



# INSIGHTS

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**THE PROPOSED UNITED KINGDOM “DIVERTED PROFITS TAX”**

**TAX 101: UNDERSTANDING U.S. TAXATION OF FOREIGN INVESTMENT IN REAL PROPERTY – PART II**

**2014 TAX EXTENDERS LEGISLATION FINALLY APPROVED**

**B.E.P.S. UPDATE**

**CORPORATE MATTERS: IS YOUR DEAL SAFE?**

**AND MORE**

Insights Vol. 2 No. 1

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### In the News

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## EDITORS' NOTE

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

- **The Proposed U.K. "Diverted Profits Tax."** Last month, guest author John Chown alerted readers on the Diverted Profits Tax proposal in the U.K. This month, he provides views on the wisdom of the proposal.
- **Filing Requirements upon Conversion of a Trust Between Foreign and Domestic Status.** U.S. tax law provides filing obligations for domestic trusts that differ from the obligations on foreign trusts. Beate Erwin, explains the standard by which trusts are considered foreign or domestic and discusses a recent I.R.S. Chief Counsel Memorandum on filing requirements when the status of a trust changes in mid-year.
- **Tax 101: Understanding U.S. Taxation of Foreign Investment in Real Property – Part II.** Nina Krauthamer and Sheryl Shah continue their series of articles on tax rules applicable to foreign investment in U.S. real property.
- **2014 Tax Extenders Legislation Finally Approved.** The 2014 extender legislation has a limited shelf life. Nonetheless, important provisions were extended to cover the 2014 tax year. Philip R. Hirschfeld explains.
- **B.E.P.S. Action 4: Limit Base Erosion via Interest Payments and Other Financial Payments.** In December 2014, the O.E.C.D. issued a discussion draft regarding Action 4, which addresses aggressive tax plans using inter-company interest. Stanley C. Ruchelman and Sheryl Shah explore the way in which the O.E.C.D. proposes to stop those tax plans.
- **B.E.P.S. Actions 8, 9 & 10: Assuring that Transfer Pricing Outcomes are in Line with Value Creation.** Beate Erwin and Christine Long look at discussion drafts under Actions 8, 9, and 10. These actions are intended to assure that transfer pricing outcomes are in line with value creation.
- **B.E.P.S. Action 10: The Profit Split in the Context of Global Value Chains.** Also in December 2014, the O.E.C.D. issued a discussion draft regarding Action 10, Rusudan Shervashidze and Stanley C. Ruchelman explain how the O.E.C.D. proposes to assure that transfer pricing outcomes are in line with value creation.
- **B.E.P.S. Action 14: Make Dispute Resolution Mechanisms More Effective.** While most of the Action Items under the B.E.P.S. initiative focus on taxpayer abuse, Action 14 focuses on sub rosa attempts of tax authorities to undermine treaty-based dispute resolution procedures. Stanley C. Ruchelman and Sheryl Shah explore the O.E.C.D. proposal.
- **Corporate Matters: Is Your Deal Safe? How the F.C.P.A. Affects Mergers and Acquisitions.** Guest author James Keneally of Harris, O'Brien, St. Laurent & Chaudhry explains how the Foreign Corrupt Practices Act affects a foreign company looking to partner with, or be acquired by, a U.S.-based entity. Behavior that works overseas may be disastrous once the F.C.P.A. applies.

- **F.A.T.C.A. 24/7.** Philip R. Hirschfeld and Galia Antebi provide a monthly update on F.A.T.C.A. compliance. This month, they address additions to the list of countries considered to have in-substance I.G.A.'s, additions to the I.R.S. F.A.T.C.A. web site, the status of foreign trusts and family holding companies under F.A.T.C.A., and events in Chile.
- **Updates and Other Tidbits.** Kenneth Lobo, Christine Long, Cheryl Magat, and Sheryl Shah review current events in international taxation. Topics include tax evasion Indian style, document production in the Microsoft tax litigation, economic conditions in O.E.C.D. member countries, I.R.S. retraining of domestic examiners to cover international clients, discoveries about the client base of Sovereign Management & Legal Ltd., the tax effect of a change in a Hedge Counterparty, developments in I.F.R.S. and G.A.A.P. integration, filing changes for dual resident companies having foreign financial accounts, reductions to the I.R.S. operating budget, boycott list developments, and the treatment of real property tax equivalent payments.

We hope you enjoy this issue.

- The Editors

# THE PROPOSED UNITED KINGDOM “DIVERTED PROFITS TAX”

**Author**  
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**Tags**  
Diverted Profits Tax  
Tax Policy  
U.K.

## INTRODUCTION

The United Kingdom proposes to introduce, on profits arising as of April 1, 2015, a “Diverted Profits Tax.” This is intended to override the normal international tax arrangements when H.M.R.C. (the U.K. tax authority) does not like the outcome. Domestic laws, O.E.C.D. practice, and a network of Double Tax Agreements provide a definition of “Permanent Establishment” defining what income is or is not taxable within the country of operation. Similarly, “Transfer Pricing” rules should enable the tax authorities to ensure that the price used for transactions between related entities is appropriate for calculating proper division of taxable revenue between the countries concerned. While many believe that these are not working as well as they should, the problems need a more subtle and sophisticated solution rather than a blunderbuss approach.

The “Diverted Profits Tax,” at a rate of 25% (mildly penal, compared with the Corporation Tax rate of 21%), is to be imposed if H.M.R.C. does not like the answer produced by these well-established procedures and succeeds in claiming, under this new law, that profits have, nevertheless, been “diverted.” The draft legislation sets out very detailed rules. These are available on the H.M.R.C. website, but those who follow matters very closely would be well-advised to continue to examine the extensive comments that are being made. The draft legislation gets very close to giving H.M.R.C. the power to determine unilaterally the level of taxable income. “Tax by administrative discretion” is a policy normally associated with authoritarian or left-wing governments. The United Kingdom may well, post-election, have a left-wing government who will be delighted to be presented with what, to them, is a very attractive measure.

## APPROPRIATE STRATEGIES FOR AFFECTED BUSINESSES

What do those affected by the draft legislation and their advisers need to do or know? The provisions will not apply to S.M.E.’s, *i.e.*, groups with less than £10 million of annual sales within the U.K. Others will need to consider their position very carefully and make contingency plans on the assumption that the provisions will be enacted, although perhaps in a substantially amended form. H.M.R.C. forecasts that the measure will eventually bring in £350 million per annum, but goes on to say that it “is not expected to have a significant economic impact.” American readers in particular will be well aware that there is a huge gap between the initially-forecast yield of a tax avoidance measure and the outcome. Hastily proposed and badly designed tax legislation is often more successful at creating economic damage than producing revenue or desirable changes in activities.

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*“In a normal year, this legislation would then go through several Parliamentary stages before being signed into law. This year, though, the General Election on May 7 will intervene.”*

There may well be technical loopholes in the final form of the legislation, but no sensible commentator would draw attention to these before the Parliamentary process is complete. The legislation will be included in the 2015 Finance Bill and may or may not take into account the invited public comments. In a normal year, this legislation would then go through several Parliamentary stages before being signed into law (“the Royal Assent”) in late July. This year, though, the General Election on May 7 will intervene. Normal practice in these circumstances is to introduce a brief bill quickly to ensure that taxes can continue to be collected and include certain announced provisions. A more detailed bill is then brought forward by the incoming government. There is a danger, in this case, that controversial measures may be rushed through without Parliamentary scrutiny, resulting in years of challenges before the Courts – in particular regarding the breach of Double Tax Agreements. (The European Court of Justice may, uncharacteristically, actually be helpful.)

International companies with significant operations (£10 million plus) in the U.K. will, as usual, calculate their strategies and their options in after-tax terms, and where, as here, the law is not clear and leaves too much to administrative discretion, they will be advised to make commercial decisions on “worst-case” assumptions. This, though, still leaves the option to pursue all available remedies in the Courts to secure a better answer. As an adviser on tax policy, I have often pointed out (notably, on this topic in Russia, where the excellent Tax Minister and the Kremlin had predictably different views) that lack of certainty can result in the country receiving both lower investment and lower tax revenue than if it had imposed more responsible policies.

Affected companies may decide, commercially, to retain much of their U.K. activities as at present. If they have been pursuing an aggressive tax planning strategy, they may simply decide that the game may be over. Many others, who have been taking normal, unaggressive advice on optimizing after-tax profits taking account of international tax provisions, may find they have to watch their position. They may decide to err on the side of making sure that their tax charge is high enough to satisfy the U.K. revenue, paying their 21% tax and avoiding the risk, hassle, and expense of precipitating an investigation into alleged “Diverted Profits.” They must then remember that any change in strategy resulting in more tax being paid to the U.K. will deprive another jurisdiction of revenue, and these might well (if they are not blatant tax havens) try to insist on the proper interpretation of agreements. Many years ago, transfer pricing rules were only invoked against blatant transfers of profits to “tax havens,” but when the U.S. began using them aggressively to get a larger share of the total revenue from transactions with other high-tax countries, the latter were forced to retaliate.

Other strategies could include making significant changes to avoid the problem. It is too early to know the exact rules, but the principles are straightforward enough. The simplest is to stop trading into the U.K. or, in the case of small companies, make sure that sales are below the £10 million limit. Where appropriate, they may simply cease to have any relevant activities within the U.K. and treat it simply as an export market. There are some interesting compromises that will surely be pursued, but detailed advice will be needed on where the line is drawn when the legislation is in its final form.

What preparatory operations, if any, could be carried on within the United Kingdom? The obvious ruse of having U.K.-based employees soliciting orders where they are

then referred to Dublin or wherever for the final contract to be drafted surely won't work. What if the people concerned are moved to Dublin (or replaced by new people employed there) who solicit their orders by telephone or email? If they, personally, are or become nonresident in the U.K., to what extent, if at all, can they visit customers in the U.K. during short visits?

Another variation, which might help to enable profits to arise in a moderately low tax country in a Treaty relationship with the U.K., would substantially be to increase the activities carried on in that country to give substance to the activities and to justify a reasonable proportion of the profits arising there under Treaty rules and procedures. Another, which I have used in the past, would be to hive off the U.K. sales and service operations to an independent company, which could employ and possibly be owned by the existing staff. Great care would have to be taken to make sure this is genuinely independent.

## THE POLITICS

H.M.R.C. is probably hoping that, faced with the hassle and penalties, companies will simply cease to attempt to optimize their tax liabilities and will be terrorized into paying more tax than they need legally to do. Unfortunately, though, they may react by concentrating their business efforts elsewhere. Remember that Starbucks was criticized for having a trivial corporation tax liability. However, it would have been collecting and handing over to H.M.R.C. Value Added Tax on this turnover, and Social Security and Income Tax on its employees. Published statistics of the breakdown of tax revenue indicates that the first three taxes bring in over ten times as much revenue as corporation tax.

The Diverted Profits Tax has all the hallmarks of over-hasty legislation rushed into law in response to a press-oriented public campaign. A reader need not be British to know that, in the run-up to an election campaign, politicians are far more interested in proposing populist measures than financially sensible ones.

As with the U.S. approach to "Inversions," this solution is addressing the wrong question. The old rules regarding C.F.C.'s and transfer pricing, which used to work perfectly well, now seem to be less effective. One reason is the sheer complexity of legislation that has grown out of ill-conceived political reactions to perceived problems. There are also some real issues and abuse, notably in electronic trading. These need to be addressed, and Double Tax Agreement provisions need to be updated for a range of reasons. However, this requires an international solution, on which the O.E.C.D., through its B.E.P.S. initiative, is working. This may or may not produce the right answer - but why not wait and see?

Political initiatives these days, including this one, often represent an overreaction to an understandable, but not well advised, press campaign against particular abuses. Oddly, many of the companies that are accused of diverting profits from the U.K. to associated, lower-tax companies are American-owned and are likely advised by highly paid professionals who know how to navigate around complex anti-abuse rules, as well as U.S. C.F.C. legislation.



## BRIEF DETAILS

Last month in *Insights*, I described briefly the key issues in the draft legislation. The new tax is to apply in two broad circumstances. One involves avoiding a taxable presence in the form of a Permanent Establishment in the U.K. of which H.M.R.C. disapproves and creating a tax advantage by means of transactions or entities which lack economic substance.

- The first case arises if there are activities within the U.K. in connection with the supply of goods and services to customers there by a foreign company in such a way that there is no Permanent Establishment under established rules. If it is then “reasonable to assume” (by H.M.R.C.) that these activities are designed to ensure that the company is not carrying on a taxable trade, it will be attacked.
- The second case may involve financial arrangements or non-financial arrangements leading to a tax mismatch. Both are liable to be attacked. There is an effective tax mismatch if there is an increase of expenses by, or a reduction in the income of, the U.K. party (with a corresponding change in the foreign party and the tax charge on the foreign party is less than 80% of the U.K. charge). There are full details available on the H.M.R.C. website.

## SOME GENERAL THOUGHTS ON ANTI-AVOIDANCE POLICY

Several years ago, a badly directed campaign began in the British Press on tax avoidance policy. Many thought the press campaign to be an overreaction, but since then, precisely these types of overreaction measures have been overwhelming us everywhere. We are getting dangerously close to the type of anti-avoidance provision that effectively means that the tax authorities can re-write a transaction to get the best result for themselves. This produces uncertainty. Where there is uncertainty, a properly advised investor, particularly a foreign investor, will work out the tax consequences and make their decision whether or not to go ahead on a worst-case assumption. If, however, they do go ahead, they will then do their best to secure the better solution. As mentioned above, the net result of the Diverted Profits Tax will be well received headlines in the press followed by less investment and less revenue for the U.K. economy.

*“The net result of the Diverted Profits Tax will be well received headlines in the press followed by less investment and less revenue for the U.K. economy.”*

# FILING REQUIREMENTS UPON CONVERSION OF A TRUST BETWEEN FOREIGN AND DOMESTIC STATUS

## Author

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## Tags

C.C.A. 201432022  
Decanting  
Domestic Trust  
Foreign Trust  
Form 1041  
Form 1040NR  
Grantor Trust  
Helfer v. Clifford  
Non-grantor Trust  
Notice 2011-101  
Rev. Proc. 2012-3  
Trust Conversion  
Trust Filing Requirements

## INTRODUCTION

Whether a trust is categorized as a U.S. domestic trust or a foreign trust leads to different tax consequences and different filing obligations. This leads to the following questions: Which tax return must be filed when a trust is converted from a U.S. domestic trust to a foreign trust, and which applies when a foreign trust is converted to a U.S. domestic trust? A Chief Counsel Advice Memorandum, C.C.A. 201432022 issued on August 8, 2014, provides guidance on filing requirements in these fact patterns. Though it stated the obvious, the C.C.A. still leaves questions open, in particular with respect to grantor trusts. This article summarizes the conclusion reached by the C.C.A. and addresses issues for which clarification was not provided.

## C.C.A. 201432022

In approaching the issue, the C.C.A. began by outlining the rules under which the filing status of a trust is determined for U.S. federal income tax purposes.

### U.S. Trust versus Foreign Trust – General Tax Rules

Domestic trusts, like U.S. citizens and residents, are taxed on worldwide income, whereas foreign trusts, like nonresident aliens, are taxed only on U.S.-source income and income effectively connected with the conduct of business in the United States.

Generally, a trust is domestic if it is subject to primary supervision by a U.S. court and all substantial decisions are made by U.S. persons, the so-called “Court Test” and the “Control Test,” respectively, under the regulations.<sup>1</sup> Under the Court Test, a trust is a U.S. person (“Domestic Trust”) if a “court within the United States is able to exercise primary supervision over [its] administration.” The Control Test requires that U.S. persons have “authority to control all substantial decisions of the trust.” “Substantial decisions” of a trust are those nonministerial decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law. These include:

Whether and when to distribute income or corpus;

- The amount of any distributions;
- The selection of a beneficiary;
- The power to make investment decisions;

<sup>1</sup> Treas. Reg. §301.7701-7(a).

- Whether a receipt is allocable to income or principal;
- Whether to terminate the trust;
- Whether to compromise, arbitrate, or abandon claims of the trust;
- Whether to sue on behalf of the trust or to defend suits against the trust;
- Whether to remove, add, or replace a trustee; and
- Whether to appoint a successor trustee or trustees.<sup>2</sup>

Examples of ministerial decisions include bookkeeping, collection of rents, and the execution of investment decisions made by others.<sup>3</sup>

If both of these requirements are not met, a trust is a “Foreign Trust.”<sup>4</sup> The application of both tests depends on the “terms of the trust instrument and applicable law.”<sup>5</sup> The tests are applied daily, and a trust is a Domestic Trust on each day that it meets both tests. The Court and Control Tests were enacted in 1996 to provide “an objective test for determining whether a trust is foreign or domestic.”

### **Filing Requirements for U.S. versus Foreign Trusts**

A Foreign Trust is treated like a nonresident alien individual and must file Form 1040NR to report income. A Domestic Trust must file Form 1041. An income tax return is required if the Domestic Trust has:

- Any taxable income for the tax year;
- Gross income of \$600 or more for the tax year, whether or not it has any taxable income; or

A beneficiary who is a nonresident alien.

In determining whether the trust has gross income of \$600 or more, income taxable to a grantor as owner of the trust is viewed as part of the trust’s income. However, certain grantor trusts do not file Form 1041, as explained below under “Open Issues.”

### **I.R.S. Counsel’s Conclusion on Conversion Year Filings**

According to the C.C.A., a trust that is a U.S. person on the last day of the tax year must file Form 1041 and enter “Dual-Status Return” across the top. The trust should also attach Form 1040NR as a schedule showing the income for the part of the year during which it was a Foreign Trust. If a trust is a Foreign Trust on the last day of the tax year, it must file Form 1040NR with “Dual-Status Return” written across the top and attach Form 1041 as a schedule showing the income for the part of the year during which it was a Domestic Trust.

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<sup>2</sup> Treas. Reg. §301.7701-7(d)(1)(ii).

<sup>3</sup> *Id.*

<sup>4</sup> Code §§7701(a)(30)(E), 7701(a)(31)(B), as amended by Pub. L. No. 104-188, §1907, 110 Stat. 1755 (1996) (applicable for taxable years beginning after 1996 or, at trustee’s election, for taxable years ending after August 20, 1996).

<sup>5</sup> Treas. Reg. §301.7701-7(b).

## OPEN ISSUES

*“Trusts that do not fall under the Grantor Trust rules deflect tax liability away from the grantor to either the beneficiaries or the trust.”*

The C.C.A. refers only to the filing obligations of the trust itself. Generally, these rules are applicable to so-called “Non-Grantor Trusts,” *i.e.*, trusts that are either simple or complex trusts. Trusts that do not fall under the Grantor Trust rules deflect tax liability away from the grantor to either the beneficiaries or the trust, generally depending on whether income is distributed in the year received (a simple trust) or accumulated by the fiduciary (a complex trust).<sup>6</sup> This result is accomplished by including all of the income on the trust’s return, with a deduction for amounts taxable to the beneficiaries, who then pick up these amounts for inclusion on their own returns. Since the trust is viewed as a pass-through, *pro tanto*, distributed income usually retains its original character (*e.g.*, as tax-exempt interest, capital gain, or foreign-source income) in the hands of the beneficiaries. Each must report his or her *pro rata* portion of specially treated items, unless the governing instrument applies a different allocation.

The C.C.A. does not address that in specific circumstances it is not the trust per se that is taxable, but rather it is the grantor who is taxable on trust income as though the grantor retained the property instead of creating a trust (the so-called “Grantor Trust”). Hence, in the latter scenario, specific filing obligations that may apply to the grantor remain unclear, in particular with respect to years where the status of a trust changes from domestic to foreign, non-grantor to grantor, foreign to domestic, and grantor to non-grantor. The following addresses some of these circumstances including a brief description of the statutory framework.

### **Change from Grantor to Non-Grantor and Domestic to Foreign Trusts and Vice Versa**

#### **Grantor v. Non-Grantor Trusts – General Tax Rules**

Many years ago, the Grantor Trust rules, which when applicable prevail over the rules governing ordinary trusts, subjected the grantor to taxation only if the grantor could revoke the trust or reclaim the income. However, in a series of cases leading up to the landmark decision in *Helvering v. Clifford*,<sup>7</sup> the courts held that the grantor could be taxed, even in the absence of a power to revoke, if the grantor retained significant control over beneficial enjoyment of trust income or corpus. These “Clifford Trust” principles, which required determination on a case-by-case basis, were replaced subsequently by Treasury Regulations that set forth relatively precise rules. In 1954, these regulations were superseded by the detailed statutory rules of Code §§671-677.

Under these provisions, a trust is treated as a Grantor Trust if the grantor retains a reversionary interest with an initial value that is greater than 5% of the value of the trust or specified rights to control beneficial enjoyment of the corpus or income or if the grantor retains or vests in a non-adverse party unusual administrative powers of a non-fiduciary character. In addition to these rules, a person other than a grantor is treated as owner of trust property under Code §678 if the person has power to vest corpus or income in himself (so-called “Mallinckrodt Trusts”).

In addition, Code §679 treats a U.S. person as the grantor of a Foreign Trust even

<sup>6</sup> Treas. Reg. §301.7701-7(a)(2).

<sup>7</sup> *Helvering v. Clifford*, 309 U.S. 331 (1940).

in the absence of an interest in or power over trust assets or beneficiaries, if the trust has one or more U.S. beneficiaries. Under Code §679, a U.S. person who transfers property, directly or indirectly, to a Foreign Trust is treated as owning the portion of the trust that is attributable to the transferred property if a U.S. person is a beneficiary of that portion. If a nonresident, non-citizen individual becomes a U.S. resident within five years after having transferred property to a Foreign Trust, Code §679 applies as though the person, on his or her residency starting date, transferred to the trust the property then held by the trust that is attributable to the transferred property, including an appropriate share of any income accumulated in the trust. Also, if a U.S. citizen or resident transfers property to a Domestic Trust that subsequently becomes a Foreign Trust, the transferor, if then living, is treated as transferring to a Foreign Trust the portion of the trust that is attributable to the transferred property.

### Grantor Trust Filing Obligations and Exception

While a Grantor Trust is a legal trust under applicable state law, it is not recognized as a separate taxable entity for federal income tax purposes due to the grantor or another person having retained substantial dominion or control over the trust. The grantor or other person is treated as owner of the trust and is taxed on all or part of its income. Nevertheless, except in the case of certain revocable trusts, a Grantor Trust may be required to file Form 1041.

For tax purposes, the income is ordinarily treated as though it had been received by the grantor and then transferred by nontaxable gift to the trust beneficiary. A beneficiary who reports the amount as taxable income on the mistaken assumption that the trust is not a Grantor Trust is entitled to a refund of the tax when it becomes clear that the grantor is the proper taxpayer.

The owner of a Grantor Trust (or of a part of such a trust) is directly taxable on that part of the trust income that he or she is deemed to own and is entitled to the deductions and credits allocable to it. Consequently, the trustee should not report such income, deductions, or credits on Form 1041. Instead, the trustee should attach to Form 1041 a separate statement showing the owner's name, taxpayer identification number ("T.I.N."), and address; and the trust income, deductions, and credits owned by that owner. Those items will then be reported by the grantor or other person on his return as income, deductions, and credits, as though the trust were not in existence. If the owner's tax year differs from that of the trust, the statement should contain the information needed to assign the items of income, deduction, and credit to the proper tax year of the owner.

Instead of filing a Form 1041 and attaching a statement, the trustee of a Grantor Trust, all of which is owned by one or more grantors or other persons, can elect one of three optional reporting methods. The reporting options available depend on whether the trust is treated as owned by one grantor or by two or more grantors. If the trust is treated as owned by one grantor, the trustee may choose between two alternative methods of reporting.<sup>8</sup>

The trustee is required to furnish to all payors either (i) the grantor's name and T.I.N., and the address of the trust, under the first alternative, or (ii) the name, T.I.N., and address of the trust, under the second alternative.

<sup>8</sup>

Exceptions to this rule include, *inter alia*, common trust funds defined in Code §584; trusts with a situs outside the U.S. or with any trust assets located outside the U.S.; qualified Subchapter S trusts, as described in Code §1361; and a trust which is wholly treated as owned by one grantor having a fiscal tax year.



A trustee who follows the first method does not have to file any return with the I.R.S.<sup>9</sup>

### Decanting

The trustee is vested with various discretionary powers regarding trust arrangements. Such powers are of great importance in estate planning for both tax and nontax reasons. While they are not the focus of the discussion here, one form of trustee power, a so-called “Decanting” power, has attracted increased attention in recent years.

Decanting is the term generally used to describe “the distribution of [irrevocable] trust property to another trust pursuant to the trustee’s discretionary authority to make distributions to, or for the benefit of, one or more beneficiaries [of the original trust].” Such distributions can be used to make various changes in the trust arrangements, including changes in trustee arrangements or other administrative aspects of the trust. They can also be used to change the tax status of the trust, such as changing a Grantor Trust into a Non-Grantor Trust or vice versa.

The New York State Bar Association, the State Bar of Texas, and the American Institute of Certified Public Accountants have thus far submitted comments in response to the I.R.S. request in Notice 2011-101, urging, in particular that a Decanting which does not change beneficial interests in a material way should not be considered a distribution for income tax purposes.

Despite the moratorium announced in Rev. Proc. 2012-3 and Notice 2011-101, in Private Letter Ruling 201223012 (February 28, 2012), the I.R.S. ruled favorably on a ruling request submitted August 31, 2011. The request concerned the income tax, as well as the gift, estate, and generation-skipping tax, consequences, of the proposed division of an irrevocable trust after the settlor’s death into separate trusts for the benefit of his two children and their issue. The aim was to better provide for their diverse economic interests and needs, notwithstanding the fact that the trust as originally drafted appeared to embody a “family pot” approach until the death of the last of the settlor’s children. For income tax purposes, the ruling holds that the division would not be regarded as a distribution under Code §661, or as a taxable event to any of the trusts or their beneficiaries. The ruling was contingent on the entry of a state court order authorizing the division into two essentially separate shares.

### **Limits of Guidance by C.C.A. 201432022**

For changes from Non-Grantor to Grantor Trust status, as outlined above, as well as Decanting, it is not clear how such a change should be treated from a filing perspective. C.C.A. 201432022 might be misleading in a way to suggest that filing of Form 1041 may be required, whereas under the applicable rules an exception from filing may apply (e.g., Grantor Trust exception under Treas. Reg. §1.671-4(b)(2)(ii)(B)) or filing requirements are not clear (e.g., Decanting).

## **SUMMARY**

While providing clear guidance on filing requirements in the case of conversions from Domestic or from Foreign Trusts that fall under the Non-Grantor Trust rules and for Grantor Trusts that file Forms 1041, C.C.A. 201432022 leaves open questions with respect to certain conversion-related issues. In particular, it does not address cases where Grantor Trusts are not required to file Form 1041.

<sup>9</sup> Treas. Reg. §1.671-4(b)(2)(ii)(B).

*“Decanting can be used to make various changes in the trust arrangements, including changes in trustee arrangements or other administrative aspects of the trust.”*

# TAX 101: UNDERSTANDING U.S. TAXATION OF FOREIGN INVESTMENT IN REAL PROPERTY – PART II

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## Tags

Disposition  
Estate Tax  
F.I.R.P.T.A.  
Gift Tax  
Mortgages  
Sale of Real Estate  
U.S.R.P.I.  
Withholding

This article examines the U.S. income, gift, and estate tax consequences to a foreign owner upon a sale or other disposition of U.S. real property, including a sale of real estate, sale of stock of a U.S. corporation, or a sale of a mortgage secured by U.S. real property.

In addition to (or sometimes in lieu of) rental income, many foreign investors hope to realize gain upon a disposition of U.S. real property. The Foreign Investment in Real Property Tax Act of 1980 (“F.I.R.P.T.A.”) dictates how gains are taxed from the disposition of United States Real Property Interests (“U.S.R.P.I.’s”). The law has a fairly extensive definition of U.S. real property for this purpose. Most significantly, the law provides for a withholding mechanism in most cases.

## WHAT IS A U.S.R.P.I.?

A U.S.R.P.I. includes the following:

- Land, buildings, and other improvements;
- Growing crops and timber, mines, wells, and other natural deposits (but not severed or extracted products of the land);
- Tangible personal property associated with the use, improvement, and operation of real property such as:<sup>1</sup>
  - Mining equipment used to extract deposits from the ground,
  - Farm machinery and draft animals on a farm,
  - Equipment used in the growing and cutting of timber,
  - Equipment used to prepare land and carry out construction, and
  - Furniture in lodging facilities and offices.
- Direct or indirect rights to share in appreciation in value, gross or net proceeds, or profits from real property;
- Ownership interests other than an interest solely as a creditor, including:<sup>2</sup>
  - Fee ownership;
  - Co-ownership;

<sup>1</sup> Treas. Regs. §1.897-1(b)(4)(i)

<sup>2</sup> Treas. Regs. §1.897-1(d)(2)

- Leasehold interest in real property;
- Time-sharing interest;
- Life estate, remainder, or reversionary interest; and
- Options, contracts, or rights of first refusal.
- Certain partnership interests, if 50% or more of the value of the gross assets consists of U.S.R.P.I.'s and 90% or more of the value of the gross assets consists of U.S.R.P.I.'s plus any cash or cash equivalents (the "50/90 Test");
- With certain exceptions, a corporation characterized as a U.S. Real Property Holding Corporation ("U.S.R.P.H.C.") at any time during the five-year period preceding the sale. A corporation will be so characterized if the fair market value of U.S.R.P.I.'s held by it on any determination date equals or exceeds 50% of the sum of the fair market values of:
  - U.S.R.P.I.'s,
  - Non-U.S. real property interests, and
  - Other trade or business assets.

This can be expressed as a formula:

$$\text{U.S.R.P.H.C.\%} = \frac{\text{F.M.V. of U.S.R.P.I.}}{\text{F.M.V. of U.S.P.R.I.} + \text{F.M.V. of Foreign Real Property} + \text{F.M.V. of trade/business assets}}$$

However, an exception is provided for regularly traded classes of stock if the taxpayer owns 5% or less. In addition, and significantly, a corporation that has disposed of all of its U.S.R.P.I.'s in taxable transactions is also excluded from meeting the definition of a U.S.R.P.H.C.

## SALE OF REAL ESTATE

When a foreign person disposes of a U.S.R.P.I., the gain from the sale of that U.S.R.P.I. is taxed as if the foreign seller is engaged in a trade or business in the U.S. and the gain is effectively connected income ("E.C.I."), meaning that the foreign seller is taxed on gains at the same rates as a U.S. seller.

This treatment has its advantages as well as disadvantages. One of the biggest benefits is that the gain can qualify for reduced tax rates as a long-term capital gain or like-kind exchange under Code §1031, if exchanged for another U.S.R.P.I.

However, this also means that the seller is therefore required to file U.S. tax returns to determine the amount of tax owed on the gain. Generally, to ensure satisfaction of the seller's U.S. tax obligations, a portion of the gain is withheld by the buyer and remitted to the I.R.S. (as explained in detail below). A foreign seller is taxed in the same way and at the same rate as a U.S. seller, without regard to rules that may be applicable in the seller's home country. To complete this process, a foreign seller will need a tax identification number.

## WITHHOLDING REQUIREMENT

The law provides for a withholding requirement to make sure that the tax owed on the gain of the disposition of real property will be paid. This withholding amount has to be retained by the “Withholding Agent,” which is often the buyer, and remitted to the I.R.S. Any tax withheld in excess of what is owed will be refunded to the seller when the appropriate tax returns are filed.

Generally speaking, 10% of the amount realized must be withheld by the buyer. Distribution by a domestic entity requires 10% to be withheld unless the entity has a foreign partner or beneficiary. If a partner or beneficiary of that domestic entity is a foreign person, 35% of the gain realized has to be withheld to the extent allocable to such foreign person.

However, since this can often be more than the tax owed on the gain, an exemption or reduced rate certificate (“Withholding Certificate”) can be obtained by filing Form 8288-B before or at the same time as the property transfer to reduce the required withholding.

### **Exceptions to Withholding**<sup>3</sup>

There are certain situations when the buyer is not required to withhold:

- The buyer receives a non-foreign affidavit or non-U.S.R.P.H.C. affidavit from the seller, if the purchase is of a U.S. corporation but not a U.S.R.P.H.C. under Treas. Reg. §1.897-2;
- The property is not a U.S.R.P.I. under Treas. Reg. §1.897-1 and §1.897-2, and therefore, the gain from the sale will not be considered U.S.-source income;
- The sales price is less than \$300,000 and the buyer or a family member will use the property as a residence for at least 50% of the first two 12-month periods following the sale;<sup>4</sup>
- Withholding is required under partnership withholding rules §1446;
- Non-recognition transactions wherein the sale is afforded non-recognition treatment by an I.R.C. provision or the seller is not required to recognize a gain under the provisions of a tax treaty. This may include §1031 like-kind exchanges, involuntary conversions, and inter-spousal transfers;
- The seller provides a written notice to the buyer stating that the seller is not a foreign person at the time of the transfer and is therefore required to file a U.S. tax return. The notice should be provided at the time of or prior to the transfer, should include the seller’s name, tax identification number, and home address, and should be signed under penalties of perjury.

*“The law provides for a withholding requirement to make sure that the tax owed on the gain of the disposition of real property will be paid.”*

<sup>3</sup> Internal Revenue Manual 21.8.5.5.1 (05-20-2008) Exceptions to F.I.R.P.T.A. Withholding

<sup>4</sup> Treas. Reg. §1.1445-2(d)(1)

***“Any foreign or domestic partnership must pay a withholding tax on its foreign partner’s E.C.I.”***

### **Partnership Withholding Rules §1446<sup>5</sup>**

Any foreign or domestic partnership must pay a withholding tax on its foreign partner’s E.C.I. The applicable tax rate is 39.6% under §1 for non-corporate partners or 35% under §11 for corporate partners.

In a publicly traded partnership, withholding is based on distributions rather than income allocations. The Withholding Agent can be either the Publicly Traded Partnership or a nominee who is a domestic person that holds an interest in the Publicly Traded Partnership on behalf of the foreign person.

If the foreign partner certifies that the partnership investment is the only E.C.I. for that taxable year, the partnership is not required to pay the §1446 withholding tax on the foreign partner’s income if the partnership estimates that the actual §1446 tax due is less than \$1000.

Section 1446 withholding does not apply to F.D.A.P. income that is not effectively connected to the partnership’s U.S. trade or business. Nonetheless, F.D.A.P. income is subject to 30% withholding on U.S. sourced income paid to a foreign person under the N.R.A. withholding tax regime.

### **Withholding Certificate<sup>6</sup>**

To reduce or eliminate the withholding amount required, the seller, buyer, or either party’s agent may request a Withholding Certificate on the day of or prior to the transfer by submitting a Form 8288-B, *Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests*, to the I.R.S. If the requesting party is the seller, he/she should notify the buyer before or during the transfer so that the full withholding amount is not remitted prior to I.R.S. notification on the application of the Withholding Certificate. The parties may also agree to place the withholding amount in escrow while the I.R.S. reaches a decision. The I.R.S. will generally notify the requesting party within 90 days after receipt of a complete application, which includes the taxpayer identification numbers of all parties. Once a Withholding Certificate has been received, the buyer or escrow agent must submit the amount specified on the certificate to the I.R.S. within 20 days and remit the remainder to the seller.

Form 8288-B may be used to apply for a Withholding Certificate in the following cases:

1. The transferor claims it is entitled to non-recognition treatment or is exempt from tax,
2. A calculation shows the transferor’s maximum tax liability is less than the tax otherwise required to be withheld, or
3. Special installment sales rules described in §7 of Rev. Proc. 2000-35 allow for reduced withholding.

<sup>5</sup> Internal Revenue Service. [“Partnership Withholding: Withholding Tax on Foreign Partners’ Share of Effectively Connected Income – IRC Section 1446.”](#)

<sup>6</sup> Internal Revenue Service. [“Withholding Certificates.”](#)

## SALE OF STOCK OF U.S. CORPORATION

Usually, the gain from the sale of stock of a U.S. corporation is not U.S.-source F.D.A.P. income and does not make the investor engaged in U.S. trade or business. Under F.I.R.P.T.A., the gain is taxable if the stock sold is that of a U.S.R.P.H.C. because the gain is treated as E.C.I. Branch profits taxes may be incurred by a foreign corporate holder, as well.

## SALE OF A U.S. MORTGAGE

The gain from the sale of a U.S. mortgage generally is not considered F.D.A.P. or E.C.I. unless:

- The taxpayer is in the U.S. lending business making the gain E.C.I. and therefore taxable, or
- The mortgage loan has contingent interest which makes it a U.S.R.P.I. and the gain from its sale taxable under F.I.R.P.T.A.

## GIFT TAX

A foreign person is taxed on gifts of tangible property located in the U.S.:

Gift of...	Tax
U.S. Real and Tangible Property	Gift Tax
Stock (domestic or foreign corporation) <sup>7</sup>	No Tax
Partnership Interest <sup>7</sup>	No Tax

## ESTATE TAX

The estate of a nonresident alien individual is subject to estate tax on U.S. real property and tangible property and U.S. situs intangibles, such as stock in U.S. public or private corporations. The unified credit is limited to a to a \$60,000 exemption.

The estate taxation of foreign partnership interests where the partnership holds U.S. property is not as clear. If the partnership is engaged in a U.S. trade or business, the I.R.S. may argue that the situs may be domestic.

*The next installment will address the different ways an investor can structure an investment to minimize tax liability.*

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<sup>7</sup> Note that a transfer of real property to a corporation or partnership, followed by a gift of the shares or interests in the entity, may be subject to gift tax, if integrated as a “step transaction.”

# 2014 TAX EXTENDERS LEGISLATION FINALLY APPROVED

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## Tags

C.F.C.  
Extenders  
F.P.H.C.I.  
R.I.C.

## SUMMARY

On December 19, President Obama signed into law the Tax Increase Prevention Act of 2014 (the “Act”). The Act extended more than 50 expired tax-related provisions through the end of 2014, allowing taxpayers to claim a number of tax deductions, credits, and other benefits for the 2014 tax year. Since the Act does not generally cover 2015 and later years, Congress will have to debate the merits of these many expiring provisions all over again in 2015. Taxpayers are once again faced with making decisions based upon the hope that Congress will act to renew the provisions.

Legislative materials indicate that the 2014 expiration date was based upon budgetary and political concerns. The Act is projected to cost U.S. taxpayers \$41.6 billion over 10 years, with no new federal revenue to offset the cost. Half of the cost comes from the \$7.6 billion credit for business research and development costs, a \$6.4 billion tax break for renewable energy production plants, and a \$5.1 billion tax exception that allows financial firms and other businesses to defer U.S. taxes on certain foreign profits.

## EXTENDED PROVISIONS

The heart of the Act is the extension of many tax deductions and credits that expired on January 1, 2014. The many tax deductions and credits now effective in 2014 include the following:

- Tax credits for qualified research and development (“R&D”) activities would be retroactively extended for one year to amounts paid or accrued through December 31, 2014. The R&D credit is extremely important to the pharmaceutical industry and many other industries.
- The special 50% bonus depreciation deduction allowed for the first year a property is placed in service would be extended for any property placed in service before January 1, 2015.
- Apart from first-year bonus depreciation, I.R.C. §179 allows a business owner to take an immediate deduction for part of the cost of placing property in service. The amount that can be taken as an immediate deduction or expensed had been increased in prior years, but on a temporary basis. The Act extends for 2014 the increased \$500,000 maximum expensing amount and also the increased \$2 million investment based phase-out amount. If Congress fails to act in 2015, then the maximum expensing amount will drop to \$25,000 in 2015 and, likewise, the phase-out amount will drop to \$200,000.

- The tax deduction for state and local general sales taxes in lieu of state and local income taxes will also be extended through the 2014 year. This deduction is helpful for people in states with no income tax such as Texas and Florida.
- An individual who wishes to borrow for the purpose of purchasing a residence is often required by the institutional lender to take out private mortgage insurance (“P.M.I.”) that will protect the lender if the person fails to repay the loan. The deduction for the cost of P.M.I. has also been extended through the end of 2014.
- Older individuals who may want to use money in their Individual Retirement Accounts to make charitable gifts are generally required to (i) include in their taxable income the amount of the distribution and then (ii) claim a charitable deduction for the gift. The deduction is subject to many limitations and restrictions. To make this process simpler, individuals age 70½ or older are allowed through the end of 2014 to make tax-free distributions of up to \$100,000 for charitable contributions.
- U.S. investment funds known as mutual funds are generally classified for tax purposes as Regulated Investment Companies (“R.I.C.’s”). R.I.C.’s and their shareholders were also aided by the Act. One change in particular will benefit foreign investors in R.I.C.’s:

As background, investors invest their money in a R.I.C. and then get dividends from the R.I.C., which reflect the investor’s share of the underlying income of the R.I.C. The R.I.C. is a favorable tax entity since it gets a tax deduction for dividends paid to its shareholders, which can eliminate any corporate level tax on the R.I.C. Dividends paid by the R.I.C. to non-U.S. shareholders are normally treated as corporate dividends that are subject to 30% withholding tax (subject to treaty reduction).

Previously, foreign investors in a R.I.C. that earns interest income from a bond were at a disadvantage since the dividend was subject to 30% withholding tax, whereas an investor who directly owned the bond (or was a partner in a partnership that owned the bond) may have been exempt from the 30% withholding tax under the portfolio interest exemption. Several years ago, this problem was fixed by allowing the dividend paid by a R.I.C. to a foreign shareholder the same treatment as a payment of interest, if the source of the dividend was interest income received by the R.I.C. The dividend was therefore exempt from 30% withholding tax (assuming the debt is eligible for the portfolio interest exemption).<sup>1</sup> However, this change was not permanent – the provision expired and then was renewed, and the last renewal expired at the end of 2013. The Act extends this special treatment one more year, through the end of 2014, but does not benefit the foreign investor in 2015 or later years.

- Several important law provisions affecting international companies have been extended for 2014:

For several years, there has been a temporary reprieve from the Subpart F rules for certain active financing companies. The Act makes this exemption

<sup>1</sup> I.R.C. § 871(k)(1)(a).



*“Included in the Act are several provisions which are intended to increase the costs of failures to timely pay taxes or timely file tax returns.”*

last through the end of 2014. This extension will help a worldwide operating group of companies that has one non-U.S. corporate affiliate act as the financing center for the group.

There are several categories of gross income that can generate subpart F income, one category of which is foreign personal holding company income (“F.P.H.C.I.”). F.P.H.C.I. generally includes interest; dividends; rents; royalties; the excess of gains over losses on the sale of property which gives rise to such income; and income from derivatives.<sup>2</sup> There are certain exceptions to F.P.H.C.I., including the “same country” exception, which applies to interest and dividends received from related corporations incorporated in the same country as the C.F.C.<sup>3</sup> The §954(c)(6) look-through rule, which first was applicable to taxable years of foreign corporations beginning after December 31, 2005, is a further exception to F.P.H.C.I. for certain payments from a related corporation that is incorporated in a different country than the C.F.C. I.R.C. §954(c)(6) specifically states that:

Dividends, interest, rents and royalties received or accrued from a [C.F.C.] which is a related person shall not be treated as [F.P.H.C.I.] to the extent attributable or properly allocable...to income of the related person which is neither subpart F income nor income treated as effectively connected with the conduct of a trade or business in the United States.

This rule has now been extended through the end of 2014.

## ADDED COSTS FOR NON-COMPLIANCE

Included in the Act are several provisions which are intended to increase the costs of failures to timely pay taxes or timely file tax returns. The Act indexes certain penalties for inflation. Among those covered by this change are the penalties for failures to file a tax return or pay taxes, tax preparer penalties, and penalties for failures to file tax returns relating to partnerships and S corporations.

## CONCLUSION

The Act represents a much-needed conclusion to 2014, with legislation extending many beneficial tax provisions through the end of the year. Regrettably, the Act does not allow for certainty with regard to future tax planning. It is hoped that Congress will act sooner in the coming year to alleviate this uncertainty and determine the fate of expiring provisions in tax year 2015 and beyond.

<sup>2</sup> I.R.C. § 954(c)(1).

<sup>3</sup> I.R.C. § 954(c)(3).

# B.E.P.S. ACTION 4: LIMIT BASE EROSION VIA INTEREST PAYMENTS AND OTHER FINANCIAL PAYMENTS

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## Tags

Action 4  
Financial Payments  
Interest Equivalents  
Interest Expense  
Over Leveraged  
Recharacterization  
Related Party Debt  
Thin Capitalization  
Third-party Debt

Action 4 of the B.E.P.S. Action Plan focuses on best practices in the design of rules to prevent base erosion and profit shifting using interest and other financial payments economically equivalent to interest. Its stated goal is described in the following Action:

Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. The work will evaluate the effectiveness of different types of limitations. In connection with and in support of the foregoing work, transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. The work will be coordinated with the work on hybrids and CFC rules.

On December 18, 2014, the O.E.C.D. issued a discussion draft regarding Action 4 (the “Discussion Draft”).<sup>1</sup> The Discussion Draft stresses the need to address base erosion and profit shifting using deductible payments such as interest that can give rise to double non-taxation in both inbound and outbound investment scenarios. It examines existing approaches to tackling these issues and sets out different options for approaches that may be included in a best practice recommendation. The identified options do not represent the consensus view of the Committee on Fiscal Affairs, but are intended to provide stakeholders with substantive options for analysis and comment. This article discusses the Discussion Draft for Action 4 of the B.E.P.S. Action Plan.

## INTRODUCTION

Most countries tax debt and equity differently for the purposes of their domestic law. Interest on debt is generally a deductible expense of the payer and taxed at ordinary rates in the hands of the payee.

Dividends, or other equity returns, on the other hand, are generally not deductible and are typically subject to some form of tax relief (an exemption, exclusion, credit, etc.) in the hands of the payee. While, in a purely domestic context, these differences in treatment may result in debt and equity being subject to a similar overall tax

<sup>1</sup> O.E.C.D. (2014) “BEPS Action 4: Interest Deductions and Other Financial Payments.”

burden, the difference in the treatment of the payer creates a tax-induced bias, in the cross-border context, towards debt financing. The distortion is compounded by tax planning techniques that may be employed to reduce or eliminate tax on interest income in the jurisdiction of the payee.

The policy concerns surrounding interest expense deductions relate to debt funding of outbound and inbound investment by groups. Parent companies are typically able to claim relief for their interest expense while the return on equity holdings is taxed on a preferential basis. The result is a net reduction of tax revenue. At the same time, subsidiary entities may be heavily debt financed, bearing a disproportionate share of the group's total third party interest cost and incurring interest deductions used to shelter local profits from tax. Taken together, these opportunities surrounding inbound and outbound investment potentially create competitive distortions between groups operating internationally and those operating in the domestic market. According to the Discussion Draft, this has a negative impact on capital ownership neutrality, creating a tax preference for assets to be held by overseas groups rather than domestic groups.

Base erosion and profit shifting techniques include the use of intragroup loans to generate deductible interest expense in high tax jurisdictions and taxable interest income in low tax jurisdictions; the development of hybrid instruments which give rise to deductible interest expense but no corresponding taxable income; the use of hybrid entities or dual resident entities to claim more than one tax deduction for the same interest expense; and the use of loans to invest in structured assets which give rise to a return that is not taxed as ordinary income.

To illustrate the planning opportunity in an outbound context, a multinational group consists of two companies, A Co (the parent) and B Co (the subsidiary). A Co is resident in a country with a 35% rate of corporate income tax. It relieves double taxation through a territorial system under which foreign source dividends are exempt from tax. B Co is resident in a country with a 15% corporate tax rate. B Co borrows €100 from a third party bank at an interest rate of 10%. B Co uses these funds in its business and generates additional operating profit of €15. After deducting the €10 interest cost, B Co has a pre-tax profit of €5 and an after-tax profit of €4.25.

Alternatively, A Co could borrow the €100 from the bank and contribute the same amount to B Co as equity. In this case, B Co has no interest expense and its full operating profit of €15 is subject to tax. B Co now has a pre-tax profit of €15 and an after tax profit of €12.75. Assuming A Co can set its interest expense against other income, A Co has a pre-tax cost of €10 and an after tax cost of €6.50. Taken together, A Co and B Co have a total pre-tax profit from the transaction of €5 and a total after-tax profit of €6.25 reflecting a rational group treasury decision. The Discussion Draft describes this as a negative effective rate of taxation (*i.e.*, the group's after tax profit exceeds its pre-tax profit). Management would, however, describe this as an effective tax rate reduction.

A similar result can also be achieved in an inbound investment context. In this case, A Co (the parent) is resident in a country with a 15% rate of corporate income tax and B Co (the subsidiary) is resident in a country with a 35% corporate tax rate. B Co borrows €100 from a third party bank at an interest rate of 10%. B Co uses these funds in its business and generates additional operating profit of €15. After deducting the €10 interest cost, B Co has a pre-tax profit of €5 and an after tax profit of €3.25.



*“Action 14 is intended to encourage multinational groups to adopt funding structures that more closely align the interest expense of individual entities with that of the overall group.”*

Alternatively, A Co could replace €50 of existing equity in B Co with a loan of the same amount. In this case, B Co has a pre-tax and after-tax profit of nil. A Co has interest income on its loan to B Co, and has a pre-tax profit of €5 and after-tax profit of €4.25. The group has reduced its effective tax rate from 35% to 15% by shifting interest costs from B Co to A Co. Again, this is a rational business decision, but is viewed by the Discussion Draft as profit shifting. This can be taken one additional step by having A Co replace €100 of existing equity in B Co with a loan of the same amount. Assuming B Co can set its interest expense against other income, from this transaction B Co now has a pre-tax cost of €5 and an after tax cost of €3.25. A Co receives interest income from B Co, and has a pre-tax profit of €10 and after-tax profit of €8.50. Taken together, A Co and B Co have a pre-tax profit of €5 and after-tax profit of €5.25. As a result of thinly capitalizing B Co and shifting profit to A Co, the group is now subject to a negative effective rate of taxation. Again, the group treasury function has made a rational decision and reached a rational result.

In all examples, B is resident in a country that has chosen to impose high rates of tax in relation to the country where A is resident and operates. One rational result of this tax policy choice by that country is the encouragement of corporations to remove high profit items from companies subject to tax in that country and to increase discretionary expenses to that country. A second rational decision is to disinvest in that country, removing jobs and all related income from that country's tax base.

The Discussion Draft maintains a different view regarding these potential reactions. According to the Discussion Draft, a consistent approach utilizing international best practices is essential to address base erosion and profit shifting arising from intercompany loans. This will promote group-wide systems that produce required information and remove opportunities for base erosion and profit shifting.

## POLICY CONSIDERATIONS

Action 4 is intended to encourage multinational groups to adopt funding structures that more closely align the interest expense of individual entities with that of the overall group. Overall, groups should still be able to obtain tax relief for an amount equivalent to their actual third party interest cost. However, the opportunity of stuffing interest expense into countries based in in high-tax jurisdictions will be removed. This result reflects various government concerns including (i) addressing base erosion and profit shifting, (ii) minimizing distortions to competition and investment when comparing tax outcomes of groups operating in a solely domestic environment with other groups operating globally, (iii) avoiding double taxation that might arise from unilateral action of one or more countries, (iv) reducing administrative and compliance costs, (v) promoting economic stability by de-emphasizing tax benefits from over-leveraged structures, and (vi) providing certainty of outcome.

Certain arrangements are targeted to prevent circumvention of Action 4. These include (i) the use of orphan entities or special shares to disguise control of an entity or break a group relationship, (ii) arrangements to disguise payments through back-to-back loans, (iii) structures to convert other forms of taxable income into an interest-like return in order to reduce an entity's net interest expense below the level of a limit or cap, and (iv) the use of foreign exchange instruments to manipulate the outcome of rules. Action 4 is intended to adopt rules that are consistent with E.U. rules in order to be fully implemented on a global basis.

## EXISTING APPROACHES

Rules currently applied by countries fall into six broad groups, with some countries currently applying combined approaches. These are:

- Rules that limit the level of interest expense or debt in an entity with reference to a fixed ratio. Examples of these rules include debt to equity ratios, interest to E.B.I.T.D.A. ratios and interest to assets ratios. This approach is relatively easy to apply and links the level of interest expense to a measure of an entity's economic activity. However, the same ratio is applied to entities in all sectors and as a tool, these rules are relatively inflexible. Finally, the Discussion Draft comments that the ratios may be set too high to be an effective tool in addressing base erosion and profit shifting.
- Rules that compare the level of debt in an entity by reference to the group's overall position. Existing rules that compare the level of debt in an entity to that in its group often operate by reference to debt to equity ratios. Again, these are reasonably easy to apply, but the Discussion Draft expresses the view that the amount of equity in an entity is not a good measure of its level of activity and equity levels can be easily subject to manipulation.
- Targeted anti-avoidance rules that disallow interest expense on specific transactions. These can be an effective response to specific base erosion and profit shifting risks. However, as new tax planning opportunities are exploited, new targeted rules may be required. Ultimately, this may result in a more complex system that is costly to administer.
- Arm's length tests that compare the level of interest or debt in an entity with the position that would have existed had the entity been dealing entirely with third parties. This approach is not considered in the Discussion Draft. An arm's length test requires consideration of an individual entity's circumstances, the amount of debt that the entity would be able to raise from third party lenders and the terms under which that debt could be borrowed. It allows a tax administration to focus on the particular commercial circumstances of an entity or a group but it can be resource intensive and time consuming for both taxpayers and tax administrations to apply. Also, because each entity is considered separately, the outcomes of applying a rule can be uncertain, although this may be reduced through advance agreements with the tax administration. An advantage of an arm's length test is that it recognizes that entities may have different levels of interest expense depending on their circumstances, and should not disturb genuine commercial behavior. However, some countries with experience of applying such an approach in practice expressed concerns over how effective it is in preventing base erosion and profit shifting, although it could be a useful complement to other rules.
- Withholding tax on interest payments that are used to allocate taxing rights to a source jurisdiction. This approach is not considered in the Discussion Draft. Withholding taxes are primarily used to allocate taxing rights to a source country, but by imposing tax on cross-border payments they may also reduce the benefit to groups from base erosion and profit shifting transactions. Withholding tax has the advantage of being a relatively mechanical tool which is easy to apply and administer. However, unless withholding tax

*“Rules currently applied by countries fall into six broad groups.”*

is applied at the same rate as corporate tax, opportunities for base erosion and profit shifting would remain. Where withholding tax is applied, double taxation can be addressed by giving credit in the country where payment is received, although the effectiveness of this is reduced if credit is only given up to the amount of tax on net income. In practice, where withholding tax is applied the rate is often reduced (sometimes to zero) under bilateral tax treaties. It would also be extremely difficult for E.U. member states to apply withholding taxes on interest payments made within the E.U. due to the Interest and Royalty Directive.

- Rules that disallow a percentage of the interest expense of an entity, irrespective of the nature of the payment or the identity of the lender. This approach is not considered in the Discussion Draft. While this approach reduces the general tax bias in favor of debt financing over equity, it does not address base erosion and profit shifting issues.

*“There is a general view that in many cases international groups are still able to claim total interest deductions significantly in excess of the group’s actual third party interest expense.”*

In recent years many countries have made significant changes to their approaches to combating base erosion and profit shifting through interest deductions, either through the introduction of new rules or through amendments to their existing rules. This suggests that countries have struggled to fully address the issues that they are actually seeing. There is a general view that in many cases international groups are still able to claim total interest deductions significantly in excess of the group’s actual third party interest expense. A limited survey based on published data indicates that for the largest non-financial sector groups, the vast majority has a net interest to E.B.I.T.D.A. ratio of below 10% and many do not have any net interest expense. However, the majority of countries which currently seek to address base erosion and profit shifting using earnings-based ratios allow entities to gear up to the point where net interest to E.B.I.T.D.A. reaches 30%.

International debt shifting has been established in a number of academic studies<sup>2</sup> which show that groups leverage more debt in subsidiaries located in high tax countries. Academics have shown that thin capitalization is strongly associated with multinational groups<sup>3</sup> and that multinational groups use more debt than comparable widely held or domestically owned businesses.<sup>4</sup> Additional debt is provided through both related party and third party debt, with intragroup loans typically used in cases where the borrowing costs on third party debt are high.<sup>5</sup>

<sup>2</sup> Møen *et al.*, ‘International Debt Shifting: Do Multinationals Shift Internal or External Debt?’ (2011) University of Konstanz Department of Economics Working Paper Series 2011-40, 42; Huizinga *et al.*, ‘Capital structure and international debt shifting’ (2008) 88 *Journal of Financial Economics* 80, 114; Mintz and Weichenrieder, ‘Taxation and the Financial Structure of German Outbound FDI’ (2005) CESifo Working Paper No. 1612, 17; Desai *et al.*, ‘A Multinational Perspective on Capital Structure Choice and Internal Capital Markets’ (2004) 59 *The Journal of Finance* 2451, 2484.

<sup>3</sup> Taylor and Richardson, ‘The determinants of thinly capitalized tax avoidance structures: Evidence from Australian firms’ (2013) 22 *Journal of International Accounting, Auditing and Taxation* 12, 23.

<sup>4</sup> Egger *et al.*, ‘Corporate taxation, debt financing and foreign-plant ownership’ (2010) 54 *European Economic Review* 96, 106; Mintz and Weichenrieder (n 4) 17.

<sup>5</sup> Buettner *et al.*, ‘The impact of thin-capitalization rules on the capital structure of multinational firms’ (2012) 96 *Journal of Public Economics* 930, 937.

Academics have also looked at the effectiveness of thin capitalization rules and illustrated that such rules have the effect of reducing the total debt of subsidiaries.<sup>6</sup> Where thin capitalization rules relate solely to interest deductions on related party debt, such rules are effective in reducing intragroup debt but lead to an increase in third party debt, although not to the same extent. Theoretical studies on the impact of interest limitation rules on investment reach similar conclusions.<sup>7</sup> However, the empirical analysis that has been done does not support this theory. Two studies, both analyzing the effect of German interest limitation rules on investment, find no significant evidence of a reduction of investment either in relation to thin capitalization rules<sup>8</sup> or interest barrier rules based on a ratio of interest expense to income.<sup>9</sup>

## WHAT ARE INTEREST AND INTEREST EQUIVALENTS?

At its simplest, interest is the cost of borrowing money. However, if a rule restricted its focus to such a narrow band of payments, it would raise three broad issues:

- It would fail to address the range of base erosion and profit shifting that countries face in relation to interest deductions and similar payments;
- It would reduce fairness by applying a different treatment to groups that are in the same economic position but use different forms of financing arrangements; and
- Its effect could be easily avoided by groups re-structuring loans into other forms of financing.

To address these issues, rules to tackle base erosion and profit shifting using interest should apply to interest on all forms of debt as well as to other financial payments that are economically equivalent to interest. Payments that are economically equivalent to interest include those which are linked to the financing of an entity and are determined by applying a fixed or variable percentage to an actual or notional principal over time. A rule should also apply to other expenses incurred in connection with the raising of finance, including arrangement fees and guarantee fees.

- Interest equivalent payments include:
- Payments under profit participating loans;
- Imputed interest on instruments, such as convertible bonds and zero coupon bonds;

<sup>6</sup> Blouin *et al.*, 'Thin Capitalization Rules and Multinational Firm Capital Structure' (2013) 26-27; Buettner *et al.*, *Id.*, 937.

<sup>7</sup> Ruf and Schindler, 'Debt Shifting and Thin Capitalization Rules - German Experience and Alternative Approaches' (2012) 21.

<sup>8</sup> Weichenrieder and Windischbauer, 'Thin-capitalization rules and company responses - Experience from German legislation' (2008) CESifo Working Paper No. 2456, 29.

<sup>9</sup> Buslei and Simmler, 'The impact of introducing an interest barrier □ Evidence from the German corporation tax reform 2008' (2012) DIW Discussion Papers 1215, 29.

*“Academics have also looked at the effectiveness of thin capitalization rules and illustrated that such rules have the effect of reducing the total debt of subsidiaries.”*

- Amounts under alternative financing arrangements, such as Islamic finance;
- The finance cost element of finance lease payments;
- Amounts recharacterized as interest under transfer pricing rules, where applicable;
- Amounts equivalent to interest paid under derivative instruments or hedging arrangements related to an entity's borrowings;
- Foreign exchange gains and losses on borrowings and instruments connected with the raising of finance;
- Guarantee fees with respect to financing arrangements; and
- Arrangement fees and similar costs related to the borrowing of funds.

## TARGETS OF THE RULE

A robust rule addressing base erosion and profit shifting should apply to all incorporated and unincorporated entities and arrangements, including permanent establishments, which may be used to increase the level of interest deductions claimed in a country. Four scenarios are identified:

- Companies and other entities in a group, including permanent establishments. Entities are in a group where one entity has direct or indirect ownership or control over another entity or both entities are under the direct or indirect ownership or control of a third entity.
- Connected parties. For these purposes entities are connected parties where they are under common ownership or control but are not part of a group. This may arise where (i) an individual, fund, or trust exercises control over the entities or (ii) a shareholder agreement exists which has the effect of bringing the entities under common control. The proposition is that collective investment vehicles under the control of the same investment manager should not be treated as connected parties if there is no other connection between them.
- Payments made to related parties. Related parties include (i) significant shareholders and investors (and members of their family), (ii) entities where there is a significant relationship but which is not sufficient to establish control, and (iii) third parties where the payment is made under a structured arrangement. A significant shareholding or a significant relationship is a 25% or greater holding.
- Standalone entities. Entities not otherwise described above.

Companies and entities in each of the foregoing fact patterns pose different risks. Consequently, the Discussion Draft proposes that different interest limitation rules may be applied. For example, risks posed by international groups may be addressed through rules which link interest expense deductions in each group entity to the position of the worldwide group, while risks posed by connected and related parties may be addressed through targeted rules which apply to specific arrangements. Whichever rule is applied it is the intent of the Discussion Draft to avoid rules that provide a competitive tax advantage regarding interest expense deductions to certain entities and the way they are held.

## WILL THE TARGET BE EXCESSIVE INTEREST OR EXCESSIVE DEBT? WILL EXCESSIVE RELATE TO GROSS OR NET POSITIONS?

As a preliminary matter, two key questions exist in formulating a rule to combat base erosion and profit shifting arising from excessive interest expense.

- Should the target be excessive levels of interest expense in relation to income or excessive amounts of debt in relation to assets?
- Whichever target is used, should the rule apply to an entity's gross position with regard to interest or debt, by looking only at the liability or expense item, or should the rule apply to an entity's net position, by offsetting interest expense with interest income and offsetting the debt obligations it issued with debt securities it holds?

As to the first question, the Discussion Draft concludes that rules to tackle base erosion and profit shifting should operate directly by reference to the level of interest expense in an entity and not the level of debt. Factors that support that approach include:

- Financial liabilities may be difficult to identify and value.
- The level of debt in an entity may fluctuate throughout a period, which means that the amount of debt on a particular date, or an average for the period, may not be representative of an entity's true position. On the other hand, the level of interest expense in an entity will reflect all changes in borrowings throughout the period.
- Because the target of the provision is excessive interest, a rule that refers to the level of deductible interest will directly address the key risk factor.
- A rule to limit interest expense deductions by reference to the value of the debt would still require a determination of the level of interest expense that is to be disallowed if a limit is exceeded. Also, cases of excessive interest on acceptable debt levels will be problematic.

Factors that favor the testing of debt levels, which were not persuasive, include:

- A rule based on the level of debt may provide leeway to allow an entity subject to high interest rates on its borrowings to deduct more interest expense than an entity with the same level of debt but subject to a lower interest rate.
- The level of debt in an entity is under the control of the entity's management and may be stable and easier to predict. The amount of interest expense, however, may vary reflecting market interest rate fluctuations.

Regarding the second question – net or gross valuations of interest expense – the Discussion Draft concludes that a general interest limitation rule should apply to the entity's net interest expense after offsetting interest income. The rule could be supplemented by targeted interest limitation rules to prevent groups avoiding the effect of a rule or which disallow gross interest expense on specific transactions identified as posing base erosion and profit shifting risks.

*“Should the target be excessive levels of interest expense in relation to income or excessive amounts of debt in relation to assets?”*

A gross interest rule may have the benefit of simplicity and is also likely to be more difficult for groups to avoid through planning. However, a gross interest rule could lead to double taxation where interest is paid on intragroup loans, and each entity is subject to tax on its full gross interest income, but part of its gross interest expense is disallowed. In comparison, a net interest rule will reduce the risk of double taxation, as interest income will already be taken into account before the interest limitation is applied.

## SMALL ENTITY EXCEPTION

The Discussion Draft suggests that smaller entities may pose a lower risk to base erosion and profit shifting using interest and it has been suggested that these low risk entities be excluded from the interest expense limitation rules. Action Plan 4 suggests two thresholds for exclusion:

- Size Threshold. Using a combination of indicators such as number of employees and turnover, the size threshold assumes that a “smaller” entity poses less risk. However, it ignores the fact that a highly leveraged small entity may have a high level of interest expense.
- Monetary Threshold. The monetary threshold looks at the level of net interest expense in an entity and would be simple to apply. The level of interest expense is at the heart of the issue. The threshold amount will be set based on the economic situation and interest rate in a country because it will consider the effect profit shifting using interest will have on its environment. It will consider entities of the same group as a single unit to prevent companies from forming smaller entities to escape the threshold. Current thresholds range from €0.5million to €3 million.

Introducing thresholds could make them a consideration in reducing interest expenses or raising them to reach a limitation. The Discussion Draft comments that thresholds are not part of the best practice recommendation. Where adopted, they should be designed to exclude low risk entities based on their net interest expense computed on a local country group basis in order to avoid fragmenting.

## LIMITING BASED ON GROUP POSITION

### Group-wide Tests

Group-wide rules limit an entity’s deductible interest expense based on factors applied on a worldwide basis. This approach is based on several premises. First, the best measure for total net interest deductions for a group is the difference between the interest expense paid to unrelated parties and interest income received from unrelated parties. Second, within a group, interest expense should be matched with economic activity. Groups will receive tax relief equivalent to their third party interest cost where the two premises match up.

Group-wide tests are viewed to be advantageous because they allow the centralization of third party borrowings and may be the most effective in tackling base erosion and profit shifting using interest. Consistently applied among countries, this approach avoids problems arising from contradictory application of rules by two or more countries. Nonetheless, the Discussion Draft suggests that they may need to

be supplemented by more targeted limits based on specific factors within a group. For example, specific rules could prevent base erosion and profit shifting interest expense on debt held by unrelated parties is excessive. Or they might be necessary to deal with groups in which members are engaged in different business lines having different leverage rules that tilt the computation.

The cost of compliance and administration is something that must be considered under the groupwide rule.

### **Different Rule Options**

Two variations of groupwide tests may be considered:

1. Groupwide Interest Allocation Rule. This variation allocates a worldwide group's net third party interest expense between entities of that group in proportion to economic activity in one of two ways. The first is a deemed interest rule in which allocation would be made according to earnings or asset values and this deemed interest expense would be tax deductible. The interest actually paid or received by the group as a whole would be disregarded. This rule is easy to apply. However, some countries have expressed concerns about introducing rules that allow deductions for amounts not paid or accrued by an entity.

The second variation is an interest cap rule. Here, each entity would be provided an interest cap based on the allocation made according to earnings or asset values. Interest expense on intragroup and third party debt up to the cap would be tax deductible and any interest income received by the group would be taxed.

2. Group Ratio Rule. This rule compares a relevant financial ratio of an entity with the equivalent financial ratio of the entire group. Third party and intragroup interest expense is deductible where the ratio is equal to or less than the ratio of the group. To stay with or under the ratio, groups may reorganize their intragroup financing.

Although similar, consistency is the key distinguishing factor between both approaches. While the interest allocation is more consistent, the group ratio would be more flexible for different countries that continue to apply existing laws. Furthermore, group ratios would work well for countries with volatile currencies as group ratios can also be applied directly to the earnings or asset value in its functional currency and an interest cap is more likely to be calculated in the reporting currency. Though the flexibility is a benefit for different economies, this would give a rise to a spectrum of rules. Therefore, it can be expected to increase compliance costs.

### **Entities to be Included**

It is important to define the group when designing a group-wide rule as this will identify the companies that are considered in computing the ratio or cap and the companies affected by the ratio or cap. It is important for the group to be easily verifiable by entities and tax authorities in order to facilitate the collection of financial information. The Discussion Draft cautions that control and composition of the group may change based on differing accounting standards among several affected countries.

Membership should be based on one of two methods. The first is to apply the highest and most inclusive level of consolidated financial statements prepared by the parent of the group so as not to have contradictory statements and to ensure that all of the entities have been accounted for. If an entity isn't part of a group that prefers consolidated financial statements, the entity would need to obtain financial information on the group in order for the rule to be applied. Alternatively, a single standard definition of an interest limitation group could be applied for all entities, disregarding the actual composition. This would ensure that the same definition would be used by all entities but may require accounting if the interest limitation group differs from the financial reporting group.

### **Determining Net Third-party Interest Expense**

Financial statements are a good starting point for information on the group's net interest position. These statements should be adjusted to include any income or expenses economically equivalent to interest not included in these financial reporting figures and exclude any income to expense treated as interest that wouldn't be taken into account for tax purposes.

An interest allocation rule would require agreement on the items that should be excluded. A group ratio rule would allow each country to decide based on its own tax law.

### **Measuring Income Activity**

Under the group-wide rule, the net interest expense of an entity is linked to net third party interest expense based on earnings and assets values that are used as a measure of economic activity.

Economic activity can be measured using accounting or tax figures which would reduce compliance costs. Earnings or asset values can also be determined using tax principles by basing the economic activity on taxable profits or the tax value of an entity's assets. But using tax figures poses an administrative burden on tax authorities of the different countries.

The most obvious measure of economic activity is earnings and asset values. This indicator yields a fairer result for mixed groups that include entities engaged in activities requiring different levels of investment in assets. The levels of earnings are direct measures of an entity's obligation to pay interest and determining the amount of debt that can be borrowed.

### **Earnings as a Measure**

The Discussion Draft states that a direct correlation exists between earnings and profit shifting. Entities that shift profits out of a country will reduce available net interest deductions. The measure of earnings used is most commonly known as "earnings before interest, taxes, depreciation and amortization" ("E.B.I.T.D.A."). It measures the cash flow of an entity that can be used to meet its interest expense obligations.

Gross profit is another measure of earnings that has the advantage of being calculated on a broadly comparable basis across most accounting standards, with greater differences introduced as an entity works down its income statement. However, the use of gross profit could lead to problems where one entity in a group provides,

*"Under the group wide rule, the net interest expense of an entity is linked to net third party interest expense based on earnings and assets values that are used as a measure of economic activity."*

for example, marketing or distribution services to other group entities. This is because the entity providing the service will include its income within its own gross profit whereas the entity paying for services will deduct the corresponding expense further down its income statement, making the comparison of entities difficult.

Intercompany transactions within a group may mean that there are fact patterns where an individual entity recognizes earnings that are not included in the consolidated earnings of the overall group. For example, this may arise where an entity sells components to another entity in its group. The purchaser uses the components to manufacture products for sale to customers. At an entity level, the seller will recognize revenue from these intragroup sales, but on a consolidated level, this should not be recognized until a sale takes place outside the group. Other consolidation adjustments may be required to strip out payments between entities for intragroup services.

Entity earnings may be relatively volatile compared with asset values and there is a limit to the extent this can be controlled by a group. This means that under an earnings-based rule it may be difficult for a group to anticipate the level of net interest expense that will be permitted in a particular entity from year to year. A rule could be designed to include features to reduce the impact of this volatility. One such feature would entail averaging of income over a designated period. Another possible feature would entail carryforwards of disallowed interest expense or unused capacity in order to deduct interest expense in future periods.

A particular aspect of earnings volatility is the possibility that individual entities or an entire group may be in a negative earnings position. Three issues arise as a result. First, under an earnings-based approach, loss-making entities will not be able to deduct any net interest expense, though a rule may allow disallowed interest to be carried into future periods. Second, the aggregated earnings of profitable entities in the group will exceed the group's actual total earnings. Therefore a group-wide rule could allow these entities to deduct an amount of net interest expense that exceeds the group's total net third party interest expense. Third, unless a rule takes account of the impact of losses, a group-wide rule based on earnings would become impossible to apply where a group is in a loss-making position overall.

Alternative potential solutions are provided to address this issue. One is that a group's total earnings could be determined using only the results from entities that have positive earnings. This would remove the risk that entities would be able to deduct an amount of interest expense in excess of the group's actual net third party interest expense. Alternatively, a rule could provide that, to the extent an interest limitation group includes loss-making entities, the protection offered by a group-wide rule is reduced or eliminated.

Earnings should be calculated applying the same standards that are used in preparing the group's consolidated financial statements. Where local G.A.A.P. is substantially similar to the accounting standards used in preparing the group's consolidated financial statements, a rule could provide for an entity's earnings to be calculated under local G.A.A.P. as a cost saving measure.

*“Under an earnings-based rule it may be difficult for a group to anticipate the level of net interest expense that will be permitted in a particular entity from year to year.”*



## **Asset-based Approaches**

Third-party debt is often raised to fund the group's revenue generating assets. Valuing these assets determines the amount of debt they can garner. However, the link between asset valuation and taxable income is not as strong as that of earnings and therefore an asset based approach is the less preferred method of measure under the Discussion Draft.

A wide range of assets should be taken into account to reflect a group's activities. These include land and buildings, plant and equipment, goodwill and other intangible assets, inventory or stock, trade receivables, and financial assets which do not give rise to amounts treated as interest. However, financial assets that give rise to interest income and equity instruments yielding dividend income should not be considered. The ability to deduct interest expense should be allocated to entities with economic activity and not by reference to the location of debt instruments.

The advantages of asset values are that they are more stable than earnings and reduce compliance costs. Furthermore, an asset value approach means that entities with losses would still be able to deduct an amount of net interest expense.

Intangible assets, including trademarks, patents and trade secrets, can be among a group's most valuable assets. This is particularly the case for major brands and for hi-tech groups. However, accounting standards typically impose stringent requirements on groups before they are able to recognize an intangible asset on their balance sheet, particularly where the asset has been internally created. Even where an intangible asset can be recognized, its carrying value is usually at historic cost, which may be only a fraction of its actual fair market value. Revaluations of intangible assets are generally only possible by reference to a fair value on an active market, and as such will rarely be permitted for most types of intangibles.

The impact is that for a number of large groups, an approach to limiting interest deductions based on asset values for accounting purposes will ignore the group's most valuable assets.

Groups are allowed to offset derivative assets and liabilities carried at fair value if two parties owe each other a determinable amount and there is a right to offset.

## **Accounting and Tax Mismatches**

In most cases an entity's interest cap under an interest allocation rule will have been calculated in the currency of the group's consolidated financial statements. However, an entity's taxable income will generally be calculated in its functional currency. Therefore, under an interest allocation rule, the interest cap will need to be translated into the entity's functional currency before it can be applied. This translation may be performed at the average exchange rate for the period, although a rule could allow a different exchange rate to be used if this would give a more reasonable result.

Some differences between the amount of net interest expense allowable under a group-wide rule and an entity's taxable net interest expense will be the result of mismatches in how interest is recognized for accounting and tax purposes. These will include timing mismatches and permanent mismatches. Timing mismatches arise because the interest expense is recognized in different periods for accounting and tax purposes, and in most cases these should correct over the life of a debt.

*“Related parties ... are, however, in a relationship that means they may enter into transactions to generate a tax benefit, which is typically shared between the parties.”*

Permanent mismatches arise where the payments treated as interest or economically equivalent to interest in the group consolidated financial statements are different to those treated as such for tax purposes. For example, where an instrument is treated as debt for accounting purposes but equity for tax purposes, payments on that instrument are likely to give rise to permanent mismatches. Permanent mismatches could be taken into account by allowing a small uplift in the amount of net interest expense that would be deductible under a group-wide rule.

The Discussion Draft acknowledges that the time for filing entity and group financial statements will be determined under local law applicable to the entities. As a result, an entity may be required to file its tax return and pay tax before the group financial statements are audited and published.

### **Cash Pooling**

Cash pooling arrangements are a common part of treasury management in an international group. They allow a group to reduce its net third party interest expense by setting surplus cash balances in certain entities against borrowing needs in other entities so the group only pays interest on the net position. The interest expense is then allocated based on transfer pricing mechanisms. A group-wide rule will take into account the benefits obtained from the cash pool and the interest paid and received.

### **Connected and Related Parties**

The Discussion Draft cautions that net third party interest expense can be artificially increased through transactions with connected and related parties. Connected parties include entities under a common control but not part of the group. Related parties include entities where there is a relationship below that required to establish control, and third parties which are party to structured arrangements. Related parties are not in the same economic position as members of a group. They are, however, in a relationship that means they may enter into transactions to generate a tax benefit, which is typically shared between the parties.

Targeted provisions are required to deal with risks posed by all connected and related parties. One option could be for interest payments to connected and related parties to be excluded from net third party interest expense in applying a group-wide rule. This could apply to all interest paid to connected and related parties, or to payments which meet certain conditions. The Discussion Draft views this approach as administratively cumbersome within a group and for tax authorities. An alternative approach would entail removing these payments from a group-wide rule. The entity making a payment to a connected or related party would reduce its interest cap or the amount of interest deductible under a group ratio rule by the value of the payment. At that point, a separate targeted rule would apply. It could disallow all interest payments to connected or related parties or allow payments subject to a limit based on a fixed ratio or a requirement that the recipient must be subject to a minimum level of taxation on the corresponding income. It is likely that this approach would be simpler to apply, as only the entity making a payment to a connected or related party would be required to make an adjustment. However, this approach also has disadvantages.

# LIMITING INTEREST DEDUCTIONS WITH REFERENCE TO A FIXED RATIO

## **Fixed Ratio Approach**

Fixed ratio rules are premised on the assumption that an entity should be able to deduct interest expense up to a specified proportion of its earnings, assets, or equity. This ensures that a portion of an entity's profit remains subject to tax in a country. The government determines the ratio that is applied irrespective of the actual leverage of an entity or its group.

Fixed ratio rules are relatively simple to apply because they do not require the financial information on the whole group; the tests are based entirely on the entity's own financial position. In addition, the test may use tax figures or any other figures that makes compliance easier.

The approach doesn't take into account the fact that groups operating in different sectors may require different amounts of leverage, which makes determining the correct level difficult. There is a risk that the ratio may be set too high for some entities and too low for others.

## **Interest Deductions and Level of Assets of Earnings**

Borrowing funds and paying interest enables funding a group's assets and activities. Therefore, the Discussion Draft comments that there is a natural link between the value of assets held and the interest expense of the entity.

Because the Discussion Draft acknowledges that asset values are more stable than earnings, using asset values as a basis to determine deductible interest expense would increase certainty and reduce compliance costs. Additionally, asset tests may also be suitable for tackling base erosion and profit shifting involving the use of debt to fund tax exempt or deferred income, which would stop entities from claiming a higher level of deductible interest expense. The disadvantage with using asset values is the valuation. Using asset values as a base leaves a possibility of cash manipulations and artificial inflation.

Linking fixed ratios to a measure of earnings means that a group will only be able to increase their level of net interest deductions by increasing taxable profits in that country. Excluding dividend income will help address base erosion and profit shifting using interest to fund tax exempt or deferred income. Nonetheless, as discussed before, an earnings based rule would be volatile and influenced by outside market factors. In addition, there are different types of earnings that include or don't include certain deductions.

## **Existing Fixed Ratio Levels**

The next questions is whether the group ratio rules and fixed ratio rules described above could be combined in a way that reduces administrative and compliance costs by applying simpler rules to entities that pose less risk.

Two possible options for a combined approach are presented.

*“Fixed ratio rules are relatively simple to apply because they do not require the financial information on the whole group.”*

- Under the first option, a country could provide for a monetary threshold that establishes a *de minimis* level of net interest expense below which an entity will not be required to apply a general interest limitation rule. This threshold should apply to the aggregate net interest deductions in all group entities in a country. As a result, an entity with deductible net interest expense (above the monetary threshold) would come within the group-wide interest allocation rule. The entity could deduct interest expense up to an interest cap that is equal to an allocated portion of the group's net third party interest expense, based on a measure of earnings or assets. A country may allow disallowed interest expense to be carried forward and set against unused interest cap in a future period.
- Under the second option, entities with levels of deductible interest expense above any monetary threshold would come within a fixed ratio test, whereby an entity would be able to claim relief for deductible net interest expense up to a fixed percentage of its earnings or assets. To be effective in addressing base erosion and profit shifting and to remove the risk of entities gearing up and claiming further interest deductions to the point where the fixed ratio is reached, this ratio should still be at a level that is lower than that which is currently applied in many countries. The rule would be subject to an exception under which entities in more highly leveraged groups may apply a carve-out so that where an entity's ratio is (i) higher than the fixed ratio, but (ii) does not exceed the ratio of its group, the entity does not need to apply the fixed ratio rule. Again, disallowed interest expense may be carried forward and set off against unused interest cap in a future period.

## SUPPLEMENTAL RULES FOR TARGETED TRANSACTIONS

Some countries do not currently apply a general interest limitation rule to address base erosion and profit shifting risks, but rely solely on targeted rules. One benefit of such an approach is that it reduces the risk that a rule negatively impacts on entities which are already appropriately capitalized. However, this approach has some drawbacks. Targeted rules will always be a reactive response, requiring countries to be aware of specific base erosion and profit shifting risks as they emerge. There is a risk that some groups may consider all arrangements not covered by targeted rules to be acceptable, meaning that over time new targeted rules may be required. Targeted rules also require active application, meaning the tax administration must be able to recognize situations where a rule could apply, often as part of a complex transaction, and then engage with a group to determine the correct result. In contrast, a general rule could provide an effective response to a broad range of base erosion and profit shifting issues.

Nonetheless, the Discussion Draft suggests that there could be a role for some targeted provisions to prevent entities from avoiding the effect of the general rule or to address specific risks not covered by the general rule, for example, if the general rule only applies to groups. Overall, targeted rules hold the potential to address specific base erosion and profit shifting risks. However, an approach based entirely on targeted rules may result in a large number of rules that will increase complexity and compliance and administrative costs. If the rules are not comprehensive then they are unlikely to deal with all base erosion and profit shifting risks.

## NON-DEDUCTIBLE INTEREST EXPENSE AND DOUBLE TAXATION

As discussed above, deductions interest above any limit or cap will be denied if an interest limitation rule is applied. The Discussion Draft presumes that entities will comply with the limitation rules and will attempt to rearrange financing terms to avoid problems. Nonetheless, situations will exist where interest expense deductions are disallowed and double taxation will exist within a group. To rectify the problem, certain provisions may be included to reclassify nondeductible interest or to allow it to be used in other periods.

*“Situations will exist where interest expense deductions are disallowed and double taxation will exist within a group.”*

Permanent disallowance may work for certain transactions but not all. Under targeted rules, items of interest expense that give rise to permanent base erosion or profit shifting should be disallowed. Where nondeductible interest expense is a result of a timing mismatch due to fluctuating levels of earnings, a permanent disallowance may introduce an undesirable uncertainty.

### **Recharacterization of Disallowed Interest as a Dividend**

If recharacterizing a disallowed interest expense as a dividend is accepted by the country of the recipient, the risk of double taxation can be reduced. However, several problems could arise:

- Under a general interest limitation rule, the disallowance of interest expense will not be allocated to specific payments. If the recharacterization is applied on a *pro-rata* basis to all interest payments made by an entity, a large number of very small deemed dividends would be created.
- Disallowed expenses may be financial payments that are not interest in legal form and the reclassification of which may pose issues in the countries of the payer and recipient.
- Dividend withholding rates may be different from interest withholding rates and reclassification could reduce the impact of a disallowance.

While reclassification as a dividend may not be the best approach, reclassification under a specific targeted role may still be advisable.

### **Carryforward of Disallowed Interest or Unused Capacity**

Some countries already allow disallowed interest expense to be carried forward for relief. However, an indefinite carryforward could reduce the overall impact of an interest limitation rule and introduce planning opportunities that would negate the effect of the interest limitation rule that was implemented in the first place.

One way to tackle this problem would be to restrict the number of years the carry forward could apply. It has also been suggested that a disallowed interest expense shouldn't be deductible at any point.

## GROUPS IN SPECIFIC SECTORS

- Banks and Insurance Companies. Banks and insurance companies present unique issues that do not arise in other sectors. Interest expense is the largest cost on a bank's income statement, but this is less so for insurance companies. Interest expense in banking and insurance groups is closely tied to their ability to generate income, more so than for groups operating in other sectors. Therefore, any rule that restricts deductions for general gross interest expense will have a significant impact on a bank's business model. Moreover, financial sector businesses typically are subject to strict regulations on their capital structure. The 2011 Basel III agreement is an example for banks, and the Solvency II Directive in the E.U. is an example for insurers in the E.U. Specific rules will be required for the banking and insurance sectors that may differ in the treatment of regulatory capital and other borrowing. Limits could be placed on net deductions regarding regulatory capital (ignoring the interest income generated from using the capital to write business), so that only amounts of interest paid to third parties would be deductible. Alternatively, a best practice approach could focus on a group's interest expense other than the expense related to regulatory capital.
- Oil and Gas; Real Estate. Companies operating in these sectors may be subject to special tax regimes that are designed to ensure that a country shares in the benefits derived from the extraction of natural resources. These regimes may include specific features that limit interest expense deductions.
- Infrastructure Projects. These projects are often highly leveraged using a mixture of bond issues and bank debt. Special rules may be required in light of the impact of limitations on large public infrastructure projects.
- Other Businesses in the Financial Services Sector. Entities such as asset management, leasing, and the issuance of credit cards have their own unique issues that must be addressed to ensure an appropriate result in preventing base erosion and profits shifting.

## CONCLUSION

B.E.P.S. Action 4 evidences a view that internal manipulation of capital within a group between equity and debt is an evil that must be dealt with harshly. To the drafters, all internal debt is abusive if the amount of the debt is not tied to the third party borrowing of the group. Presumably, this approach is intended to prevent internal manipulation. However, as in other anti-abuse rules designed to prevent certain action, taxpayers have found relief by adjusting business models to put actual substance in places where none previously existed. There is little doubt that the first action as contemplated in the Discussion Draft of Action 4 will beget a reaction by groups that is unexpected by the drafters.

# B.E.P.S. ACTIONS 8, 9 & 10: ASSURING THAT TRANSFER PRICING OUTCOMES ARE IN LINE WITH VALUE CREATION

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## Tags

Action 8  
Action 9  
Action 10  
Arm's Length Principle  
B.E.P.S.  
Discussion Draft  
Hard-to-value Intangibles  
O.E.C.D.  
Over-capitalization  
Recharacterization  
Risk  
Transfer Pricing

On December 19, 2014, the Organisation of Economic Co-operation and Development (“O.E.C.D.”) released a discussion draft on Actions 8, 9, and 10 of the Base Erosion and Profit Shifting (“B.E.P.S.”) Action Plan (“Discussion Draft” or “Draft”)<sup>1</sup>. Actions 8, 9, and 10 reinforce the goal of assuring that transfer pricing outcomes are in line with value creation.

In July 2013, the O.E.C.D. published the B.E.P.S. Action Plan for the purpose of establishing a comprehensive agenda to resolve B.E.P.S. issues. The B.E.P.S. Action Plan identifies 15 actions to combat B.E.P.S. and establishes deadlines for application of each action.

The Discussion Draft introduces revisions to Chapter I of the Transfer Pricing Guidelines and addresses the related topics in Actions 8, 9, and 10. Specifically, the Discussion Draft focuses on the development of the following:

- (i) rules to prevent B.E.P.S. by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation.
- (ii) rules to prevent B.E.P.S. by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be recharacterized.
- (iii) transfer pricing rules or special measures for transfers of hard-to-value intangibles.

The Discussion Draft establishes guidance on these risk and recharacterization issues in two parts. Part I consists of proposed revisions to Section D of the Chapter I Transfer Pricing Guidelines and focuses on accurately defining the actual transactions and allocating of risk. Part II introduces a framework of questions along with five potential options for special measures relevant to intangible assets, risk, and over-capitalization.

The revisions to Section D, discussed in Part I of the draft, focus on the application of the arm's length principle and provide detailed guidance on determining the economically relevant characteristics or comparability factors of the controlled

<sup>1</sup> O.E.C.D. (2014) “BEPS Actions 8, 9, and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)”

transaction. The revisions also establish criteria on when an actual transaction should not be recognized or be recharacterized. Part I stresses the importance of:

- (i) the accurate delineation of the actual transaction based on both the contractual arrangements and the conduct of the parties, (ii) the specification of associated risks and allocation of risk to risk management, and (iii) the non-recognition of transactions which lack the fundamental attributes of arrangements between unrelated parties, for purposes of matching where profits are reported and where value is created.

These issues are identified by the Discussion Draft as “giving rise to several issues at the heart of the arm’s length principle.” In this context, additional points are raised by the Discussion Draft to be taken into consideration for comments, these include “moral hazard” (*i.e.*, the lack of incentive to guard against risk where one is protected from its consequences), “risk-return trade-off” (*i.e.*, the inclination to take on or lay off risk in return for higher or lower anticipated nominal income), and whether or not distinctions should to be made in applying the guidance to the financial sector.

Part II outlines potential special measures pertaining to intangible assets, risk, and over-capitalization. These special measures are either within or beyond the scope of the arm’s length principle. The primary aims of these special measures are to ensure that transfer pricing outcomes are in line with value creation and to limit the risk of B.E.P.S. for governments.

The special measures are introduced through the following five options:

- Option 1 addresses hard-to-value intangibles;
- Option 2 addresses issues with regard to an independent investor;
- Option 3 addresses thick capitalization;
- Option 4 addresses determination of a minimal functional entity;
- Option 5 addresses appropriate taxation of excess returns.

The situations proposed in these options closely relate to Action 3 (on strengthening the controlled foreign corporation [“C.F.C.”] rules) and Action 4 (on interest deductions). According to the Draft, some of the measures are closely related to C.F.C. rules or “can be seen as [C.F.C.] rules.” The Discussion Draft explains that such measures were included in order to obtain public comments in this respect prior to the public consultation on C.F.C. rules, which is planned for April 2015. The Draft also contains a series of ten questions that serves as a framework for determining whether and how each option should be implemented in order to achieve the transfer pricing goals of the B.E.P.S. Action Plan.

The views and proposals included in the Discussion Draft do not represent consensus views of the Committee on Fiscal Affairs or its subsidiary bodies but are intended to provide stakeholders with substantive proposals for analysis and comments. Accordingly, the O.E.C.D. invites the public to submit written comments on the Discussion Draft by February 6, 2015. There will also be a public consultation on the Discussion Draft and other topics on March 19<sup>th</sup> and 20<sup>th</sup> at the O.E.C.D. Conference Centre in Paris.



# B.E.P.S. ACTION 10 – PART I: PROFIT SPLIT METHOD IN THE CONTEXT OF GLOBAL VALUE CHAINS

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## Tags

Action 10  
B.E.P.S.  
Digital Economy  
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Multisided Business Models  
One-sided Method  
Profit Split Method  
Unanticipated Events  
Unique and Valuable  
Contributions

## INTRODUCTION

There has been another release on Base Erosion and Profit Shifting (“B.E.P.S.”) deliverables. B.E.P.S. refers to the tax planning that moves profits to a low-tax jurisdiction or a jurisdiction that allows a taxpayer to exploit gaps in tax rules. These deliverables have been developed to ensure the coherence of taxation at the international level. The aim of these deliverables is to eliminate double non-taxation. The measures have been developed throughout 2014, and they will be combined with the work that will be released in 2015.

In the December 16th release on Action 10 (the “Discussion Draft” or “Draft”),<sup>1</sup> Working Party No. 6 on the Taxation of Multinational Enterprises (“M.N.E.’s.”) released various factual scenarios, posed questions and invited affected persons to suggest answers. The goals of the Draft are to assure that transfer pricing outcomes are in line with value creation and to determine whether it is more appropriate to apply the profit split method in some circumstance instead of a one-sided transfer pricing method.

## RELEVANT ISSUES

The Draft identifies relevant issues in the posed scenarios, asks questions, and invites commentary as follows.

### Value Chains

The term “global value chain” describes a wide range of activity, from the consumption of the product to the end use and beyond. Therefore, one particular method of transfer pricing may not be appropriate.

#### **Scenario 1:**

Three associated Original Equipment Manufacturing (“O.E.M.”) enterprises in the durable goods industry are located in different territories in Europe. Each of the O.E.M.’s manufactures finished goods and components for its local market and the European market. They license in technology I.P. from their non-E.U. parent, for which they pay a royalty, but otherwise the European operation of the group is largely independent of the parent. The O.E.M.’s have a number of subsidiaries in Europe providing contract manufacturing services in relation to certain components. Sales and distribution takes place

<sup>1</sup> O.E.C.D. (2014), “BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains.”

through other group subsidiaries, and, in the O.E.M.'s own state, through a division of the O.E.M. itself.

The Draft identifies that a one-sided method can be appropriate and reliable to determine arm's length pricing for the royalty and for the contract manufacturing and distribution services.

However, a one-sided method may not be reliable and the profit split method may be preferable under the following conditions:

- Highly integrated transactions involving O.E.M.'s;
- An over-arching Leadership Board on which all three O.E.M.'s are represented;
- The Leadership Board that makes decision for the business as a whole (e.g., the board identifies the new products to be developed, the location within Europe where the products will be developed, the location where the products will be built, the scope of plant investment is to be made, and strategic marketing);
- The O.E.M.'s trade with each other, buying and selling components and finished goods; and
- The success of the business depends on having a wide portfolio of products to sell across the European market.

#### **Questions:**

1. *Can transactional profit split methods be used to provide a transfer pricing solution to this Scenario? If so, how?*
2. *What aspects of Scenario 1 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?*
3. *Is the application of a transactional profit split method more useful than other methods for dealing with particular aspects of value chains, such as highly integrated functions and the sharing of risks?*
4. *What guidance should be provided to address the appropriate application of transactional profit split methods to deal with these aspects of value chains?*

#### **Multisided Business Models**

This following scenario highlights a multisided and integrated digital economy business model. The diverse functions are carried out by various entities of the M.N.E. group which closely relate to the group's core business model.

##### **Scenario 2:**

The RCo Group provides a number of internet services such as search engines, e-mail services, and advertising to customers worldwide. On one side of the business model, the group provides advertising services through an online platform and charges clients a fee

*“The Draft points out that when there are unique and valuable contributions from two parties, the transactional profit split method is the most appropriate method.”*

based on the number of users who click on each advertisement. On the other side, the RCo Group provides free online service to users that provide the RCo Group with substantial data information such as location-based data, data on online behavior, and users’ personal information. Over the years, the RCo Group refines its methodology for data collection, processing, and analysis. As a result, it provides clients with a sophisticated technology that allows them to target specific advertisements to certain users.

The technology and algorithms used in providing the internet advertising services were originally developed and funded by Company R, the parent company of the RCo Group.

In order to interface with key clients, the group formed local subsidiaries to perform various functions:

- Promote the free use of online services by users, translate advertising into local languages, tailor advertising to the local market and culture, ensure that the services provided respect local regulatory requirements, and provide technical consulting to users.
- Generate demand for and adapt advertising services.
- Regularly interact with Company R staff responsible for developing technology to provide feedback on the algorithms and technologies to enhance business in various markets.

#### **Questions:**

1. *Can transactional profit split methods be used to provide an appropriate transfer pricing solution in the case of Scenario 2? If so, how?*
2. *What aspects of Scenario 2 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?*

#### **Unique and Valuable Contributions**

The Draft points out that when there are unique and valuable contributions from two parties, the transactional profit split method is the most appropriate method. The term “unique and valuable contributions” is not defined, but it is used in the amendments to Chapter VI, contained in the 2014 report *Guidance on the Transfer Pricing Aspect of Intangibles*. The term connotes a key source of competitive advantage for the business.

#### **Scenario 3:**

Company P, located in country P, is a manufacturer of high technology industrial equipment. Company S, a subsidiary of Company P, markets and distributes the equipment to unrelated customers in country S. Both companies are members of Group X.

Company P conducts extensive R&D activities to develop and improve the technological features of its equipment; it also funds and

has legal ownership of all the technology intangibles it develops. In addition, Company P owns the global trademark, and provides broad guidance to its subsidiaries around the world on its overall marketing strategy. There are several global competitors making similar equipment that operate in Country S, which is a large market for such equipment.

Company S is responsible for sales of the equipment and undertakes marketing activities. Due to the nature of its business, Company S develops close relationships with customers. It provides on-site services, carries an extensive stock of spare parts, and is highly proactive in detecting potential problems. Company S advises customers on equipment choices and suggests modifications for particular local conditions, or to maximize performance efficiency, or to enhance effectiveness. These activities provide a significant competitive advantage as customers place high value on the reliability and performance of the equipment. In this case, Company S is recognized as not merely a “routine” distributor, but its activities constitute a key source of competitive advantage for the Group.

#### **Questions:**

1. *Does the way in which the term “unique and valuable” is defined for intangibles assist in defining the term “unique and valuable contributions” in relation to the transactional profit split method?*
2. *What aspects of Scenario 3 need to be further elaborated in order to determine whether a transactional profit split or another method might be the most appropriate method?*
3. *Based on the abbreviated fact-pattern set out in Scenario 3, what method could be used to provide reliable arm’s length results to determine the remuneration for Company S? If a transactional profit split method is used, how should it be applied?*
4. *What are the advantages and disadvantages of considering the application of a transactional profit split in Scenario 3?*

#### **Integration and Sharing of Risks**

The Draft points out that one-sided methods may not be reliable to account for the synergies and benefits created by integration. Moreover, where an M.N.E.’s business operations are highly integrated, strategic risks may be jointly managed and controlled by more than one enterprise in the group, creating a strong interdependence of key functions and risks between the parties.

#### **Scenario 4:**

Company A, in country A, manufactures and sells sophisticated medical equipment to unrelated customers. In developing a new generation of equipment, it outsources the development and production of certain key equipment components to its associate enterprises, Companies B and C. The development of the components is a lengthy and complex process. The components are highly specific



and unlikely to be useful in other types of products. Companies A, B, and C each control and perform their own research, development, and production processes.

All third-party sales revenue from the equipment will initially accrue to A. The rewards to companies A, B, and C are contractually determined by the M.N.E. group on a profit-sharing basis.

**Questions:**

1. *In what circumstances might the application of a transactional profit split method be an appropriate approach for dealing with sharing of risks?*
2. *Would a one-sided method produce more reliable results?*
3. *What aspects of Scenario 4 need to be further elaborated in order to determine whether a transactional profit split method or another method might be the most appropriate method?*

**Fragmentation**

The M.N.E.'s divide various functions within a value chain. This is sometimes referred to as fragmentation of functions. It is difficult to find comparable uncontrolled enterprises with similar specialized activities. In addition, it may be hard to account for the high level of interdependence between the functions performed by the associated enterprises that may be absent in independent enterprises. For this reason, the Draft suggest that it may be feasible to undertake a transactional profit split method approach to identify comparables for some or all the fragmented activities on a combined basis, and to apply the principles of a contribution analysis to divide benchmark profit.

**Questions:**

1. *Should the guidance on the scope of transactional profit split methods be amended to accommodate profit split solutions to situations such as those referred to in the interim guidance on intangibles? If so, how?*
2. *Can transactional profit split methods be used to provide reliable arm's length transfer pricing solutions for fragmented functions? If so how? Can other methods address the issue of fragmentation, and, if so, how?*
3. *What aspects of fragmentation need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?*

**Lack of Comparables**

The Draft points out that one-sided methods can be reliable even when there is a lack of comparables, by broadening the scope of the search to other jurisdictions with similar economic conditions and by making accurate comparability adjustments. However, when limitations to the accuracy of a one-sided method exist, the Draft considers using the transactional profit split method.

*“The M.N.E.’s divide various functions within a value chain. This is sometimes referred to as fragmentation of functions.”*

*“In cases where available comparables for the application of a one-sided method may not be reliable, a transactional profit split approach may offer a better means to measure results.”*

### Scenario 5:

An M.N.E. group operates as a supplier of office stationery in a region. The group has operations in several countries, and each operating company supplies stationery products to its local customers. Some larger customers also operate across the region and primarily want to deal with suppliers who can operate regionally. As a result, the activities of each operating company of the M.N.E. involve:

- Selling to local customers,
- Agreeing to terms and taking orders from local customers buying on behalf of their regional organizations, and
- Fulfilling orders placed with other group companies.

All orders are invoiced and fulfilled locally in accordance with the terms agreed. The mix of local and regional business varies from year to year and from operating company to operating company.

#### Questions:

1. *How can comparables be found and applied in Scenario 5? What method is likely to be appropriate for determining an arm's length remuneration for the activities of the group companies?*
2. *How can comparables be found and applied in Scenario 3 (or to any other relevant Scenario in this discussion Draft)?*
3. *What aspects of Scenario 5 need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?*

In cases where available comparables for the application of a one-sided method may not be reliable, a transactional profit split approach may offer a better means to measure results. For example, application of a one-sided method may result in establishing a range of operating margins of 4-10% for one of the parties to the transaction: a baseline return of 7% is adopted which would vary in accordance with a predetermined computation upwards to 10% and downwards to 4% depending on the levels of consolidated profits or sales achieved by the parties to the transaction.

#### Questions:

1. *In what circumstances, if any, might an approach described in the last sentence above be appropriate?*
2. *More generally, in what circumstances would a transactional profit split approach be useful in supporting the application of other transfer pricing methods, and what guidance would be useful to develop for the supporting use of such approaches?*

### Aligning Taxation with Value Creation

The Draft views the profit split method as a means of achieving an alignment between profits and value creation. But at the same time, the Draft identifies the weakness of the transactional profit split method: because it is subjective, allocation keys can be difficult to verify from objective evidence.

In Scenario 8, the Draft focuses on ways to develop objective profit split factors and asks if there are other factors that are likely to reflect value creation in particular industry sectors. Scenario 1, discussed above, involves a set of integrated activities of three manufacturing O.E.M.'s. In Scenario 8, the Draft looks at the same fact pattern adjusted to account for post-royalty residual profits or losses. These items are split between the O.E.M.'s on the basis of three factors:

- Production capacity – This recognizes capital investment;
- Headcount – This recognizes the key input of labor; and
- Value of production – This recognizes the contribution to actual output.

Each factor is intended to reflect key value drivers in the business, as identified from a detailed functional analysis. These factors may require adjustments to take into account special circumstances.

**Questions:**

1. *In what ways should the guidance be modified to help identify factors which reflect value creation in the context of a particular transaction? Are there particular factors which are likely to reflect value creation in the context of a particular industry or sector?*
2. *What guidance is needed on weighting of factors?*

In addition, Scenario 6 considers using a matrix that evaluates the relative importance of the parties' various contributions to value creation.

**Scenario 6:**

Company A, located in country A, purchases technological goods from its associated manufacturer (Company B) located in country B. Company A determines and controls the business development strategy of the group. It decides the markets in which the group will operate and the product range and pricing within each market. Company B obtains the use of relevant I.P. under a license from another group entity (Company C) which developed the I.P. The license fee payable to Company C is subject to a separate transfer pricing analysis based on comparable, independent transactions. Company A sells the products to local distribution entities.

Company B determines and controls the global group manufacturing strategy including the procurement process and the structure of the supply chain. It develops and owns I.P. related to the manufacturing processes for the group's products. The actual manufacturing is carried out on a contract basis by another group entity (Company D) also located in country B.

After undertaking a detailed analysis of the commercial and financial relations between the enterprises in the group, including the functions, assets, and risks of the parties, and considering the availability of potential comparables, the M.N.E. group adopts a transfer pricing methodology based on a split of the total system profit from transactions between Company A and Company B. From their profit shares,

Company A and Company B provide arm's length remuneration to Company C, the local distributors, and the manufacturing entity in country B using one-sided methods.

The allocation of the system profit between Company A and Company B was determined by an analysis of their respective contributions to each of the group's key value drivers. Each of the personnel (i) responsible for, or (ii) accountable for, or (iii) consulted in making, or (iv) merely informed of relevant decisions was taken into account for each process contributing to a particular value driver. The analysis was reviewed and updated annually. Risks and assets were not considered separately as they were considered by the M.N.E. group to be embedded in the processes that managed them.

**Questions:**

1. *How can other approaches be used to supplement or refine the results of a detailed functional analysis in order to improve the reliability of profit splitting factors (e.g., approaches based on concepts of bargaining power, options realistically available, or a R.A.C.I.-type analysis of responsibilities and decision making)?*
2. *Given the heterogeneous nature of global value chains, is it possible to develop a framework for reliably conducting a multifactor profit split analysis applicable to situations where an M.N.E. operates an integrated global value chain? What are the factors that might be considered, how should they be weighted, and when might such an analysis be appropriate?*

There are some weaknesses in the methodology when the cost of the contribution made by the parties may be unreliable. The cost contribution may not reflect correct value of the contribution.

**Question:**

1. *What specific aspects of transactional profit split approaches may be particularly relevant in determining arm's length outcomes for transactions involving hard-to-value intangibles?*

**Dealing with Ex Ante/Ex Post Results**

The Draft suggests that the appropriate approach may be to use a transactional profit split method when dealing with unanticipated events. Scenario 7 shows how a transactional profit split method can be used to determine from the beginning how to share profits when the outcome is uncertain.

**Scenario 7:**

Two associated enterprises jointly agree to share the development of a new product, and each associated enterprise will be responsible for developing and manufacturing one of the two key components. At the outset it is estimated by the enterprises that the development costs will be 100 in total, with 30 estimated to be incurred by one of the parties and 70 estimated to be incurred by the other. Several risks exist. First, there is risk that the project will not produce the

*“There are some weaknesses in the methodology when the cost of the contribution made by the parties may be unreliable.”*

*“In Scenario 9, the Draft questions whether losses should be split differently from profits.”*

expected returns. Second, there is a significant risk of cost overruns. Each party manages its own cost overrun risk. The parties agree that expected profits from the sale of the new product will first be allocated to provide each party with a routine return on its manufacturing functions; with the residual profit and loss split 30/70 notwithstanding that the actual development costs may vary from what was projected.

**Question:**

1. *How can transactional profit split methods be applied to deal with unanticipated results? What further guidance is advisable?*

In Scenario 8, we see how transactional profit split methods do not always results in split of actual profits, e.g., conversion of the profit split into a fixed royalty.

**Scenario 8:**

Parent Company P licenses patent rights relating to a potential pharmaceutical product to subsidiary Company S. Company S is responsible for marketing the product. P performs all of the basic research and most of the development functions, with S contributing to late stage development and marketing. For the purposes of this scenario, both companies are understood to contribute to the development of the intangible. It is possible to weigh the risk of the expenditure based on reported industry data about success rates at each development stage for products in the same therapeutic category. The current and anticipated costs, determined on a net value basis, are contributed by P and S in the ratio 80:20. At the time of the license, projections are prepared on a net present value basis of the expected sales, production and sales costs (including a benchmarked return on those costs), and resulting profits. The respective contributions to product development are then used to split the anticipated profits in the ratio 80:20. At this point, however, P's expected profit from the expected sales is converted to a royalty rate on those sales. In this Scenario, the transactional profit split method is used to calculate a royalty.

**Question:**

1. *Is the application of a transactional profit split method to calculate the royalty in Scenario 8, or in other circumstances to set a price, helpful? What are the advantages and disadvantages?*

**Dealing with Losses**

The Draft points out that under the O.E.C.D. Guidelines (paragraph 1.108), the profits and losses are split in the same manner. In Scenario 9, the Draft questions whether losses should be split differently from profits.

### Scenario 9:

Three companies in a banking group carry on trading in a type of structured financial product through an integrated model. Each operates in one of the main time zones. Profits from this business are allocated between the three companies using a multi-factor profit split methodology that gives different weight to each factor. The greatest weighting is given to the factor based on remuneration paid to the traders in each location, including bonuses based on performance.

However, significant losses may be generated in this line of business and the correlation between bonus compensation and such losses will not be the same as that between bonuses and profits. To ensure the allocation of losses would be in line with what would have been made up-front by independent enterprises, the methodology incorporates principles for the adjustment of the remuneration-based factor where losses are incurred. This is based on an analysis of the group's compensation policy in such circumstances as well as a careful consideration of the types of circumstance in which losses may be incurred in the particular business.

#### Questions:

1. *In what circumstances might it be appropriate under the arm's length principle to vary the application of splitting factors depending on whether there is a combined profit or a combined loss?*
2. *Are there circumstances under the arm's length principle where parties which would share combined profits, would not be expected to take any share of combined losses?*

The Draft poses additional questions which illustrates the difficulty of the issue:

- *Paragraph 2.114 of the Guidelines points to some practical difficulties in applying the transactional profit split method. Do those pointers remain relevant, and what other practical difficulties are encountered? How are such difficulties managed?*
- *Finally, what further points would respondents wish to make about the application of transactional profit split methods not covered by previous questions?*

These questions and factual scenarios illustrate the hard work ahead in finalizing the Chapter II of the O.E.C.D.'s Transfer Pricing Guidelines. All comments received in response to the questions provided in the Draft will be made public.



# B.E.P.S. ACTION 10 – PART II: THE TRANSFER PRICING ASPECTS OF CROSS-BORDER COMMODITY TRANSACTIONS

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## Tags

Action 10  
B.E.P.S.  
Commodity Transactions  
C.U.P. Method  
Deemed Pricing Date  
Transfer Pricing  
Global Value Chains

The discussion draft on Action 10 (the “Discussion Draft”)<sup>1</sup> deals with transfer pricing issues in relation to commodities transactions and the potential for Base Erosion and Profit Shifting (“B.E.P.S.”). The commodity sector constitutes major economic activity for developing countries and provides both employment and government revenue.

In seeking to create clear guidance on the application of transfer pricing rules to commodity transactions, the Discussion Draft identifies several problems and policy challenges and seeks to establish a transfer pricing outcome that is in line with value creation.

## PROPOSALS TO CHAPTER II OF THE TRANSFER PRICING GUIDELINES

The Discussion Draft identifies issues and invites commentary on the *O.E.C.D. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the “Transfer Pricing Guidelines”)<sup>2</sup> as follows:

- **Use of the C.U.P. Method** – the Discussion Draft identifies the Comparable Uncontrolled Price (“C.U.P.”) method as the appropriate transfer pricing method for establishing an arm’s length price. Some adjustments will be required when the “quoted price” relates to a commodity that is not similar in terms of physical features and quality. The application of the C.U.P. method should be documented in writing to assist tax authorities in carrying out an informed examination. The documentation should provide the price-setting policy and other relevant information related to the pricing of the commodity.
- **Deemed Pricing Date for Commodity Transactions** – Sometimes there is a significant delay between the date of entering into a contract and the date of delivery. During this time, the price of the commodity fluctuates, and it is often difficult for the tax administration to verify the pricing date. The Discussion Draft proposes the use of a “Deemed Pricing Date” for commodity transactions. The related parties may select the Deemed Pricing Date for the commodity, but if the evidence pertaining to this date contradicts the facts of the case, the tax authorities may impute the price date based on the evidence provided by the related parties. If reliable evidence does not exist, the date of shipment will be treated as the pricing date. This provision has the potential to wreak havoc on a business model that uses a forward price on an earlier

<sup>1</sup> O.E.C.D. (2014), “[BEPS Action 10: Discussion Draft on the Transfer Pricing Aspects of Cross-Border Commodity Transactions.](#)”

<sup>2</sup> O.E.C.D. (2010), “[OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.](#)”

date when parties enter into a commodity transaction.

- *Potential Additional Guidance* – When dealing with the transfer pricing of commodities among related parties, adjustments should be made based on physical deferences, processing costs, and other features of the transaction. The Discussion Draft invites responses to clarify the common adjustments or differentials on the quoted price and the sources of information used to conduct these adjustments or differentials. In addition, it specifies that the commodity transactions should be read with B.E.P.S. Actions 9, 10, and 13 to ensure that transfer pricing outcomes in commodity transactions are in line with value creation.

The complexity of commodity pricing has created the need for consistency within and outside the O.E.C.D. member countries. In particular, countries in the Latin American region have developed methods that create inconsistency. The potential for B.E.P.S. stemming from this inconsistency explains the O.E.C.D.'s motivation for proposing clear guidance on the application of transfer pricing rules to commodity transactions.



# B.E.P.S. ACTION 14: MAKE DISPUTE RESOLUTION MECHANISMS MORE EFFECTIVE

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## INTRODUCTION

The O.E.C.D. has continued to publish discussion drafts under its 15-part action plan (the “B.E.P.S. Action Plan”) for combatting base erosion and profit shifting (“B.E.P.S.”), with Action 14 being the most unique.

Action 14, entitled “*Make Dispute Resolution Mechanisms More Effective*,” provides as follows:

Develop solutions to address obstacles that prevent countries from solving treaty-related disputes under MAP, including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases.

While most components of the B.E.P.S. Action Plan address the problems caused by base erosion and profit shifting, the recently proposed discussion draft for Action 14 (“Discussion Draft” or “Draft”)<sup>1</sup> addresses the mutual agreement procedures (“M.A.P.”) used to resolve treaty-related disputes. Action 14 addresses the current obstacles faced by taxpayers seeking M.A.P. relief to avoid economic double taxation and provides suggestions as to how to revise provisions in order to improve the integration of M.A.P. dispute resolution mechanisms. The O.E.C.D. describes it as a unique opportunity to overcome traditional obstacles and to provide effective relief through M.A.P. The Discussion Draft proposes complementary solutions that are intended to have a practical and measurable impact, rather than merely providing additional guidance which may not be followed.

The Discussion Draft introduces a three-pronged approach to enhance the M.A.P. program as a means of resolving disputes. The three-pronged approach consists of (i) political commitments to effectively eliminate taxation not in accordance with the Convention, (ii) new measures to improve access to the M.A.P. and procedures for conducting a M.A.P. resolution, and (iii) a monitoring mechanism to check the proper implementation of the political commitment.

This article will look at the obstacles and options suggested to improve implementation of the M.A.P. In particular, it will discuss mandatory binding M.A.P. arbitration as a means of dispute resolution.

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<sup>1</sup> O.E.C.D. (2014) “[BEPS Action 14: Make Dispute Resolution Mechanisms More Effective](#).”

## BACKGROUND

Any plan to counter B.E.P.S. must be complemented with actions that ensure certainty and predictability for business. The interpretation and application of novel rules resulting from the B.E.P.S. Action Plans could introduce elements of uncertainty which should be minimized as much as possible. As a result, efforts to improve the effectiveness of the M.A.P. are an important complement to the work on B.E.P.S. Specific measures that will result from the work on Action 14 will constitute a minimum standard to which participating countries will commit. Notwithstanding this minimum standard, it is expected that the final results of the work on Action 14 will also include additional measures (such as, for example, M.A.P. arbitration) that some countries may also wish to commit to adopt in order to address obstacles to an effective M.A.P. in a more comprehensive way.

*“Without assured good faith, member states will become wary and profit shifting will continue in some form or the other.”*

## APPLICABLE PRINCIPLES

The Discussion Draft is guided by four main principles that together ensure the success of the M.A.P.

- Ensuring that treaty obligations related to the M.A.P. are fully implemented in good faith,
- Ensuring that administrative processes promote the prevention and resolution of treaty-related disputes,
- Ensuring that taxpayers can access the M.A.P. when eligible, and
- Ensuring that cases are resolved once they are within the M.A.P.

With these principles stated, the discussion draft identifies obstacles and suggests solutions. Most importantly, it seeks input from the private sector regarding specific solutions.

## OBSTACLES TO M.A.P.

### **Good-Faith Commitment to M.A.P.**

Mutual commitment is a cornerstone of a successful M.A.P. process and good faith is key to making sure that the M.A.P. is fully implemented by all member states. Without assured good faith, member states will become wary and profit shifting will continue in some form or the other. Only through good faith implementation can the M.A.P. truly prove to be effective.

Most countries consider economic double taxation resulting from the inclusion of profits of associated enterprises under paragraph 1 of Article 9 of the O.E.C.D. O.E.C.D. Model Tax Convention on Income and Capital (the “Model Treaty”) is not in accordance with the object and purpose of an income tax treaty. However, there are some countries that take the position that they are not obliged to make offsetting adjustments or to grant access to the M.A.P. in the absence of a specific obligation in the relevant treaty. This position frustrates a primary objective of tax treaties – the elimination of double taxation – and prevents bilateral consultation to determine appropriate transfer pricing adjustments.

## **Adoption of Effective Administrative Processes**

Appropriate tax administration practices are important to ensure an environment in which competent authorities are able to fully and effectively carry out their mandate (*i.e.*, to take an objective view of the provisions of the applicable treaty and apply it to the facts of the taxpayer's case for the purpose of eliminating taxation not in accordance with the terms of the treaty). The effectiveness of the M.A.P. may be undermined where a competent authority is not sufficiently independent, where a competent authority is not provided with adequate resources, or where the competent authority function is evaluated based on inappropriate performance indicators.

Objectivity may be compromised where the competent authority function is not sufficiently independent from a tax administration's audit or examination function. Similarly, issues may arise where the competent authority performs a policy-making function (*e.g.*, tax treaty negotiation) and does not adequately distinguish between the role of administering treaties that have entered into force and that of negotiating changes to these treaties. Challenges to the objective application of existing treaty provisions may also be presented where a competent authority's approach to a M.A.P. case is influenced by the changes it seeks to make regarding its country's treaties.

Problems will likely arise as a result of a lack of sufficient resources (personnel, funding, training, etc.) allocated to a competent authority. Lack of adequate resources is likely to result in an increase in the inventory of M.A.P. cases and increased delays in processing cases.

Administrative processes that promote the prevention of treaty-related disputes and the resolution of disputes that arise are also being examined in work of the Forum on Tax Administration's M.A.P. Forum (the "F.T.A. M.A.P. Forum"). The F.T.A. M.A.P. Forum has recognized that audit programs that are not aligned with international norms significantly hinder the functioning of the M.A.P. process. The evaluation of the competent authority function based on criteria such as sustained audit adjustments or the generation of tax revenue may be expected to create disincentives to the competent authority's objective consideration of M.A.P. cases and to present obstacles to good faith bilateral M.A.P. negotiations.

### **Effective Access to M.A.P.**

On occasion, field auditors in some countries may seek to encourage taxpayers not to utilize their right to initiate a M.A.P. in relation to audit adjustments that result in taxation not in accordance with an applicable tax treaty. Taxpayers may feel pressured into giving up access to the M.A.P. process if they are given the choice between a high assessment with access to M.A.P. but no suspension of collection, or a relatively moderate assessment without access to M.A.P. Alternately, taxpayers may accept such settlements based on broader concerns for their future relationship with the tax administration involved. Such audit settlements may be a significant obstacle to the proper application of the tax treaty as well as to the functioning of the M.A.P. They lead to situations in which taxation not in accordance with the Convention remains in one country while the tax administration in the treaty partner country is not aware of the situation and may be vulnerable to self-help measures taken by the taxpayer.

*"Objectivity may be compromised where the competent authority function is not sufficiently independent from a tax administration's audit or examination function."*

Advance pricing agreements (“A.P.A.’s”) concluded bilaterally between treaty partner competent authorities provide an increased level of tax certainty in both jurisdictions, lessen the likelihood of double taxation and may proactively prevent transfer pricing disputes. However, not all countries have implemented bilateral pricing agreement programs, allow a rollback of the agreement to all open years, or have administrative processes in place to allow the programs. Even where A.P.A.’s are reached by a particular country, issues resolved through an advance pricing arrangement may be relevant to earlier years, but those years are not included within the scope of the A.P.A. In a similar vein, decisions reached in a M.A.P. process may affect subsequent years where facts do not change.

In certain countries, the procedures to access the M.A.P. process are not transparent or are unduly complex. This discourages taxpayers from seeking relief under the M.A.P. process, and these taxpayers face double taxation without the opportunity for relief.

*“In certain countries, the procedures to access the M.A.P. process are not transparent or are unduly complex.”*

Questions exist regarding the ability of a taxpayer to access the M.A.P. where the tax issue results exclusively from domestic law in one country or general anti-avoidance rules (“G.A.A.R.”) in that country. Under Action 6 of the B.E.P.S. Action Plan, the benefits of a tax treaty will not be available where one of the principal purposes of a transaction is to secure a benefit under a tax treaty and obtaining the benefit would be contrary to the object and purpose of the relevant provisions of the tax treaty. Action 14 states that the interpretation or application of that rule clearly falls within the scope of the M.A.P. process.

To be admissible, a case must be presented to the competent authority of the taxpayer’s country of residence within three years following the first notification of an action giving rise to taxation not in accordance with the Model Treaty. A competent authority should consider whether the case is eligible for the M.A.P. This involves a determination of whether the taxpayer’s objection appears to be justified and, if it is, whether the matter can be handled unilaterally. The matter moves to the bilateral stage where unilateral relief is not appropriate.

In some cases, the competent authority in one country may find that the objection presented by the taxpayer is not justified, while the competent authority in the other jurisdiction reaches the opposite conclusion. To illustrate, competent authorities may be hesitant to overturn assessments made by their own tax administrations and, for that reason, may unilaterally determine that the taxpayer’s objection is not justified. This determination may result in a refusal to discuss the case with the competent authority of the other country, even where that other competent authority considers the objection to be justified. The Discussion Draft states that such results raise legitimate concerns as to the bilateral nature of treaty application and implementation.

M.A.P. relief is available irrespective of the judicial and administrative remedies provided by the domestic law of the two states that are parties to the treaty (“the Contracting States”). Generally, a taxpayer’s choice of recourse is only constrained by the condition that most tax administrations will not deal with a taxpayer’s case through M.A.P. while it undergoes domestic court or administrative proceedings. This suggests that it is preferable to pursue the M.A.P. process first and to suspend domestic law procedure because an agreement reached through M.A.P. will typically provide a comprehensive, bilateral resolution of the case. A domestic law recourse procedure, in contrast, will only settle the issues in one State and may consequently

fail to relieve the international issue of double taxation. Of course, the competent authority may only agree to consider a case on the condition that the taxpayer will forego any subsequent appeal in domestic courts.

Where the payment of tax is a requirement to access M.A.P., the taxpayer may face significant financial difficulties: If both Contracting States collect the disputed taxes, double taxation will in fact occur, and resulting cash flow issues may have a substantial impact on a taxpayer's business, at least for the duration of the M.A.P. process. A competent authority may also find it more difficult to enter into good-faith M.A.P. discussions when it considers that it will likely have to refund taxes already collected.

Time limits connected with the M.A.P. present particular obstacles to an effective M.A.P. resolution. In some cases, uncertainty regarding the "first notification of the action resulting in taxation not in accordance with the provisions of the Convention" may present interpretive difficulties. More importantly, some countries may be reluctant to accept "late" cases – *i.e.*, cases initiated by a taxpayer within the deadline but long after the taxable year at issue. Countries have adopted various mechanisms to protect their competent authorities against late objections. These include requirements to present a M.A.P. case to the other competent authority within an agreed-upon period in order for M.A.P. relief to be implemented and treaty provisions limiting the period during which transfer pricing adjustments may be made.

Under the laws of certain countries, a taxpayer may be permitted to amend a previously filed tax return to adjust the price for a controlled transaction between associated enterprises or profits attributable to a permanent establishment ("P.E.") in order to reflect a result that is in accordance with the arm's length principle, at least in the taxpayer's opinion. Any action undertaken at the initiative of the taxpayer to adjust the previously-reported results of controlled transactions in order to reflect an arm's length result is considered a "Self-Initiated Adjustment." Uncertainty exists with respect to the obligation to make a corresponding adjustment in the case of a Self-Initiated Adjustment in a foreign jurisdiction. It is by no means clear that a foreign Self-Initiated Adjustment is considered to be an action by a Contracting State that triggers taxpayer entitlement to request M.A.P. consideration. These issues have become significant as a consequence of increased pressure on transfer pricing outcomes and P.E. issues resulting from the work to combat B.E.P.S.

### **Case Resolution**

As previously stated, in M.A.P. cases, the competent authority is expected to take an objective view of the provisions of the applicable treaty and apply it in good faith with a view to eliminating taxation not in accordance with the treaty. Where one or both competent authorities do not follow that approach, the resolution of M.A.P. cases becomes difficult and risks of inappropriate results exist. To avoid these problems, a competent authority should engage in discussions with other competent authorities in a fair and principled manner. As part of a principled approach, each M.A.P. case should be approached on its own merits and not by reference to any balance of results in other cases. A principled approach also requires that competent authorities take a consistent approach to the same or similar issues and not change positions from case to case based on considerations that are irrelevant to the legal or factual issues, such as the amount of the tax revenue that may be lost and a view that both Contracting States should win and lose the same percentage of cases.

*"A competent authority should engage in discussions with other competent authorities in a fair and principled manner."*

A lack of cooperation, transparency or of a good working relationship between competent authorities also creates difficulties for the resolution of M.A.P. cases. A good competent authority working relationship is a fundamental part of an effective mutual agreement procedure.

Mandatory binding M.A.P. arbitration has been included in a number of bilateral treaties following its introduction in the Model Treaty in 2008. Nonetheless, the adoption of M.A.P. arbitration has not been as broad as expected and acknowledges that the absence of arbitration provisions in most treaties and the fact that access to arbitration may be denied in certain cases are obstacles that prevent countries from resolving disputes through the M.A.P.

One of the main policy concerns with mandatory binding M.A.P. arbitration relates to national sovereignty. In some States, national law, policy, or administrative considerations are considered obstacles to the adoption of mandatory binding M.A.P. arbitration. This is particularly the case where competent authorities are concerned about the risk of conflict between the decision of a court and the decision of an arbitration panel. Some countries may restrict access to arbitration to a specific range of issues such as residence, P.E. status, business profits, arm's length transfer pricing, and royalties.

There are two principal approaches to decision-making in the arbitration process. The format most commonly used in commercial matters is the "conventional" or "independent opinion" approach, in which the arbitrators are presented with a *de novo* presentation of the facts and arguments of the parties based on applicable law and then reach an independent decision, typically in the form of a written, reasoned analysis. This approach strongly resembles a judicial proceeding and is the model for the E.U. Arbitration Convention as well as the default approach reflected in the Model Treaty. The other main format is the "last best offer" approach, often referred to as "baseball arbitration" because in a salary dispute between baseball players in the U.S. and their ball clubs, arbitration is allowed and the arbitrator must approve the position of the player or the club and cannot choose a result in between the two. This approach is reflected in a number of bilateral tax treaties signed by O.E.C.D. member countries. Under this approach, the competent authorities submit to the arbitration panel a proposed resolution together with a position paper in support of that position. The arbitration panel is required to adopt one of the proposed resolutions submitted by the competent authorities. The determination by the arbitration panel does not state a rationale and has no precedential value.

The evidence considered by the arbitration panel may largely be determined by the form of the decision-making process. The independent opinion approach ordinarily envisions a formal evidentiary process involving testimony, the *de novo* presentation of evidence to the arbitration panel and possibly taxpayer presentations. The Final Offer approach, on the other hand, generally contemplates that the arbitration panel will make a decision based on the facts and arguments as presented in the competent authorities' submissions to the arbitration panel. The most important principle relating to evidence is that there be no opportunity or incentive for the taxpayer to undermine the M.A.P. negotiation process by seeking to have the arbitration panel consider information which was previously withheld or otherwise not provided to the competent authorities. Consistent with the nature of the mutual agreement procedure as a government-to-government activity in which taxpayers play no direct role, M.A.P. arbitration processes do not require direct taxpayer input to, or appearance



*“Participating countries could commit to making offsetting adjustments in the event of a primary transfer pricing adjustment by the competent authority of the other State.”*

before, the arbitration panel, although such taxpayer participation is not precluded. While the arbitration panel might benefit from direct interaction with taxpayers, there is a concern that taxpayer involvement in the M.A.P. arbitration procedure could result in a lengthier, more expensive and more complicated process, and thus undermine the effectiveness of M.A.P. arbitration.

In light of the significant resource constraints experienced by many countries in recent years, concerns about the potential costs of M.A.P. arbitration are an important consideration in designing the format of the arbitration process. The costs associated with arbitration fall into three categories:

- Costs related to engaging the arbitration panel, consisting principally of the fees paid to the arbitrators;
- Costs related to each competent authority’s participation in the arbitration procedure, which include, for example, costs related to the preparation and presentation of proposed resolutions and position papers; and
- Administrative costs, such as telecommunications and secretarial expenses, miscellaneous expenses (e.g., translation or interpretation) and, possibly, travel costs (airfare, lodging, etc.).

Depending upon the evidentiary procedures established, the compensation of the arbitration panel can constitute the most significant cost of arbitration. The costs of M.A.P. arbitration, however, do not have to be significant, and various design features such as a streamlined evidentiary process or a time limit for the arbitration can significantly reduce the time and other resources necessary for the arbitration process.

## M.A.P. OPTIONS

### Good-Faith Commitment to M.A.P.

- Clarify in the Commentary the importance of resolving cases. The following paragraph could be added to the Commentary on Article 25 in order to emphasize that the mutual agreement procedure is an integral part of the obligations that follow from concluding a tax treaty:

The undertaking to resolve by mutual agreement cases of taxation not in accordance with the Convention is an integral part of the obligations assumed by a Contracting State in entering into a tax treaty and must be performed in good faith. In particular, the requirement in paragraph 2 that the competent authority “shall endeavour” to resolve the case by mutual agreement with the competent authority of the other Contracting State means that the competent authorities are obliged to seek to resolve the case in a principled, fair and objective manner, on its merits, in accordance with the terms of the Convention and applicable principles of international law.

- Ensure that the obligation to make offsetting adjustments is included in tax treaties. Participating countries could commit to making offsetting adjustments in the event of a primary transfer pricing adjustment by the competent authority of the other State. This change does not create a negative inference with respect to treaties that do not currently contain the provision.

### **Adoption of Effective Administrative Processes**

- Ensure the independence of a competent authority. Participating countries could commit to adopt the best practices currently included in the O.E.C.D. Manual on Effective Mutual Agreement Procedures (“M.E.M.A.P.”) concerning the independence of a competent authority. Necessary steps should be taken to ensure the autonomy of the competent authority from the audit and examination functions, as well as to guarantee, in practice, an appropriate distinction between the objective application of existing treaties and the forward-looking determination of the policy to be adopted and reflected in future treaties.
- Provide sufficient resources to a competent authority. They could commit to provide their competent authorities with sufficient resources in terms of personnel, funding, and training to carry out their mandate to resolve cases in a timely and efficient manner.
- Use of appropriate performance indicators. Participating countries could commit to adopt the best practices currently included in the M.E.M.A.P. concerning the use of appropriate performance indicators for their competent authority functions and staffs. These would be based on factors such as consistency of position, time to resolve cases, and principled and objective M.A.P. outcomes and not on factors such as sustained audit adjustments or maintaining tax revenues already collected.
- Better use of M.A.P. process. Participating countries could commit to make more use of M.A.P. processes, and where an agreement in a M.A.P. case relates to a general matter that affects a wide group of taxpayers, to publish the agreement in order to provide guidance and prevent future disputes.
- Wider use of M.A.P. process. Participating countries could commit to adopt the best practices currently included in the M.E.M.A.P. to relieve double taxation in cases not provided for in the Convention (e.g., in the case of a resident of a third country having P.E.’s in both Contracting States).

### **Effective Access to M.A.P.**

- Ensure that audit settlements do not block access to the mutual agreement procedure. Participating countries that allow their tax administrations to conclude audit settlements with respect to treaty-related disputes which preclude a taxpayer’s access to the mutual agreement procedure could commit to take appropriate steps to discontinue that practice or to implement procedures for the spontaneous notification of the competent authorities of both Contracting States of the details of such settlements.
- Implement bilateral A.P.A. programs. Participating countries could commit to implement bilateral Advance Pricing Agreements.



- Implement administrative procedures to permit taxpayer requests for M.A.P. assistance with respect to recurring or multi-year issues. Participating countries could commit after an initial tax assessment to implement appropriate procedures to permit taxpayer requests for the multi-year resolution of recurring issues with respect to filed tax years, where the relevant facts and circumstances are the same and subject to the verification of such facts and circumstances.
- Implement administrative procedures to permit taxpayer requests for M.A.P. assistance with respect to roll-back of A.P.A.'s. Participating countries that have implemented A.P.A. programs could similarly commit to provide for the roll-back of advance pricing arrangements in appropriate cases, subject to the applicable time limits provided by domestic law such as statutes of limitation for assessment where the relevant facts and circumstances in the earlier tax years are the same and subject to the verification of these facts and circumstances.
- Improve the transparency and simplicity of the procedures to access and use the M.A.P. Participating countries could commit to adopt the best practices currently included in the M.E.M.A.P. concerning the transparency and simplicity of the procedures to access and use the mutual agreement procedure, which should minimize the formalities involved in the M.A.P. process taking into account the challenges that may be faced by taxpayers. This would include a commitment to (i) develop and publicize rules, guidelines and procedures for the use of the M.A.P. and (ii) identify the office that has been delegated the responsibility to carry out the competent authority function and its contact details.
- Provide additional guidance on the minimum contents of a request for M.A.P. assistance. Participating countries could commit to adopt the best practices currently included in the M.E.M.A.P. concerning the minimum contents of a request for M.A.P. assistance. This would include a commitment to (i) identify, in public guidance, the specific information and documentation that a taxpayer is required to submit with a request for M.A.P. assistance, seeking to balance the burdens involved in supplying such information with the complexity of the issues the competent authority is called upon to resolve and (ii) avoid denying access to the M.A.P. process on the basis of insufficient information without consulting the other competent authority where a country has not yet provided any guidance.
- Clarify the availability of M.A.P. access where an anti-abuse provision is applied. Where there is a disagreement between the taxpayer and the competent authority to which its M.A.P. case is presented as to whether the conditions for the application of a treaty anti-abuse rule have been met or whether the application of a domestic anti-abuse rule conflicts with the provisions of a treaty, participating countries could commit to provide access to the mutual agreement procedure, provided the requirements of the M.A.P. article of the applicable treaty is met. In addition, (i) a participating country seeking to limit or deny M.A.P. access in all or certain of these cases could commit to agree upon such limitations with treaty partners and (ii) where a participating country would deny M.A.P. access based on the application of domestic law or treaty anti-abuse provisions, the treaty partner should be notified.

*“When interpreting a tax treaty’s time limitation for requesting M.A.P. relief, requests in borderline cases should give the benefit of the doubt to taxpayers.”*

- Ensure that whether the taxpayer’s objection is justified is evaluated *prima facie* by both competent authorities. Where the competent authority to which a M.A.P. case is presented does not consider the taxpayer’s objection to be justified, participating countries could commit to a bilateral notification or a consultation process.
- Clarification of the term “justification.” Participating countries could commit to clarify the Commentary on the meaning of the phrase “if the taxpayer’s objection appears to it to be justified.”
- Permit a request for M.A.P. assistance to be made to the competent authority of either Contracting State.
- Clarify the relationship between the M.A.P. and domestic law remedies. Participating countries could commit to clarify the relationship between the mutual agreement procedure and domestic law remedies to facilitate recourse to the mutual agreement procedure as a first option to resolve treaty-related disputes through appropriate adaptations to their domestic legislation and administrative procedures, which may include provision for the suspension of domestic law proceedings as long as a M.A.P. case is pending.
- Publish guidelines on the relationship between the M.A.P. and domestic law remedies. Clear guidance could be provided on the relationship between the M.A.P. and domestic law remedies, the processes involved and the conditions and rules underlying these processes. Such guidance could address whether the competent authority considers itself to be legally bound to follow a domestic court decision in the M.A.P., or whether the competent authority will not deviate from a domestic court decision as a matter of administrative policy or practice so that taxpayers may make an informed choice between the M.A.P. process and domestic law remedies.

### **Case Resolution**

- Clarify issues connected with time limits to access the mutual agreement procedure. Participating countries could adopt the best practices currently included in the M.E.M.A.P. concerning time limits to access the mutual agreement procedure to facilitate early resolution of M.A.P. cases. When interpreting a tax treaty’s time limitation for requesting M.A.P. relief, requests in borderline cases should give the benefit of the doubt to taxpayers.
- Clarify implementation of M.A.P. relief. Participating countries could include in treaties a provision calling for the implementation of M.A.P. relief notwithstanding any time limits in domestic law. Where that provision is not included, a participating country should ensure that its audit practices do not unduly create the risk of late adjustments for which taxpayers may not be able to seek M.A.P. relief.
- Clarify issues related to self-initiated foreign adjustments and the mutual agreement procedure. Clarify the circumstances where double taxation may be resolved under the M.A.P. process in the case of self-initiated foreign adjustments. The clarification should emphasize the importance of bilateral competent authority consultation to determine appropriate corresponding adjustments and to ensure the relief of double taxation.

- Ensure a principled approach to the resolution of M.A.P. cases. Participating countries should ensure a principled approach to the resolution of M.A.P. cases. Best practices currently included in the M.E.M.A.P. should be adopted concerning fair and objective M.A.P. negotiations based on a good faith application of the treaty and the resolution of M.A.P. cases on their merits. Where the interpretation of a treaty provision is likely to be difficult or controversial, participating countries could agree on guidance in the form of a protocol or exchange of notes.
- Improve competent authority cooperation, transparency and working relationships. Participating countries could adopt the relevant best practices currently included in the M.E.M.A.P., including a cooperative and fully transparent M.A.P. process in which documentation and information are exchanged in a timely manner and regular communications, including meetings, are used to reinforce a collaborative working relationship. Competent authorities could agree to allow taxpayers to make presentations in order to facilitate a shared understanding of the relevant facts.
- Increase transparency with respect to M.A.P. arbitration and tailor the scope of M.A.P. arbitration.
- Facilitate the adoption of M.A.P. arbitration. Most favored nation provisions could be used as an elective mechanism for the quick implementation of M.A.P. arbitration between a country and its treaty partners where that country determines that M.A.P. arbitration should be included as part of its treaty policy.
- Clarify the co-ordination of M.A.P. arbitration and domestic legal remedies. Participating countries could commit to provide guidance on the interaction between the mutual agreement implementing the decision of the arbitration panel and pending litigation on the issues resolved through the mutual agreement procedure.
- Appointment of arbitrators. Participating countries could develop mutually agreed criteria for the appointment and qualifications of arbitrators. To ensure that prospective arbitrators are impartial and independent, participating countries may also wish to develop a standardized declaration attesting to fitness and to possible conflicts of interest.
- Confidentiality and communications. The disclosure of taxpayer information by a competent authority to the members of the arbitration panel would be made pursuant to the authority of the Convention and subject to confidentiality requirements that are at least as strong as those applicable to the competent authorities.
- Default form of decision-making in M.A.P. arbitration. Participating countries could develop additional guidance on the use of different decision-making mechanisms as default approaches in M.A.P. arbitration.
- Evidence in M.A.P. arbitration. Guidance could be developed to address particular evidentiary issues that may arise in connection with different forms of arbitral decision-making. Where the format is the independent opinion approach, standards should be established for allowance of taxpayer presentations.

*“The goal is to provide an objective M.A.P. process that addresses issues in a fair manner based on the rule of law rather than selfish interests.”*

- Multiple, contingent, and integrated issues. Participating countries could establish mutually-agreed guidance for arbitrators on how to deal with multiple, contingent and integrated issues.
- Costs and administration. Participating countries could consider ways to reduce the costs of M.A.P. arbitration procedures.
- Multilateral maps and advance pricing. The Model Treaty could be revised to address multilateral M.A.P.'s and A.P.A.'s to address the arbitration process used in a multilateral M.A.P. and to address issues connected with time limits and notification of third-State competent authorities.
- Provide guidance on consideration of interest and penalties in the mutual agreement procedure. The guidance would address the treatment of interest and penalties in the M.A.P. so that where interest and penalties are computed with reference to the amount of the underlying tax and the underlying tax is found not to have been levied in accordance with the provisions of the Convention, the penalties and interest could be addressed in the relief.

## CONCLUSION

In Action 14, the O.E.C.D. extends its inquiry into the behaviors of tax authorities that result in economic double taxation. The goal is to provide an objective M.A.P. process that addresses issues in a fair manner based on the rule of law rather than selfish interests. Whether Action 14 will succeed is an open question. In comparison to the other components of the B.E.P.S. Action Plan, the targets of Action 14 are the authorities that set the rules. It is not clear that these officials will have the political commitment to promote fairness over collection of tax revenue.

## CORPORATE MATTERS: IS YOUR DEAL SAFE? HOW THE F.C.P.A. AFFECTS MERGERS & ACQUISITIONS

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**Tags**  
F.C.P.A.  
Mergers & Acquisitions

Foreign-based companies that do not do business in the United States might understandably ask how the Foreign Corrupt Practices Act (“F.C.P.A.”) can impact them. The answer is unexpectedly and profoundly – if the foreign company becomes an acquisition target of a U.S. company.

As 2015 begins, it is no longer news to anyone that a U.S. company doing business abroad must have a robust anti-corruption and anti-fraud compliance program. An effective compliance program can prevent F.C.P.A. problems from arising or, if such problems do arise, reduce a company’s penalties. It is equally important to remember that the F.C.P.A. can have as significant an impact on a company’s merger and acquisition transactions as it can on its everyday operations. For that reason, a foreign company looking to partner with, or be acquired by, a U.S.-based entity, must make sure that its conduct does not adversely affect or jeopardize such efforts. Recent developments in 2014, as well as past history, illustrate this point.

The F.C.P.A. plays a significant role in mergers and acquisitions. An acquiring company is expected to conduct due diligence to ascertain the acquired entity’s F.C.P.A. compliance. If in the course of that due diligence, the acquiring company uncovers violations by the entity to be acquired, it is expected to disclose them and remedy them. Otherwise, it risks F.C.P.A. liability of its own. In guidance issued in 2012, the D.O.J. warned:

[A] company that does not perform adequate FCPA due diligence prior to a merger or acquisition may face both legal and business risks. Perhaps most commonly, inadequate due diligence can allow a course of bribery to continue—with all the attendant harms to a business’s profitability and reputation, as well as potential civil and criminal liability.<sup>1</sup>

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In practice, the D.O.J.’s guidance is illustrated as follows: Suppose Company A acquires Company B, which it knows to conduct substantial business outside of the United States. Suppose further that Company A performs only cursory due diligence regarding Company B’s F.C.P.A. compliance, choosing instead to rely mostly on Company B’s representations and warranties. Now suppose that several months after the acquisition closes, Company A discovers that prior to the acquisition, under predecessor management, Company B had bribed foreign officials in one or more of those foreign countries but that such practices had ceased prior to the closing. Company A subsequently discloses Company B’s pre-acquisition conduct to the D.O.J. for the first time. In this scenario chances are likely that Company A will face significant financial penalties, as well as the possibility of a guilty plea.

<sup>1</sup> D.O.J./S.E.C. Publication: “[A Resource Guide to the U.S. Foreign Corrupt Practices Act](#)”

A scenario very similar to the one just described occurred in 2009 with regard to eLandia, International Ltd. (“eLandia”). In 2007, eLandia acquired Latin Node, an Internet telecommunications company. Shortly after the acquisition, eLandia discovered that Latin Node had made payments to foreign officials and reported those findings to the D.O.J. The D.O.J. required Latin Node, whose operations eLandia had shut down in January 2008 (partially due to Latin Node’s foreign bribery activities), to enter a guilty plea to an F.C.P.A. violation and pay a substantial fine.

Now, let’s change the facts of our hypothetical. Suppose that instead of a perfunctory, on-paper-only compliance structure, Company A has a vigilant, well-staffed one, and while carrying out a thorough vetting of Company B’s operations, Company A discovers that Company B’s compliance is lacking and that it has been making payments to foreign officials, but there is a question as to whether those payments would fall under the F.C.P.A.’s jurisdiction. How should Company A proceed?

The safe bet would be for Company A to impose pre-acquisition remediation on Company B and institute its own compliance standards. Then, Company A might have its counsel make an opinion request to the D.O.J. and have the transaction, and Company B’s behavior, evaluated in advance. If it follows this strategy, the D.O.J. is likely to decide not to take any enforcement action. A recent D.O.J. Opinion Procedure Release confirms this.

In Opinion Procedure Release 14-02, a U.S.-based issuer (the “Requestor”) discovered that the company it was acquiring had made several payments to foreign officials. Those payments had “no discernible nexus” to the United States. Nonetheless, the Requestor developed a pre-acquisition remediation program, and articulated the post-acquisition steps it would take to ensure that the acquired company was fully integrated into its compliance program. Based on these represented facts, the D.O.J. concluded that it would take no enforcement action regarding the acquired company’s pre-acquisition conduct. Quoting the D.O.J.’s 2012 Guidance, Release 14-02 stated:

It is a basic principle of corporate law that a company assumes certain liabilities when merging with or acquiring another company. In a situation such as this, where a purchaser acquires the stock of a seller and integrates the target into its operations, successor liability may be conferred upon the purchaser for the acquired entity’s pre-existing criminal and civil liabilities, including, for example, for FCPA violations of the target. ‘Successor liability does not, however, create liability where none existed before.’

The Release went on to say:

The Department encourages companies engaging in mergers and acquisitions to (1) conduct thorough risk-based FCPA and anti-corruption due diligence; (2) implement the acquiring company’s code of conduct and anti-corruption policies as quickly as practicable; (3) conduct FCPA and other relevant training for the acquired entity’s directors and employees, as well as third-party agents and partners; (4) conduct an FCPA-specific audit of the acquired entity as quickly as practicable; and (5) disclose to the Department any corrupt payments discovered during the due diligence process. See FCPA Guide at 29. Adherence to these elements by Requestor may, among

several other factors, determine whether and how the Department would seek to impose post-acquisition successor liability in case of a putative violation.

Release 14-02 addresses the efforts of the acquiring party to rectify an acquiree's wrongful conduct. However, it would be fair to speculate that the acquiree's conduct likely affected the terms of the acquisition, especially the purchase price. Other events in 2014 remind us that the F.C.P.A. issues can have practical effects on mergers and acquisitions. The past year saw the largest fine in F.C.P.A. history as part of the settlement the D.O.J. reached with the French engineering company Alstom SA ("Alstom"). The D.O.J. required Alstom to plead guilty and pay a \$772 million fine. The guilty plea and huge settlement were predicated on Alstom's failure to disclose and voluntarily remediate its conduct in a timely manner. Notably, however, the settlement with the D.O.J. provided that GE, which is in the process of acquiring Alstom's core assets, will not be liable for any payments. That issue had created uncertainty regarding the asset sale. With Alstom alone responsible for the guilty plea payments under the settlement, GE is able to go ahead with its asset purchase.

In another case, the acquisition of medical device maker Biomet by Zimmer Holdings has been delayed by a D.O.J. investigation into alleged bribes paid by Biomet to officials in Brazil and Mexico. Whether the acquisition will occur, under its present terms or at a reduced price, remains to be seen. Further, there is no telling what conditions the D.O.J. will require going forward to ensure that future violations do not occur. For example, even if the acquisition takes place, the D.O.J. could require the hiring of a monitor to oversee compliance efforts.

All of the problems described in the examples above could have been avoided if the companies being acquired had developed and maintained thorough and effective anti-bribery and anti-corruption policies and practices. Foreign companies envisioning relationships with U.S.-based firms are well advised to establish compliance programs, regardless of whether they currently do business in the U.S.



## F.A.T.C.A. 24/7

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F.A.T.C.A.

## IN-SUBSTANCE I.G.A. JURISDICTION STATUS EXTENDED & AFFECTED F.F.I.'S MUST OBTAIN G.I.I.N.'S

Foreign financial institutions ("F.F.I.'s") that are based in jurisdictions that have (or are treated as having) entered into a Model 1 Intergovernmental Agreement ("I.G.A.") with the U.S. must register and obtain a Global Intermediary Identification Number ("G.I.I.N.") as part of the process to properly certify its status as an F.F.I. that complies with F.A.T.C.A. Withholding for residents of Model 1 jurisdictions who do not comply with F.A.T.C.A. started on January 1, 2015.

Jurisdictions which are treated as having entered into a Model 1 I.G.A. include countries which have not yet signed, but have reached an agreement in principle to sign, a Model 1 I.G.A. Those countries are referred to as having an "in-substance I.G.A." with the U.S. In early 2014, the I.R.S. announced that such in-substance I.G.A.'s can be treated as in effect and relied upon through the end of 2014. The I.R.S. F.A.T.C.A. webpage has a list of these in-substance I.G.A.'s. Announcement 2014-38 provides that a jurisdiction that is treated as if it has an I.G.A. in effect (*i.e.*, an in-substance I.G.A. country) but that has not yet signed an I.G.A. retains such status beyond December 31, 2014, provided that the jurisdiction continues to demonstrate firm resolve to sign the I.G.A. that was agreed in substance.

Announcement 2014-38 does not change the F.A.T.C.A. requirements relating to payments made on or after January 1, 2015. Therefore, F.F.I.'s subject to an in-substance I.G.A. will still need to meet the registration requirements and all due diligence and reporting requirements under F.A.T.C.A. to avoid withholding on payments received starting January 1, 2015.

## F.A.T.C.A. INTERNATIONAL DATA EXCHANGE SERVICE WEB PAGES

The I.R.S. has added an additional web page to the F.A.T.C.A. International Data Exchange Service ("I.D.E.S."). The I.D.E.S. system allows for the U.S. to securely exchange data with foreign tax authorities and F.F.I.'s. The I.D.E.S. enrollment process may be different based on the relevant I.G.A., but will generally entail the following steps:

1. Create a sender payload;
2. Encrypt an A.E.S. key;

3. Create a metadata file; and
4. Create a transmission archive.

## FOREIGN TRUSTS AND FAMILY HOLDING COMPANIES UNDER F.A.T.C.A.

F.A.T.C.A. divides the world of non-U.S. investors into two categories: foreign financial institutions (“F.F.I.’s”) and non-financial foreign entities (“N.F.F.E.’s”). It is crucial for any foreign person to correctly determine its F.A.T.C.A. status as an F.F.I. or a N.F.F.E.

A foreign trust or family holding company which derives its income from investments in financial assets may be treated as an F.F.I. if (i) the trust or company is “managed” by a professional entity and not an individual and (ii) that manager has investment discretion concerning what the trust or company invests in. By contrast, if the trust retains an investment manager who is a sophisticated individual not employed by an entity, whether a family member or not, then the trust could be classified as a passive N.F.F.E.

If the trust or family corporation is treated as an F.F.I., then that F.F.I. will have to register on the F.A.T.C.A. electronic portal to become a Participating F.F.I. (“P.F.F.I.”) or a Reporting Model 1 I.G.A. to avoid F.A.T.C.A. withholding. Among the many tasks imposed on a trust or family company that is a P.F.F.I. or a Reporting F.F.I. is the requirement to search its records or obtain documentation to see if it has a U.S. grantor, U.S. beneficiaries, U.S. shareholders, or U.S. controlled foreign entities. The P.F.F.I. or Reporting F.F.I. must then disclose the U.S. person’s identity and certain related information to the I.R.S.

A passive N.F.F.E. is required to disclose to any withholding agent the identity of any U.S. person that has a 10% or greater interest in the entity. If an I.G.A. is applicable, the 10% threshold is removed and control is required. U.S. withholding agents are required to report to the I.R.S. the identity of such U.S. persons. Alternatively, a passive N.F.F.E. can register with the I.R.S. to become a Direct Reporting N.F.F.E. This will allow greater confidentiality for the N.F.F.E. since the trust then only tells the I.R.S. (but not all U.S. withholding agents) the identity of any 10% or greater owner or any controlling U.S. owners under an I.G.A.

## CHILE ADOPTS LEGISLATION ALLOWING EXCHANGE OF FINANCIAL INFORMATION BUT U.S. NOT A BENEFICIARY

2014 was the year of the Inter-Governmental Agreement (“I.G.A.”). Dozens of I.G.A.’s were signed or agreed to, including a Model 2 I.G.A. with Chile. However, tax treaties and tax information exchange agreements were shunted to the side with U.S. Treasury personnel scrambling to keep up with the I.G.A. demand. To make matters worse, the U.S. Senate has been delaying ratification of some tax treaties for many years.



In a reflection of the new global mood to share information, Chile started 2015 with the adoption of a measure that allows its tax authority to exchange financial information with certain foreign countries to reduce tax avoidance. While this new measure will allow Chile to exchange tax information with countries that have in effect a tax treaty with Chile, the U.S. Senate has failed to ratify the U.S. tax treaty with Chile that was submitted to it in 2010. As a result, the U.S. does not benefit from this new Chilean measure that would have an even more far-reaching effect than the I.G.A. Hopefully, 2015 will be the year in which the U.S. Senate acts to approve the treaty with Chile so the U.S. can benefit from this new Chilean action.

## REVISIONS TO FORM 8938

One of the tax enforcement tools adopted in F.A.T.C.A. was the creation of a new reporting form, Form 8938, Statement of Specified Financial Accounts. The form was initially published back in November 2012 with four parts, but nothing remains static in life—especially the tax law. The I.R.S. made major revisions to the form in December 2013 that expanded the form to six parts. The I.R.S. recently revised it again in December 2014, but this time there is no major overhaul. The I.R.S. has not yet even published the instructions for the new form; the only still-relevant instructions available are for the December 2013 form.

The updated form still has six parts:

- Part I is a Foreign Deposit and Custodial Accounts Summary.
- Part II is an Other Foreign Assets Summary.
- Part III is a Summary of Tax Items Attributable to Specified Foreign Financial Assets.
- Part IV is a description of Excepted Specified Foreign Financial Assets.
- Part V is a Detailed Information for Each Foreign Deposit and Custodial Account Included in the Part I Summary.
- Part VI is a Detailed Information for Each “Other Foreign Asset” Included in the Part II Summary.

The new form still does not override the need to file an F.B.A.R. In fact, there are different filing deadlines and the information reported does not all match-up between the Form 8938 and the F.B.A.R. The one consistent item that remains important is that care is needed whenever a U.S. person owns any assets outside the U.S. in order to avoid potential penalties that can be very high.

## BANK OF ISRAEL EXTENDS TAX REPORTING REQUIREMENTS TO ALL FOREIGN RESIDENTS

On December 22, the Bank of Israel released a draft directive intended to standardize measures that Israeli banks must adopt as part of the country’s efforts to combat unreported capital. The directive will expand measures already adopted for U.S. customers under F.A.T.C.A. to all foreign residents. The extended measures are a

response to U.S. investigations of three major Israeli banks on suspicion of helping their customers evade U.S. taxes.

The draft directive will require Israeli banks to collect a declaration from all foreign resident account holders, both new and existing, that indicates they have paid all taxes required on those accounts in other countries. The foreign residents will also have to provide supporting documentation on the funds' source and waive confidentiality rules so that the Israeli banks can both investigate their claims and pass their account information on to relevant tax authorities abroad.

Currently, the U.S., U.K., Germany, France and the Organization for Economic Co-operation and Development have all adopted new standards to locate and tax unreported funds.

## **BANK LEUMI TO PAY \$400 MILLION TO RESOLVE U.S., N.Y. TAX PROBES**

The Justice Department brought conspiracy charges against Bank Leumi and four of its subsidiaries. On December 22, the bank announced that it agreed to pay \$270 million to the U.S. government and admit it unlawfully helped clients hide assets from the I.R.S. No criminal conviction and no limitation on the bank's activities in the U.S. will be imposed. The company will also pay \$130 million to New York's Department of Financial Services, terminate several employees including the head of Bank Leumi Trust, and hire an outside monitor. This is another continuation on the global crackdown by the U.S. to prevent the evasion of U.S. taxes on assets held abroad.

As part of a settlement with the Department of Justice, Bank Leumi and the Leumi Group are obligated to continue implementing a stringent compliance policy in order to confirm that the group is acting in accordance with F.A.T.C.A. The bank's announcement mentions that the fine to be paid to the U.S. government has been significantly reduced as a result of Leumi Group's cooperation with U.S. authorities throughout the investigation.

## **VATICAN BANK TO SIGN I.G.A.**

Effective November 30, the Holy See, that is, the Vatican Bank, reached agreement to sign a Model 1 I.G.A. and is treated as having an in-substance I.G.A. in effect. American clergy may hold accounts with the bank and be subject to disclosure. Forbes magazine reported on December 29 that "the timing is serendipitous. Pope Francis has suggested that the Vatican Bank could use a makeover."

## **SOME HONG KONG BANKS REACTION TO F.A.T.C.A. – U.S. CUSTOMERS GO ELSEWHERE**

On December 18, Chinese news media reported that rather than comply with F.A.T.C.A., some banks in Hong Kong are closing existing accounts and refusing to open new ones for U.S. taxpayers. According to the news reports, the benefits from some U.S. clients' bank accounts do not outweigh the costs associated with

*"As part of a settlement with the Department of Justice, Bank Leumi and the Leumi Group are obligated to continue implementing a stringent compliance policy in order to confirm that the group is acting in accordance with F.A.T.C.A.."*

locating, monitoring, and reporting on the accounts, or the penalties the banks may face for noncompliance. Other banks, however, see F.A.T.C.A. compliance as a way to gain a market share.

On November 13, Hong Kong and the U.S. signed a Model 2 I.G.A. The I.G.A. requires F.F.I.'s to report U.S. taxpayers' relevant account information directly to the I.R.S. (as opposed to their own governments, as done under a Model 1 I.G.A.). Under the I.G.A., Hong Kong financial institutions need to register with the I.R.S. and perform due diligence to prove their customers are not U.S. persons. Barring U.S. customers does not eliminate this registration and due diligence burden, but it does eliminate the need to report (assuming no customers who are U.S. persons or U.S. controlled foreign entities exist).

Hong Kong banks that turned their backs on U.S. customers today to minimize their administrative obligations may soon be faced with the decision of what to do for residents of other foreign countries that are joining the trend of global cross-border tax sharing. Such countries include the U.K. and members of the E.U. Will they add other countries to the list of *persona non grata*? Some banks' decision to turn away U.S. customers will open business opportunities for other banks which are taking a long term view: in a few years, tax sharing will be the global norm, and assessing that the necessary reporting may not be that burdensome in the long run.

## CURAÇAO SIGNS RECIPROCAL MODEL 1 I.G.A.

Although the Kingdom of the Netherlands and the U.S. signed an I.G.A. in December 2013, the agreement was not applicable to Aruba, Curaçao and Saint Marten. On December 16, 2014, a Model 1 I.G.A. was signed between Curaçao and the U.S., however, an I.G.A. was treated as "in effect" by the U.S. Treasury as of April 30, 2014, when the Curaçaoan government and the U.S. reached an agreement in substance.

## QATAR SIGNS MODEL 1 I.G.A.

Even though Qatar and the U.S. did not sign an I.G.A. until January 7, 2015, a Model 1 I.G.A. between Qatar and the U.S. has been treated as "in effect" by the U.S. Treasury as of April 2, 2014.

## CURRENT I.G.A. PARTNER COUNTRIES

To date, the U.S. has signed more than 50 Model 1 I.G.A.'s and more than 50 other countries have reached such agreement in substance. An I.G.A. has become a global standard in government efforts to curb tax evasion and avoidance on offshore activities and to encourage transparency.

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

*“To date, the U.S. has signed more than 50 Model 1 I.G.A.’s and more than 50 other countries have reached such agreement in substance.”*

Algeria	Gibraltar	New Zealand
Angola	Greece	Norway
Anguilla	Greenland	Panama
Antigua & Barbuda	Grenada	Peru
Australia	Guernsey	Philippines
Azerbaijan	Guyana	Poland
Bahamas	Haiti	Portugal
Bahrain	Holy See	Qatar
Barbados	Honduras	Romania
Belarus	Hungary	Saudi Arabia
Belgium	Iceland	Serbia
Brazil	India	Seychelles
British Virgin Islands	Indonesia	Slovak Republic
Bulgaria	Ireland	Slovenia
Cabo Verde	Isle of Man	South Africa
Cambodia	Israel	South Korea
Canada	Italy	Spain
Cayman Islands	Jamaica	St. Kitts & Nevis
China	Jersey	St. Lucia
Colombia	Kazakhstan	St. Vincent & the Grenadines
Costa Rica	Kosovo	Sweden
Croatia	Kuwait	Thailand
Curaçao	Latvia	Trinidad & Tobago
Cyprus	Liechtenstein	Tunisia
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
Georgia	Montserrat	
Germany	Netherlands	

The countries that are Model 2 partners by execution of an agreement or concluding an agreement in principle are: Armenia, Austria, Bermuda, Chile, Hong Kong, Iraq, Japan, Macao, Moldova, Nicaragua, Paraguay, San Marino, Switzerland, and Taiwan.

This list is expected to continue to grow.

## UPDATES & OTHER TIDBITS

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Tax Accounting  
Tax Administration  
Federal Income Tax  
Transfer Pricing

### TAX EVASION INDIAN STYLE: CRIMINAL OR CIVIL OFFENSE?

Judicial authorities in India are recommending that the country adopt a similar position as the United States with respect to offshore bank accounts. While investigating the “black money” held in undeclared Swiss bank accounts by 628 wealthy Indians, two of the judges recommended that tax evasion should constitute a criminal offense and not simply a civil one.

The scandal has been at the forefront of both political discussion and legal debate since there is a fine line that is being straddled between disclosing and punishing these tax evaders versus violating the confidentiality clause from the Indian-Swiss tax treaty. According to the treaty, these account names can only be revealed once charges identifying the specific individual have been filed.

In India, “black money” has always been an obstacle to tax collection. Black money constitutes undeclared income that has been “hidden,” profits from the undervaluation of exports, and earnings from fake invoices or unaccounted-for goods. Black money not only affects the national treasury, but has fueled corruption, too. According to the judges, classifying tax evasion as a criminal offense, and dealing with these lawbreakers more strictly should serve as a deterrent.

### HAND IT OVER, MICROSOFT?

In conjunction with its audit of Microsoft’s cost-sharing transfer pricing methods for the 2004-2006 tax years, the I.R.S. has filed a petition for enforcement of an issued summons for 50 types of documents, including those relating to marketing, R&D, financial projections, revenue targets, employees, studies, and surveys.

Microsoft’s business is split into three regions: (i) Europe, Middle-East and Asia; (ii) Asia-Pacific; and (iii) the U.S., Canada and Latin America. The I.R.S. is investigating the cost-sharing arrangements in the latter two regions, with affiliates in Bermuda and Puerto Rico, respectively.

The cost-sharing arrangement with the Puerto Rican affiliate divided rights to technology intangibles, such as software code, from rights to non-technology intangibles, such as brands, trademarks, and customer or partner relationships in the Americas. Microsoft retained the rights to the non-technology intangibles and treated the Puerto Rican affiliate as the economic owner of the technology intangibles. It paid the affiliate a portion of its revenues from its American retail business based on the relative share of profit that it allocated to its technology *vis-à-vis* the non-technology intangibles.



The cost-sharing arrangement with the Bermuda affiliate treated it as the economic owner of all intangibles supporting that business. However, the compensation due from the affiliate to Microsoft was based on the assumption, consistent with the Puerto Rican cost-sharing arrangement, that Microsoft had owned only a fraction of the covered non-technology intangibles.

This division of intangibles rights, the IRS noted, didn't occur in the other cost-sharing arrangements. Thus, it argued, there was a material, unjustified discrepancy in the amount the regions paid for the transfer and use of property rights needed to run the businesses. To the extent this discrepancy was a result of the forecast and projection methods used, the I.R.S. requested what it felt to be all relevant documentation regarding these forecast and projection methods.

The I.R.S. issued the summons in October. Microsoft had until November to comply, but objected, saying that the summons was "impermissibly vague, overbroad and burdensome." As such, Microsoft alleged that the summons constituted an abuse of process and violation of its right to privilege. Accordingly, it decided to instead review each item before handing it over in order to ensure that privilege wasn't broken.

Besides the possible multi-billion dollar penalty that may be imposed upon Microsoft, this case presents another all-encompassing and potentially game-changing issue.

This matter has attracted a lot of attention because the I.R.S. has outsourced the case to a private law firm, Quinn Emanuel Urquhart & Sullivan L.L.P. This groundbreaking move not only evidences the I.R.S.'s determined resolve to pursue such matters, but has also cost the taxpayers USD\$2,185,000 in legal bills. It should come as no surprise that Microsoft has filed a Freedom of Information Act request that would not only reveal the intentions of the I.R.S. towards Microsoft, but also shed light on how far the I.R.S. is willing to go to crack down on tax evaders. The only question that remains is whether hiring a private entity to carry out a traditionally government role blurs the line between private and public functions.

## TAX REVENUES REBOUND IN THE O.E.C.D.

Reflecting the worldwide economic recovery from the global recession, a December 2014 O.E.C.D. report indicates that tax burdens relative to gross domestic product and related tax revenue collections have generally been increasing over the past few years, reaching pre-global crisis levels.

With an average tax burden increase of 0.4% compared to 2013, tax burdens across countries have ranged from as high as 48.6% to as low as 19.7%, with some countries showing a slower growth rate than others.

The O.E.C.D. attributed most of this tax revenue growth to personal and corporate income taxes and discretionary tax changes such as V.A.T. rate increases as well as some tax base broadening. Directly aligned with increases in levels of income, these personal, corporate, and V.A.T. taxes rapidly raised revenues during the recent periods of economic growth. An interesting by-product of the report was confirmation that broadening the tax base and offering tax credits led to a greater increase in revenue than reducing rates and offering exemptions.

## RETRAINING DOMESTIC EXAMINERS

In an effort to better prepare their auditors and enable them to accurately identify applicable risks, the I.R.S. has decided to re-train their domestic examiners by teaching them how to examine international issues, as well.

An initial 50 PowerPoint training documents will be made public. These documents are part of the materials used by the examiners that will train them in unfamiliar areas.

A shortage of resources means that not all cases will be held on equal footing. A risk-based approach will be used when examining cases, which will allow the I.R.S. to prioritize those matters posing the most exposure. Rather than the quantitative amount of tax revenue involved, matters will be given weight based on the significance of the issue involved.

## YOU'VE SENT MAIL

While investigating online narcotics trafficking, the I.R.S. stumbled upon information revealing that U.S. taxpayers were using Sovereign Management & Legal Ltd. to help maintain and conceal their foreign assets. Based on this information, a U.S. district court authorized the I.R.S. to serve eight shipping and financial service providers with open-ended, non-specific “John Doe” summonses to identify the U.S. taxpayers that have used Sovereign’s services.

The eight service providers served are Federal Express Corporation, DHL Express, United Parcel Service Inc., Western Union Financial Services Inc., the Federal Reserve Bank of New York, Clearing House Payments Company LLC and HSBC Bank USA National Association. They have been asked to produce records identifying U.S. taxpayers who used Sovereign to establish, maintain, operate, or control any foreign account or entity.

The information was uncovered through a tax voluntary disclosure where one taxpayer disclosed that Sovereign helped set up and maintain a foreign entity to hold assets and conceal ownership by using FedEx, UPS, and DHL to correspond with the U.S. taxpayer, Western Union to transmit funds, Federal Reserve Bank NY and Clearing House to wire foreign transactions, and HSBC to maintain corresponding bank accounts offshore.

Besides broadening the scope of the case, these “John Doe” summonses not only show the I.R.S.’s commitment to tracking down taxpayers avoiding U.S. tax obligations, but exemplify the types of results that can be derived through interagency cooperation.

## CHANGE IN HEDGE COUNTERPARTY MEANS TERMINATION FOR HEDGE

The S.E.C. recently indicated that should there be a change in the counterparty where a derivative is hedged (called a “novation”), the hedge must be ended and a new one begun. This is true even if the counterparty is economically insignificant.

*“The fact that a new hedge must begin even if the change is economically insignificant should cause practitioners to be wary when changing counterparties in a hedge transaction.”*

Accounting Standards Codification (A.S.C.) 805 also states that if critical terms of the hedge relationship change from the terms initially agreed upon, the entities must designate a new hedging relationship. However, there are some exceptions to this rule, such as if the counterparty merges into another entity which assumes its rights and obligations or if the reporting entity previously documented that the derivative will be novated to a new counterparty at the outset of the hedging relationship. The fact that a new hedge must begin even if the change is economically insignificant should cause practitioners to be wary when changing counterparties in a hedge transaction. The issue from the income tax perspective is whether and to what extent the new A.S.C. 805 rules align financial reporting to income tax reporting under the so-called “Cottage Savings” doctrine embodied in *Cottage Savings Association v. Commissioner*.<sup>1</sup> Here the Court ruled in pertinent part, that, under I.R.C. §1001(a), an exchange of property gives rise to realization (a “disposition of property”) only if the exchanged properties are “materially different” and that material difference is not defined by an economic substitute test (whether various parties would consider their differences to be “material”), but rather on whether respective possessors enjoy legal entitlements that are different in kind or extent.

## **S.E.C. OFFICIAL SUGGESTS ALLOWING U.S. FILERS TO DO SUPPLEMENTAL I.F.R.S.-BASED REPORTING**

The S.E.C. is currently studying the idea of allowing U.S. public companies to present financial statements prepared under international accounting rules as a supplement to their required filings under U.S. G.A.A.P.

The S.E.C. argues that this alternative may be used rather than a full adoption of international financial reporting standards (“I.F.R.S.”) for the S.E.C.’s financial reporting system. Full adoption of I.F.R.S. standards is unpopular with U.S. entities due to cost/benefit concerns. S.E.C. officials mused about other alternatives such as an “optional use” clause where entities would voluntarily provide supplemental I.F.R.S. financial information. It should be noted that full adoption of I.F.R.S. remains an option available to the S.E.C.

The primary motive of the S.E.C. is to reduce uncertainty with respect to the I.F.R.S.’s future in the U.S. However, critics point out that few companies would want to enact an I.F.R.S. supplemental reporting route and inquire as to whether the I.F.R.S.-based information filed with the I.R.S. would be subject to audit.

## **CHANGES TO CORPORATE INVERSION RULES CAN ONLY BE ACCOMPLISHED BY CONGRESS**

I.R.S. Commissioner John Koskinen recently noted that despite Treasury action, only Congress can change the current corporate inversion rules. Koskinen also pointed out that there are limits to what the I.R.S. can accomplish without the support of Congress, and refused to indicate a timeline by which the I.R.S. would issue guidance on the subject.

<sup>1</sup> 499 U.S. 554 (1991)

## DUAL RESIDENT TAXPAYERS MAY APPLY FOR TREATY RELIEF ON REPORTING FOREIGN FINANCIAL ASSETS

The I.R.S. published final rules relating to foreign financial assets under Code §6038D for taxable years beginning after March 18, 2010. Under Code §6038D, where individuals have a certain interest in specific assets they must attach a statement to their income tax return providing the required information to the I.R.S. The most pertinent change is an exemption for individuals who are dual resident taxpayers that apply for treaty benefits under a treaty tie-breaking provision.

The I.R.S. also indicated that it is still considering how to treat virtual currency under Code §6038D—an issue which we highlighted in *Insights* previously.<sup>2</sup>

## BUDGET TIGHTENS FOR I.R.S. IN 2015 AND INCLUDES NEW DIRECTIVES

The year-end spending package for 2015 is to cut funding for the I.R.S. to its lowest level since before year 2008. The I.R.S. would receive \$10.9 billion, which is \$345.6 million less than in 2014. At the same time, the government is putting the agency under closer supervision with regards to its administration.

The spending measure specifically directs the I.R.S. on how to handle many issues. In response, I.R.S. Commissioner John Koskinen stated in an interview on December 9 that in order to meet their demands, the agency needed more money.

The legislation includes:

- The disallowance of funds to be used to “target groups for regulatory scrutiny based on ideological beliefs.”;
- Direction to improve telephone service and the allocation of funding for toll-free help line services;
- Direction to the I.R.S. to ensure that taxpayers seeking refundable tax credits are asked the same questions regardless of what form is used and who prepared it;
- Direction for the I.R.S. to increase its scrutiny of questionable practices by payroll service providers, to update Congress on its efforts to decrease the time required to wait for the disposition of refund fraud claims, and to examine the impact of closing Taxpayer Assistance Centers and, accordingly, report to Congress on how it will alleviate the difficulties rural taxpayers face when seeking I.R.S. guidance and assistance in filing tax returns; and
- Direction for the agency to brief Congress quarterly on its progress toward completing a five-year memorandum of understanding with Free File Alliance, the non-profit coalition of tax software providers that help taxpayers file their returns for free. The current memorandum of understanding expires in October 2015.

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<sup>2</sup> See: *Insights*, Vol. 1 No. 3, “[The O.E.C.D.’s Approach to B.E.P.S. Concerns Raised by the Digital Economy.](#)”

## DEPARTMENT OF TREASURY UPDATES BOYCOTT LIST

*“Taxpayers that participate in international boycotts may be subject to penalties resulting in a reduction of their foreign tax credit, the benefits of foreign sales corporations, and the deferral available to U.S. shareholders of controlled foreign corporations.”*

The U.S. Department of Treasury maintains anti-boycott laws and regulations. These rules impose reporting requirements on and deny certain tax benefits to taxpayers that cooperate with unsanctioned boycotts, and apply to U.S. taxpayers and their related companies, regardless of whether a transaction involves any U.S. goods or services. The Treasury also maintains a periodically-updated list of countries that require or may require participation in, or cooperation with, an international boycott.<sup>3</sup>

A boycott involves entering into certain agreements as a condition of doing business in a certain country. The agreement requires a taxpayer to abstain from doing business in or hiring employees from another country or with other persons that do business in or hire employees from the other country. Taxpayers are required to report their operations in boycotting countries. Those taxpayers that participate in international boycotts may be subject to penalties resulting in a reduction of their foreign tax credit, the benefits of foreign sales corporations, and the deferral available to U.S. shareholders of controlled foreign corporations.

The countries on the list remain unchanged from the list published on August 27, and are as follows: Iraq, Kuwait, Lebanon, Libya, Qatar, Saudi Arabia, Syria, United Arab Emirates, and Yemen.

The updated boycott list was published in the Federal Register on December 9.<sup>4</sup>

## TAX EQUIVALENCY PAYMENTS BY A CONDOMINIUM ARE DEDUCTIBLE AS REAL PROPERTY TAXES

In a recent private ruling, the I.R.S. determined that tax equivalency payments, or payments in lieu of taxes (“P.I.L.O.T.”), made by a condominium developer to its landlord that is a governmental fund, may be deducted as real property taxes under §164 of the Code. Furthermore, when the developer sells the condominium units, every unit buyer should be able to deduct a proportionate share of the P.I.L.O.T. as real property taxes.

Under §164 of the Code, a taxpayer can deduct state, local, and foreign real property taxes that are paid or accrued within a taxable year. Treasury Regulation §1.164-3(b) defines real property taxes as taxes imposed on interests in real property that are levied for the general public welfare. Assessments for local benefits are not treated as real property taxes.<sup>5</sup> Whether a particular charge is a “tax” under §164 of the Code depends on its true nature as determined under federal law, not by local law. A charge will constitute a tax if it is an enforced contribution, exacted pursuant to legislative authority in the exercise of taxing power, and imposed and collected for the purpose of raising revenues to be used for public or governmental purposes.<sup>6</sup>

<sup>3</sup> Within the meaning of section 999(b)(3) of the Internal Revenue Code of 1986.

<sup>4</sup> See [166 DTR G-6, 8/27/14](#).

<sup>5</sup> Treas. Reg. §§1.164-2(g) and 1.164-4.

<sup>6</sup> See Rev. Rul. 71-49, 1971-1 C.B. 103; Rev. Rul. 61-152, 1961-2 C.B. 42.

The I.R.S. concluded that the P.I.L.O.T. obligations are deductible as real property taxes because they satisfy the three requirements established in Revenue Ruling 71-49, 1971-1 C.B. 103: the payments are (i) imposed at the same general rate at which real property taxes are imposed; (ii) imposed under the enabling legislation as implemented by the condominium lease; and (iii) may only be used for public purposes.



## IN THE NEWS

### COMINGS AND GOINGS

Ruchelman P.L.L.C. welcomes the addition of two new members to the Firm's international tax planning and O.V.D.P. practices, Beate Erwin and Christine Long. Beate Erwin holds an LL.M. in Taxation from New York University. Ms. Erwin has practiced in New York, Dallas, and Vienna, Austria, advising clients on U.S. and international taxation with a focus on inbound investment in the U.S. Christine Long joins Ruchelman P.L.L.C. as a recent alumna of New York Law School, where she received her Juris Doctorate and LL.M. in Taxation. Previously, Ms. Long interned with the law firm of Bryan Cave LLP and the accounting firm of EisnerAmper, where she assisted in Federal, state, and local tax matters.

### FOR HE'S A JOLLY GOOD NOLAN FELLOW

Ruchelman P.L.L.C. is pleased to announce that Philip Hirschfeld is the recipient of the prestigious Nolan Fellowship, awarded by the A.B.A. Section of Taxation. The year-long fellowship is given to young lawyers who display leadership qualities in recognition of their contributions to the organization.

### AS SEEN IN...

Robert G. Rinninsland and Kenneth Lobo were published in the January edition of *Intertax*, the Wolters Kluwer journal on international taxation. The article, entitled "[US-Based Pushback on BEPS](#)," provides a comprehensive assessment of the O.E.C.D.'s B.E.P.S. initiative from the U.S. perspective. It ponders whether the O.E.C.D. has created a miracle in Washington by bringing both political parties, two branches of government, and U.S. industry into alignment on tax policy.

In April 2014, Galia Antebi attended the *GGI European Regional Conference in Edinburgh*, where she participated in discussion of the case study "[International Wealth Management and Private Equity - A Lucky Life](#)." The video featuring Ms. Antebi's insights on estate planning for U.S. greencard holders is now available on our website. Her commentary begins at 2:27.

### OUR RECENT AND UPCOMING PRESENTATIONS

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 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 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.

On October 31, 2014, Stanley C. Ruchelman and Edward C. Northwood presented on 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.

On 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 presened ["F.A.T.C.A. and the I.G.A. – How German Businesses, 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 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 13, 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.

On November 24, 2014, Stanley C. Ruchelman and Kenneth Lobo lectured at the *U.S. Tax Bootcamp* hosted by Cadesky and Associates in Toronto, Canada, where they discussed inbound investment into the U.S., including the U.S. estate and gift tax regime, structures to avoid when purchasing U.S. real property, and strategies when purchasing U.S. rental properties.

On December 19, 2014, Stanley C. Ruchelman and Kenneth Lobo presented “The Life of an Outbound Investment from the U.S. into Canada” to the B.C. chapter of the Canadian Bar Association in Vancouver, Canada. The topics addressed included entity classification, tax treatment under §367 of asset transfers, Subpart F, P.F.I.C.’s, U.S. and international attacks on excessive benefits, and permanent establishment issues.

On January 18-20, 2015, Stanley C. Ruchelman participated in the *ITSG 2015 Conference* in Calgary. Presentations included: “Double Irish Sandwich: Google Feasts, European Governments Suffer Heartburn,” on international pushback on C.F.C. planning arrangements; “How Much Equity is Enough Equity in a U.S. Entity?” regarding characterization of intercompany loans; and “Action 4: Limit Base Erosion - Interest Payments and Other Financial Payments,” which addressed O.E.C.D. guidance for combatting B.E.P.S.

Copies of our presentations are available on the firm website: [www.ruchelaw.com/publications](http://www.ruchelaw.com/publications), or by clicking the links above.

## 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](http://www.ruchelaw.com).

## Disclaimer

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