax Regime is exempt from imputed income calculated based on deemed expenses for maintaining a place of residence, such as a house or an apartment, and a private car.
- The Employee and Self-Employed tax Regime covers a maximum of seven tax years, beginning with the year of application.
- An individual covered by the Employee and Self-Employed Tax Regime is expected to qualify as a Greek tax resident for income tax treaty purposes and qualifies for the issuance of a Tax Residence Certificate upon request.
- An individual that has been included in the Employee and Self-Employed Tax Regime may opt for the parallel inclusion in the Nondom Tax Regime or the Foreign Pensioner's Tax Regime, provided the relevant conditions for the other regimes are met.
- Following revocation of the Employee and Self-Employed Tax Regime an individual who remains a tax resident in Greece is taxed on worldwide income according to the general tax rules applicable in Greece. Revocation could arise from the cessation of the employment relationship or the business activity for more than 12 months, voluntary withdrawal from the regime or the running of a period of seven years.

Qualification for the Employee and Self-Employed Tax Regime

Four main conditions must be met for coverage by the Foreign Pensioner's Tax:

- The applicant must not have been a Greek tax resident for five out of the six years prior to the transfer of tax residence to Greece.
- The applicant transfers tax residence from an E.U./E.E.A. Member State or from a State with which Greece has a valid agreement on administrative cooperation in the field of taxation.
- The applicant provides services in Greece in the context of a new employment relationship, which includes a position as a member of the board of directors of a Greek legal entity or an executive with a Greek permanent establishment. Alternatively, the applicant is self-employed and carries on business activity from a base in Greece.
- The applicant declares an intention to remain in Greece for at least two years.

Application Procedure

The procedure for obtaining tax residence under the Employee and Self-Employed Tax Regime involves the following steps:

- For employment or business activity taking place up to and including July 2 of each year, the application is filed by the end of that year. Applications filed after that date will be deferred to the following tax year.
- For employment or business activity that taking place after July 2 of each year, the application is filed in relation to the following year.
- Decisions by the applicable authority are made within 60 days.
- Supporting documentation is required to be filed within the 60-day deadline mentioned above. If supporting documents are not timely filed and the application is rejected, a partial cure is provided. Documents submitted by March 31 of the year following the rejection, the rejecting decision can be revoked. As a result, the application can be re-examined and a new decision issued within 60 days from the filing of the supporting documents.

THE FAMILY OFFICE TAX REGIME

Concept of Family Offices

A family office is a special purpose vehicle having as its exclusive purpose the management of assets and investments owned by individuals. The Family Office Tax Regime applies to family offices of Greek tax residents and members of their families. Investments of a Greek tax resident may be made directly or indirectly through legal entities. In addition to overseeing investments, a family office may manage expenses incurred by a wealthy Greek tax resident, or members of his family, relating to living costs, charitable activities, and cultural activities.

A family office may take the legal form of a *Société Anonyme*, a limited liability company, a private capital company, or a personal company or partnership, provided it is not formed for the purposes of carrying on activities of a nonprofit nature. It may be established in Greece or abroad. Similarly, its assets and investments under management may be located in Greece or abroad.

Qualifying Members of the Family Office

To benefit from the Family Office Tax Regime, the office must be operated for the benefit of (i) a Greek tax resident individual, (ii) close family members of the resident, such as a spouse, parents and grandparents, and unmarried or underage children, and (iii) Greek or foreign legal entities in which the foregoing individuals hold a majority stake. Persons who benefit under the 5A Nondom Tax Regime, the 5B Foreign Pensioners Tax Regime, and the 5C the Employee and Self-Employed Tax Regime qualify as Greek residents for purposes of the Family Office Tax Regime.

Qualifying Conditions

The family office must meet the following conditions to qualify for the Family Office Tax Regime:

- It must employ at least five employees. This condition must be met not later than the 12-month anniversary of its establishment and must continue to be met at all times thereafter. Family members do not count as employees for this purpose.
- It must incur annual expenses in Greece of at least €1.0 million.

Qualifying Services

The following services may be provided by a family office:

- **Services related to the personal and social life of family members.** This category of services includes public relations, security, cooks, housekeepers, teachers, educators, babysitters, drivers, technicians, gardeners, cleaning services, supply of goods, and management of charity work.
- **Administrative support services.** This category of services includes secretarial support, management of human resources on behalf of family members, accounting, payment of expenses, management of bank accounts, technical support for the management and maintenance of real estate and surrounding areas, and organization of business trips.
- **Financial management services.** This category of services includes investment management and management of transfers of wealth.
- **Strategic planning services.** This category of services includes business consulting, real estate planning, succession planning. and educational planning.
- **Other advisory services.** This category of services includes tax services, consulting services, legal services, engineering services, medical services, compliance advice, risk management support, and cyber security services.

The family office cannot provide services or incur expenses that are not related to the fulfillment of its purpose. When providing qualifying services, the family office may employ the individuals performing the services, outsource the services to third parties located within Greece or located elsewhere. However, payments made to individuals or legal persons that are tax residents in noncooperative states or in states with a preferential tax regime will not be deductible by the family office unless they relate clearly to real and customary transactions.

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Calculation Of Taxable Income

The gross income of a family office is determined on a cost-plus basis, using a 7% profit mark-up to all expenses maintained in properly kept tax records and paid through disbursements from the family office's bank account. Certain adjustments are made when computing the tax base.

- Depreciation expense is taken into account.
- Book tax expense is not taken income account.
- Where taxable income using the cost-plus method is less than book income, book income is used as the tax base in lieu of cost plus 7%.
- Once taxable income is determined, the general corporate tax rate of 22% is applied.
- Greek corporate income tax returns must be filed.
- Withholding tax must be collected where appropriate.
- Dividends to shareholders appear to be fully taxed, at this time.
- Payments for internal transactions taking place between the family office and its members are considered to be transactions made within one and the same entity and are outside the scope of V.AT.

"In comparison to the O.E.C.D., the European Commission, and the European Parliament, the Greek government has adopted well-thought-through provisions designed to attract wealthy families, retirees, executives, and family offices."

Qualification for the Family Office Tax Regime

Documentation is required to support the contention that the Family Office Tax Regime is applicable, meaning that the cost plus 7% income computation applies. The procedure is as follows:

- Tax returns for each year must be filed by a family office not later than July 31 following the close of the tax year.
- Within one month after filing the tax return, a family office must submit supporting documentation regarding all income and expenses taken into account in determining taxable income.
- Within one month following submission of the documentation, the tax authorities must accept the submission or notify the family office that the submission is not complete. The family office has 30 days to respond with additional information.
- The tax authorities may accept the additional information or begin an audit. An audit may also begin if the family office ignores the notification.

CONCLUSION

In comparison to the O.E.C.D., the European Commission, and the European Parliament, the Greek government has adopted well-thought-through provisions designed to attract wealthy families, retirees, executives, and family offices. At least one tax-examination cycle will be required to assure wealthy nonresidents that the plan works in practice as well as in theory.

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TAX 101:

TRICKY ISSUES WHEN A NON-U.S. PERSON INVESTS IN AN L.L.C. OR PARTNERSHIP OPERATING IN THE U.S.

Authors
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Tags
Amount Realized
Book-up
Capital Account Maintenance
Code §864(c)(8)
Code §1446(f)
L.L.C.
Partnership
Withholding

INTRODUCTION

A U.S. L.L.C. is usually treated as a partnership for U.S. Federal income tax purposes.[1]

Generally, a partnership is treated as an aggregation of its partners, meaning a flow-through treatment applies as to the partnership's income. However, for certain purposes, a partnership is treated as a separate entity from its partners, treated as if it were a corporation.

As a result of this inconsistency, various complicated and somewhat counterintuitive tax consequences may arise from the acquisition or the disposition of interests in a U.S. L.L.C. by a foreign member.

This article is intended to introduce the reader to two partnership concepts that are often encountered when a non-U.S. person invests in a U.S. partnership that engages in a U.S. trade or business.

- The first relates to withholding tax exposure when a foreign person sells an interest in a U.S. partnership or L.L.C. and encounters Code §1446(f) withholding tax. For various reasons, the withholding tax may have no connection to the ultimate tax on the gain.
- The second involves U.S. tax accounting for partnerships that take in additional members after operations have been conducted for several years. The new members may invest directly in the partnership or they may acquire a partnership interest by purchase from an existing member.

Often, the concepts are not well understood by foreign corporations and individuals who are first time investors in U.S. partnerships and L.L.C.'s.

In the balance of this article, we will assume that the form of the entity is a U.S. L.L.C. which defaults to a partnership for U.S. income tax purposes.

WITHHOLDING TAX ON A SALE OF AN L.L.C. INTEREST BY A FOREIGN MEMBER

It is not unusual for a non-U.S. investor to own units in a U.S. L.L.C. For purposes of the discussion in this section, assume two foreign corporations, A and B, and that

[1] Nonetheless, each may elect to be as an entity for U.S. income tax purposes that is separate from its owners.

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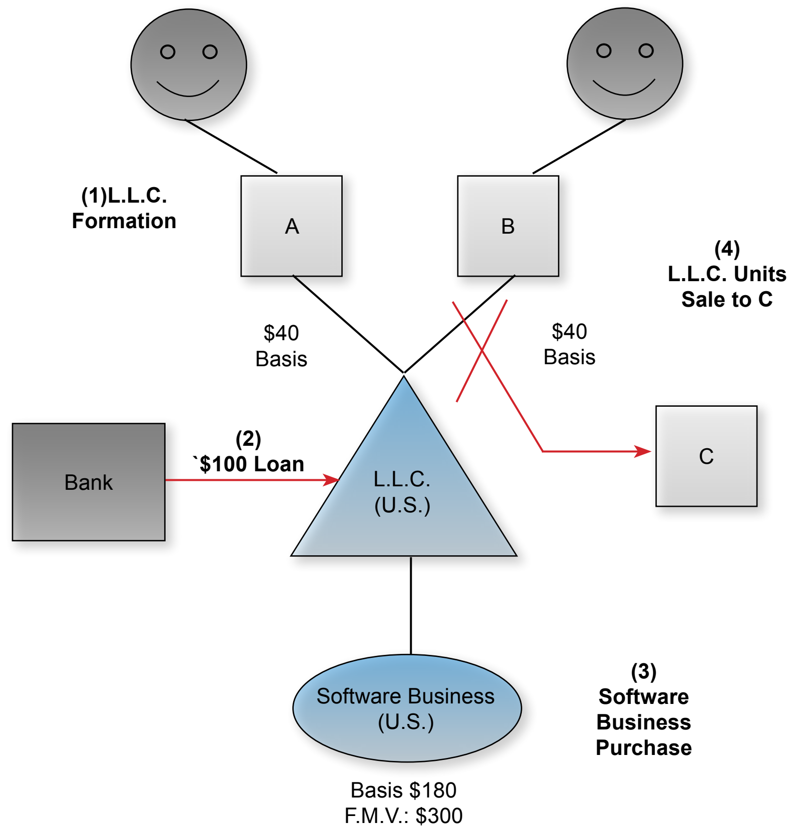
each is owned by individuals who are neither tax resident the U.S. nor citizens of the U.S. ("N.R.N.C.").

A and B form a U.S. L.L.C. ("L.L.C."), with each contributing $40 in return for a 50% interest in capital, profits and losses. See item (1) in Example A below. The L.L.C. then borrows $100 from a bank under terms that provide no recourse to the members in the event of a default and are not guaranteed by any of the members.[2] See item (2) in Example A below. Pursuant to the contribution and the loan, the L.L.C. holds cash in the amount of $180.

The L.L.C. uses its cash to purchase a U.S. software engineering business for $180. See item (3) in the Example A below. When the fair market value ("F.M.V.") of the software business reaches $300, B sells its units in the L.L.C. to U.S. investor "C" for $150. See item (4) in the Example A below. The L.L.C. has no other assets, the L.L.C. has no losses, all profits are distributed in full to A and B, and 0% Branch Profits Tax is imposed by reason of an applicable income tax treaty.

Example A



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[2] If the L.L.C. is debt-financed, the allocation of portions of the debt to the members of the L.L.C. depends on the particular facts related to the partnership and the loan. The allocation of debt amongst the members of an L.L.C. or partnership is beyond the scope of this article.

> *"The key questions are (i) whether gain arising from B's sale of L.L.C.'s units is U.S. source income, and if so, (ii) whether the gain should gain treated as effectively connected income."*

B's Basis in the Units of the L.L.C.

Even though B invested only $40 in the L.L.C., B's basis in the units is $90. For U.S. income tax purposes, B's basis is comprised of the investment of $40 made at the time of the formation of the L.L.C. plus B's share of the L.L.C.'s liability arising from the $100 bank loan ($100 x 50% = $50) loan.[3]

Exposure to U.S. Income Tax on Gain From the Sale of a Partnership Interest

The U.S. tax system generally provides that foreign corporations and N.R.N.C. individuals generally are subject to tax only on income and certain gains derived from sources within the U.S.[4]

The key questions are (i) whether gain arising from B's sale of L.L.C.'s units is U.S. source income, and if so, (ii) whether the gain should be treated as effectively connected income ("E.C.I."). E.C.I. is the domestic law equivalent of "business profits" when applying an income tax treaty.

The general source of income rules under Code §865(a) provides that income and gain arising from the sale of personal property by a foreign corporation or N.R.N.C. individual will be treated as foreign-source income. Under the general rule, the sale of L.L.C's units by B, an N.R.N.C. individual, should give rise to foreign source income.[5] This was the holding in *Grecian Magnesite v. Commr*.[6] The holding in the case was legislatively reversed on a go-forward basis by the Tax Cuts and Jobs Act, which enacted Code §864(c)(8).[7]

Code 864(c)(8) provides that all or a portion of the gain recognized in connection with a sale of an interest in an L.L.C. is treated E.C.I. when the L.L.C. is engaged in a trade or business in the U.S. The portion of the gain treated as E.C.I. is equal to the selling member's distributive share of the amount of gain that would have been E.C.I. had the L.L.C. sold all of its assets at fair market value as of the date of the sale or exchange of the interest in the L.L.C.[8]

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[3] Code §§ 722 and 752(a).

[4] Code §§871, 872, 881, 882. As an exception, limited categories of foreign source income can be treated as income that is effectively connected with the conduct of trade or business in the U.S. Foreign source income may be categorized as E.C.I. if a business is conducted in the U.S. through a fixed place of business and the income arises from one of three categories of activity, including (i) rents or royalties for the use of intangible property, (ii) dividends, interest, guarantee fees derived in the active conduct of a banking or financing business, and (iii) sales of inventory where a U.S. office materially participates in arranging the sale. See Code §864(c)(4).

[5] Treating the units of the L.L.C as a separate asset reflects the theoretical approach that an L.L.C. is an entity separate from its partners. It can sign contracts, own property, sue, and be sued, doing each in its name.

[6] *Grecian Magnesite Mining v. Commr.,* 149 T.C. 63, (2017), aff'd, 926 F.3d 819 (D.C. Cir. 2019).

[7] Pub. L. No. 115-97, §13501. See also Rev. Rul. 91-32.

[8] General guidance appears in Treas. Reg. §1.864(c)(8)-1.

Computation of Withholding Tax to be Collected by the Purchaser

Pursuant to Code §1446(f)(1)(a), any gain on the sale of an L.L.C. interest that is treated as E.C.I. under Code §864(c)(8) generally is subject to U.S. withholding tax at the rate of 10% of the amount realized by B.

Two important remarks should be made on this point. First, the amount realized on the sale includes not only the money received by B as consideration for the L.L.C.'s units, but also

- the F.M.V. of any property received by B, plus
- all liabilities of B that are assumed by the purchaser, plus
- the amount by which B's share of L.L.C. liabilities are reduced as a result of the sale.[9]

In the example above, the amount realized by B on its sale of the units includes not only the $150 in cash or its equivalent received as consideration for the L.L.C.'s units, but also $50, which represents B's share of the L.L.C.'s liabilities to the bank that was fully reduced pursuant to the sale. Because B 's cost basis in the L.L.C. units was increased to reflect its share of the underlying bank borrowing, it is consistent to increase the amount realized from the sale to reflect the reduction in that share by reason of the sale of the L.L.C. units. Therefore, the amount realized is $200 and the withholding tax is $20.

Second, since the withholding tax of 10% is levied on the amount realized and not on the net gain, neither basis nor expenses incurred in arranging the sale should be taken into account in computing the purchaser's withholding tax liability. Moreover, while Code §864(c)(8) applies only to a portion of the gain, as explained above, Code §1446(f)(a) applies to the entire consideration involved in the transaction, not just the gain recognized.

Consequently, the tax base for computing the withholding tax could be significantly higher than the tax base for computing the ultimate tax liability. In some cases, this results in a withholding tax greater than the actual U.S. tax liability, even though the rate of withholding tax (10%) is lower than tax rate for corporations. In such case, the seller is required to apply for a refund, assuming exceptions to withholding tax are not applicable.

For example, had B calculated its gain on the sale of the L.L.C. units, B would take into account a cost basis of $90.[10] Gain is the excess of the "amount realized" over the "adjusted basis."[11] Therefore, B's gain on the sale is expected to be $110. If the L.L.C. conducts an operating business in the U.S., it is likely that all or most of that assets of the L.L.C. will be taken into account.[12] Taking into account a corporate tax rate of 21%, B's U.S. Federal tax liability would have been $23.10 This amount is greater than the withholding tax amount of $20 that was calculated above. The balance must be paid under ordinary payment rules regarding estimated tax.

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[9] Treas. Reg. §1.1446(f)-2(c)(2).

[10] The sum of the investment of $40 B made on the formation of the L.L.C. and the L.L.C.'s liability B assumed in the amount of $50, is $90. Code §§752(a) and 722.

[11] Code §1001(a).

[12] *Supra* note 8.

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Withholding Tax Obligation of the Purchaser

The purchaser must report and pay the tax withheld within 20 days of the date of sale by filing Form 8288. Typically, reporting and payment is effected immediately after the closing. The form is mailed to the I.R.S. at the following address:

Ogden Service Center
P.O. Box 409101
Ogden, UT 84409

The withholding agent must also certify to the L.L.C. the extent to which it satisfied its obligations. Residual liability for the withholding tax is imposed on the L.L.C. to collect unpaid withholding tax from future distributions payable to C, the purchaser.

Exceptions That Can Eliminate the Collection of Withholding Tax

Several exceptions exist to eliminate the withholding tax requirement.

First, in appropriate facts and circumstances, a selling-member may be able to provide the purchaser with a certification that the sale would not result in realized gain or that the seller is not required to recognize gain or loss on the sale. Presumably, this certification is applicable when a sale results in a loss.

Second, in appropriate facts and circumstances, a selling-member may be able to provide the purchaser with a certification confirming that (i) the seller was a member throughout the 3-year period preceding the year of the sale, (ii) its share of the L.L.C.'s gross E.C.I. was less than $1.0 million for each taxable year in the 3-year period, (iii) its share of the L.L.C.'s gross E.C.I. was less than 10% of the seller's share of gross income from the L.L.C. for each taxable year within the 3-year period, and (iv) its distributive share of the L.L.C.'s E.C.I. has been timely reported and all tax due was timely paid.

Third, in appropriate facts and circumstances, a selling-member may be able to provide the purchaser with a certification that it is not subject to tax pursuant to an income-tax treaty in effect.

Fourth, a Certification by L.L.C., confirming that (i) the L.L.C. would have no gain that would be E.C.I. on a sale of assets, or (ii) the amount of any E.C.I. would be less than 10% of the total net gain, or (iii) the selling member would not have any distributive share of net gain that would be E.C.I. had the L.L.C. sold its assets, or (iv) the amount of such E.C.I. would be less than 10% of the seller's share of the total net gain of the L.L.C.

It is not likely that any of the exceptions are applicable.

Potential Planning Alternative That May Eliminate the Withholding Tax Obligation Imposed of the Purchaser

In principle, a two-step tax planning alternative may be available to eliminate the withholding tax obligation imposed on the purchaser. Under the two-step plan, the first step is a nonrecognition transaction that makes Code §1446(f) inapplicable to the purchaser, thereby eliminating excess withholding tax for the seller. A withholding tax would still be collected, but it would be partnership withholding under Code §1446(a), calculated on a tax base composed of the net gain recognized rather than the gross amount realized.

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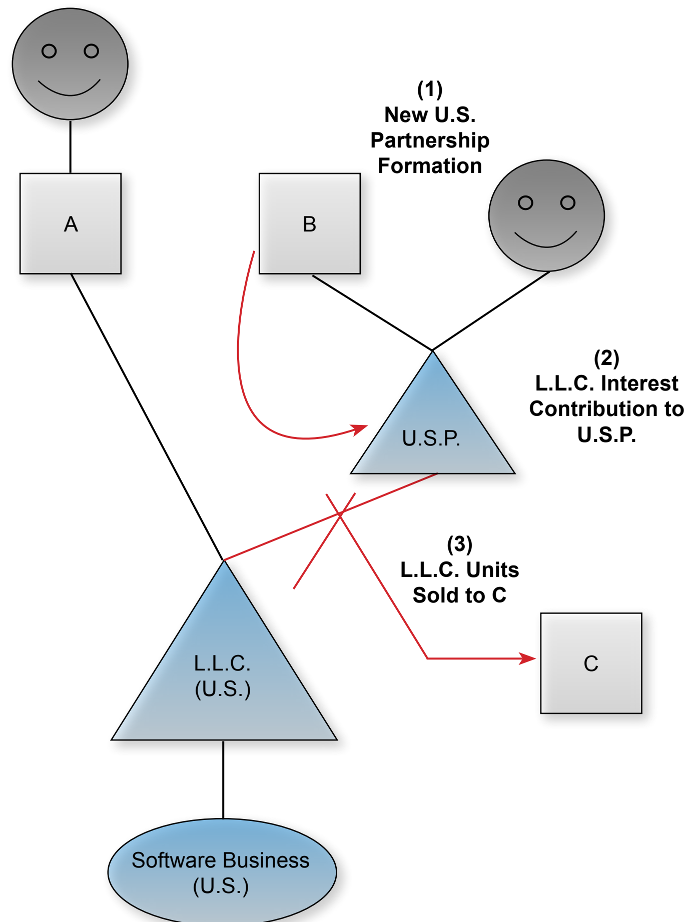
Step 1 includes B and a related party, perhaps its foreign owner or a special purpose vehicle ("S.P.V.").[13] They form a new U.S. partnership ("U.S.P."). See item (1) in Example A1, below. B will contribute the interests in L.L.C to U.S.P. and B will certify to U.S.P. that gain is not recognized on the transfer by reason of Code §721, in accordance with Treas. Reg. §1.1446(f)-2(2)(b)(6)). See item (2) in Example A1. For partnership accounting purposes, B's capital account in U.S.P. would be equal to the net F.M.V. of its partnership interest. The second partner would contribute cash or other assets having an F.M.V. that will be equal to the F.M.V. of its partnership interest.

In step 2, U.S.P. sells the L.L.C interest to C, providing the purchaser with a non-foreign affidavit. See item (3) in Example A1.

Example A1



Code §1446(f) is not expected to apply to the transfer of L.L.C. units from B to U.S.P. because such a transfer is eligible for a nonrecognition treatment under Code §721. Code §1446(f) is also not expected to apply to the sale of L.L.C. units by U.S.P. to

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[13] The S.P.V. can be a U.S. corporation or a foreign corporation. In broad terms, the choice of entity should not affect the plan. However, the choice has carry-over effects that must be taken into account, such withholding tax collected by U.S.P. and branch profits tax if S.P.V. is a foreign corporation. Those consequence are beyond the scope of this article.

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C, because U.S.P. is not a foreign entity. Code § 864(c)(8) is expected to apply to the gain realized by U.S.P. from the sale to C and therefore the gain realized on the sale is expected to be treated as E.C.I. B and its foreign owner (the other U.S.P. partner) both have E.C.I. gain through their distributive share in L.L.C.'s gain. U.S.P. is expected to collect withholding tax for each foreign member's share of E.C.I. gain under Code §1446(a) at highest rate of tax for its members, 37% for individuals and 21% for B. In principle, the second partner of U.S.P. should have relatively little gain. If properly executed, the restructure aligns the amount of withholding tax that must be collected with the final income tax due and payable by the foreign members.

ADMITTING A NEW MEMBER TO THE L.L.C.: CAPITAL ACCOUNT BOOK-UP, BASIS ADJUSTMENTS AND ALLOCATIONS OF GAIN

Overview of the Capital Account Maintenance Rules

The admission of a new member to the L.L.C. generally affects the capital accounts of the members when those accounts are maintained in accordance with U.S. income tax regulations. The result ensures that the appreciation in value of the membership interests prior to the admission of the new member will ultimately be taxed in the hands of those existing members.

An L.L.C., is not a taxpayer under the U.S. Federal income tax system. Rather, its income is determined and calculated at the level of the L.L.C. and then flows through to the members. Those members report their respective distributive shares of income, gains, losses, expenses, and credits, and pay the resulting tax in their individual capacities.[14] Where the members are foreign, the partnership has an obligation to collect quarterly withholding tax on the foreign partner's distributive share of E.C.I.[15]

A principal concern is how to determine each member's share in the L.L.C.'s income, gain or loss. The members are generally free to determine their economic relationship. L.L.C. agreements are negotiated agreements, affording significant flexibility in setting the terms and conditions for sharing revenue and expenses.[16]

However, less flexibility is given when it comes to the allocation of tax items, such as tax basis and taxable income. To prevent shifting of taxable income or loss from one member to another without any effect on cash flow, a complicated set of rules promulgated under Code §704(b) applies to ensure that the taxable income of the L.L.C. is allocated in accordance with the economics of the L.L.C., and not in accordance with tax planning considerations.

I.R.S. regulations generally provide that, for allocations to be respected for income tax purposes, one of three standards must be met:

- The allocation must have substantial economic effect, broadly meaning that it affects cash distributions.

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[14] Code §701.

[15] Code §1446(a).

[16] Code §704(a).

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- Taking into account all facts and circumstances, the allocation is in accordance with the member's interest in the L.L.C.
- They follow I.R.S. capital account maintenance regulations so that allocations are deemed to be in accordance with a member's interest (the "Capital Accounts Maintenance Rules").[17]

Very broadly, the capital accounts reflect the members' equity in the L.L.C., which more or less is the excess of the L.L.C.'s assets over the L.L.C.'s liabilities. In comparison to the balance sheet of a corporation, the balance sheet of an L.L.C. lists the capital account of each member separately. Therefore, the balance sheet is used to present each member's ratable share in the L.L.C.'s assets and liabilities. The capital accounts, if maintained correctly, should accurately reflect the financial relationship and the economic agreement among the members.

"Very broadly, the capital accounts reflect the members' equity in the L.L.C., which more or less is the excess of the L.L.C.'s assets over the L.L.C.'s liabilities."

In general, the assets are reflected in the books at their cost. This is the "book value" of the assets. In the simple case of an L.L.C. formed by cash contributions that are used to purchases assets, the book value would also reflect the basis in the assets for tax purposes. However, there are some instances when the L.L.C. will have a tax basis in its assets which is different from the assets' respective book values ("Tax/Book Disparity"). Some of these instances will be reviewed in the balance of this article. When Tax/Book Disparity occurs, the capital accounts do not reflect the members' real share in the taxable income of the L.L.C. Where that occurs, two separate sets of books must be kept, one for tax purposes and the other for books purposes.

In this section, we will address the application the Capital Accounts Maintenance Rules in some of the more common instances when a Tax/Book Disparity exists.

Test Case

For purposes of the discussion in this section, assume that foreign investors A and B form a U.S. L.L.C. ("L.L.C."), with each contributing $40. A and B share the L.L.C.'s profits and losses equally. See item (1) in Example B below. The L.L.C. agreement provides that the I.R.S. capital account maintenance regulations will be followed. In comparison to the facts in Example A, above, L.L.C. purchases a U.S. software engineering business for only $80. See item (2) in Example B. Consequently, it does not take out a loan. After a few years, when the F.M.V. of the software business is $300, B sells her units in the L.L.C. to C for $150. See item (3) in Example B. Soon afterwards, D contributes $150 to the L.L.C. in exchange for newly issued units. See item (4) in Example B. When the F.M.V. of the software business increases to $390, the L.L.C. sells the software business to an unrelated purchaser. See item (5) in Example B.

The L.L.C. has no other assets, no losses, and all profits are distributed in full to the members.

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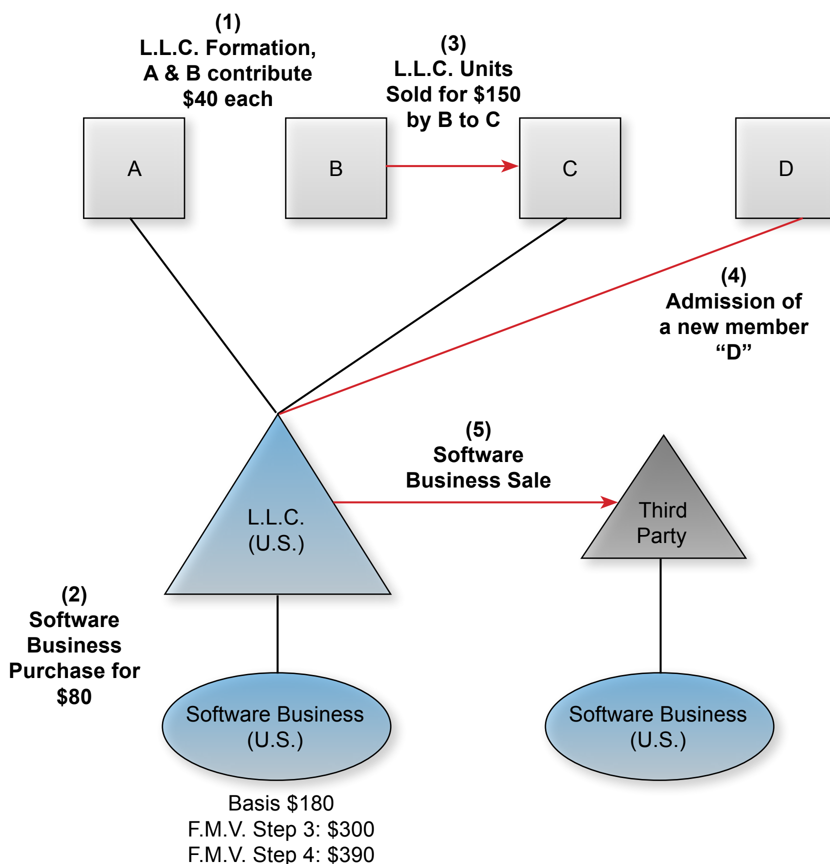
[17] The Capital Account Maintenance Rules are set forth in Treas. Reg. §1.704-1(b)(2)(iv).

Example B



The main question to be analyzed in this case relates to the way the L.L.C.'s gain on the sale of the software business will be allocated among its members, A, C and D. The first step is to determine the capital accounts of each of the L.L.C.'s members.

A's Capital Accounts

Under Code §723, an L.L.C. takes a transferred basis in contributed property. Since A and B contributed cash equal to $80, and since the value of cash also reflects its basis, L.L.C. has total assets having a book value and a tax basis of $80. When the L.L.C. purchases the software business for $80, the L.L.C. still has an asset with a book value and a tax basis of $80.

Pursuant to the agreement between A and B, A's share in the L.L.C. was exactly 50%. Therefore, A's tax capital account is $40 and his book capital account is $40.

Also relevant to this discussion is the rule under Code §722, which provides that a member's basis in the L.L.C. interest (the "outside basis") is equal to the amount of the contribution made by the member. Since A contributes $40 to L.L.C., her basis in the L.L.C.'s interest is $40. Because no debt exists in the L.L.C., A's basis is not affected by any share of debt.

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Effect of Purchase on Basis in L.L.C. Assets and Purchaser's Capital Accounts

C purchases her interests in the L.L.C. from B and makes no further contribution to L.L.C. Generally, the basis that is maintained in property owned by an L.L.C. is not adjusted as a result of a transfer of an interest in the L.L.C. by an existing member to another person in a sale or exchange.[18] However, an election can be made by the L.L.C. to step-up the basis in its assets solely to reflect the purchase price paid by the new member for purposes of determining her share of partnership taxable income.[19]

As previously mentioned,, A's tax capital account is $40 and her book capital account is $40, also. Since B was an equal member that contributed exactly the same amount to the L.L.C., B similarly had a tax capital account and a book capital account of $40. As a result of the sale to C, the same tax and book capital accounts of $40 are attributed to C.

However, C paid B $150 for the L.L.C. interest. C's capital account of $40 does not reflect the premium paid by C. As a result, when the L.L.C. sells its assets and gain is allocated to C, C is expected to be overtaxed because the inside basis in the business assets does not reflect the F.M.V. paid by C for the units. To illustrate, assume a sale of the L.L.C.'s assets for $300, effected prior to the admittance of D as a member of the L.L.C. The L.L.C.'s gain on the assumed sale is $220 (the excess of the amount realized of $300 over the basis of $80). C's share of the gain would be $110 (50% of $220). As a result, C will report a gain of $110 in her tax return even though C paid $150 for the units in the L.L.C., and B previously recognized gain of $110 on the sale of those units. Nonetheless, C realize no economic gain.

As a matter of fact, the transaction described above will create a potential built-in loss for C's interests in the L.L.C. This arises because the allocation of $110 of income to C causes her outside basis in the L.L.C. units to be increased by $110. C's outside basis is now $260.[20] Since the F.M.V. of the L.L.C. units remains $150, C will have a built-in loss of $110 (the excess of $260 over $110).[21] In principle, that loss should be available at such time as C's interest in the L.L.C. is disposed of, which may not be in the same year as the sale of the L.L.C.'s assets.

In order to eliminate the mismatch between the outside basis in the L.L.C. units and the inside basis in the assets owned by the L.L.C., the L.L.C. may elect[22] to increase the basis of its assets pursuant to Code §743(b) solely as to C. In this way, the premium paid for the L.L.C. units (in this case, $110) is pushed down to C's share of the assets owned by the L.L.C. without affecting other members. As a result, for C, the gain resulting from the sale will be reduced by the premium paid for the units acquired from B.

The adjustment will not be reflected in the L.L.C.'s balance sheet. It will only come into play to determine C's distributive share of the L.L.C.'s income and gains.

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18 Code §743(a).

19 Code §754.

20 Code §705(a)(1).

21 Note that such built-in loss is a potential tax benefit, if C ever sells her interests in L.L.C.

22 Code §754.

D's Capital Accounts

On the day of D's admission into the L.L.C., L.L.C.'s sole asset (the software business) is worth $300. That reflects a value of $150 to each of A and C.

Under such circumstances, to become an equal member, D must contribute to L.L.C. the same amount of $150.

Based on Code §723, as explained above, D's tax capital accounts and book capital accounts are $150.

A's and C's Capital Accounts are Adjusted to Reflect D's Admission

As explained above, the book value of assets purchased by an L.L.C. generally is the cost (subject to depreciation where applicable), and no adjustment is usually made when the F.M.V. of the assets is increased or decreased. Therefore, in the simple case, the balance sheet and capital accounts of the L.L.C. and A, C and D would look like this:

Assets		**Liabilities & Capital**		
	Tax/Book		Liabilities	
Soft. Bus.	$80		0	
Cash	$150	**Capital Accounts**		**Outside Basis**
			Tax/Book	
		A	$40	$40
		C	$40	$150
		D	$150	$150

". . . the book value of assets purchased by an L.L.C. generally is the cost (subject to depreciation where applicable), and no adjustment is usually made when the F.M.V. of the assets is increased or decreased."

As an exception to the general rule, the regulations allow the L.L.C. to "book up" the L.L.C.'s assets to their F.M.V on the admission of a new member.[23]

In the example provided above, the book-up will result in an increase of the book value of the software business from its cost amount, $80, to its F.M.V., $300. In addition, the book capital accounts of each of A and C will be increased from $40 to $150. As a result, A's and C's book capital accounts ($150) will no longer match their tax capital account, which will continue to reflect the cost ($40). It is at that point that a Tax/Book Disparity will be created, and separate records will need to be maintained, as illustrated in the following balance sheet:

Assets			**Liabilities & Capital**			
	Tax	Book		Liabilities		
Soft. Bus.	$80	$300		0		
Cash	$100	$150	**Capital Accounts**			**Outside Basis**
				Tax	Book	
			A	$40	$150	$40
			C	$40	$150	$150
			D	$150	$150	$150

[23] Treas. Reg. §1.704-1(b)(2)(iv)(f).

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Once the asset book-up is made, the L.L.C.'s books will reflect a gain for book purposes in an amount of $220 (the excess of $300 over $80) with respect to L.L.C., and a corresponding built-in gain of $110 (the excess of $150 over $40) with respect to each of A and C. However, no gain is recognized at this point for tax purposes.

Allocation of L.L.C.'s Gain on the Sale of the Software Business Allocated Among A, C and D for Income Tax Purposes

When the L.L.C sells the software business to a third party for $390, L.L.C.'s taxable gain on the sale will be $310 (the excess of the fair market value of $390 over the basis of $80).

The taxable gain of the L.L.C. will be divided equally among the equal members, with adjustments taking into account the built-in gain accrued in previous years in the software business assets, in the following manner:

- The built-in gain will be allocated only to A and C, the members to whom gain was allocated for book purposes at time of revaluation.[24]
- The L.L.C.'s total built-in gain is $220, and each of A and C will be allocated an equal share, *i.e.*, $110 of the gain.
- The remainder of the gain will be allocated equally among all members. Since the remainder amount is $90 (the excess of the realized gain of $310 over the built-in gain of $220) and each member has equal share, each of A, C and D will be allocated with additional $30.

As a result, A's allocable share of the gain will be $140. C's allocable share of the gain will initially be $140, also. However, as a result of the Code §743(b) Adjustment previously elected, C's share of the gain will be offset by $110 to remain $30. D's allocable share of the gain will be $30.

CONCLUSION

Investing in an L.L.C. or partnership having business operations exposes a foreign person to a set of complex rules that apply at the time of formation, during the life of the investment, and at the time a liquidity event is realized. This article was written as an introduction to those concepts. Real life calculations will be substantially more complex.

[24] See, Code §704(c), Treas. Reg. §1.704-1(b)(2)(iv)(f)(4).

WHEN IT COMES TO PENALTY ABATEMENT, IS THE I.R.S. OFFSIDE?

Author
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Tags
Form 3520
Form 5471
Form 5472
Information Returns
Neontologic v. Commr.
Penalties
Reasonable Cause
U.S. v. Boyle

INTRODUCTION

The tax press often champions the value of tax transparency. However, as tax information reporting obligations grow, many taxpayers find that the penalties for inadvertent errors can exceed the tax, even where a taxpayer has reasonable cause for not fully complying with his or her obligations.

Using Treas. Reg. §301.6651-1(c)(1) as guidance, a taxpayer who wishes to avoid the assertion of a penalty for failure to file a tax return must make an affirmative showing of all facts alleged as a reasonable cause for the failure to file such return. If the taxpayer exercised ordinary business care and prudence but was nevertheless unable to file the return within the prescribed time, then the delay is due to reasonable cause.

This article addresses how the foregoing standard is applied. One man's reasonable cause might not be reasonable cause for someone else.

REASONABLE CAUSE

The I.R.S. website[1] states the following with regard to the Delinquent International Information Return Submission Procedures:

> Taxpayers who have identified the need to file delinquent international information returns who are not under a civil examination or a criminal investigation by the IRS and have not already been contacted by the IRS about the delinquent information returns should file the delinquent information returns through normal filing procedures.
>
> Penalties may be assessed in accordance with existing procedures.
>
> * * *
>
> - All delinquent Forms 3520 and 3520-A should be filed according to the applicable instructions for those forms.
> - Taxpayers may attach a reasonable cause statement to each delinquent information return filed for which reasonable cause is being asserted. During processing of the delinquent information return, penalties may be assessed without considering the attached reasonable cause statement. It may be necessary for taxpayers to respond to specific correspondence and submit or resubmit reasonable cause information.

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[1] See here.

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In practice, the system has proven difficult to administer. Much of the confusion and disagreement have centered on what it means to be reasonable, and the I.R.S. seems to interpret the term counterintuitively. Training material prepared by the I.R.S., consisting of internal guidance and slides, indicate that the I.R.S. has raised the bar that must be met before relief can be granted in many circumstances.[2]

One level of complication is that tax compliance is not a do-it-yourself exercise for people with ordinary jobs. It requires the work of tax professionals, including advisers in regard to front-end planning and tax return preparers when filing season rolls around. The technical nature of tax law means that it can be difficult for a taxpayer to accurately navigate the ins and outs of proper compliance. If filing obligations are not met, who is at fault? An accountant may make a mistake, perhaps a taxpayer did not provide sufficient information to his or her tax preparer, or there may simply have been a breakdown in information flow. Does the assertion of automatic penalties actually promote compliance when a taxpayer other than an investment banker or rocket scientist finds that the professional she engage made an error in compliance? The I.R.S. seems to favor such an approach.

U.S. V. BOYLE

In deciding whether to reduce a taxpayer's penalty, the I.R.S. considers the hazards of litigation, or the potential risk of losing at trial. If the I.R.S. is confident that it will win, concessions to the taxpayer are not likely to be made. Moreover, reports in the tax press suggest the existence of a view that the I.R.S. is allowing mitigation of tax penalties too liberally.

This view is justified under a Supreme Court case, *U.S. v. Boyle*,[3] which addressed a failure to comply due to a tax preparer's error. In *Boyle*, an executor of an estate filed an estate-tax return three months late due to his attorney's administrative error. The executor repeatedly requested updates regarding the preparation of the estate tax return, but did not realize that the deadline had passed. The Supreme Court unanimously rejected the executor's argument that reasonable cause for late filing existed. The executor knew that a return was required and need to be filed within a specified time period beginning as of the date of death of the decedent. A reasonable person would have checked the deadline.

The case seems to provide guidance for cases involving taxpayers who were aware of a filing obligation but did not verify basic details. But when your only guidance is *Boyle*, every problem starts to look unreasonable. Some advisers that the I.R.S. overuses *Boyle* in disputes involving international information return penalties like Form 5471 (Information Return of U.S. Persons With Respect To Certain Foreign Corporations) or Form 3520 (Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts).

One I.R.S. training slide gives the hypothetical of an information return that is submitted late because of a software error. The accountant tells the taxpayer that it has been properly filed because he or she has not been notified that the software

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[2] "IRS Appeals Training Materials on Reasonable Cause Worry Practitioners," *Tax Notes*, October 10, 2022; "FOIA Materials Show Appeals' View on Approval of Penalties," Tax Notes, October 10, 2022.

[3] 469 U.S. 241 (1985).

malfunctioned. The slide concludes that *Boyle* removes any hazards of litigation, because of the I.R.S.'s interpretation of *Boyle* as the proposition that taxpayers cannot rely on others to file for them. But *Boyle* relied on the fact that "it requires no special training or effort to ascertain a deadline." Ascertaining whether software malfunctioned might similarly require only common sense, or it might require some level of expertise. But it does not have an obvious answer, which is how the I.R.S. treats the scenario.

The I.R.S. Manuel addresses Hazards of Litigation in the context of penalty abatement as follows:

> **Hazards of Litigation**
>
> 1. Penalties may be settled based on hazards of litigation. Unlike Compliance, Appeals may consider the hazards of litigation in attempting to reach a settlement. The proper use of this settlement authority given to Appeals is critical in fulfilling its mission
> 2. The settlement process is based on the ATE's[4] experience and judgment after considering the facts and the law.
> 3. ATEs must evaluate the facts pertinent to the issue under consideration, the applicable law, and the potential outcome in the event the case is litigated.
> 4. The hazards of litigation are the uncertainties of the outcome of the court's decision in the event of a trial.
> 5. Litigating hazards generally fall into three categories: factual, legal and evidentiary.
>
> Note: Lack of case law should not be considered a hazard of litigation.
>
> 6. Appeals may weigh these factors and determine an appropriate settlement range for the issue and obtain a realistic settlement.

WHERE CASES FIND REASONABLE CAUSE

Courts have held that reliance on a qualified adviser may demonstrate reasonable cause and good faith if the evidence shows that the taxpayer relied on a competent tax adviser and provided the adviser with all necessary and relevant information.[5] To conclude otherwise, would nullify the very purpose of seeking the advice of a presumed expert in the first place.[6] Even *Boyle*[7] acknowledged that when a taxpayer selects a competent tax adviser and supplies him or her with all relevant information, it is consistent with ordinary business care and prudence to rely upon his or her professional judgment as to the taxpayer's tax obligations.

[4] Appeals Technical Employee's.

[5] *Tebarco Mechanical Corp. v. Commr.,* T.C. Memo 1997-311, at p. 35 (citations omitted).

[6] *Longoria v. Commissioner,* T.C. Memo 2009-162, at p. 37.

[7] 469 U.S. 241,at 250-251 (1985).

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In *Neonatology v. Commr.*,[8] the Tax Court framed the inquiry into whether reliance on an outside advisor constitutes reasonable cause in the following manner:

1. Was the advisor a competent professional who had sufficient expertise to justify reliance?

2. Did the taxpayer provide necessary and accurate information to the advisor?

3. Did the taxpayer actually rely in good faith on the advisor's judgment?

The Tax Court further addressed the taxpayer's burden that must be met when demonstrating reliance. It held that a taxpayer must prove by a preponderance of the evidence that each of the above requirements has been met.

Kelly v. Commr.,[9] is a case involving complex facts resulting, in part, in the assertion of penalties for the failure to file timely Forms 5471 with regard to several C.F.C.'s owned by the taxpayer. The taxpayer asserted the three-prong test of *Neontology v. Commr*., and the court accepted the assertion that he reasonably relied on a firm of accountants even though the firm failed to identify the Form 5471 filing requirement.

> [The accounting firm] has prepared Mr. Kelly's personal returns since 2000, including Schedules C for his affiliated companies. [The accounting firm] prepared approximately 700 tax returns per year. Mr. Scott was the primary contact for the preparation of Mr. Kelly's returns. Mr. Scott is a C.P.A. with no history of adverse disciplinary actions or IRS preparer penalties. He had decades of experience with Federal tax return preparation but had no prior knowledge of Form 5471 in 2009. It was reasonable for Mr. Kelly to rely on Mr. Scott. [The accounting firm] was adequately advised that Mr. Kelly owned a Cayman Islands entity. Mr. Kelly's staff pointed out that there might be a different reporting. Conversely, in Flume, the taxpayer failed to provide his tax return preparer all the necessary information.
>
> Respondent contends that it was not enough for Mr. Kelly to inform [the accounting firm] that KY&C was a foreign entity, and he implies that Mr. Kelly should have advised Mr. Scott that Form 5471 was required. The failure to file the Forms 5471 does not present an obvious tax obligation which was negligently omitted from information that a taxpayer provided to the return preparer. Mr. Kelly, through his staff, provided the necessary information to [the accounting firm], identified KY&C as a foreign corporation, and stated that he was unsure of the reporting requirements. Having done this, Mr. Kelly reasonably relied on [the accounting firm] to prepare his returns properly. While it could be argued that [the accounting firm] should have done more to ascertain Mr. Kelly's filing obligations, it was reasonable for Mr. Kelly to rely on [the accounting firm] do so. A taxpayer need not question the advice provided, obtain a second opinion, or monitor the advice received from the professional. *Boyle*, 469 U.S. at 251.

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[8] *Neonatology Assocs. v. Comm.*, 115 T.C. 43 (2000).

[9] T.C. Memo. 2021-76.

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WRZESINSKI V. U.S.

Wrzesinski v. U.S.,[10] a case that was docketed earlier this, involves the late filing of a Form 3520. There, the taxpayer's Polish mother won the lottery and sent her son $830,000 across two years. The amount of the gifts and the foreign identity of the giver triggered an obligation for the taxpayer to file Form 3520 for both years. The taxpayer twice asked a U.S.-based tax accountant whether any filing obligations existed in relation to the receipt of the gift. The tax accountant was an enrolled agent authorized to practice before the I.R.S.[11] Both times, the taxpayer was told that no such obligation existed. The taxpayer had no reason to suspect that the advice was erroneous.

"The approach of the I.R.S. in Wrzesinski v. U.S., under which it would only mitigate the amount of the penalty, but would not abate it completely, raises a more serious question."

Seven years later, the taxpayer wished to make a gift to his godson. He suspected that, as a U.S. person sending a gift abroad, he might have compliance requirements and conducted some research on the internet. He discovered his missed Form 3520 obligations, which he confirmed with an attorney. The taxpayer filed the required Form 3520 for each year. A reasonable-cause statement was attached, indicating that the compliance failure was due to erroneous advice of the Enrolled Agent. Shortly after filing the forms, the taxpayer received Form CP15 Notices of Penalty Charge in the aggregate amount of $87,500 and $207,500. The Notices stated that ignorance of the tax laws was not a basis for penalty abatement under the "reasonable cause" standard and that ordinary business care and prudence require that taxpayers be aware of their tax obligations and file or deposit accordingly. In response, the taxpayer filed a protest letter with the I.R.S. The letter was lost in the I.R.S. system. With the intervention of the Taxpayer Advocate's Office of the I.R.S., the appeal ultimately proceeded. Based on hazards of litigation, not on the proper application of law to the facts, the I.R.S. offered to mitigate but not abate the penalty. This left the taxpayer with a bill for $41,500. The taxpayer paid the penalty, filed a claim for refund, and brought legal action when the claim was denied. The case has not yet been heard.

TOLL CHARGE TO OBTAIN RELIEF

The approach of the I.R.S. in *Wrzesinski v. U.S.*,[12] under which it would only mitigate the amount of the penalty, but would not abate it completely, raises a more serious question. If a taxpayer is correct in principle, should the I.R.S. be allowed to demand a reduced penalty simply as a toll charge for settling the case? Those tax advisers having a controversy practice involving significant amounts of tax at stake in an I.R.S. challenge to a highly structured transaction likely would confirm that "horse trading" is part of the resolution process. Principle is principle, but a good settlement is in the interest of the I.R.S. and the taxpayer.

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[10] E.D. Pennsylvania, Docket No. 2:22-CV-03568 (September 7, 2022).

[11] According to the I.R.S. website, an enrolled agent is a person who has earned the privilege of representing taxpayers before the I.R.S. by either passing a three-part comprehensive I.R.S. test covering individual and business tax returns, or through experience as a former I.R.S. employee. Enrolled agent status is the highest credential the I.R.S. awards. Individuals who obtain this elite status must adhere to ethical standards and complete 72 hours of continuing education courses every three years. Licensed C.P.A.'s and attorneys admitted to practice in a State are not required to become enrolled agents.

[12] E.D. Pennsylvania, Docket No. 2:22-CV-03568 (September 7, 2022).

However, the two fact patterns are not identical, and the standards for finding reasonable cause are not identical. One involves a deliberate decision to structure a transaction in a certain way to obtain a favorable tax result based on advice from sophisticated advisers. Here, the examination risk is addressed in deciding to go through with the transaction – does the tax result deserve a "will" opinion, a "should" opinion, or a "more likely than not" opinion? The other involves a taxpayer seeking advice on information reporting obligations by a taxpayer who passively receives a gift or an inheritance and clearly attempts to comply, but finds to his or her dismay that there was a compliance failure. Importantly, the taxpayer took steps to redress the shortfall in a voluntary, prompt, and appropriate way. In the second fact pattern, the threat of severe penalties would seem to be counterproductive because it is not proportional to the error.

In *Chai v. Commr.*,[13] the issue raised was whether the assessment of a penalty requires an independent determination by an I.R.S. employee as to whether the penalty should be imposed prior to its assessment. The case involved an accuracy penalty[14] and whether it could be reviewed by the U.S. Tax Court.[15] In holding that the penalty assessed by the I.R.S. was subject to the review of the U.S. Tax Court, the 2nd Circuit Court of Appeals looked to a comment in the legislative history indicating that Congress thought penalties should be issued when and as appropriate and not as a bargaining chip.

> The report from the Senate Finance Committee on § 6751(b) states clearly the purpose of the provision and thus Congress's intent: "The Committee believes that penalties should only be imposed where appropriate and not as a bargaining chip." S. Rep. No. 105-174, at 65 (1998). The statute was meant to prevent IRS agents from threatening unjustified penalties to encourage taxpayers to settle. IRS Restructuring: Hearings on H.R. 2676 Before the S. Comm. on Finance, 105th Cong. 92 (1998) (statement of Stefan F. Tucker, Chair-Elect, Section of Taxation, American Bar Association) ("[T]he IRS will often say, if you don't settle, we are going to assert the penalties.").

CONCLUSION

While *Chai* involved the jurisdiction of the U.S. Tax Court to review the assertion of a penalty, the principle has wider application. Taxpayers who passively receive a gift or an inheritance, seek advice as to their obligations, and are misadvised should not be held to the high-stakes poker approach that Mr. Wrzesinski encountered when

[13] 851 F.3d 190 (2d Cir. 2017).

[14] Code §6751(b)(1).

[15] Penalties that are imposed automatically by electronic means are exempt from the requirement for an independent determination by an I.R.S. employee as to whether the penalty should be assessed. In the case, the Notice of Deficiency issued by the I.R.S. indicated that determinations were made by the Technical Services Territory Manager of the I.R.S. or a revenue agent acting under her authority. No indication existed that it was made electronically through the IMF Automated Underreporter Program, a computerized system that uses information return matching to identify potentially underreported tax returns.

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seeking to correct the error on a voluntary basis. The goal for the I.R.S. is to encourage voluntary reporting. Taxpayers who seek to correct an error in what remains an esoteric area of the law for most individual taxpayers should not be forced to consider the amount of a toll charge when faced with a difficult choice.

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LATE FILED FORM 3520: WHAT PENALTIES TO EXPECT AND HOW TO RESPOND

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Tags
Foreign Bequests
Foreign Gifts
Form 3520
Penalty

INTRODUCTION

U.S. persons are required to file Form 3520 (Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts) with the I.R.S. to report

- certain transactions with foreign trusts,
- ownership of foreign trusts under the grantor trust rules of Code §§671 through 679, and
- the receipt of certain large gifts or bequests from foreign persons.

The penalty for filing a delinquent Form 3520 is 5% of the value of the unreported gift for each month that passes after its due date. The maximum penalty is 25% of the amount of the gift. Form 3520 is due at the time of a timely filing of the U.S. income tax return. If the due date for filing the tax return is extended, the due date for filing the Form 3520 is automatically extended.

This article addresses the winding road that must be navigated when a U.S. person discovers that the Form 3520 has not been filed on a timely basis.

REPORTABLE GIFTS AND BEQUESTS

Outright gifts and bequests received from a foreign donor or the estate of a foreign decedent in excess of $100,000 must be reported by a U.S. recipient. Gifts received from related individuals are aggregated in determining whether the threshold has been exceeded. If none of the gifts exceed $5,000, a blanket statement is used to tell the I.R.S. that no gifts or bequests exceed that level.

> **Example:**
>
> Husband and wife are nonresident, noncitizen individuals. Their daughter lives and works in the U.S. She holds an H 1B visa. H gifts daughter. Husband gifts $78,000 to the daughter and wife separately gifts $25,000 to the daughter. The threshold of $100,000 is exceeded. Daughter must file Form 3520.

Distributions from a revocable, grantor trust that has a foreign person as grantor are treated as gifts from the foreign grantor for substantive U.S. tax purposes. If they exceed $100,000, they must be reported. For reporting purposes, and reporting purposes only, the receipt retains the character of a trust distribution and must be reported as such on the form.

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I.R.S. WEBSITE

The I.R.S. website contains a page entitled "Delinquent International Information Return Submission Procedures."[1] It provides as follows in pertinent part.

> **What do I do if I have a delinquent international information return?**
>
> Taxpayers who have identified the need to file delinquent international information returns who are not under a civil examination or a criminal investigation by the IRS and have not already been contacted by the IRS about the delinquent information returns should file the delinquent information returns through normal filing procedures.
>
> Penalties may be assessed in accordance with existing procedures.
>
> * * *
>
> - All delinquent Forms 3520 and 3520-A should be filed according to the applicable instructions for those forms.
>
> * * *
>
> - Taxpayers may attach a reasonable cause statement to each delinquent information return filed for which reasonable cause is being asserted. During processing of the delinquent information return, penalties may be assessed without considering the attached reasonable cause statement. It may be necessary for taxpayers to respond to specific correspondence and submit or resubmit reasonable cause information.

On its surface, the page suggests the existence of a benign procedure designed to invite late compliance. In practice, late compliance is penalized.[2]

PENALTY REGIME

If a penalty is imposed, it is not a tax deficiency. Consequently, the U.S. Tax Court has no jurisdiction to review the asserted penalty. The I.R.S. treats the penalty as due when asserted unless appealed. The appeal is an administrative appeal to the I.R.S. Independent Office of Appeals based on reasonable cause for failure to timely file.

The appeal does not stop the running of collection notices. If the I.R.S. sends a notice to levy on bank accounts and other property under standard collection procedure, a Due Process Appeal to U.S. Tax Court may be filed.

Failure to file Form 3520 keeps the statute of limitations from. running as to the penalty until the date that is three years from filing.

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[1] See the I.R.S. website.

[2] See Wooyoung Lee, "When it Comes to Penalty Abatement, is the I.R.S. Offside?"

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I.R.S. APPEALS PROCEDURE

The first communication from I.R.S. after submitting a reasonable cause statement is Form Letter CP 854C. It Informs the taxpayer that the request for a penalty waiver or abatement has been fully or partially denied. The taxpayer is invited to appeal. The deadline for responding is typically 60 days from the date of the letter. It is not uncommon for a taxpayer residing abroad to first receive the Form Letter CP 854C after the due date for responding has passed. To date, our experience is that the appeal will be processed by the I.R.S. even if late in that set of circumstances. Of course, that may change.

The appeal is filed with the Independent Office of Appeals. Filing an appeal does not stop the collection process. Typically, the appeal includes the following information:

- The name, address, and taxpayer identification number of the taxpayer
- A statement that the taxpayer appeals the findings
- A detailed statement of facts and law
- A copy of the original request for abatement of the penalty
- A copy of CP 854C

The I.R.S. Appeals Office typically responds to a protest by issuing Form Letter 5157, in which it schedules a conference call with the taxpayer. The letter typically grants one month's time to prepare for the call. The taxpayer is typically offered the opportunity to provide additional information to assist the Appeals Officer in reaching a decision. The Appeals Officer may be contacted in advance to reschedule the conference, at least one time.

If the Appeals Officer has not responded within 60 to 90 days of the filing date of a in response to Form Letter CP 854C, the I.R.S. can be contacted at the following telephone number: (559) 233-1267. A recorded message will invite the caller to leave a message and to provide a contact telephone number. The I.R.S. will research the status of the case and return the call within 48 hours. If the case hasn't been updated in the I.R.S. system, no callback will be received.

The I.R.S. sometimes responds by issuing Form Letter CP 15 instead of Form Letter CP 854C. This invites the taxpayer to file a submission to the I.R.S. prior to an appeal to the Independent Office of Appeals. Form letter CP 15 grants 30 days for the response to be submitted. Typically, the I.R.S. will issue a letter informing the taxpayer that the I.R.S. is not equipped to handle the matter and is forwarding the matter to the I.R.S. Independent Office of Appeals. This is simply one added step that increases processing time.

As mentioned above, the Appeals process does not stop the collection process. Consequently, while an appeal is pending, the taxpayer will continue to receive the following collection notices:

- CP 501 Reminder, We Show You Still Owe
- CP 503 Notice Important – Immediate Action Required

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- CP 504 Notice Urgent Notice – We Intend to Levy on Certain Assets, Please Respond Now
- CP 90/ LT 11/ LT 1058 / Letter 3172 – Notice of Levy (prohibits the State Department from issuing or renewing a passport to a taxpayer with seriously delinquent tax debt in excess of $55,000.

COLLECTION DUE PROCESS HEARING

Before the I.R.S. can levy against the assets of a taxpayer, it will issue Form Letter 3172. This letter grants a Taxpayer the right to request a hearing under the Collection Due Process ("C.D.P.") program. The request is made by filing Form 12153. The C.D.P hearing provides a taxpayer with an opportunity to bring the case before the IRS Office of Appeals, which is independent and separate from the I.R.S. Collections office.

A hearing must be requested within 30 days from the date of Form Letter 3172. A negative determination by the Appeals Officer The Appeals determination can be challenged in Tax Court. If the 30-day period lapses, an equivalent hearing may be requested. However, the equivalent hearing does not allow a taxpayer the right to challenge the determination in Tax Court.

"A hearing must be requested within 30 days from the date of Form Letter 3172."

In a C.D.P. hearing, a taxpayer may raise issues relating to collection. In particular, a taxpayer may raise the following grounds for relief from the threat of a levy:

- The taxpayer believes all taxes due were paid.
- The taxpayer cannot pay the taxes due to one or more of the following reasons:
  - A terminal illness or high medical bills
  - Unemployment or no income
  - Reasonable expenses exceed income
  - The taxpayer's only source of income is social security, welfare, or unemployment benefits
- The taxpayer wants to pursue innocent spouse relief.
- The taxpayer thinks the statute of limitations on collection has expired.
- The taxpayer intends to propose a different way to pay the taxes owed.
- The I.R.S. made a procedural error in its tax assessment.
- The I.R.S. assessed taxes and initiated a levy when the taxpayer was in bankruptcy.
- The taxpayer wants a tax lien discharged to sell a piece of property and use the proceeds to pay off their tax liabilities.
- The taxpayer desires a tax lien subordination or withdrawal.

A taxpayer may also challenge the underlying tax liability for any tax period, but only if he or she did not receive a notice of deficiency or did not otherwise have an opportunity to dispute the liability.

A timely request for a C.D.P. hearing will prohibit levy action in most cases. It will also suspend the running of the statutory year period to collect the taxes. Both prohibition on levy and the suspension of the 10-year statutory period for collections will last until a determination by the I.R.S. Independent Office of Appeals. The suspended amount of time is, in effect, added to the time remaining in the 10-year period.

The taxpayer has a right to challenge and adverse determination in its C.D.P. hearing by filing a petition for review in the U.S. Tax Court.

THINGS TO REMEMBER WHEN DRAFTING AN APPEAL

When appealing the 25% penalty on a late-filed Form 3520, it is important to tell the whole story. A recitation of bare facts followed by a citation to a favorable decision in a court is a recipe for failure. The goal is to convince the Appeals Officer that the taxpayer acted responsibly even though a failure in compliance occurred. The Appeals Officer must be convinced that reasonable cause existed. This requires a full and complete submission that is true, accurate, and complete. False statements with the intent to mislead are punishable as felonies.

In fashioning the submission, emphasize the professional credentials of the tax adviser. Before arguing that the adviser or tax return preparer was at fault, explain in detail why it was reasonable to choose this tax adviser in the first place. Remember, the capability of the tax adviser or return preparer is a key decision point in determining that reasonable cause existed for the taxpayer's failure to timely Form 3520. If the adviser or preparer is painted as incompetent, the taxpayer's position is weakened, not strengthened.

Once it is established that the tax adviser or tax return preparer was highly competent to address this area of the law, the focus shifts to whether the taxpayer made full disclosure. This requires demonstrating that the person on whom the taxpayer relies was given sufficient information to advise properly. Avoid giving conclusions without a detailed recitation of facts.

The final piece of the puzzle is to demonstrate that the taxpayer actually relied in good faith on the advice. Here the standard of care varies depending on the profile of the taxpayer. If the taxpayer's business is in the financial services sector, a higher standard of care must be demonstrated. If the taxpayer is not a businessman, a lesser standard may be applied. Whichever standard applies, the taxpayer must demonstrate clearly that he or she exercised ordinary business care and prudence in determining applicable obligations, but nevertheless failed to comply with those obligations.

As a final point, a taxpayer should provide all facts in detail. Look for facts highlighted in cases that produced favorable results and see if they reasonably exist in the circumstances at hand. More detail is better than less detail.

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

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.

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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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