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INSIGHTS

CAVEAT DOMINUS: A COMPARISON OF POST-EMPLOYMENT ENTITLEMENTS IN THE U.S. AND ITALY WHEN EXECUTIVE EMPLOYMENT IS TERMINATED WITHOUT CAUSE

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EDITORS' NOTE

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

- ***Caveat Dominus*: A Comparison of Post-Employment Entitlements in the U.S. and Italy When Executive Employment is Terminated Without Cause.** When companies expand business operations across the Atlantic Ocean, various cultural differences between the U.S. and Europe come to the fore. The most noticeable are found in the area of employment, and among those are expectations of the rights of employers, employees, and executives at the time of termination of employment. George Birnbaum of the Law Offices of George Birnbaum P.L.L.C. and Ariane Rauber and Fabio Tavecchia of Palmer Studio Legale compare and contrast employee rights in the U.S. and Italy.

- **Circular Letter No. 17/E Clarifies Special Tax Regime for Italian "New Residents."** Late last year, the Italian government enacted a new regime designed to entice wealthy individuals into becoming tax residents. In late May, operating rules for the new tax regime were announced. In broad terms, the regime imposes an annual tax charge of €100,000 in lieu of tax imposed at standard rates and an exclusion from inheritance and gift tax on foreign assets. Andrea Tavecchio and Riccardo Barone of Tavecchio Caldara & Associati in Milan, Italy explain the details of the new regime.

- **European Commission Proposes New Advisor Disclosure Obligation for Aggressive Tax Planning.** In June, the European Commission proposed a set of rules calling on tax advisers to report aggressive tax plans submitted to clients. The proposal identifies the hallmarks of aggressive plans and provides rules for the timing of reports and the exchange of information within Europe. Fanny Karaman and Stanley C. Ruchelman explain.

- **Family Limited Partnerships in Estate Planning – Is *Estate of Powell* the End or the Beginning of Aggressive Tax Planning?** When transactional tax advisers come across estate planning advice, amazement is often expressed over the importance given to form rather than economic substance. Value can be reduced when property is transferred to a family partnership. In *Estate of Powell*, the Tax Court went beyond form to look at substance in determining the scope of the decedent's taxable estate. Galia Antebi and Rusudan Shervashidze explore the holding of the case.

- **Tax 101: Taxation of Intellectual Property – Selected Issues Involving Corporations and Partnerships.** Tax 101 continues its series regarding the U.S. Federal tax considerations involving the creation, acquisition, use, license, and disposition of intellectual property ("I.P."). This month, Elizabeth V. Zanet and Stanley C. Ruchelman focus on I.P. held through a corporation or a partnership/L.L.C. In particular, the not-well-understood rules regarding the sale of interests in a partnerships/L.L.C.'s owning "hot assets" are explained. Not all gain benefits from favorable long-term capital gains tax rates.

- **Pancake Day – End to Permanent Non-Domicile Status and Charging Non-Doms I.H.T. on U.K. Residential Property.** In July, the U.K. government announced that proposals removed from the Finance Bill that was announced in March would be reproposed with a retroactive effective date, as if adopted when originally proposed. This is bad news for non-domiciled individuals ("Non-Doms") in general and for the estates of Non-Doms who died between March and the ultimate date of enactment. If retroactive effective dates remain in the bill, rights granted by the European Convention for the Protection of Human Rights and Fundamental Freedoms, which were incorporated into U.K. law by the Human Rights Act 1998, could be violated. William Hancock and Daniel Simon of Collyer Bristow L.L.P. explain that Non-Doms should expect "too little jam and too little cream" on their pancakes if the provisions are enacted retroactively.

- **Foreign Partner Not Subject to U.S. Tax on Gain from Redemption of U.S. Partnership Interest.** After three years, the U.S. Tax Court ruled that gain from the sale of a partnership interest or the receipt of a liquidating distribution by a retiring partner is not subject to U.S. income tax even though the partnership conducts business in the U.S. Neha Rastogi, Elizabeth V. Zanet, and Nina Krauthamer explain the reasoning behind the decision and the magnitude of the defeat for the I.R.S. Unless the case is reversed on appeal, the decision invalidates the I.R.S. position announced in Rev. Rul 91-32.

- **When the (Fake) I.R.S. Calls – Memoirs of the Tax Phishing World.** "Phishing." Many have heard the word, which is used to describe scams intended to acquire sensitive information. Few are prepared to be its target. Unwary individuals are often drawn in by scammers pretending to call from the I.R.S. and threatening imprisonment unless a bogus tax bill is paid promptly. Rusudan Shervashidze offers insights into the workings of these scammers, relaying her personal experience with an "I.R.S." phishing call and providing tips to avoid falling into one of these traps.

- **I.R.S. Explains "Substantially Complete" in Relation to International Information Return.** Taxpayers having cross-border operations are confronted with numerous tax information forms to be filed as part of the annual tax return. Because the forms are not directly used to compute taxable income, they frequently are completed at the last minute and with less attention to detail. However, the I.R.S. imposes penalties for filing an incomplete form. Taxpayers faced with asserted penalties often argue that the forms are substantially complete. In a recent International Practice Unit ("I.P.U.") issued by the Large Business & International Division of the I.R.S., the I.R.S. view regarding substantially complete form was explained. Not surprisingly, the I.R.S. view is significantly different from taxpayer expectations. It also differs from holdings in several Tax Court decisions involving other forms. Neha Rastogi and Stanley C. Ruchelman discuss the I.P.U. in detail.

- **Updates and Tidbits.** This month, Neha Rastogi and Nina Krauthamer look briefly at certain timely issues: (i) a European parliament proposal to extend the scope of country-by-country ("CbC") reporting by group members when the group parent is not obligated to report and (ii) regulations identified by the I.R.S. as imposing undue burden on taxpayers.

We hope you enjoy this issue.

\- The Editors

CAVEAT DOMINUS: A COMPARISON OF POST-EMPLOYMENT ENTITLEMENTS IN THE U.S. AND ITALY WHEN EXECUTIVE EMPLOYMENT IS TERMINATED WITHOUT CAUSE

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INTRODUCTION

Management of a U.S.-based multinational is often shocked by what it hears when seeking advice from a European labor lawyer regarding employee rights in connection with the termination of a European executive. Simply put, the rules in Europe are quite different from the rules in the U.S., and unlike the in U.S., they do not favor the employer. To assist businesses and executives based in one country and doing business, or contemplating doing business, on the other side of the Atlantic, this article discusses the differences in what management and executives can expect when the employment relationship is terminated in the U.S. and Italian contexts.

EXECUTIVE RIGHTS AT TERMINATION IN THE U.S.

The general, indeed historic, rule of U.S. employment law is that, without a specific contract of employment, U.S. executives are, like most other employees, considered employees "at will" – meaning the will of the employer. This rule, by itself, is often re-stated to mean that an employer can terminate an executive "for any reason (except a prohibited reason), at any time, or for no reason at all" unless a written contract exists that provides for rights upon termination.

Legal Issues at Termination

Legal issues may arise where either of the following conditions are met:

- The executive receiving the notice of termination has a contract with the employer – usually a written (*i.e.*, express) contract or, much less often, an implied contract as the result of statements, promises, or representations by the employer or the employer's agent.[1]
- The reason for the executive's termination is a prohibited reason.

In the U.S., most prohibited reasons fall under one of the many forms of illegal discrimination. Overriding U.S. Federal law prohibits "employment actions" – including termination – motivated by discrimination based on gender, sexual harassment, age, race, ethnicity, religion, national origin, physical or mental disability, or retaliation for being a "whistleblower" or engaging in other protected conduct. Moreover,

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[1] The differences between express and implied employment contracts are beyond the scope of this article. The following discussion of executive employment agreements presumes a written agreement that is negotiated between the executive and the employer with the assistance of legal representation and customarily entered into at the commencement of the employment relationship.

each state and many localities have separate laws prohibiting discriminatory employment actions against persons in even broader categories of protected status, quality, or identity, such as *inter alia* sexual orientation, marital or domestic partner status, family responsibility, and caregiver status. With respect to new and different protections under state and local laws, the list keeps growing as each year passes.

Entitlements for Termination Without Cause

For the purpose of focusing this discussion on possible entitlements that a U.S. executive can expect when he or she is terminated by the employer "without cause,"[2] the following discussion assumes that (i) the U.S. executive is being terminated without cause (*e.g.*, the employer has decided that someone else can do a better job or the position is being eliminated) and (ii) the executive's termination is otherwise lawful and does not reflect discrimination or otherwise legally prohibited conduct by the employer.

Under these circumstances, the key issue is to determine what, if anything, the terminated executive is entitled to receive. The detailed answer varies according to the executive's particular situation, but the general answer is that the executive is entitled to whatever is provided *by the explicit terms of his or her contract* or as part of *the employer's overall company policy*, plus a *few extra entitlements under the law* regardless of what the contract says, even if there is no contract.

> ***"It is so important for executives in the U.S. to obtain a carefully negotiated agreement when they enter into employment . . . without any such agreement, the executive's legal entitlements are modest indeed."***

Limited Benefits under Law or Customary Practice

Considering these extra-contract legal entitlements, such as they are, will easily demonstrate why it is so important for executives in the U.S. to obtain a carefully negotiated agreement when they enter into employment, since without any such agreement, the executive's legal entitlements are modest indeed. They include the following:

- Up to a certain number of weeks – rarely surpassing 20 weeks – of unemployment compensation from the government, administered through a type of insurance plan into which U.S. employers are obligated to make periodic contributions
- The ability to remain on the employer's health benefits plan, at the cost of the employee, for up to 18 months (so-called C.O.B.R.A. benefits, an acronym that refers to the title of the Federal legislation that created this entitlement)
- If the employer has a generally applicable severance pay plan or policy, the

[2] Also beyond the scope of this article is a discussion of termination for cause. The definition of "cause" is a carefully negotiated term in most executive contracts, and accordingly, differs from contract to contract. It typically centers on the notion that the executive has performed an act that so egregious, anti-social, or against the letter and spirit of the employment relationship that the employer is justified in immediately terminating the executive's employment with little or no further entitlement. Examples include the following: (i) The employee has committed a crime or an act of moral turpitude or violated a material term of the employment contract or the employer's trust, or has performed an act likely to cast the employer into public disrepute; (ii) in the specific industry of the employer, the employee has broken a rule or regulation; (iii) the employee breaches the terms of employment by virtue of total or substantial non-performance of one's job duties after having been notified of this failure and given an opportunity to cure the defective performance.

number of weeks of continuing pay provided for by that plan or policy (customarily, an amount based on a formula such as one or two weeks of pay for every year of service, sometimes commencing after a fixed number of initial years of service)

- A "roll over" into another plan of portable *vested* retirement benefits under a savings, deferred compensation, or retirement or pension plan maintained by the employer (while *unvested* benefits generally disappear upon termination)

Front-End Planning for Back-End Benefits

This list of legally mandated entitlements is rather small. Accordingly, U.S. executives and their employment attorneys know that before an executive accepts employment, the focus must include termination rights and entitlements, which must be negotiated carefully with the employer pursuant to a written contract.

The most prominent of such "negotiated" entitlements are the following:

- Severance. This covers a continuation of salary in order to bridge the transition to a new position. As the trend in the U.S. is for executive contracts to be "at will" rather than for a set term of years, the executive's written employment agreement (or binding offer letter) must contain a specification of precisely what severance the executive will receive from the employer if the executive is terminated "without cause." Six months of base compensation is a minimum. Depending on the executive's level of seniority and the care with which the executive's agreement has been negotiated, severance pay amounting to a full year of the executive's base compensation (or even more) is not uncommon.

- Continuing Health Benefits. Because without a contract it is the executive, not the employer, who has the legal obligation to pay the premiums to continue health insurance coverage under C.O.B.R.A., an executive's contract should allocate payment responsibility to the employer during the severance period.

- Bonuses. Without a specific contractual entitlement, many executives, as a purely legal matter, will forfeit bonuses upon termination without cause before the date on which the bonus is to be paid, even if they have worked an entire year. The executive's contract should address this as well and provide for the payment of a bonus, or a meaningful portion of it, depending on the date of termination. This becomes especially important in those industries, such as the financial services industry, where executive compensation frequently involves a modest base salary and a far larger annual bonus.

- Accelerated Vesting of Equity Interests and Other Incentives. Similarly, without a contractual provision providing that in the event of a termination without cause, all future incentive benefits, including the right to stock or stock options, shall become vested (and thereafter payable to the executive on some agreed-on future date), the executive must assume that all *unvested* incentives and equity interests will be forfeited upon the end of his or her employment.

The foregoing should be sufficient to convince the reader that without a good written employment agreement, negotiated by a knowledgeable executive employment attorney, *none* of these items are automatic legal entitlements in the U.S. upon an executive's termination. For an executive in the U.S. to be certain of these enhanced entitlements, he or she must negotiate *an individual written agreement before accepting employment*.

EXECUTIVE RIGHTS AT TERMINATION IN ITALY

Generally speaking, and especially when compared with the situation in the U.S., Italy is very protective of employees. Individuals tend to stay with an employer, rather than move from one company to another, and it is very difficult to terminate employment agreements.

Non-executive employees may only be terminated (i) for cause, (ii) for a justified subjective reason such as serious nonperformance, or (iii) for a justified objective reason such as an internal reorganization that results in redundancy. Until 2012, companies with more than 15 employees were obligated to reinstate an unlawfully terminated employee and to pay damages for the unlawful termination. For years, this was an obstacle to job creation and the growth of the Italian economy. In 2012 and 2015, legislative reforms were passed, which limited the circumstances for reinstatement, reserving this measure only for the most serious cases of unlawful termination. In all other cases, the remedy is limited to payment of an indemnity for damages incurred by the employee.

The foregoing protections apply only to non-executive employees who, as a rule and with certain exceptions discussed below, are excluded from the legal framework that limits individual dismissals. Executives, on the other hand, are granted substantial protections with regard to termination of their employment under collective bargaining agreements.

Legal Framework

In Italy, the rights of an executive in relation to an employment agreement are ruled by the law and, most of all, by collective bargaining agreements (*Contratti Collettivi Nazionali di Lavoro* or "C.C.N.L.'s"). Although theoretically possible, employment relationships that are not ruled by a C.C.N.L. are very rare.

It is therefore uncommon for executives to enter into a proper employment agreement or to provide for the consequence of a termination. Rather, it is common to be hired by a simple letter indicating the main conditions of the employment, such as salary, title, and main duties, with all other rights and duties provided under the applicable C.C.N.L.

Italian law provides its own set of protections beyond the scope of the C.C.N.L.'s in cases of (i) discriminatory dismissal based on gender, age, religion, and other similar items; (ii) dismissal based on an illegal motivation, such as a retaliatory dismissal); or (iii) other motives considered illegal by the law. To illustrate, the executive must be reinstated in his or her position, which means that the working relationship continues. However, the executive may instead choose an indemnity amounting to 15 months' salary. In addition, the executive may claim an indemnity in the amount corresponding to the salary not received during the period of wrongful termination from the date of dismissal to the date of reintegration.

As with all other employees, the executive is entitled to a notice period, unless the dismissal is for cause. The duration of the notice period is determined by the applicable C.C.N.L. The most important C.C.N.L.'s are those applicable to the industrial and commercial sectors.

The duration of the notice period depends on seniority. In the above mentioned C.C.N.L.'s, the notice period ranges between a minimum of six months' and a maximum of 12 months' salary. The higher range applies for executives whose employment has exceeded 15 years.

It is common to substitute the notice period for an indemnity that is equal to the salary that would have been paid during the notice period and to exonerate the executive from a continuing obligation to work for the company. Bonuses or other variable remuneration may also be included. Thus, the amount involved in the indemnity may be high.

Health Insurance

All Italian residents are covered by social security, which includes access to public health care for a reduced amount, depending on income. Most executive employment packages include additional coverage that reimburses all or part of private health care. Such coverage normally continues during the notice period, even if the executive is not required to work during that time.

Vesting of Equity Interest and Other Incentives

There is no specific rule regarding the acceleration of stock options or other incentives that are generally ruled by the provisions of the incentive plan and the company policy in this regard; these aspects are often included in negotiations following termination.

Additional Indemnity

The C.C.N.L.'s also provide for the right of the executive to receive an additional indemnity when the dismissal is not justified. The range of motives for dismissal that have been considered as justified by the courts is quite wide. It includes all motives that may jeopardize the relationship between the employer and the executive.

The amount of the additional indemnity provided by the C.C.N.L.'s is based on duration of employment, age, and other case-specific facts. The most recently renewed C.C.N.L.'s reduced the number of months for which the additional indemnity may be payable to less senior executives. The minimum is now two months' salary, and the maximum can reach 24 months' salary.

T.F.R.

T.F.R. stands for *Trattamento di Fine Rapporto* (*i.e.*, severance pay), which is an amount of money that each employer must hold for all his or her employees until they leave the company or job. It is not a redundancy payout, since it is paid even in the case of voluntarily resignation, but rather a kind of compulsory savings plan.

N.A.S.P.I.

N.A.S.P.I. (*Nuova Assicurazione Sociale per l'Impiego*) is a governmental institution acting as unemployment insurance. It may provide compensation for unemployed persons, including executives, for a maximum period of 24 months.

The period of eligibility begins after the end of the notice period and its duration will depend on the amount paid by the company and the duration of the employment.

In any case, the maximum monthly amount payable by N.A.S.P.I. is currently €1.3 million (approximately $1.45 million).

Practically Speaking

In Italy, it is common for executives and their employers to negotiate a "termination package" – within the range provided by the applicable C.C.N.L. When a complaint is filed before a labor court, it is generally done in order to provide additional leverage in negotiations.

CONCLUSION

Italian employment law provides greater legal rights to a terminated executive than U.S. law. In the U.S., benefits are derived from a well-drafted employment agreement. In Italy, as in much of Europe, benefits are derived from employment law and industry-wide collective bargaining agreements. As a result, U.S. businesspersons and their attorneys are often surprised by the differences between a typical Italian employment contract and those in the U.S. The surprise is even greater when it is discovered that an employment agreement with an Italian executive is subject to a set of mandatory provisions of law and industry-wide agreements that provide significant termination rights notwithstanding the absence of a detailed agreement or any agreement at all. More importantly, these rights cannot be bargained away by the employee in an employment agreement. *Caveat Dominus!*

"Italian employment law provides greater legal rights to a terminated executive than U.S. law."

CIRCULAR LETTER NO. 17/E CLARIFIES SPECIAL TAX REGIME FOR ITALIAN "NEW RESIDENTS"

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INTRODUCTION

On December 7, 2016, the Italian Parliament approved the 2017 Budget Law, which entered into force on January 1, 2017. Article 1, paragraphs 152 through 159 of the law introduce a new tax regime for individuals who transfer their tax residence to Italy (the "New-Resident Regime"). This regime is meant to make the transfer of tax residence to Italy appealing and, in particular, to attract wealthy individuals and families. The Italian New-Resident Regime offers preferential tax treatment, which consists of a yearly lump-sum payment of €100,000 on any foreign income and gains, and exclusion from inheritance and gift tax on foreign assets, departing from ordinary treatment under Italian tax law.

The Italian tax authority (*Agenzia delle Entrate*) released Protocol No. 47060, the initial implementing rules, on March 8, 2017. Then, on May 23, 2017, it released Circular Letter No. 17/E (the "Circular"), which provides several clarifications and additional guidance for application of the regime.

WHO CAN APPLY?

The New-Resident Regime is reserved for individuals with citizenship abroad or in Italy who meet the following two conditions:

- They transfer tax residence to Italy.
- With regard to Italy, they have had nonresident status for tax purposes for nine out of the ten preceding taxable years.

As general rule, individuals are deemed to be resident in Italy if they meet any of the following conditions on 183 days or more during the tax year (184 or more days in case of leap years):

- The individual is registered in the Civil Registry of the Resident Population.
- The individual is domiciled in Italy pursuant to the Italian Civil Code.
- The individual is resident in Italy pursuant to the Italian Civil Code.

In order to prevent an abusive exercise of the election, the *Agenzia delle Entrate* has published a checklist to identify a series of factual circumstances that may be indicative of tax residence in Italy based on the individual's center of vital interests. Among the factors to be considered are the tax residence of a spouse or children in Italy and the availability of movable and real property assets in Italy. In addition, individuals who have never withdrawn themselves from the Italian Civil Registry of the Resident Population cannot apply for the regime.

When the two requirements are met, an individual may apply for the benefits of the New-Resident Regime and take steps to become registered in the Civil Registry of the Resident Population. According to the Circular, enrollment in the Civil Registry of the Resident Population is sufficient to qualify for benefits, although appropriate verification procedures may be carried out to prevent abuse.

Protocol No. 47060 clarifies that the regime is also available from 2017 for those who transferred their tax residence to Italy in 2016, provided that the nine-year residency requirement is met.

THE NEW-RESIDENT REGIME

Beginning with the 2017 fiscal year, the New-Resident Regime provides for lump-sum taxation of €100,000 per year on non-Italian-source income and gains. This payment is in lieu of the tax that would be applied ordinarily. Such income and gains are not subject to any additional income taxation, even if remitted to Italy. However, all Italian-source income and gains remain subject to ordinary tax rules under the Italian personal income tax regime.[1]

The New-Resident Regime can be extended to family members by paying an additional €25,000 per year, per relative. The family members who can benefit from the regime include spouses, sons and daughters (including sons-in-law and daughters-in-law), parents (including parents-in-law), and brothers and sisters. If the new resident does not have any sons or daughters, the direct closest descendants can benefit in their places. The New-Resident Regime may be extended to family members at different points in time. Consequently, each family member can access the regime at a later date if they remain resident abroad after Italian residence is established by the principal applicant.

The taxpayer may elect to apply the New-Resident Regime to income earned in all foreign countries or only selected countries ("cherry picking"). No tax credit is granted for taxes paid in countries for which the new resident has elected to be covered by the €100,000 Italian tax payment.

In general, income is deemed to be foreign sourced and is consequently covered by the lump-sum tax if any of the following conditions is met:

- The income is derived from assets located abroad.
- The income is derived from activities performed abroad.
- The payer is resident abroad.

In accordance with Italian law, certain foreign financial assets produce foreign income, even if they are held with Italian banks. Such foreign income is covered under the lump-sum tax. Consequently, a taxpayer utilizing the New-Resident Regime should advise the Italian bank of the election in order to avoid the application of domestic withholding tax to these financial assets. Where a bank has collected

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1 With reference only to Italian-source income and foreign income that is subject to Italian personal income tax ("I.R.P.E.F."), some deductions are granted (*e.g.*, for social security and welfare contributions, health care contributions (up to €3,615.20), and donations to certain qualifying religious organizations and universities).

withholding tax from income produced by these assets notwithstanding the income's foreign character, the withholding tax may be used to offset other Italian taxes pursuant to Article 17 of Legislative Decree no. 241 of 1997 or be recovered by submitting a claim for refund within the terms of Article 38 of D.P.R. n. 602 of 1973.

In some cases, the benefit of the New-Resident Regime is also granted to foreign-source income derived from assets held through a foreign or Italian subsidiary. In this regard, if the entity (*e.g.*, a trust, foundation, or company) is disregarded for Italian tax purposes, foreign income arising from the underlying assets is covered by the lump-sum tax. In comparison, if Italian movable or immovable assets are held through a foreign interposed entity, income arising from those assets is subject to ordinary Italian taxation.

Where an individual benefitting from the New-Resident Regime is a director in a company formed outside of Italy, the Circular clarifies that such entities are not considered to be tax resident in Italy, provided that a majority of the board of directors are not Italian resident individuals who do not benefit from the New-Resident Regime. Moreover, the Italian Controlled Foreign Companies rules do not apply to non-Italian-resident companies held by individuals benefitting from the New-Resident Regime unless the direct shareholder of the nonresident company is itself an Italian company.

In order to prevent abusive situations, the exercise of the election will not prevent the imposition of capital gains tax on foreign substantial participations ("Qualified Participations") generated in the first five years of residence under the New-Resident Regime. During that period, the gains will be subject to ordinary taxation in Italy. Pursuant to Italian law, a shareholding is a Qualified Participation when the shares meet either of the following thresholds:

- The shareholding represents a percentage of voting rights in the company's ordinary shareholders' meeting that exceeds 2% for listed shares or 20% for unlisted shares.
- The shareholding represents a participation in the share capital exceeding 5% for listed shares or 25% for unlisted shares.

Thus, if capital gains are derived on Qualified Participations during the first five years of Italian tax residence under the New-Resident Regime, the ordinary I.R.P.E.F. regime and a tax rate of roughly 25% will be applicable. However, a step up in basis is regularly available for Qualified Participations in unlisted companies provided that a charge is paid based on the fair market value of the company. Through June 30, 2017, the charge was imposed at the rate of 8%.

The five-year period starts from the first tax period of Italian tax residence. As such, if an individual transfers his or her tax residence during the 2017 fiscal year and applies for the New-Resident Regime from 2018, capital gains arising from the disposal of foreign qualified shareholdings will be out of the scope of the substitute tax through the close of the 2021 tax year.

The value of the Qualified Participation must be reported on Form RW of the Italian tax return during the first five years of Italian residence. For disposals within the initial five-year period, capital gain is calculated as follows:

- If, upon a move to Italy, the former country of residence imposed a departure tax, the value used by that country to compute taxable gain becomes the tax basis for Italian tax purposes. In all events, the basis is capped at the fair market value of such shareholdings, as determined under principles of Italian tax law.

- If, upon a move to Italy, the former country of residence did not impose a departure tax, the tax basis for Italian tax purposes is the original purchase price.

Aside from Qualified Participations, the New-Resident Regime grants exemption from the following aspects of Italian tax law:

- Reporting obligations in relation to foreign assets (Form RW)
- Payment of wealth taxes on real estate properties and financial assets held abroad (respectively, I.V.I.E. and I.V.A.F.E.)
- Inheritance and gift tax on rights and assets held abroad

Italian tax residents are normally liable for gift tax and inheritance tax on transfers of assets by way of gift or at the time of death, whether the asset is located in Italy or abroad. In cases of foreign donors or deceased residents, the foreign assets are out of the scope of Italian gift tax or inheritance tax with regard to assets located abroad. Individuals who elect to be taxed under the New-Resident Regime, and the family members who accompany them in benefitting from the New-Resident Regime, will be exempt from gift tax and inheritance tax on transfers of assets located outside Italy regardless of the residence of the recipient or heirs. No cap is placed on this benefit. In comparison to this favorable treatment, "non-donor" acts (*liberalità indirette*) and deeds establishing restrictions on use (*atti di costituzione di vincoli di destinazione*) of property located in Italy will be subject to gift tax.

As mentioned above, an individual may elect out of the New-Resident Regime on a cherry-picking basis. This may allow the individual to benefit from certain tax treaties that might not otherwise apply to Italian residents benefitting from the New-Resident Regime. Where an individual opts out with regard to a country, Form RW must be filed and wealth taxes (*i.e.*, I.V.I.E. and I.V.A.F.E.) must be paid with respect to assets held in that country.

Individuals benefitting from the New-Resident Regime can add additional "excluded States" each year. However, once a jurisdiction has been excluded, it cannot be covered by the substitute tax in the following tax periods. The Circular also clarifies that where the individual has opted out of the New-Resident Regime with regard to income and gains realized in one or more foreign countries, the election is extended to inheritance and gift tax, also.

PROCEDURE AND TIMEFRAME

The election for the New-Resident Regime must be made on the personal income tax return related to either the tax period in which the individual transferred residence to Italy or the following tax year.

It is possible to obtain prior approval from the *Agenzia delle Entrate* by filing a ruling (a so-called *interpello*), although the request for a ruling is not mandatory. The

"The lump-sum tax must be remitted in a single payment, due by June 30, each year and cannot be deducted from other taxes."

ruling can be filed even if the taxpayer has not yet transferred tax residence in Italy. In this case, the taxpayer must also submit a "checklist," which contains several questions related to the personal, social, and economic situation of the taxpayer and the taxpayer's family. The checklist published by the *Agenzia delle Entrate* is intended to identify factual circumstances that may indicate the absence of tax residence in Italy in nine of the ten years preceding the exercise of the election. If the taxpayer decides to exercise the option without filing a ruling request, the information requested in the checklist must be included on the Italian tax return in which the option is exercised.

A response to a ruling request must be issued within 120 days, which can be extended by an additional 60 days under certain conditions. If the *Agenzia delle Entrate* does not reply within the above deadline, a positive reply is deemed to have been issued.

The taxpayer must indicate in the ruling request, or in the Italian tax return where the option is exercised, the jurisdiction or jurisdictions where residence was maintained prior to acquiring Italian residence. The *Agenzia delle Entrate* will exchange information with the tax authority of each such jurisdiction.

Once the New-Resident Regime is elected, special tax treatment is allowed for up to 15 years. During this period, entitlement to benefits is automatically renewed annually, unless an early withdrawal or reason for loss of entitlement occurs. The New-Resident Regime ceases to apply in the case of omitted or partial payment of the substitute tax or in the case of a transfer of tax residence to another country. In addition, the taxpayer, or accompanying family member, may revoke the election at any time. In any event, if the principal taxpayer withdraws from the New-Resident Regime, withdrawal will apply to the accompanying family. However, a family member to whom the regime has been extended can exercise an option to remain subject to the New-Resident Regime for the remaining tax period. In any event, if the principal taxpayer revokes the election or loses status under the New-Resident Regime, or if a family member opts in and then opts out of continued status under the New-Resident Regime, the loss of status is final and cannot be reversed.

The lump-sum tax must be remitted in a single payment, due by June 30, each year and cannot be deducted from other taxes. The New-Resident Regime cannot be combined with other tax relief related to the transfer of residence to Italy.

TAX TREATY RELIEF

When making an election for coverage by the New-Resident Regime, it is important to gage the effect of the election on treaty benefits with regard to income from sources outside Italy as well as capital, gifts, and inheritances involving property located outside of Italy.

The Circular clarifies that individuals benefitting from the New-Resident Regime are considered as Italian resident for the purposes of the double tax treaties entered into by Italy, since such individuals are taxed in Italy on their worldwide income and foreign income is subject to the lump sum substitute tax. Nonetheless, it is the view of the tax authorities in countries other than Italy that could be problematic. Consequently, entitlement to benefits from double tax treaties should be verified on a case-by-case basis.

In broad terms, the O.E.C.D.'s Model Tax Convention on Income and on Capital (the "Convention") defines the term "resident of a contracting state" as any person who, under the law of that state, is liable to taxation therein by reason of their domicile, residence, place of management, or any other similar criterion. However, some treaties contain a specific "subject to tax" condition that must be met for someone to be considered a resident of a contracting state. For example, the double tax treaty between Switzerland and Italy establishes that an individual will be deemed not to be resident in either country if the individual is not subject to the taxes generally levied on all the income in the state of purported residence.

With respect to inheritance in Italy, double tax treaties exist with the following countries: the U.S., Sweden, Greece, the U.K., Denmark, Israel, and France. Notably, only the treaty stipulated with France concerns both inheritance and gift taxes. Focusing on the double tax treaty between Italy and France, Article 4 states that the term "person domiciled in a contracting state" does not include persons whose inheritance or donation is subject to tax in a state only for the properties which are situated therein. Thus, an individual who elects to apply the New-Resident Regime, generally speaking, is not considered a resident for the purpose of this treaty.

NEW INVESTOR VISA

The new flat-tax regime is accompanied by changes to Italian immigration laws designed to make it possible for individuals who are not nationals of an E.U. Member State to avoid restrictions that usually apply to the acquisition of Italian residence. Article 1, paragraph 148 of the 2017 Budget Law introduced a special two-year "visa for investors" regime, which aims to attract foreign investors and high-net-worth individuals to Italy.

The newly introduced investor visa is for foreign investors who intend to meet one of the following thresholds:

- The individual will invest at least €2 million in bonds issued by the Italian government, and maintain that investment for at least two years.
- The individual will invest at least €1 million in an Italian company, or €500,000 in an "innovative start-up" Italian company, registered with the special section of the Italian Chamber of Commerce, and maintain that investment for at least two years.
- The individual will make a philanthropic donation of at least €1 million in support of an Italian project of public interest in the field of culture, education, immigration, or scientific research.

To request and obtain the investor visa, foreign investors must (i) demonstrate beneficial ownership of the sufficient liquid sums that can be readily transferred to Italy, (ii) submit a written statement committing to make the investment or gift within three months of entering Italy, and (iii) demonstrate expected income of an amount higher than the minimum level for the exemption from healthcare contributions (*i.e.*, €8,500).

The exact application procedure for the investor visa is yet to be determined. The Italian Ministry of Economic Development, Ministry of Internal Affairs, and Ministry of Foreign Affairs and International Cooperation will issue a joint decree setting out the procedure and appointing the authority responsible for processing the application and issuing the clearance to authorize the consulate to release the visa. It is likely that the individual will be expected to submit the required documentation through a web platform. The Financial Intelligence Unit will be tasked to ascertain the lawful source of an applicant's funds. Finally, an applicant will likely be required to (i) present a copy of a passport or travel document with an expiry date that exceeds the required visa by a minimum of three months, (ii) provide proof of financial resources, (iii) provide self-certification of the legitimacy of the source of funds, and (iv) provide a clear and detailed description of the investment and its intended beneficiary.

If approved, the designated authority will send clearance to the relevant diplomatic or consular representative, who will issue the investor visa. As indicated above, the investor visa will grant the right to a two-year residence permit, which can be extended for an additional three-year period. In any event, the visa is revocable if a donation is not made within three months of the date of entering Italy or if an investment is disposed of before the two-year expiry date of the visa. After legally staying in Italy for five years, a foreign national can apply for permanent residency, provided the eligibility requirements have been met. Family members will also be allowed to join the foreign investor in Italy and receive a stay permit for family reasons.

Finally, it should be noted that specific criminal penalties are to be applied in the case of providing false documents or untrue certification regarding the lawful source of funds.

EUROPEAN COMMISSION PROPOSES NEW ADVISOR DISCLOSURE OBLIGATION FOR AGGRESSIVE TAX PLANNING

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In the current context of tax transparency, fair and effective taxation, and global tax good governance, the European Commission (the "Commission") recently pushed existing disclosure obligations one step further. On June 21, 2017, it published a proposal for a Council Directive (the "Proposal") amending Directive 2011/16/EU dealing with automatic exchange of information in the field of taxation (the "Directive").[1] The Proposal requires certain intermediaries, including tax lawyers, to report certain potentially aggressive tax arrangements.

The Proposal comes in the context of B.E.P.S. Action Plan 12 (Disclosure of Aggressive Tax Planning) and the fact that certain financial intermediaries and tax advisors – as revealed again by last year's Panama Papers scandal – presumably assisted clients in hiding wealth in offshore jurisdictions.

In the press release announcing the proposal, the Commission's Pierre Moscovici stated:[2]

> We are continuing to ramp up our tax transparency agenda. Today, we are setting our sights on the professionals who promote tax abuse. Tax administrations should have the information they need to thwart aggressive tax planning schemes. Our proposal will provide more certainty for those intermediaries who respect the spirit and the letter of our laws and make life very difficult for those that do not. Our work for fairer taxation throughout Europe continues to advance.

Currently, E.U. Member States are not required to exchange information when they are made aware of tax avoidance or tax evasion plans. The Proposal aims at changing this by scrutinizing intermediaries (such as lawyers, accountants, and bankers) and requiring them to disclose potentially aggressive tax planning arrangements that contain a cross-border element. This disclosure would be done by a timely automatic exchange of information. According to the Commission, only uniform action would provide the appropriate level of disclosure to prevent abusive tax planning involving intermediaries. Consequently, the scope of existing automatic exchange of information between tax authorities must be extended.

At the E.U. level, Ireland, Portugal, and the U.K. already have mandatory disclosure rules in place.

In an attempt to keep compliance costs as low as possible, only the minimum necessary framework for disclosure will be established. The Commission cites the

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1 Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements.

2 European Commission, "Commission Forges Ahead on New Transparency Rules for tax planning intermediaries," news release, June 21, 2017.

following examples:

- The rules set out clear reporting responsibilities to avoid double reporting.
- The common rules are limited to addressing potentially aggressive tax planning schemes with a cross-border element within the E.U.
- There will be no publication requirement of the reported tax schemes, only automatic exchange between Member States.
- Penalties for non-compliance will be established under the provisions that implement the Directive into national law and will remain under the sovereign control of Member States.

Member States will retain jurisdiction to decide how to pursue cases of illegitimate arrangements, but the exchange of information will be automatic.[3] The first reports would be due by March 31, 2019.[4]

POTENTIALLY AGGRESSIVE TAX PLANS

Since tax planning evolves, the Commission chose not to define what constitutes a potentially aggressive tax arrangement. Instead, it identified certain hallmarks of potentially aggressive tax plans. These hallmarks describe aspects of transactions that present a strong indication of tax avoidance or abuse. If a hallmark exists, the plan must be reported to the tax authorities.[5]

Annex IV[6] lists five types of hallmarks (with the two first only taken into consideration if the plan meets the "main benefit test" discussed below):

"[T]he Commission chose not to define what constitutes a potentially aggressive tax arrangement. Instead, it identified certain hallmarks."

- **Generic Hallmarks**. These hallmarks include (i) arrangements entered into to take advantage of confidentiality; (ii) arrangements under which intermediaries are entitled to a fee linked to the tax advantage provided for by the arrangement, or to the absence thereof; and (iii) arrangements that are based on the use of standardized forms that need not be adapted to every single taxpayer.[7]
- **Specific Hallmarks Which May Be Linked to the Main Benefit Test**. These include (i) arrangements triggering the use of losses, (ii) arrangements converting the nature of an income flow from ordinary to another low-taxed category, and (iii) certain circular transactions that result in offsetting certain income flows.[8]
- **Specific Hallmarks Related to Cross-Border Transactions**. These hallmarks include (i) arrangements that entail a deductible payment made to a recipient that will not be taxed on receipt, (ii) depreciation deductions taken in

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3 Proposed new article 25a of the Directive.

4 New Article 8aaa.4 added to Section II of Chapter II of the Directive.

5 Article 1(b) of the Proposal, as amending Article 3 point 19 of the Directive.

6 Article 1(b) of the Proposal, as amending Article 3 point 20 of the Directive.

7 Annex IV (A) of the Proposal.

8 Annex IV (B) of the Proposal.

more than one jurisdiction on the same asset, (iii) items of income for which more than one taxpayer can claim double-taxation relief, and (iv) arrangements containing transfers of assets to other jurisdictions that reduce the amount payable in consideration of the assets.[9]

- **Specific Hallmarks Concerning Automatic Exchange of Information Agreements in the E.U.** This category targets arrangements circumventing automatic exchanges of information, resulting in unreported income in the taxpayer's country of residence.[10]

- **Specific Hallmarks Concerning Transfer Pricing**. These include arrangements that do not conform to the arm's length principle or the O.E.C.D.'s transfer pricing guidelines. They also include arrangements that fall within the scope of existing automatic exchange of information provisions concerning advance cross-border rulings but that are not reported or exchanged.[11]

"The 'generic hallmarks' and the 'specific hallmarks which may be linked to the main benefit test' are taken into account only when the main benefit of an arrangement is to obtain a tax advantage."

The "generic hallmarks" and the "specific hallmarks which may be linked to the main benefit test" are taken into account only when the main benefit of an arrangement is to obtain a tax advantage (the "main benefit test"). This occurs:

> * * * if it can be established that the advantage is the outcome which one may expect to derive from such an arrangement, or series of arrangements, including through taking advantage of the specific way that the arrangement or series of arrangements are structured.

Plans that exemplify the various hallmarks include the following:[12]

- Plans that involve a cross-border payment to a recipient resident in a no-tax jurisdiction
- Plans that involve a jurisdiction with inadequate or weakly enforced anti-money laundering legislation
- Plans that are set up to avoid reporting income as required under E.U. transparency rules
- Plans that circumvent E.U. information exchange requirements for tax rulings
- Plans that have a direct correlation between the fee charged by the intermediary and the tax savings from the arrangement
- Plans that result in depreciation deductions to be claimed on the same asset in more than one country
- Plans that enable the same income to benefit from tax relief in more than one jurisdiction
- Plans that do not respect E.U. or international transfer pricing guidelines

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9 Annex IV (C) of the Proposal.

10 Annex IV (D) of the Proposal.

11 Annex IV (E) of the Proposal.

12 European Commission, "Questions and Answers on New Tax Transparency Rules for Intermediaries," June 21, 2017.

INTERMEDIARIES AND DISCLOSURE

Intermediaries are responsible for reporting a potentially aggressive plan, if they designed, marketed, organized, or managed the transaction while providing tax-related services. In addition, in order to be an "intermediary," an advisor must have a contact with the E.U. This means that the advisor must meet at least one of the following criteria:[13]

- Incorporated in, and/or governed by the laws of, a Member State
- Resident, for tax purposes, in a Member State
- Registered with a professional association related to legal, taxation, or consultancy services in at least one Member State
- Based in at least one Member State from where the person exercises their profession or provides legal, taxation, or consultancy services

Intermediaries can be individuals or legal entities, including entities that have no legal personality.

In certain circumstances, the obligation to report is shifted to the taxpayer. This will occur when (i) the intermediary is not able to disclose the information because of a privilege enjoyed by the taxpayer, such as the attorney-client privilege of confidentiality; (ii) the intermediary has no European presence; or (iii) the plan is designed in-house. In any such fact pattern, the disclosure obligation shifts to the taxpayer.[14] When this shift occurs due to a privileged situation, the intermediary must inform the taxpayer of this shift in responsibility.[15]

TIMING OF DISCLOSURE

In order to effectively deter implementation of aggressive tax plans, the disclosure obligation must be made at an early stage, ideally prior to implementation of a disclosed plan.

The required timing varies depending on who is subject to the disclosure obligation:

- If the intermediary must report the plan, the reporting must be made within five days, beginning on the day after the plan becomes available to a taxpayer for implementation or the first step in a series of arrangements has been implemented.[16]
- If the reporting obligation is shifted to the taxpayer, the disclosure must occur within five days, beginning on the day after the reportable plan, or the first step in a series of arrangements, has been implemented.[17]

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13 Article 1(b) of the Proposal, as amending Article 3 point 21 of the Directive.

14 Proposed new Article 8aaa.2 added to Section II of Chapter II of the Directive.

15 *Id.*

16 *Id.*

17 *Id.*

EXCHANGED INFORMATION

The disclosure will be made using the common communication network developed at the E.U. level. To ensure a standardized disclosure obligation throughout the E.U., a standard form would be created.[18]

The items of information that are expected to be exchanged include the following:[19]

- The identification of intermediaries and taxpayers, which should include the name, country of tax residence, taxpayer identification number, and (where appropriate) persons associated with the intermediary or taxpayer
- Details of the hallmarks that make the cross-border arrangement reportable
- A summary of the content of the reportable cross-border arrangement, which should include a reference to the name by which the arrangement is commonly known and a description of the relevant business activities or arrangements, excluding (i) disclosure of a commercial, industrial, or professional secret, or of a commercial process or (ii) disclosure that is contrary to public policy
- The date of implementation of the arrangement or the date of commencement of the first step in a series of such arrangements
- The national tax provisions that enable the tax advantage
- The value of the transaction
- The other Member States that are affected by the plan
- The names and identifying information of any person in another Member State that is likely to be affected by the reportable cross-border arrangement or series of such arrangements

CONCLUSION

Sophisticated corporations understand that a business transaction originating in the tax department or at a meeting with outside tax advisors can suffer from the appearance of an absence of economic substance, as the steps are laid out by tax advisors and not business people. The Proposal adopts that approach.

In principle, it is one thing to give tax advice regarding a plan that is taking place for operational reasons and another for a tax advisor to orchestrate the entire transaction. In practice, no one yet knows where the line will be drawn between an aggressive tax plan and an acceptable tax plan where the advice explains two choices for implementation: one that yields higher taxes and one that achieves greater tax savings.

18 Proposed new Article 20(5) of the Directive.

19 Proposed new Article 8aaa.6 added to Section II of Chapter II of the Directive.

FAMILY LIMITED PARTNERSHIPS IN ESTATE PLANNING – IS *ESTATE OF POWELL* THE END OR THE BEGINNING OF AGGRESSIVE TAX PLANNING?

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Tags
Estate of Powell
Estate of Strangi
Family Limited Partnership
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U.S. v. Byrum

In a recent Tax Court decision, *Estate of Powell v. Commr.*, the majority opinion of the Tax Court made two notable decisions that may affect the future use of family partnerships in estate planning:

- It extended the application of Code §2036(a)(2) to a decedent who owned only a limited partnership interest; and
- It applied Code §2043(a) for the first time to limit the Code §2036 inclusion to the amount by which a gross estate is depleted, *i.e.*, the discount applied to the value of property transferred to the partnership, plus (or minus) any change in the value of the transferred assets between the date of the transfer and the date of death.

Instead of following the standard I.R.S. approach[1] for cases where Code §2036(a) was applied, which was never contested, the court adopted a new, untested theory–one that could potentially create "problems that we do not yet know about." This uncommon approach and the potential implications are discussed in detail in the following article.

THE FACTS

- On August 8, 2008, the decedent's son, Mr. Powell, acting on her behalf as the trustee of a revocable trust, transferred approximately $10 million in cash and securities from the trust to NHP Enterprises LP ("NHP"), a family limited partnership formed by Mr. Powell, a general partner, two days earlier. In exchange for the transferred cash and securities, the decedent received a 99% limited partnership interest in NHP. Her two sons transferred unsecured promissory notes in exchange for a shared 1% general partner interest.
- The value of the limited partnership interest was based on a Duff & Phelps appraisal, which applied a 25% discount for lack of control and lack of marketability.
- NHP's limited partnership agreement gave Mr. Powell, as general partner, the sole discretion to determine the amount and timing of partnership distributions. The partnership agreement allowed for the dissolution of the partnership with the written consent of all partners.
- On August 8, 2008, the same day the $10 million was transferred to NHL,

[1] Under this approach, the value of the assets transferred during life are included in the value of the gross estate, in lieu of the value of the property received in return.

Mr. Powell, purportedly acting on behalf of the decedent under a power of attorney, assigned the decedent's 99% limited partnership interest in NHP to a charitable lead annuity trust ("C.L.A.T."). The terms of the C.L.A.T. provided an annuity to a nonprofit corporation for the rest of the decedent's life. Upon the decedent's death, the remaining assets in the C.L.A.T. were to be divided equally between two trusts for the benefit of Mr. Powell and his brother.

- The power of attorney granted Mr. Powell broad authority to deal in all property, real and personal, which the principal may own. With respect to gifts, the power of attorney authorized Mr. Powell to make gifts to the full extent of the Federal annual gift tax exclusion under the Code.
- At the time of the transfers, the decedent was hospitalized in an intensive care unit and was described by two doctors as incapacitated and unable to act on her own behalf.
- The decedent died seven days after the $10 million transfer to NHP.
- The I.R.S. claimed there was no reason for creating the partnership other than a tax reason, and the estate did not challenge this claim.

"The court concluded that the value of the property would have been included in the decedent's estate under Code §2035, provided she did not transfer the property and Code §2036 applied."

The I.R.S. claimed that the $10 million contributed to NHP was includible in the decedent's estate, without a discount, under either Code §2036(a)(1) (retained enjoyment or right to income), Code §2036(a)(2) (retained right, alone or in conjunction with any person, to designate who could enjoy the property or its income), or Code §2038 (power to alter, amend, revoke, or terminate the transfer at the time of death).[2] Additionally, the I.R.S. claimed that the transfer to the C.L.A.T is disregarded under Code §2035(a) (transfer of property by gift within three years of death, if such property would have otherwise been included in the estate under Code §§2036-2038 or 2042).

The estate, completely ignoring Code §2035(a), did not challenge the I.R.S.'s argument that the decedent may have retained certain rights. Rather, the estate argued that notwithstanding any retained right in the partnership interest, the value of the assets contributed to NHP should not be included in the decedent's gross estate because the decedent did not hold her interest in NHP upon her death. Thus, according to the estate, even if the decedent's interest in NHP gave her the right to designate the beneficiaries of the property that she transferred to the partnership, Code §2036(a)(2) does not apply.

With respect to the estate's claim, the court concluded that, under California law, the power of attorney did not allow the son to gift the 99% limited partnership interest to the C.L.A.T., deeming the transfer void. Nevertheless, since the validity of the transfer was a matter of state law, the court analyzed whether (if the gift was valid) the value of the cash and securities should be included in the decedent's estate from a tax law perspective.

Notwithstanding the question of whether the transfer to the C.L.A.T. was valid under state law, the court concluded that the value of the property would have been included in the decedent's estate under Code §2035, provided she did not transfer the property and Code §2036 applied, because the gift was made within three years

[2] Because Code §2036(a)(2) applied, the majority opinion did not consider Code §§2036(a)(1) or 2038.

of the decedent's death. Thus, the court rejected the estate's claim and turned its analysis to the I.R.S. arguments.

APPLICABILITY OF CODE §2036(A)(2) TO A MERE LIMITED PARTNERSHIP INTEREST

Unlike Code §2036(a)(1), which may be applied in cases of an express or implied understanding concerning the assets transferred rather than a legally enforceable right, Code §2036(a)(2) requires the presence of a "right" in order to include the transferred property in the gross estate of a decedent.

Normally, in the context of limited partnerships, such legal rights are held by the general partner, and indeed, the court has applied Code §2036(a)(2) before in such circumstances.[3] However, in *Powell* the decedent merely held a limited partnership interest, which does not embody such rights, and nevertheless, the court applied Code §2036(a)(2). This is the first time the Code section has been applied in this way.

It did so by adopting a theory introduced by the Tax Court 14 years ago in *Estate of Strangi*, whereby the limitation imposed by the "fiduciary duties" of a manager (duties which caused the Supreme Court to reject the application of Code §2036(a)(2) in *Byrum*) are simply "illusory." Under this theory, the decedent is treated as holding, through an agent, the rights of a general partner.[4]

In *Byrum*, the Supreme Court rejected the I.R.S. argument that through the ability to vote on the transferred shares, the decedent could affect the corporations' dividend policy and thus retained the right to "designate the persons who shall possess or enjoy the property or the income thereform" under Code §2036(a)(2). The Court's reasoning rested, *inter alia*, on its opinion that the controlling shareholder of each corporation owed fiduciary duties to the minority shareholders that impacted the controlling shareholders' decisions with respect to the corporations' dividend policies.

In *Strangi*, the Tax Court distinguished the case from *Byrum* on several counts, including the fact that, unlike the corporations transferred in *Byrum*, the limited partnership in *Strangi* consisted of only family members and did not conduct any business. The court in *Strangi* noted that the son-in-law who served as the manager of the partnership (and thus controlled partnership distributions) was also the decedent's attorney-in-fact under a power of attorney and therefore owed a personal duty to the decedent. The court thus reasoned that in exercising his duties to the partnership, the son-in-law would not disregard his "preexisting obligation to decedent." Additionally, because the decedent owned 99% of the partnership, any fiduciary duties that limited the son-in-law's authority to make distributions and manage the partnership were, in the eyes of the court, duties he essentially owed to himself and

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3 The few cases where Code §2036(a)(2) was applied before involved decedents who either held a general partnership interest directly, or held an interest in a corporate general partner; See for example *Estate of Clyde W. Turner, Sr. v. Commr.*, T.C. Memo 2011 – 209 and *Estate of Strangi v. Commr.*, T.C. Memo. 2003-145.

4 *Estate of Strangi v. Commr.* T.C. Memo. 2003-145; *U.S. v. Byrum*, 408 U.S. 125 (1972).

thus “illusory” in nature. The court concluded that “intrafamily fiduciary duties within an investment vehicle simply are not equivalent in nature to the obligations created by the *U.S. v. Byrum*.”

In *Powell*, the court concluded that the decedent’s ability to dissolve the family limited partnership with the cooperation of her sons carried with it the ability to direct the disposition of the partnership’s assets. And while this ability was viewed by the court as insufficient to apply Code §2036(a)(2), the court found that the *Powell* case could be distinguished from *Byrum* on the same grounds as the *Strangi* case. In *Powell*, the decedent’s son was her attorney-in-fact and thus owed the decedent personal duties, which he assumed either before he created the partnership or at about the same time. Thus, under the illusory fiduciary duties theory, the agent is viewed as a manager who will not exercise his or her responsibility as a general partner in a way that would prejudice the decedent’s interests. Additionally, when the decedent owns 99% of the partnership, the fiduciary duties that limit the general partner’s discretion in determining partnership distributions are owed almost exclusively to the decedent. Thus, any fiduciary duties held by the general partner (the decedent’s attorney-in-fact) were illusory and did not prevent his authority over distributions from being a right that, if retained by the decedent at her death, is described in Code §2036(a)(2).

The concurring opinion, with which six other judges agree, upheld the court’s application of Code §2036(a)(2) under these circumstances. It describes the facts as aggressive deathbed tax planning where the attorney-in-fact was essentially negotiating with himself and where the decedent clearly had retained the proverbial “string” that pulled the $10 million in cash and securities back into her estate. Notwithstanding the concurring opinion’s agreement with the application of Code §2036(a)(2), the concurring opinion did raise a different theory on which it would have based the inclusion of the assets in the decedent’s estate under Code §2033. Under this theory, the NHP partnership was invalid; therefore, the assets purportedly transferred to NHP were in fact owned by the decedent when she died.

THE LIMITATION UNDER CODE §2043(A) AND THE RISK OF DOUBLE INCLUSION

Code §2043(a) applies when property is transferred *inter vivos* for less than full consideration and the property is to be pulled back into the gross estate under certain Code provisions. The provision, initially included in the Revenue Act of 1926, is intended to limit inclusion under certain provisions in order to prevent double taxation of the same economic interest. Code §2043(a) has never been applied by the Tax Court.[5] However, in *Powell*, the majority opinion chose to “fill that lacuna” and proceeded to analyze the section without any of the parties to the case advancing an argument based on such section.

In order to prevent “double taxation of the same economic interest” – which in the

5 According to the Tax Court in *Powell*, there was only one prior case where Code §2043(a) was considered in the context of a family limited partnership. See *Estate of Harper v. Commr.*, T.C. Memo 2002-121. In *Harper*, the court did not apply Code §2043(a) to limit the inclusion under Code §2036(a) due to the court’s decision that the partnership interest received was to be ignored and not be treated as consideration.

eyes of the court is widely recognized as an illogic result, albeit one, in their opinion, without legal grounds – the majority concluded that when Code §2036(a) is read together with Code §2043(a), it only requires the amount of any depletion in gross estate (in this case, the discount allowed in valuing the limited partnership interest issued in consideration for the transferred property) to be included back in the gross estate. Code §2036(a), read together with Code §2043(a), does not require that the gross estate include the full value of the assets transferred to the partnership, as if they were never transferred and a partnership interest was never received as consideration. Under the court's analysis, the value of the interest in the limited partnership received need not be pulled back into the gross estate under Code §2036(a) because it will be included in the gross estate under the general rule of Code §2033, or be subject to gift tax if gifted *inter vivos* after the formation of the limited partnership.

While the purpose of this analysis was "to explain why double inclusion in a decedent's estate is not only illogical, it is not allowed," it only does so if the assets have not appreciated in value between the time of transfer and the time of death. If the assets appreciate, "duplicative transfer tax" would apply, resulting in more tax owed than if no transfer ever occured; likewise, if the assets depreciated in value, "duplicative reduction in transfer tax" would occur.[6] The majority opinion acknowledged this in a footnote but did not specifically mention if the court would refuse to tax the same appreciation twice. This analysis, in the words of the concurring opinion, was "a solution in search of a problem."

The concurring opinion expressed concern that by adopting this new, untested theory the court is inviting overly aggressive tax planning in search of the possibility of a "duplicative reduction in transfer tax." Further, the concurring opinion found that there was no double inclusion problem to be solved. It viewed the newly formed partnership, if at all valid, as an empty box into which the allegedly transferred property was notionally placed. Thus, the partnership interest had no value apart from the property allegedly contributed and no double inclusion arose from an inclusion of the full $10 million under Code §2036(a).

THE BONA FIDE EXCLUSION AND THE RECYCLING OF VALUE THEORY

The Tax Court's analysis highlights the importance of the "*bona fide* sale" exception to Code §2036(a), especially for taxpayers whose transferred assets may appreciate over time and until their deaths. The analysis references the two-prong interpretation of the *bona fide* sale exception, as established by the Tax Court and other courts. Meeting this exception requires an estate to establish both: (i) a nontax *bona fide* reason for creating the partnership and (ii) the existence of full and adequate consideration (*i.e.*, receiving partnership interests that are proportionate to the value of the property transferred). The court discussed this exception as it justified the application of Code §2043(a) to family limited partnerships notwithstanding the "recycling of value" theory raised by the court in *Estate of Harper*,[7] eliminating

[6] This is because Code §2036 includes the date-of-death value in the value of the gross estate, while Code §2043 reduces the inclusion by the date-of-transfer value.

[7] *Estate of Harper v. Commr.* T.C. Memo. 2002-121.

the need to consider the effect of Code §2043.

In *Harper*, the court concluded that the partnership interest received did not qualify as consideration for purposes of either Code §§2036(a) or 2043(a) because the formation of the partnership did not involve genuine pooling of assets and was nothing more than a circuitous recycling of value that does not rise to the level of a payment of consideration.

> ***"The majority opinion not only extended the application of Code §2036(a)(2) to a limited partner but adopted at the center of its analysis a theory under Code §2043(a) that was never before discussed by the courts."***

In *Powell*, the court concluded that the extent of the pooling of assets is more relevant to the first prong of the *bona fide* exception (the nontax reason for the transaction) than to the adequacy of the consideration prong. Therefore, the proportion of partnership assets contributed does not affect the treatment of the family limited partnership interest issued in return as "consideration" for the transferred property for purposes of Code §§2036(a) and 2043(a). The court further mentioned that application of discounts when valuing an interest in a family limited partnership does not prevent the partnership's formation from qualifying for the *bona fide* sale exception, if the partnership was created for a legitimate nontax reason. Otherwise, the *bona fide* exception would not apply and, according to the majority's opinion, the net effect of Code §2036(a) as limited by Code §2043(a) would be the inclusion of the discount in the gross estate.

CONCLUSION

While the fact that the taxpayer lost is not actually surprising considering the bad facts – which can best be described as aggressive deathbed tax planning – the ruling is mostly surprising in that the majority opinion not only extended the application of Code §2036(a)(2) to a limited partner but adopted at the center of its analysis a theory under Code §2043(a) that was never before discussed by the courts, was not raised by either of the parties, and "was not necessary" for the result. According to the concurring opinion, the ruling has opened the door to the risk of "creating problems that we do not yet know about." One such problem could be that the Code §2043(a) theory, which limits the Code §2036 inclusion, seemingly validates a discount for lack of marketability, even under bad facts such as these.

TAX 101:

TAXATION OF INTELLECTUAL PROPERTY – SELECTED TAX ISSUES INVOLVING CORPORATIONS AND PARTNERSHIPS

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Tags
Corporations
Intangible Assets
Intellectual Property
Partnerships

INTRODUCTION

This article will review the basic U.S. Federal tax considerations of intellectual property ("I.P.") taxation in the context of corporations and partnerships and examine some typical tax considerations when I.P. is held through a corporation or a partnership.

CORPORATIONS

Acquisitions

A corporation may acquire I.P. in several ways, including

- receiving a contribution of I.P. from a shareholder,
- purchasing or licensing the use of I.P. from another person, or
- creating I.P. in-house.

Under Code §351, a shareholder's contribution of property, such as I.P., to a corporation will be tax-free if

- the transfer is solely in exchange for stock of the transferee corporation, and
- the transferor is in control of the transferee corporation immediately after the exchange, which for this purpose means ownership of 80% or more of the total value and 80% or more of the total voting rights with respect to the corporation's stock.

In a Code §351 exchange, the transferee corporation's basis in the contributed I.P. will be the same as that of the transferor shareholder.

If the Code §351 requirements are not met, the shareholder will recognize gain, but not loss, to the extent that the value of the stock exceeds his or her adjusted basis in the I.P. Here, value of shares is closely associated with the value of the I.P. at the time of transfer. Any gain recognized by the transferor shareholder will be added to the transferee corporation's adjusted basis in the contributed I.P. Examples of circumstances in which a shareholder will recognize gain in an otherwise tax-free Code §351 exchange include a transfer where the transferor receives cash or other property in addition to the stock of the transferee corporation.

In the past, there was some doubt as to whether intangible assets, such as I.P., constituted "property" for purposes of Code §351. Though the issue has been settled in favor of the taxpayer, an issue that is not clear is whether a transfer of less than all substantial rights in the property, such as a transfer of a license to use the I.P., is a tax-free transfer under Code §351. In Revenue Ruling 69-156,[1] the I.R.S. determined that the transfer by a domestic corporation of an exclusive right to import, make, use, sell, and sublicense a patent involving a chemical compound to its foreign subsidiary was not a transfer of "property" within the meaning of Code §351. It stated that tax-free treatment under Code §351 is only available when the rights transferred by the shareholder would constitute a sale, not a license, if the transfer were a taxable transfer.

In contrast, in *E.I. Dupont de Nemours v. U.S.*,[2] the Court of Claims held that a carved-out right to a nonexclusive license would qualify for tax-free treatment under Code §351 and that there was no basis for limiting tax-free treatment under Code §351 to transfers that would constitute sales or exchanges if they were not subject to a nonrecognition provision. The I.R.S has recognized that this case has precedential value and must be strongly considered, although it has not withdrawn the ruling.[3]

"Tax-free treatment under Code §351 is only available when the rights transferred by the shareholder would constitute a sale, not a license, if the transfer were a taxable transfer."

A shareholder's receipt of stock in exchange for services does not meet the requirements of Code §351. However, if I.P. is transferred and the I.P. constitutes property for the purposes of Code §351, the transfer will be tax free under Code §351, even though the shareholder performed services to produce the property. Further, where the transferor shareholder agrees to perform services in connection with a transfer of property, the I.R.S. determined that tax-free treatment under Code §351 will be accorded if the services are "merely ancillary or subsidiary" to the transfer. These ancillary and subsidiary services could include promoting the transaction by demonstrating and explaining the use of the property, assisting in the "starting up" of the property transferred, or performing under a guarantee relating to the effective starting up.[4]

Under circumstances in which the shareholder must recognize gain on the I.P. transfer, the gain will be subject to the recapture rules of Code §1245 if the I.P. was amortizable. The rules of Code §§1221 and 1231 must be applied to determine whether the gain is ordinary income or capital gain.

A corporation may acquire I.P. as a separate asset or as part of a trade or business. In the case of separately acquired I.P., the corporation's basis in the I.P. generally will be the purchase price. In the case of I.P. acquired as part of a trade or business, the corporation's basis in the I.P. will depend upon whether the acquisition is an asset or stock acquisition. In the case of an asset acquisition, the purchase price must be allocated among the assets of the trade or business, including the I.P., under the rules of Code §1060.

In the case of a stock acquisition, the corporation will not receive a step-up in the basis of the underlying assets of the acquired corporation, unless it makes an election under Code §338 to treat the stock purchase as an asset purchase. The purchase price will be allocated under rules similar to the rules of Code §1060.

In the case of self-created I.P. where the corporation capitalizes the costs of

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1 Rev. Rul. 69-156, 1969-1 C.B. 101.

2 471 F.2d 1211 (Ct. Cl. 1973).

3 Field Service Advice 1998-481.

4 Rev. Rul. 64-56, 1964-1 C.B. 133.

developing the I.P., the corporation will have a basis in the I.P. generally equal to the capitalized costs. As discussed below, this basis may be amortized. Alternatively, if the corporation is permitted to deduct all or some of the costs incurred in developing the I.P., the corporation may have no basis or a very low basis in the I.P.

Amortization

Corporations are subject to amortization rules for self-created and acquired I.P., as discussed in our article "Tax 101: Taxation of Intellectual Property – The Basics." Thus, for example, under the rules of Code §197, a corporation generally may amortize its basis in a broad list of acquired I.P. (including, patents, trademarks, trade names, trade secrets and know-how, copyrights, and computer software) if the acquired I.P. is used in a trade or business or an activity carried on for the production of income and was not separately acquired. Though corporate taxpayers have several choices in amortization methods, Code §197 requires straight-line depreciation over a 15-year period. The rules of Code §167 must be applied to determine the amortization permitted for a corporation's self-created and separately acquired I.P.

In the case of contributed I.P., one of two situations may arise:

- A shareholder may contribute I.P. that was amortizable in the hands of the shareholder.
- A shareholder may contribute I.P. that was not amortizable in the hands of the shareholder, such as certain self-created I.P.

In the former case, the transferee corporation generally steps into the place of the transferor shareholder and, thus, receives a carryover basis, which must be amortized over the remainder of the original amortization period. If gain is recognized on the transfer, the transferee corporation's basis in the I.P. will equal the transferor shareholder's basis plus the recognized gain. The amortization of the I.P. will be bifurcated: The portion of the basis corresponding to the carryover basis will continue to be amortized over the remaining original amortization period, and the portion of the basis that corresponds to the recognized gain will be amortized under a new 15-year amortization period.

In the latter case, the corporation generally will not be permitted to amortize the contributed I.P., unless the transferor recognizes of gain. In that case, the recognized gain will be treated as a purchase price, and become the transferee corporation's basis in the I.P., which may be amortized.

Dispositions

A corporation's disposition of I.P. may take several forms, including

- a sale of I.P. to an unrelated third party,
- a sale of I.P. to a shareholder, or
- a distribution of I.P. to a shareholder.

If a corporation sells amortizable I.P. to an unrelated third-party, any recognized gain attributable to the pre-sale amortization deductions will be characterized as ordinary income under the recapture rules of Code §1245. Any remaining gain or loss may be characterized as either ordinary or capital under the rules of Code §§1221 or 1231.

In the case of a sale to a shareholder owning a significant portion of the corporation, any gain in excess of the Code §1245 recapture amount recognized on the sale will be treated as ordinary income under Code §1239, which generally applies to the transfer of property from a corporation to a shareholder if the transferred property is depreciable or amortizable in the hands of the transferee shareholder and the shareholder is considered a related person. For the purposes of Code §1239, the shareholder is a related person if it holds more than a 50% interest in the corporation.

If the shareholder does not meet the Code §1239 ownership threshold, the recapture and characterization rules applicable to an unrelated third-party buyer will apply, as discussed above.

I.P. that is amortizable under Code §197 is subject to a loss disallowance rule under Code §197(f) that prevents the recognition of loss in the case of an asset that was acquired in a transaction or a series of transactions if, at the time of the disposition, the taxpayer retains the other intangible assets amortizable under Code §197 that were acquired in the same transaction or series of related transactions. The purpose of this rule is to prevent taxpayers from recovering their basis faster than over the 15-year amortization period. The unrecognized loss is not completely forfeited, but rather, it is added to the bases of the remaining intangible assets and amortized over the remaining 15-year amortization period.

The following example illustrates the loss disallowance rule:

> In tax year 1, a corporation, C, acquires a trade or business, which includes I.P. assets. C receives a step-up in the basis of the I.P. assets and takes amortization deductions. C utilizes the I.P. assets in business line 1 and business line 2. Subsequently, in tax year 5, C decides to sell business line 1. The sale is structured as an asset sale and includes one of the I.P. assets acquired in the acquisition of the trade or business that occurred in tax year 1. The remaining I.P. assets acquired in the tax year 1 acquisition will not be sold. Under the loss disallowance rule, any loss realized on the I.P. asset sold as part of the sale of business line 1 will not be recognized by C. The loss will be added to the bases of the remaining I.P. assets, essentially meaning that the basis in excess of the fair market value of the disposed asset is transferred to the remaining assets.

The loss disallowance rule applies in the case of nonrecognition transactions. Thus, in the above illustration, the loss disallowance rule would apply if C transferred the assets of business line 1 to a corporation in a tax-free exchange for stock under Code §351 and then sold the stock in that corporation.[5]

For the purposes of the loss disallowance rule, members of a controlled group of corporations are treated as a single taxpayer so that no loss is allowed on the disposition of I.P. by one member of a controlled group of corporations if another member of the controlled group retains other Code §197 intangible assets that were acquired in the same transaction or series of related transactions as the asset that was disposed of.

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[5] Treas. Reg. §1.197-2(g)(1)(i)(C).

If a corporation transfers I.P. to a shareholder as part of a nonrecognition transaction, such as a distribution that is part of a liquidation of a subsidiary into its parent corporation or a like-kind exchange, the shareholder will step into the shoes of the corporation with respect to the I.P. Thus, the shareholder will receive a carryover basis in the I.P., and if the I.P. was amortizable in the hands of the corporation, the shareholder will continue to amortize the I.P. over the remaining amortization period.

If a corporation distributes I.P. to a shareholder in a transaction that does not qualify for nonrecognition treatment, such as a dividend in-kind under Code §301, a stock redemption under Code §302, or a distribution in complete liquidation under Code §336, the shareholder's basis in the I.P. will be its fair market value and the corporation will recognize gain. To the extent of depreciation recapture under Code §1245, the gain will be taxed as ordinary income. Any additional gain will be treated as capital gain. Note that for the corporation, capital gains and ordinary income are taxed at the same rate. In the event that the corporation has a capital loss carryover from other transactions, the carryover capital losses can reduce capital gains generated from the distribution. Any loss will likely be disallowed to the corporation under the loss disallowance rule discussed above.

PARTNERSHIPS

Joint development projects, involving two or more parties contributing services, personnel, funding, and other resources, are common arrangements for the development of I.P.

The definition of "partnership" in the Internal Revenue Code ("Code") is broad, encompassing a "syndicate, group, pool, joint venture, or other unincorporated organization through or by the means of which any business, financial operation, or venture is carried on, and which is not . . . a corporation or a trust or estate."[6] Typically, profits and losses must be shared by the participants for there to be a partnership, although the sharing ratio for losses may differ from the sharing ratio for income and gains.

Since the concept of a partnership is broadly defined for tax purposes, if the parties to a joint development do not intend to form a partnership for U.S. Federal tax purposes, they must take care to avoid falling involuntarily within the Code's broad definition of partnership. Their arrangement should be governed by documents that demonstrate that the parties are contracting parties, not partners. For example, the sharing of resources such as personnel or facilities, should be covered by fees paid by the using contracting party to the contributing contracting party in order to reimburse the latter for use by the former.

Since limited liability companies with more than one member generally are treated as partnerships for U.S. Federal tax purposes, the tax considerations discussed here also apply to L.L.C.'s.

Acquisitions

Just like a corporation, a partnership can acquire I.P. in several ways, including

- receiving a contribution of I.P. from a partner,

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[6] Code §761(a).

- purchasing or licensing the use of I.P. from another person, or
- creating I.P. in-house.

The contribution of property by a partner to a partnership is governed by Code §721, which states that neither the partner nor the partnership generally will recognize gain or loss on the transfer of property in exchange for an interest in the partnership. Unlike Code §351 (governing the tax-free contribution of property to a corporation, discussed above), Code §721 does not require the partner to be in "control" of the partnership. Thus, a transfer to a partnership is generally tax-free even if only one person transfers property to the partnership and that person ends up owning a small interest in the partnership after the transfer.

"Debt financing at the level of the partnership is often treated as if the partners borrowed the funds and contributed the proceeds of the borrowing to the partnership."

A contribution by a partner to a partnership of property encumbered by debt may result in gain recognition to the contributor because Code §752(c) generally treats the partnership as assuming the liability. This often decreases the portion of the liability allocated to the contributor. When a partner's liabilities are decreased by reason of a partnership's assumption of a liability, the partner whose debt allocation is reduced is treated as if a cash distribution were made to that partner.[7] Thus, a partner that contributes I.P. subject to a liability to a partnership, may be treated as receiving a cash distribution to the extent of the liability.

Further, debt financing at the level of the partnership is often treated as if the partners borrowed the funds and contributed the proceeds of the borrowing to the partnership. If a partner's share of the debt increases, the partner is treated as contributing cash to the partnership and the outside basis in the partnership increases. If a partner's share of debt decreases, the partner is treated as receiving a distribution of cash from the partnership and the outside basis in the partnership decreases.

The question of whether a partner transferred "property" for the purposes of Code §721 may arise in the case of a partner that transfers to the partnership less than all of its interest in I.P. This transaction is akin to transfer of a right to use I.P. and is analogous to the grant of a license to the corporation by a controlling shareholder. The tax treatment is governed by the same authorities that are applicable to transfers under Code §351, discussed above. Similarly, the question of whether a partner may provide services with the transfer of I.P. and still preserve tax-free treatment under Code §721 is governed by the same authorities applicable to transfers under Code §351, discussed above.

As in the case of a corporation, a partnership may acquire I.P. as a separate asset or as part of a trade or business. In the case of separately acquired I.P., the partnership's basis in the I.P. generally will be the purchase price. In the case of I.P. acquired as part of a trade or business, the transaction is treated as the purchase of a going concern. The price must be allocated among the assets of the trade or business, including the I.P., under the rules of Code §1060.

In the case of self-created I.P., if the partnership is required to capitalize the costs incurred in developing the I.P., it will have a basis in the I.P. attributable to the capitalized costs, which may be amortized. The amortization deductions will pass through to the partners. Alternatively, if the partnership is permitted to deduct all or some of the costs incurred in developing the I.P., it will have no basis, or a very

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[7] Code §752(b).

low basis, in the I.P. The partners will have received a tax benefit at the time the expenditure is deducted on the partnership tax return.

Amortization

In General

Partnerships are subject to the amortization rules for self-created and acquired I.P. as discussed in "Tax 101: Taxation of Intellectual Property – The Basics." Thus, for example, under the rules of Code §197, a partnership generally may amortize its basis in a broad list of acquired I.P. (including, patents, trademarks, trade names, trade secrets and know-how, copyrights, and computer software) if the acquired I.P. is used in a trade or business or an activity that is carried on for the production of income and was not separately acquired. Code §197 requires straight-line depreciation over a 15-year period. The rules of Code §167 must be applied to determine the amortization permitted for a partnership's self-created and separately acquired I.P.

Any amortization deduction is determined at the partnership level and is then allocated among the partners under the terms of the partnership agreement.

As with transfers to a corporation, discussed above, in the case of I.P. contributed to a partnership, one of two situations may arise:

- A partner may contribute I.P. that was amortizable in the hands of the partner.
- A partner may contribute I.P. that was not amortizable in the hands of the partner, such as certain self-created I.P.

In the former case, the transferee partnership generally steps into the place of the transferor partner and, thus, receives a carryover basis, which must be amortized over the remainder of the original amortization period.

As discussed earlier, it is possible for a partner to recognize gain on the contribution of encumbered property to a partnership. However, such gain recognition will not affect the partnership's basis in the contributed property. Thus, unlike with contributions to a corporation, contributions of property to a partnership do not generally result in a bifurcated treatment of the basis of the I.P. asset for amortization purposes.

In the latter case, the partnership generally will be not permitted to amortize the contributed I.P., unless the transferor recognizes gain, which is a very rare occurrence in the partnership context.

Effect of a Code §754 Election on Amortization

Generally, the sale of a partnership interest in a transaction that produces a gain – often because the fair market value of the partnership's assets exceeds the partnership's basis in those assets -- does not trigger any adjustment in the basis of the partnership in its assets. The basis of the partnership in its assets is referred to often as the partnership's "inside basis" in the assets. The partner's basis in the partnership interest is referred to often as the partner's outside basis in the partnership. Thus, for example, if X acquires an interest in partnership P, at its fair market value, and P holds only one asset with a fair market value that is considerably greater than P's adjusted basis in the asset, the partnership's inside basis in the asset will not be adjusted upward to reflect the fact that X paid fair market value for the interest in

P. If partnership P then sells the appreciated asset, X will be allocated his share of the built-in gain from the sale of the asset. X's share of the gain does not take into account the fact that he recently paid fair market value for his interest in P.

To alleviate the unfairness of the foregoing result, a partnership may make an election under Code §754 to step up the basis in the partnership's assets as they relate to the transferee partner. The basis adjustment is authorized by Code §743(b).[8] Again, only the transferee partner benefits from the election. In the above example, if partnership P makes a Code §754 election in connection with X's acquisition of a partnership interest in partnership P, X – and only X – would be entitled to benefit from an increase in the inside basis of partnership P's asset. If partnership P then sells the asset, X's share of any built-in gain would be reduced to reflect the adjusted basis that resulted from his purchase of the interest in P.

Similarly, a Code §754 election allows a partnership to elect to adjust the basis under Code §734(b) in partnership property retained after it makes a distribution of money or property to a partner if as a result of a distribution, the distributee recognizes any gain or loss or takes a basis different from the partnership's basis in the case of a property distribution.[9] So, for example, assume a partnership having appreciated property and cash distributes cash to only one partner and as a result, that partner recognizes gain because the cash exceeds the outside basis in the partnership. If a Code §754 election is in effect, Code §734(b) allows the partnership to increase its basis in property retained by the partnership. This prevents a double level of possible gain recognition among the partners – once at the time of the distribution that results in a gain to a partner and a second time when appreciated assets are subsequently sold. On the other hand, if a partnership makes a liquidating distribution to a partner that terminates the entire interest in the partnership, and the amount distributed consists of cash, unrealized receivables, and inventory worth in total less than the outside basis of the retiring partner's interest in the partnership, the retiring partner realizes a loss. If a Code §754 election is in effect, Code §734(b) requires the partnership to reduce its basis in property retained by the partnership. This prevents a double level of possible loss recognition among the partners – once at the time of the liquidating distribution that results in a loss to the retiring partner and a second time when appreciated assets are subsequently sold.

A Code §754 election may result in amortization benefits for I.P. amortizable under Code §197 to the extent a taxpayer (a partner or the partnership) obtains an increased adjusted basis in such I.P. An example of a contribution of I.P. that may

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8 Code §743 provides rules for basis adjustment to the partner's adjusted basis in the partnership property when a Code §754 election is in effect or there is a substantial built-in loss (*i.e.*, greater than $250,000) with respect to a partnership's adjusted basis in the partnership property. In the case of a substantial built-in loss, the basis adjustment is mandatory (*i.e.*, no Code §754 election is required). Further, though in the above example, the basis adjustment was advantageous to the taxpayer, the required adjustment may be disadvantageous (such as in the case of net built-in loss) because it may require the partner to decrease his adjusted basis in the partnership property, thus decreasing or eliminating the partner's potential loss on a sale of the partnership property. Further, in such a case, no amortization benefit will be obtained in the case of amortizable I.P.

9 Code §734 provides rules for basis adjustment to the partnership's retained property when a Code §754 election is in effect or, in the case of a substantial built-in loss, when a mandatory basis adjustment is required.

result in gain involves transfers to partnerships with related foreign partners as provided in temporary regulations promulgated during the final days of the Obama Administration purporting to limit the scope of nonrecognition treatment when appreciated property is transferred to a partnership having non-U.S. persons as partners in certain circumstances.[10] For those transfers, immediate gain recognition is mandated by the temporary regulations. Where gain must be recognized in connection with a transfer to a partnership, a bifurcated approach is followed: the portion of the basis that represents the upward basis adjustment is amortized over a new 15-year amortization period and the remaining basis will continue to be amortized under the remaining amortization period.

Effect of a Constructive Termination on Amortization

If 50% or more of the interests in a partnership are sold within a 12-month period, the partnership is deemed to have terminated.[11] The constructive termination is treated as a transfer of all of the assets of the terminated partnership to a new partnership in exchange for interests in the new partnership, immediately followed by the distribution of the interests in the new partnership to the partners in proportion to their interests in the terminated partnership.

Under a constructive termination, the new partnership's basis in an asset amortizable under Code §197 generally will be the same as the terminated partnership's basis in the asset. Thus, amortization will not be impacted by the constructive termination. However, if a Code §754 election is in effect, adjustments to basis may be required. In such cases, the bifurcated approach discussed above must be followed.

Deduction for R&D Expenses

Under Code §162, a taxpayer may deduct the ordinary and necessary expenses incurred in carrying on a trade or business. In the case of a start-up business, such as a partnership formed to develop new I.P., Code §162 will not apply if the business is in the development phase and not yet "carrying on" a trade or business.

In contrast, Code §174(a)(1) permits a taxpayer to deduct research or experimental expenditures paid or incurred "in connection with" its trade or business, which has been interpreted to mean that research or experimental expenditures may be deducted during the phase in which a start-up business is preparing to go into business but is not yet in business.[12]

Notwithstanding the above, the taxpayer need never be involved in a trade or business. So, a partnership that is set up to develop a new product and which then sells the I.P. without reducing it to commercial value by using it in a trade or business likely will not be allowed to take the Code §174 research and development ("R&D") deduction.[13] Similarly, a partnership that has no plans or ability to market or exploit

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10 Treas. Reg. §§1.721(c)-2T and 1.721(c)-3T.

11 Code §708.

12 *Snow v. Commr.*, 416 U.S. 500 (1974) (limited partner in start-up partnership formed to develop new product, but which had no income, was permitted to deduct his share of net operating loss attributable to the R&D deduction under Code §174).

13 *Harold J. Green*, 83 T.C. 667 (1984).

any products that it might develop likely will not be allowed the Code §174 R&D deduction.[14]

Dispositions

Disposition of I.P. by a Partnership

In a sale of amortizable I.P. to a third party, the main issues to consider are whether any gain will be characterized as ordinary income under the Code §1245 recapture rules and whether the remaining gain is capital gain, or any loss is capital loss, under Code §1231. If the I.P. is not amortizable, the gain or loss may be capital gain or loss under Code §1221.

In a sale of amortizable I.P. to a partner, any gain in excess of the Code §1245 recapture amount will be characterized as ordinary income under Code §1239 if the partner holds a greater than 50% interest in the partnership. If Code §1239 does not apply, the typical characterization rules, discussed above in the context of unrelated party sales, apply. Amounts realized in excess of the Code §1245 recapture amount may be afforded long-term capital gains treatment.

Further, the loss disallowance rule of Code §197(f), discussed above, also applies to partnerships. Thus, no immediate loss is recognized if a group of Code §197 intangibles is acquired and less than all such intangibles are sold. The amount of the loss increases the basis in the retained Code §197 intangibles.

In the case of distributions of I.P. to partners, special basis rules may apply to intangible assets amortizable under Code §197 depending on whether the distribution is a non-liquidating or a liquidating distribution. In the case of a non-liquidating distribution of such I.P., under Code §731, the distributing partnership generally does not recognize gain or loss resulting from the distribution, and this nonrecognition treatment means that the distributee partner steps into the shoes of the distributing partnership with respect to the adjusted basis and amortization period of the I.P.

In the case of a liquidating distribution, the distributed property will have a basis equal to the partner's outside basis in his partnership interest. If more than one asset is distributed, the partner's outside basis must be allocated among the assets received in the liquidating distribution. If the allocated basis is less than the partnership's basis, the carryover approach, discussed above in the case of non-liquidating distributions, applies. If the allocated basis is more than the partnership's basis, a bifurcated approach must be taken under which the distributee partner will amortize the increase in basis over a new 15-year amortization period and the remaining basis will continue to be amortized in the same manner as it was in the hands of the partnership.

In the case of distributed I.P. that is not amortizable in the hands of the distributing partnership, the distribution to the distributee partner, by itself, generally does not cause the I.P. to be amortizable in the hands of the distributee partner.

Disposition of an Interest in a Partnership that Owns I.P.

Under Code §741, gain or loss from the sale of an interest in a partnership generally is treated as derived from the sale of a capital asset, regardless of the underlying

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[14] *Harris v. Commr.*, T.C. Memo 1990-80, 58 T.C.M. 1441.

assets held by the partnership. The exception to this rule arises when the partnership holds assets described in Code §751, specifically: unrealized receivables[15] and inventory items.[16] Code §751 assets are sometimes referred to as "hot assets." If part of the sales proceeds from the sale of a partnership interest is attributable to a hot asset, that amount is treated as ordinary income. The rule prevents partners from converting ordinary income into capital gain through a sale of a partnership interest.[17]

In the I.P. context, the term "unrealized receivables" includes franchises, trademarks, and trade names as described in Code §1253(a).[18] Under that provision, a transfer of a franchise, trademark, or trade name is not treated as sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name.[19] This provision typically applies to businesses that sell franchises to customers in the ordinary course of business. In a franchise operation, the franchisee is granted the right to use trademarks and tradenames, along with specified know-how, within a specified geographic area on an exclusive or non-exclusive basis in connection with the operation of a business on a standardized basis so that the quality and appearance of the business looks alike throughout the territory where franchisees operate. In order to maintain quality and appearance throughout the territory, the franchisor retains certain rights after the "sale" of the franchise. Code §1253 was enacted to prevent franchisors from claiming favorable capital gains tax treatment each time franchise rights were sold to a franchisee. It achieves this by denying capital gains treatment when the franchisor retains significant power, right, or a continuing interest in the rights that are sold, since retention of such powers is crucial in maintaining uniformity across the territory.

"If part of the sales proceeds from the sale of a partnership interest is attributable to a hot asset, that amount is treated as ordinary income."

Code §1253(b)(2) defines "significant power, right or continuing interest" as including a right to

- disapprove any part of an assignment of such interest;
- terminate the interest at will;
- prescribe standards of quality for products used or sold, or services furnished, and of the equipment and facilities used to promote such products or services;
- require that the transferee exclusively advertise or sell products and/or services of the transferor;
- require that the transferee purchase substantially all operating equipment and supplies from the transferor; and

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15 *I.e.*, rights to income not previously included under the method of accounting used by the partnership, such as goods delivered or to be delivered or services rendered or to be rendered, to the extent that proceeds therefrom would be treated as a sale or exchange of property other than a capital asset.

16 *I.e.*, an inventory item with fair market value in excess of 120% of partnership's adjusted basis in such item.

17 Code §751.

18 Code §751(c) (flush language).

19 Code §1253(a).

- require payments that are dependent on the productivity, use, or disposition of the transferred interest.

The regulations under Code §751 are intended to prevent Code §1253 from being circumvented by creating franchising partnerships that could ultimately be sold in transactions producing capital gains in accordance with Code §741. To achieve that goal, Treas. Reg. §1.751-1(c)(4)(viii) states that hot assets include the "potential gain" that would arise from the sale of franchises and related trademarks and trade names and would be treated as ordinary income under Code §1253(a).[20]

As discussed above, if a partnership makes an election under Code §754, it may adjust the basis of the partnership's assets under Code §734(b) (relating to adjustments of bases to the assets retained by the partnership after a distribution of property to a partner) and Code §743(b) (relating to adjustments of bases of partnership properties for a partner acquiring a partnership interest). If the partnership holds I.P. assets, any increase in the bases of these assets as a result of the basis adjustments may provide additional amortization benefits under Code §197.

Similarly, if the disposition of a partnership interest results in a constructive termination of the partnership (as discussed above) and a Code §754 election is in effect, adjustments to basis may be required, which may result in additional amortization benefits under Code §197.

CONCLUSION

I.P. owned or utilized as part of a business, typically is held though a corporation or partnership. As demonstrated above, significant tax issues arise during the life cycle of the I.P.: when I.P. is created, acquired, used, licensed, sold, and in the case of a partnership or L.L.C., the interest in the flow-through entity owning the I.P. is sold. Proper planning is important at each step in the life cycle. Mistakes in tax planning can be expensive.

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20 Treas. Reg. §1.751-1(c)(4)(viii).

PANCAKE DAY – END TO PERMANENT NON-DOMICILE STATUS AND CHARGING NON-DOMS I.H.T. ON U.K. RESIDENTIAL PROPERTY[1]

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Tags
Non-Domiciled Taxation
Tax Residency
Trust & Estate Planning
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In Sweden, it is traditional on Thursdays to lunch on a split pea soup followed by pancakes, jam, and cream. Before the Reformation, when Sweden was a Catholic country, it answered the need for a hearty meal before Friday fasting.

In Westminster Hall on Tuesday July 11 Peter Dowd, the Shadow Chief Secretary, was hungry. "Why are we waiting for the Finance Bill?" he asked. "We have waited and waited for the Finance Bill. I hope we get it this side of Christmas—we might get it next Pancake Thursday."

On Thursday July 13, the U.K. government came with pancakes and there was jam and cream. In written statements to both Houses of Parliament ministers confirmed that a Finance Bill will be introduced as soon as possible after the summer recess and that provisions previously announced, which were intended to take effect from April 2017, will take effect from that date. H.M. Treasury and H.M. Revenue and Customs then followed by publishing updated draft provisions for the second 2017 Finance Bill.

Hopefully the government will find an opportunity to get the bill to the floor of the House of Commons in September. At Question Time on Tuesday July 18, the Chancellor of the Exchequer and other ministers at the Treasury answered questions addressed to the Chancellor by members of the House of Commons. One, in reference to non-domiciled ("Non-Dom") status and offshore trusts, drew a response from the Financial Secretary to the Treasury Mel Stride, who confirmed that it is the government's intention to "legislate further, making it harder for non *doms* to avoid tax on funds withdrawn from trusts." Otherwise, nothing was said to add to the prior week's written statements.

The written statement to the House of Commons on July 13 was delivered by Mel Stride. He reminded the House that at the point at which a number of changes to the tax legislation were withdrawn from the Finance Bill introduced in March 2017, including changes to the tax treatment of the non-domiciled, his predecessor had stated that there was no policy change.

The statement to the House of Commons reads:

> Where policies have been announced as applying from the start of the 2017-18 tax year or other point before the introduction of the forthcoming Finance Bill, there is no change of policy and these dates of application will be retained. Those affected by the provisions should continue to assume that they will apply as originally announced.

[1] The author would like to acknowledge the contributions of James Badcock and Peter Daniel, also of Collyer Bristow LLP, in the preparation of this section.

> The Finance Bill to be introduced will legislate for policies that have already been announced. In the case of some provisions that will apply from a time before the Bill is introduced, technical adjustments and additions to the versions contained in the March Bill will be made on introduction to ensure that they function as intended. To maximise certainty about the exact provisions that will apply, the Government is today publishing updated draft provisions.[2]

Two of the supporting documents for the second 2017 Finance Bill relate to the end to the permanent Non-Dom status and charging Non-Doms inheritance tax ("I.H.T.") on U.K. residential property and can be found here.

The policy paper "Deemed Domicile: Income Tax and Capital Gains Tax - Updated Legislation," published on July 13, 2017, introduces the new rules for deeming individuals domiciled in the U.K. for tax purposes from April 2017.

The policy paper "Inheritance Tax on Overseas Property Representing UK Residential Property – Updated Legislation" introduces the new rules to ensure that individuals deemed domiciled under the new deeming provisions will be subject to I.H.T. on their worldwide income and gains.

The news story that the government will legislate for all policies that were included in the pre-election Finance Bill had been already foreshadowed in the background briefing notes published by Cabinet Office and the Prime Minister's Office on the occasion of the opening of Parliament on Wednesday June 21, 2017. The government said at the time that it intended that all those policies originally announced to start from April 2017 would be effective from that date. The justification for this was that the bill would implement budget decisions: The Queen's speech and background notes can be found here.

On Friday July 14, the government published a list of provisions that those affected "should continue to assume that they will apply as originally announced" – the list can be found here.

The budget decisions to which the briefing notes refer are the budget resolutions that were passed by the House of Commons at the close of the Spring Budget 2017 debate "on all of which a Bill is to be brought in." However, the motions passed related to the provisions contained in the first 2017 Finance Bill, then printed and introduced into Parliament, which only had legal effect insofar as they were brought in by the Finance Act 2017.

In the April wash up negotiations between the government and the opposition, the government agreed to drop the deemed domicile changes. Consequently, a motion from the chair that those provisions be given up was carried by the House of Commons on April 25 at the Third Reading of the Bill. The effect of that, and subsequently the dissolution of Parliament on May 3, is that the budget resolution decisions that had not been brought into law lapsed. In summary, the spring budget decisions announced by the government and accepted by the last Parliament were enacted by the first Finance Act 2017. Similarly, those rejected will be implemented by this Parliament, just as if they had been accepted by the previous one.

It has been said that:

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2 U.K. Parliament, "Finance Bill: Written Statement," July 13, 2017, HCWS47.

> The rule of law stands for the view that decisions should be made by the application of known principles or laws. In general such decisions will be predictable, and the citizen will know where he is. On the other hand there is what is arbitrary. A decision made without principle, without any rules. It is therefore unpredictable, the antithesis of a decision taken in accordance with the rule law.[3]

It has also been said that:

> Whatever one thinks of this practice of backdating Budget legislation, one must concede that it does not drastically upset expectations. The law is merely enacted as was promised by prior public announcement, with effect from that date and no earlier. What is of more concern is legislation made retroactive prior to the announcement date, such that it could not have been expected, let alone acted upon, by the taxpaying public.[4]

In March 2002, then Solicitor-General Harriet Harman described the approach taken by the government of the time to retrospective legislation:

> The Government's policy before introducing a legislative provision having retrospective effect is to balance the conflicting public interests and to consider whether the general public interest in the law not being changed retrospectively may be outweighed by any competing public interest. In making this assessment the Government will have regard to relevant international standards including those of the European Convention for the Protection of Human Rights and Fundamental Freedoms which was incorporated into United Kingdom law by the Human Rights Act 1998.

Each year, at the Second Reading, the Chancellor of the Exchequer states under section 19(1)(a) of the Human Rights Act 1998, that in his view the provisions of the Finance Bill are compatible with the convention rights.

The government would presumably argue that it is in the public interest to have tax policy for the year implemented in line with the expectations at the time of the budget and that the taxpayer had due warning of this. Indeed many taxpayers will have arranged their affairs according to what was previously announced. If changes are only implemented from some future date, such as April 2018, these taxpayers may be disadvantaged. On the other hand, taxpayers will suffer tax that they would not have suffered if the changes were not introduced retrospectively. One might question whether the estates of individuals who died between April 6 and July 13 should be chargeable to I.H.T. on assets that were not chargeable to tax when they died.

Parliament rose for the summer recess on Thursday July 20. The Houses do not return again until September 5. Parliament will then rise again for the conference recess on September 14 before returning on October 9. If the bill is not debated before October, it seems unlikely that it will reach the statute book long before the end of November.

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[3] Geoffrey Marshall, "The Franks Committee: Report on Administrative Tribunals and Enquiries," (1957) 35 *Public Administration*.

[4] Geoffrey T. Loomer, "Taxing Out of Time: Parliamentary Supremacy and Retroactive Tax Legislation," *British Tax Review* 1 (2006).

It is now two years since the release of Summer Budget 2015[5] and the announcement of a change of policy in the fiscal treatment of those not U.K. domiciled. A change that was intended to create a fairer system while protecting the ability of the U.K. to continue to attract individuals to come to the U.K. and invest. What message does it send abroad about our constitutional principles that Parliament will be debating in September or October whether estates for which I.H.T. accounts were returned in April should be posthumously taxed?

The government's need to make the legislation retrospective (to the time of a previous parliament) typifies the wholly unsatisfactory way in which these changes to the taxation of Non-Dom individuals have been introduced – a manner that has been hugely damaging to the U.K.'s reputation for stability and reliability.

So, what's not to like? Too little jam and too little cream.

"So, what's not to like? Too little jam and too little cream."

[5] Summer Budget 2015 can he found here.

FOREIGN PARTNER NOT SUBJECT TO U.S. TAX ON GAIN FROM REDEMPTION OF U.S. PARTNERSHIP INTEREST

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Tags
Capital Gains
Code §741
Code §751
Code §897
Effectively Connected Income
Exchange
Grecian Magnesite
Limited Liability Company
Partnership
Sale

In *Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commr.,*[1] the U.S. Tax Court recently held that a foreign partner was not subject to U.S. Federal tax when it redeemed its interest in a U.S. partnership and that the capital gain realized was not "U.S.-source income" and not "effectively connected to a U.S. trade or business" (discussed in detail below). In so holding, the Tax Court rejected the I.R.S. analysis in Revenue Ruling 91-32.[2]

This case represents a significant victory for the taxpayer. In addition to rejecting the I.R.S.'s "aggregate" approach to the taxation of a disposition of partnership interests by foreign partners, it arguably bolsters the Tax Court's holding in *Pierre v. Commr.*,[3] a case in which it determined that a transfer of interests in a limited liability company ("L.L.C.") that was a disregarded entity for U.S. Federal tax purposes was a transfer of the interests in the entity, and not a transfer of the entity's underlying assets, for U.S. Federal gift tax purposes.

BRIEF FACTS

Grecian Magnesite Mining, Industrial & Shipping Co., S.A. ("Grecian") was a foreign corporation in the business of extracting, producing, and selling magnesite. Grecian directly owned an interest in Premier Chemicals L.L.C. ("Premier"), a Delaware L.L.C. in the business of extracting, producing, and selling magnesite in the U.S. For U.S. Federal tax purposes, Premier was treated as a partnership. Other than through its ownership of Premier, Grecian had no office, employees, nor business operations in the U.S.

Grecian entered into an agreement to redeem its entire interest, of 12.6%, in Premier for $10.6 million in cash. The redemption was effectuated in two payments in which Grecian realized total gain of $6.2 million. The parties agreed that $2.2 million of the realized gain was attributable to Premier's U.S. real property.

Though initially Grecian took the position that the full $6.2 million of gain was not U.S.-source income – and thus not subject to U.S. Federal income tax – it later conceded that the $2.2 million of gain attributable to the U.S. real property was subject to income tax under Internal Revenue Code ("Code") §897(g) (discussed in detail below) and filed a U.S. Federal corporate income tax return to report and pay the tax. The dispute that reached the Tax Court was whether the remaining $4 million was U.S.-source income that is effectively connected with a trade or business in the U.S.

1 149 T.C. 3 (2017).

2 1991-1 C.B.107.

3 133 T.C. 24 (2009).

Foreign persons, including foreign corporations such as Grecian, generally are subject to U.S. Federal income tax on "U.S.-source income," which generally consists of two broad categories of income:

- Investment income such as dividends, interest, rents, and royalties, which is referred to as fixed or determinable annual or periodic ("F.D.A.P.") income
- Income that is effectively connected with a trade or business in the U.S.

In the case at hand, the I.R.S. did not assert that the disputed gain was F.D.A.P. income. Premier was an operating company, thus most of its income likely was from the active operation of its mining business and not investment income. Accordingly, the court stated it would only consider whether the disputed gain was income effectively connected with a U.S. trade or business.

AGGREGATE V. ENTITY APPROACH

The court noted that the rules of partnership taxation (found in Subchapter K of the Code) at times treat partnerships as an aggregate of partners and under other circumstances treat partnerships as entities in their own right. An example of the aggregate approach is when a partner determines its distributive share of the partnership's taxable income or loss. In this context, the partnership as an entity with a distinct legal existence is ignored. Instead, it is considered an aggregation of partners, with each partner reporting its distributive share of the partnership's taxable income or loss.

In the context of a redemption of a partnership interest, the court determined that the entity approach (with some exceptions discussed below) must be followed. The court's analysis was as follows:

"The rules of partnership taxation . . . at times treat partnerships as an aggregate of partners and under other circumstances treat partnerships as entities in their own right."

- Code §736(b)(1) provides the general rule for liquidating payments made to a partner in redemption of its partnership interest, and states that such liquidating payments be considered as **a distribution by the partnership**.
- Code §731 governs the taxation of distributions by a partnership to a partner, and states that in such case "any gain or loss recognized under this subsection shall be considered as gain or loss from the **sale or exchange of the partnership interest of the distributee partner** (emphasis added)."
- Code §741 provides the general rule for sales or exchanges of a partnership interest, and states that gain or loss must be recognized by the transferor partner, and that such gain or loss will be considered as gain or loss from **the sale or exchange of a capital asset**.

The court noted that under the above analysis, the partnership is conceived of as an entity distinct from its partners, and a partner pays tax on a sale of its partnership interest "in a manner broadly similar to the manner in which it might pay tax on the sale of an interest in a corporation." It rejected the aggregate approach argument asserted by the I.R.S., which would have required treating the partner's redemption of a partnership interest as the partner's deemed sale of separate interests in each asset owned by the partnership.

The court acknowledged that Congress explicitly carved out exceptions to Code

§741 and that, when such an exception applies, the aggregation approach is required so that the sale of the partnership interest may be treated (at least in part) as a sale of the partnership's underlying assets. By its own terms, Code §741 acknowledges one such exception because it is a general rule that applies "except as otherwise provided in Code § 751," which applies when a partnership's underlying assets include unrealized receivables or inventory items (so-called hot assets).

Code §751(a) recharacterizes gain from a sale or exchange of a partnership interest attributable to the partnership's hot assets as ordinary income rather than capital gain. Code §751(b) provides for recharacterization of distributions (including liquidating distributions) from a partnership to a partner to the extent the partner receives a disproportionate share of hot assets, or other partnership property for the partner's share of the partnership's hot assets. The court specifically stated that since the I.R.S. did not assert that Code §751(b) was applicable, it would not consider it. Nonetheless, footnote 16 of the opinion suggests that, Code §751(b), might be an exception to Code §741 in appropriate circumstances, in the same manner as Code §897(g). It is much less clear that Code §751(a) can be read the same way.

Code §897(g) states that the amount realized by a foreign person, such as a foreign corporation, in exchange for a partnership interest, to the extent attributable to U.S. real property, will be considered as an amount received from the sale or exchange of in the U.S. of such property. Thus, under Code §897(g), the amount realized by Grecian attributable to Premier's U.S. real property was U.S.-source income that was effectively connected to a U.S. trade or business, and thus, subject to U.S. Federal income tax.

In the end, the court stated that if the I.R.S.'s aggregation approach was correct, the exceptions to Code §741 in Code §§751 and 897(g) would be superfluous.

FOREIGN PARTNER'S GAIN FROM REDEMPTION OF U.S. PARTNERSHIP INTEREST WAS NOT U.S.-SOURCE INCOME

After it established that the disputed gain constituted income from the sale of personal property in the form of an indivisible capital asset, the court turned to the question of whether that gain was subject to tax under the rules governing international transactions (found in Subchapter N of the Code).

The Tax Court declined to defer to the I.R.S.'s holding in Revenue Ruling 91-32, which determined that gains realized by foreign partners on the dispositions of interests in U.S. partnerships should be analyzed asset by asset and that, to the extent that the assets of the partnerships would give rise to effectively connected income ("E.C.I.") if sold by the partnerships, the departing partners' *pro rata* shares of such gains should be treated as E.C.I. The court stated that the ruling was incorrect because it essentially imposed a Code §751-type analysis for all partnership assets that generate E.C.I. and such an exception is not supported by the Code.

The court began its analysis with Code §882, which states that a foreign corporation engaged in a trade or business in the U.S. is taxable on taxable income which is **effectively connected with the conduct of a trade or business in the U.S.**[4]

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[4] Under Code §881, a foreign corporation may also be taxable on U.S.-source

Under Code §875(1), Premier's U.S. trade or business was attributable to Grecian because a foreign corporation is considered engaged in a U.S. trade or business if the partnership of which such corporation is a partner is so engaged.

Since Grecian was engaged in a U.S. trade or business by virtue of its Premier partnership interest, the next question was whether the gain from the redemption of the partnership interest was income effectively connected with the conduct of Premier's U.S. trade or business, which, as discussed above, was mining for magnesite.

E.C.I. is defined under the rules of in Code § 864(c). Code §864(c)(3) states that if a foreign partner is engaged in a U.S. trade or business, all income gain or loss from sources within the U.S. (other than F.D.A.P. income) is treated as effectively connected with the conduct of a trade or business within the U.S. As previously discussed, the I.R.S. did not assert that the disputed gain was F.D.A.P. income. Thus, if the disputed gain was U.S.-source income, then Code §864(c)(3) would treat it as effectively connected with Premier's U.S. trade or business. Accordingly, the next question addressed by the court was whether the disputed gain was U.S.-source income.

Code §§861 to 863 and 865 provide the income sourcing rules. The court noted that there is no Code provision that governs the source of a foreign partner's income from a sale or liquidation of its interest in a partnership. However, the general rule for gain realized from the sale of personal property, such as Grecian's partnership interest, is found in Code §865(a). Under that section, if the amount is realized by a nonresident, such as a foreign corporation, the gain is sourced outside the U.S. and, thus, is not U.S.-source income. Under this analysis, unless an exception to Code §865(a) applied, the source of the disputed gain would be non-U.S. and, thus, not subject to U.S. Federal income tax in the hands of Grecian.

The I.R.S. argued that an exception to Code §865(a), referred to in the decision as the "U.S. office rule" exception, applied. The court proceeded to analyze – and dismantle – the I.R.S. argument.

The U.S. office rule exception for nonresidents is found in Code §865(e)(2)(A), and generally states:

> If a nonresident maintains an office or other fixed place of business in the United States, then the income from a sale of personal property attributable to such office or other fixed place of business shall be sourced in the United States.

The sales income will be attributable to the U.S. office or fixed place of business, if the U.S. office

- is a material factor in the production of such income, and
- regularly carries on activities of the type from which such income, gain, or loss is derived.[5]

F.D.A.P. income. However, as discussed above, the I.R.S. did not assert that F.D.A.P. income was present in this case, so the analysis was confined to Code §882.

[5] Code §864(c)(5)(B). (Under §865(e)(3), the U.S. office rule exception must be determined under the principles of Code §864(c)(5).)

Further, the regulations state that "regularly carries on" means realized in the ordinary course.[6]

The I.R.S. argued (and the court assumed) that Premier's U.S. office is deemed to be Grecian's U.S. office. In trying to show that the disputed gain was attributable to Premier's U.S. office, the I.R.S. argued that Premier's U.S. office was material to the deemed sale of Grecian's portion of the partnership's assets and material to the increased value of Grecian's partnership interest during Grecian's tenure as partner. The court dismissed the first argument because it hinged on the aggregation approach, which it already had determined was not the correct analysis. As to the second argument, the court stated that the I.R.S. was conflating the ongoing value of a business with gain from the sale of an interest in that business. That is, the disputed gain was not realized from Premier's mining business (*i.e.*, activities at the partnership level) but rather at the partner level, from the distinct sale of Grecian's partnership interest. Further, the regulations state that adding substantial value to intangible property (in this case, the going concern value of Premier) is not a material factor.[7] Finally, since Premier's business was mining, and not buying and selling partnership interests, the redemption was not in the ordinary course but rather an extraordinary event.

In summary, the court determined that since the disputed gain was not attributable to a U.S. office or other fixed place of business, it was not U.S.-source income. Consequently, the disputed gain was not E.C.I. and, therefore, not taxable in the U.S.

COMPARISON TO THE *PIERRE* CASE

In *Pierre*, the taxpayer, Suzanne Pierre, had $10 million in cash that she wanted to use to provide for her son and granddaughter. She entered into a plan under which she formed Pierre L.L.C., a single member limited liability company ("S.M.L.L.C.") validly formed under New York law and disregarded for Federal tax purposes under the Treasury entity classification regulations (the "Regulations"). She then created two trusts, one for her son and one for her granddaughter. Approximately two months later, she transferred cash and securities worth $4.25 million to Pierre L.L.C. Shortly after funding Pierre L.L.C. with the cash and securities, she transferred the entire interest in Pierre L.L.C. to the trusts as follows: (i) a gift transfer of a 9.5% membership interest to each trust (to use a portion of her available gift tax-related credit/exemption amounts) and (ii) a sale to each trust of a 40.5% membership interest in exchange for a secured note. The notes each had a face amount of $1.092 million, which was determined by valuing a 1% non-managing interest valued at $26,965, after applying a 36.55% discount. Pierre filed a gift tax return to report each gift of a 9.5% interest in Pierre L.L.C.

The I.R.S. argued that the transfers of the Pierre L.L.C. interests to the trusts were actually transfers of the proportionate shares of the underlying assets of Pierre L.L.C. because the entity was disregarded for Federal tax purposes under the Regulations. If the transfers were treated as transfers of the proportionate shares of Pierre L.L.C.'s underlying assets, a gift tax underpayment would arise because the discount applied to the transfers of the Pierre L.L.C. interests would not apply.

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[6] Treas. Reg. §1.864-6(b).

[7] Treas. Reg. §1.864-6(b)(2)(i).

The Tax Court disagreed with the I.R.S. and determined that the transfers were transfers of interests in Pierre L.L.C. It stated that under U.S. Supreme Court precedent, state law creates property rights and Federal tax law then defines the tax treatment of those property rights. In this case, New York law created no property rights in the underlying assets of Pierre L.L.C. because it recognized the entity as separate and apart from its owners.

The court stated that the Regulations do not disturb this long-established manner of (i) determining the nature of the gift (*i.e.*, the property interest) under state law, (ii) determining the arm's length value of the gift, and (iii) then calculating the gift tax under the Federal gift tax provisions. The Regulations determine whether an S.M.L.L.C. should be taxed as a separate entity or disregarded so that tax on its operations is borne by its owner.

"The Grecian case is an exciting judicial precedent, arising at the intersection of two highly complex areas of the U.S. tax law: partnership taxation and taxation of international transactions."

Pierre is similar to *Grecian* in that the Tax Court respected the transfer of an interest in an L.L.C. as a transfer of an interest in the entity, rather than a transfer of the L.L.C.'s underlying assets. The court in *Grecian* followed the logic of Subchapter K to determine that the aggregation approach should not apply to characterize a redemption of an L.L.C. interest as a deemed sale of the L.L.C.'s underlying assets. The court in *Pierre* arguably went further because it found that an S.M.L.L.C., disregarded for Federal tax purposes, should be respected as an entity for the purpose of valuing a transfer of an interest in an S.M.L.L.C. for Federal gift tax purposes.

CONCLUSION

The *Grecian* case is an exciting judicial precedent, arising at the intersection of two highly complex areas of the U.S. tax law: partnership taxation and taxation of international transactions. The case offers the Tax Court's step-by-step analysis of the application of and interplay between those sets of rules. Importantly, it is a pro-taxpayer determination of an issue previously interpreted under an I.R.S. ruling that was unfavorable to a foreign partner disposing of an interest in a U.S. partnership. It remains to be seen whether the I.R.S. will appeal the case or whether it will continue to litigate the issue on similar or alternative grounds.

WHEN THE (FAKE) I.R.S. CALLS – MEMOIRS OF THE TAX PHISHING WORLD

Author
Rusudan Shervashidze

Tags
I.R.S.
Phishing
Tax Scam

You may have heard the warnings before: Each tax season, the I.R.S. issues guidance urging taxpayers to watch out for new and evolving phishing schemes intended, in one way or another, to relieve taxpayers of their finances or sensitive personal information. However, this year it seems that scammers are not taking the summer off. According to an announcement made by I.R.S. Commissioner John Koskinen in late June, many new iterations of these scams involve fictitious tax bills and demands for taxpayers to transfer sensitive information or make payments with a gift card or iTunes card.[1] While I, like many others, have read of these scams before, I was surprised to become the target of one myself.

Around the time of the I.R.S. warning, I received a suspicious call that purported to be from the I.R.S. The caller left a voicemail (a threatening "robocall") on my phone informing me about criminal charges resulting from an underpayment of tax going back five years. The prerecorded message used language intended to intimidate, ". . . executed by the United States Treasury intending a serious attention . . . ignoring this intentional second attempt to avoid issue appearing before magistrate judge or grand jury for a Federal criminal offence . . . I advise you to cooperate and to help us to help you," and then provided a number for me to call. I frequently represent clients before the I.R.S. and immediately knew the message could not be legitimate, but I was intrigued.

When I called back, my call was picked up right way (unlike a typical call to the I.R.S. general number). The so-called I.R.S. agent informed me of the criminal charges I was supposedly facing and warned that this was a last attempt; if I disregarded the call, the judgment would be transferred to the police, which would result in my arrest. Fortunately, I was well-versed in I.R.S. warnings and therefore able to see through the ruse.

I am sharing this experience with the so-called I.R.S. agent in the hope that it will prevent others from falling into one of these traps. If you receive a similar call, please note that the I.R.S. does not just call. If there is any change or question regarding your tax return, the I.R.S. will mail you a letter first. And, importantly, before the I.R.S. issues a final judgment (as the impostor claimed) there are procedures in place that ensure every taxpayer gets due process in determining the correct tax liability.

To avoid falling victim to one of these traps, remember these five tell-tale signs of a scam, five things the I.R.S. will never do:

- Call to demand immediate payment, or call about taxes owed without first having mailed a letter

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[1] I.R.S., "IRS Cautions Taxpayers to Watch for Summertime Scams," news release, June 26, 2017.

- Demand that a taxpayer pays taxes without giving him or her the opportunity to question or appeal the amount owed
- Require that a specific payment method be used (such as a prepaid debit card)
- Ask for credit or debit card numbers over the phone
- Threaten to bring in local police or other law enforcement to arrest a taxpayer for not paying[2]

Taxpayers should be careful not to share any personal information over the phone with a so-called I.R.S. agent. If you receive any such calls and believe that you may owe taxes, call the I.R.S. directly at 800.829.1040 to confirm the information. Do not call any other number provided by the so-called I.R.S. agent.

"The I.R.S. does not just call. If there is any change or question regarding your tax return, the I.R.S. will mail you a letter first."

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2 *Id.*

I.R.S. EXPLAINS "SUBSTANTIALLY COMPLETE" IN RELATION TO INTERNATIONAL INFORMATION RETURN

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Tags
Form 5471
Form 5472
International Information Return
International Practice Unit
Substantial Compliance
Substantially Complete

BACKGROUND

While determining whether a taxpayer has complied with its obligation to provide the I.R.S. with information on its international operations as required by Code §6038 for outbound transactions and by Code §6038A for inbound transactions, it is important that the taxpayer's information return is substantially complete. If it is not, penalties may be imposed for failure to comply with the taxpayer's information reporting obligation. Code §6038 requires certain U.S. persons who are officers, directors, or shareholders of foreign corporations to file Form 5471[1] with respect to each foreign corporation and foreign partnership that they control. Similarly, Code §6038A requires a U.S. corporation that is 25% foreign owned to furnish Form 5472[2] to the I.R.S.

Where a Form 5471 submitted by a filer omits certain required information or contains erroneous information, the filer may be relieved from penalty if, notwithstanding these shortfalls, the information in the return is substantially complete so that the I.R.S. may conclude that substantial compliance exists.[3] The same holds true for an incomplete Form 5472.[4] Thus, a taxpayer must substantially comply with the reporting obligations by providing substantially complete information returns in order to avoid penalties. However, the terms "substantially complete" and "substantially incomplete" are not defined in the Code or its regulations.

This article will discuss an I.R.S. Practice Unit published recently that addresses the I.R.S.'s view of substantial compliance in the context of existing U.S. case law.

"SUBSTANTIALLY COMPLETE" / "SUBSTANTIAL COMPLIANCE" – I.R.S. EXPLANATION

On June 19, 2017, the Large Business & International Division ("L.B.&I.") of the I.R.S. issued a Practice Unit[5] providing guidance as to the meaning of the term

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1 Form 5471 (*Information Return of U.S. Persons with Respect to Certain Foreign Corporations*).

2 Form 5472 (*Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*).

3 Treas. Reg. §1.6038-2(k)(3)(ii).

4 Treas. Reg. §1.6038A-4(a)(1).

5 Practice Units are not official pronouncements of law or directives and cannot be used, cited, or relied upon as such. Practice Units provide a general discussion of a concept, process, or transaction, and are a means for collaborating and sharing knowledge among I.R.S. employees. Practice Units may not be used or cited as precedent.

“substantially complete” with respect to international information return penalties. It provides informal guidance to I.R.S. agents examining (i) a U.S. entity with foreign ownership, or (ii) a U.S. branch or subsidiary of a foreign corporation, for purposes of determining whether the required international information return is substantially complete, so that the filing requirement is met.

The Practice Unit begins by explaining the substantial compliance doctrine, which is a judicial concept that applies to certain tax returns, elections, and substantiation of deductions. While the concept of substantially complete has not been the subject of judicial review, the body of case law concerning the substantial compliance doctrine provides guide posts for how a court may interpret whether an international information return is substantially complete. This background can be applied to supplement existing informal guidance on substantial completion or, where the I.R.S. has not provided specific informal guidance, this background can suggest a general approach for an I.R.S. examiner to follow.

The Practice Unit discusses the difference between the strict compliance and substantial compliance doctrines. If a particular item of information or requirement at issue is determined to be related to the “substance or essence” of the statute or regulation, strict compliance is necessary. However, if the requirement is seen as “procedural or directory,” then substantial compliance will suffice.

In the context of a full income tax return, the Practice Unit looked to *Beard v. Commr.*[6] for guidance. There, the Tax Court summarized the requirements for a tax return to be considered valid for triggering the start of the period of limitations on assessment:

- It must provide sufficient data to calculate tax liability.
- It must purport to be a return.
- It must reflect an honest and reasonable attempt to satisfy the requirements of the tax law.
- It must be signed under penalties of perjury.
- If a return fails to meet these requirements, it will not be considered valid and will not trigger the running of the statute of limitations.

The Practice Unit then proceeded to address whether an election authorized by law is substantially complete. *Taylor v. Commr.*[7] involved an election under prior law that allowed a farmer to obtain a certain tax benefit in connection with the sale of livestock. When made, the election prevented the application of a recapture rule that would convert some or all of the gain into ordinary income. The taxpayers followed the basic requirements for favorable treatment – including reporting the gain on a tax return – but failed to file a formal election to report the gain as capital gain. The statute required a taxpayer to file an election for the favorable treatment with the following language:

> (B) Time, manner, and effect of election. — An election * * * for any taxable year shall be filed within the time prescribed by law (including

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[6] 82 T.C. 766 (1984), *affd*. 793 F.2d 139 (6th Cir. 1986).

[7] 67 T.C. 1071 (1977).

> extensions thereof) for filing the return for such taxable year, and shall be made and filed in such manner as the * * * [I.R.S.] shall prescribe by regulations. Such election shall be binding on the taxpayer for such taxable year and for all subsequent taxable years and may not be revoked except with the consent of the * * * [I.R.S.].[8]

In the case, the I.R.S. argued that the election was necessary for it to identify those taxpayers that claimed the benefit of the provision so that the validity of elections could be reviewed easily. To that end, the I.R.S. characterized the election as "indispensable to the smooth administration of the revenue laws." Nonetheless, the court determined that the I.R.S. had all information within the return to determine that an election was made. The taxpayer was in substantial compliance with Code §1251(b)(4)(B).

> The test for determining the applicability of the substantial compliance doctrine has been the subject of a myriad of cases. The critical question to be answered is whether the requirements relate "to the substance or essence of the statute." * * * If so, strict adherence to all statutory and regulatory requirements is a precondition to an effective election. * * * On the other hand, if the requirements are procedural or directory in that they are not of the essence of the thing to be done but are given with a view to the orderly conduct of business, they may be fulfilled by substantial, if not strict, compliance. * * * Thus[,] our decision must rest upon an analysis of the purpose of section 1251 and the exception contained therein to determine whether the disputed requirements are mandatory or directory. * * * To our mind, the essence of section 1251(b)(4) is to allow a farmer capital gains treatment on the sale or other disposition of farm recapture property if the farmer utilizes the method of accounting that cannot produce the evil section 1251 was enacted to prevent. * * * The election requirements, although undoubtedly helpful in the processing and auditing of returns, are in our view merely directory. We hold that petitioners, having fulfilled the essential requirements of section 1251(b)(4), have effectively made an election under that section on their original returns for the years at issue. [Citations omitted.][9]

A similar conclusion was reached in *Bond. v. Commr.*,[10] a case involving a charitable contribution of property. The income tax regulations[11] in effect for the year required a taxpayer claiming a deduction for a charitable contribution of property worth more than $5,000 to (i) obtain a qualified appraisal, (ii) attach an appraisal summary to the return, and (iii) retain certain information, including the qualified appraisal itself. The Tax Court found that the purpose of the regulation was to provide information helpful to the I.R.S. in processing and auditing returns on which deductions for charitable contributions are claimed. The regulations did not relate to the substance or essence of whether a charitable contribution was actually made, but instead alerted the I.R.S. to the charitable contribution and required taxpayers to provide certain

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8 Code §1251(b)(4).

9 *Taylor v. Commr.*, *supra*, at 1077-1079.

10 100 T.C. 32 (1993).

11 Treas. Reg. §1.170A-13.

information. As a result, the regulatory requirement was held to be directory, rather than mandatory, and the taxpayer was held to have substantially complied.

On the other hand, in *Prussner v. U.S.*,[12] the Court of Appeals for the 7th Circuit found that substantial compliance did not exist when, in lieu of a specific election on an I.R.S.-issued form, the attorney for the taxpayer's estate attached a letter stating that the form would be filed in the near future. The case involved heirs to family farms and other family businesses electing to value the assets of the farm or business in their current use, rather than being required, like other heirs, to value the assets at their commercially most lucrative use. The attorney for the estate failed to attach a recapture agreement to the estate tax return, instead attaching a letter which stated the following:

> * * * unfortunately, the agreement * * * was not fully executed at the time because the heirs reside throughout the United States. I hope to send this agreement to you within the next few weeks.

Four months later, he filed an agreement that complied fully with all the requirements of the regulation – other than timeliness. The I.R.S. disallowed the election and the Court of Appeals affirmed, concluding that the shortfall in the estate's compliance was not a late filing but an incomplete filing:

> There are further differences between day-late filing and incomplete filing. All fixed deadlines seem harsh because all can be missed by a whisker—by a day * * * or for that matter by an hour or a minute. They are arbitrary by nature. The taxpayer in this case missed by four months, and that is the proper comparison to the (curable) case of an incomplete return. The legal system lives on fixed deadlines; their occasional harshness is redeemed by the clarity which they impart to legal obligation. "Deadlines are inherently arbitrary; fixed dates, however, are often essential to accomplish necessary results. The Government has millions of taxpayers to monitor, and our system of self-assessment in the initial calculation of a tax simply cannot work on any basis other than one of strict filing standards." * * * There is no general judicial power to relieve from deadlines fixed by legislatures or, as here, by agencies exercising legislative-type powers." To extend the time [for filing an amended return] beyond the limits prescribed in the Act is a legislative not a judicial function.
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> * * * Prussner's lawyer could have obtained some of the signatures, and if he had done so and had filed an incomplete agreement Prussner would have had the protection of the statute–at least if the Illinois beneficiaries were the principal ones. This qualification is important because the requirement of substantial compliance is not satisfied by filing an agreement signed by one contingent remainderman, the main beneficiaries being left off. * * * That would make a joke of the statute by validating the election of a taxpayer who willfully flouted the requirements for a valid election. No matter; Prussner's lawyer could easily have obtained an extension of time for filing the estate tax return. He neither sought an extension of time nor filed an incomplete recapture agreement with the return; he failed to file

"Even though the majority of the information may have been reported accurately and completely, this does not mean that there has been substantial compliance."

[12] 896 F2d 218 (7th Cir. 1990).

a recapture agreement with the return, period. For this default the statute provides, as the Eighth Circuit has also concluded, no absolution.

INFORMATION RETURNS ENSURE U.S. TAX LAWS ARE OBSERVED

The Practice Unit discusses General Counsel Memorandum ("G.C.M.") 36372,[13] which explains the purpose and goals of an information return and how it is different from an income tax return. The G.C.M. takes the position that information reported on income tax returns is necessary to determine tax liability. As such, if a taxpayer omits information that is not necessary to determine tax liability, the return may be considered complete notwithstanding the omission. By contrast, information returns are required so that the I.R.S. can properly administer the revenue laws. If material information is left off an information return, such omission can impede the I.R.S.'s ability to perform the duties assigned to it by Congress.

The I.R.S. position in G.C.M. 36372 is similar to the arguments of the I.R.S. that were dismissed in the *Taylor* and *Bond* cases, but adopted in *Prusser*. Under *Prusser*, any provision in the Code aimed at providing the I.R.S. with information related to transactions cannot be viewed to be directory. In the I.R.S.'s view, the intent of Congress when enacting those provisions was to have taxpayers provide the I.R.S. with information that could be helpful in determining whether U.S. tax laws are being properly observed. Hence, providing information goes to the essence of the statute.

SUBSTANTIAL COMPLIANCE TEST MAY NOT BE MET EVEN IF MAJORITY OF INFORMATION IS REPORTED ACCURATELY

The Practice Unit directs the taxpayers to a Field Service Advice ("F.S.A.") that explores the concepts of "substantially complied" or "substantially incomplete" with respect to international information returns.

F.S.A. 33381431 discusses substantial compliance with respect to Form 5471. The F.S.A. warns that even though the majority of the information may have been reported accurately and completely, this does not mean that there has been substantial compliance such that a taxpayer is relieved from liability for a penalty. In the F.S.A., the U.S. taxpayer accurately reported the majority of the information, but failed to accurately report major transactions with related parties. The F.S.A. took the position that the related-party information was the essence of the filing requirement. If a taxpayer is allowed to satisfy its filing requirements by accurately providing most of the information, it would have the opportunity to avoid providing any information at all or to provide incorrect information with respect to important transactions.

The F.S.A. rejected the "aggregate approach," under which a taxpayer would be considered to be in substantial compliance if it accurately reported a certain percentage of the information required to be reported on Form 5471. Instead, it concluded that substantial compliance is measured on the basis of each significant item

[13] G.C.M. 36372 discusses the application of Code §6652(d), *i.e.*, the penalty in case of incomplete Forms 990-P and 4848.

of information specified in Code §6038(a)(1) for each individual controlled foreign corporation. It concluded that the U.S. taxpayer did not substantially comply with the Code §6038 reporting requirements because certain significant items were not reported.

SUBSTANTIALLY COMPLETE REQUIRES A FACTS AND CIRCUMSTANCES ANALYSIS

The Practice Unit then proceeds to discuss two Chief Counsel Advices ("C.C.A.'s").

C.C.A. 200429007 considered the meaning of the term "substantially incomplete" in regard to Form 5472 and as that term is used in Treas. Reg. §1.6038A-4(a)(1). The U.S. taxpayer timely filed Form 5472 for transactions with its parent for the relevant tax years. All required information was included on Form 5472. However, some transactions were erroneously reported. The C.C.A. looked at whether the taxpayer had substantially complied with its reporting requirements.

The C.C.A. begins its analysis by listing the information that must be provided on Form 5472:

- Sales and purchases of stock in trade (inventory)
- Sales and purchases of tangible property other than stock in trade
- Rents and royalties paid and received
- Sales, purchases, and amounts paid and received as consideration for the use of all intangible property
- Consideration paid and received for technical, managerial, engineering, construction, scientific, or other services
- Commissions paid or received
- Amounts loaned and borrowed (except open accounts resulting from sales and purchases reported under other items that arise and are collected in full in the ordinary course of business)
- Interest paid and received
- Premiums paid and received for insurance and reinsurance
- Other amounts paid or received not specifically identified, to the extent that such amounts are taken into account for the determination and computation of the taxable income of the reporting corporation

Further, on Form 5472, a reporting corporation is required to separately categorize by type its transactions with the named foreign related party by listing the amounts paid and received.

The C.C.A. identified two approaches that could be used to determine whether a return is substantially complete. The first is strict compliance: a rigorous interpretation of the rules that would treat virtually any substantive inaccuracy as rendering the return substantially incomplete. Under the strict compliance approach, any error for which reasonable cause does not exist is a substantially incomplete filing of

Form 5472. According to the C.C.A., a taxpayer that underreports or over-reports a particular transaction in a substantial amount frustrates I.R.S. efforts to audit a taxpayer. A taxpayer's error may also compel the I.R.S. to conduct a more intensive investigation than would have been unnecessary had the taxpayer correctly reported the transaction on the Form 5472. Accordingly, it is the error itself, as opposed to whether the error involves an underreporting or over-reporting, that undermines the ability of the I.R.S. to rely upon a taxpayer's reporting of related-party transactions.

"When considering and applying these factors to any particular situation, no one factor is necessarily more important than any other factor."

The second approach is based on substantial compliance, which reflects a facts and circumstances approach. The C.C.A. identifies seven factors that should be considered in determining whether the taxpayer has substantially complied with the reporting requirements:

1. The magnitude of the underreporting, or of the over-reporting, of the erroneous reported transaction(s) in relation to the actual total amount of that reported type of transaction(s)
2. Whether the reporting corporation has reportable transactions other than the erroneous reported transaction(s) with the same related party and correctly reported such other transactions
3. The magnitude of the erroneous reported transaction(s) in relation to all of the other reportable transactions as correctly reported
4. The magnitude of the erroneous reported transaction(s) in relation to the reporting corporation's volume of business and overall financial situation
5. The significance of the erroneous reported transaction(s) to the reporting corporation's business in a broad functional sense
6. Whether the erroneous reported transaction(s) occur(s) in the context of a significant ongoing transactional relationship with the related party
7. Whether the erroneous reported transaction(s) is (are) reflected in the determination and computation of the reporting corporation's taxable income

When considering and applying these factors to any particular situation, no one factor is necessarily more important than any other factor. The factors may contain evaluative characteristics when combined with other facts to indicate the completeness of the report. Overall, these factors give informal guidance on measuring the significance of the errors. While estimates are allowed in completing Form 5472 if actual data is not readily available, the estimates must be within prescribed limits.

C.C.A. 200429007 then looked at four fact patterns and reached conclusions as to the imposition of a penalty under the strict compliance and substantial compliance approaches to penalty exposure regarding Form 5472:

1. In the first fact pattern, inventory purchases are overstated by a factor of 100%. Purchases of $1,000,000 were reported on Form 5472, whereas the actual purchases were $500,000. The I.R.S. concluded that under the strict compliance approach, the Form 5472 was substantially incomplete because of the overstatement of transactions. The same conclusion was reached under the substantial compliance standard because of the magnitude of the error.

2. In the second fact pattern, the taxpayer sold $1,000,000 of goods to its parent and borrowed $600,000 from its parent. On Form 5472, it reported that it borrowed $1,000,000 from its parent. However, only $600,000 was borrowed from the parent. The I.R.S. concluded that, under the strict compliance approach, the Form 5472 was substantially incomplete because the taxpayer did not accurately report the amounts borrowed. The same conclusion was reached under the substantial compliance standard because of the magnitude of the error.[14]

3. In the third fact pattern, the ending balance of related-party loans did not match the opening balance on the following year's Form 5472 for that party. The ending balance of the preceding year was $1,000,000, but the opening balance for the following year was reported to be $600,000, which was found to be erroneous by the I.R.S. The I.R.S. concluded that, under the strict compliance approach, the Form 5472 was substantially incomplete because the taxpayer did not accurately report the opening balance of the related-party loan. The same conclusion was reached under the substantial compliance standard because of the magnitude of the error.[15]

4. In the fourth fact pattern, the taxpayer reported inventory purchases of $1,000,000, but the I.R.S. determined upon examination that the correct amount was $500,000. On the same Form 5472, the taxpayer reported commissions paid in the amount of $1,200,000, but upon examination, the I.R.S. determined that the correct amount was $1,600,000. Considered in the aggregate, only a $100,000 difference existed between the amount of total intercompany transactions. On the other hand, each of the transactions reported were off by material amounts, in one instance by 50% (over-reporting of purchases) and in the other 33% (underreporting of commissions). The I.R.S. concluded that, under the strict compliance approach, the Form 5472 was substantially incomplete because the taxpayer did not make accurately reports in two categories of intercompany transactions. The same conclusion was reached under the substantial compliance standard because of the magnitude of the error regarding at least one of the two categories of intercompany transactions.

In C.C.A. 200645023, a U.S.-based corporate group acquired a foreign-based group in a complex tender offer for shares of the foreign target. Within four months of closing the acquisition, the foreign target and its lower-tier subsidiaries of the foreign target were liquidated into a local country subsidiary of the U.S.-based group. The U.S.-based group timely filed Forms 5471 for the foreign target and its subsidiaries for the period of ownership between the closing and the liquidation. However, with one exception, the forms did not include Schedule O of Form 5471, which is used to advise the I.R.S. of acquisitions and dispositions of share in a foreign corporation, nor did the relevant Form 5471 for each such corporation include a balance sheet under U.S. Generally Accepted Accounting Principles ("U.S. G.A.A.P.").

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14 The conclusion in the C.C.A. under the substantial compliance approach was subject to confirmation of certain facts, although Chief Counsel expressed a view that the facts likely existed.

15 The conclusion in the C.C.A. under the substantial compliance approach was subject to the development by the examiner of additional facts, although Chief Counsel expressed a view that the facts likely would show that the Form 5472 was substantially incomplete.

The U.S.-based group contended in part that substantial compliance existed for the Forms 5471 of the foreign target and its subsidiaries. Each Form 5471 was completed based on the best information available to it at that time. Moreover, the only substantive deficiency was that the financial statements were not stated in U.S. dollars or converted to U.S. G.A.A.P., which it stated would have been a monumentally costly task. The C.C.A. concluded that the forms were not substantially complete. The fact that the conversions necessary to file substantially complete Forms 5471 would have been costly is not alone a sufficient reason to demonstrate reasonable cause. The schedules on Form 5471 converted into U.S. G.A.A.P. and U.S. dollars are significant pieces of required information. Secondly, excessive costs would have constituted reasonable cause only if the exercise of ordinary business care and prudence would not have allowed the U.S.-based group to make the conversions.

CONCLUSION

The substantial compliance defense to penalties described in the regulations under Code §§6038 and 6038A is available only to penalties under those sections in connection with Form 5471 and Form 5472. Nonetheless, a court may apply the generally applicable substantial compliance doctrine to other international information returns, including

- Form 8865 (*Return of U.S. Persons with Respect to Certain Foreign Partnerships*),
- Form 8858 (*Information Return of U.S. Persons with Respect to Certain Foreign Disregarded Entities*),
- Form 926 (*Return by a U.S. Transferor of Property to a Foreign Corporation*),
- Form 3520 (*Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*), and
- Form 3520-A (*Annual Information Return of Foreign Trusts with a U.S. Owner*).

Although not binding on taxpayers, the Practice Unit provides valuable insight into the I.R.S. viewpoint on the application of the substantial compliance doctrine and the meaning of substantially complete in relation to Code §§6038 and 6038A. As demonstrated above, however, the I.R.S. view of substantial compliance differs from that held by many taxpayers. Substantial compliance for the I.R.S. is likely simply a lighter form of strict compliance, requiring more steps for the I.R.S. to impose a penalty, but ultimately arriving at the same result.

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Tags
Accounting Directive
Action 13
B.E.P.S.
CbC Reporting
Tax Reform
Undue Financial Burden
Undue Complexity

EUROPEAN PARLIAMENT EXTENDS SCOPE OF COUNTRY-BY-COUNTRY REPORTING

Background

With the objective of enhancing transparency and public scrutiny on corporate income tax, the European Commission adopted a proposal1 (the "Proposal") for an amendment to Directive 2013/34/E.U. (the "Accounting Directive") on April 12, 2016. The Proposal, which was intended to implement Action 13 of the O.E.C.D.'s B.E.P.S. Action Plan, required public country-by-country ("CbC") reporting of tax and other financial information by certain undertakings and branches operating in the E.U.2 Since that time, the Committee on Economic and Monetary Affairs and the Committee on Legal Affairs3 (the "Committees") have worked to prepare reports (together, the "Joint Report") on the Proposal, broadening the scope of the measure and increasing reporting requirements. In June 2017, the Committees jointly adopted the Joint Report and submitted it to the European Parliament for approval.

European Parliament Approves Joint Report

On July 4, 2017, the European Parliament, in its plenary session, approved the Joint Report submitted by the Committees.

In addition to CbC reporting by the ultimate parent and its branches, the Joint Report requires all subsidiary undertakings that are governed by the national laws of a Member State and controlled by an ultimate parent undertaking that has a consolidated net turnover exceeding €750 million and is not governed by the laws of a Member State to publish CbC reports on income tax information of that ultimate parent undertaking on an annual basis. The reporting requirement applies whether or not the subsidiaries constitute medium or large subsidiary undertakings referred to in Article 3(3) and (4) of the Accounting Directive.

The Joint Report also introduces a requirement to publish the CbC report in a common template, in an open data format, and in at least one of the official languages of the E.U. It also requires the reporting entity to furnish the following additional details:

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1 Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/E.U. as regards disclosure of income tax information by certain undertakings and branches

2 The Proposal has been discussed at length in the article "Country-by-Country Reporting: Where Are We Going?," *Insights* 4 (2016).

3 Both Committees are committees of the European Parliament

- Name of the ultimate undertaking and, where applicable, a list of all its subsidiaries and their respective geographical locations
- Number of employees on a full-time equivalent basis
- Fixed assets other than cash or cash equivalents
- Distinction between the turnover made with related parties and unrelated parties
- Stated capital

Whether undertakings, subsidiaries, or branches benefit from preferential tax treatment resulting from a patent box or equivalent regime

The Proposal required the information to be reported separately for each Member State, and where a Member State comprised of several tax jurisdictions, the information was required to be combined at Member State level. However, in order to increase policy coherence and limit potential tax avoidance, the European Parliament approved an amendment inserted by the Committees that requires the information to be presented separately for each tax jurisdiction in cases where a Member State comprises several tax jurisdictions. The Joint Report also removes the aggregate reporting requirement for all tax jurisdictions outside the E.U. and now requires information separately for each tax jurisdiction.

Recognizing that the disclosure of sensitive information may create a competitive disadvantage, the Joint Report permits the Member State to allow the reporting entity to omit one or more specific items of information from the report if their disclosure would be seriously prejudicial to its commercial position. However, the fact of omission shall be indicated in the report together with an explanation for such omission for each tax jurisdiction. The European Parliament has directed the European Commission to form guidelines to assist Member States in defining cases where the publication of information shall be considered seriously prejudicial.

The European Commission is also required to undertake a cost-benefit analysis of lowering the consolidated net turnover threshold beyond which undertakings and branches are required to report on income tax information, *i.e.*, €750 million.

Road Ahead

After approving the Joint Report by 534 votes to 98 with 62 abstentions, the members of the European Parliament sent the report back to the Committees for inter-institutional negotiations. The Joint Report may be subject to further revisions during the negotiation process, making it difficult to anticipate the final legislation at this time.

I.R.S. IDENTIFIES REGULATIONS IMPOSING UNDUE BURDEN ON TAXPAYERS

On April 21, 2017, President Trump issued Executive Order 13789 (the "Order") with the objective of identifying and reducing tax regulatory burdens imposed by Treasury Regulations (the "Regulations"). The Order required the I.R.S to issue an interim report identifying Regulations issued on or after January 1, 2016, that either

- impose an undue financial burden on U.S. taxpayers,
- add undue complexity to the Federal tax laws, or
- exceed the statutory authority of the I.R.S.

Pursuant to the Order, the I.R.S. issued an interim report vide Department Notice 2017-38, identifying eight Regulations that met at least one of the first two above-mentioned criteria. Five of such regulations are discussed below:

1. Temporary Regulations Under Code §337(d) on Certain Transfers of Property to Regulated Investment Companies and Real Estate Investment Trusts[4]

These temporary regulations amend existing rules on transfers of property by C-corporations to Real Estate Investment Trusts ("R.E.I.T.'s") and Regulated Investment Companies generally. Commenters expressed concern that the R.E.I.T. spinoff rules could result in over-inclusion of gain in some cases, particularly where a large corporation acquires a small corporation that engaged in a Code §355 spinoff and the large corporation subsequently makes a R.E.I.T. election.

"The I.R.S. has requested public comments on whether the above Regulations should be rescinded or modified."

2. Proposed Regulations Under Code §2704 on Restrictions on Liquidation of an Interest for Estate, Gift, and Generation-Skipping Transfer Taxes[5]

Proposed regulations under Code §2704(b) added additional restrictions to the list of restrictions on the ability to dispose of or liquidate family-controlled entities that are disregarded in determining the fair market value of an interest in that entity for estate and gift tax purposes. Commenters expressed concern that the proposed regulations would eliminate or restrict common discounts, such as minority discounts and discounts for lack of marketability, which would result in increased valuations and transfer tax liability that would increase financial burdens.

3. Temporary Regulations Under Code §752 on Liabilities Recognized as "Recourse Partnership Liabilities"[6]

These temporary regulations generally provide: (i) rules for how liabilities are allocated under Code §752 solely for purposes of the disguised sales rules under Code §707, and (ii) rules for determining whether "bottom-dollar payment obligations" provide the necessary "economic risk of loss" to be taken into account as a recourse liability. Commenters stated that the first rule would negatively impact ordinary partnership transactions and that the second rule would prevent many business transactions.

4. Final and Temporary Regulations Under Code §385 on the Treatment of Certain Interests in Corporations as Stock or Indebtedness[7]

These final and temporary regulations address the classification of related-party debt as debt or equity for Federal tax purposes. Commenters criticized the financial burdens of compliance, particularly with respect to more ordinary course transactions, the complexity associated with tracking multiple transactions through a group

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4 T.D. 9770; 81 F.R. 36793.

5 R.E.G.163113- 02; 81 F.R. 51413.

6 T.D. 9788; 81 F.R. 69282.

7 T.D. 9790; 81 F.R. 72858.

of companies, and the increased tax burden imposed on inbound investments.

5. Final Regulations Under Code §367 on the Treatment of Certain Transfers of Property to Foreign Corporations[8]

The final regulations under Code §367, which generally imposes immediate or future U.S. tax on transfers of property (tangible and intangible) to foreign corporations, eliminate the ability of taxpayers under prior regulations to transfer foreign goodwill and going concern value to a foreign corporation without immediate or future U.S. income tax. Some commenters stated that the final regulations would increase burdens by taxing transactions that were previously exempt.

The I.R.S. has requested public comments on whether the above Regulations should be rescinded or modified and, in the latter case, how the Regulations should be modified in order to reduce burden and complexity. Comments from the public are due by August 7, 2017.

According to the Order, the I.R.S. is also instructed to submit a final report to the President by September 18, 2017, recommending specific actions to mitigate the burden imposed by the Regulations identified in the interim report.

[8] T.D. 9803; 81 F.R. 91012.

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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.

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