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INSIGHTS

YEAR-END REVIEW: NET INVESTMENT INCOME TAX

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EDITORS' NOTE

On January 1, 2014, The Ruchelman Law Firm became Ruchelman P.L.L.C. With this change we thought it would be useful to provide our clients and friends with the publication of a monthly newsletter devoted to matters encountered in our practice.

Our first edition provides a year-end review of:

- The Net Investment Income Tax ("N.I.I.T."),
- The Foreign Account Tax Compliance Act ("F.A.T.C.A."),
- The Offshore Voluntary Disclosure Program ("O.V.D.P.") by the I.R.S.,
- Passive foreign investment companies ("P.F.I.C.s"),
- Dividend equivalent payments, and
- Non-profit organizations.

The newsletter provides two monthly columns devoted to matters that should be of interest to our client base. The first is called "Tax 101: Introductory Lessons" because it introduces a tax topic of relevance that may not be fully understood by corporate executives and investment managers. The column will be authored on a rotating basis by members of the firm. The second is called "Corporate Matters" and is devoted to corporate topics of interest. Simon Prisk is the author of the second column.

The 2013 calendar year was quite impressive from the I.R.S. perspective, particularly in relation to international tax issues. The I.R.S. finalized or issued proposed or temporary regulations on F.A.T.C.A., P.F.I.C.s, and dividend equivalent payments. It also dedicated substantial resources to international tax enforcement initiatives including fighting offshore tax evasion and automatic exchanges of information. What we can take from this is that the I.R.S. is relentless in its focus on international tax enforcement. Automatic information reporting appears to be the newest standard for global information reporting as illustrated by this week's release by the O.E.C.D. of a new global standard for exchanges of tax information. In this environment, it is more important than ever that the cross border investor remains in compliance with relevant tax obligations. This newsletter is one step in that process.

We hope you enjoy this issue.

-The Editors

YEAR-END REVIEW: NET INVESTMENT INCOME TAX

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Tags
Private Client

The Net Investment Income Tax ("N.I.I.T.") was added to the Code on March 30, 2010. It is imposed at a rate of 3.8% of certain net investment income ("Net Investment Income") of individuals, estates and trusts having income above specified triggering amounts. For individuals who are calendar year taxpayers, the tax first became effective in 2013. Thus, the current tax return filing season will be the first time taxpayers feel the effect of the tax. In late 2013, the I.R.S. released final and proposed regulations for the N.I.I.T.[1] These regulations clarify proposals that were issued on December 5, 2012. This article provides a summary of the N.I.I.T. and explains how the new regulations will affect taxpayers.

IN GENERAL

Applicable Thresholds

Individuals will owe the tax if they have Net Investment Income and also have modified adjusted gross income[2] over the following thresholds:

Filing Status	Threshold Amount
Married Taxpayers (Joint Filing)	$250,000
Married Taxpayers (Separate Filing)	$125,000
Single	$200,000
Head of household (with qualifying person)	$200,000
Qualifying widow(er) with dependent child	$250,000

These amounts are not indexed for inflation.[3]

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1 New regulations were released on November 26, 2013 and published on December 2, 2013.

2 For the N.I.I.T., modified adjusted gross income is adjusted gross income (Form 1040, Line 37) increased by the difference between amounts excluded from gross income under Code §911(a)(1) and the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under Code §911(d)(6) for amounts described in Code §911(a)(1). In the case of taxpayers with income from C.F.C.s and P.F.I.C.s, additional adjustments to their adjusted gross income may be required. See Treas. Reg. §1.1411-10(e).

As long as the modified adjusted gross income does not exceed the foregoing amounts, no N.I.I.T. is due. If the threshold is exceeded, the tax is imposed on the amount of the excess, or if lower, the net investment income. This is illustrated by the following example.

> *Example 1:* An individual taxpayer is single and has $170,000 in wages and $50,000 in dividends. The taxpayer has modified adjusted gross income of $220,000, which is over the statutory threshold of $200,000. The taxpayer will be taxed 3.8% on $20,000 (the amount of modified adjusted gross income which is over the statutory threshold) because that amount is less than the $50,000 of Net Investment Income. The tax is $760.00 (3.8% x $20,000).

Definition of Net Investment Income

In general, investment income includes:

- Interest, dividends, capital gains, rental and royalty income, and non-qualified annuities;

- Income from businesses involved in trading of financial instruments or commodities (*i.e.*, traders); and

- Income from businesses that are passive activities to the taxpayer (within the meaning of Section 469).[4] In broad terms, this generally includes any active business that is carried on by a partnership, an S-corporation, or an L.L.C. in which an individual has invested money but does not actively participate in the business within the meaning of the passive activity loss rules.

Net Investment Income is calculated by allocating certain expenses to gross investment income. The regulations caution that the allocations must be proper. [5] Examples include investment interest expenses, investment advisory, and brokerage fees, expenses related to rental and royalty income, tax preparation fees, fiduciary expenses in the case of an estate or trust, early withdrawal penalties,

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3 Code §1411(b). See “Net Investment Income Tax FAQs,” last updated January 30, 2014, available at: http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs.

4 The following is not considered investment income: wages, unemployment compensation, operating income from a nonpassive business, Social Security Benefits, alimony, tax-exempt interest, self-employment income, Alaska Permanent Fund Dividends and distributions from certain Qualified Plans (those described in §§401(a), 403(a), 403(b), 408, 408A, or 457(b). See “Net Investment Income Tax FAQs,” Question 9, last updated January 30, 2014, available at: http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs.

5 Treas. Reg. §1.1411-4.

net passive activity operating loss carryovers incurred in a prior year and suspended, and state and local income taxes.[6]

The N.I.I.T. will not apply to any amount of gain that is excluded from gross income for regular income tax purposes, such as the principal residence exemption. The full gain is exempt if it does not exceed $250,000 for single individuals and $500,000 in the case of a married couple. This is illustrated by the following example:

> *Example 2:* A, a single filer, earns $210,000 in wages and sells his principal residence for the preceding 10 years for $420,000. A's cost basis in the home is $200,000. A's realized gain on the sale is $220,000. Under Section 121, A may exclude up to $250,000 of gain on the sale. The entire gain is excluded from the N.I.I.T. tax base.

Payment of Estimated Taxes

The N.I.I.T must be taken into account when preparing quarterly estimated tax payments. Under-payment penalties are imposed for shortfalls of estimated tax caused by a failure to consider N.I.I.T. tax when preparing estimates.

Passive Activity and the N.I.I.T.

As mentioned above, the N.I.I.T. applies to trade or business income that arises from a passive activity and not to the active trade or business income categorized as "material participation" income by an individual.

As with the basic passive activity loss disallowance rules, the N.I.I.T. regulations allow a taxpayer the opportunity to group multiple business activities in order to convert passive business activities into active business activities of the individual. By grouping multiple business activities as a single "appropriate economic unit," a taxpayer's hours of participation in one entity can extend to another entity.[7] This causes the combined income to be considered active business income not subject to the N.I.I.T.[8] Factors that suggest activities constituting an appropriate economic unit include:

- Similarities and differences in types of trades or businesses;
- The extent of common control;
- The extent of common ownership;
- Geographical location; and

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6 The I.R.S. indicated in the final regulations that it can still impose further guidance and deductions in the future, but it would not expand on the list of deductions other than the "properly allocated" deductions as indicated above.

7 Treas. Reg. §1.469-4.

8 It is important to note that these groupings cannot be subsequently changed without I.R.S. consent. See Treas. Reg. §1.469-4(e).

- Interdependencies between or among the activities (*i.e.*, the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).

The application of these factors is illustrated by the following examples:

> *Example 3.* Mr. C has a significant ownership interest in a bakery and a movie theater at a shopping mall in Baltimore and in a bakery and a movie theater in Philadelphia. There may be more than one reasonable method for grouping Mr. C's activities. Depending on the relevant facts and circumstances, the following groupings may or may not be permissible: a single activity, a movie theater activity and a bakery activity, a Baltimore activity and a Philadelphia activity, or four separate activities.
>
> *Example 4.* Ms. B is a partner in a business that sells non-food items to grocery stores (partnership L). Ms. B also is a partner in a partnership that owns and operates a trucking business (partnership Q). The two partnerships are under common control. The predominant portion of Q's business is transporting goods for L, and Q is the only trucking business in which Ms. B is involved. Ms. B may appropriately treat L's wholesale activity and Q's trucking activity as a single activity.

Once a taxpayer chooses a particular grouping, it remains in place for all subsequent taxable years unless a material change in the facts and circumstances makes it clearly inappropriate.

Real Estate

In the preamble to the final regulations, the I.R.S. acknowledged that “in certain circumstances” the rental of a single property may require regular and continuous involvement such that the rental activity is a trade or business under Code §162 (and, therefore, is a trade or business under Code §1411) and thus excluded from the N.I.I.T.

That being said, the I.R.S. has not provided a bright line test of when a rental activity will rise to a trade or business. Instead, the I.R.S. provided several factors when it will actually be a Code §162 trade or business including:

- The type of property (whether commercial/residential);
- The number of properties currently owned;
- Day-to-day involvement of the owner; and
- The type of lease.

Some commentators believe that the lack of clarification in the regulations will ensure that there will be future litigation to determine the issue of when a rental activity is subject to the N.I.I.T.

The I.R.S. cautions that it will scrutinize transactions where the taxpayer takes the position that activities are a trade or business for purposes of the N.I.I.T. but not a trade or business for other provisions in the Code.

Disposition of Partnership Interests or S-Corporation Interests

While the sale of assets from a partnership or S-Corporation may be excluded from the N.I.I.T, the computation is somewhat more complex if the transaction involves the sale of a partnership interest, an L.L.C. interest, or shares of an S-Corporation.[9] First, a determination is made regarding the status of the entity that is being sold. The entity must not be in its entirety a passive entity. Consequently, the following tests must be met:

- The partnership, L.L.C., or S-Corporation must conduct at least one trade or business that does not involve the trading of financial instruments or commodities; and

- At least one of the businesses conducted must not be a passive activity as to the individual.

If the test is met, the gain from the sale of the interest is treated as active only to the extent active gain would be generated by the entity if it sold all its assets. In this manner, look-thru treatment is provided for an outside gain based on the character of the gain that would be recognized from a sale of assets owned by the partnership, L.L.C., or S-Corporation.

INTERNATIONAL TAX ISSUES

Inapplicable to Non-Resident Aliens

Generally, the N.I.I.T does not apply to nonresident, non-citizen individuals ("N.R.N.C."),[10] including dual resident individuals treated as residents of a foreign country under an income tax treaty. There are, of course, exceptions:

- If a N.R.N.C. makes an election to file a joint tax return with a U.S. citizen spouse under Code §6013(g), the N.R.N.C. is treated as a U.S. resident for income tax purposes. The final regulations provide that the N.R.N.C. is not subject to the N.I.I.T. unless a separate election is made to become subject to the tax. If no election is made, the threshold for the U.S. citizen spouse is $125,000, the threshold of a married person filing separately. If a special N.I.I.T. election is made by the N.R.N.C., the joint threshold is bumped up

[9] Proposed Treas. Reg. §1.1411-7.
[10] Code §1411(e).

“The regulations provide that the foreign tax credit is disallowed with regard to the N.I.I.T.,[1] which if applied in an income tax treaty context, appears to be contrary to the plain meaning of the provisions of the income tax treaty that are addressed to relief from double taxation.”

to $250,000.[11] The election is made by checking the box on Part 1 of Form 8960 (Net Investment Income Tax—Individuals, Estates, and Trusts).

- Dual-status residents who are residents of the U.S. for only a portion of the year will be subject to the N.I.I.T. only with respect to Net Investment Income generated in the residence portion of the year.[12]

Disallowance of the Foreign Tax Credit

The regulations provide that the foreign tax credit is disallowed with regard to the N.I.I.T.,[13] which if applied in an income tax treaty context, appears to be contrary to the plain meaning of the provisions of the income tax treaty that are addressed to relief from double taxation.[14] As a technical matter of treaty interpretation, the N.I.I.T appears to be an income tax “identical or substantially similar” to the income taxes in effect when an existing treaty was enacted.[15] The I.R.S. view is expressed in the preamble to the final regulations, which states that the N.I.I.T. is not an income tax. It further states that if a treaty has similar language to what is provided in Paragraph 2 of Article 23 (Relief from Double Taxation) in the 2006 United States Model Income Tax Convention, then such treaty would not provide an independent basis for a credit against the N.I.I.T. The apparent defect in the I.R.S. reasoning is that, apart from the *ipsa dixit* statement, the N.I.I.T. is a tax on income. Not only is it called a tax on income in Code §1411(a)(1), but the regulations state that income tax concepts apply in determining the N.I.I.T.:

> Except as otherwise provided, all Internal Revenue Code (Code) provisions that apply for chapter 1 purposes in determining taxable income (as defined in section 63(a)) of a taxpayer also apply in determining the tax imposed by section 1411.[16]

Presumably, all income tax treaties that come into effect on a go-forward basis will include a provision that supports the I.R.S. view, at least with regard to that treaty.

Application to Expatriation

The final regulations confirm that gains resulting from the exit tax upon expatriation are subject to the N.I.I.T.[17]

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11 Treas. Reg. §1.1411-2(a)(2)(iii).
12 Treas. Reg. §1.1411-2(a)(2)(ii). Dual status resident means an individual who is a resident of the United States for a portion of a taxable year and a nonresident alien for the other portion of the taxable year.
13 Treas. Reg. §1.1411-1(e).
14 See, *e.g.,* Article XXIV (Elimination of Double Taxation) of the Canada-U.S. Income Tax Treaty.
15 See, *e.g.*, Article II (Taxes Covered) of the Canada-U.S. Income Tax Treaty.
16 Treas. Reg. §1.1411-1(a).
17 Treas. Reg. §1.1411-4(d)(1).

C.F.C.s and P.F.I.C.s

The regulations provide special rules applicable to income derived from a controlled foreign corporation ("C.F.C.") and a passive foreign investment company ("P.F.I.C.").

Dividends and gains from the sale of shares of a P.F.I.C or a C.F.C. are included in calculating net investment income. The regulations apply to an individual, estate or trust that is a U.S. shareholder of a C.F.C. or a U.S. person that directly or indirectly owns an interest in a qualified electing fund (a "Q.E.F.").[18] Under the general rule, the N.I.I.T. first applies when cash or property is distributed from the Q.E.F. or the C.F.C., even though the income of the C.F.C. or the Q.E.F. may have been included in the taxpayer's income for a previous year. This rule promotes a mismatch in timing between income inclusion for income tax purposes and income inclusion for N.I.I.T. purposes. To address the problem, the regulations permit a taxpayer to accelerate the N.I.I.T. to match the income tax treatment of the item.[19] The election can be performed on an entity-by-entity basis, rather than on a global basis for all C.F.C.s and Q.E.F.s. However, the election can be made only once, not later than the first taxable year beginning after 2013 in which an individual reports income from a C.F.C. or a Q.E.F. and derives sufficient Net Investment Income to be subject to the tax. The regulations are not clear whether the election must be made during the year or in the return for the year. However, the Form 8960 (Net Investment Income Tax—Individuals, Estates, and Trusts) contains a box in Part 1 that should be checked to make the election.

Foreign Trusts and Estates

The N.I.I.T. applies to a trust or an estate having undistributed Net Investment Income and adjusted gross income that exceeds the dollar amount for the highest tax bracket. For tax year 2014, the highest bracket begins at $12,150.[20]

However, charitable trusts, real estate investment trust, common trust funds, and grantor trusts are exempt from the N.I.I.T. With respect to grantor trusts, if the grantor is a U.S. person, the grantor will be subject to the N.I.I.T. If the grantor is a foreign person, then, generally, the N.I.I.T will not apply to the foreign grantor.

Foreign non-grantor trusts ("F.N.G.T.") are exempt from the N.I.I.T.[21]This may encourage foreign investors in U.S. real property to consider using a foreign trust for this purpose. Existing advice typically recommended the use of a domestic trust, even where the beneficiaries are foreign N.R.N.C.s. The rationale is that once the trust accumulates income and pays tax, no further filing is required by the beneficiaries. With the imposition of the N.I.I.T., current thinking should be reviewed. A 3.8% tax on an accumulated gain may be too hefty a price to pay for the benefit of limited filing obligations.

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18 Treas. Reg. §1.1411-10(c)(1)(i)(A)(1).
19 Treas. Reg. §1.1411-10(g).
20 Rev. Proc. 2013-35.
21 Treas. Reg. §1.1411-3(b)(1)(viii).

In principle, the N.I.I.T. will apply to distributions of accumulated income to U.S. beneficiaries of a F.N.G.T. However, as of the date of this article, the I.R.S. has not issued guidance addressing the implementation of this rule.[22] Consequently, for the time being, U.S. beneficiaries of foreign non-grantor trusts who receive distributions of Net Investment Income will not be subject to the N.I.I.T. The N.I.I.T. does not apply to foreign estates but will apply to distributions made from foreign estates to U.S. beneficiaries at such point as regulatory guidance is provided.

PROCEDURE

Form 8960 (Net Investment Income Tax — Individuals, Estates, and Trusts)

Form 8960 will be used to calculate the N.I.I.T. This form has three parts: Part I, relating to investment income, Part II, relating to investment expenses allocable to investment income and modifications, and Part III, the tax computation. A copy of this form can be found at http://www.irs.gov/pub/irs-pdf/f8960.pdf. Draft instructions are available as of January 6, 2014 at http://www.irs.gov/pub/irs-dft/i8960--dft.pdf.

Reliance on the Former Proposed Regulations

For taxable years beginning before January 1, 2014, taxpayers may rely on the 2012 proposed regulations (published on December 5, 2012), the 2013 proposed regulations (published on December 2, 2013), or the 2013 final regulations (published on December 2, 2013) for purposes of completing Form 8960. However, to the extent that taxpayers take a position in a taxable year beginning before January 1, 2014 that is inconsistent with the final regulations and that position affects the treatment of one or more items in a taxable year beginning after December 31, 2013, reasonable adjustments must be made to avoid distortions in the N.I.I.T. [23]

CONCLUSION

The final and proposed regulations issued in December 2013 contain over 200 pages of guidance. Nonetheless, many issues remain open and many traps for the unwary exist. If one point has been driven home by the regulations, it is that the tax is here, it is expensive, and investors must live with the cost.

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[22] See §4(d) of the preamble to the final regulations, TD 9644, Tax on net investment income of individuals, 12/16/2013.

[23] See "Net Investment Income Tax FAQs," Question 22, last updated January 30, 2014, *available at:* http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs.

YEAR-END REVIEW: F.A.T.C.A.

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F.A.T.C.A.

Implementation of F.A.T.C.A., first enacted in 2010, took great strides in 2013.

On January 17, 2013, the I.R.S. issued the final F.A.T.C.A. regulations. In more than 500 pages, the I.R.S. laid out a roadmap for determining who is covered by F.A.T.C.A., who is exempt, and the burdens imposed on foreign financial institutions ("F.F.I."s), other foreign investors, and U.S. withholding agents to comply with its rules.

On July 12, 2013, the I.R.S. released Notice 2013-43, which revised the timelines included in the final F.A.T.C.A. regulations for withholding agents and F.F.I.s to begin their due diligence, withholding, and information reporting requirements. Specifically, it delayed implementation of F.A.T.C.A. withholding on investment income (but not gross proceeds from sale) by six months so that withholding will first start on July 1, 2014. It also adopted a six-month extension for the F.A.T.C.A. registration portal (the "Portal"). Also deferred were rules applicable to grandfathered obligations, new account opening procedures, new qualified intermediaries ("Q.I."s), withholding foreign partnerships ("W.P."s), and withholding foreign trusts ("W.T."s) agreements. Withholding on gross proceeds from sales of stocks and securities is still scheduled to come into effect on January 1, 2017.[24]

On August 19, 2013, the I.R.S. opened its long awaited electronic Portal, which serves as the primary way for F.F.I.s to interact with the I.R.S. An F.F.I. that registers on the Portal will, upon approval, receive a Global Intermediary Identification Number ("G.I.I.N."), which will be used both for reporting purposes and to identify the F.F.I.'s status to withholding agents so as to eliminate potential imposition of withholding taxes under F.A.T.C.A. The first registration list will be posted June 2, 2014 and will be subsequently updated monthly thereafter. While the Portal has been open for several months, any F.F.I. that may have completed its registration in 2013 must go back into the system, as registration on the Portal will only be effective if finalized in 2014.[25]

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24 Our client alert on this notice is available on our website at: http://www.ruchelaw.com/pdfs/Client_Alert_FATCA_Revised_Timeline_2013-43.pdf.

25 For more information, please see Philip Hirschfeld's article "FATCA Update: Navigating the Electronic Registration Portal," published in Bloomberg BNA and available on our website at: http://www.ruchelaw.com/pdfs/FATCA%20Update_Navigating%20the%20Electronic%20Registration%20Portal.pdf.

On September 30, 2013, Announcement 2013-41 was released, which provided technical corrections to certain portions of the final regulations. One major concern was an example in the final regulations, which suggested that all family owned trusts and other similar foreign entities could be classified as F.F.I.s subject to extensive F.A.T.C.A. burdens. This announcement assured that merely soliciting investment advice or receiving fees from those services, without something more, should not cause F.F.I. status in respect of F.A.T.C.A. under the investment entity prong of the test.[26]

On October 29, 2013, the I.R.S. issued Notice 2013-69, which provided for a Draft of the language required for an F.F.I. Agreement. F.F.I. Agreements will need to be provided by F.F.I.s in non-Inter-Governmental Agreement ("I.G.A.") countries and countries that have direct reporting under Model 2. In addition, that notice provided two new categories of non-financial foreign entities ("N.F.F.E."s), a direct reporting N.F.F.E. and a sponsored direct reporting N.F.F.E. Those entities will not be treated as passive N.F.F.E.s subject to withholding unless the N.F.F.E. either certifies it has no substantial U.S. owners or discloses its substantial U.S. owners. A direct reporting N.F.F.E. will have to register with the I.R.S. and report directly to the I.R.S. information on its substantial U.S. owners on Form 8966 ("F.A.T.C.A. Report"). A direct reporting N.F.F.E. could also be sponsored, in which case the I.R.S. will require the sponsoring entity to report on Form 8966 directly to the I.R.S. (on the sponsored direct reporting N.F.F.E.'s behalf) information about each sponsored direct reporting N.F.F.E.'s direct or indirect substantial U.S. owners.

In Rev. Proc. 2014-10, issued at the end of December, the I.R.S. issued the final F.F.I. Agreement. The final version incorporated certain corrections, better cross referencing for definitions and a two year transition rule that allows a Reporting Model 2 I.G.A. F.F.I. to use either the due diligence procedures in the F.F.I. Agreement or in the Model 2 I.G.A. The I.R.S. also confirmed that it will not issue signed copies of the F.F.I. Agreement, which will be deemed entered into once an F.F.I. registers on the Portal.

In 2012, only two countries signed Model 1 I.G.A.s: the U.K. on 9/12/2012 and Mexico on 11/19/2012. In 2013, this list expanded greatly: Ireland on 1/23/2013, Norway on 4/15/2013, Spain on 5/14/2013, Germany on 5/31/2013, France on 11/14/2013, Denmark on 11/19/2012, Costa Rica on 11/26/2013, the Cayman Islands on 11/29/2013, Guernsey on 12/13/2013, the Isle of Man on 12/13/2013, Jersey on 12/13/2013, Malta on 12/16/2013, and the Netherlands on 12/18/2013. On 2/14/2013 Switzerland signed onto a Model 2 I.G.A. and was subsequently followed by the signing of Model 2 I.G.A.s by Japan on 6/11/2013, Bermuda on 12/19/2013, and Mauritius on December 27, 2013. At the close of 2013, the I.G.A. list encompassed 19 different countries. In 2014 so far, an I.G.A. was signed by Italy on 1/10/2014, Hungary on 2/4/14, and Canada on 2/5/14, which brings the total number of signed I.G.A.s to 22.

U.S. withholding agents will not be able to eliminate withholding unless they obtain an updated Form W-8, corroborate that the supplied G.I.I.N. is correct on I.R.S.

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[26] Our client alert on this notice is available on our website at: http://www.ruchelaw.com/pdfs/To%20Clients%20and%20Friends%20-%20Technical%20Correction%20to%20Investment%20Advice%2010-8-13.pdf.

“For those hoping for another extension due to the government shutdown, new I.R.S. commissioner John Koskinen and other officials stated there will be no further delays.”

webpage, and ensure inclusion on the I.R.S. F.F.I. list (registration will need to be finalized by April 25, 2014, to insure inclusion on the first I.R.S. F.F.I. list, to be published in June 2014). However, reporting F.F.I.s in a Model 1 I.G.A. country will receive an extra six-month extension.

U.S. withholding agents will need to file a newly revised Form 1042-S for 2014 to deal with F.A.T.C.A.; draft instructions for the 2014 form (but not the form itself) have been published on November 1, 2013. This will require the U.S. withholding agents to file electronically, report payments subject to chapter 3 and chapter 4 withholding, report any applicable exemption if there is no F.A.T.C.A. withholding and starting in 2017, put down the recipient’s foreign taxpayer identification number and/or date of birth. The 2014 Form 1042-S will need to be filed by March 15, 2015.

Two forms are replacing the existing Form W-8BEN: Form W-8 BEN-E for entities and W-8BEN for individuals. Either of these forms will need to be provided to the U.S. withholding agents to stop F.A.T.C.A. withholding. Additionally, if the foreign entity is an intermediary such as a Q.I., foreign partnership, foreign grantor trust, or foreign simple trust, then Form W-8IMY will need to be provided instead. Draft Forms W-8BEN, W-8BEN-E, W-8IMY, W-8EXP, and W-8ECI incorporating F.A.T.C.A. were published in 2013, but are not yet finalized.

For those hoping for another extension due to the government shutdown, new I.R.S. commissioner John Koskinen and other officials stated there will be no further delays. Thus, the July 1, 2014 start-date appears to be real. Accordingly, we expect 2014 to be a busy year for the I.R.S., financial institutions, and others in addressing F.A.T.C.A. compliance. For those procrastinating, either with respect to F.A.T.C.A. due diligence or those who have an undeclared financial account, time is running out.

YEAR-END REVIEW: I.R.S. O.V.D.P.

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Tags
O.V.D.P.

The I.R.S. and the Department of Justice ("D.O.J.") continued their tenacious efforts against offshore tax evasion. Three major events took place in 2013: (i) a shift in the methodology to detect quiet disclosures; (ii) the bank voluntarily disclosure program ("B.V.D.P.") announced by the United States and Switzerland on August 29, 2013, and (iii) certain notable convictions, plea deals, and civil penalties.

We expect the I.R.S. and D.O.J.'s unwavering focus on offshore tax evasion to continue in 2014 as F.A.T.C.A begins to be implemented. Some practitioners fear that when F.A.T.C.A. information reporting begins, the O.V.D.P. may end, as the I.R.S. will have received information automatically on foreign accounts. If a U.S. taxpayer remains uncertain about declaring foreign financial accounts, now is the time to take remedial action. There is no Plan B, if time runs out.

QUIET DISCLOSURES

While the I.R.S. officially has discouraged quiet disclosures, a Government Accountability Office ("G.A.O") report, released on April 26, 2013, identified shortcomings in the I.R.S.'s ability to detect quiet disclosures.[27] According to the G.A.O. report:

> [The] G.A.O. analyzed amended returns filed for tax year 2003 through tax year 2008, matched them to other information available to IRS about taxpayers' possible offshore activities, and found many more potential quiet disclosures than IRS detected. Moreover, IRS has not researched whether sharp increases in taxpayers reporting offshore accounts for the first time is due to efforts to circumvent monies owed, thereby missing opportunities to help ensure compliance . . . Taxpayer attempts to circumvent taxes, interest, and penalties by not participating in an offshore program, but instead simply amending past returns or reporting on current returns previously unreported offshore accounts, result in lost revenues and undermine the programs' effectiveness.[28]

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27 See G.A.O. report, "Offshore Tax Evasion: I.R.S. Has Collected Billions of Dollars, but May be Missing Continued Evasion," available at: http://www.gao.gov/products/gao-13-318.

28 Id.

“The increased aggressiveness is attributable, in part, to the I.R.S.’s victories in Williams[1] and McBride[1] defining the burden of proof to assert an F.B.A.R. penalty for willful failure to file.”

In October 2013, the tax news services reported on an uptick in audits of quiet disclosures. The uptick in audits reflects an apparent change in I.R.S. methodology.[29]

Officials continue to state that the I.R.S. will be aggressive in asserting penalties for prior undisclosed foreign financial accounts that do not go through official channels. If a taxpayer with an undisclosed foreign financial account dislikes the penalty imposed on capital, he or she should enter the program and opt-out. Taking no action, however, is not an option as far as the I.R.S. is concerned. One I.R.S. agent summarized the I.R.S.’s view as follows:

> The guidance we're getting on quiet disclosures has been extremely harsh . . . Essentially those taxpayers walked past compliance three times: They didn't file correctly the first time, they didn't come in under voluntary disclosure, and now they're trying to hide it by slipping it in through an amended return. Don't expect much leniency if we have a quiet disclosure case; agents are being told to be aggressive.[30]

The increased aggressiveness is attributable, in part, to the I.R.S.’s victories in *Williams*[31] and *McBride*[32] defining the burden of proof to assert an F.B.A.R. penalty for willful failure to file. Although the facts of both cases are extremely favorable to the I.R.S., the courts stated that the burden of proof regarding the penalty for willfulness is the standard based on a preponderance of the evidence rather than clear and convincing evidence. Many practitioners believed that because the penalty was so high and the penalty is correlated with tax fraud, the burden of proof should have been the same. This view is consistent with the I.R.S.’s belief at one time.[33] However, in light of these cases, some practitioners believe that a taxpayer may be found to have acted willfully if (i) foreign financial accounts were owned, (ii) the accountant inquired into the existence of foreign financial accounts in the course of preparing the return, and (iii) the taxpayer responded that no accounts existed during that year.

Other tax practitioners express a wait-and-see approach, focusing on the difference between the behavior in the two cases and the behavior in many cases – *e.g.,* an individual who was born abroad and received an inheritance from a foreign parent – to believe that different facts will bring a different answer that is more favorable to the taxpayer.[34] However, the unfortunate taxpayer who must litigate that case will bear the costs and face possible defeat in the courts. This makes the O.V.D.P. penalty structure more attractive in the sense that the costs are fixed and the taxpayer achieves finality relatively quickly.

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29 See Tax Notes Today, I.R.S. Auditors Taking Closer Look at Quiet Disclosures of Offshore Accounts, 2013 TNT 202-4 (Oct. 18, 2013).

30 See Tax Notes Today, “I.R.S. Will Soon Examine U.S. Taxpayers with Undeclared Indian Bank Accounts,” 2013 TNT 219-4 (Nov. 13, 2013).

31 See *U.S. v. Williams*, 489 Fed.Appx. 655, 656 – 60 (4th Cir., July 2012).

32 See *U.S. v. Mcbride*, 988 F.Supp. 2d 1186 (D. Utah, Nov 8, 2012).

33 See I.L.M. 200603026.

34 See Tax Notes Today, “District Court Allows Second F.B.A.R. Penalty Collection to Proceed,” 2012 TNT 219-3 (Nov. 9, 2012).

BANK COMPLIANCE PROGRAM

On August 29, 2013, the United States and Switzerland jointly announced the B.V.D.P., which allows participating Swiss banks to resolve their civil and criminal liability with the United States on condition that information on U.S. customers is turned over to the I.R.S. Under the program, participating Swiss banks will:

- Pay substantial penalties;
- Disclose cross-border activities;
- Provide detailed information on an account-by-account basis for accounts in which U.S. taxpayers have a direct or indirect interest;
- Cooperate in treaty requests for account information;
- Provide detailed information as to other banks that transferred funds into secret accounts or that accepted funds when secret accounts were closed; and
- Agree to close accounts of account holders who fail to come into compliance with U.S. reporting obligations.

In return, the bank will be allowed to enter a nonprosecution agreement (N.P.A.) with the D.O.J.

The B.V.D.P. contains four categories of banks:

- Category 1 banks are already under investigation and are ineligible for the program.
- Category 2 banks have reason to believe that tax-related offenses or monetary transaction offenses have been committed in connection with undeclared U.S. accounts. A letter of intent to participate should have been submitted by December 31, 2013. The deadline to comply with the terms of the program is 120 days from the date of the letter of intent, plus a sixty-day extension upon showing of good cause. According to press reports, 106 banks have agreed to enter the B.V.D.P.[35]
- Category 3 banks have not committed any tax related offenses or monetary transaction offenses in connection with undeclared U.S. accounts.
- Category 4 banks, in general, limit their activities to a local client base – *i.e.*, at least 98% of the accounts by value are held by residents of Switzerland throughout the applicable period.

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[35] "DOJ Official: 106 Intent Letters Received for Swiss Bank Nonprosectution Program," Daily Tax Report (BNA) 18 DTR K-1 (Jan. 27, 2014).

“For the time being, the bank need not provide the name of the account holder. However, the U.S. can seek the account information pursuant to an official treaty request under the existing income tax treaty framework of 1996…Switzerland stated that all requests will be processed on an ‘expedited basis.’”

Under the penalty provisions applicable to Category 2 banks, those seeking a N.P.A. must agree to a penalty in an amount equal to 20% of the maximum aggregate dollar value of all non-disclosed U.S. accounts that were held by the bank on August 1, 2008. The penalty amount will increase to 30% for secret accounts that were opened after that date but before the end of February 2009 and to 50% for secret accounts opened subsequently. However, the penalty is reduced by “the dollar value of each account as to which the [bank] demonstrates . . . [it] was not an undeclared account, was disclosed by the [bank] to the I.R.S., or was disclosed to the . . . I.R.S. through the [O.V.D.P.].”[36] Thus, the program provides a significant incentive for a participating bank to encourage U.S. clients to enroll into the O.V.D.P., thereby reducing penalties for the bank.

Category 2 banks must provide the following information on U.S. account holders:

- The maximum value of the account;
- The number of U.S. persons or entities affiliated with each account, and the nature of that relationship;
- Whether the account was held in the name of an individual or an entity;
- Whether the account held U.S. securities;
- The name and function of each relationship manager, client advisor, asset manager, financial advisor, trustee, fiduciary, nominee, attorney, accountant, or other individual or entity functioning in a similar capacity known by the bank to be affiliated with each U.S. account at any time during the applicable period; and
- Information concerning the transfer of funds in and out of the account.[37]

In addition, the Category 2 bank must “provide all necessary information for the United States to draft treaty requests to seek account information” and to provide “testimony of a competent witness or information as needed to enable the United States to use the information as evidence obtained pursuant to a provision of this Program or separate treaty request in any criminal or other proceedings.”[38]

For the time being, the bank need not provide the name of the account holder. However, the U.S. can seek the account information pursuant to an official treaty request under the existing income tax treaty framework of 1996 (“1996 Treaty”). More importantly, when the 2009 Protocol amending the 1996 Treaty comes into full force and effect, names of U.S. persons affiliated with the account will be exchanged. Switzerland stated that all requests will be processed on an “expedited basis.”

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36 See §II H. of the Program for Non-Prosecution Agreements or Non-Target Letters for Swiss Banks, available at: http://www.justice.gov/opa/pr/2013/August/13-tax-975.html.

37 *Id.* at §II D.2.

38 *Id.* at §II.D.4, F.

Under the 1996 Treaty framework, exchange of information is generally preconditioned on a standard of "tax fraud or the like," which has been interpreted to require more than mere tax evasion.[39] The 1996 Treaty's technical explanation provides a non-exhaustive list of actions that will constitute tax fraud, including falsification of a document that the taxpayer used (or intended to use). Badges of tax fraud also include forged or falsified documents, double sets of books, false invoices, incorrect balance sheets or profit and loss statements, fictitious orders, false documentary evidence, falsified tax returns, or a "Lugengebäude," which is a "scheme of lies" used to deceive the tax authorities. The 2009 Protocol has a much broader standard, specifically envisioned to circumvent the problems with the 1996 Treaty framework. Its ratification, however, is being blocked by Senator Rand Paul (R. Kentucky) for due process and privacy concerns according to news sources.[40]

Although the I.R.S. has encountered at least one legal setback in obtaining account holder information from Switzerland – the matter involved a group request for account information served to Bank Julius Baer[41] – its efforts are unrelenting and have been largely successful. The B.V.D.P. is the next phase.

RECENT NOTABLE INDICTMENTS, PLEA DEALS, AND CONVICTIONS

At the end of 2013, John Koskinen was sworn in as I.R.S. Commissioner. In his first press conference in January 2014, Commissioner Koskinen said that attention to combating offshore tax evasion was one of his key goals and in particular, the I.R.S. planned to use the information it expects to obtain under F.A.T.C.A. in identifying non-compliant U.S. persons investing abroad. The Commissioner cautioned the wealthy in the following terms, "Just because you're rich and have high-priced tax lawyers and accountants doesn't mean you can figure out a way to avoid taxes by squirreling your money away somewhere offshore."[42]

The Commissioner's attitude confirms and reinforces the views of his predecessors and heightens the need for those with ongoing unreported foreign financial accounts to take corrective action. Clearly, he anticipates that F.A.T.CA. will provide the I.R.S. with information on U.S. taxpayers automatically and completely.

The case of H. Ty Warner, the billionaire creator of Beanie Baby plush toys, is a prime example of why one must take corrective action *before* being discovered. Mr. Warner created Swiss accounts in which over $100 million was squirreled away. In

39 See 1996 Treaty, paragraph 1.

40 See Voreacos & Rubin, "Rand Paul Seeks to Block Treaty Change on Swiss Accounts," Bloomberg (Apr. 30, 2012), available at: http://www.bloomberg.com/news/2012-04-29/rand-paul-seeks-to-block-tax-treaty-change-on-swiss-accounts.html,

41 See Bennet & Pruzin, "Julius Baer Decision Offers Little Safety For Hidden Swiss Accounts, Attorney Says," Bloomberg BNA (Jan. 16, 2014).

42 "Koskinen says Improving Compliance, Ensuring Funding are Top IRS Priorities," Daily Tax Rep. (BNA) No. 4 at G-4 (Jan. 7, 2014).

2009, Mr. Warner's attempt to enter the O.V.D.P was rejected, as he was already known to the I.R.S.[43]

On October 2, 2013, Warner pleaded guilty to avoiding more than $5.5 million in taxes. In pleading guilty, Warner admitted to opening an account at U.B.S., the Swiss bank whose name appears in the F.A.T.C.A. legislative history as one of the principal architects of offshore accounts used to hide money from the I.R.S. He admitted to transferring $93.6 million in 2002 to a small Swiss bank. In that same year, Warner paid significant taxes on his reported $49.1 million of taxable income, but he failed to report and pay taxes on his U.B.S. income of $3.2 million. Warner also failed to file F.B.A.R.s for that year and other years in which he hid his income from the I.R.S.

In asking for leniency at the time of sentencing, his lawyers stated:

> Ty's behavior was no different legally or factually from that of tens of thousands of taxpayers who were never sentenced – or even prosecuted – because they were admitted into the I.R.S. voluntary disclosure programs.

His lawyers failed to admit one key factor. Ty tried to enter O.V.D.P. *after* the I.R.S. knew of his actions. In January 2014, Mr. Warner was sentenced to two years of probation and the performance of 500 hours of community service. Mr. Warner has paid a civil penalty of $53 million and filed amended tax returns for the years 1999 to 2008, his lawyers said. He has also paid $14 million in back taxes and interest, according to prosecutors.[44]

Government prosecutorial actions are not limited to those as well-known as Mr. Warner. On October 24, 2013, a Florida doctor was convicted in Federal court of conspiring to defraud the I.R.S. by concealing more than $35 million deposited in offshore accounts with U.B.S. Dr. Patricia Lynn Hough and her husband were found guilty of filing false income tax returns for 2005 through 2008. She is awaiting sentencing and can face a maximum potential penalty of five years in prison and a $250,000 fine for the conspiracy charge, as well as three years in prison and a $250,000 fine for each of the false income tax return charges.[45]

Many others that have dealt with U.B.S. have faced prosecution including a retired army surgeon, Michael Canale, who pleaded guilty to hiding as much as $1.5 million with U.B.S. On April 25, 2013, he was sentenced to six months in prison, fined $100,000, ordered to pay $216,407 in restitution, and required to perform 400 hours of community service.[46]

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43 "Beanie Baby Billionaire Seeks to Avoid Prison for Tax Evasion," Daily Tax Rep. (BNA) No. 2 at K-3 (Jan. 3, 2014).

44 "Beanie Baby Founder Ty Warner Avoids Jail in Tax-Evasion Case," Daily Tax Rep. (BNA) No. 10 at K-2 (Jan. 15, 2014).

45 "Florida Doctor Convicted of Concealing $35 Million in Offshore Bank Accounts," Daily Tax Rep. (BNA) No. 207 at K-6 (Oct. 25, 2013).

46 "Offshore Tax Scorecard: Bankers, Lawyers, Other Advisers See Charges Alongside Clients," Daily Tax Rep. (BNA) No. 214 at J-3 (Oct. 5, 2013).

Government actions are not limited to U.B.S. and Swiss accounts. On August 15, 2013, the Seventh Circuit Court of Appeals upheld a Federal District Court conviction of an accountant and entrepreneur, James A. Simon, for filing false income tax returns and failing to file F.B.A.R.s, as well as mail and financial fraud. Simon created a web of foreign business dealings in the Cook Islands, Gibraltar, Cyprus, and the Ukraine that were used to hide money. Mr. Simon is still awaiting sentencing.[47]

Accounts in Israel and India have received special attention. On October 18, 2013, a federal grand jury indicted two tax return preparers for willfully failing to file F.B.A.R.s for Israeli accounts over which they had signature authority. David Kalai and two others did not have a financial interest in the accounts, but had signature authority over accounts used by clients in plans recommended to hide money from the I.R.S.[48]

On March 8, 2013, Josephine Bhasin, a resident of Huntington, NY, pleaded guilty to failing to report an account at H.S.B.C. India worth $8.3 million. On March 8, 2013, she was sentenced to two years of probation, three months of home detention, fined $30,000 and ordered to perform 150 hours of community service. Vaibhav Dahake, a New Jersey businessman, also plead guilty to hiding money with H.S.B.C. India and was sentenced, on May 22, 2013, to one year probation in light of his cooperation with the government. Sammer Gupta was not as lucky. He was sentenced July 9, 2013 to 19 months in prison and fined $2,000. He also paid an F.B.A.R. penalty of $259,045.[49]

Kathryn Keneally, Assistant Attorney General in charge of the Tax Division of the D.O.J., told the press in 2013 that the D.O.J. is looking beyond cases made public in Switzerland, Israel, and India to other countries for further actions.[50] For example, on March 1, 2013, a West Virginia doctor was sentenced to 50 months in prison for tax evasion and health care fraud. Dr. Barton Adams deposited the proceeds from their health care fraud into accounts in Canada, China, and the Philippines. In this case, the I.R.S.'s Criminal Investigation Division teamed up with the Department of Health and Human Services Office of Inspector General to act against the tax offender.[51]

The trail of government action has also extended to the advisers planning these schemes. One high profile case is that of Raoul Weil, a former head of the U.B.S. global wealth management business. Mr. Weil was indicted for conspiring from 1993 until 2010 to help clients hide assets from the I.R.S. through accounts at U.B.S. and a Swiss cantonal bank. On October 19, 2013, Mr. Weil checked into a hotel in Bologna, Italy, which triggered an alert to Italian authorities, who promptly

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47 "Conviction of Foreign Account Signatory for Tax Evasion Affirmed by Seventh Circuit," Daily Tax Rep. (BNA) No. 160 at K-7 (Aug. 19, 2013).

48 "Preparers Indicted for Stashing Millions in Israeli Accounts face New Charges," Daily Tax Rep. (BNA) No. 203 at K-4 (Oct. 21, 2013).

49 "Offshore Tax Scorecard: Bankers, Lawyers, Other Advisers See Charges Alongside Clients," supra note 5.

50 "Top DOJ tax Official Says Government 'Looking Everywhere' for Offshore Evasion," Daily Tax Rep. (BNA) No. 69 at G-2 (April 10, 2013).

51 "West Virginia Doctor Gets Four Years for Health Care Fraud, Tax Evasion," Daily Tax Rep. (BNA) No. 44 at K-5 (March 6, 2013).

arrested him. Four days later, Mr. Weil surrendered to U.S. authorities and now faces criminal action in the U.S.[52] On August 16, 2013, Swiss lawyer, Edgar Paltzer, pleaded guilty in New York to conspiracy for more than a decade of advising U.S. clients in committing tax fraud. He is now aiding the I.R.S. in investigations of clients who took advantage of his planning.[53]

Thus far, I.R.S. action has led to the fall of two Swiss banks. On October 18, 2013, Bank Frey & Co. announced plans to close because of the additional requirements being imposed on Swiss banks in relation to hidden offshore accounts. In 2012, Bank Wegelin also closed due to this situation, after it invited U.B.S. customers in the U.S. to open accounts upon learning of account closings by U.B.S.[54]

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[52] "Ex-UBS Banker surrenders to U.S. in 2011 tax Case over Secret Accounts," Daily Tax Rep. (BNA) No. 206 at K-2 (Oct. 24, 2013).

[53] "Offshore Tax Scorecard: Bankers, Lawyers, Other Advisers See Charges Alongside Clients," supra note 5.

[54] "Swiss Private Bank Announces Closure, Citing Tax Dispute with U.S.," Daily Tax Rep. (BNA) No. 203 at I-2 (Oct. 21, 2013).

NON-RESIDENT ALIEN INTEREST REPORTING RULES UPHELD

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Tags
F.A.T.C.A.

On January 13, 2014, the District Court for the District of Columbia dismissed the Florida Bankers Association and the Texas Bankers Association (collectively, the "Plaintiffs") lawsuit that challenged the 2012 regulations requiring U.S. banks (including U.S. offices of non-U.S. financial institutions) to report to the I.R.S. the amount of interest paid to certain non-residents.[55]

Pursuant to the United States' relentless fight against offshore tax evasion, the I.R.S. finalized regulations requiring U.S. banks to report certain information on non-U.S. account holders. These regulations are necessary, in part, for countries that request reciprocal information on their resident account holders who have U.S. financial accounts as a precondition to signing an I.G.A. with the U.S.[56] In particular, the regulations require reporting of deposit interest aggregating $10 or more paid to N.R.A.s on Form 1042-S (Foreign Person's U.S. Source Income Subject to Withholding) for the calendar year in which interest is paid. Interest is reportable even if there is no withholding requirement. The regulations apply to all payments of interest made after January 1, 2013, and the first Form 1042-S must be filed with the I.R.S. by March 15, 2014. The reporting will be made with respect to an N.R.A. who is a resident of a country that is identified as a country with which the U.S. has in effect an income tax agreement relating to the exchange of tax information.[57]

In *Florida Bankers Association*, the Plaintiffs argued that the regulations violated the Administrative Procedure Act ("A.P.A.") and the Regulatory Flexibility Act ("R.F.A."). The A.P.A. generally requires courts to hold unlawful and set aside acts that are arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law, and acts that are unsupported by substantial evidence. The R.F.A. generally requires agencies to either analyze a proposed rule's impact on small businesses or to certify that the rule will not have a significant economic impact on a substantial number of small entities. It is sufficient to state that the Court ultimately rejected these arguments, in very brief summation, stating that the I.R.S. considered the issues and had a reasonable basis for the regulations (*i.e.*, to deter foreign tax cheats).

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55 *Florida Bankers Association v. Treasury*, No. 1:13-cv-00529 (D.D.C. 2014)(Doc 2014-821).

56 Prior to finalizing these regulations, the only country the United States required banks to provide information on deposit interest was Canada.

57 See T.D. 9584 (effective 04/19/2012).

"It is sufficient to state that the Court ultimately rejected these arguments, in very brief summation, stating that the I.R.S. considered the issues and had a reasonable basis for the regulations (i.e., to deter foreign tax cheats)."

What is important here is that, although F.A.T.C.A. initially faced stiff resistance, automatic exchange of information is here to stay and other governments are warming up to the idea. This is self-evident in the I.G.A.s, recent efforts by the O.E.C.D.,[58] and statements made at the G20 summit in St. Petersburg Russia last September.

For example, the Model 1 I.G.A. most recently adopted by Canada provides as follows:

> The Parties are committed to working with Partner Jurisdictions, the Organisation for Economic Co-operation and Development, [and the European Union,] on adapting the terms of this Agreement and other agreements between the United States and Partner Jurisdictions to a common model for automatic exchange of information, including the development of reporting and due diligence standards for financial institutions.[59]

This is consistent with declarations made by the Leaders at the G20 summit:

> Calling on all other jurisdictions to join us by the earliest possible date, we are committed to automatic exchange of information as the new global standard, which must ensure confidentiality and the proper use of information exchanged, and we fully support the OECD work with G20 countries aimed at presenting such a new single global standard for automatic exchange of information by February 2014 and to finalizing technical modalities of effective automatic exchange by mid- 2014. In parallel, we expect to begin to exchange information automatically on tax matters among G20 members by the end of 2015.[60]

Thus tax non-compliance with respect to foreign accounts is no longer limited to the United States, it is becoming a global issue.

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58 See O.E.C.D.'s efforts to create a Model of Automatic Exchange at: http://www.oecd.org/tax/exchange-of-tax-information/automaticexchange.htm.

59 See, *e.g.*, Model 1A I.G.A, Article 6, paragraph 3, last revised 11-4-2013, available at : http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-Reciprocal-Model-1A-Agreement-Preexisting-TIEA-or-DTC-11-4-13.pdf.

60 See Tax Annex to the St. Petersburg G20 Leaders' Declaration available at: http://www.whitehouse.gov/sites/default/files/image/files/g-20taxannex.pdf.

I.R.S. ISSUES REGULATIONS REGARDING P.F.I.C. REPORTING REQUIREMENTS

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Tags
P.F.I.C.
Form 8621

On December 30, 2013, the I.R.S. released temporary and final regulations regarding P.F.I.C. reporting requirements. In T.D. 9650, the I.R.S. reaffirmed that it would not require any U.S. persons that owned any interest in a P.F.I.C. during 2010, 2011 or 2012 to file an information return on Form 8621 under the new rules *unless* they sold the stock, received a distribution or needed to make a P.F.I.C. election. However, Form 8621 will be required to be filed by any U.S. person that owned at any time during 2013 an interest in a P.F.I.C. Thus the form will filed with the 2013 income tax return that must be filed later this year.

The regulations adopted rules addressing constructive or indirect ownership. The constructive ownership or attribution rules can cause a person to become an owner of an interest in a P.F.I.C. even though no stock is *directly* owned in the P.F.I.C. As a result, ownership of P.F.I.C stock by a corporation, partnership, trust or estate can be attributed to the entity's shareholders, partners or beneficiaries, who then can become subject to the P.F.I.C. rules.

BACKGROUND

U.S. investors must determine if any foreign corporation owned may be classified as a P.F.I.C. A foreign corporation will be classified as a P.F.I.C. if either (i) 75% or more of the corporation's gross income is passive income (such as from interest, dividends or capital gains) or (ii) 50% or more of the corporation's assets are held for the production of passive income (such as stocks, bonds or cash). A typical P.F.I.C. is an offshore investment company or mutual fund although P.F.I.C. status can be a potential issue for any foreign corporation, especially if the corporation has large cash reserves or is in the services business outside the U.S.

P.F.I.C. status imposes a special tax and interest charge on any U.S. person that receives an excess distribution. An excess distribution is a current distribution that exceeds 125% of the average distributions over the prior three years. The excess distribution is deemed attributable to profits earned in an earlier year, as determined under a prescribed formula. In addition, gain on the sale of stock in a P.F.I.C. may be taxed at ordinary income rates and also be subject to an interest charge under the computations that apply to excess distributions.

U.S. tax exempt investors are generally not subject to this tax regime, although the tax reporting rules discussed below may be applicable. Also, if the foreign corporation is classified as a controlled foreign corporation ("C.F.C.") for U.S. tax purposes and the investor owns 10% or more of the corporation's voting stock, the investment would be subject to the C.F.C. rules and not the P.F.I.C. rules. The

C.F.C. rules are designed to discourage the retention of earnings at the level of the C.F.C. Instead of deferral of tax, the C.F.C. rules force a U.S. shareholder owning 10% or more of the voting stock to include in a U.S. tax return the earnings generated from Subpart F Income, typically Foreign Base Company Sales Income and Foreign Personal Holding Company Income. The goal is to tax the income on a current basis, as if it were received directly by the U.S. shareholder.

If P.F.I.C. status applies to a foreign corporation, a U.S. investor may be able to make a qualified electing fund ("Q.E.F.") election under Code §1293 to eliminate application of these P.F.I.C. rules. In their place, the U.S. investor is taxable on a current basis with respect to an allocable share of the P.F.I.C.'s income and gains even if no dividend is received. The ability to make a Q.E.F. election is dependent upon the cooperation of the foreign corporation, which undertakes to provide the investor on a timely basis sufficient information needed to determine the investor's share of the corporation's income and gain. Many foreign corporations refuse to undertake this obligation because of the added expense of compliance with U.S. tax accounting rules.

Alternatively, if the P.F.I.C. stock is marketable stock (*e.g.*, it is traded on a stock exchange), the U.S. investor can make an election under Code §1296 to be subject to a mark-to-market ("M.T.M.") regime with respect to the stock. The M.T.M. regime requires the investor to recognize as ordinary income each year's appreciation in the value of the marketable shares of the Q.E.F. If the value of the shares declines, the shareholder recognizes a loss, but the loss cannot be recognized if it exceeds previously recognized gain.

In 1992, the I.R.S. published proposed regulations providing guidance on, *inter alia*, P.F.I.C. ownership and the taxation of its shareholders.

In 2010, Congress enacted the Hiring Incentives to Restore Employment ("H.I.R.E. Act"). The H.I.R.E. Act has received a lot of attention for enactment of F.A.T.C.A. F.A.T.C.A. focused on U.S. persons investing in offshore accounts who were not paying tax on offshore income. If requires F.F.I.s to advise the I.R.S. of their U.S. investors or risk imposition of a new 30% withholding tax that will become effective on July 1, 2014. However, the H.I.R.E. Act also focused on other offshore investments and specifically added Code §1298(f) It requires any U.S. person who is a shareholder of a P.F.I.C. to file an annual statement with the I.R.S.

Prior to enactment of the H.I.R.E. Act, U.S. persons that owned an interest in a P.F.I.C. only were required to file Form 8621 if they (i) recognized gain on a direct or indirect disposition of P.F.I.C. stock; (ii) received direct or indirect distributions from a P.F.I.C.; or (iii) were making an election on the form. Form 8621 must also be filed to report liability under any Q.E.F. or M.T.M. election. Form 8621 is attached to the investor's income tax return for the year in which the P.F.I.C. interest is held.

In Notice 2010-34, the I.R.S. stated that P.F.I.C. shareholders not otherwise required to file Form 8621 prior to March 18, 2010, will not be required to file an annual report as a result of the addition of Code §1298(f) for taxable years beginning before March 18, 2010.

Subsequently, in Notice 2011-55, the I.R.S. announced that it would issue regulations under Code §1298(f) and release a revised Form 8621. Additionally, the notice suspended the Code §1298(f) reporting requirements under the new expansive reporting regime until the release of the revised Form 8621 for P.F.I.C. shareholders. U.S. persons who were not otherwise required to make a filing prior to the H.I.R.E. Act did not have to make any filing for their 2010, 2011, and later years until further guidance is issued by the I.R.S.

In December 2011, the I.R.S. published the revised Form 8621 with instructions that indicated the suspension of Code §1298(f) reporting requirements pending the publication of a subsequent revised form.

THE REGULATIONS

On December 30, 2013, the I.R.S. released new temporary and final regulations regarding P.F.I.C. constructive ownership and reporting requirements. The new regulations generally adopt the rules under the proposed regulations, subject to certain modifications or clarifications. In particular:

- Constructive Ownership (or Attribution) Rules: The temporary regulations largely adopt the attribution rules of indirect ownership in the 1992 proposed regulations.
    - Ownership through foreign C Corporations: In the case of a foreign C Corporation, that is not itself a P.F.I.C., ownership of a P.F.I.C. subsidiary is attributed back to an indirect U.S. shareholder if the person owns directly or indirectly 50% or more in value of the stock of that foreign C-corporation.
    - Partnerships and S Corporations: In the case of a partnership, or S Corporation, the partner or shareholder is treated as owning its proportionate share of the stock owned by the respective entity. However, the regulations clarify that the attribution rules apply to both domestic and foreign partnerships.
    - Trusts and Estates: In the case of a trust or estate, a beneficiary of the trust or estate is treated as owning a proportionate share of the stock owned by the trust or estate. The regulations clarify that the rules apply to both a domestic and foreign trust or estate. However, if the trust is a grantor trust, the grantor is treated as owning the stock owned by the trust.
        - The regulations further state that, until further guidance is provided on estate and trust attribution rules, beneficiaries of estates and nongrantor trusts that hold P.F.I.C. stock should use a reasonable method to determine their ownership interests in a P.F.I.C. held by the estate or nongrantor trust. Moreover, beneficiaries of estates and nongrantor trusts that are subject to these rules of attribution are exempt from the filing requirements for taxable years in which the beneficiary is not treated as receiving an excess distribution or as recognizing gain with respect to the stock of the P.F.I.C. Finally, the regulations also state that the estate or trust, or the beneficiary, must take excess distributions into account in a reasonable manner. It is unreasonable for the shareholders to take the

“The first Form 8621 that will be filed under these new rules will relate to 2013.”

position that neither the beneficiaries nor the estate or trust are subject to the tax and interest charge rules under §1291.

- Reporting: The regulations eliminate the need to file Form 8621 pursuant to the H.I.R.E. Act for any investment held in 2010, 2011, and 2012 unless the stock was sold, a distribution was made to the shareholder or a Q.E.F. or M.T.M. election was made. The first Form 8621 that will be filed under these new rules will relate to 2013. The Form 8621 must be attached to the Federal income tax return filed for 2013, due later this year. A partnership that owns stock in a P.F.I.C. must also file Form 8621 and attach it to the information return filed with the I.R.S.

  - Dealing with Chains of Ownership: The temporary regulations generally require the U.S. person that is at the lowest tier in a chain of ownership, and that is a shareholder (including an indirect shareholder) of a P.F.I.C., to file an annual report on Form 8621. In addition, a U.S. person that owns P.F.I.C. stock through another U.S. person also is required to file an annual report in certain circumstances. One such circumstance involves a U.S. citizen who owns an interest in a domestic partnership, which in turn, owns an interest in a P.F.I.C. The domestic partnership must file an annual report because the domestic partnership is the U.S. person that is at the lowest tier in the chain of ownership. In addition, the U.S. citizen is required to file an annual report when such person is treated as receiving an excess distribution or as recognizing gain that is treated as an excess distribution with respect to the P.F.I.C.

  - Avoiding Duplicative Reporting: In order to eliminate duplicative reporting, the regulations provide an exception applicable to a U.S. person that is required to include an amount in income only under the Q.E.F. or M.T.M. rules because of an ownership interest in another U.S. person. The indirect owner is not required to file Form 8621 if the direct shareholder timely files Form 8621 with respect to the P.F.I.C. This exception does not apply, however, if the U.S. person made a Q.E.F. election with respect to the P.F.I.C. and then transferred the shares of the P.F.I.C. to a domestic partnership or S corporation that did not itself make a Q.E.F. election with respect to the P.F.I.C.

  - Exceptions to Reporting: Certain exceptions were added:

    - Tax-exempt organization: A U.S. shareholder is not subject to Form 8621 filing requirements if the shareholder is a tax-exempt organization under Code §501 (*e.g.*, tax exempt hospital or qualified retirement plan) unless the income derived from the P.F.I.C. would be taxable to the tax-exempt organization as unrelated business taxable income.

    - De Minimis Ownership: A U.S. shareholder is also excepted from the filing requirements if the shareholder is not subject to tax under the P.F.I.C. rules (*e.g.*, the shareholder has not sold their stock, got a distribution from the P.F.I.C. or made a Q.E.F. or M.T.M. election) and either

(i) the value of *all* P.F.I.C. stock owned directly or indirectly by that person is $25,000 or less ($50,000 for joint returns) or (ii) the P.F.I.C. stock is owned by a shareholder indirectly through another P.F.I.C. and the value of the indirectly owned P.F.I.C. stock does not exceed $5,000. The shareholder can rely on annual statements issued by the P.F.I.C to determine the value of their stockholdings unless the shareholder has actual knowledge or reason to know that the value shown does not reflect the actual fair market value of the P.F.I.C. stock.

- Foreign Grantor Trust: A U.S. person that is treated as the owner of any portion of a foreign grantor trust that is a foreign pension fund operated principally to provide pension or retirement benefits is not required to file if, pursuant to an income tax convention to which the United States is a party, income earned by the pension fund is taxed as income of the U.S. person only when and to the extent it is paid to, or for the benefit of, the U.S. person.

DIVIDEND EQUIVALENTS: PAST, PRESENT AND FUTURE

Author
Fanny Karaman

Tags
International tax
Withholding tax
Dividend equivalents

Code §871(m) of the Code was enacted as part of the H.I.R.E. Act on March 18, 2010 and treats "dividend equivalents" as U.S. source dividends for withholding tax purposes. On January 23, 2012, Temporary Regulations (the "2012 Temporary Regulations") and a notice of proposed rulemaking (the "2012 Proposed Regulations") were published. The 2012 Proposed Regulations and Temporary Regulations provided guidance relating to U.S. source dividend equivalent payments made to nonresident individuals and foreign corporations. They also provided guidance to withholding agents. Correcting amendments to the 2012 Temporary Regulations were published on February 6, 2012, on March 8, 2012 and on August 31, 2012. On December 5, 2013 new proposed regulations (the "2013 Proposed Regulations") withdrew the 2012 Proposed Regulations. In addition and at the same date, final regulations ("2013 Final Regulations") were published that essentially adopted the 2012 Temporary Regulations.

BACKGROUND

Code §871(m) defines a dividend equivalent as one of the following:

- Any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States;
- Any payment made pursuant to a specified notional principal contract ("N.P.C.") that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States; and
- Any other payment determined by the Secretary to be substantially similar to a payment described in the two previous categories (a substantially similar dividend).

For purposes of this definition, Code 871(m) defines a "specified notional principal contract" as one of the following if the payment was made during the period ranging from September 14, 2010 to March 18, 2012. A specified N.P.C. is any N.P.C. if:

- In connection with entering into such contract, any long party to the contract transfers the underlying security to any short party to the contract;
- In connection with the termination of such contract, any short party to the contract transfers the underlying security to any long party to the contract;

- The underlying security is not readily tradable on an established securities market;

- In connection with entering into such contract, the underlying security is posted as collateral by any short party to the contract with any long party to the contract; or

- Such contract is identified by the Secretary as a specified N.P.C.

For payments made after March 18, 2012, a "specified notional principal contract" is defined by Code §871(m) as any notional principal contract unless the Secretary determines that such contract is of a type not having the potential for tax avoidance.

A dividend equivalent is treated as a dividend from sources within the United States. It is so treated whether the recipient is a nonresident individual, a foreign corporation, or a foreign organization that is a private foundation. This sourcing rule also applies for purposes of F.A.T.C.A. As a consequence, when a payment is determined to be a U.S. source dividend equivalent, the payment is subject to a U.S. withholding tax, generally at the rate of 30%.

Among other things, the 2012 Proposed Regulations contained a seven-factor test approach to determine whether a payment made on or after January 1, 2014 constituted a specified notional principal contract. A specified notional principal contract was any notional principal contract if one or more of the following seven factors were met:

- The long party is "in the market" on the same day that the parties priced or terminated the N.P.C.;

- The underlying security is not regularly traded on a qualified exchange;

- The short party posts the underlying security as collateral and the underlying security represents more than 10% of the collateral posted by the short party;

- The actual term of the N.P.C. is fewer than 90 days;

- The long party controls the short party's hedge;

- The notional principal amount is greater than 5% of the total public float of the underlying security or greater than 20% of the 30-day daily average trading volume; or

- The N.P.C. is entered into on or after the announcement of a special dividend and prior to the ex-dividend date.

The 2012 Proposed Regulations also defined a substantially similar dividend. They defined this term as (i) any gross-up amount paid by a short party in satisfaction of the long party's tax liability with respect to a dividend equivalent, or (ii) any payment made pursuant to an equity-linked instrument ("E.L.I.") that was calculated by reference to a dividend from U.S. sources if the E.L.I. satisfied one or more of the seven aforementioned factors.

“The Proposed Regulations abandon the seven-factor test approach. The determination as to whether an N.P.C. or an E.L.I. will fall under the Code §871(m) sourcing rule will be determined exclusively by the objective measurement of a derivative’s delta.”

The 2012 Proposed Regulations exclude from the definition of a dividend equivalent any payment determined by reference to an estimate of an expected but net yet announced dividend without reference to or adjustment for the amount of any actual dividend.

Under the 2012 Proposed Regulations, the provisions of an income tax treaty applying to dividends paid to or derived by a foreign person apply to dividend equivalents as defined under Code §871(m) and the regulations thereunder. This provision has been adopted in the 2013 Final Regulations.

2013 Final Regulations and 2013 Proposed Regulations

Key points of the 2013 Final Regulations and the 2013 Proposed Regulations are as follows:

1. The 2013 Final Regulations extend the definition of “specified notional principal contract” as defined for the period ranging from September 14, 2010 to March 18, 2012 under Code §871(m) to payments made before January 1, 2016. Under the 2012 Temporary Regulations this definition had only been extended until January 1, 2014.

2. The 2013 Proposed Regulations provide a similar but more precise definition of a dividend equivalent than already contained under Code §871(m) of the Code by adding an additional category to the definition. This additional category includes in the definition of a dividend equivalent any payment made pursuant to a specified E.L.I. that is directly or indirectly contingent upon or determined by reference to the payment of a dividend from U.S. sources. An E.L.I. is defined as any financial transaction (other than a securities lending or sale-repurchase transaction or an N.P.C.) that references the value of one or more underlying securities. As examples, the 2013 Proposed Regulations mention forward contracts, futures contracts, options, debt instruments convertible into underlying securities, and debt instruments with payments linked to underlying securities.

3. The definition of a specified N.P.C. as provided under the 2013 Proposed Regulations will apply to payments made pursuant to a specified N.P.C. on or after January 1, 2016. The 2013 Proposed Regulations will apply to payments made after January 1, 2016 pursuant to specified E.L.I.’s. However, the 2013 Proposed Regulations will only apply to the latter with respect to an E.L.I. that was acquired by the long party on or after March 5, 2014.

4. The 2013 Proposed Regulations abandon the seven-factor test approach. The determination as to whether an N.P.C. or an E.L.I. will fall under the Code §871(m) sourcing rule will be determined exclusively by the objective measurement of a derivative’s delta. The delta of an N.P.C. or an E.L.I. is the ratio of the change in the fair market value of the contract to the change in the fair market value of the property referenced by the contract. The delta must be determined in a commercially reasonable manner. The underlying logic of this delta-based approach is to avoid any situation of potential tax avoidance existing when a transaction approximates the economics of owning an underlying security without incurring the tax liability associated with owning that security. Under this “delta approach” a

specified N.P.C. is any N.P.C. that has a delta of 70% or greater when the long party acquires the transaction.

5. An equivalent definition is provided for specified E.L.I.'s.

6. When a transaction references more than one underlying security, the determination as to whether the transaction falls under Code §871(m) must be made on a security-by-security basis. The 2013 Proposed Regulations also include some anti-abuse rules regarding the delta determination.

7. Under the 2013 Proposed Regulations, a substantially similar payment is a dividend equivalent received by the long party in a gross-up amount when the payment is made in satisfaction of a tax liability with respect to a dividend equivalent made by a withholding agent.

8. A payment of a dividend equivalent is defined by the 2013 Proposed Regulations as any gross amount that references a U.S. source dividend and that is used to compute any net amount transferred to or from the long party even if the long party makes a net payment to the short party or the net payment is zero. The date of the payment is the date the amount of the dividend equivalent is determined. The fact that the payment occurs or is otherwise taken into account on a later date is not taken into account. A payment of a dividend equivalent also includes estimated dividend payments under the 2013 Proposed Regulations (as opposed to the 2012 Proposed Regulations), as well as any other contractual term of a potential Code §871(m) transaction that is calculated based on an actual or estimated dividend.

9. Under the 2013 Proposed Regulations, a transaction referencing an interest in an entity other than an entity treated as a C corporation for U.S. income tax purposes will be treated as referencing the allocable portion of any underlying security or Code §871(m) contracts that the entity holds directly or indirectly. A safe harbor exists where the underlying securities or section 871(m) contracts represent an aggregate amount of 10% or less of the value of the interest in the referenced entity at the time of the transaction.

10. The 2013 Proposed Regulations propose rules to calculate the amount of the dividend equivalent.

11. The 2013 Proposed Regulations propose two exceptions to transactions that may otherwise fall within the scope of Code §871(m) but that present a little potential for tax avoidance: i) a transaction into which a qualified dealer enters in its capacity as a dealer (see 2013 proposed regulations for more detailed guidance) and ii) a transaction into which a taxpayer enters as part of a plan pursuant to which one or more persons are obligated to acquire 50% or more of the entity issuing the underlying securities.

12. The 2013 Proposed Regulations exclude dividend equivalents from the definition of portfolio interest.

13. The 2013 Final Regulations also addressed the withholding obligations and reporting obligations entailed by the U.S. sourcing of dividend equivalent payments.

14. Finally, the 2013 Proposed Regulations clearly state that the Service reserves the right to treat any payment made with respect to a transaction as a dividend equivalent if the taxpayer's principal purpose in entering into the transaction is to avoid the rules relating to dividend equivalent payments.

TAX 101 – INTRODUCTORY LESSONS:

UNDISCLOSED OFFSHORE ACCOUNTS, ARE YOU ELIGIBLE FOR STREAMLINED PROCEDURES?

Authors
Stanley C. Ruchelman
and Armin Gray

Tags
O.V.D.P.
Streamlined Procedures

For persons having undisclosed offshore accounts and contemplating participation in the I.R.S. voluntary disclosure program, one frequently asked question is eligibility for the streamlined procedures ("Streamlined Procedures") announced by the I.R.S. O.V.D.I.[61] The Streamlined Procedures are effective as of September 1, 2012 and should be considered if there are offshore tax-noncompliance issues. If an individual qualifies, the benefits are substantial: he or she will be eligible for fast-track resolution of the case, the look-back period is limited to three years of delinquent tax returns and six years of F.B.A.R.s, and he or she will avoid penalties. However, most taxpayers will not qualify as eligibility is limited to a narrow class of taxpayers where intentional tax non-compliance is unlikely to exist.

To be eligible for the Streamlined Procedures:

- The individual must have resided outside of the U.S. since January 1, 2009.

- The individual must be a non-filer and must not have filed a U.S. tax return for the same period. Subject to a limited exception with respect to retirement or savings plans such as certain Canadian retirement plans for which a Form 8891 is applicable, amended returns will be treated as high-risk returns and not eligible for fast-track.

- The taxes due after foreign tax credit and after the foreign earned income exclusion must, in general, be less than $1,500 for each of the years in the three-year period. If the tax due exceeds $1,500, the return will be treated as high risk. However, the I.R.S. has stated that persons with high risk returns are not *per se* ineligible for the program Rather, the I.R.S. will review the taxpayer's file more carefully to determine whether evidence of

61 See New Filing Compliance Procedures for Non-Resident U.S. Taxpayers, Instructions for New Streamlined Filing Compliance Procedures for Non-Resident, Non-Filer U.S. Taxpayers, and Frequently Asked Questions Regarding the Streamlined Filing Compliance Procedures for Non-Resident, Non-Filer Taxpayers, *available at*: www.irs.gov.

tax fraud or willfulness exists. In addition, the I.R.S. warns that it may impose penalties where appropriate.

- None of the following "high risk" factors must be present:
  - The return seeks a refund;
  - The return reflects material economic activity in the U.S.;
  - The individual has not declared all of his or her income in the tax returns of the country of residence;
  - The individual is under audit or investigation by the I.R.S.;
  - F.B.A.R. penalties have been previously assessed against the individual or the individual has previously received an F.B.A.R. warning letter;
  - The individual has a financial interest in or authority over a financial account located outside the country of residence;
  - The individual has a financial interest in an entity or entities located outside the country of residence;
  - The individual has U.S. source income;
  - The individual engaged in sophisticated tax planning or tax avoidance.

A person participating in the Streamlined Procedures will be required to fill out a questionnaire that is reviewed by the I.R.S. to determine eligibility.[62] All answers must be certified as truthful under the penalty of perjury.

If a person is eligible for the program, complete and accurate delinquent tax returns must be filed for "the last three years for which a U.S. tax return is due," six years of F.B.A.R.s, and payment of back taxes owed (if any).

The following examples illustrate the eligibility requirements of the Streamlined Procedures.

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[62] See Non-Resident Questionnaire, *available at*: http://www.irs.gov/pub/irs-utl/non-resident_questionnaire.pdf.

"At least one I.R.S. examiner informally advised that tax returns should be filed from 2009 onwards presumably because the I.R.S. does not want participants to choose which three years are covered. According to this examiner, the three-year look-back period always begins in 2012 and additional years could be filed through the program or through regular channels."

> *Example 1* Taxpayer ("T") is a U.S. citizen who has lived for the past decade in Italy. T is employed in Italy. T has filed U.S. income tax returns (Form 1040) reporting his foreign earned income but failed to report his interest in or pay taxes on income earned from several foreign bank accounts located in Italy.
>
> Because T has filed Form 1040's in previous years, T is not eligible for the Streamlined Procedures. Amended returns are treated as high risk returns.
>
> *Example 2* The facts are the same as Example 1, except T was a non-filer and thus did not file any returns. Also, several bank accounts are maintained in Switzerland and T did not pay taxes in Italy on income earned from those accounts. Since T has not declared all of his income in Italy, T may not be eligible for the program as a high risk factor is present.
>
> *Example 3* The facts are the same as Example 1, except T was a non-filer but the aggregate U.S. tax liability was $10,000 for each year in question as T's invested in a Channel Islands partnership that was tax transparent for U.S. tax purposes but not for Italian tax purposes. No distributions were received from those partnerships even though the income of the partnerships was substantial. Although T is not *per se* disqualified from the program, T's submission may be treated as high risk.

One final point is that the I.R.S. may believe that the years included in the catch-up filing requirement can extend beyond three years. At least one I.R.S. examiner informally advised that tax returns should be filed from 2009 onwards presumably because the I.R.S. does not want participants to choose which three years are covered. According to this examiner, the three-year look-back period always begins in 2012 and additional years could be filed through the program or through regular channels.

CORPORATE MATTERS:

ORAL AGREEMENT CAN BE UNILATERALLY TERMINATED IF THERE IS NO DEFINITE TERM OR A PARTICULAR UNDERTAKING

Authors
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and Armin Gray

Tags
Partnership
Drafting Agreements

Under New York partnership law ("Partnership Law"), a partnership can be formed orally. Additionally, a partnership may be dissolved unilaterally if "no definite term or particular undertaking is specified" in the underlying agreement.[63]

In *Gelman v. Buehler* 2013 NY Slip OP 01991 (March 26, 2013, plaintiff (P) and defendant (D) were recent business school graduates who decided to form a partnership in 2007. D had proposed a plan to P aimed at acquiring $600,000 from investors for the purpose of establishing a "search fund" to research and identify and raise any additional funding needed to pay the purchase price of the targeted business. P and D were to manage the business with the goal of increasing its value until it could be sold at a profit (referred to as a "liquidity event") and the investors would share in the profits realized from the sale. P accepted D's proposal and the partnership was formed by oral agreement. P and D expected that the business plan would reach its objective in four to seven years. The partners apparently pursued prospective investors for several months. D withdrew from the venture after P refused his demand for majority ownership of the partnership.

P sued D for breach of contract, claiming that D could not unilaterally terminate his obligations under the agreement. D moved to dismiss the complaint on the ground that dissolution was permissible under New York partnership law because the oral agreement did not include a "definite term or particular undertaking." The Supreme Court of New York granted D's motion to dismiss, concluding that the complaint failed to allege that the partnership agreement provided for a definite term or a defined objective. However, the Appellate Division modified by reinstating the breach of contract cause of action, reasoning that the complaint adequately described a "definite term" by its reference to the liquidity event and sufficiently alleged a "specific undertaking of acquiring a business and expanding it until the investors would receive a return on their capital investments". Two Justices dissented, concluding that the partnership was dissolvable at will because the oral agreement contained neither a definite term nor a particular undertaking. D appealed.

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[63] New York Partnership Law §61(1)(b).

"Even if individuals starting out in a new enterprise do not want to incur the expense of a 'full blown' partnership agreement, there are some basic business understandings that could be documented by a competent attorney for relatively little expense. Most of these issues must be confronted at some point and there is no better time than at the outset of a project."

The Court of Appeals held for D, stating that P's complaint lacked a "fixed, express period of time during which the enterprise was expected to operate" and that since the complaint did not set forth a specific or even a "reasonably certain" termination date, the joint venture could be unilaterally terminated. The court further went on to hold that, "when the entire scheme is considered, the alleged sequence of anticipated partnership events detailed in the complaint are too amorphous to meet the statutory 'particular undertaking' standard for precluding unilateral dissolution of a partnership."

Often, when individuals go into business together, they do not document their initial business understanding. Usually this is not a conscious decision but simply a reflection of the fact that the parties are too busy working on a business plan or doing whatever it takes to get the business up and running to negotiate and draft a partnership or shareholders' agreement. Whatever the reason, many closely held businesses do not have adequate documentation covering the basic tenets of the enterprise. Some proceed without incident, many, as in the *Gelman v. Buehler* case, fail due to conflict over the most basic issues.

In the *Gelman* case, the defendant withdrew following a dispute over ownership of the partnership. Had the two individuals instructed counsel to draft even the most basic of partnership agreements, this issue would have been one of the first discussed and would have either been overcome or caused them to abandon the project.

We often have clients coming to see us having been in business together for some months or even years without ever having documented their business understanding. It is amazing when these people sit down to discuss a partnership agreement how different their views can be. These discussions can drag on and become quite acrimonious and distracting. *Gelman v. Buehler*'s journey through the courts is illustrative of how murky some of these issues can be.

Even if individuals starting out in a new enterprise do not want to incur the expense of a "full blown" partnership agreement, there are some basic business understandings that could be documented by a competent attorney for relatively little expense. Most of these issues must be confronted at some point and there is no better time than at the outset of a project. Questions asked by an attorney may also help cement ideas for the business plan.

The two individuals in the *Gelman* case should never have been in business together. A few hours with an attorney at the outset would have saved them a lot of time, money and anguish.

NEW YORK ENACTS NEW LEGISLATION FOR NEW YORK NONPROFITS

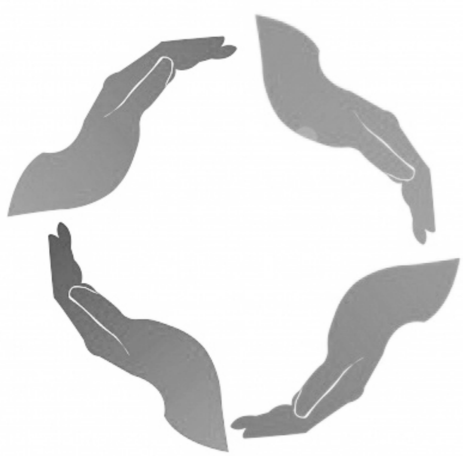
Author
Nina Krauthamer

Tags
Nonprofit

New York's Governor Andrew Cuomo has signed the Nonprofit Revitalization Act of 2013 into law, effective July 1, 2014, making a number of key reforms to New York law that have long been sought by the charitable sector and legal practitioners. Nonprofit organizations will now be able to incorporate, dissolve and merge more easily; communicate and hold meetings using modern technology like Skype and videoconference; and effect various transactions without the need to seek Court approval. The new law has added new governance provisions to provide crucial oversight and governance reforms. Nonprofit boards will have to perform stricter oversight of insider deals, and the Attorney General will be better able to hold insiders accountable for abuse. The new law requires the adoption of more robust financial oversight requirements, conflict of interest policies, and, for certain charities, whistleblower policies to protect nonprofit employees from retaliation when they identify wrongdoing.

Nonprofits will need to review existing internal controls, by-laws, policies, and committee charters, if any, to ensure that the new law is correctly implemented. All nonprofits should implement a conflict of interest policy. Some organizations will need whistleblower policies as well. Corporate by-laws and charitable trust operating procedures must reflect the strengthened oversight requirements for audit oversight and related party transactions. Nonprofits should consider changes to their by-laws to reflect the favorable new rules, particularly those relating to electronic communications.

Ruchelman P.L.L.C. represents several New York charities and will be working with those charities over the next few months to ensure compliance with the new legislation.



IN THE NEWS

OUR NAME CHANGE

Effective January 1, 2014, The Ruchelman Law Firm became Ruchelman P.L.L.C. with the same people providing the same services. Thus the change was only in form and not in substance. It was made in consideration of our recent growth and the addition over the last year of Nina Krauthammer, Galia Antebi, Ken Lobo, and Fanny Karaman. Nina, Galia, and Fanny joined our New York office while Ken joined Ed Northwood in our Toronto office. Together, their practices focus on domestic, international, and private client tax issues, and as a group, they reflect a desirable mix of technical knowledge, practical legal experience, and enthusiasm garnered in big law firms and smaller specialty practices.

CLASS AT NEW YORK LAW SCHOOL: TAXATION OF INTANGIBLES

Beginning January 2014, Stanley C. Ruchelman and Armin Gray have begun to co-lecture a course on the taxation of intangibles at New York Law School. The course focuses on the tax consequences of capitalization, amortization, character on disposition, transfers thereof, and other cross-border tax planning with respect to intangible property such as patents, trademarks, trade secrets, copyrights, and computer software. Stanley and Armin join Andrew Mitchel as the 2nd and 3rd professors affiliated with our law firm.

OUR RECENT AND UPCOMING PRESENTATIONS

On October 30, 2013, Robert G. Rinninsland presented a seminar entitled Transfer Pricing at the *I.T.S.G. World Conference* in London. He discussed the practical application of U.S. tax transfer pricing principles within the context of 2013 worldwide Base Erosion and Profit Shifting initiatives ("B.E.P.S.") taken by the O.E.C.D. and endorsed by the U.S.

On October 31, 2013, Andrew Mitchel presented on a panel entitled "GAAR Experiences" at the *I.T.S.G. World Conference* in London. The panel discussed the U.S. economic substance doctrine and international equivalents.

On November 1, 2013, Robert G. Rinnisland and Armin Gray presented on a panel entitled U.S. Tax Update at the *I.T.S.G. World Conference* in London. The panel discussed updates to the I.R.S. O.V.D.I. and I.T.I.N., as well as updates to other tax issues such as changes made pursuant to the fiscal cliff negotiations.

On November 1, 2013, Stanley C. Ruchelman and Armin Gray presented on a panel entitled F.A.T.C.A. Update and the European Versions at the *I.T.S.G. World Conference* in London. The panel discussed the updates to F.A.T.C.A. and non-U.S. equivalents or initiatives.

On January 7, 2014, Stanley C. Ruchelman presented the seminar U.S. Outbound Investment Life Cycle to the *PrimeGlobal Tax Conference* in Paradise Island, Bahamas, which addressed a full range of topics involved in managing outbound investments – including entity classification, tax treatment under Section 367 of asset transfers, working with Subpart F, working with P.F.I.C.s, U.S. rules designed to eliminate excessive benefits, and international attacks on excessive benefits.

On January 19, 2014, Nina Krauthammer presented on a panel entitled U.S. Personal Tax Basics at the Tax Specialist Group annual conference in Toronto. The panel gave a general overview of U.S. tax principles in order to provide a foundation for cross-border U.S. – Canada tax planning.

On January 20, 2014, Edward Northwood and Nina Krauthamer presented on a panel entitled Canada-U.S. Case Study at the Tax Specialist Group annual conference in Toronto. The panel addressed cross-border U.S./Canada income, trust, and estate tax planning.

On January 20, 2014, Stanley C. Ruchelman, Robert G. Rinnisland, and Armin Gray were presenters on two separate panels at the Tax Specialist Group annual conference in Toronto. The first panel, entitled U.S. Tax Update, addressed certain issues involving foreign financial accounts and F.A.T.C.A. The second presentation, entitled B.E.P.S. From the U.S. Perspective: Analyze Locally Think Globally, addressed the B.E.P.S. project, *i.e.*, tax base erosion and profit shifting to tax haven countries.

On January 24, 2014, Philip Hirschfeld participated in the panel F.A.T.C.A. for Those on This Side of the Ocean/Border at the *A.B.A. U.S. Activities of Foreigners & Tax Treaties Committee* in Phoenix. The panel explored recent developments and reviewed fundamentals of F.A.T.C.A. compliance from the perspective of the U.S. withholding agent.

On February 11, 2014, Armin Gray participated in a panel entitled F.A.T.C.A. and the U.S. Canada I.G.A. at the *Canada Professionals Seminars* in Toronto. The panel addressed F.A.T.C.A. and the new U.S./Canada I.G.A. signed on February 05, 2014.

In April, Galia Antebi will present a seminar entitled Pre-immigration Issues at the *G.G.I. European Conference* in Edinburgh. The discussion will include the green card trap, foreign gifts and foreign trusts.

Copies of our presentations are available on our website: www.ruchelaw.com/publications or by clicking the above links.

About Us

We provide a wide range of tax planning and legal services for foreign companies operating in the U.S., foreign financial institutions operating in the U.S. through branches, and U.S. companies and financial institutions operating abroad. The core practice of the firm includes tax planning for cross-border transactions. This involves corporate tax advice under Subchapter C of the Internal Revenue Code, advice on transfer pricing matters, and representation before the I.R.S.

The private client group of the firm also advises clients on matters related to domestic and international estate planning, charitable planned giving, trust and estate administration, and executive compensation.

The tax practice is supported by our corporate group, which provides legal representation in mergers, licenses, asset acquisitions, corporate reorganizations, acquisition of real property, and estate and trust matters. The firm advises corporate tax departments on management issues arising under the Sarbanes-Oxley Act. Our law firm has offices in New York City and Toronto, Canada. More information can be found at www.ruchelaw.com.

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