Pepper Hamilton LLP
Attorneys at Law

TAX UPDATE

Vol. 2015, Issue 2

Quotable:

Todd Reinstein was quoted in *Tax Notes Today* and the Bloomberg *BNA Daily Tax Report* on his thoughts regarding the finalized consolidated agency return rules (1.1502-77) on April 1 and April 2.

Lance S. Jacobs was quoted in the May 18, 2015 *Washington Times* article, "Supreme Court Strikes Down Maryland Income Tax Law."

Joan Arnold was quoted in *Tax Notes International* on her thoughts regarding tax policies to curb inversions on June 15, 2015.

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NEWS

On June 25, 2015, Pepper Hamilton hosted a program of the Federal Bar Association on Ethical Considerations in Tax Controversy. The program was moderated by Pepper partner Todd Reinstein and featured the IRS Office of Professional Responsibility Director, Karen Hawkins.

IN THIS ISSUE (CONTINUED)

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SPEAKER'S CORNER:

Recent Developments in Corporate Taxation (Federal, International & State) In-Person or Webinar Format Available Monday July 27, 2015

9:00 AM - 4:00 PM
New Jersey Law Center
One Constitution Square
New Brunswick, NJ

Presented in cooperation with the NJSBA Taxation Law Section.

Pepper partner Todd B. Reinstein will be joining this experienced panel of tax attorneys and accountants for this all day Corporate Tax Symposium. This program goes beyond the basics and features the top headlines and issues important to your practice.

Program topics will include:

- The Nuts and Bolts of Section 382 - Todd Reinstein, Esq.
- Transfer Pricing/BEPS Update - Philip Carmichael; Brian Arthur, Esq.
- Indirect Taxes - Property Taxes, Sales & Use - Jeffrey M. Gradone, Esq.; Mitchell A. Newmark, Esq.
- Advanced Topics for Accounting for Income Taxes - Darren Mills, CPA
- Current Developments in State Taxation - Peter Giroux, CPA
- Tax Controversy: Surviving Federal and State Audits - Tools to Lighten the Burden - Paul Tew, CPA; Mitchell A. Newmark, Esq.
- What Keeps a Tax Director up at Night? - Trevor Ackerman, Esq., CPA; James Sipple, Esq., CPA
- Pass Through Entities - Leonard Nitti, CPA, MST

CLE Available

For more information on the CLE available and to register for the **in-person format** version of this program, visit http://www.njicle.com/viewprogram.aspx?catid=2097&progid=10849

For more information on the CLE available and to register for the **webinar format** version of this program, visit http://www.njicle.com/viewprogram.aspx?catid=2097&progid=10850

OTHER EVENTS

Steven D. Bortnick will be speaking at the New York University School Summer Institute in Taxation on July 24 on Tax Structuring for Cross Border Investment Funds.

Pepper Hamilton LLP
Attorneys at Law

Planning For Qualified Dividend Income When Taking Foreign Companies Public

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WHERE QUALIFIED DIVIDEND TREATMENT IS IMPORTANT, SERIOUS CONSIDERATION SHOULD BE GIVEN TO ENSURING THE COMPANY IS ELIGIBLE FOR TREATY BENEFITS BEFORE TAKING IT PUBLIC.

Dividends generally are taxed at ordinary income rates (up to 39.6 percent for individuals). Qualified dividends derived by individuals, however, are taxed at the preferential rate applicable to capital gains (usually 20 percent).[2] Generally, all dividends paid by a domestic corporation are qualified dividends. Dividends paid by a foreign corporation, however, must meet certain requirements in order to be considered qualified and, thus, entitled to favorable tax rates in the hands of individual payees. This article discusses certain dividend planning opportunities and considerations to be taken into account in connection with the initial public offering of a foreign corporation, including the surprising position of the Internal Revenue Service (IRS) related to dividends on shares of a foreign public company that are not registered under the Securities Act of 1933 (the 33 Act).

Only Dividends Paid by "Qualified Foreign Corporations" Are Qualified Dividends

For dividends paid by a foreign corporation to be qualified dividends, the foreign corporation must be a "qualified foreign corporation." A qualified foreign corporation is a foreign corporation that meets one of the following criteria:

- is incorporated in a possession of the United States
- is eligible for the benefits of a comprehensive income tax treaty with the United States that includes an exchange of information program
- pays dividends on its stock if the stock with respect to which the dividends are paid is readily tradable on a U.S. securities market.

Foreign Corporations Eligible for the Benefits of a Comprehensive Income Tax Treaty

The IRS has identified 57 treaties that are considered to be comprehensive and that include exchange of information programs.[3] Corporations eligible for the benefits of such treaties are qualified foreign corporations.

To be eligible for the benefits of an income tax treaty, a foreign corporation must be tax resident in a country that has a tax treaty with the United States. In addition, that company must meet all eligibility requirements of the applicable treaty. Most U.S. tax treaties include a limitation on benefits (LOB) provision designed to preclude "treaty shopping" (*i.e.*, forming a company in a country primarily to obtain treaty benefits). The LOB provisions of modern treaties are comprehensive. At the most basic level, they require that a certain percentage of the foreign corporation's shares be owned by residents of either or both of the contracting countries. A corporation not meeting these tests may still qualify if, among other possibilities, it is engaged in a trade or business in the treaty jurisdiction. In addition, certain publicly traded corporations may satisfy the LOB clause even if its owners are not resident in either treaty jurisdiction and if its shares are traded on an exchange other than an exchange in the treaty jurisdiction.

For example, under the LOB clause of the Irish tax treaty, an Irish corporation will be eligible for the benefits of the treaty if a principal class of its shares is substantially and regularly traded on one or more recognized stock exchanges. For this purpose, a recognized stock exchange includes the NASDAQ system and any stock exchange registered with the U.S. Securities and Exchange Commission (SEC) (including the New York Stock Exchange and NASDAQ),[4] the Irish Stock Exchange, and the stock exchanges of Amsterdam, Brussels, Frankfurt, Hamburg, London, Madrid, Milan, Paris, Stockholm, Sydney, Tokyo, Toronto, Vienna and Zurich. Thus, so long as the company to be taken public is tax resident in Ireland, it will be entitled to treaty benefits if its primary class of shares are substantially and regularly traded on one or more of these exchanges. Dividends it pays on its shares will be treated as qualified dividends in the hands of individual investors, taxable at a favorable tax rate.

Pepper Perspective

If the company to be taken public would not otherwise be eligible for treaty benefits, planning likely will be available by moving the company to a jurisdiction with a favorable tax treaty with the United States, even if the plan is for the company's shares to be treated on an exchange outside such jurisdiction. Planning for the corporation may involve (a) moving its tax residence to a jurisdiction with a favorable treaty, (b) merging it into a company tax resident in a jurisdiction with a favorable tax treaty or (c) contributing it to a new corporation tax resident in a jurisdiction with a favorable tax treaty. With proper planning, these transactions typically can be accomplished in a tax-free manner for U.S. tax purposes. Of course, applicable foreign tax planning will be required.

Dividends Payable on Readily Tradable Stock

A foreign corporation that is not otherwise treated as a qualified foreign corporation (as described in the first two bullets defining qualified foreign corporations above) is treated as a qualified foreign corporation with respect to any dividends paid by such corporation if the stock with respect to which the dividend is paid is readily tradable on an established securities market in the United States. The first thing to note is that, unlike the LOB provision in the Irish treaty (as well as certain other treaties), stock must be tradable on a *U.S.* securities market.

The IRS has stated in three notices[5] that stock is considered "readily tradable" on an established U.S. securities market if it is *listed* on a national securities exchange that is registered under section 6 of the Securities Exchange Act of 1934.[6] Despite the IRS's three prior notices stating that the critical question is whether shares are listed on a national securities exchange, the IRS subsequently ruled in PLR 200606021 (Feb. 10, 2006) that unregistered shares are not readily tradable for the purposes of determining whether a corporation is a qualified foreign corporation. The ruling held that "shares that are not registered under the Securities Act of 1933 are not considered readily tradable" for the purposes of determining whether a foreign corporation will be treated as a qualified foreign corporation with respect to dividends paid on readily tradable shares. The ruling is based on the IRS's understanding that "[s]ecurities [listed on a national securities exchange] must be registered under the Securities Act of 1933." This statement, however, is not universally correct. Additionally, the IRS's revised position creates the potential for dividends paid on shares of the same class to have a different character, depending on whether the shares are qualified or not. This is inconsistent with the other requirements a foreign corporation can meet to be a qualified foreign corporation, which look to the nature of the foreign corporation itself, rather than requiring a share-by-share analysis to determine whether dividends are qualified. It also fails to take into account the proper operation of the securities laws and may be impossible to determine.

Listed Versus Registered Shares

Listing refers to the listing of shares on a national securities exchange, such as the New York Stock Exchange or NASDAQ. Each exchange has its own rules for the listing of shares. The fact that shares are registered (discussed below) does not mean that they necessarily will be listed on any exchange. Moreover, the fact that shares are listed does not mean that they can be sold without restriction.

Under the 33 Act, the sale of shares that are not registered with the SEC is subject to restriction. Shares are registered when they are identified in a prospectus filed with the SEC. It is common that a corporation will not register all of its shares for sale. Registration itself relates to a particular offer and sale. Thus, only those shares being offered and sold pursuant to a prospectus will be registered with the SEC. Thus, if the corporation's existing shareholders do not intend to sell shares pursuant to the prospectus, the shares will not be registered. Registering all of a corporation's shares could cause the public concern that founders and existing holders will rush to sell their shares and, thus, deflate the price of the shares after the IPO. This also may be inconsistent with lock-up agreements required by investment banks working on the IPO.

Example

XYZ is a Cayman Islands corporation. It has 100,000,000 shares issued and outstanding. 85,000,000 shares are held by ABC, a private equity fund, and 15,000,000 are held by managers of XYZ. ABC and its owners decide that ABC should become a public company. It registers 50,000,000 new shares and 25,000,000 shares currently held by ABC and managers to be sold in connection with an IPO. It lists all of its outstanding shares on NASDAQ. After the IPO, XYZ has 150,000,000 shares outstanding, 75,000,000 of which are registered. ABC and managers continue to own the remaining 75,000,000 shares, which are listed, but not registered.

Shares of a corporation that have not been registered with the SEC may be sold in transactions exempt from registration, including under Rule 144 of the 33 Act. Rule 144 permits sales of shares of a publicly traded company to be sold, subject to certain limitations. The nature of these limitations differs depending on whether or not the holder is considered to be an affiliate of the issuer of the stock. Similarly, even if shares of a foreign corporation are registered, an affiliate cannot simply sell as many shares as he/she/it wants. Such persons are subject to restrictions. In short, certain restrictions on the ability of a person to sell listed shares on a securities exchange are personal, and not attached to the shares. Finally, once the shares on sold on the market, it is impossible to determine which were previously sold in a registered transaction and which were not.

There is no clear policy rational for treating dividends paid with respect to listed but unregistered shares as ineligible for qualified dividend treatment, and no such distinction is made in the legislative history.[7]

Pepper Perspective

The IRS's latest position that dividends paid with respect to listed but unregistered shares are not qualified dividends seems incorrect. However, where qualified dividend treatment is important (such as where unregistered shares will continue to be held by a private equity fund with substantial U.S. individual partners), serious consideration should be given to ensuring the company is eligible for treaty benefits before taking it public, as described in greater detail above.

Endnotes

1. Special thanks to Donald Readlinger for his advice on securities law matters discussed herein.

2. Corporations are subject to the same tax rates on all income.

3. *See* Notice 2011-64, 2011-37 I.R.B. 231 (listing applicable treaties).

4. A complete listing of the exchanges registered with the SEC is available at http://www.sec.gov/divisions/marketreg/mrexchanges.shtml.

5. Notice 2003-71, 2003-43 I.R.B. 922; Notice 2003-79, 2003-2 C.B. 1206; Notice 2004-71, 2004-2 C.B. 793.

6. See footnote 3 above for a link to a listing of the exchanges registered with the SEC.

7. We note that the IRS held in PLR 9803009 (Jan. 16, 1998) that the installment method of accounting (which permits gain to be recognized over the period over which payments are made) was available to a taxpayer that sold listed shares, but, as an affiliate of the company, could only sell subject to the volume limitations in Rule 144. Although installment accounting is not permitted with respect to stock tradable on an established securities market, the IRS held that the legislative history indicated that the rule was intended to deny installment treatment only where the taxpayer in question could easily dispose of stock for cash in the public market. S. Rep. No. 99-313, 99th Cong., 2d Sess. 124.

INTERNATIONAL TAX GROWS UP: THE TAX SECTION AT 75, SUBPART F AT 53, AND THE FOREIGN TAX CREDIT AT 97

by Joan C. Arnold

5/11/2015

This article was published in the Winter 2015 Issue of The Tax Lawyer From the ABA Section of Taxation.

As the Tax Section celebrates its 75th anniversary, I was asked to reflect on the Section's contribution in the international tax arena and on how the Section's international community has grown. I started by recognizing the number years that such reflection needs to cover: In 2015 the foreign tax credit will be 97 years old, and Subpart F of the Code will be 53 years old; I am celebrating the 39th anniversary of my first cross border tax project, and I've been involved in the international committees of the Tax Section for more than half of that time. Although reflecting on the changes wrought over so many years is daunting, it has also been quite interesting.

For more visit http://www.pepperlaw.com/publications/international-tax-grows-up-the-tax-section-at-75-subpart-f-at-53-and-the-foreign-tax-credit-at-97-2015-05-11/

Fund Managers, Welcome to the Hotel California — When It Comes to Certain Taxes, It's Possible You Can Never Leave

Lance S. Jacobs | jacobsls@pepperlaw.com

FUND MANAGERS MAY BE TAXABLE IN CALIFORNIA, EVEN IF THE MANAGER HAS NO PROPERTY OR PAYROLL IN CALIFORNIA AND ALL OF THE MANAGEMENT SERVICES ARE PERFORMED OUTSIDE OF THE STATE.

Several recent law changes in California, when taken together, may make fund managers taxable in California, even though the manager has no property or payroll in California and all of the management services are performed outside of California. Potential taxes impacted by these changes are the California LLC-based taxes and fees (including the fee based on the manager's gross receipts), as well as potential withholding obligations for the income sourced to California and allocated to the members of the LLC (or partners in a limited partnership, if that is the entity of choice for the manager).

Economic Nexus

The first change that may have tremendous impact on fund managers is California's switch to an economic nexus standard. Prior to 2011, the term "doing business" in California meant actively engaging in any transaction for profit within the state. However, as of January 1, 2011, the law changed to an economic nexus threshold, whereby any taxpayer was considered to be doing business in California if its **California-sourced gross receipts** exceeded $500,000 (with provisions that index this threshold for inflation) or 25 percent of the entity's gross receipts. As a result, a fund manager operating in New York, with no physical presence in California, could nonetheless find itself with a California tax obligation if its California-sourced gross receipts exceed $500,000.

Market Sourcing

This leads to an obvious question: What constitutes a California-sourced gross receipt? Prior to 2011, like many states, California subscribed to the "cost of performance" rule — a receipt was sourced for income tax purposes to the location where the service was performed (technically, where the costs for performing the service were incurred). Under a specific rule for fund managers, this was measured based on the ratio of time spent providing services in California compared to the time spent in all jurisdictions performing services. For fund managers outside of California who never performed services within California, this meant that zero receipts were sourced to California for income tax purposes.

However, like many states, on January 1, 2011, California switched to market sourcing. Market sourcing recognizes the loss of tax revenue brought about by the reality that modern technology allows taxpayers to reach other states' markets without necessarily having to travel there. Under market sourcing, receipts are sourced to California to the extent that the purchaser receives the benefit of the service in California.

This creates a particularly thorny issue for fund managers. If, for example, the fund it manages either is formed under the laws of California or has a California mailing address, the risk is obviously that all of the receipts received from that fund as a customer could be considered California receipts. Alternatively, California could look through the fund to its investors in order to determine where the benefit was received.

Recently passed California sales sourcing regulations applicable to mutual fund service providers allowed these taxpayers to use such a "look through" approach. Thus, mutual fund managers providing services to a fund look at the percentage of investors located in California to determine California sourcing. Under this rule, a mutual fund management company that earns $2,000,000 annually in fees from a mutual fund with 50 percent of its investors in California would have $1,000,000 in California gross receipts. Under such a scenario, the amount of gross receipts would exceed the $500,000 gross receipts threshold for economic nexus, and the manager would have to file a California return.

A proposed amendment to the applicable regulation would extend the mutual fund rules to fees earned by asset managers who are providing similar services to entities other than mutual funds, such as private equity funds or hedge funds. The California Franchise Tax Board, which administers these taxes, expressed support for this position in 2013, and it is likely to be finalized soon.

Pepper Perspective

Given the inherent logic behind the rule, as well as the similarities in services offered by mutual fund managers and other asset managers, it seems likely that the mutual fund manager rule will be extended to all managers. As a result, it will require tax preparers for management companies to actively inquire as to the fund's shareholder makeup in order to make nexus determinations and file returns as necessary. Such returns (and liabilities) would include the minimum $800 LLC tax and the LLC fee calculated based on gross receipts capping at slightly less than $12,000. Managers may also have to withhold and remit California tax for its members if the California receipts exceed the economic nexus thresholds. Managers may wish to explore the possibility of filing a composite return for their members in such a situation.

WEBINAR: FUND AND ADVISER TAX ISSUES

Pepper partners Gregory J. Nowak and Steven D. Bortnick presented a webinar for West LegalEdcenter discussing issues that affect private funds and their managers.

Over the hour program, Mr. Nowak and Mr. Bortnick covered a host of various tax provisions that could impact investment funds and managers , including the Rubio and Lee Tax Reform Plan; the California's new Doing Business Standard; asset management fees; and marketplace lending and Member Payment Dependent Notes (MPDNs) issues.

To listen to the webinar visit http://www.pepperlaw.com/podcasts/fund-and-adviser-tax-issues-2015-04-22/

Joan C. Arnold Elected President of American College of Tax Counsel

Joan C. Arnold, a partner with Pepper Hamilton LLP and chair of the firm's Tax Practice Group, has been elected president of the American College of Tax Counsel (ACTC), the preeminent professional association of tax lawyers in private practice. Ms. Arnold is the first woman to hold the office in the 33-year history of ACTC. Her one-year term began on March 1.

ACTC is a selective, invitational organization for lawyers with more than 15 years of experience who have demonstrated excellence in the practice of tax law and a commitment to involvement in the advancement of tax administration and tax law. The organization's members comment on significant issues via amicus briefs, government submissions and ongoing discussions with senior leadership within the Internal Revenue Service and the U.S. Department of the Treasury. Ms. Arnold has been an ACTC Fellow since 1999, and has served as a Regent since 2009. She served as ACTC vice chair for the 2014–15 term.

Ms. Arnold is active in the leadership of many other professional organizations, including the ABA Section on Taxation, where she is the Vice Chair – CLE. She is vice president and a member of the executive committee of the U.S. Branch of the International Fiscal Association. In Philadelphia, she was for the prior eight years president of the Philadelphia Tax Conference. In Washington D.C., she is on the executive committee of the George Washington/IRS Annual International Tax Institute. Ms. Arnold also teaches at the Temple Law School and is a former adjunct professor in the Graduate Tax Program at Villanova University School of Law.

Ms. Arnold focuses her practice on federal and international income tax. She has more than 30 years of significant experience in domestic and cross border M&A, and corporate international tax counseling, including substantial tax experience in the private equity arena.

Ms. Arnold holds a B.A. in mathematics from Wagner College, a J.D. from Villanova University School of Law, and an LL.M. in taxation from New York University School of Law.

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