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INSIGHTS

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EDITORS' NOTE

This month's issue is dedicated to Ed Northwood. Vince Lombardi once said: "The harder you work, the harder it is to surrender." In the practice of law, scaling back can be a difficult but a necessary choice in that it will allow the lawyer to give more focused attention to existing clients, which is in the best interests of the lawyer and those clients. We wish Ed Northwood all the best and look forward to seeing him continue to excel in Buffalo.

In this month's edition of Insights, we focus on a number of topics. These include:

- **Using the U.K. as a Holding Company Jurisdiction: Opportunities and Challenge**s. This article is written by our guest writer, Tom Cartwright, who focuses on the U.K. as a holding company jurisdiction. The U.K. has emerged over the last decade as an increasingly viable holding company jurisdiction, particularly for investments in countries within the European Union. Tom Cartwright explains the reasons why.

- **I.R.S. Announces Major Changes to Amnesty Programs**. This month's article is co-authored by Armin Gray, Fanny Karaman, and another guest writer Benjamin Tolub, and focuses on recent changes to the I.R.S. amnesty programs.

- **Tax 101: Outbound Acquisitions – Holding Company Structures**. Stanley C. Ruchelman and Cheryl Magat discuss issues that should be considered when setting up a company overseas, particularly a foreign holding company, with an emphasis on U.S. taxation.

- **OMJ Pharmaceuticals, Inc. v. U.S*.*** Recently, the First Circuit held that Code §936 does not require a credit cap decrease for the U.S. seller of business lines in Puerto Rico if the buyer is a foreign entity that does not pay U.S. corporate income tax. Cheryl Magat discusses this case and the logic behind the decision.

- **Corporate Matters: Professional Limited Liability Companies and Professional Corporations**. Simon Prisk discusses professional limited liability companies and professional corporations, and the reasons for forming one over another type of entity.

- **F.A.T.C.A. 24/7.** Philip Hirschfield provides a monthly update on recent F.A.T.C.A. events, including additional jurisdictions that have signed an I.G.A. and recent forms and other items released or updated by the I.R.S.

- **Updates and Tidbits**. Robert Rinninsland and his team provide various other updates and tidbits on topics including tax evasion in the U.S. and abroad, changes to Circular 230, transfer pricing, gain recognition agreements, and more.

We hope you enjoy this issue.

-The Editors

USING THE U.K. AS A HOLDING COMPANY JURISDICTION: OPPORTUNITIES AND CHALLENGES

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Tags
International Tax
Holding Companies
U.K.

INTRODUCTION: AN IDEAL HOLDING JURISDICTION?

At a time when a quintet of septuagenarian comics attempt to revive former glories with a final run of a live show of *Monty Python* in London, it is worth reflecting on the Holy Grail of the international tax practitioner: to find the perfect international holding company jurisdiction.

In this, the holding company jurisdiction needs certain characteristics:

- The possibility of returning profits to shareholders with minimal tax leakage;
- The ability to receive profits from underlying subsidiaries without taxation at home;
- The ability to dispose of investments in the underlying subsidiaries without triggering a tax charge on any profit or gain;
- A good treaty network to ensure that profits can be repatriated to the holding company from underlying subsidiaries, whilst minimizing local withholding taxes; and
- Low risk from anti-avoidance measures that profits of subsidiaries will otherwise be taxed in the holding company jurisdiction.

The U.K. has emerged over the last decade as an increasingly viable holding company jurisdiction, particularly for investments in countries within the European Union. This emergence has been based on the following aspects of the U.K.'s tax regime:

- The fact that the U.K. does not levy withholding tax on dividends paid by its companies to any jurisdiction;
- The introduction of a dividend exemption in 2009, ensuring that dividends received by a U.K. company from overseas subsidiaries are exempt from tax in the U.K.;
- An extensive network of double tax treaties;

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- The reform of some of the U.K.'s more draconian anti-avoidance rules, including its Controlled Foreign Company ("C.F.C.") rules in 2013; and

- The introduction in 2002 of an exemption from U.K. taxation on the disposal of "substantial shareholdings" in subsidiaries by U.K. companies.

However, some of the U.K.'s rules in this area remain less straightforward than might be desirable and this can create uncertainty, particularly in more complex group structures. This article looks at the requirements of the regime, at some of the issues which can arise when the U.K. is used as a holding company, and lastly, how these issues may be resolved.

"A fundamental advantage which the U.K. holds over many other typical holding company jurisdictions … is that it does not levy withholding tax on dividends paid by U.K. companies."

DIVIDEND TAXATION

A fundamental advantage which the U.K. holds over many other typical holding company jurisdictions (such as the Netherlands and Luxembourg) is that it does not levy withholding tax on dividends paid by U.K. companies. This means that the U.K. is extremely tax efficient for the repatriation of dividends to shareholders, regardless of where those shareholders are based and whether a double tax treaty may also apply to provide relief.

The change in 2009 to introduce an exemption for dividends received by a U.K. company from overseas subsidiaries has further bolstered this position. Whereas the U.K. previously operated a credit method for dividends received from overseas subsidiaries, with credit given for foreign tax borne on the underlying profits out of which the dividend was paid, dividends received by a U.K. company from overseas subsidiaries are now generally exempt from tax.

It is possible to qualify for the exemption in a number of different ways. If the holding company is not a "small" company, the most straightforward basis for exemption is where the holding company controls more than 50% of the voting rights in the subsidiary through its shareholdings. Most subsidiaries will satisfy this requirement.

If the holding company is small (which means broadly that, when aggregated with all companies under common control, it has fewer than fifty employees and either its annual turnover or net asset value from its balance sheet do not exceed €10 million), it will be exempt from tax on dividends received from subsidiaries received in qualifying territories. Qualifying territories include any territory with which the U.K. has a double tax treaty containing a non-discrimination provision.

Where neither of these criteria is met (or, where the company is not small and does not hold a controlling interest in the subsidiaries), there are other ways in which dividends can qualify for exemption. These include where the dividend is paid in respect of non-redeemable ordinary shares, where there is a portfolio holding of less than 10% of the issued share capital and economic rights, or where the dividend does not reflect profits derived from transactions which are designed to avoid or reduce U.K. tax.

Whilst there are some anti-avoidance provisions, these will generally only apply where there has been deliberate structuring to manipulate the rules in order to ensure that the dividend exemption applies. These should not be relevant in most circumstances.

The result of the dividend exemption, coupled with the lack of withholding tax on dividends paid by the U.K. holding company, should ensure there is no tax leakage in the U.K. on the repatriation of dividend profits to the ultimate shareholders. Further, the U.K.'s extensive network of double tax treaties and its access to the benefits of the E.U. Parent-Subsidiary Directive should ensure that dividends can generally be received by the U.K. holding company without local withholding taxes.

ANTI-AVOIDANCE RULES

Controlled Foreign Companies

A further development which took effect on January 1, 2013 and which has enhanced the U.K. as a holding company jurisdiction was a change to the U.K.'s Controlled Foreign Companies ("C.F.C.") Regime. The fundamental change is an attempt to make the rules more targeted to scenarios where profits have actually been diverted from the U.K., rather than a more blanket provision which potentially caused overseas profits with a limited U.K. nexus to be subject to U.K. taxation.

In essence, a C.F.C. is a foreign company that is:

1. Resident outside the U.K.;
2. Controlled by U.K. persons; and
3. Subject to a level of tax which is less than 75% of the U.K. corporate tax on such profits (currently 21%, reducing to 20% as of April 2015).

The C.F.C. rules only bite on U.K. companies which have a minimum 25% participation in the C.F.C. (or are entitled to 25% of the C.F.C.'s profits). Where they apply, such U.K. companies will be taxed as if the profits were made by that company in the U.K.

In the case of a U.K. holding company, the C.F.C. rules are therefore only likely to be of relevance where profits are made in a jurisdiction with tax rates below 15%. Further, due to the broad U.K. exemption on dividends, any dividends received by overseas subsidiaries or any capital gains would not cause the C.F.C.'s profits to be subject to U.K. tax.

There are a number of exemptions from the C.F.C. rules and, in particular, they are unlikely to bite where all the significant functions of the overseas company are carried on outside of the U.K. In the case of a general intermediate holding company within an international group, this will often be the case.

Attribution of Capital Gains

Where a company which is not resident in the U.K., and would be closely controlled if it were, makes a chargeable gain on the disposal of an asset, those gains can be attributed to the U.K. "participators" (broadly speaking, the shareholders) of that company for U.K. tax purposes. This can also apply to gains made by indirect subsidiaries. A company is closely controlled if it is under the ultimate control of five or fewer participators. However, no gain would be attributed to a U.K. shareholder who holds less than 25% of an economic interest in the gain made by the underlying company, although this is likely to be satisfied in most cases where a U.K. holding company is used.

However, where relevant, these rules are often overridden by double tax treaties, so that the gain can only be taxed in the jurisdiction in which the subsidiary is located. There is also a specific exemption for companies which are (or which have an ultimate parent which is) listed on a recognized stock exchange.

There are also other exemptions from these rules which will often apply. For example, if the asset which is disposed of is used for the purposes of a trade carried on outside of the United Kingdom, or if it is used for the purposes of economically significant activities carried on by the subsidiary wholly or mainly outside of the United Kingdom, no charge will be imposed on the U.K. holding company.

"Economically significant activities" means, for these purposes, any commercial activities which make use of appropriately competent staff, premises, and equipment, and which provide added economic value commensurate in each case with the size and nature of those activities. Thus, a subsidiary carrying on a typical business activity should not find that it causes the U.K. holding company to fall foul of these rules. Further, if the arrangements under which the gain arises do not form part of a scheme or arrangement with a main purpose of avoiding a liability to U.K. capital gains tax or corporations tax, no charge will apply.

THE SUBSTANTIAL SHAREHOLDINGS EXEMPTION: A MIXED BLESSING?

The earliest of the listed measures to be brought into force in 2002 to make the U.K. a more attractive holding company jurisdiction was the U.K.'s version of a participation exemption, the Substantial Shareholdings Exemption ("S.S.E."). Unfortunately, this is also the least user-friendly measure and the vagueness of its scope can still deter some from using the U.K. as a holding company jurisdiction. In most vanilla cases, the rules will work perfectly adequately, however there are still uncertainties due both to the requirements of the regime itself and to a lack of clarity and consistency in some of the drafting.

In order to qualify for the exemption from a charge to tax on a gain made on the sale of shares in a subsidiary, the rules impose a number of different requirements on both the company which is sold and the selling entity. The company which is sold must:

- Have been a trading company or the holding company of a trading group or sub-group throughout the 12 month period ending with the disposal; and

- Be a trading company or the holding company of a trading group immediately after the time of the disposal.

There is some latitude with the second requirement, where that requirement would have been satisfied at some point in the previous two years (in other words, the fact that the purchaser of the subsidiary decides immediately to change its business such that it no longer qualifies will not of itself prevent S.S.E. from applying).

For these purposes, a "trading company" means a company whose activities do not to a substantial extent include any activities other than trading activities. The key concepts here are "trading" and "substantial" and, unhelpfully, neither is defined in the statute.

"Trading" is a concept derived from English case law. Broadly speaking, it requires a company to be carrying on activities which amount to a trade, rather than a holding, of investments. There is no definitive test of the existence of a trade, but various indicia will be taken into account including frequency of transactions, the nature of the assets which are dealt in, the structure of the business, and the intention of the company when acquiring any asset for the purposes of its business. The absence of a bright-line test causes uncertainty. However, for example, a commercial property rental business carried on by the landlord would not amount to a trade for these purposes (whereas a development activity, where the intention is to sell the property following development, would). In areas of genuine uncertainty, HM Revenue and Customs ("H.M.R.C.") may provide a non-statutory clearance on the basis of whether S.S.E. applies, although, as this will typically be prior to a sale, the opportunity to make any alterations to the structure to benefit from the relief may have passed.

The statute also does not include any definition of "substantial." However, H.M.R.C. generally takes the view that "substantial" for these purposes means more than 20%. This 20% test is applied both to the net assets of the business and to the income derived by the business, as well as expenditure and time spent by employees on trading or investment activity. This is not, however, a rigid rule and H.M.R.C. may apply some latitude. For example, they will typically accept that a cash balance does not amount to an investment if it is reasonably expected to be required for the purposes of a trade.

In addition, there are certain requirements in respect to the selling entity. This company must:

- Hold a "substantial shareholding" in the subsidiary concerned for at least a 12 month period prior to disposal;
- Be a trading company or the holding company of a trading group throughout that 12 month period; and
- Be a trading company of the holding company of a trading group immediately after the disposal.

A company holds a substantial shareholding in another company if it holds shares or an interest in shares, by virtue of which it holds:

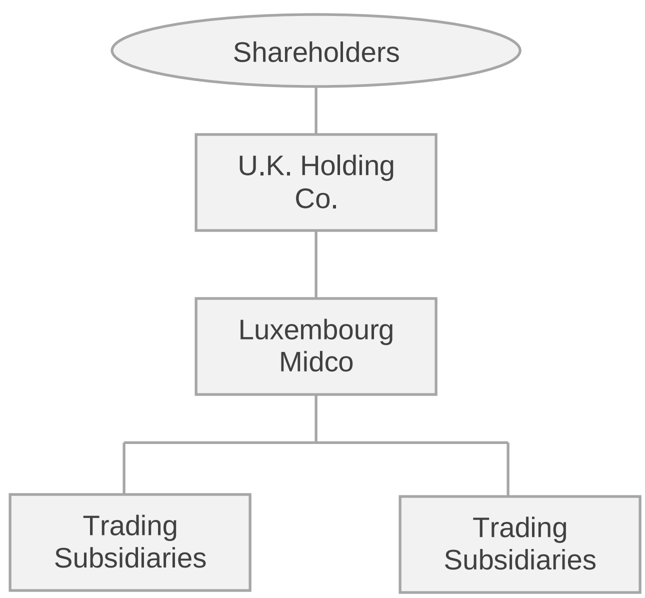
- At least 10% of the company's ordinary share capital;
- A beneficial entitlement to at least 10% of the profits available to equity holders; and
- A beneficial entitlement on a winding up to at least 10% of the assets of the company available for distribution to equity holders.

Care must therefore be taken with share classes which have a variable return if and when certain hurdles are met. Further, "equity holders" in this context includes not just shareholders but the holders of certain types of debt deemed not to be "normal commercial loans," such as convertible debt. Care therefore needs to be taken with smaller holdings in companies with a variety of different share classes and debt instruments.

Remaining a Trading Company

The requirement for the selling company to remain a trading company or the holding company of a trading group after the sale can also cause problems if all the trading entities have been sold. Again, some latitude is provided both by the statute and by H.M.R.C. practice (although the latter is unpublished and by its nature concessionary and may not be relied upon with confidence in a tax planning context). Essentially, if the selling company would no longer form part of a trading group following a sale, H.M.R.C. should accept that S.S.E. will still apply if either it is planned to liquidate the company in the near future to distribute the cash from the sale, or if there is a plan to acquire a new trade or trading group within a reasonable time. However, in any such cases, obtaining a clearance would be advisable.

If instead it is hoped that any cash proceeds from a disposal can be warehoused in the U.K. holding company for the foreseeable future until further opportunities to acquire a trading group or to make an investment present themselves, it is unlikely that S.S.E. would be applicable. In those circumstances, it may be advisable to consider adding a further layer of holding company to the structure in a jurisdiction with a more robust participation exemption, such as Luxembourg. This is shown in the diagram below and adds the additional benefit of utilizing the U.K.'s dividend exemption and lack of withholding tax on dividends to shareholders, whilst relying on the U.K./Luxembourg double tax treaty in respect to dividends paid by Luxembourg Midco to the U.K. holding company.



Joint Venture Companies and Transparent Entities

Further issues can arise when non-corporate entities form part of a group. The general meaning of "group" for the purposes of S.S.E. is a company together with its "51% subsidiaries." A 51% subsidiary is a company in which the other company owns more than 50% of its ordinary share capital. This can create a problem, since an entity without share capital can break the group above and below it. In particular, this can affect a Delaware L.L.C., which may or may not be set up with a share capital (based on H.M.R.C.'s current interpretation).

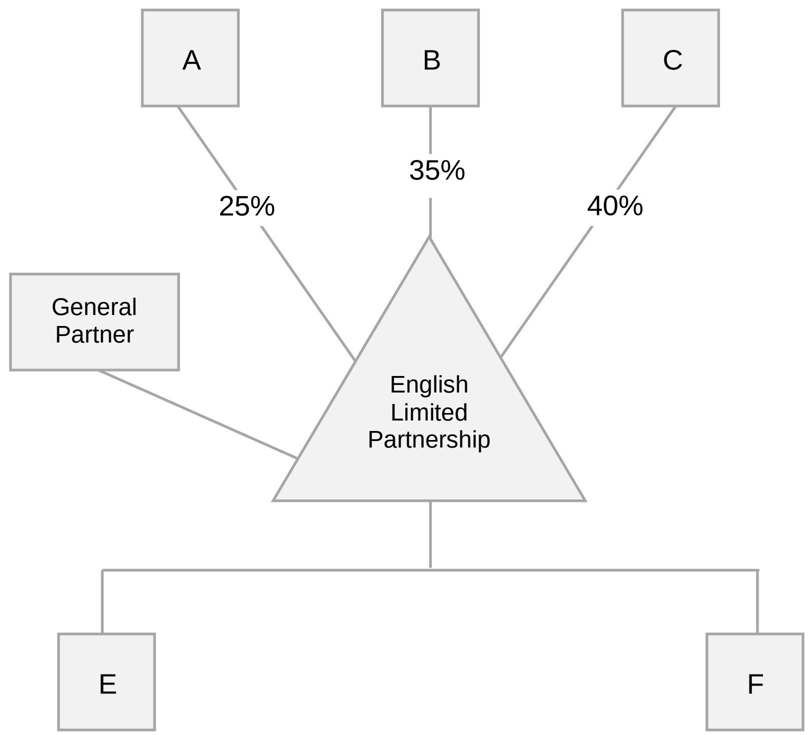
Even entities which are ostensibly transparent for tax purposes, such as a limited partnership, can cause difficulties. H.M.R.C. will generally accept that if such a partnership is inserted within a group and does not have legal personality, then it is entitled to look through it for the purposes of determining whether its subsidiaries should be treated as the 51% subsidiaries of its parent company. This would apply for an English partnership or an English limited partnership, as well as for many other types of limited partnerships which mirror the provisions of English law, such as a Guernsey or Cayman limited partnership.

However, where the partnership which is inserted has legal personality (such as a Scottish limited partnership or a U.K. limited liability partnership which are both treated as transparent for tax purposes), H.M.R.C.'s view is that the group is broken and it is not possible to look through from the parent companies to the underlying subsidiaries. This can cause unexpected problems, and in cases where any group includes companies or entities without share capital, serious care needs to be taken to determine firstly what the "group" is and, secondly, whether it is a trading group.

Similar problems arise in determining whether the rules governing qualifying shareholdings in joint venture companies apply. A company has a qualifying shareholding in a joint venture company if it has a holding of at least 10% (but less than 50%) of the ordinary share capital and there are five or fewer persons who between them hold 75% or more of the ordinary share capital of that company.

In this case, the company is entitled to attribute to itself a proportionate share of the joint venture company (which should be a trading company or the holding company of a trading group). Thus, if A holds a 25% holding in company E, which has four other shareholders, A's holding in E will amount to a qualifying shareholding in a joint venture company. This means that, for the purposes of determining whether A is a trading company or the holding company of a trading group or subgroup, A is entitled to attribute to itself 25% of E's net assets and income.

However, if A actually holds its interest in E through a partnership with other companies, this can create difficulties. Again, the rules are apparently unintentionally inconsistent. For example, if A is not a member of a group, it has a qualifying shareholding in a joint venture company if it holds shares, or *an interest in shares*, by virtue of which it holds 10% or more of that company's ordinary share capital. For these purposes, an interest in shares includes any rights in co-ownership. Thus, if A holds with other companies through a partnership without legal personality, it should qualify as a co-owner of the underlying shares in the joint venture companies E and F below the partnership. This is shown in the following diagram.



However, if the partnership has legal personality, such as a U.K. L.L.P., then arguably A's interest in the underlying subsidiaries will not amount to qualifying holdings in a joint venture. This is because the L.L.P. owns its own assets legally, so that A would have no rights in co-ownership of the shares in E and F.

Further, due to an apparently accidental omission in the drafting, if A is a member of a group, A only has a qualifying shareholding in a joint venture company if it "holds" ordinary share capital in the joint venture company. There is no reference to holding *an interest in shares.* Thus, A would arguably not have a qualifying shareholding in a joint venture company if it holds its interests in E and F through any form of partnership. In such a scenario, taxpayers would be well advised to obtain a view from H.M.R.C.

CONCLUSION

The U.K. has many advantages as a holding company jurisdiction and significant improvements have been made in recent years. However, the substantial shareholding exemption is the most problematic of the U.K. rules in this area. In most basic corporate structures it works well, provided that the trading status of the group is reasonably clear. However, where more complex structures, including fund structures, are involved, the rules are not as user-friendly as they might be.

I.R.S. ANNOUNCES MAJOR CHANGES TO AMNESTY PROGRAMS

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Tags
O.V.D.P.

The I.R.S. announced major changes to its amnesty programs last month. These changes can be broken into two parts: changes to the 2012 Offshore Voluntary Disclosure Program ("O.V.D.P."), which can be to referred to as the 2012 Modified O.V.D.P. or the 2014 O.V.D.P., and changes to the streamlined procedures ("Streamlined Procedures"). As the requirements for the latter are relaxed, the requirements for the former are tightened.

The changes in the amnesty programs reflect the new I.R.S. approach for addressing taxpayers with offshore tax issues. The new approach provides one path for willful taxpayers, with steeper penalties but certainty, and another path for taxpayers who believe their conduct was non-willful, with reduced penalties but uncertainty to the extent their conduct is subsequently proven willful.

CHANGES TO O.V.D.P.

The major changes to the 2012 O.V.D.P. include the following:

1. Changes to Preclearance Process

Under the 2012 O.V.D.P., all that was required was to submit a preclearance request was a fax to the I.R.S. O.V.D.P. department that contained the taxpayer's name, social security number, date of birth, address, and if the taxpayer was represented by an authorized party, an executed power of attorney (P.O.A.).

The 2014 O.V.D.P. made changes to this procedure effective for O.V.D.P. submissions made on or after July 1, 2014. Revised 2014 O.V.D.P. F.A.Q. # 23 which provides guidance on preclearance requests, now states as follows:

> (a) Applicant identifying information including complete names, dates of birth (if applicable), tax identification numbers, addresses, and telephone numbers.
>
> (b) Identifying information of all financial institutions at which undisclosed OVDP assets (see FAQ 35) were held. Identifying information for financial institutions includes complete names (including all DBAs and pseudonyms), addresses, and telephone numbers.
>
> (c) Identifying information of all foreign and domestic entities (*e.g.*, corporations, partnerships, limited liability companies, trusts, foundations) through which the undisclosed OVDP assets (see FAQ

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35) were held by the taxpayer seeking to participate in the OVDP; this does not include any entities traded on a public stock exchange. Information must be provided for both current and dissolved entities. Identifying information for entities includes complete names (including all DBAs and pseudonyms), employer identification numbers (if applicable), addresses, and the jurisdiction in which the entities were organized.

> (d) Executed power of attorney forms (if represented).

"The offshore penalty will be increased from 27.5% to 50% if, prior to the taxpayer's pre-clearance submission, it becomes public that the financial institution or another party … is under investigation..."

2. Penalty May Be Increased to 50%

The offshore penalty will be increased from 27.5% to 50% if, prior to the taxpayer's pre-clearance submission, it becomes public that the financial institution or another party facilitating the taxpayer's offshore arrangement is under investigation by the I.R.S. or the D.O.J.

This is reflected in 2014 O.V.D.P. F.A.Q. #7.2, which states:

> Beginning on August 4, 2014, any taxpayer who has an undisclosed foreign financial account will be subject to a 50-percent miscellaneous offshore penalty if, at the time of submitting the preclearance letter to IRS Criminal Investigation: an event has already occurred that constitutes a public disclosure that either (a) the foreign financial institution where the account is held, or another facilitator who assisted in establishing or maintaining the taxpayer's offshore arrangement, is or has been under investigation by the IRS or the Department of Justice in connection with accounts that are beneficially owned by a U.S. person; (b) the foreign financial institution or other facilitator is cooperating with the IRS or the Department of Justice in connection with accounts that are beneficially owned by a U.S. person or (c) the foreign financial institution or other facilitator has been identified in a court- approved issuance of a summons seeking information about U.S. taxpayers who may hold financial accounts (a "John Doe summons") at the foreign financial institution or have accounts established or maintained by the facilitator. Examples of a public disclosure include, without limitation: a public filing in a judicial proceeding by any party or judicial officer; or public disclosure by the Department of Justice regarding a Deferred Prosecution Agreement or Non-Prosecution Agreement with a financial institution or other facilitator.

Foreign banks already under investigation include:

- UBS AG;
- Credit Suisse AG, Credit Suisse Fides, and Clariden Leu Ltd.;
- Wegelin & Co.;
- Liechtensteinische Landesbank AG;
- Zurcher Kantonalbank;

- Swisspartners Investment Network AG, swisspartners Wealth Management AG, swisspartners Insurance Company SPC Ltd., and swisspartners Versicherung AG;

- CIBC FirstCaribbean International Bank Limited, its predecessors, subsidiaries, and affiliates;

- Stanford International Bank, Ltd., Stanford Group Company, and Stanford Trust Company, Ltd.;

- The Hong Kong and Shanghai Banking Corporation Limited in India (HSBC India); and

- The Bank of N.T. Butterfield & Son Limited (also known as Butterfield Bank and Bank of Butterfield), its predecessors, subsidiaries, and affiliates.[1]

3. Elimination of Existing Reduced Penalty Structure

The reduced penalty structure under former F.A.Q. #52 and #53 have been eliminated. Former F.A.Q. #52 allowed for a 5% penalty in the case of certain inherited accounts, certain taxpayers who were unaware that they were U.S. citizens, and certain non-U.S. residents who made a good faith showing that the taxpayer complied with their resident country's tax reporting and payment obligations, and who had $10,000 or less U.S. source income for each year. The available path forward for taxpayers who believe their conduct was non-willful is now exclusively through the new Streamlined Procedures.

4. Account Statements

Former F.A.Q. #25 required submission of account statements at the time of the full submission package only if the account exceeded $500,000 in any year of the disclosure period. In such event, the taxpayer was required to keep records available upon request. F.A.Q. #25 has been modified to require taxpayers to submit account statements regardless of account balance at the time of the full submission package. It also now provides that voluminous documents not requiring original signatures may be submitted on CD or DVD.

5. Other Notable Revisions

Other notable revisions include the following:

- F.A.Q. #33 reaffirms with no uncertain terms the I.R.S.'s position of tax non-compliance. It now states that "[e]ven one dollar of unreported gross income from an O.V.D.P. asset will bring it into the offshore penalty base."

- F.A.Q. #35.1 is added and states that the offshore penalty will be applied to the taxpayer's interest in the underlying O.V.D.P. assets without regard to valuation discounts.

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[1] A current list can be found at the following link: http://www.irs.gov/Businesses/International-Businesses/Foreign-Financial-Institutions-or-Facilitators.

6. Effective Date

The 2014 F.A.Q.s are effective for all new submissions made on or after July 1, 2014.[2]

7. Consideration Under New Rules

A taxpayer who made an O.V.D.P. submission prior to July 1, 2014 the taxpayer's case considered under the new guidelines. In this scenario, the taxpayer or the taxpayer's authorized representative must communicate the request in writing to the examiner assigned to the case and, if no examiner has been assigned, to a specified address.

8. Transitional Relief

For taxpayers who already had submitted their intake letter and attachments prior to July 1, 2014, to the extent the taxpayer is eligible for one of the streamlined programs, the taxpayer may apply for a reduced penalty *in lieu* of the 27.5% O.V.D.P. penalty. However, all other terms of the O.V.D.P., including the disclosure period and tax, interest, and other penalties, will continue to apply.

Applying for the reduced penalty entails signing a certification signed under penalty of perjury. This certification must explain that the taxpayer did not act wilfully with respect to all foreign activities/assets, must specifically describe the reasons for the failure to report all income, pay all tax, and submit all required information returns, including F.B.A.R.s, and, if the taxpayer relied on a professional advisor, must include the name, address, and telephone number of the advisor and a summary of the advice.

Relief is not automatic. Before transitional treatment is given, the I.R.S. must agree that the taxpayer is eligible for transitional treatment and must agree that the available information is consistent with the taxpayer's certification of non-willful conduct.

CHANGES TO STREAMLINED PROCEDURES

The Streamlined Procedures were substantially modified. This program is designed for non-willful taxpayers and is divided into two groups: those living in the U.S. ("Domestic Streamlined Program") and those residing offshore ("Foreign Streamlined Program"). No I.R.S. streamlined questionnaire is now required, although many tax practitioners have made their own questionnaires in order to assist in the process. The taxpayer will have to certify that their conduct was non-willful under the appropriate I.R.S. form. Further, the $1,500 threshold has also been eliminated. Each program is described in more detail below.

1. Non-Willful Conduct

Willfulness is the voluntary, intentional violation of a known legal duty, may include "willful blindness" or the reckless disregard of known statutory duties. Non-willful

[2] 2014 O.V.D.P. F.A.Q. #1.2.

conduct includes conduct that is due to negligence, inadvertence, mistake or conduct that is the result of a good faith misunderstanding of the requirements of the law. The determination of whether the taxpayer's conduct was willful or non-willful may be established by inference and circumstantial evidence.

The I.R.M. lists four examples in the context of the failure to file an F.B.A.R. These examples are reproduced below:

- Example 1. A person admits knowledge of, and fails to answer, a question concerning signature authority over foreign bank accounts on Schedule B of his income tax return. When asked, the person does not provide a reasonable explanation for failing to answer the Schedule B question and for failing to file the F.B.A.R. The example concludes that a determination that the violation was willful likely would be appropriate in this case.

- Example 2. A person files the F.B.A.R., but omits one of three foreign bank accounts. The person had closed the omitted account at the time of filing the F.B.A.R. The person explains that the omission was due to unintentional oversight. During the examination, the person provides all information requested with respect to the omitted account. The information provided does not disclose anything suspicious about the account, and the person reported all income associated with the account on his tax return. The example concludes that the willfulness penalty should not apply absent other evidence that may indicate willfulness.

- Example 3. A person filed the F.B.A.R. in earlier years but failed to file the F.B.A.R. in subsequent years when required to do so. When asked, the person does not provide a reasonable explanation for failing to file the F.B.A.R. In addition, the person may have failed to report income associated with foreign bank accounts for the years that F.B.A.R.'s were not filed. The example concludes that a determination that the violation was willful likely would be appropriate in this case.

- Example 4. A person received a warning letter informing him of the F.B.A.R. filing requirement, but the person continues to fail to file the F.B.A.R. in subsequent years. When asked, the person does not provide a reasonable explanation for failing to file the F.B.A.R. In addition, the person may have failed to report income associated with the foreign bank accounts. The example concludes that a determination that the violation was willful likely would be appropriate in this case.

2. <u>Foreign Streamlined Program</u>

In order to qualify for the Foreign Streamlined Program, the taxpayer must, in general, meet the following eligibility requirements:

a. The taxpayer must have failed to report the income from a foreign financial asset and pay tax as required by U.S. law, and may have failed to file an F.B.A.R.;

b. The failure to report income, pay tax, and submit required information returns was due to non-willful conduct;

c. The taxpayer must meet the following non-residency requirement. The non-residency requirement will vary depending on the status of the individual.

i. *U.S. Citizens and Lawful Permanent Residents*: Individual U.S. citizens or lawful permanent residents, or estates of U.S. citizens or lawful permanent residents, meet the applicable non-residency requirement if, in any one or more of the most recent three years for which the U.S. tax return due date (or properly applied for extended due date) has passed, the individual did not have a U.S. abode and the individual was physically outside the United States for at least 330 full days.

ii. *Non-U.S. citizens and Other Residents*: Individuals who are not U.S. citizens or lawful permanent residents, or estates of individuals who were not U.S. citizens or lawful permanent residents, meet the applicable non-residency requirement if, in any one or more of the last three years for which the U.S. tax return due date (or properly applied for extended due date) has passed, the individual did not meet the substantial presence test (*i.e.*, the 183-day test) under the U.S. tax residency rules.

If the taxpayer is eligible, the taxpayer must:

a. File delinquent or amended tax returns, together with required information returns, for the last three years for which the U.S. tax return due date (or properly applied for extended due date) has passed;

b. File any delinquent F.B.A.R.'s for each of the most recent six years for which the F.B.A.R. due date has passed;

c. Remit the full amount of tax and interest due in connection with these filings; and

d. Sign a written statement declaring under penalties of perjury that the taxpayer is eligible for the program, is now compliant with the F.B.A.R. filing obligations, and that the past non-compliance was due to non-willful conduct.

If the taxpayer is eligible and fulfills the other requirements of the program, the taxpayer will not be subject to the following:

a. Failure-to-file penalties;

b. Failure-to-pay penalties;

c. Accuracy-related penalties;

d. Information return penalties; and

e. F.B.A.R. penalties.

3. <u>Domestic Streamlined Program</u>

In order to qualify for the Domestic Streamlined Program, the taxpayer must, in general, meet the following eligibility requirements:

a. The taxpayer must not meet the non-residency requirements described above (for joint filers, one or both of the spouses must fail to meet the applicable non-residency requirement);

b. The taxpayer must have filed a U.S. tax return (if required) for every year out of the most recent three-year period for which the U.S. tax return due date (or properly applied for extended due date) has passed;

c. The taxpayer must have failed to report gross income from a foreign financial asset and pay tax as required by U.S. law and may have failed to file an F.B.A.R. and/or one or more international information returns with respect to the foreign financial asset; and

d. The taxpayer's failure was due to non-willful conduct.

If the taxpayer is eligible, the taxpayer must:

a. File amended U.S. tax returns for every year out of the three-year period for which the U.S. tax return due date (or properly applied for extended due date) has passed, including required information returns;

b. File delinquent F.B.A.R.s for the most recent past six years for which the due date has passed;

c. Pay a 5% penalty on the highest aggregate balance/value of the foreign financial assets during the years in the applicable tax return and F.B.A.R. period. For these purposes, the 5% miscellaneous offshore penalty applies to foreign financial assets in the following set of circumstances:

    i. If the asset should have been, but was not, reported on an F.B.A.R. in a given year;

    ii. If the asset should have been, but was not, reported on Form 8938 in a given year; and

    iii. If the asset was properly reported for a given year, but gross income in respect of the asset was not reported in that year.

d. Submit a signed written statement declaring under penalties of perjury that the taxpayer is eligible for the program, is now compliant with the taxpayer's F.B.A.R. filing obligations, that the past non-compliance was due to non-willful conduct, and that the 5% miscellaneous offshore penalty is accurate.

If the taxpayer is eligible and fulfills the other requirements of the program, the taxpayer will not be subject to the following:

a. Accuracy-related penalties;

b. Information return penalties;

c. F.B.A.R. penalties.

4. <u>Disqualifications</u>

It should be noted that if the I.R.S. has initiated a civil examination of a taxpayer's returns for any taxable year, regardless of whether the examination relates to undisclosed foreign financial assets, the taxpayer will not be eligible to use the Streamlined Procedures. However, the guidelines note that taxpayers under examination should consult with their agent.

5. <u>General Treatment Under These Programs</u>

The guidelines note that tax returns submitted under these procedures will be processed like any other return submitted to the I.R.S. Accordingly, receipt of the returns will not be acknowledged by the I.R.S. and the streamlined filing process will not culminate in the signing of a closing agreement.

6. <u>Caution</u>

The guidelines state that returns submitted under these procedures will not be subject to I.R.S. audit automatically. However, the I.R.S. warns that:

a. Submission under these procedures disqualifies the taxpayer from participating in the O.V.D.P. at a later date;

b. Returns may be selected for audit;

c. Returns may also be subject to independent verification procedures and may be checked against third-party information received from banks, financial advisors, and other sources; and

d. Returns submitted under these procedures may be subject to I.R.S. examination, additional civil penalties, and even criminal liability, if appropriate. Therefore, if willfulness is proven after submission, the taxpayer receives no penalty protection. In other words, the taxpayer may be subject to the 50% F.B.A.R. penalty (per violation) and possible criminal penalties.

The guidelines to the new procedures encourage taxpayers who are concerned that their failures were due to willful conduct to participate in the O.V.D.P. The guidelines also encourage taxpayers to consult with competent tax professionals to assess which program they should enter into before making a decision.

"The objective of the changes in the amnesty program is to bring taxpayers that have offshore tax issues back into the system as fully compliant."

CONCLUSION

The objective of the changes in the amnesty program is to bring taxpayers that have offshore tax issues back into the system as fully compliant. The prior complaint was the O.V.D.P. was too harsh for non-willful taxpayers. Therefore, certain taxpayers made so-called quiet disclosures, corrected their mistakes only on a go-forward basis, or have refrained from doing anything. Based on these recent changes, taxpayers have no excuse for not correcting known errors.

We expect that the I.R.S. will be harsh on offshore tax compliance issues to the extent the taxpayer refrains from correcting known mistakes. We further expect the I.R.S. to make examples of those who willfully avoided taxes but have entered into the revised Streamlined Procedures in order to receive a reduced penalty that they were not entitled to. The changes in the amnesty programs further reflect the policy shift to use tax professionals as gatekeepers in order to determine which program the taxpayer should enter into. This saves the I.R.S. resources by putting the burden, and the costs, on the taxpayer and the taxpayer's trusted advisor.

As these programs may close, taxpayers are well-advised to take advantage of these programs sooner than later. Taxpayers living offshore whose conduct was non-willful may be entitled to a path forward as simple as filing late returns without penalties. Taxpayers living onshore may be entitled to a substantially reduced penalty even in the case of non-willful violations that lack reasonable cause. Many tax practitioners believe that the amnesty programs may close when automatic information reporting begins under F.A.T.C.A., which may be as early as March of next year for the 2014 calendar year. Therefore, prompt attention is recommended.

TAX 101:

OUTBOUND ACQUISITIONS – HOLDING COMPANY STRUCTURES

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Tags
International Tax
Foreign Tax Credit
Inversions

When a U.S. company acquires foreign targets, the use of a holding company structure abroad may provide certain global tax benefits. The emphasis is on "global" because standard U.S. benefits such as deferral of income while funds remain offshore may not be available without further planning once a holding company derives dividends and capital gains. This article will discuss issues that should be considered when setting up a company overseas, particularly a foreign holding company, in order to maximize foreign tax credits despite the limitations under the U.S. tax rules, and to reduce the overall U.S. taxes paid. These issues include challenges to the substance of a holding company, recent trends in inversion transactions, the net investment income tax on investment income of U.S. individuals, and the significance of the O.E.C.D. Base Erosion and Profit Shifting report on tax planning structures.

U.S. TAXATION OF INTERCOMPANY DIVIDENDS AMONG FOREIGN SUBS

If we assume the income of each foreign target consists of manufacturing and sales activities that take place in a single foreign country, no U.S. tax will be imposed until the profits of the target are distributed in the form of a dividend or the shares of the target are sold. This is known as "deferral" of tax. Once dividends are distributed, U.S. tax may be due whether the profits are distributed directly to the U.S. parent company or to a holding company located in another foreign jurisdiction. Without advance planning to take advantage of the entity characterization rules known as "check-the-box," the dividends paid by the manufacturing company will be taxable in the U.S. whether paid directly to the parent or paid to a holding company located in a third country.[3] In the latter case, and assuming the holding company is a controlled foreign corporation ("C.F.C.") for U.S. income tax purposes, the dividend income in the hands of the holding company will be viewed to be an item of Foreign Personal Holding Company Income, which generally will be taxed to the U.S.

[3] Treas. Reg. §301.7701-3(a). If an election is made for a wholly owned subsidiary, the subsidiary is viewed to be a branch of its parent corporation. Intra-company distributions of cash are not characterized as Foreign Personal Holding Company Income, discussed in the text.

parent company, or any other person that is treated as a "U.S. Shareholder" under Subpart F of the Internal Revenue Code.[4]

Nonetheless, the use of a holding company can provide valuable tax saving opportunities when profits of the target company are distributed. The use of a holding company may reduce foreign withholding taxes that may be claimed as foreign tax credits by the U.S. parent. This can result in substantial savings if the operating and tax costs of maintaining the holding company are significantly less than the withholding taxes being saved.

FOREIGN TAX CREDIT – A BLUNT INSTRUMENT

Although the foreign tax credit is often described as a "dollar-for-dollar reduction of U.S. tax" when foreign taxes are paid or deemed to be paid by a U.S. parent company, the reality is quite different. Only taxes that are imposed on items of "foreign source taxable income" may be claimed as a credit.[5] This rule, known as "the foreign tax credit limitation," is intended to prevent foreign income taxes from being claimed as a credit against U.S. tax on U.S. taxable income. The U.S., as do most countries that eliminate double taxation through a credit system, maintains that it has primary tax jurisdiction over domestic taxable income. It also prevents so-called "cross crediting" under which high taxes on operating income may be used to offset U.S. tax on lightly taxed investment income. For many years, the limitation was applied separately with regard to eight different categories of baskets of income designed to prevent the absorption of excess foreign tax credits by low tax foreign source income. In substance, this eviscerated the benefit of the foreign tax credit when looked at on an overall basis. The problem has been eased now because the number of foreign tax credit baskets has been reduced from eight to two, passive and general. On the other hand, the Administration's tax proposals would impair the ability of U.S.–based multinational groups to choose whether to receive dividends from highly taxed or lightly taxed foreign corporations by putting all earnings and all taxes of foreign subsidiaries into common pools so that only a blended rate of foreign tax may be claimed as a foreign tax credit.

The benefit of the foreign tax credit is reduced for dividends received from foreign corporations that, in the hands of the recipient, benefit from reduced rates of tax in the U.S. A portion of foreign dividends received by U.S. individuals that qualify for the 0%, 15% or 20% tax rate under Code §1(h)(11)(B)(i) are removed from the

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4 There are exceptions to the general characterization of a dividend as an item of Foreign Personal Holding Company Income that might apply. One relates to dividends received from a related person which (i) is a corporation created or organized under the laws of the same foreign country as the recipient C.F.C. and (ii) has a substantial part of its assets used in its trade or business located in that foreign country. See Code §954(c)(3)(A)(i). For a temporary period of time, a look-through rule is provided in Code §954(c)(6) under which dividends received by a C.F.C. from a related C.F.C. are treated as active income rather than Foreign Personal Holding Company Income to the extent the earnings of the entity making the payment are attributable to active income. This provision terminated at the beginning of 2012.

5 Code §904(a).

numerator and denominator of the foreign tax credit limitation to reflect the reduced tax rate.[6] This treatment reduces the foreign tax credit limitation when a U.S. resident individual receives both qualifying dividends from a foreign corporation and other items of foreign source income within the same basket that are subject to ordinary tax rates.

As a result, a U.S–.based group must determine the portion of its overall taxable income that is derived from foreign sources, the portion derived in each "foreign tax credit basket," and the portion derived from sources in the U.S. This is not an easy task, and in some respects, the rules do not achieve an equitable result from management's viewpoint.

ALLOCATION AND APPORTIONMENT OF EXPENSES

U.S. income tax regulations require expenses of the U.S. parent company to be allocated and apportioned to all income, including foreign dividend income.[7] The allocation and apportionment procedures set forth in the regulations are exhaustive and tend to maximize the apportionment of expenses to foreign source income. For example, all interest expense of the U.S. parent corporation and the U.S. members of its affiliated group must be allocated and apportioned under a set of rules that allocates interest expense on an asset–based basis to all income of the group. Direct tracing of interest expense to income derived from a particular asset is permitted in only limited circumstances. Research and development expenses, stewardship expenses, charitable deductions, and state franchise taxes also must be allocated and apportioned. These rules tend to reduce the amount of foreign source taxable income in a particular category and may even eliminate that category altogether. The problem is worsened by carryovers of an overall foreign loss account.[8] This is an "off-book" account that arises when expenses incurred in a particular prior year are allocable and apportionable to foreign source income and those expenses exceed the amount of foreign source gross income of the year. Where that occurs, the loss is carried over to future years and reduces the foreign source taxable income of the subsequent year.

"The pressure that has been placed on full use of the foreign tax credit by a U.S–based group has resulted in several public companies undergoing inversion transactions."

INVERSIONS AS PART OF GLOBAL MERGERS

The pressure that has been placed on full use of the foreign tax credit by a U.S–based group has resulted in several public companies undergoing inversion transactions. In these transactions, shares of the U.S. parent company that are held by the public are exchanged for comparable shares of a newly formed offshore company to which foreign subsidiaries are eventually transferred. While the share exchange and the transfer of assets may be taxable events, the identity of the shareholder group (*i.e.*, foreign persons or pension plans) or the market value of

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6 See Code §§1(h)(11)(C)(iv) and 904(b)(2)(B).
7 See Treas. Reg. §§1.861-8 through 17.
8 Code §904(f).

the shares (*i.e.*, shares trading at relatively low values) may eliminate actual tax exposure in the U.S. Thereafter, the foreign subsidiaries are owned directly or indirectly by a foreign parent corporation organized in a tax-favored jurisdiction and the foreign tax credit problems disappear.

This form of "self-help" was thought to be no longer available as a result of the inversion rules of Code §7874. In some circumstances, Code §7874 imposes tax on inversion gains and that tax cannot be reduced by credits or net operating loss carry-forwards. In other circumstances, §7874 treats the foreign corporation as if it were a U.S. corporation. However, when global competitors merge, the anti-inversion rules may not be applicable and newspaper accounts have recently focused on companies that have moved from the U.S. in connection with a global merger, acquisition or takeover.

CHOICE OF HOLDING COMPANY LOCATION

In this universe, the combination of foreign taxes imposed on the income earned by a subsidiary and the withholding taxes imposed on the distribution of dividends may generate foreign tax credits in excess of the foreign tax credit limitation. Dividend withholding taxes represent true costs for the offshore parent company because of its location in a tax-favored jurisdiction. Intelligent use of a holding company structure may eliminate or reduce the withholding tax imposed on the distribution of foreign profits. To illustrate, most countries impose a withholding tax on dividends paid to foreign persons. Historically, the rate was often in the range of 25% to 30% when treaty relief was not available and reduced to as little as 5% – in some instances nil – when a subsidiary paid a dividend to its parent corporation resident in a treaty jurisdiction. Other dividends are often subject to withholding tax of 15% under a treaty. Dividend withholding tax is eliminated entirely in the case of dividends paid from a subsidiary resident in the E.U. to a parent company that is also resident in the E.U., assuming that no abuse is viewed to be present in the corporate structure. If the U.S. does not have an income tax treaty in place with a particular foreign country, dividends paid by a subsidiary resident in that country may be reduced or eliminated if the dividend is paid to a holding company located in a favorable jurisdiction. A jurisdiction is favorable if the withholding tax paid on dividends received by the holding company and the withholding tax imposed on dividends paid by the holding company are low or nil and relatively little income tax is paid on the receipt of intercompany dividends or on gains from the disposition of shares of a subsidiary.

NET INVESTMENT INCOME TAX FOR NON-CORPORATE TAXPAYERS

For multinational groups held by fiscally transparent entities in the U.S., such as L.L.C.'s, the maximum rate of U.S. tax for non-corporate members, such as individuals and non-grantor trusts, is 20%. In addition, dividends or inclusions of income under Subpart F or the P.F.I.C. rules are subject to the U.S. "net investment income tax."[9] The tax is imposed at the rate of 3.8% on the net investment income, or if lower, the excess of the individual's modified adjusted gross income[10] over a threshold amount varying from $125,000 to $200,000, depending on the individual's filing status. Net investment income consists of certain passive income reduced by allocable deductions. Passive income includes gross income from dividends. It also includes passive income in the form of interest, annuities, royalties, rents and other gross income if the gross income is derived either from a trade or business in which the U.S. individual does not materially participate or from a trade or business of trading in financial instruments or commodities. Net investment income also includes net gain attributable to the disposition of property held in one of those two types of trade or business activities. Regulations address the application of the 3.8% tax in the case of U.S. individual shareholders in C.F.C.'s or Passive Foreign Investment Companies by providing that the tax may be imposed either at the time of the income inclusion or a subsequent time when cash is received.[11]

INTERCOMPANY DIVIDENDS RECEIVED DEDUCTIONS IN EUROPE

In the European context, many countries have tax laws that provide favorable income tax treatment for intercompany dividends paid across borders. Among these countries are Luxembourg, Denmark, Switzerland, England, Belgium, Spain, Cyprus, and the Netherlands. In Ireland, the tax rate is extremely low for trading profits of Irish corporations. Dividends received by Irish corporations out of earnings of foreign subsidiaries that arise from trading activities may be exempt from tax. The rules in place cause these jurisdictions to be popular locations for the formation of a holding company by a U.S.-based group. Often, however, these countries have other provisions that may be considered less favorable to a holding company. Capital tax imposed on the issuance of shares and stamp tax on the transfer of shares are examples of unfavorable provisions. Other countries that have certain favorable features include Austria, France, and Germany, although none is typically thought of as a holding company location.

CHALLENGES TO EMPTY HOLDING COMPANIES

Tax benefits claimed by holding companies in Europe are now regularly challenged by the tax authorities in the European countries where the paying companies are resident. The challenges are directed at the substance of the holding company. Questions frequently asked include whether the holding company has payroll costs, occupancy costs, and local management that is involved in day-to-day decision making. In some instances, the capital structure of the holding company is queried.

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9 Code §1411.

10 Modified adjusted gross income is the individual's adjusted gross income increased (if applicable) by the excess of the individual's foreign earned income over the deductions, exclusions or credits, including foreign tax credits, allocable to the foreign earned income and not allowed as a deduction in calculating adjusted gross income. Code §1411(d).

11 Treas. Reg. §1.1411-10.

For a U.S.-based group that has little tolerance to tax risk, these challenges suggest that it is prudent for a holding company to have more than tax residence in a particular country – it should conduct group functions in that country and be ready to provide evidence of the activities performed.

These challenges within Europe should be compared with the approach to substance that is found in the limitation on benefits articles of U.S. income tax treaties. Objective standards are often provided under which substance is judged. In addition, active business activities of a group member can be attributed to related parties. In particular, the active trade or business provision of most limitation on benefits articles allows intermediary holding companies to be viewed as active participants in a business if they own at least 50% of a subsidiary or a partnership that has active business operations. These provisions eliminate intra-European challenges of tax authorities and may incentivize direct investment.

O.E.C.D. B.E.P.S. REPORT

Substance is also a key concern in the report on base erosion and profit shifting ("B.E.P.S.") published by the Organization for Economic Cooperation and Development ("the O.E.C.D.").[12] The report was commissioned by the G20. It concludes that data in several studies indicate an increased disparity between (a) the location of actual business activities and investment, and (b) the jurisdiction where the resulting profits are reported for tax purposes.

The report sets out how current cross-border taxation rules may create B.E.P.S. opportunities thereby resulting in a reduction of the share of profits associated with substantive operations. It also emphasizes on how changes in global business practices are ahead of current international tax standards, with a special focus on intangibles and the digital economy. The report identifies (i) a need for increased transparency on the effective tax rates of multinational enterprises and (ii) the existence of key pressure areas as far as B.E.P.S. is concerned. They include (i) international mismatches in entity and instrument characterization, (ii) application of treaty concepts to profits derived from the delivery of digital goods and services, (iii) the tax treatment of related party debt-financing, (iv) captive insurance and other intra-group financial transactions, (v) certain aspects of generally recognized transfer pricing rules, (v) the effectiveness of anti-avoidance measures, and (vi) the availability of harmful preferential regimes.

The report concludes that a set of comprehensive, global, internationally coordinated action plans should be developed and adopted by O.E.C.D. member countries and G-20 non-member countries to effectively address the identified problem areas. The O.E.C.D. governments are particularly committed to the development of proposals to implement this action plan. Many U.S–.based

[12] "Addressing Base Erosion and Profit Shifting," Organization for Economic Cooperation and Development, February 12, 2013.

multinational groups fear that the proposals will overturn arm's length principles that have been recognized internationally for many years.[13]

While the B.E.P.S. report has no legal authority, it indicates how the issue could be addressed in examinations by tax authorities in Europe and in legislation already in the pipeline in several countries. Consequently, the B.E.P.S. report must be considered before setting up a foreign holding company, with particular attention being given to the three tax planning structures identified in the report.[14] To illustrate, in a press release dated June 20, 2014, regarding a meeting of the Council of Economic and Finance Ministers ("E.C.O.F.I.N."), an agreement was announced in the parent-subsidiary directive designed to eliminate the exemption enjoyed by parent companies for dividends paid by subsidiaries when the subsidiary claims a deduction for the payment.

The B.E.P.S. report reflects a view that is now generally accepted by tax authorities on a global basis. Taxation should not be viewed as an expense. Rather, it reflects a partnership profit sharing arrangement between governments and businesses. When schemes with no substance are followed to deprive the governments of their "profit share," businesses may conclude that proper tax planning practices have been followed for the benefit of their investors, while governments may conclude that they are the victims of theft.

The formation of a holding company can be an attractive strategy to a U.S.-based group of companies; however, there are many considerations to consider, including B.E.P.S., the foreign tax credit limitation, as well as the rules on inversion transactions. For each jurisdiction, it is important that the tax treatment of holding companies is carefully examined and planned in order to gain the maximum benefit of the structure.

13 Declaration on Base Erosion and Profit Shifting, Meeting of the OECD Council at Ministerial Level, Paris, May 29-30, 2013.

14 "Addressing Base Erosion and Profit Shifting," Annex C – Examples of MNE's tax planning structures, Organization for Economic Cooperation and Development, February 12, 2013.

FIRST CIRCUIT HOLDS CORPORATION'S POSSESSIONS TAX CREDIT WAS NOT REDUCED

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Tags
Foreign tax credit
Corporate tax

Recently, the First Circuit held that Code §936 does not require a credit cap decrease for the U.S. seller of business lines in Puerto Rico if the buyer is a foreign entity that does not pay U.S. corporate income tax. In *OMJ Pharmaceuticals, Inc. v. U.S.,*[15] a U.S. corporation based in Puerto Rico transferred a significant portion of its assets to an Irish subsidiary; the corporation was not required to decrease its base period income for the purposes of computing the cap on its Section 936 possessions tax credit. As a result, the corporation's credit was not capped at the lower amount that was asserted by the I.R.S., thus allowing the corporate taxpayer a refund of close to $53 million.

From 1976 to 1996, Code §936 provided to U.S. corporations a credit that fully offset the federal tax owed on income earned in the operation of any trade or business in Puerto Rico. Under the Small Business Job Protection Act of 1996 (P.L. 104-188), the credit was repealed and phased out over a ten-year period. During this transition period, the credit remained available only to those taxpayers who had claimed it in previous years. Furthermore, during the last eight years of the transition period the taxable income that an eligible taxpayer could take into account in computing its credit was capped at an amount roughly equal to the average of the amounts it had claimed in previous years. Although the cap was generally fixed, it could be adjusted up and down to account for the taxpayer's purchases and sales of lines of business that had generated credit-eligible income.

Code §936 provides that rules for computing research credits when there are acquisitions or dispositions similar to those in subparagraphs (A) and (B) of Code §41(f)(3) apply here. More specifically, Code §41(f)(3)(A) requires an increase in the amount of qualified research expenses and gross receipts (*i.e.,* a cap increase) when a taxpayer acquires a major portion of a trade or business, and Code §41(f)(3)(B) requires a cap decrease when assets are disposed of in a transaction to which subparagraph (A) applies. Therefore, if, for example, one U.S. corporation sold to a second U.S. corporation assets that accounted for an average of $1 million in prior year credit claims, then the credit cap for the purchasing corporation would increase by $1 million and the credit cap for the selling corporation would decrease by the same amount (*i.e.*, $1 million).

[15] (CA 1 2014) 113 AFTR 2d ¶ 2014-892.

OMJ Pharmaceuticals, Inc. ("OMJ") was a subsidiary of Johnson & Johnson with its principal place of business in Puerto Rico. From 1993 to 2000, OMJ elected to be treated as a possessions corporation under Code §936, and from 1993 until 1998, it reported and claimed Section 936 credits for its manufacturing operations in Puerto Rico.

In 1998, OMJ transferred some of its assets in certain entities to a wholly-owned subsidiary, OMJ Ireland. The transaction consisted of two steps: first, OMJ transferred some of its assets in each entity to a newly formed L.L.C. (collectively, "the L.L.C.'s") in exchange for a membership interest; second, it transferred its interests in the L.L.C.'s to OMJ Ireland in exchange for common stock. After the transfers, OMJ still retained a small portion of its assets and continued to manufacture products in Puerto Rico and claim Section 936 credits. Each L.L.C. acquired a plant in Puerto Rico, and OMJ charged the L.L.C.'s for the wages it paid at the plants and for the federal employment taxes it paid.

OMJ argued that when a buyer is not subject to U.S. corporate income tax and therefore has no credit cap to increase or even establish, the Code §41(f)(3)(A) rule is inapplicable. OMJ emphasized the inclusion of the phrase, "in a transaction to which subparagraph (A) applies," in the text of subparagraph (B). The company reasoned that the seller cap decrease under §41(f)(3)(B) is triggered only if there is a buyer increase under §41(f)(3)(A). Thus, a cap reduction was dependent on the acquiring corporation's ability to claim an increase in its own cap.

The I.R.S. argued that regardless of whether the purchase of a line of business could increase or establish a credit cap, a seller was required to reduce its own cap by the amount associated with the line of business.

The district court, granting summary judgment for the I.R.S., concluded that OMJ had to decrease its base period income for purposes of computing the cap on its Section 936 possessions tax credit. However, the First Circuit reversed the ruling and adopted a "straightforward" reading of Code §41(f)(3). The opinion noted that if the government's interpretation of the statute was accepted, a seller-side adjustment would be required any time there was a sale of a trade or business, which would render subparagraph (B)'s cross-reference to subparagraph (A) mere surplusage. Furthermore, the Court determined that its reading of Code §41(f)(3)(A) was supported by unambiguous textual indications elsewhere in Code §41(f)(3).

Looking at the purpose of the statute, it was clear to the Court that Congress's focus in implementing Code §936(j)(5)(D) was the Puerto Rican economy. In terminating the possessions tax regime, Congress intended to provide a transition period during which pre-existing credits for existing lines of business would generally remain viable, neither increasing nor decreasing. Code §936 furthered this goal by ensuring that any increases in caps on the buyer's side would be offset by decreases on the seller's side, leaving the balance of caps in Puerto Rico as mostly unaffected as a whole. To have required a decrease in the caps with no corresponding increase would thwart Congress's objective and marginally decrease the size of the transitional cushion.

Therefore, upon analyzing the Code section, the Court rationalized that the language, structure, purpose, and history of the rules point to the conclusion that a reduction in a seller's cap as a result of the sale of a business line is appropriate only in the event of a corresponding increase in the buyer's cap. As there was no claim here that the transaction increased or could have increased any credit cap attributed to OMJ Ireland or its subsidiaries, since it was not a U.S. taxpayer, the transfers did not reduce OMJ's credit cap.

CORPORATE MATTERS:
PROFESSIONAL LIMITED LIABILITY COMPANIES AND PROFESSIONAL CORPORATIONS

Author
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Tags
Corporate
Incorporation
Entity Formation

In our March issue we discussed incorporation basics and entity selection. We focused on limited liability companies and corporations, as they are the most common entities used. We thought it might be helpful to follow up on that article with a brief discussion on professional limited liability companies and professional corporations.

PROFESSIONAL LIABILITY COMPANY

A professional limited liability company ("P.L.L.C.") is organized for the sole purpose of providing professional services by licensed professionals. Generally, states don't allow L.L.C.'s for businesses where a license is required. Licensed professionals who want the benefits of an L.L.C. must form a P.L.L.C. instead. A P.L.L.C. must be organized solely for the purpose of engaging in either a single licensed profession, or in two or more that can be lawfully practiced together. The name of the business must include the words "professional limited liability company," or the abbreviation "P.L.L.C." Generally, any person who is licensed to practice in a state under a designated profession may organize a P.L.L.C. A professional is a person licensed in a field such as health, law, engineering, architecture, accounting, actuarial science, or another similar field. However, licensing requirements may vary state by state. Therefore, one must thoroughly review the applicable statute for the state in which the P.L.L.C. will conduct business.

A professional or group of professionals considering incorporation would consider a P.L.L.C. for the favorable pass-through tax treatment and limited liability – a member of a P.L.L.C. is not liable for acts of another member or the entity's debts. Note, however, that members remain personally liable for their own professional misconduct or malpractice. So, even if you practice a profession through a P.L.L.C., it is a good idea to carry malpractice insurance.

PROFESSIONAL CORPORATION

A professional corporation is a corporation organized by individuals who offer professional services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts and consulting.[16]

The shareholders in a professional corporation must be licensed professionals who are employed by the corporation. The abbreviation "P.C." must appear after the name of the corporation and the professional corporation must state explicitly in its articles of incorporation that its sole business purpose is to render professional services. A professional service is one that is rendered by a person who is considered a professional and has been issued a license to perform that service.

A professional corporation is taxed like a C-corporation by default and, therefore, is subject to a corporate level of income tax. In addition, shareholders may be subject to a second tax when earnings and profits of the corporation are distributed as dividends. A tax advantage of practicing in a professional corporation is the ability of the corporation to provide certain fringe benefits tax-free to its employees or shareholders. Some of the tax-free benefits include accident, health and life insurance.[17] In addition, the professional corporation may deduct for ordinary and necessary business expenses that occurred during the tax year.[18] The professional corporation can use these advantages to minimize double taxation by paying shareholders a salary or fringe benefits instead of accumulating profits and then distributing dividends, effectively reducing its net income to potentially insignificant amounts. Alternatively, professional corporations may have the option of electing to become an S-corporation, an entity subject to certain limitations but with pass-through benefits, applicable in the same way as they would be for a P.L.L.C., eliminating the double taxation issue entirely. Shares in a professional corporation can only be transferred to a person who is a licensed professional, and a professional corporation must be dissolved when there are no longer any shareholders who are licensed professionals.

The decision whether to form a P.L.L.C. or a P.C. involves the same considerations as choosing between an L.L.C. and a C-corporation. Do you want a pass-through entity or one that is subject to tax at the entity level?

[16] Code §448(d)(2).
[17] Code §§79, 105, 106, 132(f).
[18] Code §162(a).

Author
Philip Hirschfeld

Tags
F.A.T.C.A.

INSTRUCTIONS TO KEY F.A.T.C.A. TAX FORMS RELEASED

On June 19, Instructions for the Form W-8IMY, Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding and Reporting, were released. The instructions provide useful guidance because they allow entities to attach alternative certifications based on an Inter-Governmental Agreement ("I.G.A.") or the regulations instead of checking a box on the form.

On June 24, the Internal Revenue Service ("I.R.S.") released final instructions on Form 8966, F.A.T.C.A. Report. The instructions provide that taxpayers must file Form 8966 for the 2014 calendar year on or before March 31, 2015. They will get an automatic 90-day extension for calendar year 2014 without the need to file any form or take any action.

On June 26, the I.R.S. released instructions for Forms W-8BEN-E, Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities). Foreign entities must present Form W-8BEN-E to their withholding agents, who must then determine whether, when and how much to withhold. The form covers requirements under both Chapter 3, which deals with more broad-based withholding, and Chapter 4, which covers F.A.TC.A.

On June 27, the I.R.S. released instructions for Form 1042-S. The Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, is the form withholding agents will use to report any U.S. source payments or withholding under F.A.T.C.A. and traditional withholding under Chapter 3 of the Internal Revenue Code. The form has been updated to accommodate reporting of payments and amounts withheld under the provisions of F.A.T.C.A.

PUTIN SIGNS BILL TO ALLOW DIRECT F.A.T.C.A. REPORTING BY RUSSIAN BANKS

On June 30, Russian President Vladimir Putin signed legislation to allow Russian banks to report information on U.S.-owned accounts directly to the U.S. under F.A.T.C.A. The action follows a breakdown of negotiations between Russia and the U.S. on adoption of an I.G.A.

F.F.I. REGISTERED LIST

By July 1, approximately 80,000 F.F.I.'s have registered to share information on their U.S. account holders under F.A.T.C.A., according to an updated list issued by the I.R.S.

QUALIFIED INTERMEDIARY AGREEMENTS

The I.R.S. released Revenue Procedure 2014-39, providing a long-awaited updated qualified intermediary agreement ("Q.I. Agreement"), which now incorporates F.A.T.C.A. The revenue procedure also provides further guidance for Q.I. registration and renewal under F.A.T.C.A. The revenue procedure provides instructions for entering into the Q.I. Agreement with the I.R.S. under Treasury Regulations §1.1441-1(e)(5). The revised Q.I. Agreement clarifies that a non-financial foreign corporation or intermediary is eligible to enter into the Q.I. Agreement and describes the specific requirements for such an entity to the extent they differ from the requirements applicable to a Q.I. that is an F.F.I.

ADDENDUM TO F.A.T.C.A. ONLINE REGISTRATION USERS GUIDE

The I.R.S. has released an addendum to the F.A.T.C.A. online registration user guide for financial institutions registering online as a participating foreign financial institution, a registered deemed-compliant foreign financial institution, a limited foreign financial institution, or a sponsoring entity.

SIGNIFICANT I.G.A. COUNTRIES WERE ADDED

More than 90 intergovernmental agreements ("I.G.A.'s") were in effect on July 1, the launch date for F.A.T.C.A., according to the latest data from the Treasury Department.

China, Saudi Arabia, Israel and the British Virgin Islands are all among the most significant recent additions to the list.

The Italian Ministry of Finance has prepared a ministerial decree required for F.A.T.C.A. and the agreement should be ratified by parliament in the coming weeks. Liechtenstein has released draft legislation to implement its agreement with the U.S. for F.A.T.C.A.

At this time, the countries that are Model I partners by execution of an agreement or concluding an agreement in principle are:

Algeria	Denmark	Jersey	Portugal
Anguilla	Dominica	Kosovo	Qatar
Antigua & Barbuda	Dominican Republic	Kuwait	Slovenia
Australia	Estonia	Latvia	South Africa
Azerbaijan	Finland	Liechtenstein	South Korea

Bahamas
Barbados
Bahrain
Belarus
Belgium
Brazil
British Virgin Is.
Bulgaria
Cabo Verde
Canada
Cayman Islands
China
Colombia
Costa Rica
Croatia
Curacao
Czech Republic
Cyprus
France
Greenland
Grenada
Georgia
Germany
Gibraltar
Guernsey
Guyana
Haiti
Hungary
Honduras
India
Indonesia
Ireland
Isle of Man
Israel
Italy
Jamaica
Lithuania
Luxembourg
Malaysia
Malta
Mauritius
Mexico
Montenegro
The Netherlands
New Zealand
Norway
Panama
Peru
Poland
Saudi Arabia
Serbia
Seychelles
Singapore
Slovak Republic
Spain
St. Kitts & Nevis
St. Lucia
St. Vincent & the Grenadines
Sweden
Romania and Thailand
The U.K.
Turkey
Turkmenistan
Turks & Caicos
United Arab Emirates
Ukraine
Uzbekistan

The countries that are Model II partners are: Armenia, Austria, Bermuda, Chile, Hong Kong, Iraq, Japan, Moldova, Nicaragua, Paraguay, San Marino, Switzerland, and Taiwan.

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Tags
International Tax
O.V.D.P.

THINK TWICE BEFORE EVADING TAXES (PART II) FOLLOW UP TO CREDIT SUISSE GUILTY PLEA

As we noted last month, Credit Suisse AG pleaded guilty to conspiracy to aid and assist U.S. taxpayers with filing false income tax returns and other documents with the I.R.S. Following Credit Suisse's guilty plea to helping American clients evade taxes, New York State's financial regulator is said to have picked Mr. Neil Barofsky as the corporate monitor for Credit Suisse Group AG. Monitors are chosen to act as the government's post-settlement proxy, shining a light on the inner workings of corporations and suggesting steps to bolster compliance procedures.

Credit Suisse agreed to two years of oversight by New York's financial regulator as part of its $2.6 billion resolution with the U.S. Credit Suisse's settlement is the first guilty plea by a global bank in more than a decade, and the penalty agreed to is the largest penalty in an offshore tax case.

For most banks, the appointment of Mr. Barofsky could be hard to swallow. Mr. Barofsky is a frequent critic of Wall Street and government bailouts, and used to serve as the Inspector General of the Troubled Assets Relief Program. Barofsky has criticized federal prosecutors for being too lenient on Wall Street and bankers whose actions fueled the 2008 financial crisis. After Credit Suisse's settlement, Barofsky was cited saying that "the Justice Department wants to be perceived as tough as nails while avoiding the collapse of a too-big-to-fail institution and other consequences." He also said that "if there are very few collateral consequences, and the criminal plea is perceived as just another cost of doing business, then the deterrent effect will be minimal." While we take Mr. Barofsky's point, we hope that criminal fines do not become generally accepted as ordinary and necessary costs of international business, banking or otherwise.

E.U. FINANCE MINISTERS MEETING SET "TAX AVOIDANCE" AND OTHER "ANTI-COMPETITION" MEASURES IN MOTION

The June 20, 2014 meeting of the E.U. Finance Ministers dealt with key issues of importance as identified by the Finance Ministers in the areas of tax loopholes and the code of contact on business taxation.

E.U. Revamp Parent – Subsidiary Provision

There was unanimous agreement to revise by legislation the E.U.'s Parent-Subsidiary directive to eliminate a double non-taxation issue. The double non-taxation at issue results from the use of hybrid instruments in conjunction with the

Parent-Subsidiary participation. Interest deductions in the country which recognizes the instrument as a debt instrument coupled with an exemption from tax under the Parent-Subsidiary Directive on the amount paid considered a dividend in the other country had resulted in billions of euros in lost tax revenue according to the Ministers.

Accordingly, to get an agreement on the E.U. legislation, a proposal was made to establish a new anti-abuse provision in the law which will address hybrid loan agreements. All E.U.-level tax laws require unanimous support from all member states. While at a previous European Council of Economic and Financial Affairs meeting in May 2014 Malta and Sweden blocked this legislation effort, the two countries lifted their objections and made this legislation possible. Malta was the last of the E.U. countries to agree with the legislation and did so in response to significant criticism by Member States of aspects of the Maltese tax law which are felt to foster tax avoidance through use of Maltese based structures.

In a statement released after the ministers' meeting, the European Taxation Commissioner Algirdas Šemeta said, "With these revisions, the Parent-Subsidiary directive will remain an important tool in creating a business-friendly environment in the E.U. without giving unintended opportunities to tax evaders."

This legislation is expected to be devised during Italy's rotating E.U. presidency, which started on July 1, 2014.

"A measure was also approved for the European Commission to begin an overall illegal state aid investigation into the use of 'patent box' tax schemes that a host of E.U. member states have introduced to attract high-tech companies."

E.U. Begins Probe of "Patent Box" Tax Schemes

A measure was also approved for the European Commission to begin an overall illegal state aid investigation into the use of "patent box" tax schemes that a host of E.U. member states have introduced to attract high-tech companies.

In the U.K., as an example, the patent box enables companies to apply a lower rate of tax (10%) to profits earned after April 1, 2013 from patented inventions, provided the patent was granted at a participating I.P. office such as the European Patent Office and the U.K. Intellectual Property Office. Last year, German Finance Minister Wolfgang Schaeuble complained that such schemes resulted in unfair competition. And the scheme has indeed attracted domestic investment and foreign investment, too. Pfizer Inc., a U.S.-based drug maker cited tax advantages as one of the attractions of its (failed) takeover approach to AstraZeneca PLC in May 2014.

Now, the move to have the European Commission start an overall investigation into patent box schemes begins. "Member states' tax incentives should never be used to lure profits away from where they should rightfully be taxed," European Taxation Commissioner Algirdas Šemeta said. He further said that the E.U. will begin assessment immediately and is hopeful that a full evaluation will be delivered by the end of this year.

Switzerland Agrees on Code of Conduct

The Ministers also formally closed the two year dialog with Switzerland with Switzerland agreeing to abide by rules outlined in the E.U. Code of Conduct against unfair corporate taxation.

The E.U. Code of Conduct was adopted initially in the late 1990s and has been an important tool designed to force E.U. member states to phase out more than 90 different tax schemes originally targeted in the E.U. member states.

In a June 20, 2014 statement issued by the European Commission, Šemeta said, "Switzerland has agreed to remove a number of harmful tax regimes that were of concern to member states. Our efforts to secure fair tax competition are bearing fruit, even beyond E.U. borders." According to Swiss reports, those "harmful" regimes will likely include the cantonal tax regimes, which the European Commission said in 2007 were seen to be distorting competition in Europe due to the differing treatment of domestic and foreign income.

These actions announced by the Ministers come shortly after the European Competition Commissioner Joaquin Almunia launched a formal investigation into the tax practices used by Apple Inc. in Ireland, Starbucks Corp. in the Netherlands, and Fiat Finance Trade Ltd. in Luxembourg.

Referencing B.E.P.S., the Ministers stated these actions were a major step forward in the fight against base erosion and profit shifting. In the statement issued by the European Commission following the June 20, 2014 ministers' meeting, Šemeta said, "We must verify that the principles of fair play are not being undermined."

If in fact this is the case remains to be seen, but on their face, the latest developments are focusing on tax avoidance in Europe in the wake of the region's financial crisis.

LUXEMBOURG RULING POSTURE ILLUSTRATES EFFECT OF EU COMMISSION SCRUTINY

As previously announced, the E.U. Commission is looking at the compliance with E.U. state aid rules of certain tax practices in some Member States in the context of aggressive tax planning, with a view to ensure a level playing field in a constrained economy. As part of this, the Commission announced an in-depth investigation involving, among others, Luxembourg. Under this authority, the Commission is examining whether decisions made by the Luxembourgish tax authorities comply with the E.U. rules on state aid. The Commission is focusing on the favorable ruling issued by the Luxembourg authorities for Fiat Finance and Trade.

The issue centers around Article 107(1) of the Treaty on the Functioning of the European Union, state aid. This Article addresses trade between Member States with a view towards prohibition of a Member State's distortion of competition by favoring certain undertakings. This is considered in principle incompatible with the E.U. Single Market and when tax rulings provide selective advantages to a specific company or group of companies, this may amount to state aid within the meaning of E.U. rules.

One area in which tax rulings are commonly used is confirming transfer pricing arrangements. Transfer pricing refers to the prices charged for commercial transactions between related parties, in particular prices set for goods sold or services provided. Transfer pricing influences the allocation of taxable profit between related parties located in different countries. If the tax authorities accept the calculation of the taxable basis proposed by a company, and this calculation is not based on remuneration on market terms, it could imply a more favorable treatment of the company compared to the treatment other taxpayers would receive under the Member States' tax rules.

We are now seeing this play out. A company that applied for a ruling in Luxembourg to confirm its transfer pricing agreement with respect to goodwill transferred from U.S.-Co to LuxCo received a rejection from the Luxembourg tax authorities. The ruling request was supported by a valuation study which defined fair market value as the estimated amount for which an asset could be exchanged between knowledgeable and willing parties in an arm's length transaction. Nevertheless, the tax inspector refused to rule arguing that the transfer pricing report failed to meet increased standards of analysis with respect to the recognition and valuation of the goodwill. We believe this is indicative of future Luxembourg rulings in the transfer pricing area and perhaps other tax ruling areas as well.

THINK TWICE BEFORE EVADING TAXES (PART III) CHANGES TO GERMANY'S VOLUNTARY SELF-DISCLOSURE PROGRAM

"As a result of ongoing media coverage of prominent tax evaders in Germany, stricter requirements have been agreed to with respect to the German voluntary self-disclosure program."

As a result of ongoing media coverage of prominent tax evaders in Germany, stricter requirements have been agreed to with respect to the German voluntary self-disclosure program. Under the current system, a taxpayer is able to avoid criminal prosecution by giving a full, complete, and accurate account of all avoided taxes along with payment of interest at a rate of 6% per annum on the back taxes owed. If taxes owed are in excess of €50,000, an additional penalty of 5% of the tax owed

Under the current system, the period for disclosure corresponds to the statute of limitation for which criminal prosecution is not statute-barred, five years for "minor" (€50,000 or less for each taxable year) and ten years for the more serious situations. The amounts must be paid within the deadline set by the revenue authority's agent.

Effective January 1, 2015, the period for disclosure will correspond with the ten year statute of limitations in all cases involving tax evasion. Back taxes, along with the 6% interest per year shall be due immediately, as will an additional penalty based on the amount of total taxes due. If the taxpayer owes more than €25,000 but less than €100,000, the rate of interest will be increased to 10%, 15% if less than €1 million and 20% if over €1 million.

Note that German rules provide that voluntary self-disclosure does not hinder criminal prosecution if, (i) the delinquent taxpayer or his representative has already been notified of the initiation of a tax audit or of criminal or misdemeanor proceedings, (ii) an the taxpayer is visited for the purpose of a tax audit or criminal investigations, or (iii) the taxpayer is or should be aware the offence has already been detected by the revenue authority.

RECENT I.R.S. ADMINISTRATIVE PERSONNEL RESIGNATIONS RAISE ISSUES OF AGENCY'S DIRECTION IN THE INTERNATIONAL TAX AREA

"Four of the I.R.S.'s highest international officials in the Large Business and International Division along with the top domestic official have recently announced their leaving the L.B. & I."

Four of the I.R.S.'s highest international officials in the Large Business and International Division along with the top domestic official have recently announced their leaving the L.B. & I.

Michael Danilack, deputy commissioner (international) and U.S. competent authority; Samuel M. Maruca, the first director of transfer pricing operations; Diana Wollman, the first director of international strategy; and Richard McAlonan, director of the Advance Pricing and Mutual Agreement (APMA) program along with Laura Prendergast, the acting deputy commissioner (domestic) have or will be leaving L.B.& I.

Any interrelationship in the departure of these individuals is not clear, however, the rumor mill is active, from a pending reorganization of L.B.&I. to fundamental disagreements with how the international BEPS initiative could affect basic tenets of international tax law as defined by Treasury and the I.R.S.

On the reorganization front, it is believed that the I.R.S. has discussed removing the international examiners from the authority of the deputy commissioner (International) and returning them to the domestic side of examinations.

One plan would be to move the international examiners back to an industry-oriented structure and convert them into general agents—a move that would reverse many aspects of the restructuring undertaken in 2010. The other alternative is to leverage the expertise of the international examiners by training domestic agents to take on some of the international workload.

As far as B.E.P.S. is concerned, recent comments by senior L.B.&I. personnel as well as Treasury officials have hinted at issues faced by the U.S. to align key B.E.P.S. action plan initiatives with internal U.S. international tax law, particularly in the transfer pricing area.

Whatever the case, the changes come at a time when the agency's international workload is immense, with F.A.T.C.A. coming online July 1 and a recent expansion of the O.V.D.P. that is intended to allow more people to qualify for streamlined procedures. And then there is the future of the transfer pricing program, which was instituted with great fanfare in 2010.

We anticipate at least a short term effect on international tax administration, both U.S.-centric and with respect to U.S. participation in and input to the B.E.P.S. process even as that process moves to its September agenda.

CANADIAN COURT DECISION AFFIRMS CRA TRANSFER PRICING ADJUSTMENT DISALLOWING MANAGEMENT FEES PAID

Document, document, document is the advice we give clients with respect to intercompany management or other service agreements. It seems the court in Canada agrees with our position in this regard. In *Marzen Artistic Aluminum Ltd. v. The Queen*, Can. Tax Ct., No. 2010-860(IT)G, 6/10/14) the Tax Court of Canada sustained nearly all of C.R.A.'s C$7.1 Million transfer pricing adjustment. The Court concluded that Marzen Artistic, the largest window manufacturer in British Columbia, was unable to prove that it received services of substantial value under a marketing and sales services agreement ("M.S.S.A.") executed in July 1999 with its wholly owned Barbados subsidiary, Starline International Inc.

The arrangement in and of itself, Canada parent/Barbados subsidiary, is subject to close scrutiny in Canada. Knowing this, Marzen should have held itself to a high standard of documentation and perhaps attempted to do so.

With respect to documentation, the Court upheld the C.R.A.'s application of transfer pricing penalties on the basis that Marzen failed to supply adequate records or documentation in response to the tax agency's request. Marzen failed to respond to a written request for documentation issued by C.R.A. in April 2003. Marzen thus failed to provide details of the data and methods it used to determine its transfer prices or allocations of profits or losses or contributions to costs of the transactions (think contemporaneous documentation under U.S. tax transfer pricing rules). The C.R.A. said the taxpayer also failed to provide any assumptions, strategies and policies that influenced its determination of transfer prices. In fact, Marzen's only discussion of the penalties issue was in oral argument, where its counsel said the taxpayer's response to the C.R.A.'s request included a statement indicating it was willing to respond to further requests to elaborate on the provided material.

On that basis, Marzen failed to meet the requirements of Section 247(4)(a) of Canada's Income Tax Act in providing adequate records or documentation, the Court said. "The appellant is deemed not to have made reasonable efforts to determine and use arm's length transfer prices and is liable to a penalty in respect of the 2001 taxation year."

Section 247(3) of the Act provides for a penalty of 10 percent of the amount by which the transfer price adjustment exceeds the lesser of the taxpayer's gross revenues for the year, or C$5 million ($4.6 million). Marzen is currently considering whether to appeal the Court's judgment.

In our view, forewarned is forearmed. Document, document, document.

I.R.S INTENDS TO FOLLOW ITS TRANSFER PRICING AUDIT ROADMAP. TAXPAYERS SHOULD PREPARE ACCORDINGLY

As we anticipated in an earlier edition of our Newsletter, the I.R.S. intends to closely follow its February 14, 2014 released “Transfer Pricing Audit Roadmap” with respect to documentation it expects during the course of a transfer pricing audit. This was confirmed by I.R.S. representatives in a recent webinar on transfer pricing documentation.

The Roadmap refers to two key orientation meetings, one on a company's financials and the other on its transfer pricing. The purpose of these meetings is to identify issues that might be consolidated which would otherwise be the subject of separate, information document requests requiring significantly more time and effort from both the taxpayer and I.R.S.

The financial orientation involves a review of the company's legal entity organizational charts and functional organizational charts as well as a review of financial statements, accounting practices, cost and profit centers and an explanation of book and tax differences, among other information.

The transfer pricing orientation is meant to give the I.R.S. an understanding of the taxpayer's intercompany transactions, its value chains and contributions to the value of any intangible, as well as an understanding of how the company's transfer pricing documentation was prepared and the key players involved in structuring the transactions.

The meetings will have to strike a balance between the opportunity for taxpayers to “tell their story” and explain their transfer pricing priorities and the I.R.S. exam team’s desire to tell taxpayers where they want to focus attention. Conflicts of interest could arise where there are differences of opinion in areas that deserve attention.

The exam team’s intent is to develop a “working hypothesis” early in the process, and the I.R.S. position is that cannot happen without a full disclosure of the facts. Consequently, taxpayers should be prepared for the I.R.S. to conduct significant “due diligence” of their transfer pricing affairs including understanding the taxpayer business model, strategic business goals, profit drivers, etc.

FINAL RULES ON GAIN RECOGNITION AGREEMENTS COMING SOON

The I.R.S. has indicated final rules relaxing the standard to seek relief from penalties for non-compliance with Gain Recognition Agreements are imminent.

The proposed rules (REG-140649-11), issued in January 2013, impose a more lenient “not willful failure” standard rather than the “reasonable cause” standard for relief. While no details have been given regarding the exact content of the final rules, the proliferation of transactions requiring consideration of Gain Recognition Agreements has made any regulatory change in the area something to closely monitor.

THE DEATH OF CIRCULAR 230 DISCLAIMERS

The Internal Revenue Service ("I.R.S.") recently modified its Circular 230, which sets forth the regulations to practice before the I.R.S. A major change made was to eliminate the need for the I.R.S. Circular 230 disclaimer. Karen L. Hawkins, director of the I.R.S. Office of Professional Responsibility, told practitioners at a tax conference on June 20 at New York University School of Continuing and Professional Studies that "the disclaimer is no longer necessary." Tax practitioners will no longer need to add Circular 230 at the conclusion of emails or other writings when communicating with clients. The Treasury Department stated that many tax practitioners "insert the disclaimer without any regard to whether or not the communication is necessary or appropriate." Consequently, tax practitioners have been misusing the disclaimer. While the intent was justified, many doubt the disclaimer ever served its purpose or was used effectively. The Treasury Department stated that the removal of the requirement should be effective by June 12, 2014. Where does this leave practitioners? Practitioners must make reasonable, factual, and legal assumptions and cannot hide behind the veil of a disclaimer. Practitioners are required to put reasonable efforts into discerning the facts and completing their due diligence.

IN THE NEWS

CALL TO THE NON-PROFIT COMMITTEE

Nina Krauthamer has been appointed to serve a three year term on the NYC Bar Association's Non-Profit Organizations Committee, beginning September 2014. As a committee member, Ms. Krauthamer will have the opportunity to be involved in drafting reports, commenting and testifying on legislation, submitting briefs, sponsoring continuing legal education and other programs and participating in public service projects. Committee service is a wonderful opportunity to help shape law and public policy, network with colleagues, improve expertise and help the public and the profession.

AS SEEN IN…

Ken Lobo published an article entitled "U.S. Estate Planning All In The Details" that was published in the July 2014 issue of The Bottom Line, Canada's premier national news source for accounting and financial professionals.

OUR RECENT AND UPCOMING PRESENTATIONS

On June 5, 2014, Nina Krauthamer lectured on "International Estate Planning – The Basics." The workshop took place at New York Law School and addressed the fundamentals of estate tax planning for foreign persons, including withholding under the Foreign Investment in Real Property Tax Act ("F.I.R.P.T.A.").

On June 5, 2014, Stanley C. Ruchelman served as co-chair of the panel "Litigation Update" at the 7th Annual U.S. – Latin America Tax Planning Strategies conference in Miami, Florida. This panel discussed recent court decisions from Europe, Latin America, and the United States and the impact of those decisions on tax planning and compliance efforts.

On June 17, 2014, Armin Gray presented a teleseminar hosted by BKR International entitled "F.B.A.R. Update: What You Need to Know." BKR International is a leading global association of independent accounting and business advisory firms representing the expertise of more than 150 member firms with over 300 offices in over 70 countries around the world. The panel addressed recent events related to the F.B.A.R. form, including civil and monetary penalties.

On July 1, 2014, Nina Krauthamer participated in a Strafford Webinar, "Foreign Investment in U.S. Real Property: Tax Issues." She also presented a lecture on July 8, 2014, "Understanding Foreign Investment in U.S. Real Estate," as part of the two-day BNA Bloomberg seminar on *Current U.S. Tax Planning for Foreign-Controlled (Inbound) Companies.*

On July 25, 2014, Philip Hirschfeld will speak at New York University's *Advanced International Tax Institute*. The presentation, entitled "Foreign Persons Investing in U.S. Real Estate and Other Assets: Partnership and Other Structures, Treaty Planning and Financing Strategies," will focus on tax-efficient structuring for non-U.S. persons investing in U.S. income producing and personal use real estate. It will also address foreign investors looking to acquire U.S. mortgage debt and direct investment, as well as investment made in holding entities.

A copy of our presentations is 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.

Disclaimers

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*Photos used in this issue were taken by Joan Ruchelman