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INSIGHTS

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EDITORS' NOTE

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

- **C.J.E.U. Judgments on Danish Beneficial Ownership Cases.** Earlier this year, the C.J.E.U. released two judgments dealing with the interpretation of the Parent-Subsidiary Directive ("P.S.D.") and the Interest & Royalties Directive in the E.U. In each case, a structure was meticulously built to comply with national and E.U. law allowing global investors to bring funds to the E.U. in return for dividends and interest that were subject to little or no national tax in any E.U. country. Nothing in the structure was unique, other than the reticence of the Danish tax authorities to grant withholding tax exemptions. To the surprise of many, the C.J.E.U. looked at the structure and concluded that it lacked economic substance and should be disregarded by reason of a general E.U. anti-abuse principal. The internal E.U. recipients of the dividend and interest payments were not considered to be the beneficial owners of the income. Almost 50 years after the *Aiken Industries* case in the U.S. Tax Court and 25 years after the anti-conduit regulations were adopted by the I.R.S., European substance-over-form rules have now been adopted by judicial fiat. Thierry Lesage and Adnand Sulejmani of Arendt & Medernach SA, Luxembourg, meticulously explain the reasoning of the court and suggest that the court may have erred by conflating anti-abuse rules with beneficial ownership concepts.

- **Employers in the Netherlands: Prepare for Changes to Labor and Dismissal Laws in 2020.** In May, the Dutch Senate adopted the Labor Market in Balance Act designed to reduce the gap in legal protection and financial compensation between employment arrangements under fixed-term contracts and employment arrangements with indefinite term. The act provides greater rights on termination and, as a result, is unpopular with employers. It also aims to resolve some of the negative effects of an earlier amendment to the law that has been the subject of relentless criticism. Rachida el Johari and Madeleine Molster of Sagiure Legal, Amsterdam, explain the way Dutch labor law will affect termination rights for employees and suggest a path forward for management. This is another area of E.U. law in which companies will need to re-educate executives on proper patterns of behavior.

- **The Devil in the Detail: Choosing a U.S. Business Structure Post-Tax Reform.** Prior to the T.C.J.A. in 2017, the higher corporate income tax rate made it much easier to decide whether to operate in the U.S. market through a corporate entity or a pass-thru entity. With a Federal corporate income tax rate of up to 35%, a Federal qualified dividend rate of up to 20%, and a Federal net investment income tax on the distribution of 3.8%, the effective post-distribution tax rate was 50.47%, before taking into account State and local taxes. With the post-tax reform corporate income tax rate of 21% and the introduction of the qualified business income and foreign derived intangible income deductions, the decision to choose a pass-thru entity is no longer apparent. In their article, Fanny Karaman and Nina Krauthamer look into some important tax considerations when choosing the entity for a start-up business in the U.S.

- **Debt Characterization and Deductibility Under Domesticated International Rules.** The limitation of interest deductibility to 30% of adjusted E.B.I.T.D.A. has focused the attention of U.S. corporations and their lenders on new constraints. How does a borrower demonstrate the capacity to carry and service debt, and how do related parties demonstrate that the rate of interest and other terms attaching to a cross-border loan are arm's length? Michael Peggs and Stanley C. Ruchelman address these issues, explaining the three methods used to identify the boundary between debt and equity: (i) the qualitative approach of case law (I know it when I see it, although I can't agree to a uniform standard of application), (ii) the data-driven approach of comparative analysis (I know it when I can measure the effect, much like gravity), and (iii) the procedural approach for borrowers as set out in the Code §385 regulations which were in effect for a short period of time (I know it when I follow the recipe in the regulatory cookbook).

- **Qualified Opportunity Zones: Second Set of Proposed Regulations Offers Greater Clarity to Investors.** The Opportunity Zone tax benefit, which was crafted as part of the 2017 tax reform, aims to encourage taxpayers to sell appreciated capital properties and rollover the gains into low-income areas in the U.S. One major benefit – reducing recognition of deferred gains by up to 15% – is available only to investments made before the end of 2019, although other benefits will continue to be available to later investments. The clock is ticking on the 15% reduction, and the I.R.S. is accelerating the issuance of guidance. In late April, the I.R.S. released a second set of proposed regulations that address many of the issues that were deferred in the initial set. They also address issues raised by written comments and testimony at the well-attended public hearing in February. In their article, Galia Antebi and Nina Krauthamer lead the reader through the important and the practical parts of the second set of guidance.

- **Is the 100% Dividend Received Deduction Under Code §245A About as Useful as a Chocolate Teapot?** Remember when Code §1248 was intended to right an economic wrong by converting low-taxed capital gain to highly-taxed dividend income? (If you do, you probably remember the maximum tax on earned income (50% rather than 70%) and income averaging over three years designed to eliminate the effect of spiked income in a particular year.) Tax law has changed, and dividend income no longer is taxed at high rates. Indeed, for C-corporations receiving foreign-source dividends from certain 10%-owned corporations, there is no tax whatsoever. This is a much better tax result than that extended to capital gains, which are taxed at 21% for corporations. Neha Rastogi and Stanley C. Ruchelman evaluate whether the conversion of capital gains into dividend income produces a meaningful benefit in many instances, given the likelihood of prior taxation under Subpart F or G.I.L.T.I. rules for the U.S. parent of a multinational group. Hence the question, is the conversion of taxable capital gains into dividend income under Code §1248 a real benefit, or is it simply a glistening teapot made of chocolate, waiting to melt once boiling water is poured over the tea leaves?

- **Grecian Magnesite Put to Bed: Tax Court Ruling Affirmed on Appeal.** The battle is over. It is agreed that the emporer's new clothes are made of fairy dust, and Rev. Rul. 91-32 is not worth the paper on which it was printed in the I.R.S. Cumulative Bulletin for 1991. In June, the Court of Appeals for the D.C. Circuit affirmed the 2017 Tax Court ruling in the matter of *Grecian Magnesite Mining v. Commr.*, which held that a foreign corporation was not liable for U.S. tax on the gain arising from a redemption of its membership interest in a U.S. L.L.C. treated as a partnership. In their article, Galia Antebi and Stanley C. Ruchelman address the history of the I.R.S. position and the disdain given to it by the courts. However, they caution that the taxpayer victory applies only to sales, exchanges, and dispositions effected through November 26, 2017. Thereafter, new Code §864(c)(8) modifies the law by adopting a look-thru rule when determining the character of gain from the sale of a membership interest. Win some, lose some.

- **Updates & Other Tidbits.** This month, Fanny Karaman, Galia Antebi, and Stanley C. Ruchelman look at interesting items of tax news, including (i) the I.R.S. announcement that French *contribution sociale généralisée* ("C.S.G.") and *contribution au remboursement de la dette sociale* ("C.R.D.S.") are now considered creditable foreign income taxes as they are no longer considered to fall under the provisions of the France-U.S. Totalization Agreement, (ii) the Senate Foreign Relations Committee has recommended approval of protocols to income tax treaties with Japan, Luxembourg, Spain, and Switzerland, paving the way for Senate approval, and (iii) proposed regulations under Code §951A now allow taxpayers to claim the benefit of the high-tax kickout to limit the inclusion of G.I.L.T.I. income, thereby allowing individuals to avoid current taxation of net tested income when the controlled foreign corporation incurs foreign income taxes imposed at a rate that exceeds 18.9%.

Enjoy the read.

- The Editors

C.J.E.U. JUDGMENTS ON DANISH BENEFICIAL OWNERSHIP CASES

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INTRODUCTION

On February 26, 2019, the Court of Justice of the European Union ("C.J.E.U.") released two judgments[1] in a total of six cases dealing respectively with the interpretation of the E.U. Parent-Subsidiary Directive[2] ("P.S.D.") and the E.U. Interest & Royalties Directive[3] ("I.R.D.") (jointly referred to as the "E.U. Directives"). Under the E.U. Directives, dividends or interest paid by a company resident in a Member State to its parent company in a different Member State are exempt from withholding tax ("W.H.T."), provided certain conditions are met. The aim of the E.U. Directives is to favor the grouping of companies within the E.U. Single Market and to eliminate double taxation.[4] The E.U. Directives are often more favorable than the tax treatment reserved for dividends and interest in double tax treaties, which mostly provide a reduced W.H.T. Multinational groups operating within the E.U. structure their groups in such a way as to benefit from that W.H.T. exemption. The cases concluded that the E.U. Directives apply only in circumstances where the structure is not viewed to be abusive.

BACKGROUND

Briefly summarized, in all the cases addressed by the C.J.E.U., Danish-resident companies paid dividends or interest to their European parent companies, which were established in countries such as Cyprus, Luxembourg, or Sweden. The European parent companies were directly or indirectly owned by companies or by private equity funds resident in third countries with which Denmark had not concluded any double tax treaty. Based on the E.U. Directives, the Danish companies considered that collection of W.H.T. on the dividends or interest paid to their European parent companies was not required, as the conditions for the W.H.T. exemption were met.

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1. C.J.E.U., February 26, 2019, Case C-116/16 (T Denmark) and Case C-117/16 (Y Denmark); C.J.E.U., February 26, 2019, Case C- 115/16 (N Luxembourg 1), Case C-118/16 (X Denmark), Case C-119/16 (C Denmark I) and Case C-299/16 (Z Denmark).
2. Council Directive 2011/96/EU of November 30, 2011, on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.
3. Council Directive 2003/49/EC of June 3, 2003, on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.
4. Contrary to the P.S.D., which eliminates both economic and juridical double taxation (*i.e.*, W.H.T. exemption and exemption from corporate income tax at the level of the parent company), the I.R.D. is designed to eliminate juridical double taxation only (*i.e.*, W.H.T. exemption).

However, some other relevant facts are of importance for the understanding of these two judgments. In all these cases, the interposition of European parent companies between the ultimate parents and the Danish companies lowered the tax burden on dividends and interest paid up the chain. The following circumstances could be observed in some or all of the cases:

- The activity of the European parent companies was limited to the management of their holdings and the granting of loans to their subsidiaries.
- They did not have their own office and had no (or very limited) staff.
- They realized very low margins and only a small portion of the dividends or interest received were kept in order to cover certain costs.
- The groups had undergone a restructuring in response to changes in domestic tax law. In the case involving a Cypriot company, the latter was set up and acquired the Danish subsidiary just a few days before a dividend payment.

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The Danish tax authorities were of the opinion that the Danish companies should have levied W.H.T. on the dividends and interest paid. The cases were brought in the Danish referring court, and in this context, the C.J.E.U. had to address the questions analyzed below.

GENERAL E.U. ANTI-ABUSE PRINCIPLE

Article 1(2) of the P.S.D. and Article 5(1) of the I.R.D. provide that "this directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse" (the "anti-abuse reservation"). These provisions give Member States the right to enact provisions in their domestic laws to restrict the application of the E.U. Directives in cases of abusive or fraudulent situations. Denmark did not exercise its right to enact an anti-abuse provision. At issue was whether it was necessary to have a specific domestic anti-abuse provision or an agreement-based provision to restrict the application of the E.U. Directives or whether a Member State could directly rely on Article 1(2) of the P.S.D. or Article 5(1) of the I.R.D. to deny the W.H.T. exemption.

On May 1, 2015, Denmark adopted a general anti-abuse rule ("G.A.A.R.") in its domestic law in anticipation of the E.U. Anti-Tax Avoidance Directive[5] ("A.T.A.D. I"), but Denmark did not have any similar statutory provision at the time when the dividend or interest payments in these cases were challenged by the Danish tax authorities. Until the adoption of the G.A.A.R. in 2015, there has been a long debate in Danish tax literature whether the "Reality Doctrine" (*Realitetsgrundsætningen*) could be seen as a non-statutory G.A.A.R. to combat fraud and abuse.

In her opinion given to the C.J.E.U., Advocate General Kokott claimed that a Member State cannot invoke directly Article 1(2) of the P.S.D. or Article 5(1) of the I.R.D. without having transposed these provisions into domestic law and that it was for

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5 Council Directive (EU) 2016/1164 of July 12, 2016, laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

the referring Danish court to determine whether a general provision or principles of national law (including case law-based principles such as the Reality Doctrine) exist and enable the denial of the W.H.T. exemption. Further, Advocate General Kokott took the view that none of (i) Article 2(1)(c) of the Danish Corporate Tax Act (transposing the P.S.D.), (ii) Article 2(1)(d) of the same act (transposing the I.R.D.), and (iii) the beneficial ownership requirement under the double tax treaties can be deemed a transposition of Article 1(2) of the P.S.D. or Article 5(1) of the I.R.D., respectively.

"Member States are obliged to deny the W.H.T. exemption on the basis of the general E.U. law principle."

Nevertheless, the C.J.E.U. did not follow the Advocate General's opinion and stated that "it is settled case law that there is, in EU law, a general principle that EU law cannot be relied on for abusive or fraudulent ends." Hence, it is not necessary for a Member State to have any specific domestic provision or agreement-based provision in order to deny the W.H.T. exemption in cases of abuse or fraud. Based on that principle, the C.J.E.U. reached a contrary conclusion and stated that Member States are obliged to deny the W.H.T. exemption on the basis of the general E.U. law principle in such cases.

This appears to be a revision of the C.J.E.U.'s former position. In fact, in the *Kofoed* case,[6] the C.J.E.U. had held that a Member State may not invoke a directive-based provision (*i.e.*, the anti-abuse reservation) that has not yet been transposed into domestic law against an individual or a company. Nevertheless, the C.J.E.U. held in the present judgments, by specifically referencing the *Kofoed* case, that this should not mean that a Member State cannot rely on the general E.U. principles in order to deny the W.H.T. exemption.

From a practical perspective, the C.J.E.U.'s position on the above question will have little (if any) relevance in the future, taking into account the inclusion of a mandatory G.A.A.R. in the P.S.D. as well as the G.A.A.R. provided under A.T.A.D. I.

INTERPRETATION OF THE BENEFICIAL OWNERSHIP REQUIREMENT UNDER THE I.R.D.

The term "beneficial owner" is a concept originating from common law and was introduced into the dividends, interest, and royalties articles of the O.E.C.D. Model Tax Convention (the "Model Convention") in 1977.[7] It has been seen by many countries as the first response to treaty abuse or, more precisely, to treaty shopping. The concept continues to be heavily debated in international tax literature. Although it was held in the *Indofood* case[8] that beneficial owner should have an autonomous and international meaning, we can observe that countries go in one of two directions, giving the term either a formal interpretation or a substance-oriented interpretation.

Countries using a narrow and formal interpretation establish a very low threshold for beneficial ownership, thereby denying the treaty benefits to agents, nominees, and conduit companies that, due to a legal or contractual obligation, have no discretion

6 C.J.E.U., July 5, 2007, Case C-321/05.

7 Model Double Taxation Convention on Income and Capital, O.E.C.D., Paris, 1977.

8 *Indofood International Finance Ltd. v. JP Morgan Chase Bank*, London Branch, [2006] EWCA Civ 158.

over the use of the income received. In other countries, the beneficial ownership requirement is based on a "substance-over-form" analysis, with a particular focus on economic control over the income received. In the latter approach, the income recipient has no control over the income received if there is a legal or contractual obligation to transfer the income to another person. Contrary to the formal interpretation, under the substance-over-form interpretation, it is possible that the obligation to pass on the income to another person might also be a mere factual obligation. Hence, the concept of beneficial ownership has different meanings across jurisdictions despite the O.E.C.D.'s attempt to draw the contours of this notion.

The income recipient must be the beneficial owner in order to benefit from the W.H.T. exemption under the I.R.D. The C.J.E.U. has provided guidance on the meaning of the term and on the relevance of the Model Convention and its commentaries for the interpretation of that term.

The C.J.E.U. has made it clear that when interpreting the concept of beneficial ownership no reference should be made to the meaning given in domestic law, as domestic law concepts might vary from one Member State to the other. Further, it appears from the translations of the I.R.D. in the different languages of the Member States that various expressions are used to designate the beneficial owner. Consequently, the term beneficial owner should receive an autonomous E.U. meaning, which might be different from the meaning given to that concept under a double tax treaty or domestic law.

According to the C.J.E.U., beneficial ownership should not be understood with reference to a formally identified recipient[9] but rather with reference to the person that benefits from the income received. The focus should be on the economic reality of the ownership, which is supported by Article 1(4) of the I.R.D. Consequently, an income recipient would only be considered the beneficial owner of the income if it receives the income for its own benefit and not as an intermediary, such as an agent, trustee, or authorized signatory, for some other person. It is, in this respect, crucial for the income recipient to have the power to freely determine the use to which the income is put. In order to benefit from the W.H.T. exemption provided under the I.R.D., the beneficial owner must be resident in the E.U., even if the direct income recipient – although an E.U. resident – is not the beneficial owner (the "look-through approach").

Having said that, it is worth mentioning that Advocate General Kokott suggested that the concept of beneficial ownership should be interpreted under E.U. law autonomously without regard to the commentaries on the Model Convention, as non-E.U. countries would otherwise have a say in the interpretation of the I.R.D. Nevertheless, the C.J.E.U. found that the Model Convention and its commentaries, as well as their successive amendments, are relevant when interpreting the concept of beneficial ownership in the context of the I.R.D. The C.J.E.U. has thus taken a dynamic approach to the meaning of the term beneficial owner, and any future amendments to the commentaries might reshape the meaning of that term.

The relevance of the Model Convention and its commentaries is justified by the fact that the 1998 I.R.D. proposal was inspired by Article 11 of the 1996 Model

9 It is therefore not sufficient to be the legal owner – as foreseen under the domestic (civil) law of the country in question – of the assets from which the income is derived.

Convention, which has the same objective (*i.e.*, the avoidance of double taxation). Thus, when the C.J.E.U. makes reference to conduit companies that cannot be considered beneficial owners, it actually refers to companies that have only very narrow powers from a practical perspective, rendering them mere fiduciaries or administrators acting on account of the interested parties. Although these companies are the formal owners of the income, they are not the beneficial owners within the meaning of the commentaries on the Model Convention.

ABUSE UNDER THE E.U. DIRECTIVES

In these judgments, the C.J.E.U. clarified the constituent elements of an abuse of rights in the context of the P.S.D. or the I.R.D. In order to establish the existence of abuse, there must be:

> First, a combination of objective circumstances in which, despite formal observance of the conditions laid down by EU rules, the purpose of those rules has not been achieved and, second, a subjective element consisting in the intention to obtain an advantage from the EU rules by artificially creating the conditions laid down for obtaining it.

In this context, the C.J.E.U. specified that it is necessary to examine facts on case-by-case basis in order to determine whether a specific situation is abusive. In this context, a particular focus should be put on whether the economic operators have created purely formal and artificial arrangements that are devoid of any economic and commercial justifications and aim essentially to benefit from an improper advantage. The C.J.E.U. laid down a certain number of indicators of abuse, but the C.J.E.U. specified that, even if these indicators are present, the taxpayer should have the opportunity to adduce evidence to the contrary.

In this context, the interposition of an entity between the entity paying the income and the beneficial owner, for instance, would be abusive if the interposed entity has not been set up for reasons that reflect economic reality, its structure is purely one of form, and its principal objective, or one of its principal objectives, is to obtain the W.H.T. exemption under the P.S.D. or the I.R.D. The C.J.E.U. clearly targets conduit companies that are not considered to be the beneficial owners of the income received.

Although the beneficial ownership requirement is expressly provided under the I.R.D., the condition is not contained in the P.S.D. Instead, the C.J.E.U. seems to hold that there is an implicit beneficial ownership requirement in the P.S.D. Moreover, it is somewhat misleading that the C.J.E.U. makes reference to the concept of "beneficial ownership" when analyzing "abuse" under the E.U. Directives, as these are two different concepts that should not be confused.

In addition, the C.J.E.U. notes that an indication of an artificial arrangement exists if an entity must quickly after receiving income pass that income on to another entity that does not fulfill the conditions for the W.H.T. exemption. Consequently, the tax authorities should examine whether an entity's sole activity is the receipt and transfer of income to the beneficial owner, thereby realizing only an insignificant margin on that activity.

An arrangement is also likely to be abusive in cases where an entity conducts no actual economic activity. In order to assess the existence or absence of actual economic activity, an analysis must be performed of all the relevant factors, such as the management of the company, its balance sheet, the structure of its costs and expenditures actually incurred, the staff employed, and the premises and equipment of that entity. However, these factors are not similar if we compare, for instance, a pure holding activity with the activity of an operational entity. Consequently, that analysis has to be done in light of the features of the specific economic activity in question.

The artificiality of an arrangement may also be observed by analyzing the contracts existing between the companies involved in financial transactions in order to determine the way these transactions are financed, the valuation of the intermediary company's equity, and the latter's ability to have economic use of the income received. In this context, the C.J.E.U. held that the intermediary company might be legally or contractually obliged to pass the income received to another person, which would be an indication of an artificial arrangement. However, a legal requirement is not required in all instances as, in substance, the intermediary company may, in substance and from a factual perspective, be obliged to pass the income to another person even if no legal or contractual obligation exists to pass the income to another person.

The interpretation given by the C.J.E.U. to the term beneficial owner is in line with the commentaries of the 2017 Model Convention, which provide that the obligation to pass on the income might also be inferred from facts. However, given that the C.J.E.U. sticks to the commentaries of the Model Convention, an intermediary company involved into back-to-back financing should not be denied the status of a beneficial owner merely because it will pass the majority of the interest received to its parent company. In fact, the 2017 commentaries to the Model Convention clearly state:

> This type of obligation would not include contractual or legal obligations that are not dependent on the receipt of the payment by the direct recipient . . . and which the direct recipient has as debtor.[10]

"An intermediary company involved into back-to-back financing should not be denied the status of a beneficial owner merely because it will pass the majority of the interest received to its parent company."

In some of the cases at hand, like the one involving the Cypriot company, the group had undergone, closely before or simultaneously to changes in the domestic tax law of the countries involved, a restructuring in order to mitigate the tax burden that the group would have faced would they not have undergone that restructuring (*i.e.*, abusive restructuring). This can be a further indication of an artificial arrangement.

In a controversial manner, the C.J.E.U. states that it "is also unsure" whether there can be an abuse of rights in case where the beneficial owner of the income is a company resident in a third state with which the source country has concluded a double tax treaty providing comparable benefits to dividends, interest, or royalties. In that set of circumstances, the income paid would have been exempt had the income been directly paid to that company without interposing another entity in-between. The C.J.E.U. continues and specifies that the existence of "such a convention" providing a W.H.T. exemption in case where the income is paid directly to the beneficial owner resident in a third state would not exclude *per se* the existence of abuse. Nevertheless, the C.J.E.U. concludes that the existence of such a convention may be an indication that the group structure is unconnected with any abuse of rights and that the group cannot be reproached to have chosen such a structure rather than

[10] Paragraph 10.2 of the commentaries on Article 11 of the 2017 Model Convention.

direct payment of the income.

With regard to dividends, the C.J.E.U. seems to consider that there is an implied beneficial ownership requirement within the P.S.D. It does not matter that the direct recipient is or is not the beneficial owner, as the dividends would be exempt in both instances. Consequently, as long as (i) the conditions of the P.S.D. are met and (ii) the beneficial owner is resident somewhere in the E.U. ("look-through approach").

In comparison, the W.H.T. exemption should not be granted where the beneficial owner of the income is resident outside the E.U. Although the P.S.D. does not expressly provide for a beneficial owner requirement, the C.J.E.U. considers that the P.S.D. was not designed to apply where the beneficial owner is resident outside the E.U. The C.J.E.U. justifies its position on the ground that the aim of the P.S.D. is the avoidance of economic and juridical double taxation within the E.U. However, if the dividends are exempt from W.H.T. in the source country, and assuming that the distributed income was exempt as earned by the distributing company, the distributed income would not have been taxed at all in the E.U, which is not the aim of the P.S.D.

Another interesting point addressed by the C.J.E.U. concerns the burden of proof. In this regard, the C.J.E.U. states that the taxpayer must provide evidence that the conditions of the E.U. Directives are met, upon request by the tax authorities. However, where the tax authorities consider the arrangement to be abusive, they need only to put forward elements indicating that the arrangement is abusive, for example that recipient is not the beneficial owner. The tax authorities have no obligation to identify the entity considered to be the actual beneficial owner. The C.J.E.U. considers that identifying the beneficial owner might be impossible in certain circumstances. Taking into account the look-through approach previously described, the taxpayer would need to establish that the beneficial owner is resident within the E.U. This entails a full showing of the identity of the beneficial owner and that the latter is resident within the E.U.

S.I.C.A.R. OUTSIDE OF THE SCOPE OF THE I.R.D.

The next question addressed by the C.J.E.U. was whether a S.I.C.A.R. (*société d'investissement en capital à risque*) set up in a corporate form and governed by Luxembourg law would qualify as a "company of a Member State" within the meaning of the I.R.D. A S.I.C.A.R. is a regulated vehicle governed by the Luxembourg law of June 15, 2004, relating to the investment company in risk capital. A S.I.C.A.R. can either be set up in a corporate form or in the form of a partnership. In case where the S.I.C.A.R. is established in a corporate form, the S.I.C.A.R. is subject to corporate income tax and municipal business tax in Luxembourg. Income derived by the S.I.C.A.R. from securities is exempt. The S.I.C.A.R. benefits thus from a partial objective exemption and not from a general subjective exemption.

Three requirements must be met in order to be qualified as a "company of a Member State" for purposes of the I.R.D. The first is whether the S.I.C.A.R. takes one of the corporate forms listed in the Annex of the I.R.D. The second is whether the S.I.C.A.R. is resident in Luxembourg. The third is that the company receiving the income must be subject to one of the taxes listed in Article 3 of the I.R.D. without having the option of being exempt. The C.J.E.U. focused on the third requirement.

While recognizing that a S.I.C.A.R. is subject to corporate income tax in Luxembourg, the C.J.E.U. held that the S.I.C.A.R. would not qualify as a company of a Member State if the interest received is actually exempt from corporate income tax. According to the C.J.E.U., the recital of the I.R.D. provides that the interest income must be subject to tax at least once in a Member State, which would be impossible because the interest income is exempt at the level of the S.I.C.A.R. Hence, the S.I.C.A.R. should not be viewed as a company of a Member State.

In the authors' view, the C.J.E.U.'s reasoning is incorrect and diverges from the Advocate General Kokott's opinion on that point. Advocate General Kokott concluded that the I.R.D. does not presently contain a "subject-to-tax" requirement. Indeed, the European Commission unsuccessfully attempted to amend the I.R.D. on that aspect.

The question then becomes whether the S.I.C.A.R. would also not be considered a company of a Member State for the purpose of the W.H.T. exemption for dividends provided under the P.S.D. Given that under both E.U. Directives, the income recipient must qualify as a company of a Member State, it could be argued that the same reasoning should be transposed. However, the objectives of the P.S.D. and the I.R.D. are not identical. The aim of the I.R.D. is to exempt interest payments from W.H.T. in the source country (*i.e.*, the elimination of juridical double taxation) provided that the beneficial owner is subject to income tax in the E.U. The aim of the P.S.D. is to eliminate economic (*i.e.*, the dividends are exempt from corporate income tax in the country of the recipient) and juridical double taxation (*i.e.*, the dividends are exempt from W.H.T. in the source country) at the level of the recipient of the dividend. Given that dividends received by a S.I.C.A.R are exempt from corporate income tax in Luxembourg (*i.e.*, economic double taxation is nonexistent), it remains only to eliminate the W.H.T (*i.e.*, the elimination of juridical double taxation) in the source country in order to achieve the objective of the P.S.D. For this reason a S.I.C.A.R. which is exempt in its residence country from corporate income tax on the dividends received should qualify as a company of a Member State for the purpose of the P.S.D.

FINAL REMARKS

Although the judgments have the merit to align the meaning of beneficial owner with the meaning given to that concept in the Model Convention, it is regrettable that the C.J.E.U. is mixing the concepts of abuse and beneficial ownership – which address different matters – in its reasoning. Even if an arrangement is not artificial and abusive, the income recipient may not be considered the beneficial owner of the income. Multinational groups operating within the E.U. should thus monitor the substance at the level of the income recipient and should make sure that the latter is not factually, legally or contractually bound to pass on the income to another person. In other words, the income recipient should be able to demonstrate that it has capacity and actually retains cash (*e.g.*, in order to embrace new business opportunities).

The beneficial owner concept no longer seems to be only relevant for the application of the I.R.D. Also in the context of the P.S.D., the income recipient, or any other group entity resident in the E.U. (*i.e.*, look-through approach), should be the beneficial owner of the dividends received in order to benefit from the W.H.T. exemption.

Further, the C.J.E.U. has broadened the definition of abuse under the P.S.D. and the I.R.D. In prior cases, the C.J.E.U. always made reference to "wholly artificial arrangements" in order to define abusive situations. In the cases at hand, the threshold for abuse has been lowered, and it seems to be sufficient for an arrangement to be considered as being abusive if the principal objective or one of the principal objectives is to obtain a tax benefit under the E.U. Directives. This reasoning is similar to that of the principal purpose test ("P.P.T.") which has been recently introduced in the Model Convention. Application of the O.E.C.D. Multilateral Instrument (introducing the P.P.T. in many treaty situations among E.U. Member Countries) already has begun and tax authorities of the different Members State may rely on C.J.E.U. judgments when applying the beneficial ownership concept or the P.P.T.

EMPLOYERS IN THE NETHERLANDS: PREPARE FOR CHANGES TO LABOR AND DISMISSAL LAWS IN 2020

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Tags
Contract Law
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INTRODUCTION

On May 28, 2019, the Dutch Senate adopted the Labor Market in Balance Act (*Wet Arbeidsmarkt in Balans*, the "Act"), which will go into effect on January 1, 2020. The Act is designed to benefit both sides of the labor market, offering opportunities for employers and employees.

The year 2015 saw the first significant changes to Dutch dismissal laws since 1945, which changed the labor law landscape profoundly. These changes were intended to make dismissal laws "simpler, less costly for employers and to [sic] create more legal fairness for employees." Soon after implementation, however, it appeared that the changes achieved the opposite effect. Dismissal laws became more complicated, more time consuming, and more expensive for employers, leading to pressure on the legislator to come up with proposals to mitigate the undesirable consequences. Once the Act becomes effective, employment laws in the Netherlands will undergo additional changes.

The Act introduces new grounds for termination and changes to the statutory transition fee and extends the limitation on fixed-term contracts to 36 months, thereby reinstating the pre-2015 threshold. Other legal protections are adopted, as well.

With these changes, the Dutch government intends to encourage the signing of indefinite term employment agreements, instead of the fixed-term contracts that have become more popular with employers.

WHAT TO EXPECT AND HOW TO PREPARE FOR 2020

The anticipated changes will affect the hiring process, the cost-effective allocation of "flex workers," the substance of boilerplate contract language, the process of extending fixed-term contracts, the prerequisites for termination, and the consequences of forced terminations.

Prudence suggests that all companies doing business in the Netherlands should review the Act carefully and take measures to ensure proper implementation and compliance, specifically if any of the following circumstances apply:

- It employs staff or hires flex workers through payroll agencies, fixed-term employment contracts, or on-call contracts
- It used standard or template severance calculation tools
- It maintains a company social plan that provides for severance packages

- It plans to renegotiate the social plan and collective labor agreements ("C.L.A.'s") with works councils or trade unions
- It addresses rights and payments in dismissal matters on a case-by-case basis
- It dismissed employees after 104 weeks of continuous illness at any time since the Dutch Work and Security Act became effective in 2015 or intends to do so in the future

New Grounds for Termination – I Ground or Accumulation Ground

Dutch dismissal law is renowned for a high degree of employee protection. Employment contracts can be validly terminated only in certain circumstances:

- Mutual consent – deemed voluntary
- Resignation – deemed voluntary
- Notice of termination with the employee's consent – deemed voluntary
- Notice of termination – involuntary dismissal. Employers must obtain prior approval from the UWV (the employee insurance administration agency) before giving notice that will lead to valid dismissal
- Court rescission – involuntary dismissal

The Dutch Civil Code lists eight statutory reasonable grounds for involuntary dismissal (the "A-H Grounds"):

a. Redundancy due to shut down of the company or restructuring/re-organization;

b. Long term illness (104 weeks);

c. Regular inability to perform the agreed work due to illness;

d. Employees incapability/lack of competence to perform the agreed work for another reason than illness;

e. Culpable behavior of the employee;

f. Employee refusing to perform the agreed work due to serious conscientious objections;

g. Work related conflict between the employer and employee;

h. Other circumstances that are out of scope of the above grounds but are of such nature that the employer cannot reasonably be expected to prolong the employment contract.

Under the current legislation, involuntary dismissal due to employee conduct can occur only if at least one of the last six conditions is met ("C-H Grounds"). In the event that the employer unilaterally terminates the employment agreement under one of the eight grounds, the employee is entitled to a statutory transition fee (*transitievergoeding*).

From available case law, it appears that these grounds are not easy to prove, and the requirement is burdensome for employers who must endure a lack of flexibility, high costs of building a case file, and time-consuming litigation which is often costly. The legislator has introduced a ninth ground that allows employers to combine facts and circumstances that would otherwise not meet the requirements of one of the C-H Grounds but present a compelling case for dismissal. This additional basis for dismissal is referred to as the "I Ground" or the "Accumulation Ground."

"The year 2015 saw the first significant changes to Dutch dismissal laws since 1945, which changed the labor law landscape profoundly."

This improvement however comes at a price. If the court terminates the employment contract based on the I Ground, the court is allowed to grant the employee additional compensation up to half the amount of the transition fee.

In addition, the court can award increased "reasonable compensation" if it determines that the employer was seriously culpable in the dismissal. This compensation is by nature subjective. The court assesses the overall facts and circumstances and sets an amount that it deems "reasonable" based on its exercise of judgment. The subjectivity of court proceedings often results in a high level of out-of-court settlements, generally including more generous severance packages. If a settlement cannot be reached, the employer has no other choice than to seek termination through court proceedings. A court ruling in first instance is open to appeal and cassation.[1]

The overhaul of dismissal laws in 2015 continues to leave its mark on labor relations, and it will take many more years before the outcome of employment cases can be predicted with relative accuracy. Until then, employers must continue to carry on procedures to build accurate cases to be heard in court. This entails empowering Human Capital departments and legal teams to craft workforce management procedures that meet legal requirements and commercial objectives. As now seen in much of Europe, proactive education programs are required to ensure that managers understand the "do's and don'ts" necessary to prevent allegations of seriously culpable behavior by the company. The goal is to create bottom-up and top-down awareness of the legal and financial consequences of excellent or poor people management. The driver for this type of program is not necessarily the creation of a better product or higher profits, but the optimization of the company's legal position when justifying forced dismissals and countering claims of seriously culpable behavior by the company.

Transition Fee – Statutory Severance: The Changes

Transition Fee from First Day of Employment

As of January 1, 2020, employees will be entitled to receive statutory severance payments (the *transitievergoeding* or transition fee) from their first day of employment, including any trial period. Currently, employees are entitled to the transition fee only after two years of employment.

No Transition Fee

The transition fee is not due in the case of company downsizing or shutdown (A Ground) when the company is subject to a C.L.A. that was concluded with a trade

[1] "Cassation" refers is a second level of appeal to the Supreme Court. The Court has discretion when deciding to accept the appeal.

union includes measures aimed at limiting unemployment, offers reasonable financial compensation, or a combination thereof.

Transition Fee Calculation

The formula for calculating the transition fee will change to one-third of the monthly gross salary for each full year of service plus a *pro rata* share for each month or day of service regardless of the employee's age or duration of service. The current distinction between the first ten years of employment, which is based on one-third of the monthly salary, and subsequent years, which is based on half of the monthly salary, will be eliminated.

Over 50: No Preferential Treatment

As of January 1, 2020, the measure entitling employees age 50 or older to greater compensation will no longer apply.

Reimbursement for Employers

In 2020, compensation will be available to employers for transition fees paid upon dismissal due to long-term illness or disability.

"With these changes, the Dutch government intends to encourage the signing of long-term or permanent employment agreements instead of the shorter fixed-term contracts that have become popular with employers."

In the Netherlands, employers must continue salary payments to employees on sick leave for a maximum of 104 weeks. If the employer has met all obligations during this period, the employment agreement can be terminated, with approval from the UWV ("B Ground"). Upon dismissal, the employee is entitled to receive a transition fee, which must be issued within a month of termination. The requirement to pay the transition fee has been viewed as onerous on employers and has led to prolonged employment in order to avoid paying the fee.

As of April 1, 2020, employers can apply for reimbursement from the UWV for transition fees paid for B Ground terminations since July 1, 2015. In order to benefit from this provision, companies must keep accurate records of any such transition fees. Requests for reimbursement on a retroactive basis (*i.e.*, terminations that took place from July 1, 2015 to March 31, 2020) can be submitted beginning April 1, 2020, until six months after that date (*i.e.*, September 30, 2020). The reimbursement is also available if an employment contract is terminated due to a company shutdown resulting from the retirement, illness or disability, or death of the employer. Reimbursement requests for transition fee payments made from April 1, 2020, onwards must be submitted within six months of the payment date. Reimbursement requests that are not timely will be rejected.

Successive Fixed-Term Employment Contracts: Back to 36 Months

In 2015, the contractual sequence of fixed-term contracts was limited from "3x3x3" to "3x2x6" (outlined below).

Consequently, employers were allowed to enter into a maximum of three consecutive fixed-term contracts, each covering a period of 24 months, with a maximum of six months of unemployment between the contracts. If parties entered into a fourth contract or the period of 24 months was exceeded, an indefinite-term contract would be deemed to exist by operation of law.

As of 2020, employers will be allowed to conclude three fixed-term contracts of 36 months. The maximum period between contracts will remain six months. The

36-month period will also be applicable to current fixed-term employment contracts provided that they remain in effect until or after January 1, 2020. After 36 months or if a fourth fixed-term employment contract is agreed, the employment contract is deemed to be an indefinite-term contract.

Before 2015: 3 x 3 x 3
3 employment contracts
3 years (36 months)
3-month intervals

Current Rule: 3 x 2 x 6
3 employment contracts
2 years (24 months)
6-month intervals

Effective January 1, 2020: 3 x 3 x 6
3 employment contracts
3 years (36 months)
6-month intervals

On-Call Employment Contracts

Timely Notice

The time between when an employer contacts an on-call employee and when the employee must report to work is not regulated under current law. However, as of 2020, employers must provide at least four days advance notice to on-call employees. The on-call employee will be entitled to the agreed wage if the work is cancelled within those four days.

Deviation Under a C.L.A.

For employers who are subject to a C.L.A. with a trade union, the notice period may be reduced to 24 hours under the C.L.A.

Accrued Rights to Hours

An on-call employee who has been engaged or contracted by the company for 12 months is entitled to "guaranteed working hours." These hours must be based on the average number of hours the on-call employee worked in the preceding 12 months. If the employer does not offer sufficient hours to meet the guarantee, the employee is still entitled to the associated wages.

“Dutch dismissal law is renowned for a high degree of employee protection.”

Equality for Payroll Employees

“Payrolling” is a form of employment where companies hire workers from a third-party “payroll company” that has no other activity than employing workers to be posted at their customers’ offices. The payroll company assumes all the employer’s risks and obligations. This form of labor allocation caters to many companies’ desire to eliminate employer liabilities and reduce operational and overhead costs and their need for a flexible workforce.

The differences in compensation and benefits created a business case for some payroll companies to offer their services at commercially attractive fees. However, these practices have not received much support from the trade unions and the legislator. The main concern relates to compensation, as payroll employees generally received lower pay and fewer employment benefits than direct employees of companies.

As of 2020, the benefits of payrolling will be largely eliminated. Payroll employees will be entitled to the same compensation and benefits as employees of the company where posted. They will also be entitled to an “adequate” pension plan. It is likely that these legislative changes will increase the costs of employing payroll employees. The rules will not apply to temporary workers and seconded employees.

Lower Unemployment Insurance Contributions

Unemployment Insurance Contributions

In the legislator’s quest to promote indefinite term employment, social security insurance contributions for unemployment will no longer be differentiated depending on the sector category of the employer.

Beginning in 2020, unemployment insurance contributions for employees with indefinite-term employment agreements will be lower than contributions for employees with fixed-term contracts, with the exception of (i) on-call employment contracts and (ii) employees who are under 21 years of age and work for less than 12 hours per week.

Paystub Requirements

From 2020, paystubs must mention whether the employee works under a fixed-term or indefinite-term employment agreement. If the employer applies the lower unemployment insurance premium, a copy of the indefinite-term employment agreement must be kept on file in the salary administration office of the employer. This allows the tax authorities to verify whether the employer has correctly applied the lower premium.

Increased Premiums

In certain circumstances, the employer must retroactively adjust the lower unemployment insurance premium to the higher rate. This is applicable in the following instances:

- The employment contract is terminated within five months after the commencement date.
- Actual paid work amounts to 30% more than the agreed working hours specified by contract for a calendar year. This rule aims to prevent abuse by

employers who would deliberately require an excessively low number of working hours in order to pay lower unemployment contributions.

These changes will generally be implemented by the payroll company effective 2020. The percentage of unemployment premiums for 2020 will not be determined earlier than at the end of 2019. The government indicated a lower insurance premium of 2.78% and a higher unemployment insurance premium of 7.78%.

Premiums by Sector

Classification System Will Remain in Place

The premiums for the Work Resumption Fund (*Werkhervattingskas*) consist of charges relating to two components: (i) partial disability insurance (*Regeling Werkhervatting Gedeeltelijk Arbeidsgeschikten*) and (ii) sick benefits. For small and medium-sized employers, both components are partly determined based on commercial sector. This classification system remains in place.

Temporary Employment Agencies

Since May 18, 2017, temporary employment agencies (*uitzendbedrijven*) cannot be classified as part of the professional sector. Under a transitional rule, temporary employment agencies that were classified as in the professional sector were allowed to retain that classification. As of 2020, the transitional law will no longer apply, and all temporary employment agencies will be classified as part of the temporary employment sector.

Payroll Companies

Payroll companies will no longer be classified under the temporary employment sector but in business services. A split allocation (*gesplitste aansluiting)* may apply if the payroll company also assigns (*uitzenden*) its employees.

Personnel Companies

An exception continues to apply for limited liability legal entities (*besloten vennootschappen*) that serve as personnel companies. These companies will be classified as part of the sector to which the actual work or duties of the employees is allocated.

Self-Employed Workers: Stay Tuned, More Changes to Come

The government is currently preparing new legislation aimed to offer a legal and tax framework for self-employed workers, the equivalent of freelancers in the U.S. More clarity on these forthcoming measures is expected before 2020.

In addition, the government has installed a committee to advise on the regulation of new forms of labor, such as freelancers and members of the sharing economy, who are connected to work via digital platforms.[2] This advice is expected to be published in November 2019.

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[2] "The Sharing Economy Part 1: New Business Models + Traditional Tax Rules Don't Mix," *Insights* 4, no. 8 (2017).

THE DEVIL IN THE DETAIL: CHOOSING A U.S. BUSINESS STRUCTURE POST-TAX REFORM

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Tags
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INTRODUCTION

Prior to 2017 U.S. tax reform legislation (the "T.C.J.A."), the higher corporate income tax rate made it much easier to decide whether to operate in the U.S. market through a corporate entity (*i.e.*, a C-corporation) or a pass-thru entity (*i.e.*, a partnership or limited liability company ("L.L.C."), or a corporation that has elected S-corporation status). With a Federal corporate income tax rate of up to 35%, a Federal qualified dividend rate of up to 20%, and a Federal net investment income tax on the distribution of 3.8%, the effective post-distribution tax rate was 50.47% pre-T.C.J.A. This did not include potential state and local taxes. In contrast, assuming an active business, a pass-thru entity would have resulted in only one level of Federal tax of up to 39.6% for individual owners.

With the post-tax reform corporate income tax rate of 21% and the introduction of the qualified business income ("Q.B.I.") and foreign derived intangible income ("F.D.I.I.") deductions, this choice is no longer apparent. This is even more true when taking into account the net investment income tax ("N.I.I.T."), self-employment tax, and state and local tax exposures.

This article looks into some important tax considerations for an individual planning to start a U.S. business. While this article does not attempt to look at all relevant provisions in detail, it highlights potential points of friction. It does not focus on non-Federal tax issues or non-tax considerations, such as limits on the number or types of shareholders.

PROS AND CONS

Now, more than ever, and as shown below, pro-forma tax returns and short- and long-term investment goals are key to structuring the most tax-efficient entity.

Taxpayers must weigh the positives associated with C-corporation status:

- A 21% flat Federal rate of tax
- In certain cases, the ability to qualify for the qualified small business stock ("Q.S.B.S.") exemption for capital gains on a sale (or potentially no tax in the case of a foreign investor)
- A special reduced tax rate on export activities

And they must consider the negatives:

- A second level of tax upon distribution

- The N.I.I.T. on dividends
- The possibility of the accumulated earnings tax ("A.E.T.") or personal holding company tax

On the pass-thru entity side, there are also numerous positives:

- One single level of tax
- The possibility of a reduced rate of tax if the entity is eligible for the 20% Q.B.I. deduction
- The ability to pass losses on to equity holders
- The ability to increase tax basis for undistributed earnings
- Avoidance of the A.E.T.

And these must be compared with the disadvantages:

- The possible imposition of self-employment tax on all earnings (except in the case of an S-corporation, where self-employment tax may be limited to wages)
- The possibility of the N.I.I.T. on passive income
- The possibility of facing the highest individual tax rates
- The possible recognition of ordinary income on the sale of a partnership or L.L.C. interest and, in the case of a foreign investor, possible tax on capital gain income on the sale of a partnership or L.L.C. interest

THE N.I.I.T.

U.S. individuals, trusts, and estates are subject to the 3.8% N.I.I.T. on the lesser of (i) their net investment income or (ii) the excess of (a) their modified adjusted gross income over (b) $250,000 (for married taxpayers filing jointly).

U.S. and foreign corporations, foreign trusts, and nonresident alien individuals are not subject to the N.I.I.T.

For this purpose, net investment income is defined as the excess of the following over appropriately allocable deductions:[1]

- Gross income from interest, dividends, annuities, royalties, and rents derived in a trade or business of trading in financial instruments or commodities, or in a trade or business in which the taxpayer does not materially participate
- Gross income from interest, dividends, annuities, royalties, and rents derived in a for-profit activity that is not a trade or business

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[1] Code §1411(c)(1).

- Net gain from the disposition of property held in a trade or business of trading in financial instruments or commodities, or in a trade or business in which the taxpayer does not materially participate
- Net gain from the disposition of property held in a for-profit activity that is not a trade or business

A special rule exists for the disposition of partnership and S-corporation interests. The capital gain generated from such a sale is subject to the N.I.I.T. only to the extent of the net gain that the transferor would take into account as net investment income if all property of the partnership or S-corporation was sold for fair market value immediately before the disposition of the interest. Otherwise, to the extent the partnership or S-corporation's activity is not passive and constitutes a trade or business, the income flowing up to the partner or shareholder is not subject to the N.I.I.T.[2]

Thus, one important aspect in comparing C-corporation investments with pass-thru entity investments is whether the underlying activity constitutes an active or passive trade or business. If the activity constitutes a passive activity, the N.I.I.T. will apply in either case.[3]

SELF-EMPLOYMENT TAX

A U.S. individual is subject to self-employment tax on his or her net income from any trade or business he or she carries out.[4] In addition, an individual is also subject to self-employment tax on his or her share of trade and business income of a partnership in which he or she is a partner.

S-corporations, although transparent for Federal income tax purposes, are not transparent for Federal self-employment tax purposes.[5] Shareholders of S-corporations are generally only subject to self-employment taxes on their wages and not on their part of the S-corporation's income.

"If the activity constitutes a passive activity, the N.I.I.T. will apply in either case."

Q.S.B.S.

Under the Q.S.B.S. regime, a U.S. resident investing in Q.S.B.S. could be partially or totally exempt from U.S. capital gains tax upon a sale, assuming that a statutory five-year holding period has been met.[6] Further, and depending upon the residence of the individual, the capital gain could also benefit from an exemption at the state and local levels. Finally, the excludable gain is not subject to N.I.I.T.

The following cumulative requirements must be met for the issuing entity to be a qualified small business on the date of the issuance (the "Q.S.B. Test"):

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2. Code §1411(c)(4)(A).
3. On dividend distributions received by the individual from the C-corporation and on the individual's share of partnership income.
4. Code §1402(a).
5. Code §1402(a); Rev. Rul. 59-221.
6. Corporate investors are excluded from this provision (Code §1202(a)(1)). Please refer to "Qualified Small Business Stock & the EB-5 Visa Program – An Attractive Combination for Potential Investors" for more details on this regime.

- The issuing entity is a U.S. C-corporation.[7]
- The aggregate gross assets of the corporation (or a predecessor) do not exceed $50,000,000 from August 10, 1993, until immediately after the issuance of the stock for which preferential treatment is sought.[8]
- The issuing corporation submits reports to its shareholders and the I.R.S. as the I.R.S. may require.[9] (Although the Secretary has authority to require certain reporting obligations, no such regulations have been published yet.)
- During substantially all of the taxpayer's holding period for the stock, at least 80% of the corporation's assets have been used in the active conduct of a trade or business that is in a category *other than* any of the following:
    - Professional services (such as health, law, engineering, architecture, and brokerage services)
    - Banking, insurance, financing, leasing, or similar businesses
    - Farming
    - Mining or natural resource production or extraction
    - Operating a hotel, motel, restaurant, or similar business

For the purpose of the gross asset requirement, cash and the adjusted bases of property held by the corporation constitute "aggregate gross assets."[10] As a result, the post-issuance growth of a start-up does not disqualify such corporation from meeting the Q.S.B. Test.

All corporations that are part of the same parent-subsidiary controlled group will be treated as one person.[11] A parent-subsidiary controlled group is constituted by one or more chains of corporations connected through ownership with a common parent.[12] A 50% ownership test (by vote or value) must be met for the corporations to be part of said controlled group.

Foreign corporations that are only subject to U.S. tax pursuant to Code §881 are excluded from the definition of a member of a controlled group. Thus, absent effectively connected income ("E.C.I."), a foreign corporation is excluded from the definition of a controlled group.

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7 Code §1202(d)(1).

8 Code §§1202(d)(1)(A), (B).

9 Code §1202(d)(1)(C).

10 Code §1202(d)(2). For assets contributed to the corporation, the basis is the fair market value of the contributed assets immediately after the contribution.

11 Code §1202(d)(3)(A).

12 Code §1202(d)(3)(B). Direct ownership and constructive ownership rules under Code §§1563(e)(1), (2), and (3) apply.

PERSONAL HOLDING COMPANY REGIME

A personal holding company is any corporation meeting both of the following requirements:[13]

- Items of personal holding company income comprise at least 60% of adjusted ordinary gross income for the taxable year.
- At any time during the last half of the taxable year, more than 50% of the outstanding stock, measured by reference to value, is owned, directly or indirectly, by or for not more than five individuals. In broad terms, family groups are treated as a single shareholder. Consequently, shares of stock owned directly or indirectly by an individual's brothers, sisters, spouse, ancestors, and lineal descendants are attributed to that individual.[14] Also, stock owned directly or indirectly by or for a corporation, partnership, estate, or trust is attributed proportionately to shareholders, partners, or beneficiaries.[15]

Foreign corporations[16] are excluded from personal holding company status.

"The A.E.T. was enacted in order to incentivize corporations to distribute dividends to shareholders."

Personal holding company income includes dividends, interest, and adjusted income from rents.[17]

When a corporation is a personal holding corporation, it is subject to the regular corporate income tax and to an additional 20% tax on the undistributed personal holding company income.[18] Undistributed personal holding company income is the income determined for regular income tax purposes, with certain adjustments.

A.E.T.

The A.E.T. was enacted in order to incentivize corporations to distribute dividends to shareholders. It does this by imposing a tax on unreasonable accumulations of earnings. The tax is imposed when a corporation allows earnings to accumulate instead of being distributed.[19] Only C-corporations are subject to this additional tax. The tax does not apply if the personal holding company tax already applies. The now-reduced corporate tax rates have breathed new life into this provision.

The fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business is determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation, by the

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13 Code §542.

14 Code §544(a)(2).

15 Code §544(a)(1).

16 Code §542(c)(5).

17 Code §543(a)(1). It also includes certain income from mineral, oil, and gas royalties; certain copyright royalties; certain produced film rents; rents from 25% shareholders; and certain personal service contracts (Code §543(a)(2)).

18 Code §541.

19 Code §532(a).

preponderance of the evidence, proves otherwise.[20] The fact that any corporation is a mere holding or investment company is *prima facie* evidence of the purpose to avoid the income tax with respect to shareholders.[21]

For most other corporations, whether a tax avoidance purpose exists depends on the facts and circumstances of each case.[22] Factors indicative of a tax avoidance purpose include the following:

- Dealings between the corporation and its shareholders, such as personal loans to the shareholders or expenditures by the corporation for the personal benefit of its shareholders[23]
- Investment of undistributed earnings in assets having no reasonable connection with the business of the corporation[24]
- The dividend history of the corporation[25]
- Whether shareholder-employees are undercompensated[26]

If the A.E.T. applies, it is imposed in addition to the income tax. The rate is 20% of the accumulated taxable income.[27]

Reasonable needs of the business include the following:

- The reasonably anticipated needs of the business, such as plant expansion, market expansion, expansion, or product line[28]
- Accumulations that will be used to make distributions in redemption of stock to pay death taxes of a shareholder[29]
- Accumulations to retire *bona fide debt*[30]

The A.E.T. can be easily avoided if distributions are made regularly or the corporation's earnings are used for business.

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[20] Code §533; Treas. Reg. §1.533-1(a)(1).

[21] Code §533.

[22] Treas. Reg. §1.533-1(a)(2).

[23] Treas. Reg. §1.533-1(a)(2)(i). *See also, e.g.*, *Herzog Miniature Lamp Works, Inc. v. Comr., 481 F.2d 857 (2d Cir. 1973).*

[24] Treas. Reg. §1.533-1(a)(2)(ii).

[25] Treas. Reg. §1.533-1(a)(2)(iii). See also*, e.g., Doug-Long, Inc. v. Comr., 72 T.C. 158 (1979).*

[26] *Herzog,* 481 F.2d 857.

[27] Code §531.

[28] Treas. Reg. §1.537-1(a). A prudent-businessperson standard is used for this purpose, and the retention must be for *bona fide* business purposes.

[29] Code §§535(c)(3). When the corporation is a mere holding or investment company, the credit is limited to the amount (if any) by which $250,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

[30] Treas. Regs. §1.537-2(b)(3).

SALE OF A PARTNERSHIP INTEREST

As a general rule, the sale of a partnership interest results in capital gains treatment, with the exception of amounts attributable to inventory items and unrealized receivables of the partnership.[31] Since non-U.S. taxpayers are generally exempt from U.S.-source capital gains, a sale by a foreign partner of his or her partnership interest should logically be exempt from U.S. tax.

"An individual investor who may leave the U.S. in the long-term and wishes to ultimately exit the investment may be better advised to invest through a C-corporation."

However, new Code §864(c)(8) provides that gains or losses realized upon the direct or indirect disposition of a U.S. partnership interest by a non-U.S. partner generally constitute E.C.I. to the extent that a fair-market-value sale by the partnership of all its assets would have generated effectively connected gain or loss in the hands of the transferor partner.[32]

Code §1446(f) provides that if any gain on the disposition of a partnership interest is treated as E.C.I. pursuant to Code §864(c)(8), the transferee must withhold 10% of the amount realized on the sale. Here is the problem. The amount realized includes not only payments made by the purchaser but also the amount of the seller's distributive share of partnership debt. That share provided the selling partner with basis in the partnership interest at the time of acquisition or refinance. When that share of debt is eliminated as a result of the sale, the partner is considered to realize additional amounts in the sale.

As a result of the above, an individual investor who may leave the U.S. in the long-term and wishes to ultimately exit the investment may be better advised to invest through a C-corporation.

Q.B.I.

Taxpayers other than corporations may be allowed a deduction of up to 20% of the excess of the taxpayer's taxable income over the taxpayer's net capital gain.[33] This deduction can be less if the taxpayer's combined qualified business income amount ("C.Q.B.I.A.") is less. As a result, and to the extent the taxpayer has C.Q.B.I.A., the allowable deduction is capped at 20% of the excess of the taxpayer's taxable income over the taxpayer's net capital gain.

For this purpose, C.Q.B.I.A. is the sum of the following:

- The taxpayer's deductible amount for each trade or business carried on by the taxpayer
- 20% of the aggregate amount of the qualified real estate investment trust ("R.E.I.T.") dividends and qualified publicly traded partnership income of the taxpayer

The taxpayer's deductible amount for each trade or business is the lesser of the following:

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31 Code §§741; 751(a).

32 For more on this topic, see "Foreign Investor in a U.S. L.L.C. – How to Minimize Withholding Tax on Sale of L.L.C. Interest" and "Proposed Code §864(C)(8) Regulations Codify Tax on Gain from Sale of Partnership Interest."

33 Code §199A.

- 20% of the taxpayer's Q.B.I. with respect to the qualified trade or business
- The greater of (i) 50% of the W-2 wages with respect to the qualified trade or business, or (ii) the sum of 25% of the W-2 wages and 2.5% of the unadjusted basis immediately after acquisition of all qualified property

Q.B.I. is the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. Several items are excluded from the definition of Q.B.I. including, in relevant part the following:[34]

- Reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business
- Any guaranteed payment described in Code §707(c) paid to a partner for services rendered with respect to the trade or business
- To the extent provided in regulations, any payment described in Code §707(a) to a partner for services rendered with respect to the trade or business
- A specified service trade or business ("S.S.T.B.")
- The trade or business of performing services as an employee

An S.S.T.B. is any of the following:

- Any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services
- Any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners
- Any trade or business involving the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in Code §475(c)(2)), partnership interests, or commodities (as defined in Code §475(e)(2))

The benefit of the deduction may still be partially available to certain taxpayers having an S.S.T.B. with taxable income not exceeding $207,500 ($415,000 for joint filers).[35]

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[34] Code §§199A(c)(4), (d). Also excluded from the definition are qualified R.E.I.T. dividends, qualified publicly traded partnership income, short-term capital gains, short-term capital losses, long-term capital gains, long-term capital losses, dividends, certain dividend equivalents, payments in lieu of dividends, interest income not allocable to a trade or business, certain commodities transaction related income, certain foreign currency gains, certain income from notional principal contracts, and certain amounts received from an annuity. See Code §§199A(c)(1), (3)(B).

[35] Code §199A(d)(3).

Further, in the case of a partnership or S-corporation, the above determinations must be made at the partner or shareholder level and each of the above described items must be allocated to the partner or shareholder.[36]

As a result of the above, if the investor wishes to invest in a qualified business that is capital or wage loaded, it may make sense to invest through a U.S. partnership or single member L.L.C. to take advantage of the Q.B.I. deduction.

F.D.I.I.

F.D.I.I. constitutes a taxable U.S. corporation's income from specified export activities.[37] More precisely, the F.D.I.I. regime allows for a reduced corporate tax on hypothetical intangible income used in a U.S. business in exploiting foreign markets. Under the F.D.I.I. rules, the hypothetical intangible income is reduced by a 37.5% deduction, which is intended to result in an effective Federal corporate income tax rate of 13.125% for a U.S. corporation.[38] It is important to note that, due to the way F.D.I.I. is computed, the effective rate on export income is generally higher than 13.125% under this rule.

As a result, if an investor wishes to conduct an active business in the U.S. that will service both the U.S. and foreign markets, *pro-rata* tax returns should be run to compare the benefits of the Q.B.I. regime for pass through entities and the F.D.I.I. regime for C-corporations. Another option may be to start by operating through an L.L.C. and, at a later date, when F.D.I.I. appears more beneficial than Q.B.I., have the L.L.C. elect to be treated as a corporation for U.S. tax purposes. Here again, careful consideration must be given to the additional income tax on dividend distributions, increased by the N.I.I.T. on such distributions.

CONCLUSION

More than before, planning for U.S. businesses owned by individuals requires a careful analysis of the pros and cons of each structure. As is often stated, "The devil is in the detail." Among important factors to be taken into consideration are the nature of the business, the target market, and the long-term goal of the investor. "Detail," such as the N.I.I.T., the personal holding company tax, or the A.E.T., can tip the balance one way or the other for the individual investor.

36 Code §199A(f).

37 For further discussion of the F.D.I.I. regime, see "Proposed F.D.I.I. Regulations: Deductions, Sales, and Services."

38 For tax years beginning after December 31, 2025, the allowable deduction is decreased, and the effective tax rate will be 16.406% (Code §250(a)(3)(A)).

DEBT CHARACTERIZATION AND DEDUCTIBILITY UNDER DOMESTICATED INTERNATIONAL RULES

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Tags
Debt v. Equity
Financial Transactions
Loan
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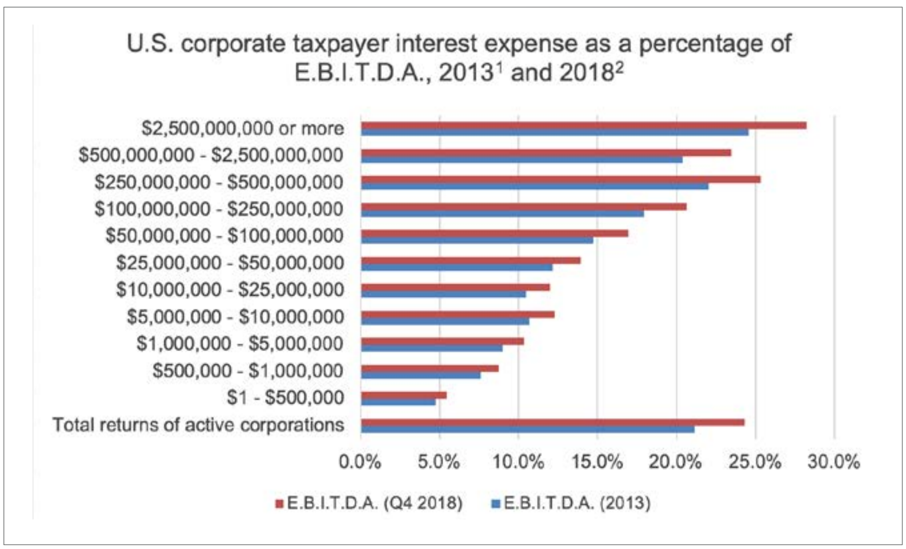
INTRODUCTION

The limitation of interest deductibility to approximately 30% of E.B.I.T.D.A. (earnings before interest, tax, depreciation, and amortization) introduced in amended Code §163(j) has focused the attention of U.S. corporations and their lenders on a new constraint.

For companies with sales less than $25 million that borrow from a foreign parent, the body of case law in the style of *Mixon* and *Laidlaw* has remained the standard against which interest deductibility is evaluated by the I.R.S. Large subsidiaries of foreign parents that do not qualify for the Code §246 gross sales exemption of $25 million are accustomed to (i) proving their capacity to carry and service debt and (ii) demonstrating that the rate of interest and other terms attaching to a cross-border loan are arm's length under Treas. Reg. §1.482-2, the concepts of Code §385 regulations, and applicable case law. These companies are also subject to the 30% E.B.I.T.D.A. limitation.

For related domestic borrowers, including companies with less than $25 million in sales, the Code §163(j) limitation introduces a requirement to think differently about debt, importing rules that were used in international transactions into a wholly domestic context. This comes at a time when debt has become a critical means of funding continuing operations and expansion for many businesses.



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1 I.R.S., *Balance Sheet, Income Statement, and Selected Other Items, by Size of Total Assets Tax Year 2013*, SOI Tax Stats – Table 4.

2 Estimate produced using Q4 2013 and Q4 2018 values from Board of Governors of the Federal Reserve System (U.S.), Nonfinancial Corporate Business;

The boundary between debt and equity has historically been located using one of three approaches: the qualitative approach of case law, the data-driven approach of comparative analysis, and the procedural approach for borrowers as set out in the Code §385 regulations.

CASE LAW

The case law focuses on the difference between the expected tax consequences of debt, on the one hand, and equity, on the other. Interest income to a lender results in an expense deduction to the borrower within certain limitations, whereas the dividend distributions on equity funding result in income to the equity-holder but no deduction to the borrower.

In a cross-border context involving most treaty partner jurisdictions, interest revenue is taxable to the lender only in its jurisdiction of residence, whereas the dividend is subject to withholding tax by the jurisdiction of the payor and typically exempted in the context of a parent-subsidiary fact pattern. While repayment of loan principal is tax-free, repayment of shareholder capital is accorded different tax treatment. Hence, legal or economic analysis is required to distinguish between an equity investment and a loan. The ultimate conclusion is whether, on balance, the instrument appears to be more like debt or more like equity.

Successive decisions added to the list of factors suggestive of *bona fide* debt and came to be known as the *Mixon* factors. These factors were applied to indebtedness circumstances other than in the financial and insurance sectors. Jurisprudence that references these factors invariably state that no single criterion or any set of criteria point conclusively to an instrument being debt or equity, and that a unique set of fact deserves a unique evaluation. As a consequence, the *Mixon* factors currently provide a useful list of do's and don'ts of debt but are suggestive of neither a process nor a definitive analytical framework.

CODE §385

The first attempt at U.S. codification was introduced in 1969 and was, through many starts and stops, either the official or unofficial rule on *bona fide* indebtedness until 2018.

Regulations issued by the I.R.S. under Code §385 in its most recent incarnation aimed to classify an interest in a corporation (or part thereof) as either stock or indebtedness for the purposes of the Code. Drafted as a response to inversion transactions, the regulations concentrated on defining indebtedness for U.S. borrowers (*i.e.*, U.S. issuers of debt) using some of the *Mixon* factors to set out a four-factor definition that referenced the issuer's binding obligation to pay a sum certain, the holder's rights to enforce payment, a reasonable expectation of repayment, and a course of conduct that is generally consistent with the debtor-creditor relationship. At once reviled by businesses and adored by consulting firms ready to meet yet another vague and onerous documentation requirement, the regulations implementing the Code §385 documentation requirement was removed on September 23, 2018, by REG-130244-17.

Debt as a Percentage of the Market Value of Corporate Equities, Level [NCBC-MDPMVCE], retrieved from FRED, Federal Reserve Bank of St. Louis.

If the *Mixon* factors and Code §385 can be thought of as theory in search of a pattern in the data, the quantitative methods that grew up to fill a gap in debt characterization and pricing analysis follow a loose approximation of the opposite approach – relying on patterns in the data to reveal and test possible theories. Where *Mixon* falls short on method, the behaviors of C.F.O.'s and lending institution credit officers offer guidance, as do loan covenant terms in credit agreements appended to S.E.C. filings and the published rating practices of credit rating agencies.

"A C.F.O. is far better off with measurements and a list of requirements in hand, as well as a budget constraint."

QUANTITATIVE APPROACH

Likening the negotiation of a term sheet between a related corporate lender and its related borrower to a C.F.O. preparing for a presentation to a bank or mezzanine lender and the inevitable follow up questions proves instructive. Rather than diving directly into the market for a dark blue suit in what may be the buyer's last known or aspirational size and trying to fit into an off-the-rack product from *Mixon*, a C.F.O. is far better off with measurements and a list of requirements in hand, as well as a budget constraint. All that remains is to determine how much suit can be purchased and, with that information in hand, let the tailoring begin.

A good starting point is to draft a term sheet. This would include the issue date, maturity date, principal amount, detail on tranches, whether security will be taken back, seniority, initial target interest rate (fixed or floating), frequency of payment of interest and principal, prepayment options, guarantees, and demand options. This will form the basis for comparability analysis, debt capacity, creditworthiness, and preparation of forecasts.

Going back to the hypothetical C.F.O.'s meeting with the credit officer, the next consideration is to think about the loan instrument in context. At any particular time, a borrower will have a certain capital structure that will be the starting point for the addition of debt. The current capital structure is the result of past activity that carries with it a history of accessible capital markets terms and covenants related to prior financing. With some knowledge of the current disposition of credit markets toward borrowers in the relevant industry, some of which can be gleaned from informal discussions with bankers and other financial industry participants, it is usually not difficult to construct a hypothetical third-party lender and to anticipate some of the constraints or concerns such a lender would want to manage through terms in a loan agreement. Some of these hypotheticals will lead to revisions in the draft term sheet, and a better understanding of the credit market that is currently relevant to the proposed borrowing.

Often, it is not a big matter to prepare a forecast for a new project, investment, or acquisition. Forecasting earnings and free cash flow is needed to determine the investment internal rate of return and also serves as the basis for understanding the capacity to borrow – commonly known as debt capacity – even in the circumstance where the lending is being contemplated to support financing ongoing operations. A good forecast will clearly show the borrower's ability to service debt and repay debt at maturity (two of the *Mixon* conditions) and allow for the calculation of certain leverage ratios that will help go beyond *Mixon* to determine whether the proposed debt can reliably be called debt by reference to comparable company or industry participant leverage ratios.

Taken together, the ability to service debt, repay principal and interest, and maintain a balance sheet of comparable attributes will lead to a conclusion about debt capacity. Does the principal amount on the term sheet push any of the debt service or leverage capacity measures offside? A scan of covenant terms using Reuters Loan Connector and Dealscan is helpful here, as is Bloomberg, S&P Capital IQ, and other sources for comparable industry or peer company data and deal terms.

When the amount and type of debt is known, the last step is to compute an arm's length interest rate. The risk profile of the borrower is often represented as a credit score or credit rating, and the same construct can apply to a controlled issuer of indebtedness. Computing a hypothetical letter rating can be done using the Moody's or S&P scales. Rating agencies publish their methodologies by industry, and with a little effort, these methods can be applied using company financial statements and forecasts. As an alternative to a first principles approach using a published rating method, a "black-box" calculator like S&P Credit Model or Moody's RiskCalc can be used to derive a synthetic credit rating.

A letter rating will allow for the screening of loan and bond issue data for issues of a similar creditworthiness. It should be noted that for Code §482 transfer pricing issues, a standard of comparability must be met. This means that the characteristics or terms of individual issues must be examined to ensure that the interest rate selected is based on issues with comparable terms. One can often find published credit spreads for composite issuers or issues of a certain credit rating. These points of data may be useful in the domestic context. However, they often are too aggregated to be used to meet the comparability criteria in the cross-border or international transfer pricing context.

Comparability encompasses all loan and guarantee terms, not just the price or interest rate. Examples of terms that must be examined for comparability to the proposed controlled indebtedness issue include currency, industry sector, purpose or use of financing, term to maturity, payment frequency, embedded options, securitization, seniority, size of borrowing or principal amount, and geographic attributes.

Perfection is not the objective here, as the effects of differences may be eliminated with appropriate adjustments. For example, fixed rates can be converted to floating rates using the appropriate interest rate swap contract data, and term to maturity can be adjusted using an appropriate yield curve.

This approach must often be taken in an iterative manner, incorporating new terms into forecasts to determine whether the financial ratios related to debt service and repayment terms are consistent with ratios sampled from comparable deals or companies. Adopting the practice of adjusting the draft term sheet while iterating toward an arm's length result creates the favorable outcome of a table that can be referenced while drafting the loan or credit agreement.

The result is a range of interest rates and collection of on-market terms that stand as an estimate of the terms of *bona fide* indebtedness for all marginal dollars of debt or of specific amounts of indebtedness within specific debt tranches.

TAX REFORM IMPACT

The T.C.J.A. in 2017 influenced debt financing through a "thin cap" rule that limits interest expense for leveraged issuers and the B.E.A.T. rule, which may apply to deductions for interest expense paid to foreign affiliates. Further, the Code §267A anti-hybrid rules deny a deduction for interest and royalty payments that constitute "disqualified related-party amounts." These anti-hybrid rules target cases in which a U.S. person gets a deduction but the foreign person has no income pick up.

SUMMARY

While Code §482 often is thought of as applying in international contexts, its scope with broad enough to apply to domestic transactions. Hence, it may be prudent to consider taking an abbreviated quantitative approach where debt principal values in domestic transactions are large or loan terms are unique. Apart from the 30% profit limitation to interest deductibility (with profit measured as E.B.I.T.D.A., transitioning to E.B.I.T. (earnings before interest and taxes) for taxable years beginning on or after January 1, 2022), case law will still apply.

The current Code §163(j) interest deductibility limitation serves only to limit the total interest expense on total indebtedness and does not define the point at which a marginal dollar of funding ceases being debt and begins to be equity in its character. The location of this cut-off point, and therefore the test for *bona fide* indebtedness, remains to be determined using case law, a quantitative approach, or some combination of the two. Code §163(j) should therefore be treated as a necessary but not sufficient condition for interest deductibility.

QUALIFIED OPPORTUNITY ZONES: SECOND SET OF PROPOSED REGULATIONS OFFERS GREATER CLARITY TO INVESTORS

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Tags
Opportunity Zones
Qualified Funds
Real Property
Tax Deferral
Tax Benefits

The clock is ticking for "Opportunity Zones," and the I.R.S. is aware. The Opportunity Zone tax benefit, which was crafted as part of the 2017 tax reform, aims to encourage taxpayers to sell appreciated capital properties and rollover the gains into low-income areas in the U.S. One major benefit – reducing recognition of deferred gains by up to 15% – is only available to investments made before the end of 2019, although other benefits will continue to be available to later investments.

While the tax benefits are attractive (see our two prior articles, "The Opportunity Zone Tax Benefit – How Does It Work and Can Foreign Investors Benefit" and "Additional Guidance on New Opportunity Zone Funds"), investors remained reserved as too many questions were left unanswered by the first round of proposed regulations. As a result, the potential of this provision has not been fully utilized as of yet.

Knowing this, in late April, the I.R.S. released a second set of proposed regulations that address many of the issues that were reserved in the prior set of proposed regulations, as well as those that were raised by written comments and at the well attended public hearing conducted in February. Another public hearing is scheduled for July 9, but reportedly, the Treasury is currently not working on a third set of proposed regulations to address any additional unanswered matters. Some of the major issues clarified by the April proposed regulations are discussed below.

BACKGROUND

Added to the Code by the 2017 Tax Cuts and Jobs Act, Code §1400Z-1 provides the criteria for areas to be designated as Opportunity Zones, and Code §1400Z-2 provides for the tax benefits associated with investments in these areas.

Three tax benefits are offered to taxpayers who timely invest rolled-over capital gains into a qualified opportunity zone fund ("Qualified Fund"). These were discussed in detail in our prior publications, and in short, can be described as follows:

- Deferral of gain recognition on taxable events in which capital gain is realized – the deferral is available until the earlier of (i) December 31, 2026, or (ii) a realizing event (as defined below)
- Reduction (exclusion) of up to 15% of the inclusion amount of the deferred gain upon recognition – investments held for five years may benefit from a reduction of 10% whereas investments held for seven years may benefit from the full 15%
- Exclusion of the entire post-acquisition gain for investments held for at least ten years

Dispositions after 2019 will not benefit from the full 15% reduction in gain recognition but only 10%, and dispositions after 2021 will not benefit from any reduction in gain recognition. Dispositions of property as late as 2026 (and timely reinvestment by as late as June 30, 2027) may still benefit from an exclusion of post-acquisition gain after a ten-year holding period (but not beyond 2047).[1]

RULES RELATING TO THE QUALIFIED FUND

The proposed regulations clarify many issues relating to the qualification as a Qualified Fund. The following only touches on some of those issues, with the goal of providing potential investors with the general lay of the land.

The 90% Investment Standard Test for a Qualified Fund

A fund (formed as a corporation or a partnership)[2] will be treated as a Qualified Fund if 90% or more of the fund's assets consist of qualified opportunity zone property ("Eligible Property"). This is tangible property used in a trade or business in the Opportunity Zone and/or an interest in other entities operating a business in an Opportunity Zone.

The 90% test is based on the average of two tests. The first test measures the percentage of Eligible Properties out of the total assets after the first six months of the taxable year, and the second measures the same on the last day of the taxable year.

The first set of proposed regulations offered some flexibility for funds to meet the 90% test by allowing funds to delay the start of their status as Qualified Funds, with the caveat that a fund should not accept capital from investors prior to being qualified, in order to avoid disqualifying the investment from the Opportunity Zone benefits.

The new set of proposed regulations allow greater relief by eliminating investments received in the six months preceding the application of the test, provided that such investments are held by the Qualified Fund in cash, cash equivalent, or short-term debt instruments.

Additionally, the new set of proposed regulations provide guidance as to the "reasonable period of time" in which a Qualified Fund must reinvest the return of capital from investments in Eligible Property (and the proceeds received from the disposition of Eligible Property) to avoid failing the 90% test.

The new proposed regulations provide that such proceeds would be treated as Eligible Property for purposes of the 90% test for a period of 12 months, provided that such proceeds are held in cash, cash equivalent, or short-term debt instruments.

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1 Opportunity Zones are scheduled to lose their qualified status in 2028, and thus, a concern was raised as to dispositions after such time. The first set of proposed regulations dealt with this concern and provided that dispositions made before December 31, 2047, but after the expiration of Opportunity Zone status would still qualify for the fair-market step-up in basis to exclude post-acquisition gain from tax.

2 No limitation is imposed on the type of entity that can qualify, as long as it is taxed as a corporation or a partnership. This means that a Qualified Fund may be a C-corporation, an S-corporation, a partnership, or an L.L.C., which may be taxed either as a partnership or a corporation.

Substantially All

As mentioned above, a fund may qualify as a Qualified Fund if it either invests in a qualified opportunity zone business ("Qualified Business") or it operates a Qualified Business itself (or any applicable combination thereof).

A Qualified Business is defined as a business in which "substantially all" of the tangible property (owned or leased) is "Qualified Business Property."

"The new set of proposed regulations allow greater relief by eliminating investments received in the six months preceding the application of the test."

Qualified Business Property is tangible property used in a trade or business for which "substantially all" of the use, during "substantially all" of the Qualified Fund's holding period, occurs in the Opportunity Zone. Additional requirements exist with respect to such property, some of which are discussed later.[3]

The first set of proposed regulations provided for a 70% threshold to determine if an entity operates a Qualified Business. However, that threshold was only available for this determination and did not apply anywhere else the term "substantially all" appears. The second set of proposed regulations provides that the 70% threshold will apply wherever the term "substantially all" appears in a "use" sense but that a 90% threshold will apply wherever the term is used in a "holding period" sense.

Tangible property will qualify as Qualified Business Property if, during at least 90% of the Qualified Fund's holding period, at least 70% of the use of the property is in an Opportunity Zone.

For an investment in another Qualified Business to meet the requirements, the entity in which the fund purchases an equity interest (other than an interest as a creditor) must operate a Qualified Business not only at the time the interest is purchased but also during "substantially all" of the Qualified Fund's holding period, namely at least 90% of the time the Qualified Fund holds the interest.

Original Use in the Opportunity Zone Commences with the Qualified Fund

The Code requires that the "original use" of a Qualified Business Property in the Opportunity Zone commence with the Qualified Fund. Alternatively, a Qualified Business Property may be substantially improved by the Qualified Fund. The Code defined what would constitute a substantial improvement of a tangible property but did not address the original use test. The first set of proposed regulations reserved on the matter.

The proposed regulations provide that the original use commences on the date when a property is first placed in service in the Qualified Opportunity Zone in a manner that would allow depreciation or amortization by the property's owner. Thus, used tangible property can satisfy the original use test if that property has not previously been used in the Opportunity Zone in a manner that would have allowed it to be depreciated or amortized by any taxpayer.

Vacant buildings and other used tangible property (used in a manner that previously allowed it to be depreciated or amortized) may still qualify if the property has not

3 These include, but are not limited, to (i) the requirement that the tangible property be acquired after December 31, 2017, (ii) the requirement that such acquisition be from an unrelated person, and (iii) the requirement that the original use of the property in the Opportunity Zone commences with the Qualified Fund or Qualified Business, or that the fund or business substantially improves the property.

been utilized, or has been abandoned, for some time. The proposed regulations suggest that usage history be disregarded after a period of five years since the property was used in business.

Prior guidance on the application of the Opportunity Zone rules to real property provided that the improvement requirement does not extend to the land on which a building is located.[4] In line with this guidance, the second set of proposed regulations provide that the requirement that the "original use" of property in a Qualified Opportunity Zone commence with a Qualified Fund (or a Qualified Business) is inapplicable to land, whether the land is improved or unimproved. To be a Qualified Business Property, land must be used in a trade or business within the meaning of Code §162. Thus, land owned for investment would not qualify as Eligible Property.

Leased Property

The original use test is not applicable to leased tangible property. Neither is the substantial improvement requirement nor the requirement that the property be leased from an unrelated person. However, to avoid abuse, the proposed regulations include certain requirements:

- The lease must be fair market value.
- No prepayment between related parties is allowed for lease terms in excess of 12 months.
- Personal property that is leased from a related lessor may qualify as Eligible Property only if within 30 months (or by the end of the lease term, if shorter) the lessee acquires tangible property that has a value greater than the value of the leased personal property.
- In the case of real property (other than land), leased property would not qualify as Eligible Property if, at the time the lease is entered into, there was a plan, intent, or expectation for the real property to be purchased for less than fair market value (at the time of the purchase) or for the purchase price to be reduced by rent payments.

RULES RELATING TO INVESTORS IN QUALIFIED FUNDS

A Timely Investment in a Qualified Fund

Deferred gain must be reinvested in a Qualified Fund "during the 180-day period beginning on the date of such sale or exchange." The proposed regulations clarify that a qualifying investment may be made directly in a Qualified Fund or by purchasing an interest in such a fund from another investor.

With respect to the 180-day period, the first set of proposed regulations clarified that taxpayers have 180 days from the day on which the gain would be recognized for Federal income tax purposes but for the Qualified Opportunity Zone election. Further guidance was necessary to advise taxpayers as to the proper date.

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[4] Rev. Rul. 2018-29 published concurrently with the first set of proposed regulations.

In the case of capital gains from the sale of property used in a trade or business ("Code §1231 Gain"), the first set of proposed regulations clarified that only Code §1231 Gains in excess of the "Code §1231 Losses" will be treated as capital gain that is eligible for the Opportunity Zone tax deferral election. Consistent with this guidance, the second set of proposed regulations provides that, because the eligible amount of Code §1231 Gain is determined only as of the last day of the taxable year, the 180-day period for reinvesting this capital gain in a Qualified Fund in a manner qualifying for the deferral begins on December 31 of the year of disposition (*i.e.*, the last day of the taxable year), even when Code §1231 Losses are remote.

Similarly, when capital gain is realized by a partnership, the 180-day period ordinarily begins on the last day of the partnership's taxable year and not on the day of the disposition. Partners who wish to reinvest their allocable share of such gains within 180 days from the disposition may do so only if the partnership does not intend to elect to defer the gain and subject to an appropriate election to begin the 180-day period at such time. In the absence of the election, an investment in a Qualified Fund made within 180 days of the disposition date may not qualify for the Opportunity Zone tax benefits if the reinvestment occurs on or before December 31 of the year (*i.e.*, the last day of the taxable year).

"Tangible property will qualify as Qualified Business Property if, during at least 90% of the Qualified Fund's holding period, at least 70% of the use of the property is in an Opportunity Zone."

Eligible Investment Made by Contributing Property Other than Cash

Taxpayers who wish to enjoy the Opportunity Zone election must purchase an equity interest in a Qualified Fund. This purchase may be made for cash received in the disposition of the appreciated property or by contributing other property. The transfer of another property to the Qualified Fund may be a tax-free transaction under any of the nonrecognition provisions (*e.g.*, Code §351 or Code §721) or taxable (if any one of the requirements for a nonrecognition is not applicable). The proposed regulations provide rules regarding the amount treated as invested in the Qualified Fund in a nonrecognition transaction because a taxpayer utilizing a nonrecognition provision generally takes a carryover basis in the interest acquired in return for the transferred property.

The proposed regulations provide that the amount of the investment will be the lesser of (i) the adjusted basis in the transferred property or (ii) the fair market value of the interest in the Qualified Fund received. The proposed regulations further provide that the rules apply to each item of property contributed separately.

This can create a mixed-funds investment situation when the fair market value of the transferred property is higher than the basis in the property and when the investment exceeds the deferred gain. In line with the rule relating to mixed-funds investment, which provides that cash amounts in excess of the deferred gain are treated as a separate investment not eligible for the Opportunity Zone tax benefits, the proposed regulations provide that the total amount of eligible investment made for contributions of non-cash property is limited to the amount of deferred gain and that any excess in fair market value of the Qualified Fund interest received over the adjusted basis of the property contributed will likewise be treated as an ineligible investment.

The proposed regulations provide that the taxpayer's basis in the ineligible investment portion would be the excess (if any) of the basis in the total investment in the Qualified Fund received in return for the property contributed (determined without regard to the Opportunity Zone election) over the basis allocated to the eligible portion of the investment (without regard to the Opportunity Zone election). The basis in the eligible portion may later be increased by the step-up provision available after five, seven, and ten years.

To illustrate, assume a taxpayer has $60 of capital gains eligible for the deferral; the taxpayer decides to invest in a Qualified Fund using another property with a fair market value of $100 and an adjusted basis of $80. As a result, the taxpayer would be treated as having two separate investments in the Qualified Fund:

- An eligible investment of $60 (*i.e.*, the lesser of the fair market value of the interest received ($100) and the adjusted basis of the property contributed ($80) but limited to the deferred gain ($60))
- An ineligible investment of $40 (*i.e.*, the balance of the fair market value of the interest received ($100) over the eligible investment ($60))

The basis of the ineligible investment would be $20.

Investment in a Qualified Fund Formed as a Partnership

The proposed regulations provide for special rules applicable to partnerships.

A transfer of cash or property to a partnership that is characterized as something other than an investment (*e.g.*, a disguised sale rather than a contribution) would not be an eligible investment for purposes of the Opportunity Zone election.

To the extent that the contribution is not disregarded, the amount of the eligible investment is determined in the same manner as provided above, however net of any liabilities. That is, the eligible investment would be the lesser of (i) the net basis in the property contributed (*i.e.*, the adjusted basis over the debt to which the property is subject, but not below zero) or (ii) the net value of the property contributed (*i.e.*, the fair market value over the debt to which the property is subject, but not below zero). The amount of the ineligible investment would equal the excess (if any) of the net value of the contributed property over the eligible investment.

The basis in the eligible portion of an investment would equal the net basis in the contributed property, and the basis in the ineligible portion would be the excess (if any) of the net basis over the basis in the eligible portion of the investment. Both bases are then increased by any debt allocated to the partners and any income allocated to them pursuant to partnership taxation rules. The basis in the eligible portion is further increased by the step-up provision of the Opportunity Zone election available after five, seven, and ten years.

To illustrate, assume a contribution of a property worth $130 subject to a $30 debt and having an adjusted basis of $20. The net basis in $0 (the adjusted basis over the debt, not below zero) and the net value is $100 (fair market value over debt). As a result, the eligible investment would be $0, and the entire investment would be ineligible. The basis of the ineligible investment would be $0 increased by the partner's share of the partnership liability.

Holding Periods

The proposed regulations provide that the holding period, as measured for purposes of the Opportunity Zone rules, is linked to the holding of the qualifying investment. Therefore, if a taxpayer transfers a property in an Opportunity Zone to a Qualified

Fund in return for interest in the Qualified Fund, the holding period requirements that must be met to qualify for each of the relevant tax benefits (five, seven, or ten years) are measured by reference to the receipt of the interests in the Qualified Fund and not to any prior holding period. Likewise, if a taxpayer disposes of an interest in a Qualified Fund and within the 180-day period reinvests the deferred gain in a new Qualified Fund, the holding period begins with the reinvestment in the new Qualified Fund.

Exceptions apply. Generally, when a transfer does not trigger an inclusion event (as discussed below) – *e.g.*, for a transfer by death – the holding period of the transferor would continue.

Deferred Gain Recognition

As mentioned earlier, the deferred gain will be recognized at the earlier of (i) disposition of the investment in the Qualified Fund or (ii) December 31, 2026. The proposed regulations provide a general rule that, unless an exception applies, an inclusion event occurs any time a taxpayer "cashes out" on the rolled-over investment (*i.e.*, when (i) a transfer reduces, for Federal tax purposes, the taxpayer's equity in the qualifying investment in the Qualified Fund or (ii) the taxpayer receives property in a distribution from the Qualified Fund). For this purpose, "property" does not include stock or rights to acquire stock in a Qualified Fund (formed as a corporation). More specifically, the proposed regulations provide a nonexclusive laundry list of transactions that will trigger deferred gain recognition, some of which are mentioned below:

- A taxable disposition of all or part of the investment in the Qualified Fund
- A taxable disposition of an interest in an S-corporation that is the direct investor in a Qualified Fund if, immediately after the disposition, the taxpayer's interest in the S-corporation has changed by more than 25% compared to the ownership at the time that the deferral election was made (Note that the deferred gain will be recognized in whole and not just the portion of the gain relating to the disposed portion of interest.)[5]
- A transfer by a partner of an interest in a partnership that is the direct or indirect owner of interests in a Qualified Fund except if such transfer is tax free contribution into a partnership under Code §721 or a continuation of a partnership through merger under Code §708 which will not result in a reduction in the amount of the deferred gain
- A transfer by gift of interest in a Qualified Fund except for a gratuitous transfer to a trust treated as a grantor trust to the donor

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5 In such circumstances, the proposed regulations view the greater-than-25% change in ownership of the S-corporation as a disposition by the S-corporation of the investment in the Qualified Fund, and the S-corporation will have an inclusion event with respect to the deferred gain. Thereafter, the remaining tax benefits offered by the Opportunity Zone provision (*i.e.*, the partial step-up after five or seven years and the ten-year post-acquisition gain exclusion) will not be available for this investment, which is not in actuality disposed of by the S-corporation.

- A change in the status of a grantor trust causing a change in the owner of the trust property for Federal income tax purposes except for a change by reason of the grantor's death
- A distribution to a partner, by a Qualified Fund formed as a partnership, of property that has a value in excess of the partner's basis in the partnership fund[6]
- A distribution to a partner, by a direct or indirect partnership investor in a Qualified Fund formed as a partnership, of property that has a value in excess of the partner's basis in the partnership
- A distribution of property or a redemption by a Qualified Fund formed as a C-corporation (under Code §301) or an S-corporation (under Code §1368) that is treated as a sale or exchange of property for U.S. tax purposes
- A taxable liquidation of a Qualified Fund (formed as a corporation)
- Nonrecognition corporate transactions involving interests in Qualified Funds formed as corporations where the shareholder has effectively cashed out of the Qualified Fund investment

The proposed regulations describe the methods by which the amount of the recognized deferred gain is calculated.

The Effect on Investors of Disposition of Eligible Property by a Pass-Thru Qualified Fund

When a Qualified Fund taxed as a partnership or an S-corporation disposes of Eligible Property, the disposition may create taxable gain to the partners and shareholders. While commenters were concerned with the gain recognition under such circumstances, the I.R.S. addressed this in the preamble to the proposed regulations and determined that it lacked the authority to exclude such income or gain from recognition. However, because the tax benefits under this provision are tied to the length of the investor's stake in a Qualified Fund and not to the specific portfolio investment, the disposition would not trigger an inclusion of an investor's deferred gain and would likewise not affect an investor's holding period for purposes of the five-year, seven-year, and ten-year tax benefits.

However, for investors holding interests in Qualified Funds formed as partnerships or S-corporations for longer than ten years (after all deferred gain was recognized), the proposed regulations offer an election to exclude gain on the disposition of Eligible Property (reported on Schedule K-1) from gross income. For basis purposes, the exclusion from gross income will nevertheless be treated as distributive share, which increases the taxpayer's basis in the interest in the Qualified Fund.

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6 Note that while the basis of a qualifying investment begins with zero, debt allocated to this investment will increase the basis and a distribution is excess of this adjusted basis will trigger deferred gain recognition to that extant. In a mixed-funds investment, the tracking for purposes of the Opportunity Zone rules will be different than tracking of the investment for purposes of partnership taxation rules, which will treat the mixed-funds investment as one and thus may not tax a distribution under Subchapter K as a distribution that is taxed as an inclusion event of the deferred gain.

A similar rule applies to a Qualified Fund that is a real estate investment trust ("R.E.I.T."). As a result, holders of shares in a Qualified Fund R.E.I.T. may receive specially designated capital gain dividends (limited by the long-term capital gains on sales of Eligible Property) on a tax-free basis, provided that they meet the ten-year requirement and would have been eligible to elect to step up the basis in the stock to fair market value if they were disposing of the stock.

Transfer of a Qualifying Investment by Death

Unlike a transfer by gift, the transfer of an interest in a Qualified Fund by death is not an inclusion event that triggers deferred gain recognition. Here, the recipient will have the obligation to include the deferred gain in gross income come December 31, 2026, or an earlier inclusion event.

Investing Foreign-Source Capital Gains

No limitation applies with respect to the source of the deferred capital gain that is reinvested in a Qualified Fund. However, as noted in previous articles, due to foreign tax being paid in the source country, and the availability of a foreign tax credit to offset the U.S. tax imposed on the foreign-source gain, it may be inefficient to defer gain recognition in the U.S.

"An inclusion event occurs any time a taxpayer 'cashes out' on the rolled-over investment."

Notwithstanding the aforementioned, if the goal is to reap the ten-year tax benefit (*i.e.*, the complete exclusion of the post-acquisition gain), a deferral may be worth considering. For example, assume foreign tax is imposed at 25% and foreign capital gain is equal to $1,000,000. If the taxpayer is a U.S. individual, the U.S. long-term capital gains tax rate is 20%. As a result, the tax due in the U.S. for the year of the sale would be $200,000. But, if $250,000 were paid in foreign taxes, the individual would not necessarily owe additional U.S. tax for this sale if foreign tax credits can be utilized, and deferral would not appear to be tax efficient. However, if the individual is considering an investment in a Qualified Fund that seems attractive regardless of the tax incentive, and if we assume the value is expected to appreciate substantially over a ten-year period, the deferral should be considered. Assume the new property triples in value:

- Without the Opportunity Zone election, in 2019, the individual invests the net proceeds ($750,000); when the value triples to $2,225,000 in year ten and the individual disposes of the investment, the U.S. tax liability is 20% on capital gains of $1,500,000, *i.e.*, $300,000.
- The total tax is $250,000 in foreign taxes on the first transaction (no U.S. tax if foreign tax credits are available) plus $300,000 on the second transaction, *i.e.*, $550,000.
- With the election, the amount available to invest in a Qualified Fund is $750,000 (unless the taxpayer has other funds or property to invest). In 2026, the individual has a mandatory inclusion of $750,000 ($1,000,000 if additional funds are invested) deferred from 2019. However, if the initial investment was in 2019, in 2026 the taxpayer is eligible for a 15% step up in basis. Thus, the gain included in 2026 is only $637,500 (in the case of a $750,000 investment) or $850,000 (in the case of a $1,000,00 investment), and the tax due is $127,500 or $170,000, respectively. In year ten, when the property is sold for $2,225,000 ($750,000 investment) or $3,000,000 ($1,000,000

investment), there will be no U.S. tax due to the Opportunity Zone election.

- The tax is $250,000 in foreign taxes on the first transaction – with no U.S. tax on the $250,000 gain realized in the year of the sale and with respect to which no deferral election is made if foreign tax credits are available ($750,000 investment) or no U.S. tax without regard to any foreign tax credit, as all gain is deferred ($1,000,000 investment) – plus $127,500 ($750,000 investment) or $170,000 ($1,000,000 investment) in the U.S. on the deferred date of 2026 (or possibly less if excess foreign taxes can be utilized) and $0 on the second transaction. On an investment of $750,000, the total is $377,500 if foreign tax credits offset the tax on the gain in the year of sale that is not deferred. On an investment of $1,000,000, the total tax is $420,000.

- Additionally, there may be circumstances where no foreign tax is imposed on a disposition of capital property but U.S. tax is still imposed, and as a result, the deferral itself would also be an attractive benefit. For example, Israel does not tax the sale of an individual's personal home if certain conditions are met. If the individual is a dual citizen of Israel and the U.S., notwithstanding the Israeli tax exemption, U.S. tax would apply to the disposition, and an Opportunity Zone election should be considered.

CONCLUSION

The clock is ticking for investors that are still observing the Opportunity Zones from the sidelines. While those who wish to utilize the fullest tax benefits should hurry, investment opportunities should be carefully scrutinized, particularly because Opportunity Zones are often unfamiliar areas for investors. The analysis should ensure that the tax benefits associated with the election are a sweetener but that the transaction is sound without those benefits. The I.R.S. is working hard to assist the industry so that capital injections in Opportunity Zones can become a reality.

IS THE 100% DIVIDEND RECEIVED DEDUCTION UNDER CODE §245A ABOUT AS USEFUL AS A CHOCOLATE TEAPOT?

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Tags
Code §245A
Code §1248
C.F.C.
D.R.D.
G.I.L.T.I.
P.T.I.
Transition Tax

INTRODUCTION

Imagine a lush green garden on a bright sunny day. A glistening teapot sits on a table in the garden. As you approach the table, you see that the teapot is made of chocolate. It doesn't make sense, does it? What is the use of a teapot that would melt in on itself by the time the hot, steaming tea is poured into a cup?

A similar question may be raised as to the relevance of the 100% dividend received deduction ("D.R.D.") under Code §245A in the context of the gain arising from the sale of the stock of a controlled foreign corporation ("C.F.C.") that is treated as a dividend for certain shareholders.[1] This article will discuss exactly that – the usefulness of Code §245A D.R.D. and the interplay between the Code §245A and Code §1248, especially in light of the enactment of the Transition Tax and Global Intangible Low-Taxed Income ("G.I.L.T.I.") regime.

GENERAL RULE FOR SALE OF AN ASSET

Let's start with the general rule. Assuming no depreciation recapture under Code § 1245 or Code §1250, the amount realized from the sale or other disposition of a capital asset in excess of its adjusted basis is taxed as a capital gain.[2] If the asset has been held for more than one year at the time of the sale, the gain is treated as long-term capital gain taxed at the rate of 20%[3] if the taxpayer is an individual or 21% for an entity taxed as a corporation. If the property were held for a year or less before the sale, the gain is treated as a short-term capital gain, which is taxed at ordinary rates, up to 37%, in the case of an individual or the same tax rate of 21% for an entity taxed as a corporation.

GAIN FROM THE SALE OF C.F.C. STOCK MAY BE TREATED AS DIVIDENDS

Generally, a U.S. Shareholder, as defined, recognizes gain or loss on the sale or exchange of stock in a C.F.C. equal to the difference between the sales price and the shareholder's adjusted basis in the stock sold or exchanged. If applicable, Code §1248 recharacterizes the gain from the sale of the stock of a C.F.C. as dividend income (instead of the default capital gain tax treatment).

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1 Governed by Code §1248.

2 Code §1001.

3 U.S. individuals are also subject to the Net Investment Income Tax of 3.8%.

“If the amount of E&P is not established, then the entire amount of gain is treated as dividends.”

Code §1248 provides that if a U.S. Person, as defined, sells or exchanges stock in a C.F.C. and that person owns[4] 10% or more of the total combined voting power of all classes stock entitled to vote, then the gain recognized on the sale or exchange of the stock must be included in the person’s gross income as a dividend. The original purpose of the provision was to prevent accumulated earnings in a C.F.C. from being converted to capital gains under prior U.S. tax law, which imposed high tax on dividend income and low tax on capital gains.

Code §1248 includes a five-year look back rule that treats the gain from the sale of the stock of a foreign corporation as a divined even if it is not a C.F.C. at the time of the sale, provided the corporation was a C.F.C. at any time during the five-year period ending on the date of the sale or exchange.

Also, Code §1248 does not apply to any amount of gain that is a short-term capital gain or gain from the sale of an asset that is not a capital asset.[5] Again, under prior law, such short-term gain was taxed in the hands of an individual at ordinary income rates, which often exceeded 50%.

Limitations to Dividend Treatment

The gain is treated as a dividend only to the extent of the foreign corporation’s earnings and profits (“E&P”) attributable to the shares of stock that are sold or exchanged. The E&P attributable to those shares of stock consist of a *pro rata* share of the earnings that were accumulated (i) after 1962, (ii) while the taxpayer held the stock, and (iii) while the corporation was a C.F.C.[6] In other words, the §1248 dividend is the lesser of two amounts:

- The actual gain recognized on the sale or exchange (which includes redemption or liquidation)
- The E&P attributable to the stock sold or exchanged

The limitation of treating the gain as dividends only to the extent of the foreign corporation’s E&P attributable to the disposed stock applies only if the taxpayer establishes the amount of its E&P.[7] A taxpayer is said to have established this amount if a schedule is attached to the income tax return for the relevant taxable year clearly demonstrating the computation.[8] If the amount of E&P is not established, then the entire amount of gain is treated as dividends.[9] At a time when dividends and long-term capital gains are taxed at the same rate, the provision is somewhat of an anachronism in the context of an individual shareholder effecting the sale.

The allocation of the C.F.C.’s E&P to the shares of stock being sold can be explained with the help of the following example.

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[4] Either directly or indirectly under Code §958(a) or constructively under Code §958(b).

[5] Code §1248(g)(2)(C); Treas. Reg. §1.1248-1(e).

[6] Code §1248(a).

[7] Code §1248(h).

[8] Treas. Reg. §1.1248-7(a)(1)(i).

[9] Treas. Reg. §1.1248-7(a)(1).

Example 1:[10]

On May 26 of Year 1, Ms. Green, a U.S. individual, purchases 100 outstanding shares of the only class of stock of a C.F.C., F.C., at a price that is the fair market value foreign currency equivalent of $25. She sells 25 of the shares on January 1 of Year 3. Ms. Green did not include any amount in gross income under Code §951 during the period in which the shares were held. The E&P accumulated by F.C. is $10,000 for Year 1, $13,000 for Year 2, and $11,000 for Year 3.

The E&P of F.C. attributable to 25 shares of F.C. stock is as follows:

E&P Attributable to Ms. Green's Shares	
Year 1	219 / 365 * $10,000 = $6,000
Year 2	$13,000
Year 3	$11,000
Total	$30,000
E&P attributable to 25 shares of F.C. stock	30,000 * 25 / 100 = $7,500

Example 2:

D.C., a domestic corporation, purchases 25 shares of the single class of stock of a foreign corporation, F.C., at the beginning of Year 1. Mr. A, a U.S. citizen, owns 20 shares of F.C., and Mr. B, a nonresident alien, owns 55 shares. No other shares of F.C. are issued and outstanding. D.C. purchases ten of Mr. B's shares at the beginning of Year 2 and purchases ten of Mr. A's shares at the beginning of Year 3. At the beginning of Year 4, D.C. sells the F.C. stock it owned at a gain of $400. F.C. has E&P of $100 for each of the first three years.

The E&P attributable to F.C. stock held by D.C. is as follows:

- None of Year 1's earnings is attributed to F.C. stock held by D.C. because F.C. is not a C.F.C. in Year 1. This is because only 45% of the stock of F.C. is held by U.S. Shareholders (25% by D.C. and 20% by Mr. A).
- In the beginning of Year 2, F.C. becomes a C.F.C. because more than 50% of the total voting power is owned by U.S. Shareholders. In Year 2, the aggregate ownership of D.C. (35%) and A (20%) increased from 45% to 55%.
- In the beginning of Year 3, D.C. bought ten shares from A, and therefore, its total ownership interest in F.C. was increased to 45%. F.C. continues to remain a C.F.C. for Year 3 since more than 50% of the total voting power is owned by U.S. Shareholders.
- The E&P attributable to D.C.'s shareholding is the *pro rata* share of the E&P of F.C. accumulated after 1962 while D.C. held the stock and while F.C. was a

[10] Treas. Reg. §1.1248-2(e)(4), ex. 1.

C.F.C. The E&P attributable to D.C.'s shareholding in F.C. is $80, calculated as follows:

- $0 of the E&P for Year 1
- $35 (35% of $100 of E&P) for Year 2
- $45 (45% of $100 of E&P) for Year 3

- The Code §1248 dividend amount on D.C.'s stock sale is $80, *i.e.*, the lesser of the actual gain ($400) and the E&P attributable to F.C. stock owned by D.C. ($80). The tax treatment of the Code §1248 dividend recognized by a corporate U.S. Shareholder is different from the treatment of one recognized by an individual U.S. Shareholder, which is discussed in a later section.
- The remaining gain of $320 is taxed to D.C. as capital gain at the rate of 21%, the same rate as ordinary income for a corporation.

Adjustments to E&P

In the above examples, F.C.'s E&P was given for each year, and the E&P attributable to the shares of stock was calculated for all shares sold. However, the real question is what are the rules for computing the foreign corporation's E&P for the purposes of Code §1248? Let's take a step back and dig deeper to determine how E&P of a C.F.C. is computed for Code §1248 purposes.

A C.F.C.'s E&P for Code §1248 purposes is generally computed by following the rules applied to determine E&P of a domestic corporation.[11] However, several adjustments are provided under the regulations. Essentially, the adjustments are made to ensure that the income that has already been subject to U.S. tax under Code §951 is not given dividend treatment. Stated differently, the E&P attributable to the disposed interest is the E&P that is not previously taxed income ("P.T.I."). One of the more practical and important adjustments to determine a foreign corporation's E&P is discussed in the next segment of this article.

Amounts Included in Gross Income Under Code §951

Code §1248(d)(1) provides that E&P previously included in the gross income of the selling shareholder under Code §951 ("Subpart F P.T.I.") is excluded from the foreign corporation's E&P when determining the E&P attributable to the disposed stock.[12] Therefore, E&P attributable to Subpart F income under Code §951 does not turn a gain into dividend income on the later sale of stock. Moreover, if the selling shareholder included amounts in income under Code §951 but then received distributions, that amount is added back to the foreign corporation's E&P. Without the add-back, the E&P would be reduced twice: once for the Subpart F inclusion and a second time for the dividend distribution.

It should also be noted that the G.I.L.T.I. amount determined under Code §951A is also treated as Subpart F Income for purposes of Code §1248(d)(1).[13] Similarly, the amount subject to the Transition Tax determined under Code §965 is treated as

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[11] Code §1248(c)(1).

[12] Code §1248(d)(1).

[13] Code §951A(d)(1).

Subpart F Income ("Code §965 P.T.I.") and is included in the gross income of a U.S. Shareholder under Code §951(a).[14] Thus, Code §965 P.T.I. is likely to be treated in the same manner as Subpart F Income for purposes of Code §1248(d)(1).

Example 3:[15]

Assume the same facts as in Example 1. Additionally, Ms. Green includes in gross income under Code §951 the aggregate amount of $2,800 for Year 1 and Year 2. F.C. distributed $2,300 to Ms. Green on January 15 of Year 3. The actual distribution is excluded from gross income under Code §959(a)(1).

The E&P attributable to F.C. stock held by Ms. Green is as follows:

- Before any adjustments for Subpart F Income inclusions and actual distributions, E&P is $7,500, as computed in Example 1.
- After the adjustments, Subpart F income inclusions, and actual distributions, E&P is $7,000, computed as follows:

Adjustments to E&P Attributable to Ms. Green's Shares	
E&P attributable before any adjustments	$7,500
E&P attributable to income taxed under Code §951	($2,800)
Distributions excluded from gross income under Code §959(a)(1)	$2,300
E&P attributable after adjustments	$7,000

Example 4:

On January 1, 2017, Ms. A, a U.S. Person, incorporated a foreign corporation, F.C. Ms. A owned 100 shares of the only class of stock of F.C. She sells all of the stock of F.C. on January 1, 2019, at a gain of $2,500. For 2017, F.C.'s total E&P is $11,000, out of which Ms. A included $ 5,000 in gross income as Subpart F Income taxable under Code §951. The untaxed undistributed foreign E&P of F.C. subject to the Transition Tax under Code §965 for 2017 is $6,000 (*i.e.*, $11,000 - $5,000). The Transition Tax was paid in 2018; the election to defer the payment of the Transition Tax was not made. The E&P for 2018 is $14,000, all of which is properly characterized as foreign-source income. The qualified business asset investment is $10,000. Therefore, the tested income for G.I.L.T.I. purposes for 2018 is $13,000 (tested income of $14,000, less $1,000 attributable to 10% of the qualified business asset investment).[16]

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14 Code §965(a).

15 Treas. Reg. §1.1248-2(e)(4), ex. 2.

16 The G.I.L.T.I. computation is too simplistic. For detailed analysis on the computation of the G.I.L.T.I. rules, see "A Deep Dive into G.I.L.T.I. Guidance," Insights 5, no. 10 (2018) and "A New Tax Regime for C.F.C.'S: Who Is G.I.L.T.I.?" Insights 5, no. 1 (2018).

The E&P attributable to F.C. stock owned by Ms. A is as follows:

E&P Attributable to Ms. A's Shares	
2017	$11,500
2018	$14,000
Total E&P attributable before any adjustments under Code §1248(d)	$25,000
Adjustments under Code §1248(d)	
Subpart F Income under Code §951	($5,000)
Untaxed undistributed foreign earnings subject to Transition Tax, treated as included in gross income under Code §951	($6,000)
G.I.L.T.I. inclusion under Code §951	($13,000)
E&P attributable after adjustments	$1,000

To recap, the above computation of E&P attributable to F.C. stock is relevant to determine the portion of the gain arising from the sale of F.C. stock that will be treated as dividends under Code §1248(a). In the above example, Ms. A earned $2,500 from the sale of F.C. stock, but only $1,000 is E&P attributable to F.C. stock. Therefore, $1,000 will be treated as dividends taxed at ordinary rates,[17] and the balance of $1,500 will be treated as capital gain taxed at 20%. The amount treated as dividend income is properly characterized as foreign-source income for foreign tax credit purposes. The source of the amount treated as capital gain will be based on Ms. A's residence, as determined under Code §865(a).

It should be noted that the enactment of the Transition Tax and the G.I.L.T.I. provisions has the effect of substantially reducing the amount of gain attributable to the Code §1248 dividends. Only non-P.T.I. is treated as Code §1248 dividends. With the Transition Tax and G.I.L.T.I., virtually 100% of the foreign corporation's E&P is P.T.I.

<u>*Other Adjustments*</u>

Other exclusions from E&P of the foreign corporation include (i) the E&P accumulated from effectively connected income ("E.C.I.") of the C.F.C., provided that the tax on the income is neither reduced nor eliminated by a tax treaty and (ii) the E&P previously included in the taxpayer's gross income under the rules for passive foreign investment companies that are also qualified electing funds, exclusive of the portions of these earnings that have been distributed to the taxpayer in nontaxable distributions of P.T.I.[18]

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17 Here, since A is an individual, the limitation under Code §1248(b) will apply in determining the tax on §1248 dividends.

18 Code §§1248(d)(4), (6).

ARE CODE §1248 DIVIDENDS REALLY 100% EXEMPT FROM U.S. TAXATION?

The tax treatment of the Code §1248 dividends depends on whether the taxpayer is an individual or a C-corporation. In the case of an individual, the Code §1248 dividends are taxed at ordinary rates or long-term capital gains rates, if qualified.[19] However, the tax liability is limited under the provisions of Code §1248(b).[20] In the case of a C-corporation, the provisions of Code §245A apply. The portion of the gain recharacterized as a Code §1248 dividend is treated as a dividend for the purposes of Code §245A.[21] Code §245A provides for a 100% deduction of the foreign-source portion of dividends received from a foreign corporation by a domestic corporation that owns 10% or more of the voting rights or total value of the foreign corporation. The 100% D.R.D. is available only if the taxpayer is a domestic C-corporation (and not a regulated investment company or real estate investment trust). Further, no foreign tax credit is allowed pursuant to Code §901.[22] In other words, the Code §1248 dividends are 100% exempt from U.S. tax in the hands of a corporate U.S. Shareholder if the conditions of Code §245A are met.

Holding Period Requirement

Code §245A has a holding period requirement. The domestic corporation must hold the shares of stock of the foreign corporation for more than 365 days during the 731-day period beginning 365 days before the date on which the share becomes ex-dividend.[23] A day is counted towards the holding period only if the domestic corporation's interest in the foreign corporation does not fall below 10% (by vote or by value).[24] Stated differently, if the domestic corporation holds at least a 10% interest in the foreign corporation for more than 365 days during a period of two years, which begins one year before the ex-dividend date, the domestic corporation will be entitled to a 100% deduction of the foreign-source portion of the dividends received.

Determining the Foreign-Source Portion of the Dividend

The foreign-source portion of the dividend received is calculated as follows:[25]

Foreign-Source Dividend Calculation
$\text{Dividend Received} * \dfrac{\text{Undistributed Foreign Earnings}}{\text{All Undistributed Earnings}}$

19 Code §1(h)(11).

20 Code §1248(b) limits the tax under Code §1248(a) to the hypothetical tax that would have been paid at the corporate level and the individual level if the U.S. person were to have invested in a U.S. corporation rather than a foreign corporation.

21 Code §1248(j).

22 Code § 245A(d)(1).

23 Code §246(c)(1)(A); Code §246(c)(5)(A).

24 Code §246(c)(1)(B).

25 Code §245A(c)(1).

The undistributed earnings of a foreign corporation is its E&P as of the close of the taxable year during which the dividend is distributed, without a reduction for the dividends actually distributed during the taxable year.[26] In addition, all undistributed earnings are treated as undistributed foreign earnings, except the earnings attributable to E.C.I., as alluded to above. Also excluded from undistributed earnings are dividends received by the foreign corporation from a domestic corporation in which 80% of the shares of stock (measured by vote or value) are owned by the foreign corporation.[27]

The I.R.S. has not issued any guidelines explaining the meaning of "undistributed earnings." However, the New York State Bar Association published a report on Code §245A, dated October 25, 2018, suggesting that the undistributed foreign earnings appear to include all U.S.-source income other than E.C.I. that is fully taxed and portfolio dividend income.

Is the 100% D.R.D. Under Code §245A Relevant or Is It a Mere Pacifier?

With the introduction of the Transition Tax and G.I.L.T.I., it may be argued that the relevance of the 100% D.R.D. under Code §245A has been diminished in the context of Code §1248.

"If a foreign corporation does not have any non-P.T.I. then Code §245A appears to be a mere formality."

The one-time Transition Tax imposed for 2017 had the effect of converting a foreign corporation's untaxed undistributed E&P accumulated through the close of tax year 2017 into P.T.I. ("Code §956 P.T.I."). Effective 2018, the T.C.J.A. imposed a G.I.L.T.I. tax on an ongoing basis which, for trading companies or internet companies, is imposed on almost the entire income of the foreign corporation not already taxed in the U.S. in its hands or at the level of its U.S. Shareholders. Stated differently, the untaxed post-2017 foreign-source income of a foreign corporation is subject to the G.I.L.T.I. regime and becomes P.T.I. ("Code §951A P.T.I.") as a result. Therefore, subject to proposed regulations issued June 21, 2019, which are discussed below, a foreign corporation subject to the one-time Transition Tax and G.I.L.T.I. on an ongoing basis may be left with relatively little non-P.T.I.

If a foreign corporation does not have any non-P.T.I. then Code §245A appears to be a mere formality because, in the absence of non-P.T.I., no amount of gain will be treated as dividends for the purposes of the 100% D.R.D. under Code §245A.

The few instances where a foreign corporation may have non-P.T.I. and, therefore, Code §245A may be beneficial to the U.S. taxpayer include the following:

- The net tested income of one C.F.C. is offset by the net tested loss of another C.F.C., and therefore, no G.I.L.T.I. is imposed.
- Part of the deduction is not subject to G.I.L.T.I. (*i.e.*, the amount equivalent to the net deemed tangible income return, which is 10% of the qualified business assets investment).
- The C.F.C. is resident in a foreign jurisdiction that imposes corporate income tax at an effective rate in excess of 18.9%. If the quotient derived from dividing (i) the U.S. dollar amount of tax paid by (ii) the U.S. dollar amount of G.I.L.T.I. exceeds 18.9%, under proposed regulations issued June 21,

[26] In essence, this means that tax imposed under Code §1248(a) is applied to all E&P before tax on dividend income is computed.

[27] Code §245A(c)(2)-(3).

2019,[28] the foreign corporation may elect to be exempt from G.I.L.T.I. The proposed regulations will be effective for C.F.C. taxable years beginning on or after the date the final regulations are published in the Federal Register. Likely, publication will be later this year, and the final regulations will be effective for tax year 2020.

Example 5:

A domestic corporation, D.C., owns stock in a C.F.C., F.C., with an initial basis of $100 on January 1 of Year 1. On January 1 of Year 2, D.C. sold F.C. stock for $250. For Year 1, F.C.'s E&P is $65. F.C.'s Subpart Income for Year 1 is $50 and foreign-source income subject to G.I.L.T.I. is $10. Other foreign-source income not subject to U.S. tax is $5.

This is illustrated in the following chart:

	Year 1	Year 2
Adjusted Basis	$100	$160
E&P	$65	
Subpart F Income	$50	
G.I.L.T.I.	$10	
Other Foreign-Source Income (non-P.T.I.)	$5	
Sale of F.C. Stock		$250

- D.C. will include $50 of Subpart F Income in its gross income in Year 1 under Code §951(a).
- D.C. will also include $10 of G.I.L.T.I. in its gross income in Year 1 under Code §951A(a).
- D.C.'s adjusted basis in the stock of F.C. at the end of Year 1 will be $160 ($100 + $50 + $10) under Code §§961(a) and 951A(f)(1)(A).
- Because D.C. sold the stock of F.C. for $250, the taxable gain from the sale of the stock is $90 ($250 - $160).
- The amount already included in D.C.'s gross income under Code §§951 and 951A is $60 (Subpart F P.T.I. of $50 + Code §951A P.T.I. of $10).
- E&P attributable to the stock sold by D.C. for the purposes of Code §1248 is $5 ($65 - $60) after making adjustments for amount already included in gross income under Code §951.
- Code §1248(a) will recharacterize the gain from the sale of the stock of F.C. to dividends, but only to the extent of E&P attributable to the stock sold (also

[28] See Prop. Treas. Reg. §1.951A-2(c)(6).

regarded as non-P.T.I. E&P). Therefore, out of the total gain of $90, only $5 will be treated as dividends.

- The $5 recharacterized as a dividend is eligible for the D.R.D. under Code §245A, subject to the satisfaction of its requirements.
- The balance of the gain is $85 ($90 - $5); it would be subject to a 21% corporate tax of $17.85 ($85 * 21%).

Some interesting observations from Example 5 are as follows:

- Because of G.I.L.T.I., D.C.'s adjusted basis in the F.C. stock has increased by $10. In the pre-T.C.J.A. era, the adjusted basis in F.C. stock would have been $150 ($100 + $50 of Subpart F Income already included in the gross income) instead of $160. Thus, the net gain would have been $100 ($250-$150). Out of the $100 gain, $15 ($65 - $50 of Subpart F P.T.I.) would have been treated as dividends. The non-Subpart F P.T.I. portion would have been taxed as dividends at the rate of 35% (subject to foreign tax credits), and the capital gain would have been subject to a tax of $29.75 ($85 * 35%).
- The dollar amount of the capital gain remains the same in the example before and after the enactment of the T.C.J.A. However, for tax years beginning in 2018, even though D.C. paid the $1.05 G.I.L.T.I. charge ($10 * 10.5%), D.C. is better off in the aggregate because of the reduced capital gain tax rate of 21%. The total tax liability is $18.90 ($17.85 + $1.05)
- The 100% D.R.D. under Code §245A may be beneficial if the C.F.C. is actively engaged in a trade or business outside the U.S. and the U.S. Shareholders are not subject to G.I.L.T.I. – likely beginning in 2020. This is because the foreign corporation's E&P will include a substantial amount of non-P.T.I., and the gain from the sale of the corporation's stock, to the extent it is non-P.T.I., will be exempt under Code §245A.
- The D.R.D. under Code §245A is available only to a corporate shareholder. Therefore, if the shares in this example were held by an individual U.S. Shareholder, Code §245A would be inapplicable. In such a case, $5 of the dividend would be subject to tax at ordinary rates or long-term capital gains tax rates if treated as a qualified dividend, while the balance $85 would be treated as long-term capital gain. In addition to income tax, a 3.8% Net Investment Income Tax will be due. Here, that total amount would be $20.23.

IT'S ONLY THE BEGINNING

While the T.C.J.A. amended the definition of the term "U.S. Shareholder" under Code §951(b) to include a U.S. Person owning 10% or more of the total value of a C.F.C., Code §1248(a) remains untouched. Code §1248 continues to be applicable only to those U.S. Persons (not U.S. Shareholders) who own 10% or more of the total combined voting power of all classes of stock entitled to vote (and not 10% or more of the total value). Thus, a U.S. Person who owns nonvoting common or preferred stock constituting 10% or more of the total value of a C.F.C. will be treated as a U.S. Shareholder for Subpart F purposes but will not be governed by the provisions of Code §1248. Therefore, Code §245A will not be applicable either. The tax treatment for those shareholders will be discussed in a subsequent edition of *Insights*.

GRECIAN MAGNESITE PUT TO BED: TAX COURT RULING AFFIRMED ON APPEAL

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Tags
Effectively Connected Income
Grecian Magnesite
Partnership
Sale
U.S. Source

INTRODUCTION

Recently, the Court of Appeals for the D.C. Circuit affirmed the 2017 Tax Court ruling in the matter of Grecian Magnesite *Mining v. Commr.*,[1] which held that a foreign corporation was not liable for U.S. tax on the gain from a redemption of its membership interest in a U.S. limited liability company ("L.L.C.") treated as a partnership where the L.L.C. was engaged in a U.S. trade or business. Gain attributable to U.S. real property was not at issue in the initial decision or the appeal. In so holding, it affirmed the entity view of partnerships for U.S. tax purposes as it relates to the character of the interest owned by a member.

BACKGROUND

The I.R.S. has a long history in misapplying U.S. tax rules applicable to a sale of a partnership interest. For U.S. tax purposes, a partnership interest is treated as an asset separate and apart from an indirect interest in partnership assets. In Rev. Rul. 91-32, the I.R.S. misinterpreted case law and Code provisions to conclude that gains derived by foreign investors in U.S. partnerships are subject to tax.[2] No one thought the I.R.S. position was correct, but then, in a field advice to an agent setting up an adjustment, the I.R.S. publicly stated that the ruling was a proper application of U.S. law when issued.[3]

The validity of the I.R.S. position was presented to the Tax Court in *Grecian Magnesite, Mining, Industrial & Shipping Co., SA v. Commr.*, a case that was tried and briefed in 2014. The facts in the case are relatively straightforward. Grecian Magnesite was a privately-owned corporation organized under the laws of Greece. From 2001 through 2008, it was a member of a U.S. L.L.C. that was engaged in the business of extracting, producing, and distributing magnesite. The business operations were carried on in the U.S. In 2008, Grecian Magnesite's interest in the L.L.C. was completely redeemed – a transaction treated as a sale or exchange of the membership interest. Although there were no negotiations, as such, whatever discussions took place with the L.L.C. were carried on by officers of Grecian Magnesite based in Greece. The decision to proceed with the redemption was made in Greece, and all documents were signed in Greece. Grecian Magnesite did not maintain an office of its own in the U.S. but did employ individuals located in the U.S.

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1 149 T.C. 3 (2017).

2 For a full discussion of the validity of Rev. Rul. 91-32 prior to the holdings in the *Grecian Magnesite* decisions in the Tax Court and the Court of Appeals, see "Sale of a Partnership Interest by a Foreign Partner – Is Rev. Rul. 91-32 Based on Law or Administrative Wishes?" *Insights* 6 (2017).

3 FAA 20123903F.

A portion of the redemption proceeds was properly allocable to appreciation of U.S. real property. The balance related to active business operations that appreciated in value during the period in which Grecian Magnesite was a member of the L.L.C. Grecian Magnesite was examined by the I.R.S., and a notice of deficiency was issued in 2012 – about the time that the I.R.S. field service advice was issued asserting the validity of the Rev. Rul. 91-32.

The I.R.S. asserted that the capital gain was properly treated as effectively connected income ("E.C.I.") because Grecian Magnesite was engaged in a trade or business as a result of its investment in the L.L.C. Grecian Magnesite's position on audit was that the assets of the L.L.C. did not control the character of the gain from a disposition of an interest in the L.L.C. Even if it did, the gain was not treated as U.S.-source gain under U.S. tax law[4] and cannot be taxed in the U.S. as E.C.I. under the general rule that foreign-source income cannot be E.C.I.[5] except in three instances that are not relevant to the facts of the case. After almost three years from submission of briefs, the Tax Court ruled in favor of Grecian Magnesite.

TAX COURT DECISION

At the level of the Tax Court, the I.R.S. argued that the aggregate theory of partnerships should prevail. Under this view, the redemption of the partnership interest is properly viewed as a sale of the partner's indirect interest in all the underlying assets that make up the business of the partnership. Because those assets produced E.C.I. for the foreign partner, the I.R.S. argued that the redemption gain is characterized as E.C.I. In broad terms, the I.R.S. argued that whether the L.L.C. sold the assets or the foreign partner sold a partnership interest, the tax result should not differ materially as to the character of the gain. The Tax Court rejected the I.R.S. argument and ruled that in the context of a sale of a partnership interest the entity theory should prevail. Under this view, a partnership interest is viewed as a sale of an indivisible capital asset in the form of the membership interest.

In reaching its conclusion, the Tax Court dismissed the validity of Rev. Rul. 91-32 because it improperly interpreted the text of the statute and was not supported by adequate reasoning. In declining to defer to the ruling, the court also criticized the ruling's treatment of the international issues. The Tax Court then addressed the nature of the redemption under the partnership rules of Subchapter K and determined that a redemption payment is treated as distribution by a partnership, and to the extent the distribution exceeds the basis in the partner's interest in the partnership, gain recognized in the transaction is considered gain from the sale or exchange of the partnership interest. For purposes of that transaction, the partnership is properly treated as an entity, so that the asset exchanged is the interest held by the partner and not an undivided interest in all assets owned by the partnership.

The Tax Court then addressed the source of the gain. To be taxable for Grecian Magnesite, the gain must be from a U.S. source. As the source of gain from the sale of personal property is generally allocated to the country of residence of the seller, the gain recognized by Grecian Magnesite would be considered to be foreign-source

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4 Code §865(a)(2). An exception that applies to sales attributable to a U.S. office that materially participates in a sale is not applicable as no such office existed and could not have engaged in material participation. See Code §865(e)(2)(A).

5 Code §864(c)(4)(A).

income unless an exception were to apply. Here the relevant exception is that gain derived by a foreign corporation could be viewed to be U.S.-source gain where attributable to the partner's U.S. office.

While Grecian Magnesite had no office in the U.S., the L.L.C.'s office was, arguably, attributed to it in connection with income generated by day-to-day operations. However, that does not mean that gain from the redemption of an interest in an L.L.C. is attributable to the office of the L.L.C.

For the gain to be U.S.-source income the L.L.C. office must (i) be a material factor in the production of the redemption gain of Grecian Magnesite and (ii) regularly carry on activities of the type from which the gain is derived – namely the redemption of membership interests. Because the actual transaction was a redemption of a membership interest and not a hypothetical sale of underlying L.L.C. assets, the L.L.C.'s office was not be a material factor in the redemption transaction.

The I.R.S. did not offer an explanation of why it believed the U.S. office was a material in the redemption transaction. Instead, it argued that the office was material in the realization of the gain because the office increased the overall value of the interest through its operation of the business. This argument was dismissed by the Tax Court.

In the Tax Court's view, the I.R.S. confused the ongoing value of a business operation and gain arising from the redemption of a membership interest. The L.L.C. office did not represent the foreign member in negotiating or performing an activity that was necessary in the realization of the redemption gain by Grecian Magnesite.

Additionally, the Tax Court ruled that even if the U.S. office of the L.L.C. were a material factor in the redemption transaction, the gain was not realized in the ordinary course of the L.L.C.'s business conducted through its office. Redeeming membership interests was not part of the day-to-day business operation of the L.L.C. Consequently, the redemption gain of a foreign member was not part of the ordinary trade or business activity carried on by the U.S. office of the L.L.C. In sum, the gain was not attributable to a U.S. office.

COURT OF APPEALS DECISION

On appeal, the I.R.S. argued that issue related to the character of the gain and the gain arose from the activity of the U.S. office. It was therefore proper to treat the gain as U.S.-source gain attributable to a U.S. office. In its view, the Tax Court erred by focusing exclusively on the selling activity. It should have looked at value creation. Because the partnership interest appreciated in value as a result of the success of the business in which the U.S. office undoubtedly participated in a material way, the gain must be attributed to that office. This argument was dismissed by the Court of Appeals.

The I.R.S. also argued the validity of the I.R.S. position enunciated in Rev. Rul. 91-32 and claimed that a long-held position of the I.R.S. is entitled to deference. The Court of Appeals disagreed. Initially the appeals court determined that Rev. Rul. 91-32. was not entitled to deference no matter the length of time it was held by the I.R.S.:

> While the Revenue Ruling has the benefit of longevity—it has been the IRS's unchanged position for some thirty years—little else militates in favor of deferring to it. The pertinent portion comprises a single unreasoned sentence in a Ruling that spans four pages of the Cumulative Bulletin. . . . That sentence cites the relevant statute, § 865(e)(3), but without any elaboration. And it also cites a Tax Court decision, *Unger v. Comm'r*, 58 T.C.M. (CCH) 1157, 1159 (1990), which neither involved nor purported to opine on the attribution of income from the sale of personal property by a foreign partner.

Having addressed the first two arguments of the I.R.S., the Court of Appeals focused on the regulations and legislative history behind the adoption of the E.C.I. concept in the Code. Both clearly indicate that the U.S. office rule is directed to the transaction rather than the appreciation of the asset. The Court of Appeals explained:

> The provisions at issue apply not only to the disposition of partnership interests but also to the sale of myriad other personal property. It is doubtful that Congress would have intended to source income according to the innumerable forces that change the market value of most personal property. In that light, Congress's choice to emphasize the sale struck an understandable balance between its dual aims of administrability and avoiding manipulation.

"The Court of Appeals noted that its decision has little significance as a matter of prospective transactions."

Having ruled that the gain can be effectively connected only when the activity of the U.S. office is a material factor in arranging the transaction, the Court of Appeals examined whether the U.S. office materially participated in the redemption transaction. The I.R.S. argued that partnerships are inherently engaged in the business of managing transactions with members, and therefore, the U.S. office of the L.L.C. should be viewed as regularly being engaged in activities like redemptions. Again, this argument was dismissed.

In the view of the Appeals Court, the U.S. office of the L.L.C. regularly carried on activities related to the magnesite-mining business. It was not in the business of carrying on the redemption activities of its members. Production and sale of magnesite comprised the principal activity of the L.L.C., and that activity was carried on regularly by L.L.C. employees. In comparison, the redemption of membership interests was a rare occurrence. Therefore, redemptions were not part of the regular trade or business of the L.L.C.

CONCLUSION

As a final point, the Court of Appeals noted that its decision has little significance as a matter of prospective transactions. The Tax Cuts and Jobs Act of 2017 revised the tax law after the Tax Court issued its decision by adopting the aggregate theory of partnerships when determining the character of gain arising from a disposition or redemption of a partnership interest. That legislation enshrines one of the positions the I.R.S. unsuccessfully advanced before the Tax Court. The amended provision will control the outcome of disputes arising under the revised law. A dispute arising from prior law is controlled by the principles of prior law discussed here.

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Tags
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THE HIGH-TAX KICKOUT: G.I.L.T.I. OR NOT G.I.L.T.I.?

On June 21, the Treasury published proposed and final regulations under Code §951A. They address, *inter alia*, an expansion of the high-tax kickout exception applicable to Subpart F Income.

In a nutshell, Code §951A excludes several items from gross tested income, and thus from G.I.L.T.I., including foreign base company income ("F.B.C.I.") and insurance income subject to the high-tax kickout. The final regulations do not allow for the high-tax kickout exception to apply to gross tested income not otherwise constituting F.B.C.I. or insurance income. Instead, they defer to the proposed regulations to suggest a framework under which taxpayers could elect for non-F.B.C.I. or non-insurance income to benefit from the high-tax kickout.

The proposed regulations provide that controlling domestic shareholders of a C.F.C. can elect for the high-tax kickout exception to apply to all the C.F.C.'s items of income for the taxable year that meet the effective 18.9% foreign tax rate. This effective rate must be computed on a unit-by-unit basis for each Qualified Business Unit. For this purpose, controlling domestic shareholders generally are U.S. Shareholders owning more than 50% of the voting rights in the C.F.C. in the aggregate. The election is made by attaching a statement to the return (including to amended returns) and is binding on all the U.S. Shareholders of the C.F.C. In the case of a controlling domestic shareholder group, the election applies to each C.F.C. in that group. Unless revoked, the election applies to the year of the election and subsequent years. Finally, it should be noted that, if the high-tax kickout exception is elected for, the foreign income taxes associated to the excluded income and the property generating the excluded income are, respectively, excluded from the Code §960 indirect foreign tax credit and from qualified business asset investments.

The final regulations caution that taxpayers cannot rely on the proposed regulations to elect for non-F.B.C.I. or non-insurance income to benefit from the high-tax kickout before the proposed regulations become final.

SENATE TO VOTE ON TAX TREATIES

On June 25, the Senate Foreign Relations Committee approved protocols to four income tax treaties, clearing the way for the treaties to be considered by the full Senate. Senate approval is the final step needed in order for instruments of ratification to be exchanged with the treaty partner jurisdiction. The protocols relate to income tax treaties with Japan, Luxembourg, Spain, and Switzerland.

Senator Rand Paul (R-K.Y.), a member of the Senate Foreign Relations Committee, has held up consideration of the protocols because of his opposition to exchange of information provisions without what proper safeguards in place to protect U.S. businesses and citizens abroad.

Apparently, the protocols will require a formal vote by the full Senate rather than a streamlined process of unanimous consent by voice vote. In any case, this is a significant step, as no tax treaty or protocol has been approved by the Senate since 2010.

FRENCH SOCIAL SECURITY CHARGES (C.S.G. AND C.R.D.S.) ARE CREDITABLE

As stated in our June 19 Client Alert, the French *contribution sociale généralisée* ("C.S.G.") and *contribution au remboursement de la dette sociale* ("C.R.D.S.") perviously were not considered creditable foreign income taxes since they were considered falling under the provisions of the France-U.S. Totalization Agreement. The U.S. Court of Appeals for the District of Columbia Circuit reversed this holding but remanded the case back to the Tax Court for further review and possible reconsideration. Based on a joint status report recently filed with the Tax Court, the French and U.S. agreed that neither the C.S.G. nor the C.R.D.S. fall under the provisions of the France-U.S. Totalization Agreement.

On June 26, the I.R.S. circulated an agency statement providing that the C.S.G. and the C.R.D.S. were not social "taxes" covered by the Totalization Agreement. The I.R.S. thus does not intend to challenge foreign tax credit claims for these two types of French social charges "on the basis that the Agreement on Social Security applies to those taxes."

The I.R.S. statement further provides that affected taxpayers have ten years to file a claim for refund. The I.R.S. intends to issue further guidance soon.

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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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We maintain offices in New York and Toronto. The practice of the Toronto Office is limited to U.S. law and focuses on cross-border transfer pricing issues.

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Insights, the monthly tax journal of Ruchelman P.L.L.C., provides in-depth reporting on the evolving landscape of U.S. and international taxation. It offers complex analysis of current issues, legislative updates, and practical introductions to the tax law from leading tax professionals in their respective countries.

Special features include an annual examination of the use of holding companies in European tax planning and a look at the year in review.

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