Financial Services Industries
Insurance

Tax Court ruling clarifies definition of insurance risk

In a reviewed opinion (RVI Guaranty Co. Ltd., et al. v. Commissioner), the Tax Court has held that a company’s contracts, insuring against the risk of drops in value of property, covered insurance risks not investment risks and constituted contracts of insurance for federal income tax purposes.

Background

RVI Guaranty Co. Ltd. (RVIG) is a Bermuda property and casualty insurance company that has elected under Section 953(d) to be treated as a domestic corporation for federal income tax purposes. It is the common parent of an affiliated group of corporations that includes RVI America Insurance Company (RVIA). RVIG is domiciled in Connecticut and authorized to sell insurance policies in Connecticut, New York, Pennsylvania, Ohio, Texas, Illinois and Georgia. RVIG, together with RVIA and the other members of the affiliated group, filed a consolidated return for 2006 (the year at issue) on Form 1120-PC, US Property and Casualty Insurance Company Income Tax Return.

During the tax year in issue, RVIA’s sole business consisted of selling residual value insurance contracts to leasing companies, manufacturers and financial institutions (insureds) that leased assets to individuals and businesses. The insureds priced each of their leases by taking into consideration an expected residual value of the leased asset at the conclusion of the lease term. The risk insured under the insurance contracts (RVI policies) was the risk that the actual value of the asset upon termination of the lease might be significantly lower than the insured residual value of the asset. The insured residual value was set slightly below the expected residual value; accordingly, the insured retained the risk for an initial layer of loss (the difference between the expected residual value and the insured residual value) and RVIA accepted the risk for the balance (the difference between the insured residual value and the actual residual value).

The RVI policies insured assets in three different business segments — passenger vehicles, commercial real estate and commercial equipment (such as rail cars and airplanes). During the tax year in issue, each business segment comprised roughly one-third of RVIA’s business as measured by unearned premiums at year-end. At the end of 2006, RVIA had 951 policies in force insuring 714 unrelated insureds. Assets covered by the policies included a diverse selection of approximately 754,500 passenger vehicles, 2,100 pieces of real estate, and 1.4 million pieces of commercial equipment. Within each business segment, RVIA insured a wide variety of assets subject to leases of varying length.

RVIA wrote three types of residual value policies — “FASB,” "primary" and "hybrid." A FASB policy was one under which the insured value of the covered property was set at a level to provide the insured with enough insurance coverage to enable it to use "financing lease" accounting under the applicable accounting standard issued by the Financial Accounting Standards Board. Financing lease accounting permits a lessor to accelerate income into the earlier years of a lease for financial accounting purposes. A primary policy was one under which the insured residual value was not set at a level tied to financing
lease accounting, and a hybrid policy was one under which the insured asset was subject to both primary and FASB coverage.

RVIA's policies typically required the insureds to pay a single, nonrefundable premium at the beginning of the contract. The amount of a particular premium depended on how much risk RVIA assumed under the contract. The RVI policies were written using standard insurance terminology and some policies included a loss limitation, like a deductible, that would reduce the premium paid.

Each state in which RVIA sold RVI policies required RVIA to be licensed to sell insurance and the policies were treated as insurance for insurance regulatory purposes during 2006 by each state. RVIA was subjected to state premium taxes on the RVI policies sold and was required by each state in which it did business to file "statutory financial statements" prepared in accordance with the "statutory accounting principles" (SAP) prescribed by the National Association of Insurance Commissioners. RVIA's independent auditor issued an unqualified opinion that RVIA's statutory financial statements were fairly stated in accordance with SAP, and, after examination, the Connecticut Insurance Department approved RVIA's statutory accounting for the RVI policies.

By the end of 2013, RVIA had paid more than $150 million in claims. Although its ratio of paid losses to earned premiums varied significantly from year to year from a low of .2% to a high of 97.9%, RVIA's cumulative ratio of paid losses to earned premiums from its first year of business in 1995 through 2006 was 27.7% and from inception through the end of 2013, it was 34%.

The IRS examined RVIA's 2006 tax year and determined that RVIA was not entitled to compute its taxable income attributable to the RVI policies under the insurance accounting rules of Section 832. The IRS contended that RVIA's contracts were akin to puts — the option to transfer stock to a third party if the stock's value drops to a certain level by a particular date — and did not qualify as insurance contracts. Rather, according to the IRS, RVIA was selling protection against an investment risk and not protection against an insurance risk. The IRS issued a notice of deficiency in which it determined that RVIA owed approximately $55.2M in tax for 2006, and RVIA petitioned the Tax Court. The sole question before the Court was whether the RVI policies constitute insurance contracts for federal income tax purposes.

**Tax Court decision**

Because the term "insurance" is not defined in the Code, the Tax Court applied its usual test for determining whether a transaction qualifies as insurance. That test involves an evaluation of whether: (1) there was risk shifting, (2) the transaction involved risk distribution, (3) the transaction constituted insurance "in its commonly accepted sense," and (4) the risk shifted was an insurance risk.

The Tax Court had "no difficulty concluding that the lessors and finance companies that purchased the RVI policies transferred to petitioners a meaningful risk of loss" and therefore risk shifting existed. The Tax Court pointed out that the value of the vehicles and other property the insureds leased to third parties might decline "more precipitously than expected by the end of the lease term," and the lessors would bear the burden of this loss but for the RVI policies. Accordingly, the Tax Court found, the lessors purchasing the policies had significant business risks of economic losses being insured or shifted under the RVI policies.

In addition, RVIA was well-capitalized and capable of paying claims and absorbing the risk shifted to it, a conclusion supported by the unqualified opinion issued by RVIA's financial auditor. The Tax Court also rejected the Service's contention that insufficient risk was transferred. It noted that, due to the terms of the policies, compensable loss would be determined at the end of the particular lease term and that the IRS thus erred in using a methodology to measure loss ratios that cut off before the end of term (e.g., at the end of 2006, which was before the end of the lease for most of the assets insured in 2006).

Ultimately, the Court concluded that the level of risk transferred under the policies "was more than sufficient to treat them as 'insurance contracts'" for federal tax purposes.

Further, the Court found that the RVI policies sufficiently distributed risk because they insured a large
number and variety of leased assets over lease terms that varied in length. The Court noted that perfect independence of risk is not required; only meaningful risk distribution must be present.

In determining whether a policy constitutes insurance in its commonly accepted sense, the Court noted that it typically considers whether: (1) the insurer is organized, operated and regulated as an insurance company in the state in which it does business; (2) the insurer is adequately capitalized; (3) the insurance policies are valid and binding; (4) the premiums are reasonable; (5) premiums are actually paid and loss claims are satisfied as promised. The Court found that RVIA satisfied each of these points and the IRS did "not seriously challenge" any of these findings.

Instead, the IRS contended that the policies do not qualify as insurance because "they differ in certain respects from insurance policies with which most people are familiar." For example, the IRS argued, the RVI policies pay nothing until the lease term ends, rather than immediately after a triggering event that would diminish residual value, such as a car accident. The Court noted that the IRS cited no authority to support the validity of this contention. The Court also rejected the assertion of the IRS that RVIA's refusal to refund premiums indicated that RVIA was not really selling insurance. Rather, the Court found that making premiums nonrefundable made good business sense because it prevented lessors from canceling policies if, for example, economic conditions changed and the lessor became confident that the value of the leased property would exceed its insured value at the end of the lease term. "To prevent the insured from taking a self-serving 'wait and see' attitude in this setting, RVIA may rationally choose to disallow premium refunds upon midstream policy cancellation," the Court explained.

Giving little credence to the IRS assertion that RVI policies do not qualify as insurance, the Tax Court made a number of interesting points:

-- For more than 80 years, the states have regulated as insurance contracts that provide coverage against a decline in market values for particular assets.

-- RVIA's state regulators and external auditors all concluded that RVI's contracts involved insurance risk.

-- There is no "pure risk" bright-line test demarcating insurance risk from speculative risk, and the Court refused to draw one.

-- The Court found the IRS's "attempt to distinguish between a 'pure risk' and a 'speculative risk' [to be] essentially metaphysical in nature."

-- The assets being insured were not investment assets, but rather "ordinary business assets in the nature of inventory and equipment" that the lessors did not acquire as appreciating assets.

-- The IRS's definition of the "fortuity" required for insurance risk to exist, by requiring a loss to be compensable shortly after the occurrence of the underlying event leading to a loss, was too "narrow and esoteric."

-- "Analogizing the RVI policies to put options … is little more than a simile," because put options are typically settled for cash rather than involving transfers of stock and at "a conceptual level, many insurance products could be likened to put options."

**Implications**

For years, in its rulings on whether an arrangement qualifies as insurance, the IRS has drawn a distinction between "pure risk" and "speculative risk" in defining what it would respect as an insurance risk. A pure risk is one in which there is a binary possibility of loss or no loss. A speculative risk involves a possibility of loss, gain, or a neutral outcome. The IRS has limited its definition of insurance risk to include only pure risk.

More recently, the IRS has also asserted that an insurance transaction must also involve an element of
fortuity. In doing so, it has applied a narrow scope to what it would treat as a fortuitous event.

In addition, the Court's acknowledgment that a business risk is properly the subject of an insurance contract, contrary to a position the IRS has historically taken, is important. In doing so, the Court debunks a notion that has prevented many taxpayers from seeking to establish insurance programs to cover significant risks they regularly encounter.

In the present case, the Tax Court did not disavow its historical test for determining the presence of insurance. Rather, it applied a broader understanding of insurance risk that allows for risks that include some investment or financial risk element to be viewed as insurance. In reaching its decision, the Court clearly viewed as significant that RVIA: (1) had been regulated as an insurance company and (2) had structured its agreements with customers as insurance contracts. Accordingly, this appears to provide taxpayers with legitimate options for structuring the mitigation of risks as either insurance arrangements or other financial products. As Judge Lauber stated in the opinion, "When it comes to mitigating risk, there is more than one way to skin a cat."

Essentially, the Court did not reject the idea that there may be a distinction between insurance and other risks. Rather, it said the IRS's definition was too limiting and did not reflect the economic reality of residual value risk or accurately characterize fortuity.

This case is a significant win for taxpayers. The analysis employed opens potentially significant planning opportunities relating to non-traditional insurance risks and related risk management structures. Any evaluation of a proposed insurance structure must still involve a traditional analysis of whether there is an insurance risk, whether the risk is shifted and distributed and whether the arrangement satisfies commonly accepted notions of insurance. This decision, however, invites us to bring a 21st Century mind set to this evaluation, opening the door for insurance arrangements that address all the risks to which an insured is exposed.

This case has important implications for companies across all industries, not just insurance companies. In particular, any company that has, or should be considering, a captive or group mutual insurance company or has significant risks that it is otherwise self-insuring, should go through this case with the contacts listed below. For example, every industry, similar to the company in the subject case, has assets that may decline in value and likely many other risks that are properly the subject of an insurance contract. Moreover, any taxpayer in need of a timing deduction for year-end should be considering this case as well.

In many situations, the results of this case will warrant a re-thinking of positions the company may have been previously taking.

**Contact Information**

For additional information concerning this Alert, please contact:

**Insurance Group**
- Marc Rockower (212) 773-5602
- Paul H. Phillips III (312) 879-2898
- Ann Cammack (202) 327-7056
- Maureen Nelson (202) 327-6021
- Karey Dearden (212) 773-7056

**International Tax Services — Capital Markets Tax Practice**
- Alan Munro (202) 327-7773
- Matthew Stevens (202) 327-6846
Insurance

Company may deduct insurance premiums paid through captive insurance arrangement, despite parental guaranty of captive’s performance

In Securitas Holdings Inc., et al. v. Commissioner, TC Memo 2014-225 (Oct. 29, 2014), the Tax Court held that related corporations were entitled to deduct as insurance premiums amounts their parent paid on their behalf to a sister Vermont captive that reinsured the risk with a related Irish reinsurer. The Tax Court found that: (1) risk shifting existed, despite the parent’s guaranty of the Vermont captive’s performance, (2) risk distribution existed, despite that, in one year, the captive insured only four sister corporations, one of which owned close to 90% of the risk, and (3) insurance in its commonly accepted sense existed, despite the captive’s relatively low gross premium-to-surplus ratio and the group’s use of offsetting journal entries to credit premiums and claim payments. The Tax Court re-emphasized its view that risk shifting for a subsidiary is not vitiated by its parent’s guaranty of the captive’s performance and that risk distribution requires a multitude of statistically independent risk exposures, not a multitude of separate corporate insureds.

Background

Securitas Holdings Inc. (SHI), a US company with a Swedish parent, owned several US and foreign operating subsidiaries providing security services. Each subsidiary had various kinds of risk, including for workers’ compensation, general liability and automobile liability. During the years in issue, these subsidiaries had more than 90,000 employees and operated more than 2,000 vehicles in connection with business activities. In an effort to manage the costs of each of SHI’s domestic subsidiary’s insurance retentions, SHI caused a long-dormant Vermont captive, Protectors, to issue insurance coverage for most of the domestic subsidiaries’ retentions; coverage for the foreign subsidiaries’ retention risks was purchased from an unrelated insurer. All of this risk was reinsured with an Irish reinsurer, SGRL, owned by SHI’s foreign parent; SGRL reinsured risks of more than 25 separate entities.

SHI also owned an insurance company, Centaur, which received no premium income and reported as a tax-exempt entity described in Section 501(c)(15). Because eligibility for this tax-exemption is determined on a controlled-group basis, Protectors’ receipt from its sister corporations of amounts qualifying as insurance premiums would disqualify Centaur as tax-exempt. To prevent this from occurring, SHI guaranteed Protectors’ performance of its insurance obligations, which, under existing Internal Revenue Service (Service) guidance, would mean that the amounts received by Protectors would not qualify as insurance premiums. No amounts were ever paid under this guaranty.

Upon examination, the Service determined approximately $30.3 million in tax deficiencies for SHI, based on the Service’s partial disallowance of interest expense deductions and deductions for insurance expenses involving a captive insurance arrangement. The only question at issue before the Tax Court was whether the amounts paid to Protectors were deductible as insurance premiums.

Law & analysis
Courts have stated that, for insurance premiums to be deductible as ordinary and necessary business expenses under Section 162(a), the underlying insurance policies must involve insurable risks and shift the risk of loss to the insurer; the insurer must distribute the risks among its policyholders; and the arrangement must constitute insurance “in the commonly accepted sense.” In this case, the Service did not dispute that the insurance at issue covered insurable risks.

In ascertaining the presence of risk shifting, the Tax Court noted that it has applied a “balance sheet” test in “brother-sister” captive insurance arrangements to determine whether risk has been shifted. Under the balance sheet test, the court examines the economic consequences to the purported insured of the captive insurance arrangement to see whether risk has actually been shifted. When the insured sister corporation owns no interest in the captive, the insured corporation may shift insurance risk to the captive.

The Tax Court rejected the Service’s contention that, under Tax Court precedent, SHI’s parental guaranty to Protectors prevented risk shifting. Instead, the Court noted that its previous decisions involved undercapitalized captives whose parent corporation provided indemnification or additional capitalization in order to persuade a third-policy insurer to issue policies. In contrast, the Court found that the instant case “falls squarely within our analysis in Rent-A-Center,” where we distinguished a line of cases, stating that the parental guaranty at issue in Rent-A-Center did not shift the ultimate risk of loss; did not involve an undercapitalized captive; and was not issued to, or requested by, an unrelated insurer.” (For more on the Tax Court’s decision in Rent-A-Center Inc. v. Commissioner, see Tax Alert 2014-142.)

Noting that the parental guaranty here was provided to preserve Centaur’s tax-exempt status and that nothing was paid under the guaranty, the Court next considered “whether something else was present to vitiate risk shifting.” The Court rejected the Service’s contention that Protectors was undercapitalized because its gross premium-to-surplus ratio was below industry averages, noting that Protectors’ reinsurance arrangement with SGRL meant its net premium-to-surplus ratios were within industry norms.

The Tax Court also disputed that the SHI group’s method of paying claims and premiums through offsetting book entries prevented risk from shifting. Ultimately, the Court concluded that, under its balance sheet test, the captive insurance arrangement had shifted any economic consequence of a risk from the SHI subsidiaries to Protectors and then to SGRL.

The Tax Court then turned to the risk distribution question and noted that an insurer distributes risk by pooling “a large enough collection of unrelated risks” that these risks are not likely to be affected by the same event. Protectors, and by extension SGRL, insured varied and numerous risks: workers’ compensation, automobiles, employment practices, fidelity liabilities, and other general risks. The SHI group employed approximately 100,000 people and operated more than 2,250 vehicles, and SGRL received premiums from approximately 25 separate entities in 2003 and 45 separate entities in 2004. Nonetheless, the Service argued that risk distribution had not been achieved because Protectors insured only a small number of corporate entities in 2004 and one insured accounted for almost all of the total risk in that year. The Court disagreed, finding that, “[r]isk distribution is viewed from the insurer’s perspective.” Regarding the present matter, it stated that:

As a result of the large number of employees, offices, vehicles, and services provided by the U.S. and non-U.S. operating subsidiaries, SGRL was exposed to a large pool of statistically independent risk exposures. This does not change merely because multiple companies merge into one. The risks associated with those companies did not vanish once they all fell under the same umbrella.

Because risk distribution is achieved by pooling risks, according to the Court, the focus is not on who owns exposure to those risks, but on whether the risks are sufficiently disparate and voluminous to provide risk distribution.

To determine whether an arrangement constitutes insurance “in the commonly accepted sense,” the Court considered whether the insurer was organized, operated and regulated as an insurance company and adequately capitalized; the insurance policies were valid and binding; the premiums were reasonable.
and had been paid; and loss claims were satisfied. The Court found that both Protectors and SGRL were organized, operated and regulated as insurance companies, were adequately capitalized, and premiums were paid and losses were satisfied. (The Service did not assert that the premiums at issue were unreasonable.) Therefore, based on all of the facts and circumstances, the Court found that the insurance at issue was insurance in the commonly accepted sense.

Holding for the taxpayer, the Court concluded that the captive arrangement shifted risk from SHI’s subsidiaries to Protectors and then to SGRL, and it distributed risk among “a large pool of differing risks.” Therefore, the arrangement constituted insurance for federal tax purposes.

Implications

The Tax Court decision in *Securitas*, which expands on its decision in *Rent-A Center*, further clarifies the Court’s view of the effect of a parental guaranty on captive insurance arrangements. The Tax Court’s position is that a parental guaranty of a captive’s obligation does not automatically result in the loss of risk shifting if the captive is adequately capitalized. The Tax Court concluded that its decision in *Securitas* falls squarely within its analysis in *Rent-A-Center*, in which it distinguished a line of cases holding that a parental guaranty of a captive’s obligation when the captive was undercapitalized caused the arrangement to fail the risk-shifting requirement. The captive in *Rent-A-Center* was not in fact undercapitalized, and the parental guaranty at issue in *Rent-A-Center* (which was not issued to, or requested by, an unrelated insurer) did not shift the ultimate risk of loss away from the captive insurance company.

The Tax Court rejected the Service’s argument that the presence of the parental guaranty mitigates risk shifting because of the theoretical possibility that SHI may have to pay in accordance with the guaranty. The Court noted that this possibility exists whenever a guaranty from the parent is involved and, under *Rent-A-Center*, the existence of a parental guaranty by itself is not enough to justify disregarding the captive insurance arrangement. In *Securitas*, the guaranty was provided only to preserve the tax-exempt status of Centaur and, as in *Rent-A-Center*, no amount was paid out under the guaranty. Accordingly, the Tax Court concluded that risk shifting was established. The Court did not opine on whether the guaranty preserved the tax-exempt status of Centaur, as that question was not before the court.

The *Securitas* decision is also notable for its holding that the risk distribution requirement was met, even though most of the risks insured belonged to one company, a result at odds with the Service’s position enunciated in Revenue Ruling 2005-40. The Tax Court agreed with the taxpayer’s expert witness, who noted that “[i]t is the pooling of exposures that brings about the risk distribution — who owns the exposures is not crucial,” in ruling that risk distribution should be viewed from the insurer’s perspective. From that perspective, the fact that most of the risks were from one company did not undermine a finding of adequate risk distribution when the captive insured a large, statistically independent number of risks.

As noted by the Tax Court, “[t]he risks associated with those companies did not vanish once they all fell under the same umbrella.” Accordingly, the Tax Court held that there was adequate risk distribution. Query whether the opinion in *Securitas* will provide the final nail in the coffin that is the Service’s position on risk distribution, as set forth in Revenue Ruling 2005-40, which is that the captive must insure a certain number of legal entities to achieve risk distribution.

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<th>Contact Information</th>
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<tbody>
<tr>
<td>For additional information concerning this Alert, please contact:</td>
</tr>
<tr>
<td>Insurance Group</td>
</tr>
<tr>
<td>• <strong>Marc S. Rockower</strong> (212) 773-5602</td>
</tr>
<tr>
<td>• <strong>Maureen Nelson</strong> (202) 327-6021</td>
</tr>
</tbody>
</table>
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Insurance

Brother-sister premium payments to captive insurance company are deductible, Tax Court holds

In a court-reviewed opinion, Rent-A-Center Inc. v. Commissioner, 142 T.C. No. 1 (Jan. 14, 2014), a divided Tax Court held that transactions between a captive insurance company located in Bermuda and its 15 sister corporations qualified as insurance for federal income tax purposes and that the premiums were deductible. The majority opinion concluded that insurance risk was present, risk shifted and was distributed, and the arrangement resembled insurance in its commonly accepted sense (the requirements for concluding that insurance exists). There was no finding that the arrangement was a sham or that there was an impermissible circular flow of funds. The Tax Court reached this conclusion despite the Service's claims that Rent-A-Center's (RAC's) guaranties of the value of the captive's deferred tax assets (DTAs) and its liabilities under the Bermuda Insurance Act up to $25 million vitiated any risk shifting that might otherwise be found to occur in a brother-sister insurance arrangement.

Background

RAC is the parent of 15 affiliated subsidiaries that, during the years in issue, owned and operated more than 2,500 rent-to-own stores throughout the United States, employed more than 14,000 individuals and owned more than 7,000 vehicles. As the costs of directors and officers insurance, workers' compensation insurance, and automobile and general liability insurance continued to increase, RAC explored alternative insurance arrangements, ultimately purchasing "unbundled" coverage from Discover Re and paying Specialty Risk Services Inc. (SRS) to provide administrative services. Nonetheless, RAC retained significant risk, as the deductible for each claim insured by Discover Re bore a $350,000 deductible. RAC subsequently asked Aon Risk Consultants Inc. (Aon), to study whether forming and insuring the retained risk with a captive insurance company would be economically worthwhile.

As a result of this study, in December 2002, RAC formed a captive insurer, Legacy Insurance Co. Ltd. (Legacy), registered as a class 1 insurance company (eligible to insure only the risks of its owners and affiliates) incorporated in Bermuda. Bermuda law requires class 1 captives to have minimum initial capitalization of $120,000, but in its feasibility study, Aon recommended initial capitalization of at least $8.8 million; RAC provided $9.9 million. Legacy made the election under Section 953(d) to be taxed as a US taxpayer.

The annual premium charged by Legacy was actuarially determined based on expected total losses of the insured group. RAC paid the premium and allocated the expense among the operating subsidiaries using the same rate formula that was used to allocate the premium and administrative expenses charged by Discover Re and SRS. This formula was based on total number of stores owned by each subsidiary, each store's payroll, and each store's vehicles. RAC (the parent) did not directly own any stores, have employees, or operate vehicles; therefore, none of the insurance expense was allocated to RAC. (Notably, the majority opinion made no finding regarding how much risk was with any one operating subsidiary, and the information cannot be gleaned from the other opinions.) Intercompany financial obligations were tracked and paid through offsetting journal entries.
The annual insurance policies issued by Legacy to the RAC subsidiaries were initially effective on December 31, 2002, and ran through December 30 of the following year. According to the majority opinion, for tax purposes, Legacy reported the full amount of the premium for the policy year beginning December 31 on its 2002 tax return ($42.8 million for the year beginning December 31, 2002), but Legacy recognized for book purposes only 1/365 of the premium and carried an unearned premium reserve for the balance. This timing difference created a DTA because Legacy in effect prepaid its tax liability attributable to the $42.68 million that was recognized as taxable income in 2002, but not recognized as income for book purposes until 2003. This DTA arose in the succeeding years as well, given the renewal of the annual policy.

Bermuda’s "minimum solvency margin" requirement in 2002 required a class 1 insurer to have assets in excess of liabilities (surplus) by the greater of: (i) $120,000; (ii) 10% of the insurer's losses and loss reserves for the year; and (iii) 20% of the first $6 million of net premium, plus 10% of net premiums in excess of $6 million. Accordingly, Legacy’s net premiums written of $42.8 million for 2002 would require surplus of at least $4.88 million. To achieve the required surplus level, Legacy received permission from the Bermuda regulator to treat the value of the DTA as a general business asset that would count towards surplus. In return, the Bermuda regulator required Legacy to obtain a guaranty from RAC that it would pay Legacy the value of the DTA should a change in tax law require recognition of an impairment of the DTA. In addition, in 2003, RAC issued a guaranty that, as sole shareholder of Legacy, it would provide financial support for Legacy's liabilities under the Bermuda Insurance Act, not to exceed $25 million, should such support be necessary. The Bermuda regulator also approved counting this parental guaranty towards Legacy's required minimum surplus. The guaranty remained in effect through 2006, when it was cancelled because Legacy met the solvency requirement without it. Finally, the regulator permitted Legacy to purchase treasury stock with a combined value of $108 million from RAC during 2004, 2005 and 2006 that was counted towards Legacy's minimum surplus requirement as well. RAC was never required to make any payments on these guaranties and dividends were not paid on the treasury stock.

Legacy had no employees and used an outside management company to administer its business operations. Policies were priced using actuarial standards that estimated the total insured losses of the corporate group. The policy forms were like those used elsewhere in the insurance industry. Legacy and its affiliates dealt with each other at arm's length. During the five years in issue (2002-2006), Legacy's net premiums written ranged from $42.8 million to $64.8 million and, over that period, Legacy's net underwriting income was $28.7 million. Its ratio of premiums written to surplus ranged from 8.98:1 in its first year of operations, to 6.37:1 in its third year of operations, to 2.54:1 in the final year at issue before the Tax Court.

Legacy's assets consisted of a portion of the guaranties issued by RAC, the DTA, the RAC treasury stock, and cash on hand in money market accounts.

Majority opinion

Writing for the majority, Judge Foley first found that Legacy was created for legitimate and significant nontax reasons, stating that "[f]ederal income tax consequences were considered, but the formation of Legacy was not a tax-driven transaction." The majority rejected the Service's assertion that the transactions among RAC, its subsidiaries, and Legacy resulted in a circular flow of funds that amounted to nothing more than "an accounting device." Rather, according to the majority, the netting of premiums and claims was “simply a bookkeeping measure performed as an administrative convenience.” Judge Foley also rejected the Service's argument that, given Legacy's large premium-to-surplus ratios compared to those of US property and casualty insurance companies and commercial insurers during the years at issue, Legacy was a sham, noting that commercial insurance companies insuring unrelated parties underprice their premiums and supplement that revenue with investment income in order to pay claims. In contrast, Bermuda captives, according to the majority, price premiums to reflect the undiscounted cost of future claims and therefore have much higher premium to surplus ratios than commercial insurers. Ultimately, the Court concluded that RAC had "presented convincing, and essentially uncontradicted, evidence that Legacy was a bona fide insurance company."
Next, the majority found that the insurance policies effectively shifted insurance risk from the operating subsidiaries to their sister insurance company. (The IRS had conceded that the workers' compensation policies, automobile policies and general liability policies at issue involved insurance risk.) Notwithstanding the Service's concession in Revenue Ruling 2001-31 that brother-sister captive insurance transactions will not automatically result in a conclusion that insurance does not exist, the majority disagreed with the Tax Court's holding to the contrary in *Humana Inc. et al. v. Commissioner*, 88 T.C. 197 (1987), in which the court held that risk shifting cannot exist when a captive's sole insureds are its affiliated sister corporations, a holding later reversed by the Sixth Circuit (see 881 F.2d 247 (6th Cir. 1989)). Like the *Humana* appellate court, in *Rent-A-Center*, the majority adopted a "balance sheet" test and held that although the rationale for finding risk shifting does not exist when a parent insures with a subsidiary (because the parent, as the owner of the captive, is not financially indifferent to the occurrence of an insured loss when the loss is paid by a company it owns) that rationale does not apply when a subsidiary insure with its sister insurance corporation as it does not own shares of the captive.

Finally, the majority rejected the Service's argument that the existence of the parental guaranties vitiated any risk shifting that might otherwise exist, noting that RAC's guaranty did not affect the balance sheets or net worth of its insured subsidiaries. The Court also pointed out that, although RAC guarantied Legacy's liabilities under the Bermuda Insurance Act, which required Legacy to maintain a certain degree of solvency and liquidity, RAC made no payments under the guaranty, and Legacy's liabilities under the Act did not include its contractual obligations to the subsidiaries or any obligations to unrelated insurers. Ultimately, the majority concluded that the policies at issue shifted risk from the RAC subsidiaries to Legacy, which it held was an "independent and viable entity" formed for valid business purposes.

The majority also found the Legacy policies provided adequate risk distributed for workers' compensation, automobile and general liability policies, noting that RAC subsidiaries, in the aggregate, owned more than 2500 stores, had between 14,300 and 19,740 employees, and operated between 7,143 and 8,027 vehicles. In addition, the Court found that the arrangement among RAC, its subsidiaries and Legacy constituted "insurance in the commonly accepted sense," noting that Legacy was backed by adequate capital, regulated by Bermuda authorities, and organized and operated as an insurance company. Based on its findings, the majority held that payments made by RAC's subsidiaries to Legacy are deductible, under Section 162, as insurance expenses.

Tax Court Judges Thornton, Vasquez, Wherry, Holmes, Buch, and Nega, in addition to Judge Foley, formed the majority. Judge Goekie did not participate in the case. Judge Buch wrote a concurring opinion, asserting that the majority did not need to reach the IRS's argument that a captive insurance arrangement between brother-sister corporations cannot be insurance as a matter of law. Because the policies at issue constituted insurance, the main issue presented, Judge Buch asserted, is "when, not whether, *Rent-A-Center* is entitled to a deduction relating to workers' compensation, automobile and general liability losses."

**Dissenting opinions**

In his dissent, Judge Halpern argued that the majority erred in "overruling" the Tax Court's decision in *Humana*, admonishing that, "[u]nder our Conference procedures, the Conference may not adopt a report overruling a prior report of the Court absent the affirmative vote of a majority of the Judges entitled to vote on the case." Judge Lauber agreed with this dissent.

Dissenting separately, Judge Lauber objected to the majority's overruling of *Humana* in part and its holding that amounts Legacy charged RAC's subsidiaries constituted deductible insurance premiums. "It has been clear from the outset of our tax law," Judge Lauber wrote, "that taxpayers (other than insurance companies) cannot deduct contributions to an insurance reserve." Further, Judge Lauber contended that the continuing validity of *Humana* is not controlling in this case. Rather, the majority should have sustained the Service's determinations based on all of the facts and circumstances presented, he contended. For instance, Judge Lauber asserted that RAC's parental guaranty indicated that risk was not shifted as the majority found. Judges Colvin, Gale, Kroupa, and Morrison joined this dissent.
Implications

A review of the various opinions in this case may leave a taxpayer comforted, confused, and somewhat concerned. The majority and concurring opinion contain a number of interesting, taxpayer-favorable holdings and implications. Holding that a limited parental guaranty may be acceptable based on the specific facts of an individual case will likely be welcome news to certain taxpayers that have captives or are considering forming captives. The focus of the court on a "sufficient number of statistically independent risks" widely diversified, e.g., across all 50 states, Puerto Rico, and Canada, is a departure from the view presented in Revenue Ruling 2005-40, which looks to the number of entities insured to determine whether risk distribution is present.

The Court noted the purchase of treasury shares did not result in a circular flow of cash. This finding may be helpful for captive owners that want to purchase related-party financial instruments. Although the assets of the captive were relatively undiversified, the majority apparently did not find this matter overly troubling. The preferred approach is for a captive to hold assets of the type similar to those held by commercial insurers.

The majority also did not take issue with how premiums and claims were netted. Loss payments due to the insureds were netted against premium payments due to the captive. The majority found "the netting was simply a bookkeeping measure performed as an administrative convenience," and the concurring opinion stated, "It is unrealistic to expect members of a consolidated group to cut checks to each other." Thus, according to the Court, journal entries are an appropriate measure to track flow of funds between members of a consolidated group.

Taxpayers will likely find interesting that the Court respected the form of the insurance contracts, despite the fact that the annual contracts commenced one day before the close of RAC's tax year.

Notwithstanding the perceived victory for the taxpayer, the captive industry may appropriately still be hesitant and cautious about implementing certain of the above-discussed concepts contained in the RAC opinion. While RAC is a welcome development and potentially a useful tool, given its departure from certain current positions of the Service, there remains a real question as to whether the divided Tax Court majority opinion will be appealed and whether the opinion, if appealed, will be confirmed.

ENDNOTES

1 The majority opinion does not indicate whether Legacy held an unearned premium reserve (UPR) for tax purposes for the portion of the policy yet to expire as of year-end. Typically, a property/casualty insurance company would have a book/tax difference in the UPR equal to 20% of the UPR under Section 832(c)(4) and Treas. Reg. Section 1.832-4, resulting in a deferred tax asset on Legacy's books.

2 This ratio, net of DTAs and guaranties, as cited in the Dissent, ranged from 48:1 in year one to approximately 5:1 in the final two years.

Contact Information

For additional information concerning this Alert, please contact:

Insurance Group
• Karey Dearden (212) 773-7056
• Maureen Nelson (202) 327-6021
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Recent legislation creates new FBAR filing date and offers extension option

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (the Act) has changed the filing date for the Report of Foreign Bank and Financial Accounts (FBAR), electronically filed with the Financial Crimes Enforcement Center (FinCEN) on Form 114, effective for reports for calendar year 2016 accounts due in 2017. The Act also extends the due date (as so modified) and provides for the possibility of penalty relief for first-time FBAR filers.

Background

In general, and subject to certain exceptions, persons having either a financial interest (as defined) or signature authority (as defined) over a foreign bank, brokerage or other financial account during a calendar year must report it to FinCEN (not the IRS) electronically using the BSA E-Filing System on FinCEN Form 114 (which has superseded the prior Form TDF 90-22.1, Report of Foreign Bank and Financial Accounts). Questions on both corporate and personal income tax returns are designed to remind taxpayers of this requirement, but the filing of the FBAR is distinct and separate from the requirement to report ownership of foreign financial assets on Form 8938, Statement of Specified Foreign Financial Assets.

For years prior to the application of the changes made by the Act, FBARs are due to FinCEN on or before June 30 for reportable foreign financial accounts from the previous calendar year. For example, to report signature authority or financial interest in a foreign bank account for calendar year 2014, the FBAR was due to FinCEN by June 30, 2015. In addition, the June 30 deadline for FBARs for such years cannot normally be extended.

New FBAR reporting guidelines

New due date for Form 114

For calendar year 2015, the current due date of June 30, 2016, is expected to remain unchanged. For reports for calendar year 2016 accounts due in 2017 and subsequent years, however, the Act changes the due date from June 30 to April 15 following the year for which an FBAR must be filed, thereby aligning the timing of the reporting requirement with that for income tax returns filed by individuals and
C-corporations.

Newly available extensions of time to file Form 114

In addition, the Act provides authority to grant a six-month FBAR filing extension period ending on October 15. Such an extension had not previously been available for filing of the FBAR forms. Although the Act states that the provisions for requesting an extension should operate “under rules similar to the rules in Treas. Reg. Section 1.6081-5,” the details on the mechanics are currently unclear.

Potential first-time filer penalty relief

The Act also calls for a potential penalty relief for those with the first-time requirement to file FBARs. It explicitly states that, “[f]or any taxpayer required to file [an FBAR] for the first time, any penalty for failure to timely request for, or file, an extension, may be waived by the Secretary.”

Implications

The new accelerated deadline will create some complications for FBAR filers, not only for an individual with his or her own financial interests but also for US organizations with foreign bank accounts and US organizations with officers and employees holding signature authority over foreign bank accounts. The ability to request an extension, however, provides welcome relief and may mitigate some of these issues. FBAR filers will now have to determine by April 15, 2017, whether they will need an extension because they might have had a reportable financial interest in or signatory authority over a foreign account in the prior calendar year. Questions still remain on the extension, such as to what the request for an extension will look like, if it will be required to be filed electronically as the FBAR filing is, with what organization (i.e., FinCEN or the IRS) the extension may need to be filed, and whether third-party preparers filing signature authority FBARs on behalf of others will be able to apply for such extensions.

The grant of authority to waive penalties for first-time filers is also welcome news. the details and the mechanism for requesting such relief, however, are unclear. Additionally, it is unknown how the first time waiver provision will interact with the current Delinquent FBAR Submission Procedures for taxpayers who currently qualify for penalty waiver.

It is expected that FinCEN or the IRS will issue additional written guidance sometime late in 2015 or in 2016.

Contact Information

For additional information concerning this Alert, please contact:

**Tax Controversy and Risk Management Services**
- Frank Cannetti (412) 644-0571
- Elvin Hedgpeth (202) 327-8319
- Saul Tilmann (312) 879-5403

**Financial Services Office**
- Debra Taylor (212) 773-2978
- Ann Fisher (617) 585-0396

**International Tax Services — Capital Markets Tax Practice**
- Matthew Blum (617) 585-0340

**Human Capital**
- Renee R. Zalatoris (312) 879-2247
ENDNOTES

1 P.L. 114-41.

2 However, see Tax Alert 2014-2269, which discusses some limited signature authority extensions of time granted to certain persons for calendar years 2010 through 2014.

3 Note that the Act also, among other things, changed the due date of tax returns filed by C corporations, S corporations, partnerships, estates and trusts.

4 Either directly owning or through the indirect ownership rules required to be used for FBAR purposes.

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OECD issues two new reports on the implementation of the
Common Reporting Standard, updates global voluntary
disclosure publication

Executive summary

On 7 August 2015, the Organisation for Economic Co-operation and Development (OECD) released two new reports to help jurisdictions and financial institutions implement the Common Reporting Standard (CRS), a global standard for automatic exchange of financial account information. In addition, the OECD released a publication which provides an up-to-date review of voluntary disclosure programs in 47 jurisdictions.

The CRS reports are specifically aimed towards government stakeholders, but will be of interest to all financial institutions in order to understand how CRS may potentially be implemented into local law. In particular, the CRS Implementation Handbook provides more detail on a number of key issues including data protection and security, the possibility that implementation may vary by jurisdiction and the potential for using a single Foreign Account Tax Compliance Act (FATCA) and CRS reporting system.

Detailed discussion

The CRS was developed by the OECD at the request of the G20 in order to create a global standard for the automatic exchange of financial account information. The Standard requires jurisdictions to obtain information from their financial institutions and automatically exchange that information with other jurisdictions on an annual basis. It sets out the financial account information to be exchanged, the financial institutions that are required to report information, the different types of accounts and taxpayers covered, as well as common due diligence procedures to be followed by financial institutions.
As part of the ongoing implementation of CRS, the OECD has developed these reports to support the implementation of CRS into local law.

The reports released are:
2. Model Protocol to the Tax Information Exchange Agreements (TIEAs)
3. Offshore Voluntary Disclosure Programmes (updated publication)

Common Reporting Standard Implementation Handbook
The first edition of the CRS Handbook aims at providing practical guidance to assist tax authorities and governmental officials in the implementation of the Standard. The stated purpose is to assist in the understanding and implementation of the rules, and it is not intended to be read as expanding on the Standard itself. The CRS Handbook is expected to be updated on a regular basis.

The CRS Handbook provides an overview of the “four core requirements” required to implement the Standard, which are:

1. Translating the reporting and due diligence rules into domestic law, including rules to ensure their effective implementation
2. Selecting a legal basis for the automatic exchange of information
3. Putting in place information technology (IT) and administrative infrastructure and resources
4. Protecting confidentiality and safeguarding data

As well as the key points addressed above, the CRS Handbook also includes:
- Detailed background on the treatment of trusts under the CRS
- A comparison of the CRS to the FATCA Model 1 Intergovernmental Agreement
- Frequently asked questions (FAQs) on the application of the CRS

Model Protocol to the Tax Information Exchange Agreements (TIEAs)
The second report provides a basis for jurisdictions to extend the scope of their existing TIEAs to cover the automatic exchange of tax information under the CRS.

The report notes that the most effective way to implement CRS is through the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (the Multilateral Convention) which has already been signed by 61 countries committed to the adoption of CRS from either 1 January 2016 or 1 January 2017.

The document notes, however, that there may be circumstances where jurisdictions wish to put in place a legal framework for their CRS commitments through TIEAs and that the current model TIEA does not allow for that.

Offshore Voluntary Disclosure Programmes
The final report provides details of the voluntary disclosure programmes being used in 47 countries and provides some guidance on the design and implementation of such programmes.

This is the second version of this document to be published with the first having been issued by the OECD in 2010. The introduction to the document notes that there is a short time before the automatic exchange of information under CRS comes into effect and that this will mean this is the last opportunity for taxpayers to make voluntary disclosures.

The annex to the report includes details on the voluntary disclosure programmes which are or have been in effect globally, and is likely to be of interest to all multinational financial institutions.

Endnotes
For additional information with respect to this Alert, please contact the following:

**Ernst & Young LLP (United Kingdom), London**

- Julian Skingley  
  +44 20 7951 7911  
  jskingley@uk.ey.com

- James Guthrie  
  +44 20 7951 4366  
  jguthrie@uk.ey.com
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The US Foreign Account Tax Compliance Act (US FATCA), which has resulted in a network of intergovernmental agreements (IGAs), represents a major commitment by the U.S. Government and its IGA partners, including the Cayman Islands, to cross-border tax cooperation. FATCA has also resulted in extensive new reporting obligations by financial institutions, including Cayman Islands financial institutions (FIs) in accordance with the terms of the IGA between the Cayman Islands and the United States.

The Cayman Islands was at the forefront of global jurisdictions requiring its resident financial institutions to comply with US FATCA. Cayman Islands reporting began in 2015, and the move toward global information reporting gained further momentum with development by the Organisation for Economic Co-operation and Development (OECD) of the Common Reporting Standard (CRS) and a model Competent Authority Agreement (CAA), which were issued in 2014. The result of this process is the development of a global blueprint for cross-border tax information sharing between countries that meet the requirements of CRS and CAA. The early adoption by the Cayman Islands of CAA and CRS require onboarding processes in place effective 1 January 2016 to identify the tax residency of account holders and investors, including the mandatory gathering of tax residency self-certifications. The first reporting for CRS will be required to be filed in 2017 for the 2016 calendar year. Cayman Islands FIs will be required to report account holders or investors with tax residency in other CRS adopting jurisdictions.
The Cayman Islands issued initial CRS regulations on 16 October 2015, and the penalty and enforcement components are expected to be issued in 2016. The current CRS regulations are available for review on the Cayman Islands Department for International Tax Cooperation (DITC) website.

DITC issued an industry advisory on 8 December 2015 regarding the ongoing implementation of CRS in the Cayman Islands. Effective 1 January 2016, if a Cayman Islands FI fails to obtain a valid self-certification within 90 days, the FI has an obligation to report the account to DITC as an undocumented account. Cayman Islands FIs with a significant number of undocumented accounts may be subject to DITC compliance reviews.

See the Appendix for links to Cayman Islands FATCA and CRS legislation, regulations and guidance notes.

FIs located in the Cayman Islands now must comply with a set of new rules (both FATCA and CRS) that require internal compliance processes and systems that enable them to meet the requirements of both FATCA and CRS, which are different in many respects. The purpose of this alert is to explain and compare the Cayman Islands FATCA compliance process and the process under the Cayman Islands CRS regulations, and to provide EY observations (detailed below) that identify key implementation considerations. This comparison of FATCA and CRS highlights their key differences. This comparison is a summary and is not a substitute for the actual regulations and guidance notes issued by the Cayman Islands.

A. FATCA - Cayman Islands

General overview

US FATCA was designed to prevent US taxpayers from avoiding US tax on their worldwide income by failing to disclose income earned through non-US financial institutions and offshore investment vehicles.

US FATCA requires Cayman Islands FIs (including investment funds) to identify and report accounts and investments held by US persons. By virtue of the IGA with the United States, Cayman Islands FIs report directly to the local Cayman Islands competent authority (DITC), which in turn submits the information directly to the Internal Revenue Service (IRS).

As part of the FATCA reporting process, Cayman Islands FIs are required to register directly with the IRS to obtain a Global Intermediary Identification Number (GIIN).

FATCA’s impact on Cayman Islands financial institutions

US FATCA generally requires Cayman Islands FIs (including investment funds) to classify all account holders and investors as either US or non-US and as individuals or entities. Non-US entities are further classified as either foreign financial institutions (FFIs) or non-financial foreign entities (NFFEs).

Cayman Islands FFIs, other than those meeting the criteria of non-reporting FFIs, must report information about US individuals, certain US entities and FFIs that are not US FATCA compliant, as well as controlling US owners of passive NFFEs.

Cost of noncompliance

Since the Cayman Islands has entered into a Model 1 IGA with the United States, Cayman Islands FIs that continue to be compliant with the Cayman Islands FATCA regulations will be treated as FATCA compliant and will not be subject to FATCA withholding on US source income they receive.

Cayman Islands financial Institutions not compliant with the FATCA regulations will be subject to thirty percent withholding on all US source dividend and interest payments plus the gross sales proceeds resulting from the sale of an asset that gives rise to US source income if paid to either a “recalcitrant” account holder, “nonparticipating FFI” or an NFFE that has not disclosed its substantial US owners.

Guidance notes

The Cayman Islands issued guidance notes for FATCA on 22 July 2014 for the purpose of assisting Cayman Islands institutions to better understand the regulations and assist with their compliance with those regulations. Since their initial gazetting, the Cayman Islands FATCA guidance notes have been updated three times and will continue to be enhanced as situations and circumstances dictate. See the Appendix for links to this guidance.
Local registration required
Cayman Islands FIs were required to complete a registration process via the Automatic Exchange of Information (AEOI) portal on the Cayman Islands DITC website to prepare for FATCA reporting.

Once an FI has completed the registration process, it will not be required to do so again unless a change in circumstances occurs in future years that would require an update.

Reporting: information returns
The original due date for submission of FATCA reports was 31 May 2015 for the 2014 tax year; however, this deadline was extended to 26 June 2015. The report submission due date will be 31 May for future years.

Submission of the FATCA report is required to be performed through the AEOI Portal.

FATCA reports should be uploaded into the AEOI site in an XML format and submitted. Cayman Islands reporting FIs also have the option to manually enter the report data into the AEOI Portal; however, this is not recommended because it is very time intensive.

Nil returns
Initially, the Cayman Islands FATCA regulations had required nil reporting by Cayman Islands FIs; however, in March 2015 that requirement was rescinded (officially in June 2015) and nil returns are no longer a requirement.

Cayman Islands FIs do, however, have the option to file nil returns if they so choose, and EY suggests that this option be considered by FIs to document the institution’s FATCA compliance efforts.

Enforcement and penalties
The regulations detail anti-avoidance measures directed at arrangements put in place by any person to avoid the obligations required by the regulations. These anti-avoidance provisions mirror existing penalty provisions found under Exchange of Information Laws in the Cayman Islands, for example, the Reporting of Savings Income Information (European Union) Law enacted in 2005.

Specific details on the penalties related to noncompliance can be found in the Cayman Islands DITC regulations enacted for the US IGA.

B. CRS - Cayman Islands

General overview
FATCA legislation has created a precedent in ideology and process for international sharing of account holder information. Essentially inspired by FATCA, the OECD has sought to globalize this information sharing through its Automatic Exchange of Financial Account Information (AEOI) and CRS initiative.

While CRS is essentially modeled after the FATCA Model 1 IGAs, there are some differences.

The G20 countries mandated the OECD to develop CRS, and all (with the exception of the United States) are committed jurisdictions. As of this time, there are currently 97 countries that have committed to implementing CRS by 2018, with 56 early-adopter jurisdictions for CRS for which reporting will begin in 2017. The Cayman Islands is an early-adopter CRS jurisdiction. Another large group of secondary-adopter jurisdictions is expected to come on board for 2018 reporting.

Generally speaking, CRS will require the systematic and periodic transmission of taxpayer financial account information by the source country (i.e., the Cayman Islands) to the residence country, including income paid to those accounts (dividends, interest, royalties, salaries, pensions, etc.).

CRS contains the reporting and due diligence rules for the AEOI. The Cayman Islands has recently issued its CRS regulations, which detail the specific reporting process for Cayman Islands institutions as well as the account holder/investor identification and due diligence requirements.

Ultimately, CRS will result in a more complex reporting environment compared to FATCA due to the large number of participating jurisdictions and a significantly increased volume of data to be reported by Cayman Islands FIs.

CRS’ impact on Cayman Islands financial institutions
Effective 1 January 2016, Cayman Islands FIs will need to identify and document the tax residency of their account holders and report them to the Cayman Islands competent tax authority. Self-certifications of tax residency are required...
to be obtained from account holders/investors, and must also be reviewed for reasonableness taking into account other information in the FI’s files.

**EY observation:** The US is not a CRS participant at this time. FI investment entities in non-participating jurisdictions may be treated as passive NFEs, and therefore required to disclose their controlling persons.

**Cost of noncompliance**

CRS and the Model CAA do not include a withholding regime (unlike FATCA), although participating jurisdictions can impose penalties on noncompliant financial institutions.

Administrative and criminal penalties will be enforced under the Cayman Islands CRS regulations for noncompliance, and the penalties, compliance and enforcement measures will be introduced via a proposed amendment to the Cayman Islands CRS regulations in 2016.

**Guidance notes**

The Cayman Islands has not currently issued CRS guidance notes as the view of the Cayman Islands DITC was that the existing OECD CRS regulations sufficiently detailed the requirements (the 40-page OECD CRS regulations are included in the Cayman Islands CRS regulations issued on 16 October 2015).

Industry feedback may eventually result in the Cayman Islands DITC issuing some form of CRS guidance notes addressing specific areas of interest in order to clarify and assist institutions with CRS compliance.

**Registration**

There will be a registration requirement for CRS for FIs similar to the process for FATCA. Cayman Islands FIs are required for CRS to complete a registration process via the AEOI portal on the Cayman Islands DITC website. The registration due date is 30 April 2017 for the 2016 tax year, and will continue to be 30 April for future years.

Registration is not required for those Cayman Islands FIs that have a nil return status.

Once an institution has completed the registration process, it will not be required to do so again unless a change in circumstances occurs in future years that would require an update to that institution’s registration information or status.

**Reporting: information returns**

The due date for submission of CRS reports for the initial 2016 tax year is 31 May 2017. The report submission due date will be 31 May for future years as well.

The CRS report submission has not yet been formalized, but, similar to FATCA reporting, it will be performed through the Cayman Islands DITC AEOI portal.

The format for CRS reports is also still being formalized as the intent is to have a single standardized format for all jurisdictions to implement. Current expectations are that the reports will need to be in XML format, again similar to FATCA, which will be uploaded into the Cayman Islands AEOI site and submitted.

**Nil returns**

Nil returns are not required to be filed for CRS purposes. Cayman Islands FIs do, however, have the option to file nil returns if they so choose, and EY suggests that this option be considered by FIs.

**EY observation:** In practice, it is expected that few Cayman Islands FIs will have nil return status unless all account holders or investors of the Cayman Islands FI are in fact Cayman Islands residents for tax purposes.

**Enforcement and penalties**

At this time, the Cayman Islands have not yet issued the final regulations addressing penalties and enforcement associated with CRS. However, these regulations are expected to be issued in 2016 and will include both administrative and criminal penalties.
**FATCA/CRS comparison chart**

The following is a summary of high-level differences between FATCA and CRS:

<table>
<thead>
<tr>
<th></th>
<th>FATCA</th>
<th>CRS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>De minimis limits</strong></td>
<td>Accounts with balances under $50,000 for individuals/$250,000 for entities are exempt from pre-existing due diligence and FATCA reporting</td>
<td>No de minimis threshold for review and reporting of accounts held by individuals; pre-existing accounts held by entities with a value lower than $250,000 are exempt</td>
</tr>
<tr>
<td><strong>Indicia</strong></td>
<td>Focused on US citizenship and US residency</td>
<td>Focused on tax residency in any CRS participating jurisdiction outside the jurisdiction where the account is maintained</td>
</tr>
</tbody>
</table>
| **Due diligence**      | Separate due diligence for pre-existing and new accounts, and for individuals and entities. Significantly different processes between FFI agreement and Model 1 IGA | Due diligence modeled on IGA, but with a number of key differences:  
  • New accounts must collect self-certification  
  • Investment entities resident in non-participating CRS jurisdictions (includes the US) that are managed by another FI will be classified as passive non-financial entities (NFE)  
  Under CRS, all passive NFEs disclose a controlling person which may be the senior managing official |
| **Who is an FI?**      | Most financial institutions, including investment funds, unless specifically exempted as being lower risk | FATCA exemptions removed for CRS; thus includes smaller local entities excluded under FATCA |
| **Account scope**      | Most banking products unless low risk, some insurance, most asset management | Banking and asset management broadly similar, though regularly traded exemption removed |
| **Sharing of reporting** | Primarily to US (US FI obligations for reciprocal reporting are limited)  
  Account balances from 2014, with income and sale proceeds phased in | Many-to-many, via local authority  
  Account balances, income and sale proceeds from day one |
Cayman Islands FATCA update timeline

- The Cayman Islands issued initial IGA Guidance Notes on 22 July 2014. The most recent updated version (2.1) was issued on 1 July 2015 and is available on the Cayman Islands DITC website, www.tia.gov.ky.
- The Cayman Islands announced on 19 March 2015 the opening of the AEOI portal for registration and reporting for FATCA. An AEOI Portal User Guide was also issued in March 2015 with the most current version (1.2a) issued on 17 May 2015.
- There is a registration requirement via the AEOI portal for FIs. The registration due date was ultimately 29 May 2015 for the 2014 tax year. New filers will be required to complete the registration by 30 April for future years.
- The FATCA report submission date was 31 May 2015 for the 2014 tax year; however, this deadline was extended to 26 June 2015 for this first reporting year. It will be 31 May for future years. *It should be noted that no nil return filing is required for FATCA; however, the registration process via the Cayman Islands AEOI portal is required to be performed by reporting FIs regardless of whether they have any reportable accounts.

Cayman Islands CRS update timeline

- The Cayman Islands issued final CRS regulations on 16 October 2015, though the penalty and enforcement provisions of those regulations are still pending.
- The Cayman Islands DITC will publish a list of participating jurisdictions for CRS at least once every year.
- The Cayman Islands CRS regulations are only for financial account information – other data requests are not covered.
- The Cayman Islands as part of its CRS regulation has adopted the “wider approach” to data and account holder residency identification. This will require FIs to obtain tax residency of all account holders up front at account opening regardless of whether the account holder's tax residency jurisdiction is a CRS participating jurisdiction.
- There will be a registration requirement for CRS for FIs similar to the process for FATCA. This registration due date is 30 April 2017 for the 2016 tax year. The registration due date will be 30 April for future years.
- The report submission date will be 31 May 2017 for the 2016 tax year, and 31 May for future years. It should be noted that no nil reports are required, and no registration is required if there are no reportable accounts.
- CRS reports are expected to be submitted in electronic format as specified by DITC.
- Third parties may be used to perform duties required by the CRS regulations.
- Enforcement and penalties are expected to be much more specific than how they are stated in the FATCA regulations.

Conclusion

As global information reporting continues to evolve, FATCA and CRS have presented new regulatory challenges for not only Cayman Islands FIs but global institutions in general.

The Cayman Islands has sought to assist industry in meeting these compliance requirements by entering into formal agreements with the US and the OECD, diligently enacting formal tax law regulations for FATCA and CRS, and issuing respective guidance notes and self-certification templates to assist industry with compliance.

As the FATCA and CRS regulations continue to evolve, it is expected that the Cayman Islands and its competent authority (DITC) will look to provide additional guidance and insight as might be required.
Appendix

Relevant documents
Attached are the following links: (A) the US FATCA Agreement with the Cayman Islands (IGA) and amendments, (B) the Cayman Islands FATCA tax law regulations, (C) the Cayman Islands FATCA guidance notes, (D) the Cayman Islands DITC website, (E) the Cayman Islands AEOI portal, (F) the Cayman Islands CRS regulations and (G) the OECD AEOI portal:


For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP, United States
- Jun Li, New York  +1 212 773 6522  jun.li@ey.com
- Maria Murphy, Washington, DC  +1 202 327 6059  maria.murphy@ey.com
- Lisa Chavez, Chicago  +1 312 879 2331  lisa.chavez@ey.com

Ernst & Young Ltd. (Bermuda)
- Bill Bailey  +1 441 294 5319  bill.bailey@bm.ey.com
- Chris Maiato  +1 441 294 5346  chris.maiato@bm.ey.com

Ernst & Young Ltd. (Cayman Islands)
- Chris Larkin  +1 345 814 8919  chris.larkin@ky.ey.com
- Blaise Ting  +1 345 814 8918  blaise.ting@ky.ey.com
- Mike Mannisto  +1 345 814 9003  mika.mannisto@ky.ey.com
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Financial Services Group

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OECD releases additional guidance on implementation of country-by-country reporting

Executive summary

On June 29, 2016, the Organisation for Economic Co-operation and Development (OECD) released additional guidance aimed at the consistent implementation of country-by-country (CbC) reporting under Action 13 of the Base Erosion and Profit Shifting (BEPS) Action Plan (the Guidance). The Guidance addresses four topics:

-- Transitional filing options for multinational enterprises (MNEs) that voluntarily file in the parent company jurisdiction
-- Guidance on the application of CbC reporting to investment funds
-- Guidance on the application of CbC reporting to partnerships
-- The effect of exchange rate fluctuations on the agreed €750 million filing threshold for MNE groups

The Guidance also explains that, given the nature of the CbC Reporting (i.e., one of the BEPS minimum standards), a peer review of the implementation of CbC reporting will be conducted to ensure that the implementation is timely and in accordance with the Final Report on Action 13.

Detailed discussion

As part of the OECD/G20 BEPS project, and efforts to assist a swift and consistent implementation of the final reports, the OECD released further guidance relating to Action 13 (Transfer Pricing Documentation and Country-by-Country Reporting). The Guidance addresses four issues that have resulted in discussion on the approach to follow in certain circumstances.

Transitional and voluntary filing

The majority of countries implementing CbC reporting to date have followed the OECD's recommendations and would require CbC reporting for MNEs' fiscal periods commencing on or from January 1, 2016. If the CbC report cannot be obtained from the ultimate parent's tax authority, then most countries have secondary reporting rules in place that would require surrogate or local filing.

Some jurisdictions that are in the process of implementing CbC reporting that would require reporting for periods beginning after January 1, 2016. Thus, there is a mismatch with respect to effective dates that could potentially cause multiple filing requirements during this period of transition.
To prevent this, the OECD guidance notes some jurisdictions may accommodate voluntary filing of CbC reports for periods commencing after January 1, 2016, by ultimate parent entities (UPEs) resident in those jurisdictions. The OECD guidance refers to this voluntary filing as "parent surrogate filing" and recommends that, when the constituent entity jurisdiction accepts surrogate filing and the following conditions are met, no local filing would be required:

1. The UPE has made available a CbC report to the tax authority of its jurisdiction of tax residence by the filing deadline (i.e., 12 months after the last day of the Reporting Fiscal Year of the MNE Group)

2. By the first filing deadline of the CbC report, the jurisdiction of tax residence of the UPE has a CbC reporting obligation in place (even if filing of a CbC report for the Reporting Fiscal Year in question is not required under those laws)

3. By the first filing deadline of the CbC report, a Qualifying Competent Authority Agreement is in effect between the jurisdiction of tax residence of the UPE and the local jurisdiction

4. The jurisdiction of tax residence of the UPE has not notified the Local Jurisdiction's tax administration of a systemic failure

5. Due notifications (if and when required) have been provided (i.e. the jurisdiction of tax residence of the UPE has been notified by the UPE, and the local jurisdiction's tax administration has been notified by a constituent entity of the MNE Group that is resident for tax purposes in the local jurisdiction).

The Guidance states that Japan, Switzerland and the United States have confirmed that they will have parent surrogate filing consistent with the OECD guidance.

**Investment funds**

The OECD addresses how CbC rules apply to investment funds. The Guidance reiterates that the governing principle to determine an MNE group is to follow the accounting consolidation rules, and therefore, the treatment of investment funds will closely depend on the accounting rules.

Accordingly, if the accounting rules provide that investment entities should not consolidate investee companies, the investee companies should not form part of a group or MNE group or be considered as constituent entities of an MNE group. Conversely, if the accounting rules provide that the investee company should be consolidated, then the investee should be part of a group and should be considered as a constituent entity of the MNE Group, even when the investment entity has a controlling interest in the investee.

This analysis also applies to determining the consolidated revenue of the group.

**Partnerships**

Similar to the treatment of investment funds, the governing principle to determine an MNE Group is to follow the accounting consolidation rules. If the accounting consolidation rules apply to a partnership, then that partnership may be a constituent entity of an MNE group subject to CbC reporting. The Guidance additionally explains that, when completing the CbC report, if a partnership is not tax resident in any jurisdiction, then the partnership's items, to the extent not attributable to a permanent establishment, should be included in the 'stateless entity' row in table 1 of the CbC report. Any partners that are also constituent entities within the MNE group should include their share of the partnership's items in table 1 in their jurisdiction of tax residence.

Moreover, the row for stateless entities in table 2 should include a sub-row for each stateless entity, including partnerships that do not have a tax residence. For a partnership included in the stateless entity category, the field entitled Tax Jurisdiction of Organisation or Incorporation if Different from Tax...
Jurisdiction of Residence should indicate the jurisdiction under whose laws the partnership is organized.

Finally, the Guidance points out that, for purposes of determining whether a partnership can be a UPE required to file the CbC report, the jurisdiction under whose laws the partnership is formed will govern if there is no jurisdiction of tax residence.

CbC threshold and exchanges rates

The Guidance also addresses whether, as a result of currency fluctuations, a jurisdiction may apply a local filing requirement on a constituent entity of an MNE group headquartered in a jurisdiction where the threshold is not met. The OECD reiterates that, during the BEPS project, a threshold of €750 million was agreed or a "near equivalent amount" (not defined in the guidelines) in domestic currency as of January 2015, and provided that the jurisdiction of the UPE has implemented a reporting threshold that is a near equivalent of said threshold, an MNE group that complies with this local threshold should not be exposed to local filing in any other jurisdiction that is using a threshold denominated in a different currency.

Implications

The new guidance provides greater clarity regarding the treatment of the respective issues, with the aim of ensuring that CbC reporting is implemented consistently. It is not clear, however, how jurisdictions whose secondary reporting rules do not permit the use of a surrogate (e.g., only require local filing) will apply this guidance.

According to the Guidance, it appears that, where questions of interpretation arise that would be best addressed through common public guidance, the OECD will endeavor to make this available.

As more countries implement CbC reporting consistent with Action 13, business should keep abreast of these reporting requirements and how countries implement these new rules.

Contact Information

For additional information concerning this Alert, please contact:

Ernst & Young Belastingadviseurs LLP, Transfer Pricing, Rotterdam
  • Ronald van den Brekel +31 88 407 9016
Ernst & Young LLP, International Tax Services, Washington, DC
  • Arlene Fitzpatrick +1 202 327 7284
  • Karen Kirwan +1 202 327 8731
Ernst & Young LLP, Global Tax Desk Network, New York
  • Jose Bustos +1 212 773 9584
  • David Corredor Velásquez +1 212 773 6259
  • Joana Dermendjieva +1 212 773 3106

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Final country-by-country reporting regulations analyzed in-depth

Executive Summary

On June 29, 2016, the Treasury Department (Treasury) and Internal Revenue Service (IRS) released much-anticipated final regulations (TD 9773) on country-by-country (CbC) reporting (the Final Regulations). The Final Regulations apply to reporting periods of ultimate parent entities of US multinational enterprise (MNE) groups that begin on or after the first day of the tax year of the ultimate parent entity that begins on or after June 30, 2016.


Under the Final Regulations, ultimate parent entities of a US MNE group with annual revenue of $850 million or more for the immediately preceding accounting period must file Form 8975, "Country-by-Country Report," containing information, on a country-by-country basis, related to the US MNE group's income and taxes paid, together with certain indicators of economic activity within the US MNE group.

In the preamble to the Final Regulations (the Preamble), Treasury and the IRS announced their intention to allow voluntary CbC reporting, under guidance to be published separately, for reporting periods that begin on or after January 1, 2016, and before the applicable date of the Final Regulations.

Detailed discussion

Requirement to file CbC reporting form

General provisions

In general, every ultimate parent entity of a US MNE group with annual revenue of $850 million or more for the immediately preceding accounting period must file a CbC report. The Preamble notes that new Form 8975, "Country-by-Country Report" (Form 8975 or CbC Report), is currently under development but does not indicate when the form and instructions will be issued.

An ultimate parent entity of a US MNE group is a US business entity that owns, directly or directly, a sufficient interest in one or more other business entities, at least one of which is organized or tax resident outside the United States, such that the US business entity:
i. Must consolidate the accounts of the other business entities with its own accounts for financial reporting purposes under US generally accepted accounting principles (GAAP) or

ii. Would be required to consolidate accounts if equity interests in the US business entity were publicly traded on a US securities exchange

A US business entity that is owned directly or indirectly by another business entity that consolidates the accounts of that US business entity within its own accounts under GAAP of the other business entity's tax jurisdiction of residence, or would be so required if equity interests in the other business entity were traded on a public securities exchange in its tax residence jurisdiction is not an ultimate parent entity of a US MNE group and is not required to file Form 8975.

Under the Final Regulations, the term "business entity" is modified from the way that term was defined in the Proposed Regulations. In general, for purposes of the Final Regulations, "business entity" is any entity recognized for federal tax purposes, including any entity with a single owner that may be disregarded as an entity separate from its owner under Treas. Reg. Section 301.7701-3, that is not properly classified as a trust under Treas. Reg. Section 301.7701-4. However, a grantor trust within the meaning of Section 671, all or a portion of which is owned by a person that is not an individual, is a business entity for purposes of the Final Regulations. A business entity does not include a decedent's estate or a bankruptcy estate described in Section 1398.

Additionally, a business entity includes a permanent establishment (PE) that prepares financial statements separate from those of its owner for financial reporting, regulatory, tax reporting or internal management control purposes. Under the Final Regulations, a "PE" includes a:

i. Branch or business establishment of a constituent entity in a tax jurisdiction that is treated as a PE under an income tax convention to which that tax jurisdiction is a party

ii. Branch or business establishment of a constituent entity that is liable to tax under the domestic tax law of the tax jurisdiction in which the entity is located or

iii. Branch or business establishment of a constituent entity in which the entity is located or

According to the Preamble, Treasury and the IRS modified the definition of PE in the Final Regulations to provide greater clarity and consistency with the intended meaning of the 2015 Final Report for Action 13.

A "US business entity" is a business entity that is organized or has its tax jurisdiction of residence in the United States. For purposes of the Final Regulations, foreign insurance companies that elect to be treated as domestic corporations under Section 953(d) are treated as US business entities.

Tax residence

A business entity generally is considered resident in a tax jurisdiction if the business entity is liable to tax under the laws of that tax jurisdiction based on place of management, place of organization or another similar criterion. A business entity will not be considered a resident in a tax jurisdiction if the business entity is subject to tax in that jurisdiction based solely on gross income, without any reduction for expenses, from sources in that tax jurisdiction (e.g., gross-based withholding tax), or to a tax that is levied on capital situated in that jurisdiction. If a business entity does not have a tax jurisdiction of residence, then solely for purposes of determining the ultimate parent entity of a US MNE group, the tax jurisdiction of residence is the business entity's country of organization.

The Final Regulations provide special rules for determining the tax jurisdiction of residence of a business
A corporation that is organized or managed in a tax jurisdiction that does not impose an income tax on corporations is treated as resident in that tax jurisdiction, unless that corporation is treated as a tax resident in another tax jurisdiction under a different provision of the Final Regulations.  12 A PE's tax jurisdiction of residence is the jurisdiction in which the PE is located. 13

Under the Final Regulations, as in the Proposed Regulations, a business entity that does not have a tax jurisdiction of residence, such as a partnership, and that does not own or create a PE in the jurisdiction in which it is organized or another tax jurisdiction, is considered a "stateless entity" for CbC reporting purposes, except for determining the ultimate parent entity of a US MNE group. In response to requests for clarification of the reporting requirements for stateless entities such as partnerships, the Final Regulations provide that the tax jurisdiction of residence information for stateless entities is provided on an aggregate basis for all stateless entities in a US MNE group. 14 In addition, each stateless entity-owner's share of the revenue and profit is also included in the information for the tax jurisdiction of residence of the stateless entity-owner. 15 The Preamble clarifies that this rule applies irrespective of whether the stateless entity-owner is subject to tax on its share of the stateless entity's income in the owner's tax jurisdiction of residence.

**US MNE group**

A "US MNE group" is a group of business entities, including the US business entity that is the ultimate parent entity, that is required to consolidate its accounts under US GAAP, or would be required to consolidate its accounts if equity interests in the ultimate parent entity were publicly traded on a US securities exchange. 16 The ultimate parent entity of a US MNE group must report income and tax information, together with certain indicia of the location of the economic activity within the US MNE group for each constituent entity.

A "constituent entity" is any separate business entity of a US MNE group, with the exception of a foreign corporation or foreign partnership whose ultimate parent entity is not required to report under Section 6038(a), determined without regard to Treas. Reg. Section 1.6038-2(j) and 1.6038-3(c) (exceptions to information reporting for certain constructive owners and when more than one person otherwise would be required to submit the same information), or any permanent establishment of such foreign corporation or foreign partnership. 17 In general, Section 6038(a) requires a US person report certain information related to any foreign business entity that the US person controls. 18

**Information to be reported on Form 8975**

The Final Regulations and Preamble describe the information that new Form 8975 will require for each constituent entity. 19 The reporting period covered by Form 8975 is the period of the ultimate parent entity's applicable financial statement prepared for the 12-month period (or a 52-53 week period) that ends with or within the ultimate parent entity's tax year. If the ultimate parent entity does not prepare an annual applicable financial statement, then the reporting period covered by Form 8975 is the 12-month period (or a 52-53 week period) that ends on the last day of the ultimate parent entity's tax year. 20

Based on Treas. Reg. Section 1.6038-4(d) of the Final Regulations, new Form 8975 will have three sections: i) constituent entity information; ii) financial and employee information by tax jurisdiction; and iii) additional information. This is consistent with the Proposed Regulations and the 2015 Final Report for Action 13.

**Constituent entity information**

The Final Regulations require the ultimate parent entity to report the following for each constituent entity:
-- Complete legal name of the constituent entity (added by the Final Regulations)

-- Tax jurisdiction of residence, if any

-- Tax jurisdiction in which the entity is organized or incorporated if different from the tax jurisdiction of residence

-- Tax identification number, if any, used by the tax administration in the entity's jurisdiction of tax residence

-- Main business activity or activities of the constituent entity\(^{21}\)

**Financial and employee information by tax jurisdiction**

Similar to the Proposed Regulations (with some modifications noted below), the Final Regulations describe the financial and employee information that must be reported on Form 8975 for each tax jurisdiction in which one or more constituent entities are resident.\(^{22}\) The information is to be presented for each tax jurisdiction as an aggregate of the information for all constituent entities resident in that tax jurisdiction. As noted, information would be required to be reported, in the aggregate, for any entity or entities in a US MNE group with no tax jurisdiction of residence.\(^{23}\) The following information would be required to be reported on Form 8975:

-- Revenues generated from transactions with other constituent entities

-- Revenues not generated from transactions with other constituent entities

-- Profit or loss before income tax

-- Total income tax paid on a cash basis to all tax jurisdictions, and any taxes withheld on payments received by the constituent entities

-- Total accrued tax expense recorded on taxable profits or losses, reflecting only operations in the relevant annual period and excluding deferred taxes or provisions for uncertain tax liabilities

-- Stated capital, except that a PE's stated capital must be reported in the tax jurisdiction of residence of the legal entity of which it is a PE unless there is a defined capital requirement in the PE's tax jurisdiction for regulatory purposes

-- Total accumulated earnings, except that a PE's accumulated earnings must be reported by the legal entity of which it is PE

-- Total number of employees on a full-time equivalent basis

-- Net book value of tangible assets, which for purposes of this section, does not include cash or cash equivalents, intangibles or financial assets

The Final Regulations modify the reporting requirements with respect to employees. Rather than the CbC report reflecting the employees in the jurisdiction where the employees perform work for the US MNE group as required by the Proposed Regulations, the Final Regulations require employees of a constituent entity to be reflected in the tax jurisdiction of residence of that constituent entity.\(^{24}\) The Preamble notes that this change responds to comments highlighting the administrative burden associated with determining the work location of employees in certain circumstances, and makes the reporting consistent with the 2015 Final Report for Action 13. The Final Regulations declined, however, to provide additional guidance on the definition of full-time equivalent employee.
The Final Regulations revised the definition of tangible assets to be consistent with the OECD recommendation in the 2015 Final Report for Action 13. The Final Regulations specifically provide that tangible assets do not include intangibles or financial assets.

Further, the Final Regulations clarify the definition of "revenue." Revenue includes all revenue, including revenue from sales of inventory and property, services, royalties, interest and premiums. It excludes dividends from other constituent entities that are treated as dividends in the payor's tax jurisdiction of residence, as well certain imputed earnings and deemed dividends from other constituent entities. Additionally, the Final Regulations do not consider revenue of the recipient-owner to be distributions and remittances from partnerships and other fiscally transparent entities and PEs that are constituent entities.

There is a special definition of "revenue" for certain Section 501(a) tax-exempt organizations that are constituent entities. For such tax exempt organization, the term "revenue" includes only revenue that is reflected in unrelated business taxable income — UBTI — as defined in Section 512.

Additional Information

Consistent with the Proposed Regulations, the Final Regulations suggest that there would be an "Additional Information" section on Form 8975. The Preamble notes that it is expected that the Additional Information section of Form 8975 will be included in the information transmitted under competent authority arrangements.

Data sources

The Final Regulations provide guidance on the sources of information and do not limit the constituent entity information to applicable financial statement of the constituent entity. Rather, to provide flexibility, the source of the tax jurisdiction of residence information on the CbC report must be based on applicable financial statements, books and records maintained with respect to the constituent entity, regulatory financial statements, or records used for tax reporting or internal management control purposes. Further, applicable financial statements are defined as audited financial statements for: (1) purposes of reporting to shareholders, partners, or similar persons; (2) purposes of reporting to creditors in connection with securing or maintaining financing; or (3) any other substantial non-tax purpose. Financial amounts must reported in US dollars. The Final Regulations provide that the ultimate parent entity is not required to create and maintain records to reconcile the CbC reporting information to consolidated financial statements or tax returns.

Filing and exchange of CbC reports

The new US tax return reporting form for CbC information is still under development but has been officially numbered as Form 8975.

Under the Final Regulations, the CbC Report for a reporting period must be filed with the ultimate parent entity's income tax return for the tax year in or with which the reporting period ends. That tax return, and accompanying CbC Report, must be filed on or before the due date (including extensions), for filing that return or as otherwise prescribed by Form 8975. The OECD recommends filing CbC reports by the end of the year following the year covered by the report. In contrast, the Final Regulations require the CbC Report for the reporting period to be filed when the tax return is filed, though it would appear that the Final Regulations leave open the possibility for alternate guidance on filing obligations when Form 8975 and instructions are issued.

The Final Regulations do not provide for the possibility of a US entity acting as a surrogate entity for foreign-parented MNE groups. A business entity organized in a US territory or possession of the United States that is the ultimate parent entity may, however, designate a US constituent entity that it controls (within the meaning of Section 6038(e)) to file a CbC Report on its behalf.
The ultimate parent entity that files the CbC Report must maintain records to support the information provided on that form. The Final Regulations do not create new penalties specific to the CbC Report, though the Preamble notes that general reporting-related penalties under Section 6038 apply, including reasonable cause relief for failure to file.

Confidentiality of the CbC reporting information is a major concern for taxpayers. The Preamble states that the information provided on the CbC Report is return information for purposes of Section 6103, which imposes confidentiality rules for all return information. The Preamble also indicates that the United States is committed to entering into bilateral competent authority arrangements regarding the automatic exchange of the CbC reports in a timely manner. These agreements will require the information exchanged to be treated as confidential and generally prohibit the parties to the agreements from using any information received for any purpose other than for the administration of taxes. Importantly, the Preamble indicates that Treasury and IRS will provide information about the jurisdictions with which the US competent authority has reached agreement on exchange of information.

If the US Competent Authority determines that a foreign jurisdiction has violated the confidentiality, data safeguards and appropriate use restrictions in the CbC reporting information exchange agreement, the United States will pause information exchanges with that tax jurisdiction. The Preamble notes that, in those circumstances, if the US stops exchanging CbC Reports as a result of a breach, the jurisdiction will not be able to require any constituent entity of the US MNE group in the tax jurisdiction to file a CbC report. In addition, Treasury and the IRS intend to establish a procedure for taxpayers to report suspected violations of confidentiality and other misuses of CbC reporting information.

**Applicability date**

Under the Final Regulations, the CbC reporting requirement applies to reporting periods of ultimate parent entities of US MNE groups that begin on or after the first day of a tax year of the ultimate parent entity that begins on or after June 30, 2016. This differs from the OECD recommendation that CbC reporting apply to fiscal years beginning on or after January 1, 2016, and creates the potential for constituent entities of US MNE groups with fiscal years beginning January 1, 2016 through June 30, 2016, to be subject to secondary CbC reporting requirements in foreign jurisdictions. To address this transition-year issue, the Preamble states that Treasury and the IRS intend to allow voluntary filing of the CbC Report with the IRS and subsequent exchange with foreign jurisdictions based on a procedure to be defined in forthcoming guidance.

On the same day that the Final Regulations were released, the OECD released Guidance on the Implementation of Country-by-Country Reporting (OECD CbC Guidance), which includes transitional filing options for MNEs when a tax jurisdiction has an effective date later than January 1, 2016. The OECD guidance refers to voluntary filing by the ultimate parent entity that some countries are contemplating, including the US, for periods commencing after January 1, 2016, and refers to this voluntary filing as "parent surrogate filing." The OECD guidance recommends against requiring a local filing obligation where surrogate filing (including parent surrogate filing) is available, and certain conditions are met. (For additional details on the OECD’s guidance, see Tax Alert 2016-1157.)

**Implications**

The confirmation by Treasury and IRS in the Final Regulations that they intend to address the transition year issue created by the differences between the applicability date of the US regulations and that of other countries that have implemented CbC reporting beginning on or after January 1, 2016, is helpful given the concerns expressed by many about the potential cost and administrative burden associated with possibly having to file in multiple jurisdictions for the 2016 reporting period. Such confirmation, together with the guidance released by the OECD regarding voluntary filing, is welcome.

As discussed, the Final Regulations contain a number of clarifications and modifications, including with
respect to reporting requirements for partnerships. The Final Regulations require information on all "stateless" entities in a US MNE group to be provided on an aggregate basis, and each stateless entity-owner's share of the revenue and profit to be included in the information for the tax jurisdiction of residence of the stateless entity-owner. Thus, in these circumstances, the revenue and profit of the stateless entity would be reported on two different lines on the CbC report.

The Final Regulations modify the Proposed Regulations in a number of ways to take account of comments received, including providing that a US territory ultimate parent entity may designate a US business entity that it controls to file a CbC report on its behalf in certain cases. The Final Regulations do not, however, adopt a comment that requested a national security exception for CbC reporting in certain cases. The Preamble notes, however, that the Department of Defense continues to consider the national security implications of the CbC reporting in particular fact patterns.

Taxpayers should be mindful of the importance of coordinating the preparation of the CbC Report as required under the Final Regulations, with the preparation of the Master file and local file transfer pricing documentation (also required under Action 13). In general, the Master file provides a global overview of a taxpayer's business and strategy, including transfer pricing policies. In contrast, the local file contains specific transfer pricing data for each relevant country of operation. While Treasury and the IRS have not indicated any intention to change the current Section 6662 approach to transfer pricing documentation, many other jurisdictions in which US MNE groups operate are adopting the full three-part framework of the Final Report for Action 13 (i.e., CbC reporting, Master file and local file). As such, US MNE groups with operations in those jurisdictions should be coordinating their approach to the three-part reporting framework.

Contact Information

For additional information concerning this Alert, please contact:

International Tax Services
- Arlene S Fitzpatrick + 202 327 7284
- Benjamin P Orenstein + 212 773 4485
- Louis Raniero + 212 773 9990
- Heather M Gorman + 202 327 8769

Ernst & Young LLP, International Tax Services - Transfer Pricing
- Karen Kirwan + 202 327 8731

ENDNOTES

1 Treas. Reg. Section 1.6038-4(a) and -4(h).
2 Treas. Reg. Section 1.6038-4(b)(1)(i) and (ii).
3 Treas. Reg. Section 1.6038-4(b)(1)(ii).
4 Treas. Reg. Section 1.6038-4(b)(2).
5 Id. A business entity does not include a decedent's estate or a bankruptcy estate. Id.
A person is in "control" of a corporation for purposes of Section 6038(a) if that person owns stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote, or more than 50% of the total value of shares of all classes of stock, of a corporation. (Section 6038(e)(2)). A person is in control of a partnership for purposes of Section 6038(a) if that person owns directly or indirectly more than a 50% interest in that partnership. (Section 6038(e)(3)(A)). Certain constructive ownership principles apply for purposes of determining whether a person is in "control" of a corporation or partnership. (Sections 6038(e)(2)(A) & (B) and 6038(e)(3)(A), (B) & (C)).
27 Treas. Reg. Section 1.6038-4(e)(1).

28 Treas. Reg. Section 1.6038-4(f).

29 Treas. Reg. Section 1.6038-4(j). US territories or US possessions are American Samoa, Guam, the Northern Mariana Islands, Puerto Rico and the US Virgin Islands. (Treas. Reg. Section 1.6038-4(b)(10)).

30 Treas. Reg. Section 1.4068-4(g).

31 Treas. Reg. Section 1.6038-4(k).