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INSIGHTS

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EDITORS' NOTE

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

- **Brazil 2017: Tax Developments for Business Transactions.** In Brazil, the year 2017 saw many important developments regarding cross-border and intrastate business transactions. These developments focus on the implementation of various B.E.P.S. actions, the categorization of software transactions, and subjecting certain intrastate transactions to competing levels of state and municipal tax, all done the Brazilian way by emphasizing gross basis taxation on consumption payments. Erika Tukiama, Rogério Gaspari Coelho, and Nathália Fraga of Machado Associados, São Paulo, provide guidance on these developments.

- **New Transparency Register in Germany.** October 1, 2017, was the due date for entering information on Germany's beneficial owner registry. The register brings transparency to all sorts of entities, including private law foundations and trusts, as data will be open to public inspection from December 27, 2017. Dr. Andreas Richter of P+P Pöllath + Partners, Berlin, sheds light on the registration requirements.

- **The Sharing Economy Part 2: Governments Strike Back.** The sharing economy uses digital platforms to connect suppliers willing to provide services or use of assets with consumers. Think of Uber and Airbnb. These multinationals are structured to channel profits to low-tax jurisdictions. As with Google and Microsoft, tax authorities have begun to challenge these business models. In part two of this series, Fanny Karaman and Beate Erwin explain how these business models are being challenged.

- **O.E.C.D. Releases Mutual Agreement Procedure Peer Review Report for the U.S.** The B.E.P.S. Action 14 Report, *Making Dispute Resolution Mechanisms More Effective*, acknowledged that the actions to counter B.E.P.S. must be complemented with effective dispute resolution mechanisms. Participating countries agreed to have their compliance with the minimum standard reviewed by their peers. The U.S. is among the first few countries that have been reviewed. Neha Rastogi and Michael Peggs summarize the M.A.P. report card issued for the U.S.

- **Anti-Inversion Rules Are Not Just for Mega-Mergers – Private Client Advisors Take Note.** The U.S. has rules that attack inversion transactions, wherein U.S.-based multinationals effectively move tax residence to low-tax jurisdictions. If successful, these moves allow for tax-free repatriation of offshore profits to the inverted parent company based outside the U.S. However, the scope of the anti-inversion rules is broad and can also affect non-citizen, nonresident individuals who directly own shares of private U.S. corporations. Attempts to place those shares under a foreign holding company as an estate planning tool may find that the exercise is all for naught once the anti-inversion rules are applied. Elizabeth V. Zanet, Galia Antebi, and Stanley C. Ruchelman discuss the hidden reach of the anti-inversion rules to private structures.

- **Texas District Court on Anti-Inversion Legislation – One Down but Not Out.** The final months of the Obama administration saw the hurried adoption of temporary regulations in an attempt to extend its tax policy into the current administration. However, reliance on temporary regulations that are adopted without a public comment period may have been misguided. In October, a U.S. District Court struck down a provision under temporary anti-inversion regulations for violating the required notice and comment period under the Administrative Procedure Act. Beate Erwin and Sheryl Shah explain the web of issues involved in the decision.

- **Employment Tax Basics and Paths to Compliance.** When a company expands across a border, it faces a complex web of employment-related taxes. Penalties for failure to properly comply with these rules can be severe. Fanny Karaman looks at the U.S. rules that are applicable to the payment of wages and bonuses, the penalties that can be imposed on compliance failures, and the procedures that are available to cure errors. The rules are not straightforward, guidance is often minimal, and an experienced advisor is extremely valuable.

- **Art and the Estate Part II – Nonresidents.** Foreign persons owning artwork physically located in the U.S. must be mindful of special income, estate, and gift taxes associated with that ownership. In the second of a series, Rusudan Shervashidze and Nina Krauthamer look at issues such as use tax, which is the U.S. equivalent of a reverse charge of V.A.T., estate tax, and gift tax.

- **Updates & Tidbits.** This month, Sheryl Shah and Nina Krauthamer look briefly at two I.R.S. actions: (i) the roll out of a long-awaited passport denial program and (ii) the end of favorable rulings on certain worthless stock deductions and spinoffs.

We hope you enjoy this issue.

- The Editors

BRAZIL 2017: TAX DEVELOPMENTS FOR BUSINESS TRANSACTIONS

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Tags
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INTRODUCTION

The year 2017 saw many important developments in Brazil regarding cross-border and intrastate business. This article focuses on three areas: B.E.P.S., categorization of software transactions to expand withholding tax exposure, and intrastate transactions.

BRAZIL AND THE B.E.P.S. ACTION PLAN

On May 29, 2017, Brazil formally requested entry to the O.E.C.D. Since 1994, Brazil has actively cooperated with the O.E.C.D., and it has been a key O.E.C.D. partner since May 2007 via an "enhanced engagement" program. Brazil already participates in 31 O.E.C.D. legal instruments, including the B.E.P.S. Action Plan, having signed the Declaration on B.E.P.S. in May 2013.

Brazilian tax legislation has evolved in the past few years in a way that often converges with international standards. This can be seen in the way Brazil has implemented most, but not all, B.E.P.S. actions and objectives.

B.E.P.S. Action 1: Addressing the Tax Challenges of the Digital Economy

No concrete measures were adopted. Nevertheless, Brazil has taken independent steps to address the way the digital economy is taxed, particularly with regard to B.E.P.S.

B.E.P.S. Action 3: Designing Effective Controlled Foreign Company ("C.F.C.") Rules

In November 2013, the Brazilian government published a provisional law that introduced new rules regarding the taxation of profits earned by branches and controlled or affiliate companies overseas.[1] The Brazilian provisions on profits earned overseas have broader reach than international standards, addressing all types of income earned by an foreign controlled or affiliate company.

B.E.P.S. Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

Brazil has introduced rules on thin capitalization[2] intended to prevent Brazilian companies from being funded by excessive debt held by related parties abroad. If the related lender is located in a country that is not a tax haven or is not subject to a

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1 Provisional Measure 627, later converted into Law 12,973/2014.

2 Law 12,973/2014.

privileged tax regime, the debt-to-equity ratio cannot exceed 2:1. If the lender is located in a tax haven or is subject to a privileged tax regime, the related-party debt cannot exceed 30% of the equity (*i.e.*, a 0.3:1 debt-to-equity ratio).

B.E.P.S. Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

B.E.P.S. Action 5 was implemented through two regulations issued by the Brazilian Federal Revenue Service:

- Normative Instruction 1658/2016 updates the list of tax havens and countries with privileged tax regimes, initially established under Normative Instruction 1037/2010, and introduces the concept of "substantive economic activities" for holdings in foreign subsidiaries.
- Normative Instruction 1689/2017 establishes procedures regarding the exchange of information between countries with which Brazil has in effect tax information exchange agreements covering matters such as transfer pricing and permanent establishments ("P.E.'s").

The Brazilian Federal Revenue Service system relies on the Public Digital Bookkeeping System ("SPED") and other systems to obtain information on taxpayers:

- SPED allows for a thorough online exchange of information between the Federal Revenue Service and taxpayers, providing great transparency and oversight.
- State and municipal authorities also have similar systems that allow local tax authorities to have access to the billing systems of businesses.
- Within Brazil, there are mechanisms allowing for a broad exchange of information involving the registration of vehicles, deeds, and service providers.
- Oversight of financial transactions is carried out on a regular basis by banking and tax authorities.
- Normative Instruction 1634/2016 sets forth the obligation to identify the beneficial ownership of companies.

This data is available to tax authorities in partner jurisdictions.

B.E.P.S. Action 7: Preventing the Artificial Avoidance of P.E. Status

So far, Brazil has not indicated that it intends to adopt Action 7 regarding the taxation of business profits. Questions regarding the P.E. concept are common among foreign companies interested in doing business in Brazil. Despite the absence of a formal P.E. concept in Brazil, several income tax rules[3] broadly reflect internationally accepted P.E. principles:

- Actual or *de facto* branches of foreign companies are regarded as legal entities for Brazilian tax purposes.[4] The existence of an independent division that trades or renders services on a regular basis through employees and

[3] *E.g.*, Decree 3000/1999.

[4] Article 147 II.

“The Brazilian tax authorities have little experience with P.E. issues. As a result, the imposition of Brazilian tax on foreign companies without formal branches is rare.”

local management can result in the existence of a *de facto* branch that is subject to taxation in Brazil even if a formal branch is not registered.

- *Commissionaire* arrangements can result in branch taxation for the foreign principal. The law defines a *commissionaire* as a company or individual, holding independent status with regard to the principal, that acts in its own name but for the account of a principal when selling goods. The *commissionaire* is responsible for calculating the profits of the foreign principal that supplies the goods and collecting tax under the rules applicable to branches of foreign companies.[5]

- Agents resident in Brazil concluding direct sales in Brazil for foreign companies must compute profits and collect tax on behalf of principals. This rule does not apply when the agent is an independent party or a mere intermediary acting under a grant of authority that is limited to obtaining purchase offers that are forwarded to the principal. The law defines an agent as a person that represents another party in return for a fee. When an agent is involved in a sale, the agent does not conclude contracts in its own name.

  As is apparent, the Brazilian rule for independent agents is not dissimilar to the rule in the O.E.C.D. model. The agent must not have and regularly exercise the power to bind a foreign principal. Thus, an agent is not a P.E. of its principal when acting independently, without powers to bind the foreign principal, and without a pattern of activity in which it executes agreements on a regular basis.[6]

In practice, the Brazilian tax authorities have little experience with P.E. issues. As a result, the imposition of Brazilian tax on foreign companies without formal branches is rare. Even when an entity is characterized as a P.E., the Brazilian tax system may mandate taxation but does not provide the means for paying the tax. Moreover, the risk of P.E. characterization is extremely low for service providers because Brazil imposes very high withholding taxes on payments for the import of services. Tax authorities express greater interest in collecting withholding tax from payments to foreign service providers than in collecting net tax from the profits of an unofficial Brazilian branch. Even in the context of a P.E. and an applicable income tax treaty, Brazilian tax authorities tend to focus on collecting withholding tax when Brazilian enterprises pay service fees to Brazilian offices of foreign businesses.

B.E.P.S. Action 8, 9 and 10: Aligning Transfer Pricing Outcomes with Value Creation

If approved, Brazil’s membership in the O.E.C.D. could have a significant impact on the Brazilian transfer pricing rules in a few years. Brazil chose to adopt, as of 1997,[7] transfer pricing rules inspired by the O.E.C.D. Transfer Pricing Guidelines but mostly based on objective criteria. Although the application of these criteria is relatively straightforward, more often than not the result is not necessarily an arm’s length price, due to the use of predetermined profit margins (which can amount to 40% for certain activities).

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5 Article 398.

6 Articles 399 and 539.

7 Law 9430/1996.

B.E.P.S. Action 12: Mandatory Disclosure Rules

No concrete action has been taken. Nevertheless, in 2015, the executive branch attempted to pass a bill to address mandatory disclosure of aggressive tax planning.[8] However, the Brazilian Congress vetoed significant portions of the legislation thereby eviscerating the proposal.

B.E.P.S. Action 13: Transfer Pricing Documentation and Country-By-Country Reporting

Country-by-Country reporting has been adopted.[9] However, legislation has not been enacted mandating the submission of master files and local files.

B.E.P.S. Action 14: Making Dispute Resolution Mechanisms More Effective

Procedures authorizing Brazilian participation in Mutual Agreement Procedures ("M.A.P.'s") related to Brazilian income tax treaties.[10] Brazil has in effect income tax treaties with the following countries:

Argentina	Mexico
Austria	Norway
Belgium	Netherlands
Canada	Peru
Chile	Portugal
China	Philippines
Czech Republic	Russia
Denmark	Slovakia
Ecuador	South Africa
Finland	South Korea
France	Spain
Hungary	Sweden
India	Trinidad and Tobago
Israel	Turkey
Italy	Ukraine
Japan	Venezuela
Luxembourg	

As can be seen from the list, Brazil does not have a comprehensive income tax treaty with the U.S. in effect.

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8 Provisional Measure 685/2015.

9 Normative Instruction 1681/2016.

10 Normative Instruction 1669/2016.

B.E.P.S. Action 15: Multilateral Convention to Implement Tax Treaty Related Measures to Prevent B.E.P.S.

No concrete steps have been adopted. The tax authorities have stated that Brazil may opt to renegotiate each treaty bilaterally.

Final Note on B.E.P.S.

Overall, Brazil has been a pioneer in championing B.E.P.S. objectives, especially regarding the actions towards fiscal transparency and exchange of information. Although some actions and formalities have not yet been implemented, most have been addressed by Brazilian legislation. Once Brazil becomes a full member of the O.E.C.D., further implementation of the B.E.P.S. Action Plan is expected.

BRAZILIAN VIEW ON SOFTWARE TRANSACTIONS

In recent months, the General Tax Coordination ("C.O.S.I.T.") has issued several tax rulings regarding cross-border and domestic transactions involving software. Tax policy in this area is quite controversial due to the different levels of Federal units interested in collecting taxes (municipalities, States, and the Federal Union). Policy has not kept up with new technologies and developments in high-tech solutions offered in the market. As a result, rules are inconsistent and surprises are prevalent.

Payment for Off-the-Shelf Software

One example of inconsistent treatment relates to a previously resolved issue involving the taxation of standard software imports.[11] In the past, tax authorities understood that remittances made abroad for the licensing of standard software involving off-the-shelf products was not subject to Brazilian withholding income tax ("W.H.T."). This understanding was in line with Federal Supreme Court ("S.T.F.") case law, which established a rule treating a payment for standard software as the purchase of a product. As a result, the payment is not considered to be a royalty. Standard software is defined as multiple copies manufactured on a large scale, in a uniform manner, and intended for use by an undetermined number of users.[12] If standard software were considered as a product, its import would not subject to W.H.T., even if delivery is effected by download from the internet.

In its ruling,[13] C.O.S.I.T. reached the following conclusions:

- The licensing of the right to *sell and distribute* software, which is usually transacted between Brazilian distributors and foreign companies, differs from the licensing for the right to *use* the software. The latter is generally applicable to transactions between Brazilian distributors and end consumers.
- For cases involving licensing to sell and distribute software, the S.T.F. case law mentioned above is not applicable, as this precedent only refers to cases of licensing for the right to use the software. Thus, the characterization of standard software would be irrelevant to the commercial/distribution relationship between the Brazilian distributor and the foreign company.

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[11] C.O.S.I.T. Conflict Resolution Ruling 18/2017.

[12] Extraordinary Appeal 176.626-3.

[13] Conflict Resolution Ruling 18/2017.

- Payments made abroad by Brazilian companies for the right to sell the software fall under the concept of royalties, which are subject to (i) 15% W.H.T. (increased to 25% if the recipient is based in a tax haven) and (ii) 10% Contribution for the Intervention in the Economic Domain ("C.I.D.E.") in the context of a technology transfer. In a technology transfer, the source code of the software is provided, and the acquirer of the license is able to modify the program. The C.O.S.I.T. ruling stated that C.I.D.E. is not levied if a technology transfer does not occur.

As a result of the C.O.S.I.T. ruling, all taxpayers face greater tax exposure because the ruling is binding on all Federal tax authorities. Taxpayers caught by the ruling must be prepared to pursue review at administrative and judicial levels.

The position expressed in the C.O.S.I.T. ruling – that the payment has the character of a royalty – is applied to other Federal taxes, as discussed below. However, licensing of off-the-shelf software for local end users remains unaffected by the C.O.S.I.T. ruling.[14]

Software as a Service

In terms of new technologies, C.O.S.I.T has addressed the tax treatment of remittances made abroad for the provision of "Software as a Service" or "SaaS"[15] in a ruling involving a Brazilian company engaged in the sale, maintenance, and development of data processing systems.

In the ruling, a Brazilian company made payments to a foreign company for password authorization to access and use two different SaaS packages. One package was a utilities package protecting against computer viruses and spam. The other package was a virtual platform enabling database access and participation in conference calls, meetings, and training sessions. The Brazilian company subsequently provided access and authorization to Brazilian users.

In the ruling, C.O.S.I.T. concluded that the license to use a SaaS should be regarded as the provision of a technical service that was subject to W.H.T. and C.I.D.E. The rationale for the conclusion is as follows:

- The user did not acquire any software and did not have the software installed on its hardware. Rather, it paid periodic fees for access to the utilities package that was hosted in the cloud at an unknown location or locations.
- The Brazilian company was not allowed to modify the program's characteristics. Rather, the foreign company retained exclusive responsibility for management and maintenance of the software and provision of helpdesk services.
- The Brazilian company paid for access to a service, not for use and control of intangible property.
- The agreement between the Brazilian company and the foreign company provided that the payments were compensation for rendering a package of services.

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[14] C.O.S.I.T. Ruling Request 303/2017.

[15] C.O.S.I.T. Ruling Request 191/2017.

In sum, C.O.S.I.T. applied rules for the performance of technical services. Under Brazilian tax law, a broad definition is given to technical services, which is quite different from the concept adopted by most other countries. Once categorized as a service, remittances abroad were subject to the general 15% W.H.T. and 10% C.I.D.E. C.I.D.E. is a Federal tax levied (i) on the payment, credit, delivery, use, or remittance of amounts abroad related to a technology transfer (including licensing of patents and/or trademarks and technical assistance agreements and excluding software licensing, as long as the source code is not transferred) and (ii) on a payment abroad related to technical, administrative, and similar services, as well as any royalty payments. The taxpayer is the Brazilian legal entity.

Other taxes typically levied on imports of technical services were not analyzed by C.O.S.I.T. in the ruling.

Domestic Transactions Regarding Software

Imposto de Renda sobre Pessoa Jurídica ("I.R.P.J.") is the corporate income tax in Brazil. *Contribuição Social sobre o Lucro Líquido* ("C.S.L.L.") is one of the social insurance taxes that fund Brazilian social security. Brazilian legal entities may use the actual profit system or the deemed profit system to calculate the tax base for both taxes. The actual profit system computes the tax base by reference to actual results. In comparison, the deemed profit system computes the tax base by reference to percentages of the company's gross revenues. The percentage varies depending on the company's business activity.

To illustrate, the percentage applicable to the sale of merchandise is 8% for I.R.P.J. and 12% for C.S.L.L. For services, the percentage is 32% for both taxes. The taxable base is made up of deemed business profits using the applicable percentage, non-business actual income, and capital gains.

Under the deemed profit system, the sale of standard software can be treated as either a sale of a product or the provision of services. If only minimal modifications or adjustments are made to standard software, the activity is categorized as a sale of merchandise. On the other hand, if standard software is significantly altered and modified, the activity is categorized as a service.

The *Contribuição para os Programas de Integração Social e de Formulação do Patrimônio do Servidor Público* ("P.I.S.") and the *Contribuição Social para o Financiamento da Seguridade Social* ("C.O.F.I.N.S.") are taxes based on the turnover of companies. The P.I.S. is intended to finance the Brazilian unemployment insurance system and C.O.F.I.N.S. is used to fund social security. Next to I.R.P.J., C.O.F.I.N.S. raises the most revenue for Brazil.

With reference to domestic transactions, C.O.S.I.T. ruled on withholding obligations for I.R.P.J., C.S.L.L., and P.I.S./C.O.F.I.N.S. in the context of payments for professional services.

- In one ruling, the issue was whether certain activities should be regarded as professional services that are subject to taxation.[16] The ruling addressed three separate activities. The first was the sale of standard software and updates. The second was the sale of a permanent use or temporary use license related to general and nonexclusive software. The third was the performance of maintenance and technical support regarding the software.

[16] C.O.S.I.T. Ruling 230/17.

C.O.S.I.T. ruled that the first two items were not considered to be services for purposes of I.R.P.J., C.S.L.L., and P.I.S./C.O.F.I.N.S. On the other hand, the provision of maintenance and of technical support services was considered to be the performance of services. Consequently, payments made for the performance of maintenance and support activities were subject to C.S.L.L. and P.I.S./C.O.F.I.N.S.

- In another C.O.S.I.T. ruling, the performance of technical services focused on maintenance activities for the proper functioning of a computer program. The ruling concluded that the revenue must be characterized as arising from the provision of services, even if the activity is not expressly covered in the agreement.[17]
- In a third C.O.S.I.T. ruling, the resale of permanent and temporary licenses of standard software through download was categorized as the sale of merchandise by a Brazilian company for purposes of the Special Tax Regime for Small Businesses.[18] This ruling is consistent with case law in Brazil.
- Finally, C.O.S.I.T. ruled that partial or total updates on standard software acquired through physical support or through download is properly categorized as a sale of merchandise for the purposes of the levy of Social Security Contributions on Gross Revenues.[19]

"Courts have been asked to decide which level of São Paulo's government is competent to impose tax on transactions with software related to download and cloud computing."

State V.A.T. ("I.C.M.S.")

Another important topic relates to State V.A.T. ("I.C.M.S."), where software is potentially subject to taxes on services and on products. To illustrate, the State of São Paulo, for example, recently ruled that I.C.M.S. is levied on transactions with non-customized or tailor-made software involving electronic transfers of data, regardless of whether it is by means of download or through cloud computing.[20] However, this levy is currently suspended. At the same time, the city of São Paulo ruled that a Municipal Tax on Services ("I.S.S.") should be levied on the download of any kind of software, standard or customized, when the transaction involves electronic data transfer.[21]

Courts have been asked to decide which level of São Paulo's government is competent to impose tax on transactions with software related to download and cloud computing. Is it a service or the sale of a product? It is possible that each level of government has the authority to categorize the transaction as it wishes (in which case the answer will be that both have competency to impose and collect the tax)?

RECENT CHANGES IN STATE BENEFITS RELATED TO I.C.M.S.

Supplementary Law 160/2017 was recently enacted to address a tax war between the Brazilian states. The Brazilian Constitution establishes that a supplementary

[17] C.O.S.I.T. Ruling 235/2017.

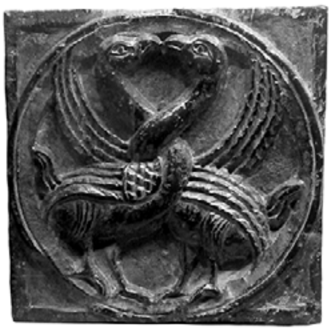
[18] C.O.S.I.T. Ruling 231/2017.

[19] C.O.S.I.T. Ruling 18/2017.

[20] Normative Decision CAT 4/2017.

[21] *Id.*

law should define how I.C.M.S. incentives would be granted – Brazil has 26 states, plus a Federal district, with competence to collect this state tax. In the Brazilian legal system, a supplementary law implements a provision set forth in the Constitution and must be approved by a two-thirds majority in both legislative houses, the Senate and the House of Representatives. Thus, the Brazilian Constitution should be seen to establish the policy, and the supplementary law addresses the details.



Supplementary Law 24/1975 established that all tax exemptions, benefits, remissions, amnesties, and tax or financial incentives should be approved by the National Council of Tax Policy ("C.O.N.F.A.Z."), composed of the 27 state treasury secretaries and the finance minister, who represents the Federal government. The quorum for a C.O.N.F.A.Z. meeting is the presence of a majority of C.O.N.F.A.Z. members. All decisions regarding the grant of a tax benefit require a unanimous vote. C.O.N.F.A.Z. decisions authorizing states to grant benefits are formalized by means of a covenant that must be ratified by the respective state's legislative branch.

In spite of a provision stating that benefits granted without the detailed approval process are null and void – meaning the tax remains due and payable, notwithstanding the act of a state – many states have ignored this rule when granting tax incentives. As a result, other states have begun to deny credits where a transaction benefitted from a tax incentive that was not approved by C.O.N.F.A.Z. In addition, several S.T.F. rulings have determined that unilaterally granted state tax benefits are unconstitutional.

Supplementary Law 160/2017 was passed to overcome the uncertainty around established. Its main provisions are as follows:

- States should list all the normative acts granting tax benefits and register them with C.O.N.F.A.Z.
- By means of a covenant executed by C.O.N.F.A.Z.,[22] the states and the Federal district can reinstitute tax credits related to unilaterally granted tax benefits.
- The approval of the covenant will require a quorum made up of two thirds of the states and consisting of at least one third of each region of the five regions of Brazil.
- Approval should occur by the beginning of February 2018.
- After that target date, the term of each incentive may be extended by the governors for up to 15 years for most economic activities, with reduced timelines of eight, five, three, and one year for other activities listed in the covenant.
- It is also possible for governors to grant incentives to other taxpayers located in their states, extending existing incentives under the same terms.
- A state may enact the same tax benefits granted by other states of the same Brazilian region.
- These rules have retroactive effect forbidding states from collecting past tax credits related to tax benefits.

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[22] Supplementary Law 24/1975.

- The granting of other tax benefits that are not consistent with Supplementary Law 24/1975 will subject the states to penalties provided under the Fiscal Responsibility Law, such as the prohibition on receiving voluntary transfers, as well as credit restrictions.

Once the covenant is approved, past tax liabilities connected to the lawfulness of the benefits will be settled. Although discrepancies between state tax incentives will continue for up to 15 years, companies can be sure that past situations will not trigger tax assessment notices drawn up by different states.

CONCLUSION

The year 2017 can be categorized as a typical year in Brazil. The country took steps to adopt internationally accepted norms regarding cross-border taxation. At the same time, taxpayers continued to encounter inconsistently applied tax rules and bureaucratic conflicts.

THE NEW TRANSPARENCY REGISTER IN GERMANY

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Tags
Germany
Information Disclosure
Reporting Requirements
Transparency

As of October 1, 2017, corporate entities (*i.e.*, companies and partnerships), other private law corporations (*i.e.*, private law foundations, co-ops, and associations), and trusts are required to report their beneficial owners to the newly-established German transparency register. The reports should have already been filed electronically.[1] The transparency register will be open to inspection from December 27, 2017.

With amendments to the German Anti-Money Laundering Act ("*Geldwäschegesetz*," hereinafter referred to as "GwG") the German Parliament has implemented the Fourth E.U. Anti-Money Laundering Directive, which directs all Member States to establish a national transparency register.[2] The purpose of this directive and the associated registers is to identify the beneficial owners of legal entities in order to prevent money laundering, in general, and terrorist financing, in particular.

FULFILLMENT OF REPORTING OBLIGATIONS

Legal representatives of legal entities and partnerships, trustees, and custodians are required to report beneficial owners or ownership to the transparency register.[3] The same applies for incorporated foundations, including charitable and private benefit foundations, each represented by their boards. Accordingly, practically all legal entities and partnerships, except for partnerships under the German Civil Code, are affected. However, the registration obligation does not apply to stock corporations that are listed on an organized (not an open) market.

Subsequent changes in ownership must be addressed and reported as well. The reporting party is required to review the completeness and correctness of all reported information at least once per year, and beneficial owners are required to provide reporting legal entities and partnerships with any relevant information.[4]

THE BENEFICIAL OWNER

For the purposes of the transparency register, beneficial owners are always and

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1 Via this website.

2 Directive (E.U.) 2015/849 of the European Parliament and of the Council of May 20, 2015 on the prevention of the use of of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (E.U.) No. 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/E.C. of the European Parliament and of the Council and Commission Directive 2006/70/E.C.

3 Sec. 20 Para. 1 and Sec. 21 Para. 1 and 2 GwG.

4 Sec. 20 Para. 3 GwG.

exclusively individuals. In the case of a corporate entity, each individual who ultimately owns or controls more than 25% of the shares or votes, or exercises similar control, is considered a beneficial owner.[5] If a corporate entity has no beneficial owner that meets the aforementioned criteria, the legal representative, managing director, or partner will be recorded in the transparency register as the beneficial owner.

In the case of a fiduciary entity or trust, a beneficial owner is each individual that acts as a custodian of a fiduciary entity, or is appointed as a trustee or protector of a foreign trust. The same applies to beneficiaries of trusts and individuals who can control distributions of profits or exercise control over investment or administrative decisions. Trustees of dependent foundations must fulfill these reporting requirements only insofar as they administer private benefit foundations.

Concerning incorporated foundations, individual members of the foundation's board are always beneficial owners. There are no constraints with regard to possible control and influence of a single board member. Therefore, all board members must be reported. Settlors of foundations, however, should not automatically be treated as beneficial owners. In contrast to prior drafts, the final GwG amendments do not include settlors as beneficial owners.

Any beneficiary or group of beneficiaries of the foundation and any individual who can control distributions of profits or exercise control over investment or administrative decisions qualifies as a beneficial owner. At least in the case of charitable foundations or family foundations, it is in question which persons belong to the circle of (potential) beneficiaries and for whom reporting obligations have to be met.

INFORMATION SUBJECT TO NOTIFICATION

The following information needs to be reported for every beneficial owner:

- First name and surname
- Date of birth
- Place of residence
- Nature and extent of the economic interest (including the percentage of shares and voting rights)

German-resident trustees must also report the citizenship of the beneficial owners of the trusts they manage.

EXEMPTION FROM REPORTING

The reporting duties are deemed to be fulfilled if the respective information has already been published in the German commercial register or certain other public sources (*e.g.*, association register, register of cooperatives, etc.).

Hence, corporations with individuals as sole shareholders are not required to register due to the compulsory filing of the shareholder list with the commercial register.

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5 Sec. 19 para. 2 GwG read in conjunction with Sec. 3 Para. 2 GwG.

In contrast, in the case of foundations, the German state registers of foundations are not considered to be sufficient, as they do not contain the complete information required.

INSPECTION OF ENTRIES

Relevant authorities are allowed to inspect the entries. The transparency register is open to public access only if a legitimate interest can be demonstrated. If the beneficial owner wishes to limit access to personal information, he or she must file a request showing that the interests worthy of protection prevail over the interests of access to the register. This requirement might be satisfied, for example, if the beneficial owners are minors.

CONCLUSION

If they have not done so already, legal representatives and beneficial owners should carefully assess their reporting duties as soon as possible, taking into consideration the specific circumstances of each case. If the required information has already been reported, it should be monitored for any changes, which then must be reported. Non-compliance with the reporting duties is a misdemeanor and administrative fines of up to €1,000,000 may be imposed.

THE SHARING ECONOMY PART 2: GOVERNMENTS STRIKE BACK

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THE TROUBLE WITH THE SHARING ECONOMY

The current international tax system was established at a time when the sharing economy did not exist and was not foreseeable. As business models evolve, governments are struggling to keep up using laws designed for brick-and-mortar stores. Ultimately, tax laws must be updated to account for the new economic realities.

Sharing economy companies, like Uber and Airbnb, use the internet to connect suppliers with consumers. The combination of new technology and careful cross-border structuring allows these companies to enhance the old brokerage business model to generate substantial profits while paying very little tax.[1]

With sharing economy structures cutting deep holes in a source jurisdictions' tax revenues, how do local governments try to obtain their fair share?

HOW ARE FOREIGN GOVERNMENTS STRIKING BACK?

Governments around the world are taking various approaches – to more or less success – to tackle the challenges of the digital economy, in general, and the sharing economy, in particular. These approaches fall into one of three categories:

- **The Income Tax Approach:**

  This approach involves (i) imposing a penalty tax in case of diversion of profits, (ii) introducing withholding tax on digital services, and (iii) redefining the concept of Service permanent establishment ("P.E.") (so as to create a taxable presence without a physical presence).

- **The Indirect Tax Approach:**

  Here, business models are qualified based on the ultimate services provided (*e.g.*, transportation or hospitality services, as opposed to internet (platform) services), thereby creating liability to V.A.T. and sales tax.

- **Regulatory Crackdown:**

  Under this approach, governments use regulatory rules to crackdown on new business models that are outside the scope of taxation.

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1 For more on the sharing economy and the business models used by Uber and Airbnb see "The Sharing Economy Part 1: New Business Models + Traditional Tax Rules Don't Mix," *Insights* 10 (2017).

The Income Tax Approach

Thus far, the income tax approach has successfully generated revenues from online businesses. However, it has not been particularly effective in tackling issues related to the sharing economy.

The U.K. Diverted Profits Tax

The diverted profits tax ("D.P.T.") was implemented in the U.K. in 2015 in an effort to crack down on multinational companies engaged in tax avoidance by shifting profits generated in th U.K. Originally, the main target was Google, hence its nickname, the "Google Tax."

For most taxpayers subject to D.P.T., a punitive 25% tax is imposed on diverted profits (compared to the standard 20% corporate tax rate for 2016), plus interest.[2] The D.P.T. regime is focused on two key scenarios where a diversion of profits may arise: (i) lack of economic substance and (ii) avoidance of a U.K. P.E.[3] A broader aspect of D.P.T. is that it targets profit stripping by U.K. companies that have previously been more profitable and, perhaps, owned I.P. before being integrated into a carefully planned supply chain.

The amount of tax collected under the regime and due to related changes in behavior has been impressive.[4] Yet, some initial targets may ultimately "escape" the Google Tax, as companies that could be subject to D.P.T. can often amend transfer pricing arrangements to ensure profits are not diverted. This result is not entirely unintended, as one of the key aims of D.P.T. is to influence taxpayer behavior.

Somewhat ironically, Google has itself avoided being "caught" by the Google Tax. In January 2016, Google settled a long-running transfer pricing enquiry with the U.K. tax authority to the tune of £130 million. In a statement, Google declared that it would apply revised transfer prices from 2015 onwards.

Sharing economy giant Uber also seems to have escaped these rules. In 2015, Uber's U.K. tax liability was reported to amount to only £411,000 while the revenues of the same year that ended up in the Netherlands reportedly reached $520 million, yet no D.P.T. was due.[5] Since then, Uber has not made headlines in connection with D.P.T., but its U.K. activity has been targeted on other fronts, in particular, as it

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[2] Guidance introduced on November 30, 2015, emphasized the government's position that D.P.T. is consistent with the goals of the O.E.C.D.'s B.E.P.S. Project, a position that U.S. Treasury officials have questioned.

[3] D.P.T. was initially targeted at I.P. structures. However, it was found to have a much broader impact on entities operating internationally, particularly multinational groups where the profitable company haves limited functions, such as computing and other support functions (*e.g.*, finance, legal, etc.).

[4] In September, the U.K. tax authority released key D.P.T. statistics. From its introduction in April 2015 to April 2017, the government collected £138 million in D.P.T. and an estimated £174 million in additional corporation tax as a result of related behavioral changes. The latter is a low estimate, only accurately reflecting situations already under inquiry. In total, the U.K. tax authority raised £281 million from D.P.T. and resulting behavioural changes for the year ending March 31, 2017, according to its 2016-17 annual report.

[5] See "Uber's Main UK Business Paid Only £411,000 in Tax Last Year," *The Guarduian*, October 10, 2016.

relates to V.A.T. and employment law, as described below.

The Australian Diverted Profits Tax

Not long after D.P.T. came into being in the U.K., Australia introduced its own version of the regime. On March 27, 2017, the Australian Parliament enacted a D.P.T. labeled as the most expansive cross-border tax change in more than a decade.

"The Australian D.P.T. has a retrospective element and can apply to arrangements entered into before July 1, 2017."

The Australian D.P.T. is even more punitive than its U.K. equivalent: a 40% penalty tax (compared to the Australian corporate income tax rate of 30%), plus interest, on profits diverted offshore through related-party arrangements. This regime applies to tax years starting on or after July 1, 2017, irrespective of whether the particular arrangements were entered into before that time.

The broad impact of this D.P.T. relates to the fact that any Australian cross-border arrangement, including financing transactions (which are excluded from the U.K. regime), is affected provided that two criteria are met: (i) At least one foreign associate taxpayer is involved, and (ii) total group-wide global income (broadly, revenue) is at least A$1 billion (approximately $750 million). The only exemptions apply to certain investment vehicles.[6]

The D.P.T. regime is incorporated into Australia's existing anti-avoidance rules. These rules require an objective conclusion that there was a tax purpose associated with the arrangements under examination. The D.P.T. regime adopts a "principal purpose" test, clearly an intentionally lower hurdle compared to the "sole or dominant purpose" test within the "original" Australian general anti-avoidance provision. Significantly, principal purpose is determined not just on the basis of a principal purpose to obtain an Australian tax benefit but also to obtain both an Australian tax benefit and reduce foreign tax liabilities.

Because the Australian D.P.T. has a retrospective element and can apply to arrangements entered into before July 1, 2017, it will impact existing positions that may have even been considered and accepted by the Australian Taxation Office ("A.T.O.") (*e.g.*, through a tax ruling, Advanced Pricing Agreement, or tax audit).

Another consequence is that recourse to double tax relief under Australia's tax treaties or arbitration mechanisms anticipated by the O.E.C.D.'s multilateral instrument are not available to challenge assessment of the tax. The only avenue for objections (beyond the A.T.O.) is the Australian Federal Court.

A D.P.T. assessment can be issued at any time within seven years of the original income tax return assessment. The harshness of the rule is aggrevated by the fact that taxpayers are required to pay a D.P.T. assessment in full before the assessment can be contested or a settlement reached with the A.T.O. Similar to the U.K. model, the Australian D.P.T. is designed to deter taxpayers from shifting profits. When faced with the threat of D.P.T. and its upfront tax collection process, it is assumed that taxpayers will more readily provide to the A.T.O. with information regarding earnings and taxation across global value chains.

Overall, the Australian D.P.T. is extremely broad and has the potential to affect a

[6] *I.e.*, managed investment trusts, certain foreign collective investment vehicles, entities owned by foreign governments, complying superannuation entities, and foreign pension funds.

significant number of multinational groups. The Australian government estimates 1,600 entities must asses their D.P.T. exposure and 130 taxpayers are high risk.

Withholding Tax on Online Services

In accordance with the O.E.C.D.'s B.E.P.S. recommendations on taxing the digital economy, the Indian government introduced an equalization levy on Indian-source online advertising revenue earned by nonresident companies. The provisions are effective as of June 1, 2016, and provide that Indian residents and nonresidents with a P.E. in India must withhold a 6% tax on amounts paid to nonresidents who do not have a P.E. in India, for specified services. The specified services include online advertising, any provision for digital advertising space, or any other facility or service for the purpose of online advertising.

While targeting the digital ecomony, this approach does not capture business models that operate via local subsidiaries, as in the cases of Uber and Airbnb. This approach also raises the question of whether a withholding tax on services can be justified if, at the same time, the sale of goods is typically not subject to a similar tax.

Service P.E. Without a Physical Presence

In a recent case involving a U.A.E. L.L.C., the Bengaluru bench of the Indian Income Tax Appellate Tribunal (the "Tribunal") reached an interesting conclusion: Physical presence in the source state is not necessary to constitute a Service P.E. in India.[7] Moreover, the services can be rendered through virtual presence. Noting the 183-day threshold under the India-U.A.E. tax treaty, the Tribunal held that services rendered for more than 183 days in a 12-month period can constitute a Service P.E. in India, even if the company does not have physical presence there.

Although the existence of a Service P.E. without the physical presence of employees in the source country is an enormous deviation from generally accepted international tax standards, it is not totally unheard of. The U.N. Committee has acknowledged this minority view, and in 2016, it was formally adopted in Saudi Arabia. The question remains, how can multinational businesses operating via local subsidiaries be captured under these rules? At this time, they are definitely outside the scope of virtual P.E. rules and able to play their "tax games."

The Indirect Tax Approach

The common element found in jurisdictions using the indirect tax approach is the attempt to tax sharing economy businesses (*i.e.*, brokerage businesses) based on the character of the ultimate service provided.

Governments have had greater success using this approach to tackle the sharing economy, as can be seen in the cases of Uber and Airbnb – whose activites are being reclassified as transportation and hospitaltity services, respectively:

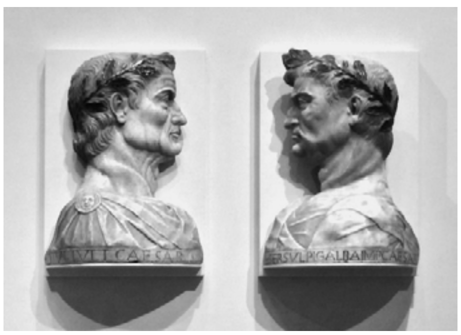
- Taiwan deemed Uber a transportation company and asserted in 2016 that Uber (together with other e-commerce businesses) was subject to a 5% sales tax. As a result, Uber briefly suspended operations there from February to

[7] See in detail "The Changing Face of Service Permanent Establishments," *Insights* 10 (2017).

April 2017,[8] and re-entry into the Taiwanese market came at a cost: Uber was allowed to hire only licensed commercial drivers.

Uber subsequently announced that it is an internet-based technology company that will partner with licensed transport companies. In response, Taiwan's highway bureau announced that it welcomed the move but would continue to supervise Uber's operations in Taiwan to ensure it did not pair up with unlicensed individual drivers.

Allegedly, Uber's fines were an estimated T$328.59 million (approximated $10.57 million) of which only T$68.25 had been paid, according to a February 2017 statement by the Ministry of Transportation and Communications.[9] A later quote from the National Taxation Bureau of Taipei alleged that Uber had not paid over T$51.24 million ($1.66 million) in business taxes dating back to 2015.[10]



- In the U.K., a V.A.T. case is currently pending against Uber to challenge its position that it is not subject to V.A.T. because it merely serves as a agent for self-employed drivers rather than a service provider. Uber allegedly collects an estimated £1 billion a year in U.K. fares, meaning if the company loses, it could be liable for £40 million a year (or more) in V.A.T.[11]
- In Berlin and Barcelona, a crackdown on Airbnb resulted in concessions in its business models. Confronted with a parallel market for online private bookings of €6.1 million and 30.2 million overnight stays in 2015, Berlin introduced a law that would limit the renting of private residences to rooms (as opposed to entire apartments or houses).[12] Offenders may face up to €100,000 of fines. In 2016, Barcelona fined Airbnb €600,000 for continuing to advertise unlicensed flats on its platform. Efforts to scrutinize illegal rentals were increased, and next year, the team of inspectors will be more than doubled from 40 to 100 persons.[13]
- In France, as another example, landlords renting furnished apartments, other than their principal residence, through Airbnb and other online platforms must now register with their municipality before offering lodging.[14] This resulted, *inter alia*, in the collection of tourist taxes in Paris, and in 2016, AirBnB paid back €7.3 million ($8.3 million) in tourist taxes in 2016 to French authorities.

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8 "Uber Will Suspend Service in Taiwan After Being Slapped With Over $10 Million in Fines," *Forune*, February 2, 2017; "Uber Resumes Ride-Hailing Service in Taiwan After Talks with Authorities," *Reuters*, April 13, 2017.

9 *Id.*

10 "Taiwanese Govt Raids Uber Office Over Unpaid Business Taxes," *e27*, March 17, 2017.

11 "Uber's £40m Tax Loophole: Taxi Firm Registers Each of Its Drivers as a Separate Business to Avoid Paying V.A.T. on Booking," *Daily Mail*, June 7, 2017.

12 Zweckentfremdungsgesetz; see "Berlin's Government Legislates Against Airbnb," *The Guardian*, May 1, 2016.

13 See *e.g.*, "Barcelona Cracks Down on Airbnb Rentals with Illegal Apartment Squads," *The Guardian*, June 2, 2017.

14 Article L324-1-1 of the French Tourism Code. See the registration mechanism in Paris.

Regulatory Crackdown

The third sword being swung by foreign governments seems to be the most efficient in the battle against sharing economy companies that lie outside the tax rules. Regulatory has been effective both on its own and when combined with the (indirect) tax measures discussed above.

Numerous regulatory actions have been taken against Uber:

- Germany, for example, referred a case against Uber to the European Court of Justice.[15] In its brief, Germany argued that Uber was not just an intermediary but was also involved in financial management and marketing for its luxury car-hailing business, which would constitute an infringement of competition laws.

- In another case brought before the European Court of Justice by the Barcelona taxi association,[16] Advocat General Szpunar concluded that the ride-hailing app is providing transportation services and not merely connecting drivers to passengers via technology. Therefore, Uber cannot claim the freedoms provided under E.U. law for digital services. Instead, its operations fall within the scope of transportation, which is governed by national laws.

- Shortly after his opinion in the Barcelona case, Advocat General Szpunar had to opine on a case brought before the European Court of Justice dealing with criminal law proceedings against Uber France. Uber France was allegedly organizing, by means of the UberPop service, a system for putting customers in touch with non-professional drivers who transport passengers for consideration using vehicles with fewer than ten seats. The advocat general took the view that because UberPop is not an information service but rather a transportation service, irrespective of whether that service falls within the scope of the directive, Member States may prohibit and punish the illegal exercise of such transport activity without having to notify the Commission of the draft law in advance.[17]

- While not binding, it is to be noted that in most cases the judges of the European Court of Justice followed the advocat general's opinion. Only in rare cases was a deviating conclusion reached. Final decisions in these cases are expected later this year.

- Another argument made by Uber – that its drivers are self-employed – has been rejected by a U.K. employment tribunal.[18] The tribunal ruled that the drivers were "workers" and therefore entitled to sick pay and paid holiday. It stated that "the notion that Uber in London is a mosaic of 30,000 small businesses linked by a common 'platform' is to our minds faintly ridiculous."[19]

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15 German Federal Court (Bundesgerichtshof), I ZR 3/16 (May 18, 2017).

16 *Asociación Profesional Elite Taxi v. Uber Systems Spain SL.*, C-434/15 (May 11, 2017).

17 *Uber SAS*, C-320/16 (July 4, 2017).

18 *Aslam, Farrar et. al. v. Uber B.V., Uber London Ltd and Uber Britannia Ltd.*, Cases 2202250/2015 and Others, October 28, 2016, as of May 2017 under appeal.

19 *Financial Times*, "Uber Faces New Pressure from Crowdfunded V.A.T. Case," June 28, 2017. According to the *Daily Mail*, Uber accounts for 40,000 drivers (supra note 11).

B.E.P.S. Action 1 addresses the tax challenges of the digital economy, including the need to monitor sharing economy developments.[20] Action 1 points out the impact of the sharing economy on traditional e-commerce applications as follows:

> Most individuals who participate in the sharing economy do not do so mainly to make a living, but to entertain relationships with others, to serve a cause that inspires them, or simply to make ends meet. Because the supplementary income is a net benefit and often does not involve much quantitative cost-benefit analysis, amateur providers have a tendency to share their available resources at a lower price than what a professional might have billed, thus bringing down overall prices, including those of the professionals. Through time, as certain platforms attract substantial number of individuals, these platforms become the prime access point for customers on the online market and have the potential to provide substantial competition for traditional e-commerce applications operated by professionals, which may cut their profit margins further.[21]

While Action 1 does not recommend singling out the digital economy, it identifies the following co-ordinated strategies associated with B.E.P.S. in the context of direct taxation:

- Minimisation of taxation in the market country by avoiding a taxable presence, or in the case of a taxable presence, either by shifting gross profits via trading strucures or by reducing net profit by maximizing deductions at the level of the payer.
- Low or no withholding tax at source.
- Low or no taxation at the level of the recipient (which can be achieved via low-tax jurisidctions, preferential regimes, or hybrid mismatch arrangements) with entitlement to substantial non-routine profits often built-up via intra-group arrangements.
- No current taxation of the low-tax profits at the level of the ultimate parent.[22]

In order to address the above risks, Action 1 aims at fighting "stateless income" by restoring taxation on such income.[23] It does so through several measures designed to address B.E.P.S. issues at various levels:

- Measures to prevent treaty abuse and artificial avoidance of permanent establishment status in the market jurisdiction
- Measure to address B.E.P.S. issues in the ultimate parent jurisdiction

[20] Action 1, Chapter 10, *Summary of the Conclusions and Next Steps*, p. 143.

[21] Action 1, Chapter 3, *Information and Communication Technology and its Impact on the Economy*, Chapter 3.2.5., p. 45.

[22] Action 1, Chapter 5, *Identifying Opportunities for BEPS in the Digital Economy*, Section 5.2, p. 78.

[23] Action 1, Chapter 6, *Tackling BEPS in the Digital Economy*, Section 6.2.

- Measures to neutralize the effects of hybrid mismatch arrangements, limit base erosion via interest deductions and other financial payments, counter harmful tax practices more effectively, assure that transfer pricing oucomes are in line with value creation in both the market and ultimate parent jurisdictions

Other measures, such as the mandatory disclosure of aggressive tax planning arrangements, standardized transfer pricing documentation requirements, and country-by-country reporting, are thought to enhance risk assessment processes at the level of the competent tax administrations.

In terms of direct taxation, the main policy challenges the digital economy raises can be divided as follows:[24]

- Nexus
- Data
- Characterization

A European Parliament study on the digital economy points out additional challenges that the sharing economy poses: Lack of compliance with (i) tax filing and reporting obligations, (ii) business license registration obligations, or (iii) insurance obligations.[25] Citing Airbnb and Uber as models, it states that:

- Airbnb uses jurisdictions like Ireland and Jersey to avoid paying taxes in the U.S. or elsewhere. It does so by assigning its software I.P. to a subsidiary in Jersey and shifts profits to Jersey via royalty payments from the Irish entity.
- Uber manages its operations from the Netherlands. This results in a taxable base of less than 2% in the U.S. Uber shifts its profits to Bermuda through I.P. assignments in "tax havens."

In an effort to address the tax challenges of the digital economy under a unified approach, both the O.E.C.D. and the European Commission have requested public comments on key issues.[26] Time is especially of the essence given that several countries have acted independently to counter the loss of tax revenues.

The suggested unified approach, also referred to as a "digital tax," raises tensions across the Atlantic and between European Member States.[27] While the European Commission, France, and Germany are pushing for a digital tax, countries such as Ireland and the U.S. see this project as highly damaging.

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[24] Action 1, Chapter 7, *Broader Direct Tax Challenges Raised by the Digital Economy and the Options to Address Them*, Section 7.2.

[25] European Parliament, Directorate General for Internal Policies, Policy Department A, "Economic and Scientific Policy, Tax Challenges in the Digital Economy," June 2016, p. 36.

[26] European Commission, "Commission Gathers Views on How to Tax the Digital Economy Fairly and Effectively," press release, October 26, 2017; "BEPS Public Consultation on the Tax Challenges of Digitalization," O.E.C.D., November 1, 2017.

[27] "European Digital Tax as Big a Threat as Brexit, Ministers Fear," *Irish Times*, October 28, 2017; "EU Tax Crackdown on Tech Giants Will Damage Growth, US Body Warns," *The Guardian*, September 26, 2017.

In the case of Ireland, a digital tax would inevitably affect its attractiveness for corporate headquarters. While in the U.S., a digital tax is viewed as a tax on tech giants like Amazon, Google, and Facebook. As a result, these companies could withdraw from the European market, resulting in economic losses for European countries and increased tensions between the E.U. and the U.S.

U.S. APPROACH

Broadly, the U.S. tax base is impacted by the sharing economy at both the Federal level, where the I.R.S. mostly faces income tax issues, and at the state level, where consumption and property tax issues also come into play.[28]

In the U.S., consumption taxes are generally regulated and levied at the state level. Consumption taxes include sales, lodging, gross receipts, and similar taxes. Hotels and taxi companies (Airbnb and Uber's competitors in the traditional marketplace) are generally subject to some or all of these taxes. Not subjecting sharing economy companies to the same taxes as their competitors is distortive and in breach with the neutrality principle.

States are working to rectify this issue through legislative reform. Rhode Island, for instance, enacted a law explicitally stating that "an entity . . . that uses a digital network to connect transportation network company riders to transportation network operators who provide prearranged rides" must register for and collect sales tax.[29] Most states have adopted sales tax legislation that specifically taxes or exempts services. New York, for instance, expressly exempts transportation network company riders from sales tax as of June 29, 2017.[30] In contrast, states such as Nevada and Pennsylvania have enacted laws that specifically tax transportation network companies.[31]

Yet, fundamental changes may be on the horizon. A pending case could reform state sales tax legislation, bringing it in line with the approach to P.E.'s in a treaty context: using nexus to establish taxation in the absence of physical presence. South Dakota's attorney general filed the first state petition asking the U.S. Supreme Court to reconsider a 25-year-old opinion that restricts states' ability to tax remote retailers, *i.e.*, retailers without a physical presence in the state.[32] While the outcome in the South Dakota case is still unclear, similar lawsuits are also pending in state courts in Alabama, Indiana, Tennessee, and Wyoming. A groundbreaking change may be imminent.

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28 Zach Schiller and Carl Davis, "Taxes and the On-Demand Economy," Institute on Taxation and Economic Policy, March 15, 2017.

29 R.I. Gen. Laws §44-18-7.3, as amended by 2016 H.B.7454, effective July 1, 2016, see here.

30 N.Y. Tax Law §1101(b)(34), as amended by 2017 N.Y. A.B. 3009/2017 N.Y. S.B. 2009, Part AAA, §17, effective July 9, 2017; N.Y. Tax Law §1105(c)(10); New York TSB-M-17(1)M, (1)S.

31 §372B.140 of Chapter 372B of Title 32 of the Nevada Statutes and Regulations; Pennsylvania Senate Bill. No. 984. See here.

32 *South Dakota v. Wayfair, Inc.*, U.S., petition for certiorari filed 10/2/17. South Dakota is appealing a September 13 state Supreme Court affirmation of a lower Sixth Judicial Circuit Court ruling, which found the state's "economic nexus" law, S.B. 106 (codified as S.D. Codified Laws Chapter 10-64) unconstitutional under *Quill Corp. v. North Dakota*. That ruling prohibits states from imposing sales and use tax collection obligations on vendors without a physical presence in-state.

For income tax purposes, companies acting in the sharing economy have been involved in high-level tax planning that results in little-to-no tax.[33] In the U.S., as in other countries, this issue centers around the question of whether sharing economy companies simply provide the service of connecting customers with suppliers willing to provide services or if they actually employ those suppliers.

For the suppliers of serivices, such as Uber's drivers or Airbnb's hosts, the income tax consequences often remain unclear. If suppliers are independent contractors, suppliers must pay their own social security and Medicare taxes through the self-employment tax regime and make quarterly income tax payments to avoid late payment penalties and interest. They may also be entitled to certain expense deductions. If the suppliers are employees, withholding obligations would fall on their employers, Uber and Airbnb.

There have been attempts to address this issue through regulatory crackdown. In a U.S. district courst case, Uber was singled out on the question of whether it provides transportation services or merely connects drivers to passengers through its service. The judge took the position that Uber misclassified its drivers as independent contractors, saying:

> Uber is no more a technology company than Yellow Cab is a technology company because it uses CB radios to dispatch taxi cabs, John Deere is a technology company because it uses computers and robots to manufacture lawn mowers, or Domino Sugar is a technology company because it uses modern irrigation techniques to grow its sugar cane. Indeed, very few (if any) firms are not technology companies if one focuses solely on how they create or distribute their products. If, however, the focus is on the substance of what the firm actually does (*e.g.*, sells cab rides, lawn mowers, or sugar), it is clear that Uber is most certainly a transportation company, albeit a technologically sophisticated one.[34]

Although the I.R.S. is working to address sharing economy taxation on its website,[35] more specific legislation and taxpayer guidance is necessary. One solution may be to establish an intermediate system between independent contractors and employees. This could allow and Uber driver's Form 1099-MISC, *Miscellaneous Income*, to reflect only net income received, while Uber would be subject to withholding obligations for income, social security, Medicare, and similar tax purposes.

STATE OF THE FIGHT

While governments around the world agree that sharing economy companies cannot be allowed to continue taking advantage of the current tax system, a unified approach still seems beyond reach.

Attempts to tackle these challenges with new local income and indirect tax rules

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33 See discussion in "The Sharing Economy Part 1: New Business Models + Traditional Tax Rules Don't Mix."

34 *O'Connor v. Uber Technologies*, 82 F.Supp.3d 1133 (March 11, 2015).

35 IRS.gov, "Sharing Economy Tax Center," last reviewed or updated November 2, 2017.

have only proven to be successful to a varying degree. An interim report on the issue is expected during the spring 2018 meetings of the International Monetary Fund and the World Bank Group.

In the U.S., explicit legislation exists at the state level, but Congress is still mute. The I.R.S. has acknowledged compliance issues at the individual level through its online resource, but further guidance is required.

At this stage, combatting companies like Uber and Airbnb on regulatory grounds (ranging from competition to employment to criminal law) seems to be the most efficient approach. With decisions by the European Court of Justice pending, Uber may soon be facing its Waterloo. If these predictions hold true, tax authorities may be relieved from immediate action – at least for a while.

"Combatting companies like Uber and Airbnb on regulatory grounds (ranging from competition to employment to criminal law) seems to be the most efficient approach."

O.E.C.D. RELEASES MUTUAL AGREEMENT PROCEDURE PEER REVIEW REPORT FOR THE U.S.

Authors
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Tags
Action 14
Dispute Resolution Mechanism
Mutual Agreement Procedure
U.S. Peer Review Report

The B.E.P.S. Report on Action 14, *Making Dispute Resolution Mechanisms More Effective* ("Action 14 Report"), released in 2015, acknowledged that the actions to counter B.E.P.S. must be complemented with effective dispute resolution mechanisms. Keeping this objective in mind, the Action 14 Report discussed the obstacles that prevented countries from resolving treaty-related disputes under the mutual agreement procedure ("M.A.P.") and recommended measures to overcome such obstacles.

The Action 14 Report introduced a minimum standard on dispute resolution that must be observed by participating countries to ensure that they resolve treaty-related disputes in a timely, effective, and efficient manner. The countries agreed to develop a monitoring mechanism to ensure the effective implementation of the minimum standard. They also agreed to have their compliance with the minimum standard reviewed by their peers.[1]

The peers agreed to review the following elements of a country's M.A.P. regime against the minimum standards to determine how its dispute resolution mechanisms operate:

- Preventing disputes
- Availability and access to M.A.P.
- Resolution of M.A.P. cases
- Implementation of M.A.P. agreements

On September 26, 2017, the O.E.C.D. released the Peer Review Report (Stage 1) relating to the implementation of the minimum standard on improving tax dispute resolution mechanisms by Belgium, Canada, the Netherlands, Switzerland, the United Kingdom, and the U.S.

This Article discusses the Peer Review Report (Stage 1) on the United States, including the areas of improvement and the recommendation by the O.E.C.D.

The U.S. peer review process was conducted through specific questionnaires completed by the U.S., 20 peers, and taxpayers. The U.S. was responsive in the course of the drafting of the Peer Review Report by responding timely and comprehensively to requests for additional information and providing further clarity when necessary.

The U.S. Peer Review Report was also divided into the four key areas mentioned above, which were further divided into subelements, and the same have been discussed below.

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1 Members of the M.A.P. Forum of the Forum on Tax Administration.

PREVENTING DISPUTES

Resolution by Mutual Agreement of Difficulties or Doubts as to the Interpretation or Application of Tax Treaties

The competent authority of a jurisdiction must be authorized to resolve, if possible, difficulties of interpretation or application of the tax treaty by means of mutual agreement. This practice may help to avoid submission of M.A.P. requests and/or prevent future disputes from arising. Thus, the O.E.C.D. recommended the U.S. include the first sentence of Article 25(3) of the O.E.C.D. Model Tax Convention ("M.T.C.") in all its tax treaties. The first sentence of Article 25(3) provides the following:

> The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention

The Peer Review Report stated that out of the U.S.'s 60 tax treaties, all except for treaty with U.S.S.R. and Pakistan contain a provision equivalent to the first sentence of Article 25(3) of the O.E.C.D- M.T.C.

Rollback of Bilateral A.P.A.'s in Appropriate Cases

The transfer pricing methodology determined under an advance pricing agreement ("A.P.A.") may be relevant in determining the treatment of a comparable controlled transaction in previous tax years. Therefore, the Peer Review Report suggested allowing the rollback of A.P.A.'s to previous tax years. This would mean that a negotiated position on the pricing of an international transaction reached under an A.P.A. could be applied on a retroactive basis to prior years.

The O.E.C.D. acknowledged that rollbacks are generally available in the U.S. for A.P.A.'s and recommended that the U.S. continue to provide for the rollback of bilateral A.P.A.'s in appropriate cases as it has done thus far.

AVAILABILITY AND ACCESS TO M.A.P.

Access to M.A.P. in Country of Residence Irrespective of Remedies Provided under Domestic Laws

In the Action 14 Report, the O.E.C.D. suggested the inclusion in tax treaties of the language from Article 25(1) of the O.E.C.D. M.T.C. that places emphasis on the importance of the taxpayer's ability to make a request for M.A.P. in its country of residence irrespective of the remedies provided under the domestic law of the treaty partners. Additionally, tax treaties should contain a provision allowing a taxpayer to submit a M.A.P. request within a period of 3 years, beginning on the date of the first notification of the action resulting in taxation not in accordance with the provisions of the tax treaty.

The Peer Review Report noted that three of the U.S. tax treaties do not contain a provision that is equivalent to Article 25(1). It was accordingly recommended that the U.S request the inclusion of the required provision via bilateral negotiations. Further, while 36 of the U.S. tax treaties do not contain any filing period for a M.A.P. request, 20 contain a provision allowing taxpayers to submit a M.A.P. request within a period of three years. The remaining four treaties identified the time limit for filing a M.A.P. request as four or five years.

Submission of M.A.P. Requests to Competent Authority of Either Treaty Partner

Another element of the minimum standard is that a taxpayer must be allowed to submit a M.A.P. request to the competent authority of either treaty partner. In the absence of such provision, a taxpayer may submit a M.A.P. request to the competent authority of the contracting state where it is a resident, or of which they are a national if their cases come under the non-discrimination article.

In such cases, it was suggested that where the competent authority does not consider the taxpayer's objection to be justified, it should implement a bilateral consultation or notification process which allows the other competent authority to provide its views on the case.

The Peer Review, however, was silent as to whether a taxpayer can make a M.A.P. request to the competent authority of the other contracting state when the competent authority of the first one has already rejected the request.

It was noted that the U.S. has in place a process to notify and consult the other competent authority in cases where its competent authority considers the objection raised in a M.A.P. request to be unjustified.

Access to M.A.P. in Transfer Pricing Cases

The Action 14 Report discussed expanding the scope of the matters to which M.A.P. may be applied. It suggested that M.A.P. may also be applied to the issue of what constitutes arm's length conditions for transactions between associated enterprises.

The U.S. reported that it has in the past provided access to M.A.P. for transfer pricing cases, and proposes to continue doing the same in future.

Access to M.A.P. in the Application of Anti-Abuse Provisions

In the Action 14 Report, the O.E.C.D. recommended that a taxpayer should be allowed to make a request for M.A.P. if they believe that the tax authority has interpreted or applied the tax treaty anti-abuse provisions incorrectly. Additionally, taxpayers should have access to M.A.P. in cases where the application of domestic anti-abuse legislations is in conflict with the provisions of the tax treaty.

Although the U.S. reported that there is no limitation of access to M.A.P. in cases where the application of anti-abuse provisions in tax treaties is challenged by taxpayers, the Peer Review Report observed that the U.S. M.A.P. guidance does not include information on whether taxpayers have access to M.A.P. in cases in which there is a disagreement between the taxpayer and the tax authorities as to whether the conditions for the application of a treaty anti-abuse provision have been met, or as to whether the application of a domestic law anti-abuse provision is in conflict with the provisions of a tax treaty.

Access to M.A.P in Cases of Audit Settlements

The O.E.C.D. holds that taxpayers should have the right to seek M.A.P. even after they have reached an audit settlement with the jurisdictional tax authority. However, if the taxpayer has reached a resolution via an administrative or a statutory dispute settlement/resolution process that functions independently from the audit and examination function and which is only accessible by taxpayer request, access to M.A.P. may be limited. At the same time, for the benefit of the taxpayers, the jurisdiction's M.A.P. guidance must amply clarify that audit settlements do not preclude access to M.A.P.

The Peer Review Report observed that the U.S. M.A.P. guidance clearly provides that the U.S. competent authority will not reject a M.A.P. request solely on the ground that the taxpayer entered into a settlement agreement with the I.R.S. However, where a taxpayer enters into a closing agreement through the I.R.S. examination function, the U.S. will only endeavor to obtain a correlative adjustment at the level of the treaty partner. In other words, the administrative dispute settlement/resolution process and M.A.P. are mutually exclusive.

The U.S. also indicated that a taxpayer does retain its right to present its case to the administrative appeals office if the taxpayer first submits a M.A.P. request to the competent authority and the issue is not resolved through the M.A.P.

Peers indicated that they did not come across a case where the U.S. denied a taxpayer access to M.A.P. after an audit settlement.

Publish Clear and Comprehensive M.A.P. Guidance and Provide Access to M.A.P if Adequate and Proper Information is Submitted

The countries should publish clear rules, guidelines, and procedures on access to and use of the M.A.P. and include the specific information and documentation that should be submitted in a taxpayer's request for M.A.P. assistance. At the same time, the countries should also publish their M.A.P. guidance on a shared public platform to promote public awareness, transparency, and dissemination of the M.A.P. program. Further, taxpayers should not be denied access to M.A.P. when they have complied with the information and documentation requirements as provided in such guidance.

The U.S. reported that rules, guidelines, and procedures relating to the M.A.P. function are included in Rev. Proc. 2015-40, and the same is easily found on the government website of the I.R.S. The Peer Review Report provided that the Rev. Proc. contains detailed information on the availability and the use of M.A.P. and how its competent authority conducts the process in practice. The U.S. stated and the peers and the taxpayers also agreed that the U.S. has not denied access to M.A.P. where the taxpayers submitted information in conformity to the Rev. Proc.

The Peer Review Report, however, recommended that the U.S. consider including information on whether M.A.P. is available in cases of multilateral disputes, and also on how the process of M.A.P. agreements is implemented, *i.e.*, the steps to be taken, the timing of these steps including actions to be taken by taxpayers, and the timeframe for giving consent to the M.A.P. agreement reached.

Consultation of Competent Authorities for the Elimination of Double Taxation in Cases Not Covered in the Treaty

Owing to the dynamic nature of international tax laws, the O.E.C.D. conceded that it is impossible to conceive and incorporate all possible tax scenarios in a tax treaty. Therefore, it suggested that countries should include in their tax treaties a provision which authorizes the competent authorities to consult together with respect to cases not provided for in their tax treaties.

Fourteen of the U.S. tax treaties do not include such a provision. However, the U.S. indicated that it intends to implement a provision to this effect in all such treaties.

RESOLUTION OF M.A.P. CASES

Resolution by Mutual Agreement of Cases Where a Competent Authority is Unable to Arrive at a Satisfactory Solution to a Justified Taxpayer Objection

In addition to allowing taxpayers to make a M.A.P. request, tax treaties must also include the first sentence of Article 25(2) of the O.E.C.D. M.T.C., which provides that if a competent authority is unable to arrive at a satisfactory solution to a taxpayer's objection that appears to be justified, then it shall endeavor to mutually resolve the case with the other competent authority.

Out of the U.S.'s 60 tax treaties, 14 treaties do not contain a provision equivalent to Article 25(2) of the O.E.C.D. M.T.C. The U.S. has indicated that it intends to implement the language of Article 25(2) in all its existing tax treaties.

Resolve M.A.P. Cases Within an Average of 24 Months, and Ensure Dedication of Adequate Resources

The Peer Review Report expressed concern about the tax uncertainties involved during the pendency of the M.A.P., and therefore recommended that M.A.P. cases be resolved swiftly.

"The staff in charge of M.A.P. processes should have the authority to resolve M.A.P. cases without being dependent."

It suggested that a period of 24 months is an appropriate time period to resolve M.A.P. cases on average. It also suggested that adequate resources, including personnel, funding, and training, be provided to ensure the proper functioning of the competent authority and the resolution of M.A.P. cases within the timeframe.

The U.S. reported that on an average it needed 32.20 months to resolve attribution/allocation cases and 31.50 months to resolve other cases. This resulted in an average time needed of 32.06 months to finalize all cases. It indicated that although a lack of resources might partly explain the greater than 24-month average, the lengthy resolution of cases is also commonly attributable to other reasons, such as delays in correspondence (*e.g.* sending and receiving position papers), communication difficulties, fundamental differences between treaty partners on points of law or their application to facts, or difficulties in reaching a principled resolution with certain treaty partners.

A peer reported that the communication process in the U.S. is slowed down due to its confidentiality requirements, which mandate that taxpayer data can only be exchanged by mail or fax. Therefore, one suggestion was to allow documents including confidential information to be sent via encrypted e-mail. Another suggestion for reaching resolutions more quickly was to use video conferencing to discuss cases.

M.A.P. Personnel to Have Authority to Resolve Cases in Accordance with the Applicable Tax Treaty

In order to ensure unprejudiced M.A.P. proceedings, the staff in charge of M.A.P.

processes should have the authority to resolve M.A.P. cases without being dependent on the approval or the direction of the tax administration personnel who made the adjustments at issue.

The U.S. reported that although the staff in charge of M.A.P. proceedings communicates with the I.R.S. examination department to secure the necessary extensions of the U.S. domestic statute of limitations for the period a M.A.P. case is pending and to verify or gather the necessary facts for the case under review, the independence of the U.S. competent authority in the M.A.P. cases is ensured.

Performance of M.A.P. Personnel Must Not be Evaluated on the Amounts of Sustained Audit Adjustments

The U.S. stated that its domestic legislation prohibits using quantitative criteria for evaluating the performance of staff in charge of M.A.P., such as number of cases closed or amount of tax assessed, or production quotas or goals. The U.S. reported that it evaluates the performance of the staff in charge of M.A.P. through using qualitative criteria, such as workplace interaction and environment, workgroup involvement, issue identification and resolution, technical knowledge, verbal communication/listening, written communication and interaction, accuracy of the work, and research and analysis.

Transparency With Respect to Position on M.A.P. Arbitration

Jurisdictions must be transparent about their position as to whether arbitration is available as a final stage in the M.A.P. process in their jurisdiction.

The U.S. reported that its domestic law does not have any limitations on including M.A.P. arbitration in its tax treaties. The U.S. M.T.C. includes a mandatory and binding arbitration procedure as a final stage in the M.A.P. process, which provides for last-best-offer arbitration (also known as "baseball arbitration'). It was noted that the U.S. has incorporated an arbitration provision as a final stage to the M.A.P. process in 12 tax treaties, however some are not yet effective as the arbitration provision has not been ratified.

IMPLEMENTATION OF M.A.P. AGREEMENTS

All M.A.P. Agreements Implemented on a Timely Basis

In order to provide certainty to the taxpayers and maintain trust in the M.A.P., all M.A.P. agreements should not only be implemented but they must also be implemented on a timely basis. The O.E.C.D. is of the view that the delay of implementation of M.A.P. agreements may lead to adverse financial consequences for both taxpayers and competent authorities.

The U.S. reported that procedures are in place to ensure that all M.A.P. agreements, once accepted by taxpayers, are implemented. Once an agreement has been accepted, the competent authority instructs the I.R.S. to implement such agreement by means of a letter and a disposition memorandum to the appropriate I.R.S. office. The U.S., however, does not have a mechanism to keep track of whether all M.A.P. agreements reached are actually implemented. Additionally, U.S. domestic legislation has no timeframe in place for the implementation of mutual agreements reached.

Mutual Agreement Implemented Notwithstanding Any Time Limits in Domestic Law

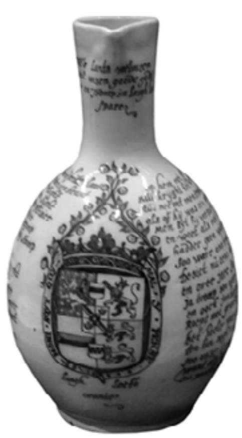
In order to provide certainty to taxpayers, it is essential that the implementation of M.A.P. agreements is not obstructed by any time limits in the domestic law of the jurisdictions concerned. Therefore, the tax treaties should either provide language equivalent to the second line of Article 25(2) of the O.E.C.D. M.T.C., *i.e.*, "any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the contracting states," or alternatively, set a time limit for making adjustments, as in Article 9(1) and Article 7(2), so that late adjustments do not obstruct the granting of M.A.P. relief.

The Peer Review Report indicated that 19 out of 60 U.S. tax treaties contain neither a provision that is equivalent to the second sentence of Article 25(2) of the O.E.C.D. M.T.C. nor the alternative provisions in Article 9(1) and Article 7(2). It was therefore recommended that in such cases, the U.S. should request the inclusion of the required provision or be willing to accept the inclusion of both alternative provisions.

CONCLUSION

The process of peer review was divided into two stages. In the U.S. context, Stage 1 reviewed the implementation of the minimum standard and the Peer Review Report acknowledged that the U.S. has met the Action 14 minimum standard concerning the prevention of disputes. However, in order to be fully compliant with all four key areas of an effective dispute resolution mechanism, the U.S. should amend and update some of its tax treaties.

Among its peers, the U.S. shares the distinction of having received a report card showing many A's and B's. Criticisms of the dispute resolution functions of other tax authorities followed the same broad themes as the U.S. peer review. The need to update treaty provisions to meet the minimum standard, improvements to varying degrees in published M.A.P. guidance, and a decrease in the time needed to resolve M.A.P. cases were also named as areas for improvement for the U.K., Switzerland, the Netherlands, and Canada. The U.S. treaty amendments require relatively more effort from Advance Pricing and Mutual Agreement Program ("A.P.M.A."), given the U.S. has not signed the Multilateral Instrument that would make these treaty amendments *en masse*. A bilateral approach is being followed by A.P.M.A. to achieve similar goals.



Stage 2, which will be due within one year of the adoption of the Stage 1 Peer Review, will review the measures taken by the U.S. to address the shortcomings identified in Stage 1.

ANTI-INVERSION RULES ARE NOT JUST FOR MEGA-MERGERS – PRIVATE CLIENT ADVISORS TAKE NOTE

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Tags
Corporate Tax
Cross-Border Tax Planning
Expatriation
Inversions
Private Client
Tax Planning

INTRODUCTION

Transactions known as corporate "inversions" or "expatriations" have made headlines for years. Recently, the proposed merger of the U.S. pharmaceutical giant Pfizer, Inc. with the Irish-based pharmaceutical company Allergan Plc was in the news. The coverage addressed the implications of creating the world's largest pharmaceutical company, the loss of yet another American corporate behemoth to a lower-tax jurisdiction, and later, the plan's cancellation, arguably as a result of the U.S. government's regulatory action.

As laws limiting tax-free inversions have developed, tax attorneys specializing in corporate mergers and acquisitions have been required to keep up with regulatory developments and consider new planning techniques – but they are not the only ones with such obligations. Tax attorneys advising individuals and families who own closely-held businesses, investment structures, and even personal use property, with cross-border aspects, must also keep the inversion rules on the forefront of tax planning. In the private client setting, inversions are sometimes overlooked, perhaps because the issue is so closely associated with large "M&A" deals.

The following article examines how the inversion rules can affect cross-border tax planning for individuals. It begins with a brief discussion on the development of the inversion rules over time and some of the planning techniques that have been used to address the legislative and regulatory changes.

U.S. CORPORATE INCOME TAX SYSTEM

To understand the impetus for inversions, it is important to have a basic understanding of the U.S. corporate income tax system.

Corporations that are formed under U.S. domestic law are U.S. persons. Like all U.S. persons, U.S. corporations are subject to U.S. income tax on their worldwide income. Accordingly, when a U.S. corporation earns income from sources outside the U.S., that income is subject to U.S. income tax, though not necessarily on a current basis. A U.S. corporation can defer income tax on active income (*i.e.*, income earned by operating a trade or business) earned outside the U.S. through foreign subsidiaries until it is paid or repatriated to the U.S. parent corporation. If a foreign subsidiary earns certain foreign-source income from passive-type investments (*e.g.*, interest, dividends, rents, royalties), its U.S. parent corporation may be required to pay tax on that income – referred to as Subpart F income – in the tax year it is earned, regardless of whether the foreign subsidiary makes a dividend distribution to the U.S. parent corporation.

For financial statement purposes, the profit and loss statement generally does not follow the Subpart F rules. Whether U.S. tax is deferred or imposed currently on the tax return of a U.S.-based multinational, U.S. tax expense must be recorded when and as income of foreign subsidiaries is reported on the U.S.-based group's consolidated financial statements prepared in accordance with U.S. G.A.A.P. The principal exception to this accounting treatment exists when the earnings of foreign subsidiaries are permanently invested abroad.

For a U.S.-based multinational, the true benefit of an inversion is the release of earnings that were permanently invested abroad for financial statement purposes. Those earnings can then be distributed to the new parent company, used internally within the group, or distributed to shareholders without affecting the reported earnings of the company.

WHAT IS A CORPORATE INVERSION?

In simplest terms, a corporate inversion is a process by which an existing U.S. corporation changes its legal domicile to a lower-tax jurisdiction. The inversion transaction involves a reorganization of a corporate structure that results in a foreign parent corporation at the top of the corporate structure, where there was previously a U.S. corporation. The original U.S. parent corporation becomes a subsidiary of a new or existing foreign corporation; at which point, the corporate structure is said to be "inverted."

"The true benefit of an inversion is the release of earnings that were permanently invested abroad for financial statement purposes."

The foreign parent corporation used in the inversion will be resident in a low-tax jurisdiction,[1] where foreign-source income is not subject to local tax or where dividends from foreign subsidiaries are not subject to income tax at the level of the new foreign parent and dividends from the parent are not subject to dividend withholding tax. The key is that dividends from low-taxed foreign subsidiaries do not trigger tax upon receipt and that the foregoing tax benefit is not reduced by withholding tax on dividends to shareholders. Because the foreign subsidiary operates in a low-tax environment, a tax system that does not provide an exemption, but instead allows an indirect credit for foreign taxes imposed on the subsidiary, is not attractive.

Corporate inversions have been achieved using one of three of the following plans:

- A merger with a larger foreign corporation, resulting in a new company controlled outside the U.S.
- A merger with a smaller foreign corporation, resulting in a new company controlled by the shareholders of the original U.S. corporation
- The formation of a foreign subsidiary in a jurisdiction in which the U.S. corporation has substantial business activities, followed by a "B reorganization" (*i.e.*, a stock-for-stock exchange creating a new structure in which the foreign corporation is the parent and the U.S. corporation is its subsidiary), and resulting in no change in effective control

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1 In the more aggressive corporate inversions of the past, the foreign parent corporation typically was formed in a jurisdiction that did not impose any corporate income tax. However, the important keys for choosing a jurisdiction are benign controlled foreign corporation rules, a participation exemption for the receipt of intercompany dividends and the realization of gains from the disposition of shares in a subsidiary, and the absence of withholding tax on dividend payments.

Prior to the enactment of the anti-inversion rules, a U.S. corporation generally was able to eliminate or reduce its U.S. income tax obligation as a result of inversion in the following ways:

- Moving its foreign business operations to foreign subsidiaries owned by the foreign parent corporation, thereby removing its foreign-source business income from its tax base
- Allowing the accumulated or future income in its foreign subsidiaries to be accessed by group members in the U.S. through loans that do not trigger tax under Subpart F
- Making accumulated or future income available as a funding source for dividends to shareholders
- Engaging in "earnings stripping" through intercompany debt, royalty payments, management fees, and other arrangements (*e.g.*, the foreign parent corporation may lend to its U.S. subsidiary – this creates an interest expense deduction for the U.S. subsidiary, which lowers its U.S. taxable income)

As discussed below, Congressional action has created substantial barriers for inversion transactions, and regulatory action has closed loopholes and curbed some tax benefits.

LEGISLATIVE AND REGULATORY RESPONSE TO CORPORATE INVERSIONS

Code §367(a)

The earliest legislative response to corporate inversions was the enactment of Code §367(a), which generally applies to U.S. persons (including individuals and corporations) that transfer appreciated property to a foreign corporation. Transactions targeted by Code §367(a) involve outbound transfers of appreciated property through a nonrecognition transaction, such as a capital contribution to a controlled corporation or tax-free outbound reorganization. Under Code §367(a), the appreciation in property is recognized and generally taxed by the U.S. at the time of transfer to a person that is beyond the scope of U.S. tax jurisdiction. Appreciated property subject to Code §367(a) includes stock in another corporation.

Code §367(a) targets such transactions by effectively denying tax-free treatment to what is otherwise a nonrecognition transaction. It does this by treating the transfer as if the consideration received is other than shares of stock. This treatment eliminates deferral opportunities since most deferral transactions involve a transfer of property – including shares of stock in a corporation – for shares of stock in an acquiring corporation.

Code §7874

Despite these efforts, Code §367(a) did not prove to be a sufficient deterrent to corporate inversions. Some U.S. corporations calculated that the upfront tax cost of Code §367(a) was worth the benefit of removing or deferring income from the reach of relatively high U.S. Federal corporate income tax (currently, the rates are 34% and 35%). In some cases, there may have been no upfront tax cost because the

U.S. corporation's stock did not appreciate during the holding period or because the shareholder group was comprised to a large extent by entities that are tax exempt in the U.S. (*e.g.*, pension funds, not-for-profit organizations, and foreign investors).

Code §7874 was enacted in 2004 to remedy the absence of an effective disincentive to inversions. For its part, the Treasury Department subsequently issued regulations to close certain loopholes found by tax planners under Code §7874. The most comprehensive Treasury Regulations were issued in 2012 and 2016.

In broad terms, Code §7874 either causes the inversion transaction to be ignored – so that the inverted corporation continues to be treated as a U.S. corporation for U.S. tax purposes – or respects the inversion transaction but subjects the transaction to unfavorable tax treatment for ten years. As discussed in detail below, whether an inversion transaction is ignored or respected depends upon the level of ownership continuity.

Code §7874 applies to "expatriated entities" and their "surrogate foreign corporations." A surrogate foreign corporation is a foreign corporation that, pursuant to a plan or a series of related transactions, meets the following benchmarks:

- It directly or indirectly acquired substantially all of the properties constituting a trade or business of a domestic corporation or a domestic partnership.
- After such acquisition, at least 60% of its stock (by vote or value) is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation or, in the case of a partnership, by former partners of the domestic partnership by reason of holding a capital or profits interest in the domestic partnership.
- Neither it nor its expanded affiliated group (*i.e.*, the group that now includes the U.S. corporation) have substantial business activities in the foreign country in which the foreign corporation is created or organized, after the acquisition described in the first bullet, when compared to the total business activities of the expanded affiliated group.[2]

An expatriated entity is a domestic corporation or domestic partnership with respect to which a foreign corporation is a surrogate foreign corporation and includes any domestic corporation or domestic partnership related to the expatriated entity.[3]

The inversion is ignored, and the foreign corporation is treated as a domestic corporation for all purposes of the Code if, after the transaction, the former shareholders of the domestic corporation or, in the case of a partnership, the former partners of the domestic partnership own 80% or more of the surrogate foreign corporation, measured by vote or value, and the substantial business activities test is not met.[4]

If (i) ownership continuity is at least 60% but not as much as 80% and (ii) the substantial business activities test is not met, the expatriated entity will be subject to U.S. income tax on its "inversion gain" for a defined period.[5] Inversion gain means

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[2] Code §7874(a)(2)(B).

[3] Code §7874(a)(2)(A).

[4] Code §7874(b).

[5] Code §7874(a)(1).

income or gain recognized by reason of the transfer of stock or other properties in the inversion transaction.[6] It also includes certain income from the licensing of property by the expatriated entity during the defined period.[7] The defined period is lengthy: It starts on the first date that properties are acquired as part of the inversion transaction and ends ten years after the last date.[8]

A number of other unfavorable tax provisions apply to the inversion gain. For example, the use of credits to offset the tax on the inversion gain is limited; net operating losses generally may not be used to offset the amount of inversion gain that is taxed; and inversion gain is considered U.S.-source income for the purpose of computing the foreign tax credit.[9]

Code §7874(c)(4) is an anti-abuse rule that disregards transactions designed to manage the value of a corporation involved in a potential inversion. Thus, the transfer of properties to enhance the value of a foreign corporation or the undertaking of liabilities to reduce the value of the U.S. corporation will be ignored when the transaction is part of a plan designed principally to avoid Code §7874. This rule would apply, for example, to the transfer of assets to a foreign corporation before the inversion transaction so that the value of the foreign corporation is increased in order to prevent the value of the U.S. corporation from breaching the 60% threshold.

Regulatory Action

Since the enactment of Code §7874, several notices and regulations have been issued, primarily to narrow the opportunities in which a transaction avoids being characterized as an inversion transaction. The rules are extensive and complicated. The following is a brief discussion of several of the more important rules.

Temporary and proposed regulations[10] issued in 2012 and recently finalized[11] include a safe harbor for the substantial business activities test that is considerably more difficult to meet than a predecessor under prior regulations. Under the rule, an expanded affiliated group will be considered to have substantial business activities in a foreign country if at least 25% of the group's employees, assets, and income are located in or derived from that country.[12] This generally means that an employee or asset must be physically present in the country in order to be located there. Income will be considered as derived in a foreign country only if customers are located in the country. Under prior regulations, the safe harbor was set at 10%. The increased safe harbor makes it considerably more difficult for transactions that meet the 60%

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6 Code §7874(d)(2).

7 *Id.*

8 Code §7874(d)(1).

9 Code §§7874(e)(1) and (3).

10 Temporary regulations generally provide guidance until final regulations are adopted and have the same authority as final regulations but generally are valid for only three years from the date of issuance. In the rule making process, temporary regulations must be issued with proposed regulations. Proposed regulations are finalized once they undergo review by the public during the public comment period (a process that can take months or years). Until finalized, proposed regulations are not binding on the I.R.S. or taxpayers. See Code §7805.

11 See T.D. 9761 and T.D. 9812.

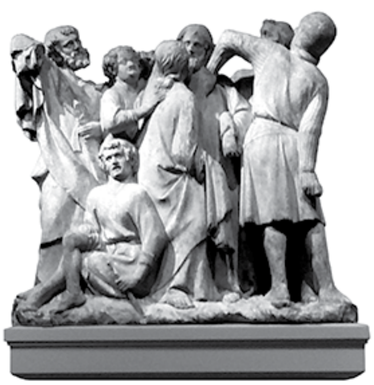
12 See Treas. Reg. §1.7874-3.

or 80% thresholds to avoid adverse tax consequences of Code §7874 by relying on the substantial business activities test.

Temporary and proposed regulations issued in 2016 would adopt several rules previously contained in I.R.S. notices,[13] including rules on multiple-step inversions. Generally, companies aim to keep inversions below the 60% ownership continuity threshold. That often requires multiple steps. In a typical multiple-step inversion, a foreign corporation acquires more than one U.S. corporation over a short period of time or through one or more corporate inversions that are not within the scope of Code §7874. Through these serial acquisitions or inversions, the value of the foreign corporation increases to the extent that it issues its stock in connection with each successive acquisition, allowing it to undertake another inversion transaction with a larger U.S. corporation while remaining below the 60% and 80% ownership continuity thresholds. In determining the ownership percentage by value, the regulations disregard the stock of the new foreign parent corporation to the extent the value of such stock is attributable to its prior U.S. corporate acquisitions during a specified three-year period.[14] To illustrate the effectiveness of this rule, the contemplated merger of Pfizer with Allergan met the 60% threshold.

CASE STUDY: INVERSION RULES IN THE PRIVATE CLIENT CONTEXT

When advising individuals, including individuals who are not U.S. citizens, U.S. residents, or U.S. domiciled persons ("non-U.S. persons") it is not uncommon to encounter a client who has purchased or acquired property in the U.S. without planning for the tax consequences of owning the property.



Consider the case of a family of non-U.S. persons who purchase U.S. residential real property for personal use and to generate rental income. The family holds the properties directly. They first consult with a U.S. tax advisor after they purchased the U.S. real property, when the properties have greatly appreciated in value. The U.S. tax advisor duly advises that directly holding U.S. real property exposes a non-U.S. person to U.S. estate tax because non-U.S. persons are subject to U.S. estate tax on U.S.-situs real property. Moreover, the U.S. tax advisor advises that the tax rate and exemption amount applicable to non-U.S. persons are highly unfavorable.[15]

The U.S. tax advisor then proposes that they hold the U.S. real property through a structure that is typically implemented for non-U.S. persons. Under the proposed plan, each property will be transferred to a newly formed U.S. corporation ("U.S. Co" or jointly "U.S. Co.'s") pursuant to a transfer in exchange for shares in the entities. This type of transaction typically is tax-free under Code §351. Two foreign corporations (each "F Holdco" or jointly "F Holdcos") will be formed in a low-tax jurisdiction. Each U.S. Co.'s shareholder will transfer all shares held to one of the F Holdcos in exchange for stock of such entity.

As a result of the restructuring, the family will indirectly own the U.S. real property through the F Holdcos, which own the U.S. Co.'s that hold the properties. Under this

13 See T.D. 9812.

14 See Treas. Reg. §1.7874-8T.

15 Non-U.S. persons have only a $60,000 exemption on the value of their U.S.-situs assets includable in their gross estate.

structure, the estate tax exposure is eliminated because the shares of the F Holdcos are not U.S.-situs property.

A closer consideration, however, suggests that the proposed plan may have negative U.S. tax consequences. First, under a tax regime introduced by the Foreign Investment in Real Property Act ("F.I.R.P.T.A."), the transfer of a U.S. real property interest ("U.S.R.P.I."), such as an ownership interest in U.S. residential real property, by a foreign person requires the foreign person to recognize income on the property's built-in gain. A U.S.R.P.I. includes an interest in a U.S. real property holding company ("U.S.R.P.H.C."), which is a U.S. corporation with 50% or more of the fair market value of its assets consisting of U.S.R.P.I.'s. However, under an exception to the general recognition rule, such a transfer generally would not trigger gain recognition, provided some additional requirements are met. The rationale for this exception is that the F Holdcos, as foreign persons, remain subject to the general gain recognition rule under F.I.R.P.T.A. when they transfer the U.S. Co.'s. or the underlying U.S.R.P.I.'s.

Thus, under the general gain recognition rule, the family's transfer of the shares of the U.S. Co.'s to the F Holdcos would result in the recognition of the built-in gain in the U.S. residential real property held by the U.S. Co.'s, but the tax can be deferred if the exception applies.

After considering the above issues, the U.S. tax advisor might decide that the U.S. analysis is complete since he or she knows that transfers to the U.S. Co.'s and F Holdcos will not trigger F.I.R.P.T.A. gain and the structure works to protect the clients from U.S. estate tax liability. However, on closer consideration, it appears that the proposed plan contains all of the elements of a corporate inversion under Code §7874, as follows:

- Each F Holdco is a surrogate foreign corporation because it acquired all of the properties constituting a trade or business of the U.S. Co.
- After the acquisition, 100% of the stock of each F Holdco is held by the former shareholders of the U.S. Co.'s.
- The expanded affiliated groups (*i.e.*, the groups that now include the F Holdcos and the U.S. Co.'s as subsidiaries) do not have substantial business activities in the foreign country in which the F Holdcos were organized since the F Holdcos are acting solely as holding companies.

Each U.S. Co. is an expatriated entity with respect to which each F Holdco is a surrogate foreign corporation. Since the inversions meet the 80% ownership continuity threshold, the inversions should not be respected under Code §7874, given a literal reading of the statute. As a result, the F Holdcos will be treated as U.S. corporations for all purposes of the Code. The clients will be subject to withholding tax on dividends from the F Holdcos and their interests in the F Holdcos may be required to be reported on Form 5472 and Form 1120. Moreover, the original objective of removing the properties from the reach of U.S. estate tax is thwarted since shares in a U.S. corporation, such as the shares of the F Holdcos under Code §7874, are U.S.-situs property.

Note that none of the facts surrounding the anti-inversion rules are present in this situation, yet it is still subject to their effects. There are no public companies, no permanently invested earnings in offshore subsidiaries, and no elimination of tax on income repatriated to the U.S. These are powerful policy reasons for arguing the anti-inversion rules should be applicable only when U.S.-based multinational groups are involved in the inversion transaction. If U.S. estate tax is repealed for non-U.S. persons owning shares of U.S. corporations, another policy reason is added to the mix.

Regrettably, private individuals do not make U.S. tax policy and U.S. tax advisors may wish to follow U.S. tax law literally. Consequently, how can the U.S. estate tax exposure be reduced?

"Anti-inversion rules should be applicable only when U.S.-based multinational groups are involved in the inversion transaction."

One possibility is to introduce into the structure a foreign partnership ("F.P.") or a foreign eligible entity that can make an election to be treated as a partnership under U.S. tax law. Under the revised plan, at least three members would own interests in the F.P., no family member would own a controlling interest, and neither the death of any individual member nor the bankruptcy of a corporate member would cause the F.P. to be terminated under local law. The clients would then contribute the shares of the F Holdcos to the F.P. in exchange for a capital or profits interest. Even if the F.P. were to be viewed as a domestic partnership for income tax purposes, it may nonetheless not be an item of U.S.-situs property for estate tax purposes.

Authority, in the form of a published I.R.S. ruling, addresses the situs of an interest in a U.S. domestic partnership that actively conducted business in the U.S.[16] The question was whether a partnership interest held by a foreign individual at the time of his death had U.S. or non-U.S. situs. If the situs of the partnership interest was in the U.S., the partnership interest was subject to U.S. estate tax. On the other hand, no U.S. estate tax would apply if the partnership interest had a non-U.S. situs. While the context of the ruling was an estate tax treaty of the U.S., the I.R.S. applied general principles not inconsistent with U.S. law.

The I.R.S. did not consider the place of formation of the partnership nor the residence of the decedent to be controlling. The ruling looked at three ways to resolve the issue:

- The decedent's interest constitutes a debt[17] and, consequently, under the terms of Article III(2)(c) of the treaty is situated at the place of his domicile.
- The situs of his interest is where the individual items of the partnership assets are located.
- The situs of a partner's interest is where the business is carried on.

The ruling concluded that an ownership interest in a partnership that does not terminate with the death of the partner is an asset that is separate and apart from the assets owned by the partnership. A partner cannot sell his or her undivided interest in the partnership assets to a third person and, therefore, cannot be held to own the assets legally owned by the partnership. This view applied in a state case involving a local estate tax. The court determined that a decedent's interest in a partnership was intangible property and not an interest in a portion of the underlying real property owned by the partnership. However, where a partnership actively carries on a

[16] Rev. Rul. 55-701, 1955-2 C.B. 836.

[17] The possibility that the partnership interest constituted debt is based on the principle that, on dissolution of a partnership, a partner is entitled to share in what would remain of the partnership assets net of liabilities.

business within a jurisdiction, the partnership interest held at death by the decedent is properly subject to estate tax in that jurisdiction.

This approach is not inconsistent with an earlier case[18] in which a Federal court of appeals held that the situs of an interest in a Cuban entity terminating on the decedent's death was controlled by the location of the underlying assets owned by the Cuban entity. In Rev. Rul 55-701, the entity continued in existence at the death of the partner. In the case involving the Cuban entity, the legal existence of the entity terminated under local law with the death of a partner. Consequently, the decedent's share of the assets in the partnership were, in effect, owed to the decedent, and therefore, the situs of those assets was viewed to be controlling.

Note that one tax reform proposal currently under consideration treats gain from sale of a partnership interest by a non-U.S. person as effectively connected gain to the extent that the assets of the partnership would result in effectively connected gain if the partnership were to affect the sale.[19] This is a manifestation of the aggregate theory of partnerships and, if adopted, would negate the effect of the plan.

CONCLUSION

Though much of the attention on corporate inversions is focused on large U.S. multinationals expatriating by becoming subsidiaries of large foreign multinationals, the above case study demonstrates that the two-tier corporate structure, often used in the structuring of U.S. investments of non-U.S. persons, can fall within the scope of Code §7874 if not properly implemented and have disastrous U.S. estate tax consequences.

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18 *Sanchez v. Bowers*, 70 F.2d 715 (2d Cir. 1934).

19 See Joint Committee on Taxation, *Description of the Chairman's Mark of the "Tax Cuts and Jobs Act"* (JCX-51-17), November 9, 2017, p. 145.

TEXAS DISTRICT COURT ON ANTI-INVERSION LEGISLATION – ONE DOWN BUT NOT OUT

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Tags
Administrative Procedure Act ("A.P.A.")
Anti-Injunction Act ("A.I.A.")
Interpretive
Inversions
Legislative
Notice Period
Tax Reform

INTRODUCTION

In October, the U.S. District Court for the Western District of Texas struck down a provision under temporary anti-inversion regulations for violating the required notice and comment period under the Administrative Procedure Act ("A.P.A.").[1] This article summarizes the court's reasoning and discusses the impact its decision may have on the future of anti-inversion regulations.

The background of the decision is notable: The disputed provision (the "Rule") was part of broader temporary and proposed anti-inversion regulations hurriedly issued by the U.S. Treasury Department in April 2016 (the "2016 Regulations"). The 2016 Regulations target tax benefits that might otherwise arise when a U.S. company re-incorporates outside the U.S. (a transaction commonly referred to as a corporate inversion)[2] – essentially replacing the U.S. entity with a foreign entity,[3] often by means of a merger with a non-U.S. company as the acquirer. Depending on the ownership percentages of its shareholders, the new foreign parent company may be treated as a U.S. company subject to U.S. Federal income tax.[4]

This statute, which was designed to put a halt to the loss of U.S. tax revenues, was promulgated without the usual period for notice and comments that precedes implementation. As such, the temporary regulations took immediate effect. The Treasury's rush to release the temporary regulations had a specific reason. A pre-existing loophole in determining the ownership percentage would have allowed pharmaceutical giants Pfizer Inc. and Irish Allergan PLC to escape anti-inversion rules in their proposed $160 billion pharmaceutical merger.[5] In issuing these regulations without the usual safeguards, the Treasury accomplished the goal: Pfizer and Allergan abandoned the merger intended to place the multinational outside the

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1 *Chamber of Commerce of the United States of America and Texas Association of Business v. I.R.S.*, 16-cv-00944-LY, September 29, 2017; amended order dated October 6, 2017.

2 Code §7874.

3 The rule applies to both corporations and partnerships.

4 If Code §7874 applies to a U.S. company, the foreign parent corporation is considered a domestic corporation after the transaction, for U.S. tax purposes (even though it is organized under the laws of a foreign country), if at least 80% of its stock is owned by former owners of the inverted domestic company (Code §7874(b)). If the ownership by former owners is less than 80% but is at least 60%, the U.S. company generally pays U.S. tax on gains realized in the inversion transaction and other special rules apply (Code 7874(a)).

5 See *The Street*, "Treasury Department Was 'Targeting' Pfizer-Allergan Deal," April 26, 2016.

ambit of U.S. taxation.[6]

The decision itself, even if limited to procedural aspects, is no less remarkable. In it, the court addressed, *inter alia*, the following issues:

1. Do the plaintiffs, the U.S. Chamber of Commerce (the "Chamber") and the Texas Association of Business, have standing to challenge the Rule under the 2016 Regulations?

2. Would the plaintiffs be barred by the Anti-Injunction Act ("A.I.A.") from challenging the Rule prior to assessment or collection of tax?

3. If the plaintiffs are not barred from such a challenge, what standards apply to the Treasury in issuing the Rule under the 2016 Regulations?

As will be explained, the court held in favor of the plaintiffs.

CHAMBER OF COMMERCE V. I.R.S.

In 2016, the I.R.S. issued the Rule (Treasury Regulation §1.7874-8T) regarding the consideration of pre-acquisition stock to acquisitions or post-inversion transactions effected on or after April 4, 2016,[7] effective immediately and a proposed regulation[8] subject to notice and comment.[9] The Rule identified stock of foreign acquiring corporations that is to be disregarded in determining ownership relevant to the categorization because the stock is attributable to prior domestic-entity acquisitions.[10] The Rule applies if, within the 36-month period ending on the signing date, with respect to the relevant domestic entity acquisition, the foreign acquiring corporation completed one or more other domestic entity acquisitions that are not excluded under an exception.

The Chamber and the Texas Association of Business subsequently brought a suit against the Treasury, on behalf of [insert names of companies when confirmed]. The suit alleged that

- the Treasury violated its regulatory authority;
- the Rule was arbitrary and capricious; and
- the Treasury violated the notice-and-comment requirement of the A.P.A. in promulgating the Rule.

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6 See *Financial Times*, "Collapse of $160bn Pfizer and Allergan merger shocks corporate US," April 6, 2016.

7 Treas. Reg. §1.7874-8T(j). The regulations were published in the Federal Register on April 8, 2016, including both final and Temporary Regulations under Code §§367 and 7874. TD 9761, 81 Fed. Reg. 20, 858 (2016).

8 Prop. Treas. Reg. §1.7874-8.

9 On the background of the regulations see Notice 2015-79 discussed in "Anti-Inversion Rules Explained," *Insights* 10 (2015).

10 Specifically, the Rule included a new provision that for purposes of calculating the ownership percentage under Code §7874(a)(2)(B)(ii) excludes from the denominator of the ownership fraction stock of the foreign acquiring corporation attributable to certain prior domestic entity acquisitions.

The Chamber moved for summary judgment on its claims, while the Treasury moved to dismiss the case on the grounds that

- the Chamber lacked standing to challenge the Rule; and
- the suit was barred by the A.I.A.

In addressing each of these claims raised, the District Court decided as follows:

Standing

Because the plaintiffs demonstrated an actual, concrete injury that was considered to be traceable to the implementation of the 2016 Regulations, the District Court concluded that the plaintiffs had standing to challenge the rule. The Chamber based its standing specifically on Pfizer and Allergan's membership in its organization and asserted that the Rule eliminated the tax benefits associated with a planned merger between the two companies. Citing relevant case law, the District Court agreed that these companies (and potentially other members of the Chamber) would have standing to sue in their own right. The Chamber also presented evidence that the Treasury specifically targeted the merger of these two companies in promulgating the Rule. For these reasons, the District Court determined that the requirements for standing and standing-by-association were satisfied.

A.I.A.

The Treasury argued that the Chamber's claims were barred by the A.I.A., which provides that:

> No suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed.[11]

In other words, the A.I.A. limits lawsuits challenging a tax before it is assessed or collected. In the case at issue, the court held that the plaintiffs' claims were not barred by the A.I.A. because the plaintiffs were not seeking to restrain assessment or collection of tax but rather to challenge the validity of the Rule that would affect a decision on whether to engage in certain future transactions. Moreover, the District Court reasoned that the Rule is not itself a tax rule but rather a rule determining who is subject to tax.

Treasury's Authority to Issue Regulations

The court held that Congress extended broad authority to the I.R.S. and the Treasury to promulgate regulations under Code §7874. Consequently, in issuing the 2016 Regulations, the agencies did not exceed their statutory jurisdiction. The District Court noted that the Rule calls for certain stock to be treated as "not stock" for purposes of certain calculations required under the statute — which corresponds to Code §7874(c)(6) stating regulations may "treat stock as not stock" to determine whether a corporation is a surrogate foreign corporation. Further, the Rule is in line with authority granted under Code §7874(g), *i.e.*, to prevent avoidance of the purposes of the statute.

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[11] 26. U.S.C. §7421(a).

Arbitrary or Capricious Rulemaking

According to the District Court the explanation and basis for the 2016 Regulations were thoroughly explained by the I.R.S. and the Treasury in the preamble to the regulations. Thus, the agencies were not deemed to engage in arbitrary and capricious rulemaking.

A.P.A.

Apart from the A.I.A. issue, perhaps the most significant District Court holding was that the I.R.S. and the Treasury violated the A.P.A.

First, the court ruled that the simultaneous issuance of corresponding proposed regulations did not release the issuing agency from the notice and comment requirement for temporary regulations provided under the A.P.A. It did not follow the Treasury's argument that Code §7805 would allow such exception from the general rules under the A.P.A. and noted that the legislative history did not support the Treasury's view.

Second, the District Court rejected the Treasury's view that the Rule was an "interpretive" regulation and therefore exempt from the notice and comment requirement under the A.P.A. Instead, the court held that the Rule was a "legislative" regulation, which has the "force and effect of law," and thus is subject to the A.P.A.'s notice and comment requirement. The court noted that the statute authorized Treasury to issue regulations modifying the application of the statute and to issue regulations "to treat stock as not stock," which changed the calculation for determining whether a corporation is treated as a surrogate foreign corporation. Thus, the District Court concluded the Rule was not an interpretation of the statute but a substantive modification.

WHAT NEXT?

It is unclear whether the Treasury will appeal this decision. No appeal has been filed as of November 10, 2017, but the window is still open.

Would the decision be upheld by an appellate court? This is also uncertain. The likelihood that the A.P.A. argument would withstand a challenge *per se* is not remote. The main question is whether the court will have to reach a conclusion on this issue because, before it can proceed, the court must decide whether the Chamber did in fact have standing and, if so, whether this bars a suit under the A.I.A.

A.P.A. Requirements – Interpretive v. Legislative Rules

The A.P.A. provides under §559 that a statute will not supersede or modify the notice and comment procedure except to the extent that it does so expressly. Under A.P.A. §553:

> (b) General notice of proposed rulemaking shall be published in the Federal Register, unless persons subject thereto are named and either personally served or otherwise have actual notice thereof in accordance with law. The notice shall include -
>
> (1) a statement of the time, place, and nature of public rule making proceedings;

> (2) reference to the legal authority under which the rule is proposed; and
>
> (3) either the terms or substance of the proposed rule or a description of the subjects and issues involved.
>
> Except when notice or hearing is required by statute, this subsection does not apply -
>
> (A) to interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice; or
>
> (B) when the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefore in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.

"Statutory requirements mandated in connection with the process of issuing rules must be upheld."

Hence, the A.P.A. provides for an exception from the comment and notice period only if the rule in issue is interpretive. An interpretive rule advises the public of the agency's construction of the statutes and rules which it administers.[12] Since the underlying statutes usually contain the necessary legal authority for the action taken, rules or statements explaining the construction of statutes are considered interpretive. Regulations that fill the gap between the rules Congress provided will often be considered interpretive. A rule that repeats law from the underlying legislative will also more often be considered as interpretive.[13] On the other hand, a legislative rule has the force and effect of law, is much more substantive and has a larger impact on individual rights and obligations. A legislative rule creates law whereas an interpretive rule explains what the statute or regulation means.[14] If an end result is provided without much explanation, the rule will often be considered legislative.

With respect to the comment and notice obligation under the A.P.A. the District Court's decision is in line with previous case law.[15] Courts have set definite boundaries to the Treasury's practice of issuing *ad hoc* regulations.

In this case, the message to Treasury was clear: Statutory requirements mandated in connection with the process of issuing rules must be upheld. This applies to promulgating tax regulations accordingly. Neither issuance of proposed regulations simultaneously with temporary regulations nor qualifying the latter as interpretive may be used as an excuse for infringing upon these procedural requirements. In this respect, it is likely that the decision would be upheld in an appeal.

Standing vs. A.I.A.

To reiterate, the issue of standing and limitations under the A.I.A. would be the preliminary question in an appeal.

In holding for an infringement of the two Chamber members' rights, the District Court asserted standing. If this is the case, the question becomes whether this infringement causes a potential increase in taxes by eliminating a tax benefit that would

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12 *Perez v. Mortg. Bankers Ass'n*, 135 S. Ct. 1199 (2015).

13 I.R.M. 32.1.1 "Overview of the Regulations Process," (2017).

14 *Phillips Petroleum Co. v. Johnson*, 22 F.3d 616 (1994).

15 *E.g.*, *Altera Corp v. Commr.*, 145 T.C. No. 3 (2015).

have been available prior to the issuance of the Rule. This would mean *Chamber of Commerce v. I.R.S.* constitutes a suit that attempts to bar future assessments. Hence, the A.I.A. would apply. While the District Court reasoned that the plaintiffs contest the validity of the Rule and their actions do not fall within the scope of the A.I.A., this view is contradictory to prior case law.

In *Florida Bankers Association v. U.S*.[16] an association of bankers contested a regulation mandating a reporting obligation for interest paid to certain foreign account holders.[17] While the regulation did not affect the banks' tax liabilities, it would result in potential penalties in the case of non-compliance.[18] Similar to the plaintiffs in the *Chamber of Commerce* case, the Florida Bankers Association argued that they were not restraining an assessment but rather contesting the regulatory aspects of the regulations. The D.C. Circuit rejected this argument. Notwithstanding the plaintiff's claim to target the regulatory aspect of the regulations, the D.C. Circuit found that the A.I.A. applied to the case at issue. Because invalidating the regulation would directly prevent collection of the tax, this would constitute a violation of the A.I.A. or as the court put it, it is at the heartland of the A.I.A.[19]

In comparison to *Florida Bankers*, the Chamber is in an even weaker position to avoid A.I.A. application. The Rule does not affect the potential tax liability of third parties but the Chamber's own members. This is why they have standing in the first place.

However, even if an appellate court turns down plaintiffs, they are not barred from challenging the regulation. It is only a matter of timing.[20] As the D.C. Circuit stated:

> To be clear, our ruling does not prevent a bank from obtaining judicial review of the challenged regulation. A bank may decline to submit a required report, pay the penalty, and then sue for a refund. At that time, a court may consider the legality of the regulation. The issue here is when – not if – the bank may challenge the regulation.[21]

CONCLUSION

Chamber of Commerce is a landmark decision. Whether it will be upheld upon review is not certain.

With respect to the underlying Rule it must be noted that this case only addressed one item of regulatory anti-inversion measures. Moreover, it does not touch upon the statutory anti-inversion rule under Code §7874. The future of the anti-inversion

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16 799 F.3d 1065 (D.C. Cir. 2015).

17 Treas. Reg. §§1.6049-4, 1.6049-8.

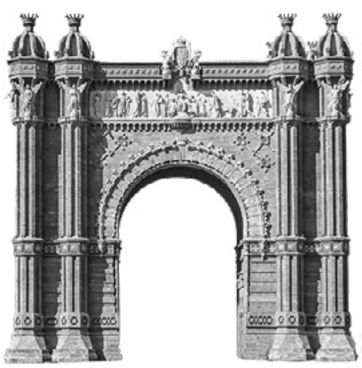
18 Code §6721.

19 799 F. 3d 1065, 1071. As a side note: On the argument raised by the plaintiffs that the penalty was not a tax, the D.C. Circuit construed tax for purposes of the A.I.A. in a broad sense. Hence, invalidating the regulation would directly bar collection of the tax.

20 Under a long-standing administrative law rule agency regulations may be challenged prior to enforcement, *e.g.*, penalties. However, this rule does not apply to the tax administration under the A.I.A.

21 *Id.*

regulations remains to be seen. Under President Trump's Executive Order 13789, the Treasury is committed to decrease the burden of tax regulations by withdrawing and/or modifying an initial eight rules including the anti-inversion regulations.[22] This reaffirms the effort to simplify tax rules and modify what is either vague or excessive while slowing down the I.R.S.'s ability to deal with tax abuse.



[22] Most recently, it was announced that the debt-equity documentation rules under Code §385, which were heavily criticized as overreaching, will be revoked. See in detail, "Treasury Turns Back the Clock on 2016 Regulation," *Insights* 10 (2017).

EMPLOYMENT TAX BASICS AND PATHS TO COMPLIANCE[1]

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Tags
Employment Tax
Form 941
Tax Compliance

When non-U.S. entities expand to the U.S., they face several issues, all of them new. These include the legal form under which business will be conducted in the U.S., certain elections for U.S. income tax purposes, filing obligations and disclosures of certain information relating to the non-U.S. owners, deciding whether to hire local employees or employees that have a background both in the U.S. and the country of the parent company, determining comparable U.S. wages to wages paid for the same job in the country of the parent, and many others. Last but not least, the newly created U.S. subsidiary must also comply with U.S. employment tax requirements relating to their employees.

If set up correctly, compliance is generally straightforward. Non-compliance often arises because certain payments made to employees are not identified as wages. Once non-compliance is identified, the matter becomes substantially more complicated and the burden on the U.S. subsidiary is considerable.

WITHOLDING OBLIGATION

The term "employment taxes" broadly refers to the income tax and social security taxes that must be withheld by employer's on an employee's wages.

Code §3402 requires employers to deduct and withhold income tax on the amount of wages that are paid to employees. Similar rules may exist at the state and local levels. For this purpose, the definition of wages is broad and the fact that an individual no longer is an employee at the time of payment is immaterial.[2]

"Wages" are generally defined as any remuneration for services performed by an employee for his or her employer, including the cash value of all remuneration (including benefits) paid in a medium other than cash.[3] This is where issues generally start for non-U.S.-owned subsidiaries. The name by which the remuneration is actually designated is immaterial. Wages include the following:[4]

- Salaries
- Fees
- Bonuses

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1 The author would like to acknowledge the contribution of Michael A. Zimmerman of Kane Kessler in the preparation of this article.

2 Treas. Reg. §31.3401(d)-1.

3 Code §3401(a).

4 Treas. Reg. §31.3401(a)-1(a)(5).

- Commissions on sales
- Commissions on insurance premiums
- Pensions
- Retired pay

An employer is liable for the payment of the tax whether or not it is collected from the employee by the employer.[5]

"An employer is liable for the payment of the tax whether or not it is collected from the employee by the employer."

In addition to income taxes, an employer must withhold employee Federal Insurance Contributions Act ("F.I.C.A.") taxes from an employee's wages.[6] The employer is liable for these taxes with respect to all wages paid to each employee whether or not it is collected from the employee.[7] The employer is also liable for employer F.I.C.A. taxes[8] and must withhold Federal unemployment tax ("F.U.T.A.").[9]

F.I.C.A. taxes are divided into old-age, survivor, and disability insurance ("O.A.S.D.I.") and hospital insurance ("H.I.") taxes.[10] The employee's part of F.I.C.A. taxes must be withheld by the employer at a combined 7.65% rate,[11] 6.2% for O.A.S.D.I. and 1.45% for H.I. An additional 0.9% tax must be withheld on wages in excess of $250,000 for joint filers (the "Additional Medicare Tax").[12] The maximum amount of wages subject to F.I.C.A. is $127,000 in 2017.[13]

F.U.T.A. is withheld at a 6% rate on the first $7,000. No limit on withholding exists for FU.T.A. purposes.[14]

Generally, employers must file Form 941, *Employer's Quarterly Federal Tax Return,* to report quarterly F.I.C.A. and income tax withholdings.[15] The filing deadline is the last day of the month following the end of each quarter. F.I.C.A. and income tax deposits must be made either monthly or semi-weekly.[16]

F.U.T.A. is reported annually on Form 940, *Employer's Annual Federal Unemployment Tax Return,*[17] which must generally be filed by January 31 of the following year.[18] F.U.T.A. taxes must generally be deposited with an authorized financial institution by the last day of the month following the end of any calendar quarter in which

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5 Treas. Reg. §31.3403-1.
6 Code §§3101 and 3102.
7 Treas. Reg. §31.3102-1(d).
8 Code §3111.
9 Code §3121(b); Treas. Reg. §31.3301-1.
10 Code §3101.
11 Code §§3101(a), 3111(a), and 3101(b)(1).
12 Code §3101(b)(2).
13 Code §3121(a)(1); S.S.A. Notice, 81 Fed. Reg. 74,854 (Oct. 27, 2016).
14 Code §3121(a)(1).
15 Treas. Reg. §§31-6011(a)-1(a)(1) and 31.6011(a)-4(a).
16 Treas. Reg. §31.6302-1.
17 Treas. Reg. §31.6011(a)-3(a).
18 Treas. Reg. §31.6071(a)-1(c).

the employer’s undeposited tax liability exceeds $500.[19]

Additionally, employers must file Forms W-2, *Wage and Tax Statement*, and W-3, *Transmittal of Wage and Tax Statements*, with the social security administration by January 31 following the calendar year of the withholdings and provide employees with copies B, C, and 2 of Form W-2 by the same date.[20]

FAILURE TO COMPLY

Interest

Underpayment interest is due for any tax imposed by the Code that is not paid on or before the payment due date for such tax.[21] As an exception, interest-free adjustments are available for F.I.C.A. and income tax underreporting and underpayments, unless, *inter alia*, the employer knowingly underreported such taxes.[22]

Interest-free adjustments are available for F.I.C.A. tax purposes (other than the Additional Medicare Tax) for the current year and previous years, by filing Form 941-X, *Adjusted Employer’s Quarterly Federal Tax Return or Claim for Refund*. The filing deadline is determined by the return period in which the error is ascertained (*i.e.*, when the employer has sufficient knowledge of the error to be able to correct it).

Interest-free adjustments are available for income tax and Additional Medicare Tax purposes only if (i) the adjusted return is filed by the Form 941 filing deadline for the return period in which the error is ascertained and (ii) the error is ascertained within the same calendar year that the wages are paid to the employee.[23] Corresponding payments must be made by the time the adjusted return is filed.[24] In addition, Forms W-2c, *Corrected Wage and Tax Statement*, and W-3c, *Transmittal of Corrected Wage and Tax Statements*, must be filed with the social security administration and a copy must be provided to the employee(s). For prior years, the Federal income tax withholding amount reported on Form W-2c and Form W-3c will not change, since the employer may not withhold income taxes from an employee after the calendar year in which the wages were paid.[25]

Penalties

In addition to interest payments, penalties can also be assessed. Their purpose is to enhance voluntary compliance,[26] which is achieved when a taxpayer (i) makes a good faith effort to meet the tax obligations defined by the Code[27] or (ii) conforms to

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19 Treas. Reg. §31.6302(c)-3(a).

20 Treas. Reg. §31.6051-1(d)(1).

21 Code §6601.

22 Code §6205; Revenue Ruling 2009-39; Treas. Reg. §31.6205-1(b)(2).

23 Treas. Reg. §§31.6205-1(b)(4) and 31.6205-1(c)(2).

24 Treas. Reg. §§31.6205-1(b)(2), 31.6205-1(b)(4), and 31.6205-1(c)(2).

25 Treas. Reg. §31.6051-1(c)(2).

26 Internal Revenue Manual (“I.R.M.”) 1.2.20.1.1 (06-29-2004); I.R.M. 20.1.1.2.1 (11-25-2011).

27 I.R.M. 20.1.1.2.1(6) (11-25-2011).

the law without compulsion or threat.[28]

Code §6651 provides a penalty for failure to pay tax, unless the taxpayer can show that the failure is due to reasonable cause and not due to willful neglect. For this purpose, "willful neglect" is defined as "a conscious, intentional failure or reckless indifference."[29]

Code §6656(a) provides a penalty for failure to deposit tax on the date prescribed, unless that failure is demonstratively due to reasonable cause, rather than willful neglect. Further, when adjusted returns are filed pursuant to Treas. Reg. §31.6205-1, the taxes will be deemed paid timely for purposes of Code §6656, if the payments are submitted at the same time as the adjusted filings.[30]

Code §6662 provides an accuracy-related penalty for underpayments of tax required to be shown on a return when the underpayment is due to (i) negligence or disregard of rules or regulations, (ii) a substantial understatement of income tax, (iii) a substantial valuation misstatement, (iv) a substantial overstatement of pension liabilities, or (v) a substantial estate or gift tax valuation understatement. For this purpose, "negligence" includes any failure to make a reasonable attempt to comply with the provisions of the Code. The term "disregard" includes any careless, reckless, or intentional disregard. No penalty is imposed with regard to any portion of an underpayment if it is shown that there was a reasonable cause and that the taxpayer acted in good faith with respect to such portion.[31] Reliance on the opinion of a professional tax advisor can constitute reasonable cause for this purpose, no matter the form of the particular advice.[32] All facts and circumstances must be taken into account and the tax advisor must be competent with respect to the specific tax matter.[33] Reasonable cause relief is generally granted when a taxpayer exercises ordinary care and prudence in determining its tax obligations but nevertheless is unable to comply with these obligations.[34]

"If the employee pays the under-withheld tax, it cannot be collected a second time from the employer."

COMING INTO COMPLIANCE

As previously stated, an employer is liable for the income tax payment, whether or not it is collected from the employee.[35] However, if the employee pays the under-withheld tax, it cannot be collected a second time from the employer.[36] Thus, an employer can eliminate its liability for failure to withhold income taxes in prior years if it can show that the relevant employee paid the related income taxes.[37] For this purpose, the employer must secure Form 4669, *Statement of Payments Received*,

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28 I.R.M. 20.1.1.2.1(1) (11-25-2011).

29 *U.S. v. Boyle*, 469 U.S. 241 (1985).

30 Treas. Reg. §31.6302-1(c)(7).

31 Code §6664(c)(1).

32 Treas. Reg. §§1.6664-4(c)(1) and 1.6664-4(c)(2).

33 Treas. Reg. §§1.6664-4(c)(1).

34 I.R.M. 20.1.1.3.2. (11-25-2011) – *Reasonable Cause*; Treas. Reg. §301.6651-1(c).

35 Treas. Reg. §31.3403-1.

36 Code §3402(d).

37 Code §3402(d); Treas. Reg. §31.3402(d)-1.

from the employee.

Equivalent forms can generally be obtained for state and local tax purposes by contacting the relevant authorities. At the New York level, for instance, the taxpayer can request Form AU-7 from the New York State Department of Taxation and Finance. This form essentially requests the same information as Form 4669.

A question often arises when (i) a former employee cannot be located or (ii) an employee, generally a former employee, does not want to cooperate. In such cases, the income tax liability could potentially be collected twice by the I.R.S.: once from the employee who paid income taxes on the compensation and once from the employer upon coming into compliance.

This exact issue was addressed by the U.S. Tax Court in *Mescalero Apache Tribe v. Commr.*[38] In this case, the I.R.S. reclassified independent contractors of the Mescalero Apache Tribe ("Taxpayer") as employees (the "reclassified contractors"), which resulted in an assessment of uncollected income tax withholdings. Taxpayer tried to secure Forms 4669 from the reclassified contractors but was unable to locate 70 of them. Taxpayer then made a motion to compel discovery, arguing that the I.R.S. had access to the information requested by Form 4669 since it had access to the reclassified contractors' past tax returns. Although returns and return information generally cannot be disclosed under Code §6103, Code §6103(h)(4)(C) provides that:

> A return or return information may be disclosed in a Federal or State judicial or administrative proceeding pertaining to tax administration, but only if such return or return information directly relates to a transactional relationship between a person who is a party to the proceeding and the taxpayer which directly affects the resolution of an issue in the proceeding.

The Tax Court held that the disclosure of third-party taxpayer information to absolve an employer of its income tax withholding obligation is not barred by Code §6103(h). This case is relevant for taxpayers in the judicial or administrative proceeding stage. However, taxpayers generally come into compliance well before this stage.

Even when providing Form 4669, the employer remains liable for any penalties or additions to tax that arise from the failure to withhold.[39]

Further, any underwithheld employment taxes paid at the time the employer comes into compliance on behalf of the employees constitute additional wages for the respective employees. These must be included in the wages of every employee in the year of compliance.[40]

In addition to any state and local amendments, the following Federal forms must be filed when coming into compliance:

- Form 941X, *Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund*, to be filed with the I.R.S.

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38 *Mescalero Apache Tribe v. Commr.*, 148 T.C. 11, April 5, 2017.

39 Code §3402(d).

40 Treas. Reg. §1.61-14(a).

- Amended Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*, to be filed with the I.R.S.

- Form W-2c, *Corrected Wage and Tax Statement*, to be filed with the Social Security administration

- Form W-3c, *Transmittal of Corrected Wage and Tax Statements*, to be filed with the Social Security administration

In order to track any mismatch between the payments made at the time of submission and the amounts requested on follow-up notices issued by the I.R.S., the taxpayer should request a transcript of the taxpayer's account. This can be obtained by calling the I.R.S. and requesting that the transcripts either be mailed or faxed. Notably, since processing takes about two months, the transcripts may not reflect the latest communications with or payments to the I.R.S.

CONCLUSION

Employment taxes include a range of income and social security taxes that must be withheld from an employee's paycheck, although the liablity for these taxes rests on the employer.

While coming into compliance always involves a substantial amount of paperwork and numerous communications, in most compliance cases, the only parties involved are the taxpayer and the I.R.S. Employment tax compliance involves an additional taxpayer: the employee. This adds complexity with an internal corporate management aspect. A voluntary disclosure program would be a welcome addition to the current regime, as it could alleviate the compliance process and costs.

ART AND THE ESTATE PART II – NONRESIDENTS

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Artwork
Estate Planning
New York

A prior article in this series discussed the way U.S. estate tax is imposed on the transfer of artwork at the time of death. For U.S. art collectors,[1] that tax liability can prove to be quite high, depending on the value of the asset and the overall estate. But what are the estate and gift tax liabilities for non-U.S. persons?

This article will address the tax consequences for nonresident, non-citizen individuals not domiciled in the U.S., as well as new developments affecting art collectors who buy or sell artwork from New York State.

U.S. ESTATE TAX

Application to Nonresidents

In the U.S., estate tax is imposed on the fair market value of a U.S. person's estate at the time of death. The Federal estate and gift tax regime is not limited to U.S. persons[2] but also applies to nonresident, non-citizen individuals who own U.S. situs assets. The regime applies to tangible property, including art, jewelry, gold coins, cash in a safe deposit box, and furniture. Therefore a nonresident alien owns artwork located in the U.S. at the time of death, his or her estate will face U.S. estate tax consequences.[3]

Exemptions

A nonresident decedent does not receive the relatively generous lifetime gift exclusion applicable to U.S. persons – $5.45 million exemption for 2017 and $5.60 million for 2018. Instead, foreign estates are entitled to a mere $60,000 exemption.[4] Generally, the effective tax rate is approximately 40%.[5]

The estate tax exemption may be increased through application of an estate tax treaty. A treaty between the U.S. and the nonresident, non-citizen individual's home country may provide for more generous rules, effectively overriding the U.S. situs rules.

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1 See "Art and the Estate: Why Planning is Important, Part I – U.S. Taxpayers," *Insights* 10 (2017).

2 Code §7701(a)(30).

3 Treas. Reg. §20.2104-1(a)(2).

4 Code §§2102(a),(b).

5 The tax is imposed at graduated rates amounting to $345,000 for the first $1.0 million in excess of the $60,000 exemption.

If at the time of death, a nonresident alien owns artwork located in the U.S., his or her estate will face U.S. estate tax.[6]

Owning artwork through an entity (such as a foreign corporation or irrevocable trust for the benefits of others) may also provide for estate tax protection. However, consideration should be given to state and local tax consequences. New York, for example, imposes an alternative tax on a corporation subject to tax on business capital allocated to New York. This could occur, for example, if a corporation owns both rental real property and art and furnishings associated with the rental real estate.

There is an exception for some artwork located in the U.S. at the time of death. Artwork owned by a nonresident is exempt from U.S. estate tax if it is

- imported into the U.S. solely for exhibition purposes,
- loaned for those purposes to a public gallery or museum, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and
- at the time of the death of the owner, on exhibition or enroute to or from an exhibition in such a public gallery or museum.[7]

The I.R.S. tends to view some of these conditions more strictly than others. For example, the I.R.S. did not require the work to be imported when it was purchased in the U.S. and immediately loaned for exhibition.[8] However, it is important that the art is loaned to a public gallery or museum that meets the description under the regulations. Otherwise, there is a substantial risk that the artwork will be included in the owner's gross estate.

STATE ESTATE TAX

In addition to Federal estate tax, most of states impose their own estate and gift taxes. States such as Alabama, California, Florida, Georgia, Louisiana, Michigan, New Hampshire, South Dakota, Texas, Virginia, and Wyoming are among the exceptions.

New York imposes an estate tax on residents, as well as on nonresidents. The top N.Y. estate tax rate is 16%. New York provides a basic exclusion amount ("B.E.A."), which is currently $5,250,000 but will increase to the level of the Federal estate tax exemption starting January 1, 2019. Unlike residents, nonresidents are only taxed on real or tangible property that is located in the New York. At first glance, the B.E.A. may seem generous, but it is not quite so. If the entire estate is more than 5% higher than the B.E.A., the B.E.A. is ignored and the entire estate will be taxed.

OTHER CONCERNS

Estate tax is not the only concern for nonresidents dealing with tangible property in New York. In addition to estate and gift tax concerns, nonresident art collectors may

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6 Treas. Reg. §20.2104-1(a)(2).

7 Code §2105(c); Treas. Reg. §§20.2105-1(b), 20.2104-1(a)(2).

8 PLR 199922038; PLR 9141014.

be affected by a recent change to the New York sales and use tax regime.

Generally, New York State imposes a 4% sales and use tax on the gross amount paid for tangible personal property. This is further increased by tax imposed at the local level. If the collector is located in New York City, for example, the overall sale or use tax is 8.875%.

In New York, sales tax is a destination-based tax that applies to artwork that is delivered to the state, while use tax applies to artwork purchased outside the state and brought into the state to be used there. New York gives full credit for sales tax paid in other states.

Both sales and use taxes apply to individuals that are N.Y. residents. In this context, N.Y. resident has a broader meaning than it does for income tax purposes. For income tax purposes, an individual is a resident if he or she maintains a "permanent place of adobe," and spends at least 183 days a year in the state. But for sales and use tax purposes, an individual is a resident of New York if he or she maintains a permanent place of abode, irrespective of how much time is spend there. A permanent place of adobe is construed broadly and may include any of the following dwelling places: (i) a home, apartment, or room at a residence hall; (ii) armed forces housing; or (iii) a trailer, mobile home, or houseboat. For sales and use tax purposes, it is possible to be a resident of more than one jurisdiction. In addition, a domestic or foreign estate or trust that carries on a business, trade, or profession or employment in New York is a resident for sales and use tax purposes. A corporation engaged in business in in New York is also treated as a resident.

Prior to a recent change of law, many holding companies could escape use tax as they were seen passive companies not doing business in New York. However, this is no longer the case.

Use tax is generally not due on taxable property or services purchased by a nonresident business. However, N.Y. tax law was amended effective April 10, 2017, to narrow this exclusion. Use tax is now imposed when a nonresident business brings tangible personal property or taxable services into New York for use here, unless the nonresident business has been doing business outside of New York for at least six months prior to the date the property or service is brought into the state.

The state offers this example:

> XYZ Corporation is a resident of New York. On May 1, 2017, XYZ Corporation forms PQR, Inc., a Delaware corporation wholly owned by XYZ Corporation. On June 1, 2017, PQR, Inc., purchases a large sculpture for installation in the lobby of XYZ Corporation's New York City offices. PQR, Inc., conducts no other business activity, and has no employees or offices. On February 1, 2018, PQR, Inc., brings the sculpture into New York and delivers it to the installation site. Even though PQR, Inc., was in existence for more than six months when it brought the sculpture into New York (May 1, 2017 - February 1, 2018), PQR, Inc., was never doing business as required by the statute. Therefore, PQR, Inc., will owe use tax on the sculpture when it is brought into New York.[9]

[9] Tax Bulletin ST-910 (TB-ST-910) August 17, 2017.

CONCLUSION

Foreign persons owning or using artwork in the U.S. must be mindful of the special income, estate, and gift taxes associated with that ownership. If you are a nonresident alien and own artwork located in the U.S., your estate will face U.S. estate tax consequences, and you must not overlook the application of state and local sales and use taxes on purchases, acquisitions, or ownership of artwork.

"If you are a nonresident alien and own artwork located in the U.S., your estate will face U.S. estate tax consequences"

UPDATES & OTHER TIDBITS

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Tags
I.R.S.
Passports
Rulings
Tax Compliance

PASSPORT DENIAL ROLL OUT

The I.R.S. announced it will slowly launch a passport denial program with the U.S. State Department beginning in January 2018. The roll out follows final rules, issued by the State Department in early September 2016, concerning passport denial and revocation requirements for individuals with seriously delinquent tax debts, as defined by the Fixing America's Surface Transportation ("F.A.S.T.") Act enacted in December 2015. As described in 26 U.S.C. 7345, a "seriously delinquent tax debt" is generally an assessment of $50,000 or more (including an interest and penalties) for which a lien or levy has been filed.

The launch will affect a randomly selected number of cases on which the I.R.S. will share data with the State Department and set up payment arrangements with taxpayers. The launch will be similar to the private tax debt collection program also created by the F.A.S.T. Act.

I.R.S. MAY END FAVORABLE RULINGS ON SOME TRANSACTIONS

On October 13, 2017, the I.R.S. announced it is rethinking its position on certain issues. The agency will rule more stringently on certain transactions, substantially scrutinizing the facts and circumstances and fully considering the legal issues and effect of a ruling on the tax administration, while others will no longer receive favorable treatment. Previous rulings will be unaffected.

Code §165(g)(3)(B) Worthless Stock Loss

The I.R.S. will no long rule on whether the character of gross receipts received by a consolidated group member in an intercompany transaction may be redetermined by reference to the character of the source funds possessed by the counter party to the intercompany transaction.

Code §355 Delayed Distributions

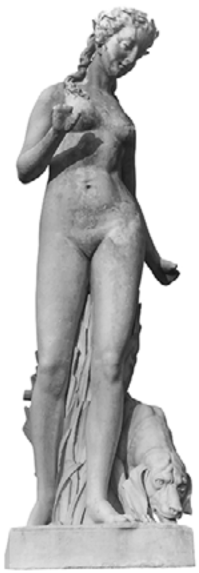
The I.R.S. will continue to rule on whether a delayed distribution to the distributing company's shareholders or creditors is tax free. However, these rulings will involve increased scrutiny and will not be based solely on the length of the delay.

Code §355 "Drop-Spin-Liquidate"

The I.R.S. will increase its scrutiny and analysis of "drop-spin-liquidate" transactions (*i.e.*, where corporations distribute assets to shareholders while liquidating into, or being acquired by, a parent company).

Code §§332 and 355 Reorganizations

The I.R.S. will increase its scrutiny and analysis of tax-free reorganizations that don't qualify under Code §§332 or 355 but result in a tax-free transfer of subsidiary assets to its corporate shareholder. These included cases where a corporate subsidiary converts into a non-corporate entity (*e.g.*, a limited liability company) that is treated as a disregarded entity owned by its parent, and as part of the same plan, the disregarded entity distributes a portion of its assets to the parent and then either elects to be taxed as a corporation or converts back into a corporation (either in the same state as the state of incorporation of the original subsidiary or a different state).



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