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a closer look

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SUBJECTS TRANSFER PRICING INTELLECTUAL PROPERTY VAT, GST AND SALES TAX CORPORATE TAXATION INDIVIDUAL TAXATION REAL ESTATE AND PROPERTY TAXES INTERNATIONAL FISCAL GOVERNANCE BUDGETS COMPLIANCE OFFSHORE

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GLOBAL TAX WEEKLY
a closer look

Global Tax Weekly – A Closer Look

Combining expert industry thought leadership and the unrivalled worldwide multi-lingual research capabilities of leading law and tax publisher Wolters Kluwer, CCH publishes Global Tax Weekly — A Closer Look (GTW) as an indispensable up-to-the minute guide to today's shifting tax landscape for all tax practitioners and international finance executives.

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a closer look

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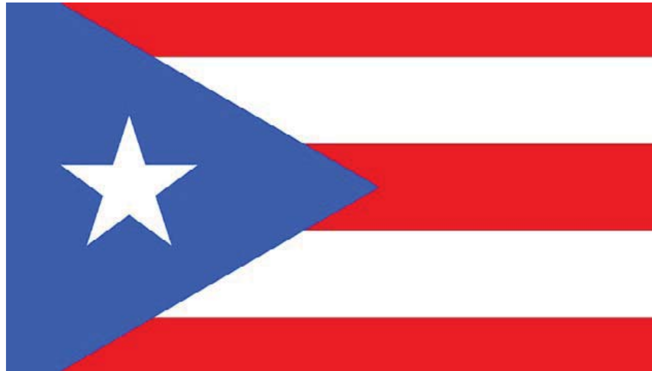
Inbound And Outbound US Tax Planning For Bona Fide Residents Of Puerto Rico



by Jeffrey L. Rubinger and
Summer Ayers LePree, Bilzin Sumberg

Since Puerto Rico enacted the "Individual Investors Act" (Act 22)[1] and the "Export Services Act" (Act 20)[2] in 2012, much press has been devoted to the number of high-net worth US taxpayers (including citizens and green card holders) who have relocated to Puerto Rico and become "bona fide residents" [3] of such US possession. The primary tax benefits available to such persons that have received the most attention are (i) the 100 percent exclusion of Puerto Rican-source interest and dividends from both US and Puerto Rican income tax; and (ii) the 100 percent exclusion of worldwide capital gains, to the extent such gains accrue after the person becomes a resident of Puerto Rico, from both US and Puerto Rican income tax. In addition, Puerto Rico corporations providing "export services" to non-Puerto Rican persons are only subject to a 4 percent corporate income tax in Puerto Rico. It should be noted that these benefits are available to bona fide residents of Puerto Rico even though they remain US taxpayers and therefore are not subject to the expatriation rules.

What has not received as much attention, however, and possibly just as significant as the benefits described above, are the provisions of the US Internal Revenue Code[4] and relevant Treasury Regulations that specifically do not apply to bona fide residents of Puerto Rico who own shares of corporations organized in Puerto Rico. For example, bona fide residents of Puerto Rico may be exempt from the US controlled foreign corporation (CFC)[5] rules, and the passive foreign investment company (PFIC)[6] rules with respect to their ownership of Puerto Rican corporations. Furthermore, as a result of the "check-the-box" rules and proper planning, these exemptions may be extended to income derived in foreign jurisdictions other than Puerto Rico (including US-source treaty benefited income), without that income being subject to tax in the United States or Puerto Rico.

Bona Fide Residents Of Puerto Rico And The US Anti-Deferral Rules

As noted above, a US taxpayer who becomes a bona fide resident of Puerto Rico is able to exclude under Section 933(1)[7] Puerto Rican source interest and dividends, and (possibly) worldwide capital gains. This income also would be excluded from Puerto Rican income tax. To become a bona fide resident of Puerto Rico, an individual must satisfy (i) the presence test; (ii) the "tax home" test; and (iii) the closer connection test.

Assuming the individual satisfies these three tests, that person may be eligible for US income tax benefits relating to Puerto Rican corporations that would not otherwise be available to foreign corporations organized in other jurisdictions. In particular, "US shareholders" who own more than 50 percent of the stock of a foreign corporation (which, for this purpose, includes Puerto Rican corporations) generally are subject to current US federal income tax on any "subpart F" [8] income earned by such CFC, even if the income is not distributed to the shareholder in the form of a dividend.[9] Similarly, US shareholders are also subject to current US federal income tax on their pro rata share of the average of the amounts of "United States property" held by a CFC at the close of each quarter of a taxable year.[10]

A US taxpayer who is a bona fide resident of Puerto Rico, however, will not be treated as a "US shareholder" for purposes of determining whether a Puerto Rican corporation is a CFC, if a dividend received by such individual from the Puerto Rican corporation would be treated, for purposes of Section 933(1), as Puerto Rican-source income.[11] Generally, for purposes of Section 933(1), the source of a dividend paid by a corporation organized in a US possession will be treated as derived from sources within that possession based on the "possession source ratio" of such dividend.[12]

A different rule applies with respect to a possession corporation that is engaged in the active conduct of a trade or business in such possession. In that case, the entire dividend will be treated as income derived from that possession if (i) 80 percent or more of the gross income of the corporation during the prior three years was derived from sources within such possession; and (ii) 50 percent or more of the gross income during the prior three years was derived from the active conduct of a trade or business within such possession.[13]

These sourcing rules do not apply, however, to dividends paid by Puerto Rican corporations for purposes of determining whether the corporation is a CFC.[14] Instead, dividends paid by a Puerto Rico corporation typically are treated as Puerto Rican-source income for purposes of Sections

933(1) and 957(c), so long as less than 25 percent of the Puerto Rican corporation's gross income is comprised of income effectively connected to a US trade or business.[15] Accordingly, unless a Puerto Rican corporation derives at least 25 percent of its income from income effectively connected to a US trade or business, that corporation will not be treated as a CFC with respect to a US taxpayer who is a bona fide resident of Puerto Rico.

Similar favorable provisions also apply to bona fide residents of Puerto Rico who are shareholders of PFICs. Typically, a US taxpayer that owns shares of a PFIC will be subject to adverse US federal income tax consequences when they receive certain distributions from a PFIC, as well as when they sell their PFIC shares. Proposed regulations, however, provide an exception to the PFIC rules for a bona fide resident of Puerto Rico for the year in question.[16]

Structuring To Take Advantage Of Puerto Rican Tax Incentives

A US taxpayer who owns shares in a Puerto Rican corporation that qualifies for benefits under the Export Services Act generally would not be concerned about the CFC or PFIC rules because income derived from the performance of services in Puerto Rico should not be treated as subpart F income under the CFC rules or passive income under the PFIC rules. Where a bona fide resident of Puerto Rico would benefit significantly from the lack of application of the CFC and PFIC rules would be with respect to income (including passive income) earned outside of Puerto Rico through foreign disregarded entities owned by a Puerto Rican corporation.[17] By having the Puerto Rican corporation own foreign subsidiaries that, for US federal income tax purposes, are treated as branches of the Puerto Rican entity, the CFC and PFIC exceptions noted above continue to apply to income (including US-source treaty benefited income) earned by those foreign subsidiaries, regardless of whether it is connected to Puerto Rico.[18]

For example, assume a US citizen taxpayer ("T") owns an operating business in the United States. T wishes to relocate to Puerto Rico and form a Puerto Rican corporation to provide export services, such as investment management services or R&D. Also assume there is valuable intellectual property involved, which T wants to license back to the US operating business. T forms a Puerto Rican company, and then causes the Puerto Rican corporation to in turn form an Irish company (IrishCo) to own the IP.[19] T causes IrishCo to elect to be treated as a disregarded entity for US tax purposes. IrishCo then licenses the IP, on a royalty-free basis, to a Luxembourg subsidiary (LuxCo), also owned by the Puerto Rican corporation and also a disregarded entity for US tax purposes. LuxCo in turn sub-licenses the IP to the US company, in exchange for royalty payments.

The royalties should be exempt from US withholding tax under the US–Luxembourg income tax treaty. LuxCo should qualify for treaty benefits in this case. The treaty's limitation of benefits (LOB) provision allows US citizens (regardless of where they are resident) who are the ultimate beneficial owners of a Luxembourg company to qualify the company for treaty benefits.[20]

When LuxCo receives the royalty payment, it should be entitled to a deemed deduction for Luxembourg tax purposes due to the royalty-free license with IrishCo.[21] Therefore, LuxCo only will be taxable on a minimal spread. Furthermore, while Ireland does have transfer pricing rules, these rules only apply to income derived from a trading activity, which would not include a single license. Therefore, this structure allows for the payment of US-source royalties that are deductible and exempt from withholding for US federal income tax purposes, and are only subject to minimal foreign income tax.[22] In addition, despite the passive nature of the income, neither the CFC nor the PFIC rules should apply because the foreign subsidiaries are treated as branches of a Puerto Rican corporation.[23]

The non-Puerto Rican source profits ultimately can be repatriated to the shareholder resident in Puerto Rico either by way of a direct loan from LuxCo,[24] or by way of a loan from LuxCo to the Puerto Rican corporation, followed by the payment of a dividend to the shareholder. The dividend will be completely exempt from US federal income tax under Section 933(1), so long as 80 percent or more of such amount is attributable to Puerto Rican source income.[25]

If more than 20 percent of the dividend is attributable to non-Puerto Rican source income, the Puerto Rican source portion will be exempt from US federal income tax under Section 933(1), whereas the remaining portion of the dividend that is attributable to non-Puerto Rican source income will be subject to US federal income tax at qualified dividend rates (*i.e.*, 23.8 percent) under Section 1(h)(11).[26] Finally, any gain realized from the disposition of the shares of the Puerto Rican corporation (including the foreign branches and their untaxed earnings) will be completely exempt from US federal income tax under Section 933(1), so long as the shares were not owned at any time during the ten-year period prior to the US taxpayer becoming a bona fide resident of Puerto Rico.[27]

Endnotes

1 *See* http://businessinpuertorico.com/en/profit/individual-investors

2 *See* http://businessinpuertorico.com/documents/ACT-20-PG.pdf

3 *See* https://www.irs.gov/pub/irs-pdf/p1321.pdf

[4] *See* https://www.law.cornell.edu/uscode/text/26

[5] *See* https://www.irs.gov/irm/part4/irm_04-061-007.html

[6] *See* https://www.law.cornell.edu/uscode/text/26/1297

[7] All references to "Section" refer to Sections of the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder; *see* https://www.law.cornell.edu/uscode/text/26/933

[8] *See* https://www.irs.gov/pub/int_practice_units/DPLCUV_2_01.PDF

[9] Section 951(a)(1)(A)(i).

[10] Sections 951(a)(1)(B) and 956.

[11] Section 957(c)(1).

[12] Treas. Reg. 1.937-2(g)(1)(i).

[13] Treas. Reg. 1.937-2(g)(1)(ii).

[14] Treas. Reg. Section 1.957-3(b)(2). These sourcing rules still apply to determine whether the dividend is excludable from US federal income tax under Section 933(1). To the extent the dividend is excludable only in part, the portion of the dividend that is attributable to non-Puerto Rican-source income will be subject to US federal income tax at qualified dividend rates (*i.e.*, 23.8 percent). Section 1(h)(11)(C)(i)(I).

[15] Section 861(a)(2)(B).

[16] Prop. Treas. Reg. Section 1.1291-1(f).

[17] In order for a dividend received by a bona fide resident of Puerto Rico from a Puerto Rican corporation that is engaged in a trade or business in Puerto Rico (*e.g.*, under Act 20) to be completely excludable from US federal income tax under Section 933(1), no more than 20 percent of the income can be attributable to income earned outside of Puerto Rico.

[18] It should be noted that Puerto Rico treats foreign LLCs that are disregarded for US tax purposes as flow-through entities for Puerto Rican tax purposes. Therefore, in order for this planning to apply, and avoid Puerto Rican corporate income tax, the foreign subsidiaries need to be organized as entities other than LLCs but are still non-"per se" entities under the check-the-box rules. See Treas. Reg. Section 301.7701-2(b)(8)(i).

[19] Care should be structured when transferring the IP to Ireland. While capital gain derived by a bona fide resident of Puerto Rico generally would be exempt from US federal income tax under Section 933(1), an exception applies for gain triggered on the sale of property within ten years of the US taxpayer becoming a bona fide resident of Puerto Rico if such property were owned prior to relocating to Puerto Rico. Treas. Reg. Section 1.937-2(f)(1).

[20] Despite the fact that LuxCo and IrishCo are disregarded for US tax purposes, Section 894(c) will not deny treaty benefits because the income is treated as "derived" in Luxembourg for Luxembourg tax

purposes. Finally, the conduit financing regulations should not apply because, if the royalties were paid directly to IrishCo, they would be eligible for 0 percent withholding under the US–Ireland income tax treaty. *See* Treas. Reg. Section 1.881-3(b)(2)(i).

[21] The base erosion provision of the LOB article should be satisfied because the deductible amounts accrued in Luxembourg are owed to another EU-country member.

[22] This planning may be affected at some point by the Base Erosion and Profits Shifting (BEPS) initiative and certain provisions of the new US Model Treaty (especially the "special tax regime" provision) being incorporated into existing or newly-enacted income tax treaties.

[23] In addition, Puerto Rico does not have CFC rules.

[24] It should be noted that any such loan will not be treated as "United States property" under Section 956 because the Puerto Rican corporation and its disregarded subsidiaries will not be treated as CFCs for US tax purposes. If a loan were made directly to the Puerto Rican corporation, interest payments may be subject to Puerto Rican withholding tax.

[25] Treas. Reg. Section 1.937-2(g)(1)(ii). Interesting issues arise under the Section 367(b) regulations if an existing CFC is re-domiciled into a Puerto Rican corporation.

[26] It should be noted that a dividend paid by LuxCo to the Puerto Rican corporation likely would be subject to Puerto Rican corporate income tax at regular corporate tax rates.

[27] The gain will be treated as Puerto Rican-source income and thus exempt under Section 933(1), so long as more than 50 percent of the Puerto Rican corporation's income is attributable to an active trade or business in Puerto Rico. Treas. Reg. Section 1.937-2(f)(2)(i)(A) and Section 865(g)(3). See also Notice 89-40, 1989-1 C.B. 681, which eliminates the 10 percent foreign tax requirement otherwise required by Section 865(g)(2) for bona fide residents of Puerto Rico who sell personal property. Section 1248 should not apply if the Puerto Rican corporation was never a CFC for US federal income tax purposes.

Knowing When To Say When

by Mike DeBlis, DeBlis Law

During its previous term, in a case that definitely took a back seat to the Affordable Care Act, same-sex marriage, and the other high-profile disputes that the Supremes attempted to resolve, the High Court might have changed the way that doctors, dentists, accountants, lawyers, and other professionals have done business for decades. In *North Carolina State Board of Dental Examiners v. Federal Trade Commission*, the Court may have ended a para-state professional organization's ability to regulate nonmembers, with potential implications for tax preparers, as will be discussed below.

It seems that an inordinate number of Carolinians were flocking to their local teeth-whitening clinics to get a bleach job. The state dental board decided to fly to the rescue and put an end to this nefarious practice. In a 6-3 decision – the four progressives and two moderates against the three conservatives – the Court ruled that the Board's prohibition violated antitrust laws, and as the Board is not technically a state agency, no immunity applies.

Some observers predict that barratry statutes may be next. State bar organizations from sea to shining sea have long maintained that there is a special corner of Hell reserved for those who dare to practice law without a license. But, in the Legal Zoom era and in the light of this case, the bar might soon lose its monopoly on legal services.

Legal Limitations On Non-Attorney Tax Preparers

As expats start to take a look at those bank statements which had been relegated to an obscure subfolder in their inboxes, this same question comes up in the context of foreign tax advisors. Under Section 7525 of the Internal Revenue Code, federally-authorized tax preparers have a duty to protect the confidential information that comes from their clients. However, there is a huge caveat: the taxpayer may only invoke the privilege provided by IRC Section 7525 in noncriminal tax matters before the IRS and in federal courts. D'oh.

The line between civil and criminal tax law is somewhat murky. As a rule of thumb, if a return preparer's limited inquiry suggests a good faith error, the return preparer may ask the taxpayer to provide the information necessary to amend the return. The filing of an amended return is the appropriate way to correct isolated, inadvertent, immaterial, and ministerial errors. In contrast, if the return preparer's internal investigation suggests that the taxpayer has a pattern of similar errors across multiple years' returns or otherwise suggests willful noncompliance, it may be time for the client to lawyer up.

Making matters worse, certain advisory actions only muddy up the waters for return preparers. These actions prohibit providing advice in any one of the following areas: conflicts of interest, privileges, and the likelihood of criminal tax prosecution. With respect to the latter, most states prohibit non-lawyer return preparers from advising the taxpayer on his or her potential for criminal prosecution.

One can see how this becomes relevant when a taxpayer makes a streamlined submission due to the fact that the taxpayer must certify that his or her tax noncompliance was due to conduct that was nonwillful. One false step could result in the rejection of the taxpayer's nonwillful certification along with a referral to CI.

Understanding The Role Of The Attorney

The American Institute of CPA's ("AICPA") Statement on Standards for Tax Services ("SSTS"), No. 6,[1] states, in relevant part, that if it appears the taxpayer could be charged with fraud or other criminal misconduct, the taxpayer should be advised to consult legal counsel. Very simply, referral to an attorney should occur at the first indication of fraud.

Gathering facts and assessing the risk of criminal prosecution are the primary roles of the tax controversy attorney. If there is little or no risk of criminal prosecution, the role of the attorney is limited. The attorney will explain to the taxpayer the impact of Circular 230 and the rules of ethics. Nothing short of providing the client with a "crash course" in Circular 230 and the ethical rules of the AICPA will suffice.

Specifically, Circular 230 [2] states that if a practitioner:

> "knows that the client has … made an error in or omission from any return, [he] must advise the client promptly of the fact of such noncompliance, error, or omission. The

> practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission."

The AICPA SSTS expands on this point. "If the taxpayer does not correct an error, a member should consider whether to withdraw from the engagement and whether to continue a professional or employment relationship with the taxpayer." Although the AICPA recognizes that the Code does not require the taxpayer to correct an error by filing an amended return, it explicitly states that "a member should consider whether a taxpayer's decision not to file an amended return or otherwise correct an error may predict future behavior that might require termination of the relationship."

If there is no risk of criminal prosecution and the taxpayer is willing to correct the error, most tax attorneys will advise the taxpayer to continue working with his or her existing tax preparer. On the other hand, if the attorney concludes that there is a risk of criminal prosecution, his role becomes even more vital.

In such cases, the attorney must advise the taxpayer on whether the continuation of the existing relationship with the return preparer is both (a) in the taxpayer's best interest and (b) ethical. In both criminal cases and in cases that have the potential to turn criminal (*e.g.*, "eggshell audits"), the government will go to great lengths to speak with the return preparer. Thus, removing the return preparer from the equation altogether by terminating the engagement agreement might be just what the doctor ordered.

At that point, the attorney will explain the options available to the taxpayer, including correcting the incorrect return by (a) filing an amended return (*i.e.*, "quiet disclosure"), or (b) applying to the voluntary disclosure program (*i.e.*, "noisy disclosure").

To sum up, this area is essentially like the difference between a bleach job and a root canal. If your teeth are really messed up and it looks like the IRS may put you in the dental chair, reach out to a tax lawyer straightaway.

Endnotes

1 See: http://www.aicpa.org/interestareas/tax/resources/standardsethics/statementsonstandardsfortaxservices/downloadabledocuments/ssts-no.6-knowledge-of-error.pdf

2 See: https://www.irs.gov/pub/irs-utl/pcir230.pdf

Topical News Briefing: Never A Dull Moment

by the Global Tax Weekly Editorial Team

The OECD's recent report to G20 Finance Ministers and Central Bank Governors, reported in this week's issue of *Global Tax Weekly*, states that while the delivery last October of the BEPS package represented a "high point" in the OECD–G20 partnership to change the face of international taxation, the world is now moving into an "exciting new era" as the BEPS recommendations are implemented. However, some might say that the future is exciting for the wrong reasons.

As the OECD noted in its report, it is certainly the case that some countries have taken up the BEPS recommendations with enthusiasm. For example, several jurisdictions have legislated for, or are in the process of introducing, transfer pricing country-by-country (CbC) reports, and last month 31 countries signed the Multilateral Competent Authority Agreement for the automatic exchange of CbC reports. Some, like the UK and Australia, are making progress with new rules preventing the use of hybrid mismatch arrangements.

However, the very fact that some governments are moving faster than others to implement BEPS measures could be one of the factors that undermine the whole project. And this has been a key concern of tax experts, business representatives, and other observers worldwide since the OECD began its BEPS work.

As the Business and Industry Advisory Committee to the OECD warned in its annual statement to OECD ambassadors on January 18, 2016, "uncoordinated implementation could lead to a less uniform international tax regime and, in turn, hinder trade and investment. In an increasingly globalized world, it is necessary to have consistent and clear tax rules for companies. The inclusive framework for monitoring and implementing BEPS and the Multilateral Instrument will be critical in this respect."

Indeed, it could be said that the OECD's two years of consultations with taxpayers and negotiations with governments was really just the easy part of the project. Now the hard work really begins.

The Association of Chartered Certified Accountants (ACCA) is one organization that believes implementing the BEPS recommendations effectively will be more challenging for governments and businesses than the earlier negotiations for those proposals.

ACCA observed in comments on a public consultation launched by the UK's All-Party Parliamentary Group on Responsible Tax that: "BEPS addresses many of the issues from the side of governments, but the response of business will be equally vital to success. The concern is that if governments do not engage constructively and consistently then the situation will get worse, not better, as the businesses which can and do try to comply with the principles inevitably lose out to those businesses which will take advantage of any continued weaknesses in the mechanisms."

Others have warned that insufficient attention has been paid to the administrative impact of BEPS-related measures on taxpayers. Most US business executives for instance anticipate an increased compliance burden from the OECD's base erosion and profit shifting initiative, according to a recent poll conducted by business advisory firm Deloitte. Respondents also expressed concerns about double taxation (17 percent) and increased effective tax rates on income from cross-border transactions (14.9 percent).

The American Action Forum (AAF) concurred with the findings of the survey, warning that CbC reporting in particular will impose significant new compliance burdens and force disclosure of sensitive and proprietary information. The AAF concluded in a report published last month that while CbC reporting "may provide taxing authorities greater insight into large MNE firms, it is far from a costless endeavor. It will impose new burdens on firms, while potentially leading to the exposure of the sensitive, proprietary information firms will be compelled to disclose."

Given the momentum that is now pushing the BEPS project along, it is unlikely that it will be derailed by this sort of criticism. But they are valid points nonetheless, and ones that seem to have been more or less glossed over by the OECD.

Still, it seems inevitable that countries are going to react to BEPS in different ways and at their own pace, which, as critics of the project point out, is only going to increase uncertainty in the short to medium term. So it seems that whatever the outcome of BEPS, those involved in the international tax industry are cursed to live in interesting times.

The 'Willfulness' Element In The IRS's Offshore Voluntary Disclosure Program

by John Anthony Castro, Castro & Co

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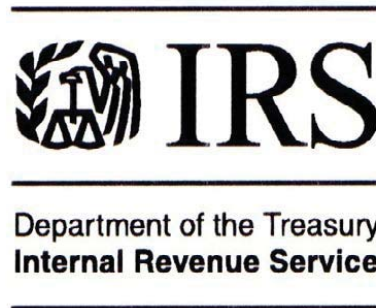

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Introduction

What constitutes "willful" in determining the meaning of the term "non-willful" as used by the Internal Revenue Service (IRS) in the Offshore Voluntary Disclosure Program (OVDP)?

The IRS recently published its own definition of non-willful conduct to mean "conduct that is due to negligence, inadvertence, or *mistake* or conduct that is the result of a *good faith misunderstanding* of the requirements of the law." [1] This definition is identical to the standard applied under Internal Revenue Code section 7203.

The willfulness element under Section 7203 requires proof that the taxpayer voluntarily and intentionally failed to file a return which the taxpayer *knew* he or she was required to file. This element is typically established by circumstantial evidence that the taxpayer previously filed the particular return, received tax documents or notifications from third-parties that should have alerted the taxpayer of the duty to file returns, such as a letter from the IRS,[2] notice from the

IRS,[3] or income tax documents,[4] or that the taxpayer had an educational, vocational or professional background which required some knowledge of tax obligations.[5]

The definition and meaning of willfulness are the same in both the civil and criminal context;[6] it is only the evidentiary standard and burden of proof requirements that differ.[7]

Willful Failure

Under section 7203, any person required to file an income tax return who willfully fails to do so is guilty of a misdemeanor.[8] The standard for willfulness is "a voluntary intentional violation of a known legal duty." [9] The elements of the offense are the failure to file a return[10] and willfulness in doing so.[11] The offense is not committed unless the taxpayer has *actual knowledge* of the existence and the *specific intent* to evade it or *reckless disregard* of the foreseen possible existence of the obligation.[12] Willfulness requires that failure be committed purposefully with awareness of action, not just negligently or inadvertently.[13] It means a voluntary, intentional violation of the known legal duty to file,[14] and the taxpayer's motives in failing to file such return are immaterial and irrelevant.[15]

It should be noted that although the US Supreme Court once stated that "until Congress speaks otherwise, we … shall continue to require, in both tax felonies and tax misdemeanors that must be done 'willfully,' the bad purpose or evil motive described in *Murdock v. US*," [16] it later quietly reversed that position and held that there is "no requirement of finding of 'evil motive' beyond a specific intent to violate the law." [17] Although the government need not show *mens rea* or that the taxpayer had an evil-meaning mind; finding of willful conduct would necessarily negate any possibility of good faith in failing to file income tax return.[18] Therefore, whether the taxpayer had a good motive[19] or a bad motive is irrelevant; the only question is whether the taxpayer knew of the duty to file and deliberately failed to file.[20]

Evidentiary Standard

As previously mentioned, the definition and meaning of willfulness are the same in both the civil and criminal context.[21] However, the burden of proof and evidentiary standards differ. In the civil context, the government must prove willfulness by "clear and convincing evidence."[22] In the criminal context, however, the standard is, of course, "beyond a reasonable doubt." [23] While a set of facts and circumstantial evidence may not be enough to prove willfulness "beyond a reasonable doubt" in a criminal case, it may be enough to prove willfulness with "clear and convincing" evidence in a civil case.

In the OVDP Streamlined context, it is fair to ask whether the Service is requesting certification of non-willfulness "beyond a reasonable doubt" or to a degree that is "clear and convincing." Because the "clear and convincing standard" is the lower threshold, the focus should be on the civil evidentiary standard. If the government can prove willfulness "beyond a reasonable doubt," the evidence would undoubtedly qualify as "clear and convincing."

Therefore, because the government can more easily prove willfulness in the civil context, the only way to certify non-willfulness is for the taxpayer to be certain that the facts do not support a finding of willfulness by "clear and convincing evidence." Generally, because IRS Forms 14653 and 14654 require the taxpayer, individually, to certify non-willfulness for purposes of the Streamlined Filing Compliance Procedures, practitioners will have limited liability exposure.

Specific Intent Required

Because willful failure to file is a specific intent crime, it absolutely requires proof of the intentional violation of a known legal duty.[24] Subjective, rather than objective, standard is to be applied in evaluating good-faith defense to charge of willfully failing to file tax returns.[25] In other words, in determining whether failure to file income taxes is willful, it is one's subjective state of mind that must be judged.[26] For example, if a taxpayer genuinely believes that the law does not require him to file an income tax return because wages are not legally considered income, it is a defense to the finding of willfulness.[27]

There must be a deliberate intent to disobey the filing requirement.[28] This may *possibly* be inferred by supporting circumstantial evidence as discussed below.

Circumstantial Evidence

Although courts will take into account both direct and circumstantial evidence,[29] the IRS has acknowledged that "cases involving willful FBAR violations will generally have to rely on circumstantial evidence." [30] Circumstantial evidence of willfulness, standing alone, *is sufficient* to prove willfulness.[31] Circumstantial evidence includes "any conduct, the likely effect of which would be to mislead or to conceal." [32] This could include the use of aliases and nominee entities,[33] concealing assets through the use of nominee trusts,[34] utilizing untraceable forms of payments like cash or money orders,[35] numbered accounts at foreign banks,[36] working with a foreign financial institution or advisor under US indictment, or earning substantial income on reportable accounts but not reporting said income on one's federal income tax return.[37]

The element of "willfulness" as used in this section requires a finding of a specific wrongful intent.[38] Nevertheless, if one intentionally disregards apprising himself or herself of the law, such deliberate ignorance may constitute willful blindness.[39]

As mentioned before, there are two ways for the government to establish willfulness. First, the government can prove *actual knowledge* of the existence and the *specific intent* to evade it. Second, the government can prove *reckless disregard* of the foreseen possible existence of the filing obligation.[40]

Under the first method, although the government can prove actual knowledge by simply showing that the taxpayer signed his or her income tax return, the government must still provide specific intent to disregard the filing obligation.[41] Nevertheless, where the government can establish specific intent by direct or circumstantial evidence, knowledge is implied. In other words, specific intent infers knowledge, which together establishes willfulness, but knowledge alone does not establish specific intent. Therefore, practically speaking, "knowledge" is a superfluous element; specific intent is the only true element of willfulness.

Under the second method, the government must establish enough circumstantial evidence to either infer specific intent or establish reckless disregard of the reasonably foreseeable likelihood of the filing obligation.[42]

Willful Blindness

In *Cheek v. US*,[43] the US Supreme Court held that a taxpayer's belief about what the law requires, regardless of how unreasonable it appears to be, is a question of fact for the jury.[44] In that case, the defendant, John L. Cheek, claimed that, based on his reading of the law, it was his understanding that he was not a "person" required to file a return because wages were not "income." The lower district court refused to instruct the jury on this defense. The US Supreme Court held that it was an error to not instruct the jury on Cheek's defense of a good-faith misunderstanding the law. Evidence that the taxpayer researched the question, attended seminars, consulted experts, inquired of the IRS, or even talked with neighbors is helpful in establishing not only that he believed it but that his belief was not a recent, convenient invention.

Essentially then, the court in *Cheek* stated that the requirement of willfulness is an exception to the general rule that ignorance is not an exception to criminal liability, and distinguished between two types of persons: one who, in good faith, is ignorant of a duty or misunderstands it, and one who recklessly avoided knowledge of a legal duty. Although the court held that willfulness cannot

attach to the former type of person, it can attach to the latter. The term "reckless" is a highly technical legal term and should not be confused with the ordinary meaning of the term. Black's Law Dictionary defines recklessness as "[c]onduct whereby the actor does not desire [an unlawful outcome] but nonetheless foresees the possibility and consciously takes the risk." Therefore, reckless disregard of the possibility of a filing obligation despite circumstances that would have apprised an ordinary, prudent person is sufficient to establish deliberate ignorance to evidence willfulness, which is not prohibited by the decision in *Cheek*.[45] In essence, this case created what is now known as the doctrine of willful blindness.

Therefore, willfulness can "be inferred from a conscious effort to avoid learning about reporting requirements" or where "a defendant was subjectively aware of a high probability of the existence of a tax liability, and purposefully avoided learning the facts point to such liability." [46] Nevertheless, the government must still prove that, at some point, the taxpayer was made aware of the possibility of compliance issues.

It should be noted that the US Court of Appeals for the Eighth Circuit[47] has held that willfulness "cannot fairly be equated with carelessness or recklessness." [48] This is not, however, the general rule; it only represents a possible exception for taxpayers in that circuit.

Good-Faith Misunderstanding Of Law

A taxpayer is not excused from the offense of willfully failing to file a return because he had not previously been prompted or notified of his duty to file a return,[49] because he *disagreed* with the law,[50] or because he held the legal *opinion* that the statute[51] or Federal Reserve System[52] was unconstitutional. However, a taxpayer's good faith belief that he need not file his tax return,[53] no matter how unreasonable the belief,[54] or a good faith misunderstanding or an inadvertence on his part,[55] constitutes justification for failure to file a return.

A failure to file income tax returns while holding the legal *opinion* that the law which includes wages is unconstitutional would be willful since it is based on an unsupported legal opinion, but the failure to file while believing in good faith that wages are not "income" as defined under the Internal Revenue Code would not be willful since it would be based on one's understanding of the law.[56] However, a *disagreement* with the Internal Revenue Code's definition of "gross income" would not entitle the taxpayer to violate the law by failing to file a proper return.[57] Nevertheless, the courts have labeled constitutional challenges as being *per se* frivolous opinions that do not prevent the finding of willfulness.[58]

There is a difference between a good faith disagreement with the law based on an opinion, and a good faith misunderstanding of the law[59] based on one's reasonable efforts to understand it.[60] If, for example, a taxpayer genuinely holds religious beliefs concerning the invalidity of income tax laws or any other good faith disagreement with the law,[61] it does not prevent the finding of willfulness for the failure to file income tax returns.[62] If a taxpayer, however, holds the unsupported legal opinion that the Internal Revenue Code is unconstitutional, such opinion disagreeing with established case law and opinions issued by the Supreme Court would not negate the element of willfulness.[63]

The misunderstanding need not be objectively reasonable to be a defense to the finding of willfulness; a jury need only conclude that the taxpayer honestly misunderstood the law.[64] Therefore, if a taxpayer believes in good faith that he was not required to file a return[65] or believes in good faith that another statute removed the obligation to file a return,[66] even if unreasonable, that would be a defense to the finding of willfulness. Similarly, if a taxpayer believes that he does not have to file a return if he is unable to pay, although clearly unreasonable, that is a defense to the finding of willfulness.[67]

In other words, it is crucial that the mistake, regardless of whether it is objectively reasonable or unreasonable, was subjectively[68] a *bona fide* misunderstanding of the law regarding the legal duty to file a return.[69] This naturally means that a less educated person is better situated to benefit from this exception.[70]

Conclusion

As a general rule, a taxpayer can establish non-willfulness by asserting that, based on a good-faith personal diligent reading of the law, there was a *bona fide* misunderstanding of the filing requirements and that the taxpayer genuinely believed he or she was not required to file the forms at issue.

It should be noted, however, that a good faith misunderstanding of the law does not constitute reasonable cause for the purpose of avoiding penalties under the Delinquent International Informational Return Procedures or Delinquent FBAR Filing Procedures.

Endnotes

1 *See* Internal Revenue Service Website, US Taxpayers Residing Outside the United States, Streamlined Foreign Offshore Procedures (June 26, 2014), http://www.irs.gov/Individuals/International-Taxpayers/U-S-Taxpayers-Residing-Outside-the-United-States

2 *See US v. Poschwatta*, 829 F.2d 1477 (9th Cir. 1987); *US v. Green*, 757 F.2d 116 (7th Cir. 1985).

3 *See US v. Sempos*, 772 F.2d 1 (1st Cir. 1985).

[4] *See US v. Bergman*, 813 F.2d 1027 (9th Cir. 1987).

[5] *See US v. MacKenzie*, 777 F.2d 811, 818 (2d Cir. 1985).

[6] *See* CCA 200603026.

[7] *See Bradford v. C.I.R.*, 796 F.2d 303 (9th Cir. 1986); *Stone v. C.I.R.*, 56 T.C. 213 (1971).

[8] *See Spies v. US*, 317 US 492 (1943); *US v. McCabe*, 416 F.2d 957 (7th Cir. 1969); *US v. Bell*, 734 F.2d 1315 (8th Cir. 1984); *Edwards v. US*, 375 F.2d 862 (9th Cir. 1967); *US v. Sullivan*, 369 F. Supp. 568 (D. Mont. 1974).

[9] *See Ratzlaf v. US*, 510 US 135 (1994). In *Ratzlaf*, the Court determined that the language of section 5324 on its own was not clear as to the requisite level of knowledge required to violate the statute and consulted section 5322(a) for additional guidance. Based on that section, the Court required that the government demonstrate proof of knowledge of illegality before a defendant could be convicted. However, since *Ratzlaf*, Congress amended section 5324 to provide "its own criminal penalty provision so reliance on § 5322 is no longer necessary." *See US v. Vazquez*, 53 F.3d 1216, n.2 (11th Cir. 1995). Thus, the only mental state apparently required under the new penalty provision is a purpose to evade the filing requirement.

[10] *See US v. Buckley*, 586 F.2d 498 (5th Cir. 1978); *Poschwatta*, 829 F.2d at 1477; *US v. Crowhurst*, 629 F.2d 1297 (9th Cir. 1980); *US v. Brown*, 600 F.2d 248 (10th Cir. 1979); *US v. Goetz*, 746 F.2d 705 (11th Cir. 1984) (Secretary of Treasury's execution of return on behalf of taxpayer as provided under statute did not relieve taxpayer of obligation to file return); *US v. Grabinski*, 558 F. Supp. 1324 (D. Minn. 1983), *aff'd*, 727 F.2d 681 (8th Cir. 1984); *US v. Birkenstock*, 823 F.2d 1026 (7th Cir. 1987) (Employer's filing of its copy of employee's W-2 form with government did not serve as substitute for employee's income tax return, for purpose of relieving employee of liability for failure to file income tax return).

[11] *See Sempos*, 772 F.2d at 1; *US v. Verkuilen*, 690 F.2d 648 (7th Cir. 1982); *US v. Moore*, 627 F.2d 830 (7th Cir. 1980); *US v. Farber*, 630 F.2d 569 (8th Cir. 1980); *Poschwatta*, 829 F.2d at 1477; *Grabinski*, 727 F.2d at 681.

[12] *See US v. Vitiello*, 363 F.2d 240 (3d Cir. 1966); *Birkenstock*, 823 F.2d at 1026; *US v. Thompson*, 230 F. Supp. 530 (D. Conn. 1964), *aff'd*, 338 F.2d 997 (2d Cir. 1964); *US v. Klein*, 438 F. Supp. 485 (S.D.N.Y. 1977).

[13] *See US v. Merritt*, 639 F.2d 254 (5th Cir. 1981); *US v. Rosenfield*, 469 F.2d 598 (3d Cir. 1972). The US Court of Appeals for the Ninth Circuit has held that the term willfully means "voluntary or purposeful, deliberate and intentional as distinguished from accidental, inadvertent, or negligent. Mere negligence, even gross negligence, is not sufficient to constitute willfulness." *See US v. Hawk*, 497 F.2d 365 (9th Cir. 1974).

[14] *See Cheek v. US*, 498 US 192 (1991); *Sempos*, 772 F.2d at 1; *US v. Shivers*, 788 F.2d 1046 (5th Cir. 1986); *US v. Burton*, 737 F.2d 439 (5th Cir. 1984); *Birkenstock*, 823 F.2d at 1026; *US v. Callery*, 774 F.2d 1456 (9th Cir. 1985); *US v. Ferguson*, 615 F. Supp. 8 (S.D. Ind. 1985), *aff'd*, 793 F.2d 828 (7th Cir. 1986); *US v. Marks*, 534 F. Supp. 663 (W.D. Mo. 1982); *US v. Powell*, 955 F.2d 1206 (9th Cir. 1991).

[15] *See US v. Edelson*, 604 F.2d 232 (3d Cir. 1979). Good motive is irrelevant if taxpayer knows of duty to file income tax returns and deliberately fails to file. *US v. Quimby*, 636 F.2d 86 (5th Cir. 1981); *US v. Weninger*, 624 F.2d 163 (10th Cir. 1980). Offenses of willful failure to file income tax returns occurred when the taxpayer willfully failed to pay taxes at a time or times required by law, despite the taxpayer's contention that offenses did not occur until his commodity futures trading company was closed because he expected, up until that time, to pay back his investors and did not consider any investor funds to be taxable income. *See US v. Morrison*, 938 F.2d 168 (10th Cir. 1991).

[16] *See US v. Bishop*, 412 US 346 (1973) (citing *US v. Murdock*, 290 US 389 (1933)).

[17] *See US v. Pomponio*, 429 US 10 (1976).

[18] *See US v. Sato*, 814 F.2d 449 (7th Cir. 1987).

[19] *See Quimby*, 636 F.2d at 86.

[20] *See Weninger*, 624 F.2d at 163.

[21] *See* CCA 200603026.

[22] *See Bradford*, 796 F.2d at 303; *also see* CCA 200603026.

[23] *See Stone*, 56 T.C. at 213.

[24] *See Birkenstock*, 823 F.2d at 1026.

[25] *See US v. Jerde*, 841 F.2d 818 (8th Cir. 1988).

[26] *See US v. Aitken*, 755 F.2d 188 (1st Cir. 1985).

[27] *See US v. Phillips*, 775 F.2d 262 (10th Cir. 1985).

[28] *See US v. Lachmann*, 469 F.2d 1043 (1st Cir. 1972).

[29] *See US v. Santiago*, 83 F.3d 20, 23 (1st Cir. 1996).

[30] CCA 200603026 (January 20, 2006).

[31] *See US v. Boulerice*, 325 F.3d 75, 80 (1st Cir. 2003).

[32] *See Spies*, 317 US at 492.

[33] *See US v. Stierhoff*, 549 F.3d 19, 26 (1st Cir. 2008) (citing *US v. Daniel*, 956 F.2d 540, 543 (6th Cir. 1992)).

[34] *See US v. Threadgill*, 3:11-CR-86 (E.D. Tenn. Apr. 29, 2013) *aff'd*, 13-5897, (6th Cir. July 11, 2014).

[35] *See US v. Conley*, 826 F.2d 551, 557 (7th Cir. 1987); *US v. Tipton*, 56 F.3d 1009, 1013-14 (9th Cir. 1995).

[36] *See* Treas. Reg. § 301.7609-2(b)(3).

[37] *See US v. Bohrer*, 807 F.2d 159, 162 (10th Cir. 1986).

[38] *See Thompson*, 338 F.2d at 997.

[39] *See Cheek*, 498 US at 192.

[40] *See Vitiello*, 363 F.2d at 240; *Birkenstock*, 823 F.2d at 1026; *Thompson*, 338 F.2d at 997; *Klein*, 438 F. Supp. at 485.

[41] *See US v. Mohney*, 949 F.2d 1397, 1407 (6th Cir. 1991) ("A taxpayer's signature on a return … is *prima facie* evidence that the signer knows the contents of the return."); *US v. Harper*, 458 F.2d 891, 894 (7th

Cir. 1971); *US v. Drape*, 668 F.2d 22, 26 (1st Cir. 1982) (holding that a defendant's signature is sufficient to establish knowledge).

[42] CCA 200603026.

[43] *See Cheek*, 498 US at 192.

[44] *Id*, at 203.

[45] *See US v. Stadtmauer*, No. 09-1575 (3d Cir. 2010); *US v. Anthony*, 545 F.3d 60 (1st Cir. 2008); *US v. Dean*, 487 F.3d 840 (11th Cir. 2007); *US v. Bussey*, 942 F.2d 1241 (8th Cir. 1991).

[46] *See US v. Williams*, 489 F. App'x 655, 658 (4th Cir. 2012).

[47] The 8th Cir. covers the states of Arkansas, Iowa, Minnesota, Missouri, North Dakota, Nebraska and South Dakota.

[48] *See US v. Bengimina*, 499 F.2d 117 (8th Cir. 1974).

[49] *See US v. Commerford*, 64 F.2d 28 (2d Cir. 1933); *US v. Bressler*, 772 F.2d 287 (7th Cir. 1985).

[50] *See US v. McMullen*, 755 F.2d 65 (6th Cir. 1984); *Moore*, 627 F.2d at 830; *US v. Gleason*, 726 F.2d 385 (8th Cir. 1984); *US v. Romero*, 640 F.2d 1014 (9th Cir. 1981); *US v. House*, 617 F. Supp. 232 (W.D. Mich. 1985), *aff'd*, 787 F.2d 593 (6th Cir. 1986).

[51] *See US v. Kraeger*, 711 F.2d 6 (2d Cir. 1983); *Bressler*, 772 F.2d at 287; *Moore*, 627 F.2d at 830; *US v. Hairston*, 819 F.2d 971 (10th Cir. 1987); *US v. Erickson*, 676 F.2d 408 (10th Cir. 1982); *House*, 787 F.2d at 593.

[52] *See US v. Jones*, 628 F.2d 402 (5th Cir. 1980).

[53] *See US v. Pry*, 625 F.2d 689 (5th Cir. 1980); *US v. Pinner*, 561 F.2d 1203 (5th Cir. 1977); *US v. Mann*, 884 F.2d 532 (10th Cir. 1989).

[54] *See Powell*, 955 F.2d at 1206.

[55] *See Burton*, 737 F.2d at 439; *US v. Wilson*, 550 F.2d 259 (5th Cir. 1977); *Green*, 757 F.2d at 116; *Callery*, 774 F.2d at 1456; *US v. Buras*, 633 F.2d 1356 (9th Cir. 1980); *Hairston*, 819 F.2d at 971.

[56] *See Cheek*, 498 US at 192; *US v. Mueller*, 778 F.2d 539 (9th Cir. 1985).

[57] *See Crowhurst*, 629 F.2d at 1297.

[58] *See Hairston*, 819 F.2d at 971.

[59] *See Buras*, 633 F.2d at 1356.

[60] *See Kraeger*, 711 F.2d at 6; *Romero*, 640 F.2d at 1014; *Moore*, 627 F.2d at 830.

[61] *See Gleason*, 726 F.2d at 385.

[62] *See US v. Kahl*, 583 F.2d 1351 (5th Cir. 1978).

[63] *See US v. Massey*, 419 F.3d 1008 (9th Cir. 2005).

[64] *See Cheek*, 498 US at 192; *Aitken*, 755 F.2d at 188; *US v. Wells*, 790 F.2d 73 (10th Cir. 1986); *US v. Edgington*, 727 F. Supp. 1083 (E.D. Tex. 1989), *aff'd*, 897 F.2d 527 (5th Cir. 1990).

[65] *See Mann*, 884 F.2d at 532.

[66] *See Powell*, 955 F.2d at 1206.

[67] *See Pinner*, 561 F.2d at 1203.

[68] *See Edgington*, 897 F.2d at 527.

[69] *See US v. McCorkle*, 511 F.2d 482 (7th Cir. 1975); *US v. Murdock*, 290 US 389 (1933).

[70] *See US v. Collins*, 457 F.2d 781 (6th Cir. 1972).

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Inversions And Earnings Stripping: Much Ado About Nothing?

by Stuart Gray, Senior Editor, Global Tax Weekly

Despite the harsh public criticism heaped on US companies choosing to shift their tax residence abroad via a corporate inversion, a steady stream of multinationals are still prepared to go through with these transactions, as the headlines attest. Does this show that the benefits for corporations in terms of reduced operating costs, especially in the area of corporate tax, are outweighing the risk of a public relations roasting in the mainstream media? And can the US Government and Congress really do anything to plug the inversion stream?

Why Invert?

So what is a corporate inversion, and what do companies achieve from these arrangements? Put simply, corporate inversions have been used by US companies when bidding for (generally smaller) foreign companies, as a means of moving away from the high American 35 percent corporate tax rate. A company that merges with an offshore counterpart can move its headquarters abroad (even though management and operations may remain in the US), and take advantage of the lower corporate tax rates in foreign jurisdictions as long as at least 20 percent of its shares are held by the foreign company's shareholders after the merger. These days, an inverted company's tax base is likely to be located in a jurisdiction with a relatively low corporate tax rate and a double tax treaty with the US, such as Ireland, Switzerland and, latterly, the UK.

There has been a clear spike in corporate inversions in recent years. According to Congressional Research Service data published in mid-2014, just under 50 inversions took place in the previous ten years,[1] which is more than in the previous two decades combined.[2] And as the news reports indicate, inversions would seem to be all the rage at moment.

It is difficult to say what has caused the inversion floodgates to open, given that the US corporate tax code has not significantly worsened during this period. However, perhaps it is no coincidence

that while the US corporate tax rate has remained static for several years, many of America's competitors have been cutting corporate tax fairly aggressively, or improving their tax regimes overall. The UK, for example, will have a corporate tax rate of 18 percent by 2020, down from 28 percent in 2010. Canada has cut corporate tax by a similar magnitude, and both countries have become home to inverted US multinationals recently.

Another reason cited for the increase in inversions is that corporations have seen how successful such a strategy can be in reducing costs, and therefore something of a herd mentality appears to have developed.

However, Senate Finance Committee Chairman Orrin Hatch believes that there is a clear cycle when it comes to inversions, "and it usually happens in four steps," he observed during remarks at a conference hosted by the Brookings Institution on January 23, 2015.

According to Hatch, "Step 1: A few high profile-inversions take place and people become concerned about the possibility of a trend. Step 2: The Government takes steps to shut these inversions down. Step 3: Inversions are temporarily halted, but the underlying economic conditions remain the same. Step 4: Companies find ways around whatever solution the government puts in place and another wave of inversions takes place." [3]

Earnings Stripping

But is there more to the corporate inversion phenomenon than merely a corporation's desire to lower its overall tax rate? Perhaps. After all, thanks to a cornucopia of deductions and credits in the US tax code, few firms actually pay the full 35 percent statutory corporate tax rate at home anyway. According to a 2014 paper by Thomas Hungerford, then of the Economic Policy Institute, the average effective rate of corporate tax is about 27 percent, not much above today's global average statutory corporate tax rate.[4]

Some commentators note that by shifting their tax base to a low-tax jurisdiction, US multinationals can further reduce their exposure to US corporate tax by engaging in "earnings stripping." This occurs when US subsidiaries borrow from their new foreign parent company (or another foreign affiliate) to increase their interest payments, reduce their taxable income, and lower their US taxes. The foreign lender then typically pays a reduced or zero tax rate on the interest income under an existing tax treaty.

Section 163(j) of the Internal Revenue Code disallows a deduction for excess interest paid by a US entity to a related party (where the interest payment is exempt from US withholding tax) when the entity's debt-to-equity ratio exceeds 1.5 and net interest expense exceeds 50 percent of its adjusted taxable income.[5] However, lawmakers, including Congressman Sander Levin, the senior Democrat on the House of Representatives Ways and Means Committee, and Chris Van Hollen (D – Maryland), the Senate Budget Committee's ranking Democrat, have pointed out that foreign-controlled groups have been able to work around the limitations on interest deductions, because the present law requires a group to exceed both thresholds before excess interest deductions are disallowed. So long as the borrowing entity is able to maintain a debt-to-equity ratio of less than 1.5, it is not limited by the 50 percent net interest expense threshold.

"After inverting, many of these companies engage in earnings stripping, a practice that enables them to significantly lower the amount of taxes they pay in the US, while taking advantage of our country's resources and strong workforce," Levin commented after introducing a bill to curb earnings stripping earlier this month (see below). Concurring, Van Hollen added that: "Putting an end to earnings stripping by inverted companies is an important step toward ensuring these companies aren't reaping taxpayer-funded benefits while failing to pay their fair share." [6]

It is these and other attendant and ongoing tax benefits that are the real driving force behind this sort of merger activity, claims Hungerford. "Despite what you hear in the media, inversions have never been primarily about fleeing high statutory corporate tax rates," he observed.[7]

"Most of the firms seeking to invert have a large stash of tax-deferred earnings sitting offshore. These earnings are subject to the US corporate income tax (with a credit for foreign taxes paid), but only when they are repatriated to the US parent as dividends," Hungerford's paper adds. "By inverting and then using a variety of schemes, the firms can have access to these earnings virtually free of US taxes. This is undoubtedly the primary motivation to invert."

Some academics say that there is clear evidence for increased levels of earnings stripping after a US company has inverted. For instance, a 2004 study of a sample of 12 corporate inversions by Jim A. Seida of the Mendoza College of Business, University of Notre Dame, and William F. Wempe of the M.J. Neeley School of Business, Texas Christian University, found that the mean foreign income share for inverted companies jumped considerably from 49 percent pre-inversion to 81 percent post-inversion. The study also found that the inversion sample's mean foreign pre-tax profit margin percentage nearly doubled in post-inversion periods, from 11 to 21 percent,

while the mean US pre-tax profit margin percentage declined from a pre-inversion 9 percent to a post-inversion –6.5 percent.

"Since both profit margin changes are significantly different from analogous control sample changes, it is unlikely that the inversion sample's changes are entirely due to economic factors (*i.e.*, changes in 'real' profitability)," the authors wrote. "When viewed in combination, these pre- to post-inversion period changes are consistent with inverted firms stripping US earnings to foreign jurisdictions." [8]

However, other studies suggest that the extent to which earnings stripping takes place following a corporate inversion is difficult to quantify. Indeed, a 2007 report by the Treasury itself was fairly circumspect on the issue, observing that "it is not possible to quantify with precision the extent of earnings stripping by foreign-controlled domestic corporations generally."

"The overall effect of income stripping on US employment is unclear," the report stated, adding: "The theoretical effect of income shifting on cross-border investment in the US is ambiguous, because income shifting may either increase or decrease investment in a high-tax country."

However, the Treasury report did admit that there is "strong evidence" of the practice by formerly US-based multinationals. "The data gathered with respect to inverted corporations … strongly suggest that these corporations are stripping substantially all of their income out of the United States, primarily through interest payments. Consequently, these corporations' US operations are very unprofitable."

The report continued: "The earnings-stripping study did not find conclusive evidence of earnings stripping from FCDCs [foreign-controlled domestic corporations] that had not inverted. However, there is strong evidence that ICs [inverted companies] have engaged in earnings stripping." [9]

Another issue that needs considering is that earnings stripping is not the sole domain of inverted corporations formerly based in the US. Foreign firms with US income can take advantage of this practice too, as can US-headquartered companies. Indeed, according to a 2014 tax policy blog on the matter by Scott A. Hodge, President of the Tax Foundation, IRS data shows that the US subsidiaries of foreign-based companies "have smaller interest deductions relative to their total receipts than do American-headquartered firms and, interestingly, they have higher effective tax rates than their domestic counterparts."

After analyzing the amount of interest deducted by foreign-owned and domestic corporations relative to their total receipts between 1994 and 2011, Hodge concluded that the ratio of interest payments to receipts for both firm types correlates closely to the peaks and troughs of the business cycle. "Indeed, the debt load of all corporations peaked during the boom years of 2000 and 2007 and collapsed during the recessionary periods of 2001 to 2003 and 2008 to 2009," he observed.

Nevertheless, the Foundation noted a distinct divergence in the interest burdens of domestic and foreign-owned companies after 2000. "What is noticeable is that the interest burdens of both foreign-owned and domestic companies were almost identical during the 1990s, then began to diverge after 2000 when the interest burden of domestic companies began to rise above that for foreign-owned companies," Hodge said. "Indeed, since 2000, the interest burden of domestic companies has averaged 6.5 percent of total receipts compared to a burden of 5.5 percent of total receipts for foreign-owned firms. In 2011, domestic firms had an interest burden of 4.1 percent of receipts, compared to foreign-owned firms which had an interest burden of 2.9 percent of receipts." [10]

Also up for debate is the wider impact of corporate inversions on the corporate tax base of the United States. In 2014, the Joint Committee on Taxation (JCT) estimated that around USD-20bn in corporate tax revenue would be lost over the following ten years as a result of corporate inversions. However, as the Committee for a Responsible Federal Budget has pointed out, while this might be a large sum of money in itself, it is but a drop in the ocean when measured against the overall federal tax take – just 0.5 percent of the USD4.5 trillion expected to be paid in corporate tax during the same period in fact.[11] While the JCT has since revised this estimate upwards, to USD33.5bn, the new figure still represents a small fraction of the expected corporate tax take over the same period.

Anti-Inversion And Earnings Stripping Bills

Nevertheless, action is still demanded at all levels to prevent US corporations from inverting. Why? Because this debate tends to provoke strong emotions. Some, like congressmen Levin and Van Hollen, argue that it is "unpatriotic" for US corporations to shift their tax residence to low- and no-tax jurisdictions, while the company continues to take advantage of the benefits of operating in the United States – benefits funded in large part by taxpayers. And some say it is simply unfair for large corporations to effectively shift part of their tax burden onto individuals and small businesses. Consequently, several, mainly Democrat-sponsored bills are pending that would seek to discourage corporations from undergoing inversions and partaking in earnings stripping.

In January 2015, the Stop Corporate Inversions Act was reintroduced in the House of Representatives and the Senate, which would restrict corporate inversions by putting the minimum foreign shareholding cap at 50 percent. The legislation would treat a combined foreign corporation as a domestic corporation under two circumstances: if the shareholders of the former US corporation own more than 50 percent of the new combined foreign corporation; or if the affiliated group that includes the combined foreign corporation is managed and controlled in the US and engages in significant domestic business activities in the US. The legislation would apply to inversions completed after May 8, 2014.[12]

Spurred by the recent reports of Pfizer Inc.'s proposed merger with and Dublin-based Allergan Plc, Rep. Mark Pocan (D – Wisconsin) introduced two bills into the House in November 2015 to discourage corporate inversions. Pocan's Putting America First Corporate Tax Act would cancel the provision in the current US tax code that allows corporations to defer paying corporate tax on foreign profits until that money is repatriated back to the US. It would require corporations to pay US taxes on all future domestic and foreign active income beginning from December 31, 2015.[13]

The intention of Pocan's second bill, the Corporate Fair Share Tax Act, is to curb the aforementioned practice of "earnings stripping" whereby domestic subsidiaries borrow from their new foreign parent company to increase their interest payments and reduce their US taxable income. Specifically, the legislation limits the US tax deductions a corporation may claim to a level at which the US entity's share of interest on debt is proportionate to the US entity's share of a financial reporting group's earnings.[14]

Levin and Van Hollen's bill represents the latest legislative attempt to reduce the number of corporate inversions by limiting the use of earnings stripping. Introduced in the House on February 23, the Stop Corporate Earnings Stripping Act would limit the foreign-controlled inverted group's ability to reduce its US tax by repealing the debt-to-equity ratio threshold; reducing the permitted net interest expense threshold to no more than 25 percent of the entity's adjusted taxable income; eliminating the excess limitation carryforward; and permitting disallowed interest expense to be carried forward only for five years (rather than indefinitely under present law). The foregoing limitations would apply if historical shareholders of the US entity own more than 50 percent (but less than 80 percent) of the new foreign parent entity following an inversion.[15]

The legislation would apply to any US corporation that has inverted (or will invert) on or after May 8, 2014, and is intended to work in tandem with the Stop Corporate Inversions Act.

Tax Reform: The Long-Term Inversion Fix?

While there is agreement on both sides of the congressional aisle that long-overdue corporate tax reform that would cut the corporate tax rate could effectively remove the incentive for US corporations to invert, Democrats and Republicans remain split on the details of such reforms, and their overall aims. Essentially the two political parties are at odds over whether large corporations ultimately should be made to pay more or less tax, and whether short-term legislative measures are needed until tax reform can be achieved.

It is an argument that boils down to whether the basis of US taxation should be worldwide, as it is at present, or territorial, like many of America's competitors. Democrats are mostly in favor of a worldwide system of taxation for corporations, and in fact some Democratic corporate tax proposals would actually strengthen the worldwide system rather than weaken it. Republicans on the other hand argue that it is America's unique worldwide system of taxation that is the problem, and that corporate tax avoidance would be reduced by reforms making the US tax code far more competitive, of which a switch to a more territorial system of tax is a fundamental part.

Senator Hatch, who as the chairman of the Senate tax-writing committee has much influence over new tax legislation, has long been skeptical of short-term measures to deter the tax inversion techniques. "I don't think it will surprise anyone here to learn that I do not believe the best solution to the inversion problem is government regulations," he said in his remarks at the Brooking Institution conference. "And, the solution is not building a wall around US companies to keep them from moving offshore." He sees inversions as "symptomatic of a dysfunctional tax code that is taxing at too high a rate and is attempting to tax worldwide income. … The best solution to this problem is, in my view, tax reform. Tax reform, if it's done right, will help grow our economy, create jobs in the US, and discourage businesses from leaving our shores and invite businesses to set up and locate here." [16]

But it is not only Republicans who hold this view. Responding to the news of the merger agreement between Pfizer Inc. and Allergan plc on November 23, 2015, Finance Committee Ranking Member Ron Wyden (D – Oregon) suggested that short-term legislative or regulatory fixes were not the answer. "[W]hen Congress or the Administration make changes in one area to solve an immediate crisis like inversions, there's always a risk of unforeseen effects popping up somewhere else," he opined. "Bipartisan, comprehensive tax reform will require serious political will and independence from members of Congress, but this inversion crisis shows that it needs to happen soon." [17]

Representative bodies of US businesses are certainly clear on the path Congress should take: tax reform. Indeed, the US Chamber of Commerce said last November that anti-inversion legislation "misses the point."

"Until Congress enacts comprehensive tax reform with a lower rate and a more competitive international tax system, corporations will continue to seek a level playing field," wrote the organization's Senior Tax Policy Counsel, Anne Warhola, in an article for the Chamber's website. She added that, "at 35 percent, the United States has the highest corporate tax rate in the developed world. Further, the US is one of the few countries that cling to a worldwide tax system. By contrast, our major trading partners all have lower tax rates and employ territorial tax systems that generally tax only the income earned within their own borders and not the earnings generated abroad."

"By creating a foreign parent in an inversion, an American company is afforded the same territorial tax system its foreign competitors enjoy – and eliminates the anti-competitive second layer of US tax on its foreign earnings," she added.[18]

Regulatory Action

Absent a legislative solution, the Government is attempting to thwart corporate inversions through the not altogether ideal method of regulatory actions, which usually do not require the consent of Congress. The latest proposed regulatory change was announced by the Treasury in November 2015 in Notice 2015-79, which contained a number of actions intended to make it more difficult for US companies to undertake a corporate inversion.

Specifically, the actions being taken make it more difficult for US companies to undertake a corporate inversion by (1) limiting the ability of US companies to combine with foreign entities using a new foreign parent located in a "third country," (2) limiting the ability of US companies to inflate the new foreign parent corporation's size and therefore avoid the 80 percent ownership rule, and (3) requiring the new foreign parent to be a tax resident of the country where the foreign parent is created or organized. The third requirement will need to be met in order to satisfy the current rule that at least 25 percent of the new entity's business activity is in the home country of the new foreign parent.

The Notice also reduces the tax benefits of inversions by limiting the ability of an inverted company to transfer its foreign operations to the new foreign parent after an inversion transaction without paying current US tax. These actions apply to inversions completed on or after September 22, 2014.[19]

Unsurprisingly, the new regulations elicited a mixed response from Congress, with some lawmakers welcoming the Treasury's move, and others reiterating the need for a more permanent fix. However, perhaps the most interesting comment was uttered by House Ways and Means Chairman Kevin Brady (R – Texas), who suggested the new regulations would make things worse: "Mandating new rules to raise taxes on American businesses simply make them more attractive takeover targets for foreign corporations. Treasury is contradicting its own call to pursue a more competitive tax code in favor of shortsighted counterproductive triage which will only lock American businesses in an even more uncompetitive tax system." [20]

Conclusion

It remains to be seen whether regulatory changes will staunch the flow of inversions in the months ahead. However, it seems improbable that such temporary fixes will influence the behavior of US corporations in a meaningful way. As US Treasury Secretary Jack Lew had to admit following the news of the merger agreement between Pfizer and Allergan, "[T[here is only so much Treasury can do to prevent these tax-avoidance transactions." [21]

As Lew also pointed out, effective change is only going to come about after the tax code undergoes fundamental reform, but the most optimistic prediction is that this will not happen until after the 2016 presidential election, possibly in 2017. Until then, the inversion issue, and all its associated controversies, is likely to run and run.

Endnotes

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2 http://www.cnbc.com/2016/01/31/greener-pastures-lower-taxes-how-to-solve-the-inversion-controversy.html

3 http://www.finance.senate.gov/newsroom/chairman/release/?id=a1a1f3ba-b83a-4d55-af84-2de6541b6c89

4 http://www.epi.org/publication/policy-responses-corporate-inversions/

5 https://www.law.cornell.edu/uscode/text/26/163

6 http://democrats.waysandmeans.house.gov/press-release/levin-van-hollen-introduce-earnings-stripping-legislation-limit-tax-inversions

7 http://www.epi.org/press/legislation-needed-immediately-stop-corporate/

8 http://www.ntanet.org/NTJ/57/4/ntj-v57n04p805-28-effective-tax-rate-changes.pdf

[9] https://www.treasury.gov/resource-center/tax-policy/Documents/ajca2007.pdf

[10] http://taxfoundation.org/blog/irs-data-contradicts-kleinbard-s-warnings-earnings-stripping-inversions

[11] http://crfb.org/blogs/inversions-reduce-revenue-extenders-cost-more

[12] https://www.congress.gov/bill/114th-congress/senate-bill/198/text

[13] https://www.congress.gov/bill/114th-congress/house-bill/3935/text

[14] https://www.congress.gov/bill/114th-congress/house-bill/3934/text

[15] https://www.congress.gov/bill/114th-congress/house-bill/4581/text

[16] *Supra*, note 3.

[17] http://www.finance.senate.gov/ranking-members-news/wyden-statement-on-pfizer-allergan-merger

[18] https://www.uschamber.com/above-the-fold/tax-inversion-talk-misses-point-real-reforms-needed-keep-us-companies-competitive

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[20] http://waysandmeans.house.gov/chairman-brady-calls-for-tax-reform-to-tackle-inversions/

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Topical News Briefing: Interesting India

by the Global Tax Weekly Editorial Team

Perhaps it's because it is a leap year that Indian Finance Minister Arun Jaitley felt disposed to announce some interesting tax measures in his Union Budget speech on February 29 (reported in this week's issue of *Global Tax Weekly*). However, while the budget contained some eyebrow-raising proposals, whether they will turn out to be effective or not is another matter.

Business taxpayers and foreign investors will have welcomed Jaitley's reconfirmation of his proposed 5 percent cut in corporate tax, and further clarity on the schedule for the hacking back of India's complex web of deductions and special tax schemes, which will pay for the tax cut. A proposal to repeal 13 "cesses," or tax surcharges, that produce less than INR500m (USD7.3m) in revenue per year also seems like a step in the right direction. And a major part of Jaitley's speech was given over to one of his top priorities: improving relations between taxpayers and the tax authorities, and the reduction of pending and new tax litigation.

Yet, when one delves deeper into the text of Jaitley's budget speech, it is hard to escape the feeling that he is sabotaging his own mission to simplify India's notoriously difficult tax system. For instance, taxpayers have long complained about vague and uncertain tax policymaking. But the transcript of Jaitley's address leaves us none the wiser about the timing of the corporate tax cut, which the Finance Minister said, rather unhelpfully, would take place "over a period." Over what period, and when, we're not sure.

Jaitley could also be undermining simplification efforts by replacing old deductions and special tax regimes with new ones. For example, he proposed that, to help employment growth, manufacturing companies should be given the option to be taxed at a reduced rate of 25 percent, plus surcharges. He also proposed to create an additional corporate tax band of 29 percent for small companies.

And, of course, it is hard to ignore the Finance Minister's most eye-catching measure, a new patent box regime with a 10 percent rate of tax on income from the worldwide exploitation of patents developed and registered in India. This is perhaps one of the boldest new tax measures

announced in recent Indian budgets, and is a marker of the Government's attempt to modernize India by encouraging the knowledge economy, which is growing rapidly in other parts of the world. However, it could merely serve to further complicate the Indian tax regime, and possibly put India on a collision course with the OECD, which is by no means keen on possibly "harmful" special tax regimes for intellectual property income.

The rate of take up of India's patent box is likely to depend heavily on the small print of the scheme, and how it is enforced. We have seen in the recent past how ambiguity in the country's tax framework has led to a huge backlog of tax litigation – by Jaitley's own admission, there are 300,000 cases pending with the 1st Appellate Authority alone, with INR5.5 trillion worth of tax in dispute – which has led to some increasingly disillusioned foreign investors questioning whether it is worth their while investing in India. So foreign companies in particular would be forgiven for approaching the patent box with a degree of caution should it be introduced.

What's more, Jaitley's new idea for reducing pending tax litigation also raises important questions. Under the proposed Dispute Resolution Scheme, taxpayers will be able to settle their cases by paying disputed tax and interest up to the date of assessment, without penalty, although larger cases may still be subject to a penalty of 25 percent. But presumably most taxpayers believe they are innocent of any wrongdoing, and many might resent having to pay up just to get out of a tax dispute, even if this turns out to be a smaller amount than would otherwise have been the case. It is doubtful therefore whether this will lead to a meaningful reduction in litigation.

Even more baffling perhaps is the fact that a lot of these pending disputes relate to the internationally controversial retrospective amendment to the Income-tax Act introduced by the former government, and heavily criticized by the current administration. Perhaps it would be far simpler for the existing Government to reverse this measure, thereby simultaneously reducing litigation and boosting the confidence of foreign investors?

As we have come to expect from India though, where tax is concerned, few things are ever simple.

Applying the Subpart F Services Rules to Disregarded And Regarded Entity Structures

by Lowell D. Yoder

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Disregarded Entity Structures

US multinationals commonly use disregarded entity structures under a foreign holding company to conduct services operations outside the United States for unrelated customers. These structures can minimize Subpart F services income taxable currently in the United States, but under certain circumstances can result in a significant increase in such income.

Income of a foreign subsidiary of a US corporation from performing services outside the United States generally is not subject to current-basis US taxation.[1] Subpart F, however, provides a limited exception, requiring a US shareholder to include in its gross income, the foreign subsidiary's services income to the extent it falls within the definition of foreign base company services income.[2]

Code Sec. 954(e) defines foreign base company services income as income derived by a controlled foreign corporation (CFC) from performing, outside its country of organization, services for or on behalf of a related person. Services income that does not satisfy both the locational and the related-person requirements is not foreign base company services income.[3]

Therefore, services performed for persons who are unrelated to the CFC generally do not give rise to foreign base company services income. This is the case even if the services are performed outside the CFC's country of organization.

Consider the following structure under a US corporation that provides services to customers in multiple countries. The US company owns a Dutch holding company ("Dutch HoldCo"), which owns the intangible property used in providing services outside the United States. Dutch HoldCo

in turn owns a Singapore entity and an Irish entity that function as regional centers of excellence. Dutch HoldCo also owns an Indian entity and a Chinese entity, each with hundreds of employees who assist in performing services for customers. In addition, Dutch HoldCo owns a number of entities organized in countries in Europe and Asia that market the services to local customers and perform some services in the countries where the customers are located. Dutch HoldCo is a CFC for US tax purposes, and all other foreign entities are electively disregarded under Dutch HoldCo.

IrishCo and SingaporeCo function as principals, providing oversight and performing certain valuable services, assuming risks and coordinating the provision of services by various related and unrelated providers. Either the principals or the companies in the countries where customers are located enter into services contracts with local customers. The principals earn the residual profits and pay a royalty to Dutch HoldCo for the use of the intangible property. The other entities earn a cost plus return.

For purposes of applying the Subpart F rules, Dutch HoldCo is the only CFC. The separate existence of all other entities is ignored, and all transactions between the entities under Dutch HoldCo are ignored for US tax purposes.[4] Accordingly, Dutch HoldCo is considered as earning service fees from performing the services for the unrelated customers. Under the general rules of Code Sec. 954(e), the services income would not be foreign base company services income because the services are not performed for related persons.[5]

With a global services arrangement, it is important that a US related person (or any other related, regarded entity) not enter the services contract and then subcontract the foreign services to Dutch HoldCo (or to one of its disregarded entities). Under those circumstances, Dutch HoldCo would be considered as performing the services for a related person, and its income would be Subpart F income to the extent attributable to services performed outside the Netherlands (which would be most of the services in our example). Rather, Dutch HoldCo (or one of its disregarded entities) should directly contract with the customer for the foreign services, and if necessary, subcontract to the US related person (or other related, regarded entities) to assist with the performance of certain services.[6]

Dutch HoldCo will be deemed to perform services on behalf of a related person if assistance provided by US related persons is substantial in the performance of the services for an unrelated customer. A CFC is considered as receiving substantial assistance if the costs of the assistance received directly or indirectly from related US persons equal or exceed 80 percent of the total costs to the

CFC of providing the services.[7] There is some uncertainty concerning whether payments for intangibles are taken into account in this determination.[8] Also, it is not clear whether costs for assistance that is not directly assisting in providing the contracted-for services are counted (*e.g.*, marketing costs). This test often should not be burdensome, although for certain high-margin businesses uncertainties surrounding the costs of intangibles and indirect costs might present risks.

A performance guarantee by a CFC's US parent (or another related person) would also cause Dutch HoldCo to be treated as deriving income from performing services on behalf of a related person if any related person performs any of the guaranteed services or performs significant related services.[9] This rule can be problematic where customers request the US parent to guarantee the services because it is likely that some related person will assist with providing the services.[10]

A disregarded entity structure can be effective to minimize Subpart F services income by eliminating transactions between related disregarded entities. If a deemed related person rule applies, however, most of the income would be Subpart F services income. Where there is a meaningful risk of a disregarded entity structure being treated as performing services on behalf of a related person, consideration should be given to using a regarded CFC structure, which would avoid Subpart F services income to the extent each CFC performs its services in its country of organization.

Regarded Entity Structures

Code Sec. 954(e) defines foreign base company services income as income derived by a CFC from performing, outside its country of organization, services for or on behalf of a related person. Income from performing services for a related person is not foreign base company services income to the extent attributable to services performed in the CFC's country of organization. While the section above discusses conducting services operations in a disregarded entity structure under a foreign holding company to minimize Subpart F income. This section discusses the use of regarded entity structures (*i.e.*, separate CFCs earning services income). Such structures may be necessary to minimize Subpart F income if substantial services are performed (or deemed performed) for related persons.[11]

The regulations state that the place where services are performed is to be determined based upon the facts and circumstances of each case. As a general rule, services will be considered performed where the persons performing the services for the CFC that derives the services income are physically located when they perform their duties in the execution of the underlying service activity

resulting in such income. The location of a customer or the place where the services are used is not relevant.[12]

The regulations provide that services income generally is apportioned on the basis of employee time spent within and without a CFC's country of organization. In apportioning income, relative weight is given to the value of the various functions performed by persons in fulfillment of the service contract. For example, clerical work will ordinarily be assigned little value, while services performed by technical, highly skilled and managerial personnel will be assigned greater values in relation to the type of function performed by each individual.[13]

Let's consider the following structure. A US corporation provides services to customers in multiple countries. The US company owns a Dutch holding company ("Dutch HoldCo"), which owns the intangible property used in providing services outside the United States. Dutch HoldCo in turn owns a Singapore entity and an Irish entity that function as regional centers of excellence. Dutch HoldCo also owns an Indian entity and a Chinese entity, each with hundreds of employees who assist in performing services for customers. In addition, Dutch HoldCo owns a number of entities organized in countries in Europe and Asia that market services to local customers and perform some services in the countries where the customers are located. All entities are CFCs.

IrishCo and SingaporeCo function as principals, providing management and oversight and performing certain valuable services, assuming risks and coordinating the provision of services by various related and unrelated subcontractors. Either the principals or the companies in the countries where customers are located enter into services contracts with local customers. The principals earn the residual profits and pay a royalty to Dutch HoldCo for the use of intangible property. The other entities earn a cost plus return.

For the sake of discussion, assume that all CFCs earning services income perform the services for, or on behalf of, a related person. A determination must be made concerning whether and to what extent a CFC derives income from performing the services outside its country of organization, which would be Subpart F income. In order to make and substantiate this determination, a CFC will need to collect and maintain information about employee travel and services performed while employees are outside the CFC's country of organization.[14]

The language of the Code and regulations indicates that only activities in the performance of the contracted-for services resulting in the services income are taken into account in determining

a CFC's income apportioned to activities outside its country of organization. For example, it would seem appropriate that advertising and marketing activities generally should not be considered for this purpose.

A CFC may hire related and unrelated companies to assist with providing services to a customer. The regulations do not explicitly address whether activities of other entities should be counted in determining where services are performed. The most straightforward reading of the regulations is that only the activities of the CFC's own employees are taken into account in determining whether any income is derived from services performed outside the CFC's country of organization. For example, the only rule for apportioning income to activities performed within and without a CFC's country refers to the activities of employees.[15]

A CFC may use machines in providing services to customers. Neither the Code nor the regulations address whether the location of equipment used in providing services should be taken into account in determining the location of the performance of services. The regulations only discuss where persons are located when they perform the services. A reference to machines would add substantial complexity; for example, it often would be difficult to obtain information concerning the location of a server used to facilitate the provision of services. The better approach is to not take into account the location of machines.

In sum, if substantial services are actually or deemed performed for related persons, a regarded entity structure is preferable over a disregarded entity structure under a foreign holding company. Income derived by each CFC would not be Subpart F services income to the extent the CFC performs any related person services in its country of organization. For purposes of determining where services are performed, the better approach is to take into account only contract-fulfilling activities of a CFC's own employees (and not activities of subcontractors or the location of machines).

ENDNOTES

1. Code Secs. 881 and 882.
2. Code Sec. 954(a)(3); Reg. §1.954-1(a)(2)(iii).
3. Code Sec. 954(e); Reg. §1.954-4(a).
4. Reg. §301.7701-2(a), -2(c)(2)(i).
5. The foreign base company services income rules do not contain a foreign branch rule like the one in Code Sec. 954(d) that applies to sales income.

[6] The regulations also treat a CFC as performing services on behalf of a related person where the related person enters a services contract with a customer and assigns it to the CFC. Reg. §1.954-4(b)(1)(i).

[7] Notice 2007-13, IRB 2007-5, 410. *See* Lowell D. Yoder, *Notice 2007-13: The New Substantial Assistance Rule 36,* Tax Mgmt. Int'l J., May 2007, at 230.

[8] If such costs are counted, issues arise concerning whether lump-sum payments are taken into account in the year paid or over a period of years, and how such costs are allocated among various services arrangements. There is support in the regulations for not counting cost-sharing payments. *See* Reg. §1.482-7(j)(3) (cost-sharing payments "generally will be considered the payor's costs of developing intangibles ...").

[9] Reg. §1.954-4(b)(2)(i).

[10] A CFC also will be considered as performing services on behalf of a related person if the CFC performs the services for an unrelated person with respect to property sold by a related person, and the performance of such services constitutes a condition or material term of the sale (*e.g.*, maintenance or warranty services). Reg. §1.954-4(b)(1)(iii).

[11] As discussed in the prior article, a CFC that performs services for unrelated customers may be deemed to perform the services for related persons if a related person guarantees performance of the services, assigns the contract to the CFC, or furnishes substantial assistance in the performance of the services. Reg. §1.954-4(b).

[12] Reg. §1.954-4(c).

[13] *Id. See* Reg. §1.861-4(b) for similar rules for determining the source of services income on the basis of services performed within or outside the United States.

[14] The royalty received by Dutch HoldCo from SingaporeCo and IrishCo should not be foreign personal holding company income to the extent the royalty expense is not allocated to Subpart F income of the payor. Code Sec. 954(c)(6)l Notice 2007-9, 2007-1 CB 401.

[15] *See also* Reg. §§1.954-3(a)(4) and 1.954-3(b)(1)(ii)(c)(3)(iv) (updated foreign base company sales income rules provide that only activities of the employees of a CFC are taken into account in determining the location of the CFC's manufacturing activity).

Countries Adopting BEPS Proposals, OECD Tells G20

The base erosion and profit shifting (BEPS) Action Plan is already becoming a reality, with countries already having implemented some of the BEPS proposals, the OECD has told the G20 member nations.

In a report submitted to the G20 Finance Ministers and Central Bank Governors on February 26–27, 2016, the OECD's Secretary General, Angel Gurría, said that a number of countries have already adopted legislative changes to implement BEPS measures, including proposals contained under BEPS Action 2 (on neutralizing the effects the hybrid mismatch arrangements) and BEPS Action 13 (on transfer pricing documentation and country-by-country (CbC) reporting).

The report states: "Many countries have already enacted legislation or regulations to require companies to file their [CbC] reports in accordance with the requirements included in the BEPS Action 13 Report, and discussions are being held at the technical level to ensure a smooth implementation. Further 32 countries have already signed the Multilateral Competent Authorities Agreement, which provides the legal mechanisms to exchange CbC reports automatically. Additional signings will happen later in 2016, and will mean that information concerning 2016 accounts of MNEs should be filed in 2017, and then exchanged as planned in 2017 or 2018."

The report states that countries are updating their transfer pricing rules to introduce the changes proposed in BEPS Actions 8–10.

In addition, the report points to another meeting held on February 15–16 to discuss the multilateral instrument to amend tax treaties, with 95 countries participating.

The report also notes agreement on an inclusive framework for BEPS implementation. Under the framework, "BEPS Associate" status in the OECD's Committee on Fiscal Affairs will be extended to all interested and committed countries and jurisdictions, bringing them on an equal footing with the G20 and OECD countries in setting anti-BEPS standards and monitoring implementation. Monitoring will in particular focus on harmful tax practices, tax treaty abuse, the CbC reporting requirement, and cross-border tax dispute resolution. The first meeting of this expanded group is proposed to be held at the end of June 2016.

Italy Consults On Branch Exemption Regime

The Italian Revenue Agency is inviting comments on the draft implementing regulations for a new, optional foreign branch exemption regime.

The new regime will allow a resident company to opt for the profits and losses of its foreign permanent establishments (PEs) to be exempt from Italian tax treatment. It will have to be applied at the same time to all of a company's foreign PEs.

If an Italian company exercises the option, as opposed to the normal worldwide taxation and foreign credit rules, the decision will be irrevocable. A company will be required to make the decision when it creates its first PE, or, with regard to existing PEs, by the end of the second fiscal year following the entry into force of the new provisions (*i.e.*, by the end of 2017).

Within the regulations, a specific method of computation is provided for the recapture of net operating losses made by a branch in the five years before the exemption election. Profits attributable to the same branch in succeeding tax years will be subject to Italian corporate taxes, until the previous losses have been completely absorbed.

Once an election is made, the Italian company has to separately disclose the income of its foreign PEs in its tax returns. A PE's profitability is to be determined with reference to the provisions of the double taxation agreement (DTA) between Italy and the country in which the PE is situated. In the absence of a DTA, the attribution of profits or losses should be made as if the PE is a separate entity, the regulations say.

Under the new rules, an Italian company will be able to request a tax ruling from the Revenue Agency on the existence of a foreign PE.

All comments on the draft regulations should be forwarded to the Revenue Agency by March 31, 2016.

No 'Sweetheart' Tax Rulings Granted By EFTA States

The European Free Trade Association Surveillance Authority (EFTA Surv) has announced that it has found no evidence of state aid infringements in the tax ruling practices of three member states.

In a brief statement published on February 24, EFTA Surv revealed that its investigations into the tax ruling practices of the tax authorities of Iceland, Liechtenstein, and Norway are not contrary to the state aid rules of the European Economic Area (EEA) Agreement.

The investigations were conducted in parallel with the European Commission's ongoing investigations into the tax ruling practices of EU member states.

The EEA includes the 28 member states of the EU, plus three of the four members of EFTA: Iceland, Liechtenstein, and Norway (the fourth member being Switzerland).

The state aid rules in the EEA Agreement are broadly equivalent to the state aid rules in the

EC Treaty, which apply across the EU. Like the EC Treaty, the EEA Agreement contains a general prohibition on state aid in order to prevent distortions of competition and negative effects on intra-EEA trade.

UK's Public Accounts Committee Reports On Google Settlement

On February 24, 2016, the Public Accounts Committee (PAC) published a report setting out its findings on Google's agreement with the UK tax authority, HM Revenue & Customs (HMRC), to pay GBP130m (USD187m) in back taxes as part of a settlement covering the period since 2005.

The report was released following a February 11 evidence session in which the PAC heard senior officials from Google and HMRC.

The report concludes that "in the absence of full transparency over the details of this settlement and how it was reached, we cannot judge whether it is fair to taxpayers. The sum paid by Google seems disproportionately small when compared with the size of Google's business in the UK, reinforcing our concerns that the rules governing where corporation tax is paid by multinational companies do not produce a fair outcome. Google's stated desire for greater tax simplicity and transparency is at odds with the complex operational structure it has created which appears to be directed at minimizing its tax liabilities. Google admits that this structure will not change as a result of this settlement."

The report calls on HMRC to "lead the way in pressing for changes in international tax rules to prevent aggressive avoidance by multinational companies." It says HMRC should consult widely on the case for changing rules that protect corporate taxpayer confidentiality "to make the tax affairs of multinational companies open to public scrutiny." The PAC also expects HMRC to "monitor the outcome of other tax authorities' investigations into Google, and re-open its settlement with Google if relevant new evidence becomes available."

On February 9, 2016, HMRC stated in a new fact sheet that the UK has taxed all of Google's profits chargeable to tax in the country.

Meg Hillier, Chair of the PAC, pointed out that "HMRC itself has identified that the current penalty regime treats corporations differently from individual taxpayers. That is why we are calling on HMRC to take a lead in reforming international tax rules. The bigger prize after a costly six-year investigation would have been to develop a new approach to the activities of internet-based companies. We are not convinced HMRC has achieved this and it must work with overseas tax authorities if we are to see lasting and effective change in the international tax system."

Meanwhile, commenting on the findings, Adam Marshall, Executive Director of Policy and External Affairs at the British Chambers of Commerce, said: "We have been calling for coordinated international action to stop a small number of companies conducting aggressive avoidance schemes for some time, so we are pleased that the [PAC] has also urged HMRC to lead the way in pressing for changes. The Government should continue its push for agreement on BEPS, and work with dozens of other countries and the OECD to get things right."

"Reforms such as this are crucial to restoring trust in the tax system, at a time when many business people are angry at what they see as two different sets of rules: one for them, and one for the biggest corporations."

Hong Kong Budget Provides Fiscal Stimulus

In his 2016/17 Annual Budget, announced on February 24, Hong Kong's Financial Secretary, John Tsang, proposed relief measures totaling HKD38.8bn (USD5bn) that are intended to help business and individual taxpayers weather weaker global economic prospects and to stimulate local consumption.

With forecasted gross domestic product (GDP) growth in real terms only reaching between 1 and 2 percent in 2016, lower than last year's growth, Tsang has included in his Budget both individual income tax and profits tax relief measures that are expected to have a stimulus effect of boosting GDP by 1.1 percent.

To ease the burden on enterprises, there will be a further 75 percent reduction in profits tax for 2015/16, with an unchanged ceiling of HKD20,000. This should benefit some 130,000 taxpayers and will reduce government revenue by HKD1.9bn.

Business registration fees will also be waived for 2016/17 to benefit 1.3m business operators. This proposal will reduce government revenue by HKD2.5bn.

To ease the tax burden on individual taxpayers, Tsang proposed a further 75 percent reduction in salaries tax and tax under personal assessment for 2015/16, with an unchanged ceiling of HKD20,000. This should benefit 1.96m individuals and will reduce government revenue by HKD17bn.

In addition to a waiving of property rates at a revenue cost of HKD11bn, he also announced an increase in individual tax allowances at a total cost of some HKD3.8bn. For example, the basic allowance and single parent allowance will rise from HKD120,000 to HKD132,000, and the married person's allowance from HKD240,000 to HKD264,000.

In his only other new tax proposal in the Budget, Tsang proposed an expansion in the scope of the tax deduction for capital expenditure incurred for the purchase of intellectual property (IP) rights. The existing five categories will rise to eight – adding the layout-design of integrated circuits, plant varieties, and performance rights. These changes, he said, were necessary "to encourage enterprises to engage in the development of related business, and to promote Hong Kong as an IP trading hub in the region."

Overall, Tsang emphasized Hong Kong's sound fiscal position, despite a growth in budgeted welfare expenditure in the next financial year that will fuel a 14 percent hike in total

government expenditure to HKD490bn, as against forecasted total government revenue of some HKD500bn.

Although there is expected to be a consequent fall in the budget surplus to around HKD11bn next year (after a surplus of HKD30bn in 2015/16), it is still estimated that fiscal reserves will be HKD870bn by the end of March 2017, representing 35.2 percent of GDP or equivalent to 21 months of government expenditure.

"On the whole, the financial position of government over the medium term [also] remains sound," Tsang added. Fiscal reserves are projected at HKD835bn by end-March 2021, representing 28.3 percent of GDP or equivalent to 18 months of government expenditure.

India To Introduce Patent Box Regime, CbC Reporting

Indian Finance Minister Arun Jaitley has unveiled the nation's 2016 Budget, which includes a slew of measures, including significant announcements in the area of international tax law.

The Budget, delivered on February 29, includes a new country-by-country (CbC) reporting requirement for large groups. It will apply to those with consolidated annual revenues over the EUR750m-equivalent in Indian rupees, INR55.8bn. A CbC report will be required from the parent entity of an international group, if it is resident in India; every constituent entity in India of an international group with an overseas parent; and in some situations, by an India entity belonging to an international group.

The CbC report would be based on the template provided in the OECD's Report on Action 13 of the base erosion and profit shifting Action Plan. The new reporting requirement, if approved, would take effect on April 1, 2017.

Next, the Budget proposes to introduce a "patent box" regime in the country with effect from April 1, 2017. A new section 115BF is proposed to be included in the Income-tax Act (ITA) to provide for a concessionary 10 percent rate for royalties from certain intellectual property developed and registered in India.

The Minister explained: "In order to encourage indigenous research and development (R&D) activities and to make India a global R&D hub, the Government has decided to put in place a concessional taxation regime for income from patents. The aim of the concessional taxation regime is to provide an additional incentive for companies to retain and commercialize existing patents and to develop new innovative patented products. This will encourage companies to locate the high-value jobs associated with the development, manufacture, and exploitation of patents in India."

To stimulate housing activity, any distribution made out of the income of a special purpose vehicle to a Real Estate Investment Trust or an Infrastructure Investment Trust having specified shareholding will not be subjected to Dividend Distribution Tax (DDT).

The Budget includes a number of tax benefits with a view to establishing an international financial services center (IFSC) in India. In particular, companies located in the IFSC will be exempt from DDT; and minimum alternate tax will be charged at a 9 percent rate. In addition, foreign currency transactions involving the sale of commodity derivatives that take place through a recognized establishment in the IFSC will be exempt from commodity transactions tax.

Jaitley's Budget also contains measures aimed at reducing litigation and providing tax certainty, particularly in the contentious area of retrospective taxation. For instance, the Budget proposes a new, one-time Dispute Resolution Scheme to allow taxpayers to settle ongoing disputes arising from the retrospective amendment to the ITA. This would allow the taxpayer to simply pay tax arrears (excluding interest and penalty), provided that they withdraw their cases filed in any court or tribunal.

Finally, the Budget defers the application of the place of effective management (POEM) test until April 1, 2017. Through the 2015 Finance Act, India amended section 6 of the ITA to introduce POEM as the test to determine the place of residence of companies in the country. The change was intended to take effect from April 1, 2016, but further amendments to the legislation are planned.

South African Budget Hikes Taxes

South Africa's 2016/17 Budget, announced by Minister of Finance Pravin Gordhan on February 24, attempts to stabilize the country's fiscal position without, as had been feared, a repeat of last year's personal income tax rate hikes, although other taxes will increase by almost ZAR50bn (USD3.25bn) over three years.

Although an additional ZAR18.1bn of tax revenue will be raised in 2016/17, with an additional ZAR15bn in each of the subsequent two years, this will be largely found from an increase in the general fuel levy by ZAR0.30/liter, with effect from April 6, 2016; a ZAR5.5bn limit on fiscal drag relief, mainly focused on lower- and middle-income earners; and a rise of about 7 percent in excise taxes on alcohol and tobacco products.

There will also be adjustments to the effective capital gains tax rate, which will rise from 13.7 percent to 16.4 percent for individuals, and from 18.6 percent to 22.4 percent for companies. Transfer duty on property sales above ZAR10m will also be raised from 11 percent to 13 percent from March 1, 2016.

In addition, the Government proposes to implement a tire levy with effect from October 1 this year, and to introduce a sugar tax on April 1, 2017, to help reduce excessive sugar intake in South Africa.

A consolidated revenue target of ZAR1.3 trillion, representing 30.2 per cent of gross domestic product (GDP), has been set for 2016/17. Personal income tax is expected to bring in 37.5 percent of government revenue, corporate tax 16.9 percent, value-added tax 25.6 percent, and fuel levies 5.5 percent.

As a result of the increase in tax revenue, and a cut in the public expenditure ceiling by ZAR25bn over the next three years, South Africa's budget deficit is forecast to fall from 3.2 percent of GDP in 2016/17 to 2.8 percent in 2017/18, and then to 2.4 percent in the following year. Public debt stock as percentage of GDP should stabilize at 46.2 percent in 2017/18.

A section of Gordhan's Budget Speech was also allocated to tax compliance matters. He confirmed that the Government "will continue to act aggressively against the evasion of tax through transfer pricing abuses, misuse of tax treaties and illegal money flows, … [and] further measures will be taken to address such revenue losses, including the inappropriate use of hybrid debt instruments."

He said that "time is now running out for taxpayers who still have undisclosed assets abroad." With the 2017 deadline for the international exchange of tax information through the OECD's Common Reporting Standard in mind, he announced that additional relief will be offered to non-compliant taxpayers through a special voluntary disclosure program for a period of six months from October 1 this year to March 31, 2017.

US Democrat Bill Takes Further Aim At Inversions

On February 23, US House of Representatives Ways and Means Committee Ranking Member Sander Levin (D – Michigan) and Budget Committee Ranking Member Chris Van Hollen (D – Maryland) introduced legislation aimed at reducing the number of corporate tax inversions by limiting the use of "earnings stripping."

Tax inversion techniques are being used by some US multinationals to move their tax residences abroad – away from the high 35 percent US headline federal corporate tax rate – even if management and operations remain in the US.

The intention of Levin and Van Hollen's bill is to curb the practice of earnings stripping, under which US subsidiaries borrow from their new foreign parent company (or another foreign affiliate) to increase their interest payments, reduce their taxable income, and lower their US taxes. The foreign lender then typically pays a reduced or zero tax rate on the interest income under an existing tax treaty.

The present law disallows a deduction for excess interest paid by a US entity to a related party (where the interest payment is exempt from US withholding tax) when the entity's debt-to-equity ratio exceeds 1.5 and net interest expense exceeds 50 percent of its adjusted taxable income.

Disallowed interest expense may be carried forward indefinitely for deduction in a subsequent year, and the entity's excess limitation for a tax year (*i.e.*, the amount by which 50 percent of adjusted taxable income exceeds net interest expense) may be carried forward to three subsequent tax years.

However, the lawmakers pointed out that foreign-controlled groups have been able to work around the limitations on interest deductions, because the present law requires a group to exceed both thresholds before excess interest deductions are disallowed. So long as the borrowing entity is able to maintain a debt-to-equity ratio of less than 1.5, it is not limited by the 50 percent net interest expense threshold.

"After inverting, many of these companies engage in earnings stripping, a practice that enables them to significantly lower the amount of taxes they pay in the US, while taking advantage of our country's resources and strong workforce," said Levin, while Van Hollen added that "putting an end to earnings stripping by inverted companies is an important step toward ensuring these companies aren't reaping taxpayer-funded benefits while failing to pay their fair share."

Their new bill, the Stop Corporate Earnings Stripping Act, would apply to any US corporation that has inverted (or will invert) on or after May 8, 2014. It would limit the foreign-controlled inverted group's ability to reduce its US tax by repealing the debt-to-equity ratio threshold; reducing the permitted net interest expense threshold to no more than 25 percent of the entity's adjusted taxable income; eliminating the excess limitation carryforward; and permitting disallowed interest expense to be carried forward only for five years (rather than indefinitely under present law).

The foregoing limitations would apply if historical shareholders of the US entity own more than 50 percent (but less than 80 percent) of the new foreign parent entity following an inversion.

The proposed bill is meant to work in tandem with the Stop Corporate Inversions Act, which was reintroduced by Democrat lawmakers last year and would also apply to any inversion on or after May 8, 2014. The bill would change the current law, under which a company that merges with an offshore counterpart can move its residence abroad so long as at least 20 percent of its shares are held by the foreign company's shareholders after the merger. It would restrict corporate inversions by putting the minimum foreign shareholding cap at 50 percent.

New Research Looks At US Patent Box Cost

The American Action Forum, a US policy institute, has released research on the cost of introducing a patent box regime in the US.

The research says that a patent box covering all patents and featuring a 10 percent rate would cost USD236bn, while a narrower incentive, covering just new patents, could cost as little as USD5bn, if coupled with comprehensive tax reform.

The hypothetical US "patent box" policy examined in the paper is broadly modeled on the system adopted in the UK, and includes features such as a reduced tax rate on qualified income from patents (either 15 or 10 percent); only C-corporations would be eligible for the reduced tax rate; the patent box regime would be limited to commercial activities conducted in the US; and the patented products would result from domestic research and development.

Gordon Gray, Director of Fiscal Policy, said: "Many of the US's major trading partners have enacted 'patent box' tax regimes, spurring consideration of a similar policy here. In the current tax environment, a 'patent box' could also retain the outflow of research intensive investment that might otherwise flee US shores."

"Designing a 'patent box' policy in the US would require the determination of several

key features of an innovation box design, all of which would affect the implications the 'patent box' would have on innovation and related-investment. Beyond these key design issues, and perhaps most consequentially, is the issue of cost."

Hilton Worldwide Confirms REIT Spin-Off Intention

Hilton Worldwide has confirmed that it plans to proceed with the spin-off of the bulk of its real estate business into a publicly traded US real estate investment trust (REIT), following the receipt of a private letter ruling from the Internal Revenue Service (IRS).

It said that the private letter ruling was obtained from the IRS with regard to "certain issues relevant to the qualification of the spin-off as tax-free." The transaction will be effected through a distribution of the new REIT's stock to existing Hilton Worldwide shareholders.

The company said that the newly formed REIT "will include approximately 70 properties and 35,000 rooms, forming one of the largest and most geographically diversified publicly traded lodging REITs. The REIT will have a high quality portfolio of luxury and upper upscale assets, located across high-barrier-to-entry urban and convention markets, top resort destinations, select international regions and strategic airport locations."

The intention is to file appropriate registration statements with the Securities and Exchange Commission during Q2 2016, and to complete the spin-off by the end of the year.

Provisions in the Protecting Americans from Tax Hikes Act passed by Congress at the end of last year were intended to make it difficult for corporations to avoid US capital gains and corporate income tax by spinning off their tangible assets into independent REITs.

US REITs do not pay corporate tax as long as at least 75 percent of their total assets are real estate assets and/or cash; at least 75 percent of gross income comes from real estate-related sources; and at least 90 percent of their taxable income is distributed to shareholders annually in the form of dividends.

Spinning-off assets into a REIT is capital gains tax-free for both the distributing corporation and its shareholders, and enables the company to limit its exposure to the US's 35 percent corporate tax rate. Subsequently, as in Hilton's spin-off, a REIT would normally lease the property back to the distributing corporation, to be utilized in the latter's operations.

The Protecting Americans from Tax Hikes Act included new measures providing that a spin-off involving a REIT would qualify as tax-free only if, immediately after the

distribution, both the distributing and controlled corporation were REITs. In addition, neither a distributing nor a controlled corporation would be permitted to elect to be treated as a REIT for ten years following a tax-free spin-off transaction.

To protect companies that were already in the spin-off process, the provisions only apply to distributions on or after December 7, 2015. They do not apply, as in Hilton's case, to any spin-off that had been described in a ruling request submitted to the IRS on or before that date.

2015 IRS Data Breach Was More Widespread

The Treasury Inspector General for Tax Administration (TIGTA) has identified additional suspicious attempts to access taxpayer accounts, during its investigation into the data breach discovered last year involving the US Internal Revenue Service's (IRS's) "Get Transcript" application.

In May 2015, the IRS found that unauthorized third parties had obtained sufficient information from a source outside the tax agency to clear a multi-step authentication process to view previous tax returns and other tax records relating to hundreds of thousands of taxpayers, via the Get Transcript system.

When the IRS first identified the problem, it determined that these third parties with taxpayer-specific sensitive data from non-IRS sources cleared the Get Transcript verification process in about 114,000 of their attempts. A review in August then revealed an additional 220,000 attempts where individual taxpayers had been affected.

The further review by TIGTA has now found potential access to approximately 390,000 additional taxpayer accounts during the period from January 2014 through May 2015. In addition, 295,000 taxpayer transcripts were targeted, but access was not successful.

The IRS is moving immediately to notify and help protect these taxpayers, including through free identity theft protection services as well as Identity Protection PINs. Mailings to these taxpayers started on February 29. The Get Transcript application has been offline since the incident was discovered.

"The IRS is committed to protecting taxpayers on multiple fronts against tax-related identity theft, and these mailings are part of that effort," IRS Commissioner John Koskinen said. "We appreciate the work of TIGTA to identify these additional taxpayers whose accounts may have been accessed. We are moving quickly to help these taxpayers."

IRS Undertook Fewer Audits In FY2015

There was a fall in the number of individual tax returns the Internal Revenue Service (IRS) was able to examine in the 2015 fiscal year, as well as a drop in revenue from enforcement actions, according to statistics from the agency.

The Enforcement and Service Results tables provide details about the number of IRS audits completed, collection activities, and taxpayer service. FY2015 began on October 1, 2014, and ended on September 30, 2015.

The agency's audit rate of individual returns fell in FY2015 to the lowest level for more than a decade, with only 0.84 percent of the 146.8m returns being examined. FY2012 was the last year that the audit rate reached over 1 percent.

The IRS has blamed budget cuts for the reduction in audit numbers and the decrease in enforcement revenue to USD54.2bn, from USD57.15bn in the previous year. It noted that its funding dropped by USD900m between FY2010 and FY2015, and that the headcount in its enforcement departments fell from 22,700 to 17,200 over the same period.

The IRS has concentrated its reduced audit resources in FY2015 on higher-income individuals. Out of the 416,000 returns compiled by individuals with annual earnings of USD1m or more, 9.55 percent were examined, although even that was markedly less than the almost 12.5 percent audited in FY2011.

European Commission Holds Debate On Future Of VAT

The European Commission has held an "orientation debate" on future reform of the EU's value-added tax (VAT) framework.

The debate, held on February 24, set the scene for the upcoming publication of the Commission's Action Plan on VAT.

The Commission said the EU VAT system "needs reform," in particular to close the VAT gap – the difference between theoretical VAT revenue receipts and the VAT actually collected by member states. This was estimated at EUR180bn (USD198bn) in 2013, resulting from avoidance, evasion, fraud, and the provision by member states of reduced VAT rates and concessions.

The Commission also noted that the current VAT system remains "fragmented and creates significant administrative burdens," especially for small businesses and online companies. The system, it said, "needs to be modernized to reflect innovative business models and technological progress in today's digital environment."

Earlier in February, the Commission issued a Roadmap ahead of the future release, in March 2016, of its Action Plan for a simple, efficient, and fraud-proof definitive system of VAT tailored to the single market.

According to the Roadmap, the Action Plan is intended to take stock of the achievements made since the 2011 Communication on the Future of VAT and set out the direction for future work. The new rules will center around the destination principle, which provides that supplies should be taxed where they are effectively used and/or enjoyed.

It will also feature some actions to address the complexity of the VAT system, in particular for SMEs; to broaden the scope of the VAT base by examining the appropriate VAT treatment of the activities of public bodies, taking into account the evolution in member states towards privatization and deregulation of activities traditionally reserved for the public sector; and to enhance the fight against VAT fraud, notably through cooperation between tax administrations.

Abu Dhabi Hosts Arab Fiscal Forum

The first Arab Fiscal Forum was held on February 22–24, 2016, by the Arab Monetary Fund and the International Monetary Fund (IMF).

The forum discusses fiscal policy and economic growth challenges in the Arab region, given

the sharp decline in oil prices and the slowdown in world economic growth.

The purpose of the forum was to share experiences on how to expand non-oil tax revenue and increase the fairness of tax regimes. Gulf Cooperation Council countries have long been discussing introducing a low-rate, harmonized value-added tax (VAT) to boost revenues. Despite more than a decade of talks, the United Arab Emirates is the only jurisdiction to officially confirm its participation in the project, recently announcing that it will implement its own VAT regime from 2018.

Christine Lagarde, the Managing Director of the IMF, attended, along with senior officials and experts from regional and international financial organizations, finance ministries, and central bank representatives from Arab countries.

Following the forum, Lagarde said: "I stressed the importance of revenue mobilization and global cooperation on taxation, including by expanding scope and coverage of measures to address tax base erosion and profit shifting by international corporations."

EU, EFTA Talk Free Trade

Lawmakers from the European Free Trade Association (EFTA) met with the EU Trade Commissioner to discuss the two blocs' priorities in the area of free trade.

EFTA's Parliamentary Committee met with Commissioner Cecilia Malmström on February 23, in one of a series of meetings with high-level personnel. They discussed the Commission's new trade strategy, "Trade for All," which aims to make the EU's trade policy more effective at delivering new economic opportunities, and more transparent in terms of opening up negotiations to more public scrutiny. Instead of focusing on the EU's interest, trade policies will uphold the EU's values.

Participants discussed the ongoing negotiations on the Transatlantic Trade and Investment Partnership and investor-to-state dispute settlement, which has been high on the political agenda in Europe recently.

The Committee also met with several Members of the European Parliament, including Viviane Reding MEP, the rapporteur for the Trade in Services Agreement. Meeting with Christofer Fjellner MEP, members of the Committee learned more about how the European Parliament engages in international trade agreement negotiations.

The EFTA states are Iceland, Liechtenstein, Norway, and Switzerland.

EU, Canada Agree On New Approach To Investment In FTA

Canada and the EU have agreed to the inclusion in their proposed free trade agreement of a new approach to investment protection and dispute resolution.

Negotiations toward an EU–Canada Comprehensive Economic and Trade Agreement (CETA) were concluded in 2014. The text of the agreement included clearly defined standards of protection, and provided for full transparency of proceedings, a ban on forum shopping, governmental control of interpretation of the agreement, a strict code of conduct, early dismissal of unfounded claims, and a "loser pays" principle.

Following the required legal review of the text, which has yet to enter into force, the main elements of the EU's new approach on investment have been incorporated into the CETA. This approach was previously outlined in the investment protection package presented by the EU to the US in September as part of their ongoing Transatlantic Trade and Investment Partnership negotiations. In that case, the EU proposed the creation of an international Investment Court System, with an appeal

mechanism based on clearly defined rules, qualified judges, and transparent proceedings.

According to the European Commission, the revisions to the CETA represent a clear break from the old Investor to State Dispute Settlement (ISDS) approach. Trade Commissioner Cecilia Malmström said: "CETA takes on board our new approach on investment and its dispute settlement. By making the system work like an international court, these changes will ensure that citizens can trust it to deliver fair and objective judgments."

The revised CETA establishes a permanent tribunal of 15 members that will be competent to hear claims for violation of the investment protection standards established in the agreement. It also provides for the creation, upon the agreement's entry into force, of an appellate tribunal.

Canada and the EU have committed to join efforts with other trading partners to set up a permanent multilateral investment court with a standing appellate mechanism. The revised text recognizes that a court of this nature will come to replace the bilateral mechanism established in the CETA.

In a joint statement with Canada's International Trade Minister, Chrystia Freeland, Malmström said: "With these modifications, Canada and the EU will strengthen the provisions on governments' right to regulate; move to a permanent, transparent, and institutionalized dispute settlement tribunal; revise the process for the selection of tribunal members, who will adjudicate investor claims; set out more detailed commitments on ethics for all tribunal members; and agree to an appeal system."

Canada and the European Commission will now complete the translation and review of the text. Malmström and Freeland said they will then "focus on the swift ratification of CETA so that individuals and businesses, both large and small, are able to benefit from the opportunities offered by this gold standard agreement."

"We are confident that CETA will be signed in 2016 and enter into force in 2017," they said.

Once the deal is fully implemented, 99 percent of the EU's tariff lines will be duty free, including 100 percent of non-agricultural tariff lines and 95 percent of agricultural tariff lines. Nearly 92 percent of EU agricultural and food products will be exported to Canada duty free.

Italian PIT Cut Could Be Brought Forward To 2017

Deputy Minister for Economic Affairs Enrico Morando, in an interview with online news website Affaritaliani.it, has indicated that a cut in personal income tax (PIT) rates, programmed for 2018, could be brought forward to 2017, depending on the state of Italy's finances.

He said that the corporate income tax (CIT) rate reduction from 27.5 percent to 24 percent will take place, as planned, from January 1, 2017, as it was found impossible to bring forward the decrease to this year. He reiterated that the Government is currently not considering any plan to alter the timing or the amount of that reduction.

However, he disclosed that the Government does intend to reconsider the timing of the PIT rates cut. "I would not exclude the possibility that, if things go right, the tax measures intended for 2018 could be brought forward to 2017," he said, "but, at the moment, it is too early to say."

Such a proposal will depend, for example, on keeping within the increased budget deficit flexibility to be agreed later this year with the European Commission, and on the results obtained from efforts to reduce government spending.

"The undertaking we have given is to reduce the tax burden on employees and companies," Morando added. "We will decide whether to act on PIT rates, or to reduce social security contributions instead, when we are in a position to make a concrete proposal."

Finally, he said the Government is seeking to provide greater certainty on future value-added tax rates. A safeguard measure, which Italy has in recent times extended annually, obliges Italy to hike the present 10 and 22 percent VAT rates by 3 percent from the next year if the Government fails to reach its fiscal deficit goals. The Government hopes to provide a reassurance in its next Budget that this will not be triggered in the next three years, he said.

Younger Australians Lose From Tax Concessions System

Australians under the age of 30 receive only 6.4 percent of the combined tax concessions on superannuation, the capital gains tax (CGT) discount, and negative gearing, according to Ben Oquist, Executive Director of The Australia Institute (TAI).

The TAI commissioned the National Centre for Social and Economic Modelling (NATSEM) to model how the savings of federal tax concessions are distributed by age group. Together, superannuation tax concessions, negative gearing,

and the CGT discount cost the budget almost AUD37.4bn (USD27bn) a year. The Treasury expects these reliefs to cost more than AUD-50bn a year in the next term of parliament.

The TAI found that these reliefs overwhelmingly favor wealthier Australians, with 73 percent of the CGT discount flowing to the top 10 percent of income earners. In addition, they disproportionately aid older taxpayers, with the under 30s receiving only 1 percent and 1.7 percent of the total CGT discount and negative gearing benefit, respectively.

According to the TAI, Australians aged over 50 receive 53 percent of these three combined tax concessions, while Australians aged over 60 receive 56 percent of the benefit of the CGT discount. In dollar terms, in 2014/15, these concessions were worth AUD20bn to the over-50s, and only AUD2.4bn to the under-30s.

Oquist said: "It is a double hit for the young with many being priced out of the home-owning market in part because of the very tax concessions they are missing out on. It is often argued that tackling tax concessions is politically difficult, but the reality is that the bulk of the concessions flow to a relatively small proportion of the population and this is particularly true when it comes to younger Australians."

"Australia has a revenue problem. A 2016 Budget that fails to recognize this will lack fiscal responsibility, economic credibility, and fairness – particularly for younger Australians. Tackling tax concessions will not just be good for the budget and fairness, we now know it will help level the playing field for the young who get little from our distorted tax system."

Study Highlights Higher UK Taxes On Hiring

UK businesses now pay employment taxes of 11.5 percent on top of employees' annual salaries, according to a new report covering 29 countries from UHY Hacker Young.

This burden, from social security contributions and other employment-related levies, is up from 11.2 percent in 2012.

UHY Hacker Young calculated the value of payments that companies have to make on top of the gross salary they pay to individual employees for 29 countries.

The global study used a US gross annual salary of USD75,000 as the basis for its calculations. The study found that in the UK, in 2015, businesses paid an average of GBP5,460 (USD7,615) per year in employment taxes for an employee earning the equivalent of USD75,000 (representing GBP47,680 for 2015), an increase from GBP5,360 in 2012. During the same period, the equivalent global average fell from GBP8,680 to GBP8,460,

equivalent to 17.7 percent of salary. The European average dropped from 19.8 percent to 19.2 percent.

Roy Maugham, Partner at UHY Hacker Young, warned that the "rise in employment-related taxes in the UK could impact competitiveness and limit much-needed growth."

He said: "The Government's introduction of 'auto-enrolment' pension schemes may also be putting an additional burden on businesses. Add to that other measures like the National Living Wage and employers are seeing cost burdens being heaped on across their workplace. Inevitably, that will hit job creation."

"At a time when the global economy is only gradually returning to health and the recovery is still very fragile, ensuring that revenue-raising policies don't disincentivize job creation and stifle income levels is more vital than ever."

UHY Hacker Young said Brazil has the highest taxes and compulsory insurance costs for employers of any country in the study, at 71.4 percent of a USD75,000 salary. This is almost 50 times higher than Egypt, the country with the lowest employment-related tax burden for employers in the study. The burden on Chinese employers saw the largest increase in 2015, with the tax burden rising from 12.6 percent to 18 percent.

Seychelles Announces Personal Income Tax Reform

Seychelles President James Alix Michel has confirmed that changes will be made to the personal income tax system, designed to make taxation "fairer and more equitable."

In his recent State of the Nation address, Michel foreshadowed reforms designed to reduce the tax burden on low-income earners and make the personal income tax system more progressive.

Under the changes, from July 2016, individuals earning up to SCR8,555.50 (USD553.74) per month will not pay any income tax. Then, from January 2017, the first SCR8,555.50 in earnings will be subject to tax at 0 percent.

Michel also announced in his address that the Ministry of Finance will undertake a review of the tax system to determine how the Government can "maximize its revenue" and reduce tax evasion in certain economic sectors.

The measures form part of the Government's medium-term fiscal framework agreed with the International Monetary Fund (IMF), which is designed to stabilize the Government's finances and reduce public debt.

The medium-term fiscal strategy was first put in place in 2008 following a default in debt payments. The plan includes an IMF-agreed

target to cut Seychelles' debt-to-gross domestic product to below 50 percent by 2018.

The IMF said following the completion of its third review of the Seychelles' Extended Fund Facility (EFF) that good progress is being made by the Government towards reducing the public debt burden, with the 2015 budget surplus expected to be around 4 percent of GDP.

Seychelles has received approximately USD9.1m in monetary assistance from the IMF under the EFF arrangement approved in July 2014.

ARMENIA - SWEDEN

Signature

Armenia and Sweden signed a DTA on February 9, 2016.

COLOMBIA - UNITED ARAB EMIRATES

Signature

Colombia and the United Arab Emirates signed a TIEA on February 9, 2016.

CYPRUS - ETHIOPIA

Ratified

According to a February 1, 2016, update from the Cypriot Ministry of Finance, Cyprus on January 18, 2016, completed its domestic ratification procedures in respect of the DTA with Ethiopia.

EGYPT - INDIA

Negotiations

According to preliminary media reports, Egypt is interested in launching negotiations towards the signing of a DTA with India.

FINLAND - GERMANY

Signature

Finland and Germany signed a DTA on February 19, 2016.

EUROPEAN UNION - MONACO

Initialed

The European Union and Monaco have initialed an automatic information exchange agreement.

GHANA - TURKEY

Negotiations

According to preliminary media reports, Ghana and Turkey completed a third round of DTA negotiations on February 19, 2016.

IRELAND - BOTSWANA

Effective

The DTA between Ireland and Botswana will become effective from January 1, 2017.

IRELAND - VARIOUS

Negotiations

Ireland has completed DTA negotiations with Azerbaijan, Kazahkstan, and Turkmenistan, and has completed discussions to sign a DTA Protocol with Mexico, with the texts to be signed in the near future, according to a new update from Ireland's tax authority.

KAZAKHSTAN - CZECH REPUBLIC

Ratified

According to preliminary media reports, Kazakhstan on February 18, 2016, ratified the DTA with the Czech Republic.

LUXEMBOURG - SENEGAL

Signature

Luxembourg and Senegal signed a DTA on February 10, 2016.

NIGERIA - QATAR

Signature

Nigeria and Qatar signed a DTA On February 28, 2016.

PAKISTAN - CZECH REPUBLIC

Effective

The DTA between Pakistan and the Czech Republic will become effective on July 1, 2016.

SINGAPORE - RWANDA

Into Force

A new DTA between Singapore and Rwanda entered into force on February 15, 2016.

SINGAPORE - THAILAND

Into Force

A DTA Protocol between Singapore and Thailand entered into force on February 15, 2016.

SOUTH AFRICA - QATAR

Ratified

South Africa completed its domestic ratification procedures in respect of the DTA with Qatar on February 11, 2016, publishing the text of the agreement in the Official Gazette.

TAIWAN - ITALY

Signature

Taiwan's Foreign Affairs Ministry on February 15, 2016 announced the signing of a DTA with Italy.

A guide to the next few weeks of international tax gab-fests
(we're just jealous - stuck in the office).

THE AMERICAS

The 5th Offshore Investment Conference Panama 2016

3/9/2016 - 3/10/2016

Offshore Investment

Venue: Hilton Panamá, Avenida Balboa and Aquilino de la Gua, 00000, Panama

Chair: Derek R. Sambrook (Trust Services)

Key speakers: Ramses Owens (Owens & Watson), Michael Olesnicky (KPMG), Joe Field (Withers), Raul Zuniga (Aleman, Cordero, Galindo & Lee), Timothy D. Scrantom (SDI Advisors), among numerous others

http://www.offshoreinvestment.com/pages/index.asp?title=The_5th_Offshore_Investment_Conference_Panama_2016&catID=12383

Hot Issues in International Taxation

3/23/2016 - 3/24/2016

Bloomberg BNA

Venue: Sheraton Raleigh, 421 South Salisbury Street, Raleigh, NC 27601, USA

Key Speakers: TBC

http://www.bna.com/hot-issues-intl-tax/

8th Regional Meeting of IFA Latin America

5/4/2016 - 5/6/2016

IBFD

Venue: JW Marriott Hotel Lima, Malecón de la Reserva 615, Lima, Peru

Key speakers: TBC

http://www.ibfd.org/IBFD-Tax-Portal/Events/8th-Regional-Meeting-IFA-Latin-America

The 7th Annual Private Investment Funds Tax Master Class

5/25/2016 - 5/26/2016

Financial Research Associates

Venue: The Princeton Club of NY, 15 West 43rd St., New York, New York 10036, USA

Key Speakers: TBC

https://www.frallc.com/conference.aspx?ccode=B998

US International Tax Compliance Workshop – San Diego

6/20/2016 - 6/21/2016

Bloomberg BNA

Venue: Marriott San Diego Gaslamp, 660 K Street, San Diego, CA 92101, USA

Key speakers: TBC

http://www.bna.com/compliance_sandiego2016/

International Practice Units: The IRS Approach to Auditing International Tax Issues

6/21/2016 - 6/21/2016

CCH

Venue: Webinar

Chair: Robert J. Misey

http://www.cchgroup.com/media/wk/taa/pdfs/training-and-support/seminar/cch-seminars-calendar-fact-sheet.pdf

Athletes and Entertainers – US International Tax Issues

10/18/2016 - 10/18/2016

CCH

Venue: Webinar

Chair: Robert J. Misey

http://www.cchgroup.com/media/wk/taa/pdfs/training-and-support/seminar/cch-seminars-calendar-fact-sheet.pdf

International Tax Issues In The Manufacturing Industries

11/9/2016 - 11/9/2016

CCH

Venue: Webinar

Chair: Robert J. Misey

http://www.cchgroup.com/media/wk/taa/pdfs/training-and-support/seminar/cch-seminars-calendar-fact-sheet.pdf

Fundamentals of US International Taxation

12/6/2016 - 12/6/2016

CCH

Venue: Webinar

Chair: Robert J. Misey

http://www.cchgroup.com/media/wk/taa/pdfs/training-and-support/seminar/cch-seminars-calendar-fact-sheet.pdf

ASIA PACIFIC

The 7th Offshore Investment Conference Hong Kong 2016

6/15/2016 - 6/16/2016

Offshore Investment

Venue: Conrad Hong Kong, One Pacific Place, 88 Queensway, Admiralty, Hong Kong

Chair: Michael Olesnicky (KPMG)

http://www.offshoreinvestment.com/pages/index.asp?title=The_7th_Offshore_Investment_Conference%2C_Hong_Kong_2016&catID=12842

International Corporate Tax Planning Aspects

7/27/2016 - 7/29/2016

IBFD

Venue: InterContinental Kuala Lumpur, 165 Jalan Ampang, 50450 Kuala Lumpur, Malaysia

Key Speakers: Shee Boon Law (IBFD), Chris Finnerty (Ernst & Young LLP) and Julian Wong (Ernst & Young)

http://www.ibfd.org/Training/International-Corporate-Tax-Planning-Aspects-1

MIDDLE EAST AND AFRICA

International Tax Aspects of Corporate Tax Structures

4/13/2016 - 4/15/2016

IBFD

Venue: Radisson Blu Gautrain Hotel, Sandton Johannesburg, Cnr Rivonia Road and West Street, Postnet Suite 2010, Private Bag X9, Benmore 2010, Johannesburg, South Africa

Key speakers: Shee Boon Law (IBFD), Boyke Baldewsing (IBFD)

http://www.ibfd.org/Training/International-Tax-Aspects-Corporate-Tax-Structures

Treaty Aspects of International Tax Planning

5/22/2016 - 5/24/2016

IBFD

Venue: Hilton Dubai Jumeirah Hotel, Jumeirah Beach Road, Dubai Marina, Dubai

Key speakers: Bart Kosters (IBFD), Ridha Hamzaoui (IBFD)

http://www.ibfd.org/Training/Treaty-Aspects-International-Tax-Planning-1

WESTERN EUROPE

Transcontinental Tax

3/8/2016 - 3/9/2016

Informa

Venue: TBC, London, UK

Key speaker: Mark Davies (Mark Davies & Associates), Justine Markovitz (Withers), Clare Maurice (Maurice Turnor Gardner), Robin Vos (Macfarlanes), Maxim Alekseyev (Alrud), among numerous others

http://www.iiribcfinance.com/event/Transcontinental-Tax-conference

ITPA Luxembourg Workshop – March 2016

3/13/2016 - 3/15/2016

International Tax Planning Association

Venue: Le Royal, 12 Boulevard Royal, 2449 Luxembourg

Chair: Milton Grundy

https://www.itpa.org/?page_id=10132

Offshore Taxation – Preparing for D-Day

3/15/2016 - 3/15/2016

Informa

Venue: TBC, London, UK

Key speakers: Emma Chamberlain (Pump Court Tax Chamber), Richard Cassell (Withers), Simon McKie (McKie & Co), Kristen Konschnik (Withers), among numerous others

http://www.iiribcfinance.com/event/offshore-taxation-conference

International Transfer Pricing Summit 2016

3/15/2016 - 3/16/2016

TP Minds

Venue: Millennium Gloucester Hotel, London Kensington, 4-18 Harringdon Gardens, Kensington, London, SW7 4LH, UK

Key speakers: Brandon de la Houssaye (Walmart), Matthew Frank (General Electric), Andrew Hickman (OECD), Michael Lennard (United Nations), Andrew Propst (Starbucks Coffee), Andrea Bonzano (FIAT), among numerous others

http://www.iiribcfinance.com/event/TP-Minds-International-Transfer-Pricing-Summit

2016 US – Europe Tax Planning Strategies Conference

3/16/2016 - 3/18/2016

American Bar Association

Venue: Hotel Gallia, Piazza Duca D'Aosta 9 20124, Milan, Italy

Key Speakers: TBC

http://shop.americanbar.org/ebus/ABAEventsCalendar/EventDetails.aspx?productId=226274045

International Tax Aspects of Permanent Establishments

4/19/2016 - 4/22/2016

IBFD

Venue: IBFD head office, Rietlandpark 301, 1019 DW Amsterdam, The Netherlands

Key speakers: João Félix Pinto Nogueira (IBFD), Carlos Gutiérrez P. (IBFD), Bart Kosters (IBFD), Tamas Kulcsar (IBFD).

http://www.ibfd.org/Training/International-Tax-Aspects-Permanent-Establishments

STEP Tax, Trusts & Estates Conference Exeter 2016

4/21/2016 - 4/21/2016

STEP Worldwide

Venue: Sandy Park Conference Centre, Sandy Park Way, Exeter, EX2 7NN, UK

Key Speakers: TBC

http://www.step.org/events/step-tax-trusts-estates-conference-exeter-2016

STEP Tax, Trusts & Estates Conference Leeds 2016

4/28/2016 - 4/28/2016

STEP Worldwide

Venue: Hilton, Neville Street, Leeds, LS1 4BX, UK

Key Speakers: TBC

http://www.step.org/events/step-tax-trusts-estates-conference-leeds-2016

STEP Tax, Trusts & Estates Conference London 2016

5/13/2016 - 5/13/2016

STEP Worldwide

Venue: Park Plazza, 200 Westminster Bridge Rd, London, SE1 7UT, UK

Key Speakers: TBC

http://www.step.org/events/step-tax-trusts-estates-conference-london-2016

STEP Tax, Trusts & Estates Conference Birmingham 2016

5/19/2016 - 5/19/2016

STEP Worldwide

Venue: Crowne Plaza Birmingham City, Central Square, Birmingham, B1 1HH, UK

Key Speakers: TBC

http://www.step.org/events/step-tax-trusts-estates-conference-birmingham-2016

Tackling Tax Avoidance in Practice

6/2/2016 - 6/3/2016

European Acadamy

Venue: Ramada Hotel Berlin-Alexanderplatz, Karl-Liebknecht-Strasse 32, D-10178 Berlin, Germany

Key Speakers: TBC

http://www.euroacad.eu/events/event/tackling-tax-avoidance-in-practice.html

Current Issues in International Tax Planning

6/29/2016 - 7/1/2016

IBFD

Venue: IBFD head office, Rietlandpark 301, 1019 DW Amsterdam, The Netherlands

Key Speakers: Tigran Mkrtchyan

http://www.ibfd.org/Training/Current-Issues-International-Tax-Planning-0

Global VAT

7/6/2016 - 7/8/2016

IBFD

Venue: IBFD head office, Rietlandpark 301, 1019 DW Amsterdam, The Netherlands

Key Speakers: Jordi Sol (IBFD), Fabiola Annacondia (IBFD), Christine Peacock (IBFD), Wilbert Nieuwenhuizen (University of Amsterdam), Laura Mattes (IBFD), among numerous others.

http://www.ibfd.org/Training/Global-VAT

The 2nd Planning for the Super-Rich, An Offshore Investment Event London 2016

7/6/2016 - 7/7/2016

Offshore Investment

Venue: Royal Thames Yacht Club, 60 Knightsbridge, London, SW1X 7LF, UK

Chair: Paul Stibbard (Rothschild)

http://www.offshoreinvestment.com/pages/index.asp?title=The_2nd_Planning_for_the_Super-Rich%2C_an_Offshore_Investment_Event_London&catID=12851

International Taxation of Banks and Financial Institutions

8/31/2016 - 9/2/2016

IBFD

Venue: IBFD head office, Rietlandpark 301, 1019 DW Amsterdam, The Netherlands

Key Speakers: Francesco Mantegazza (Pirola Pennuto Zei & Associati), Carola Maggiulli (DG TAXUD), Omar Moerer (Baker & McKenzie), Ingrid Rensema (ABN AMRO), Peter Drijkoningen (BNP Paribas).

http://www.ibfd.org/Training/International-Taxation-Banks-and-Financial-Institutions

THE AMERICAS

United States

A listing of recent key international tax cases.

The United States Tax Court has ruled in favor of the Internal Revenue Service in an appeal brought by Guidant LLC against determined federal income tax deficiencies and an accuracy-related penalty in relation to its transfer pricing affairs.

Guidant's transactions with its foreign affiliates included the licensing of intangibles, the purchase and sale of manufactured property, and services. For many products, the flow involved a "round trip" from the United States to Ireland or to Puerto Rico and back. The deficiencies and the accuracy-related penalty arise from the IRS's transfer pricing adjustments, which increased the income of Guidant Corp. and its US subsidiaries (sometimes collectively, Guidant group) by approximately USD3.5bn. The Guidant group filed consolidated federal income tax returns, and the IRS's adjustments stemmed from transactions that the Guidant group engaged in with the group's affiliated foreign entities.

During an audit, the IRS determined that the group's transfer prices were not at arm's length. The IRS, relying on Section 482, adjusted the reported prices at which items were transferred between the group and its foreign affiliates. It then determined the group's true consolidated taxable income (CTI) by posting all of the adjustments to the separate taxable income of the group's parent (which increased *pro tanto* the group's CTI) and without making any specific adjustment to any subsidiary's separate taxable income (STI). The IRS also did not determine any portion of the adjustments that related solely to tangibles, to intangibles, or to services.

The US Tax Court noted that it is the IRS's practice to compute member-specific adjustments when the taxpayer and the audit team can agree on such adjustments or when the audit team has sufficient information to make them. The IRS's practice is to defer making member-specific

adjustments in other circumstances until a final resolution has been reached because these determinations often involve complex calculations, as well as extensive and collaborative discussions with the taxpayer. Because the parties did not reach a resolution of the Section 482 issue, the IRS did not expend time or resources to determine member-specific adjustments for each Guidant group-controlled taxpayer.

The IRS said that, due to lacking documentation, it did not believe that it could independently make reliable member-specific adjustments on the basis of the information available to it. The IRS considered the complexity of the activities of each member of the Guidant group and its relationship with the activities of other members of the Guidant group and/or of their foreign affiliates. It also concluded that it could not independently make reliable member-specific adjustments for each of the Guidant group members after considering the flow of products among Guidant group entities, involving multiple steps and multiple transfer pricing transactions.

The IRS submitted that each Guidant group member's available financial statements encompassed all activities the entity performed and all products produced and sold, including those not at issue in these cases. The IRS said it was unable to extract the information necessary to ascertain the income reported by each Guidant group member with respect to the products and transactions at issue and to determine the STI of each Guidant group member for the products and transactions at issue.

The Tax Court noted that Guidant did not maintain its financial records in a manner that allowed the IRS to readily track income and expenses by place of manufacture, and that Guidant could not tie the income and expenses in the business unit financial statements to particular product lines, or to products manufactured in the United States, in Ireland, or in Puerto Rico.

Under Section 482, the Commissioner may "distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among * * * [controlled enterprises], if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such [enterprises]."

Considering Guidant's motion for a partial summary judgment, the US Tax Court noted that to counter the adjustments, the petitioner must first establish that the Commissioner abused his discretion by making allocations that are arbitrary, capricious, and unreasonable. Second, a taxpayer must establish that arm's-length consideration for the adjusted transactions is consistent with the

taxpayer's allocations. Guidant sought to argue that the IRS's adjustments were inappropriately made through a combined groupwide analysis on the basis of multiple types of controlled transactions among multiple corporations.

However, in its ruling, the US Tax Court held that neither Section 482 nor the regulations thereunder require that the IRS, when exercising its authority under Section 482, always determine the true separate taxable income of each controlled taxpayer in a consolidated group contemporaneously with the making of the resulting adjustments. Further, it held that Section 482 and the regulations thereunder allow the IRS, when exercising its authority under Section 482, to aggregate one or more related transactions instead of making specific adjustments with respect to each type of transaction.

This judgment was released on February 29, 2016.

http://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=10712

United States Tax Court: *Guidant LLC, et al v. Commissioner of Internal Revenue (146 T.C. No. 5)*

WESTERN EUROPE

European Union (EU)

The EU did not comply with certain procedural rules when adopting a regulation to impose anti-dumping (AD) duties on imports of certain leather footwear from China and Vietnam, the European Court of Justice (ECJ) has ruled.

The regulation was adopted by the EU Council on October 5, 2006. It imposed an AD duty on footwear manufactured by companies established in China at a rate of 16.5 percent (with the exception of the company Golden Step, whose AD duty was set at 9.7 percent) and a 10 percent duty on footwear manufactured by companies established in Vietnam.

Announcing its decision, the ECJ said that the EU authorities failed to properly follow the basic rule laid down in EU law to determine a product's normal market value when the exporting country is a non-market economy.

EU law lays down a basic rule that the determination of a product's normal value, for the purposes of determining whether dumping is taking place, must normally be based on the prices

that independent customers must pay in the exporting countries in the ordinary course of trade. The ECJ pointed out that where the imports come from non-market economies that are World Trade Organization members, normal value is determined in accordance with the basic rule if it is shown, after analysis of properly substantiated claims by one or more producers established in those countries and subject to the investigation, that market economy conditions prevail for this producer or these producers. That rule enables producers subject to market economy conditions, who have emerged in the countries concerned, to obtain treatment corresponding to their individual situation, rather than to the overall situation of the country in which they are established.

The ECJ concluded that the EU Council and Commission failed to adjudicate upon claims for market economy treatment submitted by the Chinese and Vietnamese exporting producers not sampled; and did not adjudicate upon claims for individual treatment submitted by Chinese and Vietnamese exporting producers not sampled. It consequently declared the regulation invalid on both counts.

The AD duties had been challenged by UK footwear manufacturer and retailer Clarks, and German sports goods company Puma.

Clarks is seeking repayment of approximately EUR60m (USD67m) in duties it paid from July 1, 2007 until August 31, 2010. After its initial claim to the UK tax authority, HM Revenue & Customs, was rejected, it brought an appeal before the First-tier Tribunal (Tax Chamber).

Similarly, Puma saw its claim for a refund of approximately EUR5.1m in duties rejected by Germany's Principal Customs Office. Puma subsequently brought an action before the Finance Court in Munich.

With both national courts having doubts about the regulation's validity, the cases were referred to the ECJ.

The ECJ's ruling was announced on February 4, 2016.

http://curia.europa.eu/jcms/upload/docs/application/pdf/2016-02/cp160011en.pdf

European Court of Justice: *C. & J. Clark International Ltd v. HMRC (C-659/13), and Puma SE v. Hauptzollamt Nürnberg (C-34/14)*

Hungary

Certain Hungarian leisure card and meal voucher schemes, used by employers to provide benefits-in-kind to their employees, confer favorable tax conditions that are incompatible with EU law, the European Court of Justice (ECJ) has decided.

Hungarian legislation enables employers to provide employees with vouchers or cards that may be used by workers to obtain certain benefits-in-kind from third-party suppliers, such as accommodation, leisure, and catering services and ready-to-eat meals. However, the ECJ found that two schemes – the SZÉP leisure card and the Erzsébet meal voucher – provide certain tax advantages not available under other schemes.

According to the European Commission, which brought the action against the Hungarian Government, the schemes infringe EU laws on the freedom of establishment and the freedom to provide services because the tax breaks are only available to users of this card or voucher, and these may only be offered by certain entities.

In its ruling, issued on February 23, the ECJ agreed that a number of aspects of the SZÉP leisure card and Erzsébet meal voucher schemes are contrary to EU law. The court observed that the legislation prevents Hungarian branches of companies established in other member states from offering the SZÉP. Only subsidiaries of companies incorporated under Hungarian law are permitted to issue the card. Further, the ECJ took issue with the requirement that SZÉP card issuers must, in each municipality in Hungary with more than 35,000 inhabitants, have an office open to customers. It said this could only be fulfilled by those financial institutions whose registered office is in Hungary.

While EU law states that the provision of services may be reserved to particular providers, this restriction is only permitted if it is not discriminatory with regards to the location of the registered office of the provider, it noted. In this case, the ECJ found that "such discrimination is established," and said the set of requirements "deprives service providers established in other member states of their right to choose to provide cross-border services without becoming established in Hungary."

The ECJ concluded that the voucher schemes constitute "a restriction of both the freedom of establishment and the freedom to provide services," regardless of the fact that profits arising from the schemes are used by the Hungarian National Foundation for Recreation to fund social and welfare initiatives.

This judgment was released on February 23, 2016.

http://curia.europa.eu/jcms/upload/docs/application/pdf/2016-02/cp160015en.pdf

European Court of Justice: *Commission v. Hungary (C-179/14)*

Slovakia

The European Court of Justice (ECJ) has issued an order stating that the first paragraph of Article 138 of the EU VAT Directive precludes a member state from legislating to begin calculating the interest it must pay on excess VAT deduction refunds repaid late to a company ten days after concluding an "unreasonably" lengthy audit.

Slovakian law provides that excess VAT credits should be carried forward to the next tax period. If the taxpayer cannot deduct the excess credit, the tax authorities will schedule a refund, but only after the completion of an audit. Under Slovakian law, payment should be made within ten days after the completion of that audit. If the payment is made late then simple interest is payable.

A case was brought after the tax authority took five months to complete its audit. Repayment was made within the ten-day window, seven days after the completion of its audit.

The ECJ ruled in favor of the taxpayer, stating that the starting point for the calculation of interest should be in line with the standard day that interest would begin to accrue under the VAT Directive.

It said that while member states are entitled to first undertake some form of verification process without interest accruing, the time period that that process takes must be reasonable and it should not go beyond what is necessary to carry out this verification process.

The ECJ in particular challenged Slovakian legislation that provides that an audit can be initiated any time 30 days after the company has filed the VAT return seeking reimbursement and thereafter it can extend the period to undertake the audit by six months, with the option to renew for a further six months, or 12 months for foreign companies. It said that simple interest must be paid where repayment of the excess VAT is not made in a reasonable period of time.

This Order was published in the Official Journal of the European Union on February 1, 2016.

This Order is not yet available in English.

http://eur-lex.europa.eu/legal-content/CS/TXT/?uri=uriserv:OJ.C_.2016.038.01.0018.01.CES&toc=OJ:C:2016:038:TOC

European Court of Justice: *Kovozber sro v. Slovakia (Case C-120/15)*

Dateline March 3, 2016

The European Court of Auditors, which acts as the EU's spending watchdog, has concluded following a review of technical assistance provided to the **Greek Government** that the program has produced "mixed results." Well I don't know about yours, but my socks certainly weren't blown off by this revelation, with this being pretty obvious even to the most casual observer.

Apparently, the major objectives of the task force were to improve public administration, improve the Greek tax system, and bring about a return to growth by fostering the country's business environment.

I suppose you could say that some progress has been made on achieving these three goals. Tax revenues have been increasing, the budget deficit falling, and the economy will only have shrunk by 0.7 percent in 2015, according to recent estimates. But to turn the Greek economy around with mere technical assistance was always going to be a tough ask for the task force, particularly given that, as the Court of Auditors report relates, it was set up rather hastily and lacked a clear remit with defined objectives.

Indeed, as Lord Mervyn King, who was Governor of the Bank of England for ten years until 2013, warns in a new book, extracts of which have been published by the UK's *Daily Telegraph*, action of a much more seismic magnitude is going to be required now to save Greece, and certain other vulnerable countries on the periphery of the Eurozone, from what looks like a never-ending cycle of bailouts and crushing austerity – and that is to allow them to leave the Eurozone and plot their own course back to growth.

While he acknowledges that such an event could cause economic chaos in the short term, in the long term, Grexit (and perhaps Pexit, Spexit and even Itexit) is likely to be the lesser of two evils. Lord King goes on to observe that the current policy of monetary transfers and forced austerity has exposed a democratic deficit between the EU's bureaucratic "elites" and ordinary taxpayers, leading to a rise in populist parties on the Left and the Right, a development he warns is potentially "dangerous."

From one danger area to another now. In this column, I've regularly praised the dynamism of certain **international offshore financial centers** in what remains an increasingly uncertain world economically.

But all is not well in the world offshore, it seems. The financial crisis highlighted just how vulnerable some of these small "countries" are (although most are independent, several IOFCs still have significant constitutional ties to the UK). In terms of size, many of these island-nations would fit snugly into the metropolitan area of a large US city, and as such they usually lack the resources enabling them to diversify away from tourism and financial services. So, the recession that struck North America and Europe was a double whammy for them, because many of the tourists stopped coming, and so did some of the international investors, meaning that income from tourism-related activities and company registration fees and other charges suddenly dropped.

Some IOFCs have weathered the storm mostly intact, but others, as the sea of red ink in government accounts attests, are still suffering something of a hangover from the financial crisis. **Bermuda** is a prime example. Last year, the British Overseas Territory entered its seventh-straight year of recession, and public debt has risen from just 5 percent of gross domestic product in 2008 to around 40 percent. **Barbados** saw its public debt almost double to 101 percent between 2008 and 2015, while the **Bahamas** saw a heart-stopping 10 percent leap in its public debt in the year to June 2015.

So what are these territories doing to turn the situation around? Just like other countries, they are raising taxes. Bermuda has just announced a payroll tax hike and the introduction of a 5 percent general services tax; the Bahamas introduced value-added tax in 2015 in an attempt to raise more revenue; and the **British Virgin Islands**, another country experiencing fiscal difficulties, plans an overhaul of its tax system next year to increase tax receipts.

What you won't see these jurisdictions doing any time soon, however, is introducing or raising corporate tax on international business, which most no-tax IOFCs would probably equate to signing their own economic death warrants. That they've made it this far into the OECD/EU-driven crackdown on "harmful" tax regimes and the post-crisis world without having done so tells you that they would probably contemplate just about any measure but income tax. Still, an uncertain future is faced by these islands.

Now to **South Africa.** It's only a month since the Government finally enacted legislation giving effect to measures announced in the 2015 Budget, and already the 2016 Budget announcement has come and gone. The parliamentary procedures of some countries really do make my mind boggle sometimes; often, when you're trying to track the progress of a particular tax announcement, you might find that the initial budget legislation has been split into two or more separate

bills, some of which might have been put out for consultation, others fast-tracked through the assembly, and others shunted into the siding for consideration at some ill-defined later date. The South African law-making progress feels a bit like this sometimes.

However, it's not the finer points of parliamentary procedure in South Africa I wish to dissect here, but the 2016 Budget itself. It raises taxes, by about the equivalent of USD3.25bn over the next three years, and doesn't appear to cut any taxes. Also, it felt as if the tax increases were hidden behind the headline announcement that 2015's income tax hikes wouldn't be repeated. But I'm going to give Finance Minister Pravin Gordhan the benefit of the doubt. He's only been back in the job a matter of weeks, and it might take a little more time for his more cautious fiscal stance to play out. Because it was beginning to look like South Africa was at the top of a slippery fiscal slope, with spending outstripping tax revenue, the budget deficit growing, and economic growth slipping.

Let's see if he can pull the country back towards safety.

The Jester