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INSIGHTS

ANTI-DEFERRAL REGIMES: U.S. TAXATION OF FOREIGN CORPORATIONS

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- **Administrative Attack on Inversions: Notice 2014-52.** Robert G. Rinninsland and Philip R. Hirschfeld continue our reporting on corporate inversions with regard to the I.R.S.'s recently issued Notice 2014-52.

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We hope you enjoy this issue.

-The Editors

ANTI-DEFERRAL REGIMES: U.S. TAXATION OF FOREIGN CORPORATIONS

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P.F.I.C.
Subpart F

When a U.S. business expands abroad, it is frequently believed that the income of foreign subsidiary corporations will not be taxed in the U.S. until dividends are distributed to the U.S. shareholder. This is known as tax deferral, which is the general expectation of clients. However, in the U.S., tax deferral may be overridden by provisions accelerating the imposition of U.S. tax on U.S. shareholders of foreign corporations. As a result, income may be taxed before a dividend is distributed. This article describes the anti-deferral provisions of U.S. tax law that may be applicable in certain situations.

ANTI-DEFERRAL REGIMES

The Internal Revenue Code contains two principal anti-deferral regimes that may impose tax on a U.S. taxpayer on a current basis when its foreign subsidiaries generate income. These provisions reflect a policy under which Congress believes the deferral rules are being abused to inappropriately defer U.S. tax, especially if foreign tax is not imposed for one reason or another. The two regimes are the:

- Controlled Foreign Corporation ("C.F.C.") regime under Code §§951-964, also known as the "Subpart F" provisions; and
- Passive Foreign Investment Company ("P.F.I.C.") regime under Code §§1291-1298.

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Controlled Foreign Corporations

Under Code §957(a), a foreign corporation is a C.F.C. if stock representing more than 50% of either the total combined voting power or the total value of shares is owned, directly, indirectly, or by attribution, by "U.S. Shareholders" on any day during the foreign corporation's taxable year. With respect to a foreign corporation, a U.S. Shareholder is defined as a "U.S. person" that owns, under the foregoing expanded ownership rules, stock representing 10% or more of the total voting power of all classes of the foreign corporation's stock that is entitled to vote.[1] A "U.S. person" includes a U.S. citizen or resident, a U.S. corporation, a U.S.

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[1] Treas. Reg. §1.951-1(g)(1).

partnership, a domestic trust, and a domestic estate.[2] Stock ownership includes indirect and constructive ownership under the rules of Code §958. Consequently, ownership can be attributed, *inter alia*, from foreign corporations to shareholders, from one family member to another, and from trusts and estates to beneficiaries, legatees, and heirs.

"If Subpart F is applicable, the U.S. person must pay tax even if no dividends are distributed. This is frequently described as phantom income."

Code §951 contains the basic rules for taxing a C.F.C.'s undistributed income to its U.S. Shareholders. Specifically, Code §951(a) provides that if a foreign corporation is a C.F.C. for an uninterrupted period of 30 days or more during any taxable year, every person who (i) is a U.S. Shareholder and (ii) owns, within the meaning of Code §958(a), stock in the C.F.C. on the last day of that year must include in gross income a *pro rata* share of certain classes of tainted income of the C.F.C. and certain investments made by the C.F.C. in "U.S. Property." The income is included in the taxable year of the U.S. Shareholder in which the C.F.C.'s taxable year ends.

For the anti-deferral rule to apply, the following must take place:

- The foreign corporation must be a C.F.C.;
- The shareholder must be a U.S. Shareholder; and
- The C.F.C. must derive certain types of income or must have invested its earnings in certain assets.

If Subpart F is applicable, the U.S. person must pay tax even if no dividends are distributed. This is frequently described as phantom income.

A C.F.C.'s Subpart F income consists of insurance income and foreign base company ("F.B.C.") income. For most C.F.C.'s and U.S. Shareholders, only F.B.C. income is relevant, and that income will be discussed further in this article.

F.B.C. income is the sum of four types of gross income:[3]

- Foreign Personal Holding Company ("F.P.H.C.") income,
- F.B.C. Sales Income,
- F.B.C. Services Income, and
- F.B.C. Oil Related Income, which is mentioned, but not discussed further.

F.P.H.C. income generally consists of a C.F.C.'s income in the form of:

- Dividends;
- Interest;

[2] Code §7701(a)(30).
[3] Code §954(a).

- Annuities;
- Rents;
- Royalties;
- Net gains from the disposition of property producing any of the foregoing types of income;
- Net gains from property producing no income, such as fallow land or collectibles, provided that the property is not used in a trade or business carried on by the C.F.C.;
- Net gains from commodities transactions;
- Net gains from foreign currency transactions;
- Income from notional principal contracts; and
- Amounts received under personal service contracts related to services performed by substantial shareholders identified in such contracts.[4]

An example of gain from the sale of non-income-producing property that is considered to be F.P.H.C. income would be the sale of a piece of machinery or office equipment used in a business. An example of C.F.C. personal service income would be income that arises from a contract of a lend-a-star company that requires a shareholder performer to appear at a performance or allows the customer to identify the person that must perform under the contract.

F.B.C. Sales Income is derived from transactions in goods in which a related person is either the buyer or seller.[5] Think of this as an incestuous transaction because the C.F.C. is dealing with a related party on either the buy side or the sale side of a transaction involving inventory. The income may be in the form of margin on purchases and sales or commissions derived by a sales or purchasing agent.

For income from the purchase or sale of personal property to trigger F.B.C. Sales Income, the following conditions must exist with regard to the property:

- It must not have been produced in the country in which the C.F.C. was incorporated; 6
- It must not be sold for use, consumption, or disposition in that country; and
- It must not be manufactured or produced by the C.F.C. unless the goods are produced in one country and sold through a branch in another country.[7]

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4 Code §954(c).
5 Code §954(d).
6 Treas. Regs. §1.954-3(a)(3)(i).
7 Treas. Regs. §1.954-3(b).

If the C.F.C. provides a substantial contribution to the manufacture of a product by a contract manufacturer in a third country, F.B.C. Sales Income will not exist provided that the services are of a kind described in income tax regulations and a branch of the C.F.C. is not created in the country where the contract manufacturer operates.[8]

F.B.C. Services Income means income (whether in the form of compensation, commissions, fees, or otherwise) that meets the following three conditions:

- The income is derived in connection with the performance by the C.F.C. of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services;
- The services are performed for, or on behalf of, a related person; and
- The services are performed outside of the C.F.C.'s country of incorporation.

The regulations identify four situations where services are considered performed for or on behalf of a related person:

"In Notice 2007-13, the I.R.S. announced that F.B.C. Services Income will exist only when a related U.S. person provides the substantial assistance."

- Where the C.F.C. receives compensation or benefit from a related person for performing the services;[9]
- Where the related person is or has been obligated to perform services that the C.F.C. performs;[10]
- Where a C.F.C. performs services with respect to property sold by a related person and the performance of such services constitutes a condition or a material term of such sale;[11] and
- Where a C.F.C. performs services on behalf of a related person if a related person provides "substantial assistance contributing to the performance of" the services.[12] In Notice 2007-13, the I.R.S. announced that F.B.C. Services Income will exist only when a related U.S. person provides the substantial assistance. Thus, substantial assistance by a foreign related party will not trigger F.B.C. Services Income for a C.F.C.

Substantial assistance consists of assistance furnished (directly or indirectly) by a related U.S. person to the C.F.C. if the assistance satisfies an objective cost test. The cost test will be satisfied if the cost to the C.F.C. of the services furnished by the related U.S. person equals or exceeds 80% of the total cost to the C.F.C. of

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8 Treas. Regs. §1.954-3(a)(4)(iv),

9 Treas. Regs. §1.954-4(b)(1)(i).

10 Treas. Regs. §1.954-4(b)(1)(ii). However, services are not performed on behalf of a related person merely because that person guarnatees the C.F.C.'s performance, if neither the grantor nor any other related person pays for those services or for "significant services relates to such services." Treas. Regs. §1.954-4(b)(2)(i).

11 Treas. Regs. 1.954-4(b)(1)(iii).

12 Treas. Regs. 1.954-4(b)(1)(iv).

performing these services. The term "cost" will be determined after taking into account adjustments, if any, made under Code §482.[13]

Passive Foreign Investment Companies ("P.F.I.C.")

In addition to the C.F.C. rules described above, a U.S. shareholder of a P.F.I.C. is taxed on excess distributions received from a P.F.I.C. and on direct or indirect gains derived from the sale, exchange, or other disposition of the shares of the P.F.I.C., plus an additional interest charge based on any deferred taxes to which the distribution relates. The effect of the interest charge is intended to eliminate the benefit of the deferral with respect to the P.F.I.C.'s earnings. Of course, actual deferral is not the same as deferral determined under the P.F.I.C. provisions -- the P.F.I.C. deferral rules assume that income is generated in equal amounts daily over the course of the holding period. That assumption may have no relation to reality, especially where a passive asset such as stock held for appreciation is sold and the proceeds are immediately distributed to the P.F.I.C.'s shareholders.

There are two alternative tests for determining whether a foreign corporation is a P.F.I.C.:

- The income test. Under the income test, a foreign corporation is a P.F.I.C. if 75% or more of its gross income is passive income of a kind that would be Foreign Personal Holding Company Income were Subpart F applicable.

- The asset test. Under the asset test, a foreign corporation is a P.F.I.C. if 50% or more of the average value of its assets (on a gross value basis) consists of assets that ordinarily produce passive income,[14]

When a foreign corporation meets either of these tests, its U.S. shareholders become subject to the P.F.I.C. provisions of the Code. Note that in comparison to the C.F.C. rules that require ownership of a certain percentage of C.F.C. shares, the P.F.I.C. rules contain no distinction with respect to the treatment of large and small shareholders. Provided that the P.F.I.C. is not a C.F.C., or if it is, provided that the shareholder is not a U.S. Shareholder, the P.F.I.C. rules apply no matter how small the percentage owned by a U.S. person.

It is relatively easy to expect that an investment fund formed outside the U.S. will be a P.F.I.C. However, the definition is extremely broad and will often cover a personal services firm formed outside the U.S. in which a U.S. individual is a minority member. Typically, cash balances on the asset measurement dates will exceed 50% of the total assets of the entity and cash is treated by the I.R.S. as a passive asset. Consulting firms and professional services firms rarely have significant amounts of hard assets on their balance sheets.

It should be noted that to the extent a foreign corporation is a C.F.C. and a P.F.I.C. it is not treated as a P.F.I.C. with regard to U.S. persons that are U.S. Shareholders in relation to the foreign entity. These are persons that own stock amounting to

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[13] Notice 2007-13.
[14] Code §1297(a).

10% or more of the voting power in the entity. The good news is that if a C.F.C does not have Subpart F income, the U.S. Shareholders do not need to be concerned with the P.F.I.C. rules. However, U.S. Persons owning less than 10% of the shares will be fully subject to the P.F.I.C. rules. Note that if the U.S. Shareholder is a U.S. domestic partnership, all partners benefit from the treatment of the entity as a C.F.C., even those having an indirect interest of less than 10% in the C.F.C./P.F.I.C.

At first glance, the P.F.I.C. rules do not appear to be an anti-deferral mechanism since the taxable event is not accelerated for the U.S. shareholder. Rather, a penalty tax regime applies at the time an "excess distribution" is received or the shares of the P.F.I.C. are sold or otherwise disposed of at a gain.[15] The excess distribution and the gain are each "thrown back" to every day of the holding period of the P.F.I.C. shares.[16] To the extent that the foreign corporation was a P.F.I.C. in the earlier throw-back year, the amount allocated to that year is taxed at the highest rate of tax imposed on ordinary income for that year, and that tax is deemed paid late. Consequently, late payment interest is imposed for each such year.[17] If the foreign corporation is not a P.F.I.C. in the throwback year, there is no interest charge, but the distribution or gain is taxed as ordinary income. The same rule applies to income or gain allocated to the current year.

The tax and interest imposed under the "throwback rules" may exceed the amount of the distribution. This treatment encourages a U.S. taxpayer to voluntarily forego deferral and to include the income as if the P.F.I.C. were tax transparent. This treatment is achieved by electing to treat the P.F.I.C. as a qualified electing fund ("Q.E.F.").[18] A shareholder making this election is required to include in income its *pro rata* share of the ordinary earnings and net capital gain of the P.F.I.C. when and as earned by the P.F.I.C. The income and gains retain their character, but deferral of tax is eliminated.

To make the election, the P.F.I.C. must agree to provide information to its U.S. investors on a timely basis so that U.S. tax can be computed.[19] Many foreign investment funds refuse to take on that obligation and consequently, a Q.E.F. election cannot be made. Where, however, the foreign fund is publicly traded, a U.S. investors\ may elect to include income on a marked-to-market basis, taking into income the increase in market value of the shares each year.[20] If this election is made, reductions in value may give rise to recognized losses until the original purchase price is reached. Losses that reduce basis below the original purchase price are disallowed.

15 Code §1291(b).
16 Code §1297(a)(1)(A).
17 Code §1297(c)(3).
18 Code §1295.
19 Treas. Regs. §1.1295-1(f).
20 Code §1296.

REPORTING REQUIREMENTS

The U.S. Shareholders of a C.F.C. and the U.S. investors in a P.F.I.C. are required to provide certain financial information in respect to such foreign corporations. This information is reported on I.R.S. Form 5471 for the shareholders of a C.F.C., and I.R.S. Form 8621 for the shareholders of a P.F.I.C. [21]

CONCLUSION

The U.S. anti-tax deferral regime aims to insure that income generated outside the U.S. by a foreign corporation may become subject to U.S. tax in the hands of its U.S. Shareholders if the entity in question has the status of a C.F.C. and the income of the C.F.C. is categorized as Subpart F income. Similar treatment is provided for investors in a P.F.I.C. that makes a Q.E.F. election to avoid the penalty taxes imposed under the P.F.I.C. provisions of the law. In both instances tax may be due prior to the time that cash dividends are actually distributed.

[21] Code §§1298(f), 964(c)(1), Treas. Regs. §1.964-3.

ADMINISTRATIVE ATTACK ON INVERSIONS: NOTICE 2014-52

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INTRODUCTION

As we have reported previously,[22] corporate inversions have attracted much attention from Congress, the press, and the Obama Administration. From an administrative perspective, the I.R.S. recently issued Notice 2014-52 (the "Notice"). The Notice is intended to eliminate planning techniques used by practitioners to avoid the Code §7874 inversion rules as well as the related Code §956 controlled foreign corporation ("C.F.C.") rules. The Notice also focuses on post-inversion planning techniques used to reduce U.S. taxes. This effort may have unexpected side effects on legitimate tax planning deals in addition to those that the I.R.S. is trying to stop.

It is generally accepted that legislation from Congress is the most appropriate way to address the inversion issues in the form of comprehensive tax reform. However, the likelihood of such reform in the near future must now be considered within the framework of a Republican controlled House and Senate. In the interim, the Treasury and the I.R.S. are concerned about the erosion of the U.S. tax base due to inversion transactions triggered in reaction to the perceived complexities and relatively high rates of U.S. taxation. This concern is warranted from their perspective in light of many recent high profile inversion transactions. Accordingly, the Notice is intended to retroactively foreclose transactions that occur on or after September 22, 2014 but before regulatory changes are formally adopted or legislation is enacted.

BACKGROUND: MOTIVATION FOR INVERTING

As noted in our recent article, a U.S. parent corporation with non-U.S. subsidiaries may be subject to tax under the U.S. Subpart F regime on certain income earned before U.S. repatriation. An inversion seeks to restructure the corporate group so that a non-U.S. corporation heads the group with the U.S. corporate subsidiaries

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[22] See *Insights* Vol. 1 No. 8, "Corporate Inversion Transactions: Tax Planning as Treason or a Case for Reform?"

used only to conduct U.S. operations. Income from the non-U.S. operations conducted in the non-U.S. subsidiaries is consequently not subject to U.S. tax.

The Subpart F tax treatment is consistent with the U.S. concept of worldwide taxation with avoidance of double tax by application of the foreign tax credit regime. Dividends from a foreign subsidiary, whether deemed dividends under Subpart F or repatriated cash dividends, can be fully taxed with relief coming from direct and indirect foreign tax credits. This is contrasted to the territorial income tax system found in many countries that either does not tax or lightly taxes dividends from the non-local subsidiaries under a participation exemption. Net tax after foreign tax credits generally remains due to (i) the complexities of the foreign tax credit calculation's requirement to allocate U.S.-based expenses to foreign source income, and (ii) the high U.S. corporate tax rate (up to 35% federal plus state and local taxes) in comparison to other countries such as the U.K., Canada, and Ireland, which have dramatically lowered their corporate tax rates. In addition, compliance with U.S. tax laws has become more complex in general with the proliferation of U.S. "anti-avoidance" tax rules.

"Compliance with U.S. tax laws has become more complex in general with the proliferation of U.S. 'anti-avoidance' tax rules."

As a result, U.S. multinational corporations look for a combination of a U.S. Parent corporation with worldwide subsidiaries and a non-U.S. Parent corporation with its own set of worldwide subsidiaries. Proper structuring of these legal entity ownership chains can potentially produce significant tax savings. One way to achieve this type of acquisition is by a triangular merger by which either (i) the U.S. Parent merges into a special purpose transitory subsidiary of the Foreign Parent that was set up specifically for the purposes of the merger (a "forward triangular merger"), or (ii) the special purpose transitory subsidiary of the Foreign Parent merges into the U.S. Parent (a "reverse triangular merger"). In either case, the shareholders of the U.S. Parent will receive stock of the Foreign Parent in exchange for their U.S. Parent stock, and the U.S. Parent will become a subsidiary of the Foreign Parent. Thus, the U.S. corporate tax structure is "inverted" into a foreign-based corporate tax structure.

CODE §7874'S ATTACK ON INVERSIONS

The anti-inversion legislation that currently exists is embodied in Code §7874, enacted in 2004. Code §7874(a)(2) treats a foreign corporation as a surrogate foreign corporation (*i.e.*, still subject to provisions of U.S. tax law) if:

1. The foreign corporation ("Foreign Parent") completes the acquisition of substantially all of the properties held by a domestic corporation ("U.S. Parent"), or, alternatively, if the Foreign Parent acquires substantially all of the properties constituting a trade or business of a domestic partnership;

2. After the acquisition, at least 60% of the stock (by vote or value) of the Foreign Parent is held by former shareholders of the U.S. Parent (or partners in the domestic partnership) by reason of holding stock in the U.S. Parent (or partnership interests in the domestic partnership); and

3. After the acquisition, the expanded affiliated group that includes the Foreign Parent does not have "substantial business activities" in the foreign country in which the foreign corporation was created or organized.

If the former shareholders of the U.S. Parent own 60% or more but less than 80% of the Foreign Parent which has been deemed a foreign surrogate corporation, then the U.S. Parent and its subsidiaries are prevented from using tax attributes such as net operating losses or foreign tax credits to offset tax recognized in the next 10 years from any transfer of stock or securities. If the former shareholders of the U.S. Parent own 80% or more of the Foreign Parent, then the Foreign Parent (or surrogate foreign corporation) is treated as a U.S. corporation and subject to worldwide taxation by the U.S.

Following this legislative change in 2004, inversions slowed and even stopped for a few years. However, as we have chronicled, they have resurfaced in the last few years in a way that has prompted the I.R.S. to take action—in this circumstance, by issuing Notice 2014-52.

NOTICE 2014-52: APPLICATION TO PRE- & POST-INVERSION PLANNING

Pre-Inversion Planning

The following are three of the pre-inversion planning techniques the I.R.S. recently made efforts to curb. While the I.R.S. has said that regulations will be promulgated that will adopt these measures, the I.R.S. also indicated that the regulations will only apply to transactions occurring on or after September 22, 2014.

Cash Box Inversion

A common pre-merger technique is for the Foreign Parent to issue new stock for cash, resulting in a sharp increase in its fair market value ("F.M.V.") in anticipation of the impending inversion. The intentions is that as a result, after the merger, the former shareholders of the U.S. Parent will own less than the 60% or 80% of the F.M.V. of the post-inversion Foreign Parent as described under §7874, thereby reducing or even eliminating the adverse tax impact of these rules.

The Treasury indicated that the regulations that will be implemented ignore the new shareholders and the cash contributed to the Foreign Parent if this stock issuance occurred as part of the overall plan of the inversion. The pre-issuance F.M.V. of the Foreign Parent would then be evaluated rather than the post-issuance F.M.V. in applying the inversion rules, which may again apply to the inversion in question.

Downsizing the U.S. Corporation Target

On the reverse end of the spectrum, the U.S. Parent can make a distribution to its shareholders thereby shrinking its F.M.V. Similar to the intention of a cash box inversion, as a result of the distribution the shareholders of U.S. Parent should own less than the 60% or 80% of the post-inversion Foreign Parent as described under §7874, again hopefully avoiding the possible adverse tax impact.

New rules have been adopted to ignore any such distributions to the U.S. shareholders, resulting in an increased F.M.V. for the U.S. Parent when applying the inversion rules, which, as above, may again apply to the inversion in question.

Spin-Offs Before Inversion

A final common technique is for the U.S. Parent to form a Foreign Holding Company, transfer one U.S. subsidiary to the Foreign Holding Company (but keep the rest) and then spin off the Foreign Holding Company to the U.S. Parent's shareholders before the inversion.

The U.S. Parent will still have business assets after the spin-off. The spin-off is not caught by the current inversion rules since these rules require that there be a distribution of "substantially all" of the assets of the U.S. Parent.

The Treasury has changed the rules so that an earlier spin-off is included in the later inversion.

Post-Inversion Planning

"Post-Inversion Planning…techniques assume that the ownership of the former U.S. Parent shareholders is less than 80% in the Foreign Parent so that the Foreign Parent has not been re-characterized as a U.S. Corporation."

Practitioners have developed additional post-inversion techniques to pull cash out of the controlled foreign corporations ("C.F.C.'s") without generating U.S. tax. These techniques assume that the ownership of the former U.S. Parent shareholders is less than 80% in the Foreign Parent so that the Foreign Parent has not been re-characterized as a U.S. Corporation.

Hopscotch Loan

In nearly all inversions, the U.S. Parent owns one or more C.F.C.'s. After the inversion, the Foreign Parent owns the U.S. Parent and the U.S. Parent still owns the C.F.C.'s. A common strategy used by practitioners to get cash out of the C.F.C. and back to the Foreign Parent is to have the C.F.C. make a loan directly to the Foreign Parent. The cash then bypasses the intermediate U.S. Parent, as the loan effectively hopscotches over it.

The Code §956 provisions regarding C.F.C.'s results in a deemed dividend to the U.S. Parent if the C.F.C. invests its money in the U.S., even if the investment is with a third party and not just the U.S. Parent. However, no such investment is made in the U.S. with this hopscotch loan.

The Treasury has indicated that it will adopt regulations under §956 so that the one loan will be treated as two loans, thereby bringing the U.S. back into the loop. The loan from the C.F.C. to the U.S. Parent would be considered the first loan and the loan from the U.S. Parent to the Foreign Parent would be considered the second. The first loan would be captured by the §956's C.F.C. rules as a deemed dividend to the U.S. Parent equal to the lesser of the amount loaned or the C.F.C.'s earnings and profits.

Inter-Company Stock Sale

Another common technique is for the post-inversion Foreign Parent to sell the stock of U.S. Parent to the C.F.C. for cash. The Foreign Parent has no U.S. tax impact since the sale of U.S. stock by a foreign person is not taxable by the U.S. Additionally, F.I.R.P.T.A. is not applicable here, as the typical inversion involves active operating businesses and not real estate companies.

The new regulations will provide that under the above circumstances, the cash will be viewed as a deemed dividend from the U.S. Parent to the Foreign Parent. This

"Some practitioners have complained that the Treasury does not have the power under existing law to issue this Notice and make changes of this scope to the regulations. If anyone chooses to make such a challenge, resolution of the issue will be left to the courts."

results in this deemed dividend being subject to a 30% F.D.A.P. withholding (or a lower treaty rate, if applicable).

Sale of Newly Issued C.F.C. Stock

Lastly, a different strategy that is sometimes used is for the Foreign Parent to acquire newly issued C.F.C. stock from the C.F.C after the inversion. This brings the U.S. Parent ownership of the C.F.C. to below the 50% amount used in determining whether a non-U.S. company is a C.F.C. The result is that the foreign corporation is no longer a C.F.C.

The Treasury plans to attribute the ownership of C.F.C. stock to the U.S. Parent instead of the Foreign Parent so that there will be no change in the stock ownership. This will pull the corporation back into being classified as a C.F.C.

All these regulations, when formally adopted, will apply to transactions occurring on or after September 22, 2014.

CONCLUSION

Notice 2014-52 is a continuation of a long line of legislation, regulations, and provisions designed to further inhibit the erosion of the U.S. tax base due to inversions and other techniques. Some practitioners have complained that the Treasury does not have the power under existing law to issue this Notice and make changes of this scope to the regulations. If anyone chooses to make such a challenge, resolution of the issue will be left to the courts.

The immediate effect of the Notice has been a dampening of the inversion trend, although certain high profile companies such as Pfizer have indicated an intent to proceed regardless of the changes. Perhaps in response to the Pfizer announcement, Treasury International Tax Counsel's Office (Douglas Poms, Senior Counsel) surmised at the fall meeting of the American Institute of C.P.A.'s that additional notices and Treasury Regulations will most likely be forthcoming. The notices and regulations will most likely address the implementation of Notice 2014-52. So-called "earnings stripping" intercompany financing techniques would also be addressed within the context of a broader consideration of corporate tax reform and the taxation of financial products. Prospective versus retroactive effect of the notices or regulations is also being considered.

RECAPITALIZATION OF L.L.C. INTERESTS AND ISSUANCE OF PROFIT INTERESTS HELD TO BE GIFTS IN ESTATE FREEZE

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Tags
Code §2701
Estate Freeze
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L.L.C.
Partnership

Code §2701 is a provision which renders the transfer of a partnership or membership interest to a family member a gift. The tax typically applies in an "estate freeze" scenario, where one generation attempts to transfer assets which appreciate in value to another generation, thereby removing it from their estate for estate tax purposes. In its latest Chief Counsel Advice ("C.C.A."), the I.R.S. held that a recapitalization of a limited liability company ("L.L.C.") triggers a gift under Code §2701 in a case where a mother retained a right of distribution but transferred the gain or loss attributable to the L.L.C.'s assets to her sons. The I.R.S. held that the interest retained by the transferor (a distribution right on the existing capital account balance) was a senior interest, whereas the transferred interest held by the sons (the right to future gain of the L.L.C.'s assets) was found to be a subordinate interest. What is notable and most troubling here is that the interests transferred to the sons are so-called "profits interests," issued for future services to be rendered to the L.L.C.

IN GENERAL

Code §2701 imposes special gift tax valuation rules when partnership or membership interests are transferred to family members.[23] Family members covered under Code §2701 include the spouse of the transferor, any lineal descendant of the transferor or the transferor's spouse, and the spouse of any such descendant.[24] In general, Code §2701 devalues interests of senior family members in order to increase the value of interests transferred to junior family members. Code §2701 generally applies to situations where the transferor retains a senior interest and transfers a subordinate interest to the transferee – such as when a parent keeps preferred shares and transfers common shares to family members.

Code §2701 will assign a value of zero to certain interests retained by the transferor or by "applicable family members," thereby increasing the value of the

[23] Code §2701(a).
[24] Code §2701(e)

interests that have been transferred.[25] This rule effectively loads value onto the transferred interests and thereby defeats some traditional freeze arrangements.

A gift exists where there is a contribution to capital or a redemption, recapitalization, or other change in the capital structure of a corporation or partnership, if the taxpayer or applicable family member receives a retained interest of the entity pursuant to the transaction.[26] Furthermore, a transfer will take place where the transferor holding an applicable retained interest before the transaction surrenders an equity interest that is junior to the applicable retained interest and receives property other than an applicable retained interest.[27] An applicable retained interest is an equity interest in a controlled corporation where there is a distribution right.[28] A senior interest is an interest that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest.[29]

C.C.A. 201442053

In C.C.A. 2014402053, a mother and her sons formed an L.L.C. which was effective as of Date 1. The L.L.C. had a 20-year term that, if not wound up sooner, was to terminate on Date 4. The mother's capital contribution consisted of real property. She was the only member to make a capital contribution. Subsequently, she made gifts of the membership interests in the L.L.C. to her sons and their children.

Under the L.L.C.'s operating agreement, each member's capital account is credited with the amount of his or her capital contribution. Profits and losses are then allocated to a member's capital account *pro rata*, based on his or her ownership interest. A member's ownership interest is the proportion that his or her capital account bears to the aggregate positive capital accounts of all members. Distributions are made based on a member's ownership interest. No member has priority over any other member as to participation in profits, losses, and distributions or the return of capital contributions. No member has the right to withdraw a capital contribution.

The L.L.C. was recapitalized on Date 3, when the mother held an X% ownership interest, each son held a Y% ownership interest, and the grandchildren held the remaining Z% ownership interest. The operating agreement was amended to provide that going forward, all profit and loss, including all gain or loss attributable to the L.L.C.'s assets, would be allocated equally to the sons in exchange for their management of the L.L.C. After the recapitalization, the sole remaining equity interest of the mother and the grandchildren was the right to distributions based on their capital account balances as they existed immediately before the recapitalization.

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25 Code §2701(a)(1)(B).
26 Code §2701(e)(5).
27 Treas. Regs. §25.2701-1(b)(2)(B)(2).
28 Treas. Regs. §25.2701-2(b)(1)(ii).
29 Treas. Regs. §25.2701-3(a)(2)(ii).

The I.R.S. noted that the mother and her family controlled the L.L.C. at all times. On Date 3, the L.L.C. was recapitalized and the mother surrendered her right to participate in future profit and loss, including future gain or loss attributable to the L.L.C's assets. However, both before and after the recapitalization, the mother held an equity interest in the company coupled with a distribution right, which the I.R.S. indicated was a retained interest. The mother held a distribution right based on the existing capital account balance, as opposed to the sons, who held a right to *future* profit and gain. Thus, the I.R.S. determined that the mother held a preferred interest because she maintained a right to the existing capital account balance as opposed to the right to potential future profit and gain held by the sons. Additionally, the mother received "property" in the form of the sons' agreement to manage the real property.

"Thus, the I.R.S. determined that the mother held a preferred interest because she maintained a right to the existing capital account balance as opposed to the right to potential future profit/gain held by the sons."

Consequently, different classes of interest existed, and since the mother received a "senior" interest in exchange for "property," part of the recapitalization was considered a gift under Code §2701.

In determining the amount of the gift, as stipulated under Code §2701, the value of any family-held retained interests and other non-transferred equity assets is subtracted from the aggregate value of the family-held interest. Any distribution right in a controlled entity is generally valued at zero when determining the value of any applicable retained interest.

CONSEQUENCES

Practitioners should always be aware that the issuance of a carried interest (profits interest) in a family L.L.C. partnership setting can invoke the harsh application of Code §2701. Many commentators have suggested that the issuance of a carried interest (profits interest) for services should not necessarily create different classes of interest. The facts presented in C.C.A. 201442053 are somewhat unusual. Nonetheless, the granting of a profits interest should be carefully analyzed in the family partnership/L.L.C. context.

TAX 101:

UNDERSTANDING U.S. TAXATION OF FOREIGN INVESTMENT IN REAL PROPERTY – PART I

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Tags
Active Income
F.I.R.P.T.A.
Foreign Income
Passive Income
Portfolio Interest
Shared Appreciation Mortgages
U.S. Real Estate
Withholding

INTRODUCTION

U.S. real estate has been a popular choice for foreign investors, whether the property is held for personal use, rental or sale, or long-term investment. Since the passage of the Foreign Investment in Real Property Tax Act of 1980 ("F.I.R.P.T.A."), the governing tax rules have developed and evolved, but have not succeeded in discouraging foreign investment. F.I.R.P.T.A. can be a potential minefield for those unfamiliar with U.S. income, estate, and gift taxation – all of which come into play. This article is the first of a series on understanding U.S. taxation of foreign investment in real property.

TAXATION OF A FOREIGN PERSON

"A foreign person is subject to U.S. income tax only on income that is characterized as U.S. source income."[30]

As simple as the concept sounds, there are applicable nuances, caveats, exemptions, and exceptions. Therefore, several questions must first be answered to determine the U.S. income tax consequences for a foreign person engaged in U.S. economic activities, including ownership of real property:

1. Is the income derived from a U.S. source and therefore potentially taxable?

2. Is the income taxable or exempt from tax?

3. Is the income passive or active, subject to a flat withholding tax on gross income or, alternatively, to graduated rates on net income?

4. Is the income earned by an individual or corporation or other entity, each of which may have different rules and applicable tax rates?

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30 For regulations regarding source of income, see I.R.C. §§861–865. These rules are discussed at length in BNA 905 T.M., Source of Income Rules.

For a foreign investment in U.S. real estate, income may be derived through several means:

1. Rental income from leased property;

2. Interest on a debt investment secured by real estate;

3. Dividends received from a corporation owning U.S. real estate;

4. Sale or disposition of a real estate asset or an entity owning a real estate asset.

RENTAL INCOME

Rent continues to be a significant source of income from ownership of U.S. real estate. Generally, rental income is U.S. sourced if the property is located in the United States.[31]

Rental income can be "passive" or "active," and the character of the income as such will dictate the tax regime applied. The difference in the tax levied can be dramatic.

Passive Income

For all U.S.-source "fixed or determinable, annual or periodical" ("F.D.A.P.") income,[32] a flat 30% withholding tax is levied on the *gross* amount at source.

I.R.S. literature states that:

> Income is fixed if it is paid in amounts known ahead of time. Income is determinable whenever there is a basis for figuring the amount to be paid. Income can be periodic if it is paid from time to time. It does not have to be paid annually or at regular intervals. Income can be determinable or periodic, even if the length of time during which the payments are made is increased or decreased.

Rental income generally falls under this category because it is typically agreed upon in advance and paid by a specified date. Should the income be treated as F.D.A.P., the tax can equate to a large percentage of net income since it is levied on the gross amount. This concept is illustrated in the following example.

Ex: A tenant pays $100 in rent to the owner and $100 in property-related expenses to third parties (taxes, insurance, etc.).

- Gross rental income = $200

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[31] See Code §861(a)(4).

[32] F.D.A.P. income is described in Code §§871 and 881.

- Withholding tax = 30% of $200 = $60
- Net cash to owner = $100 - $60 = $60
- Effective tax rate = 60%

Active Income

If the foreign individual or corporation is engaged in a U.S. trade or business ("E.T.B."), the income effectively connected with that business ("E.C.I.") is subject to U.S. income tax on a net basis using a graduated rate, which requires the filing of a U.S. tax return. Whether or not an entity is considered to be E.T.B. is determined by the nature, extent, continuity, time devoted, and income derived from its activities in the U.S.

"Rental income can be 'passive' or 'active,' and the character of the income as such will dictate the tax regime applied. The difference in the tax levied can be dramatic."

Simply leasing out a property does not suffice.[33] In *Neill*, the petitioner was a nonresident alien that rented out her apartment in Philadelphia. The court found that owning and leasing the property constituted no more of a business than her ownership of stocks or bonds held in U.S. companies by her U.S. agent. It was held that the mere ownership of property from which income is drawn does not constitute the carrying on of trade or business.

Nonetheless, owning and renting multiple properties, and managing them or hiring an agent to do so may constitute E.T.B.[34] Using agents who negotiate, renew leases, arrange for repairs, collect rents, pay taxes and assessments, and remit net proceeds will be E.T.B. since the activities of these agents extend beyond the scope of mere ownership and the receipt of income.[35]

Once E.T.B. is established (or deemed present), the following income will be treated as E.C.I.:

- All U.S.-source income derived from a U.S. trade or business;
- U.S.-source capital gains, F.D.A.P., or similar income that is derived from assets held or used for a U.S. trade or business;
- Income for which a U.S. trade or business is material to its realization;
- Income derived under a net election (as discussed below); and
- Gain derived by a foreign person from the disposition of a U.S. real property interest.

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33 Neill v. Comr., 46 B.T.A. 197 (1942).

34 Pinchot v. Comr., 113 F.2d 718 (2d Cir. 1940) (taxpayer owned 11 properties that were actively managed by an agent); de Amodio v. Comr., 34 T.C. 894 (1960), aff'd on another issue, 299 F.2d 623 (3d Cir. 1962); Lewenhaupt v. Comr., 20 T.C.

35 See http://www.andrewmitchel.com/charts/amodio.pdf; Andrew Mitchel is of counsel to Ruchelman P.L.L.C.

The tax consequences of this regime are significantly different from those for passive income simply because the rate is applied on a net income rather than a gross income basis.

Ex: A tenant pays $100 in rent to the owner (a corporation) and $100 in property-related expenses to third parties (taxes, insurance, etc.).

- Gross rental income = $200
- Net rental income before deductions = $200 - $100 = $100
- Maximum tax applicable = 35%
- Effective tax rate = 35%

Each situation plays out differently depending on whether the income is considered passive or active. A foreign owner may choose to be E.T.B., and therefore subject to a lower effective tax rate, through a net election.

Net Election

As indicated above, it is often difficult to say with certainty whether rental income is considered to be active or passive. When a foreign person's activities do not amount to E.T.B., an option exists for the election of income to be treated as E.C.I.[36] The net election treats the foreign person as though they were engaged in U.S. trade or business, and rental income is therefore effectively connected with that trade or business. In turn, the net election allows the deduction of depreciation, taxes, and other expenses before applying a graduated tax rate.

A foreign corporation or individual is eligible for the net election if:

- Income is derived from ownership of or an interest in U.S. real property during the taxable year in which the election is made; and
- The foreign individual's interest in or holding of that property is for the purpose of producing income.

The net election only applies to income that would not otherwise be considered E.C.I.

A net election for also exists in tax treaties between the U.S. and other countries. The *2006 U.S. Model Income Tax Convention* provides that a resident of a Contracting State (who is liable for tax in the other country) may make a net election for income from real property in any taxable year. This election provides for tax on income from real property located in that other country to be calculated on a net basis, as if it were business profits attributable to a permanent establishment that country.[37]

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36 26 C.F.R. §1.871-10, 26 U.S.C. §882(d).
37 2006 U.S. Model Income Tax Convention, Article 6(5).

INTEREST

Interest income may be earned on real estate, such as through mortgages and other debts secured by real estate. This income from interest is considered to be passive (*i.e.*, F.D.A.P. income subject to 30% withholding tax). The source of that interest is usually determined by the place the obligor is a resident.[38]

However, there are several exceptions:

- Interest paid after December 31, 2003 by a foreign partnership predominantly engaged in a foreign trade or business is considered U.S. sourced if it is effectively connected with a U.S. trade or business;[39]

- Interest paid by a foreign corporation engaged in a U.S. trade or business, which is effectively connected with that U.S. trade or business, is considered U.S.-source income.

On the flipside, the following interest payments made from U.S. debtors to foreign persons are exempt from U.S. income tax:

- Portfolio interest[40] – The interest on specified debt obligations paid to certain foreign persons is tax free if in registered form:

  - Issuer of investment must be a U.S. person;

  - Holder must be a foreign person providing proof of foreign status;

  - Holder is not a bank extending credit while E.T.B.;

  - Holder that is a "controlled foreign corporation" is not related to the issuer;

  - Holder is not a 10% or greater shareholder of the issuer;[41]

  - Interest must not be contingent interest;[42]

  - Foreign person cannot be from a country that the Secretary of the Treasury has determined to have inadequate exchange of information with the U.S.;

  - Income cannot be E.C.I. and must be F.D.A.P.;[43]

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38 §§861(a)(1) and 862(a)(1).
39 §861(a)(1)(B), as redesignated by P.L. 111-226.
40 §§871(h) and 881(c), http://www.lexisnexis.com/legalnewsroom/tax-law/b/federaltaxation/archive/2013/10/08/portfolio-interest-free-money.aspx.
41 The holder does not own (i) 10% or more of the total combined voting power of all classes of stock of the corporation or (ii) 10% or more of the capital or profits interest in a partnership, at the time the interest is received.
42 Interest is not treated as contingent if the timing (rather than the amount) of the payment is subject to a contingency. See I.R.C. §871(h)(4)(C).

“U.S.-source dividends are considered to be F.D.A.P. income subject to 30% withholding tax.”

- Underlying debt cannot be treated like equity in the hands of the Holder.

- Interest subject to tax treaties[44] – Almost all treaties provide for exemption or a reduced rate, which can be claimed by filing a Form W-8BEN with the withholding agent. Among other things, the foreign person must provide:
  - A U.S. Taxpayer Identification Number;
  - Certification that it is the resident of a treaty country;
  - Certification that it is the beneficial owner of the income; and
  - Certification that it meets any applicable limitation on benefits provision contained in the treaty.
- Bank deposit interest;
- Interest paid on a debt instrument that matures in 183 days or less from the date of issue.

Other types of debt instruments, while not providing for tax-free interest, are beneficial because the adverse tax consequences under F.I.R.P.T.A. may not be induced. Principal payments on straight debt instruments investments (interests solely as a creditor) are exempt from F.I.R.P.T.A. rules. A Shared Appreciation Mortgage (“S.A.M.”) requires the borrower to pay a portion of the gain in value of the property in the form of interest. While such instruments are subject to F.I.R.P.T.A., if held to maturity, there is no gain upon repayment of the loan balance or interest.

DISTRIBUTIONS

Dividends

If real estate is owned by a corporation, excess cash flow may be paid in the form of dividends. The source of dividend income is generally determined by the country or state of incorporation[45] unless certain exceptions apply. Dividends paid by domestic corporations are generally U.S. source; dividends paid by foreign corporations are generally foreign source. Dividends from a foreign corporation, however, may be treated as U.S. source if the corporation is engaged in a U.S.

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43 A foreign lender is not considered to be E.T.B. if it buys outstanding mortgages but is E.T.B. if it originates or makes new loans in the U.S. (or is treated as if it does).

44 http://www.irs.gov/Individuals/International-Taxpayers/Claiming-Tax-Treaty-Benefits.

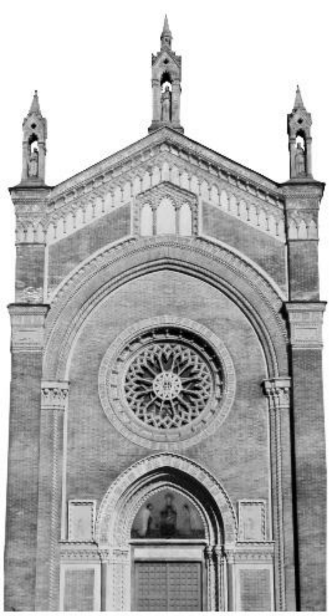
45 §§861(a)(2) and 862(a)(2).

trade or business and 25% or more of its worldwide gross income over a three-year period is connected to such U.S. trade or business.[46]

U.S.-source dividends are considered to be F.D.A.P. income subject to 30% withholding tax, which may be reduced or eliminated through applicable tax treaties. Note that a dividend is defined in §316 of the United States Code (the "U.S. Code") as a payment out of current or accumulated earnings and profits.

A non-dividend distribution by a U.S. Real Property Holding Corporation ("U.S.R.P.H.C."), discussed more in the next article, will attract a 10% withholding tax (subject to possible reduction if a withholding certificate can be obtained from the I.R.S.) pursuant to §1445(e)(3) of the U.S. Code. Special rules apply to Real Estate Investment Trust ("R.E.I.T.'s").

The next article will look at tax consequences that arise during disposition.



[46] §861(a)(2)(B).

MARKS AND SPENCER: THE END OF AN ERA?

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Tags
C.J.E.U.
Freedom of Establishment
Group Relief
Marks and Spencer

The creation of the European Union dates back to the aftermath of World War II. Its objective was mainly to prevent the return of war between neighboring European countries. Over time, the now-called "E.U." evolved, and today its 28 Member States share one single internal market. Unlike the United States, the E.U. is not a federal country but is composed of 28 independent Member States, much like the Confederation that existed immediately after the end of the Revolutionary War. In order to create its internal market, the Member States of the E.U. handed over to the E.U. certain aspects of their sovereignty. This process resulted in the establishment of four fundamental freedoms that underpin the internal market and are supervised by the E.U. institutions. The fundamental freedoms are:

- The freedom of capital,
- The freedom of goods,
- The freedom of people, and
- The freedom of services and establishment.

These freedoms allow capital, goods, people, services, subsidiaries, and branches to freely move and be located throughout the E.U. It is with regard to the freedom of establishment that the Court of Justice of the European Union ("C.J.E.U.") handed down its landmark 2005 *Marks and Spencer* decision.[47] In a nutshell, and as explained in detail below, that case provided that losses of an out-of-country subsidiary of an entity resident in an E.U. member state should be eligible for group relief if and to the extent group relief was available to a group of wholly domestic companies. Certain conditions were imposed under the case, but in general, the freedom of establishment meant that member states could not discriminate against a foreign E.U. based subsidiary in establishing certain tax rules allowing for the utilization of losses incurred by domestic subsidiaries and disallowing the same use for foreign E.U. based subsidiaries. In a recent opinion, the C.J.E.U.'s Advocate

[47] Case C-446/03, Marks & Spencer plc v. David Hasley (Her Majesty's Inspector of Taxes), 12/13/2005.

General, Juliane Kokott, suggested that the terms used in the *Marks and Spencer* decision should now be abandoned.[48]

I. MARKS AND SPENCER: GROUP RELIEF AND FREEDOM OF ESTABLISHMENT

Marks and Spencer involved U.K. group relief legislation that, among other things, allowed a U.K. group parent company to offset the losses of its U.K. subsidiaries against the parent's profits. In this case, the U.K. parent company, Marks & Spencer plc ("M&S"), had loss-generating subsidiaries in France, Germany, and Belgium. M&S claimed these losses against its U.K. profits, and the claims were rejected on the grounds that profits of the group parent could only be offset by losses recorded in the U.K.

The key issue in *Marks and Spencer* was whether the above-mentioned legislation constituted a restriction on freedom of establishment. Freedom of establishment prohibits a Member State from treating foreign nationals and foreign companies differently from its own nationals and companies established in its jurisdiction. It also prohibits a Member State from preventing its nationals or companies established in its jurisdiction from seeking establishment in another Member State.

"In a recent opinion, the C.J.E.U.'s Advocate General, Juliane Kokott, suggested that the terms used in the Marks and Spencer decision should now be abandoned."

In *Marks and Spencer*, the C.J.E.U. concluded that the U.K. legislation placed a restriction on the freedom of establishment principle. It did so because a U.K. company that had only U.K. subsidiaries had a cash advantage in being able to immediately offset the subsidiaries' losses against its profits. A U.K. parent company was deprived of that cash advantage when its loss-generating subsidiaries were located in other E.U. member states. The C.J.E.U. advised that this type of restriction may be permitted only where:

- It is enacted pursuant to a legitimate objective compatible with the Treaty Establishing the European Community,
- It is justified by an imperative objective in the public interest, and
- Its application is appropriate to ensure the attainment of the pursued objective and does not extend beyond what is necessary for the attainment of that objective.

After analysis of these various factors, the C.J.E.U. concluded that because less restrictive measures existed, the U.K. group relief legislation at issue was contrary to the freedom of establishment principle.

The C.J.E.U. decided that freedom of establishment does not inherently prohibit domestic legislation which provides for a domestic parent to offset losses suffered by a domestic subsidiary but not those suffered by a foreign subsidiary organized in

[48] Opinion of Advocate General Kokott, delivered on 23 October 2014 in Case C-172/13, European Commission v. United Kingdom of Great Britain and Northern Ireland

a member state of the E.U. However, such legislation will be viewed to violate this principle where a nonresident foreign subsidiary is precluded from using its losses in the past, present, or future, in its country of residence or in the group's country of residence. This is especially the case where less restrictive measures could be followed. In other words,the restriction must be proportional to the attainment of the freedom of establishment.

II. ADVOCATE GENERAL KOKOTT'S OPINION IN CASE C-172/13

Ultimately, the European Commission (the "Commission") doubted the compatibility of post-*Marks and Spencer* U.K. legislation with the *Marks and Spencer* decision, and requested that the U.K. modify its domestic implementation. The Commission argued that subsequent U.K. legislation made it virtually impossible to obtain cross-border group relief because it provided for very limited time in which to determine the existence of potential future relief. Absent any change in U.K. law, the Commission then referred the issue to the C.J.E.U.

In her opinion in Case C-172/13, Advocate General Juliane Kokott argued that the *Marks and Spencer* decision should be reconsidered and that it conflicts with other European case law relating to tax matters. She underscored that the circumstances of *Marks and Spencer* are far from clear and that the decision resulted in costly disputes between relevant tax administrations and the taxpayers.

Furthermore, the U.K. group relief legislation at issue did and does not violate the proportionality principle according to Kokott. Materially, a non-U.K. subsidiary is not in the same position as a U.K. subsidiary, and the U.K. legislation does allow for losses of a foreign subsidiary to be taken into account in limited circumstances. Hence, Kokott held that it does not restrict freedom of establishment.

While some speculate on the far-reaching implications of this argument, it is unlikely that the C.J.E.U. will follow Kokott's non-binding opinion. Two reasons exist for this view. First, were the opinion to be followed by the C.J.E.U., it would result in the imposition of the high costs on European groups because their tax planning arrangements would be invalidated. Second, this is not the first time that Kokott has argued in favor of abandoning the *Marks and Spencer* decision,[49] and it would not be the first time the C.J.E.U. looks the other way.

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[49] See, for instance, her opinion in Case C-123/11, A Oy, 11/19/2012.

T.I.G.T.A. ADVISES THE I.R.S. ON IMPROVING INTERNATIONAL TAX COMPLIANCE

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Tags
International Collection Program
International Compliance
T.I.G.T.A.

In 2006, the I.R.S. created the International Collection program ("International Collection"), whereby collections officers are primarily responsible for collection of all delinquent taxes and tax returns of taxpayers located outside the U.S., but subject to the United States tax and reporting requirements. Since its inception, International Collection has undergone certain changes with the intention of developing a well-structured, long-term strategy to curb international tax noncompliance.

INTERNATIONAL TAXPAYERS

Significant emphasis now is placed on international tax compliance. The I.R.S. is concentrating on collecting delinquent payments, and through the three voluntary programs alone, it collected $6.5 billion from 45,000 participating taxpayers.[50]

There are four types of international taxpayers that are of interest to the I.R.S.

- U.S. individual taxpayers and resident aliens working, living, or doing business abroad;
- U.S. corporations doing business abroad;
- Nonresident aliens working or doing business in the United States; and
- Foreign corporations doing business in the United States.[51]

On September 30, 2014, the Treasury Inspector General for Tax Administration ("T.I.G.T.A.") came out with a report (the "Report") criticizing the I.R.S.'s efforts with

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[50] Internal Revenue Service, "IRS Offshore Voluntary Disclosure Efforts Produce $6.5 Billion; 45,000 Taxpayers Participate," FS-2014-6, June 2014, http://www.irs.gov/uac/Newsroom/IRS-Offshore-Voluntary-Disclosure-Efforts-Produce-$6.5-Billion;-45,000-Taxpayers-Participate.

[51] Treasury Inspector General for Tax Administration, "The Internal Revenue Service Needs to Enhance Its International Collection Efforts," 2014–30–054, http://www.treasury.gov/tigta/auditreports/2014reports/201430054fr.pdf.

regard to International Collection.[52] Among other things, the Report pointed out that the I.R.S. does not have reliable statistics on the rate of noncompliance for international taxpayers with U.S. tax obligations.

> *"Among other things, the Report pointed out that the I.R.S. does not have reliable statistics on the rate of noncompliance for international taxpayers with U.S. tax obligations."*

Moreover, the Report pointed out two specific areas that require change:

1. The Internal Revenue Manual (the "Manual") does not provide policies and procedures on International Collection issues. The Manual provides for the same time frame and procedures with regard to international and domestic cases, which places a heavy burden on International Collection officers.

2. In addition, International Collection officers do not receive the proper training or tools to perform their jobs. In some instances, officers were actually given wrong information, which created delays in resolving international cases.

While the Report identified many other problems, it also provided the following recommendations for the I.R.S. to improve the program:

- Adequate policies, procedures, position descriptions, and training to ensure that I.R.S. officers can properly handle International Collection cases.

- A specific inventory selection process to ensure that International Collection cases with the highest risk are pursued.

- Performance measures and enforcement results reported separately from Domestic Collection.

- A process to measure the effectiveness of the Customs Hold as an enforcement tool.[53]

The I.R.S. has undertaken the obligation to implement the changes recommended in the Report; it will develop training programs for International Collection officers and will make appropriate changes to the Manual. The open question is whether a tax bill can be collected from persons physically located outside the U.S. who own no U.S. assets absent the cooperation of the jurisdiction of the individual's residence.

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52 *Id*.
53 *Id*.

CORPORATE MATTERS:
SERIES LIMITED LIABILITY COMPANIES

Author
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Tags
Corporate
Delaware
L.L.C.
Series L.L.C.

Clients frequently tell us they have heard of series limited liability companies but are unsure what they are and when they should be used. In this issue we will briefly explain the series limited liability company ("Series L.L.C.") and outline some of the pros and cons, with respect to its formation and use.

SERIES L.L.C. ESSENTIALS

Delaware and a handful of other states have allowed the formation of Series L.L.C.'s since the mid-1990's. A Series L.L.C. is a limited liability company ("L.L.C.") composed of an individual series of membership interests where the L.L.C. is essentially subdivided into many separate series, each series holds distinct assets, and obligations with respect to the assets designated as being in a series. The creation of the series must be included in the Certificate of Formation[54] and the management and operation of each series must be set forth in the Series L.L.C. agreement. The Delaware statute provides that "a limited liability company agreement may establish or provide for the establishment of one or more designated series of members, managers, limited liability company interests or assets"[55] and that each series may have a separate business purpose or investment objective.[56] This allows, in theory, for each series to have its own management structure and distinct business purpose.

The feature that most piques the interest of our clients is the ability of the assets of each separate series to be protected from the creditors of another. An owner of an L.L.C. that holds real estate assets, for example, that comprises both ownership and management could hold each business in a separate series of the same L.L.C., and a suit against the ownership series could not attack the assets of the management series.

54 DEL. CODE ANN tit. 6. §18-215(b).
55 DEL. CODE ANN tit. 6. §18-215(a).
56 *Id*.

ADVANTAGES OF A SERIES L.L.C.

A very tangible benefit of a Series L.L.C. is the low cost to form the entity relative to alternative structures. Typically a real estate holding company will have many subsidiaries, each holding a different asset in order to segregate assets and liabilities. Each entity has its own formation cost and annual costs associated with keeping the entity in good standing. With a Series L.L.C., only one entity need be formed, and that entity could hold multiple assets. The owner would only need to file one certificate of formation and, in terms of annual costs, pay only one Delaware Franchise Tax and one registered agent's fee.

As mentioned above, the overriding advantage of a Series L.L.C. is its ability to segregate assets by the creation of a series within a single entity and protect the assets of a particular series from the creditors of another.

DISADVANTAGES OF A SERIES L.L.C.

There is uncertainty around treatment of Series L.L.C.'s in states that do not recognize them. If a Delaware Series L.L.C. owns property in another state, it is really not known how that state's courts would react to a law suit against the L.L.C. as a whole, as opposed to a suit against a series within the L.L.C. There is no case law on the point, and it must also be pointed out that a court in another state could choose not to recognize legal separation. If registered as a foreign L.L.C. in California, for example, the Series L.L.C. is charged a franchise tax for *each* series.

It is a different take on piercing the corporate veil, and it is still somewhat of an unknown quantity. As with other types of entities, one can improve the likelihood of the legal separation being recognized by keeping books and records in a way that clearly shows the distinction. The Delaware statute provides that the records for each series must "account for the assets associated with such series separately from the other assets of the limited liability company, or any other series thereof."[57] More specifically, the section goes further with respect to the standard required to protect the limited liability:

> Records maintained for a series that reasonably identify its assets, including by specific listing, category, type, quantity, computational or allocational formula or procedure (including a percentage or share of any asset or assets) or by any other method where the identity of such assets is objectively determinable, will be deemed to account for the assets associated with such series separately from the other assets of the limited liability company, or any other series thereof.[58]

Again, there is no case law on the point, and although the above provides some guidance, without case law it is hard to advise what would or would not suffice in terms of record keeping. It should be remembered at all times each series in a

57 DEL. CODE ANN tit. 6. § 18-215(b).
58 *Id*.

Series L.L.C. is supposed to be treated as a separate entity. This means that each series should have separate meetings, minutes, and resolutions of action. Each series should maintain distinct financial books of accounts. Failure to segregate the books and records of each series may give a creditor grounds to pierce the veil of the particular series or the entire Series L.L.C.

There are other areas of uncertainty relating to Series L.L.C.'s, including broader questions relating to creditors rights and bankruptcy – how would the Uniform Commercial Code apply and how would an individual series be treated in bankruptcy?

Each series in a Series L.L.C. would need its own bank account, and some banks have trouble with the concept.

One reason why Series L.L.C.'s are not widely used is the uncertainty that exists as to how they will be treated for federal and state tax purposes. Proposed federal regulations addressing series and series organizations were formulated in 2010 but as yet have not been finalized.[59]

CONCLUSION

When L.L.C.'s were first introduced there was a general reluctance to use them for many of the same reasons that people are now reluctant to use Series L.L.C.'s. Over time banks, investors, title companies, and other institutions became comfortable with L.L.C.'s. When more clarity exists as to how Series L.L.C.'s will be treated for federal and state tax purposes, we think they will become more popular for businesses looking for limited liability for distinct activities and assets without the expense of forming and maintaining multiple entities.

[59] Prop. Reg, §301.7701-1(a)(5).

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Tag
I.G.A.
F.A.T.C.A.
T.I.G.T.A.

CENTRAL AMERICAN COUNTRIES MOVE TO COMPLY WITH F.A.T.C.A.

While Mexico, the largest Central American nation, signed an I.G.A. in April of 2014, other Central American nations are also deciding to join the F.A.T.C.A. bandwagon. Panama, which has the greatest number of U.S. residents in Central America along with Costa Rica, are leading an effort to have Central America move towards compliance by the September 2015 deadline. In May 2014, Panama reached an agreement in substance to adopt an I.G.A., and has been treated as if an I.G.A. has been in effect since then. Costa Rica had already signed a Model 1 I.G.A. in December 2013.

Though Guatemala has not yet signed an I.G.A., many local financial institutions have registered for direct exchange with the I.R.S. under the Treasury Regulations. It was reported that nearly 100 foreign financial institutions ("F.F.I.'s"), including 18 banks, ten stock brokerages, and 28 insurance firms have registered with the I.R.S. to start sharing information by March 31, 2015, as required under the Regulations with respect to F.F.I.'s in non-I.G.A. jurisdictions. Edgar Morales, operation sub-director at banking trade group Asociación Bancaria de Guatemala, said that unlike Panama or Costa Rica, where aggregating these lists of U.S. resident account holders "will be much harder," the process in Guatemala hasn't been so complex because "there aren't that many people who qualify under F.A.T.C.A. here." Guatemala has a robust banking secrecy law that forbids banks from sharing customer data with other government institutions, and therefore banks that register with the I.R.S. have to obtain privacy waivers from customers to be able to reveal their information under F.A.T.C.A.

El Salvador and Guatemala are the last Central American nations that have still yet to sign I.G.A.'s. Like Guatemala, El Salvador has strict secrecy laws which may be the reason for the government's reluctance to sign an I.G.A. However, local banks are reported to be registering with the I.R.S. for direct reporting.

Honduras, Central America's poorest country, has entered into a Model 1 I.G.A. in March 2014 and has made similar efforts to comply. Nicaragua has reached an agreement in principle to sign a Model 2 I.G.A. on June 30, 2014, which will be effective until December 31. Nicaragua will then have to sign an I.G.A. to continue avoiding F.A.T.C.A. withholding.

RUSSIA RELEASES F.A.T.C.A.-RELATED GUIDANCE

Russia has not signed an I.G.A. and is not on the I.R.S.'s list of countries that are on the verge of signing an I.G.A. Without an I.G.A., there is concern about how a local financial institution can comply with F.A.T.C.A. without violating local law on confidentially of accounts. The Russian government reported on June 30, a new law that would allow Russian banks to transfer data relating to F.A.T.C.A. directly to the I.R.S. upon client consent. Before submitting this information to the I.R.S., Russian banks will report this information to the Russian government.

On October 29, the Russian Central Bank released new guidance and provisions on how banks should implement F.A.T.C.A. In a series of letters to banking businesses and financial organizations, the Central Bank addressed issues such as whether the law requires financial institutions to identify only U.S. taxpayers and whether securities markets operators can change in-house criteria to identify foreign taxpayers. Russia's local legislation sets penalties for failure to comply with the provisions in the law.

The issue that still remains unclear is whether or not Russia will agree to sign an I.G.A. So far, there is no indication that this will happen.

T.I.G.T.A. RECOMMENDS IMPROVED SECURITY FOR F.A.T.C.A. REGISTRATION SYSTEM[60]

"The Russian government reported on June 30, a new law that would allow Russian banks to transfer data relating to F.A.T.C.A. directly to the I.R.S. upon client consent."

Treasury Inspector General for Tax Administration ("T.I.G.T.A.") said that the I.R.S. has not implemented performance standards for the F.A.T.C.A. financial reporting system. An October 27 report, T.I.G.T.A. lists several standards it claims the I.R.S. has not fully implemented. This list includes evaluating the risks of using electronic signatures for the registration forms. The I.R.S. objected to the specific accusations, saying:

> T.I.G.T.A. asserts that contractors have maintained all information regarding the source of design and implementation of security in a proprietary fashion such that the I.R.S. has no access to the knowledge of such information. This is both inaccurate and misleading and leads to the inaccurate conclusion that there is potential security vulnerability in the design of the FRS based on such proprietary knowledge.

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60 For additional information on the October 27 T.I.G.T.A. report, see our discussion in Updates and Other Tidbits.

RECALCITRANT ACCOUNTS INFORMATION CAN BE SUBMITTED ON AN 'AD HOC' BASIS

The I.R.S. announced that foreign countries will be able to send information on recalcitrant U.S. accounts at any time. Foreign banks will make the information available to the host country's tax administration using the International Data Exchange Services ("I.D.E.S."), expected to launch in January 2015. This flexibility in transmission of data is also available for jurisdictions that have agreed to a schedule for information exchange in an I.G.A.

CURRENT I.G.A. PARTNER COUNTRIES

At this time, the countries that are Model 1 partners by execution of an agreement or concluding an agreement in principle are:

Algeria	Georgia	Netherlands
Anguilla	Germany	New Zealand
Antigua & Barbuda	Gibraltar	Norway
Australia	Greenland	Panama
Azerbaijan	Grenada	Peru
Bahamas	Guernsey	Poland
Bahrain	Guyana	Portugal
Barbados	Haiti	Qatar
Belarus	Honduras	Romania
Belgium	Hungary	Saudi Arabia
Brazil	India	Serbia
British Virgin Islands	Indonesia	Seychelles
Bulgaria	Ireland	Slovak Republic
Cabo Verde	Isle of Man	Slovenia
Canada	Israel	South Africa
Cayman Islands	Italy	South Korea
China	Jamaica	Spain
Colombia	Jersey	St. Kitts & Nevis
Costa Rica	Kosovo	St. Lucia
Croatia	Kuwait	St. Vincent & the Grenadines
Curaçao	Latvia	Sweden
Cyprus	Liechtenstein	Thailand
Czech Republic	Lithuania	Turkey
Denmark	Luxembourg	Turkmenistan
Dominica	Malaysia	Turks & Caicos Islands
Dominican Republic	Malta	Ukraine
Estonia	Mauritius	United Arab Emirates
Finland	Mexico	United Kingdom
France	Montenegro	Uzbekistan

The countries that are Model 2 partners are: Armenia, Austria, Bermuda, Chile, Hong Kong, Iraq, Japan, Moldova, Nicaragua, Paraguay, San Marino, Switzerland, and Taiwan.

This list is expected to continue to grow.

HUNDREDS RELINQUISH U.S. PASSPORTS

The number of Americans renouncing their U.S. citizenship increased by 39% in recent months. This increase is said to be related to local tax disclosure rules created as a result of F.A.T.C.A. implementation. The number of people giving up U.S. nationality at U.S. embassies reached 776 in the third quarter of this year, a significant increase from 560 in the same period last year.

More than six million Americans live overseas and the tougher asset-disclosure rules have prompted more of them to give up their passports. Over 9,000 Americans living overseas gave up their passports over the 5 years following the settlement between Swiss bank UBS AG and the I.R.S., in which UBS agreed to pay $780 million and report the names of thousands of U.S. account holders.

Those thinking of going down this path should recognize that an “exit tax” may be imposed, and it is very difficult to get a passport back once it is given up.

As of September, the fee to renounce U.S. citizenship was raised 400% to $2,350.

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Tags
A.P.A.
Common Reporting Standard
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Exchange Financial Information
F.A.T.C.A.
Foreign Tax Credit
Inversions
Israel
O.E.C.D.
Statute of Limitations
Tax Amnesty
Tax Evasion
Transfer Pricing
UBS

ISRAEL ANNOUNCES ADOPTION OF O.E.C.D.'S COMMON REPORTING STANDARD

Israel has announced that it will adopt the *Standard for Automatic Exchange of Financial Account Information: Common Reporting Standard* ("C.R.S.") issued by the O.E.C.D. in February 2013.

The C.R.S. establishes a standardized form that banks and other financial institutions would be required to use in gathering account and transaction information for submission to domestic tax authorities. The information would be provided to domestic authorities on an annual basis for automatic exchange with other participating jurisdictions. The C.R.S. will focus on accounts and transactions of residents of a specific country, regardless of nationality. The C.R.S. also contains the due diligence and reporting procedures to be followed by financial institutions based on a Model 1 F.A.T.C.A. intergovernmental agreement ("I.G.A.").

At the conclusion of the October 28-29 O.E.C.D. Forum on Transparency and Exchange of Information for Tax Purposes, about 50 jurisdictions had signed the document. The U.S. was notably absent as a signatory to the agreement. In addition to the C.R.S., the signed agreement contains a model competent authority agreement for jurisdictions that would like to participate at a later stage.

A large group of the countries that signed the C.R.S., the so-called early adopters, are aiming to implement the C.R.S. as early as January 1, 2016. The initial information is expected to be automatically exchanged with the early adopters beginning in September 2017. The other signees are expected to follow a year later.

The Israeli Finance Ministry said that the C.R.S.'s advantage lies in its "simplification of procedures, greater effectiveness, and reduction of costs." However, Israel's participation will still require legislative changes and extensive preparations. Financial institutions will need to collect declarations of residency from their account holders and to make their own independent inquiries to verify those declarations' reliability. Israel has already signed an I.G.A. with the U.S. for the exchange of information under F.A.T.C.A. Israel, along with other F.A.C.T.A. compliant jurisdictions, anticipates that compliance with the C.R.S. can be leveraged off of F.A.C.T.A. procedures put in place. Israel is now expected to adopt the C.R.S. in 2018.

While the C.R.S. has no direct legal force, it is expected that jurisdictions will follow it closely when implementing bilateral agreements.

WEIL'S ACQUITTAL: U.S. LACKED HARD PROOF IN OFFSHORE TAX EVASION TRIAL

Raoul Weil, a former top UBS AG official accused of helping Americans evade U.S. taxes, was acquitted of tax conspiracy charges on November 3 by a Florida jury that found insufficient hard evidence had been presented to link him to helping wealthy Americans hide $20 billion in secret Swiss accounts. This decision was a major setback to the government's efforts to prosecute other high-level executives for criminal conduct.

"Reliance on the testimony of co-conspirators benefitting from plea bargains is a slippery approach when hard evidence is missing. A smoking gun is required for a successful prosecution."

Former UBS bankers who worked under Mr. Weil testified against him in exchange for leniency, but prosecutors failed to introduce hard evidence showing that Mr. Weil was at the physical location of meetings with taxpayers. The jurors were skeptical of the testimony and considered the documentary evidence, such as e-mails, insufficient to tie him to the conspiracy.

The credibility and truthfulness of the testimony were called into question. One banker, Hansruedi Schumacher, admitted under questioning from defense lawyer Matthew Menchel that Weil had nothing to do with a plan to distort legal advice against promoting certain offshore structures to American clients, according to a transcript of the trial.

The Department of Justice based its case on the confluence of Mr. Weil's leadership position at UBS and the bank's admission that it helped thousands of U.S. individuals avoid payment of U.S. taxes. This reasoning reflects current Congressional sentiments that senior executives must bear responsibility for the acts of their subordinates. While the move may be politically advantageous, it is not sufficient grounds, by itself, to warrant conviction. The prosecutors should have placed less attention on political rhetoric and instead should have focused on linking the defendant to the crime through evidence that he both knew about and participated in the illegal conduct.

Similar approaches exist in civil cases where attorneys for the I.R.S. and Department of Justice have raised pejorative arguments, alleging lack of economic substance without addressing the actual facts or justifying the appropriateness of their view of substance. It is one thing to explain why a transaction is a sham. It is another thing entirely to accept the facts as presented and contend that the economic reality is something else.

Mr. Weil is the highest-ranking executive at a major bank to face criminal charges for assisting U.S. taxpayers in accessing hidden foreign accounts. Mr. Weil resigned from UBS after the indictment was handed down in 2008. The prosecutors had strong evidence against UBS bankers, but the evidence against Mr. Weil himself, beyond his position at the bank, was tenuous.

The Weil prosecutors forgot a basic element of their craft: reliance on the testimony of co-conspirators benefitting from plea bargains is a slippery approach when hard evidence is missing. A smoking gun is required for a successful prosecution.

BANK LEUMI REJECTS $300 MILLION DEMAND IN N.Y. SETTLEMENT BUT MAY FACE MORE

According to an October 29 report by Reuters Jerusalem, Bank Leumi rejected offhand a $300 million settlement offer as not being grounded in any documents or calculations. The controversy stems from an investigation into whether Bank Leumi Le-Israel BM helped U.S. citizens evade taxes. The $300 million exceeds the $254 million reserve already recorded by the bank in its financial accounts, but some estimates anticipate an amount as much as $600 million.

As we noted earlier in the year, U.S. Justice Department efforts to address foreign banks that aid and abet U.S. tax evasion are largely concentrated on Swiss banks, but in fact, the banks in Israel have been under investigation since 2011. Bank Leumi is the first major non-Swiss bank for which a separate criminal investigation by the U.S. Justice Department and related settlement has been publicized.

REVENUE DISAGREEMENT ON TRANSACTION TAX BETWEEN E.U. NATIONS

In an attempt to discourage speculative trading, ten nations in the E.U. vowed to seek an agreement on a "progressive" tax on equities and certain derivatives by the end of 2014, with implementation to commence the following year. However, issues remain regarding how to handle the revenues from the proposed financial transactions tax, as well as how to allocate income between the nations in which the financial transactions take place and the nations in which the trading firms are based. On the latter point, Italy, currently holding the rotating E.U. Presidency, proposed three possible revenue shifting models. These models would allow the tax to be collected in the country of issuance and then allocated out to take account of other parameters such as residence. No final agreement was reached, but this initiative represents the nascent stages of another tax plan intended to closely monitor and regulate the financial industry.

VANGUARD SEEKS TO DISMISS QUI TAM ACTION BASED ON VIOLATION OF ATTORNEY-CLIENT CONFIDENTIALITY

The issue of whether an in-house counsel may bring a "whistleblower" lawsuit regarding improper corporate conduct has been raised as a part of the Vanguard Group, Inc. litigation. The improper conduct at issue relates to the company's transfer pricing practices, which the in-house counsel alleges evaded more than $1 billion in U.S. federal and $20 million in New York state income taxes. By doing so, the attorney claims that Vanguard gained an unwarranted commercial advantage and essentially operated as a tax shelter.

Vanguard has filed a motion to dismiss the whistleblower lawsuit on the grounds that the in-house counsel violated attorney-client privilege in publicizing the action. Counsel for the in-house attorney has asserted that lawyers are not prohibited from bringing whistleblower suits. From a more narrow transfer pricing perspective, the case raises interesting issues with respect to how the transfer pricing policies within the business organization are developed and reviewed.

U.K. ISSUES PAYMENT DEMANDS TO TAX AVOIDANCE SCHEME USERS

The U.K. HM Revenue and Customs ("H.M.R.C.") has issued notices to tax avoidance scheme users demanding that they pay over $404.2 million of disputed tax under the accelerated payments regime that was implemented in 2014. This regime gives certain powers to the H.M.R.C. to receive payments immediately on tax amounts in dispute from taxpayers who have implemented particular tax avoidance schemes.

Financial Secretary to the Treasury, David Gauke, said that the H.M.R.C. is on track to deliver 43,000 notices to tax avoidance scheme users, comprising £7.1 billion ($11.5 billion) of disputed tax by the end of March 2016.

The notices give recipients 90 days to pay the demanded tax. However, some taxpayers are electing to settle their tax affairs before receiving such notices, H.M.R.C. said.

MEDTRONIC'S I.R.S. TRANSFER PRICING DISPUTES MATERIAL TO EFFECTIVE TAX RATE

As we have covered in previous issues,[61] Medtronic is currently challenging $2 billion in proposed transfer pricing adjustments for tax years 2005 and 2006. As reported in recent public documents filed by the Company, the 2005 and 2006 transfer pricing dispute with the I.R.S. extends through Medtronic's 2011 tax year. In addition, the I.R.S. is proposing income reallocations associated with Medtronic's acquisition of other medical device manufacturers where the intangible property acquired was sold in intercompany transactions within the Medtronic group.

The I.R.S. position with respect to Medtronic's transfer pricing practices is that *all* U.S. goodwill, the value of the ongoing business, and the value of the workforce should be included in the intangible or tangible asset value, and the price for the property should reflect a return on these items.

From a financial reporting perspective, Medtronic has reported unrealized tax benefits of $3 billion for its 2012 to 2014 tax years and indicated that the transfer pricing disputes could have a material adverse effect on its tax rate. The trial is scheduled to commence on the Medtronic transfer pricing issues in February 2015.

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[61] See *Insights* Vol. 1 No. 8, "Current Tax Court Litigation Illustrates Intangible Property Transfer Pricing and Valuation Issues."

FOREIGN FINANCIAL INSTITUTIONS MUST APPLY U.S. LAW TO DETERMINE U.S. ACCOUNT HOLDER STATUS UNDER F.A.T.C.A.

Since July 1, foreign financial institutions ("F.F.I.'s") have been responsible for opening accounts with new individual customers consistent with the directives under F.A.T.C.A. Identification of new account holders by the F.F.I.'s as U.S. taxpayers is of course key to the F.A.C.T.A. regime. The question then arises as to how a given F.F.I. will accomplish this. Instructions issued to the F.F.I.'s confirm an anticipated downside to F.A.C.T.A. compliance in that the F.F.I.'s are expected to apply U.S. tax law principles in making U.S. taxpayer determinations. This will entail the collection and analysis of information that is far more technical than what may have been intended, particularly given the "self-certification" process under which individuals provide documentation to the F.F.I. F.F.I.'s most likely will have to become proficient in the application of the U.S. tax residency "substantial presence" test.

"Both the substantial presence test and the U.S. formwork involve considerations that are beyond current 'know your client' rules which would generally apply to F.F.I.'s."

Under the substantial presence test, an individual is a U.S. tax resident if physically present in the U.S. for at least (i) 31 days in the current year, and (ii) 183 days during the three-year period that includes the current year and the two prior years, counting all the days of the current year, one-third of the days in the first prior year, and one-sixth of the days in the second prior year. There are additional rules to determine what constitutes physical presence in any given iteration of facts and circumstances.

In addition, the technicalities of individual tax forms such as the Form W-9 Request for Taxpayer Identification and the W-8 series of international forms may have to be considered by the F.F.I.

Both the substantial presence test and the U.S. formwork involve considerations that are beyond current "know your client" ("K.Y.C.") rules which would generally apply to F.F.I.'s. Ruchelman P.L.L.C. has advised entities as to their F.F.I. status and their related F.A.C.T.A. obligations. In doing so, we have seen firsthand some of the chilling effects F.A.T.C.A. has had on U.S. individuals' ability to access foreign bank accounts.

CORPORATE INVERSIONS: PFIZER STILL CONSIDERING MOVE OUTSIDE THE U.S. WHILE ABBVIE BACKS DOWN

In contrast to the halt of many inversion deals in recent weeks, Pfizer, Inc. is still considering moving the United States' biggest drug manufacturer out of the country under the right circumstances.

Pfizer has been looking for a deal that would allow the company to cut costs, add to the drug maker's pipeline, and make it eligible for a lower corporate tax rate than it currently is in the U.S. However, Pfizer C.E.O. Ian Read also added that a tax inversion transaction isn't necessarily required. It seems from Mr. Read's comments that Pfizer is considering tax structuring one facet of the strategic financial and business goals of its overall acquisition strategy, as opposed to the driving factor. How this will play out for the company, from both a business and public relations standpoint, remains to be seen.

On the other hand, Abbvie Inc. has decided not to buy Shire, a Dublin-based drug manufacturer, despite initially stating that they would continue with their plan.

Meanwhile, Tax Inversions Become a Lobbying Phenomenon

In general, the number of inversions is slowing due to recent administrative action by the Treasury Department.[62] The new Republican-led Congress may still legislate against inversions, and outgoing Senate Finance Committee Chairman Ron Wyden (D-Ore.) claims he will continue to push legislation to curb corporate inversions, at least until his term expires in January.

The issue under dispute is whether legislative changes should be retroactively applied to companies that have already completed inversion transactions, or if legislation should cut the U.S. corporate tax rates in such a way that they are more in line with foreign jurisdictions, as well as moving towards a more territorial system of taxation. Ruchelman P.L.L.C. has recommended the latter approach.

In the meantime, as of the close of the quarter ending September 30, 41 companies have reported that they lobbied on the issue of tax inversions. In the previous quarter, the number was at a mere 16. With the control of both the House and Senate in Republican hands, it will be interesting to see if this lobbying will reverse the recent restrictions placed on inversion transactions by the Obama Administration.

SWISS BANKS REQUEST U.S. AMEND DEMANDS IN TAX AMNESTY DEALS

Swiss banks seeking to avoid U.S. prosecution by disclosing how they helped U.S. citizens evade taxes have asked the Department of Justice to rescind demands that they also cooperate with other nations. The terms of a non-prosecution agreement describes how banks can achieve amnesty through a disclosure program announced last year, but a letter to the Justice Department suggested that there were many changes to the model accord, including a requirement that banks cooperate with "any other domestic or foreign law enforcement agency" in any investigation. Lawyers for the Swiss banks argue that the requirement is not found in the program and turns a program focused on U.S. tax issues into a global agreement with no safeguards in place.

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62 See "Administrative Attack on Inversions: Notice 2014-52," in this edition of *Insights*.

“The Court’s decision illustrates a trap for the unwary with respect to the interplay of the ‘when’ and ‘how much’ aspects of corporate foreign tax credit planning.”

STATUTE OF LIMITATIONS FOR FOREIGN TAX CREDIT STARTS COUNTING AT YEAR OF INCOME, NOT YEAR LIABILITY IS DETERMINED

Applying the Internal Revenue Code (the “Code”) §6511(d) 10-year statute of limitation rule for claim of foreign tax credit, a U.S. Court has ruled that the 10-year statute of limitations period runs from the years for which the credits would have offset income, and not the year the company settled the liability. In *Albemarle Corp. v. United States*,[63] the company realized debenture income in 1997 and 1998 which it considered not subject to Belgian tax. In fact, the income *was* subject to Belgian tax, and the amount of the liability was settled with the Belgian authorities in 2002. The Court held that Albemarle’s foreign tax credit accrued in 1997 and 1998, not 2002, and therefore the 10-year statute of limitations ran from the earlier years.

Under U.S. tax law, allowable credit for foreign taxes paid is generally determined under the principles of U.S. tax law. U.S. tax law principles govern both the determination of income and the triggering of the related tax liability. Administrative procedures govern the amount of the foreign tax liability. The Court’s decision illustrates a trap for the unwary with respect to the interplay of the “when” and “how much” aspects of corporate foreign tax credit planning.

CAMP PROPOSAL NOT MEANT TO CREATE A NEW DEFINITION OF INTANGIBLE PROPERTY

Rep. Dave Camp (R-Mich.), chairman of the House Ways and Means Committee, along with other committee representatives, have confirmed that his February 2014 tax overhaul proposal does not create a new definition of intangible assets. Their comments were meant to address concerns raised that his proposed new category of Subpart F income, “foreign based company intangible income,” did just that. Foreign based company intangible income under Camp’s proposal would be subject to a possible 15% U.S. tax, unless earned in a country that has a tax treaty with the U.S. or an effective rate of tax of at least 12.5%. Specifically, intangible property income would not be based on a “facts and circumstances” test.

COURT ORDERS I.R.S. TO MAKE WITNESS AVAILABLE FOR EATON CORP. DEPOSITION IN EATON A.P.A. CANCELLATION LITIGATION

The ebbs and flows of the Eaton litigation, as we reported on earlier this year, continue, as the U.S. Tax Court ordered the I.R.S. to make former Advance Pricing Agreement (“A.P.A.”) Program team leader, Patricia Lacey, available for further

[63] Fed. Cl., 2014 BL 277726, No. 1:1-cv-00184, 10/19/14

deposition. The Court has also ordered both sides to agree on another witness out of the six the Company has asked to depose.

The Court appears to have agreed at least in part with Eaton's assertion that Lacey and Associate Chief Counsel (International), Steven Musher, did not provide the information that they sought with respect to their rationale for the cancellation of the A.P.A.'s. In fairness to Eaton, a more robust explanation from the government for cancellation of the A.P.A.'s is deserved, than merely that the I.R.S. believed it intentionally deviated from the terms of the A.P.A.'s. In the Court's order, Ms. Lacey and the other witness are ordered to provide "substantial knowledge" of the specific ground(s) that the I.R.S. relied on in cancelling the A.P.A.'s and the factual basis of the underlying justifications.

WEGLIN CLIENT SENTENCED TO THREE-MONTH PRISON TERM

As we noted earlier in the year, an individual client of Wegelin & Co. pled guilty to willfully failing to file Reports of Foreign Bank and Financial Accounts ("F.B.A.R.'s") with the I.R.S. with respect to funds in a secret Swiss bank account that he maintained and controlled at Wegelin & Co. The individual had opened the account when he was a Russian citizen. He emigrated to the U.S. in 1984 and obtained U.S. citizenship in 1986. No F.B.A.R.'s were ever filed for the account. He used the account as an operating and investment fund for his business in New York.

"An individual client of Wegelin & Co. pled guilty to willfully failing to file F.B.A.R.'s… [and] was sentenced to a three-month prison term as well as three years of supervised release, and was ordered to pay more than $100,000."

The individual, Viktor Kordash, was sentenced to a three-month prison term as well as three years of supervised release, and was ordered to pay more than $100,000 in back taxes and civil penalties.[64]

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[64] *United States v. Kordash*, S.D.N.Y., No. 14-cr-00345.

IN THE NEWS

OUR RECENT AND UPCOMING PRESENTATIONS

On August 10, 2014, Philip Hirschfeld participated in the panel "Planning for Foreign Persons Investing in U.S. Real Estate" at the *2014 ABA Annual Meeting* in Boston. The panel focused on planning tips on how to structure an investment in U.S. real estate by a foreign investor in a tax efficient manner and foreign investors acquiring or originating U.S. mortgage debt.

On October 29, 2014, Edward C. Northwood participateed on the panel "International Estate Planning (Focus on Taxation of Distributions from a Foreign Trust or Estate)" at the *ITSG 2014 World Conference* in Paris, France.

On October 29-30, 2014, Robert G. Rinninsland gave two presentations in conjunction with the *ITSG 2014 World Conference* in Paris, France. The first presentation, "Transfer Pricing – The IP Paradigm – U.S. Context," was part of the special interest group "Transfer Pricing, a Sharing of Experiences," and drew on recent U.S. court cases to address recent developments in I.P. valuation methodologies. "International Tax and B.E.P.S. a Reality Check" provided a review of various aspects of the O.E.C.D. proposals taken from the B.E.P.S. reports.

On October 30, 2014, Andrew Mitchel participated on the panel "International Tax and BEPS" at the *ITSG 2014 World Conference* in Paris, France where he addressed "Anti-Treaty Shopping: Limitation on Benefits Provisions." The panel discussed the anatomy of the current international tax system, its evolution and fundamental components (such as permanent establishment, withholding tax, thin capitalization, treaty interpretation, treaty shopping, C.F.C. rules, corporate residence, and transfer pricing), and examined whether the current system can survive the challenges of the modern world.

October 31, 2014, Stanley C. Ruchelman and Edward C. Northwood presented the "Foreign Grantor Trust" before the *ITSG 2014 World Conference* in Paris, France. The presentation addressed the foreign grantor trust as a viable solution to benefit U.S. persons and included practical guidance for grantors and beneficiaries.

October 31, 2014, Stanley C. Ruchelman also presented the "U.S. Tax Update" to the *ITSG 2014 World Conference* in Paris, France. He provided a look at major tax developments in the U.S. with particular focus on corporate inversions.

On November 3-4, 2014, Galia Antebi addressed "F.A.T.C.A. and the I.G.A. – How German business, U.S. Citizens, and German Financial Advisors are Affected" before the American German Business Club in Munich and Frankfurt, Germany. The presentation included a top level review of Form W-8BEN-E for German businesses, Form W-9/W-8BEN for German resident individuals, and the due diligence process for the financial services sector.

On October 29, 2014, Fanny Karaman participated in the panel "Oktoberfest-German VAT" at New York Law School. The panel provided an introduction to the European V.A.T. system, with discussion of how the system affects U.S. businesses today and how it can serve a model for future U.S. legislation.

On November 12, 2014 Stanley C. Ruchelman and Kenneth Lobo presented at the Halton-Peel C.P.A. Association's *Life of a U.S. Investment – U.S. Tax Issues Commonly Encountered* in Mississauga, Ontario. The discussion, entitled "U.S. Tax Points to Remember in a Cross Border Investment," addressed a full range of topics involved in managing inbound and outbound investments, including entity classification, tax treatment under §367 of asset transfers, working with Subpart F, working with P.F.I.C.'s, U.S. rules designed to eliminate excessive benefits, international attacks on excessive benefits, and permanent establishment issues.

On November 13th, 2014, Nina Krauthamer lectured on "Understanding U.S. Taxation of Foreign Investment in Real Property: F.I.R.P.T.A. and Beyond" at New York Law School. The program, aimed at demystifying U.S. tax considerations for a foreign person investing in U.S. real estate, explained basic income, estate, and gift tax rules; presented special tax planning considerations; and considered common tax traps for the unwary foreign investor.

Copies of our presentations are available on the firm 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 Stanley C. Ruchelman, Simon H. Prisk, Galia Antebi, Philip R. Hirschfeld, and Jennifer Lapper.