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US Inbound Investment

The Portfolio Interest Exemption

BY HANNAH M. TERHUNE (GREENTRADERTAX.COM)

This article focuses on planning opportunities available to foreign (non-US) persons that invest in offshore partnerships, such as hedge funds, which own US debt instruments.

US-source, non-business (or investment-type) income earned by a nonresident alien or a foreign corporation is taxed at a flat rate of 30 percent per §§871(a) and 881 of the Internal Revenue Code. This tax, collected by withholding, is imposed on gross income (*i.e.*, no deductions are allowed). Generally, US withholding tax may be reduced or eliminated by income tax treaty.

Even without the benefit of a treaty, US withholding tax can be avoided through careful tax planning. For example, US withholding tax does not apply to US-source portfolio interest income earned by a nonresident alien or foreign corporation. This exemption from US withholding tax is called the "portfolio interest exemption." *See* §§871(h) and 881(c) of the Code.

US tax law limits the use of the portfolio interest exemption. For example, if a foreign person (*e.g.*, a lender) owns a 10-percent or greater interest in a US bor-

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A Pitfall in Establishing a US Holding Company

Taxation and Compliance Under FIRPTA

BY MAKOTO NOMOTO (KPMG)

This article explores a number of issues concerning the establishment of a US holding company by a Japanese corporation. The focus is on the particular challenges arising from the duty to comply with the US Foreign Investment in Real Property Tax Act, otherwise known as "FIRPTA."

Background

As Japanese companies became more familiar with the holding company concept -- a result of the recent introduction of the new corporate reorganization rules and consolidated return system in Japan -- many Japanese companies are considering establishing US holding companies to reduce their tax burden and/or improve the management efficiency of their US operations. However, the effect of the US Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") is not carefully analyzed, in many cases, and thereby causes significant tax risks and even unrecorded liabilities.

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Misunderstandings with regard to the FIRPTA implications of establishing US holding companies are common. They include:

- ***Misunderstanding No. 1:*** "Establishing a US holding company should always be tax-free in both the US and Japan."

  This is generally true. However, as an exception to the general rule, a Japanese parent company may be taxed on the built-in gain on the stock of existing US subsidiaries under FIRPTA.

- ***Misunderstanding No. 2:*** "We are not in the real estate business. None of our US subsidiaries hold significant real property. Accordingly, we believe we do not need to worry about FIRPTA."

  FIRPTA applies to businesses in any industry. Often, a service company is determined to be a US real property holding company when a capitalized leasehold improvement is the only significant asset on its balance sheet.

- ***Misunderstanding No. 3:*** "We don't have to take any action because there is no risk as long as the gain is not subject to tax under FIRPTA."

  Even if gain is not actually taxed under FIRPTA, a US holding company could be held liable for FIRPTA withholding and could be charged with interest several years later unless FIRPTA compliance requirements are fully satisfied.

Misunderstandings with regard to the FIRPTA implications of establishing US holding companies are common.

The compliance requirements under FIRPTA typically are not difficult to follow. However, it should be noted that a failure to comply may result in serious problems, as discussed more fully below. Although it is not possible to cover all of the FIRPTA provisions in this article, issues concerning the establishment of a US holding company by a Japanese corporation are analyzed here.

What Is FIRPTA?

The fundamental concept of the FIRPTA provisions, as set forth in §897 of the Internal Revenue Code, can be summarized as follows:

> If a foreign person, whether an individual or a corporation, realizes gain on the disposition of a "United States Real Property Interest" (a "USRPI"), such gain is taxable in the US as effectively connected income.

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Planning Alert

US Multinationals Risk Losing Tax Deferral

"Grandfather" Protection Lost for Certain Groups

BY KEITH MARTIN
(CHADBOURNE & PARKE)

Some US multinational groups are now at risk of losing their US tax deferral after a change in ownership of their offshore subsidiaries.

The risk discussed here is to offshore subsidiaries that have existed since at least May 1996.

As we all know, American companies are subject to US income tax on their worldwide earnings. However, most US multinational groups adopt ownership structures that allow them to delay any US tax on their profits earned in foreign (non-US) countries until those profits are repatriated back to the United States.

This deferral strategy requires operating abroad through an offshore holding company -- in the Netherlands or the Cayman Islands, for example -- and ensuring that all legal entities formed in other countries as subsidiaries of the offshore holding company are considered "transparent" for US tax purposes.

Transparency is usually a matter of making an election on a tax form filed with the Internal Revenue Service. However, the IRS publishes a list of legal entities for which the election is not allowed. There is generally one such "non-allowed" entity in each country.

An example of an entity that cannot be transparent for US tax purposes is a *Sociedad Anonima* or "S.A." in a number of Latin American countries.

However, in the past, an offshore subsidiary that had existed since at least May 1996 could be "grandfathered." Thus, for example, an S.A. in Argentina that existed since at least May 1996 might be allowed to be treated as transparent for US tax purposes.

Now, beware -- the IRS said in late October that this kind of subsidiary will lose its grandfather protection after a change of ownership of 50 percent or more of the subsidiary. The IRS had proposed this rule in 1999, but did not formally adopt it until late October. The agency said any 50-percent or greater change in ownership since November 29, 1999, will cause a loss of the grandfather protection previously available. It does not matter if the change was incremental or spread over a number of years. Once the 50-percent threshold has been reached, grandfather protection is gone.

Now, the IRS has said that this kind of subsidiary will lose its grandfather protection after a change of ownership of 50 percent or more of the subsidiary.

The loss of this grandfather protection in circumstances in which too much ownership change has already occurred became effective as of October 22, 2003.

The IRS also said that changes in indirect ownership can trigger the same adverse result -- it is not only direct changes that are required for the new rule to kick in. ❑

Practical US/International Tax Strategies wishes to thank Keith Martin of Chadbourne & Parke LLP for contributing this article to our publication. Mr. Martin has been a tax partner in the Washington office of Chadbourne & Parke since 1983. He is a valued member of WorldTrade Executive, Inc.'s International Tax Advisory Board. Keith can be contacted by email at kmartin@chadbourne.com.

Regional Focus

Cross-Border Cash Management

Inter-Company Arrangements and Canadian Tax Consequences

BY KATHLEEN PENNY
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This article examines how pooling the liquidity of Canadian and non-Canadian affiliates can produce unforeseen tax consequences.

When related Canadian and affiliated non-Canadian companies pool or share their surplus cash, or have transactions in which they may become indebted to each other, care must be taken not to trigger undesirable Canadian tax consequences.

The provisions discussed here also apply to other forms of indebtedness of non-Canadian affiliates to Canadian corporations, such as outstanding receivables.

Loans from a Canadian Subsidiary

In cases in which a Canadian corporation lends money to an affiliate outside of Canada and that loan remains outstanding at the end of the Canadian corporation's following tax year, then, for Canadian tax purposes, the affiliate must include the amount of the loan in its income for the year in which the loan was made.

To enforce the taxation of this amount, the Canadian corporation is deemed to have paid the amount of the loan as a dividend to the affiliate. The Canadian corporation is liable for withholding tax on the dividend at the rate specified in the relevant Canadian tax treaty.

A refund of the withholding tax may be applied for if the loan is repaid. The application for refund must be made no later than two years after the end of the calendar year in which the repayment is made.

These provisions also apply to other forms of indebtedness of non-Canadian affiliates to Canadian corporations, such as outstanding receivables. They do not normally apply if the affiliate is a downstream foreign affiliate corporation of a Canadian taxpayer.

Under another Canadian tax provision, each year that a Canadian company fails to charge a reasonable rate of interest to a person outside of Canada on a loan or other indebtedness that remains outstanding for more than a year, the Canadian company must include an amount of imputed interest in its taxable income for the year. The amount of interest to be included is a prescribed amount specified by the tax statute, minus any interest actually charged.

To prevent the application of both the deemed dividend treatment and the imputed interest income treatment to the same loan, if the Canadian company remitted withholding taxes as a result of the deemed dividend provision described above, then the interest imputation provision does not apply.

To avoid the imputation of interest, the Canadian company should charge a reasonable rate of interest on loans to persons outside of Canada and their other debts with a term of more than one year, and the Canadian company should collect its receivables on a timely basis.

The concept of a "reasonable rate" is not defined by the tax statute. Instead, an annual determination must be made, considering factors such as the creditworthiness of the borrower, security for the loan, and current market rates.

A Series of Loans

One might think that a simple way around these rules would be to pay off the loan before the end of each tax year of the Canadian company and issue a fresh loan. However, the Canadian government considered this possibility and provided that the deemed dividend provisions still apply notwithstanding repayment before the end of the next tax year if the repayment is regarded as part of a series of loans or other transactions and repayments.

The loan is likely to be deemed part of a series if a repayment is of a temporary nature, such as a loan that is repaid shortly before the end of the year and the same amount, or substantially the same amount, is borrowed shortly after the end of the year. However, the Canadian tax authority accepts that *bona fide* repayments of loans that result from, for example, the payment of bonuses or dividends, are not part of a series of loans or other transactions and repayments.

When related companies have a "running account" between them for day-to-day transactions and the amount owing between a non-Canadian group member and a Canadian company is regularly increasing and decreasing, there is strong evidence of a series of loans or other transactions and repayments.

If the outstanding balance of a running account owing to the Canadian subsidiary by a particular non-Canadian group member at the end of a tax year is higher than the balance at the end of the previous year, the administrative position of the Canadian tax authority is that there is a "deemed dividend" equal to the increase in the outstanding balance, and Canadian withholding tax is owing.

However, if the outstanding balance at the end of the next tax year is lower and this is in the nature of a non-temporary repayment, there is considered to have been a partial repayment to the Canadian subsidiary.

When there is a non-temporary repayment, the non-Canadian company can apply for a refund of withholding tax.

Any "permanent" excesses of cash are best paid out by the Canadian company as actual dividends on the shares of the Canadian company rather than loans, because the treaty-reduced withholding tax rate on dividends paid to the direct shareholder is generally lower than the rate applicable on deemed dividends to a company that does not directly own shares of the Canadian company.

Also, it is somewhat cumbersome to pay withholding tax on a deemed dividend and go through the refund procedure.

Voluntary Disclosure

If a Canadian subsidiary realizes that it has provided a loan (or other indebtedness) to a non-Canadian affiliate that was deemed to be a dividend and the related withholding tax has not been paid, or it has a receivable subject to imputed interest income that has not been reported, there is a voluntary disclosure program under which the Canadian subsidiary can disclose the issues and pay the taxes and interest owing, in exchange for relief from penalties.

Even in the event that an outstanding loan (or other indebtedness) that was deemed to be a dividend has since been repaid, the matter should not be simply ignored. The Canadian company can use the voluntary disclosure program to work out an arrangement with the Canadian tax authority, which may involve remitting withholding taxes that should have been previously paid (plus interest) and then applying for a refund of the taxes.

Inter-company cash management arrangements with a Canadian subsidiary are certainly possible, but the Canadian tax consequences of these arrangements need to be understood and monitored.

Borrowings by a Canadian Subsidiary

When the Canadian subsidiary owes money to affiliated non-Canadian persons, to deduct the interest payments from its income it is important that the subsidiary is not charged more than a reasonable rate of interest, and that the subsidiary has a legal obligation to pay interest.

The determination of a "reasonable rate" of interest depends on prevailing market rates for debts with similar characteristics and creditworthiness, and this determination should be documented.

To satisfy the requirement that there be a legal obligation for the Canadian company to pay the interest, the parties should have a written agreement regarding the terms of the loan, or other debt.

The Canadian Company's Debt Level

The debt-to-equity ratio of the Canadian company may also impact interest deductibility. Under Canadian thin capitalization rules, interest deduction is disallowed on the portion of interest-bearing debt owed to non-Canadian group members that exceeds two times the amount of equity of the company.

To avoid the application of this provision, the level of interest-bearing debt owed by the Canadian company to non-Canadian group members should be monitored against the equity of the company. There are detailed rules concerning the calculation of average debt and equity for this purpose.

Equity Contributions

Contributions of equity to a Canadian company by a non-Canadian person should be made by way of subscription for additional shares of the Canadian company, rather than by a capital contribution with no share issuance. This is because the paid-up capital of shares may be returned to a

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non-Canadian shareholder without Canadian withholding tax. Contributed surplus can only be distributed by way of a dividend that is subject to Canadian withholding tax.

If capital contributions have been made, it may be possible to transform the contributed surplus into paid-up capital of shares by following the proper Canadian corporate law procedure and confirming that this will not result in a deemed dividend under Canadian tax law.

With proper planning, groups can set-up inter-company cash management arrangements that minimize undesired Canadian tax consequences.

Inter-Company Payables

The Canadian tax statute specifically addresses a situation in which deductible expenses accrued by the Canadian company and deducted in computing its income for Canadian tax purposes (such as interest or royalties) remain owing to an affiliate for too long. The Canadian corporation, at the beginning of its third tax year after the year the expense was accrued, must either add the outstanding amount back into its income or elect with its creditor to deem the amount paid.

If the election is filed, any resulting withholding taxes must be paid. For example, there would be withholding taxes if the deductible expense were interest or a trademark royalty. A Canadian company should promptly pay inter-company payables to avoid this situation.

Conclusion

Inter-company cash management arrangements with a Canadian subsidiary are certainly possible, but the Canadian tax consequences of these arrangements need to be understood and monitored.

To stay within Canadian tax rules, a reasonable rate of interest should attach to loans and other debts owing to the Canadian subsidiary (other than short-term, ordinary accounts payable and receivable) and the group members should settle inter-company payables, receivables, loans, and other debts in a timely manner.

Dividends should be declared and paid by the Canadian subsidiary instead of allowing loans or debts owing to the Canadian subsidiary to be deemed to be dividends. The Canadian subsidiary also needs to monitor its inter-company debt-to-equity ratio to avoid losing the ability to deduct its interest payable to non-Canadian affiliates.

With proper planning, groups can set-up inter-company cash management arrangements that minimize undesired Canadian tax consequences. ❑

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Regulatory Developments

New, Revised Rules for Reporting Inversion Transactions

On December 12th, the US Treasury Department and the Internal Revenue Service issued revised temporary regulations requiring corporations to notify the IRS and their shareholders when they move their headquarters offshore (*i.e.*, outside the US), or are acquired by a foreign (non-US) company.

Temporary regulations for reporting inversion transactions were first issued in November 2002, and covered transactions occurring after 2001. *[For more information about the original inversion transaction reporting regulations, see the January 31, 2003 issue of Practical US/International Tax Strategies.]*

The revised regulations being issued now cover transactions occurring after 2002 and include "clarifications" that the US tax authorities believe will ensure better information reporting by brokers. The regulations are part of US tax authorities' efforts to discourage corporate inversion transactions, which were first announced by the US Assistant Secretary of the Treasury for Tax Policy in testimony before the House Ways & Means Committee in June 2002.

Look for a detailed summary of the revised temporary and proposed regulations in the next issue of *Practical Strategies*. The regulations are currently in the process of being published in the Federal Register and are subject to minor technical changes.

Source: US Treasury Department Release No. JS-1053a, December 12, 2003. ❑

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rower, the interest earned by the foreign person does not qualify for the portfolio interest exemption.

US Preference for Debt Financing

When planning for specific tax results (*e.g.*, a zero-rated transaction), it is useful to be familiar with the tax policy underlying a tax deduction or exemption. With respect to the portfolio interest exemption, it is important to note that US tax law favors debt over equity as a matter of longstanding congressional policy.

The availability of the portfolio interest exemption provides an incentive for foreign investors to structure their US inbound investments as debt rather than equity because US tax law does not provide a parallel tax exemption for US-source dividends. Generally, income tax treaty withholding tax rates applicable to US-source interest are lower than those applicable to US-source dividends. Additionally, debt financing is attractive from the perspective of a US borrower because it gives rise to an interest deduction, while no deduction is allowed for a dividend payment.

Example

A foreign (non-US) person lends $1 million to a US corporation. No withholding tax is imposed on the lender's US-source interest income if the interest qualifies as portfolio interest. However, if the foreign person invests $1 million in a US corporation (*e.g.*, buys stock), any US-source dividend income is subject to the 30-percent withholding tax (unless it is reduced by treaty).

Given the backdrop of congressional tax policy favoring debt over equity, it is interesting to consider the Internal Revenue Service position regarding the portfolio interest exemption and offshore partnerships. The IRS position, as disclosed in a field service advice ("FSA") dated February 2, 1994, suggests that where a foreign partnership (with foreign partners) loans money to, and also owns an equity interest in, a US borrower, the 10-percent ownership limitation is applied at the partner level and not at the partnership level.

The approach of this FSA is beneficial for the foreign partners in a partnership that loans money to a US borrower and also owns a 10-percent or greater equity interest in the US borrower. Under the FSA, the foreign partners can receive a distributive share of the partnership's interest income free of the 30-percent withholding tax, as long as the partners do not each own a 10-percent or greater direct or indirect equity interest in the US borrower.

IRS Position

In the FSA mentioned above, a Japanese person was a partner in a Japanese general partnership. The Japanese partnership loaned funds to a US partnership (*i.e.*, the US debtor). The debt instrument was convertible into a 10-percent or greater ownership interest in the US debtor.

The US debtor withheld tax at the reduced withholding rate specified in the US-Japan income tax treaty on the Japanese partner's distributive share of the interest income. Treating a conversion feature of the debt as an option (*see* Rev. Rul. 68-601, 1968-2 C.B. 124, ruling that warrants and convertible debentures are options for purposes of §318 of the Code), the US debtor took the position that the Japanese partnership owned a 10-percent or greater interest in the US debtor and that the Japanese partner's distributive share of the interest income did not qualify for the portfolio interest exemption.

Given the backdrop of tax policy favoring debt over equity, it is interesting to consider the IRS position regarding the portfolio interest exemption and offshore partnerships.

The Japanese partner filed a refund claim for the amount withheld by the US debtor on the grounds that the interest qualified for the portfolio interest exemption and, as such, was not subject to US withholding tax. The Japanese partner took the position that, although the debt instrument was convertible into a 10-percent or greater ownership interest in the US debtor, the Japanese partnership's option could not be attributed to the Japanese partner because of the statutory limitation on option attribution.

The IRS agreed with the Japanese partner.

In the FSA, the IRS refused to apply an entity approach and test the 10-percent ownership limitation at the partnership level. According to the FSA, that treatment would, in effect, attribute all of a partnership's equity interest in a borrower to each partner.

The FSA notes that its conclusion results in an inconsistency between the taxation of US inbound investment through foreign corporations and the taxation of foreign investment through partnerships. If a foreign corporation were to loan money

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to a US borrower in which it also owned an option to acquire a 10-percent or greater ownership interest, the interest income received by the corporation would not qualify for the portfolio interest exemption. Although the corporation's option would not be attributed to its shareholders, the corporation itself is a taxable entity, and is taxed on the interest received from the US borrower.

This FSA is significant and magnifies the planning opportunities available to foreign persons that invest in offshore partnerships investing in US debt instruments.

Portfolio Interest

As noted above, the 30-percent withholding tax does not apply to portfolio interest earned by a foreign (non-US) person. Portfolio interest includes original issue discount and must meet specific requirements, depending upon whether the debt obligation is issued in "registered" or "bearer" form).

The portfolio interest exemption does not apply to interest received by a 10-percent shareholder of the US borrower.

Generally, interest on an obligation in registered form constitutes portfolio interest if the withholding agent receives a form stating that the beneficial owner of the obligation is not a US person. Interest earned on an obligation in bearer form can constitute portfolio interest if the issuer of the obligation complies with certain procedures generally designed to ensure that the holder of the obligation is not a US person.

Attribution and the 10-Percent Ownership Limitation

The portfolio interest exemption does not apply to interest received by a 10-percent shareholder of the US borrower. For debt issued by a US corporation, a 10-percent shareholder is any person who owns 10 percent (or more) of the total combined voting power of all classes of stock entitled to vote. For debt issued by a US partnership, a 10-percent shareholder is any person that owns 10 percent (or more) of the capital or profits interest in the partnership.

The corporate attribution rules under §318 of the Code apply in determining ownership for purposes of the 10-percent ownership limitation (with several key modifications). For example, a person who owns an option to acquire stock is treated as owning that stock.

However, that rule is modified under the portfolio interest exemption. The modification provides that the ownership of an option to acquire stock is not treated as stock ownership in applying the attribution rules to determine whether stock ownership is attributed from a partnership to its partner, from a trust to its beneficiaries, or from a corporation to its shareholders (or vice versa). *See* §871(h)(3)(C)(iii) of the Code.

If a corporation is deemed to own a 10-percent or greater interest in a US borrower by virtue of its option to acquire the stock of the borrower, the corporation's deemed stock ownership is not attributed from the corporation to its shareholders. While the statutory language in §318 only addresses the determination of the ownership of stock in corporations, those rules apply, "[u]nder regulations prescribed by the Secretary," for determining whether a person is a 10-percent owner of a partnership.

The US tax authorities have not issued regulations concerning option attribution and partnerships.

Convertible Debt

The FSA discussed in this article allows foreign investors to use an offshore partnership to acquire convertible debt instruments and secure any upside potential (*e.g.*, an equity interest and control) in a US borrower while at the same time earn interest on the debenture free of US tax. These benefits are not unavailable if the lender is an offshore corporation. Here's why:

The portfolio interest exemption statutory attribution rules employ an entity approach. The rules provide that an option owned by a partnership is not attributed from the partnership to its partners. The attribution rules allow foreign partners to obtain certain ownership attributes, such as equity upside potential and control potential, in a US business through convertible debt, yet at the same time receive interest income from the US company free of US tax because of the portfolio interest exemption. Stated again, these benefits are not unavailable where the lender is a foreign corporation.

The potential for an equity upside is very compelling from a planning point as foreign persons generally are not taxed in the US on gain from the sale of stock. A foreign investor, upon the conversion of debt into equity, could sell the equity interest free of US tax.

Planning Caveat

The portfolio interest exemption does not apply to interest income that is effectively connected with a

US trade or business. It is often unclear whether a foreign lender is engaged in a US trade or business by virtue of its lending activities. The standards for determining whether an inbound lender is a passive investor or is engaged in an active US financing business remain somewhat vague.

A nonresident alien or foreign corporation that is engaged in a trade or business in the US is taxed on income that is "effectively connected" with that trade or business. Effectively connected income is taxed at the applicable graduated US individual or corporate rates on a net basis (*e.g.*, deductions allocable to that income are allowed).

This issue should be fully vetted because of the potential tax ramifications (*e.g.*, the possibility of a zero-rated transaction).

Cash Flow

As a practical matter, the forward use of the portfolio interest exemption may require preparing a US tax filing to obtain a refund of taxes withheld by a US withholding agent. This need to file for a refund flows from the fact that potential withholding agents must cautiously monitor any payments made to foreign persons to ensure that the appropriate amount of tax is being withheld.

A withholding agent that fails to withhold is liable for the uncollected tax under §1461 of the Code. Thus, tax may be withheld even though it qualifies for the portfolio interest exemption. This was the case in the FSA discussed in this article.

The issue of whether the 10-percent ownership limitation is tested at the partnership level or at the partner level has not been addressed by any case or published ruling. Some tax professionals think that the 10-percent ownership limitation should be tested at the partner level. Others think it should be tested at the partnership level.

In the FSA, the IRS takes the position that the 10-percent ownership limitation is applied at the partner level.

The US tax authorities have not issued regulations concerning option attribution and partnerships.

Until the US Treasury Department issues guidance in this area (*e.g.*, regulations that treat an option owned by a partnership as directly owned by the partners for purposes of the 10-percent ownership limitation), the FSA discussed in this article presents a good planning opportunity for foreign investors in offshore partnerships, especially when the option attribution rules are in play. ❑

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In The News

New Director of US International Tax And US Competent Authority

The Internal Revenue Service has announced the selection of Robert H. Green to lead the agency's efforts on international tax issues.

Green will serve as Director, International, and as the US Competent Authority. In this position, he will be responsible for a wide range of issues relating to international tax matters and global trading. They include ensuring consistent tax treatment of US taxpayers concerning international issues, providing timely and effective implementation of tax treaty and tax information exchange. Green will report to the IRS Commissioner of the Large and Mid-Size Business Division (the "LMSB").

Green comes to the IRS from the Procter & Gamble Company, where he directed the company's Taxes and Corporate Planning Office in Germany. Green previously served as Director of International Taxes for Procter & Gamble in the US. Before joining Procter & Gamble, Green served as Vice-President of Tax Policy for the National Foreign Trade Council, Inc. (the "NFTC").

Source: Internal Revenue Service Release No. IR-2003-137, Dec. 11, 2003. ❑

Understanding Information Exchange in US Tax Treaties

BY MICHAEL I. SALTZMAN AND JEAN-CLAUDE M. WOLFF
(WHITE & CASE, NEW YORK)

The US tax authorities are aggressively pursuing tax information maintained outside of the US. Among other things, the authorities are using the US income tax treaty network and other specialized agreements to exchange information to prevent US taxpayers from using or misusing offshore facilities. This article examines the subject of information exchange in US tax treaties.

Countries throughout the world understand that exchanges of information between fiscal authorities are critical in deterring tax avoidance or evasion. However, the actual implementation of information exchanges, for issues such as transfer pricing and criminal tax evasion, has been underway for a long time.

Through its income tax treaty network, the US has attempted to gather information about its residents and citizens to prevent a loss of revenue from tax evasion.

As long ago as 1977, a European Union directive established administrative assistance, but discussions about the automatic exchange of information aimed at taxing interest earned by individuals of another EU member state were delayed for years by the refusal of some countries to provide information protected by banking secrecy.

Also, the effectiveness and implementation of the savings directive is conditioned on an effective exchange of information between global financial centers.

In 1998, the Organization for Economic Cooperation and Development (the "OECD") issued a report entitled "Harmful Tax Competition: An Emerging Global Issue." The report has spurred an international effort to bring more transparency to cross-border tax issues. It identified "the lack of effective exchange of information" as one of the key reasons why deterring harmful tax practices has been so difficult.

Since then, the OECD has produced several working papers and memoranda, as well as a model agreement on exchanges of information on tax matters.

US Treaty Network

Through its income tax treaty network, the US has also attempted to avoid double taxation on taxpayers conducting business in more than one tax jurisdiction, and to gather information about its residents and citizens to prevent a loss of revenue through tax evasion.

Income tax treaties are in effect between the US and most countries with which the US does substantial business. These income tax treaties have articles or sections, entitled "Exchange of Information," that contemplate the use of each contracting state's competent authority to process requests for information made by the other contracting state.

The exchange of information article has gained importance over the years as competent authorities have received and made specific requests for information about individual and corporate taxpayers within the jurisdiction of the competent authority of the other contracting state. Under the exchange of information authority, information that is pertinent to carrying out the provisions of the treaty is always exchanged. Also, under broad exchange of information articles, information is exchanged to prevent fraud or fiscal evasion, or to carry out the domestic provisions of the tax laws of both countries without any limitation on the persons or taxes.

Income tax treaties generally limit the exchange of information to taxes covered by the treaty. Thus, the exchange usually only covers the federal income or similar taxes of the other contracting state. However, the exchange of information clause in some treaties, including the US treaties with Canada and Mexico, covers all taxes imposed by each country.

The US has extended the scope of covered taxes in its more recent treaties and through the use of protocols. A tax treaty applies only to the persons entitled to its benefits, as described in the personal scope clause of the treaty. If there is no specific exception to the scope clause of the treaty, the exchange of information clause is limited to residents or nationals of the contracting states.

Some tax treaties do not contain an exception to the personal scope clause, but under most recent treaties, including the treaties with the United Kingdom and Japan, which actually constitutes a change with respect to the former treaty with Japan, information can be exchanged with respect to nonresidents between the US and its treaty partner.

Once the scope of the exchange of information has been established, it is important to determine what information can be exchanged between the competent authorities. Normally, a state can only exchange information that is obtainable under its domestic laws, and the treaties usually specify that no deviation from the state's administrative practice should be undertaken.

Further, a requesting state generally cannot ask for information that is not obtainable under its own domestic laws. Thus, information in the possession of the tax administration of a contracting state can generally be exchanged.

Treaties also generally limit the exchange of information to information relevant for taxes that are subject to the convention or for the prevention of tax fraud or evasion. It is interesting to note that some treaties limit the exchange of information to cases of tax fraud, whereas others allow the transmission of information to prevent tax evasion. The determination of what constitutes tax fraud or evasion will generally be made at the requested contracting state level.

Most recent treaties, including the US treaties with Japan, the UK, Australia and the People's Republic of China, allow exchanges of information for the application of domestic statutory provisions concerning taxes to which the convention applies.

Summons Power

Exchanges of information under income tax treaties are not one-way exchanges of information from a contracting state to the US. When a contracting state has made a request for information through its competent authority to the US competent authority, the US Internal Revenue Service has had to use its summons power to obtain the information, and US courts have enforced the summons and ordered the information produced. There have been a number of case, some of them well-publicized, where the IRS sought to obtain foreign-based information -- for example, the so-called Gucci litigation that took place in both US and Hong Kong courts -- but these cases do not tell the whole story.

The US routinely serves summonses on US persons to obtain information requested by a contracting state to enforce its tax laws. In the *Stuart* case, 489 US 353 (1989), the Supreme Court ruled that the IRS had the authority to summon witnesses and order the production of documents to gather information for another country under an income tax treaty, whether the other contracting state requests the information for a civil or a criminal tax investigation.

Income tax treaties generally limit the exchange of information to taxes covered by the treaty. However, the exchange of information clause in some treaties, including the US treaties with Canada and Mexico, covers all taxes imposed by each country.

Moreover, the summons will be enforced over the objection of the affected taxpayer, unless the objection is one that defeats the summons if it had been served by the IRS for its own investigation.

Under this rule of law, IRS summonses have been enforced when they were served by the IRS to gather information for an investigation under the criminal tax laws of Canada, as well as to obtain information for tax investigations by tax or fiscal authorities in Mexico, France and South Korea.

Under US domestic law, the IRS may gather a wide range of information and turn it over to a treaty partner. The IRS has gathered, or can gather, information because of its broad summons power.

Using its summons authority, the IRS may gather information from taxpayers in the US and it may even compel such persons to produce records located abroad.

Also, the IRS may obtain foreign-based information from foreign persons located in the US who are subject to a US court order. The IRS can obtain records of non-US branches and subsidiaries of US companies and even from non-US corporations with US branches.

The IRS may also obtain information concerning a non-US parent corporation from its US subsidiary under the reasoning that the US subsidiary served as a conduit for the parent corporation. The IRS has obtained information located outside the US even when the disclosure of that

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information violated the secrecy laws of the country where the records were located.

There are US procedures for a taxpayer to oppose the transmission of information by the US to a foreign competent authority, but no procedure exists for the notification of a taxpayer of a request for information. In many cases, the subject of the inquiry is unaware of the transmission of information and cannot effectively prevent the transmission if the IRS has decided that the information can be transmitted.

IRS Procedures

The IRS has five special programs for information exchange. *See* Internal Revenue Manual §4.60.1.

> **Most treaties provide an exception to the transmission of information if the information concerns trade or business secrets. This protection in treaties is likely to be put to the test with the greater availability of proprietary information in the APA process and under the PATA procedures.**

Specific request information is provided to a treaty partner through the competent authorities when the treaty partner requests information about a specific person. In a request for specific information, the request must describe the taxpayer and the specific information requested. If the information can be found in IRS files, the person who is the subject of the request will not be notified by the IRS. However, if the IRS uses a summons to obtain information from a bank, then notice of the summons will be sent to the taxpayer.

Also, the IRS will not turn over tax returns to a treaty partner, and the treaty itself, as well as US tax law, requires that the information be kept confidential, unless there is a judicial or administrative proceeding.

Typically, specific request information is information about property ownership, financial records, such as bank account information, the verification of income tax return filing and filing status, and the types and amounts of income and expense reported.

Another method of information exchange the IRS uses is routine exchanges of information, such as dividend, interest, rents, and royalties, records of which are computerized and capable of being communicated without difficulty.

The IRS has some treaty partners with which it conducts simultaneous examinations. Further, the IRS also discloses information to treaty partners that its agents discover in the course of an IRS examination that suggests the taxpayer has not complied with a treaty partner's tax laws.

Apart from taxpayer-specific exchanges, there is a trend towards industry-wide exchanges of information that promote the international understanding of the operations of major industries and toward simultaneous examination procedures across jurisdictions.

Types of Information Exchanged

Information reporting to the IRS constitutes a vital part of the IRS' audit activities. This information is computer-accessible to the IRS, and so the IRS can easily supply the information to a treaty partner.

Withholding agents are generally required to file information returns following the year of specified payments of income to a foreign person. The US Department of the Treasury has also issued proposed regulations, not yet in effect, which will increase the reporting requirements for interest and original issue discount paid to residents of various countries, such as Australia and New Zealand.

Further, wide-ranging reporting and recordkeeping requirements apply to companies engaged in a trade or business in the US, or to those having foreign affiliates.

Under relatively new regulations, "qualified intermediaries" or "QIs," such as international financial institutions, now must collect extensive data about their clients to avoid US withholding tax on payments made to those clients.

Extensive documentation must be provided to obtain advance pricing agreements ("APAs") under IRS procedures, as well as the procedures of the fiscal authorities of treaty partners. Because this information is in the possession of the tax administration, it can be exchanged with the competent authorities of a requesting state under a tax treaty.

This possible exchange may be more likely to occur under the Pacific Association of Tax Administrators (the "PATA"), which provides principles under which taxpayers can create uniform transfer pricing documentation.

The availability of the same documentation in transfer pricing negotiations leading to a bilateral APA with the US may well reduce the number of specific requests the IRS may make under exchange of information procedures to obtain information in the hands of a treaty partner. Exchanged information must be treated as secret in the same way as information obtained under domestic law, and disclosure is generally limited to the persons involved with the administration of the tax laws.

Most treaties provide an exception to the transmission of information if the information concerns trade or business secrets. This protection in treaties is likely to be put to the test with the greater availability of proprietary information in the APA process and under the PATA procedures.

Information obtained under a treaty must generally be kept confidential in the same manner as information obtained by a requesting state pursuant to its domestic laws.

Criminal Tax Procedures

Under exchange of information articles, treaty partners may request information to prevent tax evasion. Requests for information under income tax treaties may be used by both parties, and there is every indication that they are being used more frequently for criminal tax investigations.

The US has been particularly active in the criminal area. In criminal tax cases, the US has also used existing mutual legal assistance treaties ("MLATs") to obtain information from a treaty partner. The role of MLATs is likely to increase in the future, especially since the US and the European Union signed an MLAT on June 6, 2003, which will generally apply if no MLAT is in force between the US and the relevant EU member state.

Under an MLAT, information can generally only be obtained if there are serious suspicions of tax fraud. In the absence of a treaty, letters rogatory may allow a state to obtain information from abroad in case of criminal conduct.

Also, the US and the OECD realized that substantial tax revenues were being lost through the use of tax havens in the Caribbean. This motivated the US to conclude tax information exchange agreements ("TIEAs") with numerous Latin American countries and various countries in the Caribbean. The TIEAs closely resemble the exchange of information clauses of tax treaties, but do not grant tax advantages to the participants.

Under exchange of information articles in treaties, treaty partners are able to obtain more easily than ever before the information necessary to assess taxes. Even the financial centers that have had the most solid reputation for banking secrecy have not been able to withstand international pressure to give access to information relevant to detect fraud. The trend is toward transparency of the location and the availability of information.

There can be no doubt that the IRS will aggressively pursue information maintained outside of the US. The IRS will continue to use the US treaty network and investigate specialized treaties to exchange information for use in its efforts to prevent US taxpayers from using or misusing the facilities in non-US nations.

By using exchange of information clauses in treaties, as well as other international agreements, the IRS can avoid issuing a summons to obtain foreign-based information.

Because the EU is continuing negotiations with non-member states (including the US) regarding the EU savings directive, it is likely that over the next decade information will be exchanged on a global scale regarding interest payments to foreign resident individuals.

In the last two years, the US has concluded eight new tax information exchange agreements with significant offshore financial centers and has entered into a mutual agreement with Switzerland to facilitate more effective tax information exchanges.

One illustration of the US administration's efforts to obtain foreign-based information is that, since last year, the IRS has successfully obtained information about taxpayers who used foreign accounts at offshore banks which issued credit cards through the enforcement of summonses against credit card companies to identify the US taxpayers using the offshore accounts.

Finally, in the last two years, the US has concluded eight new TIEAs with significant offshore financial centers (Antigua and Barbuda, The Bahamas, the British Virgin Islands, the Cayman Islands, Guernsey, Isle of Man, Jersey, and the Netherlands Antilles), and has entered into a mutual agreement with Switzerland, which is intended to facilitate more effective tax information exchanges. ❑

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In other words, "you should pay US tax if you make a profit by selling American real estate." As for gain from the sale of real property, this falls in line with the rules contained in most of the international tax treaties currently in effect, including the Organization for Economic Cooperation and Development ("OECD") and United Nations model treaties. They generally provide that gain on the sale of real property may be taxed in the country where the real property is located. *See, e.g.*, Article 6 of the OECD model treaty.

Compliance requirements under FIRPTA typically are not difficult to follow, but the failure to comply may result in serious problems, as explained in this article.

However, a foreign person could attempt to avoid tax on gain realized from the sale of US real property by establishing a US corporation to hold the property and later selling the stock of the US company. Because many US tax treaties provide that gain realized by a non-US person on the sale of stock in a US corporation is generally taxed only in the country of residence of the non-US person, and may not be taxed in the US, US tax on gain from the sale of real property can be avoided by holding the US real property indirectly through a US corporation.

(Even under US domestic law, this gain is not taxable as long as the foreign person is not engaged in US trade or business in the absence of FIRPTA.

To prevent this tax avoidance, FIRPTA's definition of a "USRPI" includes stock in a "US Real Property Holding Corporation" (a "USRPHC"), in addition to a direct ownership interest in US real property. Thus, if a foreign person sells stock in a US corporation that holds a certain amount of US real property, this person is treated as if it had sold a direct ownership interest in the US real property.

For this reason, FIRPTA is often applied when establishing a US holding company, even if no direct transfer of US real property is involved.

It should be noted that, because the US generally applies the "*lex posterior* principle," if a treaty provision is in conflict with a provision under US domestic law, the rule that came into effect later usually overrides the older rule. Thus, although capital gain earned by a Japanese resident upon the transfer of stock in a US corporation is taxable only in Japan under Article 16 of the current US-Japan income tax treaty, which came into effect in 1972, to the extent that the stock is a USRPI, the gain is taxed in the US under FIRPTA (which was enacted in 1980).

The new US-Japan treaty, which was signed on November 6, 2003, and is now awaiting ratification, will allow the US to apply FIRPTA to Japanese residents, although the treaty definition of real property is not exactly identical to the FIRPTA definition of a USRPI. *See* Article 13-2(a) of the new treaty. The new treaty will also allow Japan to apply a FIRPTA-like tax on US residents.

[Editor's Note: For more information about the new US-Japan income tax treaty, see the November 30th issue of Practical US/International Tax Strategies.]

Definition of "USRPI"

Under §897 of the Code, in addition to a direct ownership interest in real property located in the US (or the US Virgin Islands), stock in any US corporation is presumed to be a USRPI unless it is established that the company was at no time a USRPHC during last five years. In practice, and in accordance with §1.897-2(c) of the US Income Tax Regulations, whether a company has been a USRPHC is determined on certain testing dates during the last five years. Testing dates include each taxable year-end, the date of acquisition of a USRPI, and the date of disposition of certain business assets other than USRPIs.

However, if the US corporation has already disposed of all USRPIs in taxable transactions in the past and currently holds no USRPI, stock in the US company would not be treated as a USRPI.

Whether a US corporation is a USRPHC depends on whether 50 percent or more of the company's business assets consists of USRPIs in terms of fair market value. More specifically, the US company is a USRPHC if the percentage obtained by applying the following formula equals or exceeds 50 percent:

$$\frac{\textbf{Fair Market Value (FMV) of USRPIs}}{\begin{array}{c}\textbf{FMV of USRPIs +}\\ \textbf{FMV of Real Property Outside the US +}\\ \textbf{FMV of Other Business Assets}\end{array}}$$

Under §1.897-2(b)(2) of the regulations, if the percentage obtained by applying this formula is 25 percent or less, using the US GAAP book value of the assets, the US corporation is presumed not to be a USRPHC. Taxpayers may rely on this presumption and treat the company as not being a USRPHC, unless there is a specific reason to deny the presumption.

In applying the formula above, the following rules should be considered carefully:

- Certain personal property, including furniture used in lodging facilities or machinery and equipment used in mining, is considered part of real property.

- Personal property that is not a business asset (*e.g.*, an asset held for investment) may not be counted in the formula. According to the regulations, "liquid assets," including cash and cash equivalents, securities, receivables, and financial assets, such as options, may be treated as business assets up to five percent of the fair market value of other business assets excluding USRPIs (the "five percent rule"). However, liquid assets in excess of the five percent limitation may be treated as business assets only if it can be established that the assets are in fact used or held for use in the trade or business. Under §1.897-1(f)(2)(iii) of the regulations, an asset is used, or held for use in a trade or business, if it is held in a direct relationship to the trade or business.
- Intangible assets must be valued at the purchase price or book value determined under US GAAP. While other reasonable valuation methods are permitted, the taxpayer is required to file a report with the Internal Revenue Service explaining what kind of method is used to determine the fair market value of the intangible asset.

It is often difficult to determine which portion of liquid assets should be included in business assets without relying on the five percent rule. Also, considering the requirement to file a report with the IRS, many companies would hesitate to take an aggressive position in valuing intangible assets.

As a result, if a conservative approach is chosen, a company with seemingly little in US real estate holdings is often found to be a USRPHC. For example, as mentioned above, a small service company could be a USRPHC if a capitalized leasehold improvement (which is a USRPI) is the only significant asset on its balance sheet. Thus, unexpectedly, a small US subsidiary that has nothing to do with the real estate business could be found to be a USRPHC in many instances.

Investment in Subsidiaries And Other Entities

In determining whether a US corporation is a USRPHC based on the formula set forth above, the following rules are applied with respect to the US company's investment in another corporation or a partnership:

- If the US corporation holds an interest in a partnership, the company is treated as if it holds a proportionate share of the assets held by the partnership.
- If the US corporation holds 50 percent or more of the fair market value of all classes of stock of another company, the US corporation is treated as if it holds a proportionate share of the assets held by the other company.
- If the US corporation holds less than 50 percent of the fair market value of all classes of stock of another company, the fair market value of the stock in the other company is included in the fair market value of the USRPI -- if the stock qualifies as a USRPI. Although a foreign corporation cannot be a USRPHC, by definition, the stock of a foreign company held by the US company may be treated as if it is a USRPI for purposes of determining whether the US company is a USRPHC. If the stock is not a USRPI, the stock may be treated as a business asset to the extent allowed under the five percent rule discussed above. In some cases, the stock may be treated as a business asset without regard to the five percent rule if the stock is held for certain specific purposes, such as maintaining a business relationship with the investee.

The new US-Japan treaty, signed on November 6, 2003, and now awaiting ratification, will allow the US to apply FIRPTA to Japanese residents, although the treaty definition of real property is not exactly identical to the FIRPTA definition. The new treaty will also allow Japan to apply a FIRPTA-like tax on US residents.

Relationship with the Nonrecognition Provisions

Under US tax law, "nonrecognition treatment" is accorded a number of transactions involving the exchange of assets under some conditions. Specific examples include:

- the liquidation of an 80-percent (or more) owned subsidiary (*i.e.*, the exchange of the subsidiary's stock and the assets distributed in liquidation, *see* §332 of the Code);

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- the contribution in-kind of assets to a corporation under control with 80 percent (or more) equity ownership (*i.e.*, the exchange of the assets being contributed and the stock of the controlled corporation, *see* §351 of the Code);
- corporate mergers and divisions in specified forms (*e.g.*, the exchange of stock of the target corporation for stock of the acquiring corporation, *see* §368 of the Code); and
- like-kind exchanges (*e.g.*, the exchange of US real property for other US real property, *see* §1031 of the Code).

It is often difficult to determine which portion of liquid assets should be included in business assets without relying on the five percent rule.

According to the US income tax regulations, if a transaction qualifying for nonrecognition treatment is also subject to FIRPTA, the nonrecognition provision is generally respected if the foreign person exchanges a USRPI for another USRPI. (*See* §1.897-6T(a) of the temporary regulations. As discussed later, certain reporting requirements must be met to apply a nonrecognition provision to an exchange of USRPIs.)

In other words, even if the conditions for nonrecognition treatment are satisfied, gain recognition is generally required under FIRPTA when a USRPI is exchanged for an asset that is not a USRPI.

If an exchange of one USRPI for another occurs, gain recognition is generally deferred because the US government can tax the gain in the future when the foreign person disposes of the USRPI acquired in the exchange. If the foreign person exchanges a USRPI for an asset that is not a USRPI, however, the US government would lose the opportunity to tax the gain unless it is taxed at the time of the exchange.

Withholding Provisions

Because of the nature of FIRPTA, which imposes tax on foreign persons who reside outside the US jurisdiction, a series of withholding provisions are set forth under §1445 of the Code to ensure the collection of the US tax due under §897. Thus, when a foreign person disposes of a USRPI, the transferee of the USRPI must withhold and pay to the IRS 10 percent of the amount realized on the disposition of the URSPI.

Further, to ensure that the withholding provisions are applied comprehensively, the transferee must obtain documentary evidence to claim an exemption from the duty to withhold. For example, if withholding is not required because the transferor is not a foreign person, the transferee must obtain a "non-foreign affidavit" from the transferor. Likewise, for a transferee to be exempt from the duty to withhold upon the transfer of a US corporation's stock that is not a USRPI, the transferee must obtain a copy of a statement issued by the US company representing that its stock is not a USRPI.

For transactions subject to FIRPTA, if the actual amount of the tax on the gain is expected to be less than 10 percent of the amount realized on the disposition of the USRPI, either the transferor or the transferee may apply in advance to the IRS for a reduction in the amount of tax required to be withheld. Also, if no tax is due, either because the transfer generates a loss or because a nonrecognition provision applies, the transferor or the transferee may apply in advance for complete elimination of the withholding requirement. The IRS usually will act within 90 days of the receipt of the application and will issue a "withholding certificate" upon approval.

When a nonrecognition provision applies to the transfer, the transferee may also be exempted from the duty to withhold by filing a "notice of nonrecognition" with the IRS, instead of obtaining a withholding certificate. Under this procedure, within 20 days from the date of the transfer, the transferee must provide the IRS with a copy of the statement issued by the transferor certifying that the transfer qualifies for nonrecognition treatment.

This procedure may not be used if the nonrecognition treatment is only partially applicable, or if the transferee has reason to believe that the statement issued by the transferor is incorrect.

Further, after November 2, 2003, all foreign transferors of USRPIs must provide their US taxpayer identification numbers ("TINs") on withholding tax returns, applications for withholding certificates, and all other notices and elections under §§897 and 1445. If filed without the TIN, an application for a withholding certificate, notice, or election will be considered incomplete and will not be processed by the IRS.

Therefore, Japanese companies planning to execute a transaction that requires reporting under FIRPTA should prepare themselves by obtaining a US TIN well in advance.

Applying FIRPTA to Establish a US Holding Company

The following examples illustrate how FIRPTA provisions are applied, in terms of taxability and reporting / withholding requirements, to a transaction in which a Japanese corporation establishes a new US holding company by contributing the stock of existing wholly-owned US subsidiaries:

- Common assumptions for all cases: J-Co, a Japanese corporation, wholly owns two US subsidiaries, A-Co and B-Co. J-Co contributes A-Co stock and B-Co stock to a newly established US corporation, H-Co, in exchange for 100 percent of the issued and outstanding stock of H-Co. In the absence of FIRPTA, the transaction qualifies as a nontaxable capital contribution to an 80-percent (or more) controlled corporation (*i.e.*, an exchange of assets contributed in-kind and the stock of the controlled corporation) under §351 of the Code. Under Japanese law, a contribution in-kind of stock in a foreign subsidiary is tax-free. Further, the fair market value of both A-Co stock and B-Co stock significantly exceeds the respective basis in the hands of J-Co.

  Common procedural requirements for all cases: J-Co must issue a statement to each existing US subsidiary (*i.e.*, A-Co and B-Co) inquiring whether its stock would be a USRPI on the proposed transfer date. Upon receipt of the inquiry from J-Co, A-Co and B-Co must examine whether they have been USRPHCs on each testing date during the five-year period before the proposed transfer date and report the result back to J-Co. At the same time, each US subsidiary must file a statement signed by an officer under penalties of perjury notifying the IRS of the result of the determination reported to J-Co. If A-Co or B-Co does not reply to J-Co's inquiry, J-Co may request a determination by the IRS. However, this situation is unlikely given the parent-subsidiary relationship.

- ***Case No. 1:*** Based on analyses performed by A-Co and B-Co of their assets for the last five years, both companies determine that they were at no time USRPHCs. Thus, neither A-Co stock nor B-Co stock is a USRPI.

  Taxability: In this case, J-Co's disposition of A-Co or B-Co stock is not a disposition of a USRPI. Thus, J-Co is not taxed under FIRPTA.

  Procedural requirements: Using the procedure described above, J-Co must obtain statements from A-Co and B-Co certifying that their stock is not a USRPI. The statements must be obtained on or before the due date of J-Co's tax return for the year in which the transfer took place. H-Co, the transferee of A-Co and B-Co stock, is relieved from its duty to withhold by obtaining copies of the A-Co and B-Co statements from J-Co.

- ***Case No. 2:*** Both A-Co stock and B-Co stock are determined to be USRPIs. Further, H-Co is determined to be a USRPHC immediately after its incorporation.

  Taxability: Because J-Co's transfer of A-Co and B-Co stock in exchange for H-Co stock is an exchange of one USRPI for another USRPI, the transaction is respected as a tax-free capital contribution. (Section 1.897-6T(a) of the US income tax regulations provides that, if a foreign person acquires stock in a US corporation in exchange for a USRPI, the transfer qualifies as an exchange of one USRPI for another USRPI only if the US company is a USRPHC immediately after the transfer.) Thus, the tax under FIRPTA is deferred if the procedural requirements below are satisfied.

Under US law, if a transaction qualifying for nonrecognition treatment is also subject to FIRPTA, the nonrecognition provision is generally respected if the foreign person exchanges one USRPI for another.

  Procedural requirements: Generally, J-Co must file IRS Form 1120-F, *US Income Tax Return of a Foreign Corporation*, to report the transfer of A-Co and B-Co stock to H-Co. If J-Co does not file this form, the transfer will not be respected as a nonrecognition transaction. However, J-Co could secure nonrecognition treatment without filing Form 1120-F if the following three conditions are met (per IRS Notice 89-57):

  - J-Co's contribution of A-Co and B-Co stock to H-Co is accorded nonrecognition treatment under the regulations;
  - J-Co has no effectively connected income (*i.e.*, no income that is effectively connected with a US trade or business) in the tax year of the transfer; and
  - H-Co is exempt from the duty to withhold, either by obtaining a withholding certificate from the IRS or by filing a notice of nonrecognition with the IRS. If H-Co is not exempt from the duty to with-

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hold, it must withhold and pay over to the IRS 10 percent of the amount realized on the disposition of A-Co and B-Co stock. J-Co then must file a tax return to claim a refund of the tax withheld by H-Co. To avoid this complicated and inefficient process, this third condition must be satisfied. At the same time, because the first condition is also assumed to be satisfied in our example, whether J-Co needs to file a tax return will depend upon the second condition (*i.e.*, whether J-Co earned effectively connected income in the year of the transfer).)

If an exchange of one USRPI for another occurs, gain recognition is generally deferred because the US government can tax the gain in the future when the foreign person disposes of the USRPI acquired in the exchange.

- ***Case No. 3:*** While A-Co stock is determined to be a USRPI, B-Co stock is determined *not* to be a USRPI. H-Co is a USRPHC immediately after its incorporation.

Taxability: Because J-Co's transfer of A-Co stock to H-Co is an exchange of one USRPI for another USRPI, the nonrecognition treatment is respected. No gain recognition is required under FIRPTA with respect to J-Co's transfer of B-Co stock to H-Co because B-Co stock is not a USRPI.

Procedural requirements: The procedure with respect to J-Co's transfer of A-Co stock to H-Co is the same as the procedure in Case No. 2 above. The procedure with respect to J-Co's transfer of B-Co stock to H-Co is the same as the procedure in Case No. 1.

- ***Case No. 4:*** While A-Co stock is determined to be a USRPI, B-Co stock is determined *not* to be a USRPI. Further, H-Co is *not* a USRPHC immediately after its incorporation. (It may be possible for a foreign corporation that holds a USRPI, and is entitled to nondiscriminatory treatment under a US tax treaty, to elect to be treated as a domestic corporation for purposes of §§897, 1445, and 6039C.)

Taxability: J-Co's contribution of A-Co stock to H-Co is a disposition of a USRPI (*i.e.*, the

Tax Shelters

Certain Transactions Involving Foreign Currency Options Barred by US Government

The US Treasury Department and the Internal Revenue Service have decided to bar transactions in which taxpayers dispose of a pair of offsetting options, claiming a loss on one of the options, but contending that they never have to recognize the corresponding gain on the other.

The transactions are now considered "listed transactions" for purposes of applying the US anti-tax shelter regulations. Taxpayers that have entered into the transactions must disclose them to the IRS, and tax advisors that promote the use of the transactions must maintain lists of participating taxpayers.

According to the US Treasury Department's Assistant Secretary for Tax Policy, "We have given taxpayers notice that if they assign an option in one of these transactions they must recognize the gain. If they fail to do so, they will have to disclose their transaction to the IRS."

The particular transactions in question typically involve two pairs of offsetting options on foreign currencies that, collectively, are structured to have little real risk of economic gain or loss. A taxpayer assigns two offsetting options to a charity, claiming an immediate loss on one of the options and taking the position that it does not have to take into account the offsetting gain in the other assigned option.

The taxpayer then disposes of the remaining pair of offsetting options. The result is a large tax benefit (the claimed tax loss on one assigned option), without recognition of the matching economic gain on the other assigned option.

The US tax authorities assert that the promoters and taxpayers involved in these transactions are misapplying the rules relating to the inclusion of gain on assigned options in taxable income. The IRS will challenge the tax benefits claimed by taxpayers that have entered into these transactions.

Source: US Treasury Department Release No. JS-1034, December 4, 2003. ❑

exchange of A-Co stock, a USRPI, and H-Co stock, a non-USRPI). Thus, J-Co is taxed in the US on the built-in gain on A-Co stock under FIRPTA. (Although J-Co is taxed in the US under FIRPTA, J-Co's contribution of A-Co stock to H-Co is tax-free under Japanese law. Thus, J-Co may not be able to claim a foreign tax credit in Japan.) J-Co's contribution of B-Co stock to H-Co is not taxable because it is not a disposition of a USRPI.

Procedural requirements: Generally, upon J-Co's transfer of A-Co stock to H-Co, H-Co must withhold 10 percent of the amount realized on the disposition of A-Co stock (*i.e.*, the fair market value of A-Co stock) and pay it to the IRS. J-Co must file a US tax return to report the gain on the transfer of A-Co stock. If the actual amount of the tax on the gain is less than the amount withheld by H-Co, J-Co may claim a refund on its return. Alternatively, J-Co or H-Co could apply for a withholding certificate from the IRS and obtain permission for reduced withholding. On the other hand, if the actual amount of the tax is greater than the amount withheld, J-Co. must pay additional tax. If additional tax is due, J-Co may have to make an estimated tax payment to avoid a penalty for the underpayment of estimated tax. The procedure with respect to J-Co's transfer of B-Co stock to H-Co is the same as the procedure in Case No. 1.

Penalties for Failure to Follow Compliance Requirements

Penalties for the failure to follow reporting and withholding requirements vary based on the particular situation.

As discussed above, H-Co may not be exempt from its duty to withhold unless certain procedural requirements are met. If A-Co or B-Co stock is not a USRPI, H-Co must obtain a copy of the statement issued by A-Co or B-Co in response to J-Co's inquiry certifying that its stock is not a USRPI (Case No. 1 above).

If the transfer of A-Co or B-Co stock is accorded nonrecognition treatment, it is necessary to obtain a withholding certificate from the IRS or submit a notice of nonrecognition to the IRS (Case No. 2 above).

If these procedures are not followed properly, regardless of whether the transaction is actually taxed under FIRPTA, H-Co is *not* exempt from the duty to withhold. Thus, the IRS can assess H-Co tax for the amount that H-Co should have withheld (*i.e.*, 10 percent of the amount realized on the disposition of A-Co and B-Co stock) along with interest.

In some cases, civil and criminal penalties may be imposed on H-Co. Further, a penalty under §6672 of the Code in the same amount as the amount of tax required to be withheld (*i.e.*, a 100-percent penalty) may be imposed on H-Co's officers and other individuals responsible for withholding.

However, if J-Co files a tax return and pays the liability, or if the IRS issues a withholding certificate and determines that J-Co's tax liability is zero, H-Co is deemed to have fulfilled its withholding responsibility and thus is relieved from the duty to withhold at that time.

The examples in this article illustrate how FIRPTA provisions are applied, in terms of taxability and reporting/withholding requirements, to a transaction in which a Japanese corporation establishes a new US holding company by contributing the stock of existing wholly-owned US subsidiaries.

At the same time, unless H-Co's failure to withhold is due to criminal intent, any penalty against H-Co is automatically abated.

However, although H-Co is deemed to have fulfilled the duty to withhold and is relieved from the withholding tax liability and the penalty, the IRS generally will not abate the interest accrued for the period from the date that H-Co should have paid the withholding tax over to the IRS to the date that H-Co's duty to withhold is deemed fulfilled upon the filing of the tax return by J-Co, or upon the issuance of the withholding certificate by the IRS. Under the US income tax regulations, while a deemed satisfaction of H-Co's duty to withhold is equivalent to a late payment of tax, interest on a late payment of tax may not be abated.

Therefore, as a result of a failure to comply with the reporting requirements, even if the transaction is not actually taxed under FIRPTA (as in Case Nos. 1, 2, and 3 above), H-Co's liability for interest payable to the IRS will continue until H-Co is formally exempt from the duty to withhold.

For example, assuming that the average interest rate is seven percent, if the fair market value of the stock contributed to the holding company was

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$50 million, interest is accrued at the rate of at least $350,000 per year (50 million x 10 percent x 7 percent). In reality, interest is compounded daily.

Of course, until H-Co is relieved from the duty to withhold, there is no expiration of the statute of limitation. It should be noted that the IRS generally has no discretion to abate the interest imposed on companies as a matter of law, regardless of whether there is reasonable cause. Thus, one would not be successful in an attempt to have the interest abated by arguing that the noncompliance was the result of an inadvertent clerical error or lack of awareness of the procedural requirements.

Advance preparation and planning are obviously the keys to avoid getting trapped by the pitfalls created by the stringent procedural requirements under FIRPTA.

In addition to the interest imposed on H-Co, J-Co would also be required to file a tax return and pay the tax, potentially with penalties, if the transaction is actually subject to tax under FIRPTA (as in Case No. 4 above).

Summary

The procedural requirements under FIRPTA may seem extremely difficult to understand, especially in light of the somewhat intricately interconnected provisions of the regulations under §§897 and 1445 of the Code. However, if carefully prepared in advance, it should not be difficult to follow the procedures.

While the worst-case scenario would be getting hit with a large interest assessment many years later, this situation can be avoided simply by ensuring that the required procedures have been followed properly.

Even when a transaction is subject to tax under FIRPTA, as in our Case No. 4 above, it is still possible to avoid the tax by planning ahead. In our example, J-Co could avoid tax on the built-in gain on A-Co stock by contributing B-Co stock to A-Co, instead of establishing H-Co (*i.e.*, by making A-Co the holding company) because, in this case, J-Co would not be disposing of A-Co stock.

Before new corporate reorganization rules came into effect in Japan in April 2001, a contribution of appreciated property to an existing subsidiary did not qualify for tax-free treatment under §51 of the Japanese corporate tax law. Thus, in our example, J-Co would have been taxed on the built-in gain on B-Co stock in Japan. However, under current Japanese law, a contribution in-kind of stock in a foreign subsidiary to an existing subsidiary is tax-free.

Alternatively, it may be possible to take the position that A-Co stock is not a USRPI by taking the fair market value of the intangible assets into account based on a careful valuation analysis and thorough supporting documentation. In this case, a notice regarding the valuation of the intangible assets must be filed with the IRS.

In any event, advance preparation and planning are obviously the keys to avoid getting trapped by the pitfalls created by the stringent procedural requirements under FIRPTA. ❑

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