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INSIGHTS

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EDITORS' NOTE

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

- **Private Investment Funds in Israel.** The State of Israel has encouraged foreign investments in Israel for many years. One of its primary tools is the special tax regime applicable to private investment funds. If listed conditions are met, a range of tax benefit benefits are granted to the fund and its investors. These include exemptions from Israeli tax for non-Israeli limited partners with respect to (i) income derived from non-Israeli investments, (ii) capital gains, dividends, and interest form venture capital investments, and (iii) income derived from the realization of Qualified Investments. Anat Shavit, a partner of FBC & Co., Tel Aviv, and Yuval Peled, a senior associate at FBC & Co., Tel Aviv explain the conditions that must be met.

- **New Italian Transfer Pricing Regulations Affect Multinational Enterprises.** Italian transfer pricing documentation rules were introduced in 2010. The system affords taxpayers the possibility of penalty protection for transfer pricing adjustments, provided that qualifying transfer pricing documentation is maintained by the taxpayer. Late in 2020, new regulations were introduced. The new regulations contain several important changes for multinational enterprises based in Italy or having an Italian member. Marco Valdonio, a partner of Maisto e Associati, Milan, and Mirko Severi, an associate of Maisto e Associati, Milan, explain the principal revisions to the Italian rules. They address the changes that broaden the scope of companies required to maintain a master file, reductions in the scope of the exception to annual filing for certain local members of a foreign-based multinational group, and changes to the content of both the master file and the local file.

- **Tax Competition Between Member States of the European Union – An Academic View.** In May, the European Commission lost its second case in the E.U. General Court when Amazon's tax arrangement in Luxembourg was found to be onside as to rules prohibiting illegal state aid among Member States. A companion case was issued the same day in which the penalty asserted by the European Commission was upheld. These cases bring the Commission's record before the Court to two wins and three losses, with three cases in progress. For those readers asking why Commissioner Vestager continues to bring these cases, the answer is explained by Professor Pietro Boria, of Sapienza University of Rome. A new electorate has arisen in Europe that is multinational in its scope and led by a governing body answerable to all Member States. Parochial interests that existed through the end of the 20th Century no longer control. Tax policy is no longer the realm of national governments.

- **The 15 Most Important Questions That Should be Asked When Estate Planning for a Foreign Parent With U.S. Children.** U.S. estate tax planning is said to be among the most complicated aspect of tax planning because of the numerous moving parts and the changing needs and objectives of the family. The exercise becomes complicated when the client is not a U.S. person, but the heirs live in the U.S. and have started families in the U.S. For an estate planner with a focus on domestic clients, the customary tools may not work. It is easy to know what you know, but not always easy to know what you don't know. Neha Rastogi and Stanley C. Ruchelman ask and answer 15 questions that highlight the favorable and unfavorable provisions of U.S. tax law affecting nonresident, non-citizen individuals having U.S. persons as heirs.

- **Final Regulations for Withholding on Foreign Partners' Transfers of Specified Partnership Interests – Construct, Exceptions, and Reporting.** For U.S. tax purposes, gain or loss upon a sale or exchange of property is generally sourced based on the tax home of the seller. For a foreign person investing in a partnership conducting a U.S. trade or business, the source rules change. A foreign partner that sells an investment in a U.S. partnership operating in the U.S. will be subject to tax on the portion of the gain deemed to be effectively connected with a U.S. trade or business. This change stems from Code §864(c)(4), which recharacterizes a sale of a partnership interest as an indirect sale of partnership assets, resulting in gain to the selling foreign partner. Under Code §1446(f), withholding tax of 10% applies to the seller's amount realized. Andreas A. Apostolides and Nina Krauthamer take a deep dive in the I.R.S. regulations issued in late 2020. A must read for advisers to foreign partners in partnerships with U.S. fixed offices and U.S. trades or businesses.

- **Clarity on Recharacterization of Carried Interests.** Earlier this year, the I.R.S. issued final regulations providing guidance on Code §1061, which recharacterizes certain long-term capital gains as short-term gains for holders of partnership interests entitled to carried interests. The provision impacts fund managers of alternative investments, such as private equity and hedge funds, who receive carried interests. When gains are derived through a carried interest, they are treated as long-term capital gains only when the carried interest is held for 36 months and one day, significantly longer than the 12 months and one day ordinarily required. In her article written while an extern at Ruchelman P.L.L.C., Susan F. Robinson explains how the final regulations address two workarounds that were widely proposed to circumvent the lengthened holding period and cautions that the policy debate on carried interests may not be over.

- **Beauty is in the Eye of the Taxpayer.** As a counterpoint to the view in Europe regarding tax competition, the view in the U.S. is that tax competition is an acceptable policy to influence a multinational corporation to locate operations in a particular State. In his article written while an extern at Ruchelman P.L.L.C., Corey L. Gibbs looks at policies adopted by the State of Alabama pointing out that U.S. citizens and residents are "voting with their feet," when relocating to States that impose lower taxes. In Europe, there may be a duty to pay tax, in the U.S. there is a right to carry on one's affairs in a way that results in the lowest tax possible.

We hope you enjoy this issue.

- The Editors

PRIVATE INVESTMENT FUNDS IN ISRAEL

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Tags
Beneficial Tax Arrangement
Encouragement of Investment
Israel
Private Equity Funds
Venture Capital Funds

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INTRODUCTION

The State of Israel has encouraged foreign investments in Israel for many years. One of its primary tools is the special tax regime applicable to private investment funds. Over the years, the Israeli Tax Authority ("I.T.A.") has issued substantial guidance and numerous private rulings under Section 16A of the Income Tax Ordinance [New Version], 5721-1961 (the "Ordinance") to private investment funds operating in Israel. In general, these rulings provide significant tax benefits to foreign investors and funds if certain conditions are met.

This article outlines various income tax arrangements that are applicable to private investment funds operating in Israel.[1] It is based predominantly on I.T.A. Income Tax Circulars 9/2018 and 10/2018 (the "Circulars"), which govern the taxation of venture capital funds and private equity funds operating in Israel. Note that limited partners holding more than 4% of the interests in a fund cannot control the entities managing the fund and cannot hold more than 10% of the general partner if they wish to enjoy the tax benefits described below.

At present, the special tax regime applicable to private investment funds is currently under review by the I.T.A. and the Israeli Ministry of Finance. Consequently, tax benefits that are available under the existing regime may be adjusted, and additional conditions may be added. It is generally understood that any changes to the regime likely will not affect existing tax arrangements for non-Israeli limited partners.

CONDITIONS FOR BENEFICIAL TAX ARRANGEMENT

A private equity fund or a venture capital fund must comply with the following conditions in order for a non-Israeli investor to be entitled to beneficial tax treatment:

- The fund must have at least 10 investors, each of whom is unrelated to the others, as of the closing of fund raising and throughout the lifespan of the fund.
- Investors in the fund may not hold more than 20% of the capital of the fund. However, the anchor investor may hold up to 35% of the capital of the fund.
- At least 30% of the investors in the fund must be non-Israeli investors.

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1 This article does not address the application of value added tax to the fee charged for management services provided by the general partner.

- Throughout the duration of the fund, the total investment commitments must be at least U.S.$10 million, of which at least U.S.$5 million comes from non-Israeli investors.
- The fund may not invest in excess of 25% of the fund's total commitments (net of management fees) in any single company.
- The fund may not invest more than 20% of its total funds raised (after deduction of management fees) in companies whose securities are publicly traded.
- The fund may not hold short-term cash deposits or publicly traded securities, except if they originate from monies which investors transferred in accordance with their investment commitments in the fund, or if they originate from the realization of profits prior to their distribution or reinvestment.
- The fund must invest in "Qualifying Investments" in Israel equal to the lesser of the following amounts:
  - U.S.$10 million in Qualifying Investments, of which at least U.S.$6 million must be invested, directly or indirectly, in Israeli resident companies owning intellectual property that was developed in-house, or the non-Israeli parents of those companies.
  - At least 50% of the fund's total commitments is in Qualifying Investments, of which at least 30% of the fund's total commitments must be invested, directly or indirectly, in Israeli resident companies owning intellectual property developed in-house, or the non-Israeli parents of those companies.
- The fund must be managed by the general partner or by a person on its behalf. The limited partners may not take any role in identifying target companies or managing the portfolio companies, or in the day-to-day management of the fund, and shall not have any voting rights in the investment committee of the fund.
- The fund may be required to provide certain financial information to the I.T.A.
- Investors in the fund may be required to provide certain information to the fund or the I.T.A. in order to establish their right to enjoy the benefits of an I.T.A. ruling issued with respect to the fund.

The terms used in the above requirements have specific meaning.

- An investment is a Qualifying Investment if it relates to shares of an Israeli resident company or in the shares of an Israel affiliated company whose principal activity is a Qualifying Activity. Qualifying investments include venture capital investments. Investments in securities traded on a stock exchange will not be considered to be a Qualifying Investment unless the fund has held the shares for at least one year.
- An activity is a Qualifying Activity when it relates to the establishment or expansion of enterprises that are engaged in designated activities in Israel, such as (i) industry, (ii) agriculture, (iii) tourism, (iv) transportation, (v) construction other than real estate, (vi) water, (vii) energy, (vii) technology, (viii) communications, (ix) computing, (x) security, (xi) medicine, (xii) biotechnology, (xiii)

nanotechnology, and (xiv) research and development related to the foregoing activities in Israel.

- A foreign company is an Israel Affiliated Company where its principal assets or activities are directly or indirectly located in Israel.
- Shares include stock options or warrants, convertible notes, and convertible bridge loans that are not secured by assets other than the technology or other assets of the target company.
- Venture capital investments are Qualifying Investments in the hi-tech sector, where at least 75% of the total investment relates to an initial issuance of shares.

THE BENEFICIAL TAX ARRANGEMENT

If all of the conditions listed above are met, the following will apply to the non-Israeli investors in the fund and in the general partner:

Tax Arrangement for Non-Israeli Limited Partners

- Any income derived from non-Israeli investments (*i.e.*, non-Israeli companies or non-Israeli Affiliated Companies) will be exempt from tax in Israel.
- Income derived from venture capital investments (*i.e.*, capital gains, dividends, and interest) will be exempt from tax in Israel.
- Income derived from Qualified Investments that are not venture capital investments will benefit from the following favorable tax-related provisions.
  - Income from the realization of Qualified Investments will be exempt.
  - Dividend income derived by individual investors directly or through an entity that is tax transparent in the home country of the individual will be subject to tax at the rate of 15%, unless a treaty applies.
  - Dividend income derived by corporate investors will be subject to tax at the corporate income tax rate (currently 23%) unless a treaty applies.
  - Dividend income derived by investors from a treaty jurisdiction are entitled to the tax rates set forth under the applicable treaty, subject to confirmation by the I.T.A. of tax residence and beneficial ownership by the investor.
  - Interest income will be subject to tax at the regular tax rates set forth in the Ordinance. Individual tax rates range between 15% and 50% depending on the nature of the interest. Corporations are taxed at a flat 23%.
  - Non-Israeli investors resident in a treaty jurisdiction are entitled to the tax rates set forth under the applicable treaty, subject to confirmation by the I.T.A. of tax residence and beneficial ownership by the investor.

- Any other income that is not covered above, including income from management fees received from portfolio companies, will be subject to the regular tax rates set forth in the Ordinance, which have been described above.
- Foreign investors in the fund will not be considered as tax residents of Israel and will not have filing obligations in Israel as a result of their investments in the fund.

Tax Arrangement for Non-Israeli Fund Managers

Once the fund qualifies for tax benefits, the general partner and the mangers of the fund may be entitled to certain tax benefits. Again, the special tax regime applicable to private investment funds is currently under review by the I.T.A. and the Israeli Ministry of Finance. It is possible that tax benefits may be adjusted and additional conditions may be added.

"Once the fund qualifies for tax benefits, the general partner and the mangers of the fund may be entitled to certain tax benefits."

Taxation of Carried Interests Held by Fund Managers

Carried interest income attributable to Israeli Investments will be subject to tax at the rate of 15% in the hands of non-Israeli fund managers. Carried interest income attributable to investments in foreign entities will not be subject to tax in Israel.

Non-Israeli general partners and fund managers resident in a treaty jurisdiction may be eligible for tax rates set forth under the applicable treaty, subject to confirmation of the recipient's tax residence and beneficial ownership by the I.T.A.

Taxation of Management Fees

Income derived from management fees will generally be subject to the regular tax rates as set forth in the Ordinance, which have been described above.

ALTERNATIVE TAX ARRANGEMENTS IF CONDITIONS ARE NOT MET

Over the years, the I.T.A. has also issued alternative tax arrangements for funds that do not meet the conditions listed above. Included are funds that have fewer than 10 unrelated investors, funds with commitments of less than U.S.$10 million, funds in which the limited partners are involved in the management of the fund, and funds in which the general partner is a substantial investor.

Funds That Have Fewer Than 10 Investors

Here, the tax rules are as follows:

- Income from realizations of Qualifying Investments will be subject to 15% income tax in Israel.
- Income from interest and dividend payments that are derived from Qualifying Investments will be subject to tax at a rate of 15%, or a lower rate that applies under a tax treaty.

- Other income that is not derived or accrued from Qualified Investments will be subject to the tax rates established in the Ordinance. As mentioned above, the rates for individuals range between 15% and 50%. The rate for corporations is 23%.

- Income derived from non-Israeli companies and non-Israel Affiliated Companies will be exempt.

<u>Funds With Less Than U.S.$10 million in Commitments</u>

- A beneficial tax arrangement will be available to funds that are focused on making venture capital investments.

- Income from the realization of venture capital investments will be exempt from tax in Israel.

- Income from interest and dividend payments will be subject to the tax at the lesser of (i) the tax rates established in the Ordinance or (ii) a lower rate that applies under a tax treaty.

<u>Non-Israeli Fund Investing in Israel Without Representation in Israel</u>

- Generally, such a fund will enjoy the same tax benefits as enjoyed by non-Israeli limited partners, discussed above.

- Non-Israeli managers of the fund will be entitled to exemption from Israeli tax with regard to their carried interest and management fees.

NEW ITALIAN TRANSFER PRICING REGULATIONS AFFECT MULTINATIONAL ENTERPRISES

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Tags
Country File
Hidden Permanent Establishment
Master File
M.N.E.
Penalty
S.M.E.
Transfer Pricing

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BACKGROUND

Italian transfer pricing documentation rules were introduced in 2010 by Article 26 of Law Decree 31 May 2010 No. 78 and implemented with the regulations issued by the Director of the Italian Revenue Agency on September 29, 2010 ("Existing Regulations"). The system gives taxpayers the possibility to obtain penalty protection in case of transfer pricing adjustments, provided that they timely prepare and maintain qualifying transfer pricing documentation.

On November 23, 2020, the Italian Revenue Agency issued Regulation No. 360494 ("New Regulations"), which entirely replaced the Regulations, introducing important changes that may have a relevant impact on multinational enterprises ("M.N.E. groups").

REVISIONS CONCERING GENERAL ASPECTS

Broadening the Scope of Companies Required to Maintain a Master File

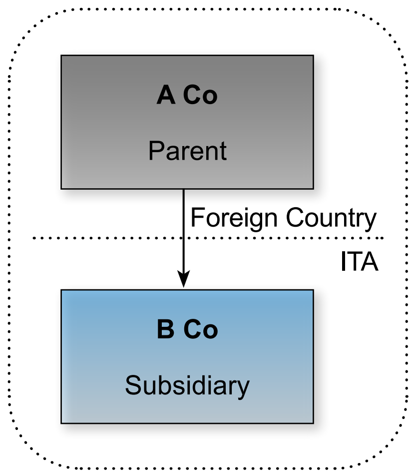
The system governing transfer pricing documentation under the New Regulations retains the same three-tiered structure of the consisting of

- a Master File containing information relevant for all M.N.E. group members,
- a Local File referring specifically to the local taxpayer, and
- a Country-by-Country Report for those M.N.E. groups having a turnover of €750 million.

However, the scope of companies required to maintain a Master File is broadened. In the previous framework of the Existing Regulations, maintenance of a Master File was required in order obtain penalty protection differed depending on whether an Italian company held foreign subsidiaries or simply was a subsidiary of a foreign M.N.E. group. In the latter case, the Italian company was not required to prepare a Master File if it did not own control shareholdings in non-Italian companies. This exception is deleted in the New Regulations. Now, all Italian subsidiaries of foreign M.N.E. groups that desire penalty protection arising from transfer pricing adjustments must maintain a Master File and a Local File, even when ownership or control stakes are not maintained in companies resident outside Italy. The new requirement applies also to permanent establishments of non-Italian companies when the permanent establishment holds shares in companies resident outside of Italy.

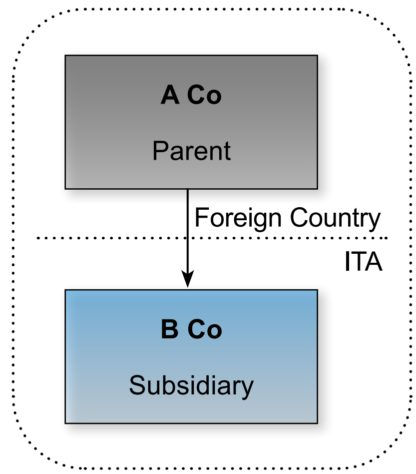
The difference in the requirement regarding the maintenance of a Master File is illustrated in the following diagram.

ANTE



Proper Documentation;
Local File

POST



Proper Documentation;
Country File & Masterfile

Reporting Exception for an S.M.E. Member of an M.N.E. Group

The New Regulations strengthen the requirements that must be met for a "Small and Medium Enterprise ("S.M.E.") to qualify for tri-annual reporting when it is a member of an M.N.E. Group. Tri-annual reporting is permitted for certain S.M.E.'s when (i) the comparability analysis has been performed using publicly available information sources and (ii) the five comparability factors have not changed substantially. The five factors are the following:

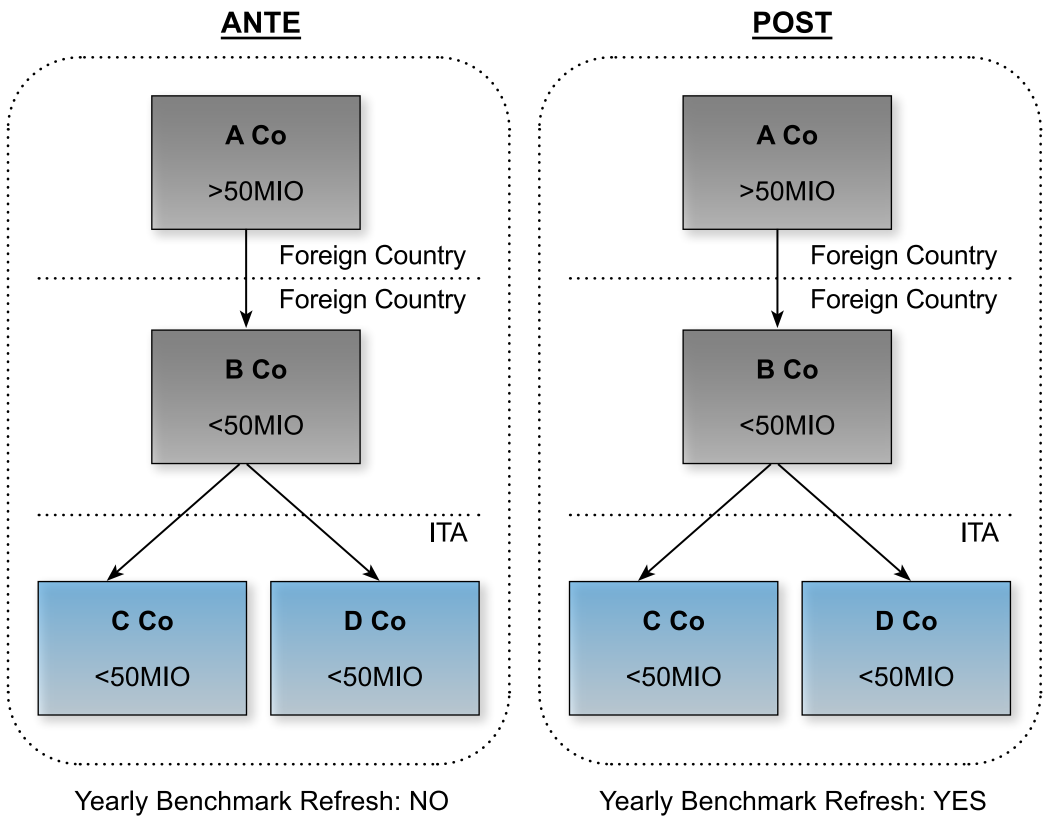
- The contractual terms of the transactions
- The functions performed by each of the parties involved in the operations, taking into account the capital goods used and the risks assumed, including the way in which these functions relate to the broader generation of value within the M.N.E. group to which the parties belong, the circumstances that characterize the operation, and the customs of the sector
- The characteristics of the goods sold, and the services provided
- The economic circumstances of the parties and the market conditions in which they operate
- The business strategies pursued by the parties

The Existing Regulations provide that where the foregoing conditions are satisfied, an S.M.E. qualifies for tri-annual reporting when the S.M.E. meets the following two requirements:

- It has an annual turnover not exceeding €50 million
- It does not control any company with an annual turnover exceeding €50 million.

The New Regulations introduce a third condition that must be met in order to qualify for the benefit. The S.M.E. cannot be controlled by a company with an annual turnover exceeding € 50 million. The additional condition begins with the 2021 fiscal year. As a result, an S.M.E. owned by an M.N.E. likely will no longer qualify for tri-annual reporting. Benchmark analysis will need to be performed annually.

The difference in the requirement regarding annual benchmarking for an Italian S.M.E. owned by an M.N.E. is illustrated in the following diagram.



REVISIONS CONCERNING THE CONTENTS OF THE MASTER FILE AND LOCAL FILE

The New Regulations raises the level of information and data reporting in the Master File in order for an Italian company or permanent establishment to obtain penalty protection.

Master File

The Master File contains information relating to the M.N.E. group. The information must be presented in the manner provided by the New Regulations. Where the Italian company and the M.N.E. group carry on separate lines of business, with each line subject to its own specific transfer pricing rules, more than one Master File can be prepared. Where that occurs, taxpayers must submit the entire Master File for each business line in order to assure that an appropriate overview of the M.N.E. group's global business is provided. This requirement is consistent with paragraph 20 of B.E.P.S. Action 13.

Each Master File must contain separate sections, one for each of the group's (i) value chain, (ii) intangibles, and (iii) financial transactions. It must also include specific items of additional information.

Value Chain Section

The section on value chain must include the important drivers of business profit so that the economically relevant activities that allow the group as a whole to generate value are identified. Here, it is important for the Italian company to consider carefully the information that is included. The information and data provided in this section can be used by the tax authorities to apply a profit split method to the intercompany transaction.

In this regard, paragraph 2.173. of the O.E.C.D. *Revised Guidance Profit Split* states that the M.N.E. group's Master File might be a useful source of information relevant to the determination of appropriate profit splitting factors. Indeed, the Master File should include information on the important drivers of business profit, the principal contributions to value creation by entities within the group, and key group intangibles used to generate profit. Consequently, the value chain section should describe the supply chain relating to the first five products and/or services of the group by turnover, plus any other products and/or services whose turnover exceeds 5% of the overall group turnover.

Intangibles Section

A second area of scrutiny in the Master File is that of intangibles. A general description must be included that explains the global strategy of the M.N.E. group for the development, ownership, and exploitation of intangible assets, including the location of main research and development structures and of the management of research and development activities. The description must include a list of intangibles with indication of the legal owner and of the important agreements related to those intangible assets.

Financial Transactions Section

The last section of the Master File is that of financial transactions. It should provide a general description of how the group is financed, with indication of important financing arrangements with unrelated lenders. Also to be included in this section are details on who performs centralized financial functions and the transfer pricing policy adopted for this type of transactions.

Specific Additional Information

Taxpayers must include enclose the annual consolidated financial statements of the M.N.E. group for the fiscal year concerned and a list and a short description of the advance pricing agreements ("A.P.A.'s") and advance cross-border rulings in place. The New Regulations specifically require that the latter be categorized by country and that the description must include scope, subject and validity.

Local File

The New Regulations address the Local File, and provides important changes which, in some regards, differ from the provisions of B.E.P.S. Action 13.

The New Regulations require general information about the local entity. Included are topics such as history, recent occurrences, and a general overview of the relevant markets. The taxpayer must identify the individuals within the M.N.E. group who oversee local management, specifying the location where those individuals are based. The information contains risks for the M.N.E. group because it can be used by the Italian Tax as evidence of the existence of a hidden permanent establishment of the foreign affiliate in Italy merely due to the reporting lines. The risk is that the business belongs to the foreign affiliate and the Italian company, as a dependent agent, is carrying on the business of the affiliate, thereby creating a permanent establishment in Italy for that affiliate. The ultimate conclusion is that Italian tax may be imposed on the foreign affiliate regarding its revenue from Italy.

In this regard, the Italian Revenue Agency have ruled out the possibility that the functional reporting of an Italian company to a foreign affiliate is automatically relevant in determining whether the affiliate maintains a permanent establishment in Italy where the affiliate is responsible for the production, marketing, and distribution activities of the M.N.E. group.[1]

The general section of the Local File also requires a description of the company's business and business strategy pursued including an indication as to whether the local entity has been involved in or affected by business restructurings or transfers of intangibles. A specific requirement of the Italian Local File is the request of information about the main competitors of the local entity, together with a description of the activities carried out by them.

The New Regulations request information that, in part, already is required by the Existing Regulations.[2] The taxpayer must provide the elements of the related party transactions, and the performance of the comparability analysis in order to accurately delineate the transaction. The elements of the transaction include the amount, parties, and any comparable third-party transactions. In addition, taxpayers must provide a description of the process for selecting the most appropriate method and related comparable transactions. In this regard, a multi-year analysis may be allowable. Italian practice has consistently allowed the use of multiple year data in order

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1 This is the position also taken by the Italian Tax Police in the Circular letter no. 1/2018.

> [I]t may be * * * physiological that local entities, in addition to being subject to the power of direction and control of the parent company, receive directives and are also recipients of policy indications from other subsidiaries that limit their independence also in terms of their operational management. For these reasons, the findings regarding a hidden permanent establishment (being a fixed place of business or an agency), in the presence of a legal entity resident for tax purposes in Italy and belonging to a multinational enterprise, must be carefully weighed and cannot, in any case, be based on the mere management dependency or lack of economic autonomy of the subsidiary, since these characteristics, as mentioned, can constitute aspects that are completely 'usual' in highly integrated structures.

2 A specific set of documentation is provided low value-added services. In order to use the simplified approach for the determination of arm's length charges in a controlled transaction involving low value-added services the taxpayer is required to prepare specific documentation which is consistent with that provided in the O.E.C.D. Guidance.

to improve the process of selecting third-party comparables. However, the wording included in the New Regulations seems to allow for the use of multiple-year analysis also to obtain a complete understanding of the facts and circumstances surrounding the controlled transaction.[3]

A further change in the New Regulations allow the Italian Revenue Agency to request important assumptions made in applying the selected transfer pricing methodology and the indication of the effects deriving from their modification. The scope of this provision is not clear at this time. It may mean that the Italian Revenue Agency will seek information on any assumptions made in the context of transactions involving intangibles. Among the items of interest will be assumptions on valuation techniques, such as useful life of the intangible, projections of future revenue and future expense, and growth rate.

"A further change in the New Regulations allow the Italian Revenue Agency to request important assumptions made in applying the selected transfer pricing methodology and the indication of the effects deriving from their modification."

Finally, the New Regulations provide that the documentation should include copies of existing unilateral and bilateral/multilateral A.P.A.'s and advance cross-border rulings. In particular, A.P.A.'s and rulings must be attached even if they do not involve the local entity, but which are in any event related to the controlled transactions described in the local file. An example might involve an affiliate that licenses an intangible under the same conditions to both its Italian and Spanish subsidiaries, except that the license to the Spanish affiliate is the subject of a bilateral A.P.A. The potential downside of noncompliance with this provision is that it may result in the loss of protection from penalties added to a transfer pricing adjustment. Many advisers expect that a circular will be issued by the Italian Tax Authorities that limit the scope of the provision.

REVISIONS CONCERNING THE FORMAL REQUIREMENTS (LANGUAGE, ELECTRONIC FORMAT, AND TIME STAMP) AND DELIVERY DEADLINES

The New Regulations confirm that transfer pricing documentation must be prepared on an annual basis and in Italian except for the Master File, which may also be submitted in English. Once the Master File and the Local File have been completed, both must be signed by the taxpayer's legal representative or by a delegate by digital signature with time stamp affixed and date of submission of the tax return, which means that the documentation cannot be modified after submission. This documentation will need to be prepared by end of November. Several commentators have questioned whether subsidiaries of foreign-based M.N.E. groups will be able to acquire the necessary documentation on a timely basis prior to the date of filing income tax return.

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[3] This clarification could be relevant for the analysis of the effects of COVID-19. The Guidance on the transfer pricing implications of the COVID-19 pandemic published by the O.E.C.D. excludes the application of multiple-year data so long as

> * * * the data from independent comparables can be measured over a similar period in a consistent manner." In the remaining cases, which are certainly the most frequent, the O.E.C.D. states that "the use of combined periods (that include both years that are impacted by the pandemic and years that are not impacted) may improve reliability.

It is unclear whether the time stamp must also be affixed to attachments, but arguments support a conclusion that attachments need not be stamped. In several places in the circular, the Italian Revenue Agency refer to the attachments as separate documents from the Master File and the Local File. This approach is consistent with a provision that prescribes a deadline of 20 days for the delivery of documents to the tax examiners. This time limit would be unnecessary as long as all the documents to be delivered are ready by the deadline for the tax return with the time stamp.[4]

All the documentation referred to in the present regulations must be submitted in electronic format.

PENATLY PROTECTION

The New Regulations specifies when the documentation is sufficient to protect a taxpayer from penalties arising from a transfer pricing adjustment. The documentation, data ,and information must be sufficient for the tax examiners to conduct a transfer pricing analysis. In contrast with the Existing Regulation, the Italian Revenue Agency place emphasis on data and information regarding the accurate delineation of transactions and the comparability analysis, including functional analysis.

Any disagreement between taxpayer and the tax examiner on the selection of the transfer pricing method adopted and on the search of comparables do not automatically affect the penalty protection. Similarly, any omissions or partial inaccuracies not material to the examination conclusions also are not relevant.

Finally, the New Regulations introduces the possibility for the taxpayer to prepare the proper transfer documentation for only a part of the transfer pricing transactions carried out. In such case, the penalty protection regime is applied exclusively to the transactions expressly described.

CONCLUSION

The New Regulations conforms Italian tax practice to B.E.P.S. Action 13 in a manner consistent with Italian tax practice in general. A significant amount of data must be provided on a timely basis in order for a taxpayer to benefit from penalty protection.

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[4] Par. 5.2.1. of the New Regulations provides that the delivery of the documentation to the tax authorities must be made not later than 20 days from the relevant request.

TAX COMPETITION BETWEEN MEMBER STATES OF THE EUROPEAN UNION – AN ACADEMIC VIEW

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European Commission
Globalization
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INTRODUCTION

In May, the European Commission lost its second case in the E.U. General Court when Amazon's tax arrangement in Luxembourg was found to be onside as to rules prohibiting illegal state aid among Member States. In a companion case having a lesser amount in issue, the tax arrangement between Luxembourg and Engie, a French power company, was found to violate the illegal state aid rules in the E.U. Commissioner Vestager's record stands at two wins (Engie and Fiat) and three losses (Amazon, Apple, and Starbucks) at the E.U. General Court. Three investigations continue, involving Ikea and Nike in the Netherlands and Huhtamaki in Luxembourg. This article examines policy views that support Commissioner Vestager's position in attacking tax arrangements under illegal state aid rules.

THE ABSENCE OF A CENTRALIZED TAX POLICY LEADS TO FRAGMENTATION OF TAX SYSTEMS WITHIN THE E.U.

The rise of favorable tax rulings based solely on accepted tax concepts – without considerations of other factors – has disrupted the normal functioning of the tax systems of Member States. Historically, the role of a national tax system of a Member State was to fund government expenditures for the benefit of residents of that State. However, with globalization and the advent of unilateral advance pricing agreements ("A.P.A.'s"), the Member State's role in governing the economy has taken second seat to promoting the interests of multinational financial and business entities, with the expectation that jobs will be created as a bi-product. Because these A.P.A.'s often favor multinational groups based outside the Member State, they tend to favor nonresidents over residents and detract from the role of the state as a model of political unity within a community.

It is acknowledged that the economic strength of multinational enterprises competes with governmental power and has led to political pluralism. However, it has diminished the main function of a Member State as the sole political decision maker elected by the voters. The tax function is an example of decision-making that is no longer the exclusive province of governments of Member States or the governance structure of the E.U. Where the right to issue favorable A.P.A.'s on a selective basis solely belonged to the Member State, recent cases brought by the European Commission to address tax subsidies reflect limitations now applicable to the authority of Member States to use tax policy for the sole benefit of that State.

THE DISCONNECT BETWEEN NATIONAL TAX POLICY AND PLURALISTIC VALUES WITHIN THE E.U.

The economic power of multinational financial and business entities has contributed to the diminished role of the national government in managing a country's economy. In the 20th Century, the tax system exclusively reflected goals of the government of each Member State. Tax policy reflected local needs. In a sense, this was true whether the government was formed by a party holding a majority in parliament or was a coalition formed by political parties have different constituencies. Granted, policies changed from time to time, reflecting the outcome of parliamentary elections. But either way, government policy was set by the elected government and its various constituencies within the Member State. In this context, the obligation to contribute to public expenses became a fundamental obligation of citizenship. Whether a resident voted for a political party in government or in opposition, the payment of taxes funded local goals.

In a liberal single-class State, legislative decisions are conceived in such a way as to reflect the homogeneous values of the ruling class. Government decision-making responsibilities are shared by political parties reflecting the view of the majority according to accepted guidelines of the national constitution. In comparison, in a modern multiclass state, a need exists to include the values of various classes and interest groups in political life.

The arrival of economically powerful multinational enterprises was accompanied by a shift of fiscal sovereignty in Europe from Member States to E.U. administrators. The issuance of Directives on Administrative Cooperation issued by the European Commission has reduced the role of Member States in making funding choices.

Nineteenth-century concepts regarding the rule of law led to the recognition of the inherent legitimacy of policy choices made by a parliamentary majority. This acceptance of majority rule, as an underlying philosophy, no longer exists. In a modern democracy that reflects a pluralistic society, legitimacy is based on shared values. The liberal state tax system was a legal instrument for achieving the objectives set by the ruling class. Inherently, the policy reflected the ideological convictions of society. The transition to a single policy center within the E.U. has undermined the connection between the tax system within a Member State and the values of the supporters of the majority party. Instead, E.U. mandated tax policy reflects a plurality of collective purposes and aims, and for that reason, often contradicts values in a particular Member State.

Stated simply, the 21st Century has witnessed the devolution of national tax systems within the E.U. into an E.U.-wide tax system that reflects its own values, often promoting a broader pluralist society designed to be homogeneous throughout the E.U.

TAX COMPETITION AMONG E.U. MEMBER STATES – IS IT HELPFUL OR HARMFUL?

The spread of globalization has had a significant impact on the mechanisms which shape the tax choices of Member States. Tax burden is an expense that directly or indirectly contributes to the pricing of a product. Corporate effective tax rates vary among Member States and tax burden has become an important factor when deciding the location for the next plant or value driver. Consequently, the choices made by Member States regarding effective tax rates affects a company's decision on where to locate production plants or other value drivers. While tax is only one of many factors that are considered by management, a Member State that has adopted a taxpayer-friendly tax system for companies has an advantage in attracting multinational companies to the Member State.

The illegal state aid cases brought by the European Commission serve as evidence of (i) the absence of mechanisms to regulate the behavior of companies seeking lower effective tax rates and (ii) the competition among certain Member States attempting to attract plants and value drivers by offering lower effective tax rates. The question posed is whether a Member State should be free to shape its tax system to meet its own goals related to employment and general welfare brought about through investments made by a particular multinational enterprise seeking lower effective tax rates.

At the level of the European Commission, the answer is straightforward. A Member State cannot offer an effective tax rate that is below the effective rate paid by its resident companies, whether based on reduced nominal rates or special deductions under an A.P.A. In policing this concept, the European Commission inherently attacks the independence of Member States to independently manage local tax policy, potentially creating local economic problems.

FASHIONING A COMPETITIVE TAX SYSTEM IN A MEMBER STATE

Tax competition between Member States is a decidedly recent strategy designed to attract capital and business to the territory of a Member State through use of an attractive effective rate of corporate income tax. A Member State that participates in this competition is called upon to configure a tax system capable of convincing multinational enterprises to establish production plants and value drivers within its territory. To be attractive, the effective rate must be lower than the average for all Member States in the E.U., possibly tending towards zero or close to zero.

A Member State participating in this strategy assumes that the establishment of companies and capital compensates for the low effective rate of tax through an increase in other benefits for the population. The benefits may include direct employment of employees, indirect employment of companies and self-employed individuals providing goods and services to the local branch established by a multinational enterprise, higher levels of consumption of consumer goods by residents, infrastructure development, and increases of available capital. The reduction in corporate income tax is offset by an increase in individual tax rates and collections of value added tax. It may also be offset by a reduction in the overall cost of unemployment benefits. In light of these anticipated benefits, offering a lower effective tax rate to a multinational enterprise does not damage the Member State or its residents. Rather, the opposite is achieved because of the stimulus of the national economy.

A different view is held by the European Commission. It views tax competition as a never-ending race to lower effective tax rates. Consequently, it proposes greater coordination of tax policies among Member States to prevent effective tax rates from being eroded in other Member States. The O.E.C.D. supports this approach. Both maintain the view that international tax competition penalizes Member States that do not participate in the competition, ultimately resulting in fiscal problems in those states.

MEMBERSHIP IN THE E.U. TRANSFERS FISCAL POLICY TO NEUTRAL E.U. ADMINISTRATORS

The phenomenon of tax competition has long been the subject of advanced economic studies, in which the differential use of tax policy as a productive system growth lever has been analyzed. Studies typically focus on the economies of developing countries. By and large, the studies conclude that tax competition does not result automatically in market distortion. Rather, it is a legitimate tool of economic policy to the extent it promotes the development of certain business initiatives or investments through foreign capital that would otherwise be available in the country.

"The phenomenon of tax competition has long been the subject of advanced economic studies, in which the differential use of tax policy as a productive system growth lever has been analyzed."

Beginning in the late 20th century, the notion of harmful tax competition among Member States developed, looking at tax competition as an inappropriate lever to distort normal market logic. Under this view, the harm results from the selective process of determining which industries will benefit from a reduction in effective tax rates. Certain activities were favored, typically the financial sector, and the beneficiaries were multinational companies, rather than companies involved in the local economy and its internal production system. In the end, benefits were given to revenue streams consisting of interest, dividends, royalties, rather than the production of goods for local consumption.

Whether due to the growth in economic power of multinational enterprises, or the rise of transnational advisory bodies such as the O.E.C.D., or the empowerment of centralized policy organs of the E.U., such as the European Commission, globalization diminished the role of Member States in setting tax policies. In a sense, pluralism overtook the central governing function of Member States as to economic policy decisions. The tax function no longer is identified with the central function of the Member State. The result is a fragmentation of the tax system into a plurality of systems, each responding to values expressed by the various legal systems. No single Member State has the power or authority to choose a path that is destructive to other Member States as determined by the governing agencies of the European Union.

In this context, the duty to contribute to public expenses is considered a responsibility connected to membership in the European Union. In terms of fiscal policy, paying taxes is a fundamental obligation of citizenship necessary for the survival of the European Union. The shift of fiscal sovereignty from the Member States to the various organs of the European Union has led to a profound transformation in the ethical concept of the tax system. The European Union is a multi-class community comprised of various cultures each with its own value system and interest groups that need to combine interests of majorities and minorities throughout the Community.

Nineteenth-century formation of the rule of law consisted of neutrality in respect to society in a single state, which led to t the validity of decision-making choices of a parliamentary majority. This has been overturned within the E.U. by the inclusion of pluralist communities in all Member States that share a common value system.

Consistent with this transformation, all tax systems within the E.U. reflect an open structure that is not supported by the pre-eminence of values coming from a particular social class in any particular country. Instead, tax systems of member states reflect compromise solutions resulting from the political and social mediation of a plurality of demands emerging from various stakeholders throughout the E.U.

CONCLUSON

The spread of globalization and market approximation processes have limited the range of choices by Member States in regard to tax policy. Use of tax policy to make one Member State more attractive than another for the location of foreign investments is no longer acceptable. Rather, tax policy has become an instrument governing the allocation of foreign investment throughout the E.U. based on the combined needs of all Member States. The importance of greater coordination of tax policies among Member States prevents inappropriate distortions that erode the tax base of other States.

Increasingly, it can be argued that the tax system is the result of the concurrent action of a plurality of sources, located at the state, sub-state, and international levels. To the extent that divergent goals exist, the differences are addressed in the regulatory process that takes into account community-wide needs.

THE 15 MOST IMPORTANT QUESTIONS THAT SHOULD BE ASKED WHEN ESTATE PLANNING FOR A FOREIGN PARENT WITH U.S. CHILDREN

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Tags
Domestic Trust
Estate Tax
Foreign Trust
Gift Tax
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Non-Domiciled
N.R.A.

INTRODUCTION

U.S. estate tax planning is said to be among the most complicated aspect of tax planning because of the numerous moving parts and the changing needs and objectives of the family. The exercise becomes complicated when the client is not a U.S. person, but the heirs live in the U.S. and have started families in the U.S.

This article is intended to guide an adviser in dealing with the specific issues that arise when a client has roots outside the U.S. and heirs in the U.S. It does so by setting up a typical fact pattern and then identifying 15 issues that are unique to this type of client. It is based on U.S. tax law currently in effect. The reader is cautioned that many provisions may change, possibly with retroactive effect.

FACT PATTERN

Mrs. Smith walks into your office. She advises that she is not a U.S. citizen and lives permanently outside the U.S. She does not hold a green card. Mrs. Smith has two adult children and several grandchildren. One child qualifies as a U.S. resident and the other is a citizen of the U.S. by naturalization.

Mrs. Smith seeks advice on how to structure her estate in order to reduce or eliminate U.S. Federal estate tax. Her assets include the following:

- All the issued and outstanding shares of a corporation formed in her home country
- A term life insurance policy issued by a U.S. insurance company
- A house in a foreign country
- All issued and outstanding shares of a U.S. corporation. The principal asset of the corporation is a condominium apartment located within the U.S.
- All the furnishings for the condominium apartment that were purchased by Mrs. Smith and which have never been contributed to the U.S. corporation
- A portfolio of publicly traded shares of U.S. corporations
- A portfolio of publicly traded bonds
- An automobile owned and registered in her name in the state where her resident child resides, which is used by that child

She has many concerns about U.S. estate tax, but does not know where to begin. Her daughters will inherit, but she wishes to provide for them during her lifetime.

She asks for your advice. Below are the 15 most important questions that should be asked and answered in fashioning a plan for her to minimize U.S. estate tax exposure – as it exists under current law – and to plan for tax issues she and her two daughters may face in the U.S.

15 ESTATE PLANNING QUESTIONS AND ANSWERS

1. What properties listed above will be subject to U.S. estate tax for a foreign individual such as Mrs. Smith?

For an individual that is neither a U.S. citizen nor a U.S. resident for estate tax purposes ("an N.R.N.C. individual"), such as Mrs. Smith, the only assets that are subject to U.S. estate tax are assets having a situs in the U.S.[1] This includes shares of a U.S. corporation, debt instruments issued by a U.S. person, unless specifically exempt, tangible personal property physically located in the U.S., and U.S. real property.

If an N.R.N.C. individual were to own U.S. situs property, the first $1,000,000 of taxable value will be taxed at graduated rates totaling in $345,800. Thereafter, the estate tax is imposed at a flat 40% rate at Federal level. A benefit can be claimed for a portion of global administration expenses and claims against the estate. However, direct tracing of expenses to various countries is not allowed for U.S. tax purpose. Rather, the percentage of the global estate that is situated in the U.S. controls the portion of global administration expenses and claims that reduce the gross U.S. estate. Note that deductions are allowed only if the executor files a true and accurate U.S. estate tax return that lists all of the gross estate situated outside of the U.S. There is no unlimited marital deduction for bequests to a surviving spouse. However, the estate tax can be deferred through the establishment of a Qualified Domestic Trust ("Q.D.O.T.") until a triggering event occurs. Finally, the unified credit that may be claimed by U.S. persons to eliminate estate tax on $11.7 million in 2021 is reduced to $60,000.

For Mrs. Smith, the shares of the U.S. corporation owning an apartment, the portfolio of publicly traded shares, the automobile, and the furnishings in the apartment are U.S. situs assets. Certain other assets owned are specifically treated as foreign situs assets, as discussed in the answer to the following question. For those assets that are considered to be U.S. situs assets, the estate tax in the U.S. can be burdensome.

2. Are certain assets generally thought to be U.S. situs assets exempt from U.S. estate tax at the time of Mrs. Smith's death?

As a matter of tax policy, certain assets that would be considered to be U.S. situs assets under the general rule discussed in the answer to the preceding question are treated as foreign situs assets and for that reason are not subject to U.S. estate tax. These assets include the following:

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[1] Code §2103.

- Account balances in domestic U.S. banks and foreign branches of U.S. banks that are not connected to the conduct of a U.S. business by the N.R.N.C. individual[2]

- Portfolio debt obligations for which interest income is not subject to U.S. tax under Code 871(h) for an N.R.N.C. individual, such as publicly traded debt instruments or privately issued debt obligations that meet certain conditions, of which the most important are that the instrument cannot be freely transferred by endorsement, the creditor cannot be related to the U.S. debtor as defined in the statute, and the rate of interest cannot be contingent because it is based, *inter alia*, on profits, cash flow, value of assets, and like items[3]

- Short-term O.I.D. obligations, generally commercial paper or Treasury instruments having a term of 183 days or less from the date of original issue[4]

- Insurance proceeds on the life of an N.R.N.C. individual[5]

- Works of art on loan to a not-for-profit public gallery or museum in the U.S.[6]

"In comparison to estate tax which covers all U.S. situs assets other than those treated as foreign situs assets, U.S. situs intangible property is not subject to gift tax when given away during life."

For Mrs. Smith, the U.S. situs assets that are treated as foreign situs assets are the portfolio of publicly traded bonds and life insurance policy. While Mrs. Smith's taxable estate will not include the foregoing items, so that nothing need be done during Mrs. Smith's lifetime to restructure ownership, her executor may face a practical problem for account balances with banks and investment portfolios held in street name by financial institutions. These institutions may refuse to release assets to Mrs. Smith's executor until such time as a closing letter is issued by the I.R.S. regarding satisfaction of estate tax liability, if any. Anecdotally, advisers have complained that the I.R.S. has taken up to two years to issue a closing letter even when the estate of an N.R.N.C. individual is involved, and the assets have a foreign situs. Consequently, it may be prudent for Mrs. Smith to raise the matter with all banks and financial institutions she uses. If written assurances are not received, it would be prudent to move the investments.

3. <u>Are all items of U.S. situs property that are subject to U.S. estate tax at the time of Mrs. Smith's death subject to gift tax if given away during her lifetime?</u>

No. In comparison to estate tax which covers all U.S. situs assets other than those treated as foreign situs assets, U.S. situs intangible property is not subject to gift tax when given away during life.[7] For purposes of the U.S. Federal gift tax, intangible property is not defined in the Internal Revenue Code. Over the years, various rules have developed. Some of these are as follows:

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2 Code §2105(b)(1).

3 Code §2105(b)(3).

4 Code §2105(b)(4).

5 Code §2105(a).

6 Code §2105(c).

7 Code §2501(a)(2).

- Cash money and currency in physical form are items of tangible property, and gift tax will be due if gratuitously transferred in the U.S. by an N.R.N.C. individual.[8]

- Treasury Regulations discussing the situs of property in the context of gifts or bequests by foreign individuals state that intangible personal property consists of a "property right," and includes stocks, bonds, and debt obligations, including bank deposits.[9]

- In Private Letter Ruling 7737063, the I.R.S. stated that intangible property refers to choses in action[10] such as corporate stock, bonds, notes, bank deposits, patents, partnership interests, goodwill, but not to physical cash.

Note that no unified credit is allowed for gifts made by an N.R.N.C. individual. However, the $15,000 annual exclusion for gifts to each recipient remains applicable to an N.R.N.C. individual. There is no unlimited marital deduction for an N.R.N.C. individual in connection with gift tax. However, the $15,000 annual exclusion for an interspousal gift is increased more than tenfold. In 2021, the amount is $157,000.

For Mrs. Smith, the shares of the U.S. corporation owning the apartment, the portfolio of publicly traded shares of U.S. corporations, the portfolio of publicly traded bonds, and the life insurance contract can be given away without triggering the obligation to pay U.S. gift tax.

4. <u>Will Mrs. Smith become a U.S. resident for estate and gift tax purposes if she were to spend substantial periods of time in the U.S. under a tourist visa in order to be with her children and grandchildren?</u>

No. Spending time in the U.S., by itself, is not sufficient to cause an N.R.N.C. individual such as Mrs. Smith to become a U.S. resident for estate and gift tax purposes.

In comparison to the definition of residence for income tax purposes, for which tax residence is determined based on two objective tests, the determination of residence for gift and estate tax purposes is based on a subjective test. For a non-citizen individual, the definition for estate and gift tax purposes is based on domicile.

> A 'resident' decedent is a decedent who, at the time of his death, had his domicile in the U.S. *** 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.[11]

Intention is generally demonstrated by objective facts relating to how the non-citizen leads his or her life. Not unexpectedly, the cases are numerous, and conclusions

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8 *Blodgett v. Silberman*, 277 U.S. 1 (1928). Rev. Rul. 55-143.

9 Treas. Reg. §§25.2511-3(b)(3), (4).

10 A chose in action is a right to sue. It is an intangible property right recognized and protected by the law, that has no existence apart from the recognition given by the law, and that confers no present possession of a tangible object.

11 Treas. Reg. §20.0-1(b).

are not necessarily consistent. Typically, the matter is decided by the existence or absence of a hook to the U.S. that is meaningful to the decedent at the time of death or the making of a gift. In broad terms, U.S. presence under a green card may be sufficient, even if presence is limited after initial entry.[12]

For Mrs. Smith, mere presence in the U.S., by itself, should not be sufficient to cause her to be domiciled in the U.S. in the absence of a green card, in the ordinary course of events.

5. <u>Why are trusts an attractive tool in U.S. Federal estate tax planning for an N.R.N.C. individual such as Mrs. Smith?</u>

Trust are an attractive tool for an N.R.N.C. individual such as Mrs. Smith because they are flexible and allow assets to pass to the next generation in a tax-free way, depending on the asset transferred and the terms in the trust instrument. They also allow the settlor to feel comfortable regarding the marital rights of a child's spouse.

Trusts vary based on the needs of the settlor who creates the trust. The settlor can choose whether the trust is revocable or irrevocable. As discussed below, even if formed in the U.S., a trust can be foreign or domestic, and tax consequences flow from that characterization.

For U.S. Federal tax purposes, the treatment of a trust depends upon the purpose and the actions of the trust. If a trust is formed to protect or conserve assets for the benefit of beneficiaries, it is treated as an ordinary trust.[13] If it is formed to carry on a business, it is treated as a business entity.[14]

A gift of U.S. situs intangible property to a trust established by Mrs. Smith may provide an effective way to pass property to the next generation with no U.S. gift tax at the time of the gift and no U.S. estate tax at her death, provided that neither certain interests nor powers over the trust are retained after the trust is funded.[15]

For an N.R.N.C. individual who has married children, such as Mrs. Smith, a gift to a trust may be more attractive than an outright gift to a married child because it can effectively prevent or limit the marital interests in the property that may be asserted by a child's spouse at the time of a divorce. Where outright gifts of property are made, a co-mingling of funds may affect the status of the gift as separate property. In comparison, if the spouse is not a beneficiary and the terms of the trust are followed, the marital right of the spouse in the property owned by the trust is presumptively limited.

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[12] *Estate of Khan v. Commr.*, T.C. Memo 1998-22.

[13] Treas. Reg. §301.7701-4(a).

[14] Treas. Reg. §301.7701-4(b).

[15] Code §§2035 (property given away "with strings attached" and a "string" is given away within three years of death), 2036 (property given away during life, but donor continues to have a right to the income from the property or retains the right to designate the persons who can possess or enjoy the property or its income), §2037 (property given away during life, but the recipient must survive the death of donor in order to enjoy possession of property), §2038 (The property is transferred during life, but donor retains power to alter, amend, revoke, or terminate the transfer), and §2041 (Property over which the decedent has at the time of his death a general power of appointment).

As a cautionary point, advice regarding potential gift tax consequences in the country of residence of the N.R.N.C. individual should be obtained from a competent tax adviser before Mrs. Smith makes a gift of property to a trust. In many countries, it is not uncommon for tax authorities to be suspicious when a local resident settles a trust formed in another country, especially when the trust is discretionary.

6. What interests and powers over the trust must not be held by Mrs. Smith and why must those powers be avoided?

In some instances the scope of U.S. estate tax may reach property that has been given away during lifetime so that property not owned at death is included in a taxable estate. In broad terms, the policy expressed when property is clawed back into the taxable estate is that retention of a specific interest or power is inconsistent with a completed gift during life.

Generally, the following interests and powers cannot be retained without having an adverse effecting on the donor at the time of death:

- The property is given away during life, but the donor continues to have a right to the income from the property or retains the right to designate the persons who can possess or enjoy the property or its income.[16]
- The property is given away during life, but the recipient must survive the death of the donor in order for the recipient of the gift to enjoy possession of property.[17]
- The property is transferred during life, but the donor retains power to alter, amend, revoke, or terminate the transfer.[18]
- The decedent has at the time of his death a general power of appointment over the property, which means the donor can appoint the property to himself or to his creditors.[19]
- The property is given away during life, but subject to one or more of the foregoing interests and powers, and the retained interest or power is relinquished within three years of death.[20]

"In many countries, it is not uncommon for tax authorities to be suspicious when a local resident settles a trust formed in another country, especially when the trust is discretionary."

7. If Mrs. Smith were to settle a trust formed under U.S. state law, what tests are applied to determine whether the trust is considered to be a U.S. domestic trust or a foreign trust for U.S. income tax purposes?

Mrs. Smith must be careful in who she appoints as protector or as the holder of a power over the governance of the trust. If a non-U.S. person can make a substantial decision for the trust, the U.S. trust may find that it is foreign for income tax purposes.

[16] Code §2036.

[17] Code §2037.

[18] Code §2038.

[19] Code §2041.

[20] Code §2035.

Two tests must be met for a trust to be treated as a domestic trust. The tests are the Court Test and the Control Test.[21] A trust that fails to satisfy either test is a foreign trust, even if formed in the U.S.[22] As is readily apparent, U.S. tax as to this matter is written to favor the finding that a trust is a foreign trust. The reason is explained below in connection with the taxation of U.S. beneficiaries of foreign trusts.

The Court Test is met if a U.S. court exercises primary supervision over the trust's administration.[23] A U.S. court exercises primary supervision when the instrument does not direct that the trust must be administered outside of the U.S., the trust is only administered in the U.S., and the trust is not subject to an automatic migration provision if a U.S. court asserts jurisdiction to supervise administration of the trust.[24]

The Control Test is met if one or more U.S. persons, as defined by Code §7701(a)(30), control all substantial decisions relating to the trust.[25] Substantial decisions are those that persons are authorized to make under the terms of the trust instrument and applicable laws. The regulations issued by the I.R.S.[26] illustrate substantial decisions with the following non-exclusive list of decisions:

- Whether and when to distribute income or corpus
- The amount of any distributions
- The selection of a beneficiary
- Whether a receipt is allocable to income or principal
- Whether to terminate the trust
- Whether to compromise, arbitrate, or abandon claims of the trust
- Whether to sue on behalf of the trust or to defend suits against the trust
- Whether to remove, add, or replace a trustee
- Whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee, even if the power to make the decision is not accompanied by an unrestricted power to remove a trustee, unless the power to make such a decision is limited so that it cannot be exercised in a manner that would change the trust's residence from foreign to domestic, or vice versa
- Investment decisions – if a U.S. person hires an investment advisor for the trust, investment decisions made by the investment advisor will be considered substantial decisions controlled by the U.S. person when the U.S. person retains the authority to terminate the investment advisor's power to make investment decisions without any preconditions set for the exercise of that authority

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[21] Code §7701(a)(30)(E).

[22] Code §7701(a)(31)(B).

[23] Code §7701(a)(30)(E)(i); Treas. Reg. § 301.7701-7(c)(1).

[24] Treas. Reg. § 301.7701-7(c)(4)(ii).

[25] Code §7701(a)(30)(E)(ii).

[26] Treas. Reg. § 301.7701-7(d)(1)(ii).

To have control means that a U.S. person must have the power to make all substantial decisions of the trust and cannot be blocked by a foreign person.[27] In broad terms, a U.S. person means a U.S. citizen or resident (determined under the objective tests set forth in Code §7701(b)), a domestic partnership, and a domestic corporation.[28]

For Mrs. Smith, the decisions that appear on the foregoing list must be made by one or more U.S. persons. In considering which of her daughters should hold a power, care must be taken to ensure that the decision-making authority does not grant to that daughter the power to appoint assets or income to herself or her creditors.

8. Why may Mrs. Smith, an N.R.N.C. individual, find it attractive to use a U.S. domestic trust for U.S. Federal estate tax purposes when her children live in the U.S.?

There are two reasons why Mrs. Smith may decide to establish a U.S. domestic trust instead of a foreign trust.

- All beneficiaries are U.S. persons, and, if a foreign trust were established, the beneficiaries would be subject to adverse tax consequences under the throwback rules, in the event the foreign trust were to accumulate its income and gains over several years after which a substantial distribution would be made that is treated in whole or in part as an accumulation distribution.
- All beneficiaries are U.S. persons, and a U.S. beneficiary of a foreign trust is deemed to have income when she receives (i) a loan that bears no interest or an interest rate that is below an arm's length rate or (ii) the use of assets from a foreign trust without having to pay arm's length compensation.

Those rules generally do not apply when a trust is a U.S. domestic trust. Consequently, because Mrs. Smith's daughters are U.S. persons and the daughters are trust beneficiaries, it may be preferable for Mrs. Smith to settle a U.S. domestic trust.

Accumulation Distributions

An accumulation distribution is a distribution that is made by a foreign trust from prior years' accumulations of income and gain (i) after the current year's income and gains have been distributed and (ii) prior to the make of distributions of capital, all as determined in accordance with U.S. income tax rules.[29] Accumulation distributions are subject to throwback rules.[30] These rules recapture the tax benefit of reinvesting income in a tax-free environment at the level of a foreign trust, especially when the trust is formed in a low-tax jurisdiction. If neither the trust nor the beneficiary is subject to U.S. tax when and as income is generated at the level of the trust, 100% of profits and gains in excess of expenses can be reinvested. In comparison, if a U.S.

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27 Treas. Reg. § 301.7701-7(d)(1)(iii).

28 Code §7701(a)(30).

29 When determining the income of U.S. beneficiaries from a trust, tax consequences follow rules that treat each dollar distributed to have the same character as each other dollar. Consequently, each dollar of a distribution that is made to a capital beneficiary is treated identically to each dollar that is distributed to an income beneficiary.

30 Codes §§ 665-668.

domestic trust were formed, only after-tax income and gains in excess of expenses can be reinvested by the trust.

Distributions from a U.S. domestic trust are not subject to the throwback rules because a U.S. domestic trust is subject to U.S. tax at the maximum rate provided under U.S. tax law on virtually all its undistributed income for the year.[31] Once a U.S. domestic trust pays the tax on accumulated income, distributions allocated to such income are not further taxed in the U.S. when distributed to a U.S. beneficiary.

"Once a U.S. domestic trust pays the tax on accumulated income, distributions allocated to such income are not further taxed in the U.S. when distributed to a U.S. beneficiary."

<u>*Loans and Use of Trust Property*</u>

The principal amount of a loan from a foreign trust to a U.S. beneficiary that does not meet the requirements to be treated as a qualified obligation of the beneficiary is treated as a distribution for U.S. income tax purposes.[32] When a loan that is treated as a distribution is repaid, the repayment has no additional tax consequences.[33]

Based on legislative history and the I.R.S. instructions to Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts,* the I.R.S. is authorized to issue regulations defining the circumstances when a loan from a foreign trust is treated as a true loan. Although no regulations have been issued, the terms set forth in the grantor trust regulations apply to loans made by foreign nongrantor trusts to U.S. beneficiaries.[34]

To be considered a qualified obligation, the following conditions must be met:

- The obligation must be embodied in a written agreement.
- The term of the obligation must not exceed five years, inclusive of options to renew and rollover.
- All payments on the obligation must be denominated in U.S. dollars.
- The yield to maturity of the obligation must be within the range of 100% to 130% of the Applicable Federal Rate ("A.F.R.") published by the I.R.S. for the month in which the obligation is issued.
- The U.S. person agrees to extend the period for assessment of additional tax for a period of at least three years following the maturity date of the obligation, unless the loan is issued and fully repaid within one calendar.
- The U.S. person properly reports the obligation on Form 3520.

When a U.S. beneficiary derives a benefit from the use of property held by a foreign trust – often, a condominium – the beneficiary must treat the use of the property as a distribution.[35] This provision does not apply when fair rental value is paid.

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31 A U.S. domestic trust reaches the maximum tax bracket of 37% under current law when its taxable income reaches $13,050.

32 Code §643(i)(1).

33 Code § 643(i)(3).

34 Treas. Reg. 1.679-4(d).

35 Code §643(i)(2)(E).

9. What is a grantor trust under U.S. tax law, and why should Mrs. Smith avoid using a grantor trust as a vehicle to benefit her daughters in light of the U.S. property owned by Mrs. Smith?

In light of the U.S. property owned by Mrs. Smith, she likely should avoid using a grantor trust in planning for her gifts. In connection with a grantor trust having a foreign person as grantor, it is likely that no gift or estate tax planning benefits would be realized as to her U.S. property if she were to use a grantor trust.

A grantor trust is tax term given to a trust where the settlor or the person who funds the trust retains certain rights and powers over the trust, its assets, or its income, and as a result, the grantor is deemed to be the owner of the trust's assets and income.[36] In broad terms, a trust is treated as a grantor trust in any of the following fact patterns:

- The grantor has a reversionary interest in either the corpus or the income therefrom, and if, as of the inception of that portion of the trust, the value of that interest exceeds 5% of the value thereof.[37]
- The grantor has the power to control beneficial enjoyment of the income or corpus.[38]
- The grantor retains certain administrative powers, including the right to substitute property in the trust and the right to borrow from the trust on an interest-free basis.[39]
- The grantor has a power to revoke the trust.[40]
- The income of the trust is or may be distributed to, held for the future benefit of, or used to pay for life insurance on the lives of, the grantor or the grantor's spouse.[41]
- A person other than the grantor has the power, exercise solely by her, to appoint the assets or the income of the trust to herself.[42]
- The grantor of the trust is a U.S. person, the trust is foreign, and one or more actual or potential beneficiaries are U.S. persons.[43]

While the foregoing seven fact patterns delineate when a trust is considered to be a grantor trust, only two apply when the person who would be the grantor is not a U.S. person. An N.R.N.C. individual is treated as the grantor of a grantor trust when (i) the trust is revocable or (ii) the only persons who may receive distributions from

36 Code §§671-679.

37 Code §673.

38 Code §674.

39 Code §675.

40 Code §676.

41 Code §677.

42 Code §678.

43 Code §679.

the trust during the lifetime of the foreign grantor are the grantor and the grantor's spouse.[44] If neither condition is met, the trust is a non-grantor trust.

In the facts, Mrs. Smith wants her daughters to be current beneficiaries of her trust. As a result, a trust can be treated as a grantor trust only if it is revocable. However, if a revocable trust owns U.S. property, the U.S. situs of the assets of the trust will be included in a U.S. taxable estate at the time of the grantor's death. Consequently, Mrs. Smith should take steps to avoid settling a trust treated as a grantor trust.

10. <u>Are there circumstances in which Mrs. Smith may wish to invest in a foreign grantor trust?</u>

Yes, if Mrs. Smith were to invest in assets located outside the U.S. that produce foreign source investment income and gains subject to little or no income tax, she might want to settle a foreign grantor trust. The trust could be formed outside the U.S. or inside the U.S.

During the time that the Trust qualifies as a grantor trust, distributions made from the Trust to a U.S. beneficiary would be treated as gifts made directly from Mrs. Smith to the beneficiary. The distributions would not constitute taxable income for a U.S. beneficiary.[45] Consequently, the U.S. beneficiaries of the foreign grantor trust would not be subject to income tax on the receipt of trust distributions.

Even though no income tax is imposed on a U.S. beneficiary in connection with the receipt of a distribution from a foreign grantor trust having a foreign grantor, Form 3520[46] reporting obligations are imposed on the U.S. beneficiary and penalties are imposed on a U.S. beneficiary's failure to properly report amounts actually received as distributions from the trust.[47] The penalties are capped at 25% of the amount that should have been reported.

11. <u>Mrs. Smith owns shares of a U.S. corporation having a condominium unit as its principal asset. Are the shares of the corporation considered to be a U.S. Real Property Interest?</u>

Yes. The shares of the corporation likely are considered to be a U.S. Real Property Interest ("U.S.R.P.I.").

A U.S.R.P.I. is an interest, other than solely as a creditor, in either of the following assets:

- Real property located within the U.S., such as a condominium unit or investment real property
- Any interest in a U.S. Real Property Holding Corporation ("U.S.R.P.H.C.")[48]

A U.S.R.P.H.C. is any domestic corporation that owns a U.S.R.P.I. with a fair market value that is equal to or exceeds 50% of the combined fair market value of its

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[44] Code §672(f).

[45] Rev. Rul. 69-70.

[46] Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*.

[47] Code §6039F.

[48] Code §897(c)(1)(A).

U.S.R.P.I.'s, interests in foreign real property, and any other of its assets which are held or used in a trade or business.[49] If the U.S.R.P.H.C. is not a domestic corporation, a foreign shareholder is not taxed in the U.S. on the gain generated from the sale of shares.

All U.S. corporations are deemed to be U.S.R.P.H.C.'s unless otherwise demonstrated. Where a U.S. domestic corporation operates a business other than rental real estate or real estate development and the business is housed in premises owned by the corporation, it may not be easy to demonstrate that the corporation is not a U.S.R.P.H.C. To address the issue, the fair market value of the corporation's U.S.R.P.I.'s is presumed to be less than 50% of the fair market value of the aggregate of its assets if the total book value of the U.S.R.P.I.'s held by the corporation is not more than 25% of the book value of the aggregate of the corporation's assets on an applicable determination date.[50] The applicable determination dates are

- the last day of a taxable year,
- any date on which its U.S.R.P.I. is acquired,
- any date on which a foreign real property interest or an asset used in a trade or business is disposed of, and
- any date that would be a determination date in for a lower-tier entity owned by a corporation.[51]

Mrs. Smith owns shares of a U.S. corporation that owns a condominium unit. The unit is not part of a separate business and the principal asset of the corporation is the condominium unit. Consequently, she owns a U.S.R.P.H.C.

12. If Mrs. Smith were to sell the shares of the U.S.R.P.H.C., what U.S. Federal income tax consequences would she encounter if the property were sold at a gain?

In general, Mrs. Smith would recognize gain from the sale of the shares of the U.S.R.P.H.C.

Capital gains derived by an N.R.N.C. individual from the sale of shares of stock generally are not subject to U.S. Federal tax. However, the sale of shares of a U.S.R.P.H.C. is taxed because it constitutes a disposition of U.S.R.P.I.[52]

Although the tax base ultimately will be the net gain realized on the sale,[53] the amount realized is subject to U.S. withholding tax that is collected by the purchaser.[54] In most circumstances, the withholding tax is imposed at the rate of 15% of the amount realized. If the U.S.R.P.I. is acquired for use by the purchaser as a residence

[49] Code §897(c)(2).

[50] Treas. Reg. §1.897-2(b)(2).

[51] Treas. Reg. §1.897-2(c)(1).

[52] Code §897(a)(1).

[53] Treas. Reg. §1.1445-1(g)(5). The amount realized is the sum of the cash paid, the fair market value of other property transferred, and the outstanding amount of liability assumed by the transferee.

[54] Code §1445(a). The transferee is required to deduct and withhold a tax equal to 15% of the amount realized on the disposition.

and the amount realized does not exceed $1.0 million, the rate of withholding tax is reduced to 10% of the amount realized.

Generally, the amount realized is the sum of

- the cash paid, or to be paid (principal only);
- the fair market value of other property transferred, or to be transferred; and
- the amount of any liability assumed by the transferee or to which the property is subject immediately before and after the transfer.[55]

The amount that must be withheld from the disposition of a U.S.R.P.I. can be reduced pursuant to a withholding certificate issued by the I.R.S. The purchaser or seller may request a withholding certificate.[56] The I.R.S. will generally act on these requests within 90 days after receipt of a complete application including the Taxpayer Identification Numbers of all the parties to the transaction. A transferor that applies for a withholding certificate must notify the transferee in writing that the certificate has been applied for on the day of or the day prior to the transfer. Several categories of withholding certificates exist, each relating to a different fact pattern. The most common category of withholding certificate relates to a fact pattern in which the withholding tax exceeds the transferor's maximum tax liability.

"The amount that must be withheld from the disposition of a U.S.R.P.I. can be reduced pursuant to a withholding certificate issued by the I.R.S. The purchaser or seller may request a withholding certificate."

Regarding Mrs. Smith, a sale of the shares of the U.S. corporation would be subject to a 15% withholding tax imposed on the amount realized for the shares.

13. If Mrs. Smith were to gift the shares of the U.S.R.P.H.C. to a U.S. domestic trust, would the gift be subject to withholding tax?

Were Mrs. Smith to gift stock of a U.S.R.P.H.C. to a trust, no tax would be due, and no withholding would be required, because the gift of shares of a U.S.R.P.H.C. to a trust is a transaction in which no amount is realized. An example of a nonrecognition transaction is a transfer of a U.S.R.P.I. to a U.S. corporation that is a U.S.R.P.H.C. in a transaction to which Code §351. Gain is realized by not recognized. In comparison, a gift is made gratuitously, so that no consideration is received as consideration for the transfer. The I.R.S. regulations state,

> If the amount realized * * * by the transferor is zero, then no withholding is required. For example, if a real property interest is transferred as a gift (*i.e.*, the recipient does not assume any liabilities or furnish any other consideration to the transferor) then no withholding is required.[57]

However, the donor must notify the donee that the event was a nonrecognition event and the donee must mail a copy of that notice to the I.R.S. within 20 days after the transfer.[58] The adjusted basis in the U.S.R.P.H.C. carries over to the trust.

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55 See "Rates of Withholding."

56 Form 8288-B, *Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests*.

57 Treas. Reg. § 1.1445-1(b)(1).

58 Treas. Reg. §1.1445-2(d)(2)(i)(B).

14. Why Is it preferable for Mrs. Smith to transfer the shares of the U.S.R.P.H.C. to a trust rather than to owned a foreign corporation?

It is preferable for Mrs. Smith to transfer the shares of the U.S.R.P.H.C. to a trust rather than to a foreign corporation because the latter likely will run afoul of the anti-inversion rules of U.S. tax law, and for that reason, likely will be treated as a U.S. corporation for U.S. income tax purposes.

If a foreign corporation were used to hold the share of the U.S.R.P.H.C. instead of a trust, the anti-inversion rules of Code §7874 likely will apply. Code §7874 is meant to discourage the restructuring of a U.S. corporation owned by one or more shareholders into a foreign corporation primarily owned by the same shareholders by reason of holding stock in the domestic corporation. Where the ownership interest in the foreign corporation equals or exceeds 60%, certain adverse tax consequences are realized by the transferor upon as a result of the restructure. Where the ownership interest in the foreign corporation equals or exceeds 80%, the foreign corporation is treated as a U.S. domestic corporation.[59]

15. Were Mrs. Smith to make no changes in the ownership of her assets, what problems likely will be encountered regarding Mrs. Smith's U.S. estate tax liability, and what other problems would be inherited by her daughters in the U.S. at the conclusion of Mrs. Smith's lifetime? What action steps might be considered to remedy that problem during Mrs. Smith's lifetime?

Under current U.S. Federal tax law, the basis of the shares of stock in the foreign corporation will be stepped up to fair market value when the daughters of Mrs. Smith inherit her property. The adjusted basis of property acquired from a deceased individual by reason of her death is the fair market value on the date of death.[60] However, the adjusted basis of assets owned by a foreign corporation that is owned by Mrs. Smith will not be stepped up simply by reason of her death.

If Mrs. Smith were to make no revisions to the way her assets are held, her estate and her daughters will face various problems. Using the list of assets that appears at the beginning of this article, the assets, potential tax problems, and potential remedial action for consideration are as follows.

ASSET	PROBLEMS	POTENTIAL ACTION
All the issued and outstanding shares of a corporation formed in her home country	The daughters will obtain a step-up in basis for the shares of the foreign corporation. However, the basis for assets owned by that corporation will not be stepped up.	If the entity is eligible, an entity classification elec-tion can be made for U.S. tax purposes, so that it becomes a disregarded entity. Daughters will obtain a step-up in basis at time of inheritance.

[59] Code §7874(b).

[60] Code §1014(a)(1).

ASSET	PROBLEMS	POTENTIAL ACTION
A term life insurance policy issued by a U.S. insurance company	None. The term life insurance policy is a foreign situs asset.	No action is required.
A house in a foreign country	None, because the house is a foreign situs asset for estate tax purposes.	No action is required.
All issued and outstand-ing shares of a U.S. corporation having a condominium apartment located within the U.S. as its principal asset	The shares of a U.S. corporation will be subject to U.S. estate tax if owned at death.	Consider gifting the shares to a nongrantor U.S. domestic trust. No gift tax will be due. No gain realized. No income tax will be due in connection with the gift.
The furnishings for the condominium apartment that were purchased by Mrs. Smith and never contributed to the U.S. corporation	The furnishings will be subject to U.S. estate tax if owned at death and gift tax if given away during life.	Prior to the transfer of shares to the trust, consider transferring furnishings to U.S. corporation. No gain should be recognized.
A portfolio of publicly traded shares of U.S. corporations	The shares will be subject to U.S. estate tax if owned at death.	Consider transferring the shares to a U.S. domestic nongrantor trust, or altering the investment to publicly traded bonds and short-term commercial paper. Alternatively, consider a transfer of shares to a corporation in the home country of Mrs. Smith; plan for an entity classi-fication election effective retroactively to the second day following date of death.

ASSET	PROBLEMS	POTENTIAL ACTION
A portfolio of publicly traded bonds	None. The publicly traded bonds are foreign situs asset.	No action is required other than to obtain assurance as to the release of the portfolio at death.
An automobile owned and registered in her name in the state where her resident child resides, which is used by that child	The automobile will be subject to estate tax if owned at death and gift tax if given away during life.	Consider selling the automobile to a nongrantor domestic trust at some point in the future.

CONCLUSION

These are not the only questions a N.R.N.C. parent will have. However, these questions provide a basis for understanding how one can adequately assist a Non-Resident Non-Citizen to reduce or eliminate U.S. Federal estate tax. U.S. estate tax planning may be the most complicated aspect of international tax planning, but with a basic understanding any client's needs can be met.

FINAL REGULATIONS FOR WITHHOLDING ON FOREIGN PARTNERS' TRANSFERS OF SPECIFIED PARTNERSHIP INTERESTS – CONSTRUCT, EXCEPTIONS, AND REPORTING

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Code §864(c)(8)
Grecian Magnesite v. Commr.
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T.D. 9919
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Treas. Reg. §1.1445-11T
Treas. Reg. §1.1446(f)-1 to -5
Treas. Reg. §1.864(c)(8)-1, -2
Treas. Reg. §1.897-7(c)

For U.S. tax purposes, gain or loss upon a sale or exchange of property is generally sourced based on the tax home of the seller. For a foreign person investing in a partnership conducting a U.S. trade or business ("specified partnership"), it is important to keep in mind that when at some later date she sells or otherwise disposes of the investment, and no matter where she resides, she will be subject to tax on gain deemed to be effectively connected with a U.S. trade or business.

Code §864(c)(8), added by the Tax Cuts and Jobs Act of 2017 ("T.C.J.A."), and repealing the holding of the *Grecian Magnesite* case,[1] recharacterizes a sale of a partnership interest as a sale of partnership assets, resulting in gain to the selling foreign partner. Under Code §1446(f), withholding tax of 10% applies to the seller's amount realized.

I.R.S. Regulations adopted in 2020 address sales and comparable transactions by non-U.S. persons of direct and indirect interests in a U.S. partnership. Final regulations under Code §1446(f) (T.D. 9926) provide the mechanical rules for withholding by transferees (acquirers) and follow up on previously released guidance under Code §864(c)(8) (T.D. 9919) which contained substantive rules. In short, the acquirer or transferee of the partnership interest is required to deduct and withhold 10% of the gross purchase price. Foreign partners in partnerships with U.S. fixed offices and U.S. trades or businesses will want to master these rules and exceptions.

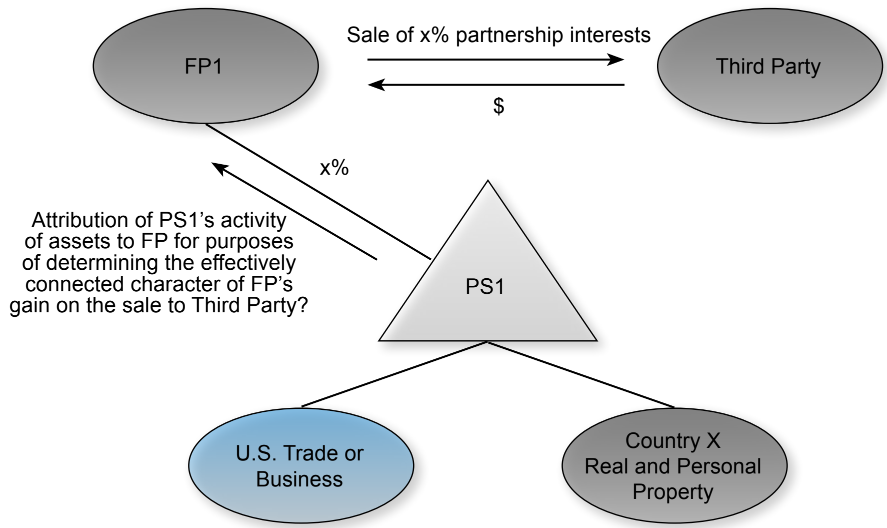
BACKGROUND

The statutory enactment of Code §§864(c)(8) and 1446(f) could be viewed as the final word by the I.R.S. in a long-standing, heated back-and-forth conversation.

In Rev. Rul. 91-32, 1991-1 C.B. 107, a foreign partner ("FP1") in partnership PS1, sold its interests for cash, as depicted below.

1 *Grecian Magnesite Mining, Indus. & Shipping Co. v. Commr.*, 149 T.C. 63 (2017), aff'd, 926 F.3d 819 (D.C. Cir. 2019).

Rev. Rul. 91-32 (Situation 1)



Concluding that for treaty purposes a portion of the resulting gain relating to FP1's partnership interests should be treated as E.C.I. attributable to a U.S. permanent establishment ("P.E."),[2] the I.R.S. could not rely on Code §864(c)(8) (which did not exist) so it analogized based on rules like Code §875(1).[3]

This was followed by an important *Tax Notes* article six years later, criticizing the ruling and arguing that it should be set aside;[4] a 2017 Tax Court case, *Grecian Magnesite* refusing to follow the ruling as "cursory in the extreme" (affirmed by the D.C. Circuit Court of Appeals); and the 2017 legislative enactment repealing *Grecian Magnesite* and providing a statutory basis for the I.R.S. position.

Effectively Connected Income

A foreign person engaged in a trade or business in the United States is taxed on income effectively connected with that conduct of the trade or business ("E.C.I."). Partners are treated as engaged in the conduct of a business if the partnership is so engaged.[5] A U.S. trade or business exists for each year that a foreign person engages in "considerable, continuous, and regular" activity in the U.S.[6] Tests are applied to determine whether income, gain or loss is effectively connected with assets used in that trade or business ("asset use test"), or activities of the business were a material income-producing factor ("business activities test"). Code §865(e) treats gain on the sale of personal property attributable to a U.S. office as U.S. source unless a foreign office materially participated in the sale (the "U.S. office rule").

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2 The P.E. question is addressed in Situation 3.

3 Code §875(1) provides that "a nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged." Also see *Donroy, Ltd. v. U.S.*, 301 F.2d 200 (9th Cir. 1962).

4 Kimberly Blanchard, "IRS Rev. Rul. 91-32: Extrastatutory Attribution of Partnership Activities to Partners," Tax Notes, Sept. 14, 1997.

5 Code §875.

6 For example, see *Pinchot v. Commr.*, 113 F.2d 718 (2d Cir. 1940).

The new regime does not change these rules, nor create a new rule of income recognition; rather it simply recharacterizes the sale of partnership interests as a disposition of assets. The recharacterization requires facts-and-circumstances rules like the above to be applied to a fictional sale. The Regulations explain how.

FINAL REGULATIONS

"It is important to note that if a partnership distribution results in gain recognition, these new rules may be implicated."

T.D. 9919 — Substantive Rules under §864(c)(8)

Final regulations under Treas. Reg. §1.864(c)(8)-1 determine the disposing partner's effectively connected gain or loss or "aggregate deemed sale E.C.I." ("A.D.S.E.C.").

The Regulations address how the deemed sale is to be analyzed for the business activities test or U.S. office rule, where no actual sale takes place and include special rules for inventory,[7] intangibles, and other property. Modified sourcing rules apply. The partner's distributive share of A.D.S.E.C. may vary based on the partners' agreement. Special rules apply to publicly traded partnerships. This article focuses on non-publicly traded partnerships.

It is important to note that if a partnership distribution results in gain recognition, these new rules may be implicated.

T.D. 9926 — Withholding of 10% Tax under §1446(f)

The Regulations under T.D. 9926 address the numerous practical matters relating to a sale of partnership interests, including required notifications (see end of this article). If the transferor is a U.S. person and provides Form W-9, then 10% withholding is inapplicable. Otherwise, the transferee must withhold 10% of the amount realized and submit the same to the I.R.S. unless an exception or adjustment applies.

Exceptions include the following cases:

- The transferor certifies non-foreign status.
- The transferor certifies that no gain, including ordinary income from deemed sales of "hot assets", will be realized by reason of the transfer.
- The transferor certifies that gain will not be recognized because the transaction is a nonrecognition exchange, or that the provisions of a tax treaty apply.
- The transferor certifies that during a prescribed look-back period the transferor was a partner throughout such period, and that the transferor's distributive share of gross E.C.I. was less than $1 million and less than 10% of the transferor's total distributive share of gross income (and that other technical requirements are satisfied).
- The partnership certifies that effectively connected gain is less than 10% of the total net gain inherent in its assets.
- The partnership certifies that based on partnership allocations, the transferor would be allocated E.C.I. equal to less than 10% of the total amount allocable.
- The partnership certifies it was never engaged in a U.S. trade or business.

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[7] Historical sales data is used to determine the transferor's A.D.S.E.C.

Other certifications and circumstances may result in a reduction of the amount to be withheld. For example, a transferor is permitted to present a certification of its maximum tax liability expected in connection with the deemed sale. Furthermore, if a portion of the gain realized is due to the transferor's reduction in partnership liabilities (treated under the tax laws as a deemed distribution), the amount otherwise required to be withheld may be reduced so that it only reflects the gain realized without regard to the decrease in the transferor's share of partnership liabilities. This prevents the need to withhold on phantom (non-cash) gain.

If no exception applies and the transferee fails to withhold, the partnership is required to withhold from subsequent distributions to the transferee until the missed amount is made up, plus interest.[8] While the new withholding rules are reminiscent of certain of the F.I.R.P.T.A. rules, Code §1446(f) Regulations dispense with major elements of F.I.R.P.T.A. such as withholding certificates, relying instead on notifications between the parties. Another point of departure is the supplemental withholding by the partnership where the transferee fails to withhold.

F.I.R.P.T.A. OVERLAP – EXCEPTION

Recognizing that there will be cases governed by both the new partnership rule and the preexisting F.I.R.P.T.A. rules of Code §897, Code §864(c)(8)(C) provides:

> If a partnership described in subparagraph (A) holds any United States real property interest (as defined in section 897(c)) at the time of the sale or exchange of the partnership interest, then the gain or loss treated as effectively connected income under subparagraph (A) shall be reduced by the amount so treated with respect to such United States real property interest under section 897.

In addition, Treas. Reg. §1.864(c)(8)-1(d) provides that if a foreign transferor transfers an interest subject to Code §864(c)(8) and the partnership has U.S. real property interests (as defined under the F.I.R.P.T.A. rules), the gain or loss analyzed under Code §864(c) will not be reduced (and Code §897(g) no longer applies); presumably this will simplify calculations for many foreign partners tangled in the U.S. tax net.[9] However, if the transaction is a nonrecognition exchange with respect to the F.I.R.P.T.A. asset, the F.I.R.P.T.A. rules applicable to such transfers apply.[10]

The F.I.R.P.T.A. rules treat sales of U.S. real property interests as E.C.I., whether or not such income would have been E.C.I. under general tax principles. Thus, as a general matter, to the extent that a U.S. real property interest is used in a U.S. trade or business, withholding at a rate of 10% will apply. If the asset is not used in a U.S. trade or business, the withholding rules applicable to transfers of F.I.R.P.T.A assets will continue to apply. While U.S. tax will apply to the transfer, F.I.R.P.T.A. withholding (generally at a rate of 15%) does not apply, unless the partnership is a "50/90" partnership (a partnership in which fifty percent or more of the value of the gross assets consist of U.S. real property interests, and ninety percent or more of the value of the gross assets consist of U.S. real property interests plus any cash or cash equivalents).

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8 Code §1446(f)(4); Treas. Reg. §1.1446(f)-3(a)(1).Treas. Reg. §1.1446(f)-3 indicates its effective date is January 1, 2022.

9 A cross-reference is included in Treas. Reg. §1.897-7(c).

10 Treas. Reg. §1.864(c)(8)-1(d) (last sentence).

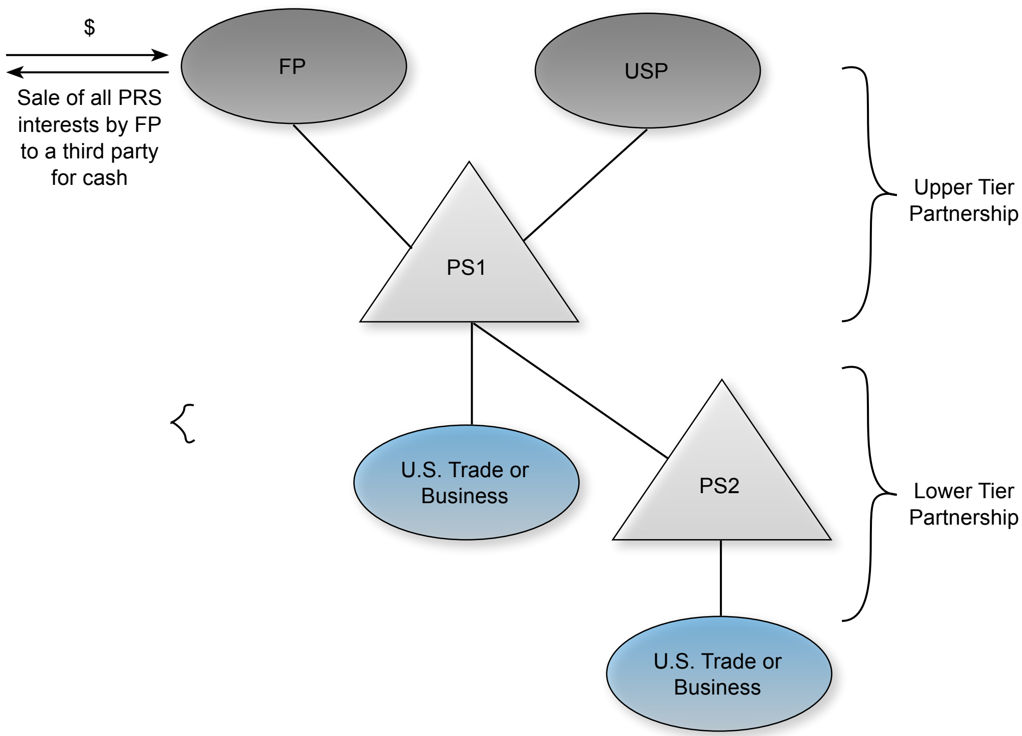
In other words, a transferee that is otherwise required to withhold with respect to a transfer of an interest in a 50/90 partnership under Code §1445(e)(5) as well as under the new partnership withholding provisions under Code §1446(f) because the activities of the 50/90 partnership give rise to E.C.I. will be subject only to the payment and reporting requirements of Code §1445, and not section Code §1446. However, if the transferor has applied for a F.I.R.P.T.A. withholding certificate the transferee must withhold the greater of the amounts required under Code §1445(e)(5) or Code §1446(f)(1). A transferee that has complied with the withholding requirements under either Code §1445(e)(5) or Code §1446(f)(1), as applicable, will be deemed to satisfy the withholding requirement imposed by the new partnership withholding rules.

TIERED PARTNERSHIPS

In the case of tiered partnerships like PS1 (an "upper-tier partnership") and PS2 (a "lower-tier partnership") illustrated below, gain can be recharacterized as E.C.I. to the extent of both their assets where FP sells a PS1 partnership interest. Beginning with the lowest-tier partnership in a chain of partnerships that is engaged in the conduct of a trade or business within the United States and going up the chain, each partnership that is engaged in the conduct of a trade or business within the United States is treated as selling its assets in a deemed sale.

In addition, if PS1 owned no U.S. trade or business except through PS2, and PS1 disposed of any interest in PS2, FP's A.D.S.E.C. includes gain on the deemed sale of PS2 assets, and will be allocated to FP.[11]

Tiered Partnership – Example



[11] Treas. Reg. §1.864(c)(8)-1(e)(2).

NOTICES, FORMS, AND PAYMENTS

The transferee is required to report and pay the 10% tax withheld to the I.R.S. within 20 days using Form 8288, *U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests* and Form 8288-A, *Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests*.[12] If the transferee is not required to withhold, however, the forms are not required.[13] The I.R.S. will stamp Form 8288-A to show receipt and mail a stamped copy back.[14]

In addition, the following actions are required, with various deadlines:

- ***Transferee*** — is required to
  - certify to the partnership within 10 days the extent to which it satisfied its obligation to withhold, including either (a) Form 8288-A filed with respect to the transfer, or (b) a certification of the amount realized and the amount withheld, in addition to any special certifications relied on to determine the amount realized or to reduce withholding;[15] and
  - if the transferor provided a certification to benefit from reduced treaty withholding, mail a copy to the I.R.S. within 30 days.[16]
- ***Transferor*** — is required to
  - provide the partnership with notice in writing of the transfer within 30 days, including identifying details of transferor and transferee(s);[17] and
  - if the transferor is a foreign partnership, it may provide the transferee a certification of a modified amount realized based on presence of both U.S. and non-U.S. interest holders, using Form W-8IMY, *Certificate of a Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding and Reporting*.[18]
- ***Partnership*** — is required to
  - provide the transferor a statement detailing transferor's share of A.D.S.E.C. items described in Treas. Reg. §1.864(c)(8)-1(c)(3)(ii) by

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[12] Treas. Reg. §1.1446(f)-2(d).

[13] *Id.*

[14] Treas. Reg. §1.1446(f)-2(e)(3). The transferor attaches the stamped form to its return to claim a credit.

[15] Treas. Reg. §1.1446(f)-2(d)(2). The Preamble to T.D. 9926 clarifies that the notification is intended to allow for sufficient time to consult with the partnership as to transferor's eligibility for any claimed exception to withholding in advance, and if appropriate to release an amount withheld to transferor rather than deposit it with the I.R.S.

[16] Treas. Reg. §1.1446(f)-2(b)(7)(i).

[17] Treas. Reg. §1.864(c)(8)-2(a). This notification requirement is inapplicable for transfers of interests in publicly traded partnerships, or transactions in which a partnership is treated as the transferee because it redeems its interests from a partner.

[18] Treas. Reg. §1.1446(f)-2(c)(2)(iv).

the time it issues to transferor a Schedule K-1, *Partner's Share of Current Year Income, Deductions, Credits, and Other Items*;[19]

- if the transferor is relying on the maximum tax liability rule to reduce withholding, provide a certification of the transferor's A.D.S.E.C. ordinary income and A.D.S.E.C. capital gain on the relevant determination date;[20] and
- if the transferee failed to withhold or pay the full amount withheld, the partnership must commence withholding beginning 30 days after the transfer or 15 days it acquires (or is deemed to acquire) actional knowledge of the transfer, whichever date is later.[21]

Partnership's Supplemental Withholding

Tax withheld on distributions by the partnership must be reported and paid using Forms 8288, *U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests*, and 8288-C, *Statement of Withholding Under Section 1446(f)(4) for Withholding on Dispositions by Foreign Persons of Partnership Interests*. The transferee may apply for a refund for any excess withholding.[22]

Foreign persons who dispose of interests in partnerships conducting a U.S. trade or business should note that withholding by the transferee will not relieve them from U.S. income tax filing obligations with respect to the transfer, or the requirement to pay any unsatisfied tax.[23] To meet these requirements, foreign partners must obtain a U.S. tax identification number.

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19 Treas. Reg. §1.864(c)(8)-2(b)(3).

20 Treas. Reg. §1.1446(f)-2(c)(4)(iv). The determination date referenced is one of a number of dates, including the transfer date —see Treas. Reg. §1.1446(f)-1(c)(4).

21 Treas. Reg. §1.1446(f)-3(c)(1).

22 Treas. Reg. §1.1446(f)-3(e)(2).

23 Treas. Reg. §1.1446(f)-2(e)(1).

CLARITY ON RECHARACTERIZATION OF CARRIED INTEREST

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Tags
Applicable Partnership Interest
Applicable Trade or Business
Carried Interests
Code §1061
Holding Period
Long-term Capital Gain
Promote
Recharacterization Amount
Service Partner

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INTRODUCTION

On January 7, 2021, the I.R.S. issued final regulations ("the Final Regulations")[1] that provide guidance under §1061 of the Internal Revenue Code of 1986, as currently in effect ("the Code"). Code §1061 recharacterizes certain long-term capital gains as short-term gains for holders of partnership interests entitled to carried interests. It was enacted as part of the Tax Cuts and Jobs Act (T.C.J.A.) in 2017.[2]

The guidance particularly impacts fund managers of alternative investments, such as private equity and hedge funds, who receive carried interests in exchange for the substantial services provided to investment funds. Notwithstanding the relatively recent enactment of Code §1061, there is strong debate over whether long-term capital gains treatment should apply to gains derived through carried interests. Critics seek to treat the income as compensation subject to ordinary income tax rather than a return on investment deserving the preferred long-term capital gains rate.

Carried interests are a significant incentive for general partners to manage alternative funds as the return on performance is substantial. In addition to the administrative fee, investment managers are compensated by way of partnership interests in the fund. A carried interest allows general partners of hedge funds and private equity funds to retain a fixed percentage (usually 20% or more) of the fund's profits and to enjoy favorable long-term capital gains tax rates (under Code §1061) instead of the much higher ordinary income tax rate to the extent of the general partner's share of long-term capital gains.[3] This performance compensation is contingent on the fund's success under their management.

RECHARACTERIZATION OF LONG-TERM CAPITAL GAINS

Applicable Partnership Interest

An applicable partnership interest ("an A.P.I.") is any interest in a partnership which, directly or indirectly, is transferred to or is held by the taxpayer in connection with the performance of "substantial services" by the taxpayer, or any other related person, in any applicable trade or business. Code §1061(c)(2) provides that an applicable trade or business is any activity conducted on a regular, continuous, and substantial basis which consists, in whole or in part, of raising or returning capital, and either investing in or disposing of specified assets or developing specified assets. The

1 T.D. 9945.

2 §13309 of Public Law 115-97, 131 Stat. 2054 (2017).

3 Andrew Needham, *Hedge Funds*, 736-2nd TAX MGMT. PORT. (BNA).

activity may be conducted in one or more entities. It also applies to businesses involved in identifying specified assets for investment or disposition.

The Final Regulations provide that if an interest in a partnership is transferred to or held by a taxpayer, pass-through entity, or any related person for the performance of services, a presumption exists that such holder or transferee provided substantial services.[4]

The Final Regulations confirm that Code §1061 applies to long-term capital gains as defined in Code §1222. Generally, a taxpayer's capital assets held for at least 12 months and one day are taxed as long-term capital gains. However, Code §1061 increases the required holding period for A.P.I.'s from 12 months and one day to 36 months and one day.

An A.P.I. held by a corporation is not covered by Code §1061. The Final Regulations clarify that the term "corporation" refers only to a C-corporation,[5] which presumably includes an eligible entity treated as a C-corporation under the entity characterization rules.[6] An A.P.I. held by or through an S-Corporation or a P.F.I.C.'s where shareholders have Q.E.F. elections in effect are subject to Code §1061 recharacterization rules because they are passthrough entities.

Thus, a passthrough entity may be a partnership, trust, estate, S-corporation, or P.F.I.C. with respect to which the shareholder has a Q.E.F. election. Many investment managers have converted from partnership entity to C-corporation already. This is partly due to the lower corporate tax rates on income from administrative fees. Others may consider restructuring by weighing any advantages of avoiding recharacterization of long-term gains against the cons of double taxation.

Additionally, gains and losses from capital interest are excluded from Code §1061. Final Regulations set forth rules for bifurcating and calculating capital interest allocations.[7] These include that the allocation of the A.P.I. holder's capital interest must be determined in a similar manner as those held by similarly situated unrelated non-service partners.

Lookthrough Rule

The Final Regulations include a lookthrough rule that will cause the holding period of a partner with a carried interest to be treated as being three years or less.[8]

The lookthrough rule applies in two circumstances. One circumstance is that the partner holding the carried interest enters into a transaction or a series of transactions having as a principal purpose the circumvention of the three- year holding requirement for long-term capital gains under Code §1061(a).[9] Here, all gain not attributable to A.P.I. held for more than three years is subject to recharacterization under Code §1061(a). The second circumstance involves the sale or disposition of an A.P.I. held for more than three years where the partnership owns assets with a

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4 Treas. Reg. §1.1061-2.

5 Treas. Reg. §1.1061-3(b)(2).

6 Treas. Reg. §301.7701-3.

7 Treas. Reg. §1.1061-3(c)(3).

8 Treas. Reg. §1.1061-4(b)(9).

9 Treas. Reg. §1.1061-4(b)(9)(i)(A)(2).

holding period of less than three years and that asset was acquired with a capital contribution from an unrelated non-service provider. The service partner's holding period for the carried interest is deemed to begin not sooner than the date on which the unrelated non-service partner is legally obligated to contribute substantial money or property directly or indirectly to the partnership.[10] Here, the gain from the disposition of the A.P.I. is traced to two pools of assets – the first is the holding period of assets held for more than three years by the partnership. The second is the holding period of assets held for three years or less by the partnership.[11]

"Critics of the preferential tax rate contend that it provides an unfair advantage to investment managers because carried interests are merely a salary and bonus to a taxpayer for services."

TAX POLICY DEBATE

On February 15, 2021, U.S. legislators introduced the Carried Interest Fairness Act of 2021.[12] The bill seeks to tax carried interest at ordinary income rates.

Critics of the preferential tax rate contend that it provides an unfair advantage to investment managers because carried interests are merely a salary and bonus to a taxpayer for services. This is viewed as no different from a salary and bonus paid to a broker for meeting a firm's periodic performance goals.

They argue that investments warranting long-term gains should have some risk of loss associated. Such risk is born by the non-service partners who fund the capital investments of the fund. The investment manager does not bear the same burden. Embedded in the criticism is hostility towards service providers who share in the gains of a partnership, thereby exploiting a "loophole" not typically available to employees receiving a bonus based on performance.

Although similar legislation was introduced in 2015, the recent change in control of Congress may influence the passing of the 2021 legislation. There has been bipartisan support in favor of changing the tax treatment.[13] President Joe Biden has expressed support for eliminating the preferred tax rate for long-term capital gains completely for taxpayers having income in excess of $1 million.[14]

On the other hand, proponents of the long-term capital gains rate view the approach as consistent with the treatment of profits from partnership interests generally. They equate the investment manager's substantial sweat equity with the investor's capital contribution to the fund. A fund's profits should be treated as a return on investment whether in the hands of a manager as A.P.I. or an investor as capital interest. According to one commentator:

> Some people argue that if you do not put up dollars for your ownership, you must be working for a bonus or a salary, and that carried interest means you are just an investment banker working for a fee.

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10 Treas. Reg. §1.1061-4(b)(9)(i)(A)(1).

11 See Treas Reg. § 1.1061-4(c)(2)(i), Example 1.

12 H.R. 1068 was preceded by H.R. 2889, the "Carried Interest Fairness Act of 2015," but died in the Ways and Means Committee.

13 "Broad Support for Closing the Carried Interest Loophole," Ways and Means Committee Democratic Staff.

14 Cumming, Chris. "A Biden Win Could Mean a Tax Rewrite for Private Equity," *Wall Street Journal* (November 3, 2020).

> However, private equity firms are not transaction bankers; rather, [the firms] own and control entire companies over many years.[15]

CONCLUSION

The Final Regulations clarify several concerns, including

- limiting the Code §1061 exception for corporations as applying solely to C-Corporations,
- guidance on calculating the recharacterization amount,
- imposing a lookthrough rule when the A.P.I. is sold by the service partner rather than a sale of the underlying capital assets by a partnership that ultimately lead to long-term capital gains for the holder of the carried interest, and
- tracing the holding period of gains upon the sale of an A.P.I. to the holding period of the underlying assets at the level of the partnership.

Given the intense debate and legislative momentum around carried interests and preferred tax rates generally, the guidance may need to be revisited sooner than later.

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15 Klinsky, Steven. "The Carried Interest Loophole? What Loophole?" *New York Times* (July 15, 2016).

BEAUTY IS IN THE EYE OF THE TAXPAYER

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Tags
Business Relocation
State Grants
Tax Competition
Unlawful State Aid

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INTRODUCTION

In "Tax Competition Between Member States of the European Union – an Academic View," which appears earlier in this edition of *Insights*, Professor Boria analyzed the history and political ideologies that led to the view that all tax benefits offered companies as an inducement to locate a business value driver in a particular Member State of the European Union are examples of harmful tax competition constituting unlawful State Aid. He concluded,

> * * * the notion of harmful tax competition among Member States [of the European Union] developed, looking at tax competition as an inappropriate lever to distort normal market logic. Under this view, the harm results from the selective process of determining which industries will benefit from a reduction in effective tax rates.

By and large, this view is not shared by State governments in the U.S., where tax competition has provided benefits to States and their residents. States have an obligation to balance attractiveness with actual attraction when implementing competitive tax policies. It is only when competitive tax policies fail to deliver new businesses, new private investment, and new residents that the policy falls short.

For many years, residents and businesses have made decisions regarding where to live, where to work, and where to invest based on self-interest, including tax competition between States. To an extent, the Tax Cuts and Jobs Act amplified tax competition due to limitations imposed on individuals wishing to deduct State and local taxes.[1] While income tax is not the only factor that drives a decision on where to live or invest, it is a key consideration when individuals and entities plan their futures.[2] Tax competition provides a way for States to increase revenue by attracting new businesses and residents. It is a decision influenced by the ends, rather than the means.

TAX ATTRACTIVENESS: MOVEMENT AND CONSEQUENCES

Under the Tenth Amendment, States are granted a general police power to preserve public health, safety, and general welfare of their populations. The amendment has also been interpreted to create an ethical obligation for States to do so.

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1 "How Did the TCJA Change the Standard Deduction and Itemized Deductions?" *Tax Policy Center* (Nov. 29, 2020, 11:36 PM).

2 Carly Stern, "Why People Are Flocking From California to Arizona," *OZY* (Nov. 29, 2020, 11:39 PM).

Tax attractiveness has become a tool in fulfilling the obligation when more revenue becomes available for investment in State-funded projects.

By reducing tax rates and providing incentives, States can increase their attractiveness to new businesses and residents. This may seem counterintuitive if the goal is to raise more revenue. However, if the State is attractive and more taxpayers are driven to the State, the reduction in tax can lead to an increase in State revenue. When businesses move into a State or expand, society recognizes certain benefits, such as job creation. Thus, the benefits of reduced rates and additional incentives may exceed any losses.

Recent census results in the U.S. indicates citizens have been migrating from higher taxed States to those with more favorable tax policies. In that regard, the Wall Street Journal recently commented that "[f]or the past several years, Wall Street has been colonizing [Florida], attracted to more favorable tax policies and sunnier climes."[3] Aside from New York, California has also seen a large exodus of residents to Arizona and Nevada.[4]

In 2019, the Arizona Department of Revenue's annual report showed that $19.3 billion of gross revenue was collected.[5] This is a 23.7% increase from the gross revenue reported in 2017.[6] When comparing the 2017 and 2019 reports, one will notice a nearly $1 billion increase in revenue collected through individual State income and wage withholding tax. According to North American Moving Services, Arizona remained a popular inbound State and California remained a leader for outbound migration during the same period.[7] While tax may not be Arizona's only attractive factor, it is an undeniably important one that influenced many Californians to move.

While these movements increase revenue for inbound States, some consequences may be negative. Political climates of destination States may shift.[8] More students may require an increase in education-related spending and the need for financial assistance.

ALABAMA, THE BEAUTIFUL

I was brought up in the State of Alabama. Alabama has an abundance of natural resources and a lower unemployment rate than the national average. However, it suffers from a higher poverty rate than the national average. The State has not adopted a minimum wage. So, employees can be paid as little as $7.25, but a dollar in Alabama goes much further than it does in New York. As is the case with every

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3 Katherine Clarke & Cara Lombardo, "As Wall Street Migrates to Florida, Hedge-Funders Move to Offload Manhattan Homes," *The Wall Street Journal* (March 3, 2021, 3:29 PM).

4 Sarah Holder, "Is the 'California Exodus' Turning Arizona Blue?" *Bloomberg CityLab*, (March 3, 2021, 3:34 PM).

5 Arizona Department of Revenue, Annual Report Fiscal Year 2019 (2019).

6 Arizona Department of Revenue, Annual Report Fiscal Year 2017 (2017).

7 "Where Are Americans Moving?" *North American Moving Services*, (March 3, 2021, 4:01 PM); See also Micah Alise Bledsoe, "California's Cost of Living Pushes People to Arizona," *Southern California Public Radio*, (March 3, 2021, 4:01 PM).

8 See Holder, note 4.

State, it has both attractive and unattractive qualities that businesses and individuals may consider when planning their futures.

> ***"In order to increase revenue, it is imperative for Alabama to attract residents in order to encourage growth in economic activity."***

Alabama has one of the lowest property taxes in the nation.[9] Revenue raised through property taxes account for less than 5% of the State's gross revenue. In comparison, sales tax and income tax account for 86% of the revenue collected in 2020.[10] In order to increase revenue, it is imperative for Alabama to attract residents in order to encourage growth in economic activity.

According to United Van Lines' National Migration Study, Alabama had a higher percentage of inbound movement than most other States during 2020.[11] Job opportunity is one of the main factors driving persons to move to the State.[12] While an individual may need to accept lower wages in Alabama, she may prefer job security over potential unemployment in another State. In any event, it is a personal choice for the individual.

In recent years, Alabama has seen an influx of foreign direct investment that has led to thousands of jobs. Since 2013, foreign companies have announced $16 billion in new capital investments.[13] In early 2019, Alabama offered Hyundai an investment credit of $58.2 million over ten years and a jobs credit of almost $1 million over ten years.[14] Later that year, Hyundai announced it put $292 million towards new equipment and machinery at its Montgomery plant.[15] Foreign companies are actively choosing to invest and create jobs in Alabama.

While Alabama has been experiencing significant inbound movement, it nonetheless actively works to further increase its tax competitiveness. On February 12, 2021, Governor Kay Ivey signed House Bill 170 into law, which enacted more competitive tax legislation. In her Statement regarding the bill, she said,

> Thanks to [the Alabama Legislature's] work, the people of Alabama who received any type of CARES Act dollars will not pay one penny in State income taxes on that relief. Additionally, we are ensuring that our State will continue to grow our diverse economy, and we are protecting our existing businesses from any frivolous lawsuits due to COVID-19.

This bill also retroactively excluded G.I.L.T.I. from taxation, repealed its throwback rule, and created a workaround the U.S. tax law provision that capped deductions for State and local taxes. One commentator stated the following regarding the tax policy of Alabama:

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9 Taxes In Alabama," Tax Foundation (March 4, 2020, 11:31 AM).

10 Alabama Department of Revenue, 2020 Annual Report (2021).

11 "United Van Lines' National Migration Study Reveals Where and Why Americans Moved in 2020," *United Van Lines* (March 3, 2021, 4:38 PM).

12 *Id.*

13 Jerry Underwood, "Foreign Investment Sparks Growth in Rural Alabama Communities," *Made In Alabama* (March 3, 2021, 4:45 PM).

14 William Thornton, "State Offered $59 Million in Incentives to $388 Million Hyundai Project," *AL.com* (March 4, 2021, 4:39 PM).

15 William Thornton, "Alabama Gets Top Marks for Foreign Investment," *AL.com* (March 3, 2021 5:20 PM).

> Repealing the State's throwback rule and excluding GILTI from taxation are both significant changes that will benefit the State's competitiveness, and the exemption of relief payments is an important clarification that will benefit those struggling in the midst of the pandemic.[16]

Governor Ivey made Alabama more beautiful with a simple signature.

Through tax competition, Alabama can attract new businesses and residents that may have otherwise chosen another State. However, there are still disparities in the State, despite its attractiveness. Revenue in the State has steadily risen over recent years, but Alabama remains one of the poorest and most uneducated States in the Union. Perhaps tax competition has not failed the people of Alabama, but rather the State's spending has failed them.

UNATTRACTIVE SPENDING

Alexander Hamilton wrote,

> I believe it may be regarded as a position, warranted by the history of mankind, that in the usual progress of things, the necessities of a nation, in every stage of its existence, will be found at least equal to its resources.[17]

Where there are needs in society, it is the responsibility of the government to ensure they are met. Meeting the needs of citizens requires both appropriate tax policies and spending.

Alabama's 2021 State Budget Report shows that education accounted for 2.44% of the State's total budget during the 2019 fiscal year. In comparison, corrections accounted for 10.61% of the State's budget during that same fiscal year. One may argue that corrections requires more funding due to the high rate of incarceration, but this may be a problem Alabama Legislators created. On this point, one commentator wrote the following:

> [The rate of incarceration] has grown exponentially over the last 40 years, driven in part by the State's adoption of—and prosecutors' subsequent reliance on—the Habitual Felony Offender Act.[18]

Laws like the Habitual Felony Offender Act led to harsher, taxpayer-funded sentences.

While the State allocates a hefty chunk of its budget to corrections, Alabama school systems are forced to rely on other sources of revenue. For instance, enrollment in the Phenix City school system has grown and is expected to continue to grow. Expansion and new hires will be required to meet the needs of the growing student

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[16] Janelle Cammenga, "Alabama Passes Tax Reform Aimed at Throwback, GILTI, and More," *Tax Foundation* (March 3, 2021 5:34 PM).

[17] Alexander Hamilton, "Concerning Taxation," in *The Federalist* 158, 161 (Barnes & Noble Classics ed., 2006).

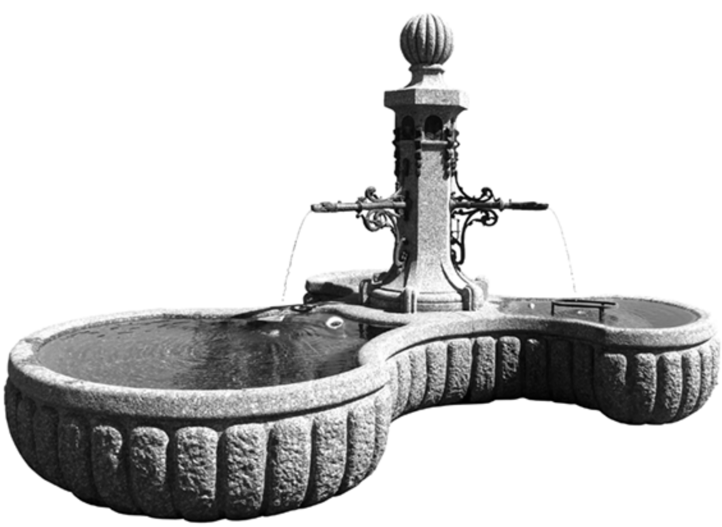
[18] John Fowler, "To Address the Alabama Prison Crisis, Put an End to Over-Incarceration in the State," *Injustice Watch* (March 4, 2021 12:02 PM).

body. The Phenix City school system has plans for capital projects, which will use a combination of State and local funding.[19]

The Alabama resident has little control over the cracks in the walls of her child's public school and the child's textbooks that have been used and re-used for years, but she has control as to whether she will stay in or leave Alabama. When her tax money is no longer being used by the State to meet the needs that matter to her most, she may leave. Alabama may be a beautiful State, but its spending may be unappealing for some.

CONCLUSION

Tax competition is not exclusively harmful. States make themselves attractive to new businesses and residents by reducing rates and adding incentives to their respective tax codes. If more revenue has been raised through competitive tax policies, then States are acting ethically by implementing competitive tax policies with the intention of increasing revenue. The unanswered question is how the funds are spent. California and New York are high tax and high spending States. As indicated by loss of residents; it is not clear whether residents get as much value for money as residents elsewhere in the country.



[19] Mark Rice, "Two More Phenix City Schools to be Expanded. Here's the Plan for Additional Projects," *Ledger-Enquirer* (March 4, 2021, 12:37 PM).

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

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

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