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INSIGHTS

2020 YEAR IN REVIEW

A YEAR OF GUEST FEATURES

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EDITORS' NOTE

As is our tradition at *Insights*, the December special edition acknowledges the contributions of guest authors throughout the year. Twelve articles written by 18 guest authors appeared in *Insights* 2020, down from 25 in 2019, when the world was unaware of the COVID-19 virus and worldwide lockdowns. Of the 12 guest articles, three addressed U.S. tax issues (Subpart F, source of income, personal use real estate), two addressed E.U. issues related to exchanges of information (D.A.C. 6 in the U.K. and taxpayer rights in exchange of information), two addressed Indian taxes (source of income from gains and implementation of the M.L.I.) , and one each addressed issues in Germany (real estate transfer tax), Switzerland (tax reform), the Netherlands (labor law), Israel (taxation of real estate income), and Portugal (treatment of trusts).

To our guest authors, we extend our heartfelt thanks. To our readers, we wish you all the best in 2021. Happy Holidays!

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- **A gRETT-able Situation: New Trends in German Real Estate Transfer Tax on Share Deals.** For decades, the German Real Estate Transfer Tax Act ("gRETT Act") has imposed a transaction tax on the sale of real estate in Germany. In recent years, the tax has applied to the sale of shares that indirectly transfer real estate located in Germany. When initially enacted, a sale of all shares was taxable under the gRETT Act. In the year 2000, the triggering percentage was reduced to 95%. Last year, proposed legislation

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would have reduced the triggering percentage to 90%, but the draft bill was never enacted. In 2020, the triggering percentage may be reduced to as low as 75% or some other percentage whenever new legislation is adopted. Exactly what constitutes an indirect sale of German real estate is surprisingly broad, and unlike comparable taxes in other countries, the sales need not be related nor contemporaneous. In recent years, a populist clamor has arisen to broaden the scope of indirect transfers subject to the tax. Michael Schmidt of Schmidt Taxlaw, Frankfurt am Main, Germany, explains how and when the tax is imposed under current law and how it may be modified in the coming months.

- **Portuguese Taxation of Distributions from Trust Capital: A Critical Assessment.** How does a country adopt a law to tax the income of an entity that generally is not recognized under local law? In Portugal, there is room for improvement. The 2014 reform of the Portuguese Personal Income Tax ("P.I.T.") Code introduced certain taxing provisions that specifically address "fiduciary structures," the Portuguese term for trusts. Two separate categories of payments were established for purposes of imposing tax. Under the first category, all amounts paid or made available to a Portuguese tax resident are taxable. This includes capital distributions. Under the second category, gains realized by the taxpayer who formed the fiduciary structure are taxed at the time of a final distribution incident to the structure's liquidation, unwinding, or termination. Other beneficiaries can receive liquidation distributions without suffering any tax. João Luís Araújo and Álvaro Silveira de Meneses of Telles Advogados, Porto and Lisbon, Portugal, suggest that solid arguments support the view that certain distributions should be seen as outside the scope of the P.I.T. Code, including (i) distributions of trust capital to the settlor during the ongoing existence of a trust and (ii) distributions to non-settlors that are akin to gifts.

- **Same Same, But Different: Taxing a Sale of Indian Stock by a U.S. Person.** While tax rules generally appear to be similar in India and the U.S., several divergent provisions in the domestic law of each country produce adverse consequences for those who are not well advised. The prime example involves the taxation of gains from the sale of shares of an Indian company by a U.S. person: India sources the gain based on the residence of the target while the U.S. sources the gain based on the residence of the seller. No relief from double taxation is provided, notwithstanding the capital gains and relief from double taxation articles in the U.S.-India income tax treaty. The result is tax that can be as high as 33.8% of the gain. Rahul Jain and Sanjay Sanghvi of Khaitan & Co., Mumbai, India, along with Neha Rastogi and Stanley C. Ruchelman explain the problem and, more importantly, suggest a path forward for U.S. individuals realizing sizable gains.

- **Swiss Corporate Tax Reform: T.R.A.F. in a Nutshell.** As a result of a favorable vote last year, T.R.A.F. – the tax reform in Switzerland – came into effect on January 1, 2020. T.R.A.F. was crafted to generate additional revenue for cantons, enhance old age pensions and survivors insurance funding, and reform corporate tax rules. Peter von Berg of Blum&Grob Attorneys at Law in Zurich, Switzerland, identifies the major changes for companies and individuals and provides examples of the effects on various entities.

- **The Netherlands Introduces Compensation Regulation to Discourage "Dormant Employment."** For U.S. tax advisers not versed in Dutch labor law, the world of employee rights and employer obligations is a thing to behold. To illustrate, in 2015, the Dutch parliament enacted a law under which an employee in the Netherlands having spent 104 weeks on paid sick leave is entitled to a transition payment if the employment contract was terminated by the employer. However, many employers attempted to avoid the payment by retaining these employees under "dormant contracts," where the contract remained in force but there was no position available and no pay. New legislation effective April 1, 2020, breaks the deadlock. The transition fee remains in effect, but all or most of the payment is funded on a deferred basis by the Dutch government. Rachida el Johari and Madeleine Molster of Saguire Legal, Amsterdam, the Netherlands, explain how the Compensation Regulation works and propose a winning strategy for employers.

- **The Multilateral Instrument and Its Applicability in India.** One of the most significant outcomes of the B.E.P.S. Project is the signing of the multilateral instrument ("M.L.I.") in 2017. The O.E.C.D. initiated the B.E.P.S. Project in 2013 with a view to curtail tax avoidance. The M.L.I. addresses B.E.P.S. concerns in thousands of bilateral tax treaties through one common treaty. India has been at the forefront of implementing B.E.P.S. measures, and India's covered tax treaties will need to be read with the M.L.I. from April 1, 2020. Sakate Khaitan of Khaitan Legal Associates, Mumbai, India, and Abbas Jaorawala, a chartered accountant and consultant to that firm, explain India's positions on various provisions of the M.L.I. for those engaged in trade or investment opportunities relating to India.

- **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.

- **Home Thoughts From Abroad: When Foreigners Purchase U.S. Homes.** Remember when tax planning was an exercise in solving two or three potential issues for a client? Memorandums ran eight pages or so. Those days are long gone, especially when planning for a non-U.S. individual's purchase of a personal use residence in the U.S. A myriad of issues pop up once the property is identified, so that planning which begins at that time often misses significant tax issues encountered over the period of ownership and beyond. Michael J.A. Karlin, a partner of Karlin & Peebles, L.L.P., Los Angeles, and Stanley C. Ruchelman, address the big-picture issues in an article that exceeds 50 pages. Included are issues that arise leading up to the acquisition, during ownership and occupancy, the time of disposition, and at the conclusion of life. The article is the "go-to" document for tax planners.

- **Exchanges of Information in Tax Matters and Fundamental Rights of Taxpayers – E.C.J. Delivers Landmark Ruling in the Aftermath of *Berlioz*.** In a post B.E.P.S. world, tax transparency is a mantra among stakeholders in government, media, and nongovernmental organizations. The taxpayer may own the funds, but the stakeholders wish to ensure that a chunk of the funds are spent as they deem appropriate. In this environment, governments have a stake in obtaining information on where taxpayers hold their funds and exchanges of information between governments has become a regular occurrence. In the European Union, questions arise as to whether an information request violates a taxpayer's fundamental rights, and in the event of a fishing expedition, whether the taxpayer has an effective remedy. In a recent decision issued by the E.C.J., the court held that financial institutions holding information have rights to intervene, but not taxpayers must wait until a tax authority assesses tax. Werner Heyvaert, a partner in the Brussels Office of AKD Benelux Lawyers and Vicky Sheikh Mohammad, an associate in the Brussels Office of AKD Benelux Lawyers, explain the rationale of the court and question the validity of its conclusion.

- **Watch Out Whirlpool: The I.R.S. Has Put 50 Million Wrinkles in Your Permanent Press Cycle.** As 2020 comes to a close, Subpart F is approaching its 59th anniversary as part of the Internal Revenue Code. During that period of time, various portions have been revised, but by and large, the branch rule has remained untouched. Under that rule, a C.F.C. based in a country that exempts income of a permanent establishment can be treated as two companies where manufacturing takes place in one country and selling activity takes place in a different country. From a U.S. viewpoint, the same abusive tax planning can be undertaken between the head office and the branch as can be undertaken between brother-sister or parent-subsidiary C.F.C.'s. Nonetheless, no taxpayer ever lost a case brought by the I.R.S. until this year. In *Whirlpool Financial Corp. v. Commr.*, Whirlpool Corporation determined that the branch rule regulations were invalid when manufacturing operations were conducted by the branch and selling activities were conducted by the head office. Arguing that the law permitted the loophole because a single corporation conducted the manufacturing operations, Whirlpool became the first U.S. Shareholder to lose a case in which the I.R.S. asserted the application of the branch rule to a manufacturing branch. Gianluca Mazzoni, S.J.D. 2020 and L.L.M.2016 International Tax, University of Michigan Law School, explains the plan that was adopted, the argument presented by the taxpayer, the decision of the court, and the likely issues that will be addressed on appeal.

- **Final Regs Implement Changes to Source-of-Income Rules for Inventory Sales.** In late 2019, the I.R.S. proposed regulations modifying rules for determining the source of income from sales of inventory property produced by a taxpayer outside the U.S. and sold within the U.S., or produced by the taxpayer within and sold without the U.S. Final regulations were published in October. The regulations implement changes made by the Tax Cuts and Jobs Act provide guidance under Code §865(e)(2) regarding sales of inventory through a U.S. office or fixed place of business. In her article, Léa Verdy, an attorney admitted to practice in New York and Paris, presents the sourcing rules for sales of inventory before the T.C.J.A, the changes implemented by the T.C.J.A., the guidance offered by the I.R.S., and the consequences of the regulations for taxpayers.

We hope you enjoy this issue.

- The Editors

A GRETT-ABLE SITUATION: NEW TRENDS IN GERMAN REAL ESTATE TRANSFER TAX ON SHARE DEALS

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Tags
Germany
Real Estate
Transfer Tax
Share Deals

Michael Schmidt is the founder of Schmidt Taxlaw, a boutique firm in Frankfurt am Main, Germany. Schmidt Taxlaw is focused, in particular, on cross-border tax and legal advice for family-owned businesses and their owners. Michael is qualified as both a lawyer and a certified tax adviser in Germany. Michael advises his German and foreign clients with respect to cross-border investment structures, corresponding corporate work, estate planning, as well as tax defense strategies.

From a historic perspective, German Real Estate Transfer Tax ("gRETT") is a transaction tax triggered by the transfer of title held in real estate located in Germany. For decades, the German Real Estate Transfer Tax Act ("gRETT Act") followed an approach driven by the legal transfer of title pursuant to applicable civil law. This also applied to direct or indirect share deals regarding German or foreign entities holding real estate located in Germany. Because gRETT is a transaction tax originally imposed on the transfer of legal title, commercially driven concepts that commonly appear for income tax purposes were not relevant.

As originally enacted, only the direct or indirect transfer of 100% of either a partnership holding German real estate (a "Real Estate Holding Partnership" or "R.E.H.P.") or a company holding German real estate (a "Real Estate Holding Company" or "R.E.H.C.") was deemed to be similar to an asset purchase of real estate for gRETT purposes.[1]

The terms R.E.H.P. and R.E.H.C. are not limited to legal entities belonging to real estate developers or real estate investors but include all partnerships and companies that own real estate located in Germany. Thus, all direct or indirect transfers of a participation in such legal entities require the assessment of a potential gRETT liability. This applies even if the "transfer" of real estate held by the legal entity is not the main focus of the transaction, such as an M&A transaction involving a manufacturing entity or an intra-group transfer of shares pursuant to a merger or demerger within the group.

gRETT can apply to all share transfers that revise the ownership chain of an R.E.H.P. or R.E.H.C.; it does not matter whether this share transfer involves an R.E.H.P. or an R.E.H.C. only indirectly. Also, a share transfer regarding a foreign direct or indirect shareholder of an R.E.H.P. or R.E.H.C. is relevant. The gRETT debtor is either the R.E.H.P. or R.E.H.C. or the direct or indirect shareholder depending on the gRETT-able event. The taxpayer is obligated to notify the responsible German tax office of the change in ownership. If the notification is not filed, this non-compliant conduct is typically discovered in a tax audit, when the tax officer checks the requested group charts.

NEW COMMERCIAL APPROACH TO INDIRECT SHARE DEALS

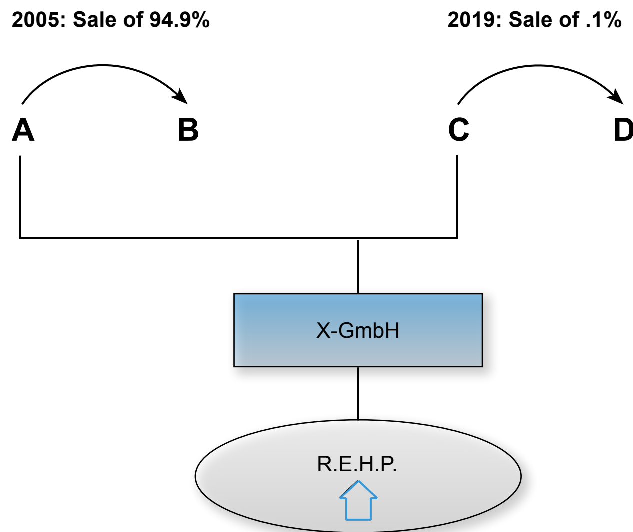
In 2000, the law changed regarding share transfers. From that point, a direct or indirect transfer of a 95% interest in an R.E.H.P. or R.E.H.C. is subject to gRETT.

1 Sales of shares of an R.E.H.P. holding German real estate have been subject to gRETT since 1996. Sales of interests in a partnership owning German real estate have been subject to gRETT since 1999.

The underlying premise of the change in law is that no significant difference exists between a transfer of a 100% interest in an R.E.H.P. or R.E.H.C. and a transfer of a 95% interest in an R.E.H.P. or R.E.H.C. Consequently, a transfer of a 95% interest in an R.E.H.P. or an R.E.H.C. has become subject to gRETT. This was the beginning of a limited commercial approach to the understanding of what kind of share deal should be subject to gRETT.

From that rather limited beginning, the legislator and the tax authorities have expanded this commercial approach step-by-step. In particular with respect to indirect transfers of participations held by companies in an R.E.H.P., this commercial approach has been expanded significantly. A decree published by the Federal Ministry of Finance on November 12, 2018,[2] (the "Decree") significantly changed the gRETT treatment of share deals indirectly affecting an R.E.H.P. in a tiered ownership structure. The following examples illustrate this tendency:

Example 1:



"No significant difference exists between a transfer of a 100% interest in an R.E.H.P. or R.E.H.C. and a transfer of a 95% interest."

The gRETT Act provides that the direct or indirect transfer of at least 95% of the participation held in an R.E.H.P.'s assets to new partner(s) triggers a gRETT liability only if a participation of 95% in total is transferred within five years to new partner(s).

The Decree modifies the rule in a tiered structure where a corporation owns shares in an R.E.H.P. The five-year limitation no longer applies. Any direct or indirect transfer in X-GmbH triggers gRETT irrespective of this five-year period.

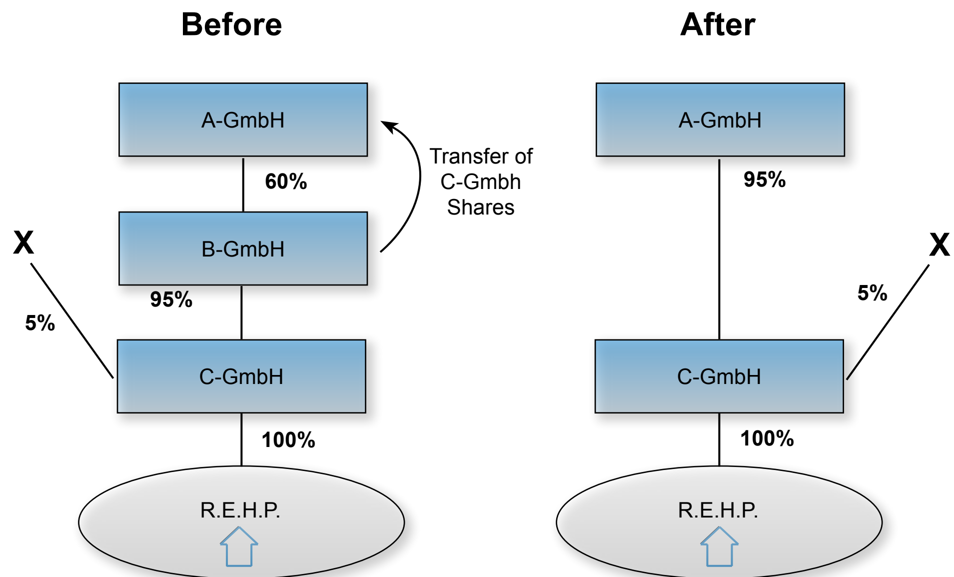
The scope of the decree is illustrated in Example 1. There, X-GmbH was owned until 2005 by A and C. In 2005, B acquired from A 94.9% in X-GmbH and became therefore a new indirect partner of R.E.H.P., while C still held 5.1% in X-GmbH. In 2019, C sells 0.1% of the shares in X-GmbH to D. Since then, B, C, and D hold the entire shares of X-GmbH which owns 100% of R.E.H.P. At all times, A, B, C, and D are unrelated to each other.

Before this Decree. it was the common understanding that the transfer of 0.1% of the shares in X-GmbH from C to D in 2019 would not trigger a gRETT liability,

[2] Decree dated November 12, 2018, Federal Tax Gazette 2018 II, p. 1314 ff.

because B held 94.9% of the shares in X-GmbH for more than five years. However, the Decree changes the result. Under the Decree, the transfer of 0.1% of the X-GmbH shares by C to D in 2019 triggers a gRETT liability. It does not matter that 99.9% of the shareholdings in X-GmbH have been held by the same shareholders in the same percentages for five years or more. The German tax authorities qualify B and D as new (indirect) partners of R.E.H.P. due to the transfer of 95% of the shares held in X-GmbH in two sales, separated by as much as 14 years, among independent parties.

<u>Example 2:</u>

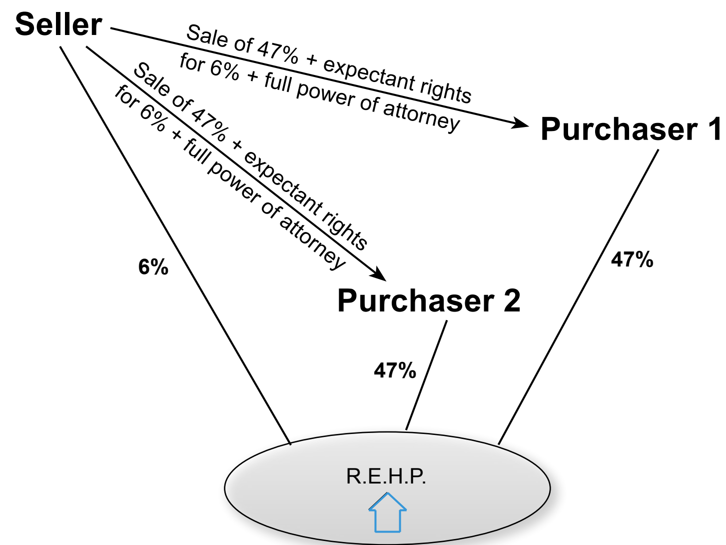


By way of the said Decree, the Federal Ministry of Finance applies a new interpretation that inflicts with the compression of a multi-layer chain of shareholdings in an R.E.H.P. held directly or indirectly by a company. The new approach is based on a commercial view that 95% ownership equates to actual ownership subject to a minority interest.

In the past, a compression of a multi-layer chain of shareholdings in an R.E.H.P. triggered a gRETT liability only when the direct partner of an R.E.H.P. (*i.e.*, C-GmbH in Example 2) was substituted, for example, by a merger. Compression of the ownership chain was not subject to gRETT if the shares of an upper-tier member was removed from the chain of ownership. Consequently, in Example 2, the transfer of shares in B-GmbH to A-GmbH did not trigger a gRETT liability.

According to the tax authorities' new interpretation of the still unchanged gRETT Act, the transfer of shares in B-GmbH to A-GmbH results in a new 95% shareholder of C-GmbH, which redefines C-GmbH as a new partner of R.E.H.P. The transfer of shares in B-GmbH to A-GmbH triggers a gRETT liability for 100% of the real estate held by R.E.H.P. because of the deemed transfer of at least 95% of the participation held in R.E.H.P.'s assets to R.E.H.P.'s deemed new partner C-GmbH.

Example 3:



According to the new interpretation of the still unchanged gRETT Act by the Decree, the transfer of the mere right to enjoy the benefits of a direct or indirect 95% participation in an R.E.H.P. is also treated as a taxable transfer of German real estate owned by an R.E.H.P. The following are examples for possible ways how to enjoy such benefits:

- The grant of an option to acquire (i) the shares held in the direct or indirect partner of the R.E.H.P. or (ii) the interest in the R.E.H.P, which cannot be withdrawn unilaterally from the option holder.
- The voting rights or profits rights held by the title holder of 95% of (i) the shares in the direct or indirect partner of the R.E.H.P. or (ii) the interest in an R.E.H.P. have been transferred to a third party already prior to the transfer of the legal title.
- A deferred transfer of legal title in a transaction that immediately grants to the acquirer the risks and rewards of ownership in 95% of (i) the shares in the direct or indirect partner of the R.E.H.P. or (ii) the interest in the R.E.H.P.

Even the grant of a full irrevocable and open-ended power of attorney could be viewed as a taxable transaction. Under the Decree, both the terms of the power of attorney and the facts surrounding its operation must be taken into account in determining whether the grant triggers a gRETT liability. The result is a lack of certainty as to tax exposure. This is illustrated in Example 3, where the sale of two separate and unrelated transfers of 47%-interests in R.E.H.P. to Purchaser 1 and Purchaser 2 could trigger exposure to a gRETT liability under the Decree, if Seller has granted Purchaser 1 and Purchaser 2 additionally a full joint power of attorney to exercise his partner's rights in R.E.H.P.'s general assembly and to sell his 6% interest for him, even though the Seller has transferred less than 95% of the interests in R.E.H.P.

These new interpretations of the unchanged gRETT Act provisions are controversial, and their validity is questionable. Taxpayers receiving an assessment notice in this context should carefully consider an appeal.

DRAFT BILL EXPANDS SCOPE OF GRETT

Following this administrative expansion of share transfer transactions considered to be subject to gRETT, the German Ministry of Finance published a draft bill[3] (the "Draft Bill"), which proposed changes to the gRETT Act provisions applicable to share deals in a way that further expands the commercial approach to an R.E.H.P. and R.E.H.C. The Draft Bill exposes more share deals to gRETT, which is imposed at the rate between 3.5% and 6.5% of the real estate value. The Draft Bill reflects the government's view that share deals are merely an instrument of illegitimate but legal tax structuring, in particular, in cases of high-volume real estate transactions.

The Draft Bill expands the scope of harmful share deals that are subject to gRETT. The new rules shall apply to the following list of direct or indirect transfers of (i) partnership interests held in an R.E.H.P. and (ii) shares held in an R.E.H.C.:

- A gRETT liability shall be triggered by the transfer of a participation in an R.E.H.P. if, as a result of the transaction, at least 90% of the interests in the R.E.H.P. have been transferred directly or indirectly to new partners within the preceding ten-year period in multiple transactions. In comparison to the existing law, more transactions are covered because the triggering level of share transfer has been reduced by five percentage points and the period looked at has been expanded by five years.
- For the first time, the Draft Bill provides for a provision according to which any transfer of a share held in an R.E.H.C. shall trigger a gRETT liability if, as a result of that transfer, at least 90% of the shares in an R.E.H.C. are transferred directly or indirectly to new shareholder(s) within a period of ten years. This new calculation will include each shareholding at each level, while the current gRETT Act includes only shareholdings of at least 95%.
- In the case of an R.E.H.C., any claim for a legal transfer or any legal transfer of the R.E.H.C. shares, which results either directly or indirectly in a unification of at least 90% (formerly 95%) of an R.E.H.C. in one hand, shall be subject to gRETT.
- In the case of an R.E.H.C., any claim for a legal transfer or any legal transfer of at least 90% (formerly 95%) of an R.E.H.C. – either directly or indirectly – shall be subject to gRETT.
- gRETT is imposed on 100% of the value of the real estate even when the total direct or indirect transfer is limited to as little as 90% of the shares of an R.E.H.C. or the interests in an R.E.H.P.
- The minimum period for holding the participation in an R.E.H.P. shall be extended from five years to ten years after the transfer of the real estate by the partner to an R.E.H.P., which is a precondition for the gRETT exemption applicable to the transfer of real estate to an R.E.H.P. in accordance with the transferor's participation in an R.E.H.P.
- The minimum period for holding the participation in an R.E.H.P. shall be extended from five years to ten years and 15 years, respectively, before the transfer of the real estate to the partner of an R.E.H.P., which is a precondition for

[3] Draft Bill published on the website of the Federal Ministry of Finance on July 31, 2019.

the gRETT exemption applicable to the transfer of real estate from an R.E.H.P. to its partner in accordance with the transferee's participation in an R.E.H.P.

- All these gRETT transactions must be reported on a timely basis to the appropriate German tax authorities.

The Federal government withdrew the Draft Bill on October 24, 2019. It is anticipated that a revised bill will likely be introduced in 2020. The Federal government announced that the Draft Bill will be reworked within the first six months of 2020. High-volume share transactions continue to be viewed by the Federal government as illegitimate, but legal, if they avoid gRETT. In that regard, certain commentators proposed that the trigger that exposes a share transaction to gRETT should be reduced to 75% of the shares of the company. Other commentators cautioned that taxpayers will develop new structures for avoiding gRETT if the government tightens the gRETT anti-abuse rules. Still other commentators suggested that extending the holding period from five years to ten years would be in breach of German constitutional law. Finally, several experts highlighted the negative impact the reform would have on the housing market. According to the information received, a completely new concept for specific real estate holding entities, which at the beginning was in the main focus of the lawmaker, seems to be unlikely, as it is unclear how such specific real estate holding entities shall be defined.

PATH FORWARD

Lobbying Activity

Groups with differing agendas as to gRETT have been lobbying actively, focusing on political parties, the Federal government, the German states, and the legislature. No clear way out of a messy situation is readily apparent. In general, legislators are eager to increase gRETT revenue for the German states.

On the other hand, the real estate industry is lobbying against change. However, it seems unlikely that this gRETT reform can be stopped as the intention to raise the gRETT revenue is backed by the story of so-called fair taxation. The supporters of this gRETT reform point out that ordinary citizens cannot use advantageous share deals when buying a family home. For that reason, they are subject to gRETT, while real estate developers, companies, and wealthy individuals who use share deals can avoid paying gRETT.

It is to be expected that the gRETT Act shall become even more complex and less predictable. Alternatively, it might be worth simplifying the law and reducing the gRETT rates significantly instead. Not long ago, the gRETT rate was 3.5% in all German states. Now, each state is free to set its own gRETT rate. Consequently, the gRETT rates vary between 3.5% in Bavaria and Saxony and 6.5% in other German states. The higher the gRETT rates are, the more attractive share deals become. Regrettably, this approach has not gained traction in political discussions.

Prognostication

At the end of the day, the gRETT reform is not about fairness but only about increasing the gRETT revenue for the German states in times of already well-funded public budgets. From a share deal perspective, it is likely that the gRETT Act will be revised to link the tax to transfers of commercial value of real estate located

in Germany. Under this approach, share deals will become more often subject to gRETT if an R.E.H.P. or an R.E.H.C. is involved.

Structuring real estate acquisitions by way of a share deal has become much more difficult in recent years as a result of decisions made by the German tax authorities. Even though the Draft Bill was withdrawn, there is no political will to retain the status quo. The withdrawn Draft Bill will be reworked by June 2020 and will likely provide lower transfer thresholds for the imposition of tax and longer holding periods to be met in order to escape aggregation of transfers. With the likelihood of new legislative proposals an almost forgone conclusion, the lobbying activity has focused on the adoption of a set of grandfathering rules for existing ownership and structures.

Although the gRETT reform was originally intended to focus on real estate developers and big real estate investors with high-volume real estate transactions, the anticipated gRETT reform will hit also ordinary companies and partnerships that own real estate used as a business asset. These ordinary companies and partnerships face an increased risk of an additional gRETT burden whenever a reorganization occurs regarding global structures above an R.E.H.C. or an R.E.H.P.

"Ordinary companies and partnerships face an increased risk of an additional gRETT burden whenever a reorganization occurs regarding global structures above an R.E.H.C. or an R.E.H.P."

Existing real estate investment structures should be assessed to confirm their alignment with the new trend set out in the current decrees of the German Federal Ministry of Finance and in the new draft bill expected in 2020.

Monitoring of Ownership

Group structures should be checked for effectiveness in light of anticipated revisions to the gRETT rules. Groups with operations in Germany may wish to consider the establishment of a single real estate company that should own all German real estate used within the group. It would provide facilities to group members and would not be affected by future internal reorganizations.

Real estate investments done by way of a share deal, which were finalized by end of 2019, are still subject to the currently applicable gRETT rules.

Existing call options and put options with respect to a direct or indirect participation in an R.E.H.P. should be reviewed to determine whether measures should be taken to adapt to the new gRETT interpretation found in the Decree. Similarly, existing call options and put options covering shares held directly or indirectly in an R.E.H.C. should be reviewed to determine the effect of likely new gRETT legislation on exercise.

If a direct or indirect participation of less than 90% is held in an R.E.H.C. or an R.E.H.P., it might be worth considering an increase of this participation so that it will exceed the 90% threshold – but not the 95% threshold – while the current gRETT rules are still in effect. This should be done only with the understanding that a retroactive effective date is not off the table.

The intended reduction of the 95% threshold to 90% or less will mean that an R.E.H.P. and an R.E.H.C. with a large number of direct and indirect partners or shareholders will need to monitor changes in the ownership chain of each of their members closely. Those changes may trigger gRETT imposed on the R.E.H.P. and R.E.H.C.

A stock exchange proviso in the new draft bill might help listed companies. However, such a proviso would not help unlisted companies or partnerships that are either an R.E.H.C. or R.E.H.P., or directly or indirectly hold shares in an R.E.H.C. or interests in an R.E.H.P.

PORTUGUESE TAXATION OF DISTRIBUTIONS FROM TRUST CAPITAL: A CRITICAL ASSESSMENT

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Tags
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INTRODUCTION

As a general rule, trusts are alien to Portuguese law, with the exception of the legal framework for the Madeira Free Trade Zone. Foreign trusts are not recognized in Portugal, which may pose practical problems for family and succession planning when individuals who lived abroad come to reside in Portugal and become treated as tax residents. The attractiveness of Portugal has resulted in a substantial number of wealthy immigrants. For these individuals, the taxation of trust distributions has become a significant part of tax planning, both in the pre- and post-immigration stages.

The 2014 reform of the Personal Income Tax ("P.I.T.") Code introduced certain provisions that specifically address "fiduciary structures." The new provisions address two separate classes of payments related to a fiduciary structure. The first class involves amounts paid or made available to the taxpayer by a fiduciary structure. The second class involves amounts received by the taxpayer who formed the fiduciary structure as a result of its liquidation, unwinding, or termination. Since virtually none of the trusts established by new immigrants have been formed under the laws of Portugal[1] and inasmuch as none are deemed to be tax-resident in Portugal under Portuguese tax legislation, the income generated abroad by the trusts generally is not taxed in Portugal, except in the hands of the beneficiary who is tax-resident in Portugal or if controlled foreign company rules apply. The receipt of the trust distribution triggers tax issues for the beneficiary who is deemed or registered as tax-resident in Portugal.

The first class of distributions qualifies as investment income ("*Categoria E*" as named in the law) and is subject to tax in the hands of a Portuguese tax resident. The second class is subject to tax on a capital gain basis (under "*Categoria G*" rules), meaning a taxpayer who, as written in the law, "constituted the structure" is taxed only on the gain when the value received upon the liquidation, unwinding, or termination exceeds the basis in assets transferred to the fiduciary structure during its existence. As such, note that amounts received by a non-settlor beneficiary as part of a liquidation, unwinding, or termination distribution are outside the scope of P.I.T.

All trust distributions are allocated between the two classes above. Hence, they are framed as *Categoria E* (investment income) or *Categoria G* (capital gains). It follows that all distributions arising out of the capital of the trust are prima facie taxable in full as a Class 1 distribution, therefore following *Categoria E* rules. Whether this literal approach is correct is open to question as, in the author's view, it lacks a

[1] See below at note 3 relating to the fact that Portugal has not signed the Hague Convention on the Law Applicable to Trusts and Their Recognition.

sound legal basis under the general principles of Portuguese tax law. In addition, solid technical arguments support the view that a distribution made from the capital of a trust should be deemed outside the scope of Portuguese P.I.T. when made to a non-settlor of the trust or that the capital gains rules should apply when the person receiving the distribution is a settlor of the trust.

OVERVIEW OF DISTRIBUTIONS FROM TRUSTS

The Commentary to Article 1 of the O.E.C.D. Model Convention on Estates and Inheritances and on Gifts states that a trust exists when (i) one person, the "trustee," who is the "legal" owner of property, (ii) holds the property under a legally enforceable obligation (iii) to use it for the benefit of another person or group of persons, the "beneficiary" or "beneficiaries," (iv) who are the "beneficial" owners of the property.

Hence, a trust holds and distributes funds following the terms of the trust deed, which sets forth the purpose of the trust and identifies the beneficiaries. Assets are transferred to the trust by a settlor, with the purpose of designating the management of the assets to a third party and the enjoyment of the trust to the beneficiaries. The trust assets may produce income, which is realized for the benefit of the beneficiaries, or gain, which typically is an accretion to capital and is treated separately from the income. The trust deed generally provides for how the trust income is retained or distributed and how the capital may be held as an endowment or distributed to capital beneficiaries which may differ from income beneficiaries.

Consequently, trust distributions can be divided into two separate baskets. The first basket relates to distributions of the income generated by the trust from the investment of its capital into income producing assets. The second basket relates to distributions of capital – the original capital contributed increased by the net gains from the sale of the assets. Conceptually, capital distributions should not be considered to be income. Rather, they should be viewed as the current value of the capital contributed to the trust, as it may have appreciated over time. Viewed this way, a capital distribution to a person who is not a settlor of the trust could be viewed as a form of gift.

The result should not change even when tax transparency is applied. Income arising at the level of the trust but flowing to the beneficiaries is usually subject to tax in the hands of a beneficiary under income tax provisions in the beneficiary's country of residence. In the off chance that the jurisdiction of residence for the trust imposes a general income on capital gains, typically, the trust pays that tax. Transfers of capital to the trust may be subject to a gift tax[2] payable by the settlor when the trust is not considered to be transparent. Transfers of capital from the trust are, as a general rule, not taxable. If the jurisdiction of residence for the trust imposes a general income tax, capital gains may be imposed when a capital asset owned by the trust is sold at a gain.

INCOME ARISING FROM TRUSTS

Trust law has its origins in English law, and trusts are widespread in common law jurisdictions. Portugal is a civil law jurisdiction that does not recognize trusts.

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[2] See, *e.g.*, Pierre Gillioz and Nicole Fragnière Meyer, "Trusts and Taxation in Switzerland," *IBFD Bulletin for International Taxation* 69, no. 4/5 para. 2.3 (2015).

Portugal is not a signatory to the Hague Convention on the Law Applicable to Trusts and Their Recognition.[3] However, trusts have generated tax issues in Portugal where former nonresidents have migrated to Portugal and retained their status as beneficiaries of foreign trusts.

From the viewpoint of the Portuguese media and, to some extent, the tax authority, the use of trusts is mainly associated with tax evasion and tax avoidance schemes. With the exception of the Portuguese income tax treaties with the U.S. and Canada, neither Portuguese income tax treaties in general nor the O.E.C.D. Model Tax Convention make reference to the allocation of taxing rights in the case of a trust that is tax-resident in a treaty partner jurisdiction. Hence, income tax treaties are usually not useful when individuals that are newly arrived Portuguese residents are settlors or beneficiaries of trusts.[4]

"Portuguese legislation is not entirely up to speed when compared with international practices and standards."

While treaties are silent as to the tax treatment of trusts, the 2014 revisions to the P.I.T. Code specifically addresses fiduciary structures. As mentioned above, the provisions covering the tax treatment of trusts appear straightforward and cover two situations, *viz.*¸ Class 1, involving any amounts paid or made available by the trust, which the author construes as being distributions of income; and Class 2, involving distributions that are incident to the liquidation, unwinding, or termination of a trust. Nonetheless, many practical problems exist, and certain unexpected complications may rise, partly because the legislation does not reflect standard practices followed in jurisdictions where trusts generally are formed and administered. This is understandable in a civil law context where trusts are not commonly used in estate

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[3] For an historical overview of the recognition of trusts in Portugal and the tax landscape surrounding a foreign trust, see Francisco de Sousa da Câmara "The Taxation of Trusts in Portugal," *IBFD European Taxation* 57, no. 11 (2017). Article 2, Chapter 1 of the Hague Convention on the Law Applicable to Trusts and Their Recognition states that "for the purposes of the Convention, the term 'trust' refers to the legal relationships created – inter vivos or in death – by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose."

[4] As can be read in "Trusts and the Fundamental Freedoms – The Exit Tax Regime in Trustees of the P Panayi (Case C-646/15)," *IBFD European Taxation* 58, no. 6 (2018):

> The Commentary on the OECD Model mentions trusts in connection with the possibility to claim treaty entitlement, which is dependent on meeting the requirements under the personal scope of a particular treaty, *i.e.* whether a legal vehicle – a trust – can be considered a person that is resident in one or both of the contracting state(s). The Commentary mentions trusts in the context of collective investment vehicles (CIVs), and indicates that CIVs could be considered companies or trusts, simple contractual arrangements or a form of joint ownership. In this sense, trusts are compared to CIVs in terms of their nature. The Commentary states that, 'whether a CIV is a 'resident' of a Contracting State depends not on its legal form (as long as it qualifies as a person) but on its tax treatment in the State in which it is established.' This means that the qualification of a trust, as either a transparent or non-transparent entity, is dependent on its nature under the domestic tax law of the contracting state. The Commentary implies that the domestic tax regime should be decisive.

planning.[5] In this respect, Portuguese legislation is not entirely up to speed when compared with international practices and standards.

With respect to typical distributions from a trust, the P.I.T. Code casts a broad jurisdictional net, providing that all amounts paid or made available to the taxpayer by fiduciary structures are taxed. Under the plain meaning of the statute, all payments received from a trust by a Portuguese resident are subject to tax in Portugal as investment income (*Categoria E*).

This interpretation can lead to inconsistent tax treatment triggered by inconsequential differences in facts. This can be illustrated as follows:

- A liquidation distribution made to a non-settlor is outside the scope of P.I.T.[6] It is not taxed.
- If the liquidation distribution is made to the settlor, the distribution is subject to tax on a capital gains basis. This means the tax base is the amount by which the value received exceeds the cost basis in assets transferred to the trust.
- If the same asset is distributed to a beneficiary in an ordinary trust distribution, the entire distribution would be taxed at the standard rate of 28%, or at 35% if the trust is located in a tax advantaged jurisdiction (within the so-called blacklist published by the Portuguese government).
- Were a nonresident individual to transfer the same asset to a Portuguese resident as a gift, the gift would be outside the scope of P.I.T. No gift or inheritance tax would be due as Portugal does not have a formal gift tax regime.[7]

In sum, a literal interpretation of the statute contains logical flaws, as no single baseline tax is relied on to determine abusive situations, taxable transactions, and gifts that are completely exempt from income tax. The literal interpretation is inconsistent with fundamental principles of Portuguese tax law and the Portuguese Constitution.

TAX TREATMENT OF DISTRIBUTIONS FROM THE CAPITAL OF A TRUST

It can be argued that the guidelines incident to the 2014 P.I.T. reform suggest that income distribution from a trust should be taxed in a manner that is consistent with investment income and other similar gains. The P.I.T. Code defines the term "income" as an amount received that results in an increase in the purchasing power and net worth of the taxpayer (rendimento-acréscimo). Gifts are excluded from giving rise to taxable income.

The Portuguese Constitution contains a principle of "taxation following the ability to pay." It follows that the purpose of the P.I.T. is to tax income, not wealth. Hence,

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5 *E.g.*, in the case of discretionary trusts, see "Dutch Tax Treatment of Discretionary Trusts," *ITSG Global Tax Journa*l, 1, no. 3 (2018).

6 Article 12.8 of the P.I.T. Code.

7 However, Portuguese Stamp Duty may be imposed if the operation is deemed within its territorial scope of application. In the case of free transfers, the Stamp Duty rate is 10% and can amount to 10.8% in the case of free transfers of real estate.

distributions from the capital of a trust should not be taxed, as there is no accretion to wealth when all that is received is capital over which the beneficiary held a beneficial interest prior to receipt. In addition, the P.I.T. Code adopts a schedular approach to the imposition of tax. Under this approach, a particular type of income is taxable only if it falls within a specific schedule of taxable income. In general, receipt of capital is not covered by any schedule. The fact that the capital is held in a trust should not be a material factor to prevent application of the general rule.

Distributions of Capital to a Settlor

In principle, distributions of capital to a settlor do not represent a net increase in the settlor's ability to pay, since it is essentially a return of capital previously transferred to the trust. At the same time, and for the same reason, it does not increase the settlor's net worth and purchasing power. In this sense, the receipt of a distribution of capital to the person who settled the trust and contributed capital assets to the trust is not an income event. It was the settlor's capital before it went into the trust, the settlor held a beneficial interest while the capital was an asset of the trust, and it remained the settlor's capital when returned in the form of a contribution.

Nonetheless, in the hard, cold light of day, the law is what the law is; and a capital distribution not incident to the liquidation, unwinding, or termination of a trust potentially is taxable income. If so, how should it be categorized for the schedular tax system in Portugal?

Investment Income?

Investment income may be thought of as income arising from figures akin to civil fruits under Portuguese law, meaning the amounts that are produced by an asset and to which an individual is entitled to under some sort of a legal relationship.[8] In other words, the "fruit" that grows from an investment "tree."

Investment income may be interpreted as any economic advantage acquired directly or indirectly, under whatever of name or designation, in cash or in specie, from patrimonial elements, assets, rights, or juridical situations of a movable nature, including their modification, transmission, or termination whenever not subject to tax in a different category. Article 5.1 of the P.I.T. Code is meant to tax the fact that an individual receives the fruits but not the income that arises from the disposal of the tree.

Therefore, interpreting a return of trust capital to a settlor as falling within a legal provision dealing with investment income is inconsistent with the type of income that is meant to be taxed as investment income for P.I.T. purposes. A distribution of trust capital is not akin to fruit growing on a tree each summer; it is not akin to civil fruit. The taking of the fruit does not diminish the value of the tree, whilst a distribution of capital is, in fact, akin to taking down a major limb and diminishes the growth potential of the trust.

From a technical perspective, taking into account the income that is subject to tax under the Portuguese P.I.T. system, a distribution of capital may not represent an accretion of taxable income in the hands of the beneficiary. Or, even if it does, it is only on a capital gain basis. Taxation following the investment income rules would not take into account the gain that actually may rise: The rules would deem the full

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[8] See Article 212 of the Portuguese Civil Code.

amount received by the beneficiary under a capital distribution to be subject to tax, irrespective the actual gain that can be raised in the hands of the beneficiary. In this light, if a capital distribution is interpreted as investment income in the hands of the Portuguese tax-resident beneficiary, the tax imposed would not follow the actual net gain; it would outweigh the actual "income" received. Hence, such an approach is inconsistent with the constitutional principle of taxation following the ability to pay and other general taxation principles of Portuguese law.

> ***"When the P.I.T. Code imposes tax on 'amounts paid or made available by fiduciary structures,' the statute was intended to address income distributions and not distributions of capital."***

Other Taxable Income?

Having established that an eventual net capital gain is income but not investment income, the question remains whether any other provision in the P.I.T. Code subjects that income to tax. Income arising from the disposal of assets is potentially taxed under the category of income pertaining to other asset increases (*Categoria G*), under capital gains (*mais-valias*). Therefore, it is logical for distributions arising from the liquidation, unwinding, or termination of a trust to be outside the scope of P.I.T. when made to a non-settlor or subject to tax as a capital gain if made to a settlor. The same line of reasoning should be applicable to distributions of capital that is not incident to a liquidation or similar event. The positive increase in fair market value may give rise to a taxable gain.

The tax treatment of a capital distribution of a trust should not be materially different from the treatment of a distribution of capital from a company to its shareholders. When a company reduces its share capital, Portuguese tax law treats the capital distribution to the shareholders as return of capital, not as taxable income. It is a simple return of the amount previously invested. It is not income in the sense of *rendimento-acréscimo*, the relevant income for P.I.T. purposes.

In any event, Portuguese law contains a principle under which income that is not of a kind that is addressed under the law should be deemed to be outside the scope of taxation. Following this line of reasoning, the law does not clearly foresee the taxation of the capital gain arising from a distribution of capital to a settlor of a trust as long as the trust is not connected to the individual's business activity. Arguably, the capital distribution is outside the scope of Portuguese P.I.T.

Distributions of Capital to a Non-Settlor

Considering all that has been discussed above, it is clear that, when the P.I.T. Code imposes tax on "amounts paid or made available by fiduciary structures," the statute was intended to address income distributions and not distributions of capital. Hence, when looking at a distribution out of the capital of a trust, the transaction is akin to a gift in the hands of the beneficiary, which is not subject to income tax. This conclusion is supported by the treatment of distributions to non-settlors that are incident to a liquidation, unwinding, or termination of a trust. Those distributions are not taxed under the P.I.T. Code. No policy reason exists to provide different treatment for a distribution of trust capital to a non-settlor that is not incident to the liquidation, unwinding, or termination of a trust.

CONCLUSION

Although untested, solid arguments support the view that distributions of trust capital to the settlor of a trust should be seen as outside the scope of the Portuguese

P.I.T. Code. Only income under P.I.T. concepts should be taxed. Distributions to non-settlors are essentially akin to gifts, which are outside the scope of income taxation in Portugal.

When dealing with a return of trust capital and a distribution arising from the liquidation or termination of the trust, a capital distribution made to the settlor should be construed as a "return" of the capital previously contributed to the trust. No income or gain is generated as long as the value of the distribution does not exceed the basis in assets previously contributed. In addition, a capital distribution made to a person who is not the settlor of the trust should be treated as a gift.

SAME SAME, BUT DIFFERENT: TAXATION OF THE SALE OF STOCK OF AN INDIAN COMPANY BY A U.S. PERSON

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INTRODUCTION

This article explains the U.S. and Indian tax considerations that apply to the sale of shares of an Indian company by an individual who is a U.S. Person holding the shares for investment purposes. It provides a holistic analysis for U.S. Persons investing in shares of an Indian company. The important takeaway is that while tax rules generally appear to be similar in India and the U.S., several different provisions in the domestic law of each country produce adverse consequences for those who are not well-advised.

Notably, both jurisdictions take into account the residency status of the seller and the source of the gain from the sale of shares of stock to determine taxation rights. As an experienced global investor may anticipate, while the principles appear to be the same, the results are very different.

RESIDENCY STATUS OF THE SELLER

U.S. – A U.S. Person Is Subject to Tax on Worldwide Income

The U.S. taxes individuals who meet the definition of a "U.S. Person" on a worldwide basis. An individual is treated as a U.S. Person[1] if the individual is a U.S. citizen or a U.S. resident. A U.S. resident includes a lawful permanent resident ("Green Card Holder") and an individual who meets the "Substantial Presence Test"[2] in the year for which residence is at issue.

For an individual who is a U.S. Person because of citizenship or the issuance of a Green Card, gain from the sale of shares in an Indian company will be subject to U.S. tax regardless of physical residence.

India – A Nonresident Is Taxed on Indian-Source Income

Indian tax law follows residence-based taxation for Indian tax residents and source-based taxation for nonresidents. Income of a nonresident is sourced in India only

1 Code §7701(b)(30).

2 Code §7701(b)(1)(A)(ii). An individual is said to meet the Substantial Presence Test in the current year if the individual is physically present in the U.S. on at least 31 days during the current year and 183 days during the three-year period that ends with the year in issue. In applying the 183-day test, days in the current year are given full weight. Those in the preceding year are given one-third weight. Days in the second preceding year are given one-sixth weight.

if the income is received, or deemed to be received, in India or it accrues or arises, or is deemed to accrue or arise, in India.[3]

"Income deemed to accrue or arise in India" has been defined to include income derived by a nonresident from the transfer of a "capital asset" situated in India. "Capital asset" means property of any kind held by a taxpayer, and hence, shares of an Indian company are regarded as a capital asset situated in India unless the taxpayer is a dealer in securities and the shares are treated as the equivalent of inventory. Therefore, any income derived by a nonresident from the transfer of shares of an Indian company is deemed to accrue or arise in India and, hence, is subject to capital gains tax in India.

Conflict of Laws

Because the capital gain is taxed in the U.S. under concepts of residence-based taxation and, at the same time, the gain is taxed in India under concepts of source-based taxation, each country claims the right to impose tax on the capital gain derived from the sale of the stock of an Indian company by a U.S. Person.

"Each country claims the right to impose tax on the capital gain derived from the sale of the stock of an Indian company by a U.S. Person."

SOURCE OF THE GAIN AFFECTS FOREIGN TAX CREDIT RELIEF

In order to avoid double taxation, U.S. domestic tax law allows a taxpayer to claim a foreign tax credit to reduce the U.S. tax due on the same stream of foreign-source income.[4] Domestic law is augmented by the terms of the India-U.S. Income Tax Treaty (the "Treaty").[5]

Briefly, U.S. tax law allows taxpayers to claim the benefit of the foreign tax credit to reduce the U.S. tax liability on the same gain only if both of the following conditions are satisfied:

- The income is considered to be foreign-source income under the provisions of U.S. tax law.[6]
- The foreign tax is an income tax in the U.S. sense.[7]

Therefore, U.S. tax law requires another layer of analysis to ascertain whether the Indian income taxes paid on the capital gain on the sale of the stock of an Indian company can reduce the U.S. tax liability on the capital gain.

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3 Section 5 read with Section 9 of Indian Income tax Act, 1961 ("I.T. Act").

4 Code §901.

5 Article 26 (Relief from Double Taxation) of the Treaty.

6 If the income is considered to be U.S.-source income for U.S. tax purposes, the foreign tax credit provides no relief (Code §904(a)). Unused foreign taxes may be carried back one year and carried over ten years (Code §904(c)) and may provide relief if excess limitation exists in the year to which the tax is carried.

7 Under paragraph 1(b) of Article 2 (Taxes Covered), the term "Indian Tax" means the income tax, the surcharge, and the surtax. It also includes o any identical or substantially similar taxes which are imposed after the date of signature of the Treaty. Under paragraph 1 of Article 25 (Relief from Double Taxation) those taxes are considered to be income taxes for foreign tax credit purposes.

Source of the Gain Depends on the Residence of the Seller

The source of the gain controls how much of the U.S. tax can be reduced by the foreign tax credit. If none of the gain is deemed to be foreign-source income, no portion of the U.S. tax on that gain can be reduced by a credit for Indian tax in the year of the sale. Of course, if the U.S. taxpayer reports other items of foreign income that fall in the passive basket or the high-tax basket, as the case may be, the Indian tax paid on the sale of the stock of the Indian company can be used to reduce the U.S. tax on that other foreign income.

The U.S. follows the common law principle of *mobilia sequuntur personam* in determining its right to tax the capital gain arising from the sale of a personal property. The Latin phrase "*mobilia sequuntur personam*" literally means "movable things follow the person." In other words, it holds the situs of a property to be the domicile of the owner.

Code §865 incorporates the general theme of *mobilia sequuntur personam* and provides that the taxation of the gain on the sale of a personal property depends on the residence of the seller. Any gain from the sale of a personal property by a U.S. resident is a U.S.-source income and is therefore subject to U.S. Federal income tax.[8] On the other hand, any gain from the sale of a personal property by a U.S. nonresident is a foreign-source income.[9] In other words, the source of the gain is in the taxpayer's country of residence. The place of sale, place of execution, place of the taxpayer's activities with respect to the property, and location of the property are irrelevant.

Special Definition of "U.S. Resident" for Foreign Tax Credit Purposes

The definition of the term "U.S. resident" under general U.S. tax principles, discussed above, is adjusted when determining the source of income under Code §865. An individual is a U.S. resident for foreign tax credit purposes in any of the following circumstances:[10]

- Any individual who is a U.S. citizen or a resident alien (*i.e.*, a Green Card Holder or an individual who meets the Substantial Presence Test) who does not have a "tax home"[11] in a foreign country
- A nonresident, non-citizen individual who has a tax home in the U.S.

Subject to one major exception, all other individuals are nonresidents under Code §865.

The exception is relatively straightforward. No person can be considered to be a nonresident with respect to a particular sale of property unless that individual

[8] Code §865(a)(1).

[9] Code §865(a)(2).

[10] Code §865(g).

[11] Code §911(d)(3) and Treas. Reg. §301.7701(b)-2(c)(1). An individual has a tax home at a particular place if it is the individual's regular place of business or, if there is more than one regular place, if it is the principal place of business. If an individual does not have a principal place of business, the tax home is at the person's regular place of abode in a real and substantial sense.

actually pays a foreign income tax of at least 10% of the gain[12] on the sale in question.[13] Since (i) the tax rate in India on the capital gain from a sale of corporate stock is 10% or more under all circumstances and (ii) no special set-offs, such as increases to basis to offset reduce the effect of inflation, are allowed, this issue is not discussed further.

Thus, two types of individuals are nonresidents for foreign tax credit purposes:[14]

- A nonresident alien individual (*i.e.*, an individual who is not a U.S. citizen, Green Card Holder, nor non-citizen individual who is a resident under the Substantial Presence Test) who does not maintain a tax home in the U.S.
- A U.S. citizen or resident for tax purposes who maintains a tax home in a foreign country or a U.S. possession and pays a foreign income tax of at least 10% on the gain in question

Because the definition of a U.S. resident is qualified by the requirement that the individual must not have a tax home outside the U.S., if a U.S. citizen or Green Card Holder has been living in India for a considerable period of time with a permanent business or employment located in India, the individual should not fall within the definition of a U.S. resident for foreign tax credit purposes. Consequently, the gain from the sale will be treated as a foreign-source income.

Example 1: A Green Card Holder with a Tax Home in India

Mr. X, an Indian citizen, arrives in the U.S. in the 1980's and obtains a Green Card. He returns to India in 1990, when he is offered a lucrative full-time job from an Indian employer. He retains his Green Card after departing the U.S. Through 2019, he invests in shares of several Indian companies. He sells the stock at a substantial gain in 2019 and is subject to Indian tax at the rate of 10%. That tax is fully paid.

"If a U.S. citizen or Green Card Holder has been living in India for a considerable period of time with a permanent business or employment located in India, the individual should not fall within the definition of a U.S. resident for foreign tax credit purposes."

- **Residence for Foreign Tax Credit Purposes: Code §865**

  Mr. X is a U.S. Green Card Holder (*i.e.*, a lawful permanent resident). However, his principal place of employment is in India in 2019, the year in which the gain is recognized. Therefore, it appears that he does not have a tax home in the U.S. Also, the tax liability in India is equal to or more than 10% (20% in this example). Consequently, he is treated as a U.S. nonresident for Code §865 purposes. The gain will be treated as foreign-source income.

- **Residence for Purposes Other than Foreign Tax Credit: Code §7701(b)(30)**

  Merely because Mr. X is a U.S. nonresident for purposes of Code §865 does not mean that he is a nonresident for other purposes of the Code. In the absence of a treaty election to be treated solely as a resident of India under the Treaty's dual-resident tiebreaker provision,[15] Mr. X will continue to be treated as a U.S. resident under Code §7701(a)(30). Consequently, he is a

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[12] Code §865(g)(2).

[13] To determine whether the foreign tax paid meets the 10% hurdle, the amount paid is divided by the gain determined under U.S. tax concepts.

[14] Code §865(g)(1)(B).

[15] Paragraph 2 of Article 4 of the Treaty.

U.S. Person and is taxed on his worldwide income, including gains from sales of stock of Indian companies.

The foregoing example indicates that the relevance of Code §865 is to ascertain the source of the gain to determine whether a portion of Mr. X's U.S. tax liability is attributable to net foreign-source income. In the facts presented, Mr. X's tax return will report foreign-source gain. Within the limitations of Form 1116, the Indian tax should be available to reduce taxable income.

The above is an example of a perfect fact pattern that allows Mr. X to benefit from the credit. That would not be so if Mr. X were a resident of the U.S. under Code §865(g)(2), as discussed below.

Example 2: A Green Card Holder with a Tax Home in the U.S.

Mr. Z, an Indian citizen, arrives in the U.S. in the 1980's and obtains a Green Card. He remains in the U.S. with his family where he runs a successful business. Over the years, he invests in shares of several Indian companies. He sells the stock at a substantial gain in 2019 and is subject to Indian tax at the rate of 10%. That tax is fully paid.

- **Residence for Purposes Other than Foreign Tax Credit: Code §7701(b)(30)**

  Mr. Z is a U.S. resident under Code §7701(a)(30) for purposes other than the foreign tax credit. He is a Green Card Holder (*i.e.*, a lawful permanent resident in the U.S.). As a result, Mr. Z is taxed on his worldwide income including the gain on the sale of stock of the Indian companies.

- **Residence for Foreign Tax Credit Purposes: Code §865**

  Mr. Z is a U.S. Green Card Holder (*i.e.*, a lawful permanent resident). His principal place of employment is in the U.S. in 2019, the year in which the gain is recognized. He is treated as a U.S. resident for Code §865 purposes. The capital gain recognized by Mr. Z is U.S.-source gain. No portion of Mr. Z's U.S. tax liability relates to foreign-source income or gain. As a result, no portion of Mr. Z's tax can be offset by the foreign tax credit.

CAPITAL GAIN COMPUTATION

In both jurisdictions, the computation of the quantum of the capital gain is a function of the adjusted basis and the sale price.

U.S. – Adjusted Basis of Stock Depends on Form of Acquisition

Typically, the purchase price of the stock is the starting point for determining the adjusted basis in the shares. Additional capital contributions increase the basis. Distributions in excess of earnings and profits and redemptions of shares reduce the basis. If the shares are received as a gift, the recipient of the gift takes a carryover basis from the person making the gift. This means that the adjusted basis in the hands of the person making the gift becomes the adjusted basis for the recipient. If the shares are inherited from a relative or another person, the basis equals the fair market value of the shares on the date of death of the relative or other person. Once the adjusted basis is determined, the gross capital gain is the excess of the selling price over the adjusted basis. Expenditures made to effect the sale, such as

commissions and fees, reduce the net sales proceeds, which in turn reduce the net capital gain.

India – Capital Gain Is the Excess of Selling Price Over Cost of Acquisition

As in the U.S., the purchase price paid for shares forms the adjusted basis in the shares. In a plain vanilla transaction, the taxable capital gain is the excess of the sales price over the adjusted basis, essentially the price originally paid by the seller to acquire the shares. The net capital gain is then reduced by the expenses that are incurred wholly and exclusively in connection with the sale.[16] Typically, the commercially agreed price between unrelated parties is considered as the sale consideration. However, where the shares transferred are unquoted, minimum price requirements are applicable.

- The fair market value for tax purposes ("Tax F.M.V.") is determined pursuant to specified tax rules[17] that form the minimum sale consideration for the seller.
- The excess of the Tax F.M.V. and the acquisition price is taxed as ordinary income in the hands of the purchaser.[18]

In addition, where the transaction is between related parties, the consideration is subject to the arm's length tests under Indian transfer pricing rules. As a result, the sale consideration for computation of capital gains in a related-party transaction is the highest of the following three values: (i) the commercial price, (i) the Tax F.M.V., and (ii) the arm's length transfer pricing value.

IMPACT OF HOLDING PERIOD ON THE TAX RATE

U.S.

Short-Term v. Long-Term Capital Gains

The tax rate imposed on an individual selling shares depends on the length of the holding period for the shares that are sold.

Gain from the sale of an asset held for at least 12 months and one day is subject to reduced tax rates of 0%, 15%, or 20%, depending on the taxable income and gain reported in the tax return for the year of the sale as well as the filing status of the taxpayer.

The gain from the sale of an asset held for not more than 12 months is characterized as short-term capital gain. It is taxed at ordinary income rates of up to 37%.

Tax Rates

For 2020, the tax rate brackets are as follows for a married individual who files a joint tax return with a spouse.

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16 Section 48 of the I.T. Act.

17 Section 50CA of the I.T. Act read with Rule 11UA of the Income Tax Rules, 1962.

18 Section 56(2)(x) of the I.T. Act read with Rule 11UA of the Income Tax Rules, 1962.

Total Taxable Income (Married Filing Jointly)	Long-Term Capital Gains Tax Rate
Up to $78,750	0%
$78,750 to $488,850	15%
Above $488,850	20%

Total Taxable Income (Married Filing Jointly)	Short-Term Capital Gains Tax Rate
Above $0	10%
Above $19,750	12%
Above $80,250	22%
Above $171,050	24%
Above $326,600	32%
Above $414,700	35%
Above $622,050	37%

Net Investment Income Tax

Additionally, a U.S. resident is also subject to net investment income tax ("N.I.I.T.") at the rate of 3.8% on net investment income and gains. For a married individual who files a joint tax return with a spouse, the N.I.I.T. is imposed if the taxpayer's return reports $250,000 or more of modified adjusted gross income. Investment income includes interest, dividends, capital gains, rental and royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments or commodities, and income from businesses that are passive activities to the taxpayer.

India

Short-Term v. Long-Term Capital Gains

The applicable tax rate on capital gains earned by a nonresident individual is dependent on whether the gains are characterized as short-term or long-term capital gains.

Where the shares of the Indian company are listed on a recognized stock exchange in India, capital gains are treated as long-term when the shares are held for a period of at least 12 months and one day before the date of transfer.[19] If the holding period is less, the gain is characterized as short-term capital gain.

[19] Section 2(42A) of the I.T. Act.

Where the shares of the Indian company are unlisted, capital gains are treated as long-term when the shares are held for a period of 24 months and one day. If the holding period is less, the gain is characterized as short-term capital gain.[20]

Tax Rates

For listed shares, the tax on long-term capital gains is 10%.[21] The tax on short-term capital gains is 15%.[22]

For unlisted shares, the tax on long-term capital gains is 10%.[23] Short-term capital gains are taxable at ordinary income tax rates.

The foregoing tax rates do not include the applicable surcharge and educational cess.

TAX PAYMENT MECHANISM

U.S. – Payment of Federal Income Tax Net of Foreign Tax Credit Due by Tax Return Filing Date

The individual will be liable to report the gain on the sale of the stock on Schedule D of Form 1040, *U.S. Individual Income Tax Return*, for the year in which the sale took place. Estimated tax is generally due in four installments throughout the year, and 90% of the ultimate tax due must be paid by the original due date of the return if an extension of the filing date is requested. In broad terms, the estimated tax payments must equal the lower of 100% of the prior year's tax or 90% of the tax that will be due ultimately for the year of the sale.

In Example 1, Mr. X will be subject to a U.S. tax of 20% (assuming the highest capital gain tax rate) and the N.I.I.T. at 3.8%. He will be able to claim the credit of the Indian taxes paid (10%) against his U.S. tax liability. He must file Form 1116, *Foreign Tax Credit*, with Form 1040. He will be liable to pay the N.I.I.T. thereby bringing his total U.S. and India tax liability on the sale to 23.8%.[24]

In Example 2, Mr. Z will be subject to a tax of 20% (assuming the highest capital gain tax rate) and the N.I.I.T. at 3.8%. No portion of his U.S. Federal income tax can be offset by a credit for the Indian taxes paid (10%). As a result, his net global income tax liability arising from double taxation will amount to 33.8%.[25] Mr. Z will also be subject to state and local taxes, if any.

In both instances, the total cost will be increased by a surcharge and an educational cess, which combined range from 2% to 5% depending on the total taxable income in India.

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[20] Section 2(42A) of the I.T. Act.

[21] Section 112A of the I.T. Act.

[22] Section 111A of the I.T. Act.

[23] Section 112 of the I.T. Act.

[24] The surcharge and the educational cess, if applicable, should also be allowed as credit against Mr. X's U.S. tax liability because the cess is typically treated as "tax" in a U.S. sense and, therefore, meets the foreign tax credit eligibility requirement.

[25] The surcharge and the educational cess, if applicable, will be an additional cost to Mr. X.

As explained in greater detail below, the Treaty will not provide any relief from double taxation.

India – Obligation on Purchaser to Withhold Tax

Indian income tax law imposes a withholding tax obligation on Indian residents making payments to nonresidents.[26] Generally, the seller provides a computation of capital gain realized, and on that basis, the purchaser withholds taxes from the payments to the seller.

Where the purchaser does not withhold and deposit applicable taxes, it is treated as a taxpayer in default of its tax obligations.[27] The tax authorities can seek to recover the applicable taxes along with the interest and penalties. Alternatively, the purchaser may be treated as a representative assesse.[28] As the seller's representative, the purchaser is at risk for all taxes, penalties, and interest owed by the seller.

IMPACT OF THE TREATY – TWO STEPS FORWARD AND THREE STEPS BACK

Article 13 (Gains) of the Treaty provides that each country may tax capital gains in accordance with its domestic tax law. The Treaty establishes the taxing rights of both countries. Paragraph 3 of Article 25 (Relief from Double Taxation) of the Treaty provides rules for determining the source of income for purposes of the foreign tax credit. It provides as follows:

> (3) For the purposes of allowing relief from double taxation pursuant to this Article, income shall be deemed to arise as follows:
>
> (a) income derived by a resident of a Contracting State which may be taxed in other Contracting State in accordance with this Convention (other than solely by reason of citizenship in accordance with paragraph 3 of Article 1 (General Scope)) shall be deemed to arise in that other State . . . . Notwithstanding the preceding sentence, the determination of the source of income for purposes of this Article shall be subject to such source rules in the domestic laws of the Contracting States as apply for the purpose of limiting the foreign tax credit.

At first glance, Article 25(3)(a) appears to provide that income derived by Mr. Z in Example 2, who is a U.S. resident (since he is a Green Card Holder), will be deemed to arise in India because it is taxed in India. However, this change in the source of income is immediately reversed, as the provision goes on to state that U.S. rules for determining the source of income for foreign tax credit purposes will control if they differ from the general rules stated in the Treaty. In other words, Article 25(3)(a) gives with one hand but takes away with the other. Consequently, going back to Mr. Z in Example 2, U.S. domestic tax law continues to apply, and as a result, the gain continues to be a U.S.-source income. As is apparent, the Treaty does not come to Mr. Z's rescue.

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[26] Section 195 of the I.T. Act.

[27] Section 201 of the I.T. Act.

[28] Section 160 read with Section 163 of the I.T. Act.

In these circumstances, the only possible remedy would be for Mr. Z to manage his facts to cause the gain to be foreign-source gain under both U.S. tax law and the Treaty. This can be achieved if Mr. Z were to dispose of his U.S. place of residence and move to a foreign country that either provides for a step-up in basis upon the establishment of residence, such as Canada, or that does not impose tax on offshore income of arriving residents or non-domiciled residents, such as the U.K., Switzerland, Portugal, Italy, and Cyprus. In these instances, careful planning is required to ensure that no hidden traps exist in the new place of residence that might prevent Mr. Z from enjoying the expected tax benefit. A re-entry permit should be obtained from U.S. Citizenship and Immigration Services.

Note, the goal is not to relinquish U.S. tax residence or renounce citizenship. It simply is to establish that Mr. Z in a nonresident within the meaning of Code §865(g)(2) for foreign tax credit purposes. The gain will continue to be taxable in the U.S. but will be treated as foreign-source gain because of the move. The Indian tax will continue to be imposed. However, since the tax rate should exceed the 10% threshold provided in Code §865(g)(2), Mr. Z can be treated as a nonresident for purpose of the sourcing rule under that provision. Mr. Z cannot have a place of abode available in the U.S. That is why the abode in the U.S. should be disposed of.

CONCLUSION

Like Mr. X, there are numerous taxpayers who are left with no relief at all and are subject to tax in both countries without any foreign tax credit. This is a classic example of what the tax treaties intend to avoid, yet the governments of the two countries have failed to address the issue. Therefore, given the varying tax implications in the U.S. and India for capital gains on the sale of stock of an Indian company, it is pertinent to undertake an in-depth analysis to evaluate the most tax efficient structure and to have certainty on the overall tax impact. The need to undertake analysis becomes more relevant considering that credit of taxes paid in India may not be available in the U.S., thereby resulting in double taxation. From an Indian tax perspective, one may consider investing through corporate structures in countries having favorable tax treaties with India.

SWISS CORPORATE TAX REFORM: T.R.A.F. IN A NUTSHELL

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Tags
Corporate Tax
Holding Company
Patent Box
Step-up
Switzerland
Tax Reform

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INTRODUCTION

It has taken a while for the Swiss corporate tax reform to be adopted. As outlined in our previous articles, Swiss voters defeated the initial tax reform package by a majority of almost 60-40 in 2017.[1] In the aftermath of the defeat, a steering committee representing the cantons and the Swiss Federation issued Tax Proposal 17, recommending a modified version of corporate tax reform.[2] An analysis showed that important reasons for the defeat of the initial proposal were an adverse view of reform that was held by many and cantonal concerns over a loss of tax revenue.

More than one year later, on September 28, 2018, the Swiss parliament approved the amended bill, which was renamed the Federal Law on Tax Reform and Old-Age and Survivors' Insurance Financing ("Tax Reform and A.H.V. Financing" or "T.R.A.F."). As the modified name indicates, the law was newly linked to old-age and survivors' insurance ("A.H.V.").

T.R.A.F. was crafted to generate additional revenue for the cantons, enhance A.H.V. pensions, and reform corporate tax rules. As a result, the modified bill was approved by a large majority of Swiss voters, who went to the polls on May 19, 2019. The tax reform and A.H.V. financing provisions came into force on January 1, 2020.

T.R.A.F. IN A NUTSHELL

The final law follows the initial reform package. The existing tax regimes for companies, such as holding companies and mixed companies have been abolished, as they no longer are in line with international standards. No changes have been made to (i) the new cantonal and municipal patent box regimes based on the O.E.C.D. nexus approach, (ii) the additional deduction for research and development ("R&D") costs, and (iii) the step-up mechanism.

The following tables provide an overview of all measures adopted in T.R.A.F.

Measures Affecting Companies

Measure	T.R.A.F. Provision
Abolishment of Tax Regimes	At a cantonal level, tax regimes enabled certain Swiss companies, such as holding companies, to pay little or no corporate income tax. These tax privileges are abolished subject to a phase-in provision.

[1] "Swiss Corporate Tax Reform Postponed," *Insights* 4, no. 2 (2017).

[2] "New Proposal for Swiss Corporate Tax Reform," *Insights* 4, no. 4 (2017).

Measure	T.R.A.F. Provision
Patent Box	The profits from patents and comparable rights are separated from other profits and are taxed at a lower rate. Each canton has discretion to determine the extent of the minimum base to be taxed. As an example, the tax base in Zurich is 10%, which is the minimum permitted by Federal law.
Additional Deductions for R&D	Additional deductions of up to 50% may be claimed for R&D expenditures. Each canton has discretion to determine whether it will adopt the provision and, if so, the percentage increase for the additional deduction. As an example, the increased rate to expenditures in Zurich is 50%.
Notional Interest Deduction ("N.I.D.")	The cantons may allow an interest deduction on equity where the effective Federal, cantonal, and municipal income tax burden in the cantonal capital is at least 18.03%. At this time, the N.I.D. will be applicable only in the canton of Zurich, which is the only canton having a rate in excess of the threshold.
Limitation of the Aggregate Relief	The aggregate tax relief resulting from the patent box, the additional deductions for R&D, and the N.I.D. cannot exceed 70% of income prior to these deductions. Several cantons have introduced lower ceilings on the aggregated relief, among them Basel, where the ceiling is 40% of income prior to these deductions.
Adjustments to Capital Tax	All cantons levy capital tax on the equity of resident companies. The cantons may introduce a reduced tax rate on equity attributable to participations, patents, comparable rights, and intercompany loans.
Step-Up Mechanism	Companies that relocate their headquarters to Switzerland can benefit from a step-up in the base used to compute depreciation.
Extension of the Lump-Sum Tax Credit	The lump-sum tax credit prevents international double taxation. It allows a Swiss-resident company to claim a credit for foreign taxes under certain conditions, such as a receipt of dividends. Now, this credit may be claimed by a Swiss permanent establishment of a foreign company.

Measures Affecting Shareholders with Domicile in Switzerland

Measure	T.R.A.F. Provision
Partial Taxation of Dividends	Shareholders resident in Switzerland holding a participation of at least 10% of the capital of a company may profit from a special partial taxation of dividends received from such company. In other words, only 60% of a divided is taxed at the Federal level and at least 50% of is taxed at the cantonal and municipal levels.

Measure	T.R.A.F. Provision
Restrictions on Tax-Free Repayment of Capital Contribution	The principle that paid-in capital and capital reserves may be paid back to the local or foreign shareholder without any tax consequences was introduced to Swiss tax law in 2011. Swiss companies were free to decide whether a payment to a shareholder would be a dividend distribution or a repayment of such reserves. The reform restricts tax-free repayments of capital contributions for Swiss listed companies, as these companies will have to match every capital repayment with an equal dividend. This will ensure that some extent of dividends is taxed for income tax purposes. The new rule does not affect non-listed companies.
Capital Gains Tax	In general, no capital gains tax is levied on the sale of shares by an individual resident in Switzerland. Among other exemptions, the new law includes a stricter practice on capital gains tax when the shares are sold to a company controlled by the shareholder.

Fiscal Policy Measures

Measure	T.R.A.F. Provision
Cantonal Share of Direct Federal Tax	The cantons' share of direct Federal tax revenue will be increased from 17% to 21.2%, limiting the cantons' risk of a loss of tax revenues.
Municipality Clause	The cantons will compensate the municipalities for the financial effects of tax reductions at the cantonal level.
Adjustments in Financial Equalization Between Cantons	The fiscal equalization aims to mitigate cantonal differences regarding financial capacity. When calculating financial equalization between the cantons, the profits of companies having certain status are now to be given lesser weight than other profits.
A.H.V.	As originally proposed, the corporate tax reform favored Swiss corporations to the exclusion of individuals. This gave rise to an apprehension that individuals would face a tax increase in order to make up for a shortfall in tax revenue, which led to its defeat at the polls. To make T.R.A.F. attractive to voters, it includes additional financing for the Swiss social security system. Starting in 2020, an additional C.H.F. 2 billion per year will be paid into the A.H.V. system, of which approximately C.H.F. 800 million will be funded by the Swiss Confederation. Employers and employees will contribute another C.H.F. 1.2 billion.

EFFECT ON COMPANIES

The following two examples illustrate the ways companies are affected by T.R.A.F.

Example 1: Swiss Holding Company

A Swiss corporation has its registered seat in Zurich. As the corporation met the cantonal requirements for the holding company privilege, it was exempt from corporate income tax on a cantonal and municipal level until the end of 2019. With the implementation of the tax reform, the holding privilege has been abolished at the cantonal and municipal levels. The corporation will become subject to ordinary corporate income taxes. It is allowed to claim the benefit of the participation deduction as currently applicable for Federal taxes.

The company's assets consist mainly of 10% or greater participations and some cash and securities. At the end of 2019, various securities are accounted at acquisition cost, although the fair market value was higher as a result of unrealized capital gains.

Provisional Balance Sheet 2019			
Assets		**Liabilities and Equity**	
Cash	$100	Liabilities	$100
Securities*	$1,000	Loans	$3,000
Participations	$3,000	Equity	$1,000
Total	$4,100	*Total*	$4,100
* Market value $3,000 (unrealized capital gain = $2,000)			

According to Swiss accounting rules, a company may choose to account for securities at acquisition or fair market value. If fair market value is used, all securities must be accounted for at fair market value in one entry in the balance sheet. Reference must be made in the notes to the accounts.

As the holding privilege is still applicable in 2019, the company may choose to increase the value of the securities from acquisition to fair market value, resulting in a realized gain.

Final Balance Sheet 2019			
Assets		**Liabilities and Equity**	
Cash	$100	Liabilities	$100
Securities	$3,000	Loans	$3,000
Participations	$3,000	Equity	$1,000
		Income 2019	$2,000
Total	$6,100	*Total*	$6,100

“A Swiss company may reduce its tax burden significantly if unrealized gains are included in the balance sheet for 2019.”

On the level of cantonal and municipal tax, the company may apply the holding privilege in the year 2019. Consequently, the realized gain of $2,000 is not taxed. However, beginning with the financial year 2020, the book values that were reported at the end of 2019 will be recognized for tax purposes.

The company will report taxable income including the realized gain of $2,000 for direct Federal taxes in 2019, and tax will be paid.

In summary, a Swiss company may reduce its tax burden significantly if unrealized gains are included in the balance sheet for 2019. From 2020 on, realized gains will be fully taxed on all three levels. See simplified example as follows, effective tax rate included.

	2019	2020
Direct Federal Tax	7.8%	7.8%
Cantonal/Municipal Tax*	0.0%	13.5%
Aggregated Tax Burden	7.8%	21.3%
Profit on Securities	$2,000	$2000
Profit Tax	$156	$426

* The canton of Zurich will reduce its tax rate in 2021 slightly (aggregate tax rate as of 2021 will be approximately 20%).

With regard to the participations (shareholdings of >10%), there is – in general – no need for a revaluation. Income arising from such participations will be subject to the participation relief, as currently applied for Federal taxes, also on the cantonal and municipal levels.

The participation exemption is a percentage deduction from corporate income tax that is equal to net participation income (gross participation income from qualifying dividends and capital gains, less related administration and financing costs) divided by taxable income. In most cases, the participation relief results in a full exemption from corporate income tax for all or most of the participation income. The participation relief applies to dividends and capital gains. No significant tax consequences should be applicable. If participations have been depreciated in the past, it must be determined whether a step-up is possible.

In summary, Swiss holding companies should analyze their assets for unrealized gains and may decide to realize them in the final 2019 financial accounts. If so, they should act immediately since the transition must be addressed with the competent tax authorities (*i.e.*, via ruling request) and/or should be included in the final balance sheet and profit and loss statement for 2019.

Finally, since tax rates vary from canton to canton, management may wish to relocate the headquarters location and functions to a more tax-favorable canton such as Zug, where the aggregate effective tax rate is approximately 12%.

Example 2: Swiss Industrial Company

A Swiss corporation has its registered office in Zurich. Until the end of 2019, the company paid ordinary corporate income taxes at the cantonal and municipal levels. The company invents industrial products in R&D centers that are located principally in Europe (outside Switzerland) and the U.S. Consequently, the operation in Switzerland has been limited to distribution activities.

The company explores whether it can benefit from T.R.A.F. It identifies that new product A will be fully developed in Switzerland and that new product B could be developed in Switzerland. If so, the Swiss contributions to R&D is expected to be 52.5%.

Additional Deductions for R&D

One of the measures provided by T.R.A.F. is the allowance of an additional deduction for R&D performed in Switzerland. The cantons may allow a deduction for up to 50% of the R&D expenses incurred by the taxpayer directly or indirectly through third parties in Switzerland. The additional deduction is allowed on the directly attributable personnel expenses for R&D plus a surcharge of 35% as well as 80% of expenses for R&D invoiced by third parties.

In our example, the canton of Zurich introduced the additional deduction for R&D. Therefore, the company may apply this additional deduction to reduce taxable income. If the company had its research facility in Basel-Stadt, it could not claim the deduction, as Basel-Stadt has not introduced the additional deduction. Again, consideration should be given to a move of headquarters and functions from Basel-Stadt.

Patent Box

Another measure of T.R.A.F. to be considered is the introduction of a patent box tax regime. Philosophically, R&D is a tax benefit that is realized at the time expenditures are made whereas the patent box regime provides benefits at a later point in time when revenue is realized. It is inappropriate to claim both benefits. Consequently, when adopting the patent box tax regime, the benefit of R&D expenses that have been deducted must be recaptured. Consequently, a corporation must analyze whether it is worthwhile to switch to the patent box regime. In our example, this question is irrelevant, as no R&D has been carried out in Switzerland in the past.

In making an analysis, the first step is to identify the patents that generate income qualifying for the patent box regime. Covered patents include

- patents registered under the European Patent Convention,
- patents registered under the Swiss Patent Act, and
- foreign patents corresponding to European or Swiss patents.

Intellectual property such as trademarks or know-how are not included for the patent box calculation.

When computing the benefit under the patent box regime, profits from intellectual property must be adjusted using the modified nexus approach. Under this approach, the expenditures for qualifying R&D performed in Switzerland is divided by

total R&D expenditures. The resulting percentage is applied to the net income from patents to determine the portion that qualifies for the benefit.

In our above-mentioned very simplified example, the company has a 100% nexus for product A and a 52.5% nexus for product B. Therefore, future profits from such patents should benefit from the patent box mechanism. Note that the computations required to be made under the patent box regime are quite complex, including analysis of functions, relations to products, and proper use of transfer pricing concepts to identify the enhanced return attributable to the application of the patented technology in the manufacture of the product.

Step-Up in Basis

Where moving a foreign company's seat to Switzerland or transferring certain business operations or functions to Switzerland is feasible, the availability of a tax neutral step-up in the depreciable basis of transferred assets should be analyzed. Under the new rules, a tax-neutral realization of unrealized capital gains or other hidden reserves is possible as a result of the transfer. Again, tax rates vary from canton to canton. Consequently, identification of the most tax-favorable canton is important.

OUTLOOK

"Companies having no operation or location in Switzerland may consider building R&D centers in Switzerland to profit from the advantageous tax and business environment."

With the approval of T.R.A.F. by Swiss voters, a tax system based on internationally acceptable measures came into force effective January 1, 2020. Switzerland remains an interesting tax location for individuals and companies looking to expand operations to Europe.

For companies already conducting operations in Switzerland, T.R.A.F. rewards those companies that are located in cantons with favorable tax rules. Important tax benefits may be lost for those companies that are unwilling to undergo the proper study. Companies having no operation or location in Switzerland may consider building R&D centers in Switzerland to profit from the advantageous tax and business environment, including the patent box regime illustrated in Example 2 above.

Having implemented T.R.A.F. does not mean that all tax can be eliminated through operations within a tax favored jurisdiction. Additional global reforms are under consideration by the O.E.C.D. At the end of 2019, the O.E.C.D. published a proposal to ensure that large and highly profitable multinational companies, especially I.T. companies, must pay a minimum level of tax. The proposal is currently under review and is expected to be finalized by the close of 2020.[3] Adopting a market-based approach to tax jurisdiction, the O.E.C.D. proposes that part of the profits should be taxable in jurisdictions with significant consumer-facing activities and where profits are generated. The upcoming discussions of the O.E.C.D. proposal will be interesting, as European companies may face increased taxation abroad by reason of the proposals.

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[3] See "Statement by the O.E.C.D./G-20 Inclusive Framework on B.E.P.S. on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy," as approved by the O.E.C.D./G-20 Inclusive Framework on B.E.P.S. on January 29-30, 2020.

THE NETHERLANDS INTRODUCES COMPENSATION REGULATION TO DISCOURAGE "DORMANT EMPLOYMENT"

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INTRODUCTION

Companies that employ staff in the Netherlands have a statutory obligation to continue salary payments when employees are absent on sick leave. Paid sick leave can extend up to 104 weeks, a full two years. During the entire period, the employer and employee are required to meet reintegration obligations designed to plan for the employee's return to work. If the employer fails to observe the statutory reintegration obligations the paid sick-leave period can be extended by an additional 52 weeks.

After 104 weeks, the employer may request permission from the Employee Insurance Agency ("U.W.V.") to terminate the employment contract. If instead the employer does not opt for termination of the employment contract and has observed its reintegration obligations, after the end of the 104th week, the employee is no longer entitled to salary payments for the remainder of the sick leave. Because the employment contract remains valid, the post-payment period is generally referred to as "dormant employment."

With the overhaul of dismissal laws in 2015, the Netherlands introduced a statutory transition fee due upon termination of an employment contract in certain circumstances. The transition fee offers financial compensation for the loss of a job and promotes employability. It enables the transition from one employment arrangement to another. The transition fee is essentially a form of legally mandated severance in a case of forced dismissal. When the employer opts for termination after 104 weeks of sick leave, it is deemed a forced dismissal and the employee is entitled to the transition fee.

The transition fee is not payable if the employee resigns or if the parties come to a mutual agreement on the termination of the employment contract. Under an exception applicable to older employees, the transition fee is also not payable if the employee has reached the state pension age. Since its implementation in 2015, many employers keep employment contracts dormant to circumvent the obligation to pay the transition fee.

This article will address recent changes to the rules that control the payment of transition fees intended to break the stalemate in the employment situation that has arisen from dormant contracts:

- The Dutch parliament has enacted legislation, known as the "Compensation Regulation," that offers employers the opportunity of being reimbursed by the Dutch government for a transition fee paid in relation to a dismissal of an employee for reason of continued sick-leave after 104 weeks. This regulation is effective as of April 1, 2020. The regulation has retroactive effect and

will cover terminations due to long-term sick leave and corresponding paid transition fees from July 1, 2015, onwards. This is discussed in greater detail below, under **The Compensation Regulation**.

- In addition, the Supreme Court of the Netherlands recently ruled that the practice of dormant employments must come to an end. If the employee wants a termination of a contract after 104 weeks of sickness – viewed under prior law as a voluntary termination instead of a unilateral forced termination – the employer has the obligation to terminate the employment contract and pay the transition fee, making the termination involuntary.

The termination fee, employer compensation mechanism, and relevant court cases are discussed in detail below.

CALCULATING THE STATUTORY TRANSITION FEE

July 2015 – December 31, 2019

With the introduction of the transition fee effective July 1, 2015, the calculation was as follows. Note, the transition fee is calculated as of the formal termination date of the employment contract (*i.e.*, years of employment includes sick leave).

Years of Employment	Remuneration for Every Six Months
0-10 years	1/6 monthly gross salary
10+ years	1/4 monthly gross salary

A more generous calculation applied to employees age 50 or older with at least ten years of service:

Years of Employment if Age 50+	Remuneration for Every Six Months
0-10 years	1/6 monthly gross salary
10+ years	1/2 monthly gross salary

The transition fee was capped at (i) €75,000 gross (for 2015) or (ii) one year's salary if the employee earned more than €75,000 gross per year.

January 1, 2020 and Beyond

Effective January 1, 2020, Dutch labor legislation underwent yet another set of significant changes with the implementation of the so-called Labor Market in Balance Act (*Wet Arbeidsmarkt in Balans*). This act implements various changes, including changes to the calculation of the transition fee.

The law now stipulates that the amount of the transition fee is as follows:

> The transition fee is equal to one third of the monthly wage for each calendar year that the employment contract lasted and a proportional

> part thereof for a period that the employment contract has lasted for less than a calendar year. Further rules concerning the method of calculating the transition fee may be laid down in a separate order.

The simplest way to calculate the transition fee is in two steps: by month and by day. Take the following example:

An employee worked at a company for nine years and five days. The gross monthly salary was €3,000 on the basis of a 40-hour work week and an hourly wage of €20. How much is the transition fee?		
Step 1:	Calculate the transition fee for the full nine years of service	9 x (1/3 x €3,000) = €9,000
Step 2:	Calculate the transition fee for the five days	40 x €20 = €800 (800/3000) x ((1/3 x 3000)/12) = €22.22
The transition fee is €9,022.22 gross.		

The gross monthly salary is based on the most current salary that the employee receives including holiday allowance. If the employee is on sick leave and receives a lower amount, the calculation still takes into account the higher salary that the employee received prior to the sick leave. Furthermore, the monthly salary includes the average of fixed and variable compensation that was paid out to the employee, such as bonus payments.

The transition fee is capped at €83,000 gross (for 2020) or one year's salary if the employee earns more than €83,000 gross per year. The maximum amount is adjusted annually in January to reflect inflation.

Significant Difference in Outcome

The calculation method of the new transition fee has resulted in a huge difference in outcomes for employees age 50 and older who have more than ten years of service with a company. Sometimes they are eligible for only half of the amount that they would have received prior to the new legislation. Take the following example:

An employee born on January 1, 1960, was employed with a company since January 1, 2000. His gross monthly salary was €3,000. What is the transition fee?	
Contract Terminated on December 31, 2019:	[20 x (1/6 x 3,000)] + [20 x (1/2 x 3,000)] = €40,000
Contract Terminated on January 1, 2020:	20 x (1/3 x 3,000) = €20,000

The portion of the monthly salary that forms the base of the transition fee remains flat, at one-third, irrespective of the employee's age.

SICK LEAVE IN THE NETHERLANDS

Dutch law provides that during the first 104 weeks of sickness or disability, the employer must continue to pay the employee a minimum of 70% of the salary (capped at €219.28 per day as of January 2020). It is common that in individual employment contracts or in collective bargaining agreements, employers pay a greater percentage, often up to 100% of the contractual salary for the first 52 weeks of sick leave.

During sick leave, both employer and employee should (demonstratively) make the best effort to ensure that the employee can recover and resume work. These are the re-integration obligations mentioned above. If both parties have observed their respective re-integration obligations well, the employer can stop paying salary after 104 weeks. The governmental agency U.W.V. then takes over the re-integration obligation, and the employee is entitled only to long-term sickness benefits per state rules. If the employer failed to observe its statutory re-integration obligations, U.W.V. can determine that the salary payment must continue for a maximum of 52 weeks, resulting in the continuous payment of salary for a total of three years of sickness.

For the period in which the employer has the obligation to continue salary payments, there is a strict prohibition against terminating employment during sick leave (*opzegverbod*). This means that during a period of two or potentially three years (the "Sickness Period"), the employer may not terminate the employment contract.

After the Sickness Period, the obligation to continue salary payments and the prohibition against termination cease to exist. If the employer does not opt for termination under one of the statutory forms of legally valid termination, the employment contract remains in a dormant state.

"Dutch law provides that during the first 104 weeks of sickness or disability, the employer must continue to pay the employee a minimum of 70% of the salary."

Since the introduction of the transition fee in 2015, there has been a tendency among employers to keep employees who are on long-term sick leave "on the books." Employers experience that the transition fee, when combined with salary payments during the Sickness Periods and the costs of reintegration efforts, is problematic and unjust because of the financial burden it entails. As long as the employment contract is not terminated, the transition fee is not due.

THE COMPENSATION REGULATION

In the period leading to enactment of the Compensation Regulation Transition Fee Act (*Wet Regeling Compensatie Transitievergoeding* or the Compensation Regulation), it was estimated that there were thousands of dormant employment contracts in the Netherlands. The Dutch parliament concluded that the number of dormant contracts was undesirable. All employees, including long-term sick employees, are entitled to a transition fee when their employment contract is terminated by the employer. At the same time, the Dutch parliament acknowledged that the transition fee places a burden on employers. In order to encourage employers to terminate an employment contract after the Sickness Period runs out, the Compensation Regulation was adopted with an effective date of April 1, 2020.

As of that date, an employer can submit an application to U.W.V. requesting compensation for transition fees paid to employees once the Sickness Period runs out. The Compensation Regulation will cover employment contracts that have been

terminated from July 1, 2015, onward. Please refer to the two situations (old and new) described below.

The Compensation Regulation passes some or all of the transition fee from the employer to the government. In order to receive compensation, the employer must meet two conditions. First, the transition payment must be due were the contract terminated with U.W.V.'s permission or via the courts. Second, the payment of the transition fee is related to the termination of the contract due to the employee's long-term sickness.

We can differentiate two situations where employers would be eligible to apply for compensation:

Applications Based on "Old Situations"

- The employee's contract was terminated in the period between July 1, 2015 – March 31, 2020.
- The transition fee was paid to the employee before April 1, 2020.
- The application to U.W.V. can be submitted in the period April 1, 2020 – October 1, 2020.

Applications Based on "New Situations"

- The employee's contract is terminated on or after April 1, 2020.
- The transition fee has been paid in full.
- The application to U.W.V. must be submitted within six months from the date of payment of the transition fee.

There are some limitations as to the amount of compensation that the employer will receive:

- In principle, the compensation may not be greater than the actual amount of transition fee paid to the employee.
- The compensation may not be greater than the transition fee calculated at the time the employee was on sick leave for 104 weeks. If a higher fee is paid because the employment agreement is terminated at a later date, *i.e.*, because the employment was left dormant or the employer was ordered by U.W.V. to continue payment for another 52 weeks, the compensation is still capped at the transition fee payable after the initial 104-week Sickness Period.
- The compensation may not be greater than the salary amount that the employer paid to the employee during the Sickness Period. This amount is the gross salary excluding the employer's costs. If the employer paid more than the statutory minimum of 70% of the salary, these costs will generally be greater than the transition fee. The Minister of Social Affairs is investigating whether certain state benefits and subsidies impact the compensation as mentioned under this point.

A possible consequence of these limitations is that an employer may force an employee to agree on a payment that is not higher than the compensation the employer

will receive from U.W.V. If the transition fee is higher than the compensation due to the limitations described above, the employer can threaten not to terminate the contract, leaving the employment dormant.

CASE LAW: LOWER COURTS

Prior to the introduction of the Compensation Regulation, case law in the lower courts showed that it was almost impossible for an employee on long-term sick leave to force termination on an employer by initiating a court proceeding. Courts generally ruled that, according to Dutch law, no legal obligation was imposed on an employer to terminate an employment contract after the Sickness Period. The courts also did not consider this to violate good employment practices.

Despite the introduction of the Compensation Regulation, many employers remain unwilling to terminate dormant employment contracts. However, case law has been divided on whether dormant employments are allowed after adoption of the Compensation Regulation. To illustrate, one district court ruled that continued employment under a dormant contract was not contrary to the practice of good employment. In comparison, another district court ruled in a comparable situation that the continuation of a dormant contract was contrary to the standard of good employment practice. This employer was instructed to terminate the contract. In the second case, the district court took into account the Compensation Regulation, and on that basis, the district found that no justification existed for the employer to keep the employment dormant.

THE SUPREME COURT AND DORMANT EMPLOYMENTS: "WAKE UP AND PAY UP!"

In light of these divisions, the Supreme Court issued a preliminary ruling on November 8, 2019, on questions of law regarding the termination of dormant employments.

The Supreme Court does not share the view of some lower courts that keeping employees in a dormant employment status is allowed. With the introduction of the Compensation Regulation, employers will be compensated for the costs they incur in terms of the payout of the transition fee. Consequently, they are no longer confronted with an unreasonable financial burden on top of their reintegration obligations and continued salary payments during the 104-week period. Moreover, it is clear that the Dutch parliament intended to reduce the number of dormant employment contracts as much as possible. The principle of good employer conduct implies that a dormant employment agreement should, in principle, be terminated if the employee desires termination and the employer does not have any reasonable or legitimate interest in continuing the employment agreement.

The employer may have a legitimate interest if, *inter alia*, realistic re-integration opportunities exist for the employee. Denying termination because the employee will soon reach pensionable age – resulting in a termination of the employment contract by operation of law without entitlement to the transition fee – is not considered to be a legitimate interest. The main principle remains that the transition fee is payable once the Sickness Period runs out and the employee has requested a termination of the employment contract.

IMPLEMENTATION OF THE SUPREME COURT RULING: PRACTICAL TIPS AND TRICKS

In principle, employers are not obliged to take the initiative to terminate dormant employments. The Supreme Court only adopted an obligation for employers to agree to a request from the employee on long-term sick leave to terminate the employment contract and pay the transition fee.

While the notion of a dormant employment may still sound attractive to employers, certain risks exist when dormant contracts are allowed to continue. As long as the employment is dormant, the employer has the duty to phase the employee into the work force once the employee is at least partially recovered, provided that realistic opportunities exist. At some point, a recovered employee can claim reinstatement and continued payment of salary. If the recovered employee is fulfilling a suitable other position for a period of four weeks or longer, the entitlement to the Sickness Period starts anew, exposing the employer to continued salary payments.

Moreover, the transition fee is calculated as of the formal termination date of the employment contract. The Compensation Regulation creates the possibility to be compensated for the transition fee, but that compensation is not greater than the transition fee calculated at the time the employee was on sick leave for 104 weeks. The difference between the actual transition fee that must be paid to the employee (*i.e.*, as of the formal termination date of the employment contract) and the compensation that the employer will receive from U.W.V. (*i.e.*, the transition fee payable after the 104 weeks of sick leave) remains for the account of the employer.

In view of the potential risks as well as the continued accrual of the transition fee, we recommend starting discussions with employees on long-term sick leave and agreeing on a mutual termination of their employment after the Sickness Period. If the employee rejects the offer, the employer cannot be viewed to have neglected the principles of good employer conduct. As in many aspects surrounding a disputed termination of employment, the employer must carefully record its negotiation position with the employee on a contemporaneous basis. The employer then has the choice of maintaining a dormant contract. Should the employee have a change of mind and request a termination offer, it is prudent for the employer to offer an amount that is equal to the anticipated compensation under the terms of the Compensation Regulation. In this way, the employer clearly will have followed the letter of the law, and it is expected that the difference between the actual transition fee at the time of termination and the compensation that will be received from the Dutch government will not have to be paid by the employer directly after 104 weeks of sick leave.

Alternatively, the employer can request permission from U.W.V. to terminate the employee's contract. The cost of the transition fee is then equal to the compensation under the Compensation Regulation.

CONCLUSION

The stalemate generated by dormant contract arrangements has come to an end as a result of the Compensation Regulation. The Compensation Regulation calls for payment of transitions fees following the end of an employee's Sickness Period

that will be reimbursed entirely or mostly by the by Dutch government. In many, if not most, situations the Dutch government will bear the cost of the transition fee on a deferred basis. Aside from timing and professional fees incurred, this appears to be a win-win situation for both parties to the employment contract.

"The stalemate generated by dormant contract arrangements has come to an end as a result of the Compensation Regulation."

THE MULTILATERAL INSTRUMENT AND ITS APPLICABILITY IN INDIA

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INTRODUCTION

The O.E.C.D. initiated the Base Erosion and Profit Shifting ("B.E.P.S.") Project in 2013 with a view to curtail tax avoidance. The B.E.P.S. Project seeks to nullify tax planning strategies that exploit gaps and mismatches in tax rules in order to artificially shift profits to low-tax or no-tax locations with inadequate economic substance or activity. It is estimated that B.E.P.S. strategies cost countries $100-240 billion in lost revenue, annually. Under the B.E.P.S. Project, over 90 countries and jurisdictions are collaborating to implement the recommended 15 B.E.P.S. measures.

One of the most significant outcomes of the B.E.P.S. Project is the signing of the multilateral instrument ("M.L.I.") in 2017. The M.L.I. seeks to address B.E.P.S. concerns in thousands of bilateral tax treaties through one common treaty. While the M.L.I. does not replace bilateral tax treaties, it acts as an extended text to be read along with the covered bilateral tax treaties for implementing specific B.E.P.S. measures. In order to be considered a "covered tax treaty" under the M.L.I., each partner jurisdiction to a tax treaty must notify the treaty and then agree on the specific provisions of the M.L.I. that will apply.

India has been at the forefront of implementing B.E.P.S. measures and submitted a ratified M.L.I. with the O.E.C.D. on June 25, 2019. The date of entry into force of the M.L.I. has been notified by India as of October 1, 2019. Accordingly, India's covered tax treaties will need to be read with the M.L.I. from April 1, 2020. India has notified tax treaties with 93 jurisdictions (including the U.S.) under the M.L.I. India has not notified the tax treaty with China under the M.L.I. since the treaty was recently amended bilaterally to incorporate B.E.P.S. measures.

As of January 10, 2020, 23 Indian bilateral tax treaties are treated as covered. These are the following:

Austria	Australia	Belgium	Finland	France
Georgia	Ireland	Israel	Japan	Lithuania
Luxembourg	Malta	Netherlands	New Zealand	Poland
Russia	Serbia	Singapore	Slovak Republic	Slovenia
Sweden	U.K.	U.A.E.		

IMPACT OF THE M.L.I. ON INDIAN STRUCTURES OF U.S.-BASED BUSINESSES

The U.S. is not a signatory to the M.L.I. However, many U.S.-based businesses have in the past used either Mauritius, Singapore, or the Netherlands to route investments into India or for rendering managerial, technical, or consultancy services to Indian entities, due to the beneficial tax treatment in India's treaties with these countries. Benefits include the following:

- Exemption on capital gains arising on disposal of shares of Indian companies in certain situations
- Exemption from withholding tax or lower withholding tax on service payments
- Relaxed conditions for constituting a Service Permanent Establishment in India

Given that India's tax treaties with Singapore and the Netherlands will be covered by the M.L.I. from April 1, 2020, onwards, this development would be of keen interest for U.S.-based businesses that have routed their Indian interests through these countries.

"The U.S. is not a signatory to the M.L.I. However, many U.S.-based businesses have in the past used either Mauritius, Singapore, or the Netherlands to route investments."

Importantly, while Mauritius has signed the M.L.I., it has yet to notify the tax treaty with India under the M.L.I. Accordingly, the India-Mauritius Tax Treaty will not be currently impacted by the M.L.I. However, the treaty is expected to be bilaterally amended along the lines of the B.E.P.S. measures, especially the minimum standards required under the M.L.I. India's position on each of the articles of the M.L.I. and its generic impact is discussed below.

INDIA'S RELEVANT POSITIONS ON THE M.L.I.

Article	In Brief	India's Position & the Impact
Article 3: **Transparent Entities**	A fiscally transparent entity will be granted tax treaty benefits only to the extent the income is considered to be that of a resident of the jurisdiction for taxation purposes and taxed at the level of its members.	India has not adopted this article, and accordingly, this article will not impact or modify any of India's tax treaties. Interestingly, Indian tax authorities have, in the past, denied complete tax treaty benefits to fiscally transparent entities on the grounds that they themselves are not tax residents of their jurisdiction. Although courts have overruled this view in a number of instances, the tax authorities continue to deny tax treaty benefits to fiscally transparent entities. Accordingly, the position remains unsettled.

Article	In Brief	India's Position & the Impact
Article 4: **Dual Resident Entities**	This article deals with cases where a non-individual is dual tax resident. In such a case, the final tax residency will be decided by mutual agreement between competent authorities of the jurisdictions involved. To arrive at a conclusion, the authorities will consider factors such as the place of effective management ("P.O.E.M.") of the entity, its place of incorporation or constitution, and any other relevant factors. In absence of such agreement, a dual tax resident will be denied tax treaty benefits altogether, unless otherwise agreed between the authorities.	India has adopted this article. It will apply to all Indian tax treaties notified and covered under the M.L.I. and where the other jurisdiction has similarly adopted this article. Under Indian tax law, companies are tax resident in India if they are incorporated in India or have their P.O.E.M. in India. If a company incorporated outside India is held to be resident in India under the P.O.E.M. rule, this article will mandate mutual agreement to be reached between Indian tax authorities and authorities of the other jurisdiction. In absence of such agreement, the tax treaty benefits are likely to be denied.
Article 5: **Application of Methods for Elimination of Double Taxation**	Three options are provided for eliminating double taxation under domestic tax law: • Option A: Exemption method (the foreign income is not taxed at all in the jurisdiction of residence) • Option B: Exemption method (for all income other than dividends that are deductible in the jurisdiction of source) • Option C: Credit method (the foreign income is taxed in the jurisdiction of residence with an appropriate tax credit for foreign taxes)	India has adopted Option C (*i.e.*, the credit method). Most of India's tax treaties already provide for the credit method. Only four of the India's tax treaties (*i.e.*, with Bulgaria, Egypt, Greece, and the Slovak Republic) provide for the exemption method. Since these tax treaties are not commonly used in India-related structures, this article is not expected to have major impact.

Article	In Brief	India's Position & the Impact
Article 6: **Purpose of a Covered Tax Agreement**	This is a minimum standard that requires clarifying the intention of the tax treaty through modification, or insertion, of the preamble of the tax treaty. The preamble will clarify that the intention of the jurisdictions is to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including cases of treaty shopping for indirect benefits for residents of third jurisdictions.	The standard preamble provided in the M.L.I. and adopted by India, being a minimum standard, will apply to all Indian tax treaties notified and covered under the M.L.I. Indian courts have, in the past, relied on the preamble text while interpreting tax treaty provisions. This is a very important update and is expected to influence the interpretation of tax treaty provisions while adjudicating tax treaty benefits in India.
Article 7: **Prevention of Treaty Abuse**	This is one of the most anticipated and important articles of the M.L.I. The article requires insertion of the following one or more tests in the tax treaty for preventing tax treaty abuse: • Principal Purpose Test ("P.P.T.") – minimum standard • Simplified Limitation of Benefits ("S.L.O.B.") clause – optional and in support of the P.P.T. • Detailed Limitation of Benefits ("D.L.O.B.") clause – to be bilaterally agreed in line with B.E.P.S. measures and can replace the P.P.T.	India has adopted both the P.P.T. and S.L.O.B. with an option to bilaterally agree to a D.L.O.B., as required. The P.P.T. being a minimum standard, it will apply to all Indian tax treaties notified and covered under the M.L.I. However, an S.L.O.B. will apply only in cases where it has also been adopted by the other jurisdiction. Most of India's key tax treaty partners have not opted for an S.L.O.B. Singapore and the Netherlands have both applied only the P.P.T. and not the S.L.O.B. clause, and hence, their tax treaties with India will be modified only to the extent of the P.P.T. The applicability of the P.P.T. is one of the most significant updates arising from the M.L.I. in the context of India's tax treaties. In fact, the P.P.T. could result in increased litigation with the tax authorities if not implemented carefully and in spirit. A detailed discussion on the possible impact of the P.P.T. is provided in the next section for better understanding.

Article	In Brief	India's Position & the Impact
Article 8: **Dividend Transfer Transactions**	Many tax treaties provide for exemptions or concessional withholding tax rates on dividends for certain shareholders, which are different than the withholding tax rates otherwise applicable under the tax treaty. Article 8 requires meeting additional criteria of shareholding of minimum 365 days to avail the exemption or concessional withholding tax rate.	India has adopted this article. It will apply to all Indian tax treaties notified and covered under the M.L.I. and where the other jurisdiction has similarly adopted this article. Currently, India does not impose any withholding tax on dividend payments by Indian companies, since these companies pay a dividend distribution tax ("D.D.T.") and the dividend is exempt from tax in hands of the nonresident shareholder. However, the Finance Bill, 2020, has proposed to abolish the D.D.T. with effect from April 1, 2020. Resultantly, the dividend would be taxable in the hands of the nonresident shareholder. With the proposed abolishment of the D.D.T. regime, the impact of this article on withholding tax on dividend payments must be considered going forward, as applicable.
Article 9: **Capital Gains from Alienation of Shares or Interests of Entities Deriving their Value Principally from Immovable Property**	This article expands the taxing rights of the jurisdiction of source if the capital gain is essentially derived from immovable property in that jurisdiction held through a company, partnership, trust, or others.	India has adopted this article. It will apply to all Indian tax treaties notified and covered under the M.L.I. and where the other jurisdiction has similarly adopted this article. India will now have the right to tax • capital gains arising from the alienation of shares or comparable interests (such as interests in a partnership or trust), • if at any time during the 365 days preceding the alienation, • these shares or comparable interests derived more than 50% of their value directly or indirectly from immovable property situated in India.

Article	In Brief	India's Position & the Impact
Article 10: **Anti-abuse Rule for Permanent Establishments Situated in Third Jurisdictions**	This article denies tax exemptions to P.E.'s situated in a third state and not engaged in active business if the tax rate in the third state is less than 60% of the tax rate in the country of residence of the taxpayer.	India is silent on this article in the ratified M.L.I. In absence of any reservation, it will apply to all Indian tax treaties notified and covered under the M.L.I. and where the other jurisdiction has similarly adopted this article. However, Indian tax treaties generally permit the taxation of an overseas P.E. of an Indian tax resident. A requisite foreign tax credit is provided against the Indian tax payable on profits of such P.E. Hence, this article is not expected to have much impact on Indian structures in usual circumstances.
Article 11: **Application of Tax Agreements to Restrict a Party's Right to Tax its Own Residents**	This article seeks to clarify that a jurisdiction continues to have a right to tax its own residents unless the tax treaty specifically provides for other treatment.	India is silent on this article in the ratified M.L.I. In absence of any reservation, the same will apply to all Indian tax treaties notified and covered under the M.L.I. and where the other jurisdiction has similarly adopted this article. However, since India follows the credit method under most of its tax treaties, this article is not expected to have a material impact on Indian structures.
Article 12: **Artificial Avoidance of P.E. Status Through Commissionnaire Arrangements and Similar Strategies**	This article tackles cases that would otherwise not be covered in the definition of P.E. (especially Agency P.E.) under existing tax treaties. The article brings the following activities under the P.E. definition: A person • habitually concluding contracts or • habitually playing a principal role in the conclusion of contracts on behalf of another entity.	India has adopted this article. It will apply to all Indian tax treaties notified and covered under the M.L.I. and where the other jurisdiction has similarly adopted this article. India has also amended its tax law to include such cases within its own concept of taxable presence, akin to a P.E. (*i.e.*, "Business Connection"). This amendment may result in Indian tax authorities adopting an aggressive approach to establish a foreign company's P.E. status in India.

Article	In Brief	India's Position & the Impact
Article 13: **Artificial Avoidance of P.E. Status Through the Specific Activity Exemptions**	This article provides two options for determining a P.E. in cases where a P.E. is currently not constituted due to specific exemptions provided under the tax treaty: • Option A: The exempted activities stated in the tax treaty will not result in a P.E. only if they are, singularly or in combination, of a preparatory or auxiliary character. (This is a stricter provision to satisfy.) • Option B: Exempted activities will continue to not result in a P.E., irrespective of whether they are of auxiliary or preparatory character. (This is a more lenient provision to satisfy.)	India has adopted Option A. It will apply to all Indian tax treaties notified and covered under the M.L.I. and where the other jurisdiction has similarly adopted this article. Foreign entities taking a position of not having a P.E. in India on the grounds that the activities are specifically exempt or are preparatory or auxiliary in nature should re-analyze their positions in light of the impact of the M.L.I. on the relevant Indian tax treaty.
Article 14: **Splitting-up of Contracts**	This article seeks to tackle cases where contracts for building or construction sites or installation projects are artificially split amongst group entities to avoid P.E. status due to each entity's presence in the other jurisdiction not exceeding the threshold of days provided for constitution of P.E. under the tax treaty.	India is silent on this article in the ratified M.L.I. In absence of any reservation, it will apply to all Indian tax treaties notified and covered under the M.L.I. and where the other jurisdiction has similarly adopted this article. Foreign entities having similar structures should re-analyze the position of not having a P.E. in India, in light of the M.L.I.
Article 15: **Definition of a Person Closely Related to an Enterprise**	This article defines who is a person "closely related" to an enterprise, a term used in Articles 12, 13, and 14.	India is silent on this article in the ratified M.L.I., and hence, it will apply where Articles 12, 13, and/or 14 are applicable.
Article 16: **Mutual Agreement Procedure ("M.A.P.")**	This article describes how M.A.P. procedure or practices can be implemented.	India has opted for a bilateral notification or consultation process. It will apply to all Indian tax treaties notified and covered under the M.L.I. and where the other jurisdiction has similarly adopted this article.

Article	In Brief	India's Position & the Impact
Article 17: **Corresponding Adjustments**	This article deals with double taxation of profits due to Transfer Pricing adjustments. It recommends that competent authorities in the other jurisdiction should provide corresponding adjustments arising on account of transfer pricing.	India has accepted the application of this article but has reserved the right not to apply it to tax treaties that already contain a similar provision. It will apply to all Indian tax treaties notified and covered under the M.L.I. and where the other jurisdiction has similarly adopted this article.
Articles 18 to 26: **Mandatory Arbitration**	This article provides for mandatory binding arbitration where agreement cannot be reached under M.A.P.	India has not adopted this article, and accordingly, this article will not impact or modify any of India's tax treaties.
Article 35: **Entry into Effect**	A specific provision of the article refers to the term "calendar year" for application of M.L.I.	India has substituted "calendar year" with the term "taxable period."

IMPACT OF THE P.P.T. ON TAX TREATIES NOTIFIED AND COVERED UNDER THE M.L.I.

The main impact of the M.L.I. on all covered Indian tax treaties will be the amendment or insertion of the preamble under Article 6 of the M.L.I. and, at the minimum, insertion of the P.P.T. under Article 7 of the M.L.I. For instance, both articles will apply to India's tax treaties with Singapore and the Netherlands. The P.P.T. in particular needs careful attention as it broadly states that:

A benefit under a tax treaty shall not be granted an item of income or capital if having regard to all relevant facts and circumstances it is reasonable to conclude that obtaining tax benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit unless granting that benefit in the circumstances would be in accordance with the object and purpose of the relevant provisions of the tax treaty.

Accordingly, the P.P.T. is a discretionary and subjective test for denying tax treaty benefits where obtaining the tax benefit under the tax treaty is one of the principal purposes (if not the main purpose) of the arrangement or transaction.

INTERPLAY BETWEEN THE P.P.T. AND G.A.A.R.

As the P.P.T. is an anti-abuse provision, its interplay with the General Anti-Avoidance Rule ("G.A.A.R."), introduced in India's tax law from April 1, 2017, makes for an interesting situation. Both the P.P.T. and G.A.A.R. permit the tax authorities to deny

tax treaty benefits. However, at present, the manners in which they can be invoked have stark differences, as explained below:

"Going forward it is imperative that any Indian inbound or outbound cross-border structuring of investment or business operations should factor in the B.E.P.S. and M.L.I. impact."

- G.A.A.R. can be invoked only if the main purpose of an arrangement is to obtain a tax benefit. However, the P.P.T. can be invoked even if one of the principle purposes of the arrangement is to obtain a tax benefit under the tax treaty.
- G.A.A.R. can be invoked only if the tax benefit amounts to I.N.R. 30 million or more in a financial year with respect to the parties in the arrangement. The P.P.T. does not prescribe any such threshold.
- G.A.A.R. grandfathers investment structures before April 1, 2017. The P.P.T. does not provide for any such grandfathering.
- G.A.A.R. requires the income-tax officer to obtain their senior's approval and also consult the Approving Panel ("A.P.")[1] before invoking G.A.A.R. No such mechanism is provided under the P.P.T.

Accordingly, the P.P.T. has the potential of becoming a quick way for a tax officer to unilaterally deny tax treaty benefits instead of complying with the conditions or process provided under G.A.A.R. It is hoped that the Indian government amends the tax law or issues necessary administrative directions to ensure that the P.P.T. is not casually invoked by tax officers to deny tax treaty benefits. For now, no such clarification has been proposed in the Finance Bill, 2020, although the M.L.I will become effective in India from April 1, 2020.

CONCLUSION

With the M.L.I. becoming applicable to Indian tax treaties from April 1, 2020, onwards, going forward it is imperative that any Indian inbound or outbound cross-border structuring of investment or business operations should factor in the B.E.P.S. and M.L.I. impact, especially if the structuring involves availing of tax treaty benefits (in India or overseas).

[1] The A.P. is comprised of a judge of the High Court (retired or not) as a chairperson, one member of Indian Revenue Service, and one member who is an academic or scholar having special knowledge.

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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Tags
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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.

- 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.

HOME THOUGHTS FROM ABROAD: WHEN FOREIGNERS PURCHASE U.S. HOMES

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PROLOGUE

Your real estate partner comes into your office, saying:

> We have a new client, Mr. N.R.A., who is buying the most expensive house in town. Here is what he wants to do: not buy it in his own name; not pay rent; allow his wife and children (some of whom are U.S. residents) to use the house; not pay estate tax, should he die; not pay gift tax, should he give it away; not file a tax return; and not pay tax when he sells the property.

"No sweat," I told him. "We can do it; my tax partner is the smartest planner in town."

Is it doable? Does our quiver hold enough tax planning arrows to meet all those goals?

INTRODUCTION

This report is concerned with a seemingly simple subject: how to plan the acquisition, ownership, and disposition — by sale, exchange, gift, or bequest — of residential real property in the United States for a nonresident alien client.[1]

For many Americans, as we are regularly reminded, the purchase of a home is the single largest financial transaction of our lives and, because it is the policy of the federal and state governments to encourage homeownership, this investment benefits from extraordinary tax advantages. We are not required to report as income the economic benefit derived from occupation of the property rent free, nor, as a practical matter, do we report as a gift the rent-free use of our property by friends and family members, even those whom we are not obligated to support.[2] We are allowed to deduct interest on mortgage loans (up to $1 million in some circumstances,

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[1] This report is a comprehensive update of Michael J.A. Karlin and Stanley C. Ruchelman, "Home Thoughts From Abroad: Foreign Purchases of U.S. Homes," *Tax Notes*, Sept. 3, 2007, p. 863, whose genesis was a panel presentation at the 2006 autumn meeting of the American Bar Association Section of Taxation in Denver. The title of this report is taken from the title of a poem by Robert Browning. See Daniel Karlin (ed.), Robert Browning: *Selected Poems* (1989).

[2] See *infra* note 45 and accompanying text.

but capped at $750,000 through 2025 in many instances).[3] We can deduct the cost of state and local property taxes.[4] If the home qualifies, deductions are available for home offices. We can exempt up to $250,000 (or $500,000 if filing jointly) of gain from the sale of our principal residence.[5] Until 2022, tax credits subsidize the installation of energy-efficient devices.[6] We have established the most sophisticated market in the world to securitize our home loans, offer those mortgage-backed securities loans tax free to foreigners[7] — as well as many domestic financial institutions and investment funds — and, out of an essentially illiquid financial asset, create the liquidity needed to drive down the cost of our mortgages. We can even rent the home out a few days a year without paying tax on the rental income.[8] For most Americans, the estate tax is not an issue, and their mortgage is deductible in full from the value of their estate.[9] In short, homeownership is a deal that fewer and fewer adult Americans can resist, and there are no obvious fiscal drawbacks — indeed, no real drawbacks at all.

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3 Section 163(h)(3). For tax years beginning after December 31, 2017, and before January 1, 2026, §163(h)(3)(F), enacted by the so-called Tax Cuts and Jobs Act (hereinafter "the 2017 act"), provides that (1) the limitation is $750,000 instead of $1 million unless the indebtedness was incurred on or before December 15, 2017, or before April 1, 2018, if there was a binding contract to purchase the residence in existence on or before December 15, 2017, that closed before April 1, 2018; and (2) eliminates any deduction for interest on home equity indebtedness that existed in tax years before 2018. The caps on the deduction were offset to some extent by expanding the amounts in each tax bracket and thus subjecting additional income to lower rates of tax.

4 Section 164 (regular income tax) taxes are not deductible in computing income subject to the alternative minimum tax. §56(b)(1)(A)(ii). In tax years beginning after December 31, 2017, and before January 1, 2026, the aggregate deduction for state income and property taxes is capped at $10,000 ($5,000 for a married individual filing separately) under §164(b)(6).

5 Section 121.

6 Section 25D. The 2017 act reduced the rate of subsidy for property placed in service from 2016 on and eliminates it altogether for property placed in service after 2021.

7 See §§871(h) and 882(c), and especially reg. §1.871-14(d).

8 Under §280A(g), if a home is used during the tax year by the taxpayer as a residence and the dwelling unit is actually rented for less than 15 days during the tax year, the income derived from that use is not included in gross income, but no deduction otherwise allowable because of the rental use is allowed. Under §280A(d), a taxpayer is treated as using a home as a residence if he uses it for personal purposes for a number of days during the tax year that exceeds the greater of 14 days or 10% of the number of days during that year for which the home is rented at a fair rental. For this purpose, the home is not treated as rented at a fair rental for any day for which it is used for personal purposes.

9 Congress has made changes to exemption levels over the years. The exemption level is now $10 million per person, adjusted for inflation, so for individuals dying in 2020, the level is $11.58 million. For individuals dying after 2026, the exemption level is scheduled to revert to $5 million per person adjusted for inflation since 2010 — the amount that has been in effect since 2010. And if the first spouse to die cannot use the full exemption, the unused portion inures to the benefit of the estate of the surviving spouse as a deceased spousal unused exclusion amount. See §2010(c).

Foreign persons buy homes in the United States for a variety of reasons — for personal use during temporary or indefinite stays that may be long term, such as a job posting in the United States, or short term, such as a vacation. The U.S. home may be one of several homes they live in during the year, moving around the world with the seasons. They may buy homes for children who may be N.R.A.'s (such as students), U.S. residents, or even U.S. citizens. They may also buy permanent homes for their own use in preparation for moving to the United States, or they may remain the owners of homes they lived in before leaving the United States and ceasing to be U.S. residents. In some cases, a home may have a mixed use, such as a vacation residence that is put into a rental pool.

For most of these foreign persons, the tax position is not quite as attractive as it is for U.S. persons. Foreign persons must juggle exposure to capital gains taxes, estate and gift taxes, and, in many cases, imputed rental income, without the benefit of many of the tax exemptions and deductions and other favorable treatment bestowed on U.S. residents.

In this report, we look at the issues faced by foreign owners of U.S. homes held primarily for personal use by the owners and their families. We try to answer the question in the prologue so that we can live up to the praise from our real estate partner.

"Foreign persons must juggle exposure to capital gains taxes, estate and gift taxes, and, in many cases, imputed rental income, without the benefit of many of the tax exemptions and deductions and other favorable treatment bestowed on U.S. residents."

OVERVIEW

Foreign buyers of U.S. homes face tax issues on acquisition of the property, during the ownership of it, and on disposition of it, whether by sale or exchange or by gift or bequest. In this section, we provide an overview of these issues as well as privacy considerations.

Big-Picture Issues

Although in any given case, a specific issue may prove to be of particular importance, in many cases, as the introductory colloquium suggests, planning will revolve around four key objectives:

1. Minimizing tax on sale of the property so as to pay, if possible, no more than the preferential rate of tax on long-term capital gains of individuals[10]
2. Avoiding paying 30% withholding tax on the use value of the property (or on actual rent paid to avoid uncertainties concerning imputed rent and the *bona fide*s of a cross-border structure)
3. Avoiding the federal estate tax (and state taxes on inheritance) should the owner die while still owning the property, and still allowing the heir to obtain a step-up in basis
4. Minimizing compliance and contact with the U.S. tax system — many foreigners have a deep-rooted aversion to having to file personal income tax returns in the United States or having an individual taxpayer identification number.

[10] The corporate tax rate cuts enacted by the 2017 act have scrambled planning for this tax.

Other issues may also arise, such as a desire to maintain privacy; the need to take account of the income, capital gains, gift, and succession taxes in the home country; and the need to coordinate succession planning for the home with the planning for other assets. The client's particular situation also must be considered, such as whether family members and presumptive heirs are U.S. citizens or residents, and whether the client may wish to move to the United States permanently or temporarily.

It will be readily apparent that accomplishing all these objectives is extremely difficult. Every structure, from direct ownership to a multitiered corporate structure, may involve compromise on one or more of the objectives, and the adviser's role may be to identify each particular client's most important concerns and offer a plan principally addressing them. In this context, the prioritization of goals is critical.

Acquisition

The acquisition of real property, as with any asset, has no immediate consequences to the buyer. A purchase from an unrelated seller is not a taxable event for the buyer. Nevertheless, several tax issues associated with the acquisition of a home by a foreign person deserve attention.

F.I.R.P.T.A. Withholding

As with any buyer, the foreign buyer is a withholding agent for purposes of the 1980 Foreign Investment in Real Property Tax Act and must therefore either obtain a certification of nonforeign status or withhold 15% of the purchase price (or some lesser amount if the seller produces a withholding certificate from the I.R.S.).[11] Buyers must also be alert to state withholding tax requirements.

In almost any transaction handled with the participation of a title company, an escrow company, one or more attorneys, a lender, or other real estate professionals, these requirements, enacted in 1984, will likely be known and implemented. However, the parties have to be concerned about marginally competent real estate industry participants when both the seller and the purchaser are not U.S. persons.

For example, one of us has more than once encountered an escrow company that withholds tax and then sends the tax to the government without the F.I.R.P.T.A. withholding tax forms or without properly completing them. This makes it difficult to ensure that the I.R.S. associates the seller with the amount withheld. The problem is compounded if the buyer does not have a U.S. T.I.N. to affix to Form 8288, "U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests."[12] Without a proper T.I.N., the I.R.S. may be unable to track collection of the withholding tax, which can be problematic at the time of a future sale, as discussed later.

The buyer, too, should be concerned because she is the person legally responsible for compliance with the withholding rules. That responsibility cannot be avoided by leaving everything to an escrow agent or attorney. Thus, the buyer will be liable for late payment (or, in an extreme case, complete nonpayment) of the withheld tax and will be the party that must deal with an angry seller who is unable to get credit for withheld tax.

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[11] Section 1445(a).

[12] See instructions to line 1 of Form 8288 for 2019; see also I.R.S., "ITIN Guidance for Foreign Property Buyers/Sellers" (Mar. 16, 2020).

However, foreign buyers have a special need to maintain good records following their purchase. When the foreign buyer later seeks to sell the property, the buyer-turned-seller may wish to obtain a F.I.R.P.T.A. withholding certificate to reduce the amount of tax withheld based on a calculation of the seller's maximum tax liability. This is particularly true since 2015, when the withholding rate increased to 15% of the gross proceeds.[13] This calculation requires the seller not only to compute F.I.R.P.T.A. gain but also to establish that he has no unsatisfied withholding liability based on compliance with §1445 when he purchased the property.[14] All too often, we have been asked to assist foreign sellers who couldn't locate their records concerning the purchase of the real estate or locate the attorney who represented them in that transaction, and therefore could not readily demonstrate compliance with F.I.R.P.T.A. withholding at the time of an earlier purchase. As a result, it was difficult to obtain a F.I.R.P.T.A. withholding certificate at the time of sale.

Financing

Foreign buyers must also be alert to the financing of the price of a home being acquired in anticipation of a move to the United States. Not infrequently, those buyers pay all cash or at least they don't obtain a mortgage loan at the time of the purchase. Once they become resident, they might wish to deduct interest on the first $750,000 of their loan amount as qualified residence indebtedness.[15] However, the buyers will not be able to do so unless the loan was obtained by them and secured by the home within 90 days of the date of purchase (or was obtained to refinance such a loan).[16]

Tax Residence

The ownership or availability of a home in the United States does not alone make a foreign person a U.S. resident for tax purposes. Nevertheless, that ownership can affect application of the rules for determining whether an alien is a resident alien — that is, under the closer connection test or a treaty's tiebreaker provision for dual-resident individuals.[17]

First, regardless of whether a foreign individual resides in a treaty country, he may seek to apply the foreign-tax-home/closer-connection test to avoid being treated as a resident alien.[18] This test applies to individuals present in the United States between 31 and 182 days during the calendar year when the addition of one-third of the days in the preceding calendar year and one-sixth of the days in the second

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[13] Protecting Americans From Tax Hikes (PATH) Act of 2015, Division Q, §324. For 15% of the proceeds to be large enough to be less than a 20% tax on capital gains, a property would had to have quadrupled in value. For example, a property sold for $1 million would have to be generating a $750,000 gain. The level of appreciation required for gain taxed at the corporate rate of 21% would be similar.

[14] Reg. §1.1445-3(c)(1)(ii) and (3).

[15] See *supra* note 3 regarding changes in §163(h) made by the 2017 act.

[16] For the 90-day rule, see Notice 88-74, 1988-2 C.B. 385, applying the tracing rules of reg. §1.163-8T. Interest on a secured home equity loan of up to $100,000 may also be deducted by a U.S. resident irrespective of when the loan was obtained.

[17] Section 7701(b)(3)(B).

[18] Section 7701(b)(3)(B) and reg. §301.7701(b)-2.

preceding calendar year takes the total days of presence in that period to 183 or more. The closer-connection portion of the test looks at the individual's personal and family ties to the United States and compares them with his ties to the foreign country. Plainly, the ownership of a home that is regularly used for personal purposes is a factor to be considered in the application of the test — there being an obvious difference between a vacation home used just a few days a year and a home used for longer or more frequent stays.

Second, the ownership or availability of a permanent home is the first tiebreaker in virtually all tax treaty provisions dealing with individuals who are resident both in the United States and another country under the respective internal laws of the two countries.[19]

Gift Tax

Foreign buyers sometimes buy homes for U.S. relatives. The relative might be a U.S. resident, but frequently the relative will be a child who is a student with non-immigrant student (F or J) status. Buyers should be warned that making a gift of real property located in the United States may subject them to gift tax (regardless of whether the relative is resident for U.S. income tax purposes), whereas a gift of cash funds through an interbank transfer that is used to purchase the home can readily be structured to avoid gift tax, as long as the cash is not used to purchase a property owned by the donor.[20] How the funds transfers are handled can make a significant difference.

Estate Tax Planning

Planning before the acquisition of the home also often provides the best opportunity to avoid a future estate tax on the home, as described later.[21]

Ownership and Occupation

Deductions

As a general matter, an individual cannot deduct expenditures associated with a home that is used for personal purposes. The principal exceptions are for qualified residence interest and property taxes, which are both itemized deductions.

N.R.A.'s are not entitled to itemized deductions because they are taxed on a gross basis on U.S.-source income not effectively connected with a U.S. trade or business. This nondeductibility will also apply when the property is held through a trust or partnership, although in the case of a trust, expenses to maintain trust assets may reduce distributable net income ("D.N.I."). However, if the acquisition is structured through a corporation, as we will see, expenses related to maintaining the property may be allowed, but personal use of the property will raise actual or imputed rental income issues.

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[19] In most U.S. income tax treaties, the dual-residence tiebreaker is set out in article 4. See 2006 U.S. Model Tax Convention on Income, article 4(3).

[20] *Davies v. Commissioner,* 40 T.C. 525 (1963), *acq*., 1966-1 C.B. 2.; and *De Goldschmidt-Rothschild v. Commissioner*, 168 F.2d 975 (2d Cir. 1948).

[21] See *infra* "Estate Tax" under **Structuring Alternatives**.

Imputed Rental Income

When the home is owned directly by an individual, there is no income tax consequence to its occupation by the owner. Nor does it appear that, as a practical matter, the I.R.S. seeks to impose income tax or gift tax consequences when property is used by relatives, even adult children to whom parents no longer owe a duty of support.

However, the moment the home is owned by an entity, the possibility that rent should be charged comes into play. For a home owned by a corporation, personal use by a director or officer will likely attract imputed rental income for the corporation if actual rent is not paid at a fair market rate. It is less certain that rental income would be imputed to a shareholder who did not have an executive role when the corporation conducted an ongoing business unrelated to the real estate. When the home is owned by a partnership, the picture is cloudier, but there is definitely some risk that rent-free use will result in the imputation of rental income. The $250,000 or $500,000 exemption for gain derived from the sale of a principal residence may be jeopardized if the owner of the property is a partnership. By contrast, it appears that personal use of property held in a domestic trust does not give rise to imputed income to the trust, nor is it even treated as a distribution to the beneficiaries.[22] The same is true for a foreign grantor trust and even a foreign non-grantor trust, as long as the user is not a U.S. person.[23]

Tax Compliance

If a home produces no income, there is no need for an N.R.A. owner to file a tax return, except for the year of sale. Because the deductions (mortgage interest, property taxes, etc.) associated with a home held by an individual for personal or family use are not available to the N.R.A., there is no reason to file a return just to preserve the benefit of those deductions. Nonetheless, a mortgage lender may insist on receipt of an individual T.I.N. from the owner.

Similarly, a foreign trust does not need to file a U.S. return simply because it holds a U.S. home that is used exclusively by beneficiaries and related family members.

Neither a foreign or a domestic partnership nor a foreign corporation is required to file a U.S. return unless it is engaged in a U.S. trade or business or receive fixed or determinable annual or periodic income, such as rent, from U.S. sources. Imputed rental income would trigger an obligation to file a return.

If the home is held through a domestic corporation, the corporation must file a return even if it has no income. The imputed rental income issue may also cause compliance requirements.

Finally, U.S. users of a foreign-owned home may have various compliance issues.[24]

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[22] *Plant v. Commissioner*, 30 B.T.A. 133 (1934), *aff'd*, 76 F.2d 8 (2d Cir. 1935), *acq*., 1976-2 C.B. 2; and *Alfred I. duPont Testamentary Trust v. Commissioner*, 66 T.C. 761 (1976), aff'd, 574 F.2d 1332 (5th Cir. 1978). See dicta in *Dickman v. Commissioner*, 465 U.S. 330 (1984).

[23] See the table in "Ownership Through a Trust" under **Structuring Alternatives** and the discussion in "Care in Planning with Trusts" under **Foreign Owner's Family Includes U.S. Persons**.

[24] See *infra* **Foreign Owner's Family Includes U.S. Persons**.

Disposition

Income Tax

Under F.I.R.P.T.A., foreign persons are subject to tax on gains from the sale or exchange of a U.S. real property interest ("U.S.R.P.I."), which fairly obviously includes real property used as a home, as well as associated personal property.[25]

"An N.R.A. can qualify for the exclusion under §121 for $250,000 on the sale of a principal residence, assuming the alien meets the general requirements for the exclusion. The I.R.S. appears to have accepted this."

An N.R.A. can qualify for the exclusion under §121 for $250,000 on the sale of a principal residence, assuming the alien meets the general requirements for the exclusion. The I.R.S. appears to have accepted this.[26] Of course, if the alien is using the home as a principal residence, he is often likely to be a resident alien under the substantial presence test, but this is not invariably the case. For example, an alien may be a former resident who sold the home after ceasing to be a resident.[27] Less commonly, the exemption may be available to a peripatetic alien whose U.S. home is the principal residence even though he does not meet the substantial presence test or, in a case that would require a combination of unusual facts, is nonresident by virtue of a treaty tiebreaker.

The $500,000 exclusion for married couples is not available because it requires the filing of a joint return, and N.R.A.'s generally cannot file joint returns.[28] Therefore, a couple seeking to maximize the exclusion would need to be joint owners of the house, and each spouse would need to qualify separately for the $250,000 exclusion — that is, each would had to have owned their joint interest in the home for at least two years and have lived there as their primary residence for at least two years. If these requirements could not be met, the couple should sell the home in a year when both are still resident aliens.

Withholding at 15% of the amount realized will be required on the sale if the seller's interest is held directly or by a foreign corporation or foreign partnership.[29] If the buyer will use the property as a principal residence, withholding is not required if the price is $300,000 or less. If the seller is a domestic partnership or trust, the purchaser has no withholding obligation under F.I.R.P.T.A.; instead, the domestic

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25 Section 897(a).

26 See I.R.S. Publication 519, "U.S. Tax Guide for Aliens, 2019," ch. 3 (Mar. 4, 2020). Section 897(e) bars the application of nonrecognition provisions, but §121 provides for exclusion of gain from gross income rather than for nonrecognition. It does not appear that §897(e) overrides a provision for an exclusion from gross income.

27 Section 7701(b)(2)(B). Bear in mind that a former resident who was a long-term permanent resident for purposes of the expatriation rules of §877A may be treated as having sold the home for fair market value on the day before the date of expatriation, and there is some doubt whether the §121 exemption applies to the resulting gain. However, §121 could apply to gain on post-expatriation appreciation, assuming the former resident sells the property no more than three years after it ceased to be the principal residence (which, depending on the facts, is not automatically the date tax residence ended). If the home was acquired before the establishment of tax residence in the United States, the cost basis in the property is not less than its FMV on the residency starting date. See §877A(h)(2).

28 But see §6013(g), which permits the filing of a joint return by a couple when one of the spouses is a U.S. citizen or resident alien and the other is an N.R.A., if the N.R.A. agrees to be treated as a resident alien for all purposes and to waive treaty benefits.

29 Section 1445(a).

partnership or trust must withhold U.S. tax at 15% or 35% of the foreign partner's or beneficiary's share of the gain.[30]

States may also require withholding when a nonresident individual or entity sells real property situated in the state.[31]

A §1031 exchange generally is not an option for property held for personal use. But one can imagine circumstances in which a property originally held as a residence for the foreign investor is converted to a rental property. In those circumstances, a §1031 exchange should be possible. Remember, however, that the property would have to be exchanged for other real property situated in the United States because foreign and U.S. real property are not considered to be of like kind.[32]

Gift Tax

The gift by an N.R.A.[33] of real estate located in the United States is subject to gift tax at the same rates as apply to a gift by a U.S. citizen or resident alien, but without the unified credit that would shelter up to $11.58 million in lifetime gifts.[34] By contrast, a gift of an intangible asset, such as shares of stock or of a partnership interest, is not subject to gift tax. An alien contemplating the gift of U.S. real property should consider transferring it to a domestic corporation in a §351 tax-free incorporation or in a §721 transfer to a partnership. If at a future point the original transfer is "old and cold," a gift of the stock or partnership interest could be made without triggering gift tax. In comparison, a transfer to a foreign corporation would require the recognition of any appreciation in the value of the property, unless the corporation is eligible to make an election under §897(i) to be treated as a domestic corporation for F.I.R.P.T.A. purposes.

We describe later the effect of a gift of property subject to a debt secured by a mortgage on the property.

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[30] Section 1445(e)(1) and reg. §1.1445-5(c). See *infra* text accompanying notes 129 and 130.

[31] *E.g.*, Cal. Rev. & Tax Code §§18662 and 18668 (California even requires withholding on sales by California-resident individuals); Colo. Rev. Stat. §39-22-604.5; Md. Code Ann. Tax-Gen. §10-912; N.Y. Tax Law §663; and S.C. Code Ann. §12-8-580. The scope of withholding, rates, filing procedures, and the availability of refunds varies considerably.

[32] Section 1031(h)(1), enacted by the Revenue Reconciliation Act of 1989. Before 1989, it was possible for an alien to rent out the home and resume status as a nonresident (in either order) and later exchange the property for property outside the United States.

[33] Note that the definition of an N.R.A. for purposes of subtitle B of the Code, dealing with estate, gift, and generation-skipping transfer taxes, is not governed by §7701(b). Rather, whether an alien is a resident is determined by the more subjective test of whether the alien is domiciled in the United States. Reg. §20.0-1(b)(1) provides:

> A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.

[34] Interspousal gifts to an N.R.A. are not subject to the unlimited marital deduction. However, the annual exclusion is increased to $100,000 for an interspousal gift. See §2523(i). The $100,000 has been inflation-adjusted since 1997, and for 2020 is $157,000. Rev. Proc. 2019-44, 2019-47 IRB 1093, §3.43(2).

Estate Tax

The taxable estate of an N.R.A. is subject to the estate tax.[35] The rates again are the same as for residents but, subject to some limited exceptions for decedents who were domiciled in treaty countries, the unified credit (which in 2020 will reach an exemption equivalent of $11.58 million) is also unavailable.[36] Instead, the credit available to N.R.A.'s is equivalent to an exemption of just $60,000, an amount that has not increased for decades.

The taxable estate of an N.R.A. is limited to property situated in the United States.[37] Real property held directly is situated in the United States, as is stock of a domestic corporation.[38] Tangible property located at the home is also part of the taxable estate; however, there is a limited exception for artwork, which applies only to works on loan for purposes of exhibition at a public gallery or museum or in transit to or from the exhibition in accordance with the loan.[39] Stock of a foreign corporation is situated outside the United States even if its only asset is U.S. real property. The position with partnership interests is unclear, and is discussed in more detail later in the context of a partnership that owns a property held for personal use by the partners.

It should not be assumed that the value of a home or other real property is reduced by any debt secured by a mortgage. In fact, under a fungibility concept long espoused by the I.R.S., debt may be deducted only to the extent the estate establishes the worldwide assets and liabilities of the decedent and deducts the U.S. proportion of the liabilities. That proportion is determined by multiplying the worldwide liabilities by a ratio in which U.S.-situated assets comprise the numerator and the worldwide assets comprise the denominator.[40] Under this fungibility rule, this treatment applies even to a note secured by a mortgage or deed of trust on U.S. real property.[41] For a nonrecourse debt, however, the Tax Court has held, with I.R.S. acquiescence, that only the value of the equity of redemption is includable. For this reason, if an N.R.A. purchases a home with a mortgage, it is desirable that the mortgage be nonrecourse.[42] The Tax Court has held that a loan will be treated as recourse despite state procedural rules that have the practical (even quasi-universal) effect of making the loan nonrecourse.[43]

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35 Sections 2101 and 2102.

36 Rev. Proc. 2019-44, §3.41.

37 Section 2106.

38 Section 2104(a).

39 Section 2105(c).

40 See also §2601(b).

41 *Rodiek v. Commissioner*, 33 B.T.A. 1020 (1936), *aff'd*, 87 F.2d 328 (2d Cir. 1937).

42 See reg. §20.2053-7; and *Johnstone Estate v. Commissioner*, 19 T.C. 44 (1952), *acq*., 1953-1 C.B. 5.

43 A few state laws provide that a mortgage secured by an owner-occupied residence is nonrecourse. See Cal. Civ. Proc. Code §580b. See *Estate of Fung v. Commissioner*, 117 T.C. 247 (2001). Another provision found in many state laws is a bar on deficiencies when the buyer's obligation is seller-financed and such an obligation will be treated as nonrecourse. Many states also have rules that bar deficiencies after a foreclosure proceeding under the power of sale given by statute or the mortgage or deed of trust, but if state law permits an election of alternative remedies, the loan will not be treated as nonrecourse for estate tax purposes even if the lender would be most likely to elect power of sale foreclosure.

Privacy

Ownership of Property

Legal title to real estate is generally a matter of public record in the United States. Foreign investors, often to a greater extent than their domestic counterparts, are concerned about liability and privacy in relation to their ownership of U.S. residential real estate. Privacy is a particular concern for the very wealthy, who do not want to have residential addresses made available through public land records readily accessible on the internet.

"The agricultural foreign investment rules would be relevant to a foreign homebuyer who purchased a farm or ranch. These rules pose a more serious obstacle to privacy because the reports are a matter of public record."

Foreign investment nontax reporting rules may require some level of disclosure of ownership to the government. There are three sets of rules that may be relevant to homebuyers. The first is the International Investment and Trade in Services Survey Act, administered by the Commerce Department's Bureau of Economic Analysis.[44] The foreign direct investment rules do not require disclosure to the government of the ultimate beneficial owners of "business enterprises" engaged in foreign investment, and in any event the information is not public and may be used by the government only for statistical purposes. The Bureau of Economic Analysis requires a survey to be completed for any investment if the total assets of a newly acquired or newly established entity are more than $3 million, or the transaction involves the acquisition of 200 or more acres of U.S. land. The bureau also requires quarterly and annual reports if the amount of investment exceeds $30 million and a survey every five years when the minimum drops to $10 million.

The second set of rules is under the Agricultural Foreign Investment Disclosure Act, administered by the Agriculture Department's Farm Services Agency.[45] The agricultural foreign investment rules would be relevant to a foreign homebuyer who purchased a farm or ranch. These rules pose a more serious obstacle to privacy because the reports are a matter of public record. Disclosure of beneficial ownership can be avoided only by having at least three tiers of entities between the ultimate owner and the property.

A third requirement arises under the Bank Secrecy Act. Under the act, Treasury's Financial Crimes Enforcement Network — the same agency that together with the I.R.S. enforces foreign financial account reporting — has issued a series of geographic targeting orders under which U.S. title insurance companies must identify the natural persons behind shell companies used to pay for high-end residential real estate in seven metropolitan areas, when no bank financing or similar form of external financing is involved. The latest geographic targeting order does not include a minimum purchase price, as had previously been the case, with amounts

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[44] International Investment and Trade in Services Survey Act, 22 U.S.C. ch. 46, §§3101-3108; regulations at 15 C.F.R. pt. 801.

[45] Agricultural Foreign Investment Disclosure Act, 7 U.S.C. ch. 66, §§3501-3508; regulations at 7 C.F.R. pt. 781.

varying according to location.[46] FinCEN generally does not share this information with other government agencies, but there are law enforcement circumstances in which it could do so.

For most other purposes, privately held trusts and other entities offer some measure of protection from the inquisitive public. Trusts do not have to be registered in the United States. The names of trustees may appear on real estate records, and beneficial owners concerned about privacy should not act as trustees and should not include their own name as part of the name of their trust. For corporations and limited liability companies, public registration is required. However, the names of the owners are not a matter of public record in most states, with New York being a notable exception. For limited partnerships, public registration is required, but only the name of the general partner needs to appear in the public records. By contrast, for a general partnership, registration is not technically required but may be necessary as a practical matter, in which case at least one of the partners' names will become a matter of public record.

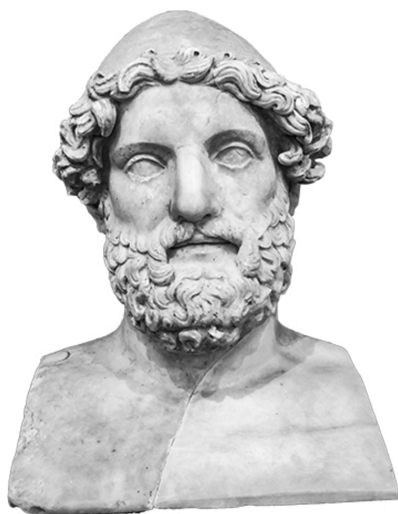
Finally, as a general matter, law enforcement authorities concerned with criminal investigations can usually determine the ownership of property or compel its disclosure.

Filing Tax Returns

Many nonresidents do not want to file U.S. income tax returns or have any contact with the U.S. tax system at the federal or state level. Of these, most do not want to file returns during the period of ownership, and some object to filing returns even on sale of the property.

This antipathy to the U.S. tax system does not necessarily mean that the nonresidents do not wish to pay tax, but they would more gladly do so if it could be done anonymously, in the same way that they can invest in the U.S. securities markets largely without having to identify themselves to U.S. tax authorities.

Our system of taxing real estate transfers, whether by sale or exchange or by gift or bequest, does not facilitate anonymity vis-à-vis the tax authorities. Anonymity will come at a cost, most notably by requiring the use of some form of entity that cannot be fiscally transparent — and therefore prevents the availability of preferential rates of capital gains tax — or may require planning to avoid or mitigate double taxation.



The tax authorities — federal, and to some extent state — have the power in some circumstances to require disclosure of the identities of the ultimate owners of real property. The scope of this power depends on the chosen structure; however, anyone who has completed a Form 5472, "Information Return of a 25 Percent Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business," or answered question 5 of Schedule K of Form 1120 or question V of Form 1120-F likely has come across some disclosure requirements.

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[46] FinCEN, "Geographic Targeting Order" (Nov. 8, 2019). The areas covered are (1) the Texas counties of Bexar (San Antonio), Dallas, and Tarrant (Fort Worth); (2) the Florida counties of Broward, Miami-Dade, and Palm Beach; (3) the New York City boroughs of the Bronx, Brooklyn, Manhattan, Queens, and Staten Island; (4) the California counties of Los Angeles, San Diego, San Francisco, San Mateo, and Santa Clara; (5) the city and county of Honolulu in Hawaii; (6) the Nevada county of Clark (Las Vegas); (7) the Washington county of King (Seattle); (8) the Massachusetts counties of Suffolk and Middlesex (Boston); and (9) the Illinois county of Cook (Chicago).

STRUCTURING ALTERNATIVES

In this section, we consider various ways a foreign person might structure the ownership of a residence. In particular, we look first at the simplest possible approach — direct ownership — and then at alternatives, including the use of corporate, partnership, and trust structures and some possible combinations. The use of these structures for foreign investors is well known, and this report is not intended to be a detailed review of issues common to all foreign investment in U.S. real estate. We mention these issues, but the focus is on how they play out in the case of real property held primarily for personal use.

Direct Ownership

Fairly obviously, the simplest way for a foreign individual to acquire real property in the United States is to purchase it outright. This approach has the virtue of (comparative) simplicity. It is easy to understand. It avoids the cost of establishing and maintaining a foreign blocker corporation. It eliminates imputed rental income issues.[47] It assures long-term capital gains treatment on a sale more than one year after the purchase, and in some cases it even permits the use of the principal residence exclusion under §121. Gain for heirs who take the property upon the owner's death may be eliminated because the successors will obtain a step-up in basis.

The key disadvantages are the need to deal with privacy (which can be addressed relatively straightforwardly), the treatment of losses, and the estate tax.

Privacy

As noted earlier, legal title to real property is a matter of public record. When direct ownership of property is deemed desirable, privacy can nevertheless be improved through completely transparent vehicles, which largely replicate the tax results of direct ownership but not necessarily the nontax results. To be fully effective, these devices must be put in place before the property is acquired.

Single-Member L.L.C.

A single-member domestic L.L.C. would be disregarded as an entity separate from its owner for federal and state income tax purposes but would offer some limited liability protection and a significant level of privacy in most states. One notable exception is New York, where the names of the stakeholders in an L.L.C. must be published for limited liability to exist.[48] Also, the funding of the L.L.C. by the member is a reportable event on a pro forma Form 1120, "U.S. Corporation Income Tax Return," that includes Form 5472.[49] To file the Form 5472, a T.I.N. must be obtained from the I.R.S., and to obtain the number, information concerning the responsible person must be provided. The responsible party is the person who ultimately owns

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[47] There is no dispute that the owner of a residence derives no income from his enjoyment of the residence. Moreover, regarding the use of the residence by family members, the I.R.S. was warned off this area by the Supreme Court in *Dickman*, 465 U.S. at 341: "It is not uncommon for parents to provide their adult children with such things as the use of cars or vacation cottages, simply on the basis of the family relationship. We assume that the focus of the Internal Revenue Service is not on such traditional familial matters."

[48] N.Y. Tax Law §1409; N.Y. City Admin. Code §11-2105.

[49] Reg. §§301.7701-2(c)(2) and 301.6038A-1(c)(1).

or controls the entity or who exercises ultimate effective control over it. The person should have a level of control over, or entitlement to, the funds or assets in the entity that, as a practical matter, enables the person, directly or indirectly, to control, manage, or direct the entity and the disposition of its funds and assets.[50]

L.L.C.'s are not cost free, however. Apart from annual fees, some states, like California, have special taxes on L.L.C.'s. Moreover, they may create income tax and estate planning issues in the foreign owner's home country. Countries are split between those like the United Kingdom that for the purposes of their own tax treat U.S. L.L.C.'s as corporate bodies,[51] and those like France that will conform their treatment of the L.L.C. to the U.S. treatment.[52] Further, an interest in an L.L.C. is personal property,[53] which means that its devolution may be governed primarily by the laws of the foreign owner's domicile, whereas devolution of real estate directly held would be governed by the law of the state in which it was located.

Some care needs to be exercised to avoid having the L.L.C. be treated as a partnership. Although there are advantages and disadvantages to partnership classification, as discussed later, these should not come about through inadvertence. In particular, if the home is owned by more than one person, the owners should do so as joint owners, each choosing whether to do so through his own L.L.C. There is an exception for couples married under community property laws; in that case, the I.R.S. allows the couple to choose whether the L.L.C. should be treated as having more than one owner.[54]

Grantor Trust

Another privacy alternative is the grantor trust. The simplest form of grantor trust would be a revocable living trust. The enactment of §672(f) in 1996 narrowed the application of the grantor trust rules when the grantor is a foreign person. Nevertheless,

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[50] Instructions for Form SS-4, "Application for Employer Identification Number (EIN)," line 7a-7b (Dec. 2019).

[51] See Her Majesty's Revenue & Customs, "Double Taxation Relief Manual," DT 19853 (May 18, 2020). H.M.R.C. does not willingly give credit to a U.K. resident individual who is a member of an L.L.C. for U.S. tax paid. This issue was successfully litigated by the taxpayer in *Anson v. HMRC* [2015] UKSC 44. However, H.M.R.C. responded by stating that it "has after careful consideration concluded that the decision is specific to the facts found in the case." One has to wonder how the U.K. Supreme Court, which like the U.S. Supreme Court, generally only takes on cases of broad interest, will respond to this peremptory statement, which is completely unreasoned. It is also somewhat mysterious why H.M.R.C. insists on its hard line, which forces unwilling taxpayers to treat U.S. L.L.C.'s as hybrid entities, to which tax authorities are normally quite hostile.

[52] Before its elimination by the January 2009 protocol, paragraph 2(b)(iv) of article 4 (Resident) of the France-U.S. income tax treaty treated partnerships and similar entities as passthrough entities qualifying for treaty benefits to the extent owned by a resident of one of the two treaty jurisdictions. Treasury's 1994 technical explanation expressly stated that an L.L.C. is an entity that is similar to a partnership.

[53] *Pierre v. Commissioner*, 133 T.C. 24 (2010).

[54] See Rev. Proc. 2002-69, 2002-2 C.B. 831. The revenue procedure applies to marriages governed by the community property laws not only of states but also of U.S. possessions and foreign countries. The concept of community property is recognized principally in continental Europe and in Latin America, but it does not exist in many other countries where English common law is the basis of jurisprudence.

a revocable trust will be a grantor trust during the owner's lifetime, even if the owner is an N.R.A.[55] An irrevocable trust can also qualify as a grantor trust under §672(f) if the only beneficiaries that may receive distributions during the grantor's lifetime are the grantor and/or the grantor's spouse. However, this would limit the flexibility of the trustees to allow the use of the property to nondependent members of the grantor's family, as often occurs when the foreign owner has acquired the property for the use of adult children, particularly children attending college in the United States. Both types of trusts lose their status as grantor trusts upon the death of the grantor, even if a surviving spouse exists, although if the survivor is a grantor, the trust will remain a grantor trust for the survivor's share.

Normally, the trust will be formed under the law of the state where the property is located, but this will not always be the case. The foreign individual may own homes in more than one state but may wish to form only one trust. The choice of trust jurisdiction may also be influenced by regulatory considerations. Some foreign owners may wish to form the trust in a state that offers superior asset protection, longer perpetuity periods, or the ability to form a private trust company. The trust can also be formed offshore, where trustee fees are typically lower than in the United States, or in the foreign owner's home country. Consideration should also be given to the interaction of the trust with the overall estate plan and to the potential location of successor beneficiaries.

Foreign owners need to understand that a trust of which they are the trustees will not offer much privacy. Full privacy means having to select a trustee, with all the competing considerations (cost, flexibility, financial strength, and trustworthiness) involved in the use of institutional trustees, professional trustees, family members and friends, or any such combination. If the foreign owners start out as trustees, these same considerations will still affect the selection of successor trustees even if their only role is to distribute the property to the successor beneficiaries.

Treatment of Losses

Although F.I.R.P.T.A. treats gain or loss from the sale of U.S.R.P.I.'s as effectively connected with a U.S. trade or business, it also provides that for an individual, the loss will be taken into account only to the extent it is incurred in a trade or business or in a transaction entered into for profit, or if it qualifies as a casualty or theft loss.[56] A home acquired for occupation by a foreign owner or members of his family will generally not qualify for deduction by an individual (or a trust), whereas losses may be available if property is held through a corporation. Even if the loss is allowed, typically this type of owner does not have effectively connected income against which the loss can be claimed to reduce tax.

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[55] Small Business Job Protection Act of 1996, §1904(d)(2) (uncodified). Note that practitioners generally use the word "revocable," which is also used in the caption to the statute, but the more precise formulation is that the grantor must have "the power to revest absolutely in the grantor title to the trust property . . . exercisable solely by the grantor without the approval or consent of any other person or with the consent of a related or subordinate party who is subservient to the grantor." The expressions "related or subordinate party" and "subservient to the grantor" are terms of art that are subject to statutory and regulatory definition and explanations. Section 672(a)-(c); and reg. §§1.672(a)-1, (b)-1, and (c)-1.

[56] Sections 897(b) and 165(c).

Estate Tax

The biggest single tax issue with direct ownership — including ownership through one of the transparent vehicles described in the preceding paragraphs — is the exposure to the U.S. estate tax should the foreign owner die before selling the property. Leaving aside taking a chance on survival, which may actually be reasonable if the home is being purchased only for a short term and the buyer is in reasonably good health, perhaps the simplest way to address this liability is through life insurance, whose proceeds will not be includable in the estate of an N.R.A.[57] Term life insurance, in particular, is relatively inexpensive, especially compared with the costs of establishing and maintaining offshore corporate structures. Insurance may not always be available. Some U.S. life insurance companies do not offer competitive rates for nonresidents, but there is no requirement that the insurance company be based in the United States. The amount of the insurance may have to be adjusted if property values increase. But in many cases, this may be the easiest way to fund the payment of the estate tax.

A second way of dealing with the tax is to sell the property before death. Proceeds from the sale of real property that was held for personal use will not be includable in an N.R.A.'s gross estate for estate tax purposes if they are held in a bank account (even a U.S. bank account) at the time of death. How easy or difficult this alternative may prove to be will depend on practical factors, such as the desires of an aging homeowner and the ability to anticipate death. Clearly, death from a lingering illness allows for this type of planning if the individual is physically residing in other property and is competent enough to sign a deed or execute a power of attorney. Death from an accident or a virulent illness does not allow this. Further, it comes at a cost of recognizing gain on any sale, although the tax will almost certainly be less than the estate tax.[58]

A third planning device is to ensure that any loan is nonrecourse to the foreign owner, so that the full amount of the loan is effectively deductible.[59]

Some care needs to be exercised with installment sales. If the buyer is a U.S. person, the installment debt owed by the buyer will have a U.S. situs for estate tax purposes.[60] This can be avoided if the interest on the debt is structured as portfolio interest, which means that the debt should not be indicated by a promissory note that is in negotiable form. Rather, the note should be in registered form within the meaning of the portfolio debt rules. Thus, it should not be payable "to order," and the foreign holder of the note should deliver to the buyer an I.R.S. Form W-8BEN, "Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals)."[61] The problem disappears if the obligor is not a U.S. resident.[62]

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57 Section 2105(a).

58 Some estate tax treaties allow a partial unified exemption to treaty country domiciliaries.

59 See *supra* note 41 and accompanying text.

60 See §§2104(c) (estate tax definition of location of debts) and 7701(a)(30) (definition of U.S. person).

61 Section 871(h) and reg. §1.871-14. Form W-8BEN is required for the portfolio interest exemption but not for the estate tax exemption. Section 2105(b)(3).

62 The definition of residence here is set out in §865, not §7701(b), and a U.S. citizen who resides abroad under this definition is a nonresident for these purposes.

Finally, estate tax may be less of a consideration if the country of the owner's domicile provides for an estate tax that is imposed at similar or higher marginal rates than in the United States and that allows a credit for the U.S. estate tax. Such a credit may be provided unilaterally under the laws of the country, or it may be required by an estate tax treaty between the country of domicile and the United States.

Use of Corporate Structure

In many cases, foreign homebuyers will be told that the simplest way to avoid estate and gift taxes is to have the property owned through a corporate structure, generally with a foreign corporation somewhere in the chain of ownership. This advice is not only simple but simplistic. Whether it is actually right depends on the client's principal concerns.

If we look at structuring the acquisition of a home in light of the big-picture issues described earlier, the use of a structure with a foreign corporation has only one clear, albeit important, advantage, which is that shares of that corporation are indubitably not located in the United States for purposes of the estate tax.[63] But the use of a corporation raises concerns about all the other issues, including the imputation of rental income, the potential for double taxation of income and gain at corporate and perhaps shareholder levels, the loss of preferential rates on long-term capital gains, and the lack of a step-up in basis on death for the inside basis in the U.S. asset. It can also create tax problems in the owner's home country.

Entity Classification

The U.S. entity classification rules must be applied to any foreign entity through which a home is acquired. This report does not review the entity classification regulations, but any adviser must be thoroughly acquainted with them, especially in relation to foreign entities.[64] Those entities will have a default classification, and nearly 90 of them are classified as corporations *per se*.[65] In most cases, a foreign entity with limited liability for its members has a default classification as a corporation but is often an eligible entity that can elect to change its default classification.

When a country has a form of entity that is primarily used for publicly traded companies, the *per se* corporation list includes that form of entity, so that all other entities used as privately held entities are eligible. Examples include the public limited company in Hong Kong, India, Pakistan, Singapore, Sweden, and the United Kingdom. As a result, a limited company in those countries other than a public limited company is an eligible entity. In other countries, the same kind of entity is used for both public and private companies. Examples include many of the continental European countries, such as France, Germany, Italy, Spain, and Switzerland, where the "anonymous company" is used. As a result, in those countries care must be taken to use some other form of company if an eligible entity is desired. In Canada, the only

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[63] Section 2104(a). However, the foreign taxpayer must respect the corporate formalities or risk an assertion by the I.R.S. that the corporation is a mere alter ego or agent of the taxpayer. Nonetheless, U.S. tax law's prejudice against disregarding the corporate form voluntarily chosen by the taxpayer is strong, as most famously demonstrated in *Moline Properties v. Commissioner*, 319 U.S. 436 (1943) (corporation formed at urging of mortgage holder to hold real estate must be recognized as separate entity), and the innumerable cases that have cited it.

[64] Reg. §§301.7701-2 and -3.

[65] The list is set out in reg. §301.7701-2(b)(8).

form of corporate entity that can be classified as a partnership is an unlimited liability company formed under the laws of specific provinces (Alberta, British Columbia, or Nova Scotia) — in fact, because its shareholders all have unlimited liability, an unlimited liability company is classified as a partnership by default.

As it happens, the regulatory list of *per se* corporations does not include entities established under most, but not all, of the traditional tax haven jurisdictions. Therefore, essentially every entity in those jurisdictions is an eligible entity that can elect out of its default classification. For example, all entities in the Bahamas, the British Virgin Islands, the Cayman Islands, the Channel Islands, and Malta can make an election to change status. In Cyprus, Gibraltar, and Malta, public limited companies are listed as *per se* corporations, and in Panama the *sociedad anonima* is by default a corporation.

One other point on classification: The check-the-box regulations have a relevance rule that might act as a trap for the unwary. According to the regulations, a foreign eligible entity's classification is relevant when it affects the liability of any person for federal tax or information purposes. One can imagine circumstances in which it might be desirable to change the default classification of a foreign entity, only to discover that no person's liability for tax or information reporting would be affected by the classification. For example, suppose a foreign company holds title to a home. The payment of rent to the foreign company would be subject to withholding at a rate of 30% whether it was classified as a partnership or as a corporation, so the liability would not be affected. Nor would there be any requirement for the entity or any foreign owner to file a tax return.[66]

On the other hand, the regulations provide for deemed relevance in the following terms: "The classification for Federal tax purposes of a foreign eligible entity that files Form 8832, 'Entity Classification Election,' shall be deemed to be relevant only on the date the entity classification election is effective."[67]

This suggests that the filing of Form 8832 alone makes the election relevant. Were this viewed not to be the case, a minor investment in the United States could force relevance as a factual matter.

It's interesting to consider whether the enactment of the Foreign Account Tax Compliance Act in 2010 has effectively gutted the relevance rule.[68] F.A.T.C.A. requires just about any foreign entity to explain its F.A.T.C.A. status to any financial institution in the world with which it seeks to do business, even if the foreign entity has absolutely no other connection with the United States. Many such institutions require Form W-8BEN-E from their non-U.S. entity customers. Completing Form W-8BEN-E is not a trivial exercise. The easy part is stating that the entity is foreign by giving its country of incorporation. But question 5 asks for F.A.T.C.A. status, with 28 possible choices, which cannot be answered without understanding how the various terms are defined.[69]

66 However, an election to treat the entity as a partnership would be required if the foreign owner decided she wanted to elect to treat the rent as E.C.I. under §871(d).

67 Reg. §301.7701-3(d)(1)(ii)(A).

68 F.A.T.C.A. was enacted as part of the Hiring Incentives to Restore Employment (HIRE) Act of 2010 and codified at §§1471 through 1474.

69 One of us well remembers an executive at a reputable offshore trust company a few years ago who thought that the company was an "international organization." For the true definition, see §7701(a)(18) and the International Organization Immunities Act.

And that's before we get to issues of how to deal with tax transparency.

Making an election to treat the entity as having a non-default classification would affect the date of the election, but unless the point about F.A.T.C.A. is answered in favor of indefinite relevance, the election would cease to have effect five years later (that is, 60 months after relevance ceases), and classification would be determined either by default or by election on the first day classification again became relevant.[70] It's not clear how all this works if classification was not relevant until a particular event takes place, at which point classification becomes relevant going back before — in some cases, long before — the event took place. For example, the death of a foreign owner with U.S. heirs may cause the classification to become relevant not just going forward but looking backward as well. Suppose the entity would be classified by default as a corporation. Would a check-the-box election to treat the entity as a partnership result in a deemed corporate liquidation, or cause it to be treated as always having been a partnership? We pose those questions without answering them, but they have obvious practical consequences for planners.

Imputed Income

Whether a corporation is domestic or foreign, we need to consider the possibility that the use of the home by the owner or his family will give rise to imputed income.

Denial of Deductions

The I.R.S.'s historic approach to a situation in which a corporation allows its controlling shareholder or his family to make personal use of corporate property has been to deny deductions to the corporation and to treat the excess of fair rental value over any actual rent as a constructive dividend.[71]

This treatment may not be much of a deterrent to foreign owners of a special purpose vehicle that owns the home in the United States. A foreign owner may not be seeking deductions for expenses, which might only generate a loss that could not be used. A constructive distribution by a foreign corporation would not be taxed to the foreign owner. A constructive distribution by a domestic corporation would be taxed only if the corporation had earnings and profits — which it might well not. Otherwise, the distribution would simply result in a reduction in the foreign owner's basis in the shares in the domestic corporation — and this too may have no adverse effect if the corporation owned a single asset and was intended to be liquidated following the ultimate sale of the property. In that case, the liquidation that would be tax free under §897(c), as long as sufficient notice is filed with the I.R.S. so that an early termination will occur regarding its status as a U.S. real property holding corporation ("U.S.R.P.H.C.").[72]

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[70] Reg. §301.7701-3(d)(3).

[71] *E.g.*, *Transport Manufacturing & Equipment Co. v. Commissioner*, 434 F.2d 373 (8th Cir. 1970), *aff'g* T.C. Memo. 1964-190; *Yarbrough Oldsmobile Cadillac Inc. v. Commissioner*, T.C. Memo. 1995-538; *Nicholls, North, Buse Co. v. Commissioner*, 56 T.C. 1225 (1971); *Offshore Operations Trust v. Commissioner,* T.C. Memo. 1973-212; and *Cirelli v. Commissioner*, 82 T.C. 335 (1984); but see *Sparks Farm Inc. v. Commissioner*, T.C. Memo. 1988-492.

[72] Reg. §§1.897-2(f)(2) and (h).

Transfer Pricing

Therefore, one might wonder whether the I.R.S. would forgo the traditional approach or combine it with an attack based on the imputation of rental income to the corporation under the transfer pricing rules of §482. Section 482 provides:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary [that is, the commissioner of internal revenue] may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Section 482 is not so felicitously worded that it is immediately clear that it would apply to a transaction between a corporation and its shareholder that involves the use of corporate property for personal use rent free or at below-market rents.[73]

If, however, §482 were applied to the use of corporate property by a shareholder, the result would be the imputation of rental income to the corporation. The law is clear that §482 can create a payment of income between the parties and is not limited to allocating actual income.[74] In those circumstances, the income would be taxable, and it would seem inappropriate to use the traditional approach to disallow expenses incurred by the corporation.[75] However, if the corporation failed to file a tax return in a timely fashion, as defined, income tax regulations would disallow deductions as a matter of course.[76]

Deemed Distribution

The 2012 Tax Court decision in *G.D. Parker*[77] may indicate how this issue will be addressed in the future, although the case is not without unanswered questions. It involved an N.R.A. who owned 80% of the shares of a Panamanian corporation that owned all the shares of a Florida corporation (the taxpayer in the case). A Florida subsidiary of the taxpayer corporation owned a couple of homes and a yacht, which were used for personal purposes by the N.R.A. and his family. The I.R.S. argued that the value of the rent-free use was a distribution up the corporate chain from the subsidiary

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73 See, *e.g.*, *Sparks Farm*, T.C. Memo. 1988-492, in which the unique facts of the case apparently precluded §482 from applying. The breadth of the holding is open to debate, however.

74 See reg. §1.482-1(f)(2)(i).

75 Section 482 cannot, in general, be invoked by the taxpayer. However, reg. §1.482-1(a)(3) provides that "if necessary to reflect an arm's length result, a controlled taxpayer may report on a timely filed U.S. income tax return (including extensions) the results of its controlled transactions based upon prices different from those actually charged."

76 Reg. §1.882-4(a)(3). These regulations were held invalid by the Tax Court, but that decision was overruled by the Third Circuit in *Swallows Holding Ltd. v. Commissioner*, 515 F.3d 162 (3d Cir. 2008), rev'g 126 T.C. 96 (2006).

77 *G.D. Parker Inc. v. Commissioner*, T.C. Memo. 2012-327.

to the taxpayer, to the Panamanian corporation, and on up to the N.R.A. The court held that the taxpayer's distribution to the Panamanian corporation was subject to withholding tax at 30%[78] to the extent it constituted a dividend, and the parties were ordered to determine the amount of the top-level Florida corporation's E&P.[79]

The court would have allowed a deduction from the amount of the distribution for rent paid by the N.R.A., but under the particular circumstances it rejected on various factual grounds the taxpayer's claim that the N.R.A. had paid rent.

Two other notable points: For one of the homes — a vacation home in Spain — the court treated only one month's usage a year as subject to tax and withholding. It did not address why the full annual rental value of the vacation home was not subject to tax and withholding when, as the court had found, the taxpayer did not rent, or offer to rent, the vacation home at any time during the three tax years at issue. The I.R.S. conceded the value of one month's rent for the vacation home, but there seems to have been no deeper analysis of this question. (Without explanation, the court also did not require any tax or withholding for use of the yacht.)

We believe that if the home is constantly available for use by the shareholder or family members, the amount of the distribution would be the full annual rental value (less any rent paid). However, if the home were regularly available for rent (or, as in one case we have dealt with, as a shooting location for movies and television shows), it would be appropriate to include only the fair rental value of the time the property was being used for personal purposes.

Another notable feature of *G.D. Parker* is why the court believed that withholding was limited to the amount found to be a dividend. Although the tax on the shareholder is so limited, the amount of withholding is not, at least not when the corporation is a U.S.R.P.H.C.

In fact, the court in *G.D. Parker* did not consider in detail the withholding regulations. Had it done so, it would have found that when a domestic corporation makes a distribution, it is required to withhold 30% of the full amount of the distribution, regardless of whether the corporation has E&P, and not just the amount of the distribution that is treated as a dividend.[80] There is an exception when the corporation is willing to project that it will have no E&P, but this exception effectively does not apply when the corporation is a U.S.R.P.H.C.

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[78] Sections 881(a) (imposition of tax on foreign shareholder) and 1442(a) (imposition of withholding tax).

[79] Although the court's holding necessarily meant that the Panamanian corporation was treated as having made a distribution to the N.R.A. shareholder, such a distribution would not have been taxable or subject to withholding because neither tax nor withholding applies to a dividend from a foreign corporation to an N.R.A. Also, although this was not mentioned, the deemed distribution from the Florida subsidiary to the taxpayer would not have been subject to tax because the subsidiary and the taxpayer filed a consolidated return (and even if they had not, the taxpayer would have been entitled to a 100% dividends received deduction).

[80] Without diving into yet further technicalities, a distribution is taxable as a dividend to the extent the distributing corporation has E&P accumulated from prior years or current-year E&P, regardless of whether deficits were accumulated in prior years. A distribution not treated as made out of E&P is treated as a return of the shareholder's basis in the shares and then as a capital gain. Section 301(c).

Instead, under the regulations, the corporation must choose between (1) applying withholding on the full amount of the distribution (the rate being 30%, subject to reduction by a tax treaty) or (2) applying 30% tax on the amount estimated by the corporation to be a dividend from E&P and then applying F.I.R.P.T.A. withholding at 15% of the remaining amount of the distribution, subject to reduction of this latter amount under a withholding certificate obtained from the I.R.S.[81]

So, what have we learned from *G.D. Parker*? Most important, that personal use of corporate property can result in (1) corporate distributions that can in turn expose a domestic corporation to withholding liability, and (2) if there is E&P, dividend income that is F.D.A.P. income to the immediate foreign shareholder. Even more alarming, as discussed later, is the outcome if, at the top of the corporate chain, there is a foreign non-grantor trust with a U.S. beneficiary.

Rental Income

The *G.D. Parker* analysis, combined with the requirements of the withholding regulations, makes any corporate structure in which there will be personal use of residential property quite challenging. However, if the individual users of the property pay rent, some of the complexities are reduced or eliminated, while other complexities perhaps take their place.

When the user of the property, whether a shareholder or a family member, pays rent to use the property, the corporation will have income. That income is taxable, but it can be reduced by an allocable share of expenses, as well as by deductions for depreciation. Depreciation for residential rental property is favorable, being straight line over a useful life of 27.5 years.[82] If the corporation is foreign, expenses treated as rent to the corporation are F.D.A.P. income subject to withholding by the user, unless the foreign corporation provides Form W-8ECI, "Certificate of Foreign Person's Claim That Income Is Effectively Connected With the Conduct of a Trade or Business in the United States," to the user and then files a tax return either taking the position that it is engaged in a trade or business or actually electing that treatment under §882(d) or a treaty provision. Many foreign corporations and their shareholders in this position are unlikely to have received advice on this point.

One issue regularly encountered with entity structures is how to fund expenses. Expenses can include property taxes, insurance, utilities, repairs, maintenance, and — particularly at the higher end — security and staffing. It is not uncommon for the user to pay these expenses directly. Those payments should be treated constructively as if they were rent paid by the user to the owner of the property and then by the owner. Like any other rent, it is taxable to the owner.[83] If the owner of the property is foreign (for example, a foreign corporation or a foreign trust), the gross amount of rent is subject to tax and withholding at 30% — again, unless the owner provides a Form W-8ECI.

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[81] Reg. §1.1441-3(c)(4).

[82] Section 168(c).

[83] Reg. §1.61-8(c) (as a general rule, if a lessee pays any of the expenses of his lessor, those payments are additional rental income of the lessor); see also reg. §1.162-11(a) (taxes paid by a tenant to or for a landlord for business property are additional rent and taxable income to the landlord); and Rev. Rul. 76-474, 1976-2 C.B. 135.

Structuring Alternatives

Assuming the taxpayer avoids the hazards of the entity classification regulations, there are two principal ways to structure the acquisition of a home using a corporation:

- Direct ownership of the home through a foreign corporation
- Ownership of the home through a domestic corporation, which in turn may be owned by a foreign corporation, a trust, or an individual

Ownership Through a Foreign Corporation

As noted earlier, ownership of a home through a foreign corporation eliminates any exposure to the estate tax. Moreover, from a compliance point of view, it enables the foreign individual to avoid almost all contact with the U.S. tax system — a not insignificant concern for many high-net-worth individuals. As previously mentioned, there will be some identification in the corporation's tax return on Form 1120F, "U.S. Income Tax Return of a Foreign Corporation," as a more than 50% owner[84] and as an ultimate 25% foreign shareholder on Form 5472.[85] However, that identification does not mandate the issuance of a T.I.N. for the individual, although the responsible person must be identified when the foreign corporation applies for a U.S. T.I.N.

"As noted earlier, ownership of a home through a foreign corporation eliminates any exposure to the estate tax. Moreover, from a compliance point of view, it enables the foreign individual to avoid almost all contact with the U.S. tax system. . ."

In doing so, however, the foreign owner incurs a long list of other tax disadvantages. These include loss of the long-term capital gains preference, which applies only to individuals and non-grantor trusts (although with the corporate income tax rate reduced to 21% since 2018, this may not be a significant disadvantage — until, that is, a future round of tax reforms);[86] possible double taxation[87] of income and gains of the corporation to the extent the income and gains are, or are treated as, effectively connected with a U.S. trade or business; having to deal with the imputed rental income and related issues described earlier; and loss of step-up in basis of the real property on death of the foreign owner. Moreover, any U.S. heirs of the foreign owner will inherit shares in an entity that will either become (1) a controlled foreign corporation if one or more U.S. heirs own 10% or more of the voting shares and those 10%-plus owners together are in the majority or (2) a passive foreign investment company, if either such condition is not met for some or all of the beneficiaries.[88] As we will see, this can be a cursed inheritance.

As noted earlier, foreign taxpayers are occasionally advised that they do not have to pay U.S. tax on the sale of their stock in a foreign corporation. Although this is technically true because stock in a foreign corporation is not a U.S.R.P.I.,[89] the use of a foreign corporation rarely achieves the goal of avoiding the cost of taxation on the sale of U.S. real property. The issues here are generic for foreign investors in U.S. real property, but they are particularly acute when the property is a home, given the nature of the potential buyers of residential property. Even if one could find a buyer of a home willing to risk dealing with the unknown — and in some cases,

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[84] Question S on Form 1120F.

[85] Line 4a of Form 5472.

[86] In California, it is actually not a disadvantage at all when the top personal income tax rate is 13.3% and the tax rate on corporate income is 8.84%.

[87] Corporate income tax under §882 and branch profits tax under §884

[88] Sections 957(a) (definition of C.F.C.) and 1297 (definition of P.F.I.C.).

[89] Section 897(c).

unknowable — risk of liabilities of a privately held foreign corporation, a well-advised buyer will realize that the purchase of the foreign corporate stock will not result in a step-up in basis in the underlying real property. This typically results in a requested discount to cover the assumption of the tax cost of the seller that arises from a carryover of inside basis for the property. Moreover, it is hard to imagine a U.S. buyer being interested in acquiring a home by acquiring stock in a foreign corporation, for reasons explained later.

The cost of losing the capital gains tax preference available to individuals can be made worse by the branch profits tax. The branch profits tax is imposed on a foreign corporation on the "dividend equivalent amount," which is defined as the E&P arising from effectively connected taxable income for the year, which would include gain from the sale of any U.S. real property, increased by any reduction (or reduced by any increase) in the corporation's U.S. net equity. U.S. net equity in turn is a function of U.S. assets and liabilities.[90] The rate of tax is 30%, the same as the rate of withholding tax on dividends paid by a domestic corporation, and it is subject to reduction by treaty.[91]

A foreign corporation will not be subject to the branch profits tax if, following the sale of a home, all the proceeds are reinvested in U.S. assets. However, in comparison with a sale of business property, U.S. assets might not include the purchase of a new home, unless the home produces E.C.I. U.S. assets are defined as "the money and aggregate adjusted bases of property of the foreign corporation treated as connected with the conduct of a trade or business in the United States" under applicable regulations. The regulations provide that property will be treated as a U.S. asset if income from the asset is E.C.I. (or would be if the asset produced income on the date for determining the amount of U.S. assets) *and* gain on sale would be treated as effectively connected. The problem is the first leg of this requirement if there is no rental income or the rental income is not treated as effectively connected trade or business income.[92] The second leg is not a problem because §897(a) treats all gains from sale or exchange of U.S.R.P.I.'s as E.C.I.

If less than all the proceeds are reinvested, either because the foreign corporation trades down or because it finances its next purchase with more debt, branch profits tax will be payable. In any event, if sales proceeds are used to pay taxes, the N.R.A. shareholder of the foreign corporation will be required to invest additional amounts in the corporation to cover the corporate income taxes — otherwise, there will be a shortfall in the amount that is reinvested.

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[90] Section 884(a).

[91] Section 884(e); reg. §1.884-1(g). The United States has renegotiated many of its treaties to allow imposition of the branch profits tax at the direct investment dividend rate. That rate was usually 5% or 10%. The 5% rate remains the official starting point in the current version of the U.S. model income tax treaty (article 10, para. 10(b)), but several recent U.S. treaties now provide for a 0% rate, beginning with the 2002 U.K.-U.S. treaty and the 2001 protocol to the Australia-U.S. treaty. Note that the zero rate may not apply if the shares of the corporation have been recently acquired. Each treaty must be checked for this point.

[92] See reg. §1.884-1(d)(1), discussed in Joseph Isenbergh, *Foundations of U.S. International Taxation*, Tax Management Portfolio No. 900-2nd, at Section II.H.2.c.(1), which refers to the conjunctive requirement of the regulation. Presumably, if the home were rented out (including to the owner of the foreign corporation), the foreign corporation made an election under §882(d) (election to treat real property income as effectively connected).

A foreign corporation will not be subject to the branch profits tax for the tax year in which it completely terminates all of its U.S. trades or businesses.[93] The foreign corporation must meet several conditions, including either having no U.S. assets or having adopted an irrevocable resolution by the shareholders to completely liquidate and dissolve, in which case the corporation's U.S. assets must have been distributed, used to pay liabilities, or ceased to be U.S. assets. There is also a prohibition on reinvesting the former U.S. assets in new U.S. assets, directly or indirectly, for three years following the close of the year of the sale. This rule is equivalent to a liquidation-reincorporation rule and is exceptionally harsh (as well as bad policy that discourages investment in the United States). It requires a taxpayer to ring-fence the sales proceeds and keep them in an identified investment outside the United States. The statute of limitations is extended to six years to allow the I.R.S. to monitor reinvestment.

"When a domestic corporation is used to acquire the home, several of the big-picture issues we have described will play out differently."

The consequences appear less severe for a foreign shareholder when he makes personal use of a home owned by a corporation — if the corporation is foreign. As noted earlier, the double tax exposure is captured at the level of the foreign corporation in the form of corporate income and branch profits taxes. The real tax risk comes when the foreign corporation wishes to sell the property. It may be faced with a potential basis reduction because the property is depreciable from its inception yet the corporation may not have filed tax returns over the years in which losses have been established. As a result, a maximum tax determination letter from the I.R.S. may not be realistically available, and a full 15% withholding tax may be due at the time of sale.

Ownership Through a Domestic Corporation

When a domestic corporation is used to acquire the home, several of the big-picture issues we have described will play out differently.

The domestic corporation will be subject to federal income tax on any future capital gain at up to 21%, as well as any state and local income taxes that may be applicable. Because the corporation will be presumed to be engaged in business, it can usually deduct its expenses — including interest; taxes; and the costs of maintenance, repair, and insurance — as well as other corporate costs such as accounting and tax return preparation fees. On the other hand, if the shareholders make personal use of the home without paying a reasonable rent, these expenses may be disallowed in accordance with the case law described earlier.[94]

On sale of the property, the foreign owner will presumably want to have access to the sale proceeds. Any distribution of the proceeds other than in liquidation of the corporation will be a dividend to the extent of the corporation's E&P and therefore subject to tax at a flat rate of 30% or a lower treaty rate. Moreover, the entire amount of the distribution will be subject to withholding, even if less than all of the distribution is a dividend, although the corporation would have the right to withhold less based on a reasonable projection of its E&P at the end of the tax year.[95]

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[93] This concession has no basis in the language of the statute but is provided by reg. §1.8842T, apparently to provide treatment equivalent to the tax-free treatment of a foreign shareholder on liquidation of a domestic corporation whose shares are not U.S.R.P.I.'s. It is authorized by §884(g), a general grant of authority to issue regulations that carry out the purpose of the statutory provision.

[94] See *supra* note 65.

[95] Reg. §1.1441-3(c)(2)(i)(C).

To avoid dividend treatment, the foreign shareholder can cause the domestic corporation to be liquidated. However, the shareholder should not do this unless the corporation has purged itself of all U.S.R.P.I.'s in taxable transactions in which gain is fully recognized; otherwise, the shareholder may have to recognize gain inherent in the shares of stock of the corporation without liquidity to satisfy tax.[96] Generally, this is not a problem if the corporation is a single-asset vehicle for the ownership of just one house and the house has been sold. However, if the corporation holds an installment note from the buyer, the note will be a U.S.R.P.I. The corporation must therefore either dispose of the note by collection or sale, or else it will have to make an election out of installment sale under §453(d), thereby accelerating gain recognition by the corporation but also removing the U.S.R.P.I. status of the note. As mentioned earlier, these planning opportunities exist only if the corporation notifies the I.R.S. of the early termination of its status as a U.S.R.P.H.C.[97]

A gift of stock in a domestic corporation is not subject to gift tax because of the rule that only gifts of tangible personal property and real property located in the United States are taxable to an N.R.A. donor.[98]

The consequences of the death of the foreign owner depend on the structure of the ownership of the domestic corporation. If the corporation is owned directly by the foreign owner, the taxable estate will include the shares, and the estate will be subject to estate tax on those shares upon the owner's death. This is because stock in a domestic corporation has a U.S. situs for estate tax purposes.[99] In a few cases, the stock could be exempt under a treaty.[100]

If the domestic corporation is owned by a trust, the consequences will depend on whether any of §§2036 (transfers with retained life estate), 2038 (revocable transfers), and 2041 (powers of appointment) apply to the foreign decedent.[101] If so, the value of the stock in the domestic corporation will be includable in the estate of the foreign owner; otherwise, there will be no estate tax, except in unusual circumstances, possibly when the foreign corporation is treated as an alter ego during the individual's lifetime. This trio of provisions that cause property owned by a trust to be included in a taxable estate may be thought of as the estate tax counterpart to the grantor trust rules. We refer to them collectively as the retained interest rules.

Stock in the domestic corporation will be stepped up upon death of a foreign owner who held the stock directly or through a trust governed by the retained interest rules,

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[96] See §897(c).

[97] See *supra* note 66.

[98] Section 2511(a). Note that the tax would apply if the donor were subject to §877(b) during the year the gift was made. See §2501(a)(2). Section 877(b) applies to both citizens and long-term green card holders who gave up their citizenship and met specific financial and filing tests.

[99] Section 2104(a).

[100] The United States has entered into a relatively small number of treaties that address estate tax (15 plus the Canada income tax treaty, which deals with some estate tax issues), and the older treaties do not provide an exemption from the estate tax. Newer treaties (with Austria, Denmark, France, Germany, the Netherlands, and the United Kingdom) do provide such an exemption. Notably, the Swiss treaty does not.

[101] These provisions are the estate tax counterparts to the grantor trust provisions of subchapter J, part E (§§671-679).

but the basis in the underlying property will not be stepped up.[102] If the trust is not governed by any of the retained interest rules, there will be no step-up in the basis of the shares at the time of the settlor's death.

If the domestic corporation is owned by a foreign corporation, no estate tax will be due. Any step-up will occur only at the level of the stock in the foreign corporation, but not at any lower tier. Once again, if the stock was held by a trust governed by any of the retained interest rules, no step-up will occur at any level.

Ownership Through a Partnership

The foreign individual could form a partnership or an entity classified for federal tax purposes as a partnership to acquire and hold the home. The check-the-box regulations[103] changed the rules of the game here. The traditional definition of a partnership was set out in the regulations under §761 and included:

> a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on. The term "partnership" is broader in scope than the common law meaning of partnership, and may include groups not commonly called partnerships. . . . A joint undertaking merely to share expenses is not a partnership.[104]

However, beginning in 1997, the definition of a partnership for all purposes of the IRC was set out in the entity classification regulations (more commonly known as the check-the-box regulations). Those regulations provide that a partnership is a business entity that is not treated as an association (corporation) or a trust, and that a business entity is any entity recognized for federal tax purposes (including a disregarded entity) that is not properly classified as a trust or otherwise subject to special treatment under the code. There no longer appears to be a requirement that the partnership be formed for profit.

So what are the consequences to our foreign home buyer of using a partnership, or an entity classified as a partnership, to purchase the property?

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[102] Taxpayers and the I.R.S. (depending on whose interest it serves) tend to value stock in a single-asset corporation as being identical to the value of the underlying real property. But there are many differences, including that the value of the stock will be reduced by any liabilities — the full amount of any mortgage, whether recourse or nonrecourse. The courts and, grudgingly, the I.R.S. may accept discount for some or all of the capital gains tax that would be payable on the sale of the property. A discount will also be appropriate for marketability, which will reflect both the fact that the stock is not listed and the natural concern of any buyer about buying stock in a privately held corporation rather than the underlying asset. Minority or reduced interest discounts may also apply if, for example, a decedent held less than all the shares, as will occur if a husband and wife each own exactly 50% of the shares of the corporation.

[103] T.D. 8697.

[104] Former reg. §1.761-1, added by T.D. 6500 and amended by T.D. 7208 and T.D. 8697.

Income Tax

Contribution

If the N.R.A. acquires the property and transfers it to the partnership in exchange for a partnership interest or as a contribution to the partnership, the transfer is a realization event but entitled to nonrecognition under the domestic tax law,[105] and that treatment is not overridden by F.I.R.P.T.A. rules regarding nonrecognition. However, to avoid F.I.R.P.T.A. withholding, the alien or the partnership must notify the I.R.S. of the transaction that is afforded nonrecognition treatment.

Imputed Rental Income

If a partner, foreign or domestic, is permitted to use the home free of rent or at a below-market rental rate, the question arises whether the partnership will have imputed rental income.

It's easier to see how rental income might be imputed between a corporation and its shareholders than between a partnership and its partners. As discussed elsewhere in this report, corporations and shareholders are separate taxpayers, and a corporation is assumed to be engaged in business. But there is something intuitively odd about treating a partner as paying rent to a partnership for the use of partnership property when that same income will be allocated right back to the partner. And that oddity is reinforced in the post-check-the-box world by the fact that a partnership formed solely to hold property for the personal use of its partners cannot really be said to be engaged in a business. When, however, a second partner holds more than a *de minimis* interest in the partnership, the oddity is diminished.

In any event, §707(a)(1) explicitly recognizes the idea of partnerships entering into transactions with partners not acting in their capacity as partners. This concept is frequently encountered in transactions in which a partner lends money or leases or licenses property to a partnership for which the partnership pays interest, rent, or royalties. But there is nothing in §707 that makes it a one-way street in which partners provide assets to the partnership. It could arguably be interpreted as applying to a transaction in which a partnership as the owner of property allows the property to be used by a partner as a tenant or licensee.

The question is then directed to the authority for imputing income in these circumstances. The most obvious possibility is §482.

Whether §482 covers a partner's rent-free use of partnership property requires us to consider whether the transaction involves "organizations, trades, or businesses" on both sides of the transaction. Fairly obviously, a partnership is an organization. But is the partner an organization, trade, or business? Section 482 is often thought of as having a broad reach, but it seems doubtful that it reaches quite as far as an individual who is not actually engaged in a trade or business and does no more than make personal rent-free use of partnership property.

We have been unable to find any direct authority on this point in the partnership context. Some courts have given broad meaning to the term "organization, trade

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105 Section 721.

or business" so that, for example, it includes employees.[106] Others have adopted a more limited approach.[107]

The closest case would seem to be *Dolese*,[108] which involved an individual, his wholly owned corporation, and a partnership in which the individual and the corporation were partners. The partnership made a distribution of partnership property to the partners that was not proportionate to their partnership interests in order to facilitate a subsequent tax-efficient sale and charitable gift of the property. The taxpayer argued that §482 could not apply to a partnership and one of its partners because they are not separate taxpaying entities. The Tenth Circuit held that the taxpayer did have a trade or business as a corporate executive and that the transaction was related to that trade or business.

The court's reasoning was a little strained. Moreover, somewhat gratuitously, it added:

> The fact that no prior case has addressed the application of §482 to the distribution of income and deductions from a partnership to an individual and the individual's wholly-owned corporation does not persuade us that application of the section is precluded. Cases addressing the dual business requirement have held that the terms "trade," "business," and "organization" are to be broadly construed. *Wilson v. United States*, 530 F.2d 772, 777 (8th Cir. 1976). See also *Keller*, 77 T.C. at 1022. Furthermore, §482 gives the Commissioner broad discretion to place a controlled taxpayer in the same position as an uncontrolled taxpayer. *Foster*, 756 F.2d at 1432; *Peck*, 752 F.2d at 472. Expansive construction of the terms comports with the Commissioner's broad discretionary power. We therefore conclude the tax court's application of the dual business requirement was not contrary to law.

It is not certain what would happen in a case, one more straightforward than the facts of *Dolese*, in which a partner makes personal use of partnership property such as a residence. If the tax adviser making the determination deals with a broad spectrum of cross-border tax issues facing individuals, it may be more persuasively contended that §482 should not be applicable in the absence of two businesses. These advisers may find §7872 instructive because it relates to loans that bear rates of interest that are below market. The transfer pricing regulations contain rules for an arm's-length interest rate. Presumably, those rules should apply under the theory that a loan between related parties should be subject to §482 as much as a rental. Section 482 is likely inapplicable, which is the reason that §7872 was enacted. Reasoning by analogy, it certainly can be argued that below-market rentals between related parties in the nonbusiness context should be removed from §482, and in the absence of a provision comparable to §7872, should be immune from adjustment. The validity of this argument awaits the next case.

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[106] See, *e.g.*, *Ach v. Commissioner*, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir. 1965); and *Dolese v. Commissioner*, 811 F.2d 543 (10th Cir. 1987). See also *Powers v. Commissioner*, T.C. Memo. 1982-567, *aff'd*, 724 F.2d 64, 66 (7th Cir. 1983) (involving the lease of property).

[107] See, *e.g.*, *Foglesong v. Commissioner*, T.C. Memo. 1976-294, *rev'd and remanded*, 621 F.2d 865 (7th Cir. 1980), *on remand*, 77 T.C. 1102 (1981), *rev'd*, 691 F.2d 848 (7th Cir. 1982).

[108] *Dolese*, 811 F.2d 543.

On the other hand, if the tax adviser's practice concentrates on transfer pricing issues, the likelihood is that he — as well as the I.R.S. — will argue that §482 permeates every nook and cranny of tax law. These advisers would look to *B. Forman Co.*,[109] involving a joint undertaking of operating corporations. There, the Second Circuit had no difficulty applying §482 in a partnership context. They may also look to *Procacci*,[110] in which a partnership leased a golf course to a related party and charged no rent under the circumstances involved in the case. The issue revolved around a prior version of the transfer pricing rules (reg. §1.482-2(c)(2)), which contained a method of determining an arm's-length charge for the use of tangible property when neither party to the lease was engaged in the trade or business of leasing tangible property.

In any event, the foreign taxpayer who uses a partnership to acquire a home must be willing to respond to a challenge by the I.R.S. under which the partnership is assessed with imputed income under §482 without any offsetting deduction for the partner.

Is there any other basis for imputing income between the partnership and the partner? We haven't found any statute or case law that would provide or allow for this. As we have already seen in the somewhat analogous position of a corporation that allows its shareholder personal use of corporate property, the traditional approach has been to disallow deductions to the corporation and impute a constructive dividend to the shareholder. This would usually be an adequate way to counteract whatever tax avoidance was thought to occur when a shareholder uses corporate property, because in most cases the deductions would be valuable and the constructive dividend would be income as long as the corporation had E&P.

But the traditional approach is not much of a threat to a partnership or the partners when the only asset of the partnership is a personal use residence. Absent imputed income, the partnership has no income and therefore no immediate use for the deductions, and the partnership distributions are generally not taxable to partners.[111] Might the holding in *G.D. Parker* apply so that the partnership is treated as making a distribution of the fair use value of the home? Perhaps it might, but unlike in the corporate case, a partnership distribution is not taxable unless it consists of cash that exceeds the partner's basis in the partnership. This might reduce the incentive for the I.R.S. to delve too deeply into this argument.

Actual Rental Income

The partnership might in fact have rental income. A cautious planner might choose to have the partnership charge the partners for use of the property. As a practical matter, the partners may be paying the partnership's expenses for the home, which, as we have seen, is a form of rent.[112] Alternatively, the property might be vacation property that was placed in a rental pool or otherwise made available for lease when not in use by the owner.

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[109] *B. Forman Co. Inc. v. Commissioner*, 453 F.2d 1144 (2d Cir. 1972).

[110] *Procacci v. Commissioner,* 94 T.C. 397 (1990).

[111] As we have seen, however, a corporation that owns only a personal use residence may not care about the deductions, and the constructive distribution may only cause a reduction in the shareholder's shares. See *supra* text accompanying and following note 65.

[112] See *supra* note 76 and accompanying text.

How the income is taxed requires first that we determine whether the partnership, and therefore by imputation under §875 the partner, is engaged in a U.S. trade or business with which the rental income is effectively connected. Under one view, this may seem unlikely when the property is primarily a personal use residence (and if it is not, the situation is outside the scope of this report). But other views may be possible as well.

Assuming there is no actual trade or business, rental income may be taxed to foreign partners either as F.D.A.P. income at a flat rate of 30% of the gross income, or the foreign partner can affirmatively elect under §871(d) to be taxed on the income as if he, she, or it were engaged in a trade or business within the United States and as if the income is effectively connected to that business. The §871(d) election is made at the partner level on the partner's tax return. If the election is made, graduated rates would apply to the net income.

As noted later, the treatment of the income in turn has withholding consequences for the partnership.

Gain on Sale

There is no real doubt that if the partnership held residential real property for more than a year, any gain on the sale of the property would be long-term capital gain.

The question arises whether the partnership should have taken depreciation deductions on the portion of the basis attributable to the building. If so, those deductions would have been allocated to the partner and should be deductible at the partner level.

This question answers itself rather easily in the case of property held for investment or use in a trade or business. But the position is not so clear when the property is held for personal use as a residence by the partners. Any excess deductions could contribute to a net operating loss and result in a carryover for an indefinite period under current law.[113] However, use of the loss would be limited under the alternative minimum tax rules.[114]

Withholding

One consequence of holding property through a partnership with one or more foreign partners is that the collection of withholding tax may be required for some income items of the partnership. If the partnership is domestic, the partnership will have to withhold tax under chapter 3 (specifically, §§1441, 1445, and 1446), and if the partnership is foreign, §§1445 and 1446 would apply.

The final regulations confirm the I.R.S.'s position that a payment is considered made to the extent income subject to withholding is allocated under §482. Further, income arising as a result of a secondary adjustment made in conjunction with a reallocation of income under §482 from a foreign person to a related U.S. person

[113] Section 172(b)(1)(A)(ii)(II), as amended by the 2017 act and the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136). For N.O.L.'s arising in tax years beginning before January 1, 2018, the carryover period is limited to 20 years.

[114] See §56(d), which limits the benefit of an N.O.L. when computing alternative minimum taxable income.

is considered paid to a foreign person unless the taxpayer to whom the income is reallocated has entered into a repatriation agreement with the I.R.S. and the agreement eliminates the liability for withholding. The secondary adjustment accounts for the absence of cash in the U.S. entity once taxable income has been increased. The I.R.S.'s position is that the cash that should have been charged was actually received and distributed to the owner. Although a deemed distribution of profits has a taxable effect in the corporate context, the effect in the partnership context should be negligible in most situations.

Section 1441 applies to income that is not effectively connected with a U.S. trade or business. It would therefore apply to rental income, including rental income imputed under §482.[115] If the partnership is domestic, the tenant of the property would not be required to withhold tax on the rent; rather, it is the partnership that would have to withhold the tax on distributions to the partner or, if no distribution is made, then on the date Form K-1 is due or is actually mailed to the partner, whichever is earlier.[116]

If the partnership takes the view that the rental income is effectively connected with a U.S. trade or business, or if the foreign partner elects to treat it as E.C.I., withholding under §1441 on rental payments can be avoided. If the partnership is domestic, the tenant does not have to withhold, and the partnership can rely on a Form W-8ECI from a foreign partner.[117] If the partnership is foreign, and if, as will normally be the case, the partnership is a "nonwithholding foreign partnership," the partnership can provide a Form W-8ECI to the tenant.[118]

Section 1446 will apply to any income or gain allocated to the foreign partners, to the extent the income or gain is effectively connected with a U.S. trade or business. Section 1446 requires the partnership to withhold tax on the "effectively connected taxable income" of the partnership allocable to foreign partners at the highest rate applicable to that partner, which for an individual is now 35%. However, the §1446 regulations allow the use of preferential rates for long-term capital gains and

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[115] Reg. §1.1441-2(e)(2) confirms the I.R.S.'s position that a payment is considered made to the extent income subject to withholding is allocated under §482. Further, income arising as a result of a secondary adjustment made in conjunction with a reallocation of income under §482 from a foreign person to a related U.S. person is considered paid to a foreign person unless the taxpayer to whom the income is reallocated has entered into a repatriation agreement with the I.R.S. and the agreement eliminates the liability for withholding. See also *Central de Gas de Chihuahua v. Commissioner*, 102 T.C. 515 (1994); and FSA 199922034.

[116] Reg. §1.1441-5(b)(2).

[117] Reg. §1.1441-5(b)(2) says that a foreign partner is not required to furnish a withholding certificate to claim an exemption from withholding under §1441 on the grounds that income is E.C.I.. However, reg. §1.1446-2(b)(2)(ii) provides that (1) a foreign partner that makes an election under §871(d) or 882(d) must furnish the partnership with a statement indicating that the election has been made; and (2) if a partnership receives a valid Form W-8ECI from a partner, the partner is deemed, for purposes of §1446, to have E.C.I. subject to withholding under §1446 to the extent of the items identified on the form. See also reg. §1.871-10(d)(3).

[118] Reg. §1.1441-5(c)(1)(ii)(B). Because a withholding foreign partnership is one that has entered into an agreement with the I.R.S. concerning guaranteed payments to partners, we can reasonably assume that in most cases involving a private use residence, the partnership will be a non-withholding foreign partnership. See reg. §1.1441-5(c)(2).

depreciation recapture, currently 15% and 25%, if the partnership has documentation that allows it to determine that the partner is an individual (or presumably, a trust taxed as an individual). A full discussion of §1446 is beyond the scope of this report.[119]

Gifts of Partnership Interests

A foreign partner in a partnership may wish to make a gift of the partnership interest or may bequeath it to his heirs.

An N.R.A.'s gift of a partnership interest generally will not be subject to U.S. gift tax. That tax does not apply to gifts by N.R.A.'s of intangible assets, with an exception in cases involving expatriates subject to §877.[120]

Two income tax issues nevertheless must be considered in connection with an N.R.A.'s gift of a partnership interest.

First, the recipient of the gift takes a basis in the partnership interest that is the lower of the donor's basis and fair market value. A gift can therefore result in a decrease but not an increase in the basis of the interest. A transfer of a partnership interest by gift does not result in a basis adjustment to the partnership's assets under §743, even though the partnership may previously have made the optional basis adjustment election under §754, an election that remains in effect for future years unless it is revoked with the I.R.S.'s consent.

Further, a gift of a partnership interest may be treated as a sale or exchange if the partnership has liabilities and any portion of those liabilities is allocable to the donor partner. This is likely to be an issue if the home owned by the partnership is mortgaged. There are two schools of thought on this.

The I.R.S. takes the position that any transfer of a partnership interest is a sale or exchange when the partnership has any liabilities that are transferred to the successor partner, based on the classic case of *Crane*[121] and an expansive but plausible reading of §752(d). The *Crane* argument is that any transfer of property that is subject to a liability results in an amount realized by the transferor and is part of the transferee's basis. Section 752(d) provides that in any sale or exchange of a partnership interest, liabilities will be treated in the same manner as liabilities in connection with a sale or exchange of property not associated with partnerships.[122]

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[119] For a more detailed discussion, see Alan Appel and Karlin, "At Long Last . . . Final Regulations on Foreign Partner Withholding," 16 J. *Int'l Tax'n* 20 (Oct. 2005); and Appel and Karlin, "Uncle Sam Meets Uncle Scrooge — The Temporary Regulations on Foreign Partner Withholding," 16 J. *Int'l Tax'n* 32 (Dec. 2005).

[120] Section 2501(a)(2).

[121] *Crane v. Commissioner,* 331 U.S. 1 (1947); see also *Tufts v. Commissioner,* 461 U.S. 300 (1983).

[122] See Rev. Rul. 77-402, 1977-2 C.B. 222 (grantor of a trust treated as realizing gain from the reduction in his share of liabilities on the deemed transfer of a partnership interest when the trust ceased to be a grantor trust). See also T.D. 7741, which states that the regulations promulgated under §1001 make this clear when in fact they do not.

The consequence of the I.R.S.'s position is as follows: A transaction in which the donee takes the partnership subject to liabilities of which the donor is thereby relieved is bifurcated into (1) a sale to the extent of the liabilities in question and (2) a gift of the value of the partnership interest net of those liabilities. If the liabilities exceed the basis, the donor may realize a gain, which would normally be a capital gain. The donee also has to be concerned with possible consequences under the F.I.R.P.T.A. withholding tax rules.[123]

The other possible position is that §752(d) applies only to transfers of partnership interests that are actually sales or exchanges. The basis for this position is, not surprisingly, the literal language of the §752(d) — the notion that §752(d) explains what to do when there is a sale or exchange but says nothing about converting a transaction such as a gift into a sale or exchange.

If this interpretation is correct, the transferor is still not out of the woods because then §752(b) comes into play. Section 752(b) says that any decrease in a partner's share of partnership liabilities is treated as a distribution of money by the partnership to the partner. This will not result in a gain, however, unless the deemed distribution exceeds the transferor's basis in the partnership.[124]

Readers are invited to do their own analysis of this issue, which does not appear to have been definitively resolved by any court.

Death of a Partner

Estate Tax

When the partnership interest passes to the heirs of a deceased N.R.A. partner, the estate tax position is less than clear.[125] The I.R.S.'s position is that a partnership interest has U.S. situs if the partnership is engaged in a U.S. trade or business. In the estate tax area, the I.R.S. has given no consideration to the relative sizes of U.S. business and other activities and assets, which can lead to the bizarre results in an atypical fact pattern involving a partnership that has a tiny U.S. business and substantial assets in other places around the world that are not related to the U.S. business. This approach should be contrasted with the I.R.S.'s position in the income tax area, which was that the taxable status of the gain is controlled by the assets in

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[123] Section 1445(e)(5).

[124] Section 731(a). For a more detailed discussion on these conflicting theories, see William S. McKee, William F. Nelson, and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, para. 15.05 (2020).

[125] See M. Annette Glod, "United States Estate and Gift Taxation of Nonresident Aliens: Troublesome Situs Issues," 51 *Tax Law*. 110 (1997); Robert F. Hudson Jr., "Tax Effects of Choice of Entities for Foreign Investment in US Real Estate and US Businesses," 4 *Bus. Ent*. 4 (Mar. 2002); Patrick W. Martin et al., "Why Section 2104 Must Address When Partnership Interests Owned by Foreign Investors Are (and Are Not) Subject to United States Estate Tax," State Bar of California, Taxation Section, International Committee (2003); and Richard A. Cassell et al., "U.S. Estate Planning for Nonresident Aliens Who Own Partnership Interests," *Tax Notes*, June 16, 2003, p. 1683.

the partnership.[126] (That position was discredited by a 2017 Tax Court decision[127] but was later enacted by Congress in the so-called Tax Cuts and Jobs Act.)[128]

The approach in the estate tax area likely helps the estates of some deceased N.R.A.'s and harms the estates of others. In particular, the I.R.S.'s position is rather favorable to the estates of N.R.A.'s when the sole asset of the partnership is a residence held exclusively for private use. This is because a partnership does not appear to be engaged in a U.S. trade or business if it simply holds the residence for use by the partners and, arguably, their family members, provided that §482 is inapplicable.[129]

Nonetheless, several issues remain unaddressed by the I.R.S. It is not clear if the I.R.S. would try to apply its position to a partnership that was not engaged in a U.S. trade or business but had income or gain that was deemed to be effectively connected with a U.S. trade or business for purposes of imposing tax under §871(b), 882, or 897(a). Also unclear is the case of a partnership that has income that is not actually effectively connected to an ongoing trade or business but that, as a result of a §871(d) election or because of F.I.R.P.T.A. gain under §897(a), is deemed to be E.C.I. It is also unclear when the partnership must be engaged in a trade or business. Is it the date of death? Any time during the year of death? Any time whatsoever before death?

One interesting point: Section 875 provides that "for the purposes of this subtitle" a foreign person is considered to be engaged in a U.S. trade or business in which a partnership in which that foreign person is a member is so engaged. But §875 does not apply for purposes of the estate tax. The subtitle referred to in §875 is subtitle A (income taxes). Estate taxes are the subject of subtitle B. Whatever else the I.R.S. may argue, it cannot use §875 as support for the argument that a partnership of which a deceased foreign partner was a member was engaged in a U.S. trade or business for purposes of the estate tax.

Other theories may apply. These include treating the residence of the deceased partner as the situs of the partnership interest (*mobilia sequuntur personam*) or treating the partnership's place of organization as the situs, similar to the rule for corporations.

Planning should also take into account the case law developed in the family limited partnership area. The risk here is that if an N.R.A. contributes residential property to a partnership but retains the right to live there, §2036 may apply.[130] This can be

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[126] See Rev. Rul. 91-32, 1991-1 C.B. 107. This ruling concluded that a foreign person recognizes taxable gain on the sale of a partnership interest to the extent the gain is attributable to assets used or held for use in a U.S. trade or business.

[127] The I.R.S.'s position was wholly unsupported by authority except when the underlying asset is a U.S.R.P.I., and no U.S.R.P.I. is mentioned in the ruling. In fact, had the I.R.S.'s position been correct, there would have been no need for §897(g) (enacted in 1980). The I.R.S.'s arguments were dismantled by the Tax Court in *Grecian Magnesite v. Commissioner*, 149 T.C. 63 (2017), *aff'd*, 926 F.3d 819 (2019).

[128] Section 864(c)(8).

[129] See *supra* discussion accompanying notes 103 and 104.

[130] See *Estate of Disbrow v. Commissioner*, T.C. Memo. 2006-34.

avoided by having the partnership enter into a lease with its foreign partner that provides for an F.M.V. rental. But again, this approach has adverse income tax consequences and may not resolve the underlying estate tax problem because the partnership will have the appearance of being engaged in a trade or business.

Step-Up

On death of the foreign partner, the basis of any partnership interest held by the decedent will be adjusted to F.M.V. — usually, but not invariably, upward. To achieve a step-up at the partnership level, the partnership should make an election under §754 to provide a special allocation of basis to the estate and ultimately to the successors.

Ownership Through a Trust

The trust is a vehicle that can serve a variety of purposes for the purchase of a home. At its simplest, as we have already discussed, a trust structured as a grantor trust can be a tax-transparent method of ownership whose principal benefit is to avoid probate on the death of the settlor.[131] In this section, we discuss the application of the non-grantor trust rules.

Summary of Non-Grantor Trust Rules

The non-grantor trust is another way for a foreign person to hold property. The trust may be foreign or domestic and may be simple or complex. The property originally settled may be the property — generally not preferable because the transfer of the property to the trust may be a gift[132] — or cash used to purchase the property. As a general rule, a trust is treated as if it were an individual, so a foreign non-grantor trust is treated as an N.R.A. individual.

The table summarizes the effects of these alternatives.

Planning with Trusts

In General

A trust is potentially an attractive vehicle for newly acquired residential property. To avoid gift tax, the trust should be funded with cash, preferably cash transferred from outside the United States.[133] As the table indicates, a gift of real property into trust

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[131] See *supra* note 50 and accompanying discussion.

[132] A transfer to a grantor trust can also be a gift if it is structured as a completed gift, but this is practically impossible when the grantor is foreign.

[133] Cash in the form of currency notes is treated as tangible personal property; no authority exists on whether cash credited to a bank account should be treated as tangible because it is the equivalent of currency or instead treated as intangible because technically an amount credited to a bank account is an (intangible) claim against the bank. The conservative view is that gifts of cash should be structured by wire transfer from or draft drawn on a foreign bank account. The ultraconservative view is that the donee (the trust in this case) should receive the transfer or deposit the draft in a non-U.S. account. Whether the ultraconservative view can be easily implemented is open to debate.

will be subject to gift tax, and the I.R.S. may take the position that a gift of cash that is conditioned on its being used to purchase property already owned by the settlor will be treated as a gift of real property.[134]

> *"The throwback rules, which were repealed in 1997 for domestic trusts, continue to apply to foreign trusts."*

Once the property is owned by the trust, a beneficiary who lives in the house rent free or for below-market rent should not have imputed income, nor, in general, will expenditures by the trustees on taxes, insurance, and repairs be treated as distributions to the beneficiary.[135] There is, however, a significant exception, introduced in 2010, when the trust is foreign and the beneficiary is a U.S. person. We discuss this later.[136]

Trusts are taxed at rates applicable to individuals, albeit with essentially no progression through the brackets, and are therefore entitled to the preferential rate of 20% now applicable to long-term capital gains.[137]

However, if the trust is foreign, a trap lurks for amounts distributed to U.S. beneficiaries from the trust in a year following the year of sale.

The problem is this: The throwback rules, which were repealed in 1997 for domestic trusts, continue to apply to foreign trusts.[138] Moreover, capital gain of a foreign trust is treated as D.N.I., regardless of whether the trust distributes it in the year of sale. As a result, any undistributed gain becomes undistributed net income ("U.N.I."). When a distribution is made out of a foreign trust, the distribution does not retain the character of the gain from which it was derived, and it is therefore ordinary income to a U.S. beneficiary. It follows that a U.S. beneficiary who receives a distribution made out of gain accumulated from an earlier year may have to pay tax at ordinary income tax rates, comforted only by being allowed to take credit for the long-term capital gains tax previously paid by the trust for the year of sale.[139] Fortunately, this character rule does not apply if the beneficiary is an N.R.A., which is why the problem is confined to distributions to U.S. beneficiaries.[140]

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[134] The I.R.S.'s view is supported by *De Goldschmidt-Rothschild*, 168 F.2d 975 (conversion of domestic stocks and bonds into Treasury notes under a prearranged program or understanding and solely for the purpose of making a tax-exempt gift in trust was held ineffectual for gift tax purposes). *Cf. Davies*, 40 T.C. 525.

[135] *Plant*, 30 B.T.A. 133, aff'd, 76 F.2d 8, acq., 1976-2 C.B. 2 (mere right or privilege under the terms of will to occupy the former home of the testator is not income; expenditures on maintenance of the premises, including payment of taxes, also do not represent income distributed or distributable to the beneficiary); see also *Alfred I. duPont Testamentary Trust*, 66 T.C. 1976.

[136] Section 643(i).

[137] Section 1(h).

[138] Section 665(c).

[139] See §§665 through 668. For a discussion of the throwback rules, see Boris Bittker, *Federal Taxation of Income, Estates and Gifts*, ch. 83.4, (2003); and Daniel C. Knickerbocker, *Subchapter J — Throwback Rules*, Tax Management Portfolio No. 856-2nd.

[140] This is the effect of §667(a), even if it does not explicitly so state. The character is preserved in the hands of a foreign beneficiary by §667(e).

Table 1. Comparison of Trusts as Ownership Vehicles

	Foreign Trust	Domestic Trust
Creation of Trust with Gift of Cash Used to Buy Property	Gift of cash by N.R.A. is not subject to U.S. gift tax if funded from outside the U.S. Note the I.R.S.'s position that a cash gift is treated as a gift of the underlying property if cash must be used to purchase the settlor's property. For this purpose, cash means dollar bills, not necessarily funds in an account; nevertheless, the most cautious planning involves transferring funds outside the U.S. or transferring value in the form of Treasury bills or other highly liquid intangible assets.[a]	
Creation of Trust with Gift of Tangible Property Located in the U.S.	Taxable gift; there is no income tax consequence unless the amount of debt assumed or taken subject to the trust exceeds the grantor's adjusted basis.	
Reporting	No Form 3520 reporting.	Form 3520 reporting required.
Use of Property by Grantor	No tax consequences to the grantor — but note the possible effect on the application of §2036 when the grantor dies.	
Use of Property by Other Beneficiaries	No tax consequences to the foreign beneficiaries — they should not have imputed rent if the trust instrument permits free use of the property. But if there is a U.S. beneficiary, the trust will be deemed to make a distribution to the beneficiary of the fair use value of the property.[b] Whether this is taxable presumably depends on whether the trust has distributed net income ("D.N.I.") or undistributed net income, but note that the use of the property does not appear to create income for the trust.	No tax consequences to the grantor or other beneficiaries — they should not have imputed rent if the trust instrument permits free use of the property.
Sale of Property — F.I.R.P.T.A. Withholding	Yes — by the buyer.[c]	**Simple Trust.** Yes — by the trust on distributions out of "U.S. real property interest account."[d] **Complex Trust.** Yes — by the trust on distributions out of "U.S. real property interest account"; note that this account is reset to zero at the end of each year, so there is no withholding on gain accumulated by the trust.[e]
Sale of Property — Rate of Taxation of Gain	**Simple Trust.** Capital gains rates. **Complex Trust.** Capital gains rates, but if distributed to a U.S. beneficiary in a later year, the gain is ordinary (for a foreign beneficiary, the character is preserved).[f]	Capital gains rates.

	Foreign Trust	Domestic Trust
Sale of Property — Incidence of Taxation of Gain	**Simple Trust.** Gain (and credit for tax withheld or paid under F.I.R.P.T.A.) passes through to the beneficiary.[g] **Complex Trust.** Gain and credit pass through to the beneficiary if distributed in the year of sale; otherwise, the trust is taxable on gain in the year of sale; the beneficiary is taxable in the year of the distribution as ordinary income (U.S. beneficiary) or capital gain (foreign beneficiary) with credit for tax paid; U.S. beneficiary may also pay interest under §668 to the extent the tax exceeds credit.	**Simple Trust.** Gain passes through to the beneficiary.[h] **Complex Trust.** Gain and credit pass through to the beneficiary if distributed in the year of sale; otherwise, the trust is taxable in the year of sale; no further tax on the beneficiary on distribution in a later year.[i]
Loss on Sale	The trust is treated as an individual, and loss will be allowed only if it is incurred in a trade or business or in a transaction entered into for profit, or if it qualifies as a casualty or theft loss.[j]	
Estate Tax on Death of Grantor	Depends on the application of §2036.	
Generation-Skipping Transfer Tax	Not applicable if the property given or bequeathed to the trust by the N.R.A. settlor was not subject to U.S. gift tax or estate tax at the time of the gift or bequest.	
Reporting — Trust	Form 1041.	
Reporting — Foreign Beneficiary	**Simple Trust.** In year of sale; Form 1040NR. **Complex Trust.** In year of required or actual distribution; Form 1040NR.	**Simple Trust.** In year of sale; Form 1040NR. **Complex Trust.** Form 1040NR if proceeds distributed in the year of sale; no reporting if proceeds are distributed in a later year in which the trust has no D.N.I.
Reporting — U.S. Beneficiary	**Simple Trust.** In year of sale; Form 1040 and Form 3520. **Complex Trust.** In year of required or actual distribution; Form 1040 and Form 3520.	**Simple Trust.** Form 1040. **Complex Trust.** Form 1040 if proceeds distributed in year of sale; no reporting if proceeds distributed in a later year in which the trust has no D.N.I.

[a] Rev. Rul. 55-143, 1955-1 C.B. 465.

[b] Section 643(i), as amended by §533 of the Hiring Incentives to Restore Employment (HIRE) Act of 2010.

[c] Section 1445(a).

[d] See reg. §1.1445-5(c)(1)(iii)(A).

[e] See *id.*, especially the seventh and eighth sentences.

[f] Section 667(e).

[g] Technically, under §§641, 643, 661, and 662, the gain is taxable to the trust, but the trust can deduct the amount distributed, up to the amount of the trust's D.N.I.; the gain is treated as D.N.I. to the extent distributed; and the beneficiary includes in income the amount distributed up to the amount of the D.N.I.

[h] Same as explained *supra* note g.

[i] This assumes that the distribution in the later year does not carry out D.N.I. from some other source earned during the year of distribution.

[j] Section 165(c), confirmed for N.R.A. individuals by §897(b).

In short, if the beneficiaries of a foreign non-grantor trust are or become U.S. persons, it would generally be advisable for a distribution representing proceeds of sale of the residence to be made to the beneficiaries in the year of sale. This might entail a distribution to all beneficiaries, only to foreign beneficiaries, or to what is commonly referred to as a decanter trust, which is a second trust (with different terms and a nonidentical group of beneficiaries) that receives distributions in an amount sufficient to zero out U.N.I. U.S. beneficiaries generally will not participate in the decanter trust while the principal trust has assets. As a result, U.S. beneficiaries will receive either current distributions without an interest charge under the throwback rules or capital distributions.

At time of settlor's death, as long as one of the retained interest rules does not apply, there is no transfer of property; therefore, there should be no estate tax even though trust corpus at time of death consists of U.S. real property. However, as is always the case when property is held in a trust (other than a retained interest trust), there is no basis step-up because the property is not included in the estate.

The question does arise whether the retained interest rule of §2036(a) might apply to the trust. This section applies if the grantor retained an interest in the trust because of any right to use the residence during her lifetime. To avoid the application of the rule, the settlor must not have a right to trust income or gains, and the trust must have an independent trustee with complete discretion over the use of trust assets.[141] This means that the trustee's exercise of discretion cannot be subject to any standard that would be enforceable by the settlor, and there cannot be a "wink and a nod" understanding or other informal arrangement.

Section 2036(a) may come back into play if an informal agreement allows the settlor to control the income. The U.S. tax authorities have become more sophisticated in their understanding of the role played by trust protectors, appointors, and similar persons.

Another requirement is that creditors of the settlor should not be able to reach trust assets, at least in theory. This may require the trust to be formed in a foreign jurisdiction that allows spendthrift provisions that will protect the settlor or a settlor-beneficiary of a discretionary trust from creditors that arose after the trust was funded (no jurisdiction to our knowledge will protect a trust from the application of fraudulent conveyance or fraudulent transfer laws that can be used to void a gratuitous transfer of assets of the trust as against the claims of creditors in existence at the time of the transfer).[142] Some U.S. states, including Alaska, Delaware, Nevada, South Dakota, and Wyoming, also provide for such trusts,[143] although the practical efficacy of

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141 *Commissioner v. Irving Trust Co*., 147 F.2d 946 (2d Cir. 1945); and *Sherman v. Commissioner*, 9 T.C. 594 (1947).

142 Not all of the traditional offshore jurisdictions have provisions in their laws that protect settlors (as opposed to other beneficiaries). For example, Jersey and Guernsey in the Channel Islands do not, whereas such provisions can be found in the laws of the Bahamas, Barbados, Bermuda, the Cayman Islands, the Cook Islands, and Gibraltar, among others.

143 Alaska Stat. §34.40.110; Del. Code Ann. tit. 12, §3570 et seq.; Nev. Rev. Stat. ch. 166; S.D. Codified Laws §§55-1-24 et seq.; and Wyo. Stat. Ann. §§4-10-506 and 4-10-510 et seq.

spendthrift provisions to protect a settlor-beneficiary has been questioned in light of federal bankruptcy reforms enacted in 2005.[144]

The message for planners is therefore that the non-grantor trust must be implemented with considerable care, and once in place, it must be respected by all concerned, especially the settlor and the trustees.

Section 643(i)

We discuss in the following section the issues created by §643(i) for the U.S. beneficiary of a foreign non-grantor trust who makes use of a home owned by the trust.

FOREIGN OWNER'S FAMILY INCLUDES U.S. PERSONS

Any structure must take into account the possibility that ownership will find its way into the hands of U.S. persons. This happens quite often. The following are some of the typical fact patterns:

- A foreign owner buys a home for use by one or more children who are students in the United States and who typically are not considered residents for income tax purposes during that period. After college, the students remain in the United States and become residents for income tax purposes.
- A foreign executive on a medium-term stay in the United States has a child born in the United States or marries an American and moves back to his home country. The couple has children, who are automatically U.S. citizens even if they are born abroad.
- A foreign individual has children who move to the United States for personal or business reasons.
- A beneficiary of a foreign trust moves to the United States, and the trustees are asked to assist with the purchase of a home for the beneficiary.

In all these situations, planning must be reviewed to consider the use of the home by U.S. citizens or residents and the possibility that those persons might inherit or otherwise acquire an interest in the house.

Reconsider Use of Corporations

One situation we have encountered is when the foreign owner heeds the all-too-frequent advice — often given by foreign banks or financial advisers — to purchase the home using an offshore corporation. If by the time of the owner's death, one or more of the heirs is a U.S. person, this is the fiscal equivalent of jumping off the

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144 11 U.S.C. §548(e), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, permits the bankruptcy trustee to avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the bankruptcy petition if (1) the transfer was made to a self-settled trust or similar device; (2) the transfer was by the debtor; (3) the debtor is a beneficiary of the trust or similar device; and (4) the debtor made the transfer with the actual intent to hinder, delay, or defraud any entity to which the debtor was or became indebted on or after the date that the transfer.

Empire State Building and claiming, as one passes the 34th floor, that everything is fine so far. When the owner dies, shares of the corporation indeed pass to his heirs free of estate tax. Unfortunately, the landing is not so soft: The heirs now face a string of tax disadvantages.

First, they are now the owners of a corporation that, so far as the U.S. heirs are concerned, is either a C.F.C. if they are in the majority, or a P.F.I.C. if they are not or if they are among a class of persons that own less than a 10% interest in the foreign corporation.

Second, if they make personal use of the home, they must continue to deal with imputed rental income issues, which may be worse for U.S. shareholders and their U.S. relatives than for foreign shareholders.

Third, the basis in the stock of the corporation may have been adjusted to F.M.V. but the basis in the home itself is not adjusted. Therefore, if the home has increased in value, gain on the sale will include both pre- and post-mortem appreciation. Moreover, the gain will be taxed at corporate rates, and there will be no §121 exemption, even if the home becomes the principal residence of the U.S. heir.[145]

It is not in the interest of the U.S. taxpayer for the property to be held by the foreign corporation for any significant length of time following the death of the foreign decedent. Any increase in the value of the property that is reflected in an increase in the value of the shares of the corporation will ultimately be double taxed. If the corporation is a P.F.I.C., this gain may be largely converted to ordinary income.

Assuming the sale takes place soon after death or at least before additional appreciation has occurred in the property, the U.S. shareholder should try to get the foreign corporation liquidated as soon as possible after the sale. There is no benefit to the shareholder having the proceeds locked up in a foreign corporation. Prompt liquidation following the sale will result in a taxable transaction for the corporation and the U.S. shareholder, but the gain at the shareholder level should be low because of the step-up.

The prospect of this catalogue of issues should persuade those advising foreign purchasers to think carefully before recommending use of a foreign corporation as the vehicle for purchase. Unfortunately, we have frequently found that advisers don't seriously press their clients to obtain U.S. tax advice in these situations.

Care in Planning With Trusts

On the grantor's death, the retained interest rules can apply to the trust, and if they do, the estate tax will apply to any assets held by the trust.

Moreover, the trust will become a non-grantor trust on death of the grantor. This will potentially affect the U.S. beneficiaries of the trust in several ways.

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[145] The gain should not be subpart F income. Section 952(b) excludes from the definition of subpart F income any income that is effectively connected with a U.S. trade or business. It would be helpful if the regulations under §952(b) clarified that this includes income deemed to be E.C.I. under §897(a). See reg. §1.952-1(b)(2).

First, the simplification of the treatment of complex trusts brought about by the 1997 amendments does not apply to foreign trusts with U.S. beneficiaries.[146] Those beneficiaries remain subject to the throwback rules, which may also apply to domestic trusts that were formerly foreign, and to the interest charge on distributions made out of U.N.I., which clearly also applies to distributions made by domestic trusts that are former foreign trusts.

Second, the conversion to non-grantor trust status will require the U.S. beneficiaries to deal with the compliance requirements of §6048(a) — including the filing of Form 3520, "Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts" — in any year that the beneficiaries receive a distribution from the trust, and they will need to obtain information from the foreign trust in the form of a foreign non-grantor trust beneficiary statement.[147]

Third, and perhaps most important, is an amendment to the distribution rules. Section 643(i), which was first enacted in 1996, originally provided that the amount of a loan of cash or marketable securities by a foreign trust to a grantor or beneficiary who is a U.S. person is to be treated as a distribution by the trust. In 2010 §643(i) was amended so that if a foreign trust permits a U.S. grantor or beneficiary to use any other trust property, the F.M.V. of the use of the property is to be treated as a distribution by the trust.[148] The rule does not apply to the extent the trust is paid the F.M.V. of the use within a reasonable time of that use.[149]

For a trust that holds only real property for personal use by the grantor and beneficiaries, a distribution by the trust might not be taxable because such a trust likely would have neither D.N.I. nor U.N.I. But there is a trap here: Form 3520 must be filed by any U.S. beneficiary each year to report distributions from a foreign trust. The form requires the beneficiary to choose between reporting under the so-called default method or the actual method. And once the beneficiary has ever been subject to the default method, he cannot use the actual method in any future year, except the final year of the trust.[150]

To be able to use the actual method, the beneficiary must also receive from the trust a foreign non-grantor trust beneficiary statement. If the beneficiary uses the actual method, the distribution may indeed be tax free if the trust had no D.N.I. or U.N.I. However, if instead the default method applies, whether by choice or by failure to file Form 3520, the full amount of the distribution is treated as ordinary income and is taxable, even if it would not have been taxable had the beneficiary been able to use the actual method. Moreover, the tax distribution will attract interest based on how long the trust has been a non-grantor trust.

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[146] See §665(c).

[147] If the U.S. beneficiaries receive a distribution during the lifetime of the grantor while the trust is a grantor trust, compliance requirements regarding Form 3520 apply, but the information reporting is generally viewed to be significantly less because no portion of the distribution is taxable to the beneficiary.

[148] HIRE Act §533.

[149] There is no guidance on what is reasonable. We would generally recommend that rent be paid at least yearly, although we can envision cases in which delay might reasonably be permitted if a trust became a non-grantor trust following the death of the grantor.

[150] See §6048(c)(2).

An early failure to recognize the need to file Form 3520 using the actual method can therefore result in the fair market rental value of a residence being taxed at quite unfavorable rates.

All these problems result from the trust being a non-grantor trust. A trust cannot, by definition, have D.N.I. or U.N.I. before it becomes a non-grantor trust. Because the death of the foreign grantor will definitively cause a trust that may previously have been a grantor trust to become a non-grantor trust, a decision on whether to maintain the trust as a foreign trust should be made shortly after the grantor's death. Consideration should be given to terminating the trust (or at least distributing out the residence). Another possibility would be to domesticate the trust, a strategy that may make it possible to keep the property out of the estate of the successor beneficiaries, as well as eliminate issues under §643(i).

What if the N.R.A. Has Already Died?

Suppose the adviser is consulted in a situation in which the N.R.A. owner of the home has already died and the heirs include U.S. individuals. What can be done?

Foreign Corporation Structure

As we have seen, the foreign corporation, whether owned directly or through a trust, may, depending on the percentage of U.S. ownership, have become a C.F.C. or a P.F.I.C.

If U.S. persons are the only beneficiaries, one step would be to consider domesticating the corporation. There are various ways to domesticate the foreign corporation, all of which are treated similarly for U.S. tax purposes. Domestication can be accomplished, if permitted by foreign law, through the use of a continuation statute in the country of incorporation and a U.S. state.[151] Alternatively, domestication can be accomplished by dropping the property into a new domestic corporation or dropping the foreign corporation into a new domestic corporation and, in either case, having the foreign corporation liquidate. All these methods are essentially treated by the I.R.S. as C or D reorganizations.

All of these should be tax free,[152] except for any §367(b) toll charge. Even if the foreign corporation has E&P, the inclusion at the time of repatriation is keyed to the earnings accumulated during the taxpayer's holding period.[153] That period begins at the time of the grantor's death.

The first step in the plan is for the trust to distribute the shares of the corporation to the U.S. beneficiaries. The second step is to take advantage of Delaware's favorable continuation statute allowing foreign corporations to domesticate into Delaware

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[151] *E.g.*, Del. Code Ann. tit. 8, §388.

[152] Reg. §1.897-5(c)(4); and Notice 2006-46, 2006-1 C.B. 1044. The domestication would not be adversely affected by the antiavoidance rule of reg. §1.897-5(c)(4) — as amended by Notice 89-85, 1989-2 C.B. 403, and Notice 2006-46 — because Notice 89-85 only requires the foreign corporation to pay an amount equal to any taxes that §897 would have imposed on all persons who had disposed of interests in the foreign corporation. No tax would have been imposed on the transfer of the shares of the foreign corporation upon the death of the N.R.A., even though the transfer results in a step-up in basis.

[153] Reg. §1.367(b)-2(d)(3).

relatively easily.[154] (If foreign law does not permit re-domiciliation, the desired result can also be achieved transactionally with a new Delaware corporation and combining the foreign corporation and the Delaware corporation in one of several ways.)

Following the domestication, the next step would be to make a subchapter S election. The S election can be made only if the corporation has no foreign shareholders, no corporate shareholders,[155] only one class of shares, and is held by no more than 100 shareholders.[156] Assuming this is the case as a result of the distribution in step 1, the S election offers the U.S. beneficiaries the ability to freeze the amount of gain that is potentially taxable at both the corporate and shareholder levels. If the shareholders can hold out for 10 years, the corporate-level tax would be eliminated altogether.[157] If they wish to cause the S corporation to sell the house, it may be possible to use one or a series of §1031 exchanges to defer taxation of the gain until the expiration of the 10 years. The property must be held for investment or as part of a trade or business before the exchange is undertaken.

The domestication/S election strategy addresses double taxation and secures the benefit of individual rates of tax on capital gains. It does not work if any foreign persons continue to have an interest in the corporation, and it does not solve the imputed rental income problem. In other words, the potential to domesticate the foreign corporation and make an S election is a partial escape route from an unfavorable structure and not a justification for using a foreign corporation structure to begin with.

As an alternative to the domestication/S election strategy, it is worth considering the liquidation of the foreign corporation if not much taxable appreciation has occurred since the property was acquired.

Domestic Corporation Structure

Ownership through a domestic corporation will lead to estate tax on the death of the foreign shareholder, corporate-level capital gains tax to extract property, and shareholder-level tax on liquidation, although because of step-up in the corporate stock, the shareholder gain may be limited if the sale occurs soon after the death.

As in the case of a newly domesticated foreign corporation, it is worth considering making an S election, followed by a 10-year delay before sale to avoid two levels of tax, and in the meantime using a §1031 exchange.

Foreign Trust Structure

As noted earlier, following the death of the foreign grantor of a foreign grantor trust, consideration should be given to domesticating the foreign trust or at least the portion that owns the U.S. real property.

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[154] Del. Code Ann. tit. 8, §388. Other states permit domestication or continuation, but the Delaware procedure is our preferred jurisdiction for this exercise.

[155] If the sole shareholder of a corporation is itself an S corporation, the lower-tier corporation can make an election to be a qualified S corporation subsidiary.

[156] Section 1361(b).

[157] See §1374.

> *"While the big four tax issues — capital gains treatment, planning for gift and estate taxes, imputation of rental income, and basis step-up on death — dominate tax planning, the purchase of a home by a foreign person potentially involves several practical tax compliance and nontax issues."*

Tiered Structure

If the property was held by a tiered structure, the techniques described above may have to be combined. Consider, for example, the structure of a revocable foreign trust that owned a foreign corporation that in turn owned the domestic corporation that owned the property. One approach would be to domesticate the foreign corporation; merge the domesticated corporation with the existing domestic corporation (the latter should be the survivor to avoid the need to change title to the property); domesticate the trust, with a modification permitting the trust to hold the merged corporation as an S corporation; and finally, make the S election. The domestication of the foreign trust after the domestication of the foreign corporation would prevent the trust from holding stock in a foreign corporation for even a short time, when it would be a C.F.C.

A LITANY OF PRACTICAL ISSUES

While the big four tax issues — capital gains treatment, planning for gift and estate taxes, imputation of rental income, and basis step-up on death — dominate tax planning, the purchase of a home by a foreign person potentially involves several practical tax compliance and nontax issues. This section surveys those issues.

Tax Compliance

Obtaining T.I.N.'s.

Whatever structure is used, at some point the taxpayers involved will have to acquire T.I.N.'s. The I.R.S. makes this relatively easy for corporate and partnership entities but miserably difficult for individuals. Armed with no more than a properly completed Form SS-4, "Application for Employer Identification Number," and a fax machine, the representatives of corporations and partnerships can obtain employer identification numbers over the telephone and, for domestic entities, online.[158]

Applying for an E.I.N. for a trust can be more difficult because of Form SS-4's requirement to list a grantor, owner, or trustor as the responsible party and to provide a T.I.N. for that person — something that may be impossible if the grantor is no longer alive or unwilling to obtain the number, as can occur for a non-grantor trust. Our experience is that I.R.S. representatives will accept that no such number will be available in those circumstances.

Applications for I.T.I.N.'s are a much different matter. In general, an application for an I.T.I.N. requires the applicant's tax return and identification documents as well as a completed Form W-7, "Application for I.R.S. Individual Taxpayer Identification Number." The identification documents must be originals or certified copies. This means that the individual has to either mail the original documents (such as passports) to the I.R.S. or visit a U.S. embassy or consulate. Starting October 1, 2016, the I.R.S. no longer accepts notarized identification documents.

Recognizing the challenges of these requirements and as envisaged by the Protecting Americans From Tax Hikes ("PATH") Act of 2015, the I.R.S. launched a certified

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[158] I.R.S., "How to Apply for an EIN" (viewed Apr. 20, 2020). Amazingly, it can still be done by fax. International applicants can call 267-941-1099. Since May 21, 2012, the I.R.S. limits E.I.N. issuance to one per responsible party per day.

acceptance agent ("C.A.A.") program. A C.A.A. is a person or an entity (usually a professional services firm) that is authorized by the I.R.S. to authenticate the applicant's identification documents and certify copies thereof to the agency. The I.R.S. has recruited C.A.A.'s worldwide and publishes a list of them on its website.[159]

It is no longer possible to obtain an I.T.I.N. by filing a tax return or information return without a number. In its desire to process the return, the I.R.S. used to assign a number to the individual in question without all the formalities. However, in 2015 Congress provided that the I.R.S. is authorized to issue a T.I.N. to an individual "only if the applicant submits an application," using an I.R.S.-prescribed form and documentation.[160]

Recordkeeping and Tax Returns

If not enamored of extensive recordkeeping requirements, U.S. taxpayers are at least accustomed to them. Foreign taxpayers need to become familiar with the records they should maintain, especially long-term records concerning basis in property and the accumulations of corporations and trusts. The preparation of a pro forma tax return is often a prudent exercise as part of the recordkeeping function. The records need to be maintained in such a way that any required foreign currency translations can be accounted for. As noted earlier, it is important for any potential foreign taxpayer to keep records to show that it has no unsatisfied withholding liability.

Foreign taxpayers then must make arrangements to file all necessary tax returns. This routine, if not a necessarily welcome chore for U.S. taxpayers, can be quite burdensome for foreign persons.

Establishing and Managing Entities

The average U.S. homebuyer does not have to establish an entity to buy a house. At most, the buyer will establish a living trust. For foreign homebuyers, the establishment of trusts, partnerships, L.L.C.'s, or corporations involves a significant and sometimes unanticipated level of expense and complexity.

One of the most significant of these complexities involves opening bank accounts. In the wake of the USA PATRIOT Act, this has become a real challenge. This is because in many cases, local banks will not open accounts for nonresident individuals, and they do not want to open accounts for business entities — especially foreign entities that are not actually engaged in business, as will be the case when the only activity is acquiring and maintaining a residence.

Banks often want the entities to qualify to do business in the state where the entity owns the residence. That qualification may be necessary,[161] but in a check-the-box world, the entity that must qualify may not be the entity that needs the bank account. For example, if a trust owns a property through an entity that is disregarded under the check-the-box regulations, the trust is the taxpayer, but the disregarded entity may need to qualify.

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159 I.R.S., "Acceptance Agent Program" (viewed Apr. 20, 2020).

160 Section 6109(i), added by §203(a) of the PATH Act.

161 California, for example, considers a corporation or L.L.C. to be doing business in California merely by virtue of owning California real property.

Entities must be respected if they are to serve their intended purpose. This is true of all structures, but the fact that the underlying asset is dedicated to personal use will tend to increase the likelihood that the foreign owner will pay less than the full measure of attention required to behave in accordance with the chosen structure. For example, if a corporation is used, a lease should be entered into, a fair rent should be determined, the rent should be paid on time and in accordance with the lease, and expenses — such as property taxes, insurance, repairs, and maintenance costs — should be paid by the persons on whom the legal responsibility falls under the terms of the lease. When possible, checks drawn on corporate bank accounts should be used to pay operating expenses. This is over and above the usual requirements to maintain the corporation in good standing.

Finally, the home itself must be maintained. Taxes must be paid, the property must be insured, repairs must be made, the house must be cleaned, and the surrounding grounds must be tended. Neighbors may have to be accommodated, and homeowners' and condominium associations must be heeded and their dues paid. Fire prevention measures are desirable and may in fact be required, especially in many western states, and flood control rules may also apply. The usual difficulties for any owner in maintaining a vacation home in the United States are magnified by the distance usually involved for foreign owners, and occupation of the home by members of the younger generation adds a whole new layer of risk and worry unrelated to the tax and other issues discussed in this report. Foreign persons should not purchase homes without making a plan for all these considerations.

If real compliance requirements were not enough, scams have been reported for companies that are apparently owned by persons having Islamic names. Bogus PATRIOT Act bank reporting forms are now being faxed to these companies with officious cover letters printed on apparent Treasury Department letterhead. The form seeks bank account information and statements signed under penalties of perjury by all parties with signatory authority over the account. Presumably, the scam artist will use scanned copies of the signatures to sign bogus checks drawn on real accounts.

Home-Country Taxation

Planning must take account of home-country tax considerations and the potential application of U.S. income treaties and estate and gift tax treaties. The interaction of foreign and U.S. taxation adds a significant additional layer of complexity that requires coordination with the foreign owner's home-country advisers.

CONCLUSION

We began this report with a visit from our real estate partner, the lawyer with unverified faith in our magical powers to accomplish a simple set of objectives for a foreign client interested in buying a home in the United States. As we have made clear from the beginning, there is no single plan that meets all the major objectives — our wand can make many but not all the obstacles disappear. The challenge is to inform our clients of these obstacles and help them choose which ones they are prepared to live with and which ones must be made to go away. We have had clients tell us not to worry about capital gains because they anticipated that the property would never be sold, and we have had clients who were completely unconcerned about the estate tax and very anxious to avoid tax on the sale. For some clients, privacy trumps all tax concerns. There is, in short, no one preeminent plan.

EXCHANGE OF INFORMATION IN TAX MATTERS AND FUNDAMENTAL RIGHTS OF TAXPAYERS – E.C.J. DELIVERS LANDMARK RULING IN THE AFTERMATH OF *BERLIOZ*

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Tags
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BACKGROUND FOR NON-EUROPEAN READERS

The Court of Justice of the European Union ("C.J.E.U.") is the European Union's judicial arm. When people talk about the C.J.E.U., they are usually referring to the European Court of Justice ("E.C.J."). However, the C.J.E.U. includes the General Court and the European Civil Service Tribunal in addition to the E.C.J. They all serve different purposes.

Two additional sources of confusion may exist, as well. First, the E.C.J. is often confused with the European Court of Human Rights ("E.C.H.R."). The E.C.J. rules on E.U. law, while the E.C.H.R. rules on the European Convention on Human Rights, which covers the 47 Member States of the Council of Europe. Second, an Advocate General ("A.G.") assists the E.C.J.. The job of the A.G. is to provide an independent opinion on each case. These opinions offer impartial advice to the judges to help them reach their decision and are not binding – even where the E.C.J. reaches the same conclusion as the A.G., it may do so for different reasons. The tricky thing is that, too often, the A.G.'s opinion is either presented as a judgment of the E.C.J. or as something the E.C.J. will almost certainly follow. Neither assertion is true.

INTRODUCTION

On October 6, 2020, the European Court of Justice ("E.C.J.")[1] delivered a landmark ruling in Joined Cases C-245/19 and C-246/19[2] about the fundamental right to an effective remedy in the context of cross-border exchange of information between Member States of the European Union ("E.U.") in application of Directive 2011/16/EU on Administrative Cooperation in the Field of Taxation ("D.A.C.").[3] In contrast with the Opinion of its A.G.,[4] the E.C.J. ruled that, when *indirect* remedies are available, Member States can deny the taxpayer under investigation and other third parties concerned the right to a *direct* judicial remedy.

1 Reported at https://curia.europa.eu.

2 E.C.J., 6 October 2020, Joined Cases C-245-19 and C-246/19, *Luxembourg v B and Others*, ECLI:EU:C:2020:795 ("Ruling").

3 Council Directive 2011/16/EU of 15 February 2011 on Administrative Cooperation in the Field of Taxation and Repealing Directive 77/799/ EEC, OJ L 64, 11 March 2011, pp. 1-12 ("D.A.C.").

4 Opinion of A.G. Kokott, 2 July 2020, Joined Cases C-245/19 and C-246/19, *Luxembourg v B and Others*, ECLI:EU:C:2020:516 ("Opinion A.G.").

In the aftermath of *Sabou* in 2013 (C-276/12)[5] and *Berlioz* in 2017 (C-682/15),[6] the decision sets new standards for fundamental rights in the era of information exchange.[7]

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5 E.C.J., 22 Oct. 2013, Case C-276/12, *Jiří Sabou v. Finanční ředitelství pro hlavní město Prahu*, ECLI:EU:C:2013:678 ("*Sabou*"); For a detailed analysis of this case, see: J. Calderon and A. Quintas, "The Taxpayer's Right of Defence in Cross-Border Exchange-of-Information Procedures," *Bulletin for International Taxation*, 2014, Vol. 68, Issue 9, pp. 498-507; G. Zeyen, "*Affaire Sabou: en route vers un droit à l'information garanti à l'échelle européenne du contribuable,*" *Revue générale du contentieux fiscal*, 2014, Issue 3-4, pp. 234-241; C.-G. Fernlund, "*Quelques réflexions sur la jurisprudence de la Cour de justice de l'UE en matière d'échanges d'informations dans le domaine des impôts directs,*" in *Liber Amicorum Vassilios Skouris*, Brussels, Bruylant, 2015, pp. 215-225.

6 E.C.J., 16 May 2017, Case C-682/15, *Berlioz Investment Fund SA v. Directeur de l'administration des Contributions directes*, ECLI:EU:C:2017:373 ("*Berlioz*"); For a detailed analysis of this case, see: E.C.J. Taskforce, "CFE Opinion Statement ECJ-TF 3/2017 on the Decision of the Court of Justice of the European Union of 16 May 2017 in Berlioz Investment Fund SA (Case C-682/15)," *European Taxation*, 2018, Vol. 58, Issue 2-3, pp. 93-96; J. Frey, A. Jupp and F.-M. Schwarz, "The CJEU's Berlioz Judgment: A New Milestone on Procedural Rights in EU Audits," *Tax Notes International*, 2017, pp. 679-689; L. Neve, "The Berlioz-decision of the CJEU provides legal protection for concerned persons in transnational setting, but will it hold in the international area?" *Review of European administrative law*, 2017, Vol. 10, Issue 2, pp. 95-119; P. Malherbe, "*Arrêt Berlioz: Contester la pertinence vraisemblable des renseignements fiscaux à échanger,*" *Journal de droit européen*, 2017, Issue 9, pp. 361-363; C. Docclo, "*La pertinence, vraisemblable ou non, des informations échangées entre administrations fiscales et la perspective des déclarations de dispositifs transfrontaliers prévues par DAC 6,*" *Journal de droit fiscal*, 2018, Issue 7-8, pp. 242-253; A. Maitrot de la Motte, "*Cour de justice, gde ch., 16 mai 2017, Berlioz Investment Fund SA c/ Directeur de l'administration des contributions directes, aff. C 682/15, ECLI:EU:C:2017:373, Jurisprudence de la CJUE 2017,*" in *F. Picod (dir.), Jurisprudence de la CJUE 2017 – Décisions et commentaires*, Brussels, Bruylant, 2018, pp. 450-466; D. Berlin, "*Souveraineté et protection des droits fondamentaux,*" *Revue des affaires européennes*, 2017, Issue 2, pp. 307-320; S. De Raedt, "*De reikwijdte van de rechtsbescherming bij internationale uitwisseling van fiscale inlichtingen verder toegelicht,*" *Tijdschrift voor Fiscaal Recht*, 2017, Vol. 18, Issue 530, pp. 853-857.

7 On this topic, see B. Gangemi, "General Report," in I.F.A., *Cahiers de Droit Fiscal International. Vol 75b – International Mutual Assistance through Exchange of Information*, Deventer, Kluwer Law and Taxation Publishers, 1990; X. Oberson, "General Report," in I.F.A., *Cahiers de Droit Fiscal International. Vol. 98b – Exchange of information and cross-border cooperation between tax authorities*, The Hague, I.B.F.D., 2013 ; J.M. Calderón, "Taxpayer Protection within the Exchange of Information Procedure Between State Tax Administrations," *Intertax*, 2000, Vol. 28, Issue 2, pp. 462-475; T. Schenk-Geers, *International Exchange of Information and the Protection of Taxpayers*, Zuidpoolsingel, Kluwer Law International, Coll. Eucotax, 2009, 344 pp.; N. Diepvens and F. Debelva, *op. cit.*, pp. 210-219; F. Debelva, "*Internationale fiscale gegevensuitwisseling op basis van artikel 26 DBV's en de vraag naar rechtsbescherming,*" *Algemeen Fiscaal Tijdschrift,* 2015, Issue 1, pp. 5-32; N. Diepvens and F. Debelva, "The Evolution of the Exchange of Information in Direct Tax Matters: The Taxpayer's Rights under Pressure," *EC Tax Review*, 2015/4, pp. 210-219; P. Baker and P. Pistone, "The Practical Protection of Taxpayers' Fundamental Rights: General Report," in I.F.A., *Cahiers de droit fiscal international. Vol. 100B – The Practical Protection of Taxpayers' Fundamental Rights*, The Hague, I.B.F.D., 2015, pp. 17-68; P. Baker and P. Pistone, "BEPS Action 16: The Taxpayers' Right to an Effective Legal Remedy Under European Law in Cross-Border Situations," *EC Tax Review*, 2016, Vol. 25, Issue 5-6, pp. 335-345; S. André Rocha, "Exchange of Tax-Related Information and the Protection of Taxpayer Rights: General Comments and the Brazilian Perspective," *Bulletin for International Taxation*, 2016, Vol. 70, Issue 9, pp. 502-516; M. G. De Flora, "Protection of the Taxpayer in the Information Exchange Procedure," *Intertax*, 2017, Vol. 45, Issue 6-7, pp. 447-460.

BACKGROUND AND ISSUES: FUNDAMENTAL RIGHTS IN THE ERA OF EXCHANGE OF INFORMATION

Since the Great Recession,[8] the international exchange of information in direct tax matters has evolved considerably.[9] This reflects the growing awareness among tax authorities, progressive journalists, and non-governmental organizations ("N.G.O.'s") that wealthy individuals and large multinational corporations engage expert advisers to fashion effective tax plans resulting in the payment of little or no taxes. Think of the investigations carried out by the International Consortium of Investigative Journalists that revealed the *Lux Leaks, Swiss Leaks*, and *Panama Papers*. Given the pressure of mass media and the indignation of public opinion, the Organization for Economic Co-operation and Development ("O.E.C.D."), the E.U., and the U.S. committed for international tax coordination to effectively counter Base Erosion and Profit Shifting ("B.E.P.S.") in a framework of global tax transparency.

The underlying rationale is simple: national tax authorities collect income taxes based on information received from taxpayers themselves. Where appropriate, they conduct inquiries into the taxpayers' activities or request information from third parties, such as banks. While this system works reasonably well for taxpayers involved in purely domestic activities and transactions, difficulties arise for resident taxpayers earning some or most of their income in other countries. When national tax authorities investigate foreign-source income, their investigative authority stops at the national border, which serves as the outer limit of sovereignty. This fact pattern is viewed as an invitation for tax evasion or avoidance on one hand, but also can lead to international double taxation when authorities in two states each claim the primary right to impose tax. Cross-border cooperation between domestic tax authorities is viewed as a means of ensuring effective taxation for global investors and a means of relieving double taxation.[10]

In this "Brave New World" of tax transparency, two international standards ensure cross-border cooperation: the automatic exchange of information ("A.E.O.I.") and

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8 The "Great Recession" is the global economic downturn from 2007 to 2009 that devastated world financial markets as well as the banking and real estate industries. The crisis led to increases in home mortgage foreclosures worldwide and caused millions of people to lose their life savings, their jobs, and their homes. Even though its effects were global, the Great Recession mostly struck the U.S., where it originated in the subprime mortgage crisis, and Western Europe.

9 Similarly, see S. Gadzo and I. Klemencic, "Effective International Information Exchange as a Key Element of Modern Tax Systems: Promises and Pitfalls of the OECD's Common Reporting Standard," *Public Sector Economics*, Vol. 1, Issue 2, 2017, pp. 208-226. For an overview of the main EOI instruments, see N. Diepvens and F. Debelva, "The Evolution of the Exchange of Information in Direct Tax Matters: The Taxpayer's Rights under Pressure," *EC Tax Review*, 2015, Vol. 24, Issue 4, pp. 210-219, spec. 210-214; R. Biebel and J. Voje, "EU Report" in I.F.A., *Cahiers de droit fiscal international. Vol. 105B – Exchange of information: issues, use and collaboration*, The Hague, I.B.F.D., 2020, pp. 65-93.

10 This is all the more true in the current global economic environment, characterized by high mobility of capital and labor across national borders. On this topic, see M. Stewart, "Transnational Tax Information Exchange Networks: Steps towards a Globalized, Legitimate Tax Administration," *World Tax Journal*, 2012, Vol. 4, Issue 2, pp. 152-179.

the exchange of information on request ("E.O.I.R"). In the annotated cases, the E.C.J. reviews the E.O.I.R. standard, which enables one State to request from another State any foreseeably relevant information for the administration or enforcement of its domestic tax laws, such as ownership, accounting or banking information. Numerous legal instruments provide for an E.O.I.R., for instance: the 2002 O.E.C.D. Model Agreement on Exchange of Information on Tax Matters and its commentary; Article 26 of the O.E.C.D. Model Tax Convention and its commentary; and Article 26 of the United Nations Model Double Taxation Convention and its commentary.[11]

Within the E.U., the provisions of D.A.C. also enter into play. Currently, E.U. Member States are sharing unprecedented levels of tax information.[12] Between 2013 and 2017, Member States sent between 8.200 and 9.400 requests for information per year, based on D.A.C.[13] This represents a substantial increase compared to the period between 2008 and 2012, when the figures ranged between 4.000 and 5.800 per year under the predecessor of D.A.C., namely the E.U. Mutual Assistance Directive.[14] The rising figures inevitably raise the question of a balance between administrative efficiency for tax authorities and respect for taxpayers' fundamental rights.[15] In the words of Schaper:

"Currently, E.U. Member States are sharing unprecedented levels of tax information. Between 2013 and 2017, Member States sent between 8.200 and 9.400 requests for information per year, based on D.A.C."

> There is a clear contrast between the speed at which the powers of tax administrations have been increased through Union legislation in the last years and the apparent lack of urgency on the side of the Union legislator to balance this with taxpayers' rights grounded in EU law. The Union legislator appears reluctant to regulate data protection rights through Union legislation and seems to prefer to leave the matter to the Member States.[16]

This delicate equation lies at the heart of the recent decision in the E.C.J. cases.

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11 For further details, see T. Falcão and A. Lara Yaffar, "General Report Subject 2," in IFA, *Cahiers de Droit Fiscal International. Vol 105b – Exchange of Information: Issues, Use and Collaboration*, The Hague, I.B.F.D., 2020, pp. 17-62.

12 See N. Diepvens, *De grensoverschrijdende administratiefrechtelijke gegevensuitwisseling op verzoek in de inkomstenbelastingen vanuit Belgisch standpunt*, Gent, Larcier, 2018, pp. 395-396.

13 See R. Biebel and J. Voje, "EU Report" in IFA, *Cahiers de droit fiscal international. Vol. 105B – Exchange of information: issues, use and collaboration*, The Hague, I.B.F.D., 2020, p. 70.

14 Council Directive 77/799/EEC of 19 December 1977 concerning Mutual Assistance by the Competent Authorities of the Member States in the Field of Direct Taxation, OJ L 336, 27 December 1977, pp. 15-20.

15 For further details on (i) the origin of the administrative cooperation between tax authorities of different States for the correct establishment of income taxes, (ii) the tension between the procedure of cross-border administrative exchange of information on request, and (iii) judicial protection of the taxpayer and the procedural safeguards necessary for the taxpayer, see the doctoral thesis of N. Diepvens (*op. cit.*).

16 M. Schaper, "Data Protection Rights and Tax Information Exchange in the European Union: An Uneasy Combination," *Maastricht Journal of European and Comparative Law*, Vol. 23, Issue 3, pp. 514-530, spec. p. 530.

JOINED CASES C-245/19 AND C-246/19

Facts

In the context of an investigation of the tax position of a Spanish tax resident ("Taxpayer"), Spanish tax authorities ("Requesting Tax Authorities") sent two requests for information to their Luxembourg counterparts ("Requested Tax Authorities") based on D.A.C. and the Luxembourg-Spain Income Tax Treaty.[17] Since the Requested Tax Authorities did not possess the requested information, they addressed information orders to a Luxembourg based company and a Luxembourg based bank ("Addressees"). As each Addressee faced a possible fine of up to €250,000 for noncompliance, significant incentives existed for compliance. The company was asked to provide copies of contracts involving the Taxpayer[18] and the bank was ordered to share information concerning accounts, account balances, and other financial assets held or beneficially owned by the Taxpayer.[19]

The Addressees, the Taxpayer and other third parties concerned disputed the orders before the *Tribunal Administratif* (Luxembourg Administrative Court),[20] which partly annulled them.[21] The Luxembourg tax authorities then lodged an appeal before the *Cour Administrative* (Luxembourg Higher Administrative Court, "Referring Court").[22] The latter stayed the proceedings and referred two preliminary questions to the E.C.J.

The "preliminary reference" mechanism under Article 267 of the Treaty on the Functioning of the European Union ("T.F.E.U.") constitutes one of the cornerstones of the E.U. judicial system as it ensures the uniform interpretation and application of E.U. law in the Member States. It is designed as a noncontentious mechanism through which a national judge asks guidance from the C.J.E.U. regarding the interpretation of E.U. law or the validity of E.U. acts. The C.J.E.U.'s preliminary ruling strongly influences the outcome of the national procedure, as it is binding for the national courts. The preliminary reference procedure, however, is not a remedy available to the parties since individuals cannot make use of it and it is within national judges' power to decide whether to refer a question.[23]

Regarding the first question, the Referring Court asked whether the Luxembourg legislation that precluded a direct judicial remedy against information orders violated a fundamental right of the Addressees, the Taxpayer and other parties concerned under Article 47 (right to an effective remedy and to a fair trial) of the Charter of Fundamental Rights of the E.U. ("Charter"), as well as Articles 7 (right to privacy), 8 (right to protection of personal data), and 52(1) (restriction of fundamental rights in specific circumstances).[24] Regarding the second question, the Referring Court

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[17] Ruling, § 24; Opinion A.G., § 29.

[18] Ruling, § 26; Opinion A.G., §§ 30-33.

[19] Ruling, § 36; Opinion A.G., §§ 34-36.

[20] Ruling, §§ 28 and 38; Opinion A.G., § 37.

[21] Ruling, §§ 29 and 39; Opinion A.G., § 38-40.

[22] Ruling, §§ 30-31 and §§ 40-41.

[23] See C. Lacchi, *Preliminary References to the Court of Justice of the European Union and Effective Judicial Protection*, Brussels, Larcier, 2020, 348 pp.

[24] Ruling, § 44; Opinion A.G., § 46.

asked how one should interpret the term "foreseeably relevant information" within the meaning of Article 5 of D.A.C., read in conjunction with Article 1(1) thereof.[25]

Analysis and Ruling of the E.C.J.

The Direct or Indirect Right to an Effective Remedy

In *Berlioz*, the E.C.J. ruled that, under Article 47 of the Charter, an Addressee of an Information Order that was fined for noncompliance has the right to challenge the order's legality when disputing the fine ("indirect judicial remedy").[26] However, the ruling did not address the right to an effective remedy where no fine was imposed for a compliance failure ("direct judicial remedy"). In addition, the decision in *Berlioz* focused exclusively on the Addressees of Information Orders without addressing the fundamental rights of the Taxpayer under investigation and third parties concerned. In the cases at hand, the Referring Court asked the E.C.J. to address the two open questions.

"In her Opinion, A.G. Kokott . . . evaluated the procedural safeguards available for each of the Addressees, the Taxpayer, and the third parties."

In her Opinion, A.G. Kokott positioned herself in favor of taxpayers' rights and explained that the Addressees, the Taxpayer, and the third parties concerned should each have a right to a direct judicial remedy against information orders.[27] The E.C.J., however, took a different approach. It separately evaluated the procedural safeguards available for each of the Addressees, the Taxpayer, and the third parties.

- **Rights of the Addressees of Information Orders.**[28] The E.C.J. explained that Article 47 of the Charter guarantees the right of the Addressee to an effective remedy, without having to infringe any legal rule and await to receive a penalty for such an infringement.[29] The E.C.J. found that the Luxembourg law applicable to Addressees provides a remedy only when the Addressee does not comply with the order and receives a fine. Only then can the Addressee challenge the order indirectly by challenging the penalty.[30] Consequently, the Luxembourg law is incompatible with Article 47 and Article 52(1) of the Charter, read together.[31]

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25 Ruling, § 107; Opinion A.G., § 109.

26 See Berlioz, §§ 49, 51, 55, 56, and 59.

27 Opinion A.G., §§ 58, 82, and 108.

28 For the E.C.J.'s position about the Addressees, see Ruling, §§ 56-69.

29 Ruling, § 66 (and case-law cited therein); See, similarly, Opinion A.G., § 57 (and case-law cited therein):

> In a country based on the rule of law and in a union based on the rule of law, it is unreasonable to require a person concerned to violate an administrative order in order to be able to review the legality of the order indirectly. This applies all the more so if […] the decision as to whether to initiate proceedings for an administrative penalty is within the discretion of the tax authority. This is because, in such cases, the tax authority would be able to prevent a review of the legality of the request for information by refraining from initiating proceedings for an administrative penalty.

30 Ruling, § 67.

31 Ruling, § 69.

- **Rights of the Taxpayer under investigation.**[32] The E.C.J. explained that Article 47 of the Charter applies to the Taxpayer since the disclosure of the Taxpayer's personal data[33] to a public authority affects the fundamental rights to privacy and the protection of personal data guaranteed by Articles 7 and 8 of the Charter.[34] Nevertheless, the E.C.J. departed from the view of the A.G. and ruled that the right to an effective remedy does not necessarily mean that the Taxpayer must have a direct action against information orders. The Taxpayer could challenge the tax assessment note established at the end of the Spanish investigation and, in that context, indirectly dispute the information order. Therefore, the Luxembourg law – which prevented the Taxpayer from lodging a direct action against information orders – does not frustrate the right to an effective remedy under Article 47 of the Charter. The restriction imposed by the Luxembourg law meets an objective of general interest, *viz.*, combating international tax evasion or avoidance and strengthening cooperation between the Member States, and is proportional to that interest.

- **For third parties concerned.**[35] Article 47 of the Charter guarantees the right to an effective remedy to third parties.[36] However, in contrast with the Addressees, third parties are not under the threat of a fine in case of noncompliance.[37] Therefore, like the Taxpayer under investigation, national law can exclude their right to a direct judicial remedy against information orders when they can obtain the effective respect of their fundamental rights through other actions, such as an action to ascertain liability.[38]

The Foreseeably Relevant Information Test

Pursuant to Article 1 of D.A.C., Member States are obligated to cooperate with each other with a view to exchanging information that is foreseeably relevant to the administration and enforcement of the domestic tax laws of the Member States. In particular, Recital 9 of the Preamble to D.A.C. states:

> Member States should exchange information concerning particular cases where requested by another Member State and should make the necessary enquiries to obtain such information. The standard of 'foreseeable relevance' is intended to provide for exchange of information in tax matters to the widest possible extent and, at the same time, to clarify that Member States are not at liberty to engage in 'fishing expeditions' or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer.

[32] For the E.C.J.'s position about the Taxpayer, see Ruling, §§ 70-93.

[33] See Opinion A.G., §63 and case-law cited therein:

> Personal data is all information relating to an identified or identifiable person. Information regarding the amount of income received is personal data. The same applies to information about bank details.

[34] Ruling, §§ 72-75 and case law cited therein; Opinion A.G., §§ 61-67.

[35] For the E.C.J.'s position about third parties, see Ruling, §§ 94-105.

[36] Ruling, §§ 94-97.

[37] Ruling, § 99.

[38] Ruling, §§ 99-102.

This serves to ensure that Requesting Tax Authorities do not carry out investigations on a speculative basis, without having any concrete suspicions.[39]

In *Berlioz*, the E.C.J. interpreted the foreseeably relevant standard as enabling the Requested Tax Authorities to obtain any information that seems to it to be justified for the purpose of its investigation, while not authorizing it manifestly to exceed the parameters of that investigation nor to place an excessive burden on the Requested Tax Authorities.[40] In other words, Requesting Tax Authorities choose the information they need for their investigations, but Requested Tax Authorities can refuse to provide information when the request is manifestly devoid of any foreseeable relevance, having regard to the taxpayer, the information holder and the tax purpose pursued by the request.[41]

In the subject cases, A.G. Kokott went a step further, and held that in order for the Requested Tax Authorities to ascertain that the requested information is foreseeably relevant, the Requesting Tax Authorities must indicate the facts they wish to investigate or, at least, concrete suspicions surrounding those facts and their relevance for tax purposes.[42] Put otherwise, the request must provide concrete evidence of the facts or transactions that are relevant for tax purposes, to rule out any fishing expedition.[43]

Building on the analysis held in *Berlioz*, the E.C.J. ruled that the requested information is not manifestly devoid of foreseeably relevance when:[44]

- The request states (i) the identity of the Addressees of the Information Order, (ii) the identity of the Taxpayer subject to the investigation giving rise to the request for exchange of information, and (iii) the period covered by that investigation.
- The request relates to contracts, invoices, and payments that are defined by personal, temporal, and material criteria establishing their links with (i) the investigation, and (ii) the Taxpayer subject to that investigation, even though not expressly identified in the request.

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[39] Opinion A.G., § 134.

[40] Berlioz, § 68.

[41] Berlioz, § 82; The scope of the Requested Tax Authorities' review is however limited (§ 76). They must indeed trust the Requesting Tax Authorities and assume that the request for information complies with both the domestic law of the Requesting Tax Authorities and is necessary for the purposes of its investigation. Furthermore, the Requested Tax Authority does not have extensive knowledge of the factual and legal framework prevailing in the Requesting State. Hence, the Requested Tax Authorities cannot substitute their own assessment of the possible usefulness of the information sought for that of the Requesting Tax Authorities (§ 77).

[42] Opinion A.G., § 138.

[43] Opinion A.G., § 146.

[44] Ruling, § 124.

CONCLUSION

After making an important step forward in the protection of taxpayer rights within the framework of cross-border tax disputes[45] with Berlioz, the E.C.J. seems to have taken a step or two backward[46] with its annotated preliminary ruling. Clearly, the E.C.J.'s statement is welcome because it recognizes that Addressees of information orders have the right to seek direct judicial review against information orders. However, the absence of an equivalent right for the Taxpayer under investigation seems unreasonable. Indeed, a Taxpayer subject to an investigation will have to wait until the Requesting Tax Authorities issue a tax assessment note to take action, and then seek a review of the legitimacy of the information order. The E.C.J.'s position proves, yet again, that Taxpayers are perceived as "the object" of the exchange of information, and not as holders of rights requiring adequate and timely protection.[47]

"After making an important step forward in the protection of taxpayer rights within the framework of cross-border tax disputes with Berlioz, the E.C.J. seems to have taken a step or two backward with its annotated preliminary ruling."

The E.C.J. should have followed the A.G. Opinion which pointed out that the requested information contained personal data. Consequently, the request could affect the fundamental rights to privacy and protection of personal data, both of which are fundamental rights that belong to the Taxpayer. Applying these rights indirectly, only when the Requesting Tax Authorities issue a tax assessment note, provides inadequate protection. How does a taxpayer protect against fishing expeditions when the Taxpayer has no procedural avenue available? One might wonder whether, in the eyes of the judges, the political considerations surrounding the importance of exchange of information in tax matters took over the technical legal analysis.[48]

Regarding the foreseeably relevant information test, the E.C.J. correctly followed Berlioz and ruled that the Requested Tax Authorities may deny the provision of information where a request is devoid of any foreseeable relevance. This time, however, the E.C.J. enumerated a combination of criteria establishing the personal, temporal and material criteria establishing their links with the investigation and the taxpayer subject to that investigation. We believe that the threshold remains insufficient to effectively secure the protection of the Taxpayer's rights and offer protection against fishing expeditions[49] or shots in the dark.[50]

To conclude, the words of Baker and Pistone are appropriate when evaluating the position of the E.C.J.:

> The BEPS and tax transparency projects strengthened the powers of tax authorities across the borders, but kept silent on the protection of taxpayers' rights, which has become almost a taboo word for international tax coordination under the erroneous assumption that honest taxpayers have nothing to worry about this development and may anyway seek for legal protection at the national level in each country. However, silence won't lead the protection of fundamental

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45 E.C.J. Taskforce, *op. cit.*, p. 95.

46 M. Van Herksen and Gary Barnett, "Judicial review of exchange of information requests," *Tax Journal*, 23 October 2020, pp. 11-12.

47 M. G. De Flora, *op. cit.*, p. 460.

48 M. Van Herksen and Gary Barnett, *op. cit.*, p. 12.

49 Opinion AG, § 146.

50 Opinion AG, § 132.

> rights of taxpayers to oblivion. Global tax law cannot ignore them for long, since it would otherwise severely undermine the natural correspondence with legal remedies that is the quintessence of the rule of law."[51]

They propose a two-tier system for the conciliation and settlement of cross-border tax disputes with the involvement of taxpayers at all stages. The procedure should be supplemented by notification requirements in respect of all forms of international mutual assistance between tax authorities, subject to specific carve-outs where this would undermine effective tax auditing prerogatives.[52]

Solutions, therefore, are available, but require political consensus and courage on a sensitive topic. For the time being, and in contrast with the Latin maxim, *Ubi jus, ibi remedium*, the recent decision of the E.C.J. show that where there is a right, not always is there a remedy.

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[51] P. Baker and P. Pistone, *op. cit.*, p. 345 ; In the same light, see P. Pistone, "Co-ordinating the Action of Regional and Global Players during the Shift from Bi-lateralism to Multilateralism in International Tax Law," *World Tax Journal*, 2014, Vol. 6, Issue 4, pp. 4-5:

> Stronger powers for tax authorities to cooperate in cross-border scenarios worldwide should march hand-in-hand with a stronger protection of taxpayers' basic rights. The plea for an effective and timely protection of human rights across borders in this field is even more obvious insofar as one considers that taxpayers are, after all, human beings! Besides, the need to sharpen the fight against fraudsters should not turn into a disproportionate bonfire of all basic values that constitute the bulk of customary international law and the legal background of civilized nations across the world in the protection of persons.

[52] *Ibid.*

WATCH OUT WHIRLPOOL: THE I.R.S. HAS PUT 50 MILLION WRINKLES IN YOUR PERMANENT PRESS CYCLE

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Tags
Foreign Base Company Sales Income
Foreign Branch Rule
Subpart F Income

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INTRODUCTION

On May 5, 2020, the U.S. Tax Court held that income earned by Whirlpool Financial Corp.'s Luxembourg controlled foreign corporation ("C.F.C.") from the sales of products manufactured in Mexico should be treated as foreign base company sales income ("F.B.C.S.I.") under the branch rule of Code §954(d)(2) and taxable to Whirlpool Financial Corp. as Subpart F income under Code §951(a).[1]

Although the Whirlpool case concerns a tax year prior to the Tax Cuts and Jobs Act of 2017 ("T.C.J.A.") that significantly changed the U.S. international tax regime by introducing a new anti-deferral direct tax, initially at an effective 10.5% rate, on global intangible low-tax income ("G.I.L.T.I.") earned by foreign subsidiaries, it remains relevant for a variety of reasons. First and foremost, this is the first time the I.R.S. managed to overcome planning involving check-the-box regulations[2] by relying on Code §954(d)(2). Historically, the I.R.S. has never won a Subpart F sales or services case. Courts have always and consistently rejected government's arguments to expansively apply the definition of Subpart F sales income in order to carry out asserted Congressional intent.[3]

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1 *Whirlpool Financial Corp. v. Commr.*; No. 13986-17; No. 13987-17; 154 T.C. __, No. 9 (2020).

2 Treas. Reg. §301.7701-3, Classification of certain business entities.

3 See *Ashland Oil Inc. v. Commr.*, 95 T.C. 348 (1990); *Vetco, Inc. v. Commr.*; 95 T.C. 579 (1990); *Brown Group, Inc. v. Commr.*, 77 F.3d 217 (8th Cir. 1996), *rev'g* 104 T.C. 105, 111 (1995); *Dave Fischbein Manufacturing Co. v. Commr.,* 59 T.C. 338 (1972), *acq.* 1973-2 C.B. 2; *Bausch & Lomb, Inc. v. Commr.*, 71 T.C.M. 2031 (1996); *The Cooper Companies Inc. v. Commr.*, T.C. No. 14816-11 (settlement order entered Feb. 2, 2012). For example, in *Vetco Inc. v. Commr.,* a Swiss C.F.C. entered into a contract manufacturing arrangement with its wholly owned U.K. subsidiary. whereby the U.K. subsidiary assembled oil and gas drilling equipment, from parts and designs provided by its parent corporation, the Swiss C.F.C., in exchange for a fixed fee. At all relevant times, title to the materials was held by the Swiss C.F.C., which bore the full risk of loss. The Swiss C.F.C. did not have any employees, but contracted with various affiliates to handle certain functions, such as purchasing raw materials and components. The U.K. subsidiary earned a fixed fee for its manufacturing services. The Swiss C.F.C. sold the fined products to unrelated purchasers. The I.R.S. contended that Vetco used the Swiss C.F.C. and the U.K. subsidiary to avoid U.S. tax by splitting their sales and manufacturing operations in order to take advantage of Switzerland's lower tax rate. The I.R.S. urged the Tax Court to look past Vetco's "contractual wizardry" and to apply the branch rule as a *loophole-closing device*. The Tax Court rejected the I.R.S.'s argument and agreed with Vetco, who argued that a branch should be distinguished from a wholly owned subsidiary. The Tax Court noted that branches or similar establishments could be established in a foreign country without the stock ownership required of a separately incorporated subsidiary. Accordingly, the branch rule was intended to prevent C.F.C.s from avoiding 954(d)

Secondly, on September 10, 2018, the I.R.S. Large Business and International division ("L.B.&I.") announced the approval of five compliance campaigns, one of them being F.B.C.S.I. and manufacturing branch rules. According to the I.R.S., the goal of this campaign is, 'to identify and select for examination returns of U.S. shareholders of C.F.C.'s that may have underreported subpart F income based on certain interpretations of the manufacturing branch rules. The treatment stream for the campaign will be issue-based examinations.' Practitioners and taxpayers should note that this campaign is still currently active in 2020.[4] Thirdly, Whirlpool case is also important for the court's application of the regulations' tax disparity test and for the court's rejection of Whirlpool's arguments that the operative regulations are invalid.

This article discusses Whirlpool court's analysis and conclusions focusing on whether Whirlpool's position was consistent with the legislative history and the purposes of Subpart F. It is divided in four parts. The first part summarizes the facts. The second part analyzes Whirlpool's foreign tax treatment under the Mexican *maquiladora* program[5] and the Mexico-Luxembourg tax treaty.[6] It will be shown how the 2009 revised structure led to the creation of stateless income. The third part carefully assesses the main issues considered by the Tax Court. The fourth and final part concludes.

BACKGROUND INFORMATION

Operations Before 2009

("Whirlpool") is a Delaware corporation with its principal place of business in Michigan. Whirlpool manufactures and distributes major household appliances, including refrigerators and washing machines, in the U. S. and abroad. Whirlpool owned

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(1) because there would be no transaction with a related person within the meaning of 954(d)(3). In examining the structure of 954(d) and its legislative history, the Tax Court concluded that only specified related-person transactions give rise to F.B.C.S.I. As in *Ashland Oil, Inc. v. Commr.*, the Tax Court rejected I.R.S.'s assertion that the branch rule was intended as a broad *loophole-closing device* to prevent the use of multiple foreign countries to take advantage of lower tax rates in those countries, noting, instead, that legislative history suggests that the term branch should be interpreted narrowly. For a discussion of *Vetco* and those other cases, see Lowell D. Yoder, "The I.R.S. Has Never Won a Subpart F Sales or Services Case," 46 *Tax Mgmt. Int'l J.* 636 (Oct. 13, 2017), Howard J. Levine & Allen J. Littman, "Contracting Out, Not Branching Out: Manufacturing Revisited," 22 *Tax Mgmt. Int'l J.* 343 (July 1993); Richard A. Gordon et al., "Foreign Branches After Ashland Oil," 20 *Tax Mgmt. Int'l* 24 (Jan. 1991); see also Kathleen Matthews, "U.S. Official Discusses Subpart F Rules on Contract Manufacturing," 93 *TNI* 157-4 (Aug. 16, 1993).

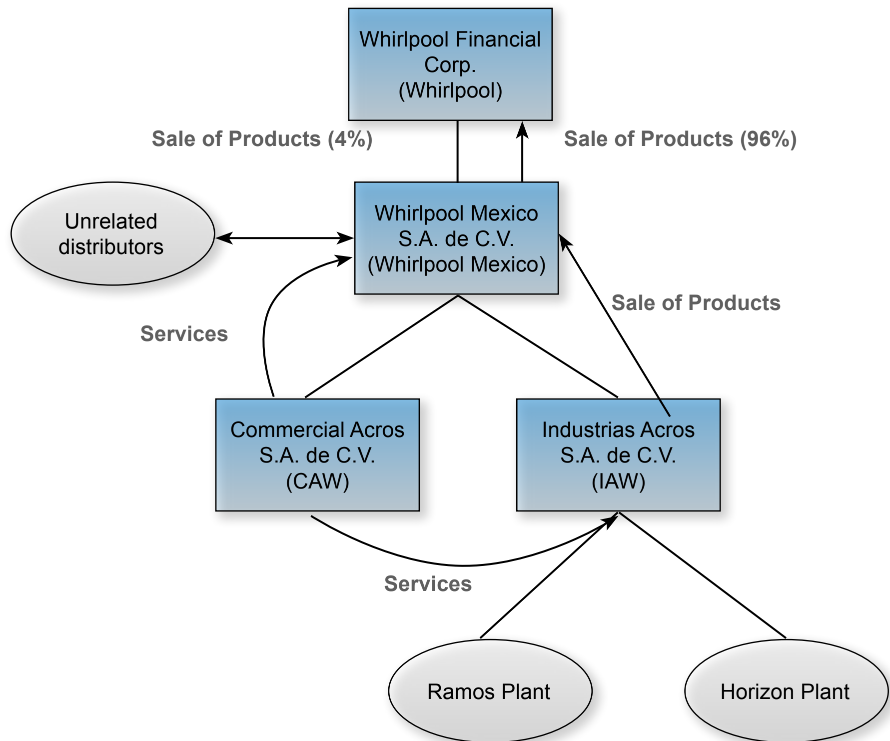
4 Also, over the summer of 2015, the I.R.S. released two International Practice Units ("I.P.U.'s") providing audit guidance regarding cases that Code §954(d)(2) targets, *i.e.*, the use of branches – that are disregarded for U.S. purposes - to avoid foreign base company sales income. For a detailed discussion of those I.P.U.'s see B. Erwin, K. Lobo, and S. Ruchelman, "I.R.S. Releases Subpart F Sales And Manufacturing Rules."

5 See J. Diaz de Leon Galarza, "Tax Reforms to the Maquiladora Regime," 21 *Intl. Transfer Pricing J.* 3 (2014), Journals IBFD (accessed 7 Sep. 2020); W. Hoke, "Maquiladoras Still Coming to Grips With Tough Mexico Tax Reforms," *Tax Analysts*, DOC 2014-23120.

6 Mexico – Luxembourg Income and Capital Tax Treaty (2001) (as amended through 2009).

Whirlpool Mexico, S.A. de C.V. ("Whirlpool Mexico"), a Mexican C.F.C. subsidiary. Whirlpool Mexico owned *Commercial Acros S.A. de C.V.* ("C.A.W.") and *Industrias Acros S.A. de C.V.* ("I.A.W."), both organized under the laws of Mexico. C.A.W. and I.A.W. performed different activities. C.A.W. was the administrative arm of Whirlpool Mexico and I.A.W. was the manufacturing arm. It owned land, buildings, and equipment and employed workers who manufactured refrigerators, washing machines, and other appliances ("Products") at two separate plants in Mexico: the Ramos Plant and the Horizon plant. I.A.W. sold these products to Whirlpool Mexico, which in turn sold the majority of the products (almost 96%) to Whirlpool and the remaining balance to unrelated distributors in Mexico. In the author's opinion, although the Tax Court did not expressly state that, Whirlpool's operations in Mexico before 2009 did not give rise to F.B.C.S.I. due to the "C.F.C. manufacturing exception" as the final products I.A.W. sold were substantially transformed from the raw materials it had purchased.

The following chart represents how Whirlpool's operations were conducted before 2009 Whirlpool Financial Corp.



Description

- CAW provided selling, marketing, finance, accounting, human resources, and other back office services to Whirlpool Mexico and IAW
- IAW owned land, buildings, and equipment and employed workers who manufactured refrigerators, washing machines, and other appliances ("Products") at two separate plants: Ramos plant (1,000,000.00 refrigerators) and Horizon plant (500,000.00 washing machines)
- IAW sold these products to Whirlpool Mexico, which in turn sold the majority of the products to Whirlpool and the remaining balance to unrelated distributors in Mexico.

Revised Structure Effective for TY 2009

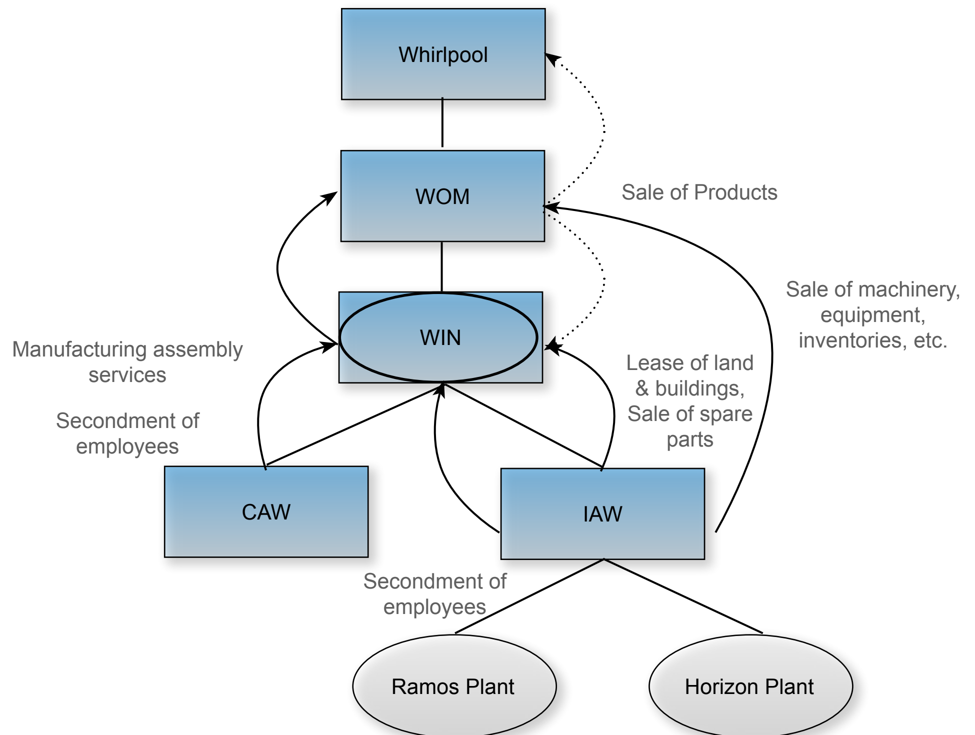
During 2007 and 2008, I.A.W. entered into a series of manufacturing arrangements involving a newly formed Luxembourg corporation Whirlpool Overseas Manufacturing, S.a.r.l. ("LuxCo") and a newly formed Mexican company *Whirlpool Internacional, S. de R.L. de C.V.* ("W.I.N."), in order to obtain significant tax savings. Under the restructured arrangements, I.A.W., the owner of the plants and prior manufacturer, leased to W.I.N. the land and buildings that housed the Ramos and the Horizon manufacturing plants; sold to W.I.N. the spare parts, hand tools and other items needed to support manufacturing activities at those plants; and sold to LuxCo all of the machinery, equipment, furniture, and other assets within the Ramos and Horizon plants, including all raw materials and work-in-progress and finished inventory. In addition, the restructured arrangements ensured that high-level and rank-and-file employees of I.A.W. and C.A.W., the administrative arm of Whirlpool Mexico, were seconded and subcontracted to W.I.N. to perform their respective duties.

Further, W.I.N. entered into an agreement with LuxCo whereby W.I.N. became the lessee of the Ramos and Horizon plants; LuxCo became the owner of the machinery, equipment, inventories, furniture and other assets situated within the Ramos and Horizon plants; LuxCo held title to all raw materials, work-in process and finished goods inventory; and W.I.N., through employees subcontracted from C.A.W. and I.A.W., provided manufacturing and assembly services to LuxCo to produce the goods. As a result, LuxCo became the owner of the manufactured products, which it then sold as finished products to Whirlpool and to W.I.N. for distribution in the U.S. and Mexico, respectively.

"Whirlpool killed two birds with one stone as it got the benefits of both domestic incentive tax regime (Mexican maquiladora program) and enjoyed the benefits of the Mexico-Luxembourg tax treaty to avoid the imposition of Luxembourg income tax."

By doing this, Whirlpool killed two birds with one stone as it got the benefits of both domestic incentive tax regime (Mexican *maquiladora* program) and enjoyed the benefits of the Mexico-Luxembourg tax treaty to avoid the imposition of Luxembourg income tax. For U.S. tax purposes, Whirlpool treated W.I.N. as a disregarded entity and thus treated LuxCo as the company that manufactured and sold the products, much like Whirlpool Mexico did under the old structure. The next part discusses the tax consequences of this revised structure under Mexican domestic tax law and the Mexico-Luxembourg tax treaty.

The following chart represents how Whirlpool's operations were conducted after its restructuring.



Description

- IAW leased to WIN land and buildings that house the Ramos and Horizon plants; sold to WIN spare parts, hand tools and other items needed to support manufacturing activities at those plants; and sold to WOM all of the machinery, equipment, inventories, furniture, and other assets
- Employees of IAW and CAW were seconded and subcontracted to WIN to perform their respective duties
- WIN agreed to supply WOM the services necessary to manufacture the products at the Ramos and Horizon plants using the workers subcontracted to it from CAW and IAW
- WOM in exchange supplied "free of charge" machinery, equipment, and raw materials necessary to manufacture the products
- WOM retained all right, interest to all raw materials, work in process, and finished goods inventory at all times during the manufacturing process
- WOM invoiced the products at the end of manufacturing process with title and risk of loss passing to Whirlpool and WIN at that point

FOREIGN TAX CONSIDERATION

Under the Mexican Income Tax Law (M.I.T.L.), companies resident in Mexico were subject to tax during 2009 at a 28% rate on their worldwide income. Non-resident companies operating through a permanent establishment ("P.E.") in Mexico were likewise subject to tax at a 28% rate on all income attributable to the P.E.

For many years Mexico has had in a place an incentive "*maquiladora* program" as set forth in the Decree for the Promotion of the Manufacturing Industry, *Maquiladora* and Exportation Services ("I.M.M.E.X. Decree"). This program was designed to promote Mexico's industrial development, generate new employment and increase the level of foreign direct investments.

In order to benefit from the *maquiladora* tax and trade incentives, the following three requirements must be satisfied: (i) the foreign principal (LuxCo) provides machinery, equipment, and raw materials to the resident *maquiladora* company (W.I.N.) so that the latter may import such assets and inventory temporarily into Mexico on a tax-free basis; (ii) the *maquiladora* (W.I.N.) must use the machinery, equipment and raw materials to provide manufacturing and assembly services pursuant to the intercompany agreements, in addition to some ancillary tasks dealing with the custody, warehousing and transportation of the imported and finished goods; (iii) the *maquiladora* (W.I.N.) must return (export) the finished goods and assets within certain deadlines.[7]

As LuxCo's activities conducted in Mexico through W.I.N. qualified for the *maquiladora* treatment, W.I.N.'s manufacturing income earned under its assembly agreements with LuxCo was taxed at the preferential 17% tax rate rather than the general corporate tax rate of 28%. In addition, by locating its manufacturing operations in Mexico, LuxCo would ordinarily be considered to have a P.E. in Mexico.[8] However, under Mexican law, provided that W.O.M. and W.I.N. satisfied specified transfer-pricing requirements, LuxCo was deemed to have no P.E. in Mexico and was thus exempt from Mexican income tax.

Surprisingly or not, the results under treaty and Luxembourg domestic law were quite different. Paragraph 1 of Article 7 (Business Profits) of the Mexico-Luxembourg Income Tax Treaty ("the Treaty") provides as follows, as translated into English:

> The profits of an enterprise [LuxCo] of a Contracting State (Luxembourg) shall be taxable only in that State [Luxembourg]unless the enterprise carries on business in the other Contracting State [Mexico] through a permanent establishment situated therein [W.I.N.]. If the enterprise [LuxCo] carries on business as aforesaid, the profits of the enterprise [LuxCo] may be taxed in the other State (Mexico) but only so much of them as is attributable to:
>
> a. that permanent establishment [W.I.N.];
>
> b. sales in that other State [Mexico] of goods or merchandise of the same or similar kind as the goods or merchandise through that permanent establishment [W.I.N.].
>
> However, the profits derived from the sales described in subparagraph (b) shall not be taxable in the other Contracting State [Mexico] if the enterprise (LuxCo) demonstrates that such sales have been carried out for reasons other than obtaining a benefit under this Convention.[9]

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7 See J. Diaz de Leon Galarza, *supra* note 5.

8 LuxCo would ordinarily be considered to have a P.E. in Mexico because it owned the equipment, tooling, raw materials, component parts, supplies, and inventories used in its Mexican manufacturing operations, as well as because it used fixed places of business at the Ramos and Horizon manufacturing plants and sold in Mexico some of the refrigerators and washing machines it produced.

9 Art. 7 of the Treaty.

In this regard, an English translation of Paragraph 1 of Article 5 (Permanent Establishment) of the Treaty defines permanent establishment as, "a fixed place of business through which the business of an enterprise is wholly or partly carried on." In Paragraph 2, the term "permanent establishment" includes especially: (i) a place of management; (ii) a branch; (iii) an office; (iv) a factory; (v) a workshop; and (vi) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.[10] As can be seen, the Treaty is relatively standard.

LuxCo took the position that it had a P.E. in Mexico because it: (i) owned equipment, raw materials, component parts, supplies, and inventory used in its Mexican manufacturing operations; (ii) used fixed places of business in Mexico whereby it regularly conducted commercial activities; and (iii) sold products in Mexico. This position was also "certified" by a ruling that LuxCo obtained from the Luxembourg tax authorities stating that it had a P.E. in Mexico and that all income earned under its supply agreements with Whirlpool and W.I.N. was attributable to that P.E. The end result was that LuxCo paid no tax to Luxembourg on the income earned from the sale of finished products.[11] But also, most importantly, none of the income derived by LuxCo under its supply agreements was subject to tax in the U.S. under subpart F. LuxCo took the position that its sales income was not F.B.C.S.I. under Code §954(4)(1) because the final products it sold were substantially transformed by W.I.N. from the raw materials it had purchased.

THE I.R.S. CHALLENGE

After examining Whirlpool's tax return, the I.R.S. issued a notice of deficiency that determined that LuxCo's sale of products to Whirlpool and W.I.N. gave rise to F.B.C.S.I. of approximately $50 million. The I.R.S. included that sum in Whirlpool's income under Code §§954(d) and 951(a). After petitioning the Tax Court, Whirlpool filed motions for partial summary judgment contending that LuxCo's sales income was not F.B.C.S.I. under Code §954(d)(1) because the final products it sold were substantially transformed by W.I.N. from the raw materials it had purchased. The I.R.S. opposed that motion, contending that genuine disputes of material fact exist as to whether LuxCo actually manufactured the products. The parties filed cross-motions for partial summary judgment. The main question was whether the sales income was F.B.C.S.I. under Code §954(d)(2), the so-called "branch rule."

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10 Art. 5 of the Treaty.

11 Luxembourg was prohibited under the Treaty from taxing the income, even though Mexico elected not to tax it as long as LuxCo and W.I.N. remained complaint with the *maquiladora* program. See art. 23(1)(a) of the Mexico – Luxembourg Income and Capital Tax Treaty (2001) (as amended through 2009):

> Subject to the provisions of the law of Luxembourg regarding the elimination of double taxation which shall not affect the general principle hereof, double taxation shall be eliminated as follows: [w]here a resident of Luxembourg [LuxCo] derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in Mexico, Luxembourg shall, subject to the provisions of subparagraphs (b) and (c), exempt such income or capital from tax, but may, in order to calculate the amount of tax on the remaining income or capital of the resident, apply the same rates of tax as if the income or capital had not been exempted.

U.S. TAX GOVERNING STATUTORY STRUCTURE

Before 1962 the income of a foreign corporation, even one wholly owned by U.S. shareholders, generally was not subject to current U.S. income tax but only when repatriated in the form of a dividend. This system incentivized U.S. corporations to shift passive and highly mobile income abroad, particularly to subsidiaries in low-tax jurisdictions. Congress enacted Subpart F to inhibit the accumulation of earnings by base companies in tax haven countries by adding Code §§951-964.[12]

"To better understand the governing statutory structure behind the Whirlpool's case, especially Code §954(a)(2) on F.B.C.S.I., it is necessary to discuss the case law which led Congress to enact Subpart F."

To better understand the governing statutory structure behind the Whirlpool's case, especially Code §954(a)(2) on F.B.C.S.I., it is necessary to discuss the case law which led Congress to enact Subpart F. The case is *E.I. Du Pont de Nemours & Co. v. U.S.* ("*Du Pont*,") which was decided by the U.S. Court of Claims on October 17, 1979.[13] Although the issue at stake there concerned the I.R.S.' reallocation of profits between the parent corporation and its wholly owned subsidiary on the sale of chemical products, the facts of *Du Pont* are very helpful in understanding the concept of F.B.C.S.I. and the reasons why Congress enacted Subpart F. Du Pont, the American chemical concern, had various subsidiaries in various high-tax jurisdictions, such as France, Germany, Italy, United Kingdom etc. Du Pont wanted to engage in transfer pricing tax planning, little would have been accomplished other than to shift profits and tax from the United States to all of these other countries that imposed tax at effective rates similar to those in the United States.

A decreasing volume of domestic sales, increasing profits on exports, and the recent formation of the Common Market in Europe convinced Du Pont's president of the need to form an international sales subsidiary. As such, Du Pont created early in 1959 a wholly-owned Swiss marketing and sales subsidiary for foreign sales – Du Pont International S.A. ("D.I.S.A."). Thus, Du Pont's tax strategy was simple and unsophisticated in terms of today's standards: it first sold most of its chemical products marketed abroad to D.I.S.A., at prices *below* fair market value which then arranged for resale, at prices *above* fair market value, to the ultimate consumer through independent distributors. D.I.S.A. did not provide any technical services to nor did it perform any work on these products. The products D.I.S.A. purchased and resold were substantially the same. Not surprisingly, the result was that D.I.S.A. was able to accumulate large, tax-free profits in Switzerland which were used to finance capital improvements and further foreign investments in Western Europe.

Ultimately, the I.R.S. was able to win the case after 20 years of litigation[14] but, in the meantime, it went to the Department of the Treasury ("Treasury") and asked for some rules against these situations because it was too hard to litigate them on

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12 See Revenue Act of 1962, Pub. L. No. 87-834, sec. 12, 76 Stat. at 1006.

13 608 F.2d 445 (Fed. Cir. 1979).

14 The I.R.S. found several Du Pont's internal memoranda with references to tax advantages, particularly in planning prices on goods to be sold to D.I.S.A.

> It would seem to be desirable to bill the tax haven subsidiary at less than an 'arm's length' price because: (1) the pricing might not be challenged, by the revenue agent; (2) if the pricing is challenged, we might sustain such transfer (3) if we cannot sustain the prices used, a transfer price will be negotiated which should not be more than an 'arm's length' price and might well be less; thus we would no worse off than we would have been had we billed at the higher price.

a transfer pricing base. As a result, in 1962, Congress enacted Subpart F and the F.B.C.S.I. rules which can be seen as a backstop against transfer pricing abuse.

According to Code §954(d)(1), F.B.C.S.I. means income (whether in the form of profits, commissions, fees, or otherwise) that meets two tests.

The first test is that the income is derived in connection with any of the following activities:

- The purchase of personal property from a related person and its sale to any person.
- The sale of personal property to any person on behalf of a related person.
- The purchase of personal property from any person and its sale to a related person.
- The purchase of personal property from any person on behalf of a related person.

The second test is that the property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is

- manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized; and
- sold for use, consumption, or disposition outside such foreign country, or in the case of property purchased on behalf of a related person, is purchased for use, consumption, or disposition outside such foreign country.[15]

Also, the F.B.C.S.I. rules contain a foreign branch rule that can cause a portion of sales income to be Subpart F income. According to Code §954(d)(2), for purposes of determining F.B.C.S.I. in situations in which the carrying on of activities by a controlled foreign corporation (LuxCo) through a branch or similar establishment (W.I.N.) located outside the country of incorporation of the controlled foreign corporation (Luxembourg) has substantially the same effect as if the branch or similar establishment (W.I.N.) were a wholly owned subsidiary corporation deriving such income. Under the branch rule, the I.R.S. is authorized to prescribe regulations defining when the carrying on of activities of such branch or similar establishment (W.I.N.) is to be treated as income derived by a wholly owned subsidiary of the controlled foreign corporation (LuxCo) so that F.B.C.S.I. is deemed to be generated by the controlled foreign corporation (LuxCo).[16]

While enacting Subpart F and the F.B.C.S.I. rules, Congress was concerned that, by artificially separating sales income from manufacturing income both U.S. and foreign tax would have been avoided. In today's parlance, Congress was concerned with the creation of "stateless" income This is described in legislative history as follows:

> Your committee also has ended deferral for American shareholders in certain situations where the multiplicity of foreign tax systems has been taken advantage of by American-controlled businesses to

[15] See Code §954(d)(1).

[16] See Code § 954(d)(2).

> siphon off sales profits from goods manufactured by related parties either in United States or abroad. In such cases the separation of the sales function is designed to avoid either U.S. tax or tax imposed by the foreign country.[17]

The 2009 revised corporate structure was particularly advantageous for LuxCo being incorporated in Luxembourg that employs a territorial system of taxation as it would pay no tax to Luxembourg on income sourced through W.I.N. in Mexico, thus creating the possibility that Whirlpool could achieve indefinite deferral of both U.S. and foreign taxes. The legislative history goes on and describes F.B.C.S.I. in the following terms:

> [It is] income from the purchase and sale of property without any appreciable value being added to the product by the selling corporation. This does not, for example, include cases where any significant amount of manufacturing, installation, or construction activity is carried on with respect to the product by the selling corporation. On the other hand, activity such as minor assembling, packaging, repackaging, or labeling would not be sufficient to exclude the profits from this definition.[18]

Congress considered F.B.C.S.I. as particularly subject to being moved abroad to a shell corporation in a low-tax jurisdiction without any significant impact on the company's actual business operations. In this regard legislative history stated:

> The sales income with which your committee is primarily concerned is income of a selling subsidiary (whether acting as a principal or agent) which has been separated from manufacturing activities of a related corporation merely to obtain a lower rate of tax for the sales income. As a result, this provision is restricted to sales of property to a related person or purchases of property from a related person. Moreover, since the lower tax rate for such a company is likely to be obtained through purchases and sales outside of the country in which it is incorporated, the provision is made inapplicable to the extent the property is manufactured, produced, grown, or extracted in the country where the corporation is organized or where it is sold for use, consumption, or disposition in that country. Mere passage of title, however, is not intended to be determinative of the location of the purchase or sale for this purpose.[19]

The legislative history then concluded with the following statement as to the scope of F.B.C.S.I.:

> Also included in foreign base company sales income are operations handled through a branch (rather than a corporate subsidiary) operating outside of the country in which the controlled foreign corporation is incorporated, if the combined effect of the tax treatment accorded the branch, by the country of incorporation of the controlled foreign corporation and the country of operation of the branch, is

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[17] BNA Legislative History, Sec. 951, The Revenue Act of 1962 (P.L. 87-834) at p. 58.

[18] See *supra* note at p. 62.

[19] See *supra* note at p. 62.

to treat the branch substantially the same as if it were a subsidiary corporation organized in the country in which it carries on its trade or business.[20]

ISSUES CONSIDERED BY THE TAX COURT

Manufacturing Exception

The first issue that the Tax Court considered was whether LuxCo could itself be considered to have purchased personal property from unrelated suppliers and sold it to a related person, *i.e.* Whirlpool and W.I.N. In this regard, Treas. Reg. §1.954-3(a)(4)(i) provides for a so-called "manufacturing exception,"[21] under which income of a C.F.C. from the manufacture and sale of property is not F.B.C.S.I. subject to the Code §954(d)(2) branch rule if the C.F.C. performed any of the following tasks:

"The first issue that the Tax Court considered was whether LuxCo could itself be considered to have purchased personal property from unrelated suppliers and sold it to a related person ..."

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20 BNA Legislative History, Sec. 954, The Revenue Act of 1962 (P.L. 87-834) at p. 84. When section 954(d)(2) was first proposed, it met the resistance of almost all of the witnesses who participated in the hearings before the Finance Committee. Comments included:

> We are opposed to this provision. We see no reason for permitting the Treasury in effect to disregard the form of business organization adopted by the controlled foreign corporation in such circumstances * * *
>
> In a nutshell, this provision will interfere with normal business decisions, will cause some existing branches to be abandoned with a resulting decrease in foreign sales, and will deter U.S. businesses from setting up manufacturing subsidiaries in any underdeveloped country which does not itself provide a sufficient potential market for the product * * *
>
> The entire provision is vague and uncertain in the extreme. Its application and operation are so uncertain that comment upon the provision is most difficult. Many foreign countries do not tax corporations organized under their laws with respect to income attributable to branches located in other countries. * * *
>
> In such cases it would appear that section 954(d)(2) might well lead those countries not taxing branch income to impose a "soak-up" tax on U.S. controlled corporations organized under their laws, but not on their foreign competitors.

21 Treas. Reg. 1.954-3(a)(4)(i): "Foreign base company sales income does not include income of a controlled foreign corporation derived in connection with the sale of personal property, manufactured, produced, or constructed by such corporation in whole or in part from personal property which it has purchased. *A foreign corporation will be considered,* for purposes of this subparagraph*, to have manufactured, produced, or constructed personal property which it sells if the property sold is in effect not the property which it purchased.* In the case of the manufacture, production, or construction of personal property, the property sold will be considered, for purposes of this subparagraph, as not being the property which is purchased if the provisions of subdivision (ii) or (iii) of this subparagraph are satisfied." (Emphasis added.)

- It substantially transformed the product.[22]
- It conducted substantial activities in incorporating component parts.[23]
- It made a substantial contribution to the manufacturing.[24]

In *Whirlpool*, the I.R.S. contended that LuxCo and W.I.N. did not actually perform or contribute meaningfully to any manufacturing operations. Treas. Reg. 1.954-3(a)(4)(i) proposed in 2008 and finalized in 2011 provide that the manufacturing exception can be satisfied only by looking to the activities of the C.F.C.'s own employees.[25]

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22 Treas. Reg. 1.954-3(a)(4)(ii): "If purchased personal property is substantially transformed prior to sale, the property sold will be treated as having been manufactured, produced, or constructed by the selling corporation."

23 Treas. Reg. 1.954-3(a)(4)(iii): "If purchased property is used as a component part of personal property which is sold, the sale of the property will be treated as the sale of a manufactured product, rather than the sale of component parts, if the operations conducted by the selling corporation in connection with the property purchased and sold are substantial in nature and are generally considered to constitute the manufacture, production, or construction of property. Without limiting this substantive test, which is dependent on the facts and circumstances of each case, the operations of the selling corporation in connection with the use of the purchased property as a component part of the personal property which is sold will be considered to constitute the manufacture of a product if in connection with such property conversion costs (direct labor and factory burden) of such corporation account for 20 percent or more of the total cost of goods sold. In no event, however, will packaging, repackaging, labeling, or minor assembly operations constitute the manufacture, production, or construction of property for purposes of section 954(d)(1)."

24 Treas. Reg. 1.954-3(a)(4)(iv)(a) added by T.D. 9438, is effective after 6/30/09: "If an item of personal property would be considered manufactured, produced, or constructed (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) prior to sale by the controlled foreign corporation had all of the manufacturing, producing, and constructing activities undertaken with respect to that property prior to sale been undertaken by the controlled foreign corporation through the activities of its employees, then this paragraph (a)(4)(iv) applies. If this paragraph (a)(4)(iv) applies and if the facts and circumstances evince that the controlled foreign corporation makes a substantial contribution through the activities of its employees to the manufacture, production, or construction of the personal property sold, then the personal property sold by the controlled foreign corporation is manufactured, produced, or constructed by such controlled foreign corporation."

25 Treas. Reg. 1.954-3(a)(4)(i) after amendment by T.D. 9438, is effective after 6/30/09: "Foreign base company sales income does not include income of a controlled foreign corporation derived in connection with the sale of personal property manufactured, produced, or constructed by such corporation. *A controlled foreign corporation will have manufactured, produced, or constructed personal property which the corporation sells only if such corporation satisfies the provisions of paragraph (a)(4)(ii), (a)(4)(iii), or (a)(4)(iv) of this section through the activities of its employees (as defined in § 31.3121(d)-1(c) of this chapter) with respect to such property. A controlled foreign corporation will not be treated as having manufactured, produced, or constructed personal property which the corporation sells merely because the property is sold in a different form than the form in which it was purchased* …" (Emphasis added.)

The preamble to the regulations states that: "[t]his definition of the term 'employee' may encompass certain seconded workers, part-time workers, workers on the payroll of a related employment company whose activities are directed and controlled by C.F.C. employees, and contractors, so long as those individuals are deemed to be employees of the C.F.C. under § 31.3121(d)-1(c)."

“The Tax Court ... decided the case under the branch rule of Code §954(d)(2).”

Neither LuxCo nor W.I.N. themselves had employees who performed manufacturing activities, as such activities were performed by employees of C.A.W. and I.A.W. The Tax Court stated that the 2011 version of the regulation did not apply to the years at issue, but it did not decide whether the 2002 version of the regulations required the manufacturing activities to be carried out by the C.F.C., itself.

In Rev. Rul. 75-7, revoked by Rev. Rul. 97-48, the I.R.S. held that, for purposes of applying the C.F.C. manufacturing exception, the manufacture, production, or construction activities need not be performed by the C.F.C.'s own employees. Rather, the C.F.C. could, under certain circumstances, subcontract those manufacturing activities to another person (including persons not related under 954(d)(3) and have those third-party activities attributed to itself for purposes of meeting the C.F.C. manufacturing exception. The I.R.S. issued a number of private rulings that followed Rev. Rul. 75-7 prior to its revocation, attributing the activities of a contract manufacturer to a hiring C.F.C. for purposes of qualifying the C.F.C. for the manufacturing exception to F.B.C.S.I.

In addition, the Tax Court in *Electronic Arts v. Commr.,* 118 T.C. 226 (2002), stated the following at p. 265.

> Our examination of (1) section 936(h)(5)(B)(ii) and the legislative history of that provision's enactment in 1982, and (2) section 954(d)(1)(A) and the legislative history of that provision's enactment in 1962, convinces us that there is not an absolute requirement that only the activities actually performed by a corporation's employees or officers are to be taken into account in determining whether the corporation manufactured or produced a product in a possession, within the meaning of sections 936(h)(5)(B)(ii) and 954(d)(1)(A).

Other cases have generally concluded that, in the absence of a specific definition of manufacturing, a person is the manufacturer of products even though its employees do not physically manufacture the products if the person

- controls the manufacturing process;,
- provides the intangible property necessary to the manufacturing process, and
- is the economic entrepreneur who enjoys the benefits and assumes the risks associated with the products.

See, *e.g.*, *Charles Peckat Mfg. Co. v. Jarecki*, 196 F.2d 849 (7th Cir. 1952) and *Polaroid Corp v. U.S*., 235 F. 2d 276, 277 (1st Cir. 1956).[26]

Application of the Branch Rule

The Tax Court took a different approach to the issue. It decided the case under the branch rule of Code §954(d)(2). As mentioned above, under the manufacturing branch rule of Code §954(d)(2), when: (i) LuxCo conducts manufacturing outside its country of incorporation (Luxembourg) by or through a branch or similar establishment (W.I.N.) and (ii) the use of the branch (W.I.N.) has substantially the same tax effect as if the branch were a wholly owned subsidiary deriving the income, the

[26] For a more detailed analysis of these I.R.S. rulings and Court cases, see Yoder, Lyon, and Noren, 6240 T.M., “C.F.C.s – Foreign Base Company Income (Other than FPHCI),” at pp. A67 thru A-72.

manufacturing branch (W.I.N.) and the remainder of the C.F.C. (LuxCo) are treated as separate corporations for purposes of the F.B.C.S.I. rules. Consequently, the sales made by or through the remainder of the C.F.C. (LuxCo) are treated as made on behalf of the manufacturing "separate corporation" (W.I.N.), which generally results in F.B.C.S.I.

The Tax Court found that the two conditions to the application of the branch rule applied in Whirlpool's facts. In particular, the Tax Court noted that LuxCo manufactured the products in Mexico using assets that it owned in Mexico (machinery, equipment, raw materials, and inventory) and services provided by W.I.N., which elected to be disregarded as a separate entity, making it a branch of LuxCo. In the view of the court, this mode of operation had substantially the same effect as if W.I.N. were a wholly owned subsidiary of LuxCo.

> By carrying on its activities through W.I.N. in Mexico, LuxCo avoided any current taxation of its sales income. It thus achieved "substantially the same effect" – deferral of tax on its sales income – that it would have achieved under U.S. tax rules if W.I.N. were a wholly owned subsidiary deriving such income. That is precisely the situation that the statute covers … Even without the refinements supplied by the regulations implementing Section 954(d)(2), the bare text of the statute, literally read, indicates that LuxCo's sales income is F.B.C.S.I. that must be included in Whirlpool's income under Subpart F.

Evaluation of Branch Rule Under Treas. Reg. Sec. 1.954-3(b)

The Tax Court then continued to evaluate the application of the branch rule under Treas. Reg. §1.954-3(b). As noted by the Tax Court, the text of the regulation "is […] quite dense, and […] not one that Ernst Hemingway would have written," and dictates a two-phase inquiry. First, there is an allocation of income between the branch (W.I.N.) and the remainder of the C.F.C. (LuxCo). Then, a comparison is made between actual and hypothetical "effective rates of tax" ("E.T.R.s") applicable to the sales income allocated to the remainder (LuxCo).

With regard to the first phase, the Tax Court noted that activities and income of LuxCo and W.I.N. can be separated quite easily given that the two are separate corporations. W.I.N. earned all of the manufacturing income, and all of the sales income was allocable to the remainder of LuxCo. The Tax Court then applied the tax rate disparity test under Treas. Reg. §1.954-3(b)(1)(ii)(b) by looking at the actual Luxembourg E.T.R. and the hypothetical Mexican E.T.R. The Tax Court noted that LuxCo, as a foreign principal under the *maquiladora* program, was deemed to have no P.E. in Mexico and thus was not subject to tax in Mexico. At the same time, for Luxembourg tax purposes, LuxCo was deemed to have a P.E. in Mexico and thus was not subject to tax in Luxembourg. Accordingly, LuxCo paid no tax to either jurisdiction in 2009. The actual Luxembourg E.T.R. was thus 0%.

The next step in the analysis was to determine the E.T.R. that would apply to the sales income under Mexican law if LuxCo were a Mexican corporation doing business in Mexico through a P.E. in Mexico and deriving all of its income from Mexican sources allocable to that P.E. In making the analysis, the Tax Court did not look to the 17% reduced rate applicable to *maquiladora* companies. Rather, it looked at the 28% rate applicable to Mexican corporations generally. As a 0% rate is less than 90% of and is more than 5 percentage points below the 28% rate, LuxCo's use of

W.I.N. in Mexico was considered to have had substantially the same tax effect as if the branch were a wholly owned subsidiary corporation. Whirlpool would have passed the tax rate disparity test if the effective Luxembourg tax rate and hypothetical Mexican tax rate were 24.2% and 28% or 0 and 0.56%, respectively.[27]

The approach undertaken by the I.R.S. in determining whether the tax rate disparity test is met resembles Prof. Avi-Yonah's single tax principle ("S.T.P."), which states that cross-border income should be taxed only once at the source-country rate for active income and at the residence-country rate for passive income. But if the preferred country (*i.e.*, source for active, and residence for passive) does not tax, it is incumbent upon the other country to do so because otherwise double non-taxation would result.[28] In other words, having determined that LuxCo has a P.E. in Mexico and that all but a small portion of its profits are attributable to W.I.N. under the Treaty, in the event that Mexico elects not to tax the income due to its domestic tax incentives, Luxembourg should tax the income even though is prohibited from doing so under the Treaty.

As explained by Lowell Yoder in his article soon before the decision was rendered,[29] the I.R.S. in *Whirlpool* argued that the actual tax rate on income of the home office must be calculated by attributing to the Luxembourg home office any income that is not subject to tax in Mexico or Luxembourg. For example, let us assume that $100 of income arises from the sale by LuxCo to a related person of products manufactured in Mexico. Under Luxembourg tax laws, and pursuant to a tax ruling, $95 of income is attributed to a Mexican P.E. (W.I.N.) and therefore only $5 of income is considered as derived by the home office in Luxembourg (LuxCo). That office had one administrative employee, who likely was housed in a "substance office" in Luxembourg. The $5 allocated to that office would have been subject to a 25% tax rate in Luxembourg. Under Mexican tax laws, only $5 of income from selling products manufactured in Mexico by LuxCo (which owned the tooling, raw materials, work in process and finished products located in Mexico) was taxable in Mexico. The tax rate was 28%. On the surface, the tax rates appear to be comparable. However, in *Whirlpool*, the I.R.S. argued and the Tax Court held that for purposes of determining the actual effective rate of tax on purchasing or selling income in the home office (LuxCo), the $90 of income not subject to tax in any country should be deemed to be derived by LuxCo. This is certainly one of the most controversial aspects that the 6th Circuit will have to look into when examining the Tax Court's decision in *Whirlpool* and determining whether there is authority supporting I.R.S.'s novel approach to applying the tax rate disparity test or reaffirming the principle that the statutory

27 PLR 200945036 (Nov. 6, 2009); PLR 200942034 (Oct. 16, 2009). See Yoder, "Local Law Governs Manufacturing Branch Determinations," 36 *Int'l Tax J.* 3 (July-Aug. 2010). AM 2015-002 (Feb. 13, 2015), see Yoder, "I.R.S. Provides Guidance for Calculating The Subpart F Branch Rule's Tax Disparity Test," *Tax Management Weekly Report (BNA)* (Feb. 8, 2016).

28 Reuven. S. Avi-Yonah, "Who Invented the Single Tax Principle?: An Essay on the History of US Treaty Policy" N.Y.L. Sch. L. Rev. 59, no. 2 (2015): 305-15.

29 Lowell D. Yoder, "Subpart F Sales Income: The 'Whirlpool' Case," *International Journal (BNA)* (Jan. 10, 2020).

branch rule does not treat as F.B.C.S.I. any income attributed to a C.F.C.'s home office, but only the income derived in a foreign branch.[30]

Are Manufacturing Branch Regulations Valid?

Finally, the Tax Court rejected Whirlpool's argument that the manufacturing branch regulations are invalid because they exceed Treasury's authority. Whirlpool's argument was that, based on the plain language of Code §954(d)(2), the branch rule applies only in situations where a C.F.C. conducts manufacturing activities and has a sales branch, not in the situation at issue where LuxCo conducts sales activities and has a manufacturing branch in Mexico, W.I.N.. The Tax Court thus turned to Chevron two-step test for assessing the validity of the regulations. The Tax Court stated that legislative history of subpart F leaves no doubt about Congress' intent as it indicated a concern about a tax motivated separation of a sales function from a manufacturing function. This is the second most controversial aspect of the Tax Court's decision in *Whirlpool*.

> ***"[T]he Tax Court rejected Whirlpool's argument ... based on the plain language of Code §954(d)(2), the branch rule applies only in situations where a C.F.C. conducts manufacturing activities and has a sales branch ..."***

In 1965, Stanley R. Fimberg was one of the first to study the language of Code §954(d)(2). He provided three different readings of Code §954(d)(2). Section 954(d)(2) reads as follows:

> For purposes of determining foreign base company sales income in situations in which the carrying on of activities by a controlled foreign corporation through a branch or similar establishment outside the country of incorporation of the controlled foreign corporation has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving *such income*, under regulations prescribed by the Secretary the income attributable to the carrying on of such activities of such branch or similar establishment shall be treated as income derived by a wholly owned subsidiary of the controlled foreign corporation *and shall constitute foreign base company sales income of the controlled foreign corporation*. (Emphasis added.)

For Stanley Fimberg, absent this emphasized language, there would be no problem in interpreting Code §954(d)(2) in such manner as to make it applicable to

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[30] Andrew Velarde, "Whirlpool to Appeal Tax Court Manufacturing Branch Rule Decision," *Tax Notes Federal*, (Jul. 27, 2020); see also Whirlpool 10-Q, Quarterly Report, (Jul. 23, 2020) at p. 29:

> During its examination of Whirlpool's 2009 U.S. federal income tax return, the I.R.S. asserted that income earned by a Luxembourg subsidiary via its Mexican branch should be recognized as income on its 2009 U.S. federal income tax return. The Company believed the proposed assessment was without merit and contested the matter in United States Tax Court (US Tax Court). Both Whirlpool and the I.R.S. moved for partial summary judgment on this issue. On May 5, 2020, the US Tax Court granted the I.R.S.'s motion for partial summary judgment and denied Whirlpool's. The Company intends to appeal the US Tax Court decision to the United States Sixth Circuit Court of Appeals. The Company believes that it will be successful upon appeal and has not recorded any impact of the US Tax Court's decision in its consolidated financial statements.

manufacturing branches.[31] His question was whether such emphasized language could have prevented a court from applying the branch rule to manufacturing branches.

According to his first interpretation,[32] which is the strictest and most literal reading, Code §954(d)(2) was intended to cover only sales activities conducted through a branch. Section 954(d)(2) did not intend to cover manufacturing activities conducted through a branch. Thus, the emphasized language "such income" refers back to the sales income generated by the branch and indicates that such income shall constitute F.B.C.S.I. of the C.F.C.. According to Mr. Fimberg, this is not the only plausible construction of the statute.

A second possible construction of the statutory language would be to construe Code §954(d)(2) as applying to the branch, no matter what activities the branch is engaged in, *i.e.* manufacturing or selling activities. According to Fimberg, the income derived by a branch which has the requisite tax savings effect will be considered F.B.C.S.I., even though such branch is engaged in manufacturing and the selling is done by the remainder of the C.F.C. This construction results in the conversion of what would have been manufacturing income, if the activities had been conducted through a separate wholly owned subsidiary, to F.B.C.S.I. But, according to Mr. Fimberg, the conversion of manufacturing income into F.B.C.S.I. makes so little sense from the standpoint of proper interpretation of the overall statute that this construction was not advanced by the regulations.[33]

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[31] As mentioned above, see *supra* note n. 22, section 954(d)(2) was highly criticized by almost everyone who participated in the hearings before the Finance Committee. On October 3, 1962, Senator Carson added the following,

> My attention has been called to a serious ambiguity in connection with the language in proposed section 954(d)(2), found in section 12 of the bill. This concerns itself with treating a separate foreign wholly owned subsidiary, when the branch is located outside the country of incorporation of that controlled foreign corporation. The Secretary of the Treasury, under this section, is given the power to prescribe regulations for the purposes of treating as foreign base company sales income, certain income attributable to the carrying on of activities of this type of branch. This section has been criticized because the language might subject to tax the income of a branch which would not be treated as foreign base company sales income if it had been derived by a separate controlled foreign subsidiary. This was never intended. I want to set the record straight. The purpose of section 954(d)(2) is to treat as foreign base company sales income only such items of income of the branch which would have constituted foreign base company sales income to a controlled foreign corporation incorporated where the branch is located and performing the same or similar activities and functions. It was never intended that this section could be used to broaden the types of income, subject to tax under section 12, beyond those encompassed by these provisions when earned by controlled foreign corporations.

[32] Stanley R. Fimberg, "The Foreign Base Company Engaged in Selling Activities: A Reappraisal of the Conduct of Foreign Business," 17 *MAJOR TAX PLAN*. 237 (1965), at pp. 267-268.

[33] See *supra* note at p. 268.

Mr. Fimberg's opinion is that such emphasized language was

> intended only to prevent a constructive dividend, which constructive dividend was possible only in the sales branch case. Unless "such income" of a sales branch constitutes "foreign base company sales income of the controlled foreign corporation," there would be a substantial possibility that after the creation of the branch and the allocation of income thereto, in order to explain how the income actually got back to the remainder of the corporation, the branch would be treated as distributing a dividend to the remainder of the corporation. Thus, in the case of a sales branch, this emphasized language is very important. On the other hand, where manufacturing occurs in a branch, there is no need to provide special language in order to avoid a constructive distribution, since the sales income is already considered to be income of the remainder of the corporation and Subpart F does not, by its terms, deal with the manufacturing income. Therefore, in the manufacturing branch case, this phrase could be treated as surplusage and ignored.[34]

"[A] C.F.C.'s use of a manufacturing branch presented similar tax savings effect as the C.F.C.'s use of a purchasing or sales branch ..."

According to Stanley Fimberg[35] and Lowell Yoder,[36] when the Treasury Department and the I.R.S. promulgated the manufacturing branch rule, they believed that a C.F.C.'s use of a manufacturing branch presented similar tax savings effect as the C.F.C.'s use of a purchasing or sales branch, and that the manufacturing branch rule in the regulations therefore, is within the scope of Congress' intended purpose of Code §954(d)(2). Otherwise, an apparent loophole would have existed if manufacturing branches were not covered as taxpayers could easily avoid taxation simply by switching the functions around, placing the sales activities in the C.F.C. rather than in the branch. There is no doubt that Stanley Surrey would have regarded this as an absurd result.

In conclusion, as of consequence of Code §954(d)(2), W.I.N. is deemed to be a wholly owned subsidiary of LuxCo and LuxCo is deemed to have sold products to Whirlpool and W.I.N. on behalf of its deemed Mexican subsidiary. LuxCo thus derived income in connection with the sale of personal property to any person on behalf of a related person. Products were manufactured outside Luxembourg and were sold for use or consumption outside Luxembourg. LuxCo's sale income thus constituted F.B.C.S.I. under Code §954(d) and was taxable to Whirlpool as

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34 See *supra* note at pp. 268-269.

35 See *supra* note at pp. 265-266: "Obviously, the same potential for separating the income derived from selling activities from the income derived from manufacturing activities and thereby obtaining a lower rate of tax for such selling activities than would obtain if all of the income had been subject to tax in the country in which manufacturing is undertaken exists with respect to a manufacturing branch as with respect to a sales branch."

36 Yoder, Lyon, and Noren, 6240 T.M., "C.F.C.s – Foreign Base Company Income (Other than FPHCI).“

Subpart F income under Code §951(a). In particular, the Tax Court pointed to example 2 under Treas. Reg. 1.954-3(b)(4) which

> reache[d] a similar conclusion after positing facts substantially identical to those here … [and] conclud[ed] that income derived by a manufacturing branch was not F.B.C.S.I. but that sales income derived by the remainder of the C.F.C. was F.B.C.S.I. under the branch rule because it was derived from 'the sale of personal property on behalf of the branch.[37]

The Tax Court thus concluded that

> Whirlpool's manufacturing activity in Mexico was conducted after 2008 exactly as it had been conducted before 2009, using the same plants, workers, and equipment. But the sales income was carved off into a Luxembourg affiliate that enjoyed a 0% rate of tax. The Luxembourg sales affiliate epitomizes the abuse at which Congress aimed … If LuxCo had conducted its manufacturing operations in Mexico through a separate entity, its sales income would plainly have been F.B.C.S.I. under sec. 954(d)(1). Sec. 954(d)(2) prevents Whirlpool from avoiding this result by arranging to conduct those operations through a branch.

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[37] *Whirlpool*, n.11. Treas. Reg. Sec. 1.954-3(b)(4) Example 2, "Controlled foreign corporation C is incorporated under the laws of foreign country X. Corporation C maintains branch B in foreign country Y. Branch B manufactures articles in country Y which are sold through the sales offices of C Corporation located in country X. These activities constitute the only activities of C Corporation. Country Y levies an income tax at an effective rate of 30 percent on the manufacturing profit of C Corporation derived by branch B but does not tax the sales income of C Corporation derived by the sales offices in country X. Country X does not impose an income, war profits, excess profits, or similar tax, and no tax is paid to any foreign country with respect to income of C Corporation which is not derived by branch B. If C Corporation were incorporated under the laws of country Y, the sales income of the sales offices in country X would be taxed by country Y at an effective rate of 30 percent. In determining foreign base company sales income of C Corporation, branch B is treated as a separate wholly owned subsidiary corporation of C Corporation, the zero rate of tax on the income derived by the remainder of C Corporation being less than 90 percent of, and at least 5 percentage points less than, the 30 percent rate. *Branch B, treated as a separate corporation, derives no foreign base company sales income since it produces the product which is sold. Income derived by the remainder of C Corporation, treated as a separate corporation, from the sale by or through it for use, consumption, or disposition outside country X of the personal property produced in country Y is treated as income from the sale of personal property on behalf of branch B, a related person, and constitutes foreign base company sales income*." (Emphasis added.)

CONCLUSION

After *Ashland Oil*[38] and *Vetco*,[39] it seems that the Tax Court finally accepted the I.R.S.'s argument that Congress intended the C.F.C. branch rule to be a broad "loophole closing" provision, which should apply any time an arrangement separates the manufacturing and sales functions so as to avoid or limit tax on the sales income. There are some interesting takeaways for practitioners from the *Whirlpool* case: the court's application of the regulations' tax disparity test and the court's rejection of Whirlpool's arguments that the manufacturing branch regulations are invalid. But the most important one is whether and to what extent the result in *Whirlpool* will impact other cases, such as the one involving Apple,[40] and whether Code §954(d)(2) can be used to capture some stateless income.

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38 *Ashland Oil, Inc. v. Commr.*, 95 T.C. 348, 358 (1990).

39 *Vetco, Inc. v. Commr.,* 95 T.C. 579, 590 (1990).

40 See Lee A. Sheppard, "What About Cupertino?" *Tax Notes Federal* (Jul. 27, 2020) at p. 565 where the author argued that Apple would have had F.B.C.S.I. under the branch rule. Similar arguments had been made by Jeffery Kadet. See, Jeffery M. Kadet, "Attacking Profit Shifting: The Approach Everyone Forgets," *Tax Notes*, (Jul. 13, 2015), at p. 193.

FINAL REGS IMPLEMENT CHANGES TO SOURCE-OF-INCOME RULES FOR INVENTORY SALES

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INTRODUCTION

In late 2019, the I.R.S. proposed regulations modifying rules for determining the source of income from sales of inventory property produced by a taxpayer without and sold within the United States, or produced by the taxpayer within and sold without the United States.[1] A public hearing on the proposed regulations was held on June 2020, and final regulations were published in October.[2]

The regulations implement changes made by the Tax Cuts and Jobs Act[3] (the "T.C.J.A."), to Code §863(b). These regulations also provide guidance under Code §865(e)(2) regarding sales of inventory through a U.S. office or fixed place of business. The regulations resolve interpretative issues arising from the T.C.J.A. and have important international tax planning implications for cross-border sales of inventory by U.S. corporations in outbound transactions and non-U.S. corporations in inbound transactions.

This article proceeds in three parts. The first presents the sourcing rules for sales of inventory before the T.C.J.A. The second describes the changes implemented by the T.C.J.A. and the guidance offered by the I.R.S. in the published regulations. Finally, the third part details some of the consequences of these regulations for taxpayers.

SOURCING RULES BEFORE THE T.C.J.A.

Code §865(a) generally sources income derived from the sale of goods to the residence of the taxpayer. However, Code §865(b) provides special sourcing rules for certain categories of sales, including sales of inventory property.

The Code distinguishes three types of inventory property sales and prescribes specific sourcing rules for each of them:

- Sales of purchased property, subject to sourcing rules under Code §§861(a)(6) and 862(a)(6);
- Sales of produced property, subject to sourcing rules under Code §863;
- Sales by nonresidents through a U.S. office, subject to sourcing rules under Code §865(e)(2) and (3).

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[1] REG-100956-19, issued December 30, 2019.

[2] T.D. 9921 announced on October 19, 2020.

[3] Pub. L. 115-97 (2017).

Of the three categories, the T.C.J.A. created uncertainty regarding the sale of produced inventory property sourced under Code §863 and the sale of inventory property through a U.S. office sourced under Code §865(e)(2).

Sale of Produced Inventory Property Under Code §863

"Prior to the effective date of the T.C.J.A., Code § 863(b) and Treas. Reg. §1.863-3 provided a three-step analysis to determine the source of income resulting from Code §863 sales."

Prior to the effective date of the T.C.J.A., Code §863 focused on income from the sale of inventory produced in one location and sold in a different location. To illustrate, the property could have been produced wholly or partly within the U.S. and sold outside the U.S., or it could have been produced wholly or partly outside the U.S. and sold within the U.S. ("Code §863 Sales"). The source of gross income from Code §863 Sales was considered to be derived from sources partly within the U.S. and partly from sources outside the U.S.

Code § 863(b) and Treas. Reg. §1.863-3 provided a three-step analysis to determine the source of income resulting from Code §863 sales. The first step was to apportion gross income between the production function and the sales function, using one of the following three methods:

- **The 50/50 method.** Under this method, 50% of the gross income from Code §863 Sales could be allocated to production activity and 50% could be allocated to sales activity.[4] This method applied to all Code §863 Sales unless the taxpayer properly elected the independent factory price ("I.F.P.") method or the books and records method for those sales.[5]
- **The I.F.P. method.** Under this method, a taxpayer could allocate its gross income based on the price at which the taxpayer regularly sold its inventory to wholly independent distributors or other selling concerns, provided that the taxpayer's sales activities with respect to such sales were not significant.[6]
- **The books and records method.**[7] Under this method, a taxpayer could allocate its gross income from Code §863 Sales between production and sales activities based upon the taxpayer's books of account.[8] The books and records method required prior approval from the District Director having audit responsibility over the taxpayer's tax return. Anecdotally, this method is believed not to have been widely used. It required a taxpayer to "fully explain . . . the methodology used, the circumstances justifying use of that methodology, the extent that sales are aggregated, and the amount of income so allocated."[9]

The second step was to determine the source of production income and sales income.[10] The source of the former category of income looked to the place of production,[11] whereas the source of the latter looked to the place of sale.[12] Production

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[4] Treas. Reg. § 1.863-3(b)(1), as in effect at the time.

[5] Treas. Reg. § 1.863-3(e)(1), as in effect at the time.

[6] Treas. Reg. § 1.863-3(b)(2)(i), as in effect at the time.

[7] Treas. Reg. § 1.863-3(b), as in effect at the time.

[8] Treas. Reg. § 1.863-3(b)(3), as in effect at the time.

[9] Treas. Reg. §1.863-3(f)(2), as in effect at the time.

[10] Treas. Reg. §1.863-3(c), as in effect at the time.

[11] Treas. Reg. §1.863-3(c)(1), as in effect at the time.

[12] Treas. Reg. §1.863-3(c)(2), as in effect at the time.

activity meant “an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory.”[13] The only production activities taken into account were those conducted directly by the taxpayer. Activities by contract manufacturers were not taken into account. If production activity was carried on both within and outside the U.S., the source of income was apportioned under a formula that looked to the average adjusted basis of all production assets within and outside the U.S.[14]

$$\text{Income attributable to production activity} \times \frac{\text{Average adjusted basis of production assets located outside the U.S.}}{\text{Average adjusted basis of production assets located within and outside the U.S.}}$$

The source of the taxpayer’s income that was attributable to sale activities was determined under the title passage rule, according to which a sale of inventory property occurred when and where title passed.[15]

The third and final step was to determine the taxable income by allocating and apportioning expenses, losses, and other deductions to the various classes of gross income from Code §863 Sales.[16] Expense was first allocated and apportioned between Code §863 Sales and other sales under Code §863(b), and the portion allocated or apportioned to Code §863 Sales was then apportioned between gross income from sources within and without the United States.

Sale of Inventory Through a U.S. Office Under Code §865(e)(2)

Code §865(e)(2) addresses sales of inventory by a nonresident through a U.S. office. It provides the following:

Notwithstanding any other provisions of [Code §§861 to 865], if a nonresident maintains an office or other fixed place of business in the United States, income from any sale of personal property (including inventory property) attributable to such office or other fixed place of business shall be sourced in the United States.

Under Code §865(e)(3), the principles of Code §864(c)(5) related to the computation of effectively connected income apply to determine whether a nonresident maintains a U.S. office and whether a sale is attributable to that office. In determining whether a nonresident alien individual or a foreign corporation has a U.S. office, Code §864(c)(5)(A) disregards an agent’s office or other fixed place of business except when the following two facts exist with regard to the agent:

- The agent:
  - Has, and regularly exercises, the authority to negotiate and conclude contracts in the name of the individual or foreign corporation or
  - Has merchandise from which the agent regularly fills orders on behalf of the nonresident individual or foreign corporation, and
- The agent is not a general commission agent, broker, or other agent of independent status acting in the ordinary course of its business.

[13] Treas. Reg. §1.863-3(c)(1)(i)(A), as in effect at the time.

[14] Treas. Reg. §1.863-3(c)(1)(ii)(A), as in effect at the time.

[15] Treas. Reg. §§1.863-3(c)(2) & 1.861-7(c), as in effect at the time.

[16] Treas. Reg. § 1.863-3(d)., as in effect at the time.

Additionally, Code §864(c)(5)(B) does not attribute income, gain, or loss to a U.S. office unless the U.S. office is a material factor in the production of that income, gain, or loss, and the U.S. office regularly carries on activities that generate such income. In practice, for inventory produced outside the U.S. and sold through a U.S. office, the I.R.S. historically approved a 50-50 split between U.S. source and foreign source income in applying Code §865(e)(2) to such produced inventory.

Code §864(c)(5)(C) further provides that, with respect to certain sales of inventory involving a sale or exchange outside the U.S. and described in Code §864(c)(4)(B)(iii), the amount attributable to the office or fixed place of business cannot exceed the income that would otherwise have been U.S. source had the sale been made in the United States. Among other things, this rule ensures that taxable effectively connected income from the sale of inventory is computed in the same manner whether the sale generates foreign source effectively connected income or U.S. source effectively connected income.

"... the place of production solely determines the source for sales of produced inventory."

CHANGES IMPLEMENTED BY THE T.C.J.A. AND THE FINAL REGULATIONS REGARDING SOURCE RULES FOR INCOME FROM THE PRODUCTION OF INVENTORY

The T.C.J.A. added the following sentence to the flush language of Code §863(b):

> Gains, profits, and income from the sale or exchange of inventory property described in paragraph (2) shall be allocated and apportioned between sources within and without the United States solely on the basis of the production activities with respect to the property.

Hence, the place of production solely determines the source for sales of produced inventory. This change gave rise to three distinct issues, addressed by the proposed regulations:

- The move to a single factor rule to determine source of income;
- The overlap of Code §863(b) and Code §865(e)(2) for a nonresident's foreign-source income attributable to a U.S. office;
- The applicability of Code §864(c)(5)(C)(iii) for purposes of Code §865(e)(2).

<u>The Move to a Single Factor Rule to Determine Source of Income</u>

To reflect the changes made by the T.C.J.A., the final regulations remove the three apportionment methods of Treas. Reg. § 1.863-3(b). In their place, the final regulations reiterate the flush language of Code §863 by providing that income from Code §863 Sales is sourced "solely on the basis of the production activities with respect to the inventory."[17]

Where production activity takes place within the U.S. and outside the U.S., the final regulations adopt several rules to avoid inappropriate computations that increase foreign source production activity:

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[17] Treas. Reg. §1.863-3(b).

- The first is an anti-abuse rule to ensure that *de minimis* activity outside the U.S. does not affect the source of the income. This is achieved by reference to production activity as defined in the Foreign Base Company Sales rules that appear in Treas. Reg. §954-3(a)(4), which specifically eliminates packaging, repackaging, labeling, or minor assembly operations.[18]

- The second eliminates the consideration of any activity that constitutes a "substantial contribution to the manufacturing of personal property" under Treas. Reg. §1.954-3(a)(4)(iv).[19]

- Third, when there is production activity both within and without the United States, the ability of a taxpayer in the U.S. to write down the cost of qualifying property under Code §168(k) is expressly eliminated. Instead, the final regulations mandate use of the alternative depreciation system ("A.D.S.") of Code §168(g)(2) when computing the adjusted cost basis of production assets in the U.S. and outside the U.S.[20] The basis of both U.S. and non-U.S. production assets should thus be measured consistently on a straight-line method over the same recovery period.

- Lastly, the final regulations adopt a general anti-abuse rule ("G.A.A.R.") to prevent a corporate group from artificially skewing the computation of the amount of production activity apportioned to the U.S.[21] The G.A.A.R. rule has broad application. It can be used to neutralize any plan, such as a plan in which domestic production assets are acquired by a related partnership rather than the taxpayer if a principal purpose of the plan is a reduction in income subject to tax under Code §863.

<u>The Overlap of Code §§863(b) and 865(e)(2)</u>

The amendment to Code §863(b) under the T.C.J.A. raised several questions as to the scope and application of Code §865(e)(2) to determine the amount of gross income from sales of inventory through a U.S. office. Code §865(e)(2) applies notwithstanding any other provisions in Code §§861 through 865. Consequently, the statute may be read as overriding Code §863(b), where Code §863 Sales of a nonresident are attributable to an office or another fixed place of business in the United States. In this case, all inventory income from Code §863 Sales—*i.e.*, both production and sales income—attributable to a U.S. office would automatically be treated as U.S. source income. On the other hand, Code §865(e)(3) limits the scope of Code §865(e)(2) by providing that the principles of Code §864(c)(5) apply in determining whether a taxpayer has a U.S. office and whether a sale is attributable to that office. More specifically, Code §864(c)(5)(C) limits the amount of "income, gain, or loss" from sales that meet the "material factor" threshold of Code §864(c)(5) to the amount of income "properly allocable" to the office in the United States.

Before the T.C.J.A., the I.R.S. interpreted the amount properly allocable to the U.S. office as the amount reflecting sales activity rather than production activity. It is therefore a lesser amount of income than would be allocated under a literal reading of Code §865(e)(2) (*i.e.*, the entire amount of income). This seemed in turn to indicate that Code §865(e)(2) did not sweepingly override Code §863(b).

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[18] Treas. Reg. §1.954- 3(a)(4)(iii).

[19] Treas. Reg. §§1.863-3(c)(1)(i) and 1.865- 3(d)(2).

[20] Treas. Reg. §1.863-3(c)(2)(ii)

[21] Treas. Reg. §1.563-3(c)(3).

This approach is retained in the final regulations. Treas. Reg. §1.865-3 applies only if a nonresident maintains an office or other fixed place of business in the United States to which a sale of personal property is attributable.[22] Otherwise, the source of the income, gain, or loss from the sale will be determined under other applicable provisions of section 865, such as section 865(b) through (d).

When an office exists in the U.S., the final regulations retain rules for determining the portion of gross income from sales and production activities that are attributable to the office.[23] The 50/50 method remains the default method in the final regulations. because it is viewed to be an appropriate and administrable way to apply Code §865(e)(2).[24] As in the proposed regulations, the final regulations allow nonresidents to elect a books and records method that would more precisely reflect gross income from both sales and production activities in the U.S., provided the nonresidents meet certain requirements for maintaining their books of account. However, once a taxpayer demonstrates the ability to use books of account to determine U.S. source gross income under the books and records method, it must continue to apply the books and records method until revoked. Moreover, the election to use the books and records method may not be revoked without the consent of the I.R.S. for any taxable year beginning within 48 months of the end of the taxable year in which the election is first made.

The Applicability of Code §864(c)(5)(C)(iii) for Purposes of Code §865(e)(2)

Code §864(c)(5)(C)(iii) imposes a limitation on income from sales outside of the United States made through an office or other fixed place of business in the United States: this income "shall not exceed the income that would be derived from sources within the United States if the sale or exchange were made in the United States." This special limitation appears to cap the amount of income from sales of inventory outside the United States that can be attributable to the U.S. office by the amount that would be U.S. source under the rules of Code §863(b). This is based on the assumption that the sale is made in the United States. Without application of Code §865(e)(2)(A), which treats the income from such foreign sales domestic income, the U.S. would not have the primary right to impose tax on the resulting income. Consequently, U.S. tax on such income could be offset by a foreign tax credit. Under the approach of the regulations, that is no longer the case.

But if income from the sale of inventory produced by a taxpayer is now sourced solely based on production activity under Code §863(b), is the rule in Code §865(e)(2)(A) overridden? If the answer is yes, none of the income would be allocable to a U.S. office under Code §865(e)(2).

The regulations disagree with this interpretation. As explained above, the I.R.S. believes that it is appropriate to maintain apportionment between production and sales activity when a foreign taxpayer maintains a U.S. office that materially participates in sales of inventory produced outside of the United States, even though such apportionment is no longer necessary under the general sourcing rule of Code §863(b). Under this view, Code §865(e)(2) applies notwithstanding any other provisions of Code §s 861 through 865, because the T.C.J.A. did not amend Code §865(e)(2) when it amended Code §863.

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[22] Treas. Reg. §1.863-3(b).

[23] Treas. Reg. §1.865-3(d).

[24] Treas. Reg. §1.865-3(d)(2)(i).

IMPLICATIONS OF THE FINAL REGULATIONS

Effective Dates of Final Regulations

Wiggle room exists as to the effective date of the proposed and final regulations. The proposed regulations were proposed to apply to taxable years ending on or after December 23, 2019, although taxpayers and their related parties could generally apply the rules in their entirety for taxable years beginning after December 31, 2017, and ending before December 23, 2019.

The final regulations generally apply to taxable years ending on or after December 23, 2019. Taxpayers may choose to apply the final regulations for any taxable year beginning after December 31, 2017, and ending before December 23, 2019, provided that the taxpayer and all persons that are related to the taxpayer within the meaning of section 267 or 70 apply the final regulations in their entirety and, once applied, the taxpayer and all such related persons continue to apply the final regulations in their entirety for all subsequent taxable years.[25]

Alternatively, taxpayers may rely on the proposed regulations for any taxable year beginning after December 31, 2017, and ending on or before December 31, 2020 provided that the taxpayer and all persons that are related to the taxpayer rely on the proposed regulations in their entirety and provided that the taxpayer and all such persons have not applied the final regulations to any preceding year.

Manufacturers of Inventory Property

Given that the T.C.J.A. amendment to Code §863(b) applies to tax years beginning after December 31, 2017, the removal of the apportionment methods available under the current Code §863(b) regulations was expected.

"Wiggle room exists as to the effective date of the proposed and final regulations."

In comparison, the computation of adjusted basis of U.S.-located production assets using the A.D.S. method may be a surprise to nonresident taxpayers who believed that the T.C.J.A. should be read as a unified whole, including Code §§863(b) and §168(k).[26]

The burden of maintaining multiple asset books cannot be overstated. According to Fox Rothschild LLP, taxpayers may have to maintain as many as four sets of depreciation schedules covering various provisions of the Code and financial accounting reporting.[27]

Nonresidents Selling Inventory Property Through a U.S. Office

The proposed regulations require sourcing of Code §863 Sales based solely on the location of production activities, consistent with the amended Code §863(b). However, this does not mean that sales are necessarily foreign source if the production activities are entirely outside the United States. Under Code §865(e)(2), a portion of this income can be characterized as U.S. source income if the nonresident maintains

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25 See section 7805(b)(7).

26 US: Source-of-Income Rules Modified by Proposed Regulations Implementing T.C.J.A. Changes, EY (Jan. 9, 2020).

27 Fox Rothschild LLP, comment. on Notice of Proposed Rulemaking: Proposed Amendments to Regulation Code §1.863-3 on Source of Income from Certain Sales of Personal Property, at 7 (Feb. 28, 2020).

a U.S. office, and if such U.S. office is a material factor in generating the income. As a result, in order to avoid U.S source income under the proposed regulations, a nonresident must establish that it does not have a U.S. office or place or business or, if it does, that such U.S. office is not a material factor in generating the income. Of course, if personnel in the U.S. receive compensation that is directly tied to sales, the ability to avoid U.S. source income is likely remote.

Individuals Operating a Business as a Sole Proprietorship/Pass-Through

The proposed regulations also raise questions in the context of Code §199A. Code §199A provides a deduction to owners of sole proprietorships, partnerships, S corporations, and some trusts and estates in connection the operation of a qualified trade or business. Subject to certain limitations, the Code §199A deduction generally equals 20% of the individual's qualified business income ("Q.B.I.").[28] Q.B.I. arises from qualified items of income, gain, loss and deduction in a qualified trade or business. Code §199A(c)(3)(A) further provides that whether the income arises in a qualified business is determined under concepts developed under Code §864(c) related to nonresident persons and income that is effectively connected to the conduct of a trade or business in the U.S. Thus, whether an individual is a U.S. resident or a nonresident, noncitizen, the tax return preparer must be familiar with the concepts of Code §864.

CONCLUSION

The final regulations issued under Code §s 863(b) and 865(e)(2) provide necessary guidance on the changes implemented by the T.C.J.A. The application of the new rules may change the amount of U.S. and foreign source income for certain taxpayers, who must be particularly attentive to the implications of the proposed regulations.

[28] Code § 199A(a)(1).

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