

U.S. TAX UPDATE

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Stanley C. Ruchelman
Ruchelman P.L.L.C.
New York City
ruchelman@ruchelaw.com

Recent Developments Covered

- New U.S. Model Income Tax Treaty
- Reporting obligations of disregarded entities
- Loss importation rules
- Crowd funding – tax treatment for investors and issuers
- Debt characterization rules

NEW U.S. MODEL INCOME TAX TREATY

New Model Treaty

- The Model Treaty reflects the current treaty negotiating position of the U.S.
- Announced in February
- Contains several B.E.P.S. and other comparable measures to prevent double non-taxation
- Addresses some technical issues in favor of taxpayers

New Provisions

- **Special Tax Regimes**

- Denial of Treaty benefits for a treaty resident benefitting from special tax regimes for highly movable income such as interest, royalties, and guarantee fees

- **Subsequent Changes in Domestic Law**

- Notification and consultation to amend a treaty is required when changes in domestic law affect balance of benefits and creates the potential for double non-taxation

- **Derivative Benefits**

- Expansion of the derivative benefits coverage
- Dividends paid to an individual who is an equivalent beneficiary resident in a different E.U. country will qualify for treaty benefits

New Provisions

- **Anti-Inversion Rule**

- Treaty benefits for U.S. withholding taxes on U.S.-source dividends, interest, royalties, and certain guarantee fees paid by an expatriated entity that continues to be treated as U.S. corporation
- Applies only to payments to related parties

- **Mutual Agreement Procedure**

- MAP to provide for mandatory binding arbitration
- This follows four treaties that await the advice and consent of the Senate

- **B.E.P.S.**

- Prevention of double non-taxation now an overall purpose of an income tax treaty
- Not all of the recommended permanent establishment provisions have been adopted

REPORTING OBLIGATIONS OF DISREGARDED ENTITIES

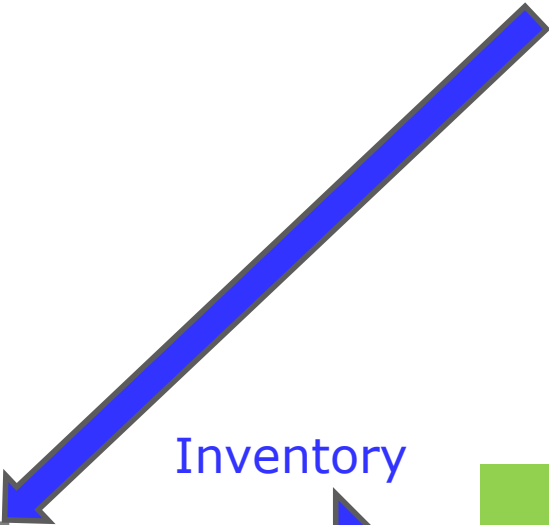
Actual Transaction

European Supplier

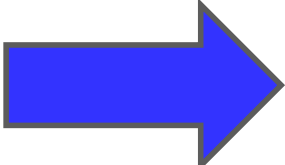
XYZ LTD.
(Bahamas)

XYZ L.L.C.
(U.S.)

Customers
in Europe



Inventory



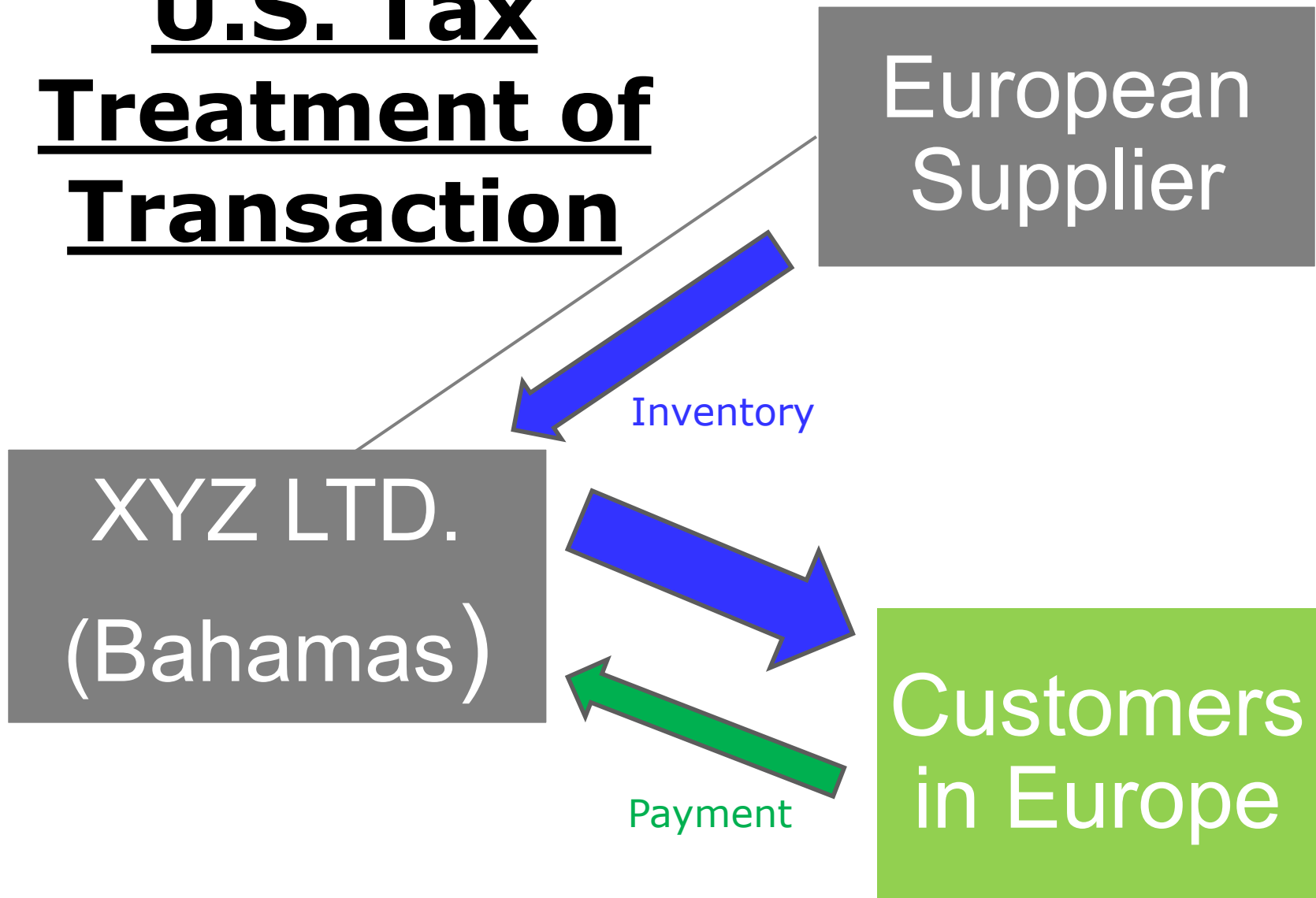
Payment



Tax treatment for structure

- Price charged XYZ L.L.C. is low
- XYZ L.L.C. is a disregarded entity
- Price charged customers in Europe is high
- No tax in U.S. if no office is maintained
- No tax filing in U.S.
- No U.S. tax identification number
- No information to provide to tax authority in country of residence of European supplier

U.S. Tax Treatment of Transaction



Proposed Information Reporting Regulations

- Regulations proposed in May will mandate information reporting by a disregarded entity (“DRE”), but no change in U.S. tax treatment
- The regulations will be effective in 2018
- U.S. tax identification number will be required of DRE
- Record maintenance will be required of DRE
- Failure to comply can result in a \$10,000 civil penalty, which can be increased if the failure continues after notification by the I.R.S. and criminal penalties

Proposed Information Reporting Regulations

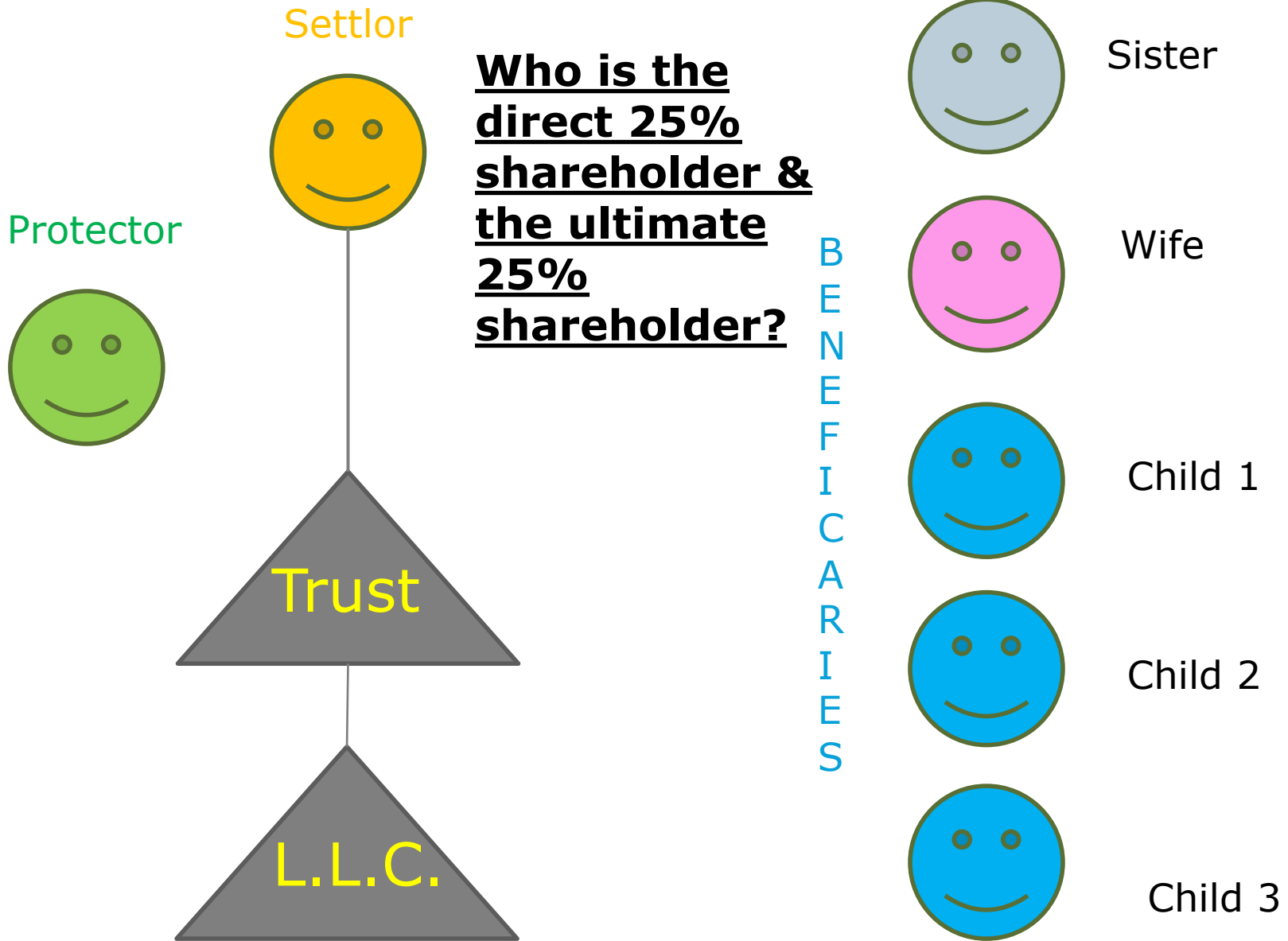
- Form 5472 filing obligation will cover a DRE and the following must be reported annually
 - Direct foreign 25% shareholders and ultimate 25% foreign shareholders:
 - Name, address, countries where business is conducted, country of citizenship, country where income tax return is filed
 - Transactions:
 - All related party sales, assignments, leases, licenses, loans, advances, contributions, transfers of property, transfers of right to use property, services for the benefit of, or on behalf of, another taxpayer

Indirect Application to Trusts

- Another typical fact pattern where a DRE is used involves trusts
 - Often a DRE is placed underneath the trust to limit the scope of trustee obligations
- Today we see an influx of U.S. foreign trusts formed by non-U.S. individuals
 - Once the reporting rule applies, the compliance question involves the identification of the ultimate 25% shareholder
 - This involves the application of constructive ownership rules, that attribute ownership from the trust to the beneficiaries and if the beneficiaries are members of the settlor's family, from family member to family member

Indirect Application to Trusts

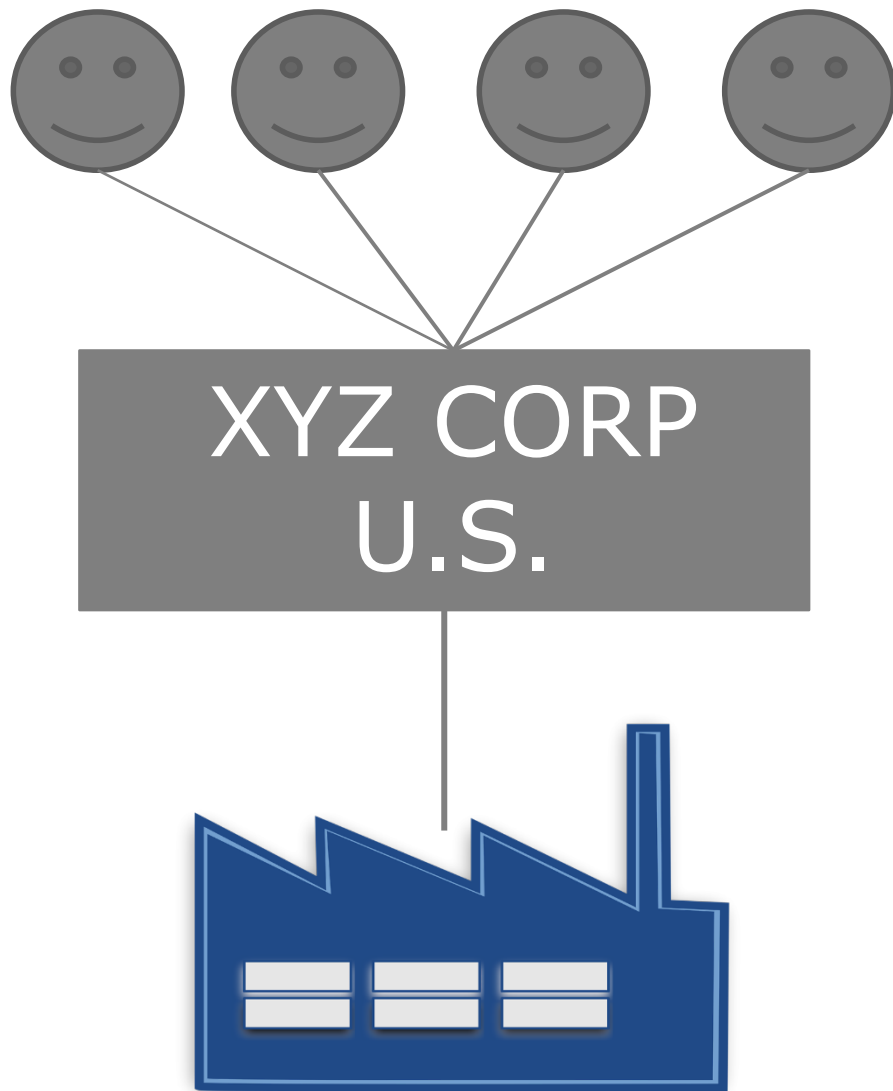
- Typical fact pattern:
 - Settlor and beneficiaries are non-U.S. persons
 - Trust is formed in New York, Delaware, or South Dakota
 - For U.S. tax purposes, the trust is a foreign trust because, *inter alia*, protector is a foreign person and holds the power to trigger trust distributions
 - The beneficiaries are three children of settlor, his wife, and his sister, whose interest is capped at 5%
 - The trust is fully discretionary, subject to power of the protector
- Who is the direct 25% foreign shareholder and who are the ultimate 25% foreign shareholders?



Application to Trust + Beneficiaries

- The direct 25% foreign shareholder is the U.S. foreign trust – for tax purposes it is a foreign trust in this fact pattern
- The ultimate 25% shareholders are each of the children and the wife
 - Each is deemed to own 23.75% of the L.L.C. by attribution from the trust
 - Each child is deemed to an additional 23.75% from their mother
 - The wife is deemed to own an addition 71.25% from her children

LOSS IMPORTATION RULES



Which to Purchase – Assets or Shares?

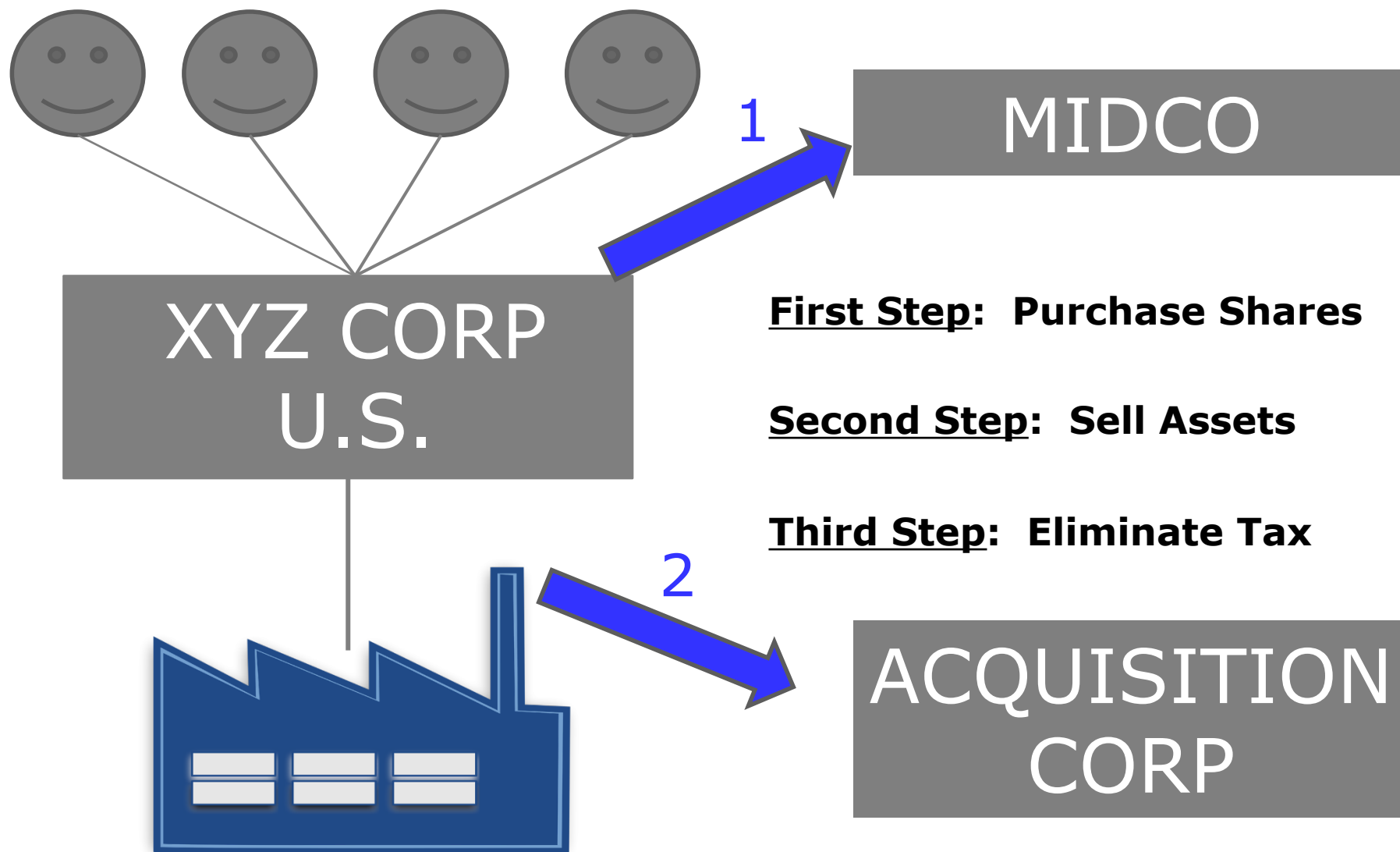
ACQUISITION
CORP

Tension in Transaction

- Acquisition Corp proposes to purchase business assets of XYZ Corp
 - This results in a step-up in basis to FMV with regard to assets
 - This results in a corporate tax for XYZ Corp and a capital gains tax for its shareholders
- Shareholders of XYZ Corp prefer sale of shares in XYZ
 - No step-up in basis to FMV with regard to assets
 - Only one level of tax for sellers – at the level of the shareholders of XYZ Corp

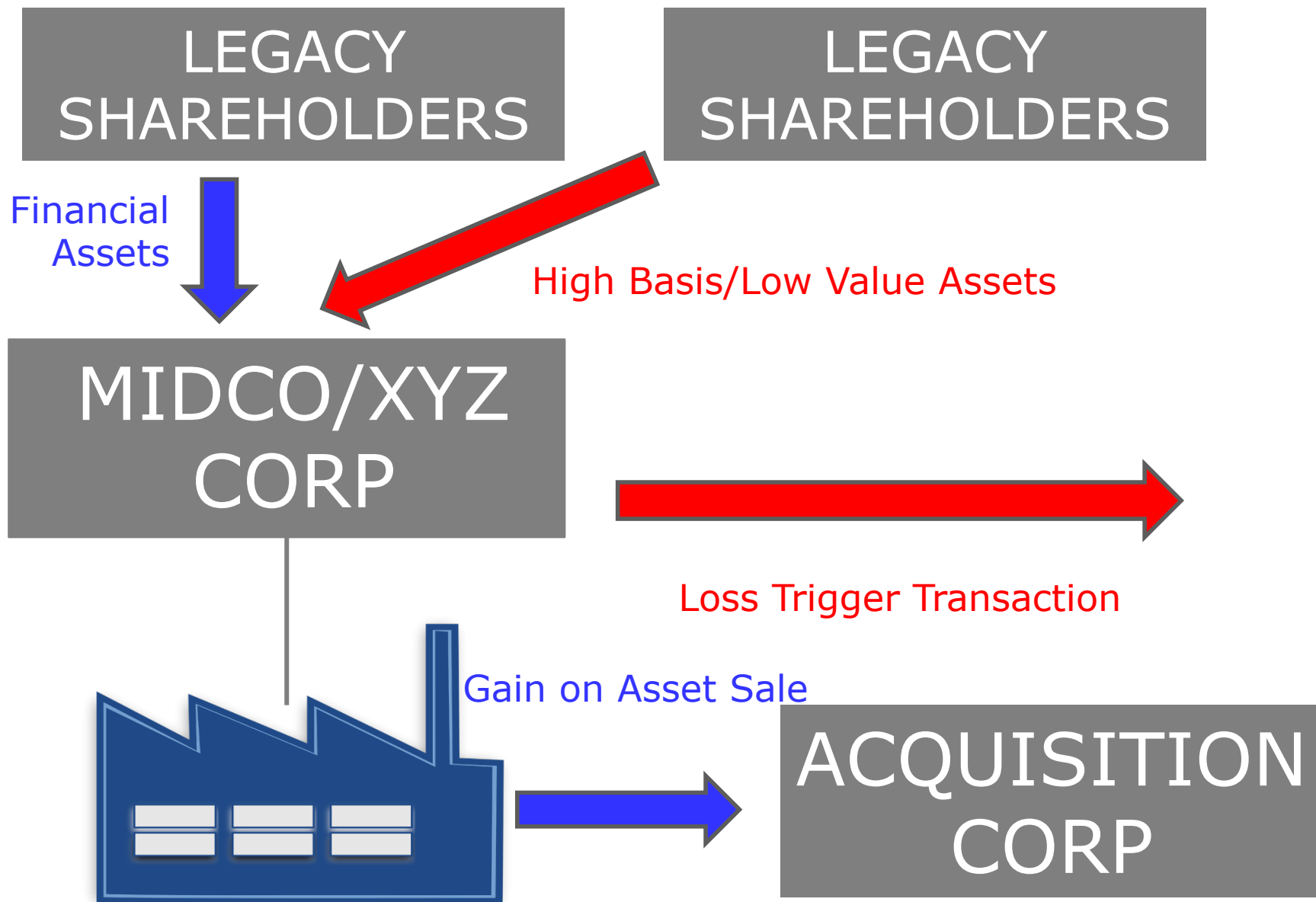
Enter MIDCO Company

- MIDCO purchases shares, merges XYZ Corp into MIDCO, and sells assets
- MIDCO realizes substantial gain
- How does MIDCO eliminate tax?



Parallel Transaction by MIDCO

- MIDCO participates in a tax-free §351 transaction
 - Existing MIDCO shareholders transfer cash to MIDCO and unrelated foreign entity transfers high basis/low value assets to MIDCO, typically a distressed financial asset
 - Because the transaction is tax-free and the assets are easily valued, stock is issued to both transferors in appropriate proportion to values
- The inherent loss is triggered by disposing of the high basis/low value assets, offsetting the income from sale of the appreciated XYZ Corp business assets
 - If properly planned, the loss is an ordinary loss



FINAL REGULATIONS LIMIT IMPORTATION OF BUILT-IN LOSSES

- Final regulations were adopted in March to limit the use of built-in losses attributable to the import of high basis/low value assets in nonrecognition transactions
- The corporation's basis in property is reduced to FMV when property with a built-in loss is transferred to a corporation

FINAL REGULATIONS LIMIT IMPORTATION OF BUILT-IN LOSSES

- The rule applies when:
 - The transferor's gain or loss on the sale of property immediately before the transfer would not be subject to U.S. Federal income tax and
 - The acquiring corporation's gain or loss on the sale of the transferred property immediately after the transfer is subject to U.S. Federal income tax
- The first condition is met when the transfer of the asset is from abroad or from a U.S. domestic entity that does not pay tax on gains, such as a R.E.I.T. or a R.I.C. or an exempt entity that has not funded asset with debt
 - This rule does not apply to flow-through entities that are transferors

CROWD FUNDING

Crowd Funding

- An internet-based form of raising capital for businesses and other endeavors
- Utilizes social media to communicate with potential sources of capital based on political, social, investment criteria that typically are not used by traditional sources of capital
- Many different crowd funding structures:
 - Donation based – no financial return expected
 - Rewards based – the reward is a form of service or product
 - Equity based – partial ownership is available

Tax Consequences

- Kickstarter and Indiegogo web sites mention tax, but provide no further explanations
- The vacuum was filled by the I.R.S. in Information Letter 2016-0036
- For campaign owner, the proceeds of the funding produce taxable income unless the funds represent:
 - Loans that must be repaid
 - Capital contributed in exchange for an equity interest – this means it must be bargained for by the parties or
 - Gifts made out of detached generosity and without any quid pro quo – raising funding for charitable purposes
 -

DEBT/EQUITY CHARACTERIZATION

I.R.S. Proposes Regulations

- In April, controversial proposed regulations involving related-party debt were proposed by the I.R.S.
- The regulations characterize debt issued to related parties as equity in several circumstances:
 - The debt is issued in certain tainted transactions where debt replaces equity, such as dividends in the form of a debt instrument, stock purchases in affiliates in return for a debt instrument, and debt used in certain internal reorganizations
 - The debt is not supported by contemporaneous documentation
 - The debt capacity of borrower is less than the face amount of the debt, in which case the debt is bifurcated by the I.R.S. between the part that is debt and the part that is equity

Documentation

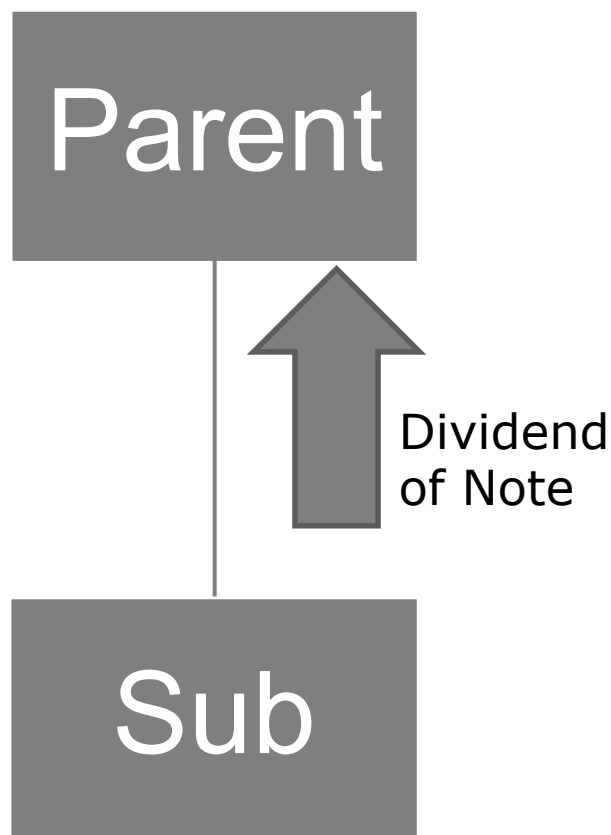
- The proposed regulations required documentation and analysis as to the credit capacity of the borrower at a time that is contemporaneous with the loan
- The documentation consists of:
 - A binding obligation to repay the loan
 - The inclusion of typical creditor terms to enforce the terms of the loan
 - An analysis demonstrating the credit capacity of the borrower, which cannot be exceeded
 - Evidence of an intent to enforce the rights of a creditor against the borrower
- The note must come into existence within the 30-day period following the loan and the credit analysis must be completed within the 120-day period following the loan

I.R.S. Proposes Regulations

- Over 29,600 comments were received by the I.R.S.
 - **Congressmen and Senators** were concerned about the effect of the rules on the U.S. economy
 - **The U.S. Chamber of Commerce** was concerned on the cost for companies that are not part of a group that has participated in an “inversion”
 - **The Business Roundtable** commented that the proposed regulations exceeded the authority of the Treasury Department
 - **The American Bar Association Section on Taxation** commented that the proposed regulations depart from a century of Federal income tax law regarding debt and equity
 - **The New York State Bar Association** commented that there were too many traps as a result of the documentation and that the grant of regulatory authority by Congress was limited to factors
 - **Industry** submissions complained that group cash pooling arrangements would not meet the documentation standards
 - **Hedge fund** associations complained about the definition of “control” that triggers application of the rules

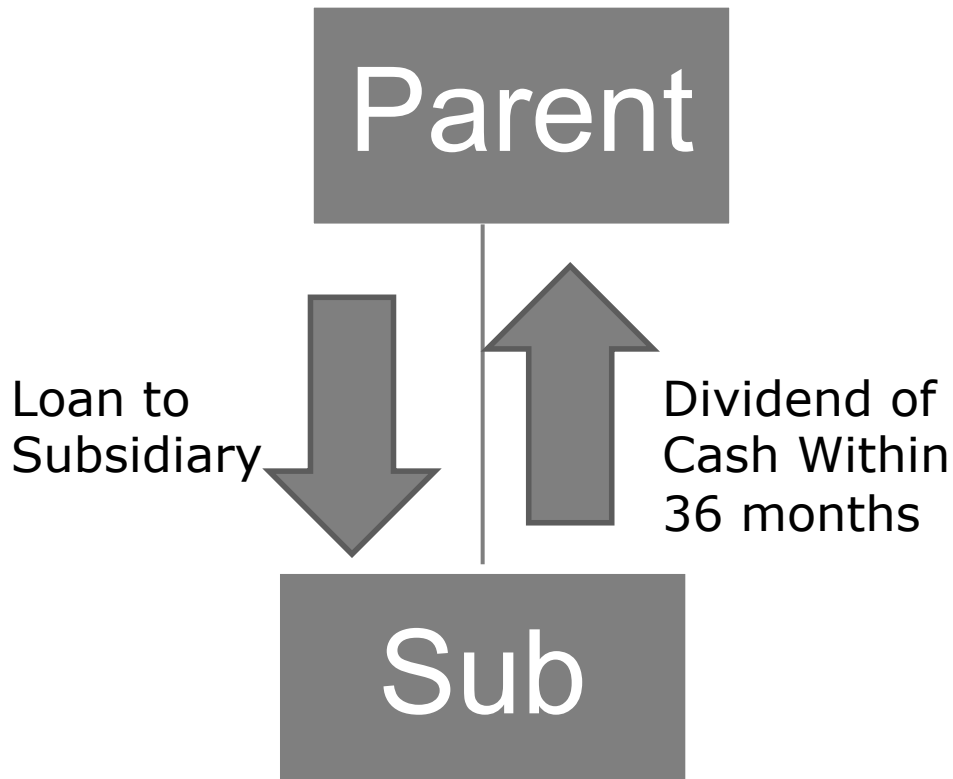
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- Final regulations were adopted in October
 - Many but not all provisions are scaled back
 - In particular, loans to fund tainted transactions that replace equity with debt remained
 - It is now estimated that only 1,200 corporations will be affected

Debt Replaces Equity



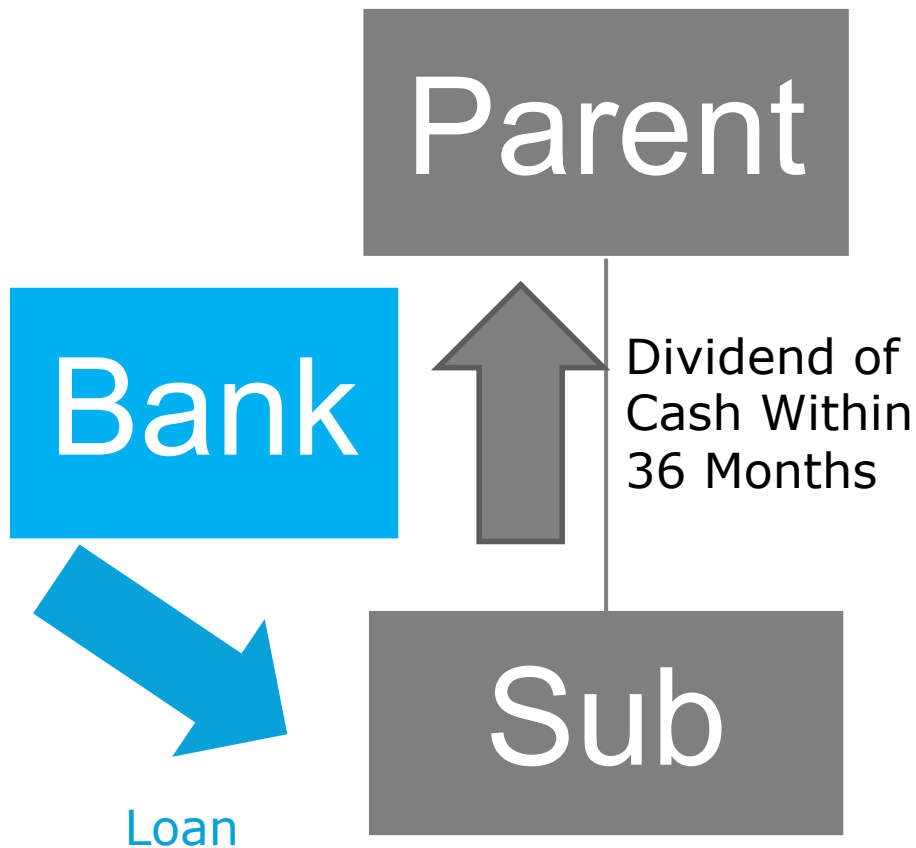
- Here, Sub pays dividend in the form of a note
- U.S. case law is inconsistent
- If the parent benefits from a treaty, the dividend may be subject to 0% or 5% withholding tax
- Interest on the note is deductible

Debt Replaces Equity



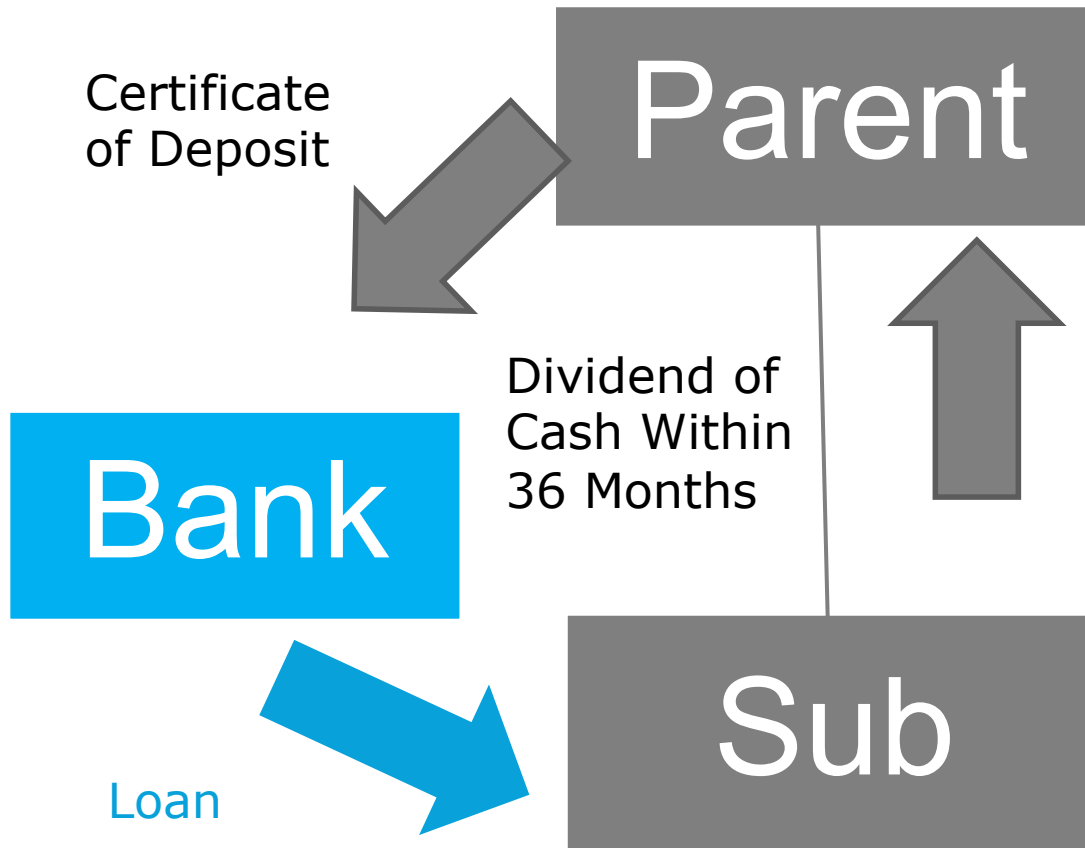
- Loans made within 36 months before or after a dividend is paid are deemed to fund dividend
- Exception for dividend equal to current and accumulated earnings

Third Party Debt Replaces Equity



- This transaction is not caught by the regulations because the debt is from a third party

Third Party Debt Replaces Equity



- This transaction is abusive because the bank is an intermediary under a principal purpose test

Documentation

- The final documentation rules are modified as follows:
 - The documentation rules become effective on a deferred basis – Instruments issued before January 1, 2018, are subject to the rules
 - The documentation requirements apply only if the issuer is a member of a group with at least one publicly traded corporation, a group with at least \$100 million in assets, or a group with at least \$50 million in revenue
 - Documentation is timely if prepared by the time for filing the issuer's Federal income tax return (taking into account extensions)
 - The rights of the creditor may be provided by applicable state law referred to in the instrument
 - A prohibition on subordination that existed in the proposed regulations have been removed
 - The annual credit analysis will cover all loans within the period, provided that the borrower's credit capacity is not exceeded

Other Provisions in Final Regulations

- The final regulations do not apply to debt issued by non-U.S. issuers.
- Financial service entities subject to Federal regulation are generally exempt
- Short-term loans are generally excluded from the final regulations, including cash pooling arrangements and international treasury centers
- All taxpayers can exclude the first \$50 million of debt

ruchelman

corporate
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NEW YORK

Ruchelman P.L.L.C.
Architects and Designers Building
150 East 58th Street, 22nd Floor
New York, New York 10155
Tel. 212-755-3333

TORONTO

Ruchelman P.L.L.C.
The Exchange Tower, P.O. Box 233
130 King Street West, Suite 2300
Toronto, Ontario M5X 1C8
Tel. 416-350-2026

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