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INSIGHTS

A PROPOSED TREATMENT FOR H.T.V.I.

PRESIDENT'S LEGISLATIVE PROPOSALS

AN ENGLISHMAN IN NEW YORK – TAX CONSIDERATIONS FOR FOREIGN INDIVIDUALS

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EDITORS' NOTE

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

- **A Proposed Treatment for H.T.V.I.** Michael Peggs, co-head of the transfer pricing practice of Ruchelman P.L.L.C., makes a valiant attempt at explaining a method to value intangible property that is "hard to value" while being compliant with the B.E.P.S. Action Plan. He suggests a combination of common sense and reliable data.
- **President's Legislative Proposals.** In late September, the Obama Administration released the tax revisions that are part of its budget proposal. Philip R. Hirschfeld, Elizabeth Zanet, and Rusudan Shervashidze explain new twists to seasoned proposals.
- **An Englishman in New York – Tax Considerations for Foreign Individuals.** What tax challenges do foreign individuals face when they are present in the U.S. on a temporary, non-immigrant basis? Nina Krauthamer and guest author Anastasia Tonello look at the main tax obligations of U.S. citizens and residents, including the significant tax and financial information reporting and disclosure requirements.
- ***Russian Recovery Fund v. U.S.*** For many tax advisers, it is fashionable to complain about the O.E.C.D.'s B.E.P.S. project because it imposes an unrealistic standard of behavior on multinational groups. Then, along comes a case such as *Russian Recovery Fund, Ltd. v. U.S.*, and one understands the problem of real base erosion. Stanley C. Ruchelman and Kenneth Lobo explain.
- **I.R.S. Argues Mylan's Contract is a License of Drug Rights – Not a Sale.** The question of the proper treatment of a contract transferring exclusive rights to the use of a patent – as a sale or a license – is one that has been addressed many times in U.S. jurisprudence. It has recently popped up again in a case before the U.S. Tax Court involving the generic pharmaceutical company Mylan Inc. In September, the I.R.S. filed a memorandum in support of a motion for summary judgment. Stanley C. Ruchelman, Andrew Mitchel, and Christine Long explain the basis for the I.R.S. position and comment on its merits.
- **Indian M.A.T. Exemption.** Following months of debate, the Indian Finance Ministry recently clarified that the Minimum Alternate Tax ("M.A.T.") will not apply to foreign companies that do not have a permanent establishment and/or place of business in India. Shibani Bakshi and Sheryl Shah discuss why the announcement is an affirmation of India's positive attitude towards foreign investment. The next move is up to the Indian Revenue.
- **The Transparent World: Exchange of Information Has Begun & Pacts to Assist Implementation Have Been Assigned.** Despite efforts to repeal F.A.T.C.A. in the U.S. and opposition from abroad, it appears that F.A.T.C.A. is here to stay. Galia Antebi and Philip R. Hirschfeld address the recent September 30 milestone and the advent of exchanges of financial account information with tax administrations of I.G.A. partner jurisdictions.

We hope you enjoy this issue.

- The Editors

A PROPOSED TREATMENT FOR H.T.V.I.

Author
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Tags
B.E.P.S.
H.T.V.I.
Intangible Property
Transfer Pricing

****This article was written prior to the October 5, 2015 release of the B.E.P.S. report on hard to value intangibles. It remains a relevant discussion of the subject with the proviso that tax administrations may consider using actual outcomes (i.e., sales or profits) from intangible asset transactions in place of expected or forecasted outcomes when actual and forecasted outcomes differ and either (a) compensation for the asset or the right to use the intangible changes by more than 20% or (b) sales during the first five years of commercialization of the intangible asset vary by more than 20%. This is the most significant change from the June draft, and interestingly, weakly parallels, in part (b), the commensurate with income exception in Treas. Regs. §1.482-4(f)(ii)(B)(6).****

If you or your clients suffer from H.T.V.I., or "hard to value intangibles," news of a promising treatment has been announced by the O.E.C.D. Centre for Tax Policy and Administration.[1]

Back in the heady days of the emergence of Web 2.0, many young companies and partnerships inadvertently contracted H.T.V.I. in transactions involving the sale or cost-sharing of new technologies and other intangible assets whose future revenues and cash flows were necessarily difficult to forecast. More recently, H.T.V.I. has been singled out as being one of the leading causes of base erosion and profit shifting ("B.E.P.S."), the current affliction of the international tax system as identified by the O.E.C.D.

Many previously untreatable cases of H.T.V.I. have been hotly debated in the course of (i) transfer pricing audits, (ii) mutual agreement discussions between Competent Authorities, and (iii) litigation in courts. Often the arguments related to asset valuations and assumptions were relatively unsophisticated, resembling home remedies applied to cure a serious illness. Now that Web 2.0 has established itself in the business world, the use of hindsight has become popular among tax authorities looking for a rationale to challenge pricing. As a practical matter, tax authorities often do not have the same information as a company, owing simply to the lack of experience with the business. Hindsight, while logically inconsistent with a classic arm's length approach, diminishes the value of information asymmetry during the course of a tax examination.

The O.E.C.D.'s approach to the valuation of H.T.V.I. recommends that multinational companies look to independent transactions in order to find evidence to support the

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1 See "Discussion Draft on Arm's Length Pricing of Intangibles When Valuation is Highly Uncertain at the Time of the Transaction and Special Considerations for Hard-to-Value Intangibles," supplemented by "Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project," O.E.C.D. Publishing, 2015.

treatment of uncertain future events. For example, a company may look to agreements that it has previously entered into or agreements between similarly situated independent parties.

In the event that independent parties to an agreement view the future as highly uncertain, related parties are encouraged to follow these examples and adopt similar terms used to manage the effects of uncertainty, such as agreements with a shorter term or those that include price adjustment clauses, milestone or contingency payments, or stepped royalty rate schedules. Some evidence from arm's length agreements of events that trigger contract renegotiation indicates that renegotiation is proper when it is clear that the initial agreement was entered into at a time that is characterized by uncertainty of success and value. This approach is suggested as a way to conform related-party negotiations with negotiations carried out wholly at arm's length, with respect to the terms of the agreement and future obligations of the contracting parties to revisit said terms. At an unsophisticated level, think of a professional athlete refusing to report to pre-season training camp as a tactic to renegotiate his contract.

Evidence of the form of independent agreements, as well as the ability to discern a foreseeable event from a truly unforeseeable event, are two things that become critically important in the O.E.C.D. approach. It follows that the difference between the expected profit from the exploitation of an intangible asset and the actual profit can differ at arm's length, provided there have been demonstrably unforeseeable events in the period following the intangible asset transaction.

"To become immunized against the future adverse effects of H.T.V.I., the O.E.C.D. proposes that taxpayers provide a full explanation of all forecast inputs and assumptions used at the time of the intangible asset transfer."

To become immunized against the future adverse effects of H.T.V.I., the O.E.C.D. proposes that taxpayers provide a full explanation of all forecast inputs and assumptions used at the time of the intangible asset transfer, as well as how the risks expected to be incurred by the contracting parties are incorporated into these forecasts. This explanation should include a comprehensive "consideration of reasonably foreseeable events." The second and final recommended step is to document differences between forecasted and actual outcomes in subsequent years, and to show that these differences are the result of developments that were unforeseeable at the time of the intangible asset transaction.

Though more burdensome, these recommendations reflect a good measure of common sense, especially if some reliable evidence of contractual terms agreed between independent parties can be found. Of some concern, however, are the examples of a natural disaster and a bankruptcy as unforeseeable events in the discussion draft. The list of surprises or unforeseeable events in business is considered by many to be longer than acts of god or business failures. One need only look at the long lists of risk factors found in S.E.C. filings to appreciate the diversity of events that a business might consider unforeseeable.

A recurring theme of the B.E.P.S. Project, as it relates to transfer pricing matters, is the availability of relevant and reliable data upon which to base comparability analysis and adjustments. The H.T.V.I. discussion draft reprises this theme, as the proposed procedures and tests depend critically on the presence and quality of information and contractual terms. As is noted by the O.E.C.D., this type of information is difficult to find. Though information exists, it must be recognized that much of the building of the digital economy has been funded privately, making the terms of agreements that are relevant to modern businesses significantly harder to locate. While this constraint affects both companies and tax authorities, the approach proposed by the discussion draft places the initial burden of proof on the taxpayer. Availability of examples of intangible asset transactions and contractual terms at the time of a transaction, supplemented by examples found after the conclusion of the transaction, will become increasingly important to supporting valuation assumptions and documenting the entirety of the valuation process. Left unresolved is the relevance of the timing of the transfer pricing documentation due date compared with the transaction date when determining which data were available to the taxpayer under relevant country law.

Clearly the O.E.C.D. views opportunistic asset valuations as abusive. In view of this position, the consistency of the forecasting methods and assumptions employed by companies and their advisors across time and between transactions will become the subject of transfer pricing scrutiny. A company may be at risk of a transfer pricing adjustment if, for example, a tax authority obtains records of both (i) a valuation calculation prepared in respect of a Year 1 transaction of Intangible Asset Type A that assumes the intangible asset's economic life is X years in duration, and (ii) a buy-in payment valuation in respect of a Year 3 transaction of Intangible Asset Type A that assumes the intangible asset's economic life is Y years in duration. It will be ever more important to document the analytical process that is followed to determine the accuracy of assumptions[2] and the standard employed to identify and model uncertain events.

For some, the promise of a cure[3] offered by the O.E.C.D. approach will present an opportunity to vaccinate against certain strains of future transfer pricing uncertainty (once clinical trials are complete and legislative approvals have been granted, of course). Unfortunately for others, a tax authority may well administer the treatment involuntarily, at great expense, and without regard for possible side effects.

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[2] Assumptions that consist of statements that reference the analyst's or valuator's experience would arguably no longer be acceptable.

[3] The O.E.C.D. Committee for Fiscal Affairs has not reached a consensus on the definition of the cure for H.T.V.I.

PRESIDENT'S LEGISLATIVE PROPOSALS

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Tags
14% Tax
19% Minimum Tax
C.F.C.
Deemed Mandatory Repatriation
Subpart F

On September 29, 2015, various changes to the current tax law were proposed in the Obama Administration's Fiscal Year 2016 Budget Proposal (the "Proposal"). The Proposal is designed to provide additional revenue increases and spending cuts. These changes are designed to provide deficit reduction measures. In many respects, the Proposal is a continuation of proposals that have been made, but not enacted, in prior years.

If enacted, the changes described in the Proposal could influence global patterns of investment and employment by U.S. multinationals. The likelihood that the Proposal will be enacted is not high. However, in the U.S., unenacted legislative proposals develop a patina that often make them attractive in later years for budgetary reasons. Tax reductions for some taxpayers must be offset by revenue raised from other sources. Hence, unenacted proposals serve as a resource for those favoring future tax reductions. Additionally, the winner of next year's presidential election may in turn look for revenue raisers – with the Proposal being an easy resource to tap by a future president sharing the same views as Mr. Obama.

The Joint Committee on Taxation ("J.C.T.") published a description and analysis of the Proposal's provisions. However, the magnitude of the consequences of the Proposal is not clear. This article addresses several of the provisions intended to affect U.S. taxation of global operations.

RESTRICT DEDUCTIONS FOR EXCESSIVE INTEREST OF MEMBERS OF FINANCIAL REPORTING GROUPS

The Proposal would modify deductions for excessive interest costs of members of a "financial reporting group," which is defined as a group that prepares consolidated financial statements in accordance with U.S. Generally Accepted Accounting Principles ("G.A.A.P."), International Financial Reporting Standards ("I.F.R.S."), or another method authorized by the Secretary of Treasury under the regulations.

When first proposed several years ago, the interest expense deduction for a member of a financial reporting group generally would be limited to the member's interest income plus its proportionate share of the financial reporting group's net interest expense computed under U.S. tax principles. The interest deduction rule under the original proposal does not apply to financial services entities.

This year's Proposal changes the calculation of the limitation and relies more heavily on data reported on financial statements when computing interest expense. A member's deduction for interest expense generally would be limited if the member has net interest expense for tax purposes and the member has "excess financial statement net interest expense." Excess financial statement net interest expense is the amount by which the member's net interest expense for financial reporting purposes, computed on a separate company basis, exceeds the member's proportionate share of the net interest expense reported on the financial reporting group's consolidated financial statements. A member's proportionate share is a function of its share of the group's E.B.I.T.D.A. (*i.e.*, earnings computed by adding back net interest expense, taxes, depreciation, and amortization) as reflected in the group's financial statements.

When a member has excess financial statement net interest expense, it will have excess net interest expense for tax purposes, for which a current deduction is disallowed in the same proportion that its net interest expense for financial reporting purposes is excess financial statement net interest expense. If there is no excess financial statement net interest expense and the member's net interest expense for financial reporting purposes is less than its proportionate share of the financial reporting group's net interest expense, such excess limitation is converted into a proportionate amount of excess limitation for tax purposes and can be carried forward to the three subsequent tax years.

"In the U.S., unenacted legislative proposals develop a patina that often make them attractive in later years for budgetary reasons."

If a U.S. member of a U.S. subgroup owns stock in one or more foreign corporations, this proposal applies before the Administration's minimum tax proposal. The U.S. subgroup's interest expense that remains deductible after application of this proposal is subject to the limitations on deductibility outlined in the Administration's minimum tax proposal (discussed below).

The goal of this provision is similar to existing legislation in the U.K. and to the B.E.P.S. action on interest deductions and other financial payments. Governments in high tax countries, such as the U.S., become upset when operations in those countries are financed by too much debt. Of course, the point at which debt becomes *too much* is in the eye of the beholder.

REPEAL DELAY IN THE IMPLEMENTATION OF WORLDWIDE INTEREST EXPENSE ALLOCATION

For the purpose of computing the foreign tax credit limitation of Code §904, present law provides detailed rules on how to allocate deductible expenses between U.S.-source income and foreign-source income. The foreign tax credit limitation measures the maximum amount of U.S. tax that can be offset by credits for foreign income taxes. Only U.S. tax on foreign-source income can be reduced by the credit. Since foreign-source taxable income is determined by identifying the source of all items of gross income and the expenses allocated to foreign-source gross income, the allocation of expenses affects a taxpayer's potential exposure to double taxation. As more expenses are allocated to foreign-source income, the limitation is reduced and the exposure to double taxation grows.

When allocating interest expense deductions to domestic-source or foreign-source income, money is treated as a fungible commodity and the interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid. For interest allocation purposes, all members of an "affiliated group" of corporations generally are treated as one taxpayer, and allocations and apportionments of interest expense are made on the basis of assets rather than gross income.[1] Debt is seen as advancing all assets and activities of a corporation, and as a result, the related interest costs are not specifically allocated to any particular item of income. The term "affiliated group" in this context is generally defined by reference to the rules for determining whether corporations are eligible to file consolidated returns.[2]

"Where a taxpayer apportions interest costs based on the tax book value method of apportionment... the basis of stock in shares of a 10%-owned foreign corporation, such as a C.F.C., must be adjusted for its retained earnings that are not otherwise reflected in basis."

Where a taxpayer apportions interest costs based on the tax book value method of apportionment – a method that uses historic costs, adjusted for depreciation and capital contributions – the basis of stock in shares of a 10%-owned foreign corporation, such as a C.F.C., must be adjusted for its retained earnings that are not otherwise reflected in basis. As the basis increases in the shares of a C.F.C., more interest expense is apportioned to the investment in the foreign shares and a smaller portion of worldwide taxable income is considered to be foreign-source taxable income. This rule takes into account chains of foreign corporations that are owned by a first tier C.F.C.

Financial corporations are generally excluded from the affiliate group.[3] Instead, the financial corporation is a separate single corporation for interest allocation purposes. A financial corporation includes any corporation which would otherwise be a member of the affiliated group for consolidation purposes that is a financial institution (as described in Code §581 or §591), the business of which is predominantly with persons other than related persons or their customers, and which is required by state or Federal law to be operated separately from any other entity that is not a financial institution.[4] The category of financial corporations may also include bank holding companies (including financial holding companies), subsidiaries of banks and bank holding companies (including financial holding companies), and savings institutions predominantly engaged in the active conduct of a banking, financing, or similar business.[5]

The current rules for the apportionment of interest costs do not take into account the assets, debt, and interest costs of foreign subsidiaries other than in the way interest costs reduce earnings at the level of the foreign subsidiary when retained earnings increase assets for apportionment purposes. As a result, distortions occur in computing the foreign tax credit limitation because both the U.S. parent's interest expense and the foreign subsidiaries' interest expense are allocated to foreign-source income. In legislation that was enacted in 2004, this problem was addressed by a provision calling for worldwide allocation and apportionment of interest expense.

The American Jobs Creation Act of 2004 ("A.J.C.A."), among other things, modified

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1 Code §864(e)(1) and (e)(2).

2 Code §864(e)(5).

3 Treas. Reg. §1.861-11T(d)(4).

4 Code §864(e)(5)(C) and Treas. Reg. §1.861-11T(d)(4)(ii).

5 Code §864(e)(5)(D).

the interest expense allocation rule by providing a one-time election that allows the taxable income of domestic members of an affiliated group from sources outside the U.S. generally to be determined by allocating and apportioning the interest expense of the domestic members of a worldwide affiliated group on a worldwide-group basis (*i.e.*, as if all members of the worldwide group were a single corporation). Philosophically, this provision shares the same view of interest costs as the excessive interest proposals discussed above, in that its premise is that interest should be apportioned globally.

If this election is utilized, the taxable income of domestic members of a worldwide affiliated group from sources outside the U.S. would be determined by apportioning interest expense on borrowings from the third parties to foreign-source income pursuant to a multi-step formula:

1. Determine the total interest expense of the worldwide affiliated group ("Global Interest").

2. Multiply Global Interest by a fraction in which the numerator consists of the foreign assets of the worldwide group and the denominator consists of the global assets of the worldwide group ("Group Foreign Interest").

3. From the Group Foreign Interest, subtract the portion attributable to the foreign members of the group, *viz.*, the amount that would be apportionable to foreign-source income if the group consisted only of the foreign members.

The remainder is the maximum amount of the U.S. group's interest expense that can be apportioned to the foreign-source gross income of the U.S. group. The amount of interest expense allocated to foreign-source income under these rules then would be further allocated between the three broad categories of foreign-source income on a *pro rata* basis, based on assets. Broadly, these foreign-source income categories are (i) income that is subject to taxation at the full U.S. statutory tax rate, (ii) income that is entirely exempt from U.S. taxation, and (iii) income that is taxed at a variety of different tax rates under the minimum tax system. In principle, the cap will be significantly lower than the apportioned amount under typical rules.

Taxpayers are allowed to exclude certain financial institutions from the affiliated group under the bank group rules for interest allocation purposes under the worldwide fungibility approach. A one-time "financial institution group" election is also available to expand the bank group. At the election of the common parent of the pre-election worldwide affiliated group, the interest expense allocation rules are applied separately to a subgroup of the worldwide affiliated group that consists of

1. all corporations that are part of the bank group, and

2. all "financial corporations."

For this purpose, a corporation is a financial corporation if at least 80% of its gross income is financial services income that is derived from transactions with unrelated persons. For these purposes, items of income or gain from a transaction or series of transactions are disregarded if a principal purpose for the transaction or transactions is to qualify any corporation as a financial corporation.

As discussed below, the Administration proposes to impose tax on foreign income at various rates, including a minimum tax of 19%, a tax at ordinary rates, and zero tax. The apportionment formula in the Proposal would be used to apportion interest expense to each of these baskets.

The common parent of the domestic affiliated group must make the worldwide affiliated group election. Once made, the election applies to the current taxable year and all subsequent taxable years, unless revoked with the consent of the I.R.S. When enacted originally, the election was to be available for taxable years beginning after December 31, 2008. Subsequent legislation[6] deferred the availability of the election until taxable years beginning after December 31, 2020. The Proposal repeals the delay of the worldwide affiliated group election so as to make it available for taxable years beginning after December 31, 2015.

PERMANENTLY EXTEND THE EXCEPTION UNDER SUBPART F FOR ACTIVE FINANCING INCOME

Since 1997, the C.F.C. rules have contained a temporary exception for income derived in the active conduct of a banking, finance, or similar business from the scope of foreign personal holding company income ("F.P.H.C.I.").[7] The presence of F.P.H.C.I. can result in the imposition of current tax for U.S. shareholders.[8] The same temporary exception was also provided in the definition of foreign base company services income ("F.B.C.S.I.") and insurance income, which can also result in deemed dividends to U.S. shareholders.[9]

"The Administration proposes to impose tax on foreign income at various rates, including a minimum tax of 19%, a tax at ordinary rates, and zero tax."

This temporary relief for active banking and finance income expired at the end of last year, and attention has now focused on the need for a retroactive extension.[10] The Proposal includes a permanent extension of relief from the Subpart F rules for active banking and financing businesses. The permanent extension would be effective retroactively for taxable years of foreign corporations beginning on or after December 31, 2014, and for all taxable years of affected U.S. shareholders.

PERMANENTLY EXTEND LOOK-THROUGH TREATMENT FOR PAYMENTS BETWEEN RELATED CONTROLLED FOREIGN CORPORATIONS

Under the Subpart F exception commonly referred to as the "C.F.C. Look-Through Rule," dividends, interest, rents, and royalties received or accrued by one C.F.C. from a related C.F.C. are not treated as foreign personal holding company income to the extent attributable or properly allocable to income of the payor that is neither Subpart F income nor treated as effectively-connected income of the payor C.F.C.

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6 Pub. L. No. 110-289 ("HERA").

7 Code §954(h).

8 Code §951(a).

9 Code §§954(e)(2), (i).

10 Code §954(h)(9).

For this purpose, a related C.F.C. is a C.F.C. that controls or is controlled by the other C.F.C., or a C.F.C. that is controlled by the same person or persons that control the other C.F.C. Ownership of more than 50% of the C.F.C.'s stock (by vote or value) constitutes control for these purposes.

The I.R.S. is authorized to prescribe regulations that are necessary or appropriate to carry out the C.F.C. Look-Through Rule, including regulations appropriate to prevent the abuse of the purposes of such rule. The C.F.C. Look-Through Rule applies to taxable years of foreign corporations beginning after December 31, 2005 and before January 1, 2015, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

The C.F.C. Look-Through Rule reflects the view that the Subpart F rules burden a U.S. multinational company ("M.N.C.") more heavily than the tax laws of other countries when an entity in an M.N.C. group has used business earnings to make cross-border interest, royalty, other payments to another entity in the group. On the other hand, the Administration is concerned that by allowing a C.F.C. to make an untaxed, deductible cross-border payment to a related C.F.C., the C.F.C. Look-Through Rule may facilitate foreign tax reduction because a U.S. M.N.C. might arrange intra-group payments from entities in high-tax countries to entities in low-tax countries. This latter view is consistent with the view of tax planning held by the O.E.C.D. and is reflected in the B.E.P.S. Action Plan.

The Proposal makes the C.F.C. Look-Through Rule permanent, but only as part of its overall plan to impose a 19% minimum tax on foreign income. According to the Administration, the combination of the permanent extension and the minimum tax is an appropriate policy response to concerns of foreign governments and the O.E.C.D. regarding foreign-to-foreign payments. It ensures that such payments could not be used to shift income into entities with effective tax rates below the minimum tax rate of 19%.

IMPOSITION OF A PER-COUNTRY 19% MINIMUM TAX ON FOREIGN INCOME

The Proposal aims to significantly change the taxation of a domestic C corporation's foreign earnings by imposing a per-country minimum tax on the earnings from a C.F.C. or branch from the performances of services abroad. Under the Proposal, the foreign earnings of a C.F.C. or branch from the performance of services are subject to current U.S. taxation at a rate of 19%. This minimum tax can be reduced by a foreign tax credit of 85% of the per-country foreign effective tax rate (the "Residual Minimum Tax Rate"). As a result, if the per-country foreign effective tax rate is at least 22.35% on income that is computed under U.S. income tax principles, no tax will be imposed on the domestic C corporation's foreign income.

The foreign effective tax rate under the Proposal is computed on an aggregate basis over a 60-month period ending on the date the domestic corporation's current taxable year ends or, in the case of a C.F.C., on the date on which the C.F.C.'s current taxable year ends. The foreign taxes taken into account are those taxes that, absent the Proposal, would be eligible to be claimed as a foreign tax credit during the

60-month period. The foreign earnings taken into account for the 60-month period are determined using U.S. tax principles, but would include disregarded payments deductible elsewhere, such as disregarded intra-C.F.C. interest or royalties, and would exclude dividends from related parties.

In addition, the tax base would be reduced by a risk-free return on equity invested in active assets within the country. Active assets generally would include assets that do not generate foreign personal holding company income, determined without regard to both the C.F.C. Look-Through Rule (discussed above) and any election to disregard an entity as separate from its owner.

The minimum tax proposal includes rules for assigning foreign earnings and taxes to a specific foreign country. The basic rule assigns earnings and taxes to the country based on the tax residence determined under foreign law. Thus, for example, if a C.F.C. is incorporated in Country X but is tax-resident in Country Y under both the Country X and Country Y place of management tests for tax residence, the earnings and associated foreign taxes are assigned to Country Y. On the other hand, if instead of a place of management test Country Y uses the place of incorporation test, Country X sees the C.F.C. as a tax resident of Country Y while Country Y sees the C.F.C. as a tax resident of Country X. In this case, the C.F.C. may not be subject to foreign tax anywhere and the C.F.C.'s earnings are therefore subject to the full 19% minimum tax under the proposal. If a C.F.C. is subject to tax in multiple countries, the earnings and all of the taxes associated with those earnings are taxed to the highest-tax country.

Special rules would be implemented under the proposal to restrict the use of hybrid arrangements to shift earnings from a low-tax country to a high-tax country. So, for example, no deduction would be allowed for a payment from a disregarded entity based in a low-tax country to its sole shareholder based in a high-tax country if the dividend is eligible for a participation exemption in the high-tax country. The earnings assigned to a low-tax country would be increased for a dividend payment from a high-tax country that is treated as deductible in the high-tax country.

"Under the Proposal, no U.S. tax would be imposed on the sale by a U.S. shareholder of stock of a C.F.C. to the extent that any gain reflects the undistributed earnings of a C.F.C."

The minimum tax would be imposed on current foreign earnings even if repatriated to the U.S. As a result, tax management of a U.S.-based M.N.C. would face the following choices: (i) pay tax abroad at a rate of at least 22.35%, in which case there would be no further tax upon repatriation, or (ii) pay tax in the U.S. under Subpart F at the statutory rate of 35% for C corporations with taxable income in excess of $10 million.

C corporations would no longer be taxed on increased investment in U.S. property.[11] An accompanying provision would exclude C corporations from the benefit of the previously taxed income rules of Code §959.

Under the Proposal, no U.S. tax would be imposed on the sale by a U.S. shareholder of stock of a C.F.C. to the extent that any gain reflects the undistributed earnings of a C.F.C. This is because these undistributed earnings would generally have already been subject to tax under the Subpart F rules, the 19% minimum tax rule, or the 14%

[11] Code §956.

one-time tax rule (discussed below). Also, the Proposal would tax any stock gain attributable to unrealized gain in the C.F.C.'s assets in the same manner as would apply to the future earnings from the C.F.C.'s assets. That is, the stock gain would be subject to the minimum tax or to tax at the full U.S. tax rate to the extent that the gain reflects unrealized appreciation in assets that would generate earnings subject to the minimum tax or Subpart F, respectively.

The Proposal would not change the present law on the taxation of foreign-source royalty and interest payments received by a U.S. corporate taxpayer. These payments would be subject to the full U.S. tax rate. To the extent a foreign branch of a U.S. corporation uses intangible assets owned by its U.S. parent, the branch would be treated as making royalty payments to its owner that are recognized for U.S. tax purposes.

As mentioned above regarding the apportionment of interest expense, interest expense incurred by a U.S. corporation must be apportioned to a C corporation's income as part of the full tax basket, the minimum tax basket, and/or the tax-free basket. For interest expense allocated to the last basket, no deduction would be permitted.

This provision would be effective for taxable years beginning after December 31, 2015.

MANDATORY DEEMED REPATRIATION: IMPOSITION OF A ONE-TIME 14% TAX ON PREVIOUSLY UNTAXED FOREIGN INCOME

The above-described 19% minimum tax on foreign income generated after the effective date of the provision would be accompanied by a one-time 14% tax on a C.F.C.'s deferred earnings accumulated for tax years beginning before January 1, 2016. Thus, this proposal has been described as a mandatory deemed repatriation.[12] The 14% tax would be paid over five years. A credit would be available for foreign taxes on the deferred earnings. However, the amount of the creditable tax would be reduced to reflect the fact that the taxable income under the deemed repatriation provision will be subject to U.S. corporate tax at a rate that is much less than the standard tax rate of 35%. Only 40% of creditable foreign taxes will be available for credit.

This provision would become effective on the date of enactment, but is contingent upon the enactment of the 19% minimum tax.

CLOSE LOOPHOLES UNDER SUBPART F: EXPANDING ATTRIBUTION RULES & ELIMINATING THE 30-DAY GRACE PERIOD

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12 Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal, JCS-2-15, p. 62.

The Proposal would tighten the C.F.C. rules by closing down two perceived "loopholes." These proposals expand the C.F.C. constructive ownership rules and eliminate a 30-day ownership requirement in present law. These proposals are effective for taxable years beginning after December 31, 2015.

In determining whether a foreign company is a C.F.C., Code §958(b) incorporates the constructive ownership rules of Code §318. Section 318(a)(2) provides that stock owned by a shareholder of a company may be attributed downwards to that company, which makes that company the owner of the shares. However, Code §958(b)(4) then modifies these rules by providing that constructive ownership is not to be applied to consider a U.S. person as owning stock that is owned by a non-U.S. person.

When foreign companies acquire U.S. target companies having C.F.C. subsidiaries, the post-acquisition structure is commonly referred to as a sandwich structure in which the U.S target company is the "meat" in the sandwich and the foreign acquiring company and the C.F.C.'s are the two slices of bread.

Under the current law, the C.F.C. status of the foreign subsidiaries can be eliminated if the foreign parent acquires more than half their stock. As mentioned above, ownership by the foreign parent is not attributed to the U.S. target for purposes of determining the status of the foreign corporation as a C.F.C. Consequently, the foreign company can subscribe for newly-issued stock in the C.F.C. in order to eliminate C.F.C. status. Since the C.F.C. constructive ownership rules do not attribute a foreign parent's ownership of a foreign subsidiary to a U.S. target, the foreign subsidiary is no longer a C.F.C. even though all of its stock is owned by the foreign parent group.

In Notice 2014-52, the I.R.S. issued new rules to try to halt certain inversion transactions that are the intended target of Code §7874. Section 3.02(d) of the Notice states that after an inversion transaction, the inverted group may cause an expatriated foreign subsidiary to cease to be a C.F.C. The Notice recognizes that:

> [A]fter an inversion transaction, a foreign acquiring corporation could issue a note or transfer property to an expatriated foreign subsidiary in exchange for stock representing at least 50 percent of the voting power and value of the expatriated foreign subsidiary. The expatriated foreign subsidiary would cease to be a C.F.C.

The Notice states it will stop these transactions by either preserving the C.F.C. status of the foreign subsidiary or by triggering current income inclusion under Code §956. However, the Notice does not apply to non-inversion transactions such as when the new foreign parent purchases in cash the stock of the U.S. target only. Additionally, some practitioners believe the I.R.S. Notice may extend beyond the scope of the statute and may be invalid for that reason.

The Proposal would change the statutory attribution rules to allow downward attribution from the foreign parent to its U.S. target subsidiary so that the U.S. target's foreign subsidiaries will remain C.F.C.'s. This proposal would apply to any transaction, and not just inversion transactions as addressed in the Notice.

This provision is to be applied prospectively.

The second proposed provision changes the current rule that a Subpart F deemed income inclusion can only occur if the foreign company was a C.F.C. for an uninterrupted period of 30 days. This provision eliminates this 30-day grace period. The provision addresses transactions in which a foreign corporation is acquired at the end of the relevant taxable year so that the 30-day rule is not met. During that period, restructuring can apply without recognition of income under Subpart F. An example is a check-the-box election that would otherwise result in the generation of Foreign Personal Holding Company Income. Under the proposed provision, the Foreign Personal Holding Company Income would still be realized in such cases.

ADMINISTRATION FAVORITES REPROPOSED

The Proposal contains provisions that were included in prior budgets but which have not been enacted. These include provisions to

- limit shifting of income through intangible property transfers,
- disallow the deduction for excess non-taxed reinsurance premiums paid to affiliates,
- modify tax rules for dual capacity taxpayers,
- tax gain from the sale of a partnership interest on a look-through basis,
- modify §§338(h)(16) and 902 to limit credits when non-double taxation exists,
- restrict the use of hybrid arrangements that create stateless income,
- limit the ability of domestic entities to expatriate when group management remains in the U.S., and
- exempt foreign pension funds from the application of the Foreign Investment in Real Property Tax Act ("F.I.R.P.T.A.").

AN ENGLISHMAN IN NEW YORK – TAX CONSIDERATIONS FOR FOREIGN INDIVIDUALS[1]

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Tags
Closer Connection Test
Estate Tax
Form 3520
Form 8938
Substantial Presence Test
Tax Residency
Trusts

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BACKGROUND

The phrases "green card" and "U.S. citizen" have the ability to strike panic and even terror in tax advisors around the world. It is well known that the U.S.'s Internal Revenue Service ("I.R.S.") casts a wide – indeed worldwide – net with regards to the tax obligations of U.S. persons, which include lawful permanent residents (or "green card holders") and U.S. citizens. Less well known, and often misunderstood, are the tax consequences imposed on those with non-immigrant status, those holding ownership of foreign corporations, and on U.S. property.

WHAT IS TAX RESIDENCY IN THIS CONTEXT?

Any foreign individual present in the U.S. on a temporary, non-immigrant basis should determine their U.S. tax residency.

How Does the "Substantial Presence Test" Work in Practice?

Even if a foreign individual does not become a green card holder, a foreign individual can become a U.S. tax resident if they are present in the U.S. for 183 days or more during a rolling three-year period (the Substantial Presence Test), assuming presence in the U.S. for at least 31 days during the tax year in question. The test uses a weighted formula, giving full weight to days present in the current year, one-third of the days in the prior year, and one-sixth of the days in the second prior year. A person may be present in the U.S. on average for roughly 120 days each year without becoming a resident.

What Are the Filing and Reporting Requirements?

U.S. tax residents are subject to filing and reporting requirements including the federal income tax filing (I.R.S. Form 8938, *Statement of Specified Foreign Financial Assets*) and must disclose details of non-U.S. bank accounts and other foreign financial assets on annual F.B.A.R. filings (FinCen Form 114). A comparison of Form 8938 and F.B.A.R. requirements is available on the I.R.S. website.

Are There Any Exemptions?

Certain individuals are exempt from the Substantial Presence Test (*e.g.*, a student temporarily present under an F, J, M, or Q visa as well as a teacher or trainee under a J or Q visa – the individual is required to file I.R.S. Form 8843).

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[1] The following was originally published on LexisPS and has been modified in a manner consistent with our format. The authors would like to acknowledge the contribution of Galia Antebi in the preparation of this article.

When Does Residency Begin?

The tax residence of a person who meets the Substantial Presence Test is generally the first day during the calendar year on which the individual is present in the U.S. (the "residency starting date"). A person may be present in the U.S. for up to ten days without triggering the residency starting date if the individual's tax home was in a foreign country and they maintained a closer connection to that foreign country than to the U.S.

What is the Closer Connection Exception?

A person who otherwise meets the Substantial Presence Test may be treated as a non-resident if they can demonstrate a "closer connection" to another foreign country. To come within this exception, the individual must be present in the U.S. for fewer than 183 days in the current year and must maintain a "tax home" in a foreign country during the year. Establishing a closer connection during the year to the foreign country of the tax home takes into account factors such as

- the person's home,
- family,
- personal belongings,
- social clubs,
- banking relationships,
- business,
- driver's license,
- voting status, and
- official forms filed by the person.

Special rules apply to persons who move between foreign jurisdictions.

I.R.S. Form 8840 (*Closer Connection Exception Statement for Aliens*) is used to claim the closer connection exception. An individual who claims this exemption is not required to make F.B.A.R. filings or file Form 8938.

How Do Tax Treaties Affect Matters?

Even though a foreign individual is a resident under U.S. internal law, they may be a non-resident under an income tax treaty for certain U.S. tax purposes. The residence article of an income tax treaty generally contains a tiebreaker provision applicable to an individual classified as a resident of both countries (a "dual resident") – the individual will be treated as resident of only one of the treaty countries for treaty purposes.

A series of tests is applied in a specific order to the particular facts and circumstances of the dual resident to establish residence status. Once the individual's residence is determined under a particular test, there is no need to proceed to another test. In general, exclusive residence is determined by applying the following tests in the following order:

> *"Foreign individuals should carefully plan for and be aware of the residency start date if completing pre-immigration tax planning actions... after that date has adverse U.S. tax consequences."*

1. The individual is deemed to be a resident of the country in which a permanent home is available.

2. If the individual has a permanent home in both countries or in neither country, they will be deemed to be a resident of the country with which their personal and economic relations are closer – this is known as the center of the individual's vital interests.

3. If the closer economic relations cannot be determined, the individual will be a resident of the country in which he has an habitual abode.

4. If they have a habitual abode in both countries or in neither one, they will be deemed to be a resident of the country of which he is a national.

If the issue cannot be settled by the application of these tests, the competent authorities of both countries (the I.R.S. and its overseas counterpart) will decide by mutual agreement the country of which the individual will be considered an exclusive resident.

How Do You Claim a Treaty Benefit?

To claim a treaty benefit, the individual must prepare an income tax return as a non-resident alien on Form 1040NR and file Form 8833 (*Treaty-Based Return Disclosure Under §§6114 or 7701(b)*). This should include

- a statement that the taxpayer is claiming a treaty benefit as a non-resident of the U.S.,
- the facts relied upon to support the position taken,
- the nature and approximate amount of income that is exempted, and
- the specific treaty provision for which the taxpayer is claiming a treaty benefit.

An individual who claims this exemption is required to make F.B.A.R. filings (FinCEN Form 114) reporting certain foreign financial assets, but not I.R.S. Form 8938 (*Statement of Specified Foreign Financial Assets*) under a recent policy change.

Recommendation: Foreign individuals should carefully plan for and be aware of the residency start date if completing pre-immigration tax planning actions (such as a sale of property or assets) after that date has adverse U.S. tax consequences.

WHAT IS THE POSITION AROUND THE OWNERSHIP OF SHARES OF FOREIGN CORPORATIONS?

Assuming that the foreign individual is a U.S. tax resident and has investments in foreign corporations, the potential application of the rules applicable to controlled foreign corporations ("C.F.C.'s") and passive foreign investment companies ("P.F.I.C.'s") must be analyzed.

What is a C.F.C.?

A foreign corporation will be treated as a C.F.C. if "U.S. Shareholders" (defined to mean U.S. persons holding 10% or more of the stock by voting power) own more than 50% of the stock (by voting power) after application of attribution and constructive ownership rules. Stock owned by a non-resident alien is generally not attributed to a U.S. taxpayer under these rules.

What is a P.F.I.C.?

A P.F.I.C. is defined as a foreign corporation where 75% or more of the corporation's income is considered 'passive' or 50% or more of the company's assets are investments that produce or are held for the production of passive income. A special look-through rule applies to 25% or greater subsidiaries owned by the foreign corporation.

The C.F.C. rules (which generally pre-empt the P.F.I.C. rules, discussed below) subject certain types of income allocable to a U.S. shareholder to immediate U.S. taxation, whether or not distributed, and characterize certain gains upon disposition of the stock as ordinary income. Unless certain exceptions apply, the P.F.I.C. rules are designed to penalize U.S. taxpayers on 'excess distributions' from a P.F.I.C. or upon a disposition of P.F.I.C. stock, imposing the highest ordinary income rates and an interest charge.

Recommendation: Foreign individuals should consider whether the C.F.C. rules can be avoided by restructuring the ownership of the potential C.F.C. by sale or gift of shares of in the corporation before the residency starting date. Foreign individuals should consider selling P.F.I.C. shares unless it is fairly certain that there will be no sale of or excess distributions from the P.F.I.C. during the period of the tax residency.

Note that the rules applicable to C.F.C.'s and P.F.I.C.'s can also apply if such interests are owned by a trust in which the individual has an interest or is treated as the granter. It is common for a foreign trust to own a holding company for investments in stocks and securities, which will be characterized as a P.F.I.C. It is often recommended that a special U.S. "check the box election" be made to treat the P.F.I.C. as a disregarded entity for U.S. tax purposes (assuming no other adverse U.S. income or estate tax consequences).

WHAT IS THE POSITION IN RESPECT OF TRUSTS?

Foreign persons who have settled foreign trusts or are (or will be) foreign trust beneficiaries must be cognizant of several special rules.[2] A trust will be considered to be a foreign trust unless

- a U.S. court can exercise primary supervision over trust administration (the "Court Test"), and

[2] See Code §§643, 672, 677, 679 and 684.

- U.S. persons control all substantial trust decisions (the “Control Test”).

How Are Grantor Trusts Approached?

The grantor of a “grantor trust” is generally treated as the owner of the assets, and all income and gains of the trust are taxed currently to the grantor. The grantor trust rules for U.S. tax persons differ from that with respect to foreign persons who are non-resident aliens. A trust established by a non-resident alien will be treated as a grantor trust only if the trust is revocable or can benefit the grantor and spouse exclusively. If the foreign individual becomes a U.S. taxpayer, a trust that was a foreign non-grantor trust when established may become a grantor trust if other rights are present that would otherwise make the trust a grantor trust (*e.g.*, where income may be paid to the grantor or spouse in addition to others).

The foreign individual may therefore be taxable on the income and gains of the trust. It should also be noted that when the foreign individual leaves the U.S. and is no longer a U.S. tax resident, that trust may revert to foreign non-grantor status. In that case, there may be a deemed sale or exchange of the trust’s assets, taxable to the foreign individual, under a special rule applicable to transfers of property by U.S. persons to a foreign trust or estate.

“The grantor of a ‘grantor trust’ is generally treated as the owner of the assets, and all income and gains of the trust are taxed currently to the grantor.”

A foreign trust established by a U.S. tax resident will be treated as a grantor trust. Furthermore, even if a previously-established trust would not otherwise be treated as a grantor trust, if the foreign individual transferred property to the foreign trust within five years of the residency start date, the trust will be treated as a grantor trust (as to the foreign individual) unless the terms of the trust prohibit any U.S. person from receiving any income (whether current or accumulated) or any corpus, either during the life of the trust or upon its termination.

If the foreign individual is the beneficiary (but not the grantor) of a foreign trust, the individual may be treated as the owner of the trust to the extent of any property (and cash) transferred by the foreign individual to the grantor of the trust. This prevents a foreign person intending to move to the U.S. from gifting assets to another foreign person, who then establishes a trust for the benefit of the person moving to the U.S.

Is the Position Different Around Non-Grantor Trusts?

If a foreign trust is not treated as a grantor trust, a U.S. tax resident will generally be taxed on distributions of “distributable net income” (or “D.N.I.”) which, in the case of a foreign non-grantor trust, will include capital gain income realized by the foreign trust. In addition, a distribution of undistributed net income (“U.N.I.”) from a foreign non-grantor trust may be subject to onerous throwback taxes on accumulated income. A loan from a foreign trust or the uncompensated use of trust property to or by the U.S. tax resident can be treated as a distribution from the trust, with certain exceptions, potentially taxable to the individual.

Recommendation: Planning in advance of the residency start date may mitigate some unintended and potentially harsh results. For example, distributions of D.N.I. and U.N.I. should be made prior to the residency start date. Consideration should be given to excluding any U.S. persons as beneficiaries of foreign trusts if the trust would otherwise become a U.S. grantor trust after the residency start date. Any foreign trust to be established by the U.S. tax resident to benefit non-U.S. persons should be created and funded prior to the residency start date.

WHAT ARE THE KEY CONSIDERATIONS WHEN REPORTING ON I.R.S. FORM 3520?

The U.S. requires U.S. taxpayers to report gifts and bequests from foreign persons and distributions from foreign trusts on I.R.S. Form 3520. A gratuitous transfer from a foreign corporation or partnership must also be reported and, under Treasury regulations, may be subject to income tax. In addition, U.S. tax rules will treat a distribution through an intermediary (other than the grantor of the trust) as made directly to the U.S. person. For example, a distribution to a foreign sibling of the U.S. tax resident from a discretionary foreign trust established by a foreign parent will generally be treated as a distribution directly from the foreign trust to the U.S. tax resident, if the sibling makes a gift of that distribution to the U.S. tax resident.

Recommendation: It is generally desirable to receive gifts prior to the residency start date. Trust beneficiaries should request that the appropriate trust beneficiary statement be prepared for purposes of completing I.R.S. Form 3520.

HOW DOES THE U.S. ESTATE TAX OPERATE?

U.S. estate tax is imposed on a non-resident alien decedent's U.S. situs property, as specially defined to include, among other things, shares of stock of U.S. corporations, and U.S. real and tangible property. Portfolio debt obligations, bank accounts, and life insurance proceeds on the life of a non-resident alien are not treated as U.S. situs assets. U.S. gift tax is imposed on gifts of U.S. real and tangible personal property – gifts of intangible assets (*e.g.*, shares of stock) are excluded. The estate tax exemption amount, however, is limited to $60,000 – far less than the $5.43 million lifetime exemption available to U.S. citizens and residents who are taxed on the worldwide estate.

For U.S. estate and gift tax purposes, a foreign person is treated as a resident if he or she is domiciled in the U.S. A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of leaving. A person who is temporarily present in the U.S. would not ordinarily be treated as a U.S. domiciliary, particularly if the person continues to have significant contacts with his or her original jurisdiction of domicile, but the particular facts and circumstances should be carefully reviewed. Estate and gift tax treaties to which the U.S. is a party, or, in the case of Canada, the income tax treaty with the U.S., may modify these rules. Newer treaties generally reserve taxation to the jurisdiction of the domicile, with notable exceptions for real property and business property.

Recommendation: The potential application of an estate and gift tax treaty is particularly critical and should not be overlooked. Nevertheless, foreign individuals temporarily present in the U.S. should exercise caution in purchasing a U.S. residence, moving valuable tangible property to the U.S. and acquiring other U.S. situs assets.

RUSSIAN RECOVERY FUND V. U.S.

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Tags
Built in Loss
Carryover Basis
Code §754
Partnerships
Partnership Contributions

For many tax advisers, it is fashionable to complain about the O.E.C.D.'s B.E.P.S. project because it imposes an unrealistic standard of behavior on multinational groups. Then, along comes a case such as *Russian Recovery Fund, Ltd. v. U.S.*,[1] and one understands the problem of real base erosion. Here, hubris and greed in the financial services sector team up to make the O.E.C.D. look good.

BACKGROUND

The case involved a distressed asset/debt ("D.A.D.") transaction. This is a loss importation arrangement in which high basis, low value assets owned by a tax indifferent entity with regard to the U.S. – think of Cayman Islands funds with non-U.S. investors – are transferred to a foreign entity that is structured as a partnership for U.S. tax purposes. The goal is to allow U.S. investors the opportunity to harvest built-in losses while deriving cash-on-cash gains.

Russian Recovery Fund, Ltd. ("R.R.F.") was formed to capitalize on opportunities created by Russia's 1998 default on its sovereign debt. R.R.F. was a Cayman Islands L.L.C. created to invest in distressed Russian assets. When the government of the Russian Federation defaulted on all of its sovereign debt obligations in 1998, instruments issued by Russia and derivatives of such instruments lost virtually all of their value. The ruble also collapsed and was no longer freely traded due to currency exchange limitations imposed by the Russian Central Bank. Further complicating matters was the policy of the Russian government under which only a limited number of large international banks were recognized as intermediaries that could access the debt or trade in rubles. In the wreckage, R.R.F. saw an opportunity.

R.R.F.'s financial model involved the acquisition of devalued Russian debt at pennies on the dollar in anticipation of a recovery of the ruble and something approaching face value of debt instruments. Given the depressed nature of the debt – most were worth less than 10% of face value – even small increases would produce substantial gains because of high leverage. Because non-Russian hedge funds such as R.R.F. were not eligible to own ruble-denominated Russian Federation obligations directly, the investment was structured as a credit derivative swap transaction memorialized in credit-linked notes. The authorized bank retained legal title to the bonds but swapped all of the economic risk and benefit to a third party, such as a hedge fund, for cash or some other form of consideration.

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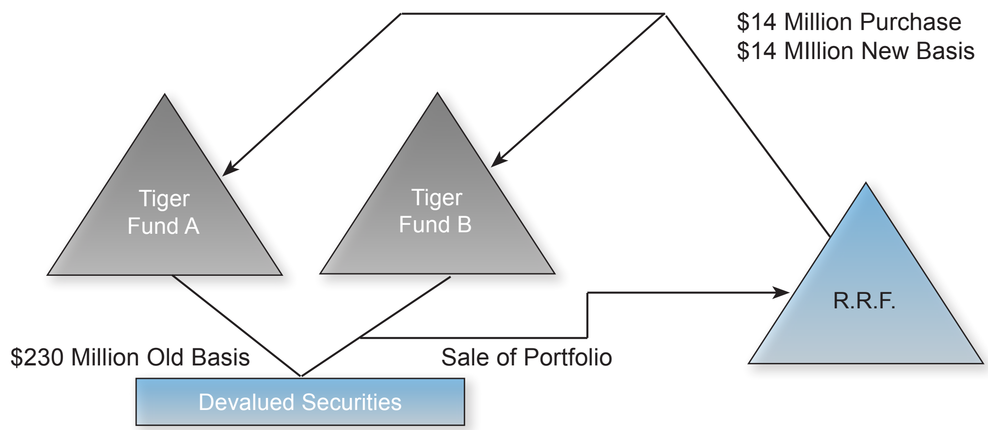
[1] 122 Fed. Cl. 600 (2015).

The offering memorandum R.R.F. used to solicit potential investors required participants to agree to stay in the fund for at least three years unless the fund appreciated by 100%, in which case a partial redemption was possible. Investors were warned that the fund was only suitable for those having no need for liquidity with respect to their investment. Investors were also warned that shares could not be transferred without approval by the Board of Directors, which could be withheld for any reason.

The serious marketing efforts lasted about six months, from the end of 1998 until June 1999. At that point, active marketing came to an end. If the scope of the investment story ended at this point, there would have been no tax controversy. Gains would have been computed based on the purchase price of the derivative instruments and all gains recognized at the level of R.R.F. would have been passed through to R.R.F.'s U.S. investor group as illustrated below:

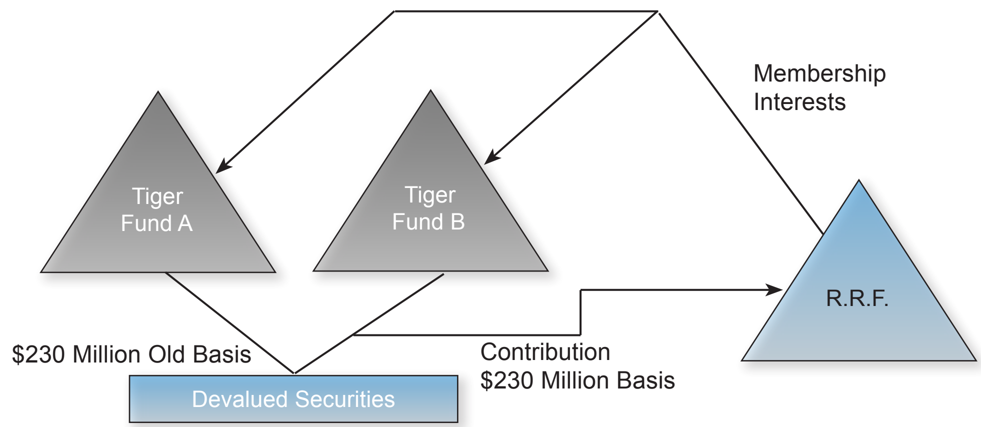


However, the year was 1999, and Gordon Gekko of movie (*Wall Street*) fame remained an icon. This investment strategy was dismissed as simplistic.

At about this point in time, R.R.F. held discussions with two offshore funds (the "Tiger Funds") managed by Tiger Management, L.L.C. At the time, Tiger Management was one of the world's largest managers of hedge funds, with assets over $20 billion under management. The Tiger Funds held significant positions in derivative instruments that reflected floating rate, coupon-bearing bonds issued by the Russian government. These securities were acquired in transactions brokered by Deutsche Bank. The plan was relatively simple in its premise. A sale of the devalued derivative instruments would have triggered a loss to the Tiger Funds that might or might not generate a tax benefit, depending on the make-up of the investor group in the Tiger Funds. If the investors were non-U.S. persons or tax exempt U.S. entities, U.S. tax benefits would be frittered away. However, if the Tiger Funds contributed the same assets to a partnership having U.S. investors, the high basis in the low-value assets would be preserved, and at the time of sale of those assets by the partnership, the U.S. members of the investor group would be entitled to claim the losses realized by the partnership. (In a sense, the losses would have been "imported" to the partnership and realized by the partner group at the time.)

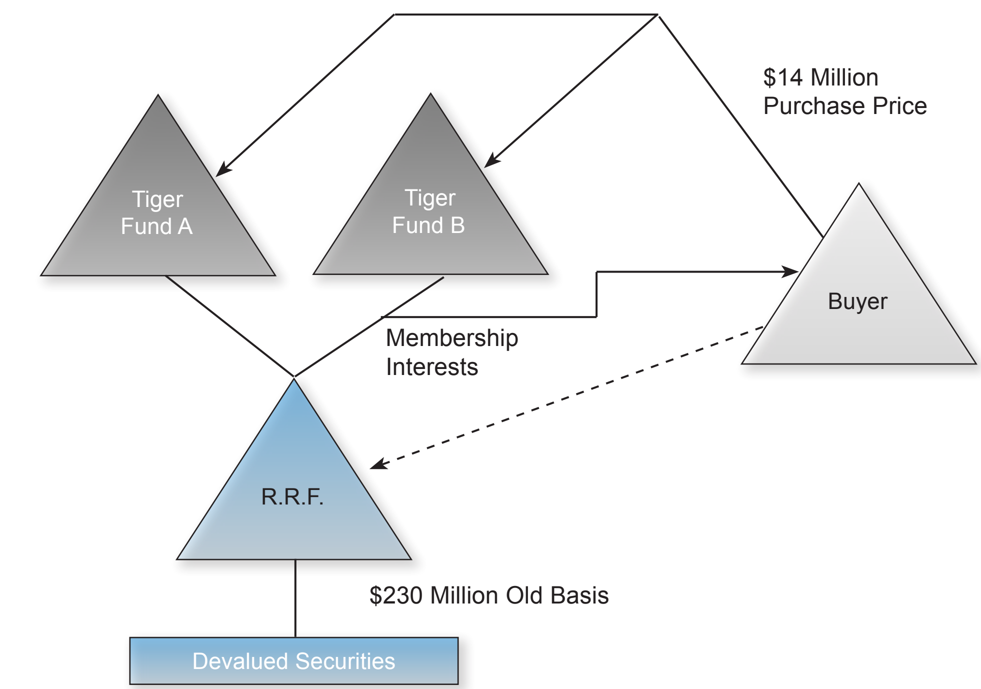
> ***"At that point, active marketing came to an end. If the scope of the investment story ended at this point, there would have been no tax controversy...***
>
> ***However, the year was 1999, and Gordon Gekko of movie (Wall Street) fame remained an icon. This investment strategy was dismissed as simplistic."***

STEP 1



As the Tiger Funds were not interested in remaining partners, they could sell their interests in R.R.F. as soon as possible, thereby cashing out of a devalued investment.

STEP 2



In March 1999, Deutsche Bank prepared a tax shelter registration under its own name for an entity to be called "Preferred Stock Financing Transaction" (a generic placeholder name).

In 1999, General Cigar Corporation, a U.S. publicly-traded corporation, was interested in acquiring investments in depreciated Russian assets. Its board of directors made a decision to invest up to $25 million in deeply discounted, high-yield instruments and to advise the financial industry that the company was looking at strategies to generate tax benefits through these investments.

Meetings were held between Deutsche Bank and R.R.F. regarding the composition of R.R.F. investors. These meetings were intended to assure Deutsche Bank that individual investors held significant interests in the entity, which would protect the benefit of the built-in losses in the derivative instruments. The fear was that significant corporate investors in R.R.F. could preclude later resale of depreciated assets to tax-interested buyers.

Ultimately, the following three transactions occurred in 1999 in relatively close proximity to each other, approximating the facts in the second diagram above, labeled "Step 1."

- The Tiger Funds contributed a derivative instrument based on credit-linked notes to R.R.F. in return for shares of R.R.F. having a value of almost $15 million.
  - The basis in the derivative instrument contributed to R.R.F. was $230 million, which was intended to be carried over to R.R.F. under ordinary U.S. partnership tax rules.
  - The hedge funds negotiated a waiver of the three-year hold in the fund in the form of a right of redemption. The funds also negotiated a waiver of the mandatory representation that the transaction was being made for the purpose of investment.
- Within a period of weeks, the funds sold the shares of R.R.F. to a party related to R.R.F. for approximately $14 million.
  - During the period in which the transaction was negotiated, the value of Russian securities may have increased. However, the price at which the transaction closed was less than the value initially sought by the funds.
  - R.R.F. negotiated a provision with Deutsche Bank under which this transaction would not be registered with the I.R.S. as a tax shelter.
- General Cigar Corporation acquired approximately 77% of the derivative instruments held by R.R.F. for approximately $21 million, consisting of cash in the amount of approximately $17.95 million and preferred stock in General Cigar Corporation valued at approximately $3.23 million.
  - As a result of the acquisition, R.R.F. claimed a loss in the amount of $178 million that flowed through to its partners, principally consisting of the related party that acquired the partnership interest from the Tiger Funds.
  - The key to the loss generated at the level of R.R.F. was the status of the first transaction as a contribution of assets to a partnership in return for the issuance of a partnership interest by R.R.F.

- On a cash-on-cash basis, R.R.F. and its related parties generated a profit in excess of almost $7.2 million from the point in time when the Tiger Funds were bought out and a significant portion of the derivative instruments were sold to General Cigar Corporation.

In the year 2000, R.R.F. sold the balance of the derivative instruments for a cash profit of approximately $7.5 million but at a tax loss of approximately $49.8 million. The balance of the tax loss was realized in 2004.

"U.S. courts have developed analytical filters to test whether a taxpayer should really benefit from certain statutory provisions."

ISSUE PRESENTED

On examination, the I.R.S. disallowed both losses. The I.R.S. asserted that the Tiger Funds never became true partners in R.R.F. and always intended to flip the partnership interest in R.R.F. to the purchaser that was related to R.R.F. In other words, the contribution of high basis, low value shares to R.R.F. was a sham transaction. The true transaction was a purchase of the derivative instruments for approximately $14 million, which would cap the loss at that amount. The Court of Federal Claims affirmed the I.R.S.'s position.

RATIONALE

The thrust of the court's decision was that the set of structured transactions engineered for R.R.F. and the Tiger Funds never created a partnership and therefore basic partnership concepts – such as carryover basis from a partner to a partnership when an asset other than cash is contributed to the partnership in return for the issuance of a partnership interest – never came into play.

U.S. courts have developed analytical filters to test whether a taxpayer should really benefit from certain statutory provisions. Because these inquiries are judicially-created overlays to the Code, they are somewhat amorphous and in some respects overlap. One such provision is whether the parties intended to form a partnership within the meaning of U.S. tax jurisprudence. According to one court:

> A genuine partnership is a business jointly owned by two or more persons (or firms) and created for the purpose of earning money through business activities. If the only aim and effect are to beat taxes, the partnership is disregarded for tax purposes...'[T]he absence of a nontax business purpose is fatal.'[2]

This parallels a decision of the U.S. Supreme Court, holding:

> A partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses. When the existence of an alleged partnership arrangement is challenged by outsiders, the question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both. And their intention in this respect is a question of

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2 *ASA Investerings Partnership v. Commr.*, 201 F.3d 505, 512 (D.C. Cir. 2000).

> fact, to be determined from testimony disclosed by their 'agreement, considered as a whole, and by their conduct in execution of its provisions.' [*Citations omitted*.][3]

A transaction must also have economic substance in order to be recognized for income tax purposes. One court described the rationale behind the economic substance test as follows:

> The economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code. From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit. In this regard, the economic substance doctrine is not unlike other canons of construction that are employed in circumstances where the literal terms of a statute can undermine the ultimate purpose of the statute. * * * [A]lthough the taxpayer has an unquestioned right to decrease or avoid his taxes by means which the law permits, the law does not permit the taxpayer to reap tax benefits from a transaction that lacks economic reality.[4]

Transactions that are mere parts of an overall integrated transaction must be judged by the substance of the overall transaction. While the step transaction doctrine has been looked to in many decisions, the Supreme Court used the following language in one case:

> Under this doctrine, interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction. By thus 'linking together all interdependent steps with legal or business significance, rather than taking them in isolation,' federal tax liability may be based 'on a realistic view of the entire transaction.' [Citations omitted.][5]

Applying these tests, the court concluded that the Tiger Funds wanted to sell the derivative instruments that had lost most of their value and were not interested in partnering with R.R.F. for a mid-term or long-term hold. They negotiated the right to sell or to have their interests completely redeemed and refused to certify that an investment intent existed for the contribution. These actions did not create a partnership in the circumstances presented. The conclusion that no partnership existed is consistent with a provision of the Income Tax Regulations addressing sham partnerships:

> The provisions of subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of subchapter K * * *. Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter

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3 *Commr. v. Tower*, 327 U.S. 280, 287 (1946).

4 *Coltec Industries, Inc. v. U.S.*, 454 F.3d 1340, 1353–57 (D.C. Cir. 2006).

5 *Commr. v. Clark*, 489 U.S. 726 (1989).

> K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances. Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K—
>
> (1) The purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners;
>
> (2) One or more of the purported partners of the partnership should not be treated as a partner; * * *
>
> (5) The claimed tax treatment should otherwise be adjusted or modified.[6]

Finally, R.R.F. was liable for a 40% accuracy-related penalty due to misstating its income. R.R.F. attempted to argue that it relied on the advice of its tax preparer, EY, and therefore, it had reasonable cause to believe the transaction was tax compliant. EY did not provide tax advice to R.R.F. because it did not independently investigate the transaction. Rather, it merely followed R.R.F.'s instructions.

CONCLUSION

In a bygone era of financial products and big law opinions in support of anticipated outcomes, one U.S. tax adviser was quoted as saying that capital gains tax for corporations was optional, not mandatory. Recognized gains could be offset by engineered losses such as those claimed by R.R.F. Now, we are in the global era of B.E.P.S., and in light of holdings such as the one in Russian Recovery Fund, it appears that the hubris expressed in the earlier statement may have given rise to the strict tax regime of the latter.

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[6] Treas. Regs. §1.704(b).

I.R.S. ARGUES MYLAN'S CONTRACT IS A LICENSE OF DRUG RIGHTS – NOT A SALE

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Tags
All Substantial Rights
Capital Gains
License
Mylan Inc.
Ordinary Income
Patent
Sale

The question of the proper treatment of a contract transferring exclusive rights to the use of a patent – as a sale or a license – is one that has been addressed many times in U.S. jurisprudence. It has recently popped up again in a case before the U.S. Tax Court involving the generic pharmaceutical company Mylan Inc. ("Mylan"),[1] a company that is the subject of much negative publicity arising from its inversion and subsequent re-immersion as a U.S. domestic company.

In September, the I.R.S. filed a memorandum in support of a motion for summary judgment. The memorandum explained why the Tax Court should rule that a 2008 amendment to a license between Mylan and Forest Laboratories Holdings Limited ("Forest") is merely an amended license agreement and not a relinquishment of all of rights to the use of drug. As a mere amendment to a license that continues to exist, Mylan should report ordinary income. As an amendment that relinquished all remaining substantial rights for the licensor, capital gain treatment is appropriate. In its tax return, Mylan reported the 2008 amendment as a sale giving rise to capital gain treatment. This allowed the corporation to utilize a capital loss carryback as a means of reducing taxable income from the transaction. A capital loss carryback cannot reduce ordinary income.

BACKGROUND

Mylan is a generic pharmaceutical company that entered into a license contract in 2001 with Janssen Pharmaceutica N.V. ("Janssen"), a Belgian pharmaceutical corporation that developed and holds patents to the anti-hypertensive compound nebivolol. The Janssen contract granted Mylan an exclusive license to import, make, use, and sell nebivolol and nebivolol products within the U.S. and Canada.

In January 2006, Mylan sublicensed its rights in nebivolol to Forest, an Irish company that develops, manufactures, and markets pharmaceutical products. The two drug companies entered into the 2006 contract in which Forest paid Mylan $75 million and agreed to royalty payments in exchange for the right to develop and commercialize nebivolol in the U.S. and Canada. The 2006 contract gave Forest all responsibility in commercializing nebivolol but provided that Mylan could participate in aspects of the commercialization. The 2006 contract referred to the agreement between Mylan and Forest as a license agreement, and Mylan treated it as such, characterizing payments received from Forest during 2006 and 2007 as ordinary income.

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[1] *Mylan Inc. v. Commr.*, T.C., No. 16145-14, *memorandum*, Sept. 16, 2015.

In 2008, the two companies executed an amendment to the 2006 contract in which Mylan assigned to Forest all rights to participate in the commercialization of nebivolol. In return for the assignment, Mylan received a one-time cash payment of $370 million and about $50 million in additional royalty payments. However, the world is not perfect, and Mylan retained certain rights and obligations in relation to the product and the supplier. These included

- the right and obligation to acquire all commercial supplies of nebivolol from Janssen and make all payments due to Janssen;
- the right to be the exclusive supplier of nebivolol to Forest combined with the obligation to purchase its supply from Janssen;
- the right to receive information and documents regarding Forest's contacts with regulatory authorities, to participate in Forest's meetings with regulatory authorities, and to provide input towards Forest's marketing plans, strategies, and pricing;
- the right to use nebivolol;
- the right to its knowhow;
- the right to prevent Forest from discounting nebivolol in order to promote sales of its other products;
- the right of first offer calling for Forest to negotiate with Mylan for the distribution of authorized generic nebivolol medication before seeking to arrange for distribution of authorized generics with a third party; and
- a co-exclusive right with Forest to develop and commercialize nebivolol for the treatment of migraine headaches.

"In its examination of the year 2008, the I.R.S. viewed the 2008 contract as a license, not a sale...[and] issued a notice of deficiency, asserting deficiencies in Mylan's 2007, 2008, and 2011."

Forest could neither assign nor sublicense its rights to third parties without Mylan's prior written consent.

In its tax return for 2008, Mylan characterized the 2008 transfer of rights in the nebivolol patent to Forest as an installment sale and reported the payments it received from Forest as capital gains. Mylan received payments in 2009 and 2010 under the 2008 amendment, which Mylan treated as installment payments under the 2008 transaction. These payments were also reported as capital gains. The support for this reporting position was that the transactions "transferred all substantial rights Mylan had in nebivolol, and binding precedent requires that the transfer of all substantial rights be treated as a sale."[2] The purported motivation for the transaction was Mylan's inadequate marketing capabilities and the need to improve its capital structure.

In its examination of the year 2008, the I.R.S. viewed the 2008 contract as a license, not a sale. The I.R.S. issued a notice of deficiency, asserting deficiencies in Mylan's 2007, 2008, and 2011 income taxes in the following amounts:

- 2007 – $1,223

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[2] *Mylan Inc. v. Commr.*, T.C., No. 16145-14, *petition*, Jul. 11, 2014.

- 2008 – $98,622,234
- 2009 – $1,215,101 (Attach. A11)

Mylan petitioned the Tax Court for a redetermination of amounts due, asserting that the I.R.S. incorrectly characterized the 2008 transfer as a license because Mylan had relinquished all substantial rights to nebivolol.[3]

Subsequently, the I.R.S. issued an additional notice of deficiency in the amount of $4,382,422 for 2009. Mylan filed a second petition to the Tax Court, this time seeking a redetermination for 2009.[4] Mylan's petitions have been consolidated into a single Tax Court proceeding asserting that the I.R.S.'s deficiency assessments are erroneous because they result from the I.R.S.'s "incorrect determination that Mylan's 2008 sale of nebivolol to Forest was not a sale of a capital asset but rather payments made by Forest in exchange for the use of intellectual property."[5] In sum,[6] Mylan's overall position is that the controversy is a "sale versus license dispute" and the I.R.S.'s position that the 2008 transfer of rights was a license generating ordinary income is "meritless" because almost all of Mylan's rights were relinquished.[7]

When the initial pleadings were completed, the I.R.S. moved for summary judgment in its favor, contending that no genuine issue of material fact exists and that a decision in its favor should be given by the Tax Court as a matter of law distinguishing between a sale and a license.

SALE V. LICENSE TREATMENT

Generally, a sale occurs for tax purposes when all substantial rights to the property have been relinquished, whereas a license occurs when the person transferring the rights retains a power or significant interest. If a transaction is characterized as a sale and the asset being sold is a capital asset, the net gain after offset for the unrecovered cost basis is taxed as a capital gain. If a transaction is characterized as a license, the gross license payments are taxed as ordinary income without any offset.

For corporate taxpayers, capital gains and ordinary income are taxed at the same rate. However, the characterization of a transaction as capital gains or ordinary income can be important if the corporation has capital losses that would be limited without the recognition of capital gains. Under Code §1211,[8] a corporation's net capital losses in any tax year may be claimed as a deduction only to the extent of

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3 *Id.*

4 *Mylan Inc. v. Commr.*, T.C., No. 16145-14, *petition*, Nov. 13, 2014.

5 *Mylan Inc. v. Commr.*, T.C., No. 16145-14, *petition*, Jul. 11, 2014.

6 Mylan further asserted that the I.R.S. erred by not allowing Mylan to recover its basis in the property and in not allowing Mylan to compute gain under income forecast method. These are secondary arguments to ensure that full relief is obtained if the Tax Court agrees with Mylan's basic position.

7 *Id.*

8 All section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the regulations promulgated thereunder.

the capital gains of that year. Unused net capital losses for any year can be carried back three years and forward five years.[9] Mylan had capital losses that could be carried over to one or more of the relevant years.

Note that special rules apply when determining if the transfer of use of a patent is properly treated as a sale by an individual that is a "holder" of a patent. This provision is intended to encourage amateur inventors by providing long-term capital gains treatment for transfers of all substantial interests in the patent. A patent "holder" is any individual whose efforts created the patent or any other individual who has acquired such interest in the patent in exchange for consideration in money or money's worth paid to the creator prior to the actual reduction to practice of the invention covered by the patent. Mylan would not be a "holder."

The Code does not define "all substantial rights," but legislative history suggests that "exclusive licenses to manufacture, use, and sell for the life of the patent, are considered to be 'sales or exchanges' because, in substantive effect, all 'right, title, and interest' in the patent property is transferred."[10] All rights of value under the patent (or an undivided interest in those rights) must be transferred. A sale of a patent will arise whenever the owner conveys the exclusive right to make, use, offer for sale, and sell an invention and, if the patented subject matter is a process, to exclude others from using, offering for sale, or selling products made by the process.[11]

The terminology used in the instruments of transfer is not the controlling factor – rather, it is the substance of the transaction that is of importance. Similarly, the retention of legal title as a security device is not inconsistent with the concept of a sale.

Because of the favorable treatment given to holders of patents under Code §1235(a), income tax regulations[12] provide that the following transactions are not sales:

- Any grant of rights to a patent that is limited geographically within the country of issuance
- Any grant of rights to a patent that is limited in duration by the terms of the agreement to a period less than the remaining life of the patent
- Any grant of rights to a patent that grants rights to the grantee, in fields of use within trades or industries, which are less than all the rights covered by the patent that exist and that have value at the time of the grant
- Any grant of rights to a patent that grants less than all the claims or inventions covered by the patent that exist and that have value at the time of the grant

For taxpayers other than "holders," case law applies a standard that is less strict than the rule in the regulations. Transfers of interests in patents subject to geographical limitations and field of use restrictions, taken alone, will not require that the transfers be characterized as licenses. For example, a sale occurred when the

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9 Code §1212(a).

10 S. Rep't No. 1662, 83d Cong., 2d Sess., 439–440, 1954 U.S. Code Cong. & Admin. News 5082.

11 *Buckley v. Commr.*, 57-1 USTC ¶ 9525 (DC Wash. 1957).

12 Treas. Reg. § 1.1235-2(b)(1).

transferor of a patent granted the exclusive right to make, use, offer for sale, and sell a patented invention in the area west of the Mississippi River despite the fact that the transferor retained all of those rights in all other geographic regions.[13] Courts have also treated the transfer of exclusive rights to make, use, offer for sale, and sell a patented invention to a particular industry as a sale when the transferor retained all of those rights with respect to all other industries.[14]

"Payment does not determine whether the transfer of patent rights is a sale or license..."

Payment does not determine whether the transfer of patent rights is a sale or license. The I.R.S. recognized in Rev. Rul. 58-353 that a purchase price contingent on the use or exploitation of a patent is not inconsistent with the treatment of a transfer as a sale. However, a transfer may fail to possess the required characteristics of a sale when payments resembling royalties are received and other rights in the transferred interest are retained by the transferor.

Although an undivided interest is conveyed, the transfer of patent rights may receive license treatment if the parties do not share the same rights. In *Eickmeyer v. U.S.*,[15] the court found the transfer constituted a license because the transferee's right to the entire award in an infringement suit was inconsistent with the co-ownership of the patent under which all owners would share in any recovery in proportion to each owner's respective interest. On the other hand, in *Graham v. Commr.*,[16] a transferee's right to retain the entire recovery in an infringement action was held not to be inconsistent with co-ownership of the patent where the parties expressly provided that such awards are part of the contract price.

Case law and I.R.S. rulings are also consistent in characterizing the transfer of an undivided interest in all rights under the patent as a sale of those rights. While there appears to be no limit on the divisibility of a patent, courts have taken a skeptical view of so-called elastic proportions, in which co-ownership interests are conveyed without reflecting any particular percentage interest or under which the original transferor may convey unlimited undivided interests.

A transfer of a purportedly undivided interest in a patent that expressly permitted the transferee to assign or sublicense its interest is not a sale, but a license. Similarly, a requirement in a transfer agreement that a subsequent assignee must account to the original transferor is inconsistent with the transfer of a co-ownership interest. Finally, a transfer is usually a license if the right to sue for infringement in the transferee's own name is not granted.[17] However, the case law is not consistent where facts differ in material ways. For example, the right to sue may be considered a security device that does not preclude sale treatment.[18]

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[13] *Crook v. United States*, 135 F. Supp. 242 (WD Pa. 1955); see also *Marco v. Commr.*, 25 TC 544 (1955).

[14] See *Merck & Co. v. Smith*, 261 F2d 162 (3d Cir. 1958); *United States v. Carruthers*, 219 F2d 21 (9th Cir. 1955); *Kavanagh v. Evans*, 188 F2d 234 (6th Cir. 1951); *First Nat'l Bank of Princeton v. United States*, 136 F. Supp. 818 (DNJ 1955).

[15] *Eickmeyer v. United States*, 86-2 USTC ¶ 9623 (Cl. Ct. 1986).

[16] *Graham v. Commr.*, 26 T.C. 730 (1956).

[17] *Oak Mfg. Co. v. United States*, 301 F2d 259 (7th Cir. 1962).

[18] *Graham v. Commr.*, supra.

I.R.S. MEMORANDUM

The I.R.S. memorandum asserts that the 2006 contract between Mylan and Forest is a license, that the 2008 amendment continued the license with amended terms, and that payments made pursuant to both documents are therefore ordinary income.[19] The memorandum bases most of its arguments on the principles of contract law interpretation. According to the I.R.S., the 2006 contract and 2008 amendment had unambiguous language that made it clear the agreements were for a license rather than a sale.

- The preamble to the 2006 contract explained that:

  > Mylan has agreed to grant certain licenses and sublicenses relating to the subject matter of the Janssen Contract to Forest and Forest has agreed to make certain payments in connection with such grants and to perform the further activities contemplated hereby.

- Article 2.1 referred to the grant as a license. It stated:

  > *License*. Mylan hereby grants to Forest an exclusive license and sublicense, as the case may be, to the Licensed Patents and Licensed Know How in the Territory and outside the Territory for the limited purpose of manufacturing products containing nebivolol for Commercialization in the Territory. [Footnotes deleted.]

- Article 2.2. stated: "*Trademark License*. Mylan hereby grants to Forest an exclusive license to use the Trademarks."
- Article 2.3, headed "*Sublicensing*," detailed conditions under which "[t]he licenses hereby granted may be sublicensed by Forest."
- Article 6.1, which discusses generics, referred to "the exclusive license grants contained in this Agreement."
- Article 10 provided for the payment of royalties based on aggregate net sales of nebivolol products.
- In article 12.1(a), Mylan represented that "it has the right to grant the other Party the licenses and sublicenses granted pursuant to this Agreement."
- In article 12.1(c), Mylan represented that no legal or contractual conflicts interfere with "the licenses and sublicenses to be granted" pursuant to the contract.
- In article 12.2(a), Mylan represented that it "has not previously granted any rights that are inconsistent with the rights and licenses granted herein."
- Article 14.4, which deals with Forest's right of termination, referred to the "payment of any license fee" and the "value of licenses."

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19 *Mylan Inc. v. Commr.*, T.C., No. 16145-14, *memorandum*, Sept. 16, 2015.

Based on the principles of contract interpretation, the I.R.S. asserted that it is clear from the language used in the 2006 contract that the parties intended to enter into a licensing agreement and that the 2008 amendment is merely an extension of that agreement. The extension of a license does not change the substance of a contract from being that of a license into that of a sale. The I.R.S. reiterates that the 2008 amendment made no mention of sale or intent to sell the rights to nebivolol. Although the terms are not determinative of whether an agreement is a sale or license, the I.R.S. contends that the terms are "indicative of Mylan's intent."[20]

The I.R.S. refers to the Form 906, *Closing Agreements on Final Determination Covering Specific Matters*, that Mylan entered into with the I.R.S. for the payments it received from Forest in 2006 and 2007. On the Form 906, Mylan admits the 2006 contract was not a sale in order to defer recognition of the advance payments it received. The I.R.S. reiterates that the Form 906 proves the 2006 contract was a license. Since the 2008 amendment modified some terms but did not alter the license arrangement, the 2008 amendment is still a license that generates ordinary income.[21]

The I.R.S. also asserts that the "Danielson Rule" is applicable. In Commr. v. Danielson, the Third Circuit held that a taxpayer may challenge the tax consequences of its own contract only by introducing evidence that would invalidate the contract itself. This line of reasoning is supported by Supreme Court decisions, such as Commr. v. National Alfalfa Dehydrating & Milling Co.

The conclusion of the I.R.S. memorandum summarizes its position as follows:

> The language of the 2006 Contract and 2008 Amendment clearly shows that Mylan intended to license its rights to Forest, not to sell them to Forest. The 2006 Contract was, in form and function, a license agreement. The 2008 Amendment did not transform what had been a license into a sale. Rather, it continued the parties' license agreement with amended terms. Accordingly, respondent's motion for summary judgment should be granted and the Court should find that payments made by Forest to Mylan from 2008 through 2011 were ordinary income to Mylan.[22]

The strength of the I.R.S. arguments is open to challenge. The focus on the repeated use of the term "license" seems to be overly simplistic. If there is any point that is clear in the case law, it is that use of a label is not controlling. *In Taylor v. Commr.*, TC Memo 1970-325, the I.R.S. relied on similar arguments only to find they were dismissed by the court.

> We note at the outset that the agreements were drafted as 'licenses,' that the parties were identified therein as 'licensor' and 'licensee,' and that the periodic payments were termed 'royalties.' Although the use of this terminology indicates a license arrangement rather than a completed assignment or sale, such language, while of some

[20] *Id.*

[21] *Id.*

[22] *Id.*

> weight, is not controlling. We must look to the substance of what the parties have put together.

It was only when the court evaluated the rights retained by the transferor that it concluded certain transactions were licenses.

> It has generally been considered necessary to transfer the exclusive right to *manufacture*, *sell*, and *use* patented property in order for a grant of an interest in the patent to qualify as a sale—at least where such rights are considered 'substantial.' * * * We think that [as to some but not all of the agreements,] petitioner failed to transfer the exclusive right to manufacture, sell, and use his manhole covers.

In the *Taylor* case, the court addressed a fact pattern in which one of the license agreements was modified several times and it was only upon the last of the agreements that all substantial rights were transferred. The court had no difficulty in concluding that by the completion of the last amendment, all substantial rights to patent were transferred.

CONCLUSION

The memorandum of law fails to explain why any or all of the rights retained by Mylan are substantial rights. These rights included (i) the right to purchase nebivolol from Janssen and to supply it to Forest, the right to receive information and documents involving regulatory authorities; (ii) the right to participate in Forest's meetings with regulatory authorities, and to provide input towards Forest's marketing plans, strategies, and pricing; (iii) the right to prevent Forest from discounting nebivolol in order to promote sales of other products; and (iv) the co-exclusive right with Forest to develop and commercialize nebivolol for the treatment of migraine headaches. It may be that such arguments raise questions of fact that would preclude the granting of summary judgment by the Tax Court. Instead, the I.R.S. focused on labels used in the two license agreements and as a result, the memorandum of law is unconvincing. A question of fact exists and a full trial is to be expected.

Mylan's response to the I.R.S. summary judgment motion is due in October.

INDIAN M.A.T. EXEMPTION

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Tags
Corporate Tax
Foreign Investment
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M.A.T.
Permanent Establishment

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Following months of debate, the Indian Finance Ministry clarified late this September that the Minimum Alternate Tax ("M.A.T.") will not apply to foreign companies that do not have a permanent establishment and/or place of business in India.

FOREIGN DIRECT INVESTMENT

Foreign investment was limited in India until economic reforms took place in 1991. This stimulated foreign direct investment in the country, as newer policies provided automatic approval for projects with foreign equity participations that could be as great as 51% for investments in certain locations. Foreign direct investment is undertaken in line with government policies. Foreign companies now have several choices of entity to carry out operations in India. The choice of entity determines whether the company will be allowed to have a direct presence in the country and the tax rules it will be applicable. Investment incentives are designed to channel investments towards specific industries, such as infrastructure and exports.

CORPORATE TAXATION

The right to impose tax in India is divided between the central government and the state governments. The central government taxes income while the state governments impose sales taxes and stamp duties, historically known as non-income taxes. The Income-tax Act, 1961 mandates that a resident of India is liable to pay tax on worldwide income, while a nonresident is liable to tax only on (i) income actually received or deemed to be received in India or (ii) any income accruing or arising, or deemed to accrue or arise, in India.[1]

A domestic company is taxed at a rate of 30% and a foreign company at 40%, plus an education cess[2] in each case. In addition, where the taxable income exceeds certain amounts, a surcharge is levied on the amount of income tax at a rate of 7% or 12% in the case of a domestic company and 2% or 5% in the case of a foreign company.

A company is considered to be a resident of India if it is incorporated in India or its place of effective management is in India. A foreign company is generally not considered to be a resident in India. Nonresident entities are liable to tax on income received in India, accruing or arising in India, or deemed to accrue or arise in India;

1 Income-tax Act, 1961, Section 5.

2 The term "cess" generally means a small surcharge to fund education.

this includes income from business assets, capital gains, interest, royalties, and technical service fees.[3]

The tax imposed on a nonresident is collected through withholding at the source at the time of payment of royalties, fees for technical services, or any other amount chargeable to tax in India. Foreign taxpayers claiming tax treaty benefits are required to provide tax residency certificates attesting to their foreign residency. Globally, India has tax treaties and trade agreements in place with many countries. These agreements attempt to prevent double taxation, allow for more beneficial treatment of nonresidents in certain cases, ensure protection of investors, and encourage trade through the regulation of duties and tariffs.

M.A.T.

M.A.T. was enacted in India in the 1980's with the intention of targeting companies that showed book profits and declared dividends but paid little or no tax. In that regard, its purpose is similar to the Alternative Minimum Tax in the U.S. M.A.T. applies when the income tax payable by a company on its taxable profits in India is less than the minimum tax payable on the book profits, computed as specified. Currently, M.A.T. is payable at 18.5% plus a surcharge and educational cess, mentioned above. Typically, the tax was intended to be levied on Indian companies that were suppressing profits. Therefore, foreign investors claimed to be exempt from this tax in the absence of a permanent establishment in India and believed that M.A.T. only applied to those Indian companies that were required to prepare books of account, as specified in the law.

"M.A.T. was enacted in India in the 1980's with the intention of targeting companies that showed book profits and declared dividends but paid little or no tax."

This approach came into question earlier this year when an amendment to the tax law was adopted, which exempted Foreign Institutional Investors ("F.I.I.'s") from the imposition of M.A.T. on income generated from trading in securities on the stock exchange. This amendment was made with effect from April 1, 2015. In typical regulatory fashion the tax authorities in India announced that if an exemption was mandated by a change in law, F.I.I.'s were taxable prior to the effective date of the law change. The Revenue sent tax demand notices to hundreds of F.I.I.'s and Foreign Portfolio Investors ("F.P.I.'s") contending that they were liable to pay M.A.T. for prior years.

In this scenario, it is pertinent to note that the issue M.A.T.'s application to F.I.I.'s, F.P.I.'s, and foreign companies has been addressed in various cases, with inconsistent results. Some judicial authorities ruled in favor of the taxpayer and others in favor of the Revenue. However, a ruling in 2012 held that M.A.T. was payable by foreign companies.

This led to an uproar among foreign investors and several representations were made to the Revenue. To take cognizance of this issue, a three-member committee was formed under a retired Chief Justice to decide the issue.

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3 Income-tax Act, 1961, Section 9(1).

“A permanent establishment may be triggered in India if the activities performed by the foreign company result in a taxable presence.”

The committee issued a report recommending that M.A.T. should not be made applicable to F.I.I.’s and F.P.I.’s that did not have a taxable presence in India. Based on the recommendations of this committee, a clarification was issued by the Finance Ministry that an appropriate amendment would be carried out in the law to provide that M.A.T. provisions will not be applicable to F.I.I.’s and F.P.I.’s not having a place of business and/or permanent establishment in India for the period prior to April 1, 2015.

Subsequently, the Finance Ministry issued a press release to clarify that, as of April 1, 2001, M.A.T. provisions will not apply to a foreign company that does not have a permanent establishment in India, in accordance with an applicable treaty, or a place of business in India, if no treaty is applicable.

A permanent establishment may be triggered in India if the activities performed by the foreign company result in a taxable presence. A permanent establishment may exist in any of several circumstances:

- The foreign company has a fixed place of business through which its business is wholly or partly carried out.
- The employees of the foreign company or its dependent agents render services in India exceeding a certain time period.
- The officers or agents in India negotiate and conclude contracts, generating revenue, or performing core business activities similar to those of the overseas head office.

A permanent establishment shows that the foreign company is doing business and generating revenue from Indian sources. A foreign company wishing to avoid being subject to the M.A.T. will be required to limit its operations that take place within India so as to avoid establishing a permanent establishment or fixed place of business. It is understood that Indian revenue authorities are contacting foreign corporationss to inquire whether a place of business exists in India that might be considered a permanent establishment.

CONCLUSION

This exemption is an affirmation of India’s positive attitude towards foreign investment. Despite the opportunity to levy a tax on foreign companies, the Indian government has decided to grant a conditional reprieve in the interest of encouraging foreign direct investment. There is some discussion on whether or not the press release would be a sufficient basis to exempt foreign companies from M.A.T. until such time that a legislative amendment is made.

THE TRANSPARENT WORLD: EXCHANGE OF INFORMATION HAS BEGUN & PACTS TO ASSIST IMPLEMENTATION HAVE BEEN SIGNED

Authors
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Tags
F.A.T.C.A.
I.G.A.
Exchange of Information

The Internal Revenue Service ("I.R.S.") issued a News Release on October 2, 2015 (IR-2015-111) announcing the advent of exchange of financial account information with certain foreign tax administrations, meeting the key September 30 milestone related to the Foreign Account Tax Compliance Act ("F.A.T.C.A."). The I.R.S. did not provide information on the specific data exchanged or the countries that met the key milestone.

While nothing requires countries to announce exchanging information under an Intergovernmental Agreement ("I.G.A."), Australia and Canada have voluntarily announced their exchanges with the I.R.S. Australia was the first country to announce turning over account information to the I.R.S. According to the announcement, 30,000 accounts worth over $5 billion were reported. The Australian Taxation Office said in a news release on September 23 that this is "the first step in a wave of transparency measures being implemented globally by governments and tax administrations."

Some found the Australian numbers surprising; however, only time will tell how these numbers compare to other jurisdictions. The only other country that has provided information concerning the exchange is Canada.

ATTEMPTS TO BLOCK F.A.T.C.A.

The Canadian Exchange

The Canadian exchange of information occurred in spite of an ongoing lawsuit, which challenges the I.G.A. signed in February 2014 between the U.S. and Canada. The story begins in August 2014, when two U.S.-born Canadians filed a lawsuit against the Canadian government asserting that the I.G.A. violates Canadians' constitutional rights and cedes Canadian sovereignty.

The Canadian government has rejected these assertions, and although the lawsuit is still pending, the Federal Court of Canada ruled in a summary trial motion on September 19, 2015 that the data exchange under the I.G.A. does not violate Canada's Income Tax Act or the Canada-U.S. Income Tax Treaty.

Following the summary trial ruling, the plaintiffs applied for an injunction to block the first data exchange under F.A.T.C.A. due on September 30 as per the I.G.A. Before the court responded to the injunction application, officials from the Canada Revenue Agency ("C.R.A.") spoke with the I.R.S. – presumably in an attempt to notify the U.S. agency of the expected delay in exchange of information and to provide assurances that the C.R.A. was making good faith efforts to exchange the information as soon as possible, in accordance with Notice 2015-66. The officials concluded that the C.R.A. had no choice but to turn over information, even if the Federal court issued an injunction.

According to a September 25 affidavit made by the director of the C.R.A.'s Competent Authority Services Division, Sue Murray, the I.R.S.'s Large Business and International Division Commissioner, Douglas O'Donnell, said that the extension offered by the I.R.S. to Model 1 countries in Notice 2015-66 does not apply in this case because Canadian legislation and systems are already in place to timely effect an exchange. According to the affidavit, the I.R.S. indicated that, even if an injunction was granted by the Canadian Court, under such circumstances:

> Canadian financial institutions will risk losing the benefit of the deemed F.A.T.C.A. compliance that they would otherwise obtain through the I.G.A. In particular, as of October 1, 2015, if the information has not been received by the I.R.S. and no extension of time has been granted, it is possible that Canadian financial institutions could be considered non-compliant.

"According to a September 25 affidavit...the extension offered by the I.R.S. to Model 1 countries in Notice 2015-66 does not apply in this case because Canadian legislation and systems are already in place to timely effect an exchange."

The affidavit, which was a part of the government's response to the ongoing lawsuit, further stated that an injunction preventing transmission of information would mean that the I.R.S. would not meet its commitment to make a reciprocal transfer of information of Canadian-born U.S. residents. This would have a significant, detrimental impact on the C.R.A.'s tax compliance work.

On September 30, the Federal court refused to grant the requested injunction. The court ruled that the plaintiffs are not among the U.S. persons resident in Canada whose information is to be provided to the I.R.S., and as such, they would not be harmed if the data exchange is permitted to occur. The Canadian court has yet not set a date to hear the lawsuit and the saga continues.

On October 1, the Canadian government confirmed that the exchange under the I.G.A. took place on a timely basis. Based on the aforementioned affidavit, the first exchange of information included 155,000 "information slips." Each slip represents one account and one account holder, but the same person or entity could hold multiple accounts. While Ms. Murray could not specify a number, she confirmed that the number of individuals represented by those slips is lower than 155,000. The value of the reported accounts was not discussed in the affidavit.

U.S. Judicial Efforts to Block F.A.T.C.A.

Efforts to block F.A.T.C.A. are also being initiated within the U.S. Back in July 2015, Republican presidential candidate Sen. Rand Paul (R-KY), together with six others, sued the Treasury Department and I.R.S. over F.A.T.C.A. and the requirement to file FinCEN Form 114, *Report of Foreign Bank and Financial Accounts* ("F.B.A.R."). The suit was filed in Federal court in Dayton, Ohio.

On September 29, Ohio Judge Thomas M. Rose ruled that Sen. Paul and the other plaintiffs do not have a standing to challenge parts of F.A.T.C.A. The judge went on to support F.A.T.C.A., indicating that the purpose of F.A.T.C.A. and F.B.A.R. reporting was to help the government stop tax evasion, and further stated that the associated penalties have a "rational basis": "Without F.B.A.R. reporting, the government's efforts to track financial crime and tax evasion would be harmed." The judge also rejected a request for injunctive relief to block exchange of information under F.A.T.C.A., holding that the harms claimed by the plaintiffs are "remote and speculative, most of which would be caused by third parties, illusory, or self-inflicted."

"The exchange of information regarding U.S. persons under F.A.T.C.A. has already begun."

COMPETENT AUTHORITY AGREEMENTS

As the process of implementing F.A.T.C.A. continues, the U.S. Competent Authority has already signed agreements with the U.K. and Australia to help in its implementation. I.R.S. Commissioner John Koskinen said, "Together in partnership with other tax authorities, we are demonstrating how far we have come in the fight against tax evasion." He noted that numerous other competent authority accords will be signed in the near future.

The signed pacts include details on information exchange, registration, and noncompliance. It intends to help with the nuts and bolts of compliance under the I.G.A. The agreements explain when the I.R.S. will treat a partner jurisdiction's F.F.I. as being in significant noncompliance, a status which will cause such F.F.I. to be treated as a "Nonparticipating F.F.I." and thus subject to withholding. The agreements signed provide that F.F.I.'s will have the chance to rectify the situation prior to such status being imposed.

EXCHANGE OF INFORMATION UNDER CODE §6049

The exchange of information regarding U.S. persons under F.A.T.C.A. has already begun. At the same time, the U.S. is preparing to begin exchanging information regarding non-U.S. individuals earning interest income pursuant to Code §6049 and the regulations thereunder. Under these regulations, reporting of certain deposit interest paid to nonresident, noncitizen individuals after December 31, 2012 is required.

On September 29, the I.R.S. published Rev. Proc. 2015-50, which supplements the list of countries with which the Treasury and the I.R.S. have determined that it is appropriate to have an automatic exchange relationship with respect to the information collected.[1] Sixteen countries were added to the list of 18 countries already determined as appropriate. The additional countries are Brazil, Czech Republic, Estonia, Gibraltar, Hungary, Iceland, India, Latvia, Liechtenstein, Lithuania, Luxembourg, New Zealand, Poland, Slovenia, South Africa, and Sweden.

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[1] See Rev. Proc. 2014-64, 2014-53 I.R.B. 1022, updating Rev. Proc. 2012-24, 2012-20 I.R.B. 913, which was published at the time the regulations were revised to require such reporting.

CONCLUSION

As those opposing F.A.T.C.A. in the U.S. and outside the U.S. recently witnessed, repealing F.A.T.C.A. is not easy – if it is at all possible. In fact, the opposite position seems to have prevailed. F.A.T.C.A. is getting stronger. With 112 countries now having an I.G.A. treated as in effect, broad support for the legislation has been shown around the world. In addition, the O.E.C.D.'s attempt at exchange of information under the Common Reporting Standard, the drafting of which was primarily based on F.A.T.C.A., is due to begin for some countries as early as January 1, 2016.

IN THE NEWS

OBTAINING AN I.T.I.N. FOR FOREIGN INDIVIDUALS – RUCHELMAN P.L.L.C. IS HAPPY TO ASSIST

A non-U.S. person claiming a tax refund for overwithholding of tax, purchasing or selling real property, or complying with U.S. filing requirements, in general, is required to obtain an individual taxpayer identification number ("I.T.I.N.") – a process that can be daunting, sometimes even fruitless, despite the foreign person's efforts. Under the regulations, the I.R.S. requires the taxpayer to furnish the original passport or copies thereof, and the latter will only suffice if it is certified by the issuing authority overseas. In many cases, the first is not an option, and the latter may not even be possible, depending on the taxpayer's home country.

However, such impediments can be circumvented by having an acceptance agent certify the accuracy of the identification documents (generally passports). Ruchelman P.L.L.C. has now been registered as a certifying acceptance agent and may offer such services. Please contact Beate Erwin at 212.755.3333 ext. 116 if you or a client require assistance in this process.

RUCHELMAN P.L.L.C. PLAYS HOST TO THE 2015 ITSG WORLD CONFERENCE

Each year, a group of tax advisers from over 30 countries gather to discuss recent developments affecting the taxation of global business and investment. This November, the group, known as the International Tax Specialist Group, met in New York City for the first time. Seventy-two tax advisers participated at the conference, which spanned three days. Conference sessions were held in partnership with New York Law School and featured contributions from eight members of host firm Ruchelman P.L.L.C.

RECENT AND UPCOMING PRESENTATIONS

On October 6, 2015, Stanley C. Ruchelman and Galia Antebi spoke on "Understanding U.S. Taxation of Foreign Investment in Real Property" as part of the two-day conference Current U.S. Tax Planning for Foreign-Controlled (Inbound) Companies, hosted by Bloomberg BNA in New York. The discussion covered legal and tax aspects of structuring U.S. real estate investments and specifically addressed Code §871(d) net income elections for real property rental income, special considerations for partnerships and withholding taxes, including the preparation of statements to reduce F.I.R.P.T.A. withholding tax, planning to reduce estate tax for individual investors, and U.S. tax aspects of cross-border M&A transactions involving U.S. R.P.I.'s.

In October 2015, Beate Erwin attended the International Bar Association Annual Conference in Vienna, Austria, where she participated on the panel “Tax Structuring for Private Clients.” The panel utilized case studies to focus on how tax issues impact structures used by private clients.

On November 2, 2015, Galia Antebi presented “An Update of F.A.T.C.A.” at the *2015 Advanced Tax Institute*, sponsored by the Maryland State Bar Association and the Maryland Association of C.P.A.’s, in Baltimore, Maryland. The discussion covered an overview of F.A.T.C.A. legislation, the current status of exchanges of financial information between I.G.A. partner countries, and other hot topics, including new account opening procedures in countries that have signed a Model 1 I.G.A.

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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