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- **"Trust" – A New Concept in Russia.** Stanley C. Ruchelman and Rusudan Shervashidze address the proposed adoption of the trust concept into the Russian legal system, part of ongoing efforts to make Russian legislation friendly to Western investors.

- **Upcoming Regulations Could Limit a Foreign Taxpayer's Refund or Credit.** The I.R.S. finds itself at a loss in circumstances where a foreign taxpayer claims the benefit of withholding for which a withholding agent failed to deposit the amounts required. Stanley C. Ruchelman and Elizabeth Zanet examine a forthcoming resolution, which will restrict the amount of a taxpayer's refund or credit.

- **India's $6.4 Billion Tax on Foreign Investment.** Christine Long and Nina Krauthamer report. The Indian government announced in April that portfolio investors in tax treaty countries with India are exempt from the 20% minimum alternative tax on past capital gains.

- **Art For Art.** Nina Krauthamer and Sheryl Shah address the application of like-kind exchange provisions under Code §1031, traditionally used for investment and business real estate, to the exchange of works of art.

- **An American Approach to Offshore Tax Evasion.** Following last month's feature on Italy's Voluntary Disclosure Program, Robert J. Alter of McElroy, Deutsch, Mulvaney & Carpenter discusses the U.S. crackdown on offshore tax evasion and the various programs available to rectify noncompliance.

- **U.K. Implements 25% "Google Tax" on Diverted Profits.** The diverted profits tax on multinational companies that "artificially divert" profits to a tax-favored jurisdiction became effective on April 1, 2015. Christine Long and John Chown discuss the guidance notes published by H.M.R.C.

- **Taxpayer Advocate Asks I.R.S. to Simplify Foreign Asset Reporting.** Philip R. Hirschfeld and Stanley C. Ruchelman discuss the comments of the National Taxpayer Advocate urging the I.R.S. to reduce dual foreign account reporting on the F.B.A.R. form and the Form 8938. Is it much ado about nothing?

- **Pre-Immigration Tax Planning, Part III: Remedying the Adverse Consequences of the Covered Expatriate Regime.** Part of the planning for coming to the U.S. involves planning to leave. Kenneth Lobo and Galia Antebi explain.

- **Ten Year Throwback.** "State aid in the E.U." are dirty words according the European Commission. Secret rulings are under attack going back ten years. Sheryl Shah and Stanley C. Ruchelman explore how the Commission intends to punish corporations that have benefitted.

- **Corporate Matters: One Clause that Should Be in Every Partnership Agreement.** The death of an investor in a private deal is sad for the family and problematic for the co-investors. Simon H. Prisk and Stanley C. Ruchelman discuss provisions that attempt to handle a stressful and touchy subject at death.

- **F.A.T.C.A. 24/7.** Philip R. Hirschfeld and Galia Antebi report on the latest I.R.S. guidance for taxpayers submitting F.A.T.C.A. reports through the I.D.E.S., filing "nil reports," the conflict that has arisen between the I.R.S. and certain I.G.A. partner countries concerning the timing of self-certifications, extension of deemed compliance status for F.F.I.'s covered by Model 1 I.G.A. countries, the opening of the F.A.T.C.A. portal in the British Virgin Islands, and the monthly list of current I.G.A. partner countries.

We hope you enjoy this issue.

- The Editors

TRANSFER PRICING IMPLICATIONS OF THE B.E.P.S. ACTION PLAN

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B.E.P.S.
M.A.P.
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Transfer Pricing

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Determined to eliminate so-called "double non-taxation," as well as no or low taxation, associated with practices that are perceived to segregate taxable income from the activities that generate them, the Group of Twenty ("G20") and the Organisation for Economic Co-operation and Development ("O.E.C.D.") released their *Action Plan on Base Erosion and Profit Shifting* ("B.E.P.S. Action Plan") in 2013. Included in the B.E.P.S. Action Plan are several provisions related to transfer pricing:

- Action 4: Limit base erosion via interest deductions and other financial payments;
- Action 8: Assure that transfer pricing outcomes are in line with value creation – Intangibles;
- Action 9: Assure that transfer pricing outcomes are in line with value creation – Risks and capital;
- Action 10: Assure that transfer pricing outcomes are in line with value creation – Other high-risk transactions; and
- Action 13: Re-examine transfer pricing documentation.

The O.E.C.D. has since delivered a number of reports and recommendations related to these actions, including revisions to the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* ("Transfer Pricing Guidelines"), and it continues to perform additional work on deliverables scheduled for later this year.

While it is difficult to project exactly what form the B.E.P.S. actions will finally take, it appears certain that a number of the recommendations will be implemented in whole or in part. The U.S. Treasury Department has joined other fiscal authorities and indicated that it will develop a form to implement the country-by-country ("CbC") report, which lists profits by jurisdiction, among other information, under the revisions to Chapter V ("Documentation") of the Transfer Pricing Guidelines.

As such, it is now time for multinational enterprises ("M.N.E.'s") to move beyond consideration of where the O.E.C.D. is heading and to determine how best to operate within a radically changed regulatory environment. Based on the agreed draft language contained in the policy documents and discussion drafts provided by the O.E.C.D., we have identified some implications of these foreseeable changes. While the implications themselves may seem relatively obvious, what taxpayers should do to best manage the transition to the new regulatory framework and to hopefully ameliorate the impact of these changes may be less clear.

Several potential implications of the B.E.P.S. Action Plan are anticipated:

1. Revenue bodies will seek to tax a greater share of an M.N.E.'s worldwide income;
2. Transfer pricing disputes will increase;
3. Profits splits will become more prevalent;
4. Taxpayers will need to revise their transfer pricing documentation;
5. Taxpayers will need to evaluate their existing transfer pricing structures; and
6. Taxpayers may need to reconsider the use of related parties versus third parties.

We discuss each of these implications further and provide some practical advice regarding how they might best be managed below.

REVENUE BODIES WILL SEEK TO TAX A GREATER SHARE OF AN M.N.E.'S WORLDWIDE INCOME

This development will come as little surprise, as it is a fundamental goal of the B.E.P.S. initiative. Although, taxpayers may be surprised by the methods tax authorities are likely to use. For example, the discussion draft on revisions to Chapter I ("The Arm's Length Principle") of the Transfer Pricing Guidelines sets out circumstances in which transactions between related parties could be disregarded for transfer pricing purposes.

While nonrecognition, or "recharacterization," of a transaction is intended primarily to address arrangements that are not considered to have arm's length attributes (*i.e.*, third parties would be unlikely to enter into such arrangements), it could, in practice, be subject to overreach by tax authorities. Additionally, any move away from the arm's length principle by a jurisdiction on one side of a transaction is bound to increase transfer pricing disputes and potential double taxation. Recharacterization will likely make the ultimate resolution of transfer pricing disputes more difficult, as the fundamental basis for discussion and agreement among the taxing authorities will have changed.

To help avoid such difficulties, taxpayers should carefully consider intercompany transactions that are likely to be challenged on their arm's length attributes and consider ways to strengthen those arrangements in a tax-efficient manner. For example, if an entity operating as a commission agent on behalf of a related-party were to be recharacterized as a fully-fledged buy-sell distributor, the taxpayer could consider having that entity purchase the rights to the customer relationships from the related-party principal. The value of that intangible asset and the subsequent amortization of the purchase price may mitigate adverse tax consequences associated with higher operating margins generally attributable to buy-sell distribution. Of course, the proper amount of the purchase price of the intangible will be another transfer pricing issue that is in play.

If any entity within a multinational group were upgraded to a more robust operation, consideration would be needed regarding the compensation required to provide that entity with the tangible assets or the rights to any intangible assets necessary to operate in an upgraded fashion. Taxpayers may consider proactive planning to restructure current operations that are considered at risk for recharacterization under the B.E.P.S. framework. Moving responsibility while leaving the service providers in place may be problematic in the home country.

TRANSFER PRICING DISPUTES WILL INCREASE

As revenue authorities expand the scope of taxation of an M.N.E.'s worldwide income, the volume of transfer pricing disputes is certain to increase. The O.E.C.D. recognizes that "the need for more effective dispute resolution may increase as a result of the enhanced risk assessment capability following the adoption and implementation of a CbC reporting requirement."[1] Although the countries participating in the B.E.P.S. project have agreed that they should not use data in the CbC report to propose income adjustments, increased transparency with regard to the distribution patterns for profits within an M.N.E. may lead to the deployment of tax examination resources on matters that could lead to even greater transfer pricing adjustments. Indeed, an explicit object of the new transfer pricing documentation requirements is to "provide tax administrations with useful information to employ in conducting an appropriately thorough audit of the transfer pricing practices of entities subject to tax in their jurisdiction."[2]

"As revenue authorities expand the scope of taxation of an M.N.E.'s worldwide income, the volume of transfer pricing disputes is certain to increase. "

To help manage transfer pricing disputes, taxpayers will want to make sure their counterparties are covered by a broad treaty network. Having access to a mutual agreement procedure ("M.A.P.") under a tax treaty will be important for preventing double taxation. The M.A.P. process is largely effective in resolving transfer pricing disputes and the O.E.C.D. is working to improve access to the M.A.P. under Action 14 (Make dispute resolution mechanisms more effective) of the B.E.P.S. Action Plan. Without such a resolution process in place, efforts to reduce double taxation in a tightened regulatory environment will be limited.

Taxpayers should review intercompany transactions to identify those between entities based in countries not having a tax treaty in effect. The goal would be to identify partner countries and to move transactions to entities in those countries in order to promote an effective M.A.P. process. Additionally, operating management should take necessary steps to ensure that any tax-advantaged entity has the functional, asset and risk profile necessary to withstand the more critical scrutiny of intercompany transaction pricing that is certain to come. Headcount and facilities will be key factors in determining the substance of the entity in a tax-advantaged jurisdiction.

PROFIT SPLITS WILL BECOME MORE PREVALENT

Another method for tax authorities to potentially tax a greater share of an M.N.E.'s worldwide profits is to employ a profit split. Traditionally, most taxpayers have relied

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1 O.E.C.D., *Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting* (2015), p. 3.

2 O.E.C.D., *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting* (2014), p. 14.

largely on profitability-based methods, such as the comparable profits method or the transactional net margin method, to support their transfer prices. These methods are typically applied in a manner by which the profitability outcome of the simpler entity is evaluated - rather than how the profit is split between the counterparties. The O.E.C.D.'s discussion draft on the use of profit splits in global value chains considers and seeks commentary on scenarios in which "one-sided" profitability-based methods might produce outcomes that are not in line with value creation.[3] In such cases, the discussion draft suggests that the profit split method may be more appropriate. At the same time, the O.E.C.D. adamantly refuses to acknowledge the validity of formulary apportionment as a driver to appropriate taxation.

To protect against arbitrary application of a profit split as the most appropriate method, taxpayers should be prepared to explain and support both sides of a transaction, even if they have applied a one-sided transfer pricing method. That is, even if a single member of the group is the "tested party" and earns only a routine return with the residual profit accruing to the counterparty, it will be important to explain the functions performed, assets used, and risks borne by both entities to support the income earned in each jurisdiction. Otherwise, with increased visibility into profits earned by an M.N.E. in different jurisdictions, tax authorities may be encouraged to split profit between entities using a factor that produces the most revenue for the tax authority undertaking the examination. As previously alluded, a profit split could essentially provide tax authorities with a means of applying a variant of formulary apportionment. In order to avoid such a result, taxpayers should make sure that the result from any one-sided analysis is consistent with value creation.

Taxpayers who have separated the trading principal entity – likely operating in a low-tax country with a good treaty network – from the entity that owns intangible assets – often in a no-tax jurisdiction – may want to consider combining these operations. Ensuring that the low-tax principal has a robust functional, asset and risk profile will help blunt the impact of the application of profit splits with lesser functionality related counter-parties.

Taxpayers will also want to consider carefully their third-party arrangements to determine whether such arrangements are comparable to their related-party arrangements and can provide support of arm's-length dealings. Such internal comparables are likely to receive greater attention from tax authorities seeking to apply profit splits, so it will be important for taxpayers to review them in detail. Likewise, they may prove invaluable to taxpayers in supporting their transfer pricing with actual third-party evidence of the manner in which they value certain functions.

TAXPAYERS WILL NEED TO REVISE THEIR TRANSFER PRICING DOCUMENTATION

Under the new Transfer Pricing Guidelines related to documentation, M.N.E.'s with revenues over €750 million will be required to complete a CbC report containing certain information by jurisdiction, including revenues, profit before income tax, number of employees, and amounts of tangible assets. While the report itself will create additional documentation, the greatest burden comes from the obligation to explain

[3] O.E.C.D., *Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains* (2015), p. 1.

value creation within the overall group and to match the levels of functionality, risks and assets to the allocation of income. As mentioned in the discussion of the profit split, increased transparency with regard to profits earned within the group will require taxpayers to explain both sides of a transaction.

The master file and local file approach embodied in the new documentation chapter of the Transfer Pricing Guidelines provides taxpayers with opportunities to re-evaluate and strengthen their documentation position. The master file, which provides information on the group as a whole, offers the taxpayer an opportunity to develop the factual analysis, describe the important drivers of business profit, and explain how those are aligned with the overall structure of the group and its transfer pricing arrangements. The local file further allows the taxpayer to explain the extent of the local affiliate's contribution to overall group profit. Recognizing that business considerations are the drivers in the structure, prudence dictates that operating management's story should be translated into the language of the transfer pricing adviser in order to promote the likelihood of a successful outcome.

"Any move away from the arm's length principle by a jurisdiction on one side of a transaction is bound to increase transfer pricing disputes and potential double taxation."

Much will likely depend on the quality and depth of this documentation. It is vitally important that tax departments have a full grasp on what is communicated in these documents and that documentation should be prepared carefully and consistently to present the group's transfer pricing in the best possible light. Where consistency does not exist, well developed reasons justifying those differences should be prepared in advance. As transfer pricing practices and outcomes become fully transparent to all tax authorities, taxpayers must control all aspects of the facts on the ground and create the narrative to support their decisions and results.

TAXPAYERS WILL NEED TO EVALUATE THEIR EXISTING TRANSFER PRICING STRUCTURES

A large focus of the work of the O.E.C.D. has been on the transfer pricing aspects of intangibles. The work in this area completed to date has helped to clarify the definition of intangibles under the Transfer Pricing Guidelines and to provide supplemental guidance for determining arm's length conditions for transactions involving intangibles. Work continues on the most thorny issues such as recharacterization and the valuation of intangibles based on ex-post results versus ex-ante forecasts (essentially a commensurate with income approach). But whatever final form the recommendations take, there appears to be support in many jurisdictions for requiring intangible ownership within an M.N.E. to be aligned with the ability to develop, enhance, maintain, protect, and exploit such intangibles. The mere funding of intangible development may not enable a member of the group to accrue economic income associated with such intangibles beyond a return on investment that is commensurate with the risk profile of the investment.

Whereas tax planning before the B.E.P.S. initiative may have focused on shifting risks and intangible ownership between members of a group, taxpayers will wish to pay greater attention to the functions performed by the different members of the group going forward. As emphasized by the work on intangibles, the profits earned by different entities will depend on value creation, and substance through value-adding functions will be vitally important. Taxpayers should work to ensure that those members of the group earning excess profits have the necessary substance and, if they do not, work to enhance that substance. Employee headcount will be crucial and use of outside contractors – especially related contractors – should be avoided.

The traditional "Intellectual Property Company," or "IPCo," that held and funded the rights to intangible assets and often collected residual profits within the taxpayer's transfer pricing structure, may need to be restructured. As mentioned previously, a combination of intangible assets, trading and investment risks, and significant functionality likely provides the most defensible structure to centralize the profit successes and failures of the organization. For management, the key will be to place sufficient functions in the IPCo without exposing the IP to risk as a result of law suits arising from the performance of those functions.

TAXPAYERS MAY NEED TO CONSIDER THE USE OF RELATED PARTIES VERSUS THIRD PARTIES

A potential result of the B.E.P.S. initiative may be in how M.N.E.'s choose to operate globally. This risk of double taxation – particularly if it results in having excess profits attributed to a member of the group that provides what are clearly considered routine functions – may lead some M.N.E.'s to use third parties in a jurisdiction where they would have otherwise established a subsidiary.

For example, if the use of a related-party distributor or contract manufacturer means that a principal company could have a share of its profits taxed by another jurisdiction through recharacterization or another measure, then it may ultimately choose to mitigate such risk by contracting with third parties to perform such services. Hopefully, policymakers will consider distortive results such as these and their impacts on foreign investment when developing their recommendations.

CONCLUSION

Measures to eliminate B.E.P.S. will come to fruition. We are now beyond the point of academic discussion on the matter. As the regulatory implications of those measures that impact transfer pricing come into sharper focus, the ramifications for taxpayers appear to be significant. We have identified a number of these transfer pricing implications and have presented some practical approaches for potentially addressing them. With proper planning, it is likely that the impacts of these changes can be mitigated. Taxpayers should develop policies and documentation to help themselves best manage their transfer pricing risk in a post-B.E.P.S. world.

“TRUST” – A NEW CONCEPT IN RUSSIA

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Tags
Deoffshorization
Doveritelnoe Upravlenie
Trust
Russia

In recent years, Russia has introduced several economic and political reforms, including a deoffshorization policy that some would say appears to be sound economic policy but others would say is more politically motivated by the centralization of power in the office of the President. In principle, the idea is to make Russian legislation friendly for Western investors, although the context suggests otherwise. Nonetheless, Russia is attempting to westernize its domestic laws and introduce economic concepts that are familiar to Western businessmen.

BACKGROUND

In 2014, the Russian government came out with a plan that would attack capital flight by residents. This was the so-called “deoffshorization” of investments. Among other things, this legislation increases the tax burden of many offshore holding companies by requiring payment of Russian taxes in the absence of any repatriation of profits. It also requires the disclosure of beneficial owners in the accounting statements of these holding companies. Again, these are concepts that are popular among policy makers in Western Europe, albeit in a different context.

Now, the Russian government is contemplating introduction of the “trust” into the Russian legal system. New laws are anticipated that are intended to formalize Russian arrangements where the nominal owner and the beneficial owner are separate individuals.

TRUST

The concept of the trust has been alien in Russian law, if not Russian practice. In external matters, many Russians have set up trusts in low tax jurisdictions, such as the Bahamas, the Cayman Islands, the Channel Islands, the Isle of Man, Cyprus, and Bermuda. In the West, these arrangements are often used as the first step of an investment in the U.S., Western Europe, or Canada. However, Russian settlors of these trusts often place Russian assets into the trusts, and Russian residents often are unknowing beneficiaries.

Although trusts are often used by businessmen for “tax planning” reasons, the Russian government believes that introduction of the trust concept in which legal ownership is separated from beneficial ownership will not conflict with the previously-announced deoffshorization initiative.

The idea of “Doveritelnoe Sobstvenost,” or trust ownership, was introduced in 1993 by executive order. In 1996, the second part of the Russian Civil Code was enacted. It dedicated an entire chapter to the idea “*Doveritelnoe Upravlenie*,” which broadly equates to trust management, and both clarified and altered the way the executive order was interpreted.

For many, *Doveritelnoe Upravlenie* appears similar to the concept of a trust. However, many important planning tools of the trust are not available under the Russian legal system. Among other things, the concept of *Doveritelnoe Upravlenie* does not recognize a distinction between legal and beneficial ownership, and the duration of the transfer is usually for a short period, much like an escrow prior to a sale or a period of administration during incompetency. These and other differences suggest that a *Doveritelnoe Upravlenie* is not really a viable alternative to a trust.

"Russia has introduced several economic and political reforms, including a deoffshorization policy that some would say appears to be sound economic policy but others would say is more politically motivated."

ISSUES TO BE RESOLVED

The lack of clear guidance creates uncertainty for Russians who wish to plan for the future and manage their assets. One of the problems that arise when creating a trust is its place of residence. Because the concept of trust is not recognized in Russia, other than the *Doveritelnoe Upravlenie*, there are no rules to determine the tax residence of a trust. Many Russians are advised to place a corporation or holding company under the trust to hold all the assets. This creates additional protection in the event that the trust is not recognized by the Russian tax authorities. The country where the entity is incorporated or managed may provide additional factors to determine the residence of the trust.

Under Russian law, foreign trusts are taxed according to the applicable foreign legislation. Russian-source income that is distributed to a foreign trust is subject to Russian withholding tax imposed at the rate of 15% on dividends. When a legal entity owns the assets, a treaty benefit may further reduce Russian withholding tax. Distributions from a foreign trust to a Russian tax resident are subject to individual income tax at a rate of 13%.

There is also talk of legislation to introduce the concept of an irrevocable trust, which would allow a Russian individual to transfer property to a trust and cease to be the owner of that property. Once the text of proposed legislation is issued, there will be a better idea of how the law will operate on a prospective basis. In meantime, the Russian Tax Code is developing rapidly.

A FOREIGN TAXPAYER'S REFUND OR CREDIT COULD BE LIMITED BY UPCOMING REGULATIONS

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Tags
Foreign Taxpayers
Foreign Income
Form 1042
Form 1042-S
Tax Credit
Tax Refund
Withholding Agent
Withholding Tax

In Notice 2015-10 (the "Notice"), issued on April 28, 2015, the I.R.S. stated that it was concerned about cases in which persons subject to withholding under Code §§1441-1443 ("Chapter 3") or Code §§1471 and 1472 ("Chapter 4") are making or will make claims for refunds or credits in circumstances where a withholding agent failed to deposit the amounts required to be withheld under §6302.

If a withholding agent fails to deposit an amount withheld under Chapters 3 or 4, or reported as withheld on Form 1042-S, and the I.R.S. issues a refund or credit for the amount, the I.R.S. may not be able to recover that amount because the claimant, and in some cases the relevant withholding agent, may be outside the United States. The new regulations aim to reduce the risk that the I.R.S. may issue improper refunds or credits for fictitious withholding or amounts that have not been deposited and are difficult to collect.

As will be seen below, the new regulations would limit a foreign taxpayer's refund or credit to the amount deposited by the withholding agent. Though collecting undeposited amounts from withholding agents located outside the United States may be difficult for the I.R.S., one wonders about the fairness of limiting a foreign taxpayer's refund or credit when the I.R.S. could use its greater resources to collect against the withholding agent.

WITHHOLDING, DEPOSITING, AND REPORTING REQUIREMENTS UNDER CHAPTERS 3 & 4

Chapter 3 generally requires withholding agents to collect the substantive tax liability of a foreign person's U.S.-source income. Enacted as part of the Foreign Account Tax Compliance Act ("F.A.T.C.A."), Chapter 4 generally requires withholding agents to withhold tax on certain payments to foreign financial institutions ("F.F.I.'s") that are nonparticipating F.F.I.'s and certain nonfinancial foreign entities ("N.F.F.E.'s") that do not provide information regarding their substantial U.S. owners.

An amount withheld by a withholding agent is required to be deposited, at certain time periods, with the Treasury Department in accordance with §6302.[1]

The withholding agent's income tax liability for the amounts of tax it is required to withhold under Chapters 3 and 4 must be reported on Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, for the calendar year. But if the amount of tax deposited is less than the amount due on Form 1042, the withholding agent must pay the balance at the end of a calendar year when filing the

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[1] Treas. Reg. §§1.1461-1(a), 1.1474-1(b), 1.6302-2.

Form 1042.[2] If the withholding agent does not pay, it will remain liable for the unpaid tax, including interest and penalties.

The withholding agent is also required to file with the I.R.S. and give to the recipient of the payment the Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, which reports any amount withheld with respect to payments made to the recipient under Chapters 3 and 4.

CURRENT RULES FOR REFUNDS AND CREDITS

Code §33 allows the amount of tax withheld at source to be credited against the income tax liability of a nonresident alien or foreign corporation. Furthermore, Code §1462 and Treas. Reg. §1.1462-1(a) provide that the beneficial owner of the income may claim a credit of the amount of tax actually withheld under Chapter 3 against the total income tax computed on the beneficial owner's return.

For purposes of Chapter 4, §1474(b)(1) and the regulations allow a credit for the amount of tax deducted and withheld under Chapter 4 as if such tax had been deducted and withheld under the provisions relating to the withholding of tax of a nonresident alien or foreign corporation. Treas. Reg. §1.1474-3(a) provides that the amount of tax actually withheld shall be allowed as a credit against the total income tax computed in the beneficial owner's return.

Treas. Reg. §1.1464-1(a) provides for a refund or credit under Chapter 65 (§6401-§6432) of an overpayment of tax that has actually been withheld at source under Chapter 3 to be made to the taxpayer from whose income the amount of such tax was in fact withheld.

For Chapter 4 purposes, Treas. Reg. §1.1474-5(a)(1) provides that a refund or credit of an amount of tax that has actually been withheld at source at the time of payment will be made to the beneficial owner of the payment to which the amount of tax withheld is attributable if such beneficial owner meets the requirements of Chapter 65.

NO REFUND OR CREDIT WILL BE ALLOWED FOR AN AMOUNT WITHHELD WHEN THERE IS A SHORTFALL IN DEPOSITS MADE BY THE WITHHOLDING AGENT

The I.R.S. says that it intends to amend the regulations under Treas. Reg. §§1.1464-1(a) and 1.1474-5(a)(1) to provide that a refund or credit will be allowed to a claimant with respect to an overpayment ***only to the extent*** the relevant withholding agent has deposited, or otherwise paid to the Treasury Department, the amount withheld and such amount is ***greater than*** the claimant's tax liability.[3]

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[2] Treas. Reg. §1.1461-1(a).

[3] Except as otherwise provided by §6401(b)(2), which provides a special rule that treats a credit under §33 as a refundable credit only in the case of a beneficial owner who is a nonresident alien and who has made an election to be treated as a U.S. resident under §§6013(g) or (h).

It also intends to issue regulations under §33 and amend the regulations under Treas. Reg. §§1.1462-1(a) and 1.1474-3(a) to provide that a credit for an amount withheld is only available to a claimant *to the extent* that the withholding agent has deposited, or otherwise paid to the Treasury Department, the amount withheld.

In cases in which the withholding agent deposited a portion of the tax withheld under Chapters 3 or 4, the new regulations would entitle the claimant to an amount that takes into account that the withholding agent did in fact deposit a portion of the required amount of tax. The amount available for refund or credit with respect to a claimant would be determined using a *pro rata* allocation method.

Under the *pro rata* allocation method, a withholding agent's deposits made to its Form 1042 account will be divided by the amount reported as withheld on all Forms 1042-S filed by the withholding agent to arrive at a "deposit percentage." Solely for purposes of refund and credit claims related to Chapters 3 or 4, each claimant will be treated as though the withholding agent made a deposit equal to (i) the amount reported as withheld on the Form 1042-S with respect to the claimant multiplied by (ii) the withholding agent's deposit percentage.

"The claimant will be entitled to a refund or credit of the amount withheld to the extent that the deposit amount allocated to the claimant exceeds the claimant's tax liability."

The claimant will be entitled to a refund or credit of the amount withheld to the extent that the deposit amount allocated to the claimant exceeds the claimant's tax liability.

The I.R.S. gives the following example:

A withholding agent pays a $100 dividend to each of ten nonresident aliens and withholds tax at 30% from each dividend, in accordance with Chapter 3. The withholding agent is required to deposit $300 of tax but instead deposits only $225 of the tax that it withheld. The withholding agent reports on a Form 1042-S issued to each nonresident alien and filed with the I.R.S. that it paid to that nonresident alien a $100 dividend and withheld $30 of tax. In this case, the withholding agent's deposit percentage is 75% (*i.e.*, $225/$330, or the amount of the deposits reflected in the withholding agent's Form 1042 account divided by the amount reported as withheld on all Forms 1042-S filed by the withholding agent). If one of the nonresident aliens properly claims that, under an income tax treaty with the United States, he is entitled to a 15% withholding tax rate and claims a $15 refund, he is allocated $22.50 of the deposit (75% of the $30 reported as withheld on the claimant's Form 1042-S). Since the nonresident alien's tax liability is $15, there is an overpayment of $7.50, and he will be entitled to a refund or credit for that amount.

Under the existing information reporting, withholding, and deposit procedures, a withholding agent does not indicate to which beneficial owner the deposit of tax relates, and such information is not reported on Form 1042 or Form 1042-S. Therefore, an amount deducted by the withholding agent with respect to a beneficial owner cannot be matched with an amount of tax deposited in the withholding agent's Form 1042 account.

In the Notice, the I.R.S. stated that it considered whether to implement a tracing or specific identification methodology under which a claimant who is a beneficial owner could prove that the deposit of tax made by a withholding agent was specifically made with respect to an amount withheld from the claimant. However, because the obstacles to developing and implementing a specific tracing methodology (*e.g.*, withholding agents such as large banks may process many thousands of payments per year) are unlikely to be overcome in the foreseeable future, it intends to adopt the *pro rata* allocation method discussed above.

Nonetheless, the I.R.S. is seeking comments on the feasibility of developing and implementing a more precise methodology at some future date.

OTHER ISSUES BEING CONSIDERED

Other issues discussed in the Notice included:

- When to compute the initial deposit percentage for a withholding agent and how frequently to re-compute it to reflect additional deposits made by the withholding agent after Form 1042 has been filed, and after the amount available for a claim is first determined;
- The manner in which withholding agents and affected claimants will be informed of a deposit percentage (whether initial or recomputed) that is less than 100%, and the process under which additional refund or credit amounts will be paid or allowed to a claimant when a withholding agent takes steps to increase its deposit percentage; and

Whether to include an exception if the under-deposited amount is *de minimis* or if the withholding agent has a demonstrated history of compliance.

INDIA'S $6.4 BILLION TAX ON FOREIGN INVESTMENT

Author
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Tags
Foreign Portfolio Investors
India
Minimum Alternative Tax

Foreign institutional investors in India have been troubled by the demands from Indi-an tax officials to pay liabilities owed under the newly enforced minimum alternate tax ("M.A.T."). India's Finance Minister, Arun Jaitley, announced that beginning April 1, portfolio investors residing in countries that have tax treaties with India are fully exempt from the tax and will not have to pay the accompanying 20% levy on past capital gains.

The M.A.T. is essentially a minimum corporate tax that creates an overall tax of 20% on capital gains. Previously, foreign investors paid 15% on short term listed equity gains, 5% on bond gains, and nothing on long term gains.

In 2014, India's Finance Ministry began issuing notices to foreign companies for the payment of the M.A.T. on past capital gains amounting to $6.4 billion, collectively. The Finance Ministry has not enforced the M.A.T. on foreign institutional investors for over 20 years, according to the international fund organization, Investment Company Institute Global. Foreign institutional investors have been contending that the M.A.T. should only apply to Indian companies, not foreign entities.

Furthermore, foreign investors claim that the M.A.T. demands issued by Indian tax authorities since 2014 generate economic uncertainty. Since the election of Prime Minister Narendra Mondi last May, foreign investors have made nearly $50 billion of new investments into India. These new investments consist of approximately $20 billion in Indian stocks and $28 billion in bonds. Within the past year, Mondi's government has attracted foreign investment and implemented pro-business policies while ending what his administration calls the "tax terrorism" of the preceding government. However, critics are claiming that Mondi's approach to aggressively reduce India's budget deficit by levying the M.A.T., among other things, undermines the country's new investor-friendly environment.

Officials in India's Finance Ministry have been reassuring foreigners that the country will continue to provide a positive environment for foreign investment and are now demonstrating this reslove by announcing that foreign portfolio investors from tax treaty countries will not have to pay the 20% M.A.T. on past capital gains.

ART FOR ART

Authors
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Tags
§1031
Artwork
Disposition of Property
Investment Property
Like-Kind Exchange

Taxpayers are usually taxed on net gains from the sale of property. However, tax may be deferred if the transaction is cast as an exchange and certain conditions are met. Code §1031 like-kind exchanges are commonly used in the real estate business to defer taxes arising from the disposition of appreciated property in return for replacement property of similar character and use. Deferral of tax is allowed even when the exchange looks like a sale because it is part of a three-party arrangement where the purchaser provides cash to a qualified intermediary, who is acting on behalf of the transferor, and that intermediary uses the cash to acquire replacement property for the transferor.

Reportedly, art investors are now employing like-kind exchanges to defer tax on gains from the sale of appreciated art. The tax is deferred by exchanging art for art. This article looks at like-kind exchanges and how the stringent requirements have been adapted by art investors.

CODE §1031

Under §1001(a), taxable gain or loss from the sale or disposition of property is defined as the difference between the amount realized from the disposition and the adjusted basis of the property. To constitute a realizable event, the properties exchanged in the transaction must be materially different. The simplest example is an exchange of real estate in return for cash. A more complex example is an exchange of real estate for a sail boat. In both these instances, the properties are materially different and the holder of the property ends up holding assets that are different in kind or extent from the asset transferred.[1]

Section 1031 of the Code provides an exception to the gain recognition rule. Under that provision, no gain or loss is recognized if certain qualifying property is exchanged solely for "like-kind" property. The benefit of the provision is available only if both the properties transferred and received in the exchange are held for productive use in a trade or business or for investment. This does not include stock, bonds, notes, securities, partnership interests, certificates of trust, or beneficial interests.

Qualified Purpose

Property held for a qualified purpose is property used in a trade or business in which the taxpayer is engaged. Although non-business and personal property does not qualify, a minimal amount of personal use generally does not disqualify property from being trade or business, or investment property.[2] Property held for investment

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1 *Cottage Sav. Ass'n v. Commr.*, 499 U.S. 554 (1991).

2 P.L.R. 8103117.

includes unproductive real estate held for future use or future realization in value at the time of the exchange.[3]

The primary intent of the ownership of the property is considered in a like-kind exchange. To illustrate, a vacation home that is exclusively used for personal purposes does not qualify for the exemption. In contrast, a vacation home that is held solely for rental purposes and not personal use will clearly qualify, since it is being used for business purposes.

Like-Kind Property

In addition to having a qualified purpose, the properties must be similar enough to each other to qualify as like-kind. Like-kind property is property of the same nature, character, or class. Quality or grade does not matter. While most real estate is usually considered like-kind to other real estate, property within the U.S. is not considered to be of like-kind to foreign property. This reflects the scope of U.S. taxing jurisdiction under F.I.R.P.T.A. more so than a rationale for the characterization of the two properties.

Timing and Basis

The exchange may be either simultaneous or deferred. In a deferred exchange, property is disposed of and property qualifying as like-kind is subsequently acquired. The taxpayer has not more than 45 days from the date the relinquished property is sold to identify the potential replacement properties. Because purchasers are generally not interested in finding, purchasing, and selling the replacement property to the seller – all those acts cost money – the purchaser generally transfers the purchase amount to a qualified intermediary. That is the name given to a designated agent who will acquire property in the name of the seller. Since the qualified intermediary is not authorized to perform any act other than the acquisition of the replacement party, it steps into the shoes of the original owner. When a deferred purchase transaction is effected, the like-kind exchange becomes a three-party transaction – the original seller, the original purchaser, and the seller of the replacement property.

The identification of the replacement property must be delivered to the seller or qualified intermediary within the 45-day time period. The purchase of the replacement property must be completed within 180 days of the date of sale of the exchanged property or by the final due date of the income tax return, including extensions, for the year in which the relinquished property was sold.[4]

The basis of the property acquired in a §1031 like-kind exchange is the basis of the property relinquished. The taxpayer does not receive a step-up, fair market value basis in the replacement property since the gain was deferred and not recognized at the time. If the taxpayer receives some cash or non-qualifying property, gain must be recognized to the extent of the cash received and the value of the non-qualifying property. Basis is stepped up to the extent cash is received.

Owners of investment and business property may qualify for like-kind exchanges. This may be an individual, a C-corporation, an S-corporation, a partnership, a limited

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3 Treas. Regs. §1.1031(a)-1(b).

4 I.R.S. "Like-Kind Exchanges Under IRC Code Section 1031," last modified August 8, 2012

liability company, or any other entity that owns business or investment property. A like-kind exchange must be reported on Form 8824, a form that is filed with the tax return for the taxable year in which the exchange occurs.

LIKE-KIND ART

Like-kind exchanges give the taxpayer the opportunity to reinvest, consolidate, relocate and diversify holdings. Art investors reportedly have applied the tax-free like-kind exchange provision to art, provided that art is held for investment and that purpose can be clearly demonstrated.

"Art investors reportedly have applied the tax-free like-kind exchange provision to art, provided that art is held for investment and that purpose can be clearly demonstrated."

Qualified Purpose

Under Code §1031, collectibles may be exchanged in a like-kind exchange if they are held primarily for investment rather than for personal use. The burden here is on the taxpayer to prove that the investment intent outweighs the personal enjoyment of the collectible property.

Works of art that are displayed in the taxpayer's home will be considered as being held for personal use.[5] The primary purpose of acquiring the pieces is considered when determining whether the purpose was qualified. Investment cannot be an incidental benefit of owning the artwork. The taxpayer must be able to show that the primary purpose of acquiring the works of art was investment by, for example, holding the pieces in storage in a venue other than the taxpayer's residence.

Other ways of demonstrating a principal investment intent include, but are not limited to, developing an expertise in art, having a history of art investments, obtaining market analyses of the artwork and appropriate insurance, and maintaining detailed records of the investment activity. Without projections of cost of capital and anticipated return on investment performed prior to the time of acquisition, a taxpayer likely has little chance of meeting the burden of proof to demonstrate an investment purpose.

Another sophisticated approach is to own the art through an investment syndicate that provides an investment memorandum at the time funds are raised for the acquisition of art. This begs the following question – from a personal viewpoint, why acquire art if it cannot be viewed other than in a vault? The answer is that the art is an alternative investment and not a thing of beauty.

Like-Kind Property

The exchange must be of like-kind property. The physical properties, nature of the title conveyed, rights of the parties, duration of the interests, and other factors are considered when determining like-kind status of replacement property. Determining whether the properties being exchanged are of like kind is challenging since there is little authority on the matter.

The I.R.S. has ruled that for the purposes of Code §1033, relating to deferral of gain from recoveries for an involuntary conversion, lithographs may not be replaced with artworks in other artistic media such as oil paintings, watercolors, sculptures, or

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[5] *Wrightsman v. U.S.*, 428 F.2d 1316 (1970).

other graphic forms of art.[6] No such result has been reached for purposes of Code §1031(a). Nonetheless, an I.R.S. official is reported to have unofficially indicated that a painting exchanged for a painting would probably qualify under Code §1031, but not a painting exchanged for a sculpture.[7] Vermeers can be exchanged for Warhols but not Berninis.

Whether or not works of art will be considered like-kind is a matter to be decided by the I.R.S. The taxpayer can request a private letter ruling on the question.

Timing and Qualified Intermediaries

The exchange must take place between the prescribed time period if it is not simultaneous. The taxpayer has 45 days in which to identify the replacement work and 180 days to complete the transaction.

A qualified intermediary is a safe harbor provision that can be used to facilitate the transfer. An art dealer, special exchange company, gallery, or auction house may be the qualified intermediary. The intermediary acquires the relinquished and replacement properties and then transfers them to their new owners. A flat fee is usually charged for such a transaction.

CONCLUSION

The Code §1031 like-kind exchange gives investors a chance to reinvest proceeds from sales back into the business and to defer tax on any gains. Traditionally used for investment and business real estate, art investors have now adopted these rules for the exchange of works of art.

If like-kind exchange treatment is granted on the exchange of works of art, the investor is granted the opportunity to refresh its holdings based on the market without incurring taxes. However, the gain will be recognized eventually when the replaced property is sold without a step up in basis.

"This begs the following question – from a personal viewpoint, why acquire art if it cannot be viewed other than in a vault?"

Like-kind exchange treatment is only available if the exchange fulfills the requirements of Code §1031. The taxpayer has to show that its activities are that of an art investor rather than an art collector. Since there is not much authority on point at the moment, the safest course of action is to acquire art through an investment partnership that keeps beauty locked in a vault until it is exchanged for other items of beauty doomed to a similar fate.

6 P.L.R. 8127089 (April 10, 1981).

7 Bloomberg BNA Daily Tax Report, "IRS May Take Liberal View of Bifurcation of Like-Kind Exchanges," November 29, 2012.

AN AMERICAN SOLUTION TO OFFSHORE TAX EVASION

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Tags
F.B.A.R.
Opting Out
O.V.D.P.
Streamlined Procedures
Tax Compliance
Tax Evasion

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BACKGROUND

The United States Department of Justice Tax Division and the I.R.S. have been ramping up an intense crackdown on offshore tax evasion, and while new budget cuts have vastly reduced I.R.S. resources, the cutbacks are having no effect on I.R.S. enforcement initiatives in this area.

At present, the U.S. government's reach has extended far beyond Switzerland, where the Department of Justice is pursuing criminal investigations against a dozen Swiss banks and is engaged in a settlement program with an additional 100 banks that will enable the banks to avoid criminal prosecution. Jurisdictions of note include India, Liechtenstein, Luxemburg, Barbados, Hong Kong, Singapore, and Israel (where Bank Leumi recently entered into a Deferred Prosecution Agreement with the Department of Justice, paid a penalty of $270 billion, and agreed to identify numerous U.S. account holders to the I.R.S.). In addition, the U.S. government is pursuing investigations in various jurisdictions that have not yet been made public.

As alluded to above, there are fourteen active federal grand jury investigations involving foreign banking institutions, and the Department of Justice has begun an amnesty program through which Swiss banks may disclose their roles in aiding tax evasion. BSI SA became the first participant in this program, agreeing to pay a $211 million penalty and turn over U.S. account holders' identities in order to escape criminal charges. Further, F.A.T.C.A. legislation now operational mandates that a foreign financial institution identify and reveal American depositors – both individuals and entities – to the I.R.S. or suffer a 30% withholding on U.S. source withholdable and pass-through payments, including gain proceeds, in the event of non-participation. Taken together, the foregoing will result in the eventual disclosure of several thousand taxpayer identities to the I.R.S.

To date, taxpayers have made more than 52,000 disclosures since the first I.R.S. Offshore Voluntary Disclosure Program opened in 2009, and tax authorities have collected more than $7 billion from these initiatives alone.

PATHS TO COMPLIANCE

For individuals and business entities with undisclosed foreign accounts and unreported income from international sources, time is of the essence to review the options available and come into compliance. These are dangerous times, and nothing is more destructive than a criminal tax investigation, which brings with it the real possibility of prison time, draconian fraud penalties, and penalties for willful failure to file Foreign Bank and Financial Account Reports ("F.B.A.R.'s").

Offshore Voluntary Disclosure Program

Fortunately, options do exist to address the exposure areas. First, the I.R.S. Offshore Voluntary Disclosure Program ("the Program") provides a way for certain taxpayers to resolve their non-compliance within set rules. Taxpayers, who are not under criminal investigation or civil audit, whether or not related to the undisclosed accounts, are eligible to participate in the Program and escape criminal prosecution and more severe civil penalties provided that their names have not been disclosed to the I.R.S. by foreign banks. This approach allows noncompliant taxpayers to stop looking over their shoulders, repatriate funds held offshore, and file truthful and accurate tax returns, thereby avoiding numerous headaches for themselves and, in many cases, their heirs.

"In addition to providing a means to avoid criminal prosecution, the Program provides participants with certainty as to their maximum civil penalty exposure."

Structure of Penalties

In addition to providing a means to avoid criminal prosecution, the Program provides participants with certainty as to their maximum civil penalty exposure, instead of a laundry list of confiscatory civil tax and F.B.A.R. potential penalties.

The overall penalty structure of the Program includes a 27.5% penalty (or 50% in the case of accounts held at any of the dozen or so already-identified "bad banks," such as UBS and Credit Suisse) levied on the highest balance in the account over the past eight years. The potential willful F.B.A.R. penalty, which it supplants, is the higher of $100,000 or 50% of the highest balance in the account for each year not closed by the running of the statute of limitations. With respect to the calculation of the substitute penalty under the Program, it is important to note that the I.R.S. includes the fair market value of any assets acquired with tainted funds in calculating the 27.5%. Foreign real estate, artwork, and jewelry are treated as financial assets for purposes of computing the penalty base.

There are certain recognized situations that may mitigate this penalty, as well as an opportunity to opt out of the Program in the least egregious, non-willful cases. Participants in the Program must file all original or amended tax returns and delinquent F.B.A.R.'s for the past eight years, and include payment for back taxes, interest, and the accurate penalty.

Opting Out

The opt-out procedure entails an irrevocable election made by the taxpayer to have the case handled under the standard audit process. Once this election is filed, together with the taxpayer's recommendation for alternative penalty calculation, the case is removed from the civil settlement structure set up in the Program and an examination is initiated. Opting out will result in an examination of the taxpayer for all open years. The scope of the examination is determined by the I.R.S., and all civil penalties may be imposed, including F.B.A.R. penalties, civil fraud penalties, and penalties for failing to file information returns, if applicable. Taxpayers who opt out of the Program must continue to cooperate with the I.R.S., provide any information requested, and subject themselves to an interview. In determining whether to opt out or not, advisers should consider the nature, size, and cause of the errors. Generally, the most important factor to assess is the taxpayer's exposure under the willful F.B.A.R. penalty.

Alternative Programs

Taxpayers who balk at incurring the financial costs associated with participating in the Program may find other compliance options more attractive. Last year, the I.R.S. expanded its Streamlined Filing Compliance Procedures ("Streamlined Procedures") and added procedures for filing delinquent international information returns and delinquent F.B.A.R.'s, all of which should be considered.

Streamlined Procedures

The expanded Streamlined Procedures are available to a wide range of taxpayers living both inside and outside the U.S. Specifically, there is now both a Streamlined Domestic Offshore Procedure for taxpayers residing in the U.S. and a Streamlined Foreign Offshore Procedure for taxpayers residing outside the U.S. and present inside the U.S. for not more than 34 or 35 days in any of the three years covered. For the Streamlined Domestic Offshore Procedure, a tax return must have been filed for the covered years.

This requirement may be problematic for a taxpayer such as a dual citizen, who is a foreign resident but is present in the U.S. for somewhat more than 34 or 35 days in each of the three years covered by the Streamlined Procedure. Such individuals do not clearly fit the requirements to participate in the Streamlined Domestic Offshore Procedure. Nonetheless, at conferences, I.R.S. officials have unofficially suggested that a taxpayer faced with this situation should file under the Streamlined Domestic Offshore Procedure, as in non-egregious cases discretionary relief may be allowed.

Under these procedures, there is a three-year look back period for filing amended income tax returns and a six-year look back period for filing delinquent F.B.A.R.'s, versus an eight-year look back period for both under the Program. For eligible taxpayers residing in the U.S., the only penalty that will be assessed is a miscellaneous offshore penalty equal to 5% of the foreign financial assets that triggered the tax compliance issue. It is calculated on the highest year-end balance and asset values during the six-year look back period applicable to F.B.A.R.'s. For eligible taxpayers residing outside the U.S., no penalty will be assessed.

Both the domestic and foreign Streamlined Procedures require taxpayers to certify under penalties of perjury that previous failures to comply were due to non-willful conduct and to submit a detailed narrative statement explaining the facts that resulted in their failure to disclose offshore accounts or assets. For this purpose, non-willful conduct is conduct that is due to negligence, inadvertence, or mistake or conduct that is the result of a good faith misunderstanding of the requirements of the law.

A decision to enter into the Streamlined Procedures can be risky, particularly under certain factual circumstances, and should not be undertaken lightly in the event the I.R.S. rejects the application. It should be noted that there is no guarantee against criminal tax investigation or prosecution under the Streamlined Procedures and an application for such relief disqualifies a taxpayer from subsequently seeking entry into the Program. In fact, Streamlined Procedures should only be utilized as an alternative in cases of truly non-willful conduct. Caution is advised in evaluating willful and non-willful conduct in this context, and any possible so-called "badges of fraud" must be identified. A false certification of non-willfulness can also result in civil or criminal liabilities.

Transitional Treatment

For those taxpayers who entered into the Program prior to July 1, 2014, another option has been offered by the I.R.S. Pursuant to the Transition Rules: Frequently Asked Questions (FAQs) No. 6, these taxpayers may request the application of the lower-penalty terms available under the Streamlined Procedures in cases that are deemed to be non-willful. In such situations, all required terms of the Program must be satisfied and taxpayers must submit a certification setting forth their non-willful conduct and formally request that transitional treatment be applied to their O.V.D.P. applications. In practice, the I.R.S. will suggest transitional treatment on its own initiative.

Delinquent International Information Return Submission Procedures

For taxpayers who do not need to use the Program or Streamlined Procedures to file delinquent or amended tax returns to report and pay additional tax, the I.R.S. Delinquent International Information Return Submission Procedures may be utilized in certain circumstances. These submission procedures are available to taxpayers who have not filed one or more required international information returns (*e.g.*, Forms 3520 and 3520-A) if they (i) have reasonable cause for not timely filing the information returns; (ii) are not under a civil examination or a criminal investigation by the I.R.S.; and (iii) have not already been contacted by the I.R.S. about the delinquent information returns. Eligible taxpayers can utilize this procedure by filing the delinquent information returns with a statement of the facts establishing reasonable cause for the failure to file.

"Taxpayers who entered into the Program prior to July 1, 2014...may request the application of the lower-penalty terms available under the Streamlined Procedures in cases that are deemed to be non-willful."

Delinquent F.B.A.R. Submission Procedures

In addition, Delinquent F.B.A.R. Submission Procedures also exist for taxpayers who do not need to use either the Program or the Streamlined Procedures to file delinquent or amended tax returns in order to report and pay additional tax, but who (i) have not filed a revised F.B.A.R.; (ii) are not under civil examination or criminal investigation by the I.R.S.; and (iii) have not already been contacted by the I.R.S. about the delinquent F.B.A.R.'s. These taxpayers should file the delinquent F.B.A.R.'s and include a statement explaining the cause for late filing.

The I.R.S. has represented that under certain circumstances it will not impose a penalty for failure to file delinquent F.B.A.R.'s. Income from a foreign financial account reported on the delinquent F.B.A.R.'s must have been properly reported on the taxpayer's U.S. tax returns, all tax on the income must have been paid, and the taxpayer may not have been previously contacted regarding an income tax examination or a request for delinquent tax returns for the years for which the delinquent F.B.A.R.'s are submitted.

Quiet Disclosure

A final option that has been utilized in the past is known as making a "quiet disclosure." Such a disclosure, which is not limited to reporting foreign accounts or income, involves filing original or amended tax returns and delinquent F.B.A.R.'s with the appropriate I.R.S. Service Center to correct deficiencies in original returns, in the hope that such filings will not be selected for audit and/or referred to the I.R.S. Criminal Investigation Division.

If the quiet disclosure is successful, it has the benefit of avoiding all penalties with respect to undisclosed foreign accounts. In addition, it may shorten the look back period. However, there are considerable risks associated with such a strategy, since the I.R.S. strongly disfavors this approach and takes the position that any taxpayer who chooses to forgo recognized procedures is attempting to "game the system."

For taxpayers who have little criminal tax exposure because they did not engage in any conduct qualifying as willful concealment, a quiet disclosure may be attractive. Nevertheless, if tax return filings are audited, the chance of leniency on penalties may be significantly compromised. Any quiet disclosure must be truthful and accurate as to every material matter.

CONCLUSIONS

For many individuals and entities with undisclosed foreign accounts or assets and unreported income from international sources, the Program and the related offshore initiatives detailed above, with their known civil penalty outcomes, currently are the last, best options to come into compliance with offshore reporting. We have entered into an environment where the I.R.S. is constantly acquiring information under new disclosure initiatives and following more leads from ongoing foreign bank investigations. It is critical that noncompliant taxpayers recognize that time is of the essence; it will be too late to take advantage of these programs once a foreign bank discloses the taxpayer's name to the I.R.S. More and more, doing nothing is not a viable option for anyone who wants to use and enjoy undisclosed foreign accounts or assets.

U.K. IMPLEMENTS 25% "GOOGLE TAX" ON DIVERTED PROFITS

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Tags
Diverted Profits Tax
Economic Substance
Google Tax
Multinational Companies
Permanent Establishment

The U.K. has implemented the controversial diverted profits tax on the profits of multinational companies that are "artificially diverted" from activity within the country. This 25% levy became effective on profits arising on or after April 1, 2015. At this point, it is unclear whether the outcome of the Parliamentary election on May 7 will impact the enforcement of the diverted profits tax, which was enacted without thorough examination by Parliament.

U.K. officials claim multinational corporations are manipulating the tax system and have imposed the 25% levy to prevent companies from avoiding a taxable presence in the U.K. This corporate diversions tax is aimed at entities that transfer profits to lower tax jurisdictions, away from the U.K. The diverted profits tax is being called the "Google tax" because it addresses the practices of well-known international entities such as Google Inc., Amazon.com Inc., and Starbucks Corp. that have used the U.K.'s permanent establishment and economic substance rules to craft tax advantages within the bounds of the law. Legislators have held hearings within the last year on how these three companies in particular have been able to generate billions of dollars in revenue in the U.K. but report little or no taxable profits.

The U.K. tax authority, Her Majesty's Revenue and Customs ("H.M.R.C."), introduced a draft of the diverted profits tax last fall and quickly implemented the legislation ahead of the May 7 election. There is great concern about the legislation's complexity and that its hasty enactment will only result in future revisions, which will further complicate the matter. On the whole, the government is targeting transactions that it does not favor even though they are legal, and the tax itself is being criticized for undermining the Base Erosion and Profit Shifting project executed by the Organization for Economic Cooperation and Development.

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The subjective basis for the tax's application is another source of criticism, with the H.M.R.C. calculating and deciding when the tax is imposed. The legislation establishes a framework for determining whether the diverted profits tax will apply to a company's profits, and the rules do not apply to small and mid-size businesses and will not include profits derived from pure loan transactions.

There are two rules that an H.M.R.C. official will utilize in levying the diverted profits tax. The first rule applies to those carrying on activity in the U.K. in connection with the supply of goods and services by a non-U.K. resident company to customers in the U.K., provided that certain enumerated conditions are met. Exemptions apply if the foreign company's or a related company's total sales revenue from all supplies of goods and services to customers in the U.K. does not exceed £10 million ($14.8 million) within a 12-month accounting period. The second rule applies to transactions lacking economic substance that involve entities with a taxable presence in the U.K. It targets activities that exploit tax differentials under certain conditions, including arrangements that result in a tax discrepancy.

According to the H.M.R.C.'s guidance on the newly implemented diverted profits tax, an official will issue a notice to a foreign entity if the H.M.R.C. believes the conditions are met. The guidance details the reasons for imposing the tax and calculates the amount of diverted profits that are taxable. The entity has 30 days to object, and the official may consider certain matters within an additional 30 days in order to issue a charging notice on the original or amended amount or to confirm that there is no charge. The H.M.R.C. officer in specific situations could issue a diverted profit charge reflecting a 30% disallowance of expenses that would otherwise be deductible if the officer considers such expenses to be greater than they would have been under the arm's length standard.

A company is required to pay the tax issued on the charging notice within 30 days, otherwise penalties are applied. Companies can appeal the diverted profits tax after the payment's due date. There is review period of 12 months in which the tax can be adjusted based upon sufficient evidence. A company can also appeal any charge resulting from a tax adjustment.

"There is great concern about the legislation's complexity and…its hasty enactment."

The diverted profits tax was simultaneously implemented as the corporate tax rate was lowered to 20%. Other tax changes that came into effect on April 1 include (i) increasing retail discounts for street shops, pubs, and restaurants; (ii) increasing the bank levy from 0.156% to 0.21%; (iii) enabling certain charities to become eligible for V.A.T. refunds; (iv) reducing the television tax credit from 25% to 10%; (v) new tax relief on the production of children's television; and (vi) restricting the amount of a bank's annual profit that can be offset by carried forward losses to 50%. The Small Business Rate Relief has also doubled in amounts. The government announced these changes are intended to enable companies to reinvest greater funds into further developing existing businesses. Although implementation of the April 1 tax benefits is positive for small and mid-size businesses, there are concerns that the effects of the complex diverted profits tax will deter multinational companies from carrying on significant business activities within the U.K.

As stated in previous *Insights* articles, the diverted profits tax is a political over-reaction to reasonable concern over foreign companies not paying their fair share of tax.[1] Enactment empowers H.M.R.C. to unilaterally override valid tax arrangements – without substantiation that it will achieve the government's goal of preventing tax exploitation – and only further complicates the already intricate tax regime. Ultimately, this creates an uncertain environment that could discourage foreign investment into the U.K.

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1 Boitelle, Thierry, John Chown, Aliasghar Kanani, and Michael Peggs, "Foreign Correspondence: Notes From Abroad," *Insights* 1, no. 11 (2014).

Chown, John, "The Proposed United Kingdom 'Diverted Profits Tax'," *Insights* 2, no. 1 (2015).

TAXPAYER ADVOCATE ASKS I.R.S. TO SIMPLIFY FOREIGN ASSET REPORTING

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Tags
F.B.A.R.
Form 8938
National Taxpayer Advocate

On April 13, the Office of the National Taxpayer Advocate ("N.T.A.") urged the Internal Revenue Service ("I.R.S.") to reduce foreign asset reporting requirements magnified by the Foreign Account Tax Compliance Act ("F.A.T.C.A."). The N.T.A. is an independent organization within the I.R.S. that aids taxpayers in resolving issues with the I.R.S. It identifies issues and suggests changes to the I.R.S. and Congress to aid both the I.R.S. and all taxpayers.

Currently, U.S. persons with foreign bank accounts file two reports relating to such accounts: one report for the I.R.S. and the other report for the Treasury Department. In a recommendation to the I.R.S., the N.T.A. said on April 13 that taxpayers shouldn't have to report assets on Form 8938, *Statement of Foreign Financial Assets*, if those assets are already reported or reflected on a Financial Crimes Enforcement Network ("FinCEN") Report 114, *Report of Foreign Bank and Financial Accounts* ("F.B.A.R.").

Form 8938 has been expanded to reflect changes under F.A.T.C.A., which requires foreign financial institutions to report U.S.-owned accounts to the I.R.S. or face, in some cases, a 30% withholding tax on their U.S.-source income.

In addition, the N.T.A. urged the I.R.S. to reduce the burden on taxpayers with accounts abroad who are *bona fide* residents of the foreign countries in which they live, suggesting that it should not require banks organized under the laws of those countries to report such accounts under F.A.T.C.A.

DIFFERENCES AND SIMILARITIES AMONG THE FILINGS

F.B.A.R.'s

A U.S. taxpayer with a financial interest in or signature authority over a non-U.S. financial accounts with an aggregate value at any point during a calendar year in excess of $10,000 must file F.B.A.R.'s. This filing is mandated by the Bank Secrecy Act and is not reported on the taxpayer's tax return, although it is enforced by the I.R.S.

Determining whether a U.S. taxpayer is required to file F.B.A.R.'s, and the scope of information that must be reported, requires an analysis of the account records of each non-U.S. financial account in which the U.S. taxpayer has a financial interest or over which signature authority exists. The F.B.A.R. is required to be filed electronically by June 30 following the close of the reporting year.

Form 8938

A U.S. taxpayer who owns non-U.S. financial assets, including accounts with non-U.S. financial institutions, is required to file I.R.S. Form 8938, *Statement of Specified Foreign Financial Assets*, if the aggregate value of those assets exceeds certain thresholds.

The information that is reported on Form 8938 is similar to the information that is required to be reported on an F.B.A.R., although several differences exist. For example, in contrast to an F.B.A.R., Form 8938 does not require reporting of assets over which the taxpayer has signatory authority. In addition, Form 8938 is filed annually as part of the U.S. taxpayer's U.S. tax return, in comparison to the separate filing of the F.B.A.R.

"The information that is reported on Form 8938 is similar to the information that is required to be reported on an F.B.A.R."

CONCLUSION

The N.T.A. raises concerns about the duplicative and burdensome nature of the current foreign account reporting requirements and the problems imposed on American citizens living and attempting to bank abroad. However, it is not clear that the suggested solutions have a realistic opportunity of implementation.

At the level of interactions between expat Americans and foreign banks, horror stories abound of account closings that prevent expat Americans from having access to normal banking relationships. As a matter of policy, forcing banks to distinguish between Americans living in the U.S. and Americans living abroad seems to be an exercise in futility when a bank prefers to avoid American clients altogether in order to avoid penalties. At the level of Congressional mandate for reporting, the consolidation of the F.B.A.R. and Form 8938 will be difficult to achieve due to differences in the filing deadlines and information required to be reported, as well as different branches of the government that receive the forms.

A more practical solution would seem to be the inclusion of the F.B.A.R. in the U.S. income tax return, in addition to the separate filing on June 30. Alternatively, the entire Form 8938 reporting obligation may better be addressed by the next Congress, which will meet after the next Presidential election.

PRE-IMMIGRATION TAX PLANNING, PART III: REMEDYING THE ADVERSE CONSEQUENCES OF THE COVERED EXPATRIATE REGIME

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Tags
Covered Expatriate
Covered Gifts
Covered Inheritance
Long-Term Green Card Holder
Long-Term Residency
Pre-Immigration

INTRODUCTION

Following our previous articles regarding pre-immigration planning and the expatriation rules applicable to covered expatriates (see here and here), this article considers some techniques for implementation before and after expatriation, with the objective to reduce the adverse treatment of the covered expatriate regime to the extent possible depending on the specific facts and circumstances of each individual.[1]

For a Green Card holder, expatriating prior to becoming a long-term resident would eliminate the application of the covered expatriate regime. For a U.S. citizen (other than children under certain situations), the circumstances that will allow for a tax-free expatriation are more restrictive. An individual is considered a covered expatriate if he or she meets one of three tests.[2] Pre-expatriation planning can eliminate the application of the covered expatriate regime for some individuals, while for others additional planning may be needed to reduce the unfavorable effect of the covered expatriate rules.

PRE-EXPATRIATION PLANNING

- If an individual is deemed to be a covered expatriate solely because his net worth is valued over $2.00 million, the individual should consider making transfers prior to the expatriation date to reduce his net worth to below $2.00 million. The individual can transfer an amount up to $5.43 million (the lifetime exemption amount) without incurring gift tax liability and in principle, these gifts should be of highly appreciated non-U.S. assets.[3]
- An individual whose net worth exceeds $7.54 million in 2015 (and adjusted as the lifetime exemption changes from year to year) should consider making taxable gift transfers prior to the expatriation date to reduce the mark-to-market exit tax liability and the succession tax liability.

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1 As with our prior articles, this article addresses U.S. taxing obligations; departure taxes in other countries are beyond the scope of this article. Additionally, the article assumes children of covered expatriates are U.S. persons in their own right so that gifts and bequests made after expatriation will be subject to the succession tax if not for suggested planning.

2 See our previous edition of Insights here, p. 54

3 This amount reflects the lifetime estate/tax gift tax exemption for 2015. It will be adjusted for inflation in the future. A married couple can transfer an amount up to $10.48 million.

“To obtain tax planning flexibility, Green Card holders that are not yet long-term residents may consider relocating on a temporary basis.”

- ○ If gifts are made prior to expatriation, the out-of-pocket cost of making a gift of a specific sum of money is significantly less under the gift tax imposed on the donor than under the succession tax imposed on the recipient. While both taxes are levied at a rate of 40%, the gift tax paid by the donor is itself not subject to gift tax. In comparison, an amount paid to a U.S. individual that is subject to post expatriation succession tax is itself subject to gift tax. Compare the transfer of a gift valued at $1.00 million. The gift tax imposed on the donor who makes a gift of $1.00 million prior to expatriation is $0.40 million. The net cash out of pocket is $1.40 million of gift and tax. In comparison, the gross amount that must be given subsequent to the expatriation that allows a recipient to retain $1.00 million is $1.67 million ($1.00 million ÷ 0.6 (the amount left after tax) = $1.67 million). Of that amount, the tax is $0.67 million and the net gift is $1.00 million.

- ○ For those who are contemplating expatriation and have minor children, completed transfers of wealth could be made to an irrevocable trust for the benefit of the expatriate’s children prior to expatriation. So long as the gift is complete when made, the gift would reduce the net worth of the individual for purposes of the mark-to-market tax, the gift tax due would be less than the potential succession tax that would apply should the transfer occur after expatriation, and most importantly from a family viewpoint, the children are not given the funds outright. The expatriating individual should not be the trustee.

- A long-term resident (*viz,* an individual who holds a Green Card for eight of the last 15 taxable years) should consider acquiring foreign domicile[4] prior to formally expatriating. A foreign domiciliary may transfer an unlimited amount of non-U.S. situs assets without incurring gift tax liability. A foreign domiciliary is subject to gift tax only with respect to transfers of real and tangible property located in the U.S. Provided that gifts are made prior to the relinquishment of status as a long-term resident, such individual could reduce his net worth to below the $2.00 million threshold. This planning alternative is extremely helpful for non-citizen individuals who were present in the U.S. while holding a green card and who left the U.S. without formally relinquishing permanent resident status.

- To obtain tax planning flexibility, Green Card holders that are not yet long-term residents may consider relocating on a temporary basis to a foreign country prior to obtaining long-term resident status. The foreign country must have an income tax treaty in effect with the U.S. and the treaty must include a tiebreaker provision with respect to residency. If an individual can allocate residence to the foreign country for the relocation year and subsequent years, the eigth year of residence under the Green Card may never be reached. Of course, this strategy can have immigration law consequences. A Green Card holder who obtains a re-entry permit may be absent from the U.S. for up to two years without losing his status. The same strategy may be applicable to non-citizen individuals who were present in the U.S. while holding a Green Card and who left the U.S. without formally relinquishing

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4 The U.S. definition of domicile is defined as living within a country with no definite present intent of leaving.

permanent resident status, provided that they claim treaty benefits for tax years earlier than the eigth year in which the Green Card is held on late filed or amended tax returns.

- If a married couple filing jointly is treated as covered expatriates solely because the tax liability test is met because the joint tax return tax liability is allocated entirely to each of the individuals,[5] consideration should be given to the submission of amended tax returns reflecting a married filing separate status for prior years. While the total tax for those years may be increased, it may be possible for neither individual to exceed the tax liability threshold, which is $160,000 in 2015.

- If an individual will be treated as a covered expatriate solely because he fails to certify U.S. tax compliance for the five years preceding the year of expatriation, the individual should consider correcting past compliance issues prior to expatriating. Individuals in this set of circumstances face issues relating to the underpayment of taxes, underpayment penalties, late filing penalties, penalties related to the failure to file specific forms, and interest. However, if the the compliance failure relates to offshore financial assets and income derived from foreign financial accounts, the I.R.S. has two programs available to bring taxpayers into compliance retroactively:

  - The offshore voluntary disclosure program ("O.V.D.P.") that is offered to taxpayers that may be willful with respect to their delinquencies, and

  - The Streamlined Procedure that is offered to non-willful delinquencies.

- Covered expatriates who desire to sell their principal residence should do so prior to expatriation to take advantage of the $500,000 capital gain tax exclusion.

Post Expatriation

- Covered expatriates are not treated as such for purposes of the succession tax for years in which they are treated as U.S. residents for income tax purposes. Thus, if possible, prior to transferring a highly valuable non-U.S. asset a covered expatriate should attempt to satisfy the substantial presence test[6] so that the transfer is not considered a covered gift subject to the succession tax. If such individual remains domiciled in a foreign jurisdiction, in principle the transfer would not be subject to gift tax for reasons mentioned above.

- As a transfer below the gift tax annual exclusion is not treated as a covered gift, a covered expatriate should considering transferring an amount up to $14,000 a year, per U.S. child (or other U.S. recipient).[7] Such annual gifts

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[5] *I.e.*, the average annual net U.S. tax liability for the last five years exceeds $160,000 – this amount is adjusted for inflation.

[6] See Code §7701(b)(3) for the test. Generally, an individual will meet the substantial presence test if he or she is present in the U.S. for 31 days or more in the tax year, and all days present in that year, plus one third of the days present in the immediately preceding, plus one sixth of the days spent in the U.S. in the second preceding year amount to at least 183 days.

[7] A married couple can gift an amount up to $28,000.

should involve foreign situs assets that would otherwise be subject to the succession tax.

- Because the generation skipping transfer tax ("G.S.T.T.") does not apply to covered gifts, a covered expatriate should consider transferring assets for the benefit of individuals more than one generation removed from himself. Such transfers would still be subject to the succession tax but not to the G.S.T.T.

- If a covered expatriate inherits property from a foreign person who is not a covered expatriate, and in time will transfer that property to a U.S. person as a covered gift or bequest, the property will be subject to the succession tax. Thus, the individual should plan for the property to bypass the covered expatriate entirely to avoid the application of the succession tax. This may entail the making of complete and timely disclaimers in trust interests, bequests, and gifts that are effective under local law.

CONCLUSION

At first glance, expatriation may result in the imposition of significant tax liability for a covered expatriate and U.S. heirs. However, in the period since the expatriation tax was enacted, planning techniques have arisen to redress the tax situation for many "near wealthy" individuals and couples with $10.00 million to $15.00 million net worth. Whether the plan involves retaining a foreign domicile for a Green Card holder or choosing to pay gift tax rather than succession tax, opportunities exist for reducing the sting of departing the U.S.

TEN YEAR THROWBACK

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Tags
Advanced Pricing Agreements
B.E.P.S.
Retroactive Tax
State Aid
Transfer Pricing

Two years ago, a U.S. Senate investigation accused Ireland of granting Apple Inc. special tax treatment. This accusation sparked a seemingly never-ending investigation into the state aid granted by certain European countries to specific multinational companies. More recently, Apple, Starbucks, Fiat, and various other companies exposed in the "Luxembourg Leaks" scandal were accused of having paid substandard taxes as a result of agreements between those companies and the Netherlands, Luxembourg, and Ireland, which constituted illegal state aid.[1]

Now, the European Commission (the "Commission") is looking into the penalties that should be levied upon the income earned through these agreements. The Commission's investigations into these advance rulings and advance pricing agreements ("A.P.A.'s") between E.U. member-states and major U.S. multinationals could lead to tax adjustments dating as far back as ten years.

STATE AID

State aid is defined as "an advantage in any form whatsoever conferred on a selective basis to undertakings by national public authorities."[2] This does not include subsidies or tax breaks available to all entities. A measure of state aid constitutes an intervention by a state, or through state resources, that gives specific companies or industry sectors an advantage on a selective basis, thereby distorting competition and affecting trade between E.U. member states.

State aid needs to be regulated so that competition between the member states may remain fair. The Treaty on the Function of the European Union (the "Treaty") generally prohibits state aid unless there is some justifiable economic reason, and the Commission is in charge of ensuring compliance under the Treaty. Since certain policy objectives justify state aid, such measures can be implemented under certain circumstance – but only after they have been approved by the Commission. The Commission holds the power to recover any unapproved state aid that is found to be incompatible.

The Commission alleges that advance rulings and A.P.A.'s between Ireland, the Netherlands, Luxembourg, and certain multinational companies constitute unlawful state aid under the E.U.'s competition rules.

The Treaty outlines four conditions that need to be met in order for an agreement to be considered state aid:

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1 Antebi, Galia, and Rusudan Shervashidze, "A Bad Month for Luxembourg," Insights 1, no. 11 (2014).

2 "What is state aid? European Commission," last modified August 8, 2013.

1. It confers a financial advantage;
2. It distorts or threatens to distort competition;
3. It selectively favors specific undertakings or production of certain goods; and
4. It is not justified by the tax system's nature and logic.

DISTORTION

The Commission found that certain A.P.A.'s allowed multinationals to move profits through subsidiaries based in the above-named E.U. member-states in ways that did not correspond with the actual sales that had taken place.

"The taxpayers cannot claim protection from the agreements if they are found to be state aid because there is no protection under the E.U. rules of competition."

Since the E.U. has no legal competence to regulate direct taxation, this matter was treated as an issue of distortion of competition. The Commission claims that these A.P.A.'s and rulings affected the decision process for determining the jurisdiction of formation and the location of the seat of management for the multinational groups involved.

The Commission found that multinationals must behave like "prudent independent market operators" and must be treated like individuals. However, this standard will be difficult to determine in practice, as the European Court of Justice is not an expert on transfer pricing.

AMOUNT OWED

If the tax agreements are found to constitute state aid, the member-states must recover the amounts granted to multinationals going back ten years, or incur infringement proceedings. The clock begins to run on this ten-year recovery period on the day when the unlawful state aid is awarded to the company. However, the ten-year limit may be extended by various events throughout the period.

In such cases, the E.U. provisions pre-empt the local four-year statute of limitations, and local authorities have no choice but to comply. The taxpayers cannot claim protection from the agreements if they are found to be state aid because there is no protection under the E.U. rules of competition.

The ten-year retroactive payment with interest may be challenged by the companies on the principles of legitimate expectations and legal certainty. To be successful in their challenge, the taxpayer would have to prove that the aid in question was lawful and that it relied on that aid.[3]

In addition to paying taxes and interest dating back ten years, if the recovered amounts are found to be penalties rather than foreign income taxes, there will be no corresponding U.S. foreign credit whenever profits are taken into account for U.S. income tax purposes. Under U.S. law, creditable foreign taxes must be imposed under local laws. a possible challenge to the status of these payments is that they If these 10-year payments are characterized as penalties charged by the Commission

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3 "Steptoe & Johnson LLP: EU State Aid Tax Investigations: A New Enforcement Landscape?," October 30, 2014.

to deter improper behavior, they will not be considered to be taxes on income in the U.S. sense.

STATE AID AND B.E.P.S.

This controversy has pushed the Commission toward adopting measures similar to the O.E.C.D.'s B.E.P.S. initiative in order to address double non-taxation. The Commission may use the state aid rules to apply anti-B.E.P.S. measures retroactively to ensure that all activity is taxed at least once.

The Commission issued a draft directive on March 18, 2015[4] that would require countries that issue advance international tax rulings to automatically disclose them to the Commission within three months. This means that although member-states would be allowed to act on mismatches, the Commission will be kept in the loop regarding any such agreements. It is an extension of the so-called "name and shame" strategy to deter tax planning.

"The Commission issued a draft directive on March 18, 2015 that would require countries that issue advance international tax rulings to automatically disclose them to the Commission within three months."

The information disclosed regarding the agreements will include identifying information for the taxpayer and the member states directly involved, the content of the agreement, and the transfer price and how it was determined.[5] Presumably, the government of the state that is an internal counterparty to the corporation that receives the ruling will treat payments to the low tax party as non-arm's length in nature and non-deductible.

This draft directive reinforces a policy of maximum transparency and exchange of information established as part of the B.E.P.S. measures. Application of this draft, with its proposition for a systematic and automatic exchange of international tax rulings, would be a major step toward the aims of the B.E.P.S. program invoked by the harmful state aid practices that have come to light.

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4 European Commission, "Proposal for a Council Directive amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation," March 18, 2015.

5 "Automatic Exchange of Tax Rulings in the EU." Tax Notes International, April 20, 2015, pg. 261.

CORPORATE MATTERS:

ONE CLAUSE THAT SHOULD BE IN EVERY PARTNERSHIP AGREEMENT

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Tags
Joint Venture
L.L.C. Agreement
Partnership Agreement

Our practice involves the drafting of many different types of partnership agreements and other agreements governing the relationship among individuals involved in a common enterprise. These agreements include general and limited partnership agreements, operating agreements or limited liability company agreements, and shareholder agreements for corporations. In this article, all these types of entities are referred to as "joint ventures."

During the initial client discussions with respect to these agreements we highlight and discuss the usual laundry list of matters that co-investors should consider at the time of formation. One matter that we believe should be addressed in every joint venture agreement is what happens upon the death of a member of the joint venture. For obvious reasons, many do not want to focus on this point. However, the procedure to be followed when surviving spouses and heirs inherit an ownership interest is best handled at the beginning of the joint venture. While it may appear that all joint venture members have similar interests, relationships can change very quickly, and the bottom line is that while one may be very interested in being in partnership with a certain individual, the same interest may not attach to that person's spouse.

A typical provision controlling what happens to a joint venture member's interest upon his or her death may provide for the purchase of the joint venture interest by the joint venture, itself, or the individual members of the joint venture is as follows (assuming the joint venture is cast as a partnership):

> Upon the death of any individual Partner, the Partnership and the other Partners may but shall not be required to purchase, and the estate of the decedent and any other person who acquires the Interests held by the Decedent at the time of his or her death as a result of the death of the decedent (collectively, the "Decedent's Transferees") shall be obligated to sell, such Interests in accordance with the provisions below.

The clause would then detail notice relating to the death and provide that the joint venture or individual members have a certain period of time to decide whether to purchase the interest of the decedent. In some cases, a joint venture agreement with the above clause may require the spouse of a partner to sign a spousal consent regarding the terms of the joint venture agreement.

Assuming the joint venture is to continue, the price to be paid for the membership interest can be determined in a variety of ways. A common method is to use fair market value as of a certain date, which is essentially the proceeds the partnership would have received if it sold all its assets as a going concern and then liquidated immediately after the sale, distributing the sales proceeds on that date. Failing an agreement as to value, an independent appraisal would be obtained from a qualified and acceptable expert.

The following clause in a partnership agreement is an example:

> For purposes of this section, the price of the Interests being purchased shall be the fair market value as of the last day of the Partnership's taxable year closest to the date of Partner's death, as determined by agreement of the Partnership and the Decedent's Transferees or, if requested by such Decedent's Transferees, by the appraisal process described below (which, if requested, shall cause the closing date to be extended as necessary to accommodate the completion of the appraisal process).

The independent appraiser can be agreed between the parties or pursuant to the rules of the American Arbitration Association.

Alternatively, the members may want surviving spouses to enjoy the fruits of a joint venture's labor by participating in the future upside of the business. The following clause in a partnership agreement is an example:

> Upon the death of any Partner (hereinafter referred to as the "Decedent"), the Partnership shall neither be terminated nor wound up but, instead, the business of the Partnership shall be continued as if such death had not occurred. Each Partner shall have the right by testamentary disposition to bequeath all or any portion of his or her Partnership Interest in the Partnership to a member of his or her immediate family (as defined) or to any trust in which any one or more members of his or her immediate family (as defined) retain the full beneficial interest; provided that in the case of any such bequest, the legatee or legatees shall hold the Partnership Interest received as a result of such bequest subject to the terms of this Agreement and shall be required to join in and execute, acknowledge, seal and deliver a copy of this Agreement as an additional Partner party hereto. In order to receive the Partnership Interest of the Decedent and be admitted to the Partnership, the recipient must first sign the Partnership agreement, agreeing to be bound by all its terms and conditions.

An agreement with this type of provision would typically give the person inheriting the interest the right to sell the interest to the joint venture for a limited time and provide for a purchase of the membership interest by the joint venture in the event of the death of that heir.

Funding the purchase by the joint venture is a separate matter, and key man life insurance is typically used to enable the venture to afford to purchase the membership interest of the deceased member. In such a case, however, the members typically agree to the value of the interest at the time the key man life insurance policy is purchased. If the value increases over time, more than one policy may be acquired for each member. Often, the expense, which is not deductible, is specially allocated for income tax purposes to the member whose life is ensured.

As can be seen by the above, wills and trust issues may also come into play, but those issues are mainly administrative, and some time and thought about this issue at an early stage can prevent a lot of headaches and potential conflict at a later time.

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

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Tags
B.V.I.
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I.G.A.
U.K.

I.R.S. OFFERS GUIDANCE TO TAXPAYERS SEEKING ELECTRONIC NOTIFICATION ON F.A.T.C.A. REPORTS

The Internal Revenue Service ("I.R.S.") provided guidance to taxpayers who do not receive notification of the status of their reports once they have uploaded the data into the electronic system used to transmit information regarding overseas bank accounts to the I.R.S. under the Foreign Account Tax Compliance Act ("F.A.T.C.A."). There has been growing concern among taxpayers as to what to do if they successfully upload a F.A.T.C.A. report into the International Data Exchange Service ("I.D.E.S.") but do not get an International Compliance Management Model ("I.C.M.M.") notification letting them know the status of the report.

The I.R.S. added a new Item D9 to its F.A.T.C.A. I.D.E.S. Frequently Asked Questions and Answers relating to data transmission. The I.R.S. has also stated that a similar question and answer was added to the F.A.Q.'s on the I.C.M.M., the I.R.S. system that ingests, validates, stores, and manages F.A.T.C.A. information once it is received.

U.K. UPDATES F.A.T.C.A. REPORTING REQUIREMENTS FOR 'NIL' RETURNS

U.K. Financial Institutions ("F.I.'s") are required to register and report information on their U.S. account holders to Her Majesty's Revenue and Customs ("H.M.R.C.") for the 2014 period by May 31. However, the U.K. tax authority has made changes to the reporting criteria under its U.S. F.A.T.C.A. I.G.A., affecting the reporting requirements of certain entities. The revisions exempt certain F.I.'s from submitting returns if they have nothing to report and also exempt holding companies and treasury center companies from the definition of an F.I., eliminating their reporting requirements altogether.

The I.R.S. confirmed on its F.A.T.C.A. Frequently Asked Questions and Answers webpage that "*nil* reports" are not necessary from certain entities. However, H.M.R.C. said that where a U.K. F.I. is in a *nil* return position because it applied the *de minimis* $50,000 or $250,000 threshold on pre-existing accounts, H.M.R.C. will still require the F.I. to submit the *nil* return in order to make the election.

FOREIGN BANKS & FINANCIAL INSTITUTIONS MUST HAVE INDIVIDUAL SELF-CERTIFICATION BEFORE OPENING ACCOUNTS

F.I.'s in jurisdictions that have Model 1 Intergovernmental Agreements ("I.G.A.'s") with the U.S. must get potential account holders to self-certify residency and citizenship information before opening a new account. Obtaining a self-certification before opening an account is a key due diligence requirement in a Model 1 I.G.A. jurisdiction for individual accounts. This point was clarified in the recently added Question 10 of the General Compliance section on the I.R.S.'s F.A.T.C.A. Frequently Asked Questions and Answers webpage and was the reason for a potential disagreement reported in last month's "F.A.T.C.A. 24/7."

"Obtaining a self-certification before opening an account is a key due diligence requirement in a Model 1 I.G.A. jurisdiction for individual accounts."

Despite this clarification on the I.R.S.'s website, some jurisdictions (such as Canada and the U.K.) allow in their F.A.T.C.A. guidance for F.I.'s to open new individual accounts without first obtaining a self-certification, provided that if a self-certification form is not obtained prior to the reporting deadline such accounts are treated as reportable accounts. At an A.B.A., I.F.A., and I.B.A. joint program in Munich, an I.R.S. official recently stated that this is not the intent of F.A.T.C.A. and goes against the basic principles of the legislation. This difference of view between the I.R.S. and other countries leaves F.I.'s operating in those countries in a quandary as to whether to adhere to local guidance or that of the I.R.S. Following the I.R.S. may be the most conservative course of conduct, but it may also leave those institutions out of step with their local competitors.

FINANCIAL INSTITUTIONS DEEMED COMPLIANT IN JURISDICTIONS WORKING TO IMPLEMENT I.G.A.'S

The I.R.S. said in December 2014 that jurisdictions with Model 1 I.G.A.'s currently treated as "in effect" can keep that status after December 31, 2014, if they can show they are actively working toward signing an agreement. As of April 2015, the U.S. has signed 58 I.G.A.'s and an additional 55 countries have reached an agreement in substance to sign an I.G.A., with most of those being Model 1 I.G.A.'s.

During a recent conference on tax planning and strategies in the U.S. and Europe, an I.R.S. official said that for jurisdictions that have signed but not yet implemented Model 1 I.G.A.'s, F.I.'s can be treated as compliant as long as those jurisdictions are taking steps to implement F.A.T.C.A. and the I.G.A. and the Treasury is notified of any delays.

These jurisdictions, and those that have not yet signed an I.G.A., will not have a mechanism to exchange F.A.T.C.A. information with the U.S. for 2014. Nevertheless, because F.I.'s resident in such jurisdictions will be treated as compliant, they must still follow the necessary due diligence procedures provided for in Annex 1 of the Model 1 I.G.A. Such due diligence requires the collection of self-certifications, which may be problematic prior to local implementation of F.A.T.C.A., and the I.R.S. has provided some leeway to F.I.'s in the form of additional time. However, if a self-certification is not collected within one year of the date the I.G.A. enters into force, such accounts must be closed. The F.I. will be required to perform pre-existing account due diligence on each closed account and report any with U.S. *indicia*. Reporting for such F.I.'s will be delayed until information exchange between the U.S. and the jurisdiction is implemented.

BRITISH VIRGIN ISLANDS OPENS PORTAL FOR F.A.T.C.A. REGISTRATION

On April 22, the British Virgin Islands ("B.V.I.") opened its Financial Account Reporting System ("B.V.I.F.A.R.S.") to enable financial institutions to register and submit information on their U.S. clients in accordance with the B.V.I.'s agreement with the U.S. on F.A.T.C.A. (the "U.S.-B.V.I. I.G.A.")

B.V.I.-resident F.I.'s that are required to report must register on the B.V.I.F.A.R.S. in order to submit information to the government under the U.S.-B.V.I. I.G.A. Registration is required by June 1, and reporting is required by June 30 with respect to information regarding the 2014 tax year. The B.V.I. government will then transmit the submitted information to the I.R.S. by September 30.

The B.V.I. government highlighted that F.I.'s with nothing to report are not obligated to file a *nil* report, following a recent I.R.S. update. Therefore, if there is nothing to report, there is no mandatory requirement to enroll with B.V.I.F.A.R.S. Although, if the F.I. chooses to submit a *nil* report, it will have to enroll.

CURRENT I.G.A. PARTNER COUNTRIES

To date, the U.S. has signed, or reached an agreement to sign, more than 100 Model 1 I.G.A.'s. An I.G.A has become the 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 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.

The countries that are Model 1 partners by execution of an agreement or concluding an agreement in principle are:

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

This list will continue to grow.

IN THE NEWS

COMINGS AND GOINGS

Ruchelman P.L.L.C. welcomes Elizabeth Zanet as the newest member of the firm's voluntary disclosure practice. Ms. Zanet is a graduate of the State University of New York at Buffalo and New York Law School, where she received her LL.M. in Taxation. Prior to joining Ruchelman P.L.L.C., Ms. Zanet practiced with a large international law firm in New York where she advised clients on U.S. and international tax matters. She is a member of the New York City Bar Association Committee on Personal Income Taxation.

AS SEEN IN...

Foreign investors in U.S. real estate or mortgage debt face the specter of U.S. income taxes, as well as estate and gift tax exposure, not to mention state and local taxes, but even after F.I.R.P.T.A., careful planning foreign investors can limit – or possibly avoid – U.S. tax liability. Philip R. Hirschfeld's article "Foreign Investment in U.S. Real Estate – Think About Taxes Before Investing" in the *Journal of Taxation of Investments* provides an overview of the applicable tax law and outlines a number of acquisition structure that may materially improve a foreign investor's post-tax from investment in the U.S.

OUR RECENT AND UPCOMING PRESENTATIONS

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 arragements; "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.

On February 19-22, 2015, Stanley C.Ruchelman joined the *GGi PG Meeting International Taxation Winter Meeting* in Marbella, Spain, where he presented "Follow up Work on B.E.P.S. Action 6: Preventing Treaty Abuse." The talk addressed the most recent work on B.E.P.S. Action 6, including the release of the second discussion draft for which over 750 pages of comments were submitted by interested parties.

On April 17, 2015, Stanley C. Ruchelman participated in the panel "Exchange of Information Going Global: FATCA, OECD, EU and Beyond" as part of the *ABA/IFA Tax Planning Strategies U.S. and Europe Conference* in Munich, Germany. The discussion outlined the evolution of global exchange of tax information, beginning with the U.S. enactment of F.A.T.C.A. in 2010 and continuing on to the proliferation of similar programs across the globe. It explored the obligations imposed on taxpayers and the overlapping nature of these separate regimes.

On April 23-26, 2015, Galia Antebi attended the *GGi European Regional Conference* in Lausanne, Switzerland, where she led a workshop on "The Post F.A.T.C.A. Form W-8." Through real world situations, particpants learned to navigate the complexities of Form W-8 and its equivalents, by which entities provide F.A.T.C.A. status certification from over 30 possibilities. Ms. Antebi also led a discussion on "Wealth Planning in the New Information Age" as part of the Trust & Estate Planning Practice Group. The panel addressed the impact information demands, information exchanges, and erosion of taxpayer confidentiality have on the modern approach to client work.

On May 8, 2015, Philip R. Hirschfeld participated in a panel on "FIRPTA, Section 892 and REITS" at the *A.B.A. Annual May Meeting* in Washington D.C. The presentation focused on efficient tax structuring for a non-U.S. person's investment in U.S. real estate and acquisition of U.S. mortgage debt by foreign investors. It addressed direct investment as well as investment in partnerships, L.L.C.'s, R.E.I.T.'s, and other investment entities holding these assets, as well as concerns of special investors such as foreign governments who are benefited by Code §892.

Copies of our presentations are available on the firm website at www.ruchelaw.com/publications.

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.

Disclaimer

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