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INSIGHTS

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EDITORS' NOTE

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

- **Dutch Corporate Tax Reform: Dividend Tax Remains, A.T.A.D. Arrives, and Tax Rates Drop.** Across the globe, the landscape for international tax is in a constant state of change. Nowhere is this more evident than in the Netherlands. On the third Tuesday of September, a repeal of the dividend withholding tax was announced. Within a month, it was withdrawn. Paul Kraan, a partner of Van Campen Liem in Amsterdam, discusses the remaining tax proposals presented by the Dutch government on the eve of the third Tuesday of September. These include provisions related to A.T.A.D. 1, such as G.A.A.R., an exit tax for corporations, a C.F.C. anti-abuse rule, and a cap on the deductibility of net interest expense. Also discussed is an existing unilateral exemption from withholding tax on cross-border dividend payments in (i) the context of an income tax treaty and (ii) the presence of economic substance for the direct or indirect shareholder. This exemption is likely to remain in the law.

- **Extension of German Taxation on Foreign Companies Holding German Real Estate.** In August, the German Federal government proposed draft legislation that will expand the scope of German taxation to cover the sale of shares in "real estate rich companies" by nonresident taxpayers. The draft legislation proposes that capital gains from shares in non-German companies will be subject to German taxation if more than 50% of the share value is attributable to German real estate. The legislative proposal has wide application, reaching a shareholding that exceeds a 1% threshold at any time in the five years preceding the sale. Dr. Petra Eckl, a partner at GSK Stockmann + Kollegen in Frankfurt, explains the proposal and the practical exposure that arises from its overly broad language.

- **Qualified Business Income – Are You Eligible for a 20% Deduction? Part II: Additional Guidance.** In August, the I.R.S. issued much-awaited proposed regulations under the new Code §199A covering Qualified Business Income ("Q.B.I"). This provision of recently enacted U.S. tax law allows entrepreneurial individuals to claim a 20% deduction on taxable business profits of a sole proprietorship, partnership, L.L.C., or S-corporation. Galia Antebi, Nina Krauthamer, and Fanny Karaman ask and answer the pertinent questions: Who may benefit? How do the rules addressing R.E.I.T.'s and publicly traded partnerships ("P.T.P.'s") affect Q.B.I when a net negative result is reported by the R.E.I.T. and the P.T.P.? When is an individual's income effectively connected to a trade or business and when is the income a form of disguised salary for which no deduction is allowed? What is a specified trade or business ("S.S.T.B.") for which the resulting income cannot benefit from the Q.B.I. deduction? How does the de minimis rule work under which a limited Q.B.I. deduction is allowed S.S.T.B. income does not exceed a specified ceiling? How does the ceiling based on W-2 wages work when calculating the Q.B.I. deduction?

- **Transition Tax – Proposed Regulations Are Here.** The I.R.S. has published proposed regulations on Code §965, which requires a U.S. Shareholder to pay income tax on a pro rata share of previously untaxed foreign earnings held in a C.F.C. and certain other foreign corporations. The tax is commonly referred to as the transition tax. It is designed to tax deferred foreign income prior to the transition to a participation exemption system for intercompany dividends from certain foreign corporations. A multi-step computation is required to (i) measure post-1986 E&P, (ii) allocate E&P deficits among affiliated foreign corporations, (iii) calculate the aggregate foreign cash position, (iv) compute allowed deductions, and (v) determine foreign tax credits. Elizabeth V. Zanet, Rusudan Shervashidze, and Beate Erwin detail the required steps as well as special rules applicable to individuals.

- **Corporate Matters: Ichabod Crane Visits His Executive Employment Attorney.** Washington Irving's "The Legend of Sleepy Hollow" tells the story of poor Ichabod Crane, a school teacher attacked by a headless horseman. It is a tale fitting for Halloween by a 19th Century American author famous for his stories about rural New York State, somewhere near the Tappan Zee Bridge. In this latest retelling, George Birnbaum, a New York State attorney whose practice focuses on labor law, brings a new twist to the story. Here, it comes to light that Ichabod made poor decisions regarding his employment contract, and those decisions exacerbated work-related problems flowing from the attack.

- **In the Fight Against Money Laundering, Europe Tackles Cash Controls.** In early October, the European Council adopted a regulation aimed at improving controls on cash entering or leaving the E.U. The new regulation provides necessary tools to address threats arising from terrorist financing, money laundering, tax evasion, and other criminal activities. It is based on current standards for combating money laundering and terrorism financing as developed by the Financial Action Task Force ("F.A.T.F."). Among other things, the new regulation requires a declaration of unaccompanied cash – that is, (i) cash sent by post, freight, or courier shipment and (ii) highly liquid instruments and commodities, such as checks, traveler's checks, prepaid cards, and gold. Once the new regulation is signed by the European Council and the European Parliament, it will be published in the E.U. Official Journal and will enter into force 20 days thereafter. Galia Antebi explains all.

We hope you enjoy this issue.

\- The Editors

DUTCH CORPORATE TAX REFORM: DIVIDEND TAX REMAINS, A.T.A.D. ARRIVES, AND TAX RATES DROP

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Tags
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Tax Reform
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TAX REFORM REVISIONS

Traditionally, the Dutch budget for the new year – which includes proposed tax legislation – is presented to parliament on the third Tuesday of September, known as Princes' Day (*Prinsjesdag*) in the Netherlands. However, this year, the relevant legislative proposals will be significantly revised before they are even discussed in parliament, pursuant to the revised tax reform announced on the eve of the third Tuesday of October.

This year's budget includes certain tax proposals that were announced last autumn, when the new Dutch coalition government took office and presented its main policy goals. At the time, the new government expressed its intention to completely eliminate withholding tax on dividends distributed by Dutch companies.

One of the main purposes of abolishing this tax was to cater to the needs of large Dutch multinationals – notably Shell and Unilever. Shell and Unilever have roots in the U.K. as well as in the Netherlands, and historically they have maintained headquarters in both countries. More recently, the two multinationals have been exploring ways to reduce the level of complexity that comes with maintaining such a structure. Certain factors, such as the impending Brexit, have increased the appeal of becoming solely headquartered in the Netherlands. In particular, Unilever recently expressed a desire to rationalize its structure by centralizing all headquarters functions in Rotterdam. However, the absence of a withholding tax on outgoing dividends from the U.K. – when dividends are taxed in the Netherlands – was perceived as an obstacle to restructuring.

This led the Dutch prime minister – a Unilever alumnus – to seek elimination of the dividend tax levy as an enticement for choosing the Netherlands as a holding jurisdiction for listed companies, particularly for companies that might consider the U.K. as an alternative and would need to be persuaded to cross the North Sea when choosing a holding company location. However, a period of heavy public criticism followed, characterizing the removal of withholding tax on dividends as a "gift" to foreign shareholders. As a result, Unilever froze its corporate restructuring plans, fearing lack of support from its British shareholders. Given the political climate, the Dutch government had no choice but to reconsider its earlier proposals, which eventually led to the revised tax reform released on the eve of the third Tuesday of October.

As this article goes to press, the revisions must be tailored into amendments to the package of legislation submitted to parliament. Nonetheless, the contours at this time are quite clear:

- Corporate income tax rates will gradually be reduced even further than previously announced.

- The Netherlands will implement the E.U. Anti-Tax Avoidance Directive ("A.T.A.D.").
- Dividend tax will remain in existence for the time being.

The normal corporate income tax will be gradually reduced from 25% to 20.5% by 2021, with the first reduction occurring in 2020. At the same time, the reduced rate corporate tax for profits up to €200,000 will be gradually reduced from 20% to 15% by 2021, also with the first reduction occurring in 2020.

In addition, the legislative package released on Princes' Day contains a variety of measures that change the basis of corporation tax in the Netherlands. Inevitably, a large part of this legislative package stems from the A.T.A.D. – as its first tranche (A.T.A.D. 1) must be implemented with effect from January 1, 2019. Simultaneously, certain favorable measures are included in order to soften the impact of A.T.A.D. 1.

Even though the Dutch government has emphasized that eliminating the dividend tax is not completely off the table, and it will again be considered in due course, it now seems clear that the dividend tax, in its current form, will remain in existence for some time.

Currently, Dutch intermediate holding companies that are part of corporate structures are exempt from the obligation to withhold dividend tax when profits are repatriated to shareholders. The exemption is effective January 1, 2018, and reflects a unilateral decision to exempt dividends from withholding tax for corporate shareholders based in all treaty countries, including Canada, China, Japan, and the U.S. Once Brexit is a fact, this exemption will continue to cover U.K. multinationals structuring their E.U. operations via the Netherlands. While this extension of the exemption for E.U. or E.E.A.[1] corporate shareholders was perceived initially as a "quick fix" until the dividend tax was eliminated, it now seems that this broad unilateral exemption may remain a permanent solution.

Since this Dutch unilateral withholding tax exemption appears to be more than just a passing fad, this article will consider its main features, as well as the impact of Dutch anti-abuse rules resulting from the implementation of international and supranational law. Broadly speaking, these rules aim to combat "abusive" structures, as only business structures with genuine economic activities can benefit from the exemption for group holding companies.

IMPLEMENTATION OF A.T.A.D.

As mentioned above, on Princes' Day, the legislative proposal to implement A.T.A.D. 1 was submitted to the Dutch parliament. This package provides for the introduction of controlled foreign corporation ("C.F.C.") legislation, as well as an entirely new limitation on the deduction of interest expense.

While A.T.A.D. 1 also requires the presence of an exit tax and a general anti-abuse rule, in the Netherlands these are already in place. Therefore, these elements require no further legislation, except for some minor modifications.

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[1] *I.e.*, the European Economic Area, or all the E.U. countries plus Liechtenstein, Norway, and Iceland.

A.T.A.D. 1 also contains certain measures to combat arrangements that make use of differences in qualification between tax systems. Well before the implementation date of A.T.A.D. 1, the scope of these “hybrid mismatch” rules was already extended through an amendment known as A.T.A.D. 2, although in fact there is just one directive. A.T.A.D. 2 will likely end the attractiveness of a Dutch C.V. or B.V. structure, as it forces the Dutch tax authorities to tax the income of the C.V. even though the C.V. may be transparent for Dutch tax purposes.

“One of the cornerstones of the A.T.A.D. is a measure to combat tax avoidance through the establishment of a low-taxed C.F.C.’s or permanent establishments.”

In any case, most of the hybrid mismatch rules that form the second tranche of A.T.A.D. implementation must be implemented into domestic law effective January 1, 2020. Before the relevant legislative proposal is submitted to parliament (expected early 2019), the government launched a consultation round on its draft proposal on October 29.

General Anti-Abuse Provision

The general anti-abuse provision (“G.A.A.R.”) laid down in A.T.A.D. 1 provides that a series of arrangements must be disregarded for corporate income tax purposes if they (i) are set up with a main purpose to obtain tax benefits, (ii) undermine the purpose or application of tax legislation, and (iii) are wholly artificial.

The Dutch government takes the view that this rule is part of existing Dutch tax law through the *fraus legis*, an abuse of law doctrine developed in the case law. Consequently, the Dutch government does not consider it necessary to further implement or codify this rule.

Exit Tax

Under current Dutch law, an exit tax is due upon the relocation of a company’s seat to a place outside the Netherlands as if capital gains are realized from the move. The exit tax triggers the realization of pregnant gains and the triggering of all reserves when assets are transferred abroad. Therefore, the A.T.A.D. provision requiring E.U. Member States to levy an exit tax does not require new legislation.

However, implementation of A.T.A.D. 1 will require some minor changes to existing regulations. Under A.T.A.D. 1, exit tax must be paid within five years for transfers of assets within the E.E.A. The period is substantially shorter than the current 10-year period provided in Dutch law. Furthermore, A.T.A.D. provides that, while interest may be charged for deferred payment of the exit tax, the posting of security for the tax payment is required only if the tax collector can clearly demonstrate that a risk of nonpayment exists.

As a final point, current Dutch law taxes gains when a Dutch enterprise transfers assets to a foreign permanent establishment. In this case, A.T.A.D. 1 does not require taxation upon transfer, meaning that no legislative change is required in this respect.

C.F.C.’s

One of the cornerstones of the A.T.A.D. is a measure to combat tax avoidance through the establishment of a low-taxed C.F.C.’s or permanent establishments and the transfer of mobile assets to the C.F.C. or permanent establishment. Income derived by the transferee from the mobile assets is taxable in the Netherlands at the level of the Dutch shareholder. This measure follows B.E.P.S. Action 3.

In brief, a foreign corporation is a C.F.C. where (i) a taxpayer holds, independently or together with affiliated entities or persons, a direct or indirect interest of more than 50% in an entity or (ii) the Dutch entity maintains a permanent establishment abroad that is taxed as if it were a foreign corporation. This means that it will also be relevant for Dutch companies to know whether lower-tier C.F.C.'s derive profits from mobile assets.

Under A.T.A.D. 1, broadly, a choice is made between two taxation models:

- **Model A:** Passive income derived by the C.F.C. (*e.g.*, dividends, royalties, and interest) is included in the tax base of its parent company if this income is not distributed by the C.F.C. promptly.
- **Model B:** The profits reported by the C.F.C. are allocated to functions performed in the Netherlands on the basis of the arm's length principle (*i.e.*, a transfer pricing approach).

The Dutch government currently takes the position that the Netherlands already applies Model B because the arm's length principle is codified in article 8b of the 1969 Corporate Income Tax Act ("C.I.T.A."). Nonetheless, it would like to do more than strictly necessary with respect to C.F.C.'s. For this reason, the government has opted for Model A treatment for C.F.C.'s established in a state appearing on the E.U. list of non-cooperative countries (the "E.U. blacklist") or with a low statutory tax rate, which is defined to be less than 7%. However, if the C.F.C. performs an economic activity of substance, its income will remain exempt.

The government has chosen this measure to deter tax avoidance arrangements from occurring in the Netherlands. To emphasize that the Netherlands no longer wants to be a participant in such arrangements, the fact that double taxation arises is explicitly accepted. For example, in situations where a C.F.C. is held indirectly and C.F.C. rules also apply on the level of a share-linked intermediary, the Netherlands does not take into account the tax payable by that share-linked intermediary.

An exhaustive list of states identified on the basis of the above criteria will be drawn up annually and published in a ministerial regulation. It will be based on the E.U. blacklist for the preceding calendar year or on the statutory tax rate as of October of that year.

A C.F.C. performs an economic activity of substance if it meets the substance requirements that apply as of April 1, 2018, for the purposes of the dividend withholding tax exemption. This includes payroll costs of at least €100,000 and office space available for at least 24 months.

Several additional exceptions apply. Under one, the additional C.F.C. measure will not apply if the C.F.C. mainly receives benefits other than the tainted benefits. Under a second exception, the C.F.C. measure will not apply where (i) the C.F.C. is an entity (not a permanent establishment), (ii) a financial business is carried on by the C.F.C., and (iii) the C.F.C. regularly receives tainted benefits in transactions with third parties.

The income of the C.F.C. will be determined according to Dutch standards. For example, an arm's length fee will be taken into account for an interest-free receivable.

Interest Deduction Limitations

The A.T.A.D. provides for a generic interest deduction limitation, known as the earnings stripping measure, which will be introduced for financial years commencing on or after January 1, 2019. Under this provision, the deduction for net interest expense is capped at 30% of the taxpayer's earnings before interest, tax, depreciation, and amortization ("E.B.I.T.D.A.") or €1 million, whichever is higher. Because the cap is placed on net interest expense, gross interest income of the taxpayer is fully deductible by gross interest expense. Note that interest income or expense relates to the cost of borrowing, whether the arrangement is structured as a loan, a financial lease, or a comparable agreement. The earnings stripping limitation applies only to the extent the interest expense exceeds the interest income. Note that the term "interest" includes currency exchange results on the principal and the interest installments. To the extent that currency risk on loan principal and interest payments is protected by an offsetting hedge, the effect of the hedge must be taken into account. In addition, the cost of the hedge is to be treated as interest expense or an offset to interest income, as the case may be.

E.B.I.T.D.A. is determined under a five-step process:

1. Determine profits under applicable Dutch tax standards.

2. Adjust the profits for certain tax-exempt items – notably, exempt participation benefits, as well as the deduction allowed with regard to gifts.

3. Increase the profits determined under the first two steps by the total depreciation and write-downs of assets taken into account during the year.

4. Decrease the profits determined under the first three steps by any write-downs of an asset that has been recaptured during the year.

5. Increase the profits determined under the first three steps by the net interest expense incurred during the year.

Interest to be capitalized in a year will be taken into account for the purposes of the 30% rule as well, meaning that the profits will not be adjusted for any such capitalization. However, the limitation of the deduction of other (*i.e.*, noncapitalized) interest expense will take precedence where the 30% criterion is exceeded. In that case, the interest to be capitalized may indeed be capitalized if, and to the extent that, the interest is less than 30% of the E.B.I.T.D.A. and carried forward to a subsequent year if, and to the extent that, it exceeds 30% of the E.B.I.T.D.A.

All net interest expense in excess of the cap can be carried forward to subsequent years in which net interest expense is below the cap and can be deducted to the extent of the unused cap in the carryover year. There is no limitation on the length of the carryover period. However, certain anti-abuse provisions will be adopted to prevent taxpayers from acquiring companies with excess deduction capacity or excess interest expense that may be absorbed by the acquiring group. Under one measure, if the ultimate beneficial ownership in the taxpayer changes substantially, the carried-forward interest arising before the change in ownership can no longer be taken into account. A change in ownership is substantial if more than 30% of the shares of the company changes hands. Another rule covers the overlap between carried-forward net interest and the consolidated group regime.

An earnings stripping measure applies to a consolidated tax group. Where a group does not compute income on a consolidated basis, but instead computes income on a standalone basis for each company, a threshold of €1 million per company can be used. In certain fact patterns, multiple caps may exceed 30% of E.B.I.T.D.A. computed on a consolidated basis. Should this rule result in large numbers of de-consolidations, corrective legislation may be considered.

As was previously announced, for the purposes of the earnings stripping measure, the government has opted for the following enforcement rules in regard to A.T.A.D. 1:

- There will be no group exemption.
- Stand-alone entities will not be exempt.
- Financial institutions will not be exempt.
- The option to delay implementation until 2024 is rejected.
- There will be no grandfathering of existing loans.

Finally, certain interest deduction limitations in the C.I.T.A. will be abolished when the earnings stripping measure comes into effect. The abolished provisions will include the following:

- The deduction limitation for excessive participation interest (article 13l C.I.T.A.)
- The deduction limitation for excessive acquisition interest (the acquisition holding company provision in article 15ad C.I.T.A.)
- The limitation of the holding company loss set-off (article 20[4] through [6] C.I.T.A.)

Nonetheless, two specific interest deduction limitations will be maintained:

- Article 10a C.I.T.A. (targeting base erosion)
- Article 10b C.I.T.A. (targeting international mismatches)

DIVIDEND TAX EXEMPTION

Where a Dutch parent company owns at least 5% of the nominal share capital of another Dutch company, the shareholding is eligible in principle for the participation exemption. Therefore, dividends distributed by the relevant subsidiary are exempt from corporate income tax in the hands of the parent company. In domestic situations, because the dividend is exempt at the shareholder level, the subsidiary is not required to collect withholding tax.

When the Parent Subsidiary Directive ("P.S.D.") was implemented in the early 1990's, a similar exemption was introduced for corporate shareholders based in E.U. Member States. Even though the P.S.D. contains a higher threshold for exemption than the Dutch participation exemption, case law from the European Court of Justice has established that the qualifying ownership percentage for exemption in intra-E.U./E.E.A. situations may not exceed the domestic threshold.

Following last year's tax reform, the scope of the existing exemption for E.U. or E.E.A. corporate shareholders was extended to corporations resident in any jurisdiction that has an income tax treaty with the Netherlands in effect where there is a clause governing the taxation of dividends. The content of the dividends article is not material. As an example, the unilateral exemption applies to qualifying Canadian-resident companies under the Netherlands-Canada Income Tax Treaty even though the treaty provides only for a reduced withholding tax rate of 5%. Similarly, the unilateral exemption applies to qualifying Chinese-resident companies under the Netherlands-China Income Tax Treaty, which reduces withholding rates on dividends to 5% in some circumstances and 10% in others. It also applies to qualifying U.S.-resident companies under the Netherlands-U.S. Income Tax Treaty when those companies do not qualify for the exemption provided under the treaty.

Because the proposed legislation contains its own test for qualification and is a unilateral provision requiring no concurrence by a treaty partner, the exemption can apply even though the recipient of the dividend fails to meet any of the tests under the limitation on benefits ("L.O.B.") clause in the treaty. This makes the Netherlands an attractive location for a European holding company owned by a group based in the U.S. or Japan, where the relevant income tax treaties contain detailed L.O.B. clauses that are not always easy to meet. Clearly, a unilateral exemption that applies irrespective of reduced treaty rates and specific treaty requirements significantly improves the position of the Netherlands as a European "hub" for multinational enterprises headquartered in the world's largest economies, such as Canada, China, Japan, and the U.S. – all of which are important trading partners for the Netherlands.

The unilateral exemption is subject to an anti-abuse rule. This rule stems from supranational E.U. law, which the Netherlands must implement, and international rules suggested by the O.E.C.D., which the Netherlands may codify.

"The exemption can apply even though the recipient of the dividend fails to meet any of the tests under the L.O.B. clause in the treaty."

Within the E.U., a special G.A.A.R. provision was inserted into the P.S.D., and the G.A.A.R. is now part of A.T.A.D. 1, as discussed above. Also, the multilateral instrument ("M.L.I.") developed by the O.E.C.D. within the context of the B.E.P.S. Action Plan provides for a principle purpose test ("P.P.T."). Even though the P.P.T. is conceptually different than the G.A.A.R. it has a similar effect. While, at present, an applicable dividend clause in a tax treaty may override a domestic anti-abuse rule, the P.P.T. will gradually become an integral part of bilateral tax treaties as the M.L.I. is adopted worldwide.

The Dutch anti-abuse rule starts with a subjective test, which essentially requires an analysis of whether avoidance of Dutch dividend tax was a main purpose for setting up the structure. This is considered to be the case if the Dutch entity making the distribution would be required to withhold more dividend tax on its distributions had the direct shareholder not been inserted into the structure.

What follows then is an objective test, which entails an assessment of whether the structure is artificial, either by itself or in conjunction with a series of artificial arrangements or transactions that lack valid business reasons reflecting economic reality. Essentially, this the mantra formulated by the European Court of Justice in its ruling in the *Cadbury Schweppes* case.

If the direct shareholder conducts an active business to which its shareholding in the Dutch entity is attributable, valid business reasons reflecting economic reality are generally deemed present. However, where the direct owner is merely an intermediary holding company, the assessment becomes more complicated. In that set of circumstances, the indirect shareholder of the Dutch entity must conduct an active business enterprise. In addition, the intermediary holding company must have a linking function (*schakelfunctie*) between that active company and the Dutch entity. Under the Dutch anti-abuse rule, that linking function must be substantiated. Most of the relevant substance criteria are of a general nature and would apply to any company. However, two additional substance requirements apply specifically to an intermediary holding company:

The intermediary holding company must incur salary costs equal to at least €100,000 for employees performing the activities that function as a link between the indirect owner and the Dutch entity. These employees may be hired from group companies through a salary-split arrangement. However, the part-time employees must perform their activities for the intermediary holding company in the jurisdiction where that company is established.

- The intermediary holding company must have its own office space at its disposal, and that space must be equipped and actually used for the performance of its activities for a period of at least 24 months.
- If the intermediary holding company meets all of these relevant substance requirements in its jurisdiction, then "valid business reasons reflecting economic reality" are considered to be present.

Pursuant to E.U. case law on which the Dutch rule is based, the taxpayer must be allowed to provide evidence demonstrating economic reality where the two-pronged test is met.[2] This would imply that even if its foreign shareholder does not meet all of the relevant substance requirements, the Dutch company making the profit distribution should still be allowed to demonstrate that the intermediary holding company was put in place for "valid business reasons reflecting economic reality." This may be particularly relevant for joint venture vehicles and private equity structures.

CONCLUSION

Across the globe, the landscape for international tax is in a constant state of change. Recently, the Netherlands accelerated the change by revising an elimination of withholding tax on dividends paid to foreign shareholders after it was announced with great fanfare, but before the provision was actually enacted. This change was accompanied by adoption of several rules embodied in A.T.A.D. 1, including a G.A.A.R. rule, an exit tax for corporations, a C.F.C. anti-abuse rule, a cap on the deductibility of interest expense, and a limited exemption from withholding tax on cross-border dividend payments in the context of an income tax treaty and the presence of economic substance for the direct or indirect shareholder. In this context, certainty is obtainable for an international tax plan only if it reflects the law that was, the law that is, and the law that may be.

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2 See "German Anti-Treaty Shopping Rule Infringes on E.U. Law," *Insights* no. 8 (2018), p. 4.

EXTENSION OF GERMAN TAXATION OF FOREIGN COMPANIES HOLDING GERMAN REAL ESTATE

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Tags
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Real Estate

On August 1, 2018, the German Federal government proposed draft legislation that will expand the scope of German taxation to cover the sale of shares in "real estate rich companies" by nonresident taxpayers. In the coming months, the draft will be subject to further discussion in the German parliament. The draft legislation proposes that capital gains from shares in foreign companies will be subject to German taxation if the share value consists of more than 50% German real estate. The sale of shares by certain institutional investors (*e.g.*, foreign corporations and domestic and foreign investment funds) is not expected to be covered by the draft legislation.

The draft legislation raises practical questions regarding implementation. These include questions regarding

- accounting and reporting requirements,
- methods that should be used when determining the value of German real estate and all other assets owned by a company in order to conclude that the company is a real estate rich company,
- the way in which German tax resulting from the adoption of the proposed legislation will interface with conflicting provisions of existing double taxation treaties,
- tax filing duties of a nonresident shareholder of a real estate rich company,
- identifying those nonresident investors that will be affected by the draft legislation once effective, and
- resolving possible double taxation issues when the shareholder's country of residence determines that it has the primary or exclusive right to tax gain from the disposition of shares

In addition to a straightforward set of facts, the draft legislation contains provisions applicable to loans extended to a real estate rich company by a nonresident lender.

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BACKGROUND

A foreign shareholder's capital gain from the sale of shares in a foreign-based real estate rich company is not subject to German taxation under existing law. The capital gain is subject to tax only if the investor holds at least a 1% interest in the company and the corporate entity being sold has its corporate seat or place of effective management in Germany.

In contrast to the domestic legal situation, Germany's most recent double taxation treaties ("D.T.T.'s") assign Germany the right to tax such capital gains. For example, the D.T.T.'s with Luxembourg and France specify that capital gains are subject to German taxation if the share value consists of more than 50% German real estate,[1] and the D.T.T. with the Netherlands allows for German taxation if the company's assets consist of more than 75% German real estate.[2] These provisions are in line with Art. 13 (4) of the O.E.C.D. Model Tax Convention, which has contained a "land-rich company" clause since 2014. According to these provisions, all capital gains from these sales of shares are taxable in the country where the real estate assets are located, regardless of the company's other assets.

Notably, D.T.T.'s can only restrict the right to tax. They cannot establish or expand the right of a contracting party to impose tax. In practical terms, this leads to an unequal distribution of taxing rights between Germany and its treaty partners whenever the domestic law of the treaty partner does not have a similar requirement allowing gain to be taxed only if the real estate rich company maintains its registered seat or place of effective management within the treaty partner jurisdiction. The treaty partner can tax gain from the sale of shares of a German company when real estate located in the treaty partner jurisdiction comprises the principal category of assets of the German company. In comparison, Germany cannot tax gain from the sale of a treaty partner corporation even if German real estate comprises most of the assets of company resident in a treaty partner jurisdiction as long as neither the registered seat nor the place of effective management is in Germany. The draft legislation[3] is intended to correct this, establishing equivalent rights for Germany to impose tax in these cases.

DETAILED OVERVIEW OF DRAFT LEGISLATION

In order to extend the German right to tax, the following amendments to existing law are proposed:

"Capital gains from shares in foreign companies will be subject to German taxation if the share value consists of more than 50% German real estate."

Extension of the Tax Liability to Foreign Companies Under Sec. 49 EStG

New Provision

The draft provides an expansion of German tax liability to capital gains arising from the sale of shares in foreign companies that are rich in German real estate. Notably, the new Sec. 49 (1) No. 2 lit e) cc) of the German Income Tax Act (*Einkommensteuergesetz* or "EStG") will not require a registered seat or place of effective management to exist in Germany in order for German tax to be imposed – as is required by the existing Sec. 49 (1) No. 2 lit e) aa) EStG.

In the future, capital gains will be taxed in Germany when the following requirements are met:

- **Real Estate Assets of More than 50%:** Capital gains arising from the sale of shares of a nonresident company will be subject to German tax if more than 50% of the share value of the company arises from German immovable

[1] Art. 13 (2) D.T.T. Lux; Art. 7 (4) D.T.T. Fra.

[2] Art. 13 (2) D.T.T. NL. Germany's D.T.T. with the U.S. deviates from this as it currently does not contain such a provision.

[3] *Entwurf eines Gesetzes zur Vermeidung von Umsatzsteuerausfällen beim Handel im Internet und zur Änderung weiterer steuerlicher Vorschriften*, formerly *Jahressteuergesetz* 2018, BR-Drs. 372/18.

property at any time during the 365 days preceding the sale. The real estate can be held directly by the company or indirectly through shares in other corporations holding immovable property.

- **Shareholding of at Least 1%:** In line with the present legal framework, only capital gains associated with a shareholding that exceeds a 1% threshold at any time within the last five years are taxed.[4] In other cas-es (shareholding below 1% during the last five years), the sale of shares will remain free of German tax.

Determination of the Real Estate Threshold

In accordance with the 2017 O.E.C.D. Model Tax Convention, the relevant real estate threshold will be determined over a set period of time. Accordingly, capital gains will be taxed as soon as the 50% threshold has been exceeded during the 365 days preceding the sale, provided that the shares were economically attributable to the seller at this point in time.[5] It is expected that tax avoidance schemes will be prevented by looking at a period of 365 days instead of looking only at the date of the sale, as in the 2014 O.E.C.D. Model Tax Convention. If only the date of sale is relevant, the 50% threshold can be avoided by capital injections of cash, securities, or movable assets to dilute the proportion of real estate assets on the date of sale.

The real estate threshold is determined based on the book value of assets only, and liabilities are excluded in computing value. The reliance on book value leads to an incongruity that allows indirect German real estate gains to go untaxed for the shareholder of a real estate rich company when German real estate in an appreciating market is mixed with non-German real estate in a stable or depreciating market.

Example 1: Nonresident Owns Real Estate in Germany and Elsewhere

Corporation X, a nonresident company, owns two parcels of real estate. Parcel A is located in a German city undergoing significant appreciation in the value of assets. Parcel B is located in a Turkish city where values are stable when measured in Turkish Lira. On the date of acquisition, Parcel A is worth €400,000, and Parcel B is worth the Lira equivalent of €500,000. The apportionment of land value to building value is the same for both parcels and depreciation is computed under equivalent rules and useful lives in both countries. After the properties have been held for three years, the fair market value of Parcel A increases to €600,000, and the fair market value of Parcel B remains at the Lira equivalent of €500,000. This reflects increased value in terms of Lira but depreciation in the value of the Lira in relation to the Euro.

Under these facts, the book values of the two parcels should reflect that not more than 50% of the value of the nonresident corporation's shares is attributable to German real estate. However, 54.5% of the total fair market value of the nonresident corporation's shares will be attributable to German real estate.

For cases where German real estate is held indirectly, the explanatory statement on an earlier draft of the bill from the Federal Ministry of Finance suggested that the 50% threshold would be determined on a consolidated basis. However, this clarification was not included in the subsequent government draft bill.

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[4] Sec. 17 EStG.

[5] Cf. Sec. 39 of the German General Tax Act (*Abgabenordnung* or "AO").

Date of Application

The new regime will apply to transactions occurring after December 31, 2018.[6] A revaluation of cost basis for the shares is adopted so that only net increases in value after December 31, 2018 are taxed. Since the draft law uses the term “value changes,” both increases and decreases will be relevant for taxation purposes.

Impact of the Amendments

In our view, the new legislation will most likely have the following consequences:

Taxable Capital Gains from the Sale of Shares

Whether the sale of shares in a foreign real estate rich company will trigger German tax depends on the shareholder’s legal form:

> **Example 2: Shareholder Is a Corporation**
>
> Corporation X has a corporate seat or place of effective management outside of Germany and holds a significant amount of shares (at least 1%) in the non-German real estate company Y. The share value of Y consists of more than 50% real estate assets located in Germany. Neither X nor Y have a permanent establishment nor permanent representative in Germany.

Under current German tax law, the capital gains from the sale of shares in this example would not qualify as taxable domestic income.

In the future, the new provision will lead to the taxation of such capital gain as domestic income.[7] However – by application of German domestic rules – the capital gains should be 100% tax-exempt. This is the result of “intercompany privilege”[8] and the Federal Tax Court decision that held the provision to tax 5% of the gain as non-deductible business expenses[9] does not apply to a sale of a foreign corporation, unless it has a permanent establishment or a permanent representative in Germany.[10]

If the selling shareholder is an investment fund in accordance with German investment tax law, capital gains should also be tax-exempt since capital gains from the sale of shares in corporations by an investment fund are generally tax-exempt pursuant to Sec. 6 (5) No. 1 InvStG.[11]

However, foreign investors who cannot claim any of the tax exemptions outlined above – such as certain finance and insurance companies to which the exemption of Sec. 8b (7) and (8) KStG does not apply[12] – are taxable on the whole capital gain.

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6 Sec. 52 (45a) EStG.

7 Sec. 49 EStG in connection with Sec. 8 (1) of the German Corporate Income Tax Act (*Körperschaftsteuergesetz* or “KStG”).

8 The intercompany privilege provision under Sec. 8b (2) s. 1 KStG sets out that capital gains received by a corporation are fully tax-exempt; however, 5% of these capital gains are considered non-deductible business expenses.

9 Sec. 8b (3) s. 1 KStG.

10 Federal Tax Court of 31 May 2017, I R 37/15, Federal Tax Gazette II 2018, p. 144.

11 German Investment Tax Act (*Investmentsteuergesetz* or “InvStG”).

12 Sec. 8b (7) and (8) KStG.

Example 3: Shareholder Is an Individual

Individual A, a German nonresident, holds a significant number of shares (at least 1%) in German nonresident real estate company B. The share value of B consists of more than 50% real estate assets located in Germany. B does not have a permanent establishment or a permanent representative in Germany.

In contrast to the current law, the sale of shares by a nonresident individual will become a taxable transaction. Taking the partial-income method[13] into account, 60% of the capital gains will be taxable, and 40% will be exempt. This is also true if the selling shareholder is a partnership. In this case, the tax consequences depend on whether the partner is a corporation or an individual.

Example 4: Attribution of Shares

Individual A, a German nonresident, holds 10% of German nonresident company B (which holds no real estate assets). On July 1, 2017, A sells 9.5% of his shares in B. B acquires German real estate on March 1, 2018, and meets the German real estate threshold of more than 50% of total value. B sells all real estate holdings on February 1, 2019. A sells his remaining 0.5% of shares in B on March 1, 2019, to the individual C (also a German nonresident), who sells her shares on June 1, 2019.

A's capital gains realized upon the sale of shares on March 1, 2019, are subject to German tax under the new provision. A holds at least 1% of the shares during the 5-year period preceding the sale, and more than 50% the share value of B is attributable to German real estate during the 365 days preceding the sale. The fact that B acquired real estate to a relevant extent only after A reduced its shareholdings to less than 1%, should not justify a different conclusion. The explanatory statement to the draft legislation explains that the 1% shareholding threshold is not required to be met at the time the 50% real estate threshold is exceeded.

However, the capital gains realized by C are not subject to German taxation because the shares in B were not attributable to C[14] when B fulfilled the relevant real estate assets threshold (March 1, 2018, until February 1, 2019).

Restrictions Due to D.T.T.'s

Depending on the country of residence of the selling shareholder – whether it is a treaty jurisdiction or a country with which Germany has no D.T.T. in effect – the tax liability may vary. The rules set out above also apply to foreign shareholders that are resident in countries with which Germany does not have a D.T.T. in effect.

In cases involving a country with which Germany has signed a D.T.T., the German tax liability and right of Germany to impose tax must be assessed under the provisions of the relevant D.T.T. Several older D.T.T.'s do not contain real estate rich company clauses. Examples are the D.T.T.'s concluded with Belgium or the U.S. Under these D.T.T.'s, gains from the sale of shares in real estate rich companies are taxable only in the contracting state in which the seller is resident. Consequently, the

[13] The partial-income method under Sec. 3 No. 40 lit c) EStG sets out that certain capital gains are 40% tax-exempt.

[14] According to Sec. 39 AO.

proposed legislation will not impact investors located in the relevant treaty jurisdiction until the D.T.T. is renegotiated.

Other D.T.T.'s may result in different thresholds. For example, the D.T.T. with the Netherlands contains a 75% real estate threshold, which means that capital gains will not be liable to German tax if the share value attributable to German real estate is more than 50% but not more than 75% of the total value.

Finally, other D.T.T.'s may result in periods of assessment for determining the real estate threshold that depart from the 365-day rule under domestic law. Like all of Germany's current D.T.T.'s that contain a real estate rich company clause, Art. 13 (2) of the D.T.T. with Luxembourg stipulates that only the date of sale is relevant for determining whether the value threshold is met for German real estate. In contrast to the draft legislation, exceeding the 50% threshold on another date during the 365-day period preceding the date of sale is not relevant. This means that the capital gains of an investor located in Luxembourg, or a country with a similar provision in its D.T.T. with Germany, will be subject to German tax only if the share value consists of more than 50% German real estate on the date of sale. It is worth noting, however, that Germany will change these provisions in its D.T.T.'s by implementing the Multilateral Instrument[15] so that all German D.T.T.'s will contain the 365-day period, provided that the contracting state in each affected D.T.T. agrees to such an amendment.

Practical Implementation

Issues remain in the draft legislation regarding the determination of the real estate threshold, itself. Contrary to the usual practice of determining book values on a specific closing date, it might now be necessary to assess the book value of the underlying real estate assets on each day throughout the year in order to determine whether the 50% threshold has been exceeded at any point during the 365 days preceding the sale. Additional issues arise for the determination of the real estate threshold in the case of indirect shareholdings. The 365-day review period may also lead to double taxation as Example 5 illustrates:

Example 5: Multiple Taxation Due to the 365-Day Period

The value of the shares of -S.à.r.l. Y, located in Luxembourg, consist of more than 50% German real estate. On November 1, 2018, Y sells all its German properties and acquires real estate assets located in Country B, which account for more than 50% of the share value from the date of their purchase. On March 1, 2019, shareholder X, a German nonresident individual, sells his shares.

The capital gains realized by X are taxable in Germany under the new provision because the value of the shares in Y consisted of more than 50% immovable German property during the 365-day period. If Country B has a similar regulation, the capital gains are taxable in Country B as well. The right to tax these capital gains is also assigned to Germany according to the D.T.T. with Luxembourg as soon as the 365-day period is introduced in this treaty. Assuming that the D.T.T. between Luxembourg and Country B contains such a 365-day review period (in line with the 2017 O.E.C.D. Model Convention), the capital gains from a single sale of shares are

15 See Art. 9 MLI.

subject to tax in two countries. Of course, the competent authorities of Germany and Luxembourg could agree to provide relief in order to avoid double taxation. The right of countries to avoid double non-taxation should not be a basis to impose double taxation where aggressive tax planning is not involved.

Further questions with regard to the practical implementation arise concerning listed foreign real estate companies:

- How will foreign share deals be monitored?
- How will the German tax authorities control tax filing duties?

"The sale of shares in foreign real estate corporations could potentially trigger (limited) domestic taxation in Germany."

Today, these and other practical questions remain unanswered.

Provisions Addressing Certain Loans

The draft legislation contains a provision stipulating that capital gains from the sale of real estate located in Germany will include changes in the value of other assets or obligations that are related to the real estate.[16] An example involves changes in the value of loans taken out to finance German real estate. Such value changes may be attributed to movements in currency value between the stated denomination of the obligation and the value of the Euro. Alternatively, they may be attributed to an enhanced credit position of the corporation issuing the debt obligation to finance the real estate.

Accordingly, income realized at the level of the debtor from a creditor's waiver of a loan that was taken out to finance real estate would lead to limited taxable earnings in Germany. In contrast to current case law,[17] there would be taxable income in Germany when a parent company waives a loan to its foreign subsidiary that was used to finance the acquisition of German real estate.

CONCLUSION

In view of the current draft law, the sale of shares in foreign real estate corporations could potentially trigger (limited) domestic taxation in Germany. In cases where the selling shareholder is either a nonresident individual or a specified foreign finance and insurance company, the capital gain might become entirely taxable in Germany.

Given that the pending changes would enter into force after December 31, 2018, any contemplated share sale transaction involving German real estate assets should be reviewed and, to the extent necessary, should be completed prior to the close of 2018, if possible.

16 Sec. 49 (1) No. 2 lit. f) s. 3 EStG-draft.

17 Federal Tax Court of 7 December 2016, I R 76/14, Federal Tax Gazette II 2017, p. 704.

QUALIFIED BUSINESS INCOME – ARE YOU ELIGIBLE FOR A 20% DEDUCTION? PART II: ADDITIONAL GUIDANCE

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Tags
Proposed Regulations
Q.B.I.
Reasonable Compensation
Specified Trade or Business
Skill or Reputation
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On August 8, 2018, the I.R.S. issued much-awaited proposed regulations under new Code §199A, which was added by the 2017 Tax Cuts and Jobs Act, (the "Proposed Regulations"). The provision was initially discussed in detail in our February 2018 edition. At the time, many issues were unclear.[2] The Proposed Regulations shed much-needed light on many of those issues and provide examples and anti-avoidance guidance.

The regulations are intended to apply to taxable years ending after the date regulations are published in their final form; however, taxpayers are allowed to rely on the Proposed Regulations, in their entirety, until such time. The anti-abuse rules in the Proposed Regulations would apply to tax years ending after December 22, 2017, the date of enactment of the 2017 Tax Cuts and Jobs Act.

SUMMARY OF THE PROVISION

New Code §199A allows owners of pass-thru businesses to, subject to limitations, deduct up to 20% of their U.S. "Qualified Business Income" ("Q.B.I."). The provision is intended to benefit those not enjoying the reduced rate of taxation applicable to C-corporations (which are now subject to a 21% Federal income tax rate). The new deduction is available to individuals, and some trusts and estates, generating income from sole proprietorships, S-corporations, and partnerships, either directly or through another pass-thru entity.

Broadly described, the provision allows eligible taxpayers a 20% deduction applicable to the lesser of

- Q.B.I. plus 20% of the combined qualified real estate investment trust ("R.E.I.T.") dividends and qualified publicly traded partnerships ("P.T.P.") income, or
- the excess, if any, of the taxpayer's taxable income over the net capital gain.

Taxpayers whose taxable income exceeds a statutory threshold are limited based on (i) the type of trade or business, (ii) the amount of W-2 wages paid with respect to the trade or business, or (iii) the amount of W-2 wages and the unadjusted basis of qualified property held for use in the trade or business. The inclusion of qualified R.E.I.T. dividends and qualified P.T.P. income is not limited by the W-2 limitation or the unadjusted basis limitation.

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1 The authors wish to acknowledge the contribution of Neha Rastogi in the preparation of this article.

2 "Qualified Business Income – Are You Eligible for a 20% Deduction?" *Insights* 5, no. 2 (2018).

GUIDANCE IN THE PROPOSED REGULATIONS

The balance of this article, which focuses on guidance provided in the Proposed Regulations, is written in a question and answer format.

Q. 1: What is Q.B.I.?

Q.B.I. is generally defined as the net amount of qualified items of "income, gain, deduction, and loss" that are "effectively connected to a qualified trade or business in the U.S."[3] To be included in the computation of Q.B.I., the items of income, gain, deduction, and loss must be recognized when determining taxable income for the tax year. Q.B.I. does not include qualified R.E.I.T. dividends or qualified P.T.P. income. [4]

With respect to certain items of income, gain, deductions, and loss, it was previously unclear how they would influence the determination of Q.B.I. The Proposed Regulations offer some clarity:

- Any gain from a sale of a partnership interest that is treated as ordinary income under Code §§751(a) or (b) (*i.e.*, attributable to a partnership's "hot assets" – generally meaning unrealized receivables and inventory) is considered attributable to the trade or business of the partnership and may be Q.B.I.
- Guaranteed payments received by a partner from a partnership for the use of capital are not taken into account in computing Q.B.I.
- Notwithstanding the above, if a guaranteed payment to a partner for the use of capital is properly allocable to the trade or business and otherwise deductible, the corresponding deduction will be taken into account in determining Q.B.I. from that business.
- Adjustments for changes in accounting methods under Code §481 are taken into account in determining Q.B.I., provided that the adjustment arose in a taxable year ending after December 31, 2017.
- Previously disallowed losses or deductions that are allowed in the taxable year are also taken into account in determining Q.B.I. However, losses or deductions that were disallowed for taxable years beginning before January 1, 2018, are not taken into account for purposes of computing Q.B.I. in a later taxable year.
- Net operating loss carryforward or carryback allowed as a deduction under Code §172 is not accounted for in the determination of Q.B.I. (because it would have been taken into account in computing Q.B.I. in the year incurred); however, net operating loss attributable to deductions disallowed under the new excess business loss limitation of Code §461(l) must be taken into account in determining Q.B.I. (because the loss was not previously accounted for in computing taxable income).
- To the extent that Code §1231 causes gain or loss to be treated as ordinary, the gain or loss must be included in Q.B.I. To the extent the gain or loss is treated as capital, it will not be taken into account in determining Q.B.I.

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3 For this purpose, the principles of Code §864(c) are applied.

4 Code §199A(c)(3)(A)(i).

- Interest income received on working capital, reserves, and similar accounts is not properly allocable to a trade or business and therefore is not accounted for in determining Q.B.I. Such income is from assets held for investment. However, interest on accounts receivable for services or goods provided by the trade or business is income received in the ordinary course of a trade or business and therefore included in Q.B.I.

- Expenses for all wages paid must be taken into account in determining Q.B.I., regardless of the application of the W-2 limitation, discussed above.

- Items attributable to several trades or businesses must be allocated to such trades or businesses using a reasonable method. Such method must be based on facts and circumstances and must be consistently applied each year. Different methods can be used for different items of income, gain, deduction, and loss.

Q. 2: Does a negative combined total of qualified R.E.I.T. dividends and P.T.P. income reduce Q.B.I.?

No. The Proposed Regulations provide that if an eligible taxpayer has an overall loss after combining the qualified R.E.I.T. dividends and qualified P.T.P. income, the portion of the taxpayer's deduction related to the qualified R.E.I.T. dividends and qualified P.T.P. income will be zero for the year. Thus, the overall loss from qualified R.E.I.T. dividends and qualified P.T.P. income does not affect the amount of the taxpayer's Q.B.I. Instead, the overall loss is carried forward and must be used to offset combined qualified R.E.I.T. dividends and qualified P.T.P. income in the succeeding taxable year or years.

Q. 3: What types of income are specifically excluded from the definition of Q.B.I.?

- **Reasonable Compensation** – Reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business are treated as wages and thus excluded. The Proposed Regulations clarify that the reasonable compensation rule applies only to S-corporations and not extend to partnerships. It provides that this rule is merely a clarification that even if an S-corporation fails to pay a reasonable wage to its shareholder-employee, the shareholder-employee is nonetheless prevented from including an amount equal to reasonable compensation in Q.B.I.

- **Guaranteed Payments Under Code §707(c)** – Guaranteed payments to a partner for services rendered with respect to the trade or business are excluded from Q.B.I. The Proposed Regulations clarify that this rule applies regardless of whether the partner is an individual, an estate, a trust, or a pass-thru entity. Thus, a guaranteed payment from a lower-tier partnership to an upper tier partnership retains its character as a guaranteed payment and is not included in Q.B.I. of a partner of the upper-tier partnership, regardless of whether it is guaranteed to the ultimate recipient.

- **Payments to a Partner Under Code §707(a)** – Payments to a partner not acting in its capacity as partner for services rendered with respect to a trade or business should be treated in the same manner as guaranteed payments, reasonable compensation, and wages and are thus excluded from Q.B.I. Similar to the rule for a guaranteed payment, this exclusion applies regardless of whether the partner is an individual or a pass-thru entity.

- **Income from a "Specified Trade or Business"** – See discussion in Q. 5.
- **The Trade or Business of Performing Services as an "Employee"** – See discussion in Q. 9.

Q. 4: To be included in Q.B.I., an item must be effectively connected with a trade or business in the U.S. What does that mean?

For purposes of Q.B.I., a trade or business must exist for income to be Q.B.I. The Proposed Regulations confirm that for a trade or business to exist, the requirements of Code §162 must be met. Generally, this means that the taxpayer must be involved in the income producing activity with "continuity and regularity" and a primary reason for engaging in the activity must be to produce income or profit in order for the income to qualify for Q.B.I.

Effectively connected income that is treated as such under a special provision in the Code but is not otherwise attributable to a trade or business may not be treated as Q.B.I. Thus, for example, a nonresident alien individual's income from real property in the U.S. with respect to which an election to treat the income as effectively connected income was made cannot be treated as Q.B.I. This may adversely affect foreign persons investing in U.S. real property through trusts, and taxpayers may find that a U.S. corporate blocker may prove to be more tax efficient.[5]

"The taxpayer must be involved in the income producing activity with 'continuity and regularity' and a primary reason for engaging in the activity must be to produce income or profit."

Similarly, the fact that a deduction is allowed for purposes of computing effectively connected taxable income (*e.g.*, a charitable contribution) does not necessarily mean that it is taken into account for purposes of determining Q.B.I.

An exception to the application of Code §162 applies in one set of circumstances only, relating to rental or licensing of tangible or intangible property to a commonly controlled trade or business. Such rental activity will be treated as a trade or business even if it doesn't otherwise rise to the level required under Code §162. This is designed to allow taxpayers to aggregate their trades or businesses with the associated rental.

Q. 5: What is a specified trade or business ("S.S.T.B.") that is generally not eligible for the deduction?

The definition of S.S.T.B. includes (i) any trade or business in a list of specified fields, as well as (ii) any trade or business that involves "investing and investment management trading or dealing in securities, partnership interests, or certain commodities."

The Proposed Regulations offer clarity on what constitutes an S.S.T.B. by referring to

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[5] In a public hearing conducted on October 16, 2018, by the Treasury Department and the I.R.S., the American Institute of C.P.A.'s ("AICPA") argued that when it comes to rental of real property, all such activities should be treated as a trade or business. They note that there is no clear definition as to when a trade or business exists in the rental real estate context and that the courts have also struggled to articulate a definitive line. Without firm guidance, inconsistent treatment among similarly situated taxpayers could result.

existing guidance under Code §§1202(e)(3)(A) and 448 and by expanding guidance by an objective interpretation to the statute. Included in the definition of S.S.T.B. are the following services in the following fields:

- **Health** – This means the provision of medical services by physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and similar healthcare professionals performing medical services in such capacity who provide medical services directly to a patient. Not included are services that are not directly related to a medical field, even though they may relate to the customer's health. For example, the operation of a health club or health spa that provides physical exercise is not an S.S.T.B.

- **Law** – This means the performance of services by lawyers, paralegals, legal arbitrators, mediators, and similar professionals performing services in their capacity as such. Services provided in the field of law that do not require skills unique to the field of law (*e.g.*, printing, delivery services, or stenography services) are not an S.S.T.B.

- **Accounting** – This includes the provision of services by accountants, enrolled agents, return preparers, financial auditors, and similar professionals performing services in their capacity as such. There is no requirement that the service be provided by a licensed certified public accountant.

- **Actuarial Science** – This means the provision of services by individuals such as actuaries and similar professionals performing services in their capacity as such. The provision of services by analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial cost of risk or uncertainty of events is not an S.S.T.B.

- **Performing Arts** – This means the performance of services by individuals participating in the creation of performing arts. It includes actors, singers, musicians, entertainers, directors, and similar professionals performing services in their capacity as such. Services that do not require skills unique to the creation of performing art (*e.g.*, maintenance and operation of equipment or facilities for use in the performing arts or the provision of services by persons who broadcast or otherwise disseminate video or audio of performing arts to the public) are not S.S.T.B.'s.

- **Consulting** – This means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems, including providing advice and counsel by lobbyists regarding advocacy with the intention of influencing a governmental agency and legislation. This does not include services other than advice and counsel such as sales or the provision of training and educational courses. The determination whether services are sales or economically similar services, or consulting services is based on facts and circumstances, including the manner in which the taxpayer is compensated for the provided services. Consulting services that are embedded in, or ancillary to, the sale of goods or the performance of services on behalf of a trade or business that is otherwise not an S.S.T.B. are also not S.S.T.B.'s, provided that there is no separate payment for the consulting services. For example, a contractor who remodels homes may provide consulting prior to remodeling a kitchen and a company that sells computers may provide customers with consulting services relating to the setup, operation, and repair of the computers without having it treated as an S.S.T.B.

- **Athletics** – This means the performance of services by individuals who participate in athletic competition (such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing). The provision of services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events or the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public, is not an S.S.T.B.

- **Financial Services** – This means the provision of services typically performed by financial advisors and investment bankers. It includes – among other similar financial services to clients – managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory, and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings (including in title 11 or similar cases), and raising financial capital by underwriting or acting as a client's agent in the issuance of securities. Banking is not treated as an S.S.T.B.

- **Brokerage Services** – This includes services in which a person, for a commission or fee, arranges transactions between a buyer and a seller with respect to certain securities, such as shares of stock in a corporation, and other securities described under Code §475(c)(2). This includes services provided by stock brokers and other similar professionals. Services provided by real estate agents and brokers, or insurance agents and brokers, are not S.S.T.B.'s.

- **Investing and Investment Management** – This means any trade or business that earns fees (either in the form of a flat fee, or a fee calculated as a percentage of asset under management) for investment, asset management services, or investment management services, including providing advice with respect to buying and selling investments. Managing real property is not considered investment and investment management and, thus, is not an S.S.T.B.

- **Trading** – This means a trade or business of trading in securities, commodities, or partnership interests. Whether a person is a trader in securities, commodities, or partnership interests is determined by taking into account all relevant facts and circumstances, including the source and type of profit that is associated with engaging in the activity, regardless of whether that person trades for the person's own account, for the account of others, or any combination thereof. A taxpayer who engages in hedging transactions as part of their nontrading trade or business is not engaged in trading for these purposes (*e.g.*, if a manufacturer or a farmer engages in hedging as part of their trade or business of manufacturing or farming).

- **Dealing in Securities, Commodities, and Partnership Interests** – This means regularly purchasing and selling securities, commodities, or partnership interests from and to customers in the ordinary course of a trade or business, or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in securities, commodities, or partnership interests with customers in the ordinary course of a trade or business. A taxpayer that regularly originates loans in the ordinary course of a trade or business of making loans – and very rarely sells loans – will not be treated as dealing in securities due to such sales, provided that such sales are not more than a negligible amount.

- **Reputation or Skill** – Any trade or business where the principal asset is the "reputation or skill" of one or more of its employees or owners is an S.S.T.B. See discussion in Q. 10.

Q. 6: What is the effect of being an S.S.T.B.?

Unless an exception applies, if a trade or business is an S.S.T.B., none of its items of income are taken into account in determining Q.B.I. If the S.S.T.B. is operated through a partnership or an S-corporation, none of the income from the trade or business flowing to an owner of the entity is Q.B.I., regardless of whether the owner participates in the specified service activity. A direct or indirect owner of a trade or business engaged in an S.S.T.B. is treated as engaged in the S.S.T.B. regardless of whether the owner is passive or participated in the S.S.T.B.

Q. 7: What exceptions from S.S.T.B. treatment are available?

Taxpayers below the statutory threshold amounts are not subject to the restrictions with respect to S.S.T.B. and are therefore eligible for the new deduction notwithstanding that a trade or business is an S.S.T.B.

The statute provides for a phase-in range. Taxpayers within the phase-in range must calculate an applicable percentage that applies to limit the Q.B.I. amount as well as the W-2 and unadjusted basis limitation.

The application of the threshold amount is done at the individual owner level and not the partnership or S-corporation level. Therefore, if a partnership operates an S.S.T.B. and the partnership's taxable income is less than the threshold amount but each of the partnership's individual partners has income that exceeds the threshold amount, the S.S.T.B. restriction will begin to phase in. Once a partner's income exceeds the threshold amount plus $50,000 ($100,000 in the case of a joint return), no deduction will be available with respect to any income from the partnership's S.S.T.B. Likewise, no W-2 wages or unadjusted basis limitations relating to such S.S.T.B. may be used.

Additionally, a *de minimis* rule exists. A trade or business will not be considered to be an S.S.T.B. if less than 10% of the gross receipts (5% if the gross receipts are greater than $25 million in a taxable year) of the trade or business are attributable to the performance of services in a specified service activity.

Q. 8: If the *de minimis* rule doesn't apply, can the non-S.S.T.B. activities be separated?

No. A strategy of separating out parts of what otherwise would constitute an integrated business in an attempt to qualify those separate parts for the Q.B.I. deduction is inconsistent with the purpose of the provision and is thus disallowed by the Proposed Regulations.

For example, a law firm may not purchase office space via a separate L.L.C. that rents the office space to the law firm to generate Q.B.I. Likewise, a law firm may not employ its administrative staff under contract as employees of a separate L.L.C.

"An employment relationship exists when the person for whom the services are performed has the right to direct and control the individual who performs the services."

The Proposed Regulations provide that if there is 50% or more direct or indirect common ownership between an S.S.T.B. and another business, any trade or business that provides at least 80% of its property or services to the S.S.T.B. is considered part of that S.S.T.B. If a trade or business that has 50% or more common ownership with a S.S.T.B. provides less than 80% of its property or services to the S.S.T.B., the portion of property or services provided to the S.S.T.B. will be treated as an S.S.T.B.

Finally, if a trade or business that would otherwise not be treated as an S.S.T.B. (i) has 50% or more common ownership with an S.S.T.B., (ii) has shared expenses with the S.S.T.B., and (iii) the gross receipts that represent no more than 5% of the total combined gross receipts of the trade or business and the S.S.T.B., then such trade or business is treated as incidental to the S.S.T.B. and thus a part of the S.S.T.B.

Q. 9: Since the trade or business of being an employee is specifically disallowed, the distinction between employee and independent contractor is important. How are they distinguished for purposes of the deduction?

Wages and compensation income earned by any employee are not Q.B.I. and are not eligible for the new deduction no matter the amount – even if the income is below the threshold. Therefore, there is an incentive to work as an independent contractor. However, changing an individual's status in the company may not provide access to the deduction.

The Proposed Regulations confirm that the distinction between an employee and an independent contractor for purposes of Code §199A is governed by common law rules. Generally, under common law, an employment relationship exists when the person for whom the services are performed has the right to direct and control the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. There is no requirement that the employer will actually direct or control the manner in which the services are performed. Having the right to control the manner of the services is sufficient for the employment relationship to exist.

The Proposed Regulations further provide that Federal employment tax classification of an employee as anything other than an employee is immaterial. Thus, if the employer treats a person as an independent contractor but the person otherwise qualifies as an employee under the statutory and common law principles, such person will be treated as an employee and no deduction will be allowed.

Because the new deduction would incentivize employees to become equity holders in partnerships or S-corporations, for purposes of Code §199A only, the Proposed Regulations provide a presumption applicable to former employees. Under the presumption, if an individual (i) was treated as an employee for Federal employment tax purposes by the person to whom the services are provided and (ii) is subsequently treated as other than an employee with regard to the direct or indirect provision of substantially the same services to that person (or a related person), the individual is presumed to be in the trade or business of performing such services as an employee. This presumption may be rebutted by the individual upon a showing that, under

Federal tax rules and common law rules, the individual is performing services in a capacity other than as an employee.

Q. 10: What guidance is available on the meaning of reputation or skill of one or more of employees or owners?

The Proposed Regulations provide that this seemingly catchall phrase was intended to address a narrow set of trades or businesses that were not otherwise covered by the S.S.T.B. fields but in which income is received based directly on the skill and/or reputation of the employees or owners. The I.R.S. believes that "reputation or skill" must be interpreted in a manner that is objective and administrable. Thus, the Proposed Regulations provide a narrow and exhaustive list of fact patterns that will meet the definition. A trade or business has the reputation or skill of one or more of its employees or owners as the principal asset in each of the following cases:

- A person receives fees, compensation, or other income for endorsing products or services, including an individual's distributive share of income or distributions from a pass-thru entity for which the individual provides endorsement services.
- A person licenses or receives fees, compensation or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity, including an individual's distributive share of income or distributions from a pass-thru entity for which the individual contributed the right to use the individual's image.
- A person receives fees, compensation, or other income for appearing at an event or on radio, television, or another media format.

The consideration for these trades or businesses need not be strictly monetary and may include the receipt of a partnership interest and the corresponding distributive share of income, deduction, gain, or loss from the partnership or the receipt of stock of an S-corporation and the corresponding income, deduction, gain, or loss from the S-corporation stock.

The Proposed Regulations offer the example of a well-known chef who is the sole owner of multiple restaurants operating through L.L.C.'s, receives an endorsement fee of $500,000 for the use of his name on a line of cooking utensils and cookware. This income is clearly due to his reputation or skill and will be S.S.T.B. income not eligible for the deduction. However, the Proposed Regulations provide that this individual is also in the trade or business of being a chef and owning restaurants and imply that this trade or business is not an S.S.T.B. This means that while customers may come to a restaurant due to the chef's reputation, it does not disqualify that trade or business. The S.S.T.B. provision does not apply to that portion of the chef's income.

Q. 11: Is there a loss carryover if a Q.B.I. result is a negative number?

If a taxpayer has multiple trades or businesses, he or she must calculate the Q.B.I. from each trade or business and, before applying the deduction, net the amounts.

If the net Q.B.I. is negative, the amount is treated as a loss from a qualified trade or business in the succeeding taxable year. The Proposed Regulations provide that the carryover rules do not affect the deductibility of the losses for other purposes.

If a taxpayer has a negative Q.B.I. in one business but an overall Q.B.I. that is greater than zero, the taxpayer must offset the net income with the net losses before the taxpayer applies the W-2 wage and the unadjusted basis limitations. The net loss must be apportioned among the trades or businesses with positive Q.B.I. in proportion to the relative amount of Q.B.I. in such trade or businesses. The Proposed Regulations provide that the W-2 wages and the unadjusted basis in qualified property from the business that produced a negative Q.B.I. are not taken into account and are not carried over into subsequent years. However, see the discussion relating to aggregation of businesses in Q. 12 below. Under certain circumstances, a taxpayer may aggregate the businesses and take into account the W-2 wages and unadjusted basis of the losing business.

Q. 12: Can an eligible taxpayer that has more than one trade or business, or that operates its business through several entities, group businesses for purposes of applying Code §199A?

The Proposed Regulations provide aggregation rules that allow taxpayers to combine their businesses for purposes of applying the W-2 wage and the unadjusted basis limitations and to potentially maximize the deduction.

Aggregation is permitted but is not required. Eligible taxpayers can aggregate trades or businesses operated directly or through pass-thru entities. The aggregation is done at the owner level. Therefore, partnerships and S-corporations must compute and provide their owners with information regarding Q.B.I., W-2 wages, and the unadjusted basis of qualified property for each trade or business operated by the entity. One owner may elect to aggregate and another not to aggregate. Additionally, a taxpayer may aggregate some but not all attributable businesses.

Trades or businesses can be aggregated only if the individual can demonstrate that the following requirements are met:

- Each trade or business meets the requirements under Code §162.
- For the majority of the taxable year in which items attributable to a trade or business are included in income, the same person, or the same group of persons, must directly or indirectly own at least 50% of each trade or business to be aggregated. (Family attribution applies, so that an individual is considered to own the interest owned directly or indirectly by their spouse, child, grandchild, or parent. Note that non-majority owners may benefit from the common ownership and are permitted to aggregate.)
- All businesses aggregated must share the same tax year. (Short taxable years are not taken into account.)
- None of the aggregated trades or businesses can be an S.S.T.B.
- The aggregated trades or business must satisfy at least two of the requirements that demonstrate that the businesses are in fact part of a larger, integrated trade or business:
    - The trades or businesses provide services and products that are the same (*e.g.*, a restaurant and a food truck) or are usually offered together (*e.g.*, a gas station and a car wash).

- The trades or businesses share facilities or significant business elements (*e.g.*, common personnel, accounting, legal, manufacturing, purchasing, human resources, or information technologies).
- The trades or businesses are operated in coordination with, or reliance on, one or more of the other businesses in the aggregate group (*e.g.*, supply chain interdependencies).

If aggregation is elected, taxpayers must compute allocable Q.B.I., allocable W-2 wages, and allocable unadjusted basis of qualified property on a trade-or-business-by-trade-or-business basis. Only then can they be aggregated. The combined W-2 wages and combined unadjusted basis of qualified property allocable to the taxpayer for all aggregated businesses is used for applying the limitations.

"Eligible taxpayers can aggregate trades or businesses operated directly or through pass-thru entities."

Finally, the aggregation must be consistently reported in all subsequent tax years, and the taxpayer must attach a statement to the taxpayer's income tax return identifying each aggregated trade or business and providing certain information relating to each aggregated trade or business. Failure to disclose may result in the disallowance of the aggregation.

Q. 13: What new guidance is available with respect to W-2 wages?

- The Proposed Regulations allow a taxpayer to take into account any W-2 wages paid by another person, provided that the wages reported on the Forms W-2 were paid to the employees of the taxpayer for employment by the taxpayer. This provision enables taxpayers who use third-party vendors to pay W-2 wages (*e.g.*, Paychex) to include such wages in the Code §199A deduction computation. The person paying the W-2 wages and reporting the W-2 wages on Forms W-2 is precluded from taking into account such wages for its Code §199A purposes.
- I.R.S. Notice 2018-64, issued on the same day as the Proposed Regulations, provides for three methods for calculating Form W-2 wages for purposes of Code §199A. The first method (the "unmodified Box method") allows for a simplified calculation, and the second and third methods (the "modified Box 1 method" and the "tracking wages method," respectively) allow for greater accuracy.
- The Proposed Regulations provide that if W-2 wages are allocable to more than one trade or business, the portion of the W-2 wages allocable to each business must be allocated among the trades or businesses using a reasonable method based on all the facts and circumstances.
- The Proposed Regulations provide for allocation of W-2 wages when a trade or business is acquired or disposed of that causes more than one taxpayer to be an employer of the employees of the acquired or disposed of trade or business during the calendar year. The allocation is based on the period during which the employees of the acquired or disposed of trade or business were employed by the taxpayer. The Proposed Regulations also clarify that acquisition or disposition include an incorporation, formation, liquidation, reorganization, or purchase or sale of assets.

Q. 14: What guidance was provided with respect to qualified property acquired in a Code §1031 exchange?

The Proposed Regulations provide that the unadjusted basis of a qualified property that is acquired in a "like-kind" exchange equals the adjusted basis of the relinquished property. In addition, the replacement property is treated as a Modified Accelerated Cost Recovery System ("M.A.C.R.S.") property, whose depreciable period generally is determined as of the date the relinquished property was first placed in service. As a result, the depreciable period under Code §199A for the exchanged basis of the replacement qualified property will end before the depreciable period for the excess basis of the replacement property ends. An election is available according to which the date the exchanged basis and excess basis in the replacement qualified property are first placed in service by the trade or business is the date on which the replacement qualified property is first placed in service by the taxpayer, with the unadjusted basis determined as of that date. In this case, the depreciable periods for the exchanged basis and the excess basis of the replacement property will end on the same day.

Q. 15: Are there additional rules worth mentioning?

- The incentive to divide assets among multiple non-grantor trusts to multiply the threshold amount was shut down by the Proposed Regulations, which provide that trusts formed or funded with a significant purpose of receiving a deduction under Code §199A will not be respected.

- An otherwise qualified R.E.I.T. dividend is ignored when computing the Code §199A deduction if the stock with respect to which it is received is held for fewer than 45 days. The day on which the stock is disposed is included in the period of holding; the day of acquisition is ignored. The holding period is further reduced for periods where the taxpayer did not bear the risk of loss. These anti-abuse rules aim at preventing dividend stripping and similar transactions by limiting what will be treated as qualified R.E.I.T. stock to R.E.I.T. stock held for a meaningful period of time allowing the taxpayer to have an economic exposure to the stock.

- The Proposed Regulations treat disregarding property as qualified property for purposes of the unadjusted basis limitation if the property is acquired within 60 days of the end of a taxable year and disposed of within 120 days without having been used in a trade or business for at least 45 days. If the taxpayer can demonstrate that the principal purpose of acquiring the property and disposing of the property was other than due to the Code §199A deduction, the property will not be disregarded.

- For purposes of determining Q.B.I., W-2 wages, and the unadjusted basis in qualified property allocated to a taxpayer from a pass-thru entity with a taxable year that begins before January 1, 2018, and ends after December 31, 2017, such items are treated as having been incurred by the taxpayer during the taxpayer's tax year during which the pass-thru's taxable year ends. This means that, in the case of a partnership or an S-corporation that has a fiscal year as a tax year, its owners may include their allocable share of the Q.B.I. from pre-2018 periods in their 2018 return.

- The Proposed Regulations provide that the Code §199A deduction does not reduce the net earnings from self-employment for the purposes of calculating self-employment tax or net investment income for the purpose of calculating the net investment income tax. Therefore, both taxes are calculated as though there is no Code §199A deduction. Additionally, the Proposed Regulations provide that the Code §199A deduction is allowed in determining the alternative minimum tax liability.

CONCLUSION

The Proposed Regulations are extensive, with many examples, and provide for much needed interpretation as well as a number of anti-avoidance rules. This article attempts to familiarize the reader with the more important aspects of the regulations to enable the reader to explore the potential benefits of the new provisions. The Proposed Regulations were opened to a public hearing on October 16, 2018. Further changes will be reported in *Insights* when announced.

TRANSITION TAX – PROPOSED REGULATIONS ARE HERE

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Tags
Code §965
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T.C.J.A.

The Treasury Department and the I.R.S. recently published proposed regulations on Code §965 (the "Proposed Regulations"). Introduced by the Tax Cuts and Jobs Act of 2017 ("T.C.J.A."), Code §965 requires a "U.S. Shareholder" (see in detail below) to pay income tax on its *pro rata* share of previously untaxed foreign earnings held in a controlled foreign corporation ("C.F.C.") and in certain other foreign corporations.[1] The tax imposed by Code §965 is commonly referred to as the transition tax. It is designed to tax deferred foreign income prior to the transition to a "participation exemption" system of taxation for the foreign portion of dividends from C.F.C.'s and certain other foreign corporations and, hence, is also a "toll tax."[2] Because this tax is imposed irrespective of whether profits of a qualifying foreign corporation are actually distributed to its U.S. Shareholders, it is also referred to as a "mandatory repatriation tax."

Prior to the Proposed Regulations, the Treasury Department and I.R.S. issued guidance on this new Code provision under Notices 2018-7,[3] 2018-13,[4] and 2018-26[5] and Revenue Procedure 2018-17.[6] The Proposed Regulations generally follow the prior guidance but, in addition, provide long awaited clarification on calculation, special election, and payment procedures.

CODE §965 BACKGROUND

In order to discuss the calculation and the workings of Code §965, several significant terms must be understood.

Transition tax applies to an S.F.C. that is a "deferred foreign income corporation" ("D.F.I.C.").[7]

An S.F.C. is (i) any C.F.C. and (ii) any foreign corporation in which one or more U.S. corporations is a U.S. Shareholder.[8] For Code §965 purposes, a U.S. Shareholder

1 Code §965.

2 Conceptually, the exempting of foreign-source dividends under this rule is a dividend received deduction ("D.R.D.") rather than a participation exemption, as provided for example under Canadian law or the E.U. Parent/Subsidiary Directive. Apart from the operation of a D.R.D. and with very limited exceptions, it does not provide for an exemption of capital gains.

3 2018-4 I.R.B. 317 (Dec. 29, 2017).

4 2018-6 I.R.B. 341 (Jan. 19, 2018).

5 2018-9 I.R.B. 384 (Fed. 13, 2018).

6 2018-16 I.R.B. 480 (Apr. 2, 2018).

7 Code §965(d)(1).

8 Code §§965(e)(1)(A) and (B). An S.F.C. does not include any corporation that is

is a U.S. person (*e.g.*, a citizen, resident, corporation, partnership, trust, or estate) that owns 10% or more of the vote of the foreign corporation.[9] A C.F.C. is a foreign corporation in which one or more U.S. Shareholders own more than 50% of the voting rights of all of the classes of stock that are entitled to vote.

A D.F.I.C. is an S.F.C. that has "accumulated post-1986 deferred foreign income" on one of two possible measurement dates, discussed below. Accumulated post-1986 deferred foreign income is "post-1986 E&P" defined below, but excludes earnings attributable to income effectively connected to a U.S. trade or business[10] or, in the case of a C.F.C., income that, if distributed to a U.S. Shareholder, would have been previously subject to U.S. taxation under the rules applicable to C.F.C.'s.[11]

Post-1986 E&P is E&P of the foreign corporation computed under the applicable rules and accumulated in tax years beginning after December 31, 1986, through one of the two applicable measurement dates, discussed below. The amount is determined without a reduction for dividends distributed during the tax year. This reflects the general ordering rule of Subpart F and actual dividends – Subpart F applies first, and dividends are not taxed a second time if and to the extent attributable to previously taxed income. For individual U.S. Shareholders, this means they are taxed at ordinary income rates and not favorable long-term capital gains tax rates that might otherwise apply to qualified dividends.

"Code §965 allows a deduction to be applied to net income that is calculated to achieve a specific tax rate."

The transition tax applies to the last tax year of a D.F.I.C. that begins before January 1, 2018. For that tax year, the Subpart F Income under Code §951 (also referred to as a Code §951 inclusion) of a D.F.I.C. must be increased by the greater of its accumulated post-1986 deferred foreign income as of November 2, 2017, or December 31, 2017, (the "E&P measurement dates"). The increase in income is the "Code §965(a) earnings" amount. The U.S. Shareholder must treat the increase as Subpart F Income.

Under Code §965(b), if a U.S. Shareholder is a shareholder of at least one D.F.I.C. and at least one foreign corporation that has an E&P deficit (an "E&P deficit foreign corporation"), the increase in income discussed above is reduced (but not below zero) by the U.S. Shareholder's aggregate foreign E&P deficit. This amount is the "Code §965(a) inclusion" amount. The amount by which the foreign E&P deficit decreased the Code §965(a) earnings amount is treated as previously taxed income ("P.T.I.") under the rules of Code §959.

Instead of prescribing a fixed tax rate on the Code §951 inclusion, Code §965 allows a deduction to be applied to net income that is calculated to achieve a specific tax rate. This is referred to as the rate equivalent percentage method. In substance, the equivalent of a partial D.R.D. is computed so that the tax imposed will equal the target rate when divided by net income before the deduction.

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a Passive Foreign Investment Income Company ("P.F.I.C."), as defined in Code §1297, with respect to the shareholder. Code §965(e)(3).

9 The definition of U.S. Shareholder was broadened under the T.C.J.A. to include a U.S. person that owns 10% or more of the vote or value of a foreign corporation. However, the expanded definition does not apply for transition tax purposes. See, Com. Report, p. 485, fn. 1503.

10 Code §965(d)(2)(A).

11 Code §965(d)(2)(B).

The effective tax rates applicable to income inclusions under this rule are adjusted by way of a deduction set forth in Code §965(c). In other words, the "exemption" is in the form of a partial deduction (the "Code §965(c) deduction"). As a result, the Code §965 deduction results in a partial "exemption" of the Code §965 inclusion amount. The Code §965(c) deduction is an amount necessary to produce a 15.5% tax rate on accumulated post-1986 E&P held in the form of cash or cash equivalents and an 8% tax rate on all other earnings. The foreign tax credit is not allowed for the applicable percentage of foreign taxes paid or accrued (or treated as paid or accrued) with respect to any amount for which a Code §965(c) deduction is allowed.

Code §965 permits the taxpayer to make certain elections. Under Code §965(h), a U.S. Shareholder may elect to defer payment of the transition tax liability by paying the amount in installments over eight years. The first five installments must each equal 8% of the transition tax liability; the sixth installment must equal 15%; the seventh installment must equal 20%; the eighth and final installment must equal 25%. The installment payments are not subject to an interest charge. Certain "acceleration events" will cause the taxpayer to lose the benefit of deferral by accelerating the payment of the unpaid portion of all remaining installments to the date of the acceleration event, discussed under **Elections and Payments** below. Note that although the payment of the net tax liability under Code §965 is deferred, the amount must be reported on an IRC 965 Transition Tax Statement.

In the case of an S-corporation that is a U.S. Shareholder of a D.F.I.C., Code §965(i) permits each shareholder of the S-corporation to elect to defer payment of the transition tax liability until a "triggering event." A triggering event occurs when the corporation ceases to be an S-corporation or is sold or liquidated, or the taxpayer transfers stock of the S-corporation (including a transfer by death).

STEP-BY-STEP CALCULATION OF THE TRANSITION TAX

Based on the foregoing, determining the amount of transition tax requires the following steps:

1. Measure post-1986 E&P of S.F.C.'s.
2. Allocate E&P deficits.
3. Calculate aggregate foreign cash position or cash equivalent amounts.
4. Compute allowed deductions under Code §965(c).
5. Determine foreign tax credits.

THE PROPOSED REGULATIONS

Definitions

The following definitions are addressed in the Proposed Regulations. These definitions generally are consistent with prior guidance.

E&P Deficit Foreign Corporation – For purposes of determining the status of an S.F.C. as a D.F.I.C. or an E&P deficit foreign corporation, it must first be determined whether the S.F.C. is a D.F.I.C. In broad terms, D.F.I.C. status trumps classification as an E&P deficit foreign corporation. More specifically, if an S.F.C. meets the definition of a D.F.I.C., it is classified solely as a D.F.I.C. and not also as an E&P deficit foreign corporation, notwithstanding the fact that the S.F.C. otherwise satisfies the E&P deficit foreign corporation definition. Thus, only in the event an S.F.C. does not meet the definition of a D.F.I.C., must it be determined whether it is an E&P deficit foreign corporation. Under certain circumstances described in the Proposed Regulations, an S.F.C. may be classified as neither a D.F.I.C. nor an E&P deficit foreign corporation despite having post-1986 E&P greater than zero or a deficit in accumulated post-1986 deferred foreign income.[12]

Accumulated Post-1986 Deferred Foreign Income – In the case of a C.F.C. that has shareholders that are not U.S. Shareholders on an E&P measurement date, the accumulated post-1986 deferred foreign income of the C.F.C. on the E&P measurement date is reduced by amounts that would be those described in Code §965(d)(2)(B) if the shareholders were U.S. Shareholders. In such cases, the principles of Revenue Ruling 82-16, 1982-1 C.B. 106, apply in order to determine the amounts by which accumulated post-1986 deferred foreign income is reduced.[13]

Cash Measurement Dates – For the purpose of computing the Code §965(a) inclusion, the cash measurement dates are as follows:

- The first cash measurement date of an S.F.C. is the close of the last tax year of the S.F.C. that ends after November 1, 2015, and before November 2, 2016, if any.
- The second cash measurement date of an S.F.C. is the close of the last tax year of the S.F.C. that ends after November 1, 2016, and before November 2, 2017, if any.
- The final cash measurement date of an S.F.C. is the close of the last tax year of the S.F.C. that begins before January 1, 2018, and ends on or after November 2, 2017, if any.

The proposed regulations provide that a U.S. Shareholder takes into account its *pro rata* share of the cash position of an S.F.C. as of any cash measurement date of the S.F.C. on which it is a U.S. Shareholder of the S.F.C., regardless of whether the U.S. Shareholder is a U. S. Shareholder of the S.F.C. as of any other cash measurement date, including the final cash measurement date of the S.F.C.[14]

Cash Position – The Proposed Regulations define the term "cash-equivalent asset" to include derivative financial instruments held by the S.F.C. that are not a *bona fide* hedging transaction.15 "Derivative financial instruments" include notional principal contracts, options contracts, forward contracts, futures contracts, short positions in securities and commodities, and any similar financial instruments.[16]

***Pro Rata* Share** – The Proposed Regulations provide that, for purposes of

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12 Prop. Treas. Reg. §§1.965-1(f)(17)(ii); 1.965-1(g), Example 5.

13 Prop. Treas. Reg. §1.965-1(f)(7)(i)(C)

14 Prop. Treas. Reg. §§1.965-1(f)(24), (31), (25), (30)(iii).

15 Prop. Treas. Reg. §1.965-1(f)(13)(v).

16 Prop. Treas. Reg. §1.965-1(f)(18).

determining a U.S. Shareholder's *pro rata* share of the specified E&P deficit of an E&P deficit foreign corporation that has multiple classes of stock outstanding, the specified E&P deficit is allocated among the holders of the corporation's common stock and in proportion to the value of the holding. The Proposed Regulations also clarify that, for purposes of determining a shareholder's *pro rata* share of a specified E&P deficit, the value of the common stock is determined as of the last day of the last tax year of the E&P deficit foreign corporation that begins before January 1, 2018.[17]

Domestic Pass-Thru Entity – The Proposed Regulations define the term "domestic pass-thru entity" to mean a pass-thru entity that is a U.S. person that is a partnership, S-corporation, or any other person to the extent that the income or deductions of such person are included in the income of one or more direct or indirect owners or beneficiaries of the person.[18]

Domestic Pass-Thru Owner's Share – In the case of a domestic pass-thru entity that is a U.S. Shareholder with respect to one or more D.F.I.C.'s, each domestic pass-thru owner takes into account its share of the aggregate Code §965(a) inclusion amount with respect to stock of one or more D.F.I.C.'s of the domestic pass-thru entity and its share of the Code §965(c) deduction amount (each a "domestic pass-thru owner's share"), regardless of whether the domestic pass-thru owner is also a U.S. Shareholder with respect to the D.F.I.C. This gives rise to a Code §965(a) inclusion and a Code §965(c) deduction for the domestic pass-thru owner.[19] An aggregate Code 965(a) inclusion amount for a U.S. Shareholder's inclusion year and the related Code 965(c) deduction must be allocated in the same proportion. For example, if a domestic pass-thru owner is allocated 50% of the aggregate Code §965(a) inclusion amount with respect to stock of a domestic pass-thru entity, the domestic pass-thru owner must be allocated 50% of the related Code §965(c) deduction amount. If the domestic pass-thru owner is also a U.S. Shareholder with respect to the D.F.I.C. because it owns stock of the D.F.I.C., the Code §965(a) inclusion amount with respect to the stock of the domestic pass-through owner and the Code §965(c) deduction amount with respect to such amount are determined separately from the domestic pass-thru owner's share of the aggregate Code §965(a) inclusion amount and Code §965(c) deduction amount of the domestic pass-thru entity.[20]

Adjustments to E&P and Basis

E&P Adjustments

The Proposed Regulations provide rules on the interaction between Code §965 and the P.T.I. regulations under Code §959, which are consistent with prior guidance.[21] The following ordering rules are set forth in the Proposed Regulations for computing adjustments to E&P for purposes of determining the Code §965(a) inclusion and the treatment of P.T.I. distributions:[22]

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17 Prop. Treas. Reg. §1.965-1(f)(30)(ii).

18 Prop. Treas. Reg. §1.965-1(f)(19).

19 Prop. Treas. Reg. §§1.965-1(f)(21), (37), (41).

20 Prop. Treas. Reg. §1.965-3(g).

21 Notice 2018-07, §3.02(d).

22 Prop. Treas. Reg. §1.965-2(b).

1. Compute Subpart F Income without regard to Code §965(a).

2. Account for the treatment of distributions from one S.F.C. to another S.F.C. made before January 1, 2018, for the purposes of Code §959.

3. Compute the U.S. Shareholder's Code §965(a) inclusion amount.

4. Take into account the treatment of all distributions from the S.F.C. (other than those described in the second step) determined under Code §959.

5. Determine any Code §956 inclusion (relating to investments in U.S. property) with respect to the S.F.C., including any P.T.I.

Basis Adjustments

In general, under Code §961(a), a U.S. Shareholder's basis in the stock of a C.F.C. (or its basis in property by reason of which it indirectly owns stock of a C.F.C.) is increased by the amount required to be included in its gross income as Subpart F Income. Under Code §961(b), the basis is reduced by the amount received that is excluded from gross income because it is P.T.I.

The Proposed Regulations state that a U.S. Shareholder's basis in the stock of a D.F.I.C. is increased by the shareholder's Code §965(a) inclusion and P.T.I.[23]

As discussed above, when the Code §965(a) earnings amount of a D.F.I.C. is reduced by a foreign E&P deficit of a Code §965(b) E&P deficit foreign corporation, the reduction amount is treated as P.T.I. The Proposed Regulations state that the allocation of the deficit foreign E&P does not result in an automatic basis increase.[24] However, the Proposed Regulations provide for the possibility of an election to apply basis adjustments.[25]

Basis adjustment rules in the case of an individual U.S. Shareholder that elected to be treated as a corporation under a Code §962 election (discussed below) were not addressed and have been reserved.

Gain Reduction Rule

In the case of a reduction of basis resulting from excluding P.T.I. from gross income, Code §961(b)(2) states that to the extent that the amount excluded exceeds the adjusted basis of the stock (or property), that amount is treated as gain. In such a case, the Proposed Regulations provide a gain reduction rule. Under the rule, the amount of the gain is reduced (but not below zero) by an amount equal to the Code §965(a) previously taxed E&P.[26] Notably and contrary to Notice 2018-13, the regulations remain silent on distributions by a lower tier C.F.C. to its C.F.C. parent.

Foreign Tax Credits and Deductions

Code §965(g)(1) states that no credit is allowed under Code §901 (the Code section that governs credits for foreign taxes directly paid or accrued by the taxpayer) for the

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23 Prop. Treas. Reg. §1.965-2(e).

24 Prop. Treas. Reg. §1.965-2(f).

25 Prop. Treas. Reg. §1.965-2(f)(2).

26 Prop. Treas. Reg. §1.965-2(g).

"applicable percentage" of any taxes paid or accrued, or treated as paid or accrued, with respect to any amount for which the Code §965(c) deduction is allowed. As discussed above, the Code §965(c) deduction is the deduction that lowers the tax rate on the Code §965(a) inclusion to 15.5% on accumulated post-1986 E&P attributable to cash and cash equivalents and 8% on the remaining earnings. The applicable percentage is a haircut on the foreign taxes related to the Code §965(a) inclusion, generally in proportion to the amount by which the Code §965(c) deduction reduces the tax on the Code §965(a) inclusion.

"U.S. citizens that live outside the U.S. and are subject to tax on a net basis in their jurisdiction of residence are not allowed a credit nor a deduction for net basis taxes imposed on the receipt of Code §§965(a) or (b) previously taxed E&P."

Note that no deduction is allowed for any amount for which a credit is disallowed under Code §965(g)(1). Thus, foreign taxes paid or accrued with respect to any amount for which the Code §965(c) is allowed are neither creditable nor deductible.

The Proposed Regulations state that "taxes paid or accrued" refers to taxes paid or accrued directly by the taxpayer under Code §901 (*e.g.*, withholding taxes) and taxes "treated as paid or accrued." The latter include foreign income taxes deemed paid by the taxpayer under Code §960 (*i.e.*, income taxes paid by the foreign corporation), foreign income taxes allocated to any entity under Treas. Reg. §1.901-2(f)(4), and a distributive share of taxes paid by a partnership.[27] This is an important clarification because the statute does not explicitly refer to indirect foreign income taxes.

The Proposed Regulations state that neither a deduction nor a credit is allowed under Code §901 for the applicable percentage of any foreign income taxes attributable to a distribution of Code §965(a) previously taxed E&P or Code §965(b) previously taxed E&P. Thus, withholding taxes imposed on a U.S. Shareholder on an actual distribution of Code §§965(a) or (b) previously taxed E&P are not creditable nor deductible. Further, U.S. citizens that live outside the U.S. and are subject to tax on a net basis in their jurisdiction of residence are not allowed a credit nor a deduction for net basis taxes imposed on the receipt of Code §§965(a) or (b) previously taxed E&P.

Code §960 provides the rules for crediting indirect foreign taxes paid or accrued on Subpart F Income. Former Code §960(a)(3)[28] states that any portion of a distribution from a foreign corporation received by a domestic corporation which is excluded from gross income as P.T.I. is treated as a dividend from the foreign corporation to the domestic corporation solely for the purpose of taking into account any foreign taxes which were not deemed paid by the domestic corporation for any prior tax year. The Proposed Regulations state that a credit allowed under Code §960(a)(3) applies only with respect to foreign income taxes imposed on an upper-tier foreign corporation on distributions of Code §965(a) or (b) previously taxed E&P from a lower-tier foreign corporation.[29] In addition, foreign income taxes attributable to the portion of a Code §965(a) earnings amount that was reduced by Code §965(b) are not creditable.[30]

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27 Prop. Treas. Reg. §1.965-5(b).

28 Under the T.C.J.A., Code §960(a)(3) was replaced with Code §960(b). The Proposed Regulations only address the application of Code §960 before the effective date of Code §960(b). The preamble to the Proposed Regulations states that future regulations will address the application of Code §960(b).

29 Prop. Treas. Reg. §1.965-5(c)(1)(ii).

30 *Id.*

Code §965(c) Deductions

Determination of Aggregate Foreign Cash Position

The Proposed Regulations provide that, for purposes of determining the aggregate foreign cash position of a U.S. Shareholder, certain obligations, such as accounts receivable, accounts payable, short-term obligations, or derivative financial instruments between related S.F.C.'s are disregarded on the corresponding cash measurement dates of the S.F.C.'s to the extent of the smallest of the U.S. Shareholder's ownership percentages of stock those dates.[31]

Further, the aggregate foreign cash position is reduced by amounts of net accounts receivable, actively traded property, and short-term obligations to the extent such amounts are attributable to amounts taken into account in determining the U.S. Shareholder's *pro rata* share of the cash position of another S.F.C. on such cash measurement date and to the extent it is not already disregarded. To disregard assets under this rule, the U.S. Shareholder must attach a statement to its timely-filed return.[32]

Determination of Aggregate Foreign Cash Position for a U.S. Shareholder's Inclusion Year

The Proposed Regulations provide that in the case of a U.S. Shareholder that has a Code §965(a) inclusion amount in more than one tax year, the amount of the aggregate foreign cash position taken into account in the first tax year will equal the lesser of the U.S. Shareholder's aggregate foreign cash position or the aggregate Code §965(a) inclusion amount taken into account by the U.S. Shareholder in that tax year. Furthermore, the amount of the U.S. Shareholder's aggregate foreign cash position taken into account in any succeeding tax year will be the lesser of (i) the excess, if any, of its aggregate foreign cash position over the amount of its aggregate foreign cash position taken into account in preceding tax years or (ii) the aggregate Code §965(a) inclusion amount taken into account by the U.S. Shareholder in such succeeding taxable year.[33]

In addition, the Proposed Regulations provide that, for purposes of determining the aggregate foreign cash position of a U.S. Shareholder for a tax year in which it takes into account a Code §965(a) inclusion amount, the U.S. Shareholder may assume that its *pro rata* share of the cash position of any S.F.C. whose last tax year beginning before January 1, 2018, ends after the date the return for such tax year of the U.S. Shareholder is timely filed (including filing date extensions) will be zero as of the cash measurement date with which the tax year of the S.F.C. ends.

If a U.S. Shareholder's *pro rata* share of the cash position of an S.F.C. was treated as zero pursuant to the above rule for a U.S. Shareholder's inclusion year (an "estimated U.S. Shareholder inclusion year"), the final cash measurement date amount, in fact, exceeds the average of the first and second cash measurement date amounts with respect to the U.S. Shareholder, and its aggregate Code §965(a) inclusion amount, in fact, exceeds the final cash measurement date amount, then interest and penalties will not be imposed if the U.S. Shareholder makes appropriate

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31 Prop. Treas. Reg. §1.965-3(b)(1).

32 Prop. Treas. Reg. §1.965-3(b)(2).

33 Prop. Treas. Reg. §1.965-3(c)(2).

adjustments by amending the return for the estimated U.S. Shareholder inclusion year to reflect the correct aggregate foreign cash position by the due date (including filing date extensions) for the return for the year after the estimated U.S. Shareholder inclusion year.[34]

Treatment of Code §965(c) Deductions Under Certain Code Provisions

The Proposed Regulations provide that a Code §965(c) deduction is not treated as an itemized deduction for any purpose.[35]

In the case of a domestic partnership or S-corporation, the Proposed Regulations state that: (i) the aggregate amount of its Code §965(a) inclusions net of the aggregate amount of its Code §965(c) deductions is treated as a separately stated item of net income solely for purposes of calculating basis, and (ii) the aggregate amount of its Code §965(a) inclusions equal to the aggregate amount of its Code §965(c) deductions is treated as income exempt from tax solely for purposes of calculating basis under certain provisions of the Code.[36]

Disregarding Certain Transactions

The Proposed Regulations disregard certain transactions for purposes of applying Code §965. In particular, Prop. Treas. Reg. §1.965-4 provides rules that disregard (i) transactions undertaken with a principal purpose of reducing the U.S. Shareholder's Code §965 tax liability, (ii) certain changes in method of accounting and entity classification elections, and (iii) certain transactions occurring between E&P measurement dates.[37] Note that for purposes of these anti-abuse rules, if a domestic partnership is a U.S. Shareholder, a domestic partner (that is not otherwise treated as U.S. Shareholder) is treated as a U.S. Shareholder.[38]

The application of the anti-avoidance rules[39] is based on whether there is a "change in the amount of a Code §965 element" rather than a change in the Code §965 tax liability.[40] For this purpose, generally, there is a change in the amount of a Code §965 element if there is a reduction of a Code §965(a) inclusion amount or aggregate foreign cash position, or an increase in deemed paid foreign income taxes as a result of a Code §965(a) inclusion.[41]

The Proposed Regulations disregard certain transactions occurring between E&P measurement dates. The amounts paid or incurred between related S.F.C.'s of a U.S. Shareholder between E&P measurement dates that would otherwise reduce such an S.F.C.'s post-1986 E&P as of December 31, 2017, are disregarded for

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34 Prop. Treas. Reg. §1.965-3(c)(3).

35 Prop. Treas. Reg. §1.965-3(f)(1).

36 Code §§705(a)(1)(B) with respect to the determination of a partner's basis with regards to tax exempt income, Code §1367(a)(1)(A) with respect to certain transfers of property by U.S. persons to foreign corporations, and Treas. Reg. §1.1367-1(f) in this context.

37 Prop. Treas. Reg. §1.965-4.

38 Prop. Treas. Reg. §1.965-4(e)(2).

39 Prop. Treas. Reg. §1.965-4(b)-(e).

40 Prop. Treas. Reg. §1.965-4(b)(1).

41 Prop. Treas. Reg. §§1.965-4(d), (e)(1).

purposes of determining the post-1986 E&P of both S.F.C.'s as of December 31, 2017.[42]

In addition, a specified transaction will be treated *per se* as abusive (*i.e.*, as having a principal purpose of changing the amount of a Code §965 element of a U.S. Shareholder) for purposes of the anti-avoidance rule. A "specified transaction" reduces E&P in one or more of the following ways: (i) a complete liquidation of an S.F.C. to which Code §331 applies; (ii) a sale or other disposition of stock by an S.F.C.; or (iii) a distribution by an S.F.C. that reduces the E&P of the S.F.C. according to Code §312(a)(3).

Elections and Payments

Prop. Treas. Reg. §1.965-7 discusses elections under Code §965. These include an election to pay the net tax liability in installments under Code §965(h),[43] an election under Code §965(i) for an S-corporation shareholder to defer the net tax liability until a triggering event,[44] and an election by a real estate investment trust ("R.E.I.T.") to defer the inclusion of its aggregate amount of Code §965(a) inclusions and Code §965(c) deductions over an eight-year period.[45]

The Proposed Regulations state that relief for late filing under Treas. Reg. §§301.9100-2 or 301.9100-3 (relating to rules for requests for extensions) of any election under Code §965, including the elections above, is not available.[46]

Code §965(h) permits a taxpayer to elect to pay the net tax liability in eight installment payments. The Proposed Regulations refer to the net tax liability subject to the deferral election under Code §965(h) as the "section 965(h) net tax liability." The election may be made by a Code §958(a) U.S. Shareholder or a domestic pass-thru owner with respect to a domestic pass-thru entity that is a Code §958(a) U.S. Shareholder but not a domestic pass-thru entity itself.

Under Code §965, an acceleration event will cause the unpaid portion of remaining installments to be due on the date of such event. An acceleration event includes: an addition to tax for failure to timely pay any installment, a liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case, a cessation of the business by the taxpayer or any similar circumstance.[47]

The Proposed Regulations add the following acceleration events:

- In the case of an individual, the death of the person or any event that results in the person no longer being a U.S. person, including a resident alien becoming a nonresident alien.
- In the case of a person that was not a member of any consolidated group, the person becoming a member of a consolidated group.

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42 Prop. Treas. Reg. §1.965-4(f).

43 Prop. Treas. Reg. §1.965-7(b).

44 Prop. Treas. Reg. §1.965-7(c).

45 Prop. Treas. Reg. §1.965-7(d).

46 See, *e.g.*, Prop. Treas. Reg. §§1.965-7(b)(2)(ii), 1.965-7(c)(2)(ii), and 1.965-7(d)(3)(ii).

47 Code §965(h)(3).

- In the case of a consolidated group, the group ceasing to exist, including as a result of an acquisition.

As a general note, these rules should be helpful to prevent an acceleration event in many common business transactions.

The Proposed Regulations address the issue of a taxpayer that elected installment payment and incorrectly computed its net tax liability. Two instances are distinguished for purposes of these rules: In the case of the I.R.S. assessing a deficiency, or the taxpayer timely filing a return, or filing an amended return, the deficiency or additional liability must be prorated to the installments. This rule does, however, not apply in the case of negligence, intentional disregard or fraud. In such case, the deficiency payment must be made on notice or demand by the I.R.S. or the additional liability must be paid with the tax return or amended tax return. Thus, an addition to tax with respect to an installment payment that is not due to negligence, intentional disregard or fraud is not an acceleration event.

The Proposed Regulations state that each shareholder of an S-corporation, other than a domestic pass-thru entity, that is a U.S. Shareholder of a D.F.I.C. may elect to defer the net tax liability until the shareholder's taxable year that includes a triggering event described Code §965(i). The Proposed Regulations refer to the net tax liability subject to the deferral election under Code §965(i) as the "section 965(i) net tax liability."

The consequences of an acceleration event in the case of a Code §965(h), or a triggering event in the case of a Code §965(i) election, will not occur if the taxpayer transfers its section 965(h) net tax liability or section 965(i) net tax liability to an eligible transferee under a transfer agreement. The Proposed Regulations set forth the requirements for such transfer agreements. Relief for late filing of a transfer agreement is not available.[48]

"An individual U.S. Shareholder that does not make a Code §962 election may by subject to tax under Code §965 at rates higher than the rates for corporate U.S. Shareholders."

Application to Individuals

In addition to rules interpreting Code §965, the Proposed Regulations include rules on Code §962, a provision that allows an individual U.S. Shareholder to elect to be treated as a domestic corporation solely for the purposes of computing his or her income tax under Code §951(a) (relating to Subpart F Income and the net tax liability under Code §965, which is treated as Subpart F Income) and Code §960 (relating to indirect foreign tax credits for foreign taxes paid by a C.F.C.).

The Proposed Regulations state that an individual domestic pass-thru owner that is a U.S. Shareholder with respect to a D.F.I.C. may make a Code §962 election with respect to the individual's share of the domestic pass-thru entity's Code §965(a) inclusion amount. However, an individual domestic pass-thru owner that is not a U.S. Shareholder with respect to a D.F.I.C. may not make a Code §962 election with respect to the individual's share of the domestic pass-thru entity's Code §965(a) inclusion amount.[49]

For the purpose of computing the Code §965(c) deduction, the Proposed Regulations clarify that, under a Code §962 election, the Code §965(c) deduction should be allowed with respect to the tax imposed under Code §11 rather than under Code

[48] Prop. Treas. Reg. §§1.965-7(b)(3)(iv)(B)(2)(i), 1.965-7(c)(3)(iv)(B)(2)(i).

[49] Prop. Treas. Reg. §1.962-2(a).

§1.[50] Thus, the Proposed Regulations clarify that an individual U.S. Shareholder that does not make a Code §962 election may by subject to tax under Code §965 at rates higher than the rates for corporate U.S. Shareholders because his or her starting point for computing the Code §965(c) deduction will be the individual income tax rate (as high as 39.67% for 2017 and 37% from 2018 onwards) rather than the corporate rate.

Further, the Proposed Regulations clarify that a Code §965(c) deduction taken to compute taxable income under Code §11 cannot be deducted again at the individual level.[51] That is, under a Code §962 election, the Code §965(c) deduction is not allowed for the purposes of determining the individual's actual taxable income.

The Proposed Regulations clarify whether a U.S. person that must pay the net investment income tax ("N.I.I.T.") on a Code §965(a) inclusion is entitled to take a Code §965(c) deduction on that amount. The N.I.I.T. is a 3.8% tax on net investment income, including dividends, of an individual, trust, or estate. The Proposed Regulations conclude that the Code §965(c) deduction was not intended to be applied against the N.I.I.T. on a Code §965(a) inclusion because the N.I.I.T. provision is a non-income tax provision outside of Chapter 1 of the Code.[52] For the same reason, the Code §965(h) election to pay in eight installments does not apply to the N.I.I.T. on the Code §965(a) inclusion.

Effective Date

The Proposed Regulations apply beginning the last tax year of a foreign corporation that begins before January 1, 2018. With respect to a U.S. person, the Proposed Regulations apply beginning the tax year in which or with which such taxable year of the foreign corporation ends. If they are issued in final form, they will apply retroactively.

CONCLUSION

While the Proposed Regulations do not address all questions raised by practitioners and their clients, they provide, *inter alia*, useful guidance on calculating the tax liability for this "toll-tax." Taxpayers and their advisors should thus review these regulations and reassess their calculations based thereupon. This is of specific importance, as this one-time application to 2017 tax years has an impact far beyond. Hence, it affects subsequent tax periods – whether by means of installment payments or by determining P.T.I.

In addition, it will be interesting to see the public comments received by the I.R.S. and the Treasury. The deadline for public comments was set to 60 days after the publication of the regulations in the Federal Register, which was dated August 9, 2018.

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50 Prop. Treas. Reg. §1.962-1(b)(1)(i).

51 *Id.*

52 The N.I.I.T. is codified Chapter 2A, Subtitle A, Code §1411.

CORPORATE MATTERS:
ICHABOD CRANE VISITS HIS EXECUTIVE EMPLOYMENT ATTORNEY

Author
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Tags
Contract Law
Corporate Law
Employment Law

The Legend of Sleepy Hollow is a wonderful story that often comes to mind this time of year. As you may remember, Ichabod Crane, the central character, comes from obscure origins before he accepts the job of village schoolmaster in Sleepy Hollow, N.Y. After Ichabod meets a terrifying Halloween apparition, little is heard from him.

It turns out, however, that – like many executives accepting a position of responsibility – Ichabod Crane sought counsel from a knowledgeable employment attorney both before he was hired and after his academic employment came to an abrupt end.

Since all the participants are long dead and even the strongest attorney-client privilege fades after 200 years, I believe it is time to reveal the never-before told details of Ichabod's conversations with his lawyer:

THE FIRST MEETING: JUNE 15, 1790

Attorney: Well, Schoolmaster Crane, I have reviewed your proposed employment agreement with the Board of Education of Sleepy Hollow. It seems a bit light on actual monetary compensation.

Ichabod: I get room and board as well. Aren't there some tax implications from that type of remuneration?

Attorney: Yes, but I don't think we need worry about that; it will be more than a century until they enact a Federal income tax.

Ichabod: That's good.

Attorney: But I don't like the provision in here that allows the Board to reduce your compensation if they determine that you are a "Prodigious Feeder." How realistic is that?

Ichabod: I like to eat. Working all day with children makes you hungry.

Attorney: Let's see if we can't eliminate that clause. . . . It also seems to me that there are important protections for you that are missing from this draft agreement.

Ichabod: Such as?

Attorney: One of the most important parts of any executive

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employment contract or offer letter is to specify the amount and timing of severance payable to you in case things simply don't work out, and you are terminated without Cause. There's nothing about severance in here, and there isn't any definition of what constitutes Cause.

Ichabod: Is that bad?

Attorney: You are an employee "at will," so the absence of these protections could make it meaningfully harder for you to obtain a decent termination package.

Ichabod: Anything else?

Attorney: The clause that says that in the event of a controversy with your employer, you have to go to arbitration before a magistrate in the neighboring village of Tarrytown who has experience sitting on a school board – someone like that is likely to be biased against you. Do you understand the difference between arbitration and being able to bring a case in court?

Ichabod: How much is it going to cost me to have you negotiate a better deal for me?

Attorney: 2, maybe 3, British shillings.

Ichabod: Let me think about it. I'll get back to you.

SEVERAL MONTHS LATER: NOVEMBER 13, 1790

Attorney: Schoolmaster Crane, good to see you. I wondered what had happened after I never heard from you again. You seemed to have suffered some kind of head injury?

Ichabod: I was hit by a flying pumpkin.

Attorney: I don't do personal injury work.

Ichabod: And I've lost my job.

Attorney: I'm sorry to hear that. Did you ever get the contract changes we discussed?

Ichabod: No, but it's a complicated story. I was courting the boss's daughter . . .

Attorney: Office romances can be very problematical these days.

Ichabod: And I wound up being bullied. I must have a bullying claim.

Attorney: Did this bullying take place in the workplace?

Ichabod: Not exactly. There was this local tough named Brom Bones, and there was a Headless Horseman . . .

Attorney: Are you quite certain you've recovered from that nasty head injury?

Ichabod: I know there isn't any teacher's union yet, but maybe I have some claim for severance.

Attorney: What about a disability discrimination claim based on your mental state? Did you tell your employer that you were having hallucinations about some Headless Horseman and ask for a reasonable accommodation at work?

Ichabod: That was no hallucination. It was a flying pumpkin.

Attorney: I know a top mental health professional who doubles as an expert witness.

Ichabod: All I want is some compensation. How much will it cost me to pursue a claim?

Attorney: Unless you can get the Headless Horseman to pay your legal fees, it will cost a great deal more than if you had listened to me before signing your contract.

THE MORAL OF THIS STORY

Don't be shilling wise and pound foolish. A bad employment contract could definitely come back to haunt you.

IN THE FIGHT AGAINST MONEY LAUNDERING, EUROPE TACKLES CASH CONTROLS

Author
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Tags
Anti-Money Laundering
Cash
E.U.

On October 2, 2018, the European Council adopted a regulation aimed at improving controls on cash entering or leaving the E.U. This follows an agreement reached with the European Parliament in June to replace the Cash Controls Regulation (regulation 1889/2005), which applies since 2007 as an integral part of the E.U.'s anti-money laundering and combating the financing of terrorism framework.

The new regulation provides the necessary tools to more efficiently tackle threats in the areas of terrorist financing, money laundering, tax evasion, and other criminal activities. It reflects the latest international standards for combating money laundering and terrorism financing as developed by the Financial Action Task Force ("F.A.T.F."). These improvements are needed as terrorists and criminal organizations have managed to circumvent existing rules.

The existing rules require travelers entering or leaving the E.U. to declare cash (or its equivalent) amounting to €10,000 or more. The new legislation extends these obligations. The new definition of cash will also cover unaccompanied cash, meaning cash that is sent by post, freight, or courier shipment, and highly liquid instruments and commodities such as checks, traveler's checks, prepaid cards, and gold. Under the new legislation, a declaration will be required irrespective of whether travelers entering the E.U. with the requisite amount of cash are carrying the cash on their person, in their luggage, or by other means of transport. If the cash is not personally carried but otherwise transported, the relevant authorities will have the power to ask the sender or the recipient to make a declaration relating to the cash. The authorities will be able to request any accompanied cash to be made available for control and carry out controls on any consignments, packages, or means of transport that may contain unaccompanied cash.

E.U. Member States will exchange information among themselves and the European Commission where there are indications that the cash is related to criminal activity that could adversely affect the financial interests of the E.U.

The new regulation will not prevent Member States from providing additional national controls on movements of cash, provided that these controls are in accordance with the E.U. basic freedoms.

Once the new regulation is signed by the European Council and the European Parliament, it will be published in the E.U. Official Journal and will enter into force 20 days thereafter.

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

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Our law firm has offices in New York City and Toronto, Canada. More information can be found at www.ruchelaw.com.

Disclaimer

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