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INSIGHTS

TAXATION OF REAL ESTATE INVESTMENT IN ISRAEL

U.K. MANDATORY DISCLOSURE REGIME (DAC6)

HOW NOT TO BORROW A TREATY: *SMITH V. COMMR.*

AND MORE

Insights Vol. 7 No. 3

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EDITORS' NOTE

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

- **Taxation of Real Estate Investment in Israel.** In almost every country, the way real estate investments are taxed depends on a wondrous blend of factors, including the status of the owner of the property (individual or corporation), the nature of the asset (residential property, commercial property, land) and the purpose of investment (producing rental income or entrepreneurial profit). Israel is no different. In their article, Anat Shavit, a partner of Fischer Behar Chen Well Orion & Co. in Tel Aviv, and Ofir Fartuk, a senior associate at the same firm summarize the main factors one should take into consideration when contemplating real estate-related investments in Israel.

- **U.K. Mandatory Disclosure Regime (DAC6).** DAC6, adopted by the European Commission and enacted into law in the U.K., imposes a mandatory obligation on intermediaries, or individual or corporate taxpayers, to make disclosures to H.M.R.C. of certain cross-border arrangements and structures that could be used to avoid or evade tax. It also provides for automatic exchanges of information among E.U. Member States. Intermediaries know a cross-border arrangement is reportable when it meets certain hallmarks. In his article, Gary Ashford, a non-lawyer partner of Harbottle & Lewis, London, explains in plain English all the key terms and obligations. The European Commission has proposed that Member States defer the start date for reporting, however, the U.K. Government has not made any public announcement. This article is timely for those who are intermediaries in a reportable transaction.

- **How Not to Borrow a Treaty: *Smith v. Commr*.** For individual entrepreneurs operating across the globe, generating profits in corporations based in tax favored jurisdictions is a key ingredient in making and keeping a substantial share of profits. However, when the entrepreneur is a U.S. citizen, bringing those profits home requires careful planning in order to take advantage of the qualified dividend rules. Having a structure that is on the right side of the rules reduces the income tax rate on dividends to 20%. Having a structure on the wrong side, leaves the top rate at 37%. Too many entrepreneurs wait until the last minute to plan and even then have difficulty in following a plan based on tax law and economic substance. Galia Antebi and Stanley C. Ruchelman discuss a case in which one taxpayer was addicted to cutting corners or did not appreciate the risk when deviating from a plan. Whatever the reason, the plan crafted by his tax advisers never made it to the implementation stage. On paper, the plan worked. In substance, nothing was done. Big tax resulted.

- **Heads I Win, Tails You (I.R.S.) Lose – Not Any More: Hybrid Dividends And Code §245A(e).** With the enactment of the Tax Cuts and Jobs Act, much hoopla was made regarding the adoption of a territorial tax system in the U.S. What was not appreciated at the time was that so many anti-abuse rules were adopted in conjunction with the adoption of the G.I.L.T.I. rules, that the foreign D.R.D. is less of a lion and more like a hamster for most cross-border businesses based in the U.S. Neha Rastogi and Nina Krauthamer explore all the nuances and exceptions that make global tax planning under prior law an ever fonder memory.

- **Anti-Abuse Rules of Temp. Reg. §1.245A-5T — A New Cerberus for the U.S. Tax System.** In a companion piece to the preceding article, Andreas A. Apostolides and Stanley C. Ruchelman explore many of the anti-abuse rules attached to the foreign D.R.D. provisions. These rules are designed to close the door on financial products that undermine the I.R.S. view of the global biosphere comprised of the D.R.D., Subpart F, P.T.I., and G.I.L.T.I. The goal is to ensure that the benefit of the foreign D.R.D. is not expanded beyond boundaries viewed proper by the writers of the regulations. The D.R.D. is not a tool to shift profits abroad and to bring those profits back to the U.S. tax-free.

- **Help – My Exclusively Foreign Trust Now Has a U.S. beneficiary! What Are the Issues a Trustee Will Now Face in 2020?** For many wealthy families based in Europe, elegant private client planning is performed to high European standards. Then, one or more of the heirs moves to the U.S. What should be done to keep the family assets away from U.S. income tax and future estate tax? Good answers are not easy to come by, especially when the adviser suggests disqualifying the U.S. beneficiary from trust benefits. Surely, there must be a better way. There is, and in her article, Nina Krauthamer explores the issues and possible solutions to the ultimate conundrum.

- **U.S.: CARES Act Loans and Business Tax Provisions and I.R.S. Announcements on Stranded Individuals.** New York City and much of the U.S. has been under some form of COVID-19 lockdown since the middle of March. During that time, Congress has enacted two stimulus packages, and a follow-up package has been approved by the House of Representatives. Stanley C. Ruchelman looks back at all that has happened in the past two and one-half months to protect the economic health of the country.

- **Corporate Matters – The Value of Par Value.** Winston Churchill is known to have said that the U.S. and the U.K. are separated by a common language. The gap is much wider with the rest of Europe as tax and business terminology may be similar, but the gap in understanding is wider. One area of the law where the chasm remains wide relates to everyday corporate terms, such as par and par value for stock. Not an important term in the U.S., the concept of "par value" in Europe is extremely important, especially if the shareholders in the U.S. want dividends and the managing director in Europe desperately keeps away from any transaction that could give rise to liability if dividend distributions are found to impair capital. Simon Prisk comments on the accepted meaning of the term in the U.S. and the surprise response he encounters when advising European clients.

Enjoy the read!

- The Editors

TAXATION OF REAL ESTATE INVESTMENT IN ISRAEL

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Tags
Israel
Real Estate

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INTRODUCTION

The Israeli tax system taxes Israeli residents globally. Nonresidents are taxed in Israel only to the extent they derive Israeli source income. The sale or disposition of a real estate asset located in Israel as well as any income produced by such real estate will be considered Israeli source income. Furthermore, under most double tax treaties, the country in which the real estate is located has the right to take the "first tax bite" of any income produced by the real estate.

Taxation of real estate investments is complex and depends on various factors, including the status of the owner of the property (individual or corporation), the nature of the asset (residential property, commercial property, land) and the purpose of investment (producing rental income or entrepreneurial profit). Investing in shares of a company whose main assets are real estate assets may also be considered real estate investment for tax purposes.

While the purchase and sale of a real property in most cases will be taxed in accordance with the Land Appreciation Tax Law (Appreciation and Purchase) 5723 – 1963 (the "Land Appreciation Tax Law"), rental and other income arising in connection with the exploitation of the land will be taxed in accordance with the Income Tax Ordinance [New Version] 5721 – 1961 (the "Ordinance"). Entrepreneurial profit earned in relation to real estate will also be subject to income tax.

In this paper we summarize the main factors one should take into consideration when contemplating real estate-related investments in Israel.

PURCHASE TAX APPLICABLE TO THE PURCHASE OF REAL ESTATE ASSETS

In principle, when buying property in Israel, the buyer will have to pay purchase tax. There are no exemptions from that tax but there are different rates, for different types of assets.

Generally, the purchase of any "real estate right" (other than rights in residential property) is subject to Land Purchase Tax at the rate of 6%. The term "real estate right" is defined broadly to include ownership rights, lease rights for a period exceeding 25 years, and certain use rights for a period exceeding 25 years.

The purchase of rights in a "Real Estate Company" is also subject to 6% purchase tax. In a "Real Estate Company," the tax will be calculated on the basis of the proportionate shareholding percentage of the buyer, multiplied by the fair market value of all underlying real estate assets free and clear of any of debt. The definition of the term "Real Estate Company" includes any association, all of whose assets directly

or indirectly, are real estate rights. Cash and cash equivalents are not considered as assets for that purpose and movable assets will be considered as an asset only to the extent they give rise to a significant and integral share of the income produced. A company or a R.E.I.T. whose shares are registered for trade on a stock exchange is excluded from the definition of "Real Estate Company."

The purchase tax rates applicable to residential property are updated from time to time and currently are as follows:

- **Single Residence Benefit** – If the purchaser resides in Israel and does not own a residence in Israel, or if the purchaser already owns one but is looking to upgrade and sell a current residence, the tax is imposed at the following rates (updated for 2020):

Value of the Asset (in NIS)	Rate
1,744,505	0%
1,744,506 - 2,069,205	3.5%
2,069,206 - 5,338,290	5%
5,338,291 - 17,794,305	8%
Above 17,794,305	10%

- **New Immigrants –** In general, the above rates apply only to a person who is an Israeli resident at the time of purchase with an exclusion for "new immigrants" who arrive no later than two years after the apartment was purchased. Alternatively, new immigrants are entitled to the following preferred rates for a total period of eight years starting one year before the new immigrant's arrival in Israel and ending seven years following the date of becoming a new immigrant. This is a one-time benefit. The following rates are updated for 2020.

Value of the Asset (in NIS)	Rate
Up to 1,838,615	0.5%
Over 1,838,615	5.0%

- **All Other Cases –** For nonresidents and other purchasers who own more than one residence in Israel, the following rates will apply (updated for 2020).

Value of the Asset (in NIS)	Rate
Up to 5,340,425	8%
Over 5,340,425	10%

VALUE ADDED TAX APPLICABLE TO THE PURCHASE OF A REAL ESTATE PROPERTY

Value Added Tax ("V.A.T.") is an indirect tax levied on the consumption of goods and services in Israel. The purchase of a real estate asset is generally subject to V.A.T. unless the seller is a private individual selling residential property.

The standard V.A.T. rate is currently 17%. V.A.T. is usually paid by the purchaser or service recipient against an invoice provided by the seller or service provider. Such "output tax" may in certain circumstances be recoverable against the "input tax" payable by the payer. V.A.T. is usually not recoverable if paid on a residential property.

HOW IS RENTAL INCOME TAXED?

Generally, rental income is classified as regular income for tax purposes. If the owner of the property is a company it will be liable for tax at the regular corporate rates (currently 23%).[1] When the rental income is distributed to shareholders, additional tax at the rate of 25%-30% will apply. If the owner of the property is an individual, the applicable rates would be in accordance with the individual's personal tax bracket. The highest rate is 50% at the present time.

"The Ordinance offers three different tracks for the taxation of rental income on a residential property produced by an individual."

Without derogating from the above, the Ordinance offers three different tracks for the taxation of rental income on a residential property produced by an individual: (i) the regular taxation track; (ii) the exemption track; or (iii) the 10% track on gross rental income. An additional fourth track may be available under the Law for the Encouragement of Capital Investments, 1959 (the "Encouragement Law") which provides tax incentives for rental income from at least six residential apartments located in one building.

- **The Regular Taxation Track** – Under this alternative the individual is taxed on the net rental income from the property. Deductible expenses such as depreciation, interest on a loan taken to finance the purchase of the land, and ongoing operating expenses will be deductible. The tax rate applicable to the *net* rental income will be the individual's regular income tax bracket.
- **The 10% Track** – Under this alternative the individual is taxed only at a 10% tax rate on the *gross* rental income from his real estate property. No expenses will be deductible. Upon the sale of the property the cost basis of the property will be reduced by the "theoretical" depreciation charges over the period such property was rented.
- **The Exemption Track** – Under this alternative the individual will not pay any tax, or will pay only certain limited taxes, on the rental income from his real estate property, when all the following conditions are met:
    - The residence, by its nature, is intended for residential use.
    - The residence is not registered as a business asset and is not required to be registered as such.

[1] Certain real estate companies may be taxed as look through entities. In those cases, the income of the company will be attributed to its shareholders.

- The residence is rented to an individual (in certain circumstances it may also be possible to rent the property to an organization).
- The property is used by the tenant strictly for residential purposes.

If the rental income from all the owner's rental properties does not exceed NIS 5,100 per month (for 2020) ("Ceiling"), the entire rental income is exempt. If the rental income is between NIS 5,100 and NIS 10,200 per month (for 2020), only a portion of the rental income will be exempt from tax. The exempt amount is reduced by one shekel for each shekel of monthly rent in excess of NIS 5,100.

- **The Encouragement Law Track** – The Encouragement Law's main objective is to encourage investments in Israel. Under the Encouragement Law, an owner of at least six residential apartments, located in the same building, will be entitled to reduced tax rates on rental income and on gains from disposing of the apartments subject to the following cumulative conditions:
  - The taxpayer is the owner of at least six residential apartments, located in the same building.
  - At least 50% of the apartments were available for rent to third parties for a period of at least five years.
  - The rental income received from each apartment does not exceed NIS 8,000 per month (for 2020).

  If these conditions are met a reduced tax rate of 11% will apply to corporations, or 20% to individuals.[2]

DISPOSITION OF REAL ESTATE ASSETS

Land Appreciation Tax is a unique capital gains tax imposed on the disposition of real property located in Israel.

The capital gain calculation begins with the sales price and allows deductions for the original purchase price and certain deductible expenses from the sale price of the property. Where the Israeli tax authority (the "I.T.A.") considers the sale price to be significantly lower than fair market value, the I.T.A. can intervene and calculate the gain based on the fair market value.

The capital gain is divided into two elements. Part of the gain which is inflationary by nature is taxable at a rate of 10% in respect of the inflationary gain earned up to December 31, 1993, and at a zero rate thereafter. The balance of the gain is taxable at the rates detailed below. Foreign residents have the option of having the real gain calculated by reference to changes in the exchange rate of NIS *vis a vis* the applicable foreign currency.

Corporations are taxed at a flat corporate tax rate (currently 23%).

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[2] A broader and more in-depth analysis of the Encouragement Law will be reviewed in a different publication.

The rates applicable to the sale of real estate assets by individuals depend on the date of purchase of the asset and the nature of the property.

Land Appreciation Tax will not be imposed on land disposition income classified as business income. Such income will be classified as regular income and taxed in accordance with the Ordinance.

Residential Properties

- **Single Residence Benefit** – Israeli residents owning only one residence will be entitled to receive an exemption from Land Appreciation Tax up to a value of NIS 4.5 million for the property, subject to certain conditions. If the value of the residential property is more than this amount, the value exceeding NIS 4.5 million will be taxed at standard rates (see below). Several less material exemptions may also be available. Practically, the single residence benefit is not available to a foreign resident who cannot prove that no personal residence is owned in another country.

- **Multiple Residence Owner** – An individual who is not entitled to receive the single residence benefit will be taxed on the sale of residential property at the following linear tax rates:

Gains Accumulated	Rate
Until January 2014	0%
From January 2013	25%

Thus, the seller is not taxed on the full amount of capital gains accrued, but only on the relative portion of the gain determined on a linear basis from January 1, 2014, until the date of the sale.

For example, if a property was purchased on January 1, 1995, and sold on December 31, 2014, with a profit of NIS 1 million, the tax authority would calculate the full gain (NIS 1 million), divide it by the number of years which elapsed between the date of the purchase and the date of the sale (20 years), calculate the relative gain for each year (NIS 50,000) and multiply that by the amount of time between January 1, 2014, and the date of the sale (one year). Thus, in our example, on a gain of NIS 1 million, only NIS 50,000 would be taxed at the capital gains tax rate (25%).

Please note, however, that additional building rights will be taxed at the same rates as nonresidential property.

Nonresidential Properties

- Gain on nonresidential properties which were purchased prior to March 1961 will be taxed at a flat rate of 25%.

- Gain on other properties will be taxed at the following linear tax rate. The number of days in each listed holding period will be divided by the total number of days in the total holding period, and multiplied by the applicable tax rate. All fractional rates will be rounded up to arrive at the applicable tax rate.

Holding Periods	Tax Rate
April 1961 to November 7, 2001	The highest applicable marginal tax brackets (highest is 50%).
November 7, 2001 to December 31, 2011	20%
January 1, 2012 onwards	25%

For example, if a property was purchased on January 1, 1995, and sold on December 31, 2014, for a profit of NIS 1 million, the tax authority would calculate and tax the full gain (NIS 1 million). The tax rate will be calculated as follows: [6/20 × 50%] + [11/20 × 20%] + [3/20 × 25%] = 30%. Such rate will be multiplied by the gain, resulting in NIS 300,000 tax.[3]

Land Betterment Levy

The disposition of a real estate asset may also require payment of a betterment levy. A betterment levy applies when a change in the zoning plans applicable to the property increases the existing building rights. The betterment levy is calculated on the basis of the appreciation of the value of the asset, to the extent the value of the property has been appreciated, compared to the value of the property prior to the change in the zoning plan. The appreciation will be multiplied by a 50% tax rate, to determine the betterment levy that is due. The betterment levy is due upon the earlier of the sale of the property or the issuance of a building permit.

The betterment levy is a deductible expense for purposes of the Land Appreciation Tax.

Value Added Tax

The sale of a real estate asset is subject to V.A.T. at the standard rate, currently 17%, if the seller is an "authorized dealer." If the seller is a private individual, V.A.T. may apply if the asset being sold is a commercial property or a plot of land. If the seller is a private individual and the purchaser is an authorized dealer, the tax liability is transferred to the authorized dealer, who self-invoices accordingly.

DISPOSITION OF SHARES IN A REAL ESTATE COMPANY

Shares in an Israeli company are considered to be an Israeli asset, and therefore the sale of shares of an Israeli company is a taxable event. A non-Israeli resident who derives capital gains from the sale of shares in a Real Estate Company will be liable for tax under the Land Appreciation Tax Law. As noted above, most double tax treaties allocate the principal right to impose tax on income generated by real estate to the country in which the real estate is located. Therefore the sale of shares in a Real Estate Company will be taxed in Israel.

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[3] To simplify, this calculation assumes 2001 is treated in full as taxable at 20%, and not divided on a days-over-days basis.

In addition, even if the shares of the company being sold do not represent shares in a Real Estate Company, but most of the assets held by the company are, directly or indirectly, real estate rights or rights in a Real Estate Company in Israel, the sale may be liable to tax in Israel, to the extent no double tax treaty is available or if the relevant double tax treaty treats such shares as a real estate asset. In such cases the Ordinance will apply ordinary capital gains treatment to the sale of the shares.

The real estate tax is calculated based on the same principles as capital gains tax. The Land Appreciation Tax Law and the Ordinance distinguish between "real capital gain" and "inflationary surplus." Inflationary surplus generated after December 1994 will be exempt from tax. The real capital gain will generally be subject to tax at the corporate tax rate, currently 23%, if the seller is a corporation, and at the following rates if the seller is an individual.

Holding Periods	Tax Rate
April 1961 to November 7, 2001	The highest applicable marginal tax brackets (highest is 50%).[4]
November 7, 2001 to December 31, 2011	20% or 25% for Significat Shareholder[5]
January 1, 2012 onwards	25% or 30% for Significant Shareholder

Land Betterment Levy

No betterment levy applies to the disposition of shares in a Real Estate Company.

Value Added Tax

The sale of shares in a Real Estate Company is subject to V.A.T. at the standard rate (currently 17%) if the seller is an authorized dealer. If the seller is a private Individual, V.A.T. may apply if the shares are sold by an individual to an authorized dealer. In such cases, the tax liability is transferred to the authorized dealer, who self-invoices accordingly.

CONCLUSION

The way real estate investment income and gains are taxed in Israel depends on a blend of factors, including the status of the owner of the property (individual or corporation), the nature of the asset (residential property, commercial property, land), the date of purchase, the purpose of investment (producing rental income or entrepreneurial profit) and the tax rates that have applied over time. Navigating the rules is not for the misinformed.

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4 Shares which were purchased prior to March 1964 will be taxed at a flat rate of 25%.

5 A shareholder who holds, directly or indirectly, alone or together with a relative, at least 10% of one of the means of control in the company (*i.e.*, shareholdings, the right to appoint a board member, voting rights or the right to receive company assets upon dissolution of the company).

U.K. MANDATORY DISCLOSURE REGIME (DAC6)

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Hallmark
Intermediary
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BACKGROUND

The E.U. Council Directive 2018/822 ("DAC6") provides for the mandatory disclosure by intermediaries, or individual or corporate taxpayers, to H.M.R.C. of certain cross-border arrangements and structures that could be used to avoid or evade tax and the mandatory automatic exchange of this information among E.U. Member States. A cross-border arrangement is reportable if it meets one or more hallmarks.

From January 2013, the E.U. introduced the Directive of Administrative Co-operation and, over time, Directive of Administrative Co-operation has evolved to include the automatic reporting of various matters. It now includes directors' fees, employment income, insurance premiums, pension income and income from and ownership of immovable property.

Member States are required to have implemented DAC6 into national law by December 31, 2019 and to apply the provisions by July 1, 2020. Reportable cross-border arrangements, where the first step is undertaken between June 25, 2018, and July 1, 2020, will need to be reported by August 31, 2020. The timetable has been affected by the COVID-19 virus, as discussed below.

WHO IS AN INTERMEDIARY?

An intermediary is any person that designs, markets, organizes or makes available for implementation or manages the implementation of a reportable cross-border arrangement. An intermediary can be an individual, a company or a trustee.

The definition of an intermediary envisages two types of intermediaries: "promoters" and "service providers." Promoters are those who design and implement the arrangements, while service providers are those that provide assistance or advice in relation to the arrangements. The reporting obligation is fundamentally the same, but there is a knowledge-based defense available to service providers, which means that they do not have an obligation to report when the defense is applicable. No equivalent defense exists for promoters.

An intermediary is a person that meets one of the following conditions:

- It is resident in the U.K. for purposes of U.K. tax.
- It has a permanent establishment in the U.K., through which it provides services in respect of the arrangement.
- It is incorporated in the U.K., or governed by the laws of the U.K.

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- It is registered with a professional association relating to legal, taxation, or consultancy services in the U.K.

Where information relating to a reportable arrangement is covered by legal professional privilege, the legal counsel is not required to report that information to H.M.R.C. Where legal counsel chooses not to disclose information because of a legal privilege enjoyed by the client, an obligation is imposed to inform other intermediaries or relevant taxpayers of their own reporting obligations, as the reporting obligation passes to other intermediaries or or the relevant taxpayer.

"An arrangement will be reportable if it meets at least one of a number of hallmarks."

WHAT IS A CROSS-BORDER ARRANGEMENT?

An arrangement is considered to be a cross-border arrangement where (i) more than one E.U. Member State are involved or a Member State and a third country are involved and (ii) at least one of the following conditions are met:

- Not all participants in the arrangement are tax resident in the same jurisdiction.
- One or more participants in the arrangement are simultaneously resident for tax purposes in more than one jurisdiction.
- A permanent establishment linked to a participant is established in a different jurisdiction and the arrangement forms part of the business of the permanent establishment.
- At least one of the participants in the arrangement carries on business activities in another jurisdiction without being resident for tax purposes or creating a permanent establishment situation in that jurisdiction.
- The arrangement has a possible impact on the automatic exchange of information or the identification of beneficial ownership.

WHAT IS A REPORTABLE ARRANGEMENT?

An arrangement will be reportable if it meets at least one of several hallmarks. For several of the hallmarks, an arrangement will only be reportable if a main benefit test is met regarding the hallmark. Under the main benefits test, obtaining a tax advantage must be one of the main objectives of the arrangement, having regard to all relevant facts and circumstances.

A brief summary of the five hallmark categories is set out below.

Category A

- **Confidentiality** – Arrangements where the participant or taxpayer enters into a confidentiality agreement that prevents disclosure to other intermediaries or tax authorities of information describing how the arrangement could result in a tax advantage. This hallmark is subject to main benefit test.
- **Premium Fee Arrangements** – Arrangements where the intermediary fee is based on the tax saved or a similar advantage gained. This hallmark is subject to main benefit test.

- **Standardized Documentation** – Arrangements involving standardized documentation without substantial customization. This hallmark is subject to main benefit test.

Category B

- **Loss Buying** – Arrangements involving buying a loss-making company to reduce the tax liability. This hallmark is subject to main benefit test.
- **Conversion of Income to Capital** – Arrangements which have the effect of converting income into capital gains or another type of income that is taxable at lower rates. This hallmark is subject to main benefit test.
- **Circular Transactions** - Arrangements involving circular transactions with little or no commercial function. This hallmark is subject to main benefit test.

Category C

- Arrangements involving deductible cross border transactions between associated enterprises where any of the following facts exist:
  - The recipient has no tax residence. Here, the hallmark is not subject to main benefit test.
  - The country of tax residence has a zero or close to zero corporation tax rate. The hallmark is subject to main benefit test.
  - The country is included in the O.E.C.D. list as being a non-cooperative jurisdiction. The hallmark is not subject to main benefit test.
  - The payment is exempt from tax in the hands of the recipient in the jurisdiction of receipt. The hallmark is subject to main benefit test.
  - The payment benefits from a preferential tax regime in the jurisdiction of receipt. The hallmark is subject to main benefit test.
- Arrangements involving deductions in more than one jurisdiction. The hallmark is not subject to main benefit test.
- Arrangements involving the claiming of relief from double taxation on the same item in more than one jurisdiction. The hallmark is not subject to main benefit test.
- Arrangements involving the transfer of assets where there is a material difference in the amount treated as payable in consideration for the assets in the jurisdictions involved. The hallmark is not subject to main benefit test.

Category D

- Arrangements which have the effect of undermining the rules on beneficial ownership or any other equivalent agreement on automatic exchange of financial account information or arrangements structured to take advantage of the absence of such automatic exchanges of information. The hallmark is not subject to main benefit test.

- Arrangements involving a nontransparent legal or beneficial ownership chain with the use of persons, legal arrangements or structures that
  - do not carry on a substantive economic activity supported by adequate staff, equipment, assets and premises; and
  - are incorporated, managed, resident, controlled or established in any jurisdiction other than the jurisdiction of residence of one or more of the beneficial owners of the assets held by such persons, legal arrangements or structures.

  This hallmark is not subject to main benefit test.

Category E

- Arrangements concerning transfer pricing, including the use of unilateral safe harbors in one of the jurisdictoins, or the transfer of hard-to-value intangible assets when no reliable comparable transactions exist and the projection of future cash flows or income are highly uncertain. This hallmark is not subject to main benefit test.

GRANDFATHERING OF HISTORICAL ARRANGEMENTS

Transactions which amount to cross border arrangements but which were already in place at June 25, 2018, are not subject to DAC6 reporting. However, if those transactions are adjusted after June 25, 2018, the adjustments will need to be reviewed to determine whether those subsequent arrangements are reportable in their own right.

MULTIPLE REPORTING

Where more than one intermediary participtes in an arranfurinshes proof of reporting by another intermediary. Where there is more than one relevant taxpayer, the Directive imposes the primary obligation onto the particular taxpayer who agreed to the arrangement and then on the one who manages the implementation.

PENALTIES

The penalty for failure to comply with DAC6 is up to £5,000. However, in a number of cases where the £5,000 penalty is inappropriately low, then the penalty can be an initial amount of £600 per day.

EFFECT OF COVID-19

As a result of the disruption to business for COVID-19, the E.U. Commission proposed a three month postponement of deadlines imposed by the Directive. The delay would be as follows:

- For transactions between July 1, 2020, and September 30, 2020, the preporting obligation would be deferred so that all reports are due by October 31, 2020.

- The start of the 30-day reporting obligation would first be effective on October 1, 2020, rather than July 1, 2020.
- The transitional period for reporting existing arrangements effected from June 25, 2018, to June 30, 2020, would be delayed unitl November 30, 2020.
- The date for initial data exchanges now scheduled to begin on October 31, 2020, would be deferred until January 31, 2021.

The new due dates for filings may be deferred by a further three months.

Because DAC6 has been enacted in the U.K., any delay in implementation will require legislation. To date, the Government has not announced any delays. However, H.M.R.C. has stated that where reasonable cause exists for failing to meet the original deadlines, no penalty will be charged. The general view is that COVID-19 disruption should qualify as a Reasonable Excuse. However, that expectation has not been confirmed by H.M.R.C.

HOW NOT TO BORROW A TREATY: *SMITH V. COMMR.*

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Tags
B.E.P.S. Action 6
Limitation on Benefits
Qualified Dividends
Smith v. Commr.
Treaty Shopping

BACKGROUND

On a fully distributed basis, profits of a corporation are taxed twice. First, profits are taxed at the corporate level.[1] They are taxed again as after-tax earnings & profits are paid out in the form of dividends. Double taxation applies whether the corporation distributing the dividend is a domestic corporation or a foreign corporation. To alleviate the problem, Code §1(h)(11) taxes "qualified dividend income" at the beneficial long-term capital gains rates of 20%. For a dividend from a domestic corporation, this results in overall Federal taxation of 36.8% on a fully distributed basis.[2] For earnings generated by a foreign corporation in a low-tax jurisdiction, this can be even more attractive if Code §1(h)(11) is applicable. If not applicable, the tax on dividends received from a foreign corporation can be quite high, as the top rate of tax on ordinary income is 37%. That rate also applies to income that is taxed under the all U.S. anti-deferral rules such as Subpart F, the Global Intangible Low-Taxed Income ("G.I.L.T.I."), and the Passive Foreign Investment Company ("P.F.I.C.") rules, all of which are beyond the scope of this article.

QUALIFIED FOREIGN CORPORATION

Code §1(h)(11)(C) provides qualified dividend income treatment to dividends received from a foreign corporation that is treated as a "qualified foreign corporation." A qualified foreign corporation ("Q.F.C.") is a foreign corporation that meets one of two tests:[3]

- The corporation is organized in a U.S. possession.
- The corporation is eligible for benefits of a comprehensive tax treaty with the U.S. that contains an exchange of information provision, and which the I.R.S. determines is satisfactory for these purposes.

A foreign corporation cannot be a Q.F.C. if it is, or was during the preceding taxable year, a P.F.I.C., unless the P.F.I.C. status is ignored because the corporation is also a controlled foreign corporation ("C.F.C.").

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1 Current U.S. Federal corporate tax rate is 21%.

2 Does not take into account 3.8% Net Investment Income Tax. Compare with the current maximum individual Federal income tax rate of 37%.

3 A separate rule provides that dividend from a foreign corporation which is not treated as a Q.F.C. will equally benefit from the reduced rate of taxation if the shares of stock are regularly tradable on an established securities market in the U.S.

I.R.S. Notice 2011-64[4] provides a list of treaties that satisfy the exchange of information requirement, and provides that a foreign corporation is considered eligible for benefits of a U.S. income tax treaty listed in the notice if

- the foreign corporation is a resident of the treaty country, within the meaning of such term under the relevant treaty, and
- the foreign corporation satisfies any other requirements of that treaty, including the requirements under any applicable limitation on benefits ("L.O.B.") provision.

The determination of a foreign entity's status as a foreign corporation for purposes of Code §1(h)(11)(C) is made under U.S. rules.[5] Thus, a foreign entity that would be treated as a partnership under U.S. rules but that made an entity classification election to be taxed as a corporation under the rules of Treas. Reg. §301.7701-3 is treated as a foreign corporation for these purposes.[6]

TREATY RESIDENCE AND ELIGIBILTY FOR TREATY BENEFITS

The determination of whether a foreign corporation is a resident of the foreign country within the meaning of the treaty with such country is made under foreign law without regard to U.S. classification.[7] The determination of whether a foreign corporation meets the limitation on benefits provision of a treaty for purposes of Code §1(h)(11)(C) is made under the same standard that is applied for allowing treaty benefits to reduce withholding tax on U.S. source income under Code §894. In other words, a foreign corporation would be Q.F.C. only if it is treated as a taxable entity in its country of residence and is eligible for treaty benefits under the applicable L.O.B. provision.

L.O.B. provisions in U.S. income tax treaties generally provide foreign corporations with qualifying status based on meeting one of several alternative tests:

- The company issued shares that are publicly traded or is owned by a company that issued publicly traded shares.[8]
- The company meets an ownership and base erosion test.[9]

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[4] Notice 2011-64, 2011-37 IRB 231, 08/18/2011.

[5] P.L.R. 200752029 published 12/28/2007.

[6] *Id.*, where the I.R.S. concluded that a Fund that was an unincorporated, open-ended, limited purpose trust established under the laws of a foreign jurisdiction is treated as a foreign corporation for purposes of Code §1(h)(11)(C) because it was an "eligible entity" that made a proper entity classification election to be treated as an association for U.S. tax purposes.

[7] *Id.*, where the I.R.S. ruled that the residence and limitation on benefits articles of the Treaty are applied to the Fund, a Country A entity, without regard to the Fund's entity classification for U.S. tax purposes.

[8] 2016 U.S. Model Treaty, Article 22(2)(c) and (d).

[9] 2016 U.S. Model Treaty, Article 22(2)(f).

- The company conducts an active business in the country of residence.[10]
- The company meets a derivative benefits test.[11]

The L.O.B. provision in the income tax treaty between Cyprus and the U.S. (the "Cyprus Treaty") differs from its counterparts in most other treaties. The L.O.B. Article of the Cyprus Treaty provides for two alternative tests, of which one must be met for a Cypriot company to be eligible for treaty benefits.[12] Under the first, more than 75% of the number of shares of each class of the corporation's shares must be owned, directly or indirectly, by one or more individual residents of Cyprus and certain base erosion tests must be met at the same time.[13] Under the second test, the establishment, acquisition and maintenance of the corporation and the conduct of its operations do not have as a principal purpose obtaining benefits under the Cyprus Treaty.[14]

In an I.R.S. legal memorandum ("I.L.M.") issued in 2013, the I.R.S. determined that a Cypriot company was a Q.F.C.[15] In the facts of the 2013 I.L.M., the Cypriot company was a holding company that never earned U.S. source income or claimed treaty benefits under the Cyprus Treaty. The I.R.S. did not challenge the status of the company as a resident. Rather, it focused on the principal purpose test in the L.O.B. of the Cyprus Treaty. The I.R.S. concluded that the company was a Q.F.C. because it was not set up for the purpose of obtaining tax treaty benefits. In support of that conclusion, the I.R.S. looked to the Treasury Department Technical Explanation ("T.E.") for the L.O.B. provision in the Cyprus Treaty and concluded that the company was established in Cyprus, and was being maintained there, for reasons unrelated to the Treaty. Hence, obtaining benefits under the Treaty was not a principal purpose of its formation and existence. Consequently, it was eligible for benefits under the L.O.B. provision of the Cyprus Treaty. A similar conclusion was reached in a C.C.A. issued shortly after the I.L.M.[16] Again, the I.R.S. did not address the residence issue, only the principal purpose issue.

SMITH V. COMMR.

Notwithstanding the I.L.M. and the C.C.A., the I.R.S. challenged a taxpayer's assertion that a Cypriot company was Q.F.C. because the company was considered to be a resident of Cyprus under Cypriot tax law and the principal purpose test was met. In *Smith v. Commr.*,[17] the Court ruled that the residency certificate issued by the Cyprus Ministry of Finance was not sufficient to establish residence and that the facts and circumstances did not support the taxpayer's assertion of residence. Having determined that the Cypriot company was not a resident of Cyprus, the Court did not address the application of the L.O.B. test.

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10 2016 U.S. Model Treaty, Article 22(3).

11 2016 U.S. Model Treaty, Article 22(4).

12 Income Tax Treaty between the U.S. and Cyprus, Article 26.

13 Article 26(1) of the U.S. – Cyprus Treaty.

14 Article 26(2) of the U.S. – Cyprus Treaty.

15 I.R.S. Legal Memorandum Number 201343019 dated 09/10/2013.

16 Chief Counsel Advice 201343019, 11/01/2013.

17 *Smith v. Commr.*, 151 T.C. 41, 09/18/2018.

In the facts of the case, a U.S. married couple owned and operated a group of domestic and foreign corporations that manufactured and sold consumer electronic products. Through grantor trusts and an S-corporation ("Hopper U.S."), they owned the issued and outstanding shares of stock of a corporation in Hong Kong ("Memcorp H.K."). Memcorp H.K. was an operating company from its inception in 1995. In 2007, the taxpayers began winding down their active business operations, and sold the operating assets of Hopper U.S. and Memcorp H.K. to a third party for $47.5 million. The U.S. and Hong Kong have no income tax treaty in effect. Consequently, the taxpayers adopted a plan in 2008 to move Memcorp H.K. to Cyprus. Upon completion of that step, a newly formed Cypriot company held all the assets and liabilities of Memcorp H.K. and a dividend was paid to its shareholders in the U.S. The dividend was paid in 2009, shortly after a residency certificate was issued by the Cypriot tax authority, although it is not clear from the pleadings that the certificate was actually issued at that time or seven years later. The shareholders were U.S. citizens and they reported the dividend on the tax return as a qualified dividend.

The I.R.S. examined the tax return for 2009 and challenged the taxpayer's treatment of the dividend as a qualified dividend. The Tax Court agreed. The Court explained that for Cyprus company to be a Q.F.C. two tests must be met. First, it must have been a resident of Cyprus under the Cyprus Treaty at the time the dividend was distributed to the taxpayer. Second, its establishment and operation must not have had, "as a principal purpose," the obtaining of benefits under the Cyprus Treaty.

For purpose of the residency test, the taxpayers obtained a certificate of residency from Cyprus and argued that this certificate, should be viewed as binding under the act of state doctrine. The I.R.S. challenged residency status. To that end, it initiated exchange of information proceedings with the Cypriot tax authority to learn the facts surrounding the issuance of the certificate of residency. The information received from the Cypriot tax authority indicated that the certificate was issued five days after the application was filed. It consisted of a series of unsubstantiated representations by the company's director, who checked "yes" boxes on the application form. There was no evidence that the Cypriot tax authority verified any of the applicant's factual representations.

In the circumstances, the Court agreed that a residency certificate is relevant, and to the extent it is based on sound reasoning and accurate factual representations, it will be accorded appropriate weight. In view of all facts and inferences presented by the I.R.S., not much weight was given to the certificate. Its ultimate conclusion was that the Cypriot company was not a resident of Cyprus for purposes of the Cyprus Treaty because, under local law, this requires management and control to be exercised in Cyprus, and this company did not provide any evidence of having any connections with Cyprus. Because the first requirement for Q.F.C. status was not met, the Tax Court did not address the principal purpose test.

B.E.P.S.? AND SUMMARY

Several questions are raised by the *Smith v. Commr.* How does borrowing a U.S. treaty sit with B.E.P.S.? Is it simply a holding that is proper for its time? Does *Smith v. Commr.* represent a changing point in the I.R.S. position with respect to borrowing a treaty for purposes of the qualified dividend provision?

Action 6 of the O.E.C.D. B.E.P.S. Action Plan published in 2013 has been widely implemented in Europe. Action 6 deals with prevention of treaty shopping and the granting of treaty benefits in inappropriate circumstances. It introduced the principal purpose test ("P.P.T.") as an add-on to the L.O.B. provisions that were not included in most income tax treaties then in effect. The P.P.T. prevents treaty benefits from applying if one of the principal purposes of any arrangement is obtaining benefits under a treaty. The U.S. generally meets the Action 6 standards as U.S. treaties include an L.O.B. provision, which was used as a model when B.E.P.S. policies were formulated. The U.S. has not otherwise adopted Action 6 and has not imposed a separate P.P.T. rule. Additionally, as mentioned above, in the absence of claiming treaty benefits, borrowing a treaty for purposes of qualified dividend income should not be viewed as treaty shopping and thus does not contradict B.E.P.S. as a matter of law.

In addition, while *Smith* represents a case where qualified dividend treatment was not granted, the facts involved were blatantly bad. The Cypriot company was incorporated until the business operations in Hong Kong ceased and the assets were sold. The company never filed Cypriot tax returns until it applied for the certificate of residency seven years after incorporation after it sought confirmation that it was a resident of Cyprus in 2016. At some point between 2009 and 2016, it was stricken from the Cypriot registry of companies for failure to file tax returns and submit annual reports to the Cypriot Registrar of Companies.

Even in this fact pattern, the I.R.S. never argued that the borrowing of a treaty for purposes of Code §1(h)(11) was a tainted purpose which fails the "principal purpose" test. The Court decided that a residency certificate is not granted a dispositive effect as an "act of state." No other credible evidence was introduced to substantiate the status of the company as a resident of Cyprus under Cypriot law, which requires showing that the management and control of the company were exercised in Cyprus. Consequently, it agreed with the I.R.S. that the company was not a Q.F.C.

"Following Smith, one can expect an I.R.S. examination to demand more than a residency certificate as a proof of residence in a treaty country for purposes of obtaining benefits under Code §1(h)(11)(C)."

Following *Smith*, one can expect an I.R.S. examination to demand more than a residency certificate as a proof of residence in a treaty country for purposes of obtaining benefits under Code §1(h)(11)(C). Also, one can expect the I.R.S. to engage in consultation and information exchanges between the U.S. competent authority and the competent authority of the treaty country to learn the facts surrounding a request for, and the country's issuance of, certificates of residency in that country. However, *Smith* should not be read more broadly. Interestingly, in a post-B.E.P.S. world, Cypriot corporate and professional advisers are acutely aware that more than a piece of paper from a tax office will suffice for a company to be treated as a resident for income tax purposes. Indeed, it is not likely that reputable Cypriot advisers or the Cypriot tax authority would allow the facts in the case to exist today.

HEADS I WIN, TAILS YOU (I.R.S.) LOSE – NOT ANYMORE: HYBRID DIVIDENDS AND CODE §245A(e)

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Tags
Anti-tax Avoidance
Code §245A
Code §245A(e)
Deduction - No Inclusion
Dividend Received Deduction
Double Dipping
Hybrid Dividends
Tiered Hybrid Dividends

INTRODUCTION[1]

Imagine a straight line. Now assume that it represents a timeline – a timeline that divides the tax world into the pre and post T.C.J.A. era. You know the magic date, December 31, 2017.

Now imagine a pizza cut into three large slices. Assume that the pizza represents the earnings and profits of a Controlled Foreign Corporation ("C.F.C.") since inception. The C.F.C. is wholly owned by a U.S. corporation. It conducts an active business and also has income from passive investments. Using the pizza analogy, the U.S. Shareholder of the C.F.C. is subject to the following taxes on undistributed income, each representing one of the three slices of the pizza:

- The Transition Tax[2] on the accumulated untaxed earnings and profits of the C.F.C. prior to January 1, 2018 (Pie 1),
- The Subpart F regime[3] on the foreign earnings and profits post December 31, 2017, attributable to the passive income (Pie 2),[4] and
- The G.I.L.T.I. Tax[5] on the earnings and profits attributable to the income generated from the active business income (Pie 3).

Each tax sucks up one of the three slices of the pizza. Holistically speaking, if a C.F.C. is subject to all three taxes, then, what is left on the table is an empty plate. In other words, after the T.C.J.A., it may be said that all or almost all of the earnings and profits of a C.F.C. are subject to U.S. tax even before they are actually distributed.

1 See also the sixth article in this edition of *Insights* by Andreas A. Apostolides and Stanley C. Ruchelman, titled "Anti-Abuse Rules of Temp. Reg. §1.245A-5T – A New Cerberus For the U.S. Tax System," addressing the general mechanics of Code §245A and the new D.R.D., including the Temporary Regulations with their anti-abuse focus.

2 The Transition Tax is a tax on the U.S. Shareholders of a C.F.C. on the untaxed foreign earnings as it stood on December 31, 2017 or November 3, 2017, if elected, as if those earnings had been repatriated to the U.S.

3 Generally speaking, Subpart F Income is the tainted income of a C.F.C. which is taxed to U.S. Shareholders on current basis regardless of any actual distributions by the C.F.C.

4 If you are lucky, you may be eligible to the few exceptions available in the Code, such as, the high foreign tax exception to Subpart F income.

5 Broadly speaking, the G.I.L.T.I. Tax is a tax imposed on U.S. Shareholders on their share of a C.F.C.'s income generated from activity outide the U.S. that is not otherwise taxed in the U.S. at the level of a U.S. Shareholder under Subpart F or to the C.F.C. as effectively connected income. The tax is imposed regardless of any actual distributions by the C.F.C.

A subsequent distribution of the previously taxed income (P.T.I.) is received tax free in the hands of a U.S. Shareholder of the C.F.C.[6] In this scenario, the question to be answered is whether Code §245A reflects an important tool for multinationals or, using the pizza analogy, is simply the leftover crumbs once other provisions adopted in the T.C.J.A. have been applied?

CODE §245A(a)

Code §245A, introduced by the T.C.J.A., offers a 100% dividends received deduction ("D.R.D.") for the foreign sourced dividends received by a U.S. corporation which owns at least 10% of the voting rights or value of the stock of a foreign corporation. By making the deduction applicable to a foreign corporation, it extends the benefit to dividends from a C.F.C. However, a careful tax adviser must ask whether any benefit is actually provided when earnings and profits are already subject to U.S. tax in one form or another (*i.e.*, the Transition Tax, Subpart F, and the G.I.L.T.I. Tax) and a subsequent distribution of P.T.I. is received tax-free in the hands of a U.S. Shareholder under Code §959? The answer lies in the P.T.I. ordering rules under Code §959(c).

INTERACTION OF CODE §245A WITH CODE §959

Code §959(c) treats a distribution from a C.F.C. as first being attributable to earnings and profits not in excess of the investments in U.S. property, then attributable to Subpart F income (including the income subject to the G.I.L.T.I. Tax), and then attributable to taxable earnings and profits of the C.F.C. ("non-P.T.E.P."). The first two types of earnings and profits are excluded from U.S. tax when distributed[7] and are not treated as a dividend, other than to reduce earnings and profits.[8] In other words, distributions from a C.F.C. to its U.S. Shareholder out of P.T.E.P. are not eligible for the Code §245A(a) D.R.D. since they already are received tax-free. As a result, Code §245A does not apply to the distributions attributable to P.T.E.P.

However, Code §959(a) does not exclude from income a distribution that is made from non-P.T.E.P. The non-P.T.E.P. is treated as dividends to the extent provided under Code §316.[9] In the absence of Code §245A(a), the distributions treated as dividends under Code §316 will be subject to U.S. Federal income tax in the hands of a U.S. Shareholder. However, Code §245A(a) provides that such dividends are no longer subject to U.S. tax in the hands of a domestic corporation that meets the definition of a U.S. Shareholder under Code §951(b). Therefore, the Code §245A D.R.D. in the context of a C.F.C. applies only when the distribution is made from non-P.T.E.P.

Example

F Co was organized under the laws of Country F on Jan 1, 2018. A U.S. corporation, US Co., is the sole shareholder of F Co. F Co is engaged in an active trade or business in Country F. It also has made investments in other companies that periodically generate dividend

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6 Code §959 and §951A(f)(1).

7 Code §959(a).

8 Code §959(d).

9 Treas. Reg. §1.959-3(b).

income. In addition to the stock, F Co. issued an instrument to US Co that is treated as debt under the laws of both countries. F Co paid interest of $20 on the debt to US Co. The interest is subject to withholding tax in Country F. US Co pays U.S. tax on the interest income of $20 after claiming a credit of the foreign taxes. At year end, F Co has active income of $400, dividend income of 100, and cash of $800.For 2018, US Co will have a Subpart F inclusion of $100. It will also be liable to pay the G.I.L.T.I. Tax on $400 representing the active trade or business income of F Co. Accordingly, P.T.E.P. of F Co amounts to $500.

In Year 2019, assume F Co., didn't earn any income but made a distribution of $700. Under the ordering rules of Code §959(c), the distribution will be treated as first coming from P.T.E.P. attributable to Subpart F and G.I.L.T.I. Therefore, US Co will receive the first $500 tax-free under Code §959(a). The balance of $200 is treated as dividend income under Code §316 (assuming there is sufficient earnings and profit). Since the recipient is a domestic corporation which meets the definition of a U.S. Shareholder, Code §245A(a) will apply and therefore, the dividend income of $200 will be received tax-free in the U.S.

"Owing to the current U.S. tax regime of C.F.C.s, it is difficult to anticipate circumstances when a C.F.C. may have non P.T.E.P. "

Owing to the current U.S. tax regime of C.F.C.'s, there are relatively few circumstances when a C.F.C. may have non P.T.E.P. Some situations that come to mind include the following situations:

- A U.S. Shareholder claims a high tax exception to Subpart F income.
- A U.S. Shareholder owns more than one C.F.C. engaged in an active trade or business and one incurs losses that exceed the profits of all other C.F.C.'s. Because the G.I.L.T.I. Tax is imposed on an aggregate basis on a shareholder level, no amount is subject to the G.I.L.T.I. Tax. Any subsequent distribution of the profits of C.F.C. 2 will be non-P.T.E.P., and therefore, the benefit of Code section 245A(a) might be available.
- If a U.S. Shareholder is subject to the G.I.L.T.I. Tax, the Code §245A(a) D.R.D. should be available to an amount equal to the return on investment which is excluded for the G.I.L.T.I. Tax computation purposes.

HEADS I WIN, TAILS YOU LOSE – HYBRID DIVIDENDS UNDER CODE §245A(e)

A cross-border transaction may be treated differently for U.S. and foreign tax purposes because of differences in the tax law of each country. Barring a few exceptions, the U.S. tax treatment of a transaction does not take into account foreign tax law. For instance, think of an instrument that is treated as debt under the laws of a foreign country but is treated as equity under U.S. tax law.

Example 2

Assume in Example 1, the instrument issued by F Co is a hybrid instrument, *i.e.*, it is treated as a debt under the laws of Country F but is treated as equity under U.S. tax law. In other words, F Co will be

> eligible to claim a deduction of $20 because it is treated as interest under the laws of Country F and US Co will be eligible to the 245A D.R.D. if the application of Code §245A(a) goes unchecked. By allowing so, both, US Co and F Co receive an economic benefit by reason of a deduction for the payer and no income for the recipient.

HEADS I WIN, TAILS YOU LOSE – NOT ANY MORE

The Code §245A(e)-1 final regulations issued by the Treasury on April 8, 2020, aim at eliminating the double tax benefit otherwise available for dividends involving hybrid arrangements. The final regulations neutralize the double nontaxation effect of these dividends by either denying the Code §245A(a) D.R.D. to the U.S. corporate shareholder or requiring an inclusion under Code §951(a) with respect to the dividend where the recipient is a C.F.C. The treatment depends on whether the dividend is a hybrid dividend or a tiered hybrid dividend.

What is a Hybrid Dividend?

In general, a dividend received by a domestic corporation from a C.F.C. is a hybrid dividend if it satisfies the following two conditions:[10]

- The dividend is one for which the C.F.C. (or a related person) is or was allowed a deduction ("Hybrid Deduction") or other tax benefit under a relevant foreign tax law.
- But for Code §245A(e), the dividend would qualify for the Code §245A(a) D.R.D.

> **Example 3**
>
> Under Example 2, the distribution of $20 meets the definition of a Hybrid Dividend. This is because, F Co received a tax deduction of $20 and in the absence of any other contrary provision, US Co will be entitled to claim the Code §245A D.R.D. As a result, Code §245A(e) will apply, thereby, disallowing the deduction.

What is a tiered hybrid dividend?

A tiered hybrid dividend means an amount received by a C.F.C. from another C.F.C. to the extent that the amount would be a Hybrid Dividend if the receiving C.F.C. were a domestic corporation.[11] In other words, whether a dividend is a tiered hybrid dividend is determined without regard to how the amount is treated under the tax law of the country in which the upper-tier C.F.C. is a tax resident. Unless mentioned otherwise, the rules applicable to a hybrid dividend are also applicable to a tiered hybrid dividend.

What is the tax treatment of a hybrid dividend in the hands of a U.S. Shareholder of a C.F.C. for U.S. Federal income tax purposes?

A domestic corporation that is a U.S. Shareholder of a C.F.C. and receives a hybrid dividend from the C.F.C. is ineligible to claim the Code §245A(a) D.R.D. The hybrid

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[10] Code §245A(d); Treas. Reg. §1.245A(e)-1(b) and (d).

[11] Treas. Reg. §1.245A(e)-1(c)(2).

dividends are subject to tax in the U.S. at 21%. Further, the U.S. Shareholder is not entitled to claim a credit or a deduction for the foreign taxes paid, deemed paid, or withheld by the C.FC. or on its behalf.[12]

What is the tax treatment of a tiered hybrid dividend in the hands of a U.S. Shareholder for U.S. Federal income tax purposes?

If a C.F.C. receives a tiered hybrid dividend from another C.F.C. and a domestic corporation is a U.S. Shareholder with respect to both C.F.C.'s, the dividend is treated as Subpart F income of the receiving C.F.C. for the taxable year in which it is received. The U.S. Shareholder of the receiving C.F.C. is required to include in its taxable income the *pro rata* share of the Subpart F income of the receiving C.F.C. and pay tax at 21% in the U.S.[13] Further, the U.S. Shareholder is not entitled to claim a credit (or a deduction) for the foreign taxes paid, deemed paid, or withheld by or on behalf of the C.F.C.[14] This treatment applies notwithstanding any other provision of the Code.[15] Thus, exceptions to Subpart F income such as those provided under Code §954(c)(3) (same country exception for income received from related persons) and Code §954(c)(6) (look-through rule for related C.F.C.s) do not apply.

Example 4

Domestic Corporation, DC, owns 100% of the stock of C.F.C.1, a resident of country X. C.F.C.1 owns 100% of the stock, including preferred instruments, of C.F.C.2, a resident of country Y. Although treated as equity under U.S. tax law and under the law of country X, the preferred instruments are treated as debt under the laws of country Y. C.F.C.2 pays C.F.C.1 $10 under the terms of the preferred instruments, for which it receives a tax deduction in Country Y. The payment is a tiered hybrid dividend, and is treated as Subpart F income of C.F.C.1 for the tax year in which it is received. DC must include its *pro rata* share in its gross income, but is not entitled to a foreign tax credit or deduction for any taxes paid by C.F.C.1 to country X.

The tiered hybrid dividend rule applies only to a domestic corporation that is a U.S. Shareholder of both the upper-tier C.F.C. and the lower-tier C.F.C. Clearly, a U.S. individual is not entitled to the Code §245A D.R.D., and that treatment is passed down to a tiered hybrid group. Thus, for example, if a domestic corporation and a U.S. individual equally own all of the stock of an upper-tier C.F.C., and the upper-tier C.F.C. receives a tiered hybrid dividend from a wholly-owned lower-tier C.F.C., the tiered hybrid dividend rule does not cause a Subpart F inclusion to the individual U.S. Shareholder. As a result, the individual who is a U.S. Shareholder in the foregoing fact pattern may take advantage of exceptions to Foreign Personal Holding Company Income, such as the same country exception.

[12] Treas. Reg. §1.245A(e)-1(b)(1)(ii) and (c)(1)(iii).

[13] Treas. Reg. §1.245A(e)-1(c)(1)(i)-(ii).

[14] Treas. Reg. §1.245A(e)-1(c)(1)(iii).

[15] Treas. Reg. §1.245A(e)-1(c)(1).

What is the tax treatment of the gains arising from the sale of the stock of a lower tier C.F.C. by an upper-tier C.F.C. which are characterized as dividends under Code §1248(a) read with Code §964(e)?

Under Code §964(e)(1), gain recognized by a C.F.C. on the sale or exchange of stock in another foreign corporation may be treated as a dividend.[16] If certain conditions are satisfied, the dividend is treated as Subpart F income of the selling C.F.C. and the U.S. Shareholder of the selling C.F.C. is required to include in its gross income its *pro rata* share of the Subpart F income. However, at the same time, the U.S. Shareholder is allowed the Code §245A(a) D.R.D. with respect to the Subpart F income. In other words, the dividend portion of the gain is not subject to tax in the U.S. in the hands of the U.S. Shareholder.

However, the final regulations coordinate the tiered hybrid dividend rules and the rules of §964(e) by providing that, to the extent a dividend arising under Code §964(e)(1) is a tiered hybrid dividend, the tiered hybrid dividend rules, rather than the rules of Code §964(e)(4), apply. Thus, in such a case, a U.S. Shareholder that includes an amount in its gross income under the tiered hybrid dividend rule is not allowed the Code §245A(a) D.R.D., or foreign tax credits or deductions, for the amount.[17]

What is a hybrid dividend account?

A U.S. Shareholder that holds a share of a C.F.C. is required to maintain a hybrid dividend account (the "H.D.A.") with respect to the share. The H.D.A. reflects the amount of hybrid deductions of the C.F.C. allocated to the share.[18] It is maintained in the functional currency of the C.F.C. Once an amount in a hybrid deduction account gives rise to a hybrid dividend or a tiered hybrid dividend, the account is correspondingly reduced.[19]

Are all shareholders who meet the definition of a U.S. Shareholder under Code §951(b) required to maintain an H.D.A.?

No. The Treasury recognized that in certain cases, Code §245A may not apply to a U.S. Shareholder and therefore it is not required to maintain an H.D.A. For example, if the only U.S. Shareholders of a C.F.C. are individuals, Code §245A doesn't apply. In another example, the upper-tier C.F.C. may be C.F.C. solely by reason of the repeal of the limitation on the downward attribution rule under Code §958(b)(4). Before the repeal, shares in Foreign Company A actually owned by Foreign Company B were not attributed to Foreign Company B's U.S. subsidiary. The repeal allows downward attribution of ownership from a foreign parent to a U.S. subsidiary. Consequently, Foreign Company A can be a C.F.C. if enough of its shares are attributed to the U.S. subsidiary of Foreign Company B. In this fact pattern, however, no abuse is viewed to exist. Even if a dividend received by the upper-tier C.F.C. from the lower-tier C.F.C. were a tiered hybrid dividend, there would be no meaningful U.S. tax

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[16] Under the provisions of Code §1248. Code §1248(a) characterizes a gain on a sale or exchange of a C.F.C. stock as a dividend to the extent of the earnings and profits of the C.F.C. attributable to that stock, but only to the extent the earnings and profits were accumulated while the seller held the stock and the corporation was a C.F.C.

[17] Treas. Reg. §1.245A(e)-1(c)(1) and (4).

[18] Treas. Reg. §1.245A(e)-1(d)(1).

[19] Treas. Reg. §1.245A(e)-1(d)(4)(i).

consequence because no U.S. Shareholder would have a Subpart F inclusion with respect to the upper-tier C.F.C.

To obviate the need for an H.D.A. in the above cases, an H.D.A. is required to be maintained only by the following two types of specified owners:[20]

- A U.S. corporation that is a U.S. Shareholder under Code §951(b).
- An upper-tier C.F.C. that is a specified owner of shares of stock of a lower-tier C.F.C. if, for Subpart F and G.I.L.T.I. purposes, a domestic corporation that is a U.S. Shareholder of the upper-tier CFC owns directly or indirectly within the meaning of Code §958(a) one or more shares of stock of the upper-tier C.F.C.

Is there a limit on the amount that is treated as a hybrid dividend?

A dividend received by a U.S. Shareholder from a C.F.C. is a hybrid dividend (or a tiered hybrid dividend) to the extent of the sum of the U.S. Shareholder's hybrid deduction account with respect to each share of stock of the C.F.C, even if the dividend is paid on a share that has not had any hybrid deduction allocated to it.[21] Absent such an approach, the purposes of §245A(e) might be avoided by, for example, structuring dividend payments such that they are made on shares of stock to which a hybrid deduction has not been allocated (rather than on shares of stock to which a hybrid deduction has been allocated, such as a share that is a hybrid instrument). Example 5 below explains the concept.

"A hybrid deduction means a deduction or other tax benefit (such as an exemption, exclusion, or credit, to the extent equivalent to a deduction) under a relevant foreign tax law with respect to an instrument issued by the C.F.C. which is treated as equity for U.S. tax purposes."

HYBRID DEDUCTION- THE HEART OF CODE §245A(e)

What is a Hybrid Deduction of a C.F.C.?

A hybrid deduction means a deduction or other tax benefit (such as an exemption, exclusion, or credit, to the extent equivalent to a deduction) under a relevant foreign tax law with respect to an instrument issued by the C.F.C. when the instrument is treated as equity for U.S. tax purposes. Examples of such a deduction or other tax benefit include an interest deduction, a dividends paid deduction, and a notional interest deduction (or similar deduction determined with respect to the C.F.C.'s equity).[22]

Does the deduction or tax benefit have to be used currently for it to be treated as a hybrid deduction?

No, the fact that the deduction or other tax benefit is not being used currently or does not currently reduce tax under the relevant foreign tax law is irrelevant.[23] For example, a current use of the deduction or tax benefit might not occur if the C.F.C. has other deductions or losses under the relevant foreign tax law, or all of a C.F.C.'s income is exempt income. An example is that the C.F.C. is a holding company and

[20] Treas. Reg. §1.245A(e)-1(f)(6).

[21] Treas. Reg. §1.245A(e)-1(b)(2) and (d).

[22] Treas. Reg. §1.245A(e)-1(d)(2)(i).

[23] Treas. Reg. §1.245A(e)-1(d)(2)(i)(A).

all of its income benefits from a 100% participation exemption. The Treasury Department is of the view that even though a deduction or other tax benefit may not be used currently, it could be used in another taxable period and thus could produce double nontaxation.[24]

__Will a deduction or tax benefit continue to be treated as a hybrid deduction even if the source country withholds income tax on interest payments?__

Yes, a deduction or tax benefit will continue to be treated as a hybrid deduction even if the source country withholds income tax on interest payments. The purpose of withholding taxes is not to address mismatches in tax outcomes, but rather to allow the source jurisdiction to retain its right to tax the payment.

__Is a deduction or tax benefit allowed to a related party of the C.F.C. included within the meaning of a hybrid deduction of the C.F.C.?__

Yes, a deduction allowed to a related party of the C.F.C. is included within the meaning of a hybrid deduction if the following conditions are satisfied:[25]

- The person is related to the C.F.C. under Code §954(d)(3).[26]
- The related person is allowed the deduction under a relevant foreign tax law which also applies to the C.F.C. (*i.e.*, the related person and the C.F.C. are tax residents of the same jurisdictions).[27]

This addresses situations in which the C.F.C. is a member of a foreign affiliated group that files a consolidated return in the name of the foreign parent or group relief benefits are otherwise provided under foreign law.

__Is an impairment loss deduction or an M.T.M. deduction (where the foreign law requires the investors to mark their investment to market price) allowed to a shareholder of the C.F.C. with respect to its stock a hybrid deduction of the C.F.C.?__

No. Those deductions do not relate to or result from an amount paid, accrued, or distributed with respect to an instrument issued by the C.F.C. and are not deductions allowed to the C.F.C. with respect to equity.

__Will an amount be treated as a deduction or tax benefit to the C.F.C. even if it is disallowed under a thin capitalization rule or a rule similar to Code §163(j) – that limits the deduction based on the taxable income?__

Yes, an amount will continue to be treated as a hybrid deduction of a C.F.C. even if it is disallowed under a thin capitalization rule or a rule similar to Code §163(j).[28] The Treasury is of the view that those rules suspend rather than disallow a deduction, and thus may not prevent eventual double nontaxation.

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[24] Treas. Reg. §1.245A(e)–1(d)(2).

[25] Treas. Red. §1.245A(e)–1(f)(4).

[26] Code §954(d)(3) - A person is related to the C.F.C. includes a shareholder that controls the C.F.C., any entity controlled by the C.F.C., and any entity that is controlled by the persons who control the C.F.C. Control is based on the ownership of more than 50% of the total voting rights or total value of an entity).

[27] Treas. Reg. §1.245A(e)–1(d)(2)(i) and (f)(5).

[28] Treas. Reg. §1.245A(e)-1(d)(2)(ii)(A).

Are the hybrid mismatch rules in a foreign country taken into account in determining whether a deduction or a tax benefit is a hybrid deduction of a C.F.C.?

No. Whether a deduction or other tax benefit is a hybrid deduction should be determined without regard to foreign hybrid mismatch rules and thus without regard to whether such rules disallow the deduction. Foreign tax law becomes relevant only for purposes of determining that the deduction or other tax benefit neither gives rise to a dividend for U.S. tax purposes nor, based on all the facts and circumstances, is reasonably expected to give rise to a dividend that will be paid within 12 months from the end of the taxable period for which the deduction or other tax benefit would be allowed but for the hybrid mismatch rules.[29]

As an example, assume that but for foreign hybrid mismatch rules, a C.F.C. would be allowed a deduction under the relevant foreign tax law for an amount paid or accrued pursuant to an instrument issued by the C.F.C. and treated as stock for U.S. tax purposes. If the deduction relates to (i) an actual payment that gives rise to a dividend for U.S. tax purposes or (ii) an accrual that is reasonably expected to give rise to a dividend for U.S. tax purposes that will be paid within 12 months after the taxable period for which the deduction would otherwise be allowed, the hybrid deduction rules under U.S. tax law apply regardless of whether the foreign hybrid mismatch rules may disallow a deduction for the amount. If, on the other hand, the amount would give rise to a dividend in a later period, the hybrid deduction rules under U.S. tax law do not apply to the extent that the foreign hybrid mismatch rules disallow a deduction for the amount.

What is a relevant foreign tax law?

With respect to a C.F.C., the term "relevant foreign tax" law means any regime of any foreign country or possession of the U.S. that imposes an income, war profits, or excess profits tax on the income of the C.F.C. (other than a foreign anti-deferral regime) under which a person that owns an interest in the C.F.C. is liable to tax.

If a foreign country has an income tax treaty with the U.S. that applies to taxes imposed by a political subdivision or other local authority of that country, then the tax law of the political subdivision or other local authority is deemed to be a tax law of a foreign country. Thus, the term includes any regime of a foreign country or possession of the U.S. that imposes income, war profits, or excess profits tax under which (i) the C.F.C. is liable to tax as a resident, (ii) the C.F.C. has a branch that gives rise to a taxable presence in the foreign country or possession of the U.S., or (iii) a person related to the C.F.C. is liable to tax as a resident. In such third instance, the relevent law is the law in the related party's jurisdiction when that party is a shareholder of the C.F.C. and the C.F.C. is fiscally transparent in computing the shareholder's net income.[30]

Example 5:[31] **Hybrid Deduction Account**

US Co holds all the shares of two classes of stock of F Co, a corporation organized under the laws of Country F. One class of shares is treated as indebtedness for Country F tax purposes ("Share A"), and

[29] Treas. Reg. §1.245A(e)-1(d)(2)(ii)(B).

[30] Treas. Reg. §1.245A(e)-1(f)(5).

[31] Based on Example 1 of Treas. Reg. §1.245A(e)-1(g)(1).

the other is treated as equity for Country F tax purposes ("Share B"). Both classes of shares are treated as equity for U.S. tax purposes. During Year 1, under Country F tax law, F Co accrues $80 of interest to US Co with respect to Share A and is allowed a deduction for the amount (the "Hybrid Instrument Deduction"). During year 2, F Co distributes $30 to US1 with respect to each of Share A and Share B. For U.S. tax purposes, each of the $30 distributions is treated as a dividend for which, without regard to Code §245A(e), US Co would be allowed a deduction under Code §245A(a). For Country F tax purposes, the $30 distribution with respect to Share A represents a payment of interest for which a deduction was already allowed for Year 1 (and thus F Co is not allowed an additional deduction for the amount), and the $30 distribution with respect to Share B is treated as a dividend (for which no deduction is allowed).

Analysis

- At the end of Year 1, US Co's Hybrid Deduction Accounts with respect to Share A and Share B are $80 and $0, respectively, calculated as follows.
  - The $80 Hybrid Instrument Deduction allowed to F Co under Country F tax law (a relevant foreign tax law) is a Hybrid Deduction of F Co , because the deduction is allowed to F Co and relates to or results from an amount accrued with respect to an instrument issued by F Co and treated as stock for U.S. tax purposes. Thus, F Co's Hybrid Deductions for Year 1 are $80.
  - At the end of Year 1, US Co's Hybrid Deduction Account with respect to Share A is increased by $80 (the amount of Hybrid Deductions allocated to Share A). Because F Co did not pay any dividends with respect to either Share A or Share B during Year 1, no further adjustments are made. Therefore, at the end of Year 1, US Co's Hybrid Deduction Accounts with respect to Share A and Share B are $80 and $0, respectively.
- The entire $30 of each dividend received by US Co from F Co during Year 2 is a Hybrid Dividend. This is because the sum of US Co's Hybrid Deduction Accounts with respect to each of its shares of F Co stock at the end of Year 2 ($80) is at least equal to the amount of the dividends ($60). This is the case for the $30 dividend with respect to Share B even though there are no hybrid deductions allocated to Share B.
- As a result, US Co is not allowed a deduction under Code §245A(a) for the entire $60 of Hybrid Dividends.
- US Co is not entitled to claim a F.T.C. or deduction with respect to taxes paid or deemed paid to Country F with respect to the dividends. [Code §245A(d)]

At the end of Year 2, US Co's Hybrid Deduction Account with respect to Share A is decreased by $60, the amount of the hybrid deductions in the account that gave rise to a Hybrid Dividend during Year 2. Therefore, at the end of Year 2, US Co's Hybrid Deduction Account with respect to Share A is $20 ($80 less $60) and with respect to Share B is $0.

CONCLUSION

The regulations impose additional compliance burden on U.S. Shareholders as they will be required to maintain Hybrid Deduction Accounts with respect to their hybrid investments. Further, the regulations will likely require a C.F.C. to adequately disclose to its U.S. Shareholders whether or not an instrument is treated as a debt or equity under the law of its organization, whether a deduction is available to the C.F.C., whether the foreign country has hybrid mismatch rules, etc., so that the corporate U.S. Shareholder can adequately rely on the information to determine the eligibility of the Code §245A D.R.D. Although, presumably the controlling U.S. Shareholder would have this information, this regime puts additional reporting pressure on C.F.C.s and their shareholders.

"The regulations impose additional compliance burden on U.S. Shareholders as they will be required to maintain Hybrid Deduction Accounts with respect to their hybrid investments."

ANTI-ABUSE RULES OF TEMP. REG. §1.245A-5T – A NEW CERBERUS FOR THE U.S. TAX SYSTEM

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Treas. Reg. §1.245-5T
Treas. Reg. §1.78-1

"Ay, sir, there's no more trick is there! You are not, like Cerberus, three gentlemen at once, are you?"

–Mrs. Malaprop to Captain Absolute in Richard Brinsley Sheridan's The Rivals (1775), Act IV, scene 2

A participation exemption is a feature of many territorial systems and eliminates incremental tax on foreign-source income. Under the Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, ("T.C.J.A."), the U.S. tax law acquired a 100% dividends received deduction ("D.R.D.") for foreign-source dividends received by domestic U.S. corporations from 10%-owned foreign subsidiaries arising in tax years beginning after December 31, 2017.[1]

The new D.R.D. applies to a certain limited class of taxable distributions by a C.F.C. to its U.S. corporate parent. It also applies to certain other distributions by a foreign corporation to a U.S. corporation owning a 10% or greater interest, where (i) all such 10% U.S. shareholders in the aggregate own shares representing not more than 50% of the value or voting power of the foreign corporation and (ii) the foreign corporation is are not considered to be a P.F.I.C. The new D.R.D. extends to capital gain on certain dispositions of foreign corporation stock, provided that the gain is attributable to retained earnings and for that reason is converted to dividend income under Code §1248.[2]

As background, the U.S. imposes tax on the worldwide income of its citizens and U.S.-incorporated companies. This feature was retained after the T.C.J.A. and has always been coupled with (i) deferral of foreign earnings earned through corporate form and (ii) provisions eliminating deferral under the C.F.C. rules of Subpart F. Confusingly, these elements are retained, the global low tax intangible income rules of Code §951A have been added, and the participation exemption has been grafted on top of the whole lot. Prior to the T.C.J.A., former Code §902 provided that when a domestic corporation received a dividend from a foreign corporation in which it

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1 Separately, see the fourth article in this edition of *Insights* by Neha Rastogi and Nina Krauthamer, titled "Heads I Win, Tails You (I.R.S.) Lose – Not Any More: Hybrid Dividends and Code §245A(e)," addressing the hybrid provisions of Code §245A, including the relevant regulations issued this spring. A pre-existing D.R.D. under Code §245 further discussed in this article applied only to U.S.-source dividends, and not deemed dividends arising from the sale or exchange of C.F.C. stock.

2 This, through the back door of Code §1248. According to a 2017 blog posting, approximately 29 countries in the O.E.C.D. offer a participation exemption or deduction for dividend income, and 26 offer it for capital gains arising from the sale of shares of subsidiaries in which a minimum participation exists, with 25 countries offering both. See Kyle Pomerlau, "Designing a Territorial Tax System: A Review of OECD Systems" (Aug. 1, 2017), available here.

owned at least 10% of the voting shares, the domestic corporation was deemed to pay a proportional share of the foreign corporation's foreign taxes. The gross taxable dividend to the U.S. corporation equaled the sum of the dividend declared and the accompanying taxes that were "grossed-up" into the dividend.[3] The T.C.J.A. repealed Code §902 and now provides the D.R.D. instead when the U.S. corporation is not taxed under Subpart F and G.I.L.T.I. rules. In such case, the indirect foreign tax credit remains in existence.[4]

Enter 105 pages of temporary regulations, issued on June 14, 2019 under Temp. Reg. §1.245-5T ("Temporary Regulations"), adopted in T.D. 9865, which provides rules to address certain base erosion concerns identified by the I.R.S., in the context of Code §245A's purpose in the broader tax system.[5]

The Temporary Regulations seem to serve a role like that of Cerberus,[6] the multi-headed canine who watched over the gates of Hades in Greek mythology. They address very specific concerns relating to erosion of Subpart F and G.I.L.T.I. This article reviews the D.R.D provisions, including the Temporary Regulations, so that their Cerberus-like complexity can be understood — transforming the task from a labor worthy of Herakles to a walk in the park.

MAIN FEATURES OF CODE §245A

The Code §245A D.R.D. applies where a U.S. domestic corporation (the "Code §245A shareholder") owns at least 10% of a foreign corporation, by vote or value – with the foreign corporation referred to as a "specified 10-percent owned foreign corporation" ("S.F.C.") – from which a dividend is received.

The ownership of the distributing's stock must be effective for a one-year holding period. The D.R.D. applies only to the foreign-source portion of a dividend received.

The foreign-source portion of a distribution is determined by multiplying the amount of the distribution described in Code §301(c)(1) (a dividend out of earnings and profits ("E&P")) by a fraction, the numerator of which is the S.F.C.'s undistributed foreign earnings, and the denominator of which is the S.F.C.'s total undistributed earnings. Congress defined "undistributed foreign earnings" as undistributed earnings that are neither effectively connected income ("E.C.I.") nor dividends received from a U.S. domestic corporation in which at least 80% is owned, directly or indirectly, by the S.F.C. The term "undistributed earnings" means total earnings at the close of the year, excluding previously-taxed earnings under Code §959(c)(1) and (c)(2) ("P.T.I.").[7] In broad terms, P.T.I. means the earnings that have been taxed in the

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3 Code §78.

4 Code §960.

5 A proposed version of the same rules was issued at the same time in REG-106282-18. Also proposed were a further 55 pages of final regulations under Code §§245A(e) and 267A, relating to hybrid dividends. Minor corrections were published at 84 Fed. Reg. 38866.

6 In Greek, "Kerberos," the offspring of the monsters Echidna and Typhon, the etymology of the name is uncertain but includes "Ker," a Valkyrie-like goddess of violent death.

7 Under Code §959(d), a distribution of previously taxed income does not constitute a dividend even if it reduces E&P, therefore Code §245A is inapplicable.

hands of the U.S. corporate shareholder under the Subpart F or G.I.L.T.I. provisions of U.S. tax law. Meanwhile, the U.S.-source portion potentially may separately also be eligible for a D.R.D. under the pre-T.C.J.A. D.R.D. provided for in Code §245(a), which has been part of the tax law for many years.[8]

A comparison of the Code §245A D.R.D. for foreign source dividends with the pre-existing Code §245 D.R.D. for U.S.-source dividends is instructive. The two provisions are similar in several ways. Both deductions

- may be claimed by only domestic corporations (not R.I.C.'s, R.E.I.T.'s, or S-corporations) with respect to foreign corporations that are not passive foreign investment company ("P.F.I.C.") with respect to the recipient,
- require 10% minimum ownership[9] in the corporation making the distribution,
- require forsaking any associated foreign tax credits or deductions, and
- limit the D.R.D.'s availability based on the source of the underlying earnings.

The two provisions differ in several ways:

- The old Code §245 D.R.D. applies only to actual dividends, whereas new Code §245A also applies to the portion of a capital gain treated as dividend under Code §1248(a) plus deemed dividends from indirectly-owned C.F.C.'s.
- The new Code §245A D.R.D. includes a longer minimum holding period. It is one year for a dividend from an S.F.C. compared to 45 days for a dividend from a domestic corporation. It is not clear what difference in policy justifies this change, although a 12-month holding period is not uncommon, globally.
- The new Code §245A D.R.D. includes provisions applicable in an adverse way to hybrid dividends.[10] Presumably the need for anti-hybrid rules is unnecessary when both corporations are incorporated in the U.S.
- The old Code §245(a) D.R.D. specifically permits a taxpayer to take advantage of treaty resourcing provisions[11] and includes provisions relating to distributions out of earnings attributable to foreign trade income under former Code §923, though the latter rules may no longer be of relevance.

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[8] P.L. 83-591, Ch. 736. Code §245 refers to a "qualified 10-percent owned foreign corporation." See also Code §243(e), which extends a domestic D.R.D. to distributions received from a foreign subsidiary attributable to E&P accumulated by a domestic corporation.

[9] Though Code §245 requires at least 10% by vote and value, Code §245A keys off of the U.S. shareholder definition in Code §951(b), meaning 10% ownership by vote or value — meaning a foreign-source D.R.D. may potentially be claimed in some cases where the Code §245 D.R.D. would be inapplicable.

[10] These regulations, issued as final in T.D. 9896 under both Code §245A(e) and §267A, are explored further in another article in this edition of Insights. The hybrid rules apply to situations in which a foreign hybrid mismatch rule does not apply. The final regulations under T.D. 9896 also provide rules on dual consolidated losses and entity classifications to prevent a deduction being claimed under the laws of both the U.S. and a foreign country.

[11] Code §245(a)(10).

BASIS ADJUSTMENTS

> *"This downward adjustment to basis applies to reduce basis available for a distribution out of P.T.I. form the same C.F.C., as well as for purposes of determining loss on any disposition of stock. . ."*

Under Code §961 as in effect prior to the T.C.J.A., a U.S. Shareholder is required to make upward adjustments to the basis for shares of stock in a C.F.C. to reflect amounts included in gross income under Subpart F, and downward adjustments to reflect distributions of P.T.I. Since distributions of P.T.I. are not treated as taxable dividends, they do not qualify for a D.R.D. When distributions are out of not previously-taxed E&P — known as Code §959(c)(3) E&P — the distribution is treated as a dividend that gives rise to a D.R.D. For those dividends, Code §961(d) requires the U.S. shareholder to make a downward adjustment to the basis in the S.F.C. stock to reflect the benefit of the D.R.D. — and thus apparently expanding Code §961's reach to S.F.C.'s that are not C.F.C.'s. This downward adjustment to basis applies to reduce basis available for a distribution out of P.T.I. form the same C.F.C., as well as for purposes of determining loss on any disposition of stock of such foreign corporation in such taxable year or any subsequent taxable year. This provision closes the door on any plan that includes (i) the purchase a cash rich foreign corporation, (ii) the receipt of a tax-free dividend once the 12-month holding period passes, and (iii) the generation of a capital loss when the corporate shell is sold that reduces an unrelated taxable capital gain.

CODE §91 — NEW BRANCH LOSS RECAPTURE RULES

An additional component of the new participation exemption architecture is Code §91, which is a loss recapture provision. It requires a domestic corporation that transfers substantially all the assets of a foreign branch -— as defined in Code §367(a)(3)(C) in effect prior to the T.C.J.A.[12] — to an S.F.C. to include in gross income an amount equal to the transferred loss amount. The "transferred loss amount" means the sum of losses incurred by the foreign branch after December 31, 2017 and before the transfer, with respect to which a deduction was allowed to the domestic taxpayer, reduced by (i) gain recognized after the year in which the loss was incurred and through the close of the table year in which the transfer is effected and (ii) certain amounts recognized under Code §904(f)(3). To avoid double taxation of the same gain, if gain is otherwise recognized on the transfer, the amount of the loss that is recaptured will be reduced. The net amount is treated as U.S source income. This departs from the treatment under the loss recapture rules previously in effect under prior law, which treated branch loss as foreign source.

In addition to the loss recapture, inherent gain in assets transferred to a foreign corporation will be recognized and taxed. Should the U.S. person instead seek to remove the assets to the U.S., foreign exit taxes may apply. Whether the tax is creditable against U.S. tax is an open question post-T.C.J.A.[13]

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[12] The T.C.J.A. repealed the active trade or business ("A.T.B.") exception to gain recognition for purposes of certain nonrecognition transactions under Code §367(a) but retained the A.T.B. definition for purposes of this branch loss recapture provision.

[13] See Kimberly S. Blanchard, "Out on a Limb: The New Significance of the Foreign Branch," Tax Notes (Jan. 6, 2020).

DEEMED DIVIDENDS UNDER CODE §§1248(A) AND 964(E)

The D.R.D. does not generally eliminate Subpart F income, nor does it apply to Code §78 "gross-up" dividends when an indirect foreign tax credit is claimed under Code §960 in connection with an amount included in income under Subpart F or G.I.L.T.I.[14] As a result, the taxable amount of the inclusion is increased by the taxes of the C.F.C. that become creditable at the level of a corporation that is a 10% shareholders.

In comparison, Code §245A applies to deemed dividends under Code §§1248(a) and 964(e). As background, whenever a U.S. person sells or exchanges stock in a foreign corporation and owns — or is deemed to own — 10% or more of the combined voting power of all classes of stock entitled to vote during the five-year period ending on the date of the sale or exchange. The amount that is converted into dividend income is equal to the earnings and profits that have been accumulated while the corporation was a C.F.C. and the U.S. person was a 10% shareholder. Code §1248 provides that:

> the gain recognized . . . shall be included in the gross income of such person as a dividend, to the extent of the earnings and profits of the foreign corporation attributable . . . to such stock which were accumulated in taxable years of such foreign corporation beginning after December 31, 1962, and during the period or periods the stock sold or exchanged was held by such person while such foreign corporation was a controlled foreign corporation. . . .

"The T.C.J.A. tweaked Code §1248 and Code §964(e) to indicate that a dividend deemed under those provisions generally would be eligible for a D.R.D."

Historically many taxpayers used this provision to "pull up" Code §902 indirect foreign tax credits from the lower-tier target, effectively allowing the U.S. 10% shareholder to use the tax to offset more of the residual U.S. tax on the subpart F Income. Without the rule, foreign income taxes paid by the lower-tier target C.F.C. would be trapped at that level. It could not be used to offset U.S. tax imposed under Subpart F on the U.S. 10% shareholder. The only way for the shareholder to access those taxes would be to force the actual payment of a dividend to the upper-tier C.F.C. Lower-tier C.F.C.'s that were cash rich could more easily pay a dividend prior to a sale than lower-tier subsidiaries that were cash poor but asset rich.

To provide parity of treatment both between sales of cash poor and cash rich lower-tier C.F.C.'s, Congress added Code §964(e), providing that gain realized by an upper-tier C.F.C. on the sale or exchange of a lower-tier C.F.C.'s stock should allow some or all of the gain to be converted into a deemed dividend, similar to Code §1248(a). The taxpayer benefit from Code §964 is that the Subpart F income of the upper-tier C.F.C. will be grossed up to include foreign income taxes actually paid by the lower-tier C.F.C. without the need for an actual dividend being declared.

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[14] REG-105600-18, 83 Fed. Reg. 63,200 (Dec. 7, 2018) (proposed regulations); T.D. 9866, 84 Fed. Reg. 29,288 (June 21, 2019) (final regulations). New Treas. Reg. §1.78-1(a) provides that a Code §78 dividend is "treated as a dividend for all purposes of the Code, except that it is not treated as a dividend for purposes of section 245 or 245A, and does not increase the earnings and profits of the domestic corporation or decrease the earnings and profits of the foreign corporation."

Consequently, when the deemed dividends and the accompanying foreign taxes of the lower-tier C.F.C. are included by the upper-tier C.F.C., the foreign taxes can be claimed as a foreign tax credit by the U.S. corporation that is taxed under Subpart F.

The T.C.J.A. tweaked Code §1248 and Code §964(e) to indicate that a dividend deemed under those provisions generally would be eligible for a D.R.D. The Temporary Regulations may cut back on that benefit in select fact patterns. Also, under a peculiar interaction between Code §§245A, 951A, and 1248, the sale by one U.S. Shareholder to another of C.F.C. stock could transmute what is otherwise G.I.L.T.I. tested income into permanently untaxed income by operation of the D.R.D.[15] After the Temporary Regulations, this loophole may have closed.

THE TEMPORARY REGULATIONS

The following passage from the N.Y.S.B.A. Report on the D.R.D. encapsulates how the U.S. participation exemption is envisaged to function as part of a "territorial" system:[16]

> In many cases, a CFC's net income that is subject to current tax [under G.I.L.T.I.] in the hands of its United States shareholder(s) will constitute a very large percentage of the CFC's total net income. Section 245A thus implements the territorial tax portion of the modified territorial tax system by effectively exempting from U.S. tax that portion of a CFC's earnings that are not subject to tax under the subpart F and GILTI rules, and thus are subject only to foreign tax.

Code §245A(g) provides broad language authorizing the I.R.S. to issue whatever rules are deemed "necessary or appropriate" to carry out the provisions of Code §245A. In the Preamble to the Temporary Regulations, the I.R.S. reaches even further, to the legislative history of the D.R.D., to justify its approach of crafting wide-ranging anti-abuse rules, suggesting that "without appropriate limits, domestic corporations might be incentivized to shift income to low-taxed foreign affiliates ''where the income could potentially be distributed back to the [domestic] corporation with no U.S. tax imposed.[17]

Before jumping into the "nitty-gritty," a word on the regulations' guiding philosophy will help us to complete our labor worthy of Herakles.

<u>The Regulations' Philosophy</u>

Code §245A may have been seeking something of a grounding philosophy to help find its home in this complicated tax system. Enter the Temporary Regulations, in which the I.R.S. sought to address situations where taxpayers might base erode the

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15 Subpart F and G.I.L.T.I. tested income can also be transmuted into permanently untaxed income in the case of regular dividends — for example, dividends paid by one C.F.C. to another may qualify for an exception to Subpart F under Code §954(c)(3) or (c)(6), and an exception to tested income under Code §951A(c)(2)(A)(i)(IV).

16 New York State Bar Association, Report on Code §245A, October 25, 2018 ("N.Y.S.B.A. Report"), at 7.

17 Citing to Senate Committee on the Budget, 115th Cong., Reconciliation Recommendations Pursuant to H. Con. Res. 71, at 365 (Comm. Print 2017).

U.S. by transferring valuable income-producing assets offshore and then claiming a D.R.D. with respect to distributions of associated earnings back to the U.S., effectively removing them from the U.S. tax net. Explaining this concern further, the Preamble states:

> The transition tax, the subpart F and GILTI regimes, and the participation exemption . . . together form a comprehensive and closely integrated set of tax rules with respect to the earnings of foreign corporations with requisite levels of U.S. ownership. Those related provisions must be read and interpreted together in order to ensure that each provision functions as part of a coherent whole, as intended

The Preamble adds that the Temporary Regulations are intended to apply where "the literal effect of Section §245A would reverse the intended effect of the subpart F and [G.I.L.T.I.] regimes," and in particular to limit the D.R.D.'s effect where income that would otherwise give rise to tax under Subpart F or G.I.L.T.I. would escape taxation under those rules. It is a testament to the ingenuity of the drafters of the Temporary Regulations that two disparate sets of rules are elegantly dealt with in a single conceptual framework.[18]

With this challenging mission in mind, in select base erosion circumstances, the Temporary Regulations (i) remove a D.R.D. for distributions received by a U.S. owner from a C.F.C., and (ii) turn off Code §954(c)(6)'s "look-thru" exception for distributions received by an upper-tier C.F.C. from a lower-tier C.F.C.

Ineligible Amount — What is it?

The ineligible amount is introduced by the Temporary Regulations and corresponds to the portion of any dividend received for which a Code §245A D.R.D. (or look-thru exception under Code §954(c)(6)) may not be claimed, and includes extraordinary dispositions and extraordinary reductions.

Extraordinary Dispositions

As a matter of background, after the T.C.J.A. was enacted, the I.R.S. realized that a disjuncture existed between effective date of the D.R.D. under Code §245A — December 31, 2017 —and the effective date of the G.I.L.T.I. tax for a fiscal year taxpayer. The G.I.L.T.I. provisions are first effective as of the first day of the first year beginning after December 31, 2017. For a fiscal year taxpayer having a year end of November 30, the gap was 11 months long. During this period, a C.F.C. could sell operating assets to an affiliate in a transaction not subject to G.I.L.T.I. for the seller. For the buyer, a step-up in basis of operating assets could reduce G.I.L.T.I. tax in future years by reason of rules applicable to ordinary returns on qualified business assets. The sales proceeds could be repatriated tax-free under the D.R.D. as Code §245A to distributions made after December 31, 2017. Hence the gap.

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[18] For Code §954(c)(6), see Notice 2007-9, 2007-5 I.R.B. 401, discussing future guidance for income eligible for "look-thru" treatment under Code §954(c)(6), shortly after that rule was introduced by the Tax Increase Prevention and Reconciliation Act ("T.I.P.R.A.") of 2005, P.L. 109-222. Code §954(c)(6)'s look-thru exception has never been made permanent and thus far has been renewed by Congress each year.

The Temporary Regulations attempt to close the planning opportunity. Using the language of the Temporary Regulations, the extraordinary disposition rule refers to dispositions of "specified property" (property that gives rise to G.I.L.T.I. tested income) in transactions with related parties occurring during the "gap" period, meaning the time between effective date of the D.R.D. the effective date of the G.I.L.T.I. provisions, or the first tax year beginning after December 31, 2017. Dispositions are examined in light of all facts and circumstances, except where they are *per se* "extraordinary." This occurs in two circumstances. The first is where the transaction is undertaken with a principal purpose of generating earnings during the gap period. The second is where the transferred asset is an item of intangible property, as defined in Code §367(d).

The extraordinary disposition rule applies to select fiscal-year taxpayers who experienced a disqualified gap period and is not relevant for transactions after this period closes.

The ineligible amount is 50% of the dividend attributable to E&P from extraordinary dispositions.

Extraordinary Reductions

This provision is designed to prevent a taxpayer reducing tax under Subpart F of a C.F.C. by means of a purchase of shares in a C.F.C. followed by the seller's distribution of a dividend to a common 10% shareholder in the U.S. The archetypal transaction is explained in the preamble to the Temporary Regulations. It appears to be based on a structured product that was being marketed by investment banks and major accounting firms.

Subpart F contains a provision that was originally intended to prevent the double taxation of Subpart F income of a C.F.C. when the shares of the C.F.C. are sold in early in a tax year. The provision is Code §951(a)(2)(B). It prevents double taxation of the same earnings by reducing a U.S. Shareholder's *pro rata* share of Subpart F income of a C.F.C. when dividends are paid by the C.F.C. to another person with respect to the same share of stock. When enacted, the expectation would be that the dividends would be fully taxable in the U.S. at rates similar to Subpart F Income. However, the math is changed under the D.R.D. provided in Code §245A.

Once the D.R.D. applies to the dividend, a U.S. taxpayer acquiring the C.F.C. stock from a related U.S. person could reduce the amount included in its income by the tax-free dividend paid to the selling U.S. Shareholder prior to the acquisition. The same benefit would apply to tested income that is subject to G.I.L.T.I. tax in the hands of a U.S. Shareholder. The Preamble cautions that this result was not contemplated by the T.C.J.A. as it results in double non-taxation, borrowing a term from B.E.P.S.

The extraordinary reduction applies in the following fact pattern:

- The transaction occurs in a tax year ending after December 31, 2017.
- A "controlling Code §245A shareholder" owns 50% or more, by vote or value, of the outstanding shares of stock in a C.F.C.
- In determining whether the 50% ownership threshold is met, any stock owned by related parties is counted.

- The “controlling Code §245A shareholder” transfers, directly or indirectly, shares representing more than 10% of value of all shares issued by the C.F.C. The transferred shares of stock constitute at least 5% by value of the total outstanding stock of the C.F.C.

Alternatively, the extraordinary reduction rule may apply where, as a result of one or more transactions carried on during the year, the controlling Code §245A shareholder’s stock that is owned directly or indirectly on the last day of the taxable year is less than 90% of the stock owned on either of two measuring dates: (i) the date on which the shareholder’s ownership percentage is highest measured by the total value of all shares outstanding in the year; or (ii) the day immediately before the first day on which any stock is transferred, directly or indirectly, in one or a series of transactions pursuant to a plan intended to reduce the percentage of stock ownership.

If the extraordinary reduction rule is triggered, a portion of the dividend received by the shareholder is ineligible for the D.R.D. under Code § 245A. The ineligible amount is the lesser of (i) the dividend received or (ii) the relevant Code §245A shareholder’s pre-reduction *pro rata* share of Subpart F income and tested income.

An exception applies where the opportunity of a double tax benefit is not available. The occurs in any of the following three circumstances:

- Another U.S. Shareholder takes additional Subpart F income or tested income into account as a result of the changes in ownership.
- The C.F.C.’s taxable year ends.
- The controlling Code §245A shareholder elects to close the taxable year of the C.F.C. the dividend, which means that Subpart F or tested income will be taken into account by the seller at a favorable rate under the effect of Code §250.

Where an election is made to close the year of the C.F.C., the election statement must contain the following information:

- It must identify the extraordinary reduction transactions and E&P attributable to the shares of stock within the meaning of Code §1248.
- It must state that each controlling Code §245A shareholder and each U.S. tax resident have entered into a written binding agreement to close the tax year.
- It must provide certain other details identified in the Temporary Regulations.

Comments at a D.C. Bar conference earlier this year suggested the I.R.S. may remove the election because it gives taxpayers too good of an answer.[19] As this rule is implicated by almost every M&A transaction, U.S. Shareholders who sell shares in a C.F.C. prior to the date the Temporary Regulations are finalized may wish to close their transactions on an expedited basis in order to take advantage of the election.

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[19] See Emily L. Foster, “Changes Coming to Dividends Received Deduction Regs Election,” Tax Notes (Jan. 24, 2020). The charge is that the election results in taxing tested income or Subpart F at a 10.5% rate instead of the 21% rate that would otherwise apply under Code §1248 (assuming the D.R.D. is not applicable to reduce it to 0%).

Based on news reports, the Temporary Regulations clearly have affected some taxpayers. One public company, Qualcomm, announced a $2.5 billion charge to income tax expense in its Q3 2019 financials.[20]

FOREIGN-TO-FOREIGN DISTRIBUTIONS

The Temporary Regulations reflect the view that the D.R.D. is not applicable to "foreign-to-foreign" distributions, *i.e.*, distributions by a lower-tier 10%-owned foreign corporation to an upper-tier C.F.C. not involving any domestic U.S. recipient. Remember, but for two exceptions in Code §954(c), such dividends generate Subpart F Income inclusions for the U.S. Shareholders of the recipient C.F.C. Without any recognition of Conference Committee Report language suggesting a foreign corporation might claim the D.R.D.[21] or the N.Y.S.B.A. Report's suggestion of permitting a D.R.D. in foreign-to-foreign distributions,[22] the Temporary Regulations take the approach that Code §§954(c)(3)(A)(i) (related party dividends from a related corporation formed in the same jurisdiction and having a substantial part of its assets located in that jurisdiction) and 954(c)(6) (look-through rule for dividends paid from active E&P)) are good enough protection for C.F.C.'s and their U.S. Shareholders. However, the Preamble to T.D. 9866,[23] relating to G.I.L.T.I and foreign tax credits, suggests that the Code §245A D.R.D. for foreign-to-foreign dividends remained open.

"The Temporary Regulations reflect the view that the D.R.D. is not applicable to 'foreign-to-foreign' distributions. . ."

CODE §956 — INVESTMENTS IN U.S. PROPERTY

Under special rules introduced last year, U.S. corporations that are U.S. Shareholders are no longer subject to inclusions under Code §956. This provision backstops the general anti-deferral rule of Subpart F by treating an "investment in U.S. property" as a dividend. The special rules are intended to achieve symmetry with the Code §245A D.R.D. provisions. Under these rules, Code §956 is inapplicable whenever a Code §245A shareholder would be entitled to a D.R.D. had a dividend been paid rather than the controlled foreign corporation engaged in a transaction that constitutes an investment in U.S. property.

CONCLUSION

Cerberus is a dog with at least 3 heads. Similarly, the Temporary Regulations have at least three heads, which respectively focus on the following tasks:

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[20] See Emily Foster, "ABA Section of Taxation Meeting: Dividends Received Deduction Rules Could Come in Discrete Pieces," Tax Notes (Feb. 10, 2020).

[21] This despite a "domestic corporation" being described as the relevant claimant in Code §245A(a). See Conference Committee Report at 599, n. 1486.

[22] See N.Y.S.B.A. Report, at 20. N.Y.S.B.A. suggests Code §245A(g) provided ample authority to extend the D.R.D. to foreign-to-foreign distributions, and also requests that guidance be issued on this — which the Temporary Regulations did, albeit indirectly, by not providing anything in this regard.

[23] I.R.B. 2019-29 (July 15, 2019), Guidance Related to Section 951A (Global Intangible Low-Taxed Income) and Certain Guidance Related to Foreign Tax Credits.

- Ensure that in legitimate cases, taxpayers benefit from the D.R.D. to repatriate cash free of further U.S. tax.
- Prevent erosion of U.S. taxing jurisdiction through transactions that remove income from U.S. tax in ways not contemplated by Congress and deemed to be abusive under a double nontaxation concept.
- Provide anti-abuse rules for Code §954(c)(6)'s "look-thru" exception, including by refusing to extend the Code §245A D.R.D. to a fact pattern involving a foreign-to-foreign dividend payment.

As the I.R.S. may soon remove the closing of the year election, taxpayers who wish to take advantage of that feature of the Temporary Regulations should do so. Based on the I.R.S. 2019-2020 Priority Guidance Plan and recent comments at D.C. Bar conference, finalized regulations may be just around the corner. Updates might address certain issues that practitioners have requested more clarity on, such as

- whether foreign-to-foreign distributions would be eligible for a D.R.D.;
- whether an S.F.C. can be owned through a partnership (it would appear so), and whether the holding period is tested at the partner or partnership level; and
- whether the D.R.D. can apply to nimble dividends, which would make sense.[24]

While the Temporary Regulations are in some ways a blunt instrument to protect the anti-deferral regimes of Subpart F and G.I.L.T.I., their Cerberus-like effect cannot be denied. They shut down some important loopholes that likely were flogged by investment banks and large accounting firms. In addition, they emphasize the rather limited scope of the D.R.D. under Code § 245A. The D.R.D. can be claimed in only two limited circumstances. The first is a 10% U.S. shareholder of an operating company that is not a C.F.C. and not a P.F.I.C. In these fact patterns the anti-abuse rules provided by the Temporary Regulations generally will not be relevant. The second is the ordinary return realized by a C.F.C. on its Q.B.A.I., which is not taxed on a current basis under the G.I.L.T.I. rules.

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[24] Other practitioners have noted interaction with consolidated return provisions can lead to harvesting of non-economic losses. See Emily Foster, "ABA Section of Taxation Meeting: Dividends Received Deduction Rules Could Come in Discrete Pieces," Tax Notes (Feb. 10, 2020).

HELP – MY EXCLUSIVELY FOREIGN TRUST NOW HAS A U.S. BENEFICIARY! WHAT ARE THE ISSUES A TRUSTEE WILL NOW FACE IN 2020?

Author
Nina Krauthamer

Tags
F.A.T.C.A.
Foreign Grantor Trust
Foreign Nongrantor Trust

Many foreign grantors establish foreign trusts to benefit themselves and their foreign beneficiaries. It is not uncommon, however, for a foreign beneficiary to relocate to the United States. This article addresses the U.S. tax consequences to a foreign trust and a beneficiary of a foreign trust who is or becomes a U.S. citizen or resident alien. It is assumed that the grantor is and always will be a foreign person. Recent tax law changes have made planning more difficult in these situations.

For U.S. tax purposes, a foreign trust can be only one of two types – either a "foreign grantor trust" or a "foreign nongrantor trust."

U.S. TAXATION OF FOREIGN TRUSTS

Foreign Grantor Trust

A trust will be characterized as a foreign grantor trust ("F.G.T.") only under two conditions: either, the grantor reserves the right to revoke the trust solely or with the consent of a related or subordinate party (and revest the title assets to himself), or the amounts distributable during the life of the grantor are distributable only to the grantor and/or the spouse of the grantor. Under these circumstances, the income of the trust is taxed to the grantor (*i.e.*, the person who made a gratuitous transfer of assets to the trust). U.S. tax is limited generally to U.S. sourced investment income and income effectively connected with a U.S. trade or business will be subject to U.S. income or withholding tax. A foreign grantor trust will generally become a foreign nongrantor trust upon the death of the grantor. However, U.S. situs assets (which would include U.S. real and tangible property, and stocks and securities of U.S. issuers, other than debt instruments that qualify as "portfolio interest" indebtedness) held by the F.G.T. upon the death of the grantor would be subject to U.S. estate tax.

Foreign Nongrantor Trust

Any trust that does not meet the definition of a foreign grantor trust is a foreign nongrantor trust ("F.N.G.T."), taxed as if it were a nonresident, noncitizen individual who is not present in the U.S. at any time. U.S. tax is generally limited to U.S. sourced investment income and income effectively connected with a U.S. trade or business.

TAXATION OF DISTRIBUTIONS TO U.S. BENEFICIARIES

Foreign Grantor Trust

Distributions to a U.S. beneficiary by an F.G.T. will generally be treated as non-taxable gifts but may be subject to U.S. tax reporting requirements.

Foreign Nongrantor Trust

A U.S. beneficiary will be subject to tax on distributions to the beneficiary of "distributable net income" ("D.N.I.") from the F.N.G.T. The character of such D.N.I. distributions will reflect the character of the income as received by the F.N.G.T. If a F.N.G.T. accumulates its income and distributes the accumulation in later years in excess of D.N.I., the U.S. beneficiary will be subject to the "throwback rules," which generally seek to treat a beneficiary as having received the income in the year in which it was earned by the trust, using a relatively complex formula. The beneficiary may be required to pay a "throwback tax" (a "catch up" tax) and an interest charge on the deferral. Furthermore, such throwback distributions will be taxed at ordinary income tax rates. The throwback rules will not apply to amounts accumulated when the trust was an F.G.T.

REPORTING OBLIGATIONS

Reporting obligations will arise when a foreign trust makes a distribution to a U.S. beneficiary. A U.S. person who receives a distribution from a foreign trust must include Form 3520 (*Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*) with his or her tax return. Generally, the Trustee should furnish to the U.S. beneficiary a "Foreign Nongrantor Trust Beneficiary Statement," which will be attached to the Form 3520. (While there is a "Foreign Grantor Trust Beneficiary Statement," that Beneficiary Statement contemplates a U.S. grantor, who will report the Trust's income on his or her U.S. income tax return, and therefore may not suitable for an F.G.T. with a foreign grantor.) For a F.N.G.T., the Beneficiary Statement includes the distributable net income for the year, the years to which an accumulation distribution is attributed, and the amounts allocable to each year. Steep penalties may apply for failing to report fully all required information and for failing to report on a timely basis.

OTHER TAX CONSEQUENCES

Special Taxing Regimes

If the foreign trust has investments in foreign corporations, the presence of a U.S. beneficiary may have the unfortunate effect of subjecting the U.S. beneficiary to two special U.S. taxing regimes: those applicable to "controlled foreign corporations" ("C.F.C.'s") and those applicable to "passive foreign investment companies" ("P.F.I.C.'s"). The C.F.C. rules (which generally preempt the P.F.I.C. rules) subject certain types of income allocable to a "U.S. Shareholder" (as specially defined) to immediate U.S. taxation, whether or not distributed, and characterize certain gains upon disposition of the stock as ordinary income. Unless certain exceptions apply, the P.F.I.C. rules are designed to penalize U.S. taxpayers on "excess distributions"

from a P.F.I.C. or upon a disposition of P.F.I.C. stock, imposing the highest ordinary income rates and an interest charge.

Tax law changes in late 2017 made significant – and unfortunate – changes to planning for investments in foreign corporations. It is not uncommon for an F.G.T. to own U.S. stocks and securities through a foreign corporate "blocker" corporation, usually in a low or no-tax jurisdiction, to avoid the imposition of U.S. estate tax upon the death of the foreign grantor. If the foreign corporation became a C.F.C. upon the death of the grantor, because of the presence of sufficient U.S. beneficiaries, it was often possible to make a check the box election (effective immediately after death) to treat the C.F.C. as a disregarded entity. The election would be treated as a taxable liquidation of the C.F.C. for U.S. tax purposes, resulting in "foreign personal holding company income" that could be subject to an income tax inclusion by a U.S. beneficiary as a form of so-called "Subpart F income." However, under prior law, no such inclusion was required unless the corporation was a C.F.C. for 30 days or more.

"The presence of a U.S. beneficiary may have unexpected tax consequences depending on the nature of the assets held by the foreign trust."

Report of Foreign Bank and Financial Accounts ("F.B.A.R.") Filings

F.B.A.R. filings on Form FinCEN Form 114 are generally required to be made by U.S. persons who have reportable financial interests in or signature authority over a foreign financial account ("F.F.A."). A U.S. person who has more than a 50% present beneficial interest in a trust's income or assets may be deemed to have an F.F.A. interest and may be required to make an F.B.A.R. filing. A trust beneficiary of a foreign nongrantor trust may receive an exemption from F.B.A.R. reporting if a trustee who is a U.S. person makes an F.B.A.R. filing disclosing the trust's F.F.A.'s and provides information as required.

FOREIGN ACCOUNT TAX COMPLIANCE ACT ("F.A.T.C.A.")

F.A.T.C.A. Entity Reporting

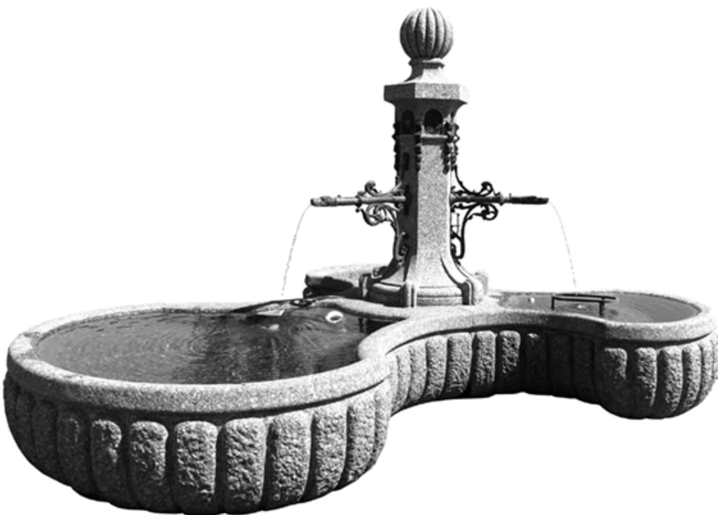
F.A.T.C.A. imposes a 30% withholding tax on payments to "foreign financial institutions" ("F.F.I.'s") that do not comply with certain disclosure requirements about their U.S. account holders. When applied, the withholding tax is imposed on principal as well as income. A foreign trust that invests (directly or indirectly) in securities and other financial interests may, under certain circumstances, be treated as an F.F.I. if the trustee is a trust company or if an entity, such as a bank or other financial institution, is acting as the investment advisor. In that case, the trust may have to register with the I.R.S. and receive a global intermediary identification number.

F.A.T.C.A. Individual Reporting

A U.S. person who holds an interest in a specified foreign financial asset must disclose such interest on Form 8938 if the aggregate value of all such assets exceeds certain threshold amounts (*e.g.*, in the case of an unmarried individual, $50,000 on the last day of the tax year, or $75,000 at any time during the year). A foreign financial asset includes an interest in a foreign trust, although special valuation rules may apply. Typically, assets are reported only when and as a trust makes a distribution to a U.S. beneficiary, the amount of the distribution being the reportable asset. This disclosure requirement is in addition to the F.B.A.R. requirement described above.

Items reported on Form 3520, described above, do not have to be reported on Form 8938, but Part IV of Form 8938 must be completed to indicate the Form 3520 filing.

The presence of a U.S. beneficiary in what had been a purely foreign trust presents tax challenges. In addition to the imposition of additional U.S. taxes and enhanced reporting requirements, the presence of a U.S. beneficiary may have unexpected tax consequences depending on the nature of the assets held by the foreign trust. It is important to identify these issues early in the process, as it may be easier to address and resolve some of these issues before the beneficiary becomes a U.S. taxpayer.



U.S.: CARES ACT LOANS AND BUSINESS TAX PROVISIONS AND I.R.S. ANNOUNCEMENTS ON STRANDED INDIVIDUALS

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Tags
Affiliates Rule
CARES Act
Eligible Forgiveness
FAQ 31
FAQ 44
P.P.P.
S.B.A.

This article explains important provisions of the Corona Virus Aid, Relief, and Economic Security Act ("CARES Act" or "Act") signed into law on March 27, 2020. As will be seen, the CARES Act is an agglomeration of tax law and rules to assist small business. The concepts do not always mesh easily. It is effective as of May 5, 2020.

PAYCHECK PROTECTION PROGRAM ("P.P.P.")

The P.P.P. authorizes the Small Business Administration ("S.B.A.") to guarantee loans made by lenders on favorable terms to eligible small businesses affected by COVID-19. If qualified, Federally guaranteed loans are available in principal amounts of up to $10 million to be used for specified expenditures. If certain conditions are met, the loan may be forgiven in whole or in part with no adverse income tax consequences. The P.P.P. applies to loans of up to the lesser of $10 million or 2.5 times average monthly payroll.

Which businesses are eligible under the P.P.P.?

The following businesses are eligible to receive a loan under the P.P.P. provided they were conducting operations on February 15, 2020, as demonstrated by salary and payroll tax expenses on that day:

- Any U.S. business concern, veterans' organization, nonprofit, or tribal business concern that employs not more than greater of:
  - 500 employees having the U.S. as their principal place of residence, or
  - The standard in number of employees established by the S.B.A. for the industry of the borrower.
- A business with more than one location is eligible if it employs 500 or fewer employees per physical location and falls within the "accommodation and food services" sector with the North American Industry Classification System ("N.A.I.C.S.") code that begins with 72.
- Sole proprietors, independent contractors, and self-employed individuals may be eligible provided that proper documentation of business operations exists, such as Forms 1099–MISC received from clients and customers who make a payments to an independent contractor in the course of their businesses, or a tax return that reports business expenses on a Schedule C, Profit or Loss From Business (Sole Proprietorship), on Form 1040, Individual Tax Return, or a Schedule K-1, Partner's Share of Income, Deductions, Credits, etc., issued by a partnership or L.L.C.

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1 Also contributing to this article are Andreas Apostolides, Neha Rastogi, and Lisa Singh.

In determining whether a business concern qualifies for a P.P.P., is it looked at by itself or with affiliates?

For purposes of the determining the number of employees of an applicant to the P.P.P., the S.B.A. looks at the applicant and all its affiliates collectively. Business concerns and entities are affiliates of each other when one controls or has the power to control the other, or one or more third parties controls or has the power to control both. It does not matter whether control is exercised, so long as the power exists. Affiliation can exist under any one of the following four different sets of rules:

1. Affiliation based on ownership. Under this test, a concern is an affiliate of an individual, concern, or entity that owns or has the power to control more than 50% of the concern's voting equity. A minority shareholder may be in control for this purpose if the individual or entity has the ability under relevant organizing documents to prevent a quorum or block action by the board of directors or shareholders.

2. Affiliation arising under stock options, convertible securities, and agreements to merge. Under this test, the S.B.A. considers stock options, convertible securities, and agreements to merge (including agreements in principle) to have a present effect on the power to control a concern. Such options, convertible securities, and agreements are treated as though the rights granted have been exercised if the effect is to make each entity the affiliate of the other. This rule does not apply in order to break affiliation that exists under another rule. The rule is also not applied if the options, convertible securities, or agreements are based on the occurrence of conditions precedent incapable of fulfillment, speculative, conjectural, or unenforceable, or where their probability of materializing is extremely remote.

3. Affiliation based on management. Affiliation arises where the C.E.O. or President (or other officers, managing members, or partners who control the management) of a business concern also control the management of one or more other concerns. Affiliation also arises where the Board of Directors or management of one concern controls the Board of Directors or management of another concern, or a single individual, concern or entity controls the management of the applicant through a management agreement.

4. Affiliation based on identity of interest. Affiliation arises when there is an identity of interest between close relatives with identical or substantially identical business or economic interests. This includes fact patterns involving relatives, individuals, firms with common investments, or firms economically dependent through contractual or other relationships (*e.g.*, an important vendor or customer where 85% of receipts originate with the other party over the last three fiscal years, on average). For relatives, this can include operating similar concerns in the same geography. For common investments, this can arise when individuals or firms own a substantial portion of multiple concerns in the same or a related industry, frequently, doing business with each other, or sharing resources, equipment, locations, or employees, or providing loan guarantees or financial or managerial support to each other. Once the S.B.A. makes the determination to aggregate interests, the conclusion can be rebutted by facts that demonstrate the absence of control. S.B.A. generally defers to the judgment of the S.B.A. lender on this count.

Affiliates must be disclosed on the application form. The affiliation rules for businesses are waived for businesses operating in the accommodation and food services industry, in addition to any business operating as a franchise that is assigned a franchise identifier code by the S.B.A.,[2] and certain businesses that received Small Business Investment Company financing.

Are foreign-owned business concerns eligible under the P.P.P.?

Yes, although the scope is not entirely clear as of the date of this article. Initially, foreign-owned businesses appeared to be expressly ineligible in the sample application form that was published. However, the troublesome language was deleted in the final application form published by the S.B.A. Anecdotal experience is mixed. Initially, most if not all foreign-owned businesses had their P.P.P. loan applications denied. This has now changed an F.A.Q. 44 discussed below suggests that U.S. subsidiaries can qualify if they meet requirements for the P.P.P.[3] Outcomes may be dependent on the bank administering the program and foreign-owned enterprises may have greater chances of succeeding with smaller banks with which they are an important customer under an existing relationship.

The open question is whether guarantees by U.S. management will be required as is normally the case in other S.B.A. loans to foreign-owned businesses, such as the Economic Injury Disaster Loan Emergency Advance Program ("E.I.D.L."). For E.I.D.L. loans that are issued to business concerns that are not foreign-owned, guarantees are required from the owners of the business. For such loans issued to foreign-owned business concerns, security must be posted, and management guarantees are required. See pages 121 and 122 of the S.B.A.'s Standard Operating Procedure (SOP) 50 10 5(K), Subpart B, Chapter 2.

"Initially, foreign-owned businesses appeared to be expressly ineligible in the sample application form that was published."

On what date must a business actually be operating?

The business must have been operating on February 15, 2020, as demonstrated by the payment of salary and payroll taxes or the payment of fees to independent contractors and the reporting of such fees on Form 1099–MISC in prior years.

In what circumstances can a business concern that meets the eligibility test be disqualified from applying for a P.P.P. loan?

A business concern can be disqualified in any of the following circumstances:

- It is engaged in any activity that is illegal under federal, state, or local law.
- The claim for employment relates to household help such as nannies or housekeepers.
- An owner of 20% or more of the equity of the business concern is incarcerated, on probation, on parole, presently subject to an indictment or has been convicted of a felony within the last five years.
- The business concern or any business owned or controlled by the concern or any of its owners has obtained a direct or guaranteed loan from the S.B.A. or another Federal agency that is currently delinquent or for which there has

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[2] See here.

[3] See discussion at "Recent Developments" below.

been a default within the last seven years and as a result caused a loss to the government.

How is the eligible loan amount determined?

An eligible borrower may borrow up to $10 million, subject to a cap. The cap is 250% of the average total monthly payroll costs incurred during the preceding year.

Payroll costs includes the sum of all payments for employee compensation, including salary, wages, commissions, cash tips, payment of vacation, parental-, family-, medical-, or sick-leave, allowance for dismissal or separation, payment required for group health benefits (including insurance premiums); payment of retirement benefits; or payment of state or local tax assessed on employee compensation. Employee compensation is capped at $100,000. In broad terms, this means that monthly salaries taken into account are capped at $8,333.33. Salaries paid to employees outside the U.S. are not taken into account.

For sole proprietors or independent contractors, the sum of payments of any compensation to a sole proprietor or independent contractor that is a wage, commission, income, net earnings from self-employment, or similar compensation, is taken into account up to $100,000 in a year.

How must the loan be used in order to be eligible for forgiveness, discussed below?

During the covered period, the proceeds of a loan received under the P.P.P. may be used for the payment of

- payroll costs,
- rent and utilities, and
- interest on any mortgage obligation and any other debt obligations incurred prior March 1, 2020.

Payroll costs consist of compensation to employees whose principal place of residence is in the U.S. Compensation includes salary, wages, commissions, or similar compensation. Also included are

- cash tips or the equivalent are included in compensation based on employer records of past tips or, in the absence of such records, a reasonable, good-faith employer estimate of such tips;
- payments for vacation, parental, family, medical, or sick leave;
- allowances for separation or dismissal;
- payment for the provision of employee benefits consisting of group health care coverage, including insurance premiums, and retirement;
- payment of state and local taxes assessed on compensation of employees; and
- for an independent contractor or sole proprietor, wage, commissions, income, or net earnings from self-employment or similar compensation.

Although at the time of this writing there is no official guidance on point, self-employment income in the context of a partnership generally is thought to be covered in self-employment income. The key issue here is the way self-employment income is measured for this purpose. One possible way looks to a partner's distributive share of income that is subject to self-employment tax. Another measure might be keyed to guaranteed payments received by partners.

What is the interest rate for a P.P.P. loan and the maturity date and is there a prepayment penalty?

The interest rate is 1% and the maturity date is two years from the date of issuance of the funds. The maturity date is significantly shorter than the maximum dated mentioned in the statute, which is ten years. The S.B.A. determined that a two-year term is sufficient because economic disruptions are expected to abate well before then. The maximum interest rate mentioned in the statue is 4% and the S.B.A. initially mentioned 0.5%. However, banks were reluctant to participate if the interest rate were that low.

There is no prepayment penalty on any payment made prior to December 31, 2020.

How does the forgiveness of the loan feature work?

The debt proceeds actually used to pay the following expenses during the eight-week period beginning on the date of the origination of a covered loan can be forgiven mostly or wholly free of income tax, provided that 75% of the proceeds of the P.P.P. are used to fund

- payroll costs (as defined above),
- interest payment on a covered mortgage obligation incurred before February 15, 2020, for which the debt is secured by a mortgage on real or personal property,
- payments of rent obligated under a lease in force before February 15, 2020, and
- payment of utility bills such as electricity, gas, water, transportation, telephone, or internet access for which service began before February 15, 2020

In principle, the amount of the loan used to pay the above expenses for the eight-week period can be completely forgiven. However, the forgiven amount of the loan can be reduced by several factors. As mentioned above, if the 75% allocation to payroll costs requirement is missed, the shortfall will not be forgiven. In addition, and assuming that the balance of the proceeds have been applied to other qualified items, a reduction in monthly average employee headcount or a reduction to any employee's salary greater than 25% will also reduce the portion of the loan that can be forgiven. The monthly average headcount during the period following receipt of funds under the loan is compared to the prior year.

Is forgiveness automatic?

The forgiveness of the loan is not automatic. The borrower must apply for forgiveness to the originating lender including the following:

- Documentation verifying the number of full-time equivalent employees on payroll and pay rates. Payroll tax filings, and unemployment insurance filings can be used for this purpose.
- Documentation including cancelled checks, payment receipts, transcripts of accounts verifying payments of other qualified expenses (including debt obligations incurred prior to March 1, 2020).
- Any other documentation determined to be necessary by the S.B.A.
- In addition, a certification is required from the borrower acknowledging that the amount of the loan that was used to pay the qualified expenses and that the documentation presented is true and correct. As a false certification is a felony, the individual making the borrower's certification has a personal interest in ensuring all representations are true.

"On April 24, 2020, a fourth stimulus package was signed into law, the Paycheck Protection Program and Heath Care Enhancement Act. It includes $310 billion to replenish the P.P.P. program."

The amount of the debt forgiven will not be treated as income from the forgiveness of debt, ordinarily subject to U.S. Federal income tax. Also, as the Federal government will repay the bank, it is expected that the debt forgiveness will not adversely affect credit scores.

Recent Developments

The S.B.A. P.P.P. program ran through all funds appropriated by April 16, 2018. Over 1.6 million loans were granted. As it turned out, some loans were made to publicly traded corporations that were likely not within the definition of a small business for purposes of the S.B.A. rules. Other loans were made to well-endowed universities who had the capital to continue to pay employees. Under public pressure and fear of criminal prosecution for the person signing the loan application, many of corporations and universities announced that the funds would be returned. Subsequently, S.B.A. P.P.P. Q&A guidelines were revised warning publicly traded corporations having substantial market value and access to capital markets that they likely are not able to make a good faith certification that the P.P.P. loan is necessary to support the ongoing operations of the applicant.

On April 24, 2020, a fourth stimulus package was signed into law, the Paycheck Protection Program and Heath Care Enhancement Act. It includes $310 billion to replenish the P.P.P. program, $60 billion for a separate emergency loan and grant program discussed below known as the Economic Injury Disaster Loan program, $75 billion for hospitals and health-care providers, and $25 billion for a new coronavirus testing program.

On April 23, 2020, the S.B.A. issued F.A.Q. 31, in response to the news stories mentioned above. It contains the following language:

> **31. Question:** Do businesses owned by large companies with adequate sources of liquidity to support the business's ongoing operations qualify for a PPP loan?
>
> **Answer:** In addition to reviewing applicable affiliation rules to determine eligibility, all borrowers must assess their economic need for a PPP loan under the standard established by the CARES Act and the PPP regulations at the time of the loan application. Although the CARES Act suspends the ordinary requirement that borrowers

> must be unable to obtain credit elsewhere (as defined in section 3(h) of the Small Business Act), borrowers still must certify in good faith that their PPP loan request is necessary. Specifically, before submitting a PPP application, all borrowers should carefully review the required certification that "[c]urrent economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant." Borrowers must make this certification in good faith, taking into account their current business activity and their ability to access other sources of liquidity sufficient to support their ongoing operations in a manner that is not significantly detrimental to the business. For example, it is unlikely that a public company with substantial market value and access to capital markets will be able to make the required certification in good faith, and such a company should be prepared to demonstrate to SBA, upon request, the basis for its certification.
>
> Lenders may rely on a borrower's certification regarding the necessity of the loan request. Any borrower that applied for a PPP loan prior to the issuance of this guidance and repays the loan in full by May 7 will be deemed by SBA to have made the required certification in good faith.

The key issue for management and its advisers is to marshal facts carefully meeting the language of the certification regarding current economic uncertainty and the necessity of the loan to support the ongoing operations of the applicant. Helpful facts include year-to-year comparisons of actual and projected operating comparisons, impairment of credit capacity resulting from lost sales, plans already adopted to reduce head count and various costs, and the dedication of existing credit lines for other uses necessary in the business, such as seasonal working capital costs that cannot go unfunded without impairing ongoing operations.

On May 5, 2020, The S.B.A. published F.A.Q. 44. It contains the following language:

> **44. Question:** How do SBA's affiliation rules at 13 C.F.R. 121.301(f) apply with regard to counting the employees of foreign and U.S. affiliates?
>
> **Answer:** For purposes of the PPP's 500 or fewer employee size standard, an applicant must count all of its employees and the employees of its U.S and foreign affiliates, absent a waiver of or an exception to the affiliation rules. 13 C.F.R. 121.301(f)(6). Business concerns seeking to qualify as a "small business concern" under section 3 of the Small Business Act (15 U.S.C. 632) on the basis of the employee-based size standard must do the same.

Many advisers read F.A.Q. 44 as providing a change in the way the 500-person headcount is applied so that all employees worldwide must be counted. However, that is not the only interpretation that is appropriate. F.A.Q. 44 must be read in conjunction with F.A.Q. 3. Both relate to businesses that are not seeking to qualify as a "small business concern," but nonetheless seeking to be eligible for a P.P.P. loan. F.A.Q. 3 establishes a 500-or-fewer-employee standard for eligibility as an alternative to the "small business concern standard." This alternative looks only to employees whose principal place of residence is in the United States. As the

affiliate rule always applied in F.A.Q. 3, F.A.Q. 44 can be read to confirm that the applicant and all its affiliates must combine all U.S. resident employees, no matter which company is the actual employer. Once the combined total of all U.S. resident employees is determined under F.A.Q. 44, that number is applied in determining whether the 500-or-fewer-employee standard for eligibility is met under F.A.Q. 3, applicable to applicants that are not "small business concerns." No further guidance has yet been issued on this point and the ultimate decision likely will be controlled by the outcome of cases that will be brought by the S.B.A. in future years.

ECONOMIC INJURY DISASTER LOAN ("E.I.D.L.")

The CARES Act expands the S.B.A.'s existing Disaster Loan Program under Section 7(b)(2) of the Small Business Act to provide financial relief to small businesses affected by the Coronavirus.

What is the purpose of the E.I.D.L. Program?

The E.I.D.L. program provides assistance to a small business located in a declared disaster area when the S.B.A. determines it is unable to obtain credit elsewhere. It is an existing program that is designed to assist small businesses suffering from a disaster such as a hurricane, flood, tornado and the like.

A small business that meets the S.B.A. Size Standard[4] is eligible to receive a loan under the E.I.D.L. program. In general, size standards define the largest size a business can be to participate in government contracting programs and compete for contracts reserved or set aside for small businesses. Size standards vary by industry, and are generally based on the number of employees or the amount of annual receipts of the business, generally under the North American Industry Classification System ("N.A.I.C.S."). When determining the size of a business concern, headcount and receipts of affiliates of the applicant small business must be taken into account. More information appears in the S.B.A. regulations.[5]

Substantial economic injury means the business is unable to meet its obligations and to pay its ordinary and necessary operating expenses. E.I.D.L.'s provide the necessary working capital to help small businesses survive until normal operations resume after a disaster.

Under the E.I.D.L. program, the S.B.A. can provide up to $2 million to help meet financial obligations and operating expenses that could have been met had the disaster not occurred. The loan amount is based on the actual economic injury to the small business and financial needs, regardless of whether the business suffered any property damage. In general, tax returns must be submitted as part of the application process and personal guaranties must be provided by the owners.

What special modifications have been made to the E.I.D.L. program to address the COVID-19 pandemic?

The Cares Act modifies certain provisions in the E.I.D.L. program to facilitate the disbursement of funds to a broader class of eligible applicants.

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[4] See guidelines here.

[5] See here.

Broader Scope of Applicants

From January 31, 2020, to December 31, 2020 ('the Covered Period"), the following organizations may apply for E.I.D.L. loans, in addition to small business concerns, private nonprofit organizations, and small agricultural cooperatives:

- Businesses with 500 or fewer employees
- Sole proprietorships, with or without employees, and independent contractors
- Cooperatives with 500 or fewer employees
- E.S.O.P.'s with 500 or fewer employees
- Tribal small business concerns

Waiver of Certain Requirements

In addition, the Cares Act authorizes that S.B.A. to waive certain requirements that ordinarily must be met when applying of a loan under the E.I.D.L. program. Consequently, the following requirements are waived:

- All rules related the personal guarantee on advances and loans of not more than $200,000 during the Covered Period for all applicants.
- The requirement that an applicant must be in business for the one-year period before the disaster, except that no waiver may be made for a business that was not in operation on January 31, 2020.
- The requirement that an applicant be unable to obtain credit elsewhere.

Standard for Approval

During the covered period, the S.B.A. may approve an applicant based solely on the credit score of the applicant and will not require an applicant to submit a tax return or a tax return transcript for such approval. Alternatively, the S.B.A. may use another appropriate method to determine an applicant's ability to repay the loan.

Emergency Grant

During the Covered Period, an eligible entity for an E.I.D.L. loan – as determined under the expanded scope of eligibility – may request an advance of $10,000. In principle, the advance must be made by the S.B.A. within three days after the request is received. While the request must be verified before the advance is disbursed, verification is effected solely by self-certification of the applicant.

An advance may be used for any allowable purpose, including

- providing paid sick leave to employees unable to work due to the direct effect of the COVID–19 virus,
- maintaining payroll to retain employees during business disruptions or substantial slowdowns,

- meeting increased costs to obtain materials unavailable from the applicant's original source due to interrupted supply chains,
- Making rent or mortgage payments, and
- Repaying obligations that cannot be met due to revenue losses.

Once the grant is received, an applicant is not be required to repay the advance even if subsequently denied a loan.

BUSINESS TAX PROVISIONS

The CARES Act provides several tax provisions to provide liquidity for business.

What is the employee retention credit and how does it work?

The employee retention credit is a refundable payroll tax credit for 50% of wages paid to employees after March 12, 2020 and before January 1, 2021. The credit is available to employers whose operations were fully or partially suspended due to a COVID-19-related shutdown order or whose gross receipts declined by more than 50% when compared to the same quarter in the prior year.

The credit is based on qualified wages paid to employees. For employers with greater than 100 full-time employees, qualified wages are wages paid to employees who are not working due to the COVID-19 virus. For eligible employers with 100 or fewer full-time employees, all employee wages qualify for the credit, whether the employer is open for business or subject to a shut-down order. The credit is provided for the first $10,000 of compensation paid to an eligible employee and includes health benefits.

The credit for businesses experiencing a downturn, such as a suspension of operations due to a COVID-19-related shutdown order or with decline in gross receipts, for any days in March 2020 should be applied for using the employer's Q2 Form 941, 941-SS, or 941-PR, reporting 50% of the qualified wages for March together with the Q2 qualified wage amount. The credit should not be reported on the first quarter form.

Have payment of employer payroll taxes been deferred?

Yes. The CARES Act allows employers and self-employed individuals to defer payment of the employer share of the Social Security tax they otherwise are responsible for paying to the Federal government with respect to employees. Employers generally are responsible for paying a 6.2% Social Security tax on employee wages. The provision requires that the deferred employment tax be paid over the following two years, with half of the amount required to be paid by December 31, 2021 and the other half by December 31, 2022. The Social Security Trust Funds will be held harmless under this provision.

Employers receiving a P.P.P. loan and benefiting from debt forgiveness cannot take advantage of this provision.

May net operating losses now be carried back?

Yes. The CARES Act relaxes the limitations on a corporation's use of net operating

losses ("N.O.L.'s"). Under current law, N.O.L.'s are subject to a taxable-income limitation equal to 80% of the taxpayer's adjusted gross income and they cannot be carried back to reduce income in a prior tax year. Now, an N.O.L. arising in a tax year beginning in 2018, 2019, or 2020 can offset 100% of taxable income or alternatively be carried back five years.

"Taxpayers may make an irrevocable election under the CARES Act to exclude years in which Transition Tax liability existed from the carryback."

If the N.O.L. is carried forward, it would reduce income that is taxed at 21%, and possibly higher rates depending on the outcome of national elections in November. If carried back, it may be usable to reduce income that was taxed at a 35% rate, but interaction with other tax attributes absorbed in the prior year, including general business credits such as foreign tax credits, special deductions, and alternative minimum tax liability in prior years are all items to be carefully considered beforehand.

Several commentators have cautioned that a carryback of an N.O.L. to a year prior to 2018 may be applied to reduce income that was subject to the one-time Code §965 Transition Tax adopted in the Tax Cuts and Jobs Act of 2017, when the U.S. adopted a dividends received deduction for dividends from 10% foreign-owned companies. The Transition Tax was imposed for 2017 on the income of 10% shareholders of foreign corporations. The rate the tax was limited to 8% for earnings invested in operating assets and 15.5% for earnings invested in financial assets. Under the Act, carrying back to years in which the taxpayer was subject to Transition Tax will result in the taxpayer being treated as having made an election not to apply the N.O.L. under Code §965(n).

Taxpayers may make an irrevocable election under the CARES Act to exclude years in which Transition Tax liability existed from the carryback. Such elections must be made by the extended due date of the 2020 return by attaching a statement for each year for which the taxpayer intends to make the election, stating that taxpayer is electing to apply Code §172(b)(3) under Rev. Proc. 2020-24 and the taxable year to which the statement is applicable.

Other commentators have pointed out that liquidity from the adoption of an N.O.L. carryback rule will not be realized until the close of the 2020, when the losses from COVID-19 will be available for carryback. However, under Rev. Proc. 2020-26 taxpayers can potentially obtain a refund within 90 days (for years other than those affected by Transition Tax) by filing Form 1139, Corporate Application for a Tentative Refund (for corporations) or Form 1045, Application for Tentative Refund (for individuals, trusts, and estates), subject to an extended due date of 18 months (or June 30, 2020 for the 2018 tax year). The I.R.S. will start accepting these forms via fax (844-249-6236 for Form 1139, and 844-249-6237 for Form 1045) starting on April 17, 2020. The I.R.S. encourages taxpayers to wait till the 17th and fax the forms to avoid delays caused by physical mail during the crisis.

New York State and New York City have decoupled from the Federal N.O.L. carryback rules. Neither jurisdiction has sufficient free cash to issue refunds of corporate tax.

How are pass-through losses from partnerships and L.L.C. affected by the CARES Act?

Prior to 2018 sole proprietors and individuals who were members of a partnership or L.L.C. in which they were active participants could use the full amount of losses generated by the business to reduce other taxable income. Effective for 2018, "excess

business losses" of individuals were not allowed for the taxable year. Such losses were carried forward and treated as part of the taxpayer's N.O.L. in subsequent taxable years. An excess business loss was defined as the amount by which aggregate deductions of the individual exceed the sum of (i) aggregate gross income or gain of the taxpayer plus (ii) a threshold amount of $250,000 or $500,000, depending on marital status.

The CARES Act modifies these loss limitation rules on a retroactive basis. For each year in the three-year period that begins in 2018, individuals can utilize excess business losses to access critical cash flow to maintain operations and fund payroll for their employees. In 2021, the loss limitation rule will come into effect again, and will stay in effect until 2026.

How are refundable alternative minimum tax ("A.M.T.") credits affected by the CARES Act?

The corporate A.M.T. was a tax computed at lower rates but on a broader tax base. If the A.M.T. produced a tax greater in amount to the ordinary corporate income tax the excess amount was added to the income tax. If in subsequent years the regular corporate tax was greater than the A.M.T., a taxpayer was entitled to a refund.

The T.C.J.A. repealed the A.M.T., allowing unused A.M.T. credits to be carried forward as refundable credits over a four-year period beginning in 2018. The CARES Act accelerates the ability of companies to recover those A.M.T. credits, permitting companies to obtain additional cash flow during the COVID-19 emergency.

How is the limitation on deductible business interest of a corporation under Code §163(j) affected by the CARES Act?

In 2018, a cap was placed on deductible interest expense of corporations. The cap was 30% of adjusted taxable income, which more or less equated to the equivalent of E.B.I.T.D.A., with certain modifications to conform with tax concepts.

For 2019, the CARES Act increases the cap place on allowable interest expense to 50% of adjusted taxable income. The provision temporarily increases the amount of interest expense businesses are allowed. More importantly, for 2020, a taxpayer may elect to use adjusted taxable income for 2019 to compute the amount of the cap, recognizing that for most, 2019 will be a year of greater profits than 2020.

How does the CARES Act correct a technical error regarding "qualified improvement property"?

The CARES ACT makes a technical correction to the T.C.J.A. that enables businesses, especially in the hospitality industry, to write off immediately the costs associated with improving facilities instead of having to depreciate those improvements over the 39-year life of the building.

What is the U.S. Federal income tax treatment of forgiveness of any portion of a P.P.P. loan?

As stated above, forgiveness for those borrowers meeting the requirements will be excluded from the borrower's gross income. Therefore, no U.S. Federal income taxes will be owed in consequence of either receiving a P.P.P. loan or later meeting the requirements to have it forgiven.

I.R.S. PRONOUNCEMENTS ON STRANDED FOREIGN INDIVIDUALS

Recognizing that the global outbreak of the COVID-19 virus has significantly limited the ability of many individuals to leave the U.S., regardless of having been infected, the I.R.S. has taken several steps to provide relief to individuals and their employees. For example, Nonresident, non-citizen ("N.R.N.C.") individuals who perform services or other activities in the U.S. and foreign corporations who employ individuals or engage individuals as agents to perform services or other activities in the U.S. may be considered engaged in a U.S. trade or business. If the individuals performing those services or other activities are temporarily in the United States solely due to COVID-19 Emergency N.R.N.C. individuals or foreign corporations may technically become engaged in a U.S. trade or business. If a U.S. income tax treaty applies, an N.R.N.C. individual or foreign corporation generally will not be liable to tax on business profits or employee compensation unless the business is conducted through a permanent establishment in the U.S.

To provide relief for those N.R.N.C. individuals and their employers and also for American expats who are stranded in the U.S. by reason of flight restrictions and closed border, the I.R.S. announced three measures for individuals stranded in the U.S.

Revenue Procedure 2020-20

In this procedure the I.R.S. announces the circumstances in which U.S. presence of up to 60 consecutive calendar days will be presumed to arise from travel disruptions caused by the COVID-19 emergency. Those days will not be counted for purposes of determining U.S. tax residency of a nonresident, non-citizen ("N.R.N.C.") individual. In addition, those days will not be counted for purposes of determining whether an N.R.N.C. qualifies for tax treaty benefits regarding income from personal services performed in the U.S. Typically, the treaty provisions will provide that presence in the U.S. for 183 days or more precludes an individual from being exempt on compensation for work performed in the U.S. on behalf of a foreign employer in circumstance where the compensation is not borne by a permanent establishment in the U.S.

Revenue Procedure 2020-27

For expat Americans who claim the benefit for the foreign earned income exclusion and the qualified housing deduction, days of presence in the U.S. can have an adverse effect on entitlement to the benefits. In this procedure, the I.R.S. announces that the two benefits will not be impacted as a result of days spent away from a foreign country due to the COVID-19 emergency based on having departed the country of residence on or after a specified date where it is reasonable to believe that the required time period abroad would have been met in the absence of the COVID-19 emergency. Dates are provided for various geographic locations as the pandemic spread across the globe.

I.R.S. Frequently Asked Questions and Answers[6]

In two frequently asked questions and answers, the I.R.S. advises that, for up to 60 consecutive calendar days, certain U.S. business activities conducted by an

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[6] See here.

N.R.N.C. individual or foreign corporation will not be counted in determining whether the individual or entity is engaged in a U.S. trade or business or has a U.S. permanent establishment. Again, the relief is extended only if those activities would not have been conducted in the U.S. but for travel disruptions arising from the COVID-19 emergency.

CORPORATE MATTERS:
THE VALUE OF PAR VALUE

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Tags
Bond Par Value
Dividend
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Par Value
Surplus

PAR VALUE

The majority of our corporate engagements begin with a request from a foreign client, or professional representing their client, to form a U.S. entity through which to engage in some activity in the United States. Depending on the nature of the activity and the client involved, we typically recommend the formation of either a Delaware C-corporation or limited liability company. If the entity is to be used as a holding company, a relatively simple corporate structure is required. In the case of a C-corporation, which is the focus of this article, a limited number of a single class of stock, few directors and basic officer appointments is usually the way the corporation is established.

When we send the incorporation documents to our client for signing, the certificate of incorporation includes the following clause, or a variation thereof:

> The total number of shares of stock which the corporation is authorized to issue is Two Hundred shares of common stock, par value $0.01 per share.

Typically, the initial capital of the corporation is considerably more than 200 times (or what ever the number of shares initially authorized is) the par value and we often receive inquiries from non-U.S. colleagues and clients as to what the par value is and why it is out of step with the capital initially paid in to the company. We thought it might be helpful to provide a brief description of par value as it relates to the common stock of a U.S. corporation.

WHAT IS PAR VALUE?

The par value of a stock is the value per share set forth in the certificate of incorporation filed with the secretary of state. Also called nominal or face value, the par value is the minimum price per share that must be paid in order for the shares to be considered fully paid and has no bearing on the fair market value of the stock. The par value also appears on the company's stock certificate. One is less likely to be aware of this now as larger, particularly public, corporations move to electronic certification and more closely held private corporations are uncertified – meaning they do not necessarily issue a stock certificate as evidence of ownership.

The only real significance of par value has to do with liability shareholders may have if stock is sold below the par value.

If shareholders pay less than the par value for a share of stock and the issuing company later becomes unable to meet its financial obligations, its creditors can sue shareholders for the difference between the purchase price and the par value

to recoup the unpaid debt. If the market price of the stock falls below the par value, the company may be liable to shareholders for the difference. For example, if company XYZ issues 10,000 shares of stock with a par value of $25, then the minimum amount of equity that should be generated by the sale of those shares is $250,000. Since the market value of the stock has virtually nothing to do with par value, investors may buy the stock on the open market for considerably less than $25. If all 10,000 shares are purchased below par, say for $15, the company will generate only $150,000 in equity. If the business goes under and cannot meet its financial obligations, shareholders could be held liable for the $10-per-share difference between par and the purchase price.

"The par value of stock is not to be confused with the par value of a bond."

Most companies opt to set a minimum par value for their stock shares to circumvent either of these scenarios – Amazon stock has a par value of $0.01, for example.

Historically, companies were required to state a par value for the their stock – most states, Delaware among them, now allow for no par value stock. The "no par" status means that the company has not assigned a minimum value to its stock. No par value stocks do not carry the theoretical liabilities of par value issues since there is no baseline value per share. However, since companies assign minimal par values if they must, there's little effective difference between a par stock and a no-par stock.

DIVIDENDS

The par value of a stock is also factored in when determing whether a surplus exists for the purpose of declaring and paying dividends.

Sections 170 and 173 of the Delaware General Corporation Law (the "Delaware G.C.L.") prohibit a Delaware corporation from declaring or paying a dividend except out of "surplus." "Surplus" is defined in section 154 of the Delaware G.C.L. as, "the excess, if any, at any given time, of the net assets of the corporation over the amount…determined to be capital."

Under Section 154 of the Delaware G.C.L., "capital" is determined for par value stock as being the par value of the consideration received for the stock and for stock with no par value, the entire consideration received for the issuance of such stock constitutes capital unless the board allocates a smaller portion of the total consideration to capital. "Net assets" is the amount by which total assets exceed total liabilities.

To determine whether a surplus exists, a valuation of the corporation's net assets is required. The value of the net assets of a corporation reflected on its books (based on generally accepted accounting principles) may not, however, reflect the current market value of the corporation's assets and liabilities. Delaware courts have recognized this conflict and have permitted the directors of a corporation to "revalue" the assets and liabilities of the corporation when determining whether a surplus exists.

BOND PAR VALUE

The par value of stock is not to be confused with the par value of a bond. Bonds are fixed-income securities issued by corporations and government bodies to raise capital. The par value of a bond is quite different to the par value of a stock. Unlike a stock, a bond has a real par value. A bond with a par value of $1,000 really can

be redeemed for $1,000 at maturity. To the average investor, the par value of a bond is quite relevant, while the par value of a stock has become something of an anachronism.

ACCOUNTING CONSIDERATIONS

In most cases, the par value of the stock today is little more than an accounting concern, and a relatively minor one at that.

The only financial effect of a no par value issuance is that any equity funding generated by the sale of no par value stock is credited to the common stock account. Conversely, funds from the sale of par value stock are divided between the common stock account and the paid in capital account. When stock is issued at a price higher than its par value, the cash account is debited with the total amount of cash received, the capital stock account is credited with the total par value of shares issued and an account known as additional paid-in capital or capital in excess of par is credited with the difference between cash received and the par value of shares issued.

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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.

Our firm provides a wide range of tax planning and commercial legal services to clients across the Americas, Asia, Europe, and the Middle East. Clients include global investors, multinational corporations expanding into the U.S., and U.S. businesses with international operations. Our core practice focuses on cross-border transactions.

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Insights, the 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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