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INSIGHTS

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EDITORS' NOTE

In this month's edition of *Insights*, the following topics are addressed:

- **Swiss Corporate Tax Reform Postponed.** Through the first ten days of February, Swiss tax advisers were contemplating life after the adoption of the Corporate Tax Reform III ("C.T.R. III"). Then, the bottom dropped out from under their feet as Swiss voters defeated the tax reform package by an almost 60-40 majority. Peter von Burg and Dr. Natalie Peter of Staiger Attorneys at Law in Zurich explain the benefits that were contemplated under C.T.R. III and ponder about what will be adopted in its place. Switzerland must act promptly to cobble together a replacement package that will appease opponents of C.T.R. III and meet the deadline under its agreement with the E.U. for eliminating existing special benefits allowed to base companies. How much of C.T.R. III can be salvaged?

- **Italy Introduces a 15-Year Preferential Tax Regime for Wealthy Individuals Taking Up Tax Residence in Italy.** As non-domiciled ("Non-Dom") residents of the U.K. scramble to restructure in light of the new rules for persons holding Non-Dom status for more than 15 years, Italy has adopted new measures to attract high net worth individuals. The rules are clearly derived from the Non-Dom rules in the U.K., but the weather is better. Fabio Chiarenza of Gianni, Origoni, Grippo, Cappelli & Partners explains the new provisions.

- **Accumulated Earnings Tax Will Hit Taxpayers, Despite Lack of Liquidity or Control.** Even absent a distribution, shareholders of U.S. corporations may, under certain circumstances, be subject to a second layer of tax: the accumulated earnings tax ("A.E.T."). The tax is imposed on the accumulation of earnings beyond the reasonable needs of the business. Although rarely imposed on well-advised taxpayers, the A.E.T. could become increasingly important if the tax rate disparity between the corporate and individual income taxes increases under proposals put forth by the current administration. Fanny Karaman and Beate Erwin look at a recent Chief Counsel Advice Memorandum where the absence of liquidity within the corporation was found to be an irrelevant factor in determining that earnings were unreasonably accumulated by the corporate taxpayer.

- **Proposed Directive on the E.U. Common (Consolidated) Corporate Tax Base – A Primer.** For decades, European bureaucrats looked with disdain at the way the various states within the U.S. compute state tax. The arm's length principle within Europe trumped state apportionment. Now, however, the European Commission has issued three proposal directives that deal with (i) the Common Corporate Tax Base ("C.C.T.B.") and the Common Consolidated Corporate Tax Base ("C.C.C.T.B."), (ii) resolution of double tax disputes, and (iii) mismatches with non-E.U. countries. To the surprise of many, the C.C.C.T.B. includes a three-factor apportionment rule for the sharing of global income by the members of a corporate group operating throughout the E.U. Stefano Grilli of Gianni, Origoni, Grippo, Cappelli & Partners, Milan, explains proposals that have been introduced.

- **§338(g) Election in the Cross-Border Context: I.R.S. Targets Foreign Tax Credit Enhancer.** Code §338(g) allows a taxpayer to elect to treat certain share purchases as if the transactions were asset purchases. As a result, the premium paid for the shares can be pushed down to increase the basis in operating assets of the acquired company. The step-up in depreciable basis results in steeper depreciation and amortization deductions for U.S. tax purposes. Because a comparable tax benefit is not obtained in the jurisdiction where the target operates, the Code §338(g) treatment magnifies the effective tax rate in the foreign country when looked at from a U.S. tax viewpoint. This creates mountains of excess foreign tax credits that can be used to reduce U.S. tax on other items of foreign-source income, provided those items are subject to little or no foreign tax and fall within the same foreign tax credit limitation basket. A similar result can be achieved through a check-the-box election, which acts as a poor man's Code §338(g) election. Code §901(m) attempts to disallow the enhanced level of the foreign tax credit, and the I.R.S. recently issued temporary and proposed regulations. Rusudan Shervashidze and Stanley C. Ruchelman explain the labyrinth of rules.

- **India – Guidelines Issued for Determining Place of Effective Management.** In Circular No. 6/2017, dated January 24, 2017, the Central Board of Direct Taxes issued final guidelines regarding the factors that will be looked to under Indian income tax treaties when determining the place of effective management ("P.O.E.M.") of a foreign company that is part of an Indian-based group. Almost as important as the substantive rules, the Circular establishes the procedure that must be followed before a tax officer may determine that the P.O.E.M. of a foreign company is in India. There are winners and there are losers in the Circular. Ashutosh Dixit, Parul Jain, and Kaushik Saranjame of BMR & Associates L.L.P. explain the new rules.

- **Debt v. Equity: Judicial Factors Still Applicable Post-§385 Regulations.** The last quarter of 2016 saw the introduction of final regulations establishing benchmarks for treating a debt instrument as true debt for U.S. income tax purposes. These regulations apply to companies over a certain size issuing debt instruments exceeding $50 million. Debt issued by owner-managed companies are not covered by the regulations and, as a result, tests established by case law will continue to apply. Galia Antebi and Kenneth Lobo look at a relatively recent case, *Sensenig v. Commr.*, in which the standard tests were applied – the equivalent of comfort food for tax lawyers.

- **I.R.S. Rules Subpart F & P.F.I.C. Income Inclusions Are R.E.I.T. Qualifying Income.** A R.E.I.T. is a tax-favorable investment entity used for investment in real estate and real estate mortgages. R.E.I.T.'s that invest in non-U.S. real estate often make such investments through foreign corporate entities that may be classified as C.F.C.'s or P.F.I.C.'s. Qualification as a R.E.I.T. requires the entity to meet certain income and passive asset tests designed to ensure that a R.E.I.T.'s gross income is largely composed of passive income related to real estate or real estate mortgage investments. In a recent private letter ruling, income from a R.E.I.T.'s ownership of C.F.C.'s and P.F.I.C.'s was determined to be passive investment income, thereby providing favorable treatment for the R.E.I.T. Elizabeth V. Zanet and Philip R. Hirschfeld explain the R.E.I.T. rules and the private letter ruling.

- **Updates & Tidbits.** This month, Astrid Champion and Nina Krauthamer look briefly at several timely issues, including (i) the expansion of the European Commission's attack on illegal State Aid to the French multinational group Engie (formerly G.D.F. Suez), (ii) the request for review by the French Constitutional Court of the penalties imposed under Article 1736, IV bis of the French Tax Code, regarding the failure to disclose a connection with a foreign trust, and (iii) the decision of the European Commission in *World Duty Free Group*, which affirms the criteria for judging whether a measure by a Member State is selective in relation to certain companies and not others and, for that reason, constitutes illegal State Aid.

We hope you enjoy this issue.

- The Editors

SWISS CORPORATE TAX REFORM POSTPONED

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Tags
Corporate Tax
Income Taxation
Notional Interest Deduction
Patent Box
Step-Up in Basis
Switzerland

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INTRODUCTION

Besides its beautiful mountains and lakes, Switzerland is traditionally known as an attractive and stable location with regard to corporate income taxation. However, in recent years, Switzerland has been under high international pressure from organizations including the E.U. and the Organisation for Economic Cooperation and Development ("O.E.C.D."), which claim that the Swiss tax system is not in line with international best practices. In particular, the E.U. has expressed the opinion that the tax regimes granted by Switzerland to certain companies – such as holding or mixed companies – represent prohibited State Aid and violate the 1972 free trade agreement between Switzerland and the E.U.

In 2014, this dispute was settled by a joint statement on business taxation between Switzerland and the E.U. In the settlement, Switzerland agreed to abolish five preferred tax regimes (see below for details), prompting a proposal for broader reform the Swiss corporate tax system. However, the E.U. has stipulated that it will re-impose sanctions against Switzerland should the agreed-upon obligations under the joint statement not be fulfilled within a reasonable amount of time or should Switzerland introduce new harmful tax regimes.

In 2012, the O.E.C.D. launched the B.E.P.S. Project, which deals with tax avoidance strategies used by multinational enterprises ("M.N.E.'s"). M.N.E.'s try to shift profits from jurisdictions that have high taxes – such as the U.S. and many countries in western Europe – to jurisdictions that have low or no taxes, even though there is little or no economic substance (*i.e.*, business activities, employees, office premises, etc.) in the latter jurisdictions. The B.E.P.S. Project has led to the publication of several reports and actions plans by the O.E.C.D. Since Switzerland is a member state of the O.E.C.D. and its goal is to be in line with international best practices, compliance with B.E.P.S. Project recommendations is an essential component of the proposed reform of Swiss corporate income taxation.

In the summer of 2016, the two chambers of the Swiss parliament formally approved new legislation that would have led to a tax system consistent with international standards. However, on Sunday, February 12, Swiss voters defeated the tax reform package known as the Corporate Tax Reform III ("C.T.R. III").

This article describes the state of the proposed reform that was put before Swiss voters and ponders steps that may be taken in order to fulfill all obligations under the settlement between Switzerland and the E.U. Even though the proposal did not find final approval by voters, substantial portions are expected to form part of a new proposal that will be submitted to the Swiss Parliament.

CURRENT CORPORATE INCOME TAXATION IN SWITZERLAND

Switzerland is comprised of 26 states (cantons). Taxes are levied at the Federal and cantonal/municipal levels. As a result, there is no standard tax rate since the cantonal/municipal rates differ. Federal corporate income tax is levied at a flat rate of 8.5% of net income. Since a company may deduct its taxes in the respective year, the effective Federal corporate income tax rate is approximately 7.8%. The aggregate effective income tax rate for Federal and cantonal/municipal taxes for ordinarily taxed companies – as opposed to preferred companies (see next paragraph) – varies from 12% to 24%, depending on the canton and municipality in which it will be taxed.

The current Swiss tax system provides for preferred tax regimes enabling certain companies (*i.e.*, holding, administrative, mixed, and principal companies and Swiss finance branches) to reduce their effective tax burdens significantly:

- Swiss holding companies are exempt from cantonal/municipal income taxes ("Holding Company Status"), provided they fulfill certain conditions:
  - At least two-thirds of the holding company's total assets must consist of substantial investments in participations, or at least two-thirds of the company's total income must be derived from such investments.
  - The company may, in general, not engage in an active business in Switzerland.
  - The company's statutory purpose is investing in subsidiaries.

  Thus, a holding company typically receives dividend income and/or realizes capital gains. On a Federal level, holding companies may profit from a participation exemption on dividends and capital gains if certain conditions are satisfied (*i.e.*, at least 10% shareholding, or the value of the shares equals more than CHF 1,000,000 with respect to dividends). In practice, such dividends are typically 90%- to 95%-exempt from corporate income tax. As a result, Swiss holding companies are currently taxed marginally or not at all.

- If a Swiss company is engaged primarily (*i.e.*, a mixed company) or fully (*i.e.*, an administrative company) in activities abroad, income from non-Swiss sources may be taxed at substantially reduced rates at a cantonal/municipal level. These companies are typically used for the sales, financing, or holding of intellectual property ("I.P.") or other activities in relation with non-Swiss markets. Although there is no preferred tax rate on a Federal level, the overall corporate income tax rate can be reduced to approximately 8% to 10%.

- In a principal company, functions, responsibilities, and risks of a group are centralized in one company while the distribution of products is carried out by group entities or agents. On a cantonal/municipal level, the above-mentioned rules regarding mixed companies apply. On a Federal level, foreign trading activities are allocated to the profit of the principal company. In other words, foreign profits may be shifted to Switzerland. On an aggregated level, these companies are able to reduce their corporate income tax rate to approximately 5% to 6%.

- A branch of a foreign company providing finance services to group members may profit from qualifying as a Swiss finance branch for Federal tax purposes. On a cantonal level, the above-mentioned rules regarding mixed companies apply. Further, there is a deemed interest deduction on the cantonal and Federal level. On an aggregated level, these companies are able to reduce their corporate income tax rate to approximately 2% to 3%.

Due to the increase in international pressure, the Swiss government approved a new law – the C.T.R. III – in 2016, in order to adapt the Swiss corporate tax system to international standards. The tax reform was not only expected to be internationally acceptable, but it would also have allowed the Swiss tax system to remain one of the most competitive and attractive tax systems in Europe. Since companies benefiting from the above-mentioned tax regimes create jobs and demand for services, they contribute to Switzerland's economy. In addition, they pay a significant part of the overall corporate income and capital taxes. It is estimated that all companies benefiting from the outgoing preferred tax regimes pay approximately half of all direct Federal corporate income taxes collected in Switzerland. Therefore, the two of the main goals of the C.T.R. III were keeping these companies in Switzerland and attracting new companies to Switzerland.

CORPORATE TAX REFORM III

Under the C.T.R. III, the above-mentioned preferred tax regimes would be abolished and holding, administrative, and mixed companies would be taxed at ordinary tax rates. Furthermore, the favorable principal allocation scheme and the Swiss finance branch taxation regime would be abolished on a Federal level. For Switzerland to remain attractive to companies profiting from these regimes, the C.T.R. III provided for a number of countermeasures. The cantons could then decide if and how the countermeasures would be implemented on a cantonal/municipal level.[1] Proposed measures regarding Federal and cantonal level taxation are outlined below.

<u>Step-up Mechanism to Reveal Hidden Reserves</u>

During a transition period of five years, the cantons would have the option to impose a tax on the realization of undisclosed hidden reserves and self-generated goodwill (*i.e.*, a step-up in basis) at a special low tax rate, provided neither was taxable under the previous tax rules. Assets such as buildings or trademarks typically bear hidden reserves since the book value is lower than the actual fair market value. The special low tax rate would lead to a fair and predictable transition for companies formerly profiting from the preferred tax regimes.

A corporation's undisclosed hidden reserves and self-generated goodwill would be determined by the cantonal tax administrations at the time of enactment of the C.T.R. III. Companies transferring assets or functions from abroad to Switzerland would be permitted to disclose hidden reserves and self-generated goodwill in the tax balance sheet. The disclosed hidden reserves would be deductible in subsequent years according to the applicable tax depreciation rates. Goodwill could be amortized over a maximum period of ten years.

To illustrate the step-up mechanism, consider a Swiss company that is currently

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1 This substantial flexibility is a consequence of the Swiss concept of federalism.

benefiting from the tax regime as a mixed company, which divides its profits into a Swiss part and a foreign part. The average profits in the years 2016 to 2018 (*i.e.*, prior to the implementation of the reform) amount to CHF 8,000 for the Swiss part and CHF 2,000 for the foreign part, totaling CHF 10,000. Additionally, the company has CHF 40,000 in hidden reserves and CHF 100,000 in equity, totaling CHF 140,000 in equity including hidden reserves. Based on a two/one ratio of capitalized income (*i.e.*, average annual profits plus interest) to equity including hidden reserves, the tax administration would calculate a weighted company value. Assuming a 5% interest rate, this would result in a weighted company value of CHF 180,000.

	SWISS	FOREIGN	TOTAL
Average Profits 2016 to 2018	CHF 8,000	CHF 2,000	CHF 10,000
Equity Including Hidden Reserves			CHF 140,000
Weighted Company Value			**CHF 180,000**

As a next step, the tax administration would calculate the goodwill by taking the difference between the weighted company value and the equity including hidden reserves, resulting, in this example, in CHF 40,000 in goodwill.

Finally, the hidden reserves and the goodwill would be divided into a Swiss part and a foreign part according to the allocation of profits from the years 2016 to 2018 (*i.e.*, an 80/20 ratio). The Swiss part would be subject to a special (lower) tax rate. Further, the total hidden reserves and goodwill could be included in the future tax balance sheet and amortized over subsequent years.

	SWISS (80%)	FOREIGN (20%)	TOTAL
Hidden Reserves	CHF 32,000	CHF 8,000	CHF 40,000
Goodwill	CHF 32,000	CHF 8,000	CHF 40,000
Amount Taxed at Special Rates	**CHF 64,000**		
Amount Taxed at Ordinary Rates		**CHF 16,000**	
Amount Included in Future Balance Sheet			**CHF 80,000**

Introduction of Federal and (Optional) Cantonal Notional Interest Deductions

While cantons would be given the option to introduce a deemed interest deduction on excessive shareholder's equity – known as a notional interest deduction ("N.I.D.") – such N.I.D. would be mandatory on a Federal level. This measure is intended to encourage companies with highly mobile financing functions to remain in Switzerland.

A similar concept is already used in European countries such as Belgium and Luxembourg. For the time being, the N.I.D. has not been addressed as a harmful tax practice by the O.E.C.D. or E.U. However, in 2016, the U.S. Department of the Treasury issued a revised U.S. Model Income Tax Convention, which provides that an N.I.D. may fall under the provisions of a preferred tax regime and will result in disadvantages with regard to U.S. withholding taxes. However, the currently applicable convention between the U.S. and Switzerland does not yet include such a clause.

To illustrate the application of the N.I.D., consider a Swiss company operating a power plant that has taxable equity of CHF 80,000,000. The balance sheet shows liquid assets of CHF 10,000,000 and real estate valued at CHF 90,000,000. The taxable profits for the given year amount to CHF 1,000,000.

"While cantons would be given the option to introduce a deemed interest deduction on excessive shareholder's equity . . . such N.I.D. would be mandatory on a Federal level."

The N.I.D. would be calculated taking the different types of assets into account. First, each type of asset would be linked to a base equity capital ratio determined by the tax administration. The assets of the company would also be weighted by a ratio determined by the tax administration. Since these ratios are not outlined in the C.T.R. III, assumptions will be used in the following example.

The asset ratio illustrates the risk linked to the asset in question and the equity needed for such assets. In the example, the estimated ratio of 55% shows that the tax administration requires equity of at least CHF 49,500,000 in order to finance the real estate.

ASSET	VALUE	ESTIMATED RATIO	BASE EQUITY
Liquid Assets	CHF 10,000,000	0%	CHF 0
Real Estate	CHF 90,000,000	55%	CHF 49,500,000
Total Base Equity			**CHF 49,500,000**

In the example, the Swiss company has an equity surplus of CHF 30,500,000. The notional interest rate would be based on the rate of return of a ten-year Federal government bond, which is currently 0%. For illustration purposes, we assume an N.I.D. rate of 1%. Therefore, the company could include a deduction of 1% of the surplus equity (*i.e.*, CHF 305,000 for (notional) interest from its taxable income for Federal corporate income tax purposes) on its tax return.

Finally – after the deduction of the N.I.D. – the taxable profits for the given year would amount to CHF 695,000. On a cantonal/municipal level, the deduction would be granted if the applicable canton introduced the N.I.D. in its cantonal law.

Taxable Equity	CHF 80,000,000
Total Base Equity	CHF 49,500,000
Surplus Equity	CHF 30,500,000
Estimated 1% N.I.D.	CHF 305,000
Taxable Profit after N.I.D.	**CHF 695,000**

Introduction of a Patent Box Regime at the Cantonal Level

By introducing an I.P. or "Patent Box" regime, revenues from specific I.P. rights could be excluded from taxable profits up to a maximum of 90% of cantonal/municipal taxes.

The Patent Box regime is also used in other European countries such as Luxembourg and the U.K. However, it should be noted that these regimes are under international pressure from the O.E.C.D. Luxembourg has already announced its plan to abolish the current regime since it is not in line with international standards.

To ensure legal certainty, the Swiss Patent Box regime would follow the approach recommended by the O.E.C.D. and thus fulfill international standards. Action 5 of the B.E.P.S. Project requires companies to have substantial activity in a jurisdiction in order to benefit from this type of preferred tax regime.

Introduction of an Optional Deduction for Research and Development at the Cantonal Level

In addition to the Patent Box regime, the C.T.R. III would introduce an optional deduction of 50% for research and development ("R&D") costs incurred in Switzerland. Since the optional deduction was limited to costs incurred in Switzerland, it was anticipated that the measure would be in line with the prospective standards of the O.E.C.D. and E.U. This incentive was intended to encourage entities with innovative activities to move to or remain in Switzerland.

Consider, as an example, a Swiss company that sells watches, parts of which are researched and developed by the Swiss company. The taxable net profit amounts to CHF 2,000,000 and the costs for R&D incurred in Switzerland amount to CHF 300,000. The final taxable profit would be calculated as follows:

Taxable Net Profit for Federal Tax Purposes	CHF 2,000,000
50% Deduction for R&D	CHF 150,000
Taxable Profit for Cantonal/ Municipal Tax Purposes	**CHF 1,850,000**

Introduction of an Overall Limitation at the Cantonal Level

The measures of the reform would have allowed for up to an 80% reduction of profits at the cantonal/municipal level. However, individual cantons could introduce lower thresholds in order to allow for more planning possibilities.

General Lowering of Cantonal Corporate Income Tax Rates

Under the C.T.R. III, the cantons would be free to decrease their cantonal/municipal corporate income tax rates, and prior to the public vote, certain cantons had already announced plans for substantial rate reductions. In Geneva, for example, the aggregate tax rate (including Federal taxes) was expected to be lowered from approximately 24% to as low as 13.5%. The canton of Zug, known as one of the most attractive cantons in Switzerland, also announced a plan to further reduce its aggregated tax rate from approximately 14.6% to 12%. However, other cantons, such as the canton of Zürich, were expected to adjust their aggregate tax rates only slightly, from 21.1% to 18.2%, while introducing the other above-mentioned measures in order to remain attractive.

Abolishment of Stamp Duty and Introduction of Tonnage Tax

In the course of Parliamentary review, other measures, such as abolishing the stamp duty of 1% on equity, were rejected or postponed. Additionally, the introduction of a so-called tonnage tax for shipping companies that operate marine transport services was deferred for further analysis within a consultation procedure and was expected to be dealt with in a separate proposal.

Tax Holidays

As a side note, the Federal and cantonal tax holidays would not affected or altered by the reform. Therefore, newly established businesses could continue to profit from a tax holiday of up to ten years in designated areas in Switzerland.

Companies Affected by the C.T.R. III

For Swiss-resident companies, the specific consequences and opportunities created under the C.T.R. III would require individual assessment. In general, all Swiss-resident companies would profit from the lower corporate income tax rates. In certain cases, a relocation of activities to a low-tax canton may have proved beneficial. For companies currently profiting from preferred tax regimes, direct implications of the C.T.R. III would have been as follows:

Holding companies would be subject to ordinary taxation on a cantonal/municipal level. However, the participation exemption, as currently applied for Federal taxes, would also become applicable on a cantonal/municipal level. Thus, the reform would, in most cases, not have a significant impact, as most holding company income is derived from participations.

Mixed, administrative, and principal companies would also be subject to ordinary taxation on the cantonal/municipal and Federal levels. During a transitional period, such companies could profit from depreciations and/or amortizations on hidden reserves and self-generated goodwill, and lower tax rates would apply. In cases where such companies have I.P. rights, they could also profit from the Patent Box regime.

Swiss finance branches would be subject to ordinary taxation on a cantonal/municipal level. While the same consequences as for mixed and administrative companies apply, Swiss finance branches may profit from the N.I.D.

OUTLOOK

On February 12, 2017, 59.1% of Swiss voters rejected the fundamental overhaul of the Swiss tax system under the C.T.R. III. Supporters argued that the reform would help to attract and keep multinational companies in Switzerland. Opponents said that taxpayers, especially of the middle class, would pay higher taxes because the lower tax rates will lead to a shortfall in revenue.

The C.T.R. III would have led to a tax system consistent with international standards. Although the C.T.R. III included significant changes to Swiss Federal and cantonal tax legislation, the measures were aimed at keeping Switzerland competitive for multinational companies operating globally. At the same time, Switzerland would have retained an internationally competitive and attractive tax system that should have held up to the new standards under B.E.P.S. and the European Commission's State Aid investigations. Small- and medium-sized companies may also have benefitted from the reform.

Accordingly, in a statement issued shortly after the referendum, E.U. Commissioner for Economic and Financial Affairs Pierre Moscovici expressed the Commission's disappointment with the outcome, saying "the rejection of the reform and referendum means we need to redouble our efforts when it comes to taxation. The Commission plans to consult the member states so we can decide together how to proceed." O.E.C.D. Tax Director Pascal Saint-Amans cautioned that "Switzerland's partners will expect it to implement its international commitments within a reasonable time period," noting that "this need not happen within the context of a wider reform, which could take longer than the two years originally foreseen for these changes." Though the consequences of not abolishing the preferential tax regime within a reasonable time are understood, neither official mentioned a potential blacklisting of Switzerland.

"It is expected that after an in-depth analysis a new reform proposal will be submitted to Parliament as soon as possible. . . [and] the main core of the above outlined C.T.R. III will be included in the reassessed reform."

It is expected that after an in-depth analysis a new reform proposal will be submitted to Parliament as soon as possible. While it may not include the N.I.D. (one of the most debated items), the patent box regime and tax incentives for R&D could remain subject to a consensus between proponents and left-wing opponents of the recent reform proposal. It is estimated that the main core of the above outlined C.T.R. III will be included in the reassessed reform and the anticipated 2019 effective date may be postponed. Finally, Swiss cantons may reassess their plans to reduce their corporate income tax rates since this was one of the main reasons the reform did not pass the vote.

ITALY INTRODUCES A 15-YEAR PREFERENTIAL TAX REGIME FOR WEALTHY INDIVIDUALS TAKING UP TAX RESIDENCE IN ITALY

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Italy
Non-domiciled Taxation
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New measures aimed at making Italy an attractive destination for high net worth individuals were contained in the 2017 Italian Budget Law and went into effect on January 1, 2017. The new Italian regime is comparable to the U.K. regime for non-domiciled individuals ("Non-Doms") and to regimes adopted in other countries. In essence, it allows individuals who become Italian tax residents to opt for a flat yearly tax of €100,000 on income from sources outside Italy, regardless of the amount of such income. The new regime, to be elected on the annual tax return, is available for up to 15 years and can be waived at any time during that term.

WHO CAN BENEFIT FROM THE NEW REGIME

To qualify for the option, an individual must have been a tax resident of one or more countries other than Italy for at least nine of the ten years preceding the year in which the individual becomes an Italian tax resident. If this condition is met, the option is available regardless of the taxpayer's nationality (*i.e.*, it is available for both non-Italian and Italian nationals).

SCOPE OF APPLICATION OF THE FLAT TAX

The flat tax, if opted for, will replace any tax to which an Italian tax resident would otherwise be subject on income from sources outside Italy. The only exception is that, during the first five years, the new resident will still be taxed on capital gains from the sale of a "qualified participation" in a company. In the case of a closely held corporation, a qualified participation means (i) an interest to which more than 20% of voting rights is attached or (ii) an interest of more than 25%, regardless of the voting rights attached to it. In the case of a publicly-traded corporation, it means (i) an interest to which more than 2% of voting rights is attached or (ii) an interest of more than 5%, regardless of the voting rights attached to it.

Income from Italian sources will be taxed in accordance with the regime ordinarily applicable to Italian tax residents. No tax credit is available for foreign taxes paid against the €100,000 annual amount. However, an option is available to exclude foreign income arising in one or more countries. This election may be made upon opting for the flat tax, or at any time during the 15-year term. Excluded foreign income will remain subject to ordinary tax rules and may therefore access the relief provided for by the applicable tax treaties.

OPTION ALSO AVAILABLE FOR RELATIVES AT A REDUCED AMOUNT

An attractive feature of the new regime is that if an individual moves to Italy together with family members who also receive income from non-Italian sources, the election for the regime can be extended to those family members, and each of them will be liable for an annual flat tax of €25,000 instead of €100,000. The range of family members who can benefit from the regime encompasses spouses, sons and daughters (including sons-in-law and daughters-in-law), parents (including parents-in-law), and brothers and sisters. Absent sons and/or daughters and their direct closest descendants may benefit as well.

"If an individual moves to Italy together with family members who also receive income from non-Italian sources, the election for the regime can be extended to those family members."

OTHER TAX ADVANTAGES ASSOCIATED WITH THE FLAT TAX OPTION

Individuals who are Italian tax residents are normally required to report on their annual tax return financial investments and other assets held outside Italy, whether or not such investments and assets produce income, (so-called "R.W. reporting obligations"). In addition, a tax is levied on financial investments ("I.V.A.F.E.") and on properties ("I.V.I.E.") so reported. New tax residents who choose to be taxed under the special regime will also be exempt from R.W. reporting obligations and, consequently, from I.V.A.F.E. and I.V.I.E. However, C.R.S. and F.A.T.C.A. reporting obligations would still apply.

Italian tax residents are normally liable for gift tax and inheritance tax with respect to transfers of assets by way of life time gift or an inheritance or bequest at death, regardless of physical location of the in Italy or abroad. The new regime provides tax relief to individuals on an elective basis. For successions and gifts taking place throughout the election period, inheritance and gift tax is indeed levied only on assets and rights situated in Italy (*i.e.*, the new tax resident will be exempt from gift tax and inheritance tax with respect to transfers of assets located outside Italy).

PROCEDURAL RULES

To benefit from the flat tax, a new tax resident must request a ruling ("*interpello*") from the Italian tax authority (the *Agenzia delle Entrate*) approving the election. The *interpello* must specifically indicate the jurisdiction(s) where the applicant was previously tax-resident, so that the *Agenzia delle Entrate* can exchange information with the tax authority of such jurisdiction(s). The *Agenzia delle Entrate* will have 120 days to approve or deny the request, and if no answer is provided to the applicant within this period, the request is deemed to have been approved. After having obtained a positive ruling, the applicant must make an election to apply the regime before the deadline for the submission of the tax return related to the tax year of transfer.

The new regime cannot be combined with other favorable regimes, such as the one provided for the repatriation of scientists and researchers. Within 90 days of the 2017 Italian Budget Law's entry into force, the *Agenzia delle Entrate* will issue additional regulations regarding implementation.

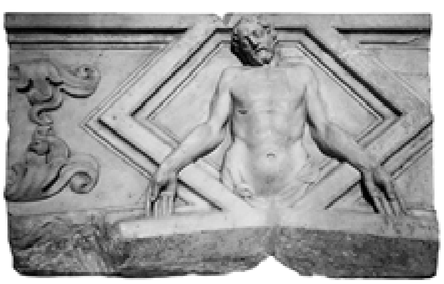
NEW INVESTOR VISA FOR NON-E.U. NATIONALS

The new flat tax regime is accompanied by changes to Italian immigration laws designed to make it possible for individuals who are not nationals of an E.U. Member

State to avoid restrictions that usually apply to the acquisition of Italian residency, as long as they are prepared to make investments in Italy.

Specifically, an individual can obtain an investor visa on the condition that he or she invests either €2 million in Italian governmental bonds or €1 million in securities issued by a company based and actually operating in Italy. The investment must be maintained for at least two years. The investor visa can also be obtained by making a donation of at least €1 million to a project of public interest in sectors such as culture, education, immigration handling, scientific research, and the like. In addition to fulfilling the investment requirement, an applicant for an investor visa will also be required to prove possession of financial resources that are sufficient to support him or herself during the planned stay in Italy.

The investor visa will have an initial term of two years and, under certain conditions, it will be possible to obtain extensions of three years each. Family members of the investor will be entitled to obtain a "family connection" visa granting residence with the investor.



ACCUMULATED EARNINGS TAX WILL HIT TAXPAYERS, DESPITE LACK OF LIQUIDITY OR CONTROL

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Tags
Accumulated Earnings Tax
C.C.A. 201653017
Control
Liquidity
Reasonable Needs

BACKGROUND

Even absent a distribution, shareholders of U.S. corporations may, under certain circumstances, be subject to a second layer of tax: the so-called accumulated earnings tax. This rarely-imposed penalty under U.S. tax law could become increasingly important if the tax rate disparity between corporate and individual income tax rates increases under the tax reform proposals put forth by President Trump and the House Republicans.[1] Recently issued I.R.S. guidance sheds some light on the application and potential impact of this rule.

In their endeavors to expand into the U.S. market, non-U.S. individuals and non-U.S. entities have various options to structure their investments. For reasons ranging from privacy concerns to substantial U.S. tax filing and reporting obligations, foreign taxpayers may prefer investing through a U.S. corporation, rather than through a U.S. partnership or a U.S. limited liability company ("L.L.C."). Generally, liquidity is not an issue, since often the investments are expected to grow over time -— with few, if any, distributions to the foreign shareholders.

A typical investment scenario could be as follows: A foreign national plans to move to the U.S. in the future and wishes to start investing in the U.S. with immediate effect. For privacy reasons, the foreign national chooses to invest via a U.S. corporation. The foreign national is a resident of a high-tax country that has a territorial system and no equivalent to the U.S. controlled foreign corporation regime or the passive foreign investment company regime. As a result, the foreign national may only be subject to home country taxation on income actually distributed by the U.S. corporation. The foreign national wishes for the corporation to only invest in passive-income generating assets, and absent any need for cash distributions from the U.S. entity, all income will remain in the U.S. corporation until the foreign national moves to the U.S.

Absent any distributions, the foreign national believes that the U.S. corporation will pay Federal, state, and local U.S. corporate income tax on the earnings, with no additional layer of shareholder tax. However, the accumulated earnings tax has been designed to prevent just this type of corporate accumulation.

While the accumulated earnings tax is not often mentioned in the news, a Chief Counsel Advice (the "C.A.A.") on the topic was issued by the I.R.S. on December 30, 2016. It is of interest to U.S. corporations claiming not to be liable to the accumulated earnings tax because of a lack of liquidity or control to make shareholder distributions.

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[1] See "Trump and the Republican-Led Congress Seek Overhaul of International Tax Rules," *Insights* 1 (2017).

ACCUMULATED EARNINGS TAX REGIME

Rules and Computation of Tax

The accumulated earnings tax is a 20% surcharge on the taxable income.[2] It applies to corporations formed for or availed of the purpose of avoiding shareholder taxes by permitting corporate earnings to accumulate rather than be distributed.[3] Personal holding companies, tax-exempt corporations, and passive foreign investment companies are not subject to the accumulated earnings tax.[4]

The accumulated earnings tax is not based on a measure of liquid assets but rather on taxable income less statutory adjustments.[5] One of the adjustments comprises distributions to shareholders or deemed distributions to shareholders under the rules applicable to consent dividends.[6] However, adjustments for undistributed partnership income are not encompassed by these rules. The earnings calculation is further reduced by amounts retained to cover the reasonable needs of the business (the "accumulated earnings credit").[7]

Purpose: Preventing Accumulations Beyond Reasonable Needs

The accumulated earnings tax was enacted to prevent a corporation from retaining earnings beyond its reasonable needs, instead of distributing earnings to shareholders. Intent to avoid tax need not be the sole reason for the accumulation; it suffices that it be one of the reasons.[8]

Evidentiary rules include a rebuttable presumption that a corporation that has accumulated earnings beyond its reasonable needs has retained those earnings for the purpose of tax avoidance.[9] Generally, the burden of establishing that a corporation's accumulation of earnings exceeds its reasonable needs lies with the I.R.S.

A corporation's status as a holding or investment company is *prima facie* evidence of the purpose to avoid income tax with respect to shareholders.[10] For this purpose, a holding company is a corporation having practically no activities except holding property and collecting income therefrom or investing therein.[11] If the activities

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2 Code §531.

3 Code §532(a). As a result, if none of the shareholders would be subject to U.S. individual income tax on distributions from the corporation, the accumulated earnings tax does not apply (P.L.R. 9422028).

4 Code §532(b).

5 Code §535(b).

6 Code §§535(a), 565.

7 Generally decreased by the amount of net capital gains in excess of taxes on those gains (Code §§535(a), 535(c)(1)). When the corporation is a mere holding or investment company, the accumulated earnings credit is limited to the amount (if any) by which $250,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year (Code §535(c)(3)).

8 *Cataphote Corp. of Miss. v. U.S.*, 535 F2d 1225, 37 AFTR 2d 76-1433.

9 Code §533; Treas. Reg. §1.533-1(a)(1).

10 Code §533.

11 Treas. Reg. §1.533-1(c).

substantially consist of buying and selling stock, securities, real estate, or other investment property such that the income is derived not only from the investment yield but also from profits subject to market fluctuations, the corporation is an investment company.[12]

For most other corporations, whether a purpose to avoid income tax exists will depend on the facts and circumstances of each case.[13] Case law and regulations provi*de facto*rs that are indicative of a tax avoidance purpose.[14]

IRRELEVANCE OF LIQUIDITIES OR CONTROL – C.C.A. 201653017

In C.C.A. 201653017, the I.R.S. held that a corporation was liable for the accumulated earnings tax, despite a lack of liquid assets and control over partnership investments.

The facts presented to the I.R.S. involved a U.S. individual shareholder (the "Shareholder") who invested in eight different partnerships (the "Partnership Interests"), along with other taxpayers. The Shareholder then contributed the Partnership Interests to a newly formed corporation (the "Taxpayer"). The Taxpayer had no other holdings and no other income other than the flow-through partnership income. The I.R.S. noted that no valid business purpose appeared to exist for the contribution.

One partnership served as the manager for all other partnerships and was itself managed by a board of six directors that had the power to vote on partnership matters. As a result, the Taxpayer had no control over partnership distributions.

During the years at issue, the Taxpayer's sole activity was holding and maintaining the Partnership Interests. The Taxpayer (i) had no operating expenses or employees and (iii) made no distributions to shareholders.

The Taxpayer included its distributive share of partnership income in its taxable income. In accordance with the provisions of the various partnership agreements, the Taxpayer only received partnership distributions up to an amount sufficient to cover its Federal and state tax liabilities. The remainder of its distributive share was retained by the various partnerships. The Taxpayer reported retained earnings for the years at issue but made no distributions out of those earnings.

Taxpayer argued that because it had no control over partnership distributions, it did not have enough cash to distribute to the Shareholder.

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12 *Id.*

13 Treas. Reg. §1.533-1(a)(2).

14 The factors are dealings between the corporation and its shareholders, such as personal loans to the shareholders or expenditures by the corporation for the personal benefit of its shareholders (Treas. Reg. §1.533-1(a)(2)(i); see also, *e.g.*, *Herzog Miniature Lamp Works, Inc. v. Commr.,* 481 F.2d 857 (2d Cir. 1973)); investment of undistributed earnings in assets having no reasonable connection with the business of the corporation (Treas. Reg. §1.533-1(a)(2)(ii)); the dividend history of the corporation (Treas. Reg. §1.533-1(a)(2)(iii); see also, *e.g.*, *Doug-Long, Inc. v. Commr.*, 72 T.C. 158 (1979)); and whether shareholder-employees are under-compensated (Herzog, 481 F.2d 857).

The I.R.S. rejected the Taxpayer's argument on the following grounds:

- Because the Taxpayer is a mere holding or investment company, the I.R.S. determined that there was *prima facie* evidence that the Taxpayer was formed to permit its shareholders to avoid tax pursuant to the accumulated earnings tax rules.
- The law does not base the accumulated earnings tax on available cash. Rather, its starting point is taxable income, less certain statutory adjustments. The undistributed income of partnerships owned by the corporation is not among these adjustments.
- To prevent the assertion of the accumulated earnings tax, the Taxpayer could have followed the consent dividend procedure set forth under the Code.[15]

"The Taxpayer remains subject to the accumulated earnings tax. The Taxpayer's lack of liquidity or control in the partnerships is irrelevant."

According to the I.R.S., the consent dividend procedure was enacted to address situations such as in the case in issue (*i.e.*, where a corporation that accumulated earnings beyond its reasonable needs lacks the liquidity to make distributions). Under the consent dividend procedure, a shareholder can agree to include in income a portion of a corpration's earnings without actually receiving cash. The included amount will be treated as having been distributed by the corporation to the shareholder and then contributed by the shareholder to the corporation's capital.

The I.R.S. refers to Private Letter Ruling 9124001 (the "P.L.R." or the "Ruling"), which dealt with a similar case except that the corporation's (*i.e.*, the taxpayer's) controlling shareholder controlled both the taxpayer and the partnership that retained all earnings. Notwithstanding the controlling shareholder's control of the partnership and, hence, the ability to resolve on a distribution, the ruling rejected the liquidity argument.

According to the P.L.R., by implementing consent dividend procedures Congress intended to remove obstacles to the distribution of taxable dividends from corporations to their shareholders. Consequently, the corporations would not have been subject to the accumulated earnings tax if, in conjunction with the shareholders, the entities had used the available consent dividend procedure. The P.L.R. concludes that the corporations' earnings and profits that are attributable to their distributive shares of the partnership income must be taken into account in determining whether the accumulated earnings tax should be imposed.

Citing the ruling, the C.C.A. stated that because the Taxpayer allowed its earnings and profits to accumulate – and because consent dividends could have been used by the Taxpayer and its sole and controlling Shareholder – the Taxpayer remains subject to the accumulated earnings tax. The Taxpayer's lack of liquidity or control in the partnerships is irrelevant.

CONCLUSION

The C.C.A. does not fundamentally change the accumulated earnings tax landscape. However, it is a good reminder that the tax has its place in tax planning. In view of a possible increase in the disparity between corporate and individual income tax rates, the accumulated earnings tax may gain significance in coming months.

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[15] Code §565.

With a suggested reduction of the corporate income tax to a rate of 15% or 20%, respectively, under the Trump and House Republican tax reform plans, corporations may be inclined to accumulate earnings in order to benefit from the rate arbitrage. Taxpayers should be aware that the I.R.S. enforces Congressional intent and does so by making certain that corporate distributions are made – whether actually or through otherwise available mechanisms, such as the consent dividend procedure.

Based on the reasoning of the C.A.A., it appears that those taxpayers that have no accumulated taxable income and no earnings and profits can continue to fall outside the accumulated earnings tax provision.

PROPOSED DIRECTIVE ON THE E.U. COMMON (CONSOLIDATED) CORPORATE TAX BASE – A PRIMER

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Tags
C.C.T.B.
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European Commission
MNE Planning
Permanent Establishment
Tax Administration

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INTRODUCTION

On October 25, 2016, the European Commission announced major corporate tax reforms for the E.U. market. In particular, the European Commission issued three proposal directives that deal with (i) the Common Corporate Tax Base ("C.C.T.B.") and the Common Consolidated Corporate Tax Base ("C.C.C.T.B."), (ii) resolution of double tax disputes, and (iii) mismatches with non-E.U. Countries.

Regarding the C.C.C.T.B. and C.C.T.B. proposals (collectively, the "Proposal Directive"), the European Commission essentially revamped a failed 2011 proposal in light of recent developments in the international tax environment (*e.g.*, the O.E.C.D. B.E.P.S. Project and the Action Plan for a Fair and Efficient Corporate Tax System in the E.U.). It may be "old wine," but the new bottles may make it drinkable.

As Commissioner for Economic and Financial Affairs, Taxation and Customs Pierre Moscovici stated:

> With the rebooted CCCTB proposal, we're addressing the concerns of both businesses and citizens in one fell swoop. The many conversations I've had as Taxation Commissioner have made it crystal-clear to me that companies need simpler tax rules within the EU. At the same time, we need to drive forward our fight against tax avoidance, which is delivering real change. Finance Ministers should look at this ambitious and timely package with a fresh pair of eyes because it will create a robust tax system fit for the 21st century.[1]

The project appears to be extremely ambitious, as the Proposal Directive would have a huge impact on the tax systems of the E.U. Member States. Indeed, should the Proposal Directive be approved, Member States would lose autonomy to set rules concerning the corporate tax bases of companies falling within the ambit of the Proposal Directive – companies that carry-on business within the E.U. market and belong to a multinational group with a total annual turnover in excess of €750 million. The Proposal Directive intrudes on the sovereignty of E.U. Member States in regard to internal income tax systems, leaving them little leeway with respect to corporation tax matters other than the establishment of a corporate tax rate in accordance with national budgetary policy. The computation of income, the allowance of credits, and accelerated deductions would be set centrally by the European Commission.

To overcome the difficulties preventing the approval of the 2011 proposal, the European Commission has overhauled the proposal – advocating for a new two-step approach. Even though the C.C.C.T.B. and C.C.T.B. proposals have been

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[1] European Commission, "Commission Proposes Major Corporate Tax Reform for the EU," news release, October 25, 2016.

submitted simultaneously by the European Commission, they represent two distinct phases that contemplate an initial approval of the C.C.T.B. and subsequent approval of the C.C.C.T.B.

AIM OF THE PROPOSAL DIRECTIVE

The Proposal Directive aims at providing E.U.-resident companies and foreign companies doing business across the internal market with a single set of corporate tax rules for calculating the tax base, thereby allowing these companies to treat the E.U. as a single market for corporate income tax purposes as well as V.A.T. purposes. The intention is to create a fair and level playing field no matter where a corporation is resident, to provide certainty to taxpayers, and to reduce costs, administration burdens, and red tape.

The Proposal Directive is expected to constitute an effective tool against tax avoidance, as the application of a single set of rules across the E.U. market would eliminate mismatches between national systems that may be exploited by aggressive tax planners, resulting in base erosion and profit shifting. Moreover, tax avoidance risk would be reduced because a uniform base would be expected to eliminate the incentive to manage transfer prices of goods, services, and the use of intangible property with the goal of directing profits towards group members based in countries with preferential tax regimes.

With regard to transfer pricing, the Proposal Directive endorses an arm's length principle that reflects the O.E.C.D. standard. In this respect, it should be noted that under the C.C.C.T.B. proposal transfer pricing only applies to intra-group dealings involving E.U.-resident companies and third-country-resident companies. In comparison, intra-C.C.C.T.B. group dealings fall outside the scope of arm's length transfer pricing because consolidated income would be subject to formulary apportionment.

The Proposal Directive also includes specific rules to address key actions under the B.E.P.S. Project. In particular, the Proposal Directive provides for (i) a general anti-abuse rule ("G.A.A.R."), (ii) a controlled foreign corporation ("C.F.C.") rule, (iii) a switch-over clause, and (iv) an anti-hybrid mismatch rule.

OUTLINE OF THE PROPOSAL DIRECTIVE

Subjective Scope

The Proposal Directive applies to companies, including permanent establishments ("P.E.'s"), based in a Member State that belong to a consolidated group with a total consolidated group revenue exceeding €750,000,000 during the prior financial year. Companies established under the laws of a third country also fall within the scope of the Proposal Directive with respect to each P.E. situated in a Member State. The Proposal Directive provides specific requirements regarding company form, liability to specific taxes, and the controlling relationship between a parent company and its subsidiaries. The application of the rules set forth by the Proposal Directive is mandatory for all entities and P.E.'s so described.

Companies that do not belong to a consolidated group with total consolidated group revenue exceeding €750,000,000 during the prior financial year but meet all the other conditions provided for by the Proposal Directive may elect to apply the C.C.T.B.

and C.C.C.T.B. rules. The election would remain in effect for a period of at least five tax years. This election includes affiliates and P.E.'s situated in other Member States.

P.E. Definition

The Proposal Directive provides for a definition of a P.E. that reflects the standard laid down in Article 5 of the O.E.C.D. Model Tax Convention, including the proposed amendments suggested by B.E.P.S. Action 7 – Preventing the Artificial Avoidance of Permanent Establishment Status.

The definition applies to a P.E. of an E.U.-resident taxpayer, if that P.E. is established in a Member State. However, if a P.E. of an E.U.-resident taxpayer is established in a third country or a P.E. of a third-country-resident taxpayer is established in a Member State, the P.E. will continue to be governed by the provisions of the tax treaty concluded between the third country and the E.U. Member State, and the domestic tax laws of the states involved.

"Eligibility for the C.C.T.B. and the C.C.C.T.B. will be determined in accordance with a two-part test based on control and ownership or profit rights."

Definition of Group

Eligibility for the C.C.T.B. and the C.C.C.T.B. will be determined in accordance with a two-part test based on control and ownership or profit rights. Control means the right to exercise more than 50% of the voting rights of another corporation. Ownership or profit rights means ownership of more than 75% of the subsidiary's capital or rights to more than 75% of the subsidiary's profits.

In calculating the thresholds for control and ownership or profit rights in relation to lower-tier subsidiaries, the following rules apply:

- Once the voting-right threshold is reached in respect of a subsidiary, the parent company will be considered to hold 100% of these rights.
- Entitlement to profit and ownership of capital will be calculated by multiplying the interests held, directly or indirectly, in subsidiaries at each tier. Ownership rights amounting to 75% or less held, directly or indirectly, by the parent company will be taken into account in the calculation. Indirect ownership rights will be taken into account whether the intermediary company is based in a Member State or outside the E.U.
- A taxpayer who is a group member must meet the above-mentioned thresholds without interruption, throughout the tax year. Newly acquired companies and companies that have been sold to third parties will be treated as group members if held within the group for a minimum period of nine consecutive months. If that minimum period of ownership is not met, the company will be treated as a non-member for the entire year. A taxpayer ceases to be a group member the day after it no longer meets the thresholds for control and ownership or profit rights.

Features of the C.C.T.B. and C.C.C.T.B.

The Proposal Directive contains the following features:

- A system is adopted for the establishment of a common base for the taxation of companies that are members of a group.

- Rules regarding the calculation of the base are established under the C.C.T.B. proposal.
- Rules regarding the allocation of the consolidated tax base to Member States and administration by the national tax authorities are established under the C.C.C.T.B. proposal.
- The tax base is to be calculated as revenues less exempt revenue, deductible expenses, and other deductible items.

Exempt Revenue

Exempt revenue includes, *inter alia*, capital gains from disposals of shares and dividend distributions, although specific exclusions apply to eliminate double taxation at the corporate level within certain related corporations.

Regarding capital gains, a participation exemption generally applies to proceeds from a disposal of shares, provided that the taxpayer has maintained a minimum holding of 10% in the capital or voting rights of the company during the 12 months preceding the disposal.

Regarding profit distributions, a participation exemption applies to the receipt of profit distributions, provided that the taxpayer has maintained a minimum holding of 10% in the capital or voting rights of the distributing company for 12 consecutive months. When a corporation establishes a P.E. in another Member State, profits distributed to the corporation's head office will qualify as exempt revenue.

Deductible Expenses

Expenses are deductible only to the extent that they are incurred in the direct business interest of the taxpayer.

"Super-Deduction" of Research and Development Expenses

Regarding research and development ("R&D") expenses, a "super-deduction" is granted to the taxpayers in addition to the R&D costs incurred for the purposes of the business. The super-deduction amounts to an extra 50% of the costs incurred during that year. When computing the super-deduction cost base, costs related to movable tangible fixed assets are excluded. Presumably, this means that expenditures for machinery and equipment are not eligible for the super-deduction.

To the extent that R&D costs exceed €20,000,000, the taxpayer may deduct 25% of the excess. The deduction ceiling may be further increased for start-up companies that meet specific conditions.

Allowance for Growth and Investment

The Proposal Directive also provides for an Allowance for Growth and Investment ("A.G.I."), which is intended to put equity and debt financing on similar a footing and boost growth. Under the measure, taxpayers are granted a tax-deductible notional yield computed on equity increases. The notional yield corresponds to the Euro Area 10-Year Government Benchmark Bond Yield as of December of the preceding tax year, as published by the European Central Bank, increased by a 2% risk premium. A 2% floor applies where the curve of the annual yield is negative. Equity base decreases are taxable in the hands of the taxpayer to an amount that corresponds to the notional yield computed on the relevant equity base decrease. Companies incurring losses will find that the loss is magnified to the extent of the clawback of prior benefits of the notional yield under the A.G.I.

Interest Limitation Rule

The Proposal Directive provides for an interest limitation rule based on a fixed ratio of net interest to earnings before interest, tax, depreciation, and amortization ("E.B.I.T.D.A.") that resembles the limitation established in Article 4 of the E.U. Anti-Tax-Avoidance Directive (the "A.T.A. Directive"). According to the rule, borrowing costs are deductible to the extent of interest, or other taxable revenues from financial assets, received by the taxpayer. Excess borrowing costs are deductible in the tax year in which they are incurred up to 30% of the taxpayer's E.B.I.T.D.A. (fixed ratio rule) or €3,000,000, whichever is greater. The interest limitation rule also provides for a group ratio rule, a carryforward rule, and a grandfathering clause.

Losses

Losses incurred in a tax year by a resident taxpayer or a P.E. of a nonresident taxpayer may be carried forward indefinitely and deducted in subsequent tax years. The Proposal Directive also provides for a specific anti-abuse provision that tackles abusive planning intended to circumvent the rules on loss deductibility through the purchasing of loss-making companies.

G.A.A.R.

The Proposal Directive provides for a G.A.A.R. in line with the rule adopted in the A.T.A. Directive. The G.A.A.R. is designed to cover gaps that may exist in Member State' specific anti-abuse rules. Taking into account all relevant facts and circumstances, Member States are entitled to disregard an arrangement, or a series of arrangements, that has been put in place for the essential purpose of obtaining a tax advantage that defeats the object or purpose of the Proposal Directive and is therefore not genuine. An arrangement is to be regarded as non-genuine to the extent that it is not put in place for valid commercial reasons that reflect economic reality. If an arrangement falls within the scope of the G.A.A.R., a substance over form approach will apply. When calculating the tax base, the arrangement will be treated by reference to its economic substance.

Formulary Apportionment

Under C.C.C.T.B., the consolidated tax base is apportioned among the group members in each tax year on the basis of a formula. The formula takes into consideration three equally weighted factors, *viz.*, labor, assets, and sales by destination. In this way, the C.C.C.T.B. is intended to reflect a balanced approach to distributing taxable profits amongst eligible Member States. The labor factor is weighted equally between payroll and headcount of employees in order to account for wage gaps across the E.U. The asset factor consists of all fixed tangible assets. Intangibles and financial assets are excluded from the formula due to their mobile nature and the risks of circumventing the system. Profits and losses arising from intra-group transactions are eliminated when calculating the consolidated tax base.

A safeguard clause is provided for by the C.C.C.T.B. proposal in cases where the parent company of the group (the "Principal Taxpayer") or a competent authority considers that the outcome of the apportionment of the consolidated tax base to a group member does not fairly represent the extent of the business activity of that group member. In such a case, the safeguard clause allows the Principal Taxpayer or competent authority to request the use of an alternative method for calculating the tax share of each group member. Specific rules apply to particular sectors, such as financial services and insurance, oil, and gas as well as shipping and air transport.

Administrative Procedures

The Directive Proposal will have a significant impact on the administrative procedures. Indeed, while companies applying only the C.C.T.B. rules will continue to fall within their national administrative provisions, taxpayers involved in the C.C.C.T.B. will deal with a single tax administration ("Principal Tax Authority") in the E.U. The Principal Tax Authority is the one based in the Member State where the Principal Taxpayer resides for tax purposes. The Principal Tax Authority is empowered to initiate and coordinate tax audits involving the consolidated group.

However, the national authorities of any Member State in which the profits of a group member are subject to tax may request the initiation of an audit. Moreover, the competent authority of a Member State in which a group member is tax resident, or a P.E. is established, may challenge a decision by the Principle Tax Authority concerning a notice to create a group or an amended tax assessment. This challenge must be made before the courts of the Member State of the Principal Tax Authority.

Disputes between taxpayers and tax authorities will be dealt with by an administrative body that will be competent to hear appeals at first instance according to the laws of the Member State of the Principal Tax Authority.

CONCLUSION

The Proposal Directive, if approved, will have a massive impact on Member States' tax systems. Indeed, the enactment of the E.U. single market through the Proposal Directive will result in a significant limitation of Member State autonomy on a crucial tax matter. That is why, at this stage, it appears difficult to predict whether a unanimous favorable decision will be reached. Moreover, even if the Proposal Directive is approved, the entry into force of the relevant provisions will not take place until 2019 with regard to the C.C.T.B. and 2021 with regard to the C.C.C.T.B.

Given the existing uncertainty regarding the approval of the Proposal Directive and the time span between approval and actual implementation of the relevant provisions, it appears too early for multinational companies that fall within the scope of the Proposal Directive to begin revising E.U. structures to cope with the provisions. It is, however, crucial for multinational companies and practitioners to keep updated on the development of the project and to the possible outcome of the Proposal Directive.

§338(G) ELECTION IN THE CROSS-BORDER CONTEXT: I.R.S. TARGETS FOREIGN TAX CREDIT ENHANCER

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Tags
Covered Assets Acquisition
Code §338(g)
Code §901(m)
Foreign Country Creditable Taxes
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Disqualified Portion

INTRODUCTION

The Internal Revenue Code (the "Code") provides a foreign tax credit to relieve U.S. taxpayers from double taxation. Specifically, Code §901 allows a direct credit against U.S. Federal income tax for foreign income taxes paid to another country by a U.S. taxpayer with regard to realized income derived from foreign sources.

Code §901(m) was enacted by the Education Jobs and Medical Assistance Act of 2010 to prevent U.S. taxpayers from benefitting from situations in which the U.S. computation of income differs substantially from the method used in a foreign country due to an election to treat a stock purchase as an asset purchase. Code §338(g) allows a U.S. taxpayer to treat a stock acquisition as an asset acquisition for U.S. tax purposes. By making the election, the premium paid for the shares – the amount by which the purchase price exceeds the book value of the shares – can be pushed down to increase the basis in operating assets of the acquired company. The step-up in depreciable basis of operating assets for U.S. tax purposes results in steeper depreciation and amortization deductions in the U.S. This magnifies the effective tax rate in the foreign country when looked at from a U.S. tax viewpoint, creating mountains of excess foreign tax credits.

EXAMPLE

To illustrate, assume the earnings before interest, taxes, depreciation, and amortization ("E.B.I.T.D.A.") of XCO, a foreign corporation, is 500,000 foreign currency units ("F.C.U.'s") and that the F.C.U. is equal in value to $1.00. If the depreciation deduction for income tax purposes in the foreign country is 50,000 F.C.U.'s, no interest expense exists and no further adjustments are made to arrive the at taxable income. The net income before taxes is 450,000 F.C.U.'s. If the rate of income tax is 30% and no further adjustments are made in computing taxable income, the foreign country income tax is 135,000 F.C.U.'s. At a 34% rate, the U.S. tax is $153,000 before foreign tax credits and $18,000 after foreign tax credits, ignoring allocations and apportionments of shareholder expense to the income.

Now assume that the shares of XCO are acquired for 15 million F.C.U.'s and an election is made for U.S. income tax purposes to treat the share purchase as an asset purchase. Assume further that the share premium is mostly allocated to depreciable assets and that the depreciation deduction is increased for U.S. purposes to 300,000 F.C.U.'s. If the E.B.I.T.D.A. and interest expense remain constant, the taxable income of XCO according to U.S. tax concepts is 200,000 F.C.U.'s. Nonetheless, for foreign tax purposes, the income and tax remain unchanged at 450,000 F.C.U.'s and 135,000 F.C.U.'s, respectively. Consequently, the foreign tax imposed at a constant 30% rate remains 135,000 F.C.U.'s. In comparison, the U.S. tax is reduced to $68,0000 before foreign tax credits and is eliminated entirely by the foreign tax credit. In addition, $67,000 of excess foreign tax credits are available to offset U.S. tax on low-tax foreign-source income.

The foregoing result is viewed to be an unintended double benefit for taxpayers. The reduction in income was not intended to free-up foreign tax credits to offset U.S. tax on other items of foreign-source income. The enactment of Code §901(m) addresses the situation by disallowing a portion of the foreign tax credit generated by the foreign corporation simply because of the increased depreciation deduction (the "Disqualified Tax Amount).[1] While the example focuses on direct foreign tax credits that would exist if foreign operations are carried on as a branch, it does not mean that Code §901(m) applies to the indirect credit that arises from intercompany dividends received by a U.S. parent corporation from its foreign subsidiary.[2] In such cases, neither Code §78 nor Code §275 apply to the Disqualified Tax Amount. The Disqualified Tax Amount is allowed as a deduction to the extent that it is otherwise deductible under U.S. tax law.

PROPOSED REGULATIONS

Overview

On December 6, 2016, the Treasury issued temporary and proposed regulations to clarify rules under Code §901(m). In general, Code §901(m) disallows foreign tax credits on taxes paid or accrued in connection with a "covered assets acquisition" ("C.A.A.").

Definitions

As with many other recent regulations issued by the I.R.S., specific jargon is used throughout. Consequently, before discussing the proposed and temporary regulations, a list of the terms used and their definitions will be helpful. As a convenience, the terminology will be defined a second time throughout the article.

- C.A.A. – a covered asset acquisition, meaning an acquisition that triggers the application of Code §901(m)
- R.F.A. – a relevant foreign asset, meaning an asset that has a lower basis for foreign tax purposes than for U.S. tax purposes, generally because of a C.A.A.
- R.F.A. Owner (U.S.) – the U.S. taxpayer that owns one or more R.F.A.'s and reports the foreign tax credit that is subject to Code §911(m)
- R.F.A. Owner (Foreign) – the foreign taxpayer that owns one or more R.F.A.'s
- Disqualified Tax Amount – the foreign income tax that is no longer creditable because of Code §901(m)
- Multiplicand – the amount of foreign tax that will be reduced by the Disqualified Ratio

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1 Code §901(m)(6).

2 Prop. Reg. §1.901(m)(2)(b)(1).

- Disqualified Ratio – a fraction in which the numerator is the sum of the basis difference for all R.F.A.'s for the year and the denominator is the foreign income reflected on the foreign tax return that relates to the Multiplicand

- Aggregate Basis Difference – the numerator of the Disqualified Ratio

- Allocable Foreign Income – the denominator of the Disqualified Ratio

- Allocated Basis Difference – the amount of the basis difference in an R.F.A. that is taken into account in a given U.S. taxable year

- Code §901(m) Payor – the person that is eligible to claim the foreign tax credit and therefore must compute the Disqualified Tax Amount for an R.F.A. arising from a C.A.A.

- Code §902 Corporation – the foreign corporation that has one or more shareholders that are entitled to claim an indirect foreign tax credit under U.S. tax law for the income taxes it pays or accrues

- Foreign Payor – the person that is subject to a foreign income tax and includes a disregarded entity

- F.C.C.T. – the foreign country creditable taxes, meaning income taxes imposed by a third country that reduce income tax in a foreign country

- Disposition Amount – the difference in basis for U.S. and foreign tax purposes

- Unallocated Basis Difference – a difference in basis that has not yet been taken into account under Code §901(m)

Technical Provisions

A C.A.A. is any one of the following four transactions that result in a tax basis for U.S. purposes that is greater than the tax basis for foreign purposes:

- A qualified stock purchase, as defined in Code §338(d)(3)), to which Code §338(a) applies

- A transaction that is treated as an acquisition of assets for U.S. income tax purposes, but is treated as an acquisition of stock of a corporation (or is disregarded) for foreign income taxes purposes – typically, this would be a purchase of shares of a foreign disregarded entity

- An acquisition of an interest in a partnership that has an election in effect under Code §754 to increase its basis in assets when a partnership interest is acquired for a premium that is over net book value

- Any other similar transaction identified by the I.R.S.[3]

To cure the creation of excess foreign tax credits arising from a mismatch of the basis in assets, a portion of the foreign income taxes paid or accrued by the foreign corporation is not taken into account when computing the foreign tax credit. The disregarded portion is the net difference in the bases of all relevant foreign assets ("R.F.A.'s") divided by the income or gain on which the foreign tax is computed.

[3] Code §901(m)(2).

In this manner, the basis differential is allocated to each dollar of income or gain attributable to the R.F.A., and to that extent a percentage of the foreign tax credit is disqualified.

To determine the difference in the bases of the assets, the adjusted basis immediately after C.A.A. is compared with the adjusted bases of those assets immediately before the C.A.A. For this purpose, basis is computed according to U.S. tax concepts. The R.F.A. includes, with respect to foreign income tax arising after the C.A.A., any asset (including goodwill, going concern value, or other intangibles) acquired in the C.A.A. that is relevant in determining foreign income for the purposes of the foreign income tax.[4] The proposed regulations clarify that basis is taken into account even if the asset is not immediately used in determining foreign income.

The proposed regulations provide three additional categories of transactions that may be considered C.A.A.'s.[5] The additions are as follows:

- Purchase of a Disregarded Entity – This includes any transaction (or series of transactions occurring pursuant to a plan) to the extent it is treated as an acquisition of assets for the purposes of U.S. income tax and as the acquisition of an interest in a fiscally transparent entity for the purposes of foreign income tax.[6]
- Partnership Distributions – This includes any transaction (or series of transactions occurring pursuant to a plan) to the extent it is treated as a partnership distribution of one or more assets, the U.S. basis of which is determined by Code §§732(b) or 732(d), or which causes the U.S. basis of the partnership's remaining assets to be adjusted under Code §734(b), provided the transaction results in an increase in the U.S. basis of one or more of the assets distributed by the partnership or retained by the partnership without a corresponding increase in the foreign basis of such assets.[7]
- Asset Acquisitions – This includes any transaction (or series of transactions occurring pursuant to a plan) to the extent it is treated as an acquisition of assets for the purposes of both U.S. income tax and foreign income tax, provided the transaction results in an increase in the U.S. basis without a corresponding increase in the foreign basis of one or more assets.[8] An example would be a transfer of property to a subsidiary that results in gain recognition for U.S. tax purposes but is entirely tax free. Disqualified preferred shares are issued as part of the consideration in the transfer. In the U.S., the basis is stepped up to reflect the recognized gain of the transfer. Because the tax law in the foreign country has no counterpart to Code §351(g), no gain is recognized and a carryover basis continues to apply to the assets.

After a C.A.A., an asset will become an R.F.A. with respect to foreign income tax if, pursuant to a plan or series of related transactions for which avoiding the application of Code §901(m) is a principal purpose, an asset that was not relevant in

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4 Code §901(m)(4); Prop. Reg. §1.901(m)-2(c)(1).

5 Prop. Reg. §1.901(m)-2(b).

6 Prop. Reg. §1.901(m)-2(b)(4).

7 Prop. Reg. §1.901(m)-2(b)(5).

8 Prop. Reg. §1.901(m)-2(b)(6).

determining the foreign income for the purposes of that foreign income tax becomes relevant immediately following the C.A.A. Moreover, a tainted principal purpose will be deemed to exist if income, deduction, gain, or loss attributable to the asset is taken into account in determining the foreign income within the one-year period following the C.A.A. To illustrate a series of transactions occurring pursuant to a plan, the proposed regulations describe a purely domestic acquisition of shares to which a Code §338(a) election is made that is followed by a drop-down of the of the property owned by the target to its foreign subsidiary where all steps occur within a single taxable year.[9] The initial domestic acquisition is a C.A.A., but the assets are not considered to be R.F.A.'s until the drop-down when the assets are taken into account in computing the foreign tax of the foreign subsidiary.

"A Disqualified Tax Amount is computed separately for each foreign tax return that takes into account income, gain, deduction, or loss from one or more R.F.A.'s in computing the foreign taxable income."

COMPUTING THE DISQUALIFIED TAX AMOUNT[10]

In general, a Disqualified Tax Amount is computed separately for each foreign tax return that takes into account income, gain, deduction, or loss from one or more R.F.A.'s in computing the foreign taxable income. It also applies for each Code §901(m) Payor that pays or accrues, or that is considered to pay or accrue, a portion of the foreign income taxes reflected on the foreign tax return. If the foreign income taxes relate to more than one separate category of income (*i.e.*, general basket or passive), then a separate computation is required for each such category. Members of a U.S.-affiliated group of corporations that file a consolidated return are each treated as a separate Code §901(m) Payors; therefore, Disqualified Tax Amounts are computed at the member level.

The proposed regulations refer to the total taxable income (or loss) that is computed under foreign law for a foreign taxable year and reflected on a foreign tax return as "foreign income," and to the total amount of tax reflected on a foreign tax return as the "foreign income tax amount." Thus, foreign income does not include income that is exempt from foreign income tax. The proposed regulations use the term Foreign Country Creditable Taxes ("F.C.C.T.'s") to refer to any foreign income tax imposed by a third country that is allowed as a credit to reduce the foreign income tax amount in the country of residence of the Code §901(m) Payor.

The Disqualified Tax Amount is the lesser of (i) the tentative Disqualified Tax Amount and (ii) the foreign income tax amount paid or accrued by the Code §901(m) Payor. The tentative Disqualified Tax Amount is determined using a modified version of the formula provided in Code §901(m)(3). The foreign income tax amount paid or accrued by the Code §901(m) Payor (the "Multiplicand") is multiplied by a ratio ("disqualified ratio"). The numerator of the ratio is the sum of the basis differences for all R.F.A.'s that are taken into account and assigned to the U.S. taxable year. The denominator of the ratio is the portion of the foreign income reflected on the foreign tax return that relates to the foreign income tax amount included in the Multiplicand. The numerator and the denominator of the disqualified ratio are referred to in the proposed regulations as the "aggregate basis difference" and "allocable foreign income," respectively.

Allocable foreign income (the denominator of the disqualified ratio) and the foreign income tax amount (the Multiplicand) are determined using the total amount of

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9 Prop. Reg. §1.901(m)-2(e), *Example (3).*

10 Prop. Reg. §1.901(m)-3.

foreign income and the foreign income tax amount reflected on the foreign income tax return instead of by reference only to the amounts determined with respect to the R.F.A.'s. The I.R.S. determined that this approach carries out the purposes of Code §901(m) while avoiding the administrative and compliance burdens that would result from a requirement to trace amounts of income to R.F.A.'s and identify the portion of foreign income tax imposed on that income.

When the numerator and denominator are both positive amounts, the Aggregate Basis Difference included in the numerator is limited to the amount of foreign income in the denominator of the disqualified ratio. This limitation ensures that the computations do not produce a Disqualified Tax Amount that exceeds the foreign income taxes paid or accrued.

When the entire foreign income tax amount reflected on a foreign tax return is paid or accrued by a single Code §901(m) Payor, the Allocable Foreign Income is simply the total foreign income reflected on the foreign tax return. When the foreign income tax amount is allocated to more than one person, the Allocable Foreign Income in the denominator will be allocated among the Code §901(m) Payors in proportion to the allocation of the foreign taxes among those Payors. Guidance is provided for making the allocation of foreign income in three types of cases:[11]

- The foreign income tax amount is allocated because of a mid-year transaction, such as a transfer of a disregarded entity or a Code §338 transaction. Principles set forth in Treas. Reg. §1.1502-76(b), involving part-year members of an affiliated group of corporations filing a consolidated tax return, apply.
- The foreign income tax amount is allocated among the partners of a partnership or a disregarded entity owned by a partnership. Principles set forth in Treas. Reg. §1.704-1(b)(4)(viii), involving allocations of creditable income taxes among the partners of a partnership, apply.
- The foreign income tax amount is allocated among members of a group whose income is taxed on a combined basis for foreign income tax purposes. Principles set forth in Treas. Reg. §1.901-2(f)(3)(iii), involving members of a foreign group benefitting from group relief, apply.

DETERMINING THE BASIS DIFFERENCE FOR AN R.F.A.[12]

Under the temporary regulations, the basis difference is equal to the U.S. basis in the R.F.A. immediately after the C.A.A., less the U.S. basis in the R.F.A. immediately before the C.A.A. Basis difference is an attribute that attaches to an R.F.A.[13] However, the proposed regulations provide for an election ("Foreign Basis Election") to use the basis under foreign law immediately after the C.A.A.[14] For this purpose, the foreign basis immediately after the C.A.A. takes into account any adjustment to that foreign basis resulting from the C.A.A. for the purposes of the foreign income tax. A

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[11] Prop. Reg. §1.901(m)-3(b)(2)(iii)(C).

[12] Prop. Reg. §1.901(m)-4.

[13] Treas. Reg. §1.901(m)-4T(b).

[14] Prop. Reg. §1.901(m)-4(c)(1).

Foreign Basis Election is made by using a foreign basis to determine the basis difference for the purposes of computing a Disqualified Tax Amount and an Aggregate Basis Difference carryover for the U.S. taxable year.[15]

The proposed regulations adopt certain terminology that is used in computing the disqualified foreign tax:

- The "R.F.A. Owner (U.S.)" is the person that owns one or more R.F.A.'s for U.S. income tax purposes and therefore is required to report, or otherwise track, items of income, deduction, gain, or loss attributable to the R.F.A.'s for the purposes of computing U.S. taxable income.
- The "R.F.A. Owner (Foreign)" is the person (including a disregarded entity) that owns one or more R.F.A.'s for the purposes of a foreign income tax and therefore generally would report, or otherwise track, items of income, deduction, gain, or loss attributable to the R.F.A.'s for the purposes of determining the income to be reported on a foreign income tax return.

Except as otherwise provided, a Foreign Basis Election is made by the R.F.A. Owner (U.S.). If, however, the R.F.A. Owner (U.S.) is a partnership, each partner in the partnership – and not the partnership, itself – may independently make a Foreign Basis Election. In the case of one or more tiered partnerships, the Foreign Basis Election is made at the level at which a partner is not also a partnership.

The election generally must be reflected on a timely-filed original Federal income tax return for the first U.S. taxable year that the Foreign Basis Election is relevant. An exception to this requirement is provided where the R.F.A. Owner (U.S.) is a partnership.[16] This exception generally provides relief when one or more of the partners and the partnership have agreed that the partnership would provide the partners with the information necessary to apply the basis under foreign tax law, but when the partner timely-filed its tax return, it failed to report the application of Code §901(m). The relief allows the partner to file an amended return using the basis under foreign tax law. Safeguards are provided that are intended to prevent partners from gaming the system through an intentional failure to address Code §901(m).

BASIS DIFFERENCE TAKEN INTO ACCOUNT

The proposed regulations provide rules for determining the amount of basis difference with respect to an R.F.A. that is taken into account in a given U.S. taxable year (referred to in the regulations as "Allocated Basis Difference").[17] The Allocated Basis Difference is used to compute the Disqualified Tax Amount for the U.S. taxable year. Basis difference is taken into account in two ways: under an applicable cost recovery method, or as a result of a disposition of the R.F.A.[18]

An applicable cost recovery method includes any method for recovering the cost of property over time for U.S. income tax purposes.[19] Examples are depreciation,

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15 Prop. Reg. §1.901(m)-4(c)(4).

16 Prop. Reg. §1.901(m)-4(c)(5).

17 Prop. Reg. §1.901(m)-5.

18 *Id.*

19 Prop. Reg. §1.901(m)-5(b)(3).

amortization, or depletion, as well as any method that allows the cost of property to be expensed in the year of acquisition or in the placed-in-service year, such as under Code §179. Applicable cost recovery methods do not include any provision allowing for the recovery of U.S. basis upon a disposition of an R.F.A.

Attributing or Allocating a Cost Recovery Amount to a Code §901(m) Payor

The applicable cost recovery method varies depending on the status of the R.F.A. Owner.

- When the R.F.A. Owner (U.S.) is a Code §901(m) Payor, the entire cost recovery amount is attributed to the Payor and assigned to the U.S. taxable year of the Payor in which the corresponding U.S. basis deduction is taken into account under the applicable cost recovery method.
- When the R.F.A. Owner (U.S.) is a Code §901(m) Payor, the entire disposition amount is generally attributed to the Payor and assigned to the U.S. taxable year of the Payor in which the disposition occurs.
- When the R.F.A. Owner (U.S.) is a fiscally transparent entity for U.S. income tax purposes in which a Code §901(m) Payor directly or indirectly owns an interest, a cost recovery amount must be allocated to the Payor to the extent that the U.S. basis deduction that corresponds to the cost recovery amount is (or will be) included in the Payor's distributive share of the income of the R.F.A. Owner (U.S.) for U.S. income tax purposes.
- If a Code §901(m) Payor acquires a partnership interest in a C.A.A. that allows for a step-up of basis for the Payor under Code §743(b), and subsequently there is a cost recovery amount or a disposition, all of the cost recovery amount or the disposition amount is allocated to that Payor.
- When a disposition of an R.F.A. occurs in the same foreign taxable year that a Foreign Payor is involved in a mid-year transaction, the portion of the disposition amount that is attributable to foreign disposition gain or foreign disposition loss must be allocated to a Code §901(m) Payor under a formula.

Rules are also provided for R.F.A. Owners that are reverse hybrid entities, which are corporations for U.S. purposes but fiscally transparent for foreign tax purposes.

General Disposition Rules

A disposition for the purposes of Code §901(m) is an event that results in a gain or loss being recognized with respect to an R.F.A. for the purposes of U.S. income tax, foreign income tax, or both. The amount of the basis difference must be determined and taken into account upon the disposition of an R.F.A. (the "Disposition Amount").

If an R.F.A. has a positive basis difference, the Disposition Amount attributable to the foreign disposition gain represents the amount of gain in the years following the C.A.A. that was included in foreign income but not in U.S. taxable income or earnings and profits. Accordingly, to the extent that a foreign disposition gain is taken into account in computing a foreign income tax amount, a portion of that foreign income tax amount should be disallowed as a foreign tax credit under Code §901(m).

On the other hand, if an R.F.A. has a negative basis difference and a foreign disposition loss is taken into account in computing the foreign income tax amount, this should reduce the amount of the foreign income tax that otherwise would be disallowed as a foreign tax credit under Code §901(m) as a result of a positive basis difference with respect to one or more other R.F.A.'s. The allocation rules vary depending on whether the Disposition Amount is attributable to foreign disposition gain or loss or U.S. disposition gain or loss.

If a disposition of an R.F.A. is fully taxable for U.S. and foreign income tax purposes, the Disposition Amount will be any remaining unallocated basis difference, whether positive or negative.[20] If a disposition of an R.F.A. is not fully taxable for U.S. and foreign income tax purposes and the R.F.A. has a positive basis difference, the Disposition Amount is based solely on the amount, if any, of foreign disposition gain and U.S. disposition loss. If, on the other hand, a disposition of an R.F.A. is not fully taxable for both U.S. and foreign income tax purposes and the R.F.A. has a negative basis difference, the temporary regulations provide that the Disposition Amount is based solely on the amount, if any, of foreign disposition loss and U.S. disposition gain.

Status of R.F.A. Owner

Like the applicable cost recovery method, the general disposition rules vary depending on the status of the R.F.A. Owner.

When the R.F.A. Owner (U.S.) is a Code §901(m) Payor, the entire Disposition Amount is attributed to the Payor and assigned to the U.S. taxable year in which the disposition occurs.[21]

For U.S. income tax purposes, when the R.F.A. Owner (U.S.) is a fiscally transparent entity in which a Code §901(m) Payor directly or indirectly owns an interest, all or a portion of the Disposition Amount is allocated to the Payor and assigned to its U.S. taxable year.[22] Separate rules apply for identifying the extent to which a foreign disposition gain or loss is taken into account in computing the foreign income tax amount that is paid or accrued by a Code §901(m) Payor in the context of an R.F.A. Owner (U.S.) that is a fiscally transparent.

"Like the applicable cost recovery method, the general disposition rules vary depending on the status of the R.F.A. Owner."

The first rule[23] applies when the foreign income tax amount is not allocated. This occurs when the foreign payor is the Code §901(m) Payor. A portion of the Disposition Amount attributable to foreign disposition gain or loss is allocated to the Code §901(m) Payor proportionally to the amount of the foreign disposition gain or loss that is included in the foreign Payor's distributive share of the foreign income of the R.F.A. Owner (Foreign) for foreign income tax purposes.

The second rule[24] applies when the foreign income tax amount is allocated under Reg. §1.704-1(b)(4)(viii) because, for U.S. tax purposes, the foreign payor is a partnership in which the Code §901(m) Payor is a partner. Here, a portion of the Disposition Amount attributable to foreign disposition gain or loss is allocated to the Code §901(m) Payor proportionally to the amount of the foreign disposition gain or loss that is included in the allocable foreign income of the Code §901(m) Payor.

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[20] Prop. Reg. §1.901(m)-5T(c)(2)(i).

[21] Prop. Reg. §1.901(m)-5(c)(1).

[22] Prop. Reg. §1.901(m)-5(d).

[23] Prop. Reg. §1.901(m)-5(d)(3)(ii).

[24] Prop. Reg. §1.901(m)-5(d)(3)(iii).

Allocation of Disposition Amount

Where a Disposition Amount is attributable to U.S. disposition gain or loss, the Disposition Amount is allocated to the Code §901(m) Payor based on the portion of the U.S. disposition gain or loss determined at the level of the R.F.A. Owner (U.S.) that is includible in the Code §901(m) Payor's distributive share of the income of the R.F.A. Owner (U.S.).[25]

When an R.F.A. has a positive basis difference, a Disposition Amount arises from a disposition of the R.F.A. only if the disposition results in a foreign disposition gain or a U.S. disposition loss. Here, it is necessary to determine the extent to which the Disposition Amount is attributable to foreign disposition gain or U.S. disposition loss. If the disposition results in either a foreign disposition gain or a U.S. disposition loss, but not both, the entire Disposition Amount is attributable to one or the other in its entirely.[26] If the disposition results in both a foreign disposition gain and a U.S. disposition loss, the Disposition Amount is attributable first to the foreign disposition gain and then any excess Disposition Amount is attributable to the U.S. disposition loss. In the case of a disposition that is fully taxable for both U.S. and foreign income tax purposes, the Disposition Amount may exceed the sum of the foreign disposition gain and the absolute value of the U.S. disposition loss if, immediately before the C.A.A., the foreign basis in the R.F.A. was greater than the U.S basis, and a foreign basis election was not made.

When an R.F.A. has a negative basis difference, a Disposition Amount arises from a disposition of the R.F.A. only if the disposition results in a foreign disposition loss or a U.S. disposition gain. In allocating the Disposition Amount to a Code §901(m) Payor, the extent to which the Disposition Amount is attributable to foreign disposition loss or U.S. disposition gain must be determined.

Special rules allocate a Disposition Amount attributable to foreign disposition gain or foreign disposition loss to a Code §901(m) Payor and assign it to its U.S. taxable year under any of the following conditions:

- There is a step-up of basis for the Payor under Code §743(b). The Disposition Amount that arises from an R.F.A. with respect to that C.A.A. must be allocated to the acquiring Code §901(m) Payor.[27]
- There is a mid-year transaction. The allocation of the Disposition Amount under the principles of Treas. Reg. §1.1502-76(b) will be made to the persons involved in the mid-year transaction.[28]
- The R.F.A. Owner (U.S.) is either a reverse hybrid or a fiscally transparent entity for U.S. and foreign income tax purposes that is directly or indirectly owned by a reverse hybrid entity. The principles are similar to those for when an R.F.A. Owner (U.S.) is a fiscally transparent entity for U.S. income tax purposes.[29] The Disposition Amount should be allocated to the Code §901(m) Payor proportionally to the amount of the foreign income of the R.F.A. Owner

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25 Prop. Reg. §1.901(m)-5(d)(4).

26 Prop. Reg. §1.901(m)-5(d)(5)(i).

27 Prop. Reg. §1.901(m)-5(e).

28 Prop. Reg. §1.901(m)-5(f).

29 Prop. Reg. §1.901(m)-5(g).

(Foreign) that is taken into account in computing the foreign payor's foreign income tax amount that is paid or accrued by the Code §901(m) Payor.

SUCCESSOR, *DE MINIMIS*, & MISCELLANEOUS RULES

Successor rules[30] are provided for the application of Code §901(m) to subsequent transfers of R.F.A.'s that have an Unallocated Basis Difference. This occurs when differences in basis have not been fully taken into account at the time of a transfer. For U.S. income tax purposes, Code §901(m) continues to apply to an R.F.A. after it has been transferred if the R.F.A. continues to have an Unallocated Basis Difference following the transfer.

De minimis rules are provided under which certain basis differences are not taken into account under Code §901(m).[31] A basis difference with respect to an R.F.A. is not taken into account for the purposes of Code §901(m) in two circumstances:

- The sum of the basis differences for all R.F.A.'s. with respect to the C.A.A. is less than $10 million, or if greater, 10% of the total U.S. bases of all R.F.A.'s immediately after the C.A.A.
- The R.F.A. is part of a class of R.F.A.'s for which the sum of the basis differences of all R.F.A.'s in the class is less than $2 million, or if greater, 10% of the total U.S. bases of all R.F.A.'s in the class. For this purpose, the classes of R.F.A.'s are the seven asset classes defined in Code §1.338-6(b).

Transactions between related parties are subject to reduced ceilings when applying the *de minimis* exception. For C.A.A.'s involving related parties, the exceptions will apply when the sum of the basis differences for all R.F.A.'s with respect to the C.A.A. is less than $5 million, or if greater, 5% of the total U.S. bases of all R.F.A.'s immediately after the C.A.A. In addition, when applying the ceiling for R.F.A.'s in the seven asset classes, a fixed ceiling of $1 million is applied for related parties. An anti-abuse provision also denies the application of the *de minimis* exemptions to C.A.A.'s between related parties that are entered into or structured with a principal purpose of avoiding the application of Code §901(m).

When effective, both the temporary regulations and the proposed regulations will generally relate back to the effective date of Notices 2014-44 and 2014-45. In some circumstances, the temporary and proposed regulations will apply to transactions occurring after January 1, 2011.

CONCLUSION

Code §901(m) and the temporary and proposed regulations issued by the I.R.S. evidence a recent trend in tax legislation and regulations. They close a perceived loophole in tax law by adopting a standalone set of rules that are relatively complex and have little relation to general concepts of U.S. tax law. Those practitioners who delve into the area without an in-depth understanding of the transactions that have been targeted by Congress due so at their own peril.

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[30] Prop. Reg. §1.901(m)-6.

[31] Prop. Reg. §1.901(m)-7.

INDIA – GUIDLINES ISSUED FOR DETERMINING PLACE OF EFFECTIVE MANAGEMENT

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Tags
Active Trade or Business
Foreign Corporation
India
P.O.E.M.
Tax Residency

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BACKGROUND

Under the Income Tax Act, 1961 ("the Act"), the tax residence of a corporation formed outside of India was determined based on whether the control or management of its affairs was wholly situated in India. On the other hand, most of India's tax treaties determined the tax residence of a foreign corporation using the place of effective management ("P.O.E.M.") principle.

The P.O.E.M. principle for determining the tax residence of a foreign corporation was introduced into the domestic law by amending §6(3) of the Act, and is effective from F.Y. 2016-17. In December 2015, the Central Board of Direct Taxes ("C.B.D.T.") released draft guidelines laying down principles to apply when determining the P.O.E.M. of a foreign corporation.[1] Now, the C.B.D.T. has issued final guidelines in the form of Circular No. 6/2017 (the "Circular"), dated January 24, 2017.

PRESS RELEASE

According to the press release issued with the Circular, the intention of the final guidelines is not to target Indian multinational groups engaged in business activities outside India. Rather, the target is shell corporations and corporations used for retaining income outside India where the real control and management of affairs is in India.

In addition, the guidelines are not intended to cover foreign corporations or to tax their global income merely because a permanent establishment ("P.E.") or a business connection exists in India. The P.O.E.M. provisions do not apply to foreign corporations with a turnover or gross receipts of less than INR 500 million (U.S. $7,424,132 converted at an exchange rate of U.S. $1 = INR 67.3479) in a financial year, although this was not stated in the Circular or in the Act.

EXISTENCE OF AN ACTIVE BUSINESS OUTSIDE INDIA

Like the draft guidelines, the final guidelines provide that for testing the applicability of P.O.E.M. provisions the first step is to determine whether the foreign corporation is engaged in "active business outside India."

A foreign corporation is engaged in active business outside India if it meets the following criteria:

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1 Regarding these draft guidelines, see "CBDT Issues Draft Guiding Principles for Determination of Place of Effective Management," Tax Edge 12.3 (2015).

- Its "passive income"[2] is not more than 50% of its total income.

- Less than 50% of its total assets and employees are situated and resident in India.

- Its payroll expenditure related to employees in India is less than 50% of its total payroll expenditure.

The final guidelines establish the method for computing the percentages used in each of the three factors listed above. Data for each factor listed above – (i) income, (ii) assets and employee headcount, and (iii) payroll expenses – is gathered for the fiscal year in issue and the preceding two fiscal years. The data is gathered first by looking at India alone and then on a global basis (*viz.*, India and the rest of the world). For each factor, the average of the Indian data is divided by the average of the global data and the relevant percentage is computed for each factor. If the Indian fiscal year differs from the tax year used by the foreign corporation, the data for the foreign corporation's tax year ending within the relevant Indian fiscal year is used.

The final guidelines further provide that interest income is not considered passive income for a foreign corporation that is engaged in the business of banking or is a public financial institution and whose activities are regulated under the applicable laws of the country of incorporation.

FUNCTIONS OF THE BOARD OF THE FOREIGN CORPORATION

The final guidelines provide that the P.O.E.M. of a foreign corporation that is engaged in an active business outside India will be considered to be outside India if the majority of its board meetings are also held outside India, provided that no person resident in India actually exercises the powers of management over the foreign corporation.

If the board of the foreign corporation merely follows the Indian group's policies in functional areas such as accounting, payroll, and human resources, the board will be regarded as not exercising its powers of management over the foreign corporation. This rule is subject to the following clarifications:

- Where board resolutions are passed through written consent of the board members instead of board meetings, the mere location of the proposer of a resolution is not determinative of the place of management. Other aspects, such as the frequency of use of this mode of decision making, the type of decisions being made, and the other parties involved, will be considered in order to determine the actual person who has the authority to make a decision.

- Shareholder activities in terms of making decisions on matters that fall within their domain as shareholders under corporation laws (*viz.*, approving mergers or acquisitions) are not relevant to the determination of the P.O.E.M. of the foreign corporation. However, where the shareholders, and not the board, are the persons who are exercising the real authority over the affairs

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2 Passive income will include, *inter alia*, interest income and income from the purchase and sale of goods from associated enterprises.

of the foreign corporation, then this will be relevant for the determination of the P.O.E.M. of the foreign corporation.

PROCEDURAL ASPECTS

While the draft guidelines provided that a tax officer must obtain prior approval of the Commissioner before deeming a foreign corporation to be a resident of India under the P.O.E.M. provisions, the final guidelines now provide a two-tier procedure:

- The tax officer must obtain prior approval of the Commissioner before initiating any inquiry into the tax residence of a foreign corporation under the P.O.E.M. provisions.
- The tax officer must further obtain prior approval of a panel of three Commissioners before deeming a foreign corporation to be a resident of India under the P.O.E.M. provisions, and as a part of the process, the panel must provide an opportunity to the foreign corporation to make submissions in the matter before issuing its directions to the tax officer.

OTHER ASPECTS

It has also been clarified that the presence of a P.E. in India on behalf of a foreign corporation does not constitute conclusive evidence that its P.O.E.M. is in India.

The final guidelines also provide certain illustrations explaining the manner of application of the guidelines, for example:

- Even where the foreign corporation meets the "active business outside India test" and the majority of its board meetings are conducted outside India, it can be regarded as a tax resident of India under the P.O.E.M. provisions if it is established that the foreign corporation seeks permission from its Indian parent with respect to virtually all business transactions.
- In a two-tier holding structure where the top tier entity is regarded as a tax resident of India under the P.O.E.M. provisions, the tax residency of the downstream entities must be separately evaluated under the P.O.E.M. provisions.

COMMENTS

The P.O.E.M. provisions could have been withdrawn and replaced by a controlled foreign corporation ("C.F.C.") provision that eliminates deferral immediately in certain circumstances, but the Indian government has refrained from adopting that approach. Instead, it adopted final P.O.E.M. guidelines with certain safeguards, clarifications, and illustrations. Notably, the safeguards now provided should give taxpayers comfort against the indiscriminate use of P.O.E.M. provisions.

Indian multinational groups with captive subsidiaries that undertake purchases and sales with group corporations may need to revisit their structures and decision-making processes, as they may not pass the active business outside India test under the P.O.E.M. guidelines.

Given that the P.O.E.M. provisions have already come into effect as of the beginning of the current F.Y. 2016-17, the final guidelines may lead to hardship because of their retroactive effect. The Indian government has been urged to consider deferring the effective date of the P.O.E.M. provisions to F.Y. 2017-18. Additionally, various other aspects related to the computation of income of foreign corporations having a P.O.E.M. in India (*e.g.*, tax rate applicable, tax credit mechanism, etc.) are yet to be clarified.

"Indian multinational groups with captive subsidiaries that undertake purchases and sales with group corporations may need to revisit their structures and decision-making processes."

DEBT V. EQUITY: JUDICIAL FACTORS STILL APPLICABLE POST-§385 REGULATIONS

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Tags
Code §385
Debt-Equity Classification
Recharacterization
Worthless Debt Deduction

In a recent Tax Court case, *Sensenig v. Commr.*, the court held that a shareholder's advance to several corporations should be considered equity investment and not debt. The reasoning behind the ruling was not based on the new regulations under Code §385 but on longstanding judicial factors determining the classification of an instrument as debt versus equity.[1]

NEW §385 REGULATIONS

New regulations under Code §385 were released in final form in October of last year.[2] Under these rules, specific regulations relating to documentation apply to instruments issued after January 1, 2018, while recasting regulations apply to taxable years ending on or after January 19, 2017 with respect to debt instruments issued after April 4, 2016.[3]

Nevertheless, not all instruments issued after such dates are affected by the new regulations. The Code §385 regulations exempt the first $50 million of debt instruments (measured by reference to an adjusted issue price) from recharacterization under the factors provided therein.[4] Other exceptions apply with respect to, *inter alia*, (i) debt issued by regulated companies, (ii) certain acquisitions of subsidiary stock where the transferor holds more than 50% of the vote and value of the stock for a 36-month period following the issuance of the shares, and (iii) "qualified short term debt obligations," which include, *inter alia*, debt instruments used to meet short term funding needs in the ordinary course of the issuer's business as well as ordinary course loans that are expected to be repaid within 120 days.[5]

Consequently, the new regulations largely impact large corporations and sizeable investments. Transactions of owner-managed companies will remain subject to the scrutiny of the judicial factors developed by years of case law. Although the recasting regulations have already taken effect, only time will tell if the new Code §385 regulations will ultimately be effective with regard to multinational corporations' transactions. Congress may seek to overturn the Code §385 regulations prior to the

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1 *John M. Sensenig, et ux. v. Commr.*, TC Memo 2017-1.

2 For a detailed discussion of the regulations, see Philip R. Hirschfeld, "Related-Party Debt: Proposed Code §385 Regulations Raise Major New Hurdles," *Insights* 5 (2016).

3 Treas. Reg. §1.385-3(j)(1).

4 Treas. Reg. §1.385-3(c)(4).

5 Treas. Reg. §§1.385-3(g)(3)(iv), 1.385-3(c)(3), 1.385-3(c)(2)(ii), 1.385-3T(b)(3)(vii), 1.385-3(g)(10)-(11). For a further discussion of these exceptions, see Hirschfeld, "Related-Party Debt: Proposed Code §385 Regulations Raise Major New Hurdles."

final January 2018 effective date, having voiced its disapproval for the new rules.[6]

JUDICIAL FACTORS

Several courts have developed checklists of factors to be considered when determining whether an advance should be treated as equity or debt.

Mixon

The leading case is *Estate of Mixon v. U.S.*, in which the Fifth Circuit listed the following factors as important in determining whether an advance is considered debt or equity:

- Names Given to the Certificates Evidencing the Indebtedness – If no documentation exists, the informality may suggest that intent to repay was not present at the time the loan came into existence.

- Presence or Absence of a Fixed Maturity Date – The absence of a fixed maturity date may suggest that intent to repay was not present at the time the loan came into existence.

- Source of Payments – In general, a purported debt can be repaid from three possible sources: (i) the liquidation of the corporation's assets, (ii) profits and cash flow from the corporation's business, and (iii) refinancing the debt. If the only reasonably assured source of funds for repayment of the debt is the liquidation of the debtor's assets, then the investment resembles an equity investment. Conversely, a purported debt will be recognized as debt if the projected cash flow is adequate to repay the obligation.

- Increased Participation in Management – If as a result of granting the loan the lender has an increased right to participate in management, this may suggest that the instrument is an equity investment.

- Right to Enforce Payment of Principal and Interest – Although junior to a secured creditor, a general creditor typically has the right to enforce repayment on demand. The absence of this right may be an indicium of equity.

- Intent of the Parties – In seeking the intent, focus is placed on how the parties treated the instrument. While not conclusive, relevant considerations, in addition to the preceding factors, include the accounting treatment of the loan on the company's books.

- "Thin" or Inadequate Capitalization – The adequacy of a borrower's capital structure at the onset of the purported debtor-creditor relationship may indicate the creditor's intent to be repaid in accordance with the terms of the instrument. Equity capitalization provides a cushion to protect the creditor from

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6 H.J. Res. 54. 115th Congress, First Session, "Disapproving the rule submitted by the Department of the Treasury and the Internal Revenue Service relating to documentation requirements for certain related-party interests in a corporation to be treated as indebtedness," introduced in House of Representatives, January 31, 2017. See also Committee on Ways and Means, U.S. House of Representatives, "Letter to the Honorable Jacob Lew, United States Treasury Secretary," August 22, 2016.

the borrower's business losses and any decrease in the value of its assets. Thus, inadequate capitalization at the time the relationship was established may be an indication of whether a reasonable expectation of repayment existed.

- Identity of Interest Between Creditor and Stockholder – If debt is provided by stockholders in proportion to their respective stock ownership, it may indicate that the investment is an equity contribution.

- Interest Payments – The lack of provisions for the payment of interest indicates that the funds loaned were intended as a contribution to equity rather than an arm's length debt obligation. The failure to insist on interest payments ordinarily indicates that the lender is not expecting interest income but is interested in the future earnings of the corporation or the increased market value of its interest.

- Ability of the Corporation to Obtain Loans from Outside Lending Institutions – If a corporation is able to borrow funds from outside sources, the shareholder loan would appear to be a *bona fide* indebtedness.

- Extent to Which the Loan Was Used to Acquire Capital Assets – Courts have held that purported debt should be treated as equity if the funds advanced are used to acquire the essential assets of a business.

- Failure of the Debtor to Repay on the Due Date or Seek a Postponement – Repayment of the loan under its terms and conditions is an indication of a true debt instrument.[7]

"No single criterion or group of criteria will be held to be more determinative over the others, and each matter is determined on a case-by-case basis."

No single criterion or group of criteria will be held to be more determinative over the others, and each matter is determined on a case-by-case basis.[8]

Fin Hay

Another notable case is *Fin Hay Realty Co. v. U.S.*,[9] which was decided in the same circuit as the *Sensenig* case. Most of the factors included in *Fin Hay* were also mentioned in *Mixon*. However, several factors were added, including the following:

- Voting Power of the Holder of the Instrument – Unlike shareholders, creditors generally do not have voting power.

- Contingency on the Obligation to Repay – If the contingency is considered too remote to occur, the instrument might be considered equity.

- Provision for Redemption by the Corporation – If the corporation can redeem the share at its option, this may suggest debt.

- Provision for Redemption at the Option of the Holder – If the holder retains the right to redeem his share, this may be an indication of equity.

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7 Galia Antebi and Nina Krauthamer, "Tax 101 – Introductory Lessons: Financing a U.S. Subsidiary – Debt vs. Equity," *Insights* 3 (2014), referencing *Estate of Mixon v. U.S.*, 464 F.2d 394, 402 (5th Cir. Ala. 1972).

8 *John M. Sensenig, et ux. v. Commr.*, TC Memo 2017-1.

9 *Fin Hay Realty Co. v. U.S.*, 398 F.2d 694, 696 (3d Cir. 1968).

- Timing of the Advance with Reference to the Organization of the Corporation – If a corporation is immediately financed by debt with a remote possibility of repayment, this may be considered an equity investment rather than a debt.

THE SENSENIG CASE

In the recent case before the Tax Court, the petitioner, John M. Sensenig, was the sole shareholder of an S-corporation, CLCL. CLCL's purpose was to invest in high risk companies. The petitioner was also a part owner of several other companies, some of which received advances from CLCL. No loan documents were prepared for these advances, nor was a due diligence analysis prepared for the lender analyzing the ability of the companies to pay interest and repay the loans. The borrowers were very thinly capitalized and the lender never attempted to collect a repayment on the advances.

CLCL raised the capital used for the above-mentioned advances from unrelated investors who received demand notes payable by Sensenig individually or by CLCL. The Pennsylvania Securities and Exchange Commission determined these notes were securities that required registration and thus barred CLCL from offering or selling securities in Pennsylvania unless a valid registration statement was granted, which CLCL never obtained. As a result, CLCL had liquidity and cash flow problems.

CLCL's C.P.A. determined that a return on the advances was considered remote and thereby recommended that CLCL take a Code §166 worthless debt deduction. Upon an audit, the I.R.S. disallowed the worthless debt deduction and charged the petitioner with an accuracy-related penalty. The shareholder then appealed the I.R.S.'s finding. The I.R.S.'s reasoning for the disallowance was that these advances were not debt but equity.

Debt-Equity Recharacterization

Sensenig was determined in the Third Circuit, and thus, it quoted judicial factors from the *Fin Hay* case, which was decided in that circuit. In *Sensenig*, the court focused on three factors in determining whether the advance was considered debt or equity:

- The intent of the parties
- The form of the instrument
- The objective economic reality of the transaction as it relates to the risks taken by investors

The court held that the advance was equity and not debt for several reasons. The court focused on the documentation requirement, and held that although shareholder and director resolutions authorized the loan, there was no evidence that a loan was actually made or that the borrower agreed to repay the funds as per the resolution. Further, the borrower did not treat the investment as a line of credit on its books. Therefore, the court held that the parties did not demonstrate the requisite intent to treat the advance as a loan.

Additionally, the investment lacked formal documentation indicating that the investment was to be repaid. The court further noted that "the absence of an unconditional right to demand payment is practically conclusive that an advance is an equity investment rather than a loan for which an advancing taxpayer might be entitled to claim a deduction for a bad debt loss." Furthermore, the court remarked that the shareholder was not unsophisticated in the matter and had issued formal demand letters to other investors, demonstrating that he previously recognized the importance of formal demand documents.

Finally, the court analyzed whether an arm's length third party would have made the same "loans" under similar circumstances. The court discovered that there were no repayment projections or business plans regarding the advances. The court also found that the lender was deducting the advances as worthless debt that could never be repaid but then continued to make future investments to the borrowers. The court thus held that an arm's length third party would not invest in a similar manner, as demonstrated by both the lack of third-party bank financing and the improbability that a lender would continue to lend funds to a person with little chance of being repaid.

For the foregoing reasons, the court concluded that the advance was to be characterized as equity and not debt.

Worthless Debt Deduction

Per Code §166(a)(1), a taxpayer can obtain a deduction for any worthless *bona fide* debt in a tax year. A *bona fide* debt arises from a "debtor-creditor relationship based on a valid and enforceable obligation to pay a fixed or determinable sum of money."[10] Because the court found that the investment was an equity investment and not debt, no worthless debt deduction can be allowed.

CONCLUSION

Among other exceptions, the new Code §385 regulations regarding the recharacterization of instruments as debt or equity only apply to instruments of over $50 million. As such, smaller investments will continue to be scrutinized using prior court decisions and I.R.S. rulings. Using these factors as a guide, an investment without proper loan documentation may be considered an equity investment rather than debt. While the documentation requirement is not controlling, lack of documentation commonly indicates a lack of interest payments, a lack of commitment to repay the loan, and a lack of penalties applicable to late or non-payment. One can satisfy the documentation requirement by having "a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest."[11]

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[10] Treas. Reg. §1.166-1(c).

[11] Code §385(b)(1).

I.R.S. RULES SUBPART F & P.F.I.C. INCOME INCLUSIONS ARE R.E.I.T. QUALIFYING INCOME

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Tags
95% Gross Income Test
C.F.C. Inclusion
P.F.I.C. Inclusion
R.E.I.T.

A real estate investment trust ("R.E.I.T.") is a tax-favorable investment entity used for investment in real estate and real estate mortgages. R.E.I.T.'s that invest in non-U.S. real estate often make such investments through foreign corporate entities that may be classified as controlled foreign corporations ("C.F.C.'s")[1] or passive foreign investment companies ("P.F.I.C.'s").[2] Qualification as a R.E.I.T. requires that the entity meet certain income and asset tests designed to ensure that a R.E.I.T.'s gross income is largely composed of passive income related to real estate or real estate mortgage investments. In a recent private letter ruling ("P.L.R."),[3] the I.R.S. ruled that certain income from a R.E.I.T.'s ownership of C.F.C.'s and P.F.I.C.'s was income that qualified as passive investment income, which is required under the 95% gross income test of Internal Revenue Code ("Code") §856(c)(2).

R.E.I.T. TAXATION

A R.E.I.T. is a corporate entity, with some of the features of a "pass-thru" entity, used to pool capital to invest in a professionally managed portfolio of real estate assets. Unlike a typical corporation, a R.E.I.T. generally is not subject to entity-level taxation if it distributes its earnings and profits as dividends to its shareholders, since a R.E.I.T. can claim a deduction for dividends paid to its shareholders.[4] As a result, a R.E.I.T. generally may avoid the double taxation that applies to corporations.

R.E.I.T. INCOME AND ASSET TESTS

In addition to several requirements regarding a R.E.I.T.'s form, management, and ownership,[5] a R.E.I.T. must meet a two-part income test and an asset test,[6] as follows:

1. A C.F.C. is a foreign corporation in which more than 50% of the total combined voting power of all classes of stock entitled to vote, or the total value of the stock, is owned by U.S. shareholders on any day during the corporation's tax year. A U.S. shareholder is a U.S. person (*e.g.*, a domestic corporation, including a domestic R.E.I.T.) who owns 10% or more of the total voting power of the foreign corporation (Code §§951, 957).
2. A foreign corporation is a P.F.I.C. if either (i) 75% or more of its gross income for the tax year is passive income, or (ii) the average percentage of its assets during the tax year which produce or are held for the production of passive income is at least 50%. "Passive income" includes interest, dividends, royalties, and rents (Code §1297).
3. P.L.R. 201649013, 12/02/2016.
4. Code §857(b)(2)(B).
5. Code §856(a).
6. Code §856(c).

- 75% of its gross income must be derived from specified passive real property-related income sources, such as rents from real property and gain from the sale of real property.
- 95% of its gross income must be from such sources, plus certain additional passive investment income items (discussed below).[7]
- 75% of its assets must be comprised of real property assets, and investments in cash, cash items, and government securities.[8]

Code §856(c)(2) specifies passive investment income that meets the 95% gross income test, as follows:

- Dividends
- Interest
- Rents from real property
- Gain from the sale or other disposition of stock, securities, and real property (including interests in real property and interests in mortgages on real property)
- Abatements and refunds of taxes on real property
- Income and gain derived from foreclosure property
- Amounts (but not amounts the determination of which depends on the income or profits of any person) received or accrued as consideration for entering into agreements to make mortgage-secured loans on real property or interests in real property, or to purchase or lease real property
- Gain from the sale or other disposition of a real estate asset which is not a prohibited transaction[9]
- Qualified temporary investment income

For the purposes of the 95% gross income test, "rents from real property" are defined in Code §856(d) and generally include rents from interests in real property, charges for services usually provided in connection with the rental of real property, and, under certain circumstances, rent attributable to personal property leased in connection with a lease of real property.[10]

The I.R.S. is authorized to determine whether any item of income or gain not specified in the Code may otherwise constitute qualifying income for purposes of the 95% and 75% gross income tests.[11]

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7 Code §856(c)(2).

8 Code §856(c)(4).

9 A prohibited transaction means the sale or disposition of property held primarily for sale to customers in the ordinary course of a trade or business (Code §857(b)(6)).

10 Code §856(d)(1).

11 Code §856(c)(5)(J).

SUBPART F AND P.F.I.C. INCOME INCLUSIONS ARE QUALIFYING INCOME FOR THE PURPOSE OF THE 95% GROSS INCOME TEST

In the P.L.R, the I.R.S. stated that, for purpose of the 95% gross income test, income inclusions attributable to a R.E.I.T.'s ownership in foreign subsidiaries that are C.F.C.'s or P.F.I.C.'s constituted qualifying income.

The taxpayer, a domestic R.E.I.T. organized for the purpose of making investments in commercial timberland businesses, operated in foreign countries through one or more foreign corporate subsidiaries (each, a "Foreign Sub"). Each Foreign Sub was treated as a taxable R.E.I.T. subsidiary ("T.R.S.") for U.S. Federal income tax purposes and was either a C.F.C. or a P.F.I.C.

For each Foreign Sub that was a C.F.C., the taxpayer was required to include in gross income its *pro rata* share of the C.F.C.'s "Subpart F income,"[12] which consisted of interest; dividends; gains from the sale or other disposition of stock, securities, or real property that was not property held as inventory; and items that also would constitute rents from real property, under Code §856(d), if received by a R.E.I.T. This income was the taxpayer's "Subpart F inclusions."

The taxpayer made an election to treat some of the Foreign Subs that were P.F.I.C.'s as qualified electing funds ("Q.E.F.'s"). As a shareholder in P.F.I.C.'s with Q.E.F. elections, the taxpayer was required to include in gross income its *pro rata* share of the ordinary earnings and net capital gain of each Q.E.F.[13] The taxpayer's income inclusions with respect to the Q.E.F.'s were attributable to: (i) interest; (ii) dividends; (iii) gains from the sale or other disposition of stock, securities, or real property that is not property held as inventory; and (iv) items that also would constitute rents from real property, under Code §856(d), if received by a R.E.I.T. This income was the taxpayer's "Q.E.F. inclusions."

As a shareholder in P.F.I.C.'s for which the taxpayer had not made a Q.E.F. election (or a mark-to-market election), the taxpayer was required to include certain amounts in gross income. The taxpayer represented that the gross income attributable to these "non-Q.E.F." P.F.I.C.'s, mostly consisted of the same type of income that was attributable to Q.E.F.'s. This income was the taxpayer's "non-Q.E.F. inclusions."

Subpart F inclusions[14] and P.F.I.C. income inclusions, attributable to Q.E.F.'s[15] or non-Q.E.F.s,[16] are included in a taxpayer's gross income for the tax year, whether or not the income is actually distributed to the taxpayer. These income inclusion rules serve the purpose of preventing a taxpayer from deferring U.S. Federal income tax on foreign passive investment income.

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12 Subpart F income includes foreign base company income, which includes foreign personal holding company income ("F.P.H.C.I."). F.P.H.C.I. generally includes passive investment income such as dividends, interest, rents, royalties, and net gains from the sale of certain specified property (Code §§952, 954).

13 Code §1293.

14 Code §951.

15 Code §1293.

16 Code §1291.

In addition to the issue of deemed income from the C.F.C.'s and P.F.I.C.'s, the taxpayer raised a concern regarding the foreign currency gains that likely would arise upon the actual distribution of income from the Foreign Subs. Such distributions would be previously taxed earnings and profits ("P.T.I."). The C.F.C.[17] and P.F.I.C.[18] rules provide that when a taxpayer includes in income Subpart F inclusions or Q.E.F. inclusions, the subsequent distribution to the shareholder of the P.T.I. attributable to the inclusion is not treated as a dividend and, therefore, is not subject to taxation for a second time. However, foreign currency gain (or loss) with respect to P.T.I. must be recognized as ordinary income (or loss) from the same source as the associated income inclusion.[19]

Treating the Subpart F and P.F.I.C. Inclusions as Qualifying Income Is Consistent with the Purpose of the 95% Gross Income Test

As noted above, in order for an entity to qualify as a R.E.I.T., at least 95% its gross income must be derived from specified sources set forth in Code §856(c)(2), including dividends, interest, rents from real property, and gain from the sale or other disposition of stock, securities, and real property (other than inventory-type property). The treatment of C.F.C. and P.F.I.C. income inclusions is not addressed in the Code or the Treasury Regulations. However, to the extent necessary to carry out the purpose of the Code's R.E.I.T. provisions, the I.R.S. is authorized to determine whether an item of income or gain that does not constitute gross income under Code §856(c)(2) may be considered gross income for the purposes of the 95% gross income test.[20]

The I.R.S. looked to the legislative history underlying the tax treatment of R.E.I.T.'s and determined that it indicates that a central concern behind the gross income restrictions is that a R.E.I.T.'s gross income should largely be composed of passive income.[21]

The I.R.S. determined that the taxpayer's Subpart F inclusions would be qualifying income since they consisted of (i) interest; (ii) dividends; (iii) gains from the sale or other disposition of stock, securities, or real property that is not property described not held as inventory property; and (iv) items that also would constitute rents from real property, under Code §856(d), if received by a R.E.I.T. The I.R.S. concluded that treating the Subpart F inclusions attributable to such income as qualifying income under Code §856(c)(2) would not interfere with or impede the policy objectives of the 95% gross income test.

The I.R.S. determined that the taxpayer's Q.E.F. inclusions and non-Q.E.F. inclusions would be qualifying income since they consisted of (i) interest; (ii) dividends; (iii) gains from the sale or other disposition of stock, securities, or real property that

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17 Code §959(d).

18 Code §1293(c).

19 Code §986(c)(1).

20 Code §856(c)(5)(J).

21 *E.g.*, H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960) at 6, 1960-2 C.B. 819, at 822-23 states, "[o]ne of the principal purposes of your committee in imposing restrictions on types of income of a qualifying [REIT] is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business."

is not property held for inventory, and (iv) items that also would constitute rents from real property, under Code §856(d), if received by a R.E.I.T. The I.R.S. concluded that treatment of the Q.E.F. inclusions and non-Q.E.F. inclusions as qualifying income under Code §856(c)(2) would not interfere with or impede the policy objectives of the 95% gross income test.

"A R.E.I.T. will not jeopardize its R.E.I.T. status under the 95% gross income test by virtue of receiving deemed income from a C.F.C. or P.F.I.C."

Foreign Currency Gains Will Not Be Taken into Account for the Purposes of the 95% Gross Income Test

Code §986(c)(1) states that foreign currency gain (or loss) with respect to distributions of P.T.I. attributable to movements in exchange rates between the times of the deemed and actual distributions generally must be recognized and treated as ordinary income or loss from the same source as the associated income inclusion. Ordinary income is not income that would meet the 95% gross income test.

Code §856(n)(1)(A) states that "passive foreign exchange gain," as defined in Code §856(n)(3), does not constitute gross income for purposes of Code §856(c)(2).

The I.R.S. determined that the Code §986(c) foreign currency gain attributable to the Subpart F inclusions and the Q.E.F. inclusions is substantially similar to passive foreign exchange gain, as defined in Code §856(n)(3). Therefore, the foreign currency gains would be excluded from gross income for purposes of the 95% income test.

CONCLUSION

Subpart F, Q.E.F., and non-Q.E.F. inclusions are qualifying income for the purpose of the 95% gross income test. Accordingly, a R.E.I.T. will not jeopardize its R.E.I.T. status under the 95% gross income test by virtue of receiving deemed income from a C.F.C. or P.F.I.C. Further, foreign currency gains attributable to a distribution of P.T.I. from a C.F.C. or P.F.I.C. will not be counted for the purposes of the 95% gross income test.

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Tags
European Commission
France
Spain
State Aid
Tax Compliance

EUROPEAN COMMISSION FINDS NEW TARGET: FRENCH MULTINATIONAL ENGIE (FORMERLY G.D.F. SUEZ)

The latest development in the E.U.'s ongoing fight against perceived illegal State Aid is the opening of an in-depth investigation into Luxembourg's tax treatment of the G.D.F. Suez group (now Engie). On January 5, 2017, the European Commission issued preliminary findings alleging illegal State Aid by the Luxembourg taxing authorities.

Two units of Engie, which received tax rulings from Luxembourg, helped the company to reduce its taxable base by up to €1.15 billion between 2009 and 2015 by causing group members to borrow money from one another using "ZORAs," certain interest-free convertible instruments. The European Commission considers the two transactions to be treated as both equity and debt, giving rise to "double non-taxation." The borrowers can significantly reduce their taxable profits in Luxembourg by deducting the provisioned interest payments, while, at the same time, the lenders are not taxed on the profits generated by the transaction because Luxembourg tax rules exempt income from equity investments. According to the European Commission, this confers a selective advantage on the Engie group companies, allowing them to reduce their taxable income in a manner not available to other companies using instruments similar to ZORAs.

For its part, Luxembourg has rejected these allegations and argued that the tax treatment granted under the tax rulings conforms with the country's domestic tax rules. In the event the European Commission's allegations are sustained, further litigation before the European Court of Justice ("E.C.J.") may ensue. If the tax arrangements are found to breach the E.U. rules on illegal State Aid, this case will have a tremendous impact, as Engie is the first European-based company to be investigated after Apple, Starbucks, and Fiat, and a third of the share capital of Engie is held by the French Republic.

FOREIGN TRUST DISCLOSURE PENALTIES UNDER REVIEW IN FRANCE

Under French tax law, trust disclosure obligations are imposed (i) if the trustee, the settlor, or at least one of the beneficiaries has a tax residence in France or (ii) when any of the assets or rights placed in the trust are located in France. Trustees are required to disclose the creation of the trust instrument, the names of the settlors and the beneficiaries, as well as the terms of the trust and any amendments made to it.[1] Violation of this rule triggers penalties equal to the greater of €20,000 or 12.5% of the assets, rights, and capitalized incomes.[2]

Objections have been raised against the difference in the applicable penalties for French tax residents holding bank accounts abroad and individuals holding an interest in a trust. Failure to declare unreported foreign bank accounts is lower and subject to a €1,500 penalty (or €10,000 if the bank account is held in a country with which France has not signed a tax treaty containing an administrative assistance clause allowing access to bank information). The French Constitutional Court has been requested by the Administrative Court (*Conseil d'Etat*) to answer whether the provisions of Article 1736, IV *bis* of the French Tax Code violate the French Constitution and specifically the principle of proportionality between penalties and criminal offences.

"Objections have been raised against the difference in the applicable penalties for French tax residents holding bank accounts abroad and individuals holding an interest in a trust."

It should be noted that last October the French Constitutional Court ruled that the French Public Register of Trusts breached privacy rights and was unconstitutional. The register provided the date of creation of the trust, the identity of the trustee, the settlor(s), and the beneficiaries. The court declared that although the register was aimed at avoiding tax evasion, public access to the register constituted a disproportionate violation of the right to privacy.[3]

SPANISH TAX SCHEME INCOMPATIBLE WITH THE INTERNAL MARKET

In its decision in *Commission v. World Duty Free Group*, the E.C.J. agreed with the European Commission on the criteria upon which a measure by a Member State may be viewed as selective and therefore constitute illegal State Aid.

The Spanish provisions in question introduced a more favorable tax treatment for financial goodwill derived from a foreign acquisition. Under these new rules, in the event a company taxable in Spain acquires an interest in the share capital of a foreign company equal to at least 5% and holds that participation for an uninterrupted period of at least one year, the resulting goodwill may be deducted (in the form of an amortization) from the corporate income tax for which the undertaking is liable. To be classified as a "foreign company," a company must be subject to a similar tax in its country of origin and its income must derive mainly from business activities carried out abroad.

In a prior decision (which had been appealed to the E.C.J), the European General Court ("E.G.C.") annulled the European Commission's decision that Spain's regime allowing companies to amortize goodwill for acquisitions of foreign subsidiaries constituted State Aid.[4] The advocate general explained that a contrary decision could "lead to every tax measure the benefit of which is subject to certain conditions being found to be selective, even though . . . [other undertakings] would be capable of satisfying the conditions."

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1 Article 1649 AB of the French Tax Code.

2 Article 1736, IV *bis* of the French Tax Code.

3 Article 2 of the Declaration of Human Rights.

4 *Autogrill Espana, SA v. Commission*, Case T-219/10.

The E.C.J. found that the measure was selective because the tax benefit granted constitutes a derogation from the normal tax regime and discriminates between taxpayers in a comparable factual and legal situation. Generally, selectivity is shown if one commercial undertaking is favored over another. This ruling expands dramatically the application of the selectivity requirement.

TAX COURT UPHOLDS I.R.S. LIEN NOTICE AND NOTICE OF PROPOSED LEVY IN ESTATE OF MYERS

On January 10, the U.S. Tax Court held that the I.R.S. did not abuse its discretion when it failed to pursue collection from non-probate assets and certain jointly owned probate property, but rather filed a lien notice and notice of proposed levy against the estate.[5]

Ruben A. Myers died on November 15, 2005, leaving family farmland, other real property, and some liquid assets. Non-probate assets were also included in the taxable estate. On February 15, 2007, the executor filed a Federal estate tax return and started making installment payments until beginning of 2014. When the petitioner became delinquent to those payments, the I.R.S. issued a Notice of Federal Tax Lien ("N.F.T.L.") and then a Notice of Intent to Levy ("N.I.L.").

After the petitioner appealed, the I.R.S. stopped all collection activity, and did not begin collection actions against the transferees of the non-probate assets. The special estate tax lien provided for in Code §6324 expired on November 15, 2015. The petitioner alleged that "the Commissioner abused his discretion by failing to file a lien against the non-probate assets" and proceeding to collect from probate assets (family farmland).

The Tax Court held that:

> The statute does not give us license to conduct a broad-ranging inquiry into the means by which respondent [the I.R.S.] has sought to collect estate tax from petitioner over the many years since decedent's death. Our focus is a narrow one: We ask only whether SO Harding [the I.R.S. agent] abused his discretion in sustaining the filing of the lien notice and the proposed levy action.

The Tax Court held that the I.R.S. did not abuse its discretion by failing to collect from non-probate assets before collecting from the estate. In a nod to the estate, the Tax Court noted, however, that it might still be possible for the I.R.S. to seek collection from third-party recipients under the rules applicable to transferees. What is important to note is while the I.R.S.'s ability to collect tax that is properly owing is broad, its actions are not necessarily designed to be taxpayer-friendly.

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5 *Estate of Myers v. Commr.*, T.C. Memo 2017-11.

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We provide a wide range of tax planning and legal services for foreign companies operating in the U.S., foreign financial institutions operating in the U.S. through branches, and U.S. companies and financial institutions operating abroad. The core practice of the firm includes tax planning for cross-border transactions. This involves corporate tax advice under Subchapter C of the Internal Revenue Code, advice on transfer pricing matters, and representation before the I.R.S.

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