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INSIGHTS

A NEW DEFINITION OF PERMANENT ESTABLISHMENT IN ITALIAN DOMESTIC INCOME TAX LAW

INDIA BUDGET 2018-19

CHANGES TO C.F.C. RULES – MORE C.F.C.'S, MORE U.S. SHAREHOLDERS, MORE ATTRIBUTION, MORE COMPLIANCE

INVESTING IN U.S. REAL ESTATE ON A (POSSIBLY) TAX-FREE BASIS

AND MORE

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EDITORS' NOTE

In this month's edition of Insights, our articles address the following:

- **A New Definition of Permanent Establishment in Italian Domestic Income Tax Law.** Italian domestic tax law has adopted the permanent establishment ("P.E.") concept when determining whether business profits of a nonresident are taxable in the absence of an applicable income tax treaty. Earlier this year, changes to the definition of the term broadened the scope of activity constituting a P.E. Effective January 1, 2018, (i) a digital P.E. is treated as a fixed place P.E., (ii) the scope of the specific activity exemption has been scaled back, (iii) an anti-fragmentation rule has been adopted applicable to groups of companies, and (iv) the scope of an agency P.E. has been broadened. Stefano Loconte and Linda Favi of Loconte & Partners, Milan, explain the new rules.

- **India Budget 2018-19.** The Indian government announced its plans for the 2018–2019 budget year. It is the last full budget before the 2019 Parliamentary elections and the first budget following the implementation of the landmark national G.S.T. regime. Tax is reduced to 25% for domestic companies generating income of approximately $40 million or less. The definition of the term "business connection," the equivalent of a P.E. under domestic law, is broadened to cover agents having and habitually concluding contracts and circumstances where a nonresident has a significant economic presence. A 10% tax is imposed on certain stock market gains. Incentives are given to international financial services companies in the form tax exemptions for certain gains. These and other provisions are explored by Jairaj Purandare of JPM Advisors Pvt Ltd, Mumbai, India.

- **Changes to C.F.C. Rules – More C.F.C.'s, More U.S. Shareholders, More Attribution, More Compliance.** T.C.J.A. changes to the Subpart F rules have the effect of deconstructing cross-border arrangements structured to prevent the creation of a C.F.C. A change to constructive ownership rules may cause all foreign members of a foreign-based group to be treated as C.F.C.'s for certain reporting purposes merely because the group includes a member in the U.S. A change to the definition of a U.S. Shareholder of a C.F.C. makes the value of shares owned as important as voting power in determining whether a U.S. person is a U.S. Shareholder and a foreign corporation is a C.F.C. The 30-day requirement for a C.F.C. to be owned by a U.S. Shareholder before Subpart F applies has been eliminated. In some instances, the changes are retroactive to the 2017 tax year. Neha Rastogi, Sheryl Shah, Beate Erwin, and Elizabeth V. Zanet explain and provide a case study that ties everything together.

- **Investing in U.S. Real Estate on a (Possibly) Tax-Free Basis.** A Real Estate Investment Trust, or R.E.I.T., is a popular type of investment vehicle. A R.E.I.T. is an entity that generally owns and typically operates a pool of income-producing real estate properties, including mortgages. Its investors generally look to a return on investment in two forms: (i) distributions from the R.E.I.T. and (ii) dispositions of the R.E.I.T. stock. If certain facts exist, U.S. tax law offers foreign investors a completely tax-free avenue to invest in a

R.E.I.T. Galia Antebi and Neha Rastogi explain the ins and outs of tax-free treatment for the foreign investor.

- **When "Defective" Is Desirable – Pre-Immigration Planning for Families with U.S. Persons.** The term "intentionally defective" sounds problematic, but in reality, is quite favorable when it comes to estate planning. Intentionally defective grantor trusts are an especially useful tool when combined with pre-immigration planning for a family where only one spouse is a U.S. citizen because these trusts are disregarded for income tax purposes but respected for estate tax purposes. If set up and funded by a non-citizen spouse before arrival in the U.S., gift and estate tax planning can be achieved in a low tax environment. In these trusts, the settlor continues to pay tax on the income even though not a beneficiary. As a result, the beneficiary does not pay income tax on trust distributions and the tax payment by the grantor is not considered to be gift to the beneficiary. Hence, no gift tax. Fanny Karaman and Nina Krauthamer explain all.

- **Can the Arm's Length Standard Beat the R.A.P.? Transfer Pricing After the T.C.J.A.** Experienced tax litigators know that Congress often protects the I.R.S. when an important case is lost. Yes, the taxpayer wins. But Congress codifies the I.R.S. position by an amendment to the law. The T.C.J.A. revised Code §482 legislatively, thereby reversing Tax Court decisions in the *Amazon* and *Veritas* cases that dismissed two arguments raised by the I.R.S. in transfer pricing litigation – mandatory use of aggregate basis of valuation (grouping of intangibles for valuation purposes) and the realistic alternative principle (challenging the business judgment for the transaction). Michael Peggs and Sheryl Shah explain this attack on the arm's length principle of taxation.

- **New York Resisting S.A.L.T. Cap Under Federal Tax Reform.** When the T.C.J.A. capped the deduction for state and local income and property taxes at $10,000 – more tax can be paid, but only $10,000 can be deducted – state governments did not take the provision lightly. One proposal that has gained traction in Albany and other state capitals involves creating charitable funds that would raise voluntary capital for specific governmental purposes. The goal is for taxpayers to claim the charitable contributions as a deduction for Federal tax purposes and, at the same time, benefitting from a substantial credit against their state income tax liabilities. Another, less contentious proposal would utilize employer-side payroll taxes to offer employees a credit against state and local taxes. Nina Krauthamer, Elizabeth V. Zanet, and Sheryl Shah assess the viability of these proposals and the likely impact of tax reform on New York State. Opinions are not consistent. Stay tuned.

- **I.R.S. Offers Additional Guidance on Code §965 Transition Tax.** On the way toward a dividends received deduction for certain dividends paid by foreign subsidiaries, Congress enacted a one-shot income inclusion of all post-1986 earnings from C.F.C.'s and foreign corporations having 10% U.S. Shareholders that are corporations. In March, the I.R.S. issued an F.A.Q. providing additional guidance on open issues for 2017 tax returns. Rusudan Shervashidze and Stanley C. Ruchelman explain the mechanics of the income inclusion and an election to defer payments for eight years, sometimes more.

- **Updates and Other Tidbits.** This month, Tomi Oguntunde, Sheryl Shah, and Nina Krauthamer look briefly at four recent developments in international tax: (i) the E.U. counteroffensive to U.S. tax reform involving stricter tax rules, (ii) the amendment of Form 1023-EZ, which is a streamlined application for non-profit entities applying for tax exempt status, (iii) Spain's crackdown on celebrities attempting to evade tax, and (iv) Luxembourg's continued push-back against the *Amazon* State Aid case.

We hope you enjoy this issue.

- The Editors

A NEW DEFINITION OF PERMANENT ESTABLISHMENT IN ITALIAN DOMESTIC INCOME TAX LAW

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Effective January 1, 2018, Italy's 2018 Budget Law[1] significantly amended the domestic definition of permanent establishment ("P.E.") and implemented certain O.E.C.D. guidelines set forth under B.E.P.S. Action 1 (Addressing the Tax Challenges of the Digital Economy) and Action 7 (Preventing the Artificial Avoidance of P.E. Status). The law revised the definitions of both the "Fixed Place P.E." and the "Agency P.E.," by amending the text of Article 162 of the Italian Income Tax Code ("I.I.T.C.").

As regards the Fixed Place P.E., the main changes are (i) the introduction of a new item in the list of cases that are presumed to constitute a Fixed Place P.E., (ii) the modification of the specific activity exemption, (iii) the repeal of Art. 162 (5) of the I.I.T.C. regarding electronic equipment, and (iv) the introduction of an anti-fragmentation rule.

The Agency P.E. rules were changed in compliance with B.E.P.S. Action 7 recommendations concerning *commissionaire* arrangements.[2]

THE OLD RULES

Prior to the 2018 Budget Law, the definition of P.E. for Italian income tax purposes – contained in Article 162 of Presidential Decree no. 917 of 22 December 1986 (I.I.T.C.) – was modelled on the current O.E.C.D. Model Tax Convention definition.

Fixed Place P.E.

For the purposes of Corporate Income Tax ("I.R.E.S.") and Regional Tax on Productive Activities ("I.R.A.P."), Italian domestic tax law defined a P.E. to be a fixed place of business through which the business of a nonresident enterprise is wholly or partly carried on in Italy (a Fixed Place P.E.).[3]

Certain fixed places of business were presumed to constitute a P.E. in Italy, unless the taxpayer could provide evidence to the contrary:

- A place of management
- A branch
- An office

1 Law No. 205 of 27 December 2017.

2 See, in detail, "O.E.C.D. Issues Proposed Changes to Permanent Establishment Provisions Under Model Tax Convention," *Insights* 9 (2017).

3 Art. 162 (1) of the I.I.T.C.

- A factory
- A workshop
- A mine, an oil or gas well, a quarry or other place for the extraction of natural resources[4]

On the other hand, a fixed place of business was not deemed to be a P.E. in Italy if it was used only to perform certain preparatory or auxiliary activities. These exempt activities included the following:

- The use of an installation solely for the purpose of storage, display, or delivery of goods belonging to the enterprise
- The maintenance of a stock of goods belonging to the enterprise solely for the purpose of storage, display, or delivery
- The maintenance of a stock of goods belonging to the enterprise solely for the purpose of processing by another enterprise
- The maintenance of a fixed place of business solely for the purpose of purchasing goods or collecting information for the enterprise
- The maintenance of a fixed place of business solely for the purpose of carrying on any other preparatory or auxiliary activity for the enterprise
- The maintenance of a fixed place of business solely for any combination of the activities indicated above, provided that the overall activity of the fixed place of business, resulting from this combination, is of a preparatory or auxiliary nature[5]

In addition to the exceptions listed above, the rules provided that the maintenance of electronic processors and auxiliary equipment used for the collection and transfer of data and information for the purpose of selling goods and services did not, by itself, constitute a P.E.[6] This provision was intended to clarify that the mere ownership and use of a server or similar equipment in Italy did not constitute a P.E.

Agency P.E.

In comparison to the lists of conditions that constitute or preclude the existence of a Fixed Place P.E. in Italy, the old rules provided that a person that habitually concludes contracts in Italy in the name of a nonresident enterprise was deemed to be a P.E. of the nonresident enterprise (an Agency P.E.).[7] One exception was provided when the person's activity was limited to the purchase of goods. Another exception was provided when the person concluding contracts in Italy was a broker, general commission agent, or any other agent of an independent status. Such persons did not constitute a P.E. when they would act in the ordinary course of a business that was carried on independently in Italy.[8]

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4 *Id.*, Art. 162 (2).

5 *Id.*, Art. 162 (4).

6 *Id.*, Art. 162 (5).

7 *Id.*, Art. 162 (6).

8 *Id.*, Art. 162 (7).

THE NEW RULES

The “Digital P.E.” as a Fixed Place P.E.

The 2018 Budget Law introduced a new concept of Fixed Place P.E. enacted in the context of tax measures for the digital economy. In time, the new definition may impact other businesses as well.

> *“A fixed place of business will not constitute a P.E. if the taxpayer can prove that any and all activities – and not only their combination as under the old rule – have a preparatory or auxiliary nature.”*

Under the amended text of Art. 162 (2) of the I.I.T.C., a foreign entity’s significant and continuous economic presence in Italy may constitute a fixed base that could give rise to an Italian P.E. even if it does not result in a substantial physical presence.

This new P.E. definition is based on the nexus rules proposed for the digital economy by B.E.P.S. Action 1 and, in particular, on the notion of “significant economic presence,” so that nonresident digital companies can trigger taxable presence in a country in ways that are not uncommon in the digital economy. These include (i) the earning of revenues from customers situated in the country, (ii) the presence of a local digital platform, (iii) the frequency of digital transactions, and (iv) the number of users.

At the same time that this new Digital P.E. concept was introduced into law, Italy introduced a Web Tax, designed to be an alternative to the income tax that applies when a foreign company does not have an Italian P.E. The Web Tax is a 3% tax on the amount realized (net of V.A.T.) for digital services supplied electronically. It will apply as of 2019 to services supplied by resident and nonresident taxpayers that carry out more than 3,000 digital transactions in a calendar year and will be levied on the recipient of the services such as Italian business taxpayers but not private individuals.

As consequence of the introduction of this new regime, Art. 162 (5) of the I.I.T.C. on servers as Fixed Place P.E.’s became redundant and was repealed.

The Specific Activity Exemption for Fixed Place P.E.’s

The list of exempting activities has been rephrased to provide that a fixed place of business will not constitute a P.E. if the taxpayer can prove that any and all activities – and not only their combination as under the old rule – have a preparatory or auxiliary nature with respect to business of the foreign entity. The amendment applies to any business activity. It may be particularly relevant for digital enterprises based abroad that maintain a stock of goods in Italy to provide prompt delivery to customers. As a consequence, the maintenance of a local warehouse and the storage of goods in the warehouse might be regarded as a core activity for digital enterprises focused on retail purchases. For these businesses, storage would not fall within the preparatory and auxiliary exemption.

The Anti-Fragmentation Rule in the Definition of Fixed Place P.E.

The 2018 Budget Law introduced the so-called anti-fragmentation rules – proposed in B.E.P.S. Action 7 – aimed at preventing foreign companies from splitting up a business into smaller units or using other related legal entities or P.E.’s to benefit from the preparatory or auxiliary exemption. In substance the new rules are designed to take into account not only the activities carried on by the same enterprise at different locations but also of the activities carried on by closely related enterprises at the same or different locations.

To this end, the new Art. 162 (5) of the I.I.T.C. now provides that the specific activity exemption shall not apply to a fixed place of business that is used or maintained by the foreign enterprise if certain conditions are met:

- The same enterprise or a closely related enterprise carries on business activities at the same location or another location in the Italian territory.
- The location(s) constitutes a P.E. for either enterprise under the provisions of Art. 162 of the I.I.T.C., or the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the enterprise(s) at the two locations, are not of a preparatory or auxiliary character.
- The business activities carried on by the two enterprises at the same place, or by the enterprise(s) at the two locations, constitute complementary functions that are part of a cohesive business operation.

Though this new provision will bring more clarity in applying P.E. identification rules, it is worth highlighting that Italian case law already applied an anti-fragmentation approach. The Italian Supreme Court Decision No. 20597 of 7 October 2011 ruled that it is irrelevant whether activities are carried out in Italy via several distinct entities, rather than by a single entity, for the purpose of ascertaining whether nonresident parent companies have a P.E. in Italy. Instead, the determination will be made by reference to facts and circumstances demonstrating whether the entities carried on business as parts of an economically integrated unitary structure that achieved an overall business purpose of the group with regard to activities in Italy.

The New Definition of Agency P.E.

Under the new Art. 162 (6) of the I.I.T.C., a P.E. is deemed to exist when a person acts in Italy on behalf of a foreign enterprise, and in so doing, habitually concludes or is involved in the conclusion of contracts that are routinely approved by the foreign company without material changes. Contracts covered by the new rule must be either (i) in the name of the enterprise, (ii) for the transfer of ownership or the right to use property owned or used by the enterprise, or (iii) for the provision of services by that enterprise.

In such cases, an Italian P.E. is deemed to exist unless the activities performed under the contract signed by the person acting in Italy on behalf of the foreign enterprise are limited to exempt activities described above. Consequently, agreements that are negotiated and signed by a person that are not binding until accepted abroad will be attributed to a P.E. and taxed in Italy as if the contract were legally binding prior to acceptance abroad.

New Art. 162 (7) of the I.I.T.C. provides an exception to the P.E. rule when the person acting in Italy on behalf of a foreign enterprise carries on its own business in Italy as an independent agent and acts for the enterprise in the ordinary course of that business. Note, however, that where a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person will not be considered to be an independent agent with respect to any such enterprise.

For the purposes of identifying an independent agent, a person is considered closely related to an enterprise if, based on all the relevant facts and circumstances, one controls the other or both are under common control of a third person or enterprise. In any event, the requisite degree of control will exist when (i) one person or enterprise directly or indirectly possesses more than 50% of the beneficial interest in the other or, in the case of a company, more than 50% of the aggregate vote and value of the issued and outstanding share capital; or (ii) another person directly or indirectly possesses more than 50% of the beneficial interests in both persons or enterprises or, in the case of a company, more than 50% of the aggregate vote and value of the share capital in both companies.

Ultimately, these changes to the Agency P.E. definition may not have a material impact on Italian business and administrative practices, since existing Italian case law contains a broad interpretation of the Agency P.E. concept. The most relevant judicial case is *Phillip Morris*,[9] where the Supreme Court affirmed, *inter alia*, the following principles:

- The participation of officers or representatives of an Italian company in phases of the negotiation or conclusion of contracts on behalf of a related company abroad constituted an Agency P.E. even if it was not granted a formal power of representation. If, under a formal grant of authority, other nonresident companies would ordinarily execute the function of the controlled Italian company, an inchoate grant of authority would be deemed to exist, resulting in an Agency P.E. in Italy. In this respect, the Court observed that the Italian company was not acting in the ordinary course of its business when providing services to related nonresident companies that were not included in its statutory business purpose and were performed without any formal mandate by the nonresident group companies.
- A national structure carrying on management of business transactions for the benefit of a nonresident company should be deemed to constitute a P.E. in Italy, even though only one area of the nonresident's business was managed by the domestic structure.
- Factors indicating the existence of a P.E. in Italy, including dependence and the authority to conclude contracts, should be assessed on the basis of the substance rather than exclusively on the basis of the mere legal form of the business transactions.
- A company situated in Italy may be deemed to be a P.E. of multiple foreign companies within the same group that pursue a common business strategy. In such instances, the nature of the activities performed in Italy will be assessed in light of the common business strategy of the group. In the view of the Court, regardless of the relationship between the Italian company and each single nonresident group company, the Italian company would be viewed to act in Italy for the benefit of the whole group. The legal and contractual relationships between the various group companies with reference to the activities performed in Italy should not be analyzed separately but should rather be considered as a whole.

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9 Supreme Court judgments 3367, 3368, and 3369 of 7 March 2002; 431926 of 26 March 2002; 7682 and 7689 of 25 May 2002; 10925 of 22 September 2002; and 17373 of 6 December 2002.

- Group companies that are subject to a unified strategy aimed at maximizing Italian profits for all nonresident companies involved have an Agency P.E. in Italy, and it is misleading to consider each fragment of the strategy separately. The Court referred to the wording of Paragraph 24 of the Commentary to Article 5 of the O.E.C.D. Model Income Tax Treaty, stating that a domestic structure could act as management office of the group in a way that has international ramifications.[10]

As a reaction to this interpretation, the O.E.C.D. amended the Commentary on Article 5 in 2005; however, Italian representatives at the O.E.C.D. inserted the following observation, "*Italy wishes to clarify that, with respect to paragraphs 33, 41, 41.1 and 42, its jurisprudence is not to be ignored in the interpretation of cases falling in the above paragraphs . . .*" Therefore, notwithstanding the fact that under Italian income tax law and constitutional law tax treaty provisions take precedence over Italian domestic provisions when they are more favorable to the taxpayer, Italian judicial interpretations of Agency P.E. override tax treaty provisions on a *de facto* basis.

ADVANCE RULINGS REGARDING AN ITALIAN P.E.

Because the Italian Tax Authorities quite aggressively audit the Italian operations of M.N.E.'s, it is advisable for an M.N.E. to seek advance clearance from the Italian Tax Authorities on the existence of and profit attribution to an Italian P.E. Several ruling procedures are available. Included are (i) advance tax rulings for international companies and (ii) advance tax rulings on new investments. The latter is reserved for investment projects with a significant impact on employment levels and worth at least €30 million. It would be shameful for management of an M.N.E. to invest substantial funds in Italy only to find out retroactively that a newly formed Italian subsidiary caused various group members to have a P.E. in the country.

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[10] In the view of the Court, the domestic structure exercised "supervisory and coordinating functions for all the departments of the enterprise located within the region concerned."

INDIA BUDGET 2018-19

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INTRODUCTION

All eyes were set on the Indian Finance Minister on February 1, 2018, as he unveiled the Union Budget for 2018-19 ("Budget 2018-19"). In addition to its several important direct tax proposals, Budget 2018-19 is notable as the last full budget before the 2019 Parliamentary elections and the first budget following the implementation of the landmark Goods and Services Tax ("G.S.T.") regime. Along with proposed amendments to the tax law, Budget 2018-19 also included key economic data from the annual economic survey and policy proposals.

DIRECT TAX

The direct tax proposals discussed below are effective from financial year ("F.Y.") 2018-19 (*i.e.*, April 1, 2018, to March 31, 2019). These provisions will be introduced in the Income-Tax Act, 1961 (the "Act") and, consequently, afforded legal authority.

Tax Rates

The basic tax rate for foreign companies remains unchanged at 40%. However, for domestic companies, the corporate tax rate will be reduced to 25%, if the turnover or gross receipts of such companies in F.Y. 2016-17 does not exceed I.N.R. 2.5 billion (approximately $40 million).

In all other cases, the income tax rate remains unchanged at 30%. The education cess on income tax and the secondary and higher education cess on income tax (which amount to 3% in the aggregate) will be discontinued. A new "Health and Education" cess will be levied at 4% of income tax including surcharge, wherever applicable.

In view of these proposed amendments, the maximum tax rates for certain taxpayers for F.Y. 2018-19 are as follows:

Taxpayer	Maximum Marginal Rate (Including Surcharge and Cess)
Individual	35.88%
Partnership Firm/Limited Liability Partnership ("L.L.P.")	34.94%

[1] Tax rate is 29.12% (including surcharge and cess) if the turnover or gross receipts of the domestic company in the F.Y. 2016-17 does not exceed I.N.R. 2.5 billion.

Taxpayer	Maximum Marginal Rate (Including Surcharge and Cess)
Domestic Company	34.94% or 29.12%[1]
Foreign Company	43.68%

Accordingly, the maximum marginal tax rate for foreign companies will increase from 43.26% to 43.68%.

Under the Budget 2018-19 provisions, the Minimum Alternate Tax ("M.A.T.") will not apply to foreign companies engaged in the business of, *inter alia*, shipping, aviation, mining, or civil construction and whose income is computed on presumptive basis.[2]

This proposal will be retroactively effective from April 1, 2000.

"The Budget 2018-19 reintroduced a 10% tax (repealed in 2004) on certain long-term capital gains."

Business Connection

With a view to align the definition of "Business Connection" – the domestic equivalent of a permanent establishment under the tax treaties – with the O.E.C.D.'s B.E.P.S. recommendations, its scope will be widened to include (i) persons who habitually conclude contracts, or play the principal role in concluding contracts, for a nonresident and (ii) nonresidents having significant economic presence.

A significant economic presence would mean transactions in respect of any goods, services, or property carried out by a nonresident in India, including providing downloading of data or software in India if the aggregate payments from such transactions exceed a specific threshold which will be subsequently prescribed. Further, it would also include systematic and continuous soliciting of business activities or engaging in interaction with such number of users in India through digital means, as may be subsequently prescribed.

Significant economic presence may be triggered whether or not (i) the nonresident has a place of business in India, (ii) the nonresident renders services in India, or (iii) the agreement for such transactions or activities is executed in India. Further, income would be taxed in India only to the extent of income attributable to the above transactions or activities in India.

This proposal is enacted despite the fact that work under B.E.P.S. Action 1 is still under way and is meant to be in the nature of an enabler to facilitate negotiation for further amendments in India's tax treaties.

Long-Term Capital Gains on the Sale of Stock and Units

The Budget 2018-19 reintroduced a 10% tax (repealed in 2004) on certain long-term capital gains ("L.T.C.G.'s"). The tax will be imposed on L.T.C.G.'s exceeding I.N.R. 100,000 (approximately $1,500) arising from the transfer of (i) equity shares in a listed company, (ii) units of an equity-oriented mutual fund, or (iii) units of a business trust. The 10% tax is a concessional rate available if Securities Transaction Tax ("S.T.T.") has been paid on the acquisition and transfer of equity shares in a

[2] Under the presumptive taxation scheme, a taxpayer is allowed to declare income at a prescribed rate defined under the Act and, in turn, is exempt from maintaining books of account and also from getting the accounts audited.

company or on the transfer of units of an equity-oriented mutual fund or a business trust. Otherwise, L.T.C.G.'s will be taxed at 20%.

The requirement to pay S.T.T. does not apply when a transfer is undertaken on a recognized stock exchange located in any International Financial Services Center ("I.F.S.C.")[3] nor where consideration is received in a foreign currency.

In the case of a capital asset acquired before February 1, 2018, the cost of acquisition will be deemed to be the higher of the following:

- The actual cost of the acquisition
- The lower of the fair market value ("F.M.V.") and the full value of consideration received or accruing as a result of the transfer

The F.M.V. of a listed capital asset is the highest price quoted on the stock exchange on January 31, 2018. In the case of unlisted capital assets, the F.M.V. is the net asset value on January 31, 2018.

The benefit of indexation, in the case of residents, and foreign currency variation, in the case of nonresidents, will not be considered in computing L.T.C.G.'s. This provision will also be applicable to Foreign Institutional Investors ("F.I.I.").[4] However, relief will be available where there is a favorable tax treaty. The benefit of indexation will be allowed in the following cases:

- Equity shares not listed on a stock exchange on January 31, 2018, but listed at the time of transfer
- Equity shares listed on a stock exchange at the time of transfer but acquired as consideration for shares that were unlisted on January 31, 2018, where such transaction does not amount to a transfer

The above amendments will be effective from April 1, 2018.

Income Computation and Disclosure Standards

In 2015, the government established ten tax accounting standards – known as the Income Computation and Disclosure Standards ("I.C.D.S.") – for computing taxable income under the categories "Profits and Gains of Business or Profession" or "Income from Other Sources." However, certain I.C.D.S. provisions were rejected by the Delhi High Court in a recent ruling.

To provide requisite legislative support for these measures, the Act will be amended in the following ways:

- A deduction will be allowed for marked-to-market loss or other expected loss as computed under the I.C.D.S.

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[3] An I.F.S.C. is a financial center that provides financial services to nonresidents and residents, to the extent permissible under the domestic regulations, in a currency other than the domestic currency (Indian rupee in this case) of the location where the I.F.S.C. is located.

[4] An F.I.I. is an investor or an investment fund registered in a country other than the one in which it is investing. In India, all F.I.I. must register with the Securities and Exchange Board of India before investing in the country.

- A gain or loss arising from a change in foreign exchange rates will be treated as income or loss
- Profit and gain arising from a construction contract or a contract for providing services will be determined on the basis of percentage of completion method

In addition, the following accounting principles will be adopted for determining taxable income under the category "Profits and Gains of Business or Profession:"

- Inventory will be valued at actual cost or net realizable value, whichever is lower.
- The purchase and sale of goods or services and of inventory will be adjusted to include the amount of any tax, duty, cess, or fees actually paid or incurred by the taxpayer to bring the goods or services to their location on the date of valuation.
- Inventories that are securities but are not listed on a recognized stock exchange or are listed but not regularly quoted on a recognized stock exchange will be valued at actual cost.
- Inventories that are securities other than above will be valued at cost or net realizable value, whichever is lower.

Any claim for price escalation in a contract or export incentive will be deemed to be the income of the financial year in which reasonable certainty of its realization is achieved.

Furthermore, assistance in the form of a subsidy will be deemed to be the income of the financial year in which it is received, unless it is taxed in a prior year.

The above amendments will be effective from April 1, 2016.

Corporate Insolvency Resolution Process

The aggregate of unabsorbed depreciation and book loss carryforward will be deductible when computing the book profit of a company whose application for Corporate Insolvency Resolution Process ("C.I.R.P.") has been accepted by the adjudicating authority.[5] Previously, the lower of the unabsorbed deprecation or book loss was allowed as a deduction; hence, in cases where either of these amounts was zero, no deduction could be claimed.

In order to ease the restructuring and rehabilitation of companies seeking insolvency resolution, a company that takes over the business of a rehabilitating company (*i.e.*, a company undergoing insolvency proceedings under the I.B.C.) will be allowed to carry forward and set off loss of the rehabilitated company pursuant to a resolution plan under C.I.R.P. This benefit is available despite a change in shareholding exceeding 49% during the year and applies to companies whose resolution plan has been approved under the I.B.C.

Both the above amendments will be effective from April 1, 2017.

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[5] The Insolvency and Bankruptcy Code ("I.B.C."), which offers C.I.R.P, was enacted in 2016 to replace existing insolvency laws with a consolidated and comprehensive piece of legislation aimed at facilitating the simple and timely winding up of insolvent businesses to maximize the value of debtor's assets.

I.F.S.C.'s

In order to develop India as a global financial center and, more specifically, to encourage investment in designated I.F.S.C.'s, transfers of the following assets on a recognized stock exchange in an I.F.S.C. by a nonresident will be exempt from both short and long-term capital gains tax:

- Global Depository Receipts
- Rupee-denominated bonds of an Indian company
- Derivatives

This benefit is available provided that the transfer takes place on a recognized stock exchange located in an I.F.S.C. and the consideration is paid in foreign currency. However, as with L.T.C.G.'s from stock and units, discussed above, L.T.C.G.'s on equity shares, units of an equity oriented mutual fund, and units of business trusts transacted on a recognized stock exchange located in I.F.S.C. will be taxed at 10%, if the gains exceed I.N.R. 100,000.

In addition, the 9% reduced M.A.T. rate applicable to corporate entities with units in an I.F.S.C. will be extended to noncorporate entities located in an I.F.S.C.

Start-Ups

Under existing law, a start-up established between April 1, 2016, and April 1, 2019, can deduct 100% of profits earned from an "eligible business" for any three of the first seven financial years. This provision will be extended for an additional two years and will sunset on March 31, 2021. The deduction is available provided that the turnover in any of the seven financial years does not exceed I.N.R. 250 million (approximately $4 million).

The term eligible business has been expanded to include any innovation, development, or improvement of products, processes, services, or a scalable business model with a high potential of employment generation or wealth creation.

Country-by-Country Reporting

The due date to file the Country-by-Country ("C.b.C.") Report, in cases of a parent entity or Alternative Reporting Entity resident in India, will be subsequently prescribed in the Income-tax Rules. The proposed amendment follows provisions under B.E.P.S. Action 13 and will be effective from April 1, 2016.

Permanent Account Number

Taxpayers (other than individuals) and their officers (*e.g.*, managing directors of a company, partners of a partnership or L.L.P, and trustees of a trust) will be required to obtain a Permanent Account Number if they enter into specified financial transactions amounting to I.N.R. 250,000 (approximately $3,800) or more during a financial year.[6] This amendment will be applicable only to taxpayers who are residents of India (*i.e.*, nonresidents will be excluded from the scope of this provision).

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[6] A Permanent Account Number is a unique ten-character alphanumeric number issued by the Indian Income-tax Department that serves as the taxpayer's proof of identification.

CONCLUSION

Budget 2018-19 has introduced many international tax provisions intended to bring India's domestic tax law in line with global standards established by the O.E.C.D.'s B.E.P.S. Project. However, the budget has also wreaked a certain amount of havoc on long-standing domestic tax law. The reintroduction of a tax on capital gains from the sale of stock, for example, caused the national stock exchange to plummet by several points due to the bearish outlook and public outcry. At the same time, the prime minister focused on the less privileged sectors of the society and proposed reforms to benefit rural communities; improve agriculture, healthcare, infrastructure, and education; and generate employment. With this budget, the government has gone one step further in improving the standard of living for the poor and bringing the country on par with international tax norms.

"The government has gone one step further in improving the standard of living for the poor and bringing the country on par with international tax norms."

CHANGES TO C.F.C. RULES – MORE C.F.C.'S, MORE U.S. SHAREHOLDERS, MORE ATTRIBUTION, MORE COMPLIANCE

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Tags
Attribution Rules
Controlled Foreign Corporation
Tax Reform

INTRODUCTION

One of the principal revisions to U.S. tax law made by the Tax Cuts and Jobs Act ("T.C.J.A.") was a series of changes to the definition of the term Controlled Foreign Corporation ("C.F.C."). Some changes were prospective. Others were enacted retroactively as of the beginning of the 2017 tax year.

As a result, cross-border joint venture arrangements between U.S. and non-U.S. parties that contained economic and legal provisions designed to prevent the creation of a C.F.C. were unceremoniously deconstructed by the T.C.J.A., in some instances on a retroactive basis.

This article examines the T.C.J.A. changes that were made to C.F.C.'s and their "U.S. Shareholders." In so doing it discusses

- the conditions for a U.S. person[1] to be considered a U.S. Shareholder of a C.F.C.,
- the attribution rules applied to determine the ownership percentage of a U.S. person in a C.F.C. under prior law that remained unchanged, and
- the major changes introduced by the T.C.J.A. to the C.F.C. regime that expanded the scope of provisions in this respect.[2]

Generally, U.S. persons that are shareholders of foreign corporations pay U.S. tax on the earnings derived from corporate profits at the time a distribution is received. Within certain limits, shareholders may indefinitely defer their taxes by deferring distributions.

In comparison, U.S. persons that hold sufficient shares in a C.F.C. to be categorized as U.S. Shareholders are required to include in their taxable income their *pro rata* share of the C.F.C.'s Subpart F Income and taxable investments in "United States Property"

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1 The term U.S. person encompasses U.S. citizens, green card holders, individuals meeting the substantial presence test, domestic partnerships, domestic corporations, estates subject to U.S. income tax and domestic trusts. Code §951(b) with reference to Code §957(c).

2 The T.C.J.A. also expanded the scope of the definition of U.S. Shareholders. According to Code §951(b), as amended by the T.C.J.A., the definition of a U.S. Shareholder applies "for purposes of this title," *i.e.*, the Code (enacted by Congress in Title 26 of the United States Code (26 U.S.C.)) and not just the Subpart F rules as under prior law.

on a current basis, without the requirement of a cash or property distribution.[3]

CHANGES TO THE C.F.C. PROVISIONS

Definition of C.F.C.

Under prior and current law, a C.F.C. is defined in the following terms: A C.F.C. is a foreign corporation from the viewpoint of the U.S. for which more than 50% of its authorized and outstanding shares, measured by total voting power or value, is owned by U.S. Shareholders, as defined.[4]

As demonstrated in Treas. Reg. §1.957-1(c), examples 8 and 9, preferred stock is counted for the purpose of determining whether a foreign corporation is a C.F.C., based on the test for value.

"A C.F.C. is a foreign corporation from the viewpoint of the U.S. for which more than 50% of its authorized and outstanding shares, measured by total voting power or value, is owned by U.S. Shareholders."

U.S. Shareholder Under the T.C.J.A. – Control by Vote or Value

Under pre-T.C.J.A. law, a U.S. Shareholder was defined as a U.S. person that owned shares of stock representing 10% or more of the total voting power of all stock of the foreign corporation.[5] Thus, a U.S. person holding non-voting preferred shares representing 10% or more of the value of all shares of the foreign corporation was not treated as a U.S. Shareholder. That U.S. person could not be taken into account for purposes of determining whether a foreign corporation was a C.F.C., and if it was a C.F.C., it was not subject to U.S. tax under Subpart F.

The T.C.J.A. expanded the definition of a U.S. Shareholder to include a U.S. person that owns shares representing 10% or more of the value of all shares of the foreign corporation.[6] As a result, U.S. person holding only non-voting preferred shares will now fall under the definition of a U.S. Shareholder.

To illustrate, assume that a U.S. person owns shares representing 5% of voting power of a foreign corporation and 3% of the value. Assume the same person owns non-voting preferred shares representing 8% of the total value of the stock of a foreign corporation. That U.S. person is not a U.S. Shareholder under prior law that looked only at voting power. However, under the T.C.J.A., it will be treated as a U.S. Shareholder because the total value of voting and non-voting shares held in the foreign corporation amounts to more than 11% of the value of all shares authorized and outstanding (value of voting shares equals 3% and value of non-voting shares equals 8%).

Whichever test is applied under the T.C.J.A., a foreign corporation is not considered to be a C.F.C. if shares representing a majority of voting power and value are owned

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3 In the following, references to "Subpart F Income" are meant to include certain investments in the United States that are also subject to the anti-deferral rules under Subpart F of the Code. Also note in this context that applicability of the C.F.C. rules is expanded under the T.C.J.A. to new regimes such as taxation of global intangible low taxed income ("G.I.L.T.I.") and the transition tax under Code §965.

4 Code §957(a). Vote refers to the total combined voting power of all classes of stock. Code §957(a)(1).

5 Code §951(b) under the pre-T.C.J.A. law.

6 Code §951(b) as amended by the T.C.J.A.; Section 14214(a) of the T.C.J.A.

by (i) foreign persons and (ii) U.S. persons that fail to own shares representing 10% of the voting power and value of the foreign corporation. This test can deceptive because shares of a foreign corporation need not be owned directly by U.S. persons for a foreign corporation to be a C.F.C.

This provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. Shareholders in which or with which such taxable years of a foreign corporation end.[7]

30-day Rule No Longer Applicable

Under the pre-T.C.J.A. law, Subpart F Income earned by a C.F.C. was not subject to U.S. taxation if the foreign corporation was not a C.F.C. for an uninterrupted period of at least 30 days.[8]

For example, assume that a foreign corporation with one class of shares and a December year end met the conditions of a C.F.C. in the last month of its taxable year because a U.S. person acquired more than 50% of all the authorized and outstanding shares of its stock on December 3rd of the tax year. The U.S. Shareholder was not subject to U.S. tax on the Subpart F Income earned during the balance of the year.[9]

The T.C.J.A. repealed this 30-day rule.[10] Thus, a U.S. Shareholder will be subject to U.S. tax on its prorated share of Subpart F Income even if the foreign corporation is only a C.F.C. for a single day in its tax year, provided the U.S. Shareholder owned the C.F.C. on the last day of the C.F.C.'s tax year.[11]

This change under the T.C.J.A. is effective for tax years of foreign corporations beginning after December 31, 2017, and taxable years of U.S. Shareholders in which or with which those taxable years of a foreign corporation end.[12]

DETERMINING OWNERSHIP IN A C.F.C.

In determining the 10% ownership requirement for a U.S. person to be treated as a U.S. Shareholder and the more-than-50% ownership requirement for a foreign corporation to be treated as a C.F.C., stock shares of stock owned directly, indirectly, and constructively by U.S. persons are taken into account.[13] Once it

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7 Section 14214(b) of the T.C.J.A.

8 Code §951(a)(1) under the pre-T.C.J.A.

9 A similar result was achievable if a check-the-box election were made with an effective date that was 30 days after the acquisition of all outstanding shares of stock of a foreign corporation by an acquiring U.S. partnership comprised of three unrelated U.S. persons owning all partnership interests equally, *i.e.*, 33.33% each.

10 Section 14215(a) of the T.C.J.A.

11 Note that similar rules may apply under new regimes introduced by the T.C.J.A. referencing U.S. Shareholders. *E.g.*, for purposes of the new provision on a C.F.C.'s G.I.L.T.I. the inclusion is subject to the condition that the owner is treated as a U.S. Shareholder on the last day in the tax year of the foreign corporation. Code §951A(e)(2) under the T.C.J.A.

12 Section 14215(b) of the T.C.J.A.

13 Code §§951(b) and 957(a), each with reference to Code §958(b), which in turn

is determined that a U.S. person is a U.S. Shareholder and a foreign corporation is a C.F.C., the method for computing taxable income looks only to shares owned directly or indirectly, but not to shares owned constructively. Subpart F Income is included in proportion to direct and/or indirect ownership only. The stock owned constructively is ignored for the purpose of allocating Subpart F Income to the U.S. Shareholder.[14]

Direct and Indirect Ownership

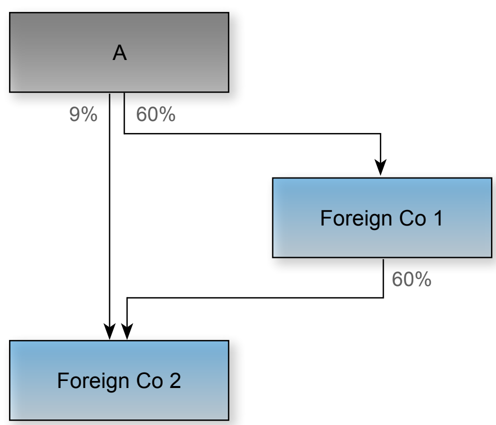
Direct ownership of shares of stock in a foreign corporation is easy to compute.

To determine whether shares of stock are owned indirectly, the shareholders of a foreign corporation, the partners of a foreign partnership, and the beneficiaries of a foreign trust or estate are considered to own proportionately the shares owned by the foreign corporation, partnership, trust, or estate under a look-thru rule.[15]

Where a shareholder owns more than 50% of the shares in a lower-tier entity, the shareholder is deemed to own all the shares owned by the lower-tier entity. This bump-up in percentage is based on the view that ownership of a majority interest in the lower-tier entity provides the shareholder with effective control all shares in other corporations owned by the lower-tier entity.[16] Consequently, it affects a determination of whether a U.S. person is a U.S. Shareholder of a C.F.C., whether a foreign corporation is a C.F.C., and whether two corporations are related.

In comparison, the bump-up in ownership percentage does not affect the amount of income that is taxed under Subpart F in the hands of a U.S. Shareholder. For that purpose, the percentages are arrived at without a bump-up in control.

This is illustrated in the following example:



references Code §318(a) with modifications.

14 An explanation by the House-Senate Committee indicates that the new downward attribution rule was not intended to result in new income allocations to 10% U.S. Shareholders who are not otherwise related (at a 50% level) with U.S. entities under the downward attribution rule (Conference Committee Report on §14213). While the text of the T.C.J.A. does not provide for language to reflect this intent, I.R.S. Notice 2018-13, includes a clarification to this effect. See also *infra* FN14.

15 Code §958(a)(2).

16 Code §958(b)(2).

Under the foreign entity look-thru rule, U.S. corporation A would be treated as owning (i) 36% in Foreign Co 2 indirectly through Foreign Co 1 and (ii) 9% of Foreign Co 2 directly, for a total of 45% ownership. If Foreign Co 2 generates Subpart F Income, A is taxed on 45% of the resulting earnings. However, when applying the constructive ownership rules (explained below) to determine U.S. Shareholder status for A and C.F.C. status for Foreign Co 2, Foreign Co 1 is treated as owning 100% of Foreign Co 2. Accordingly, for these purposes, Foreign Co 2 would be a C.F.C. because it would be deemed to own 69% of Foreign Co 2 – 9% owned directly and 60% owned indirectly.

Constructive Ownership

Constructive ownership rules treat the deemed owner as if it were the actual stock owner of the shares for the purposes mentioned above.

For purposes of determining a U.S. Shareholder and C.F.C., the Code applies the general Code §318 attribution rules with modifications.

Family Attribution

An individual is considered to own stock that is owned, directly or indirectly, by or for

- a spouse (unless legally separated by decree of divorce or separate maintenance),
- children,
- grandchildren, and
- parents.[17]

However, the family attribution rules under Code §318(a)(1) do not treat an individual as owning stock actually owned by the individual's siblings, grandparents, great-grandparents, great-grandchildren, uncles, aunts, nephews, nieces, or cousins. In addition, stock constructively owned by applying the family attribution rules cannot be attributed a second time to another family member.[18] Thus, while shares of stock owned by a child are attributed to a parent, that stock cannot be reattributed from the parent to another child.

Family attribution rules do not exist when the owner of shares is a nonresident, non-citizen individual.[19]

These rules remained unchanged under the T.C.J.A.

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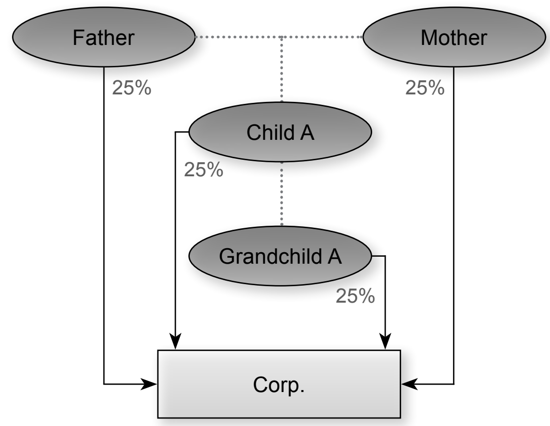
[17] Code §§958(b), 318(a)(1)(A); Treas. Reg. §1.958-2(b)(1).

[18] Code §318(a)(5)(B). For example, a child's stock that is attributed to a parent will not be reattributed from the parent to another child, because stock cannot be directly attributed between siblings.

[19] Code §958(b)(1).

They are illustrated in the following example:



- Father, Mother, and Child A are all U.S. citizens and are each deemed to own 100% (25% directly + 75% constructively).
- Grandchild A, Child A's son and also a U.S. citizen, on the other hand, is deemed to own only 50% (25% directly and 25% constructively from his father, Child A).
- While Father and Mother, Grandchild A's grandparents, are treated as constructively owning Grandchild A's stock in Corp., Grandchild A is not deemed to own their stock.
- Because there is no attribution between siblings, if Grandchild A had a sister, no stock would be attributed from Grandchild A to his sister, directly or through their father, Child A.
- If, Mother and Father are neither U.S. citizens nor residents of the U.S., the family attribution rule does not apply to any shares they own. As a result, both Child A and Grandchild A would each be treated as owning 50% of Corp., of which 25% is owned directly and another 25% is owned through parent-child attribution.

Upward and Downward Attribution – General Rules

In addition to family attribution, constructive ownership attribution can occur in two ways, upward and downward, as follows:

- From a partnership, trust or estate, and corporation to its partners, beneficiaries, and shareholders, respectively (so-called upward attribution)[20]
- From the partners, beneficiaries, and shareholders to a partnership, trust or estate, and corporation, respectively (so-called downward attribution)

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20 Stock owned, directly or indirectly, by or for a partnership shall be considered as owned proportionately by its partners (Code §318(a)(2)(A)). Similar rules apply to estates (Code §318(a)(2)(A)) as well as 10%-owned corporations (Code §318(a)(2)(C) as modified by Code 958(b)(3)). Stock owned, directly or indirectly, by or for a trust shall be considered as owned by its beneficiaries in proportion to their actuarial interests in the trust (Code §318(a)(2)(B)(i)). In the case of a grantor trust described in Code §§671 through 679, the person taxable on trust income is the constructive owner of stock owned by the trust (Code §318(a)(2)(B)(ii)).

For purposes of determining C.F.C. status, Code §958(b) changes the upward attribution rules in two ways:

- The attribution of ownership from a corporation to its shareholders applies with respect to any shareholder that owns, directly or indirectly, 10% or more of the value of the corporation's stock.[21]
- As mentioned above, if a partnership, trust or estate, or corporation owns, directly or indirectly, more than 50% of the voting power of the stock of a particular corporation, Code §958(b)(2) treats that partnership, trust or estate, or corporation as owning all of the voting stock of the particular corporation (for purposes of the upward attribution rules).[22]

As will be shown in the Case Study, this rule may cause a person with a beneficial interest in a foreign corporation of less than 10% to be a U.S. Shareholder.[23] Further, this rule may create a C.F.C. even if U.S. persons have less than 50% beneficial ownership of the foreign corporation.[24]

The downward attribution rules attribute

- stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate to the partnership or estate,
- stock owned, directly or indirectly, by or for a beneficiary or owner of a trust to the trust, and
- stock owned, directly or indirectly, by of for a 50% or more shareholder of a corporation to the corporation.

Stock attributed to an entity from certain of its partners, beneficiaries, or shareholders will not be reattributed to other partners, beneficiaries, or shareholders unless the attribution could have been made directly.[25]

DOWNWARD ATTRIBUTION UNDER THE T.C.J.A.

Under the pre-T.C.J.A. law, stock in a foreign corporation owned by a foreign person was not treated as constructively owned by a U.S. person.[26]

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21 Code §958(b)(3); Treas. Reg. §1.958-2(c)(1)(iii).

22 Treas. Reg. §1.958-2(c)(2).

23 For example, a U.S. person holding a 6% beneficial interest could be a U.S. Shareholder under this rule. See also Treas. Reg. §1.958-2(f)(2), Ex. 2.

24 *Cf.* Treas. Reg. §1.958-2(f)(2), Ex. 2; explained under "Direct and Indirect Ownership" above.

25 Code §318(a)(5)(C). For example, if two unrelated individuals are beneficiaries of the same trust, stock held by one that is attributable to the trust under the downward attribution rule of Code §318(a)(3)(B) is not reattributed from the trust to the other beneficiary. However, stock attributed from an entity to an individual under the *upward* attribution rule of Code §318(a)(2) may be reattributed from the individual to *another* entity under the *downward* attribution rule. Thus, if all the stock of corporations X and Y is owned by an individual, I, stock of corporation Z held by X is attributed to Y through I (Treas. Reg. §1.318-4(c)(1)).

26 Code §958(b)(4) (repealed by the T.C.J.A.).

For example, shares of stock of a foreign subsidiary owned by a foreign parent were not attributed from the foreign parent to a U.S. subsidiary. Therefore, the foreign subsidiary was not treated as a C.F.C. with respect to the U.S. subsidiary.

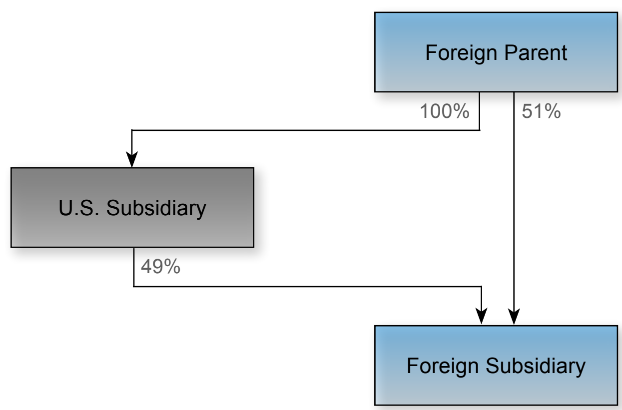
The T.C.J.A. removed this limitation thereby permitting downward attribution.[27] Consequently, a U.S. subsidiary of a foreign parent will be treated as constructively owning stock in a foreign subsidiary of that parent.

Such constructive ownership does not, however, result in a Subpart F Income inclusion for the U.S. subsidiary because, as discussed above, Subpart F Income is included in the gross income of the U.S. Shareholder only to the extent of direct and/or indirect ownership.[28] As long as no U.S. Shareholder owns stock in the C.F.C. other than by means of downward attribution, this new rule should not impose increased reporting requirements on the (constructive) U.S. Shareholder.[29]

“As long as no U.S. Shareholder owns stock in the C.F.C. other than by means of downward attribution, this new rule should not impose increased reporting requirements on the (constructive) U.S. Shareholder.”

According to the Conference Committee Report, this change is intended to stop de-control plans. By taking advantage of the anti-downward attribution rule under pre-T.J.C.A. law, a foreign parent acquired a greater than 50% interest in a C.F.C. of its U.S. subsidiary and, thus, caused the C.F.C. to be a non-C.F.C. This converted former C.F.C.’s to non-C.F.C.’s, despite continuous ownership by U.S. Shareholders.[30]

The fact pattern is illustrated in the following example:



27 Section 14213(a) of the T.C.J.A.

28 Note that for determining the hypothetical distribution under Code §951(a)(2)(A) for purposes of calculating the *pro rata* share of Subpart F Income constructive stock ownership is not taken into account. Code §951(a)(2)(A) only referring to Code §958(a) but not Code §958(b).

29 According to Notice 2018-13 the instructions for Form 5471 should be amended to provide an exception from Category 5 filing (the C.F.C. filing requirement) for a U.S. person that is a U.S. Shareholder with respect to a C.F.C. if no U.S. Shareholder (including that U.S. person) owns, within the meaning of Code §958(a), stock in the C.F.C., and the foreign corporation is a C.F.C. solely because that U.S person is considered to own the stock of the C.F.C. owned by a foreign person by means of the downward attribution rule (Code §318(a)(3)).

30 Conference Committee Report on §14213.

Pre-T.C.J.A., if a foreign parent owned 51% of a foreign subsidiary and a U.S. subsidiary (of the foreign parent) owned the remaining 49%, the foreign subsidiary would not be a C.F.C. Because Code §958(b)(4) prevented the U.S. subsidiary from being attributed ownership of the foreign parent's 51% interest, the U.S. subsidiary would not meet the 50% C.F.C. threshold. As a result of the repeal of this limitation, under these facts, the U.S. subsidiary would, for purposes of determining U.S. Shareholder and C.F.C. status, be treated as owning all of the foreign parent's stock in the foreign subsidiary. Consequently, the foreign subsidiary would be a C.F.C. Nevertheless, the U.S. subsidiary's inclusion of Subpart F Income would be limited to its directly held stock, and any stock indirectly held through foreign entities as determined under Code §958(a).

Although the legislative history suggests that a downward attribution is applicable between related parties, no provision to this effect has been incorporated into the Code. Thus, as will be shown in the Case Study an unrelated party can have C.F.C. status under the new downward attribution rules.

Contrary to the foregoing modifications, the change of the downward attribution rule under the T.C.J.A. applies retroactively, *i.e.*, to the last taxable year of the foreign corporation beginning before January 1, 2018. For a foreign parent corporation using the calendar year, downward attribution was effective January 1, 2017, at which time its U.S. subsidiaries were deemed to own all foreign subsidiaries of the foreign parent corporation.[31] While no taxable event would occur for those subsidiaries in the absence of ownership of any stock of a foreign sister corporation, all joint venture corporations owned by the foreign parent corporation and one or more unrelated U.S. Shareholders could cause the U.S. Shareholders to recognize income under Subpart F in appropriate circumstances.

CASE STUDY – PUTTING IT ALL TOGETHER

Facts

The Case Study looks at a typical global family that invests together in several countries through several trusts and corporations of various kind to illustrate the interplay of pre-T.C.J.A. legislation and the new rules under the T.C.J.A.

Family

Father is a nonresident individual with regard to the U.S. and not a U.S. citizen. Rather, he is a national of Country X and has resided in Country X all his life. Father has three adult children, Child A, Child B, and Child C. Like Father, Child A is a nonresident individual with regard to the U.S. and not a U.S. citizen. Also, like Father, Child A is a national of Country X and a has resided in Country X all his life. In comparison, Child B and Child C hold dual nationality. Each is a U.S. citizen and at the same time a national of Country X.

Trusts

Father has arranged for the settlement of Trust 1, which is domiciled and resident in Country X. Trust 1 is an irrevocable trust created under Country X law. For U.S. tax purposes, Trust 1 is a foreign trust. Trust 1 grants the trustee broad discretion

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[31] Section 14213(b) of the T.C.J.A.

in determining the timing, the amount, and the beneficiary of income distributions. Father is the only person who has received trust distributions during the period of Trust 1's existence. Those distributions are paid annually. Regarding capital, each beneficiary is ultimately entitled to set portions. Father's portion is 10%, and the portion for each child is 30%. No capital distribution within the meaning of Country X trust law has ever been made by Trust 1.

Father has arranged for the settlement of Trust 2. Similar to Trust 1, Trust 2 is an irrevocable trust created under Country X law. The beneficiaries are Father, Child B, and Child C. While the trust is discretionary, the trust instrument provides that during the lifetime of Father, only Father can receive distributions of income and capital. For that reason, Trust 2 is a grantor trust for U.S. income tax purposes, and Father is treated as the owner of the income and assets of the trust. Nonetheless, for purposes of Country X tax law, Trust 2 is recognized as any other trust formed and domiciled in that jurisdiction.

Companies

Father and Trust 1 are the sole shareholders of XCO 1, an entity that was formed under the laws of Country X. XCO 1 provides limited liability for all its shareholders. Father owns 100% of the voting common shares of XCO 1, and Trust 1 owns 100% of the non-voting preference shares of XCO 1. The preference relates to capital distributions at liquidation and a cumulative preferred dividend of 10% of the face value of the preferred shares. The preference shares do not participate in profits beyond the coupon. No dividends are paid on the voting common shares. The preferred share dividends are equal to 99% of the XCO 1 earnings, and virtually all capital in XCO 1 is reflected in the preferred shares.

Trust 1 and the three adult children are the shareholders of XCO 2, also an entity that was formed under the laws of Country X. It has the same attributes as XCO 1 so that no shareholder is responsible for its obligations. Trust 1 holds all of the preferred shares of XCO 2. The preferred shares represent 99.99% of the capital of XCO 2 and entitles the holder to a cumulative 2% dividend on the stated amount of the preferred capital. The preference shares do not participate in profits beyond the coupon. Child A owns 80% of voting common shares in XCO 2. The remaining 20% of voting common shares are held by Child B and Child C in equal portions (*i.e.*, 10% each). XCO 2 is very profitable and each year distributes a cash dividend that equals at least 10% of the total capital of the company.

XCO 1, XCO 2, and Trust 2 own all the authorized and outstanding shares of HoldCo, a private limited company formed under the laws of Country X. HoldCo has one class of voting common shares authorized and outstanding. No other class of shares exists. XCO 1 and XCO 2 each own 20% of the voting common shares of HoldCo, and the remaining 60% are owned by Trust 2.

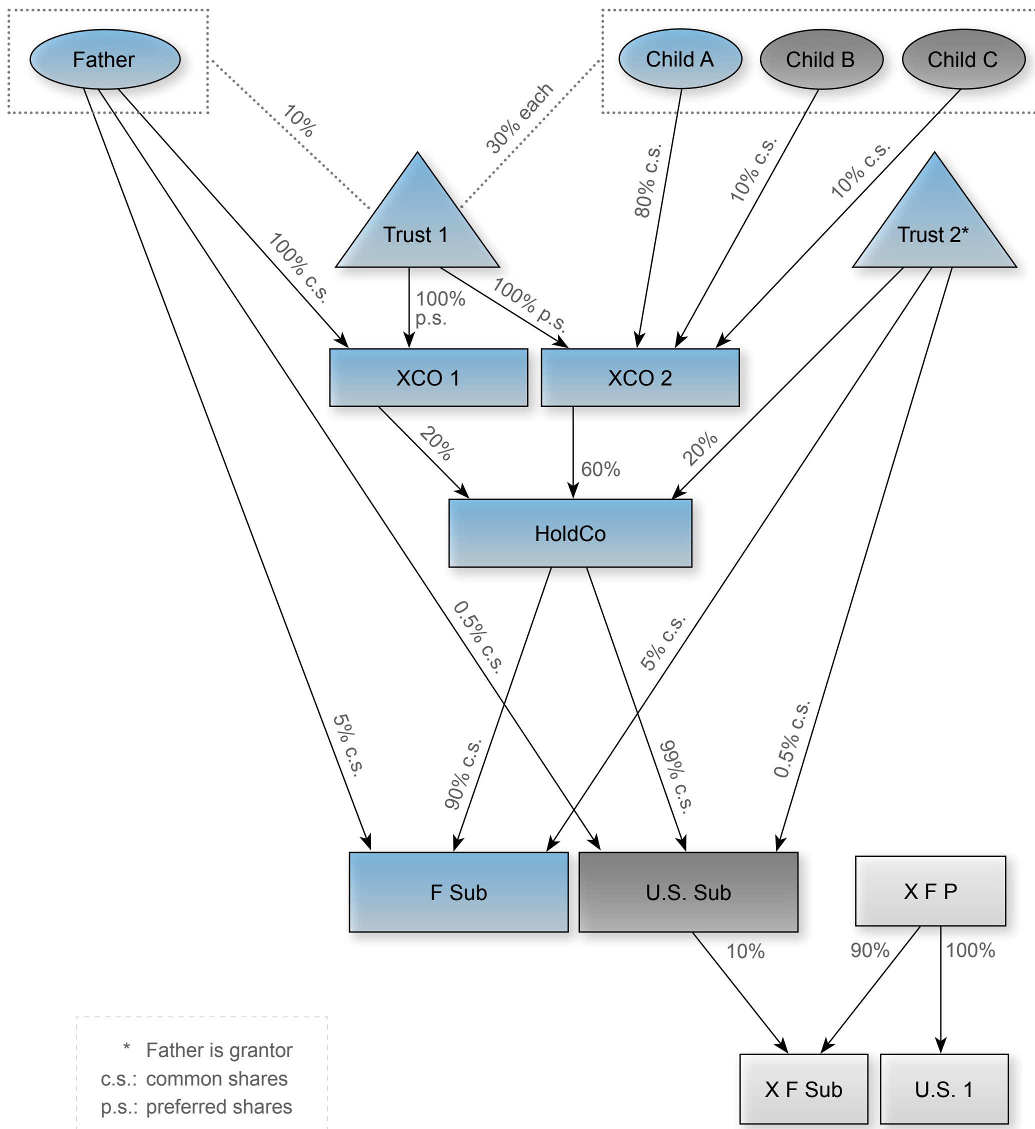
Father, HoldCo, and Trust 2 own all the authorized and outstanding shares of FSub, a private limited company formed under the laws of Country X. FSub has one class of voting common shares that are authorized and outstanding. No other class of shares exists. Father and Trust 2 each own 5% of the voting common shares, and the remaining 90% are owned by HoldCo.

Father, HoldCo, and Trust 2 also own all the authorized and outstanding shares of U.S. Sub, a domestic corporation that is subject to full corporate tax in the U.S. U.S.

Sub has one class of voting common shares that are authorized and outstanding. No other class of shares exists. HoldCo owns 99% of the common shares, and Father and Trust 2 each own 0.5% of the common shares.

XFP is a corporation formed outside the U.S. that is unrelated to Father and the three children. XFP and U.S. Sub own all the authorized and outstanding shares of XF Sub, a private limited company formed under the laws of a country other than the U.S. XF Sub has one class of voting common shares that are authorized and outstanding. No other class of shares exists. U.S. Sub owns 10% of the shares of XF Sub, and XFP owns the remaining 90%. XFP also owns 100% of U.S. 1.

The facts are illustrated in the following diagram.



Analysis Under C.F.C. Rules

To reiterate, as demonstrated in Treas. Reg. §1.957-1(c), Ex. 8 and 9, preferred stock is counted for the purpose of determining whether a foreign corporation is a C.F.C. As discussed above, under T.C.J.A., preferred stock which does not carry any voting rights is counted in the determination of whether a U.S. person is a U.S. Shareholder.

This begs the following question: Does the combination of Child B and Child C's U.S. citizenship and their interests in Country X entities cause any of the Country X companies directly or indirectly owned by Father to be C.F.C.'s?

XCO 1

- Under pre-T.C.J.A. law that looks only to voting power when deciding if a U.S. person is a U.S. Shareholder, XCO 1 could not be a C.F.C. because Father owns all the voting shares in XCO 1. Hence, no U.S. Shareholders exist.
- As a result of the T.C.J.A., voting power and value are taken into account when determining the status of a foreign corporation. In the facts set forth, the voting power is embodied in the shares of common stock owned by Father. However, the value of the company is embedded in the preferred shares owned by Trust 1.[32] Under Code §318(a)(2)(B)(i), stock in XCO 1 owned by Trust 1 is constructively owned by the beneficiaries of Trust 1 in proportion to their actuarial interests in such trust.
- Nonetheless, the trust instrument does not mandate specific distribution patterns, and actuarial tables may be inappropriate where trust distributions are discretionary.
- In Private Letter Ruling 9024076, which involves a similar fact pattern, the I.R.S. looked to facts and circumstances to determine the extent to which trust beneficiaries would be deemed to own shares of stock actually owned by a trust. These included (i) patterns of past distributions, (ii) appropriate mortality assumptions, (iii) the trustee's fiduciary duties, and (iv) the relationships among the trustees and beneficiaries. In looking at facts and circumstances, the purpose of the tax law provision being applied must be taken into account.[33] Artificial arrangements were ignored.
- Because Father is the only person who received distributions from Trust 1 and there is no indication that the Trustee will exercise his discretion in a different manner during the lifetime of Father, none of the shares of XCO 1 owned by Trust 1 likely will likely be attributed to any beneficiary other than Father.
- If, however, the Trust 1 instrument called for mandatory distributions to Father and the three children in line with capital interests, Child B and Child C would be deemed to own shares representing 60% of the value XCO 1. In that case, the indirect interests of Child B and Child C in XCO 1 would be

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32 Because no dividends have been paid on the voting common shares, no earnings have been retained, and virtually all capital in XCO 1 is reflected in the preferred shares, the value of the preferred shares should exceed the value of the common shares.

33 Treas. Reg. §1.958-1(c)(2).

sufficient to make each child a U.S. Shareholder of XCO after the enactment of the T.C.J.A. Moreover, because U.S. Shareholders would be deemed to own 60% of XCO, XCO would be a C.F.C.

XCO 2

- Under pre-T.C.J.A. law, XCO 2 could not be a C.F.C. because Child A owns 80% of the voting shares in XCO 2 and there is no attribution of ownership among siblings and no attribution of ownership from a nonresident, non-citizen individual to a U.S. person. Consequently, the U.S. Shareholder group composed of Child B and Child C own shares representing a combined 20% of the voting power in XCO 2.

- In addition, the shares of XCO 2 owned by Trust 1 are attributable to its beneficiaries in proportion to their actuarial interest in the trust or based on facts and circumstances. The value of the preferred shares is added to the value of the common shares. Assuming that valuation is determined based on discounted cash flows over a period of time, the disparity between the coupon rate on the preferred shares and the dividend rate on the common shares suggests that the common shares may be worth five times the value of the preferred shares.

- Using a facts and circumstances method of valuing trust interests as followed in Private Letter Ruling 9024076, none of the children constructively own the preferred shares actually owned by Trust 1 because all distributions of Trust 1 are paid to Father. As a result, by applying the rules of attribution, Father and Child A together own at least 83% of the value of the XCO 2, while the U.S. Shareholder group would own shares representing 17% of the value.

- If, however, the Trust 1 instrument called for mandatory distributions to Father and children in line with capital interests, Child B and Child C would be deemed to own shares representing 60% of the value of the preferred shares of XCO 2. Based on the assumption that valuation is determined based on discounted cash flows over a period of time, the preferred shares of XCO 2 are worth approximately 16.7% of total value of the company. Child B and Child C would own approximately 10% of the value of SCO 2 by attribution and 20% of the value of the voting common shares, assuming no minority discount. As the value of the common shares is approximately 83% of the total value of the company, Child A and Child B would own directly shares having an additional 16.6% of value of XCO 2. Because U.S. Shareholders would own approximately 33.33% of the value of the shares of XCO 2, XCO 2 is not a C.F.C. The status of XCO 2 is not changed by the T.C.J.A. It does not become a C.F.C. because the allocation of value remains unchanged by the new provision.

HoldCo

- Under pre-T.C.J.A. law, HoldCo is not a C.F.C. because XCO 1, XCO 2, and Trust 2 own all issued and outstanding shares.

- Regarding shares owned through XCO 1, the conditions that prevent XCO from being a C.F.C. also prevent attribution of HoldCo shares to Child B and Child C. Father owns the only voting shares of XCO 1. Consequently, no voting shares in HoldCo held by XCO 1 can be attributed to Child B and Child

C. Moreover, the history of Father receiving all distributions from Trust 1 with no likelihood of a change in the distribution pattern, would prevent Child B and Child C from being considered owners of HoldCo through XCO.

- Regarding shares owned through XCO 2, Child B and Child C, together, own 17% of the value of XCO 2 and 20% of the voting shares. Such limited ownership in XCO 2 filters down to indirect ownership in HoldCo.
- The answer should not change as a result of the T.C.J.A. The limited degree of ownership in XCO 2 combined with the absence of ownership by attribution under the principles of Private Letter Ruling 9024076 limits the degree of ownership through Trust 1.
- Even if the Trust 1 instrument called for mandatory distributions to Father and the children in line with capital interests, the answer would not change. Child B and Child C would be deemed to own shares representing 60% of the value XCO 1. Under the changes made by the T.C.J.A., Child B and Child C would be U.S. Shareholders and because they would be viewed to be in control of XCO 1, the 20% ownership of XCO 1 in HoldCo would be attributed to them in full under the constructive ownership rules of Code § 958(b).
- As mentioned above, Child B and Child C together would be deemed to own 33.33% of the value of XCO 2. This is not sufficient to provided control of XCO 2. Consequently the U.S. children will own 33.33% of HoldCo through their ownership of shares in XCO 2. 2 owns 60% of HoldCo, the U.S. children would own 20% of HoldCo through XCO 2.

XF Sub

- Under pre-T.C.J.A. law, XF Sub could not be a C.F.C. because XF P, a foreign corporation with no foreign ownership, owns 90% of its shares. Those shares could not be attributed from XF P to U.S. 1.
- Now that the attribution rule has been changed by the T.C.J.A., the shares of XF Sub can be attributed from XF P to U.S. 1, causing XF Sub to be a C.F.C. and U.S. 1 to be a U.S. Shareholder.
- Note that aside from reporting obligations placed on U.S. 1, the principal effect of the attribution is to cause the unrelated U.S. Sub – a company owned indirectly by Father and his children – to become a U.S. Shareholder in a C.F.C. for all purposes of Subpart F.
- In comparison, the absence of direct or indirect ownership in XF Sub by U.S. 1 will limit the adverse tax consequences of being a U.S. Shareholder to information reporting on Form 5471.
- If XF P owned 100% of the shares of XF Sub, the obligation to file Form 5471 would have been eliminated. In §5.02 of Notice 2018-13, the I.R.S. advised that it intends to provide an exception from the Form 5571 filing obligation for a U.S. Shareholder of a C.F.C. if the following conditions are met:
    - No U.S. Shareholder (including a U.S. subsidiary of a foreign parent) owns, directly or indirectly within the meaning of Code §958(a), stock in a C.F.C.

- The foreign corporation that is deemed to be owned by a U.S. subsidiary of a foreign parent is a C.F.C. solely because the U.S. subsidiary is considered to own the stock of the C.F.C. that is actually owned by its foreign parent.

CONCLUSION – TWO STEPS FORWARD, ONE STEP BACK

The changes made to the Subpart F rules of U.S. tax law were meant to broaden the definition of a C.F.C. To some extent, the "high tax" exception under Subpart F[34] may soften the blow now that U.S. corporate tax has been reduced to 21%.[35] Several results are certain to occur: More foreign corporations will be categorized as C.F.C.'s, and greater compliance costs will be placed on global business. Whether more tax is raised is an open issue.

"More foreign corporations will be categorized as C.F.C.'s, and greater compliance costs will be placed on global business. Whether more tax is raised is an open issue."

[34] Under the high tax exception of Code §954, Subpart F Income is not taxed in the hands of a U.S. shareholder if such income is subjected, in the country of incorporation, to an effective income tax rate greater than 90% of the U.S. maximum corporate tax rate. A C.F.C. and its U.S. Shareholder may be able to wriggle out of the C.F.C. status if the effective tax rate in the foreign jurisdiction is greater than 18.9% (*i.e.*, 90% of 21%).

[35] Code §11(b) as amended by the T.C.J.A. Contrary to most of the other provisions introduced by the T.C.J.A., this rule is not subject to sunset.

INVESTING IN U.S. REAL ESTATE ON A (POSSIBLY) TAX-FREE BASIS

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Tags
F.I.R.P.T.A.
Qualified Foreign Pension Fund
Qualified Shareholder
R.E.I.T.
Tax Reform
T.C.J.A.

A Real Estate Investment Trust ("R.E.I.T.") is an entity that generally owns and typically operates a pool of income-producing real estate properties, including mortgages. R.E.I.T.'s are generally a popular type of investment vehicle. Their investors look to a return on investment in two forms: (i) distributions from the R.E.I.T. and (ii) dispositions of the R.E.I.T. stock.

Essentially, R.E.I.T.'s do not pay corporate-level tax because they are required to distribute 90% of their income to shareholders. However, in order to enjoy this and other tax benefits under the Code, these entities must meet extremely stringent conditions to qualify as a R.E.I.T.

Many R.E.I.T.'s have their stock registered and traded on a stock exchange. These are referred to as publicly traded R.E.I.T.'s, which are granted tax incentives for foreign investors. Other types of R.E.I.T.'s and certain types of investors are also eligible for other favorable tax rules.

These beneficial rules were enhanced by the Protecting Americans from Tax Hikes Act ("P.A.T.H. Act") that was signed into law by President Obama in December 2015 and were left untouched by the Tax Cuts and Jobs Act ("T.C.J.A.") signed by President Trump in December 2017. As a result, under certain facts, some foreign investors can invest in a R.E.I.T. on a completely tax-free basis, both with respect to distributions received from the R.E.I.T. and with respect to the disposition of the R.E.I.T. stock.

TAXATION OF FOREIGN INVESTORS IN A U.S. R.E.I.T.

Taxation of R.E.I.T. Distributions

Distributions from a R.E.I.T. are generally designated as either "ordinary dividends" or "capital gain dividends." Certain distributions, or a portion thereof, may be treated as return of capital.

Typically, this treatment is a result of R.E.I.T. deductions, specifically (i) depreciation deductions, which generally were expanded and extended under the T.C.J.A., and (ii) interest expense deductions, which were limited under the T.C.J.A. (albeit R.E.I.T.'s, like other real estate businesses, are allowed to elect out of this limitation at the cost of losing some accelerated depreciation).

Ordinary Dividends

Ordinary dividends are attributable to earnings that are derived from ordinary income of the R.E.I.T., such as rents and mortgage interest. For foreign investors, ordinary dividends are treated as a Fixed or Determinable, Annual or Periodic ("F.D.A.P.") payment and are generally subject to 30% U.S. Federal withholding tax.

The withholding tax rate may be reduced or eliminated under an applicable income tax treaty. Typically, treaties restrict the benefit available to ordinary dividend income when the dividend is paid by a R.E.I.T.

The table below highlights some of the treaties under which a reduced rate is available, the type of treaty country resident that may be eligible for the reduced rate, and other general requirements that must be met (in addition to any limitation on benefits provision requirements):

Country	Eligible Resident	Rate	Ownership Requirements*
China	Individuals Pension Funds Other Residents	10% 10% 10%	None None None
Denmark	Individuals Pension Funds Other Residents	15% 0% 15%	If ownership is no more than 10% If ownership is no more than 10% If R.E.I.T. is publicly traded and ownership is no more than 5%, or if R.E.I.T. is diversified[1] and ownership is no more than 10%
France	Individuals Pension Funds Other Residents	15% 15% 15%	If ownership is no more than 10% If ownership is no more than 10% If R.E.I.T. is publicly traded and ownership is no more than 5%, or if R.E.I.T. is diversified[1] and ownership is no more than 10%
Germany	Individuals Pension Funds Other Residents	15% 0% 15%	If ownership is no more than 10% If ownership is no more than 10% If R.E.I.T. is publicly traded and ownership is no more than 5%, or if R.E.I.T. is diversified[1] and ownership is no more than 10%
Japan	Individuals Pension Funds Other Residents	10% 10% 10%	If ownership is no more than 10% If ownership is no more than 10% If R.E.I.T. is publicly traded and ownership is no more than 5%, or if R.E.I.T. is diversified[1] and ownership is no more than 10%
Luxembourg	Only Individuals	15%	If ownership is less than 10%
Thailand	Individuals Pension Funds Other Residents	15% 30% 30%	If ownership is less than 25% None None
United Kingdom	Individuals Pension Funds Other Residents	15% 0% 15%	If ownership is no more than 10% If ownership is no more than 10% If R.E.I.T. is publicly traded and ownership is no more than 5%, or if R.E.I.T. is diversified[1] and ownership is no more than 10%

* Other requirements may apply.

[1] A R.E.I.T. is treated as diversified if no one underlying property is worth more than 10% of its total holdings.

Capital Gain Dividends

A capital gain dividend is any dividend that is designated by the R.E.I.T as such in a written notice to its shareholders. Limitations apply as to the amount a R.E.I.T. may designate as capital gain dividends.

A capital gain dividend is treated as a gain from the sale or exchange of a long-term capital asset. This means that the receipt of a capital gain dividend is treated as a sale or exchange of a capital asset and thus would be taxed as long-term capital gain in the hands of the investor. However, this capital gain is not subject to U.S. tax in the hands of a non-U.S. investor to the extent that it is not attributable to gain from the disposition of a U.S. real property interest. This tax-free treatment is provided for in the Code under the general provisions applicable to the taxation of non-U.S. persons.

The disposition of a U.S. real property interest ("U.S.R.P.I.") by a foreign person is subject to U.S. tax under the Foreign Investment in Real Property Tax Act ("F.I.R.P.T.A."). Under F.I.R.P.T.A., the above-mentioned general rule for the treatment of capital gain dividends is modified. Under a "look-thru" rule, capital gain dividends attributable to a disposition of a U.S.R.P.I. will be treated as gain from the disposition of a U.S.R.P.I. Thus, such distributions ("F.I.R.P.T.A. Distributions") are generally treated as income effectively connected to a U.S. trade or business and subject to F.I.R.P.T.A. withholding. F.I.R.P.T.A. withholding applies at the maximum corporate rate applicable, currently 21% (reduced by the T.C.J.A. from 35%).

Taxation of the Disposition of R.E.I.T. Shares

As mentioned above, non-U.S. persons are subject to U.S. tax on the disposition of a U.S.R.P.I. The tax is collected by imposing a withholding obligation on the purchaser under F.I.RP.T.A.

The stock of a R.E.I.T. generally constitutes U.S.R.P.I. if the fair market value of its U.S.R.P.I. exceeds 50% of the fair market value of its world-wide real property and other business assets. However, under a special F.I.R.P.T.A. exception, the stock of a publicly traded R.E.I.T. does not constitute a U.S.R.P.I. in the hands of a non-U.S. person who owns 10% or less of the entity's stock. Additionally, the stock of a R.E.I.T. that is "domestically controlled" does not constitute a U.S.R.P.I.

As a result, the general rule is that a non-U.S. person will be subject to U.S. tax on the disposition of R.EI.T. stock. The gain on the disposition is treated as effectively connected income, and tax is collected through withholding. Over-withholding can be refunded by filing a U.S. tax return and calculating the actual tax liability or by submitting an advance determination application to the I.R.S. However, in certain instances, an exception applies, as will be discussed below.

BENEFICIAL R.E.I.T. STRUCTURES FOR FOREIGN INVESTORS

If structured properly, foreign investors in a U.S. R.E.I.T. may reduce and, in some instances, fully eliminate U.S. taxation. The following discusses possible R.E.I.T. structures that take advantage of beneficial statutory provisions.

Publicly Traded R.E.I.T.'s

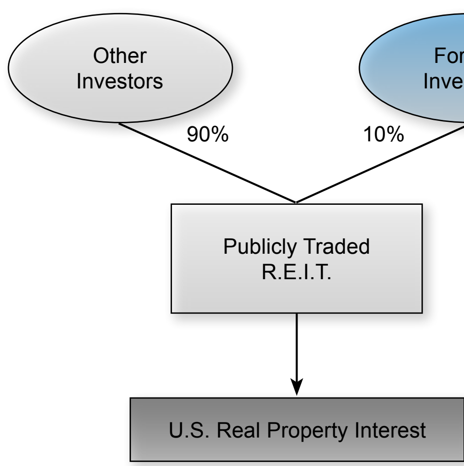
As previously mentioned, stock of a R.E.I.T. that is regularly traded on an established securities market is not treated as a U.S.R.P.I. in the hands of a non-U.S. person who owns (directly or indirectly, and by applying the constructive ownership rules) 10% or less of the R.E.I.T. stock at all times during the holding period or during the last five years, if shorter.

Additionally, the look-thru rule, mentioned above, does not apply to distributions received with respect to publicly traded stock, provided that the receiving non-U.S. person did not own more than 10% of the R.EI.T. stock at any time during the one-year period ending on the date of the distribution. However, these distributions are subject to tax under the Code as ordinary dividend distributions.

As a result, when a R.E.I.T. is publicly traded, the general taxation rules apply with the following modifications applicable only to non-U.S. investors with shareholdings of 10% or less:

- F.I.R.P.T.A. Distributions are treated as ordinary dividend distributions.
- Dispositions of R.E.I.T. stock are not subject to U.S. taxation.

Investing 10% or Less in a Publicly Traded R.E.I.T.



Ordinary Dividends: F.D.A.P. withholding applies at 30% unless reduced or eliminated by the applicable tax treaty

Capital Gain Dividends: Not subject to F.I.R.P.T.A. withholding if attributable to gain from the sale of a U.S.R.P.I. but treated as ordinary dividends and subject to tax as discussed above

Disposition of Stock: Gain realized on the sale of a publicly traded R.E.I.T. is not subject to F.I.R.P.T.A. withholding or U.S. income tax in the hands of a ≥ 10% foreign investor

Domestically Controlled R.E.I.T.'s

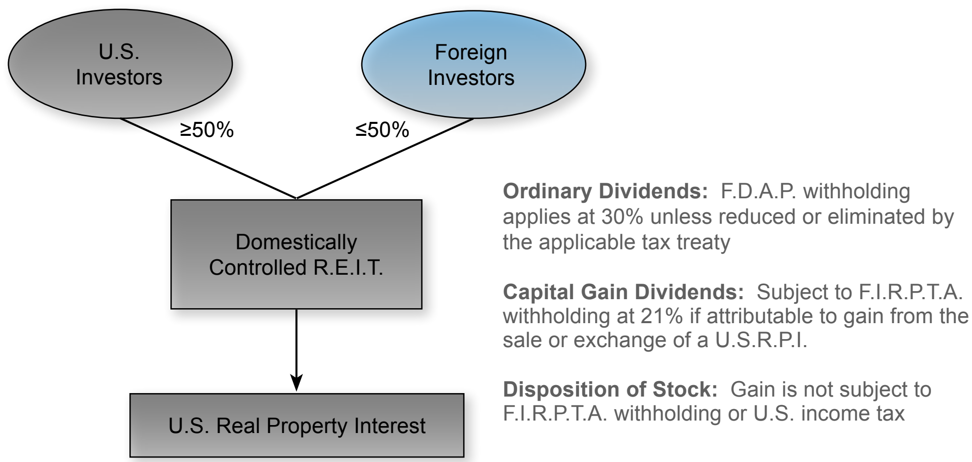
Stock in a domestically controlled R.E.I.T. is not treated as a U.S.R.P.I. A R.E.I.T. is domestically controlled when 50% or more of the value of the stock is held by U.S. persons for the five-year period ending on the determination date or the period of the R.E.I.T.'s existence, if shorter.

When a R.E.I.T. is domestically controlled, the general taxation rules apply with the following modifications:

- Dispositions of domestically controlled R.E.I.T. stock are not subject to U.S. taxation.

- The F.I.R.P.T.A. exception applicable to domestically controlled R.E.I.T. stock is not limited by ownership percentages (*i.e.*, if a R.E.I.T. is domestically controlled, a non-U.S. person may own more than 10% and the stock will not be treated as a U.S.R.P.I.).

Investment in a Domestically Controlled R.E.I.T.



BENEFITS FOR QUALIFIED SHAREHOLDERS AND QUALIFIED FOREIGN PENSION FUNDS

Qualified Shareholders

Special benefits are available to "Qualified Shareholders." These include the following:

- The stock of a R.E.I.T. held by a Qualified Shareholder is not treated as a U.S.R.P.I., and therefore, the disposition of R.E.I.T. shares by a Qualified Shareholder will not be subject to U.S. taxation.
- F.I.R.P.T.A. Distributions are treated as ordinary dividend distributions.

A Qualified Shareholder is generally a foreign person that meets the following three conditions:[2]

1. The foreign person is

    a. publicly traded and qualifies for certain U.S. tax treaty benefits or

    b. a foreign partnership that has at least half of its value represented in units that are traded on the N.Y. stock exchange or Nasdaq and was formed in a foreign country with a U.S. tax-information sharing agreement.

2. The foreign person is a "Qualified Collective Investment Vehicle" – that is, it meets any one of three conditions:

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[2] Code §897(k)(3)(A)-(B).

a. The foreign person is eligible (or would be under a U.S. tax treaty) for reduced withholding on ordinary dividends from the R.E.I.T. irrespective of the ownership percentage.

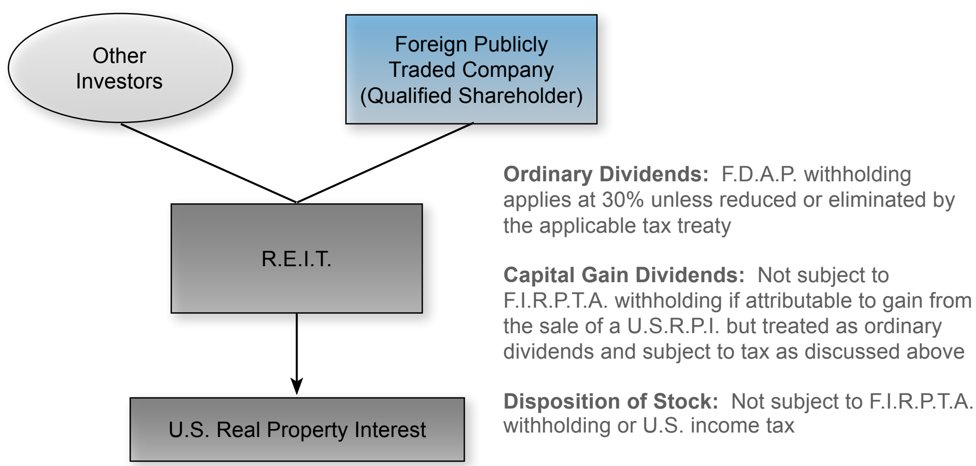
b. The foreign person is: (i) a publicly traded partnership that is a "withholding partnership"[3] and (ii) would be treated as a U.S. real property holding corporation if it were a domestic corporation.

c. The foreign person is a fiscally transparent entity (or effectively treated as such) and is designated as a Qualified Collective Investment Vehicle by the I.R.S.

3. If its shares are publicly traded, the foreign person maintains records of the identity of each person that holds directly 5% or more of its shares.

"The stock of a R.E.I.T. held by a Qualified Shareholder is not treated as a U.S.R.P.I."

Investment by a Qualified Shareholder in a R.E.I.T.



Qualified Foreign Pension Funds

F.I.R.P.T.A. is not applicable to interests held directly (or indirectly through one or more partnerships or through a wholly owned entity) by a Qualified Foreign Pension Fund ("Q.F.P.F."). As a result, capital gain dividends received by a Q.F.P.F. are not separated into F.I.R.P.T.A. Distributions and other capital gains. Rather, the general rule, according to which capital gain dividends are treated as gain from the sale or exchange of a long-term capital asset, applies. And as mentioned above, these dividends are not subject to tax in the hands of a non-U.S. person. Additionally, the disposition of R.E.I.T. shares is treated as a disposition of any U.S. asset that is not a U.S.R.P.I. and is thus not subject to U.S. tax.

Therefore, the only U.S. tax that may apply to an investment in a R.EI.T. (publicly traded or not, domestically controlled or not) made by a Q.F.P.F. is that which would apply to ordinary dividends. Ordinary dividend income may be subject to a reduced

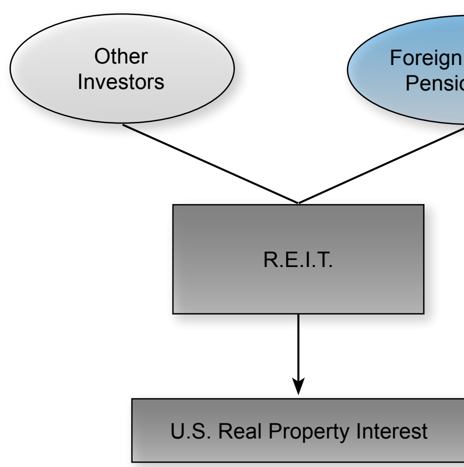
[3] Meaning, a foreign partnership that entered into an agreement with the I.R.S. to assume the withholding and reporting obligations for certain payments of U.S. source income that are included in the distributive share of its foreign partners.

rate of taxation under certain treaties, and in certain instances, as demonstrated in the table above, the tax may be eliminated.

A Q.F.P.F. means any trust, corporation, or other organization or arrangement that meets all the following conditions:[4]

- The pension fund must be created or organized under the laws of a country other than the U.S.
- The pension fund must be established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for services rendered.
- The pension fund must not have a single participant or beneficiary with a right to more than 5% of its assets or income.
- The pension fund must be subject to government regulation and provide annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates.
- Under the laws of the country in which the fund is established or operates,
    - contributions to the fund that would otherwise be subject to tax are deductible or excluded from the gross income of the entity or taxed at a reduced rate or
    - tax on any investment income is deferred or the income is taxed at a reduced rate.

Investment by a Qualified Foreign Pension Fund in a R.E.I.T.[5]



Ordinary Dividends: F.D.A.P. withholding applies at 30% unless reduced or eliminated by the applicable tax treaty

Capital Gain Dividends: Not subject to F.I.R.P.T.A. withholding if attributable to gain from the sale of a U.S.R.P.I.

Disposition of Stock: Not subject to F.I.R.P.T.A. withholding or U.S. income tax because the interest is not a U.S.R.P.I.

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4 Code §897(l)(2).

5 The F.I.R.P.T.A. exemption coupled with 0% withholding on ordinary dividends, if eligible, allows a foreign pension fund to invest in a U.S. R.E.I.T. on a tax-free basis.

SUMMARY

In general, R.E.I.T.'s offer a tax efficient investment vehicle by allowing the R.E.I.T. to deduct distributions it makes to its shareholders. But when it comes to foreign investors, R.E.I.T.'s offer additional benefits that make for interesting investment opportunities – especially through one's pension fund. In certain instances, these investments can be made on a completely tax-free basis.

In sum, a foreign investor's benefit in investing in U.S. real property through a R.EI.T. include

- avoiding state and local taxation on income earned from U.S. real property,
- converting income that would otherwise be treated as effectively connected income to F.D.A.P. income which may be subject to a reduced rate of taxation under a treaty, and
- in certain instances,
    - avoiding or reducing U.S. taxation on ordinary income from U.S. real property,
    - avoiding or reducing U.S. taxation on the disposition of underlying U.S. real property assets, and
    - avoiding U.S. taxation on the disposition of R.E.I.T. shares.

WHEN “DEFECTIVE” IS DESIRABLE – PRE-IMMIGRATION PLANNING FOR FAMILIES WITH U.S. PERSONS

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Tags
Intentionally Defective Grantor Trust
Pre-Immigration Planning
Trusts

When it comes to pre-immigration planning, there are greater opportunities when the individual moving to the U.S. is not yet a U.S. person for U.S. tax purposes: Various techniques are available to increase basis in non-U.S. assets. Trusts can be set up to shield assets from U.S. estate and gift tax exposure. Non-U.S. holdings can be restructured to avoid, for instance, holding shares in passive foreign investment companies or controlled foreign corporations. The list goes on.

However, when the non-U.S. person has a U.S. spouse, the scope of pre-immigration planning is substantially diminished for the assets held by the spouse.

This does not mean, however, that nothing can be done for U.S. tax purposes. One attractive tool is the intentionally defective grantor trust (“I.D.G.T.”).

I.D.G.T.’s take advantage of the dychotomy that exists between the U.S. income tax and the U.S. estate and gift tax treatment of trusts:

- For U.S. income tax purposes, trusts are either treated as the taxpayer (“non-grantor trusts”) or disregarded, with the settlor being treated as the actual taxpayer, (“grantor trusts”).
- For estate tax purposes, a different set of rules exist. A grantor trust does not necessarily result in estate tax inclusion upon the death of the grantor.

An I.D.G.T. is a trust that is disregarded for income tax purposes but respected for estate tax purposes. In order to achieve this result, the trust (i) must fail one of the tests for non-grantor trust status, but (ii) cannot provide the grantor sufficient powers to cause an estate tax inclusion of the trust assets under Code §§2036 and 2038.

If set up correctly, the grantor is liable for income tax on the trust’s income, but the trust assets are not included in the grantor’s estate.

In addition, the income taxes paid by the grantor may constitute, in essence, a non-taxable gift from the grantor to the beneficiaries. Furthermore, assets that are expected to substantially increase in value during the grantor’s life can be sold to the trust in exchange for an interest bearing note – a valuable estate freeze technique.

ACHIEVING AN ESTATE TAX EXCLUSION UNDER CODE §§2036 AND 2038

As a general rule, Code §2036 provides that property transferred during an individual’s lifetime, by trust or otherwise, will be included in the taxable estate if the transferor retained certain rights in the underlying property.

This rule applies to transfers where the transferor has retained certain rights for any of the following periods:

- The transferor's life
- Any period not ascertainable without reference to the transferor's death
- Any period that does not in fact end before the transferor's death

The retained rights must be either of the following:

- The possession or enjoyment of, or the right to the income from, the property
- The right, either alone or in conjunction with another person, to designate the persons who will possess or enjoy the property or the income therefrom

"Property transferred during an individual's lifetime, by trust or otherwise, will be included in the taxable estate if the transferor retained certain rights in the underlying property."

The retention of a right to directly or indirectly vote shares of stock in a controlled corporation constitutes a retention of the enjoyment of transferred property for this purpose.[1] In this context, a controlled corporation is a corporation in which the grantor, and those persons from whom ownership would be attributed under Code §318, own stock possessing at least 20% of the total combined voting power of all classes of stock of the corporation.[2] Code §318 attributes stock owned by an individual's spouse, children, grandchildren, and parents to that individual.[3]

Thus, Code §2036 applies to a transfer of property during an individual's lifetime (or within three years of death)[4] with the following retentions in said property:

- The right to, or the right to designate those entitled to, the possession of the property
- The right to, or the right to designate those entitled to, the enjoyment of the property
- The right to, or the right to designate those entitled to, the income of the property

Certain transfers are excluded from the Code §2036 inclusion rule. These include, but are not limited to, transfers that constitute a *bona fide* sale of the assets subject to the transfer.[5] These transfers must constitute actual sales for adequate and full consideration in money or money's worth.

Under Code §2038, the estate of a decedent must include the value of property transferred, by trust or otherwise, during the decedent's lifetime when certain conditions exist:

- The decedent possessed at death a power (in whatever capacity exercisable) to alter, amend, revoke, or terminate the transfer. This includes any power affecting the time or manner of enjoyment of property or its income,

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1 Code §2036(b)(1).

2 Code §2036(b)(2).

3 Code §318(a)(1). Note that Code §318 contains other attribution rules as well.

4 Code §2035.

5 Code §2036(a).

even though the identity of the beneficiary is not affected.[6]

- Such power (i) is exercisable by the decedent alone or by the decedent in conjunction with another person (without regard to when or from what source the decedent acquired such power) or (ii) was relinquished within three years of death.

As with Code §2036, exceptions exist to the application of Code §2038:

- Inter vivos transfers that constitute *bona fide* sales for adequate and full consideration in money or money's worth[7]
- Where the decedent no longer had the power at the time of death (and within three years from his or her death)[8]
- Where the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property and the power adds nothing to the rights of the parties under local law[9]
- Where the exercise of the decedent's power was subject to a contingency beyond the decedent's control that did not occur before death[10]
- Where the power held by the decedent was subject to an ascertainable standard[11]

ACHIEVING AN INCOME TAX INCLUSION UNDER GRANTOR TRUST RULES

A grantor of a grantor trust, or another person treated as the owner of any portion of a trust, must include all items of trust income, deduction, and credit in computing his or her taxable income, as if he or she had received the items of income or incurred the expenses directly.[12] A non-grantor trust, on the other hand, is treated as a separate taxpayer, and the grantor is not subject to tax on the trust's income. When setting up an I.D.G.T., the trust must be a grantor trust for income tax purposes.

Under the grantor trust rules, a U.S. grantor is generally treated as the owner of a U.S. trust, or portion of a trust, in respect of which the grantor or a non-adverse person (or both) has certain powers enumerated in Code §671 to §679.[13] As a

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6 Treas. Reg. §20.2038-1(a), last paragraph.

7 Code §2038(a)(1); Treas. Reg. §20.2038-1(a)(1).

8 Code §2038(a)(1).

9 Treas. Reg. §20.2038-1(a)(2).

10 Treas. Reg. §20.2038-1(a)(3).

11 *Jennings v. Smith*, 161 F2d 74 (2d Cir. 1947), April 14, 1947.

12 Code §671.

13 Code §672(a). For purposes of the grantor trust rules, a "non-adverse party" is any person that is not an "adverse party." An adverse party is any person that has a substantial beneficial interest in the trust that would be adversely affected by the exercise or non-exercise of that person's power with respect to the trust. A general power of appointment constitutes a beneficial interest in the trust for this purpose.

result, when intentionally desiring grantor trust status, the trust instrument must be drafted as to confer at least one of the powers contained in Code §671 to §679 to the grantor. However, not all such powers can be used without also triggering estate inclusion under Code §§2036 or 2038. Among others, certain reversionary interests,[14] the power to dispose of beneficial enjoyment of trust assets or income,[15] and the power to revest title in the trust property should generally be avoided.[16]

Generally, the following constitutes a non-exhaustive list of powers that would not trigger the Code §§2036 or 2038 inclusion rules:

- More than half of the trustees are related to the grantor or are subordinate to the grantor's wishes and have the power to sprinkle income or corpus among the beneficiaries.[17]
- The grantor retains the power to borrow trust assets without adequate security.[18]
- The grantor, or any other person, has the power, in a non-fiduciary capacity, to reacquire the trust corpus by substituting property of equivalent value.[19]

  Pursuant to Revenue Ruling 2008-22, this type of right should not cause the value of the trust corpus to be included in the grantor's estate under Code §2036 or 2038 if the following conditions are met:[20]

  - The grantor holds the power to substitute assets in a nonfiduciary capacity.
  - The trustee has a fiduciary duty (under local law or the trust instrument) to ensure that the grantor complies with the terms of the power by the trustee's satisfaction that the substituted properties are of equivalent value.
  - The substitution power cannot be exercised in a manner that shifts benefits among the trust beneficiaries.

    This last requirement is only met if the trustee has either (i) both (a) the power (under local law or the trust instrument) to reinvest the trust corpus and (b) a duty of impartiality with respect to the trust beneficiaries, or (ii) the nature of the trust's investments or the level of income produced by any or all of suh investments does not impact the respective interests of the beneficiaries (such as when the trust is administered as a unitrust or when distributions from the trust are limited to discretionary distributions of principal and income.

  Delaware law, for instance, has been modified in order to provide that trustees

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14 Code §673.

15 Code §674.

16 Code §676.

17 Code §674(c).

18 Code §675(2).

19 Code §675(4).

20 Rev. Rul. 2008-22, 4/17/2008.

have a fiduciary duty to make certain that the exchanged assets are of equivalent nature, thereby making it easier to meet the requirements of Revenue Ruling 2008-22.[21]

However, and as stated previously, the power to reacquire voting stock in a controlled corporation may result in estate tax inclusion under Code §2036. As a result, caution is required at the time of drafting the trust instrument.

- Trust income may be paid to the grantor's spouse. [22]
- The income may be used to pay insurance premiums on the grantor's life.[23]

ACHIEVING A GIFT TAX EXCLUSION FOR INCOME TAXES PAYED BY GRANTOR

In Revenue Ruling 2004-64 (the "Ruling"), the I.R.S. examined the gift tax consequences of income tax payments made by the grantor of a grantor trust.[24]

In the Ruling, the I.R.S was presented with the following facts: A U.S. grantor ("Grantor") created an irrevocable intervivos trust for the benefit of Grantor's descendants. The trustee could not be a person related or subordinate to Grantor and the appointed trustee met these requirements. The transfers into trust were not incomplete gifts and were not considered as being subject to Code §§2036 or 2038, but the trust was a grantor trust for income tax purposes.

The I.R.S. concluded that Grantor's income tax payment for trust income did not constitute a gift to the beneficiaries. Further, as long as the trust instrument or the applicable local law did not require the trustee to reimburse the grantor for the payment, the value of the trust's assets was not includible in Grantor's estate. Finally, if the trust instrument or the applicable local law gives the trustee the discretion to reimburse the grantor for such payments, the existence of such disrection (whether exercised or not) will not, by itself, cause the value of the trust's assets to be included in the grantor's gross estate.

ACHIEVING A STEP UP IN BASIS: SALE IN EXCHANGE FOR NOTE

If the grantor first contributes funds or income producing assets into the trust and subsequently the I.D.G.T. acquires assets from the grantor in exchange for a promissory note with interest at the appropriate applicable Federal rate, only the value of the note at the time of the grantor's death will be included in the grantor's taxable estate. The note must reflect the fair market value of the acquired property and a valuation is thus advised. The grantor's initial contribution would constitute a gift for U.S. gift and estate tax purposes, thus decreasing the grantor's lifetime exemption

21 12 Del. C. §3316.

22 Code §§677(a)(1) and (2).

23 Code §677(a)(3).

24 Rev. Rul. 2004-64, 07/01/2004.

amount. Generally, a contribution of 10% of the property value is acceptable,[25] although some practitioners suggest as much as 50%. The note must provide interest payments to the grantor during the grantor's life. It is important that the note bears all attributes of a debt instrument for it to be respected and for this estate freeze technique to work. This technique is especially interesting for assets expected to substantially increase in value during the grantor's lifetime since it essentially freezes the assets' value at the value of the note.

The upsides of the technique are the following:

- An estate tax inclusion is available up to the value of the note at the time of death, and not for the full value of the property, as increased post-sale.[26]
- The lifetime exemption amount is considerably optimized.
- A sale between the grantor and the grantor trust generally does not result in any capital gain or loss, since the trust is disregarded for Federal income tax purposes.[27]

The downside of this technique is the absence of a step-up in basis upon the grantor's death, since the assets are not included in the grantor's estate and the sale is disregarded.

"Only the value of the note at the time of the grantor's death will be included in the grantor's taxable estate."

CONCLUSION

While planning options are available for high net worth U.S. individuals, instruments such as the I.D.G.T. must be carefully drafted and analyzed in order to avoid future backfalls.

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25 PLR 9535026.

26 Code §1014(f), requiring basis consistency with the estate tax return.

27 Rev. Rul. 85-13, not following *Rothstein v. U.S.*, 735 F.2d 704 (2d Cir. 1984).

CAN THE ARM'S LENGTH STANDARD BEAT THE R.A.P.? TRANSFER PRICING AFTER THE T.C.J.A.

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Tags
Aggregate Basis of Valuation ("A.B.O.V.")
Arm's Length
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Realistic Alternatives Principle ("R.A.P.")
T.C.J.A.
Transfer Pricing

By certain measures, December 21 and December 23 were comparable days for the arm's length standard. The law was not changed on either day, but December 22, when the Tax Cuts and Jobs Act ("T.C.J.A.") became law, was an outlier. On that day, the T.C.J.A. introduced a number of measures that reverse the decisions in *Veritas*[1] and *Amazon*.[2]

In those cases, the arm's length standard and the Code §936(h)(3)(B) definition of intangible assets prevailed against enterprise valuation or aggregate approaches to pricing cost sharing buy-in payments. Now, mechanical rules seem to have been adopted for pricing often-controversial controlled transactions involving intangible assets and loans. The arm's length standard has been challenged, like its O.E.C.D. cousin the arm's length principle at the hand of the G-20 B.E.P.S. Project.

Where *Amazon* and *Veritas* held that the definition of an intangible asset was specific, the T.C.J.A. broadens the Code §936(h)(3)(B) definition to include goodwill (both foreign and domestic), going concern value, workforce in place, and "any other item the value or potential value of which is not attributable to tangible property or the services of any individual." Where the former definition was sufficiently specific so as to lead to separate applications of the comparable uncontrolled transaction ("C.U.T.") method by intangible asset type and an overall lower buy-in transaction value, the T.C.J.A. codifies the realistic alternatives principle ("R.A.P.") and aggregate basis of valuation ("A.B.O.V.") argued by the I.R.S. in *Veritas* and *Amazon*.

The purpose of these amendments is to increase the value of intangible asset transfers to controlled taxpayers, whether the assets are sold outright or co-developed through a cost sharing agreement. The provisions should be looked at as a "pay for," *i.e.*, a measure that offsets the lost tax revenue arising from other T.C.J.A. provisions that reduced tax.

This article examines the R.A.P. in view of current transfer pricing regulations and considers whether the A.B.O.V. can serve as an unspecified transfer pricing method under Treas. Reg. §§1.482-4 or 1.482-7.

CODE §482 AMENDMENT

The amended Code §482 reads as follows:

> For purposes of this section, the [I.R.S.] shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an *aggregate basis* ***or*** *the*

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1 *Veritas v. Commr.*, 133 T.C. No. 14 (2009).

2 *Amazon v. Commr.*, 148 T.C. No. 8 (2017).

valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the [I.R.S.] determines that such basis is the most reliable means of valuation of such transfers. [Emphasis added.]

The most reliable means of valuation is either the A.B.O.V. or the R.A.P., and not necessarily both. A.B.O.V. suggests in general terms how a grouping of intangible assets should be valued, but R.A.P. defines the data that should be used as opposed to the valuation technique or equation. This is important as realistic alternatives must be considered as part of the comparability analysis under Treas. Reg. §1.482-1(d) when applying a specified or unspecified method. Comparability is in turn a determinant of the best method under Treas. Reg. §1.482-1(c).

"A.B.O.V. suggests in general terms how a grouping of intangible assets should be valued, but R.A.P. defines the data that should be used as opposed to the valuation technique or equation."

I.R.S. POSITIONS IN *VERITAS* AND *AMAZON*

In *Veritas*, a U.S. parent ("P") and its foreign subsidiary ("S") entered into a cost sharing arrangement pursuant to which P granted S the right to use certain intangibles in exchange for a $166 million buy-in. The C.U.T. method was used to calculate the buy-in amount. The I.R.S. issued a notice of deficiency claiming that the buy-in amount should have been $2.5 billion as measured using the income method.

The income method determines the value of a buy-in payment as the present value of the best realistic alternative to cost sharing. The I.R.S. theory of the case was that this best realistic alternative was a sale of a business. This approach, known as the "akin to sale" theory, relied on the notion that the ex-post increase in the value of the intangible asset was so great that the transaction best resembled a sale in its characteristics.

The I.R.S. ultimately relied on a second report asserting a $1.675 billion buy-in valuation. The allocation took into account items that weren't transferred, like access to the research and development ("R&D") team, or were of insignificant value, such as customer lists and base. It also took into account subsequently developed intangibles, and other intangible assets not covered under Code §936(h)(3)(B) or Treas. Reg. §1.482-4(b), as well as R&D and marketing, in violation of the applicable Code §936(h)(3)(B) condition that these assets lacked "substantial value independent of the services of any individual."

Eight years later, a similar position was taken by the I.R.S. in *Amazon*.[3] In this case, a U.S. parent ("P2") and its Luxembourg subsidiary ("S2") entered into a cost sharing arrangement pursuant to which P2 granted S2 the right to use certain intangibles in exchange for a $254.5 million buy-in. In addition, S2 was also required to make annual payments for ongoing intangible development costs incurred at different centers to the extent that they would benefit S2. The C.U.T. method was used broadly to calculate the buy-in amount. The I.R.S. issued a notice of deficiency claiming that the buy-in amount should have been $3.6 billion, later reduced to $3.468 billion, as measured using the discounted cash-flow method ("D.C.F."). The D.C.F. used was equivalent to the income method application in *Veritas*.

The I.R.S. here too applied an akin to sale theory, which applied an enterprise

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[3] For detailed commentary on the *Amazon* decision, see "Amazon Makes the C.U.T. – An Important Taxpayer Win, a Reminder to Consider Transactional Evidence," *Insights* 5 (2017).

valuation that included calculation assets that were either not transferred under the arrangement or not covered intangibles. A covered intangible, as shown in *Veritas*, was defined under Code §936(h)(3)(b) to include the five listed categories that have "substantial value independent of the services of any individual" and "other similar items." In contrast, the I.R.S. enterprise valuation approach took into account items such as goodwill and going concern value, which at that time could not be bought and sold independently as they were inseparable components of an enterprise's residual business value.

AGGREGATION AND REALISTIC ALTERNATIVES

The T.C.J.A. amendment is not the first mention of aggregation in the transfer pricing regulations. Aggregation of transactions is required when transactions are so interrelated that aggregate transaction pricing is the most reliable approach under the best method rule. The decision to aggregate is based on (i) the extent to which the transactions are economically interrelated and (ii) the relative reliability of the measure of an arm's length result. In other words, the taxpayer must determine whether an aggregate analysis of all transactions leads to a more accurate result than a separate analysis of each transaction.[4]

"Companies must be prepared not only to identify the best alternative but to vigorously explain why other alternatives are inferior."

The expanded definition of an intangible asset under Code §936(h)(3)(B) may catch all types of valuable intangible assets, but the use of A.B.O.V. is not explicitly conditional on either some or all asset types being economically interrelated. A.B.O.V. instead assumes economic interrelatedness as a condition for aggregation of assets and is subject to a reliability test. A.B.O.V. would appear to be deficient as a best method in the event that there is insufficient evidence of economic interrelatedness between all the types of intangible assets aggregated for the purpose of using A.B.O.V. However, the I.R.S. is granted the discretion to make the determination.

R.A.P. is also subject to a reliability test under the amended Code §482. Reliability is itself a condition for the selection of the best method, with its two primary factors being the degree of comparability between the controlled and any uncontrolled transactions and the quality of the data and assumptions used in the transfer pricing analysis. Corroboration of a reliable measure using another specified or unspecified transfer pricing method is a further factor affecting reliability.

The term "realistic alternatives" is a familiar concept in the existing transfer pricing regulations. Realistic alternatives are the foundation of the income method used to determine a minimum buy-in or platform contribution transaction ("P.C.T.") payment using an alternative stream of long-term licensing income. This principle is also relied on to guide the selection of a discount rate that is used to calculate the value of the P.C.T., cost sharing payments, and alternative licensing income on the transaction date. It also accurately reflects the risk of a long-term licensing alternative. The income method references a controlled participant's best realistic alternative to entering into a cost sharing arrangement, as distinct from one realistic alternative among many candidates as implied by the language of the amended Code §482. Absent further guidance, controversy may arise when the convention of ranking alternatives commonly assumed to be standard behavior of company decision-makers confronts the ability of the I.R.S. to select any alternative from a set of realistic alternatives. Companies must be prepared not only to identify the best alternative

[4] Treas. Reg. §1.482-1T(a)(i)(B).

but to vigorously explain why other alternatives are inferior.

Outside of the popular cost sharing option, intangible asset sales and licensing guidance under Treas. Reg. §1.482-4 require that an unspecified method used to value an intangible asset transfer should result in prices or profits that are preferable to those otherwise obtainable from choosing a realistic alternative to the controlled transaction.[5] Here, again, the taxpayer faces an explicit ranking condition among realistic alternatives, this time expressed in terms of prices or profits. An unspecified method is one of four possible methods used to determine the arm's length amount charged in a controlled intangible property transaction. An application of any of the other three candidate methods under the best method rule requires the consideration of "the alternatives realistically available to the buyer and seller."[6]

Finally, alternatives are the basis for recharacterizing a transaction when economic substance is lacking. The cost or profit associated with an alternative may be used to adjust the consideration charged in a controlled transaction.[7] In this instance, the selection of an alternative to the actual transaction depends on whether either "would be acceptable" if evaluated by an uncontrolled taxpayer operating under comparable circumstances. While the term "reasonable" is not used here to describe candidate alternatives, it is clear that the selection of the price or cost arising from an alternative transaction must be a process of rational choice modelled on the behavior of a similar taxpayer and constrained by the circumstances of the actual transaction.

IS A.B.O.V. AN INEVITABLE APPROACH UNDER R.A.P.?

Assuming an outright sale of intangible property is a realistic alternative, as was the I.R.S. view in *Amazon* and *Veritas*, is it necessarily the case (as was also the I.R.S. view) that A.B.O.V. would be used to determine the price of the intangible assets being sold? First, it is not clear that an outright sale was the highest ranking or best alternative. Setting this important consideration aside, given the reasonable alternative is a sale, three specified transfer pricing methods and one unspecified method must be considered under Treas. Reg. §1.482-4. Only the unspecified method allows for an approach approximating A.B.O.V. The comparable profits method and profit split method appear to be non-transactional methodological options in view of their ability to capture (though not necessarily to explain) returns to a wide range of intangible asset types. Applying the best method rule and the relevant comparability criteria, it is not a foregone conclusion that A.B.O.V. should be selected as the best method.

ARM'S LENGTH STANDARD OR R.A.P.?

While at first reading the A.B.O.V. and R.A.P. appear to tend toward an *ipse dixit* approach echoing the treatment of stock option costs in cost sharing arrangements invalidated in *Altera* and the introduction of the commensurate-with-income standard,

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5 Treas. Reg. §1.482-4(d)(1).

6 Treas. Reg. §1.482-1(d)(3)(iv)(H).

7 Treas. Reg. §1.482-1(f)(2)(ii)(A).

closer analysis suggests otherwise.

Elements of intangible asset pricing guidance now appear in Code §§936 and 367, but consistency with Code §482 is maintained by the T.C.J.A. While the amendments signal a frustration with the arm's length standard exemplified elsewhere in the T.C.J.A. and in other O.E.C.D.-member Diverted Profits Tax regimes, the implementation of the Code §482 amendments is explained by existing definitions in the current regulations under Code §482. How the amendments will work with the existing regulations is another matter. The issuance of updated regulations may provide clarity over time. Until that clarity is achieved, companies should interpret the amended Code §482 and existing regulations in a forward-looking manner consistent with the I.R.S. positions in *Amazon* and *Veritas*.

R.A.P. and A.B.O.V. are not replacements for the arm's length standard and must meet the conditions of the best method approach to achieve a reliable outcome. For the time being, it looks like the arm's length standard has beaten the R.A.P. Future controversy is likely to focus on the reliability of the intangible asset valuation and the abuse of discretion exercised by the I.R.S. in determining an alternate means of valuation.

NEW YORK RESISTING S.A.L.T. CAP UNDER FEDERAL TAX REFORM

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Tags
New York
Tax Reform
T.C.J.A.

One of the most headline-grabbing provisions of the Tax Cuts and Jobs Act of 2017 ("T.C.J.A.") is the significant limitations placed on the deductibility of state and local taxes ("S.A.L.T. Taxes") under Code §164. Taxpayers in states that impose relatively high S.A.L.T. Taxes on income and property may experience Federal income tax increases. New York, like other states, is pursuing a workaround to mitigate the impact on its residents.

Under prior law, individual taxpayers were allowed to deduct state and local income and property taxes as itemized deductions under Code §164(a). Further, in lieu of deducting state and local income tax, taxpayers could deduct state and local sales taxes.[1]

Under the new law, the deductible amount of state and local income, sales, and property taxes is temporarily limited to $10,000 per tax year. The limitation applies to tax years 2018 through 2025.[2]

In a report by the New York State Department of Taxation and Finance, entitled the Preliminary Report on the Federal Tax Cuts and Jobs Act (the "N.Y. Report"), the department estimates that the limitations on S.A.L.T. Taxes deductibility will cost New York taxpayers an additional $14.3 billion per year. It further states that the new limitation could threaten the progressivity of the state's tax rates and its ability to provide government services, which could incentivize individual residents to leave the state.

PROPOSED REFORMS TO MITIGATE THE S.A.L.T. TAXES DEDUCTIBILITY LIMITATION

As a response, the N.Y. Report proposes state tax legislation aimed at reducing the state's reliance on personal income tax. Two hotly-debated proposals are

- a state charitable contribution deduction that would allow individual taxpayers to receive a charitable deduction against their S.A.L.T. Taxes for contributions to state-operated charitable funds, and
- an employer compensation expense tax system under which employers would pay a tax on payroll expense and employees would receive a credit against S.A.L.T. Taxes equal to the employer's payroll expense tax.

In February, Governor Andrew Cuomo released the Fiscal Year 2019 Executive

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1 Code §164(b)(5). This election is generally made by taxpayers in states that do not impose income tax.

2 Code §164(b)(6).

Budget legislation (the "F.Y. 2019 Budget") with several amendments to address the impact of the T.C.J.A. on New York residents. The F.Y. 2019 Budget includes proposals for the establishment of state-operated charitable contribution funds and an employer-side payroll tax and employee S.A.L.T. Taxes credit. It includes a provision to require taxpayers to add back the dividends received deduction ("D.R.D.") under Code §965(c) relating to the Federal D.R.D. on deemed repatriated income, as discussed below, to the N.Y. tax base, thereby preventing an unanticipated windfall to affected taxpayers. N.Y. tax law would decouple from the Federal tax law, where necessary, to avoid more than $1.5 billion in state tax increases brought solely by increases in Federal tax law changes.

Charitable Contribution Deduction

The F.Y. 2019 Budget seeks to establish charitable contribution funds that could be used to provide a Federal credit against N.Y. tax to compensate for the limited S.A.L.T. Taxes deduction.

If enacted, N.Y. would establish a state-operated charitable gifts trust fund for a health charitable account and an elementary and secondary education account.[3] The charitable gifts trust fund would be kept separate from other tax revenue funds and could be invested in U.S. or state obligations upon consultation with the director of the budget. The proceeds of this fund could not be transferred to or used by other funds. Funds from the health charitable account would be used exclusively to support primary, preventive, inpatient, routine dental and vision care; hunger prevention; and nutritional assistance services to N.Y. residents. Funds from the elementary and secondary education charitable account would be used exclusively to support elementary and secondary education for N.Y. children. Taxpayers who make contributions to the healthcare or education accounts would be allowed a credit equal to 85% of the amount contributed.

In addition, the governing boards of any N.Y. county or New York City could establish "charitable gifts reserve funds" for the payment of health care and medical assistance expenses. Interest earned and capital gains realized would become part of the fund. At the end of the fiscal year, the municipal funds would be transferred to the general fund or other municipal fund to pay off health care expenses. Taxpayers would be entitled to a 95% credit of the real property taxes imposed by a participating municipal corporation.

Some states already have similar charitable programs in place, and officials in Maryland, Rhode Island, New Jersey, and California have expressed interest in a establishing similar plans. Currently, businesses in New Hampshire can donate to certain school choice scholarship programs that offer a tax credit worth 85% of the contribution. A new bill proposes to expand the program to individuals with respect to certain passive income.

Ultimately, the fate of the charitable contribution funds proposals may depend on the Federal government's response.

While I.R.S. Publication 526 does not allow deductions for contributions from which the taxpayer receives or expects to receive a financial or economic benefit,[4] states

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[3] Education and healthcare comprised 60% of state spending in fiscal year 2018.

[4] I.R.S. Publication 526.

are arguing that tax benefits are not considered income or value in a traditional sense and therefore the deduction should be allowed. Those in favor of these proposals have stated that historically Federal laws, case law, and rulings have ignored the potential for state tax benefits ons and it would be inconsistent to suddenly declare otherwise.[5]

In Chief Counsel Advice 201105010 (the "Advice"), the Chief Counsel decided that a payment of cash to a state agency or charitable organization was a charitable contribution under Code §170 and not a possible deductible tax under Code §164. For a payment to be a Code §170 charitable contribution, the transfer must be a gift without receipt of adequate consideration and made with charitable intent. The intent of a transfer is not charitable if the transferor expects a direct or indirect return. If a benefit is received, the taxpayer may only deduct the contribution amount in excess of the fair market value of the benefit.

"Could such a credit be viewed as an abusive tax shelter in light of the avowed intention to circumvent Federal tax law?"

The Advice looked at taxpayer contributions to four state tax credit programs that made the taxpayers eligible to receive state tax credits. In a joint tax return, the taxpayers claimed a charitable contribution deduction and were granted state tax credits equal to a percentage of the approved contributions. The taxpayers used certain credits to offset their income tax liability, sold certain credits to other individuals, and carried forward the rest.

The Advice held that the tax benefit of a Federal or state charitable contribution deduction is not the type that negates charitable intent as decided in *Mclennan v. U.S.*,[6] where the court held that a taxpayer is entitled to a deduction even though a donation was made exclusively for obtaining a tax benefit. Instead, the Advice focused on whether the benefit of a state tax credit is distinguishable from the benefit of a state tax deduction. The Advice held that it was not.

Generally, a S.A.L.T. Taxes benefit is treated as a reduction or potential reduction in tax liability and therefore simply a reduction akin to a Code §164 deduction, not akin to a cash payment.

For alternative minimum tax purposes, a deduction for S.A.L.T. Taxes is disallowed under Code §56(b)(1)(A)(ii). As a result, taxpayers subject to the alternative minimum tax frequently opted to make charitable gifts, which generated a state tax reduction through credits. Generally, a "quid pro quo" rule applied that reduced the amount of the deduction received by the value of the benefits obtained.[7]

Historically, taxpayers have never been required to reduce the amount of a Federal charitable deduction by the value of state benefits reaped by the gift, even if the contributions were made to avoid taxes.[8] If a state grants a taxpayer an income tax credit, it is treated as an adjustment to the yet undetermined state income tax liability.[9]

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5 Joseph Bankman, et. al., *Federal Income Tax Treatment of Charitable Contributions Entitling Donor to a State Tax Credit* (January 8, 2018). UCLA School of Law, Law-Econ Research Paper No. 18-02. Available at SSRN.

6 *McLennan v. U.S.*, 23 Cl. Ct. 99 (1991).

7 Treas. Reg. §170A-1(h)(2)(i).

8 *Skirpak v. Commissioner*, 84 T.C. 285 (1985); *Allen v. Commissioner*, 92 T.C. 1(1989).

9 Rev. Rul. 79-315.

Nonrefundable tax credits should be treated as reducing tax detriments and not payments from the state to the taxpayer.[10] This is sometimes referred to as the "Full Deduction Rule" – the amount of the donor's charitable contribution deduction is not reduced by the value of state tax benefits.[11]

A reduction of the state and local tax deduction, coupled with the allowance of a charitable deduction, would appear "tax neutral," except where other provisions, such as the alternative tax come into play. Still, questions remain: Would there be a similar holding where the Code §164 deduction has been reduced by statute? Could such a credit be viewed as an abusive tax shelter in light of the avowed intention to circumvent Federal tax law?[12] If the I.R.S. determines that the credit has the potential for tax avoidance or evasion, taxpayers, promoters, certain facilitating parties (such as exempt organizations and their officers), and material advisors would have obligations to disclose their participation in these regimes. The reporting obligations are further incentivized by a series of substantial penalties or excise taxes.

Others have noted a public policy concern and a fear that these contributions will prevent funds from being allocated to public-school systems, public services, and private charities.

Using Employer-Side Payroll Taxes to Offset Personal Income Taxes

Though the T.C.J.A. significantly limits state income tax deductibility for individuals, an employer's portion of taxes on payroll (referred to as "employer-side payroll taxes") remains deductible.

Payroll taxes are taxes imposed on employers and employees by the Federal government and some states. They generally are calculated as a percentage of the salaries or wages that an employer pays to its employees. Payroll taxes on employees generally are deducted from the employee's wages and withheld and remitted to the Federal or state government by the employer. Payroll taxes on employers are paid from the employers' own funds and are directly related to employing an employee. An example of Federal payroll taxes is the taxes imposed under the Federal Insurance Contributions Act ("F.I.C.A."), which include the Social Security Tax and Medicare Tax. Employees and employers generally pay the same percentage of F.I.C.A. taxes.

The N.Y. Report proposes enacting legislation to establish a new employer compensation expense tax system under which employer-side payroll taxes would be used to raise the state's revenue. The objective of such a system is to rely more on

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10 CCA 201147024.

11 Treas. Reg. §170A-1(h)(2)(i)(B).

12 As reported by CNN Money on January 16, 2018, Governor Cuomo has made explicit statements about the purpose of the charitable contribution funds:

> He urged the state's lawmakers Tuesday to take action now to avoid it [the cap]. . . . In exchange for the charitable contribution, the state would issue the resident a tax credit, although it's not likely to be dollar for dollar, Cuomo said. In addition[,] the resident could deduct his charitable contribution on his federal tax return, since the new federal tax law does not curb charitable deductions. ("How New York's Governor Wants to Get Around the SALT Cap.")

employer-side payroll taxes and less on personal income taxes. The result would mitigate the effect of the individual S.A.L.T. Taxes deductibility limitations. Several variations of an employer compensation expense tax system are discussed in the N.Y. Report, including systems that would be either progressive or flat rate, a system that would apply only to wages above a certain threshold, or an opt-in system. Under each proposal, the personal income tax on non-wage income would be maintained. Thus, for example, interest and dividend income will remain subject to personal income tax.

Under the F.Y. 2019 Budget, if enacted, the proposed employer compensation expense tax system would be optional, requiring the employer to elect to be subject to tax on its payroll expense (referred to as the Employer Compensation Expense Tax or E.C.E.T. system).[13] For the purpose of this new tax, payroll expense is defined as wages and compensation under Federal tax law, including Code §3121 (which defines terms such as wages, employment, and employer under F.I.C.A.) paid to all "covered employees." It would apply only to employees of an electing employer whose wages or compensation exceed $40,000 per year and are subject to payroll taxes. The election must be made by October 1 of a calendar year and will apply to the immediately succeeding calendar year.

Under the proposed system, the employer would pay an E.C.E.T. on its quarterly payroll expense at the following rates:

- 1.5% for 2019
- 3% for 2020
- 5% for 2021 and thereafter

The E.C.E.T. would apply only on payroll expense paid to covered employees during the calendar year in excess of $40,000.

A covered employee would be allowed a credit against the employee's personal income tax equal to the product of the E.C.E.T. paid by the employer and a fraction:

- For 2019, the credit would equal the E.C.E.T. (*i.e.*, the product of the covered employee's wages and compensation in excess of $40,000 during the tax year subject to N.Y. personal income tax and 1.5%) multiplied by the result of one minus a fraction, the numerator of which would be the covered employee's N.Y. personal income tax before tax credits and the denominator of which would be the covered employee's N.Y. taxable income for the tax year.
- For 2020, the credit equal the E.C.E.T. (*i.e.*, the product of the covered employee's wages and compensation in excess of $40,000 during the tax year subject to N.Y. personal income tax and 3%) multiplied by the result of one minus a fraction, the numerator of which would be the covered employee's N.Y. personal income tax before tax credits and the denominator of which would be the covered employee's N.Y. taxable income for the tax year.
- For 2021 and thereafter, the credit would equal the E.C.E.T. (*i.e.*, the product of the covered employee's wages and compensation in excess of $40,000 during the tax year subject to N.Y. personal income tax and 5%) multiplied

[13] Amendments to Senate S.7509; Assembly A.9509 (Revenue Article VII Bill), New Part MM §§1, 2.

> by the result of one minus a fraction, the numerator of which would be the covered employee's N.Y. personal income tax before tax credits and the denominator of which would be the covered employee's N.Y. taxable income for the tax year.

If the credit exceeds the taxpayer's tax for the tax year, the excess would be allowed to be carried over to the following tax year or years, with no carryover limitation.

It has been argued that the economic burden of a payroll tax falls almost entirely on the employee, regardless of whether the tax is remitted by the employer or the employee, as the employers' share of the payroll taxes is passed on to employees in the form of lower wages or compensation. Under the F.Y. 2019 Budget's proposed legislation, an employer would not be allowed to deduct from the wages or compensation of a covered employee any amount that represents all or any portion of its payroll expense tax. As a result, it would prevent the employer from shifting the payroll expense tax to the covered employee in the form of lower wages or compensation.

THE T.C.J.A.'S INTERNATIONAL TAX PROVISIONS MAY PROVIDE A (THIN) SILVER LINING

The new tax law introduced significant changes to the Code's international provisions, including a shift toward a partial territorial taxation system. Since the process of computing a taxpayer's New York taxable income begins with the taxpayer's Federal taxable income, it is not surprising that such changes will impact New York. As discussed below, the N.Y. Report discusses three of the international provisions and whether they will be a benefit or detriment to New York's tax base and proposes certain reforms. The F.Y. 2019 Budget proposes amendments that generally follow the report's recommendations.

Transition Tax May Create a Taxpayer Windfall and Indirect State Revenue

Under Code §965(a), a "U.S. Shareholder"[14] owning at least 10% of a certain foreign corporation, known as a "specified foreign corporation,"[15] is required to include as Subpart F Income its *pro rata* share of the specified foreign corporation's previously untaxed foreign earnings. This provision represents a one-time tax on the unrepatriated foreign earnings of specified foreign corporations. It is referred to as the "transition tax" because it applies to previously untaxed foreign earnings to which the new participation exemption for foreign-source dividends does not apply.

Under Code §965(c), the deemed repatriated Subpart F Income is subject to tax at the preferential rates of 8% on cash and cash equivalents and 15.5% on the remaining income. The preferential rates are computed by allowing a D.R.D. for the deemed repatriated income.

For the purpose of computing N.Y. taxable income, Subpart F Income falls into the

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14 For the purposes of Code §965 and the controlled foreign corporation rules (discussed below), a U.S. Shareholder refers to a U.S. person (*e.g.*, U.S. citizen, resident, or corporation) that owns 10% or more of the total voting stock or total value of the shares of the foreign corporation.

15 A specified foreign corporation means any controlled foreign corporation (defined below) or a foreign corporation with respect to which one or more domestic corporations is a U.S. Shareholder.

category of "other exempt income"[16] and thus is removed from a taxpayer's N.Y. tax base. As a result, New York is not expected to realize a direct revenue gain from the transition tax. However, the N.Y. Report states that New York will receive an estimated $60 million in revenue attributable to the transition tax because interest expense deductions attributable to the deemed repatriated income generally must be added back to the taxpayer's N.Y. taxable income.[17]

"The N.Y. Report estimates that G.I.L.T.I. could produce approximately $30 million of revenue for New York."

A complicating factor is the deduction used to compute the preferential rates of 8% or 15.5%. In general, taxpayers must add back a D.R.D. taken at the Federal level to their N.Y. tax base. According to the N.Y. Report, it is unclear whether the new deduction can be characterized as a D.R.D. If it is not a D.R.D., it will not be added back to the N.Y. tax base. In such case, the taxpayer will receive a double benefit: the deemed repatriated income will be Subpart F Income – and, thus, subtracted from its N.Y. tax base as other exempt income – and the deduction will have already been removed from the starting point at the Federal level. Thus, the taxpayer will receive both an exemption and a deduction.

The N.Y. Report proposes legislation requiring the add-back of the D.R.D. under Code §965(c). In that manner, although the deemed repatriated income will not be subject to tax in New York, the added-back deduction will prevent a mismatch scenario where the income is not subject to tax but receives a tax benefit (in this case, a deduction).

Following the suggestion of the N.Y. Report, the F.Y. 2019 Budget proposes an amendment to require the add-back of the D.R.D. under Code §965(c).[18]

Current Year Inclusion of Global Intangible Low-Taxed Income May Create Revenue

U.S. Shareholders[19] of controlled foreign corporations ("C.F.C.")[20] must include their *pro rata* share of the C.F.C.'s global intangible low-taxed income ("G.I.L.T.I.") in gross income under new Code §951A, regardless of whether the income is actually distributed to the U.S. Shareholders. Despite its name, G.I.L.T.I. includes more than just C.F.C. income from intangible assets because it is computed by starting with the C.F.C.'s gross income and subtracting a narrow list of excluded income, such as Subpart F Income and dividends to a related person. Corporate U.S. Shareholders are allowed a deduction on G.I.L.T.I. under new Code §250. As a result, the U.S. effective tax rate on G.I.L.T.I. generally is 10.5% through tax years 2025, and 13.175% thereafter when the deduction under Code §250 is reduced and is possibly further reduced by indirect foreign tax credits.

G.I.L.T.I. is similar to Subpart F Income, and in fact under the Code, certain provisions

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16 N.Y. Tax Law §208[6-a(a)].

17 N.Y. Tax Law §208[6-a(d)]. Under this section, interest deductions attributable to other exempt income must be added back to the N.Y. tax base if the attributable interest deductions exceed the other exempt income.

18 Amendments to Senate S.7509; Assembly A.9509 (Revenue Article VII Bill), New Part KK §3.

19 *Supra*, note 4.

20 A C.F.C. is any foreign corporation with respect to which one or more U.S. shareholders are in control of the foreign corporation. For this purpose, control means ownership of more than 50% of the foreign corporations vote or value.

that apply to Subpart F Income specifically apply to G.I.L.T.I. As discussed above, Subpart F Income is specifically characterized as exempt income under N.Y. tax law.[21] However, there is no such exemption for G.I.L.T.I. Thus, unless the law is amended, G.I.L.T.I. will flow onto a taxpayer's N.Y. return as taxable income. The deduction under Code §250 would not be added-back because it is not a dividends received deduction.

The N.Y. Report notes that if no legislative changes are made, New York will tax G.I.L.T.I. If the Code §250 deduction is available, only a portion of the G.I.L.T.I. will be subject to tax in New York (similar to the Federal income tax result).

The N.Y. Report estimates that G.I.L.T.I. could produce approximately $30 million of revenue for New York. Further, the state could consider capturing 100% of G.I.L.T.I. by "decoupling" the state tax law from the Code §250 deduction and thus requiring that it be added back to the N.Y. tax base. In that case, the tax on G.I.L.T.I. at the state level could be as high or higher than the Federal tax.

Tellingly, the F.Y. 2019 Budget amends the definition of "other exempt income" to specifically include the Subpart F dividend under Code §965(a) but does not include a provision to expand the definition to include G.I.L.T.I.[22] Thus, it seems G.I.L.T.I. may remain subject to N.Y. income tax.

New Participation Exemption May Create Revenue

Under the new Code §245A, U.S. corporations will receive a 100% D.R.D. from specified foreign corporations (defined above). According to the N.Y. Report, for New York tax purposes the dividend generally will be characterized as other exempt income under N.Y. Tax Law §208[6-a(a)], and thus it will not be subject to New York corporate income tax. Since New York generally has not been receiving such income (because it has been kept offshore), the participation exemption will not create a significant revenue loss for the state. Nonetheless, the N.Y. Report estimates that the state will experience a small revenue increase from the added-back interest expense deductions attributable to such dividends.[23]

OUTLOOK FOR N.Y. RESIDENTS

While it is clear the T.C.J.A. will impact the state tax liability of some N.Y. residents, it remains to be seen how the state will ultimately respond. The proposals discussed above are still in the early stages of development and will be subject to the lawmaking process, which unavoidably includes the politics of keeping or winning votes.

Thus far, a state Assembly budget resolution has rejected the idea to create statewide charitable funds for healthcare and education but supported the proposal allowing school districts and local governments to create charitable funds. The state Senate approved a one-house budget resolution that did not contain either the proposal for a new payroll tax or the creation of charitable funds. The budget bills will be sent to a joint conference committee for reconciliation.

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[21] N.Y. Tax Law §208[6-a(b)].

[22] Amendments to Senate S.7509; Assembly A.9509 (Revenue Article VII Bill), New Part KK §1.

[23] N.Y. Tax Law §208[6-a(d)].

I.R.S. OFFERS ADDITIONAL GUIDANCE ON CODE §965 TRANSITION TAX

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Code §965
Controlled Foreign Corporation
Transition Tax

INTRODUCTION

In light of the approaching tax filing deadline for 2017, the I.R.S. issued guidance (the "F.A.Q.")[1] on the transition tax for 10% shareholders in a controlled foreign corporation ("C.F.C.") and certain other foreign corporations under Code §965. The transition tax is imposed on post-1986 earnings and profits of foreign corporations that are C.F.C.'s or have at least one 10% shareholder that is a U.S. corporation. The F.A.Q. addresses taxpayers that are required to report, the method of reporting, the method of payment, and the process for filing under Code §965 on a 2017 tax return.

INCLUSION IN INCOME

In general, Code §965 requires U.S. Shareholders,[2] to pay a transition tax on the untaxed foreign earnings of certain specified foreign corporations as if those earnings had been repatriated to the United States on the last day of the 2017 taxable year. Where taxpayers own more than one corporation affected by Code §965, the amount included is computed on an aggregate basis. Taxpayers may reduce the inclusion from one specified corporation to reflect deficits in earnings and profits in other specified foreign corporations. The effective tax rates applicable to the income inclusions are adjusted by way of a participation deduction set out in Code §965(c).

ELECTIVE INSTALLMENT PAYMENT OF TRANSITION TAX

Pursuant to Code §965(h), taxpayers, may elect to pay the transition tax in installments over an eight-year period that is back-loaded. Over the first five years, 8% of the tax must be paid annually. The balance is paid in annual installments of 15%, 20%, and 25% in years six, seven, and eight, respectively. If installment payments are timely made, no interest is charged on the deferred tax amount.

CORPORATIONS AFFECTED BY TRANSITION TAX

Generally, a specified foreign corporation[3] means either a C.F.C. or a foreign

1 "IRS Provides Additional Details on Section 965, Transition Tax; Deadlines Approach for Some 2017 Filers," news release IR-2018-53, March 13, 2018.

2 Code §951(b).

3 Code §965(e).

corporation (other than a passive foreign investment company[4] that is not also a C.F.C.) that has a U.S. Shareholder that is a domestic corporation. S-corporations and real estate investment trusts are allowed to make similar eight-year elections under Code §§965(i) and 965(m).

Code §965 applies to the last taxable year of the specified foreign corporation that begins before January 1, 2018. The specified foreign corporation's post-1986 earnings and profits are included in income for the year of the taxpayer in which or with which the entity's tax year ends.

REPORTING TRANSITION TAX

Calendar year taxpayers will be required to report the total income resulting from Code §965 when filing their tax returns in March or April 2018. Tax is due at that point or in installments.

Taxpayers who electronically file Form 1040, *U.S. Individual Income Tax Return*, are requested to wait to file their return on or after April 2, 2018. This will provide the I.R.S. time to make certain system changes to allow the returns to be accepted and processed.

WHO MUST REPORT TAX

"Transition tax is imposed on post-1986 earnings and profits of foreign corporations that are C.F.C.'s or have at least one 10% shareholder that is a U.S. corporation."

According to the F.A.Q., reporting is required by a U.S. Shareholder of a Deferred Foreign Income Corporation[5] ("D.F.I.C."). If the U.S. Shareholder is a partnership, an L.L.C. treated as a partnership, an S-corporation, or a simple trust that must distribute all income to beneficiaries, the member, partner, shareholder, or beneficiary reports the inclusion under Code §965 on its 2017 tax return. Consequently, domestic partnerships, S-corporations, or other pass-thru entities should attach a statement to the Schedule K-1's issued to their owners or beneficiaries for each D.F.I.C. that has a Code §965(a) inclusion amount. The statement should include the following details:

- The partner's, shareholder's, or beneficiary's share of the pass-thru entity's Code §965(a) inclusion amount (if applicable)
- The partner's, shareholder's, or beneficiary's share of the pass-thru entity's deduction under Code §965(c) (if applicable)
- Information necessary for a U.S. corporate partner, or an individual making an election under Code §962 to compute tax as a corporation, to compute its deemed paid foreign tax credits with respect to its share of the pass-thru entity's Code §965(a) inclusion amount (if applicable)

For corporations, and individuals who make an election under Code §962 to be taxed as a corporation with regard to income taxed under Subpart F, the indirect foreign tax credit is reduced under Code §965(g). Resolving a question among tax advisers, the F.A.Q. is silent regarding a possible reduction in foreign tax credits for an individual U.S. citizen resident in a foreign country. As no mention is made

4 Code §1297.

5 Code §965(d).

that those individuals suffer a reduction in creditable income taxes imposed by the country of residence, presumably, the matter is settled.

If the taxpayer is a U.S. corporation, or an individual who makes a Code §962 election to the partial dividends received deduction under Code §965(c), the deemed paid foreign taxes with respect to the relevant Code §965(a) amount and the disallowed foreign taxes under Code §965(g) are reported on Form 1118, *Foreign Tax Credit - Corporations*. In the absence of a Code §962 election, an individual is not entitled to a deemed paid foreign tax credit. Individuals report foreign tax credits on Form 1116, *Foreign Tax Credit (Individual, Estate, or Trust)*. There is no disallowance of foreign tax credits reported on that form.

IRC 965 TRANSITION TAX STATEMENT

A U.S. Shareholder must include an "IRC 965 Transition Tax Statement" with its return. The statement must be signed under penalty of perjury. In the case of an electronically filed return, it is submitted in Portable Document Format (.pdf) with a filename of "965 Tax."

Among other things, the IRC 965 Transition Tax Statement must include the following information:

- The total amount required to be included in income under Code §965(a)
- The person's aggregate foreign cash position (if applicable)
- The total deduction under Code §965(c)
- The deemed paid foreign taxes with respect to the total amount required to be included in income by reason of Code §965(a) if the taxpayer is a corporation or an individual making an election
- The disallowed deemed paid foreign taxes pursuant to Code §965(g) (if applicable)
- The total net tax liability under Code §965[6] that will be assessed (if applicable)
- The amount of the net tax liability under Code §965 to be paid in installments under Code §965(h) (if applicable)
- The amount of the net tax liability under Code §965 for which the payment has been deferred under Code §965(i)[7] in the case of a shareholder in a S-corporation (if applicable)
- A listing of elections under Code §965 or the election provided for in Notice 2018-13 that the taxpayer has made (if applicable)

The relevant Code §965(a) amount, the relevant Code §965(c) deduction, the deemed paid foreign taxes with respect to the relevant Code §965(a) amount, and

6 As determined under Code §965(h)(6), without regard to whether the paragraph is applicable.

7 Under Code §965(i), shareholders of S-corporations are entitled to an indefinite deferral of the start of the eight-year period for the payment of the transition tax.

the foreign taxes disallowed under Code §965(g) should not be entered on Form 1118. The deemed paid foreign taxes with respect to the Code §965(a) amount and the foreign taxes disallowed under Code §965(g) are reported on IRC 965 Transition Tax Statement, Lines 4a and 4b.

If applicable, a U.S. Shareholder must report the total amount of the net tax liability Under Code §965 on Page 3, Schedule J, Part I, Line 11. The total amount to be paid in installments under Code §965(h) for years beyond the 2017 year is reported on Page 3, Schedule J, Part II, Line 19d, if applicable.

REPORTING OF ELECTIONS

Code §965 permits multiple elections related to amounts included in income and the payment of a taxpayer's net tax liability. All elections with respect to Code §965 must be made by the due date (including extensions) for filing the return for the relevant year. This includes the following elections:

- Code §965(h) (regarding installment payments)
- Code §965(i) (regarding the indefinite deferral of the start of the eight-year installment period)
- Code §965(m) (regarding a special rule for R.E.I.T.'s)
- Code §965(n) (regarding the application of net operating losses)
- Section 3.02 of Notice 2018-13, 2018-6 I.R.B. 341 (regarding the use of October 31, 2017, rather than November 2, 2017)

For each election, a statement signed under penalty of perjury must be attached to a 2017 tax return and submitted, in the case of an electronically filed return, in Portable Document Format. Each statement must include the information specified in Q7.[8]

In the case of a consolidated group[9] in which one or more members are U.S. Shareholders of a specified foreign corporation, the agent for the group[10] must make the elections on behalf of the group members.

PAYMENT OF TAX

The date for the first installment payment of the transition tax is delinked from the date for making elections. Consequently, the first installment of the transition tax must be paid by the original due date (without extensions) for filing the return for the relevant year.

Taxpayers are advised to make two separate tax payments for 2017. One payment reflects tax owed without regard to Code §965, and the other reflects tax owed resulting from Code §965 (the "Code §965 Payment"). Both payments must be made

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8 "Questions and Answers About Reporting Related to Section 965 on 2017 Tax Returns," I.R.S., last reviewed or updated March 19, 2018.

9 Code §1.1502-1(h).

10 Code §1.1502-77.

by the due date of the applicable return (without extensions).

The Code §965 Payment must be made either by wire transfer, check, or money order. For the Code §965 Payment, there is no penalty for taxpayers electing to use wire transfers as an alternative to otherwise mandated EFTPS payments.

RECORD KEEPING

Adequate records must be kept supporting the Code §965(a) inclusion amount, the deduction under Code §965(c), and net tax liability under Code §965, as well as the underlying calculations of these amounts. Moreover, additional reporting may be required when filing returns for subsequent tax years, and the manner of reporting may be different.

TAX RETURNS PREVIOUSLY FILED

If a 2017 tax return has already been filed, the taxpayer should consider filing an amended return based on the information provided in the F.A.Q. and appendices. Taxpayers are advised that a failure to submit a return in this manner may result in processing difficulties and erroneous notices being issued. Failure to accurately reflect the net tax liability under Code §965 in total tax could result in interest and penalties. In order to amend a return, a person must file the applicable form for amending the return pursuant to regular instructions and include the following attachments:

- Amended versions of forms and schedules necessary to follow the instructions in the F.A.Q.
- Election statements
- IRC 965 Transition Tax Statement

UPDATES & OTHER TIDBITS

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E.U. COUNTEROFFENSIVE TO U.S. TAX REFORM

E.U. efforts to establish uniform corporate tax rules have stalled in recent years, but finance ministers are now pushing for approval to keep Europe competitive in light of recent U.S. tax reform.

One notable concern is the reduction of the U.S. corporate tax rate from 35% to 21%. Historically, smaller E.U. countries have used low tax rates (*e.g.*, 12.5% in Ireland) to attract investment. With a minimum tax rate now being considered to avoid a "race to the bottom," some E.U. countries are concerned that a uniform corporate rate will decrease their attractiveness.

New digital taxation rules, regulations on virtual permanent establishments, and creation a common corporate taxation base ("C.C.T.B.")[1] are also being discussed.

Establishing a C.C.T.B. along with lowering the corporate rate may ultimately increase revenue if the tax base is also expanded. The C.C.T.B. is not expected to be lower than 13.125% – the rate at which the U.S. will tax a multinational's profits under the new global intangible low-taxed income ("G.I.L.T.I.") regime.[2]

Part of defining the C.C.T.B. includes taxing virtual permanent establishments. E.U. lawmakers have already voted that a taxpayer having a digital platform or any other digital business model based on the collection and exploitation of data for a commercial purpose would be treated as having a taxable permanent establishment in a member state. This would ensure that companies such as Facebook and Google will pay more in E.U. taxes.

Final legislation is expected in the late spring.

I.R.S. AMENDS FORM 1023-EZ STREAMLINED APPLICATION FOR NON-PROFIT EXEMPTION

Small charities can apply for tax-exempt status using a streamlined process with the Form 1023-EZ. Form 1023-EZ was designed to assist the I.R.S. in clearing up a backlog of applications that, by 2013, had reached 66,000 – with charities waiting months or years for determinations and "applications requiring review" taking 18 months or more to be assigned to a reviewer.

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1 See "Proposed Directive on the E.U. Common (Consolidated) Corporate Tax Base – A Primer," *Insights* 2 (2017).

2 See "A New Tax Regime for C.F.C.'S: Who Is G.I.L.T.I.?" *Insights* 1 (2018).

However, implementation of the new form has not been seamless. The I.R.S. estimates that 20% of applicants using Form 1023-EZ failed the "organizational test" and therefore did not qualify as charities. To address this issue, the I.R.S. revised Form 1023-EZ in January 2018 to require additional information:

- Part III of the form features a text box requesting a brief description of the organization's mission or most significant activities. This provides a better understanding of the most significant activities that an organization engages in to further its exempt purposes.
- Questions about annual gross receipts, total assets, and public charity classification have been added. These questions are also duplicated on the Form 1023-EZ Eligibility Worksheet in the instructions that organizations must certify they have completed.
- Question 29 on Form 1023-EZ Eligibility Worksheet now requires that an automatically revoked organization applying for reinstatement seek the same foundation classification it had at the time of automatic revocation to be eligible to use Form 1023-EZ. Organizations that are not seeking that same foundation classification must file a full Form 1023.

The $400 application fee remains the same.

These revisions are intended to make it easier for organizations to decide whether they qualify to use Form 1023-EZ and to facilitate the I.R.S. make the correct determinations on tax-exempt status. Charities that that do not meet the requirements to use must apply for tax-exempt status using Form 1023.[3]

CELEBRITIES IN TROUBLE OVER SPANISH TAX EVASION

How long do you have to be present in a country in any given year to be liable for paying tax, even on foreign income? The rules vary from by country, and as some celebrities are finding out, there is no exception for popularity.

Singer Shakira declared her Spanish residence in 2015 and has reportedly made a $25 million back tax payment to the Spanish authorities.[4] However, Shakira is now being investigated by the Spanish authorities for the years 2011 through 2014 as to how long she was present in the country and whether she qualifies to be a resident for tax purposes and is therefore liable to pay P.I.T. on her worldwide income.

In Spain, for an individual to be considered a tax resident and be liable to Personal Income Tax ("P.I.T."), he or she must have habitual residence within the Spanish territory.[5] Presence longer than 183 days in a calendar year indicates habitual resi-

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3 For additional information on the eligibility requirements for Form 1023-EZ, see "I.R.S. Issues New Form 1023-EZ: Streamlined Exemption For Small Charities," *Insights* 8 (2014).

4 "Shakira Reportedly Pays $25M in Back Taxes to Spanish Government," *New York Daily News*, February 27, 2018.

5 "Information on Residency for Tax Purposes," Global Forum on Transparency and Exchange of Information, Spain, November 27, 2017.

dence. A person can also be subject to tax if Spain is the main base of a taxpayer's activities or if the taxpayer's dependent spouse and underage children are residents of Spain.

A taxpayer may be permitted to avail him or herself of a tax treaty to change or mitigate these rules. However, an analysis of actual time spent in a jurisdiction must be considered.

Shakira is not the only celebrity facing heat from the Spain government. In 2017, the Supreme Court sentenced Barcelona and Argentina footballer Lionel Messi to a jail term of 15 months for his use of shell companies registered in the U.K., Switzerland, Uruguay, and Belize to divert income away from Spanish taxation.[6] The Real Madrid and Portugal footballer Cristiano Ronaldo has also been accused of tax fraud. Prosecutors claim that Ronaldo understated his income while filing tax returns and used an offshore company to hide income from the tax authorities.[7]

LUXEMBOURG HOLDS FIRM: AMAZON DECISION IS STILL WRONG

Luxembourg maintains that the European Commission (the "Commission") has not shown the existence of a selective advantage and that its ruling in the *Amazon* State Aid case is incorrect. A report[8] released in late February supports the Commission's determination that Amazon obtained illegal tax benefits from Luxembourg inconsistent with the O.E.C.D. transfer pricing guidelines and arm's length standards worth $310 million (250 million) between 2006 and 2014.[9] However, Luxembourg claims that the publication will have no impact on its appeal before the European Court of Justice.

The dispute surrounds Amazon's Luxembourg tax structure, called Project Goldcrest, invlloving two Luxembourg subsidiaries of the U.S. parent, Amazon EU Group and Amazon Europe Holding Technologies. Amazon EU Group ran the company's European operations and transferred 90% of its operating profits to the untaxed Amazon Europe Holding Technologies, a shell company that had neither employees nor offices. This resulted in an effective tax rate of 7.25% and not the national rate of 29%.

The transfer pricing assessment, provided by Amazon, was based on the comparable uncontrolled price method and the residual profit split analysis, including an arm's length range for royalties, with adjustments made to account for the particulars of the transactions. After a comparison, the transfer pricing report concluded that the residual profit split analysis was adopted to reduce chances of producing bias estimates.

The Commission report looked at the facts, entities, and agreements and performed its own analysis. It found that the subsidiaries did not perform the functions or have

6 "Tax Lessons from Soccer's Messi & Ronaldo Tax Evasion Cases." *Forbes*, June 16, 2017.

7 *Id.*

8 E.U. Commission Decision C(2017) 6740.

9 OJ C 44, 6.2.2015.

the capacity to perform the functions anticipated in the transfer pricing report and cost sharing agreement. Furthermore, the subsidiaries did not have access to the intangibles necessary for performing their anticipated operations. The Commission explained that not all methods used to calculate the transfer pricing base are equal. It found that the standards used were not appropriate because they were not market based and resulted in a reduction of charges constituting a selective advantage without justified cause.

The Luxembourg appeal is one of the three high-profile State Aid cases awaiting decisions from the European Court of Justice, along with the *Apple* and *Starbucks* cases.

"Luxembourg claims that the publication will have no impact on its appeal before the European Court of Justice."

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