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INSIGHTS

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EDITORS' NOTE

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

- **Austria, France, and Italy to Introduce Digital Services Taxes.** A limerick that is popular among members of the U.S. Congressional tax writing committees sheds wisdom on the development of tax policy: "Don't tax you. Don't tax me. Tax the person behind the tree." Several countries in Europe have taken the rhyme to heart in developing unilateral digital services taxes designed to impose tax on extra-territorial activity of out-of-country companies. The issue, as Austria, France, and Italy see it, is that these companies make huge profits in Europe but pay no tax there, while payments for digital services are often tax deductible in the countries where the services are used. According to proponents such as Austria, it is only fair to tax those profits on a destination basis. Benjamin Twardosz of CHSH Attorneys-at-Law, Vienna, explains the various proposals under consideration.

- **Foreign Investment in U.S. Real Estate – A F.I.R.P.T.A. Introduction.** Many economic, political, and cultural factors make U.S. real estate an attractive investment for high net worth individuals resident in other countries. These factors are supported by a set of straightforward tax rules that apply at the time of sale. Alicea Castellanos, the C.E.O. and Founder of Global Taxes L.L.C., looks at the U.S. Federal income taxes and reporting obligations that apply to a foreign investor from the time U.S. real property is acquired to the time of its sale.

- **The Impact of Brexit on German Taxes for Private Clients and Nonprofit Organizations.** American business executives responsible for regional operations in Europe often see different approaches to problem solving in terms of cultural differences between various European countries. It can be said that British colleagues often continue to rethink decisions even after solutions are adopted, and German colleagues focus on engineering a unified approach to reach the best solution to the matter at hand. These cultural characteristics seem to have manifested in the different ways Parliament in the U.K. and the Bundestag in Germany are addressing Brexit. Parliament continues to debate whether, when, and how to implement Brexit, while the Bundestag has enacted several laws to address how a hard or soft Brexit will affect various aspects of German tax law. Dr. Andreas Richter of P+P Pöllath + Partners, Berlin and Frankfurt, provides the reader with an overview of the German tax consequences to be anticipated from a U.K. departure from the E.U. – with or without a formal Brexit agreement.

- **Anti-Tax Arbitrage the U.S. Way.** Hybrid arrangements come in various forms but share a common goal: Each is designed to enhance beneficial tax results by exploiting differences in tax treatment under the laws of two or more countries. Anti-hybrid rules were adopted as part of the T.C.J.A., which was enacted in the waning days of 2017. In December 2018, the I.R.S. released proposed regulations that provide guidance on anti-hybrid rules adopted by Congress. New terms must be understood, including (i) the deduction/no inclusion ("D./N.I.") rules, (ii) tiered hybrid dividends, (iii) the hybrid deduction account ("H.D.A.") that addresses timing, and (iv) a principal purposes test denying the benefit of the dividends received deduction. If final regulations are adopted by June 22, 2019, they will be effective retroactively to the date of enactment of the statute. In their article, Beate Erwin and Fanny Karaman explain the workings the proposed regulations.

- **The Responsible Party – Changes Effective May 2019.** The U.S. Taxpayer Identification Number used by entities is the Employer Identification Number ("E.I.N."). To apply for an E.I.N., the entity must identify the "responsible party" who ultimately owns or controls the entity or who exercises ultimate effective control over the entity – in other words, the person who controls, manages, or directs the entity and the disposition of its funds and assets. In March, the I.R.S. announced that, beginning on May 13, 2019, only individuals with a U.S. Taxpayer Identification Number will be allowed to request an E.I.N. Moreover, the responsible party must be a natural person – not an entity – unless the applicant is a government entity. This change will affect many foreign companies entering the U.S. market after the effective date. Galia Antebi and Nina Krauthamer explain all and speculate on whether revisions to the new procedure should be anticipated.

- **State and Local Tax Credit Programs – Businesses May Get What Individuals Cannot.** Since recent Federal tax law changes have capped the state and local tax deduction for individuals to $10,000, many states have been trying to implement solutions to help alleviate the effects of the change. New York State has introduced two programs to get around the $10,000 limitation: New Yorkers can make payments to state charitable programs and receive a credit against N.Y. income tax or, alternatively, use an Employer Compensation Expense Program. Nina Krauthamer and Rusudan Shervashidze look at the back and forth between N.Y. and Federal regulators.

- **It's Time for Cayman Shell Entities to Come Out of Their Shells and Show Economic Substance.** It is said that beauty is in the eye of the beholder. The same can be said about economic substance. In a step to adopt a standardized definition in the context of business arrangements that are typical for Cayman Islands companies, the country enacted the International Tax Cooperation (Economic Substance) Law, 2018 ("E.S. Law") on December 27, 2018, and issued supplemental guidance on February 22, 2019. Neha Rastogi and Galia Antebi address relevant aspects of the new rules, including (i) entities that fall within the ambit of the E.S. Law, (ii) entities that are exempt, (iii) identified business activities under the E.S. Law, and (iv) steps that may be taken to meet the economic substance test.

- **New Jersey Provides G.I.L.T.I Guidance.** Federal tax law has introduced a new type of gross income: Global Intangible Low Tax Income ("G.I.L.T.I."). The provisions are designed to stop U.S. companies from shifting their profits to offshore jurisdictions, and states are given a choice to incorporate parts of Federal law in one of three ways. New Jersey has chosen "selective conformity." Nina Krauthamer and Rusudan Shervashidze explain what this means for the state and for taxpayers.

Enjoy the read.

- The Editors

AUSTRIA, FRANCE, AND ITALY TO INTRODUCE DIGITAL SERVICES TAXES

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Tags
Austria
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E.U.

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INTRODUCTION

The aim of a digital services tax is to subject companies offering digital services to taxation in the country where the service is provided. It is directed at use within a specific country and can affect search engines, video portals, or social media platforms selling advertising as it attempts to impose tax where the content is watched or clicked. Intermediary transport or accommodation, cloud computing, online gaming, and on-demand video services could also be subject to the tax, depending on how it is structured.

The general belief is that a digital services tax is directed at out-of-country providers of digital services, mostly based in the U.S. The logic is that out-of-country providers make huge profits in Europe but pay no tax there, whereas payments for digital services are often tax deductible by businesses in the countries where the services are used. A digital services tax is intended to change that equation.

After the European Commission proposal for a directive on the taxation of digital services was rejected, Austria and several other countries in the E.U. announced the unilateral introduction of digital services taxes. Such taxes raise a number of legal questions. This article addresses the commission proposal and questions raised by the unilateral approach that followed.

INTERNATIONAL TAXATION OF BUSINESS PROFITS

Non-European companies selling their goods or services to Europeans currently do not pay income tax on profits in Europe if the goods or services in question are not produced or performed in Europe and a taxable presence is not maintained in Europe. Nonetheless, they are subject to value added taxes, and if goods are sold in Europe, customs duties may be imposed. However, no customs duties are levied on digital services.

This reflects a basic concept of international trade: Corporate profits of a manufacturer that produces a product in one country and sells it for consumption or use in another country is generally taxed in the place of production. A similar rule applies to the provision of services performed in one country but consumed elsewhere. Thus, a German car manufacturer would not expect to pay corporate income tax on the sale of vehicles in the U.S., Africa, or South America in the absence of a taxable presence in those countries. (Typically, the German manufacturer sells to a distributor in the local country.) Similarly, an Austrian beverage producer does not pay Chinese tax on profits derived from the sale of beverages in China, and an Italian consultant does not pay Russian tax on profits earned by providing advice to a Russian client. In the absence of a permanent establishment, a company in one country does not pay income tax in connection with the sales into a market located in a different country. The same is true for the performance of services in one country that benefits a consumer in a different country. In both instances, the location where activity occurs retains the principal right to impose income tax. The country where consumption occurs retains the right to collect turnover taxes and duties.

Bellwether U.S. companies such as Google, Amazon, Apple, and the like have paid little tax in the U.S. on global profits prior to U.S. tax reform at the end of 2017. While the U.S. was thought to have a global tax system in those earlier years, these companies engineered their facts and circumstances in a way that transformed the system into a territorial tax system. Only income from U.S. operations was taxed. Income from operations outside the U.S. was permanently deferred for financial accounting purposes and deferred indefinitely under tax law as long as repatriation events were avoided. This changed with the adoption of rules such as the mandatory deemed repatriation tax, the B.E.A.T. regime, and G.I.L.T.I.

However, the genie is out of the bottle as far as other countries are concerned. Developing countries and emerging economies, which historically did not have an administrative system in place to impose tax on a worldwide basis, determined that they are entitled to a share of the tax collected on income when profits arise from consumption of goods and services in their countries. The ability of industrialized nations to prevent developing countries from taxing these profits has sunset and with it the sanctity of the method of taxing business profits of a global enterprise.

THE E.U. AS A DEVELOPING COUNTRY

As far as digital services are concerned, the E.U. now appears to be in the process of adopting tax policies that were previously limited to developing countries. The vast majority of large digital service providers are based in the U.S. In this light, it makes sense from an E.U. perspective to collect consumption taxes related to the provision of digital services. Taxes on profits are not the right vehicle for raising tax revenue. E.U. countries that have adopted digital services taxes or are considering their adoption have focused on sales as the simple trigger for imposing tax. This means that customs duties and value added taxes are the mechanisms of choice. Limited constraints are imposed on the right of a country to impose a levy in connection with the sale of goods and services in the domestic market. In other words, the system of global taxation is in the process of being turned upside down in Europe in order to raise revenue from taxing companies that do not employ people who vote in local elections.

THE COMMISSION PROPOSAL

In March 2018, the European Commission proposed a council directive regarding an E.U.-wide digital services tax with the following features:[1]

- The tax would apply to revenues created from activities where users play a major role in value creation and which are the hardest to capture with current

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1 Proposal for a Council Directive on the Common System of a Digital Services Tax on Revenues Resulting from the Provision of Certain Digital Services, COM (2018) 148 final.

tax rules. This would include revenues generated from (i) selling online advertising space, (ii) the performance of digital intermediary activities allowing users to interact with other users, thereby facilitating the sale of goods and services between them, and (iii) the sale of data generated from user-provided information.

- Tax revenues would be collected by the Member States where the users were located and would only apply to companies with total annual worldwide revenues of at least €750 million and E.U. revenues of at least €50 million.

- Taxable revenues obtained by an entity in a tax period would be treated as obtained in a Member State if users of the taxable service were located in that Member State.

- The tax rate would be 3%.

During the second half of 2018, Austria held the presidency of the Council of the E.U. One of Austria's main goals at the time was to forge a consensus among the Member States regarding the adoption of an E.U.-wide introduction of a digital services tax. However, nothing came of this approach as no unanimity of views existed. Sweden, Denmark, Finland, Malta, and Ireland raised concerns regarding the proposal.[2] In addition, Germany expressed concerns that the proposal could intensify the trade conflict with the U.S.[3] and proposed a lighter version of the tax that would be restricted to online advertisements. France expressed similar views at the time.[4] Tax directives require unanimous consent in the E.U.,[5] and neither proposal was approved.[6]

UNILATERAL APPROACHES

The U.K. introduced a national digital services tax in 2018.[7] The French,[8] Italian,[9] and Austrian[10] governments now plan to enact separate national digital services taxes. In each instance, the tax is justified by the national government as a means of taxing profits of low-taxed foreign companies. However, the digital services taxes are consumption taxes aimed at a very specific, narrowly-defined economic sector.

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2 "EU-Digitalsteuer scheint *bis* Jahresende möglich," *Weiner Zeitung*, September 8, 2018.

3 "EU-Digitalsteuer: Die wichtigsten Fragen und Antworten," *Futurezone*, October 30, 2018.

4 "Deutsch-französischer Vorschlag für Digitalsteuer ist gestoppt," *Zeit Online*, December 4, 2018.

5 Article 113 of the Treaty on the Functioning of the European Union.

6 "EU States Fail to Agree Plans for Digital Tax on Tech Giants," *Financial Times*, November 6, 2018.

7 HM Treasury, "Digital Services Tax: Budget 2018 Brief," October 29, 2018.

8 "Frankreich führt ab 2019 Digitalsteuer im Alleingang ein," *Futurezone*, December 17, 2018.

9 "Italy Prepares to Introduce Web Tax Worth €114 Million a Year," *The Local IT*, November 27, 2017.

10 "Österreichische Regierung macht Ernst mit der Digitalsteuer," *DerStandard*, December 30, 2018; "Austria Ramps Up Push for EU-wide Digital Tax on Big Tech," *Financial Times*, July 15, 2018.

They are protectionist in nature, an approach currently in vogue internationally. No matter the spin given to these taxes by governments, consumers will bear the economic burden of these duties if the service providers pass the taxes on to the customers via the price. That is likely to occur when the provider has a monopoly, which more or less is the case for the specific companies that are targets of the digital services legislation.

While the introduction of protectionist measures may sound good to local voters, they often produce a backlash as individual countries focus on raising revenues by taxing foreign companies or the revenues generated by such companies as a result of local sales. Bad ideas are not one-way streets, and the concept of taxing foreign companies based on local advertising activity may be gaining traction in other sectors. European automobile companies, which are known to advertise globally, could be the next target.

To attack the trade impediments now under consideration by national governments, the O.E.C.D. seeks to find a worldwide solution for changing business taxation. The target date is 2020.[11] The U.S. is participating in this project to ensure that the final report will not be aimed solely at companies in the U.S. In that regard, the O.E.C.D. approach contrasts with the uncoordinated unilateral measures by individual states, which are aimed at specific foreign providers or industrial sectors. It is possible that the O.E.C.D. proposals will result in an increase of customs duties and value added taxes on imports.

"While the introduction of protectionist measures may sound good to local voters, they often produce a backlash."

THE AUSTRIAN LEGISLATIVE PROPOSAL

The Austrian government published a legislative proposal in April 2019. This proposal, which is yet to be reviewed and resolved upon by the Austrian parliament, provides for the following:

- The tax will apply to online advertising directed to Austrian customers and appearing on the devices of users with an Austrian I.P. address.
- The tax will be incurred by the online advertising service provider, and a self-assessment must be payed to the Austrian tax office on a monthly basis.
- The tax base will be the price for the online advertisement.
- The tax rate will be 5%.
- The tax will enter into effect as of January 1, 2020.[12]

E.U. LAW RESTRICTIONS

If individual E.U. Member States begin to implement consumption taxes unilaterally, E.U. law may be infringed upon. Turnover taxes, indirect taxes, and excise duties are harmonized across the E.U. Digital services taxes that amount to a flat percentage of sales can distort competition and infringe upon pan-E.U. fundamental freedoms. Such taxes must treat all market participants equally and not obstruct

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11 "OECD: Löger sieht entscheidenden Fortschritt für globale Digitalsteuer," *APA OTS*, January 30, 2019.

12 *Mayr*, Das neue Digitalsteuergesetz 2020, RdW 4/2019, 264.

cross-border services within the E.U., including fact patterns involving a U.S. company offering its services to Austrian, French, and Italian customers via a subsidiary in Ireland.

INTERFERENCE WITH DATA PROTECTION RIGHTS

U.S. companies that are taxed on the provision of services will be required to track where the user is located when services are used. This will lead to the creation of permanent records of the movement patterns of European customers in protection against claims of double taxation within the E.U. An open question is whether data protection rules will protect users against such data collection. At one level, data protection obligations do not apply if there is a statutory requirement to collect and store data related to the individual. At another level, the right to data protection may prevail over the obligation of a company subject to a digital services tax to comply with the tax law. In the crazy quilt pattern of domestic legislation that is likely to continue within Europe for a period of time, it would not be surprising for a government to argue that a services provider must destroy records showing place of use and then to argue for a penalty because of the absence of proper recordkeeping.

FOREIGN INVESTMENT AN U.S. REAL ESTATE – A F.I.R.P.T.A. INTRODUCTION

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Alicea Castellanos is the C.E.O. and Founder of Global Taxes L.L.C. She has more than 17 years of experience in U.S. taxation of individuals from around the world. Alicea specializes in U.S. tax planning and compliance for non-U.S. families with global wealth and asset protection structures that include non-U.S. trusts, estates and foundations that have a U.S. connection, as well as foreign investment in U.S. real estate property.

INTRODUCTION

Whether in an up or down economy, the U.S. is attractive for foreign investors. U.S. economic and legal transparency, as supported by appropriate legal protection and a predictable regulatory environment, further enhances the attraction for foreign investment. According to Henley & Partners,[1] a key concern for high net worth individuals ("H.N.W.I.") is unease over political and economic uncertainty, which continues to drive key investment decisions such as owning wealth in offshore structures. As a result, real estate has now become the third-largest asset class – with residential property being more sought-after than commercial property for those over 40.

Like anyone else who invests in real estate, foreign investors buying real estate in the U.S. must evaluate the terms and conditions of the purchase to determine if it makes sense in a particular set of circumstances. However, non-U.S. investors must evaluate an additional factor that will come into play when they dispose of the property, the Foreign Investment in Real Property Tax Act ("F.I.R.P.T.A.").

STARTING WITH THE BASICS

F.I.R.P.T.A. allows the U.S. to withhold income tax when a foreign person disposes of a U.S. real property interest ("U.S.R.P.I."). The disposition of a U.S.R.P.I. by a foreign person is treated as if the person were engaged in a U.S. trade or business, and gain or loss must generally be recognized on the transaction.[2] The disposition by the foreign person is subject to tax,[3] and the transferee (buyer or his agent) must withhold tax in the absence of certain exceptions and submit the appropriate tax returns.[4] The withholding tax is 15% of the net proceeds, typically the sales price less any sales commissions (10% for dispositions before February 17, 2016, and in limited cases involving lower cost residential properties). However, treaty exceptions may apply. The withholding obligation rests on the buyer or its agent and not on the foreign seller. This is because it is easier for the I.R.S. to collect tax from someone with a U.S. connection.

For purposes of this law, a "foreign person" includes a nonresident alien ("N.R.A."), foreign partnership, foreign trusts, foreign estate, or foreign corporation that has not

1 Henley & Partners, "How Citizenship Planning is Providing Millions in Revenue and Increased Freedom for the Wealthy," (presentation, STEP New York 15th Annual International Estate Planning Institute Conference, New York, NY, March 15, 2019).

2 Code §§897(a), 87(b) and 882(a).

3 Code §§1, 11, and 55.

4 Code §1445 and related regulations.

made an election to be treated as a domestic corporation for F.I.R.P.T.A. purposes (*i.e.*, a Code §897(i) election).

As explained in Code §§897(c)(1) through (c)(4), a U.S.R.P.I. is any interest in real property and associated property located in the U.S. or the Virgin Islands and any interest in a domestic or foreign corporation defined as a U.S. real property holding company ("U.S.R.P.H.C."). A U.S.R.P.H.C. is defined as a domestic or foreign corporation that has U.S.R.P.I.'s that equal or exceed 50% of the total fair market value of its U.S. and foreign real property and any other assets used in a trade or business. There is an exception for stock regularly traded on an established securities market. Assets held by a partnership, trust, or estate are treated as being held proportionately by its partners or beneficiaries.

Withholding Requirements

The 15% withholding rule noted above, and explained in Code §1445(a), generally applies regardless of the amount of gain or loss attributed to the foreign seller. The net proceeds realized for withholding purposes include cash, fair market value of other property, and liabilities assumed by the buyer or to which the U.S.R.P.I. is subject.

Several exceptions to the general rule are provided under Code §1445(b). These include the following situations:

- The property is acquired by the buyer for use as a residence, and the purchase price is less than $300,000.
- The corporate stock of the seller is regularly traded on an established securities market.
- A non-publicly traded corporation furnishes an affidavit that the interest being disposed is not a U.S.R.P.I., and the transferee has no knowledge that the statement is false.
- An N.R.A. transferor furnishes the transferee with an affidavit stating, under penalty of perjury, that the seller is not a foreign person, and provides a U.S. Taxpayer Identification Number on such an affidavit (the transferee can accept such an affidavit as long as no knowledge exists that the statement is false.
- The transferor applies for and receives a qualifying statement from the I.R.S. that exempts the transaction from withholding. The I.R.S. has 90 days from the date of receipt of the application to process a response.

The transferee has 20 days after the transfer date to file Form 8288, *U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests*, and Form 8288-A, *Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests*, and submit the tax withheld. The I.R.S. will return stamped copies of the forms to the transferor (and withholding agent) to be attached to the tax return at filing.[5] If the transferor was not able to obtain a Taxpayer Identification Number by the transfer date, the transferee is still obligated to file Forms 8288 and 8288-A and submit the tax withheld by the prescribed due date.

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[5] Treas. Reg. §1.1445-1(c).

The transferor may still receive credit for the amount of tax withheld by attaching substantial evidence of withholding to the return. The 15% withholding is not the amount of tax but merely a mechanism for the U.S. to ensure the collection of tax. This withholding does not relieve the seller from filing a U.S. tax return (*i.e.*, Forms 1040NR, 1120, or 1120F).

The rules are different if the seller is a domestic partnership, trust, or estate with foreign partners or beneficiaries. Code §1446 withholding tax applies to the effectively connected income ("E.C.I.") of a domestic partnership to the extent that it is allocable to foreign partners. Non-grantor trusts and estates have a withholding obligation upon the distribution of cash or property to a foreign beneficiary. The fiduciary must maintain a special U.S.R.P.I. account to withhold 37% of any distributions to a foreign beneficiary up to the balance of the U.S.R.P.I. account. If a grantor trust has a foreign owner, the fiduciary must withhold 37% of the gain realized by the trust on the disposition of a U.S.R.P.I., to the extent the gain is allocated to the foreign person. If a domestic trust or estate has an N.R.A. as beneficiary and disposes of a U.S.R.P.I., the fiduciary may be required to withhold tax on the share allocable to the N.R.A. beneficiary.[6]

"Form 8288-B must include Taxpayer Identification Numbers for all parties involved, otherwise it will be rejected."

Withholding Certificates: Rules and Exceptions

Withholding certificates are commonly called reduced withholding or exemption certificates. Application for such certificate is made on Form 8288-B, *Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests*. This form is filed when sellers claim to be entitled to nonrecognition treatment or exemption from tax. It is also filed when sellers are certain that they have a loss or that the 15% withholding obligation is greater than their maximum tax liability on the gain from the sale. Another filing instance that is less common occurs when the seller claims that the special installment sale rules described in Section 7 of Rev. Proc. 2000-35 allows for reduced withholding. This form can be filed by an N.R.A. or foreign corporation.

The most common reason for requesting an exemption is a withholding obligation in excess of maximum tax liability, described above. For this claim, the filer must attach the following information:

- A calculation of the maximum tax liability showing that the applicable tax on the sale of the property is less than the 15% withholding obligation
- Sales contracts showing the amount of sale (or an appraisal, if there is no contract)
- Either a closing statement, *H.U.D. Settlement Statement*, or sales contract showing the original cost of property, along with any receipts showing improvements made to the property[7]

Form 8288-B must include Taxpayer Identification Numbers for all parties involved, otherwise it will be rejected. However, if the transferor is applying for an individual Taxpayer Identification Number ("I.T.I.N."), the phrase "Applied for I.T.I.N." may be used in lieu of an identification number. Form 8288-B should be attached to a complete I.T.I.N. application and sent to the I.T.I.N. Operation in Austin, Texas.

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[6] Treas. Reg. §1.1445.5(c)(1)(iii)(A).

[7] Code §897(j).

Although either the buyer or seller can file this form, it is typically filed by the seller or the seller's agent. The withholding agent identified on Line 4a of the form should be the buyer or the buyer's agent. A U.S. mailing address is recommended for the withholding certificate for ease of delivery and tracking. This address does not need to be the same as the transferor's (Line 1) or transferee's (Line 2) address. If an interest in a U.S.R.P.H.C. is being transferred, the submission must include a share certificate showing the ownership percentage of the foreign seller of the U.S.R.P.H.C.

Foreign Person's Tax Filing Requirements

N.R.A.'s who have a direct investment in a U.S.R.P.I. must generally file income tax returns, except where they are engaged in a U.S. trade or business and the fair market value of the U.S.R.P.I. does not exceed $50,000. In addition, any person subject to Code §897(a), as noted above, or Code §1445 (regarding withholding tax on dispositions of U.S.R.P.I.'s) must pay the required tax and file a return.[8]

Dispositions that are taxable events are broadly defined and include the following:

- Sales, exchanges, distributions, tax-free exchanges, certain gifts, and so forth of U.S.R.P.I.'s
- Sales of interests in partnerships, trusts, and estates that have U.S.R.P.I.'s[9]
- Contributions to capital of a foreign corporation[10]

The following transactions generally are not taxable since U.S. tax is only deferred and not avoided:

- A distribution of a U.S.R.P.I. by a foreign corporation in liquidation or otherwise, if the distributee would be subject to U.S. tax on a subsequent disposition of the U.S.R.P.I. and there has been no tax-free increase in the tax basis of the U.S.R.P.I.[11]
- An exchange of a U.S.R.P.I. in a nonrecognition transaction for another ownership interest if the subsequent sale of such interest would be subject to U.S. tax and there has been no tax-free increase in the tax basis of such ownership interest[12]

The 15% F.I.R.P.T.A. withholding will be credited toward the ultimate tax liability and the excess, if any, will be refunded to the foreign person, unless the withholding was not sufficient to satisfy the tax. Early refunds of excess withholding tax can also be obtained by filing a tax return as soon as possible, if the taxpayer has no other income to report on the U.S. tax return. If this is desired, prior year tax return forms can be used to file a return for the current year as long as the prior year is crossed out and marked as the current year. If filing a final corporate return, taxpayers should include the words "Final Tax Return" at the top of the return.

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[8] Code §§6039C(a), (b), and (d).

[9] Code §897(g).

[10] Code §897(j).

[11] Code §897(d).

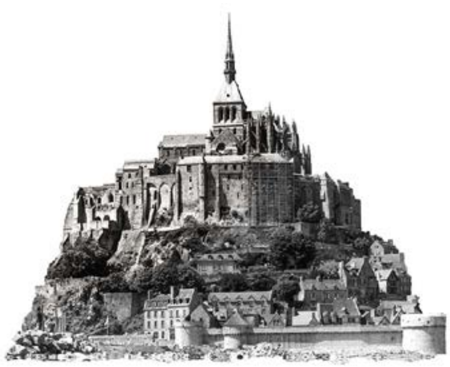
[12] Code §897(e).

The gain derived from the sale of a U.S.R.P.I. under Code §897 is considered to be E.C.I. In general, the 30% branch profits tax applies to a foreign corporation's effectively connected earnings and profits. This tax is in addition to income tax.

However, there is an exception under Treas. Reg. §1.884-2T if the foreign corporation "completely terminates" all of its U.S. trade or business. In order to be considered to have completely terminated the U.S. trade or business for purposes of this exception, the following three prongs must be satisfied:

- The foreign corporation has no assets used in a U.S. trade or business as of the close of the year.
- Neither the foreign corporation nor a related corporation uses any of the assets of the terminated U.S. trade or business nor earnings and profits of the foreign corporation in the year of the termination in the conduct of a different U.S. trade or business for a period of three years following the close of the taxable year in which the termination took place.
- The foreign corporation has no E.C.I. during the period of three years following the close of the taxable year in which the termination took place.

This last item is especially relevant if foreign investors have plans to purchase a U.S.R.P.I. at a future date and do not intend to dissolve the foreign corporation. However, if corporate dissolution is chosen, in addition to filing the corporate return (*i.e.*, Form 1120-F), Form 966, *Corporate Dissolution or Liquidation*, must be filed as required under Code §6043(a). A certified copy of the resolution or plan of liquidation and dissolution and all amendments or supplements not previously filed should be attached to the Form 966.



A second exception from branch profits tax exists when the gain relates to the sale of shares of a domestic corporation that is a U.S.R.P.H.C.

I.T.I.N.

N.R.A.'s who have never filed a U.S. tax return or are unable to obtain a social security number must obtain an I.T.I.N. by filing Form W-7, *Application for IRS Individual Taxpayer Identification Number*, with the I.R.S. An I.T.I.N. will be needed in order to file for a reduced withholding certificate on Form 8288-B and to file the required return if they are to receive a credit for overpayment of taxes.

If an I.T.I.N. application is filed for the purpose of reporting the sale of a U.S.R.P.I. on Form 1040NR, then Box "b" (Nonresident alien filing a U.S. tax return) should be checked off. When filing Form W-7, it should be the first form attached, followed by the certified (in English) passport copy, and the Form 1040NR, including Copy B of Form 8288-A stamped (typically in red) by the I.R.S. Copy B of Form 8288-A is proof of withholding.

If an I.T.I.N. application is filed for the purpose of applying for a reduced withholding certificate on Form 8288-B, then Box "h" (Other, Exception 4 – Disposition by a foreign person of U.S. real property interest – third-party withholding) should be checked off. Again, when filing Form W-7, it should be attached first, followed by the Form 8288-B, including any schedules (discussed above). It takes the I.R.S. approximately six to ten weeks to process an I.T.I.N. application.

If one or more parties involved are foreign corporations and do not have an E.I.N., they can simply apply for one by filing Form SS-4, *Application for Employer Identification Number*.[13]

CONCLUSION

This paper has covered the basic procedures for complying with Federal tax withholding requirements under F.I.R.P.T.A. Any non-U.S. person planning to purchase a U.S.R.P.I. should consult with an experienced tax advisor to learn more about how the Federal rules and applicable state laws may apply to a particular transaction.

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[13] Certain procedures for obtaining an E.I.N. have changed as of May 13, 2019. See "The Responsible Party – Changes Effective May 2019" in this edition of *Insights*.

THE IMPACT OF BREXIT ON GERMAN TAXES FOR PRIVATE CLIENTS AND NONPROFIT ORGANIZATIONS

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Tags
Brexit
E.U.
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Private Client

INTRODUCTION

On March 29, 2017, the U.K. informed the European Council of its intention to leave the E.U. and began the exit process by invoking Article 50 of the Lisbon Treaty. The U.K. was scheduled to depart from the E.U. following the passage of a two-year notice period. However, as no agreement has been reached between the E.U. and the U.K., the departure date is now postponed until October 31, 2019.

Whether the E.U. and the deeply divided U.K. will reach a withdrawal agreement ("soft Brexit") by the extended deadline is anything but certain. There have been several failed attempts and no consensus exists within the U.K. If no agreement is reached on a regulated withdrawal and the E.U. rejects a further postponement, the result will be a "hard Brexit."

The key concern of a hard Brexit is that all tax privileges enjoyed by E.U. Member States will cease to apply to the U.K. as of the departure date. Nevertheless, grandfathering will maintain the status quo for taxpayers, as long as all tax-relevant actions are completed before Brexit. Brexit itself should not cause the creation of a retroactive tax liability on completed transactions. In comparison, if a withdrawal agreement is reached, there will be no relevant changes in the status of the U.K. within the E.U. until a phase-out period is completed. The U.K. will be treated as a Member State until the end of the phase-out.

The German legislature has not waited to act with regard to the forthcoming changes. For the different scenarios, laws have been passed to take into account the tax problems that could arise. The Tax Accompanying Act (*Brexit Steuerbegleitgesetz*) and the Brexit Transitional Act (*Brexit-Übergangsgesetz*) are of particular importance.

This article provides an overview of the consequences of a departure by the U.K. in a hard Brexit and a soft Brexit.

CONSEQUENCES OF LEAVING WITHOUT AN AGREEMENT

<u>U.K. Relapse into Non-Member State Status</u>

If an agreement is not concluded or postponement of the withdrawal fails, the U.K. will cease being an E.U. Member State after October 31, 2019. The E.U. fundamental freedoms will cease to apply and all E.U. or E.E.A. entitlements to tax benefits will terminate. German law will not provide unilateral rules to mitigate the consequences of Brexit as far as post-Brexit transactions are concerned.

Consequences for U.K. Nonprofits and Their Donors

In the past, non-German not-for-profit entities encountered difficulty in meeting the requirements for tax exemptions under Section 55 et seq. of the German Fiscal Code (*Abgabenordnung*). It was difficult for a non-German entity to provide the necessary evidence to establish a civic purpose, and foreign nonprofits and their donors failed in most cases. Consequently, the practical impact of a hard Brexit is likely to be limited for foreign nonprofits.

A hard Brexit will mean that nonprofits from the U.K., which are currently subject to limited tax liability, (in particular charities under English law) will no longer be exempt from German corporation tax. At the same time, donors will no longer be able to deduct charitable donations from their taxable income, and there is an increased risk that donations will be subject to gift taxes. In addition, the carrying value privilege will no longer be in effect when an asset is withdrawn and transferred to a charitable organization in the U.K. Under this privilege, the transfer of assets will not trigger recognition of hidden reserves equal to the difference between fair market value and the carrying value on the books of the transferor. Instead, the transfer and the donation will both be measured according to the carrying value plus V.A.T. The transfer will be valued at fair market value, hidden reserves will be triggered, and no deduction will be allowed.

Example 1

Facts: German company A-Co decides to transfer its current inventory of computers to an English nonprofit.

Result: Theoretically, before Brexit, the computers could be withdrawn at the carrying value, provided the nonprofit could prove its entitlement to a tax exemption. Hidden reserves would not be taxed and the donation would equal to the carrying value (plus V.A.T.). After Brexit, the withdrawal can only take place at partial value and no deduction would be allowed for the donation when computing taxable income.

In addition, the annual tax allowances of €2,400 and €700 for training leaders and volunteers will not be allowed.

In the case of a hard Brexit, it will be imperative for German tax-privileged corporations that support recipient organizations in the U.K. to embed a fundraising clause in their statutes within the meaning of the Section 58, Article 1, of the German Fiscal Code in order to avoid risks under charitable law. Admittedly, this has been and still is recommended for any cross-border promotion.

"In the case of a hard Brexit, it will be imperative for German tax-privileged corporations that support recipient organizations in the U.K. to embed a fundraising clause in their statutes."

Consequences for Beneficiaries of Trusts

The German Foreign Tax Act stipulates that the income of a foreign family foundation is attributed to the founder or, alternatively, to the beneficiaries. This also applies to foreign trusts. The founder, settlor, or beneficiaries must pay tax on this income as if it were their own income.

The law provides for exceptions for family foundations or trusts established in an E.U. or E.E.A. Member State. In order for the exception to apply, proof must be provided that none of the founder, settlor, or beneficiaries control how the foundation will dispose of the assets. In addition, in the case of a non-German foundation or trust, information must be available to German tax authorities under the Mutual Assistance Directive. This has been the case in the U.K. thus far.

After a hard Brexit, it will no longer be possible to provide proof that a trust resident in the U.K. meets the conditions for applying the exception.

Example 2

Facts: A, domiciled in Berlin, is the beneficiary of a trust resident in the U.K., which realizes dividend income from shares in U.K.-resident companies. The settlor has already passed away. A has not yet received any distributions from the trust.

Result: After Brexit, the trust income will be attributed to A and other beneficiaries, possibly *pro rata*, on the basis of the German Foreign Tax Act, even if no distributions have been made. A will be taxed on the dividends derived by the trust as if they were received by him. If A later receives distributions from the trust, he should not be taxed a second time, provided he can prove earlier taxation at the time the underlying dividends were received by the trust.

Exemption from Inheritance and Gift Tax for Transfers of Companies

German inheritance tax law provides for relief when the assets owned by the decedent are business assets used in a permanent establishment in an E.U. or E.E.A. Member State. The relief is in the form of a total or 85% exemption from the tax. Relief is also provided under German inheritance tax law for shares that represent a holding of at least 25% in a limited company that has its seat of management in an E.U. or E.E.A. Member State. In the event of a hard Brexit, these reliefs will no longer be available.

Example 3

Facts: Mother A, domiciled in Berlin, is the sole shareholder of a corporation resident in London. After she has passes away, her daughter inherits the shares.

Result: Since Mother A was domiciled in Germany, the acquisition of the shares in the English corporation by her daughter is subject to German inheritance taxation. If the life of Mother A ends after a hard Brexit, the tax exemption for business assets and for shares in corporations can no longer be claimed for the shares in the English corporation.

In addition, the value used for computing inheritance tax on rented housing in the U.K. will no longer be capped 90% of actual value. The tax base will be increased to full fair market value. The full tax exemption for a U.K. family home when a surviving spouse or children inherit the property and continue to use it as a residence will also be abolished.

Example 4

Facts: Family A (all German citizens) has been residing exclusively in England for two years and live there in a family home that is owned. Both parents die in an accident. Their son stays in the family home. He is the only heir.

Result: Since the family has not lived abroad for more than five years, the parents' estates are subject to German inheritance tax. The family home can no longer be inherited tax-free because it is not located in an E.U. Member State after Brexit.

Finally, inheritance tax exemptions for cultural goods located in the E.U. or E.E.A. will likely end in the case of a hard Brexit.

Other Regulations

Advantageous regulations regarding the relocation of a corporation's seat to an E.U. Member State will no longer be applicable. Under a hard Brexit, the relocation will be a taxable disjunction, which is the term used to describe a deemed disposition of business assets treated as a taxable event for purposes of the German Transformation Tax Act and the provision of the German Foreign Tax Act imposing exit taxation.

"Grandfathering" When All Tax-Relevant Actions Are Completed

In order to ensure that Brexit does not have any negative legal consequences for a taxpayer that has completed an exit from Germany prior to a hard Brexit, the German Tax Accompanying Act extends special transitional rules to existing situations. The aim is to maintain the status quo, but only if the taxpayer completes all relevant actions for an exit prior to the effective date of a hard Brexit.

Inheritance Relief for Business Assets

German inheritance tax law has been amended to maintain certain tax exemptions granted in the past. Under German inheritance tax law, an 85% exemption is provided for the value of business assets if the business is continued for at least five years and the cost of direct wages during the five-year period is not less than 400% of the average annual direct wages in the five-year period prior to the death of the shareholder. Complete tax exemption is allowed if, *inter alia*, the wage expense during the seven years following the date of death does not fall below 700% of the average wage expense for the seven years prior to the date of death.

The computation is made by taking into account wages incurred by subsidiary corporations or partnerships in which an ownership percentage in excess of 25% is maintained. The subsidiary or partnership computation includes companies and partnerships based in the E.U. or E.E.A.

Provided the death occurs prior to Brexit, the exemption will continue to take into account the wage base in the U.K. both before and after Brexit takes place.

Taxable Disjunction (Deemed Disposition) of Assets

If an asset is removed from the pool of business assets located in Germany and transferred to a permanent establishment in a Member State of the E.U., an adjustment item is created in the form of a hidden reserve, which must be recognized over five years in equal annual amounts. If the asset ceases to be subject to the tax authority of a Member State, the unrecovered balance must be recognized immediately, and the resulting profit is taxed at that time. The German Tax Accompanying Act prevents the deferral from being eliminated and tax liability from being triggered solely by the U.K.'s withdrawal from the E.U.

Example 5

Facts: A-GmbH, based in Germany, has transferred a special crane from its German permanent establishment to its English permanent establishment. The special crane has hidden reserves of €10,000, which must be taken into account over five years.

Result: A-GmbH can recognize the hidden reserve in €2,000 annual increments over five years. Brexit does not end the write-off over five years. Immediate tax on the unrecovered reserve is not required.

Maintenance of the Tax-Free Investment Reserve – No Interest on Tax Deferral in Case of Reinvestments in the E.U.

The advantages of a tax-free investment reserve, which is intended to promote investment in E.U. Member States, are also preserved. In principle, the German Income Tax Act stipulates that the tax due on the capital gain can be paid in five equal annual instalments upon request if the hidden reserves are transferred to certain passive assets such as real estate. However, interest must be paid if there is no reinvestment in business assets located in the E.U. or E.E.A. According to the German Tax Accompanying Act, no interest payment is due if an application for payment in instalments is filed before Brexit and the business assets are reinvested in the U.K. after Brexit.

Example 6

Facts: A-GmbH, resident in Germany, maintains permanent establishments in Germany and in England. A plot of land that has belonged to the German permanent establishment for over six years is sold at a profit. The capital gain, which is taxable in Germany, is deferred upon request. After Brexit but within the following four financial years, another property is acquired in England.

Result: The deferral of the capital gain is not terminated by Brexit. The deferral granted by the instalments does not become interest-bearing, as the application is made before Brexit and the provisions of the German Tax Accompanying Act consider reinvestment in the U.K. to be sufficient.

No Deemed Dissolution and Taxation in the Event of Departure of a Corporation Through Transfer of Management or Registered Office

In principle, a transfer of the management or the registered office of a corporation to a non-Member State results in a deemed dissolution, since no Member State of the E.U. or the E.E.A. retains the right to impose tax on the worldwide income of the corporation. An amendment to the German Corporate Income Tax Act prevents a corporation that has transferred its management or registered office to the U.K. in the past from becoming subject to subsequent taxation due to Brexit. The amendment clarifies that Brexit is not sufficient event to trigger such tax liability.

Example 7

Facts: A-GmbH has relocated its management from Berlin to London. The U.K. then withdraws from the E.U.

> *"If the E.U. and the U.K. reach a withdrawal agreement with a transition period, the German Brexit Transition Act . . . will allow Germany to treat the U.K. as an E.U. Member State until December 31, 2020."*

Result: Since the transfer of management took place when the U.K. was a Member State, no dissolution is deemed and the hidden reserves of A-GmbH are not subject to taxation. Although Brexit is associated with the exit of A-GmbH from unlimited tax liability in a Member State, it does not give rise to any tax liability due to the provisions of the German Tax Accompanying Act.

No Subsequent Exit Taxation

If an individual departs Germany and establishes residence in a country that is not a Member State of the E.U. or the E.E.A., exit tax is imposed. The tax is deferred if the individual leaves Germany to establish residence in a Member State. The German Tax Accompanying Act prevents Brexit from triggering exit taxation on shareholdings of an individual if residence in the U.K. is established prior to Brexit.

Example 8

Facts: After 12 years in Germany, A moves his domicile back to England, his country of birth. He is the owner of various participations in domestic and foreign corporations of more than 1%. The tax office defers the tax on departure without interest and without security. After his departure, the U.K. withdraws from the E.U.

Result: Withdrawal from the E.U. does not constitute a reason for revoking the deferral. Exit tax will continue to be deferred as long as A does not, for example, sell the investments or move to another third country. If A moves his residence to the U.K. after Brexit, he must pay tax on the difference between the acquisition cost and the fair market value of the shares as a notional capital gain. If security was provided, the payment could be deferred for a period of five years, if immediate payment represents a considerable hardship for A.

Other Regulations

There are also amendments to the German Transformation and Corporation Tax Act to mitigate the adverse effects of Brexit on companies resident in the U.K. For example, retroactive taxation of capital gains will not be triggered solely by Brexit.

CONSEQUENCES OF A WITHDRAWAL AGREEMENT

If the E.U. and the U.K. reach a withdrawal agreement with a transition period, the German Brexit Transition Act will enter into force. The act will allow Germany to treat the U.K. as an E.U. Member State until December 31, 2020, if the withdrawal agreement is accepted. The tax privileges of E.U. Member States would continue to apply until then.

The German Brexit Tax Accompanying Act has already entered into force. However, the individual rules presuppose that the U.K. is no longer a Member State or is treated as such. Thus, the effects of the German Tax Accompanying Act would only be felt after the transitional period ends on December 31, 2020.

ANTI-TAX ARBITRAGE THE U.S. WAY

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Tags
Code §245A
Code §267A
Hybrid Entity
Hybrid Transaction
T.C.J.A.

The 2017 Tax Cuts and Jobs Act ("T.C.J.A.") introduced two new rules targeting hybrid arrangements. The first deals with hybrid dividends. It denies the U.S. "participation exemption" introduced under the T.C.J.A., which, conceptually, is a 100% dividend received deduction, on a dividend received by a qualifying U.S. Shareholder[1] from a controlled foreign corporation ("C.F.C.")[2] if the dividend is a hybrid dividend.[3] The second relates to certain related-party transactions. More specifically, it disallows a deduction for certain related-party amounts paid or accrued (i) pursuant to a hybrid transaction or (ii) by, or to, a hybrid entity.[4]

In December 2018, the Treasury released proposed regulations to provide guidance on these new rules.[5] While the issues are complex, the following will highlight the main anti-hybrid items addressed by the proposed regulations.

BACKGROUND

In broad terms, hybrid arrangements come in various forms: either a specific type of intercompany payment (*i.e.*, dividend, interest, or royalty payment) or the use of specific types of entities. However, they have one goal in common: to exploit differences in tax treatment between two or more countries in order to secure a more beneficial tax result, also referred to as "tax arbitrage." The proposed regulations also address long-term deferrals.[6]

An example of a hybrid arrangement is a payment treated as interest in one country but as a dividend in the other. While the source country would allow deductibility of the interest payment, the recipient's country would not tax this income because it is treated as dividend exempt from taxation under its participation exemption regime.

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1. A U.S. Shareholder is defined as a U.S. person that owns shares of stock representing 10% or more of the total voting power of all stock or, as expanded under the T.C.J.A., the value of all shares of the foreign corporation.
2. A C.F.C. is a foreign corporation from the viewpoint of the U.S. for which more than 50% of its authorized and outstanding shares, measured by total voting power or value, is owned by U.S. Shareholders, as defined.
3. Code §245A(e).
4. Code §267A.
5. REG-104352-18. The proposed regulations contain effective dates that are tied to the date of publication in the Federal Register. They also propose modifications to the dual-consolidated loss ("D.C.L.") rules under Code §1503(d) and the check-the-box rules under Code §7701, as well as amendments to a number of tax reporting requirements under Code §§6038, 6038A, and 6038C.
6. This is consistent with the Senate Committee on Finance, Explanation of the Bill, at 384 (November 22, 2017).

In an intragroup scenario this would result in a reduced (or zero) effective tax rate for the payor and no tax for the recipient – in other words, double non-taxation. While the schemes may be more elaborate, the outcome will always be similar: deduction/no inclusion ("D./N.I.").

Both the O.E.C.D. and the E.U. have launched initiatives targeting these kinds of structures.[7] While the U.S. has been criticized for half-heartedly, if at all, embracing the O.E.C.D. initiative, hybrid arrangements and other schemes aimed at base erosion have been on the Treasury Department and the I.R.S.'s radar for a long time.[8] Undoubtedly, the O.E.C.D., the E.U., and the U.S. initiatives have influenced one another, and the U.S. regulations, in fact, defer to B.E.P.S. Action 2 in various places.

ANTI-HYBRID DIVIDEND RULES

Under the new rule, hybrid dividends received by U.S. companies that are U.S. Shareholders in a C.F.C. are denied the 100% dividend received deduction on the foreign-source portion of dividends under the new participation exemption as implemented by the T.C.J.A. Similarly, hybrid dividends received by a C.F.C. from a lower tier C.F.C. must be treated as Subpart F Income at the recipient C.F.C. level. A dividend is hybrid if the dividend received deduction of Code §245A(a) would otherwise be available but for the fact that the C.F.C. (or a related party) receives, or received, a deduction or similar benefit under the relevant foreign tax law with regard to the dividend. For this purpose, several provisions are significant:

- The proposed regulations delineate relevant foreign tax law as any foreign regime that imposes an income, war profits, or excess profits tax with respect to income of the C.F.C. (other than a foreign anti-deferral regime under which an owner of the C.F.C. is liable to tax).[9]
- Only deductions or other tax benefits that are "allowed" under the relevant foreign tax law are treated as hybrid deductions. Thus, payments that are disallowed as a deduction under foreign tax laws to prevent D./N.I. outcomes will not give rise to a hybrid deduction.[10]

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7 B.E.P.S. Action 2; European Council Directive 2016/1164 ("A.T.A.D. 1"); and Council Directive amending Directive 2016/1164 ("A.T.A.D. 2"). A.T.A.D. 2, adopted on May 29, 2017, following the publication of the O.E.C.D.'s final report on B.E.P.S. Action 2, entirely replaces the hybrid mismatch rules of A.T.A.D. 1. It includes rules on hybrid mismatches with non-E.U. countries, where at least one of the parties involved is a corporate taxpayer, or an entity in an E.U. Member State. For a comparison of A.T.A.D. 1 and 2 with the new anti-hybrid transaction rule, see "Hybrid Mismatches: Where U.S. Tax Law and A.T.A.D. Meet," *Insights* 5, no. 8.

8 The new rules are, indeed, not the first set of rules under U.S. domestic tax law targeting hybrid transactions. Regulations under Code 894(c) designed to prevent taxpayers from using hybrid entities in a treaty context were already in place. Treas. Reg. §1.894-1(d) finalized July 2000. These rules were, however, limited to the eligibility of payments subject to U.S. withholding tax under an applicable income tax treaty.

9 Other than a foreign anti-deferral regime under which an owner of the C.F.C. is liable to tax.

10 This should avoid double-taxation if the dividend would be subjected to both the

- The regulations provide that foreign rules similar to the U.S. foreign currency gain or loss rules must be taken into account when determining hybrid deduction amounts.

- Dividend distributions among tiered C.F.C.'s, to the extent they would have constituted hybrid dividends had they been received by a domestic corporation, constitute "tiered hybrid dividends." In the case of a tiered hybrid dividend distributed by one C.F.C. to another C.F.C. that has the same corporate U.S. Shareholder,

    ○ the tiered dividend constitutes Subpart F Income of the receiving C.F.C.;

    ○ the U.S. Shareholder includes its *pro-rata* share of such Subpart F Income; and

    ○ foreign tax credits or deductions for foreign income taxes paid are denied to the U.S. Shareholder.

  This Subpart F inclusion is even harsher than an "ordinary" Subpart F inclusion (*e.g.*, otherwise applicable Subpart F exceptions are disallowed and the current E&P limitation under Code §952(c) is absent).

- The proposed regulations exclude distributions of previously-taxed earnings and profits ("P.T.E.P.") to U.S. Shareholders. Distributions of P.T.E.P. from a lower-tier C.F.C. to an upper-tier C.F.C. are also expressly excluded from the definition of tiered hybrid dividends. Technically, these dividends would have been included absent this express exclusion.[11]

- The regulations introduce the hybrid deduction account ("H.D.A.") to address the potential difference in timing between when the U.S. considers an amount received and when foreign tax law allows the deduction. These events may occur at different times and, even, in different taxable years, which could result in a deduction being allowed for foreign tax law purposes without a matching dividend for U.S. tax purposes. Absent a dividend, the hybrid dividend rules would not be applicable. To resolve this issue, the proposed regulations provide that for each C.F.C. share that could trigger the application of the hybrid dividend rules, an H.D.A. must be maintained. This H.D.A. reflects the amount of hybrid deductions allowed to the C.F.C. and allocated to the specific share. Upon a dividend distribution, the dividend will be treated as a hybrid dividend or a tiered hybrid dividend to the extent of the shareholder's aggregate balance of the H.D.A. in the particular C.F.C. This, in turn, then triggers a corresponding decrease in the shareholder's H.D.A.'s.[12]

- An obscure anti-avoidance rule is also provided for transactions entered into with "a principal purpose of avoiding the purposes of proposed §1.245A(e)-1."

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foreign hybrid mismatch rule and the U.S. anti-hybrid dividend rule.

[11] Certain amounts treated as dividends under Code §1248 (*e.g.*, from the sale of stock in a C.F.C. by a U.S. Shareholder) are also treated as hybrid dividends under the proposed regulations and are subject to the tiered hybrid dividend rules (see Prop. Treas. Reg. §§1.245A(e)-1(c)(1) and (4)).

[12] Specific rules exist for transfers of stock-carrying H.D.A.'s and for certain Code §1248 dividends.

ANTI-HYBRID TRANSACTIONS RULES

In broad terms, Code §267A would deny a deduction for interest and royalty payments that are paid to a related party but not included in the recipient's income due to (i) a hybrid transaction or (ii) a payment by or to a hybrid entity. For this purpose, a party is related if the Code §954(d)(3) more-than-50% test is met.

Under the proposed regulations, the anti-hybrid rules should be limited to D./N.I. cases that result from the hybrid character of either the transaction or an entity involved.[13] Generally, Code §267A applies to qualifying interest and royalty payments made to C.F.C.'s. If a payment is included in a U.S. Shareholder's gross income under the Code §951(a) rules, Code §267A does not apply. According to the proposed regulations, the Code §267A denial was not designed to apply to payments made by a C.F.C. to either another related C.F.C. or to a U.S. Shareholder of a related C.F.C. More specifically, the proposed regulations deny the deduction for interest or royalties if, in addition to the presence of related parties, the following elements exist:

- An accrual or payment of interest or royalties (a "Specified Payment")
- The Specified Payment is disqualified (a "D.S.P.")
- The D.S.P. gives rise to a deduction for Specified Parties (defined below)
- A portion of the Specified Payment is not actually included in income and subject to tax at the full marginal rate applicable to ordinary income (the "D./N.I. Amount") (Long-term deferral rules are provided in this context.)

Specified Payments

The proposed regulations define both royalty payments and interest payments in a broad sense.

Royalties include amounts paid or accrued as consideration for the use of, or the right to use, certain intellectual property and certain information concerning industrial, commercial or scientific experience.[14] This definition is based on the one used in the 2006 U.S. Model Income Tax Treaty.

Interest is essentially defined as compensation for the use of funds or the time value of money. This definition is in line with the approach chosen by the proposed Code §163(j) regulations.[15] The proposed anti-hybrid regulations provide examples of compensation that qualifies as interest.[16]

D.S.P.

The D.S.P. definition is intended to target Specified Payments resulting in a D./N.I. outcome.

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13 Three categories of payments are introduced for this purpose: "disqualified hybrid amounts," "disqualified imported mismatch amounts," and specified payments satisfying anti-abuse rules, as defined under the same regulations.

14 Prep. Treas. Reg. §1.267A-5(a)(16).

15 Limitation on Deduction for Business Interest Expense, (proposed November 26, 2018) (to be codified at 26 CFR Part 1).

16 Prop. Treas. Reg. §1.267A-5(12).

With that logic in mind, a D.S.P. is any one of the following if it results in a D./N.I. Amount (discussed below):

- A Disqualified Hybrid Amount[17]
- A Disqualified Imported Mismatch Amount[18]
- A Specified Payment satisfying the requirements of the Code §267A anti-abuse rules[19]

"Disregarded payments are only taken into account to the extent they offset non-dual inclusion income."

A Disqualified Hybrid Amount is a payment resulting in D./N.I. due to a hybrid or branch arrangement. Such arrangements include any of the following:[20]

- Hybrid Transactions (Including Hybrid Financial Instruments and Similar Transactions): These transactions carry a mismatch in their characterization. While payments may be treated as royalties or interest in the payor's jurisdiction, the tax laws of the recipient's jurisdiction characterize the transaction differently. Long-term mismatches are included in the definition.
- Disregarded Payments: This generally entails Specified Payments that disregarded in the recipient's jurisdiction and, if they were regarded, would be subject to tax as interest or royalty. For a Specified Payment to constitute a Disqualified Hybrid Amount, it must exceed dual inclusion income. Dual inclusion income is the payor's income or gain for U.S. tax purposes that the payee must include in its income under its own tax laws, reduced by the payor's deductions or losses for U.S. tax purposes that the payee is allowed to claim as such under its own tax laws.[21] In other words, disregarded payments are only taken into account to the extent they offset non-dual inclusion income.
- Deemed Branch Payments: These payments generally are interest and royalty payments that are deductible for a branch or permanent establishment but not includible in that entity's home office jurisdiction.
- Reverse Hybrids: A reverse hybrid is a U.S. or foreign entity that
  - is treated as fiscally transparent for purposes of the tax laws of its jurisdiction of establishment and
  - is not so treated for purposes of the tax laws of its direct or indirect owner (whether a tax resident or a taxable branch, also referred to as an "investor").

  A payment to a reverse hybrid is a Disqualified Hybrid Amount only to the extent that an investor does not include it in income.
- Branch Mismatch Payments: These are payments that are attributable to a branch under the tax laws of its home office's jurisdiction and, under the

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[17] As defined under Prop. Treas. Reg. §1.267A-2.

[18] As defined under Prop. Treas. Reg. §1.267A-4.

[19] As defined under Prop. Treas. Reg. §1.267A-5(b)(6).

[20] Prop. Treas. Reg. §1.267A-2.

[21] Prop. Treas. Reg. §1.267A-2(b)(3).

tax laws of the branch's jurisdiction, either no branch exists or the payment is attributable to the home office and not the branch. A branch mismatch payment is a Disqualified Hybrid Amount to the extent it is not included in the home office's income.

A Disqualified Imported Mismatch Amount is a D.S.P. that results in a D./N.I. outcome as a result of the import of an offshore hybrid or branch arrangement into the U.S.

Deductions of Specified Parties

A Specified Party is (i) a U.S. tax resident, (ii) a C.F.C. in which at least one U.S. Shareholder owns a direct or indirect 10% interest, or (iii) a U.S. taxable branch (including a permanent establishment under an applicable treaty).

Partnerships are excluded from the definition, but partners are not.

D./N.I. Amount

To make certain that only deductions not giving rise to an income inclusion are disallowed, the proposed regulations look at what amount of an otherwise D.S.P. actually is or is not included in a tax resident's or a taxable branch's income for foreign tax law purposes. For this purpose, a payment is included in income if (i) it is subject to a full marginal income tax rate applicable to ordinary income and (ii) no reduction or offset particular to that specific payment applies. A mechanism is also provided to determine the includible income in the case of a partial reduction or offset or in the case of a preferential tax rate. Permanent exclusions, as well as long-term deferrals, are treated as not giving rise to an income inclusion. For this purpose, a long-term deferral is an inclusion that occurs during a taxable year that ends more than 36 months after the end of the Specified Party's taxable year.

Further, in the context of disqualified hybrid amounts, it is only if the absence of income inclusion is due to the hybridity of the transaction that an actual absence of income inclusion occurs for purposes of Code §267A.

MISCELLANEOUS PROVISIONS

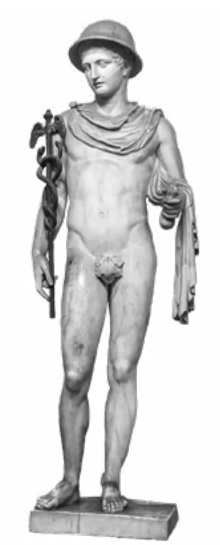
In addition to the above, the following provisions are included in the proposed regulations:

- Clarification that certain payments made in connection with repo and securities lending transactions are subject to hybrid transaction treatment under Code §267A
- An exemption for certain payments included in the income of a U.S. tax resident or taken into account under the U.S. anti-deferral rules of Subpart F or the new G.I.L.T.I. (global intangible low-taxed income) regime, which would otherwise be subjected to double-taxation, for purposes of Code §267A
- Indication that transactions which produce double deductions are addressed through other provisions or doctrines (*e.g.*, the D.C.L.) and that Code §267A addresses only D./N.I. outcomes that are the result of a hybrid transaction or entity and not, for example, due to a territorial exemption or the absence of corporate income tax under the laws of the recipient's jurisdiction

- Reporting requirements using Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*; Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*; or Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*, as applicable

CONCLUSION

Well after the release of the publication of the O.E.C.D. final report on B.E.P.S. Action 2 and the introduction of A.T.A.D. 1 and 2 in the E.U., the U.S. now presents its own set of anti-hybrid regulations.[22] The proposed regulations are highly technical and may have a significant impact on taxpayers with hybrid entity structures. Given that the effective date of final regulations may be December 31, 2017 (if the proposed regulations are adopted in final form by June 22, 2019), taxpayers are advised to examine the new regulations closely with their advisors to assess the impact.



[22] Note, however, that regulations under Code §894(c) designed to prevent taxpayers from using hybrid entities in a treaty context were already in place (Treas. Reg. §1.894-1(d), finalized July 2000). These rules were, however, limited to the eligibility of payments subject to U.S. withholding tax under an applicable income tax treaty.

THE RESPONSIBLE PARTY – CHANGES EFFECTIVE MAY 2019

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Tags
E.I.N.
Foreign Person
I.T.I.N.
Responsible Party

The Federal Taxpayer Identification Number ("T.I.N.") used by entities is the Employer Identification Number ("E.I.N."). The E.I.N. application (both online and using Form SS-4) requires that a responsible party be identified. On March 27, 2019, the I.R.S. announced that starting May 13, 2019, only individuals with T.I.N.'s will be allowed to request an E.I.N. as the responsible party on the application.

WHO IS A RESPONSIBLE PARTY?

The responsible party is the person who ultimately owns or controls the entity or who exercises ultimate effective control over the entity. In other words, the responsible party is the person who controls, manages, or directs the entity and the disposition of its funds and assets. Generally, the responsible party is the principal officer of a corporation, the general partner of a partnership, the grantor or trustee of a trust, or the owner of an entity.

Entitlement to the property of the entity alone, without any corresponding authority to control, manage, or direct the entity does not cause the individual to be a responsible party. Likewise, a "nominee" may not be designated as the responsible party to obtain an E.I.N. because a nominee is given limited authority to act on behalf of an entity, usually for a limited period of time, and is not "the true responsible party" who has authority over an entity's assets as per the above definition. The I.R.S. indicates that the use of nominees in this process prevents the I.R.S. from gathering appropriate information on entity ownership and has been found to facilitate tax non-compliance by entities and their owners.

The instructions for the current revision of the E.I.N. application provide that unless the applicant is a government entity, the responsible party must be an individual (*i.e.*, a natural person) and not an entity. Further, the instructions provide that the general requirement that the responsible party be an individual applies to entities with shares or interests traded on a public exchange or which are registered with the S.E.C. This represents a change from the instructions to the 2016 revision of the E.I.N. application, which allowed an entity to serve as the responsible party of a publicly traded entity.

One must be careful in designating the responsible party on the relevant entity's E.I.N. application and carefully review the instructions to the most current revision of the application, which specifically and directly limits the use of entities as the responsible party only to governmental entities. Merely reviewing the I.R.S. webpage on an issue may result in an incorrect application, which may be rejected by the I.R.S. The I.R.S. webpage on responsible parties could result in such a mistake. While the webpage provides that it was last reviewed or updated on February 28, 2019, the page seemingly allows an entity to be a responsible party – at least when it comes to a publicly traded entity. But this, as mentioned above, is no longer correct.

WHAT IS THE EFFECT? ARE FOREIGN RESPONSIBLE PARTIES IMPACTED?

The I.R.S. announcement provides that this change (*i.e.*, that only individuals with T.I.N.'s will be allowed to request an E.I.N. as the responsible party) will prohibit entities from using their own E.I.N. to obtain additional E.I.N.'s. In fact, this requirement was actually present prior to this announcement, and notwithstanding this, many entities previously obtained an E.I.N. using another entity as their responsible parties. The I.R.S. seems to acknowledge that the requirement has not been well observed, but it is anticipated that it will be, come May 2019.

However, the general announcement may be read broadly, requiring every individual to have a social security number ("S.S.N.") or an individual taxpayer identification number ("I.T.I.N.") in order to apply for an E.I.N. Thus, a question arises as to foreign individuals. There are many instances where a foreign entity must obtain an E.I.N. (*e.g.*, in order to apply for a withholding certificate to reduce or eliminate the F.I.R.P.T.A. withholding on distributions from a U.S. real property holding company ("U.S.R.P.H.C.") or upon a disposition of an interest in U.S. real property). Currently, if the responsible party has not obtained an S.S.N. or I.T.I.N. for a different purpose, the entity leaves the space for a T.I.N. blank.

"When the only reason for requesting an I.T.I.N. is to apply for an E.I.N., an individual is currently not treated as eligible."

Concerns have been raised whether the I.R.S. announcement would require such individuals to first obtain an I.T.I.N. and whether this will impose an impediment on certain transactions. The current instructions to the application provide that a responsible party that does not have and is ineligible to obtain an S.S.N. or I.T.I.N. should leave the line blank. An individual is eligible to apply for an I.T.I.N. only under certain circumstances, such as when there is a requirement to file a tax return or when an individual is the recipient of a dividend from a U.S.R.P.H.C. and wishes to apply for a withholding certificate. But when the only reason for requesting an I.T.I.N. is to apply for an E.I.N., an individual is currently not treated as eligible. It is not clear whether the I.R.S. intends to revise the eligibility requirements for an I.T.I.N. to permit the issuance of an I.T.I.N. for this purpose or whether it will continue its current practice.

STATE AND LOCAL TAX CREDIT PROGRAMS – BUSINESSES MAY GET WHAT INDIVIDUALS CANNOT

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Tags
Code §162
State and Local Tax
Tax Credits

Since recent Federal tax law changes have capped the state and local tax deduction for individuals to $10,000, many states have been trying to implement solutions to help alleviate the effects of the change. New York State has introduced two programs to get around the $10,000 limitation: New Yorkers can make payments to state charitable programs and receive a credit against N.Y. income tax or, alternatively, use an Employer Compensation Expense Program.

In response to the states' efforts, the Treasury Department issued proposed regulations addressing the Federal income tax treatment of these programs as applicable to individuals. The proposed regulations state that if a taxpayer makes a payment or transfers property to or for the use of a charitable organization (including a state-operated charity) and the taxpayer receives or expects to receive a state or local tax credit in return for such payment, the tax credit constitutes a return benefit, or *quid pro quo*, to the taxpayer and reduces the taxpayer's charitable contribution deduction.

In response to the proposed regulations, the I.R.S. received questions regarding the application of the proposed regulations to business entities that make payments to charitable organizations pursuant to state and local tax credit programs. These questions related to the application of Code §162 to these payments. That is, whether a business entity may deduct these payments under Code §162 as ordinary and necessary business expenses incurred in carrying out a trade or business. Taxpayers worried that the *quid pro quo* theory of disallowance could apply equally to business deductions. After all, if the taxpayer received a benefit by the contribution, would that not be sufficient to disallow the deduction? On September 5, 2018, the I.R.S. released an F.A.Q. addressing these concerns. The I.R.S. stated that the discussion in the proposed regulations addressing the deductibility of such payments as charitable contributions for individuals does not affect the availability of a business expense deduction under Code §162.

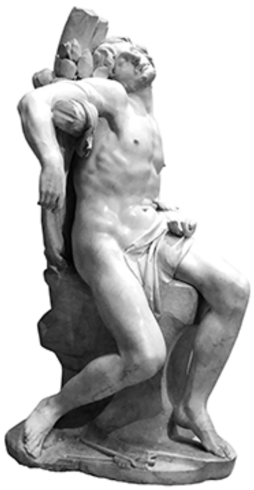
Generally, a business taxpayer making a payment to a charitable or government entity described in Code §170(c) is permitted to deduct the entire payment as an ordinary and necessary business expense under Code §162 if the payment is made with a business purpose. The rules permitting an ordinary and necessary business expense deduction under Code §162 apply to a taxpayer engaged in carrying out a trade or business regardless of the form of the business.[1]

Since the release of the F.A.Q., the Treasury Department and the I.R.S. continue to receive questions regarding the application of the proposed regulations and Code §§162 and 164 to taxpayers engaged in trades or businesses. These questions include whether payments by these taxpayers to charitable organizations in return for state income, property, and other business tax credits would bear a direct relationship to the taxpayer's trade or business, such that these payments would be

1 "State and Local Income Tax FAQ," I.R.S., last modified March, 22, 2019.

considered ordinary and necessary business expenses of carrying out such trade or business under Code §162(a) to the extent of the credit received or expected.

In further response, on December 28, 2018, the I.R.S. issued a Revenue Procedure[2] providing safe harbor rules for payments by C-corporation and pass-thru entities. Notably, the *quid pro quo* analysis does not appear to apply in this context.



To the extent a C-corporation receives or expects to receive a state or local tax credit in return for a payment to an organization described in Code §170(c), it is reasonable to conclude that there is a direct benefit to the C-corporation's business in the form of a reduction in the state or local taxes the C-corporation would otherwise have to pay. Therefore, to the extent of the amount of the credit received or expected to be received, there is a reasonable expectation of financial return to the C-corporation commensurate with the amount of the transfer.

A specified pass-thru can qualify for the similar deduction if it meets four tests:

- The entity is a business entity other than a C-corporation that is regarded for all Federal income tax purposes as separate from its owners.[3]
- The entity operates a trade or business within the meaning of Code §162.
- The entity is subject to a state or local tax incurred in carrying out its trade or business that is imposed directly on the entity.
- In return for a payment to a charitable organization the entity receives or expects to receive a state or local tax credit that the entity applies or expects to apply to offset a state or local tax.

The following two examples are offered:

- P is an L.L.C. classified as a partnership for Federal income tax purposes under Treas. Reg. §301.7701–3 and is owned by individuals A and B. P is engaged in a trade or business within the meaning of Code §162 and makes a payment of $1,000 to a charitable organization. P receives or expects to receive a dollar-for-dollar state tax credit to be applied to P's state excise tax liability incurred by P in carrying out its trade or business. Under applicable state law, the state's excise tax is imposed at the entity level (not the owner level). P may treat the $1,000 payment as meeting the requirements of an ordinary and necessary business expense under Code §162.
- S is an S-corporation engaged in a trade or business and is owned by individuals C and D. S makes a payment of $1,000 to a charitable organization. In return for the payment, S receives or expects to receive a state tax credit equal to 80% of the amount of this payment ($800) to be applied to S's local real property tax liability incurred by S in carrying out its trade or business. Under applicable state and local law, the real property tax is imposed at the entity level (not the owner level). S may treat $800 of the payment as meeting the requirements of an ordinary and necessary business expense under Code §162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by this revenue procedure.

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[2] Rev. Proc. 2019-12, 2019-4 I.R.B. 401, December 28, 2018.

[3] Treas. Reg. §301.7701-3.

IT'S TIME FOR CAYMAN SHELL ENTITIES TO COME OUT OF THEIR SHELLS AND SHOW ECONOMIC SUBSTANCE

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Tags
Cayman Islands
Economic Substance

INTRODUCTION

In response to the O.E.C.D.'s B.E.P.S. recommendations and the conclusions and concerns identified by the E.U. Code of Conduct Group of Business Taxation, the Cayman Islands enacted the International Tax Cooperation (Economic Substance) Law, 2018 ("E.S. Law") on December 27, 2018. The law was supplemented by the Economic Substance for Geographically Mobile Activities Guidance (the "Guidance") released on February 22, 2019.[1]

The Cayman Islands, being one of the O.E.C.D.-compliant "no or only nominal tax" jurisdictions, committed to take active steps to change its tax regime in order to stay out of the E.U.'s list of non-cooperative jurisdictions for tax purposes.

The E.S. Law was designed to address offshores structures attracting profits to the Islands and mandate economic substance there. The E.S. Law identifies "Relevant Entities" who conduct "Relevant Activities" and applies the law only to these entities. Notification and reporting obligations also apply.

To satisfy the economic substance test contained in the law, these entities must show that they undertake sufficient income generating activities and have sufficient operating expenditures, physical presence, and full-time employees to substantiate an economic nexus in the Cayman Islands.

OVERVIEW

Generally, the E.S. Law provides that certain entities (*i.e.*, Relevant Entities) that carry out identified business activities (*i.e.*, Relevant Activities) in the Cayman Islands must comply with the following:

- Each Relevant Activity must have adequate economic substance (explained below).
- The core income generating activities ("C.I.G. Activities") in relation to the Relevant Activities must be carried out in the Islands.
- Each Relevant Entity must comply with reporting requirements to demonstrate adherence to the E.S. Law.

Relevant Entities carrying on more than one Relevant Activity must satisfy the requirements separately in relation to each Relevant Activity.

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1 Reference to the E.S. Law throughout this article includes the Guidance.

WHAT ENTITIES FALL WITHIN THE AMBIT OF THE E.S. LAW?

A Relevant Entity is any of the following entities:

- A company that is incorporated under the Companies Law (2018 Revision) or a limited liability company ("L.L.C.") registered under the Limited Liability Companies Law (2018 Revision)
- A limited liability partnership ("L.L.P.") registered in accordance with the Limited Liability Partnership Law, 2017
- A company incorporated outside the Cayman Islands and registered under the Companies Law (2018 Revision)

WHAT ENTITIES ARE EXEMPT?

The E.S. Law does not apply to domestic Cayman Islands corporations, investment funds, or entities that are tax resident outside the Cayman Islands.[2]

A domestic company is a company that is engaged in a business in the Cayman Islands and complies with the local laws.[3] However, a company that meets the above requirement but is a part of a multinational enterprise ("M.N.E.") Group (*i.e.*, a group with annual revenues of at least $850 million) is not a domestic company. Also, a company not carrying on any business is not a domestic company even if it complies with the local laws.

An investment fund means an entity in the business of operating as an investment fund. The principal business of an investment fund is the issuing of investment interests (*i.e.*, shares, trust units, partnership interests, or other rights carrying an entitlement to participate in the profits or gains of the entity) to raise funds with the aim of enabling the holder of the interest to benefit from the profits or gains from the entity's acquisition, holding, management, or disposal of investments. Mutual funds licensed or registered with the Cayman Islands Monetary Authority are also treated as investment funds.

A company, L.L.C. or L.L.P. that is incorporated or established in the Cayman Islands and is a tax resident in another jurisdiction is not subject to the E.S. Law if it produces satisfactory evidence to substantiate the claim (*e.g.*, the tax identification number, tax residence certificate, and evidence of assessment or payment of a tax liability as well as details of the details of its parent company, ultimate parent company, and ultimate beneficial owners, including their respective jurisdictions of tax residence).

WHAT ARE THE IDENTIFIED BUSINESS ACTIVITIES UNDER THE E.S. LAW?

A Relevant Entity must be engaged in a Relevant Activity for the E.S. Law to apply.

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[2] Section II.A.2 of the Guidance.

[3] Section 4(1) of the Local Companies (Control) Law (2015 Revision) or Section 3(a) of the Trade and Business Licensing Law (2018 Revision).

A Relevant Activity includes each of the following:[4]

- Banking business
- Distribution and service center business
- Financing and leasing business
- Fund management business
- Headquarters business
- Holding company business
- Insurance business
- Intellectual property business
- Shipping business

As mentioned earlier, the C.I.G. Activities in relation to the Relevant Activities must be carried out in the Cayman Islands. The C.I.G. Activities are activities that are of central importance to a Relevant Entity in terms of generating income.[5] It is not necessary for the Relevant Entity to perform every C.I.G. Activity with respect to a Relevant Activity in the Cayman Islands. However, the assessment of whether a Relevant Entity has economic substance in the Cayman Islands will include careful consideration of what elements of the C.I.G. Activities are being carried out by the Relevant Entity in the Cayman Islands.

"The C.I.G. Activities are activities that are of central importance to a Relevant Entity in terms of generating income."

The Relevant Activities and their associated C.I.G. Activities are shown in the series of tables below:

Relevant activity	Definition	Cayman Islands CIGA
banking business	has the meaning given to that expression by section 2 of the Banks and Trust Companies Law (2018 Revision) *[where "banking business" means the business of receiving (other than from a bank or trust company) and holding on current, savings, deposit or other similar account money which is repayable by cheque or order and may be invested by way of advances to customers or otherwise]*	(i) raising funds, managing risk including credit, currency and interest risk; (ii) taking hedging positions; (iii) providing loans, credit or other financial services to customers; (iv) managing capital and preparing reports or returns, or both, to investors or the Cayman Islands Monetary Authority, or both
distribution and service centre business	means the business of either or both of the following - (a) purchasing from an entity in the same Group - (i) component parts or materials for goods; or (ii) goods ready for sale, and reselling such component parts, materials or goods outside the Islands; (b) providing services to an entity in the same Group in connection with the business outside the Islands, but does not include any activity included in any other relevant activity except holding company business	(i) transporting and storing goods, components and materials; (ii) managing stocks; (iii) taking orders; (iv) providing consulting or other administrative services

4 Section II.B of the Guidance.

5 Section III.A.2 of the Guidance.

Relevant activity	Definition	Cayman Islands CIGA
financing and leasing business	means the business of providing credit facilities for any kind of consideration to another person but does not include financial leasing of land or an interest in land, banking business, fund management business or insurance business	(i) negotiating or agreeing funding terms; (ii) identifying and acquiring assets to be leased; (iii) setting the terms and duration of financing or leasing; (iv) monitoring and revising financing or leasing agreements and managing risks associated with such financing or leasing agreements
fund management business	means the business of managing securities as set out in paragraph 3 of Schedule 2 to the Securities Investment Business Law (2015 Revision) carried on by a relevant entity licensed under that Law for an investment fund *["Managing Securities" means managing securities belonging to another person in circumstances involving the exercise of discretion.]*	(i) taking decisions on the holding and selling of investments; (ii) calculating risk and reserves; (iii) taking decisions on currency or interest fluctuations and hedging positions; (iv) preparing reports or returns, or both, to investors or the Cayman Islands Monetary Authority, or both

Relevant activity	Definition	Cayman Islands CIGA
headquarters business	means the business of providing any of the following services to an entity in the same Group - (a) the provision of senior management; (b) the assumption or control of material risk for activities carried out by any of those entities in the same Group; or (c) the provision of substantive advice in connection with the assumption or control of risk referred to in paragraph (b), but does not include banking business, financing and leasing business, fund management business, intellectual property business, holding company business or insurance business	(i) taking relevant management decisions; (ii) incurring expenditures on behalf of other entities in the Group; (iii) co-ordinating activities of the Group
holding company business	the business of a pure equity holding company *["pure equity holding company" means a company that only holds equity participations in other entities and only earns dividends and capital gains]*	all activities related to that business
insurance business	has the meaning given to that expression by section 2 of the Insurance Law, 2010 *[where "insurance business" means the business of accepting risks by effecting or carrying out contracts of insurance, whether directly or indirectly, and includes running-off business including the settlement of claims]*	(i) predicting or calculating risk or oversight of prediction or calculation of risk; (ii) insuring or re-insuring against risk; (iii) preparing reports or returns, or both, to investors or the Cayman Islands Monetary Authority, or both

Relevant activity	Definition	Cayman Islands CIGA
intellectual property business	means the business of holding, exploiting or receiving income from intellectual property assets; *["intellectual property asset" means an intellectual property right including a copyright, design right, patent and trademark]*	(i) where the intellectual property asset is a - (A) patent or an asset that is similar to a patent, research and development; or (B) non-trade or intangible (including a trademark), branding, marketing and distribution (ii) in exceptional cases, except if the relevant activity is a high risk intellectual property business, other core income generating activities relevant to the business and the intellectual property assets, which may include – (A) taking strategic decisions and managing (as well as bearing) the principal risks related to development and subsequent exploitation of the intangible asset generating income; (B) taking the strategic decisions and managing (as well as bearing) the principal risks relating to acquisition by third parties and subsequent exploitation and protection of the intangible asset; (C) carrying on the underlying trading activities through which the intangible assets are exploited leading to the generation of income from third parties.

Relevant activity	Definition	Cayman Islands CIGA
shipping business	means any of the following activities involving the operation of a ship anywhere in the world other than in the territorial waters of the Islands or between the Islands - (a) the business of transporting, by sea, passengers or animals, goods or mail for a charge; (b) the renting or chartering of ships for the purpose described in paragraph (a); (c) the sale of travel tickets and ancillary ticket related services connected with the operation of a ship; (d) the use, maintenance or rental of containers, including trailers and other vehicles or equipment for the transport of containers, used for the transport of anything by sea; or (e) the functioning as a private seafarer recruitment and placement service, but does not include a holding company business or the operating of a pleasure vessel	(i) managing crew (including hiring, paying and overseeing crew members); (ii) overhauling and maintaining ships; (iii) overseeing and tracking deliveries; (iv) determining what goods to order and when to deliver them, organising and overseeing voyages

WHAT SHOULD A RELEVANT ENTITY DO TO MEET THE ECONOMIC SUBSTANCE TEST?

A Relevant Entity is required to satisfy the economic substance test with respect to each Relevant Activity and is said to do so if the following conditions exist:[6]

- The Relevant Entity conducts some or all the C.I.G. Activities in relation to the Relevant Activity in the Cayman Islands.

  The assessment of economic substance in the Cayman Islands will include careful consideration of what elements of the C.I.G. Activities are being carried out in the Cayman Islands.

  The economic substance test does not preclude Relevant Entities seeking expert professional advice or engaging the services of specialists in other jurisdictions provided that any activities performed by advisors or specialists in other jurisdictions are not C.I.G. Activities and that the "Relevant Income" is commensurate with the C.I.G. Activity undertaken in the Cayman Islands.

- The Relevant Income (*i.e.*, the income excluded from corporate income tax in the Islands) derived from the Relevant Activity carried out in the Cayman Islands also meets certain thresholds:

  - The Relevant Entity incurs an adequate amount of operating expenditure in the Cayman Islands.
  - It has an adequate physical presence (including a place of business or plant, property, and equipment) in the Islands.
  - It has an adequate number of full-time employees or other personnel with appropriate qualifications in the Cayman Islands.

  The meanings of the words "adequate" and "appropriate" have not been quantified and are subject to facts and circumstances. The Guidance provides

[6] Section III.A.1 of the Guidance.

that adequate means "as much or as good as necessary to the relevant requirement or purpose" and that appropriate means "suitable or fitting for a particular purpose."[7] No minimum number of employees for a particular level of relevant income is prescribed either generally or for any particular type of Relevant Activity.

- The Relevant Entity is directed and managed in an appropriate manner in the Cayman Islands in relation to that Relevant Activity.

  A Relevant Entity is said to be directed and managed in an appropriate manner in the Cayman Islands in relation to a Relevant Activity if certain conditions are met:[8]

  - Its board of directors, as a whole, has the appropriate knowledge and expertise to discharge its duties as a board of directors.
  - The meetings of the board of directors are held in the Cayman Islands with adequate frequency given the level of decision making required.
  - There is a quorum of directors present in the Islands during any such meetings.
  - The minutes of those meetings record strategic decision making for the Relevant Entity occurring at the meeting.
  - Meeting minutes and appropriate records are kept in the Islands.

  This "directed and managed test" is designed to ensure that there are an adequate number of board meetings held and attended in the Cayman Islands (although it is not necessary for all of meetings to be held in the Cayman Islands). What constitutes an adequate number of meetings depends on the Relevant Activities of the company. However, it is generally expected that the majority of board meetings be held in the Cayman Islands.

DO SPECIFIC RELEVANT ENTITIES HAVE REDUCED OR INCREASED REQUIREMENTS?

Yes. Certain Relevant Entities face reduced or increased requirements to meet the local economic substance test.[9]

- A pure equity holding company (defined in the table above) satisfies the economic substance test if it merely complies with all the filing requirements under Companies Law (2018 Revision) and has adequate human resources and premises in the Cayman Islands for holding and managing the equity participations. Furthermore, the entity may engage its registered office service provider to satisfy these reduced requirements if the entity is passively holding equity interests in other entities only.

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7 Section III.A.3 of the Guidance.

8 Section III.A.5 of the Guidance.

9 Section III.B of the Guidance.

- A high-risk intellectual property business[10] is presumed not to have met the economic substance test even if the C.I.G. Activities relevant to the business are being carried out in the Islands, unless both the following conditions are met:
  - The Relevant Entity demonstrates that there was a high degree of control over the development, exploitation, maintenance, enhancement, and protection of the intangible asset, exercised by an adequate number of full-time employees with the necessary qualifications that permanently reside and perform their activities within the Cayman Islands.
  - The Relevant Entity provides sufficient information to the Tax Information Authority ("Authority") in relation to the financial year to rebut the presumption that it does not have sufficient economic substance. To rebut the presumption, a Relevant Entity with a high-risk intellectual property business must produce materials to demonstrate that development, enhancement, maintenance, protection, and exploitation functions have been under its control, where the business holds, exploits, or receives income from intellectual property assets. Evidential thresholds require further documentation, such as a detailed business plan and employee information (including level of experience), as well as evidence that key and strategic decision-making occurs in the Cayman Islands.

"C.I.G. Activities must be conducted in the Cayman Islands, and the Relevant Entity should be able to monitor and control the carrying out of the C.I.G. Activities by that other person."

CAN A RELEVANT ENTITY OUTSOURCE C.I.G. ACTIVITIES AND STILL MEET THE ECONOMIC SUBSTANCE TEST?

Yes. A Relevant Entity satisfies the economic substance test in relation to a Relevant Activity even if the related C.I.G. Activities are conducted by any other person.[11] However, the C.I.G. Activities must be conducted in the Cayman Islands, and the Relevant Entity should be able to monitor and control the carrying out of the C.I.G. Activities by that other person. Outsourcing, in this context, includes outsourcing, contracting, or delegating to third parties in the Islands or to entities in the same corporate group.

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10 A high-risk intellectual property business means an intellectual property business carried on by one of the following:

- An entity that (i) did not create the intellectual property in an intellectual property asset that it holds for the purposes of its business, (ii) acquired the intellectual property from an entity in the same M.N.E. Group or in consideration for funding research and development by another person situated in a country or territory other than the Islands, and (iii) licenses the intellectual property to one or more entities in the same M.N.E. Group or otherwise generates income from the asset in consequence of activities (such as facilitating sale agreements) performed by entities in the same M.N.E. Group
- An entity that does not carry out research and development, branding, or distribution as part of its C.I.G. Activities

11 Section III.A.4 of the Guidance.

The Guidance is silent as to whether the C.I.G. Activity can be outsourced to a foreign entity. The Guidance imposes a restriction on the place of performance, not on the residential status of the entity. Therefore, it may be argued that a Relevant Entity meets the economic substance test even if the C.I.G. Activity is outsourced to a foreign affiliate, as long as the activity is performed in the Cayman Islands and the Relevant Entity is able to monitor the activity.

Relevant Entities carrying on banking, insurance, or fund management business will be subject to the Cayman Islands Monetary Authority's "Statement of Guidance: Outsourcing Regulated Entities" in addition to the principles set out above under the economic substance test. Further, outsourced activities other than C.I.G. Activities are not subject to the economic substance test.

WHAT ARE THE REPORTING OBLIGATIONS FOR A RELEVANT ENTITY?

A Relevant Entity carrying on a Relevant Activity is required to prepare and submit a report to the Authority in order for it to determine whether the economic substance test has been satisfied for that Relevant Activity. The report must be made annually within 12 months of the last day of each financial year commencing on or after January 1, 2019.[12] The Guidance provides a long list of information to be provided by the Relevant Entity in the report.

WHAT ARE THE CONSEQUENCES OF FAILURE TO SATISFY THE ECONOMIC SUBSTANCE TEST?

If a Relevant Entity subject to the provisions of the E.S. Law fails to fulfill the economic substance requirements related to a Relevant Activity, the Authority shall inform the Relevant Entity of its failure, the reasons for the determination, the details regarding the penalty (if any), any action to be taken to satisfy the economic substance test, and its right to appeal. The Authority may impose a penalty of $10,000 or $100,000 if the entity fails to satisfy the test in the financial year after the initial notice of failure.[13]

WHAT IS THE EFFECTIVE DATE OF THE E.S. LAW?

A relevant entity is required to satisfy the economic substance test[14]

- by July 1, 2019, if it was in existence before January 1, 2019, or
- on the date on which it commences the Relevant Activity, if it was not in existence prior to January 1, 2019.

It should be reiterated that the reporting deadline is separate from the deadline for compliance with the economic substance test.

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12 Section IV.B of the Guidance.

13 Section V.A of the Guidance.

14 Section III.A.1 of the Guidance.

CONCLUSION

The guidance published earlier this year is detailed and academic in nature. While it provides for some definitions, it does not offer any practical examples and leaves room for interpretation. Structures that include Relevant Entities must pay immediate attention to the new legislation and determine whether these entities are engaged in Relevant Activities and whether measures must be taken prior to the fast-approaching effective date of July 1, 2019.

NEW JERSEY PROVIDES G.I.L.T.I. GUIDANCE

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Tags
G.I.L.T.I.
State and Local Tax
New Jersey

Federal tax law has introduced a new type of gross income. The provisions applicable to Global Intangible Low Tax Income ("G.I.L.T.I.") are designed to stop U.S. companies from shifting their profits to offshore jurisdictions. All states can incorporate parts of Federal law in one of three ways:

- Automatically follow the new Internal Revenue Code (the "Code") unless legislation affirmatively decouples, a process called "rolling conformity."
- Adopt all or part of the Code as it exists on a particular date, requiring legislative updates each time the Code changes, a process called "static conformity."
- Conform selectively, incorporating certain federal provisions or definitions by reference, a process called "selective conformity."

New Jersey uses selective conformity. State responses to international tax provisions, particularly those pertaining to the inclusion of G.I.L.T.I. remain substantially unresolved. The taxation of G.I.L.T.I. would represent an uncompetitive departure from typical approaches to state taxation and raises constitutional issues in many states.[1]

Most states compute their corporate taxable income using the Federal taxable income reported on line 28 or line 30. Therefore, Federal changes affect the states' taxable income. New Jersey is not any different; its starting point for calculating entire net income ("E.N.I.") is the Federal income tax before the net operating loss deduction and special deductions. Therefore, the income under the G.I.L.T.I. regime is included in the E.N.I.

The New Jersey Division of Taxation (the "Division") issued guidance[2] on G.I.L.T.I. treatment under Code §951 and the deductions allowed under Code §250. The Division is planning to issue regulations consistent with this guidance. According to this guidance, G.I.L.T.I. is not treated as dividend or deemed dividend income for New Jersey Corporate Business Tax ("C.B.T.") purposes. It is a separate category of income and is not treated as distributions from earnings and profits. Treatment as a dividend would escape New Jersey tax.

New Jersey allows the Code §250(a) deductions for New Jersey C.B.T. purposes, but such deductions are allowed only to the specific taxpayer that included the respective G.I.L.T.I. on its federal and New Jersey C.B.T. returns, and that actually took the deductions for federal tax purposes. If a taxpayer is not allowed the Code

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1 "Toward a State of Conformity: State Tax Codes a Year After Tax Reform," *Tax Foundation*, January 28, 2019.

2 TB-85(R) Issued December 24, 2018.

§250(a) deduction for federal tax purposes, then they will not be allowed the deduction for New Jersey C.B.T. purposes.

New Jersey sources the G.I.L.T.I. as an "all other business receipt," as the Division thinks it will be inequitable to source it as "other business receipts," thereby subjecting the entire amount to New Jersey tax. The Division has determined that G.I.L.T.I. constitutes displaced U.S. income at least in part. In order to prevent distortion to the allocation factor and arrive at a reasonable and equitable level of New Jersey taxation, all corporation business taxpayers filing Form CBT-100, New Jersey Corporation Business Tax Return or Form BFC-1, Corporation Business Tax Return for Banking and Financial Corporations will calculate the portion of G.I.L.T.I. that is subject to New Jersey tax based on a separate special accounting method.

The relevant allocation factor for computing the tax on net G.I.L.T.I. amount will be equal to the ratio of New Jersey's gross domestic product ("G.D.P.") over the total G.D.P. of every U.S. state (and the District of Columbia) in which the taxpayer has economic nexus. G.D.P. amounts should be based on the most recent quarter's data published by the U.S. Bureau of Economic Analysis as of the end of the taxpayer's privilege period.

"New Jersey sources the G.I.L.T.I. as an 'all other business receipt,' as the Division thinks it will be inequitable to source it as 'other business receipts,' thereby subjecting the entire amount to New Jersey tax."

For example, assuming economic nexus in all 50 states, the current ratio of New Jersey G.D.P. for allocation purposes approximates 3.1%. When applied to the net G.I.L.T.I. amount (after reduction for the 50% Code §250 deduction), this results in taxation of approximately 1.6% of gross G.I.L.T.I.

Some see this as an aggressive approach by New Jersey. The Council on State Taxation ("C.O.S.T.") has expressed concern with this approach and has offered the State of New Jersey a highly technical critique of the guidance.[3]

3 Karl A. Frieden, January 22, 2019, Re: COST's Concerns with TB-85R, issued December 24, 2018 ("Tax Conformity to IRC Sec. 951A (GILTI) and IRC Sec. 250 (FDII)").

About Us

Ruchelman P.L.L.C. is a boutique law firm based in New York City. It was founded in 1989 by an alumnus of a legacy firm that is now Deloitte's.

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