RUCHELMAN
the next generation of tax

INSIGHTS

STAGES IN THE LIFE OF A U.S. OWNED INDIAN COMPANY

TAXATION OF FOREIGN PENSIONS IN IRELAND

SWISS UPDATE ON TRUST REGULATION AND TAXATION

PLANNING FOR NONRESIDENT INVESTMENT IN FRENCH REAL ESTATE – THE CHOICE OF COMPANY MATTERS

AND MORE

Insights Vol. 8 No. 5

TABLE OF CONTENTS

EDITORS' NOTE

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

- **Taxation in India and the U.S.: Stages in the Life of a U.S.-Owned Indian Company.** When a U.S. corporation expands its operations to India and forms an Indian subsidiary, tax issues need to be addressed in both countries at various points in time – when the investment is first made, as profits are generated, as funds are repatriated, and when the investment is sold. In their comprehensive article, Sanjay Sanghvi, a partner of Khaitan & Co., Mumbai, Raghav Jumar Baja, a principal associate of Khaitan & Co., Mumbai, Stanley C. Ruchelman and Neha Rastogi explain all facets of tax planning in both countries at each stage of the investment and do so in an integrated way.

- **Swiss Update on Trust Regulation and Taxation.** Trusts have been of great importance to advisors all over the world. Even though trusts are mostly found in common law systems, several civil law jurisdictions have implemented the concept of trusts. To date, there is no such thing as a Swiss trust or Swiss trust law. However, Switzerland recognizes the concept of a trust. In their article, Peter von Burg, a partner at Burckhardt Ltd. in Zürich, and Matthias Gartenmann, a Swiss tax lawyer based in Zürich, provide an overview of taxation of trusts in Switzerland. One interesting aspect addressed in the article relates to Swiss administrative assistance in tax matters when the targets of the inquiry are a trust and its beneficiaries.

- **Planning for Nonresident Investment in French Real Estate – The Choice of Company Matters.** Among wealthy Europeans, it is common for those who are not French to own a secondary residence in France, and to do so through a company. Two recurring questions are posed to a French tax adviser representing a non-French client. Should the company be French or foreign? Should the company be subject to corporate tax or not? Sophie Borenstein, a Partner in the Paris office of Klein Wenner explains the variables that must be considered when providing answers. Some work in one set of circumstances and others work in other circumstances. Good advice must be tailored to the anticipated use of the property.

- **Taxation of Foreign Pensions in Ireland – Walking the Tricky Tightrope.** As more individuals relocate to Ireland, the taxation of assets brought with them takes on importance once Irish tax residence is established. Of special concern are pension products that individuals accumulate while living and working outside of Ireland. The taxation of lump sum payments from foreign pensions is a complex affair. Under Irish law, most foreign pensions schemes are considered nonqualifying overseas pension plans. Consequently, lump sum payments from such pension plans should not be taxable in Ireland because no domestic legislation exists to tax lump sums. Lisa Cantillon, a Director in the Dublin office of KTA, explains all, but cautions that the Irish Revenue have a different view, notwithstanding the absence of statutory support.

- **Domestic Trust – Does Yours Satisfy The Court Test?** In comparison to tax laws in many countries, where the tax residence of a trust may depend on the residence of the trustee or the relevant law for the trust, U.S. tax law provides that the residence of a trust is dependent on two factors. All trusts no matter where formed are considered to be foreign trusts unless two tests are met, causing the trust to be considered a domestic trust. The first is a court test, under which a U.S. court is able to exercise primary supervision over trust administration. The second is a control test, under which U.S. persons control all substantial trust decisions. Nina Krauthamer and Galia Antebi point out that while the tax law is clear, applicable trust law – not tax law – may contain hidden risk regarding the court test. Comments to Section 108 of the Uniform Probate Code and Uniform Trust Code provide that the identification of a trust's principal place of administration will ordinarily determine the court that has primary jurisdiction over the trust. Advisers representing foreign families should be mindful because facts change and unknown facts may exist. Officers of a privately held trust company may live and carry out their duties outside the U.S. or an individual trustee may move outside the U.S. Where either fact exists, a U.S. domestic trust may find that it has be-come a U.S. foreign trust. The result may not be pretty.

- **The Cameco and Glencore Transfer Pricing Cases – Comments on the Common Complications in Commodities Commerce Controversy.** Two transfer pricing cases, *Commissioner of Taxation of the Commonwealth of Australia v Glencore Investment Pty Ltd*. in Australia and *Cameco Corporation v. Her Majesty The Queen* in Canada, address arm's length transfer pricing methodology for mined minerals during a period of steep increases in spot prices. In each case, the revenue authority challenged the taxpayer's revision of pricing from the use of fixed prices to adjusted prices that were comparable in methodology to contemporaneous uncontrolled transactions. Each case was decided in favor of the taxpayer. Michael Peggs explains the reasons why the approaches of the tax authorities were rejected. He cautions that the precedential value of the cases may be limited in light of changes made in the 2017 version of the O.E.C.D. Guidelines. One ongoing takeaway from the two cases is that, to settle a transfer pricing dispute, a large multinational company must be prepared to make significant investments in data gathering, executive time, and cost of litigation.

- **The Importance of Earnestly Modeling Earnouts: Pitfalls and Planning Relating to the Purchase of a Service Business.** In representing a taxpayer interested in purchasing a business, it is important for tax counsel to understand, in simple terms, what each party is seeking to accomplish. The tax adviser's greatest contribution is often simply asking the right questions and then taking the time to think through the structure from different angles in a manner that helps the client reach a decision. In a light-hearted approach to the subject, Andreas Apostolides takes the reader through the various alternatives available in negotiating the purchase and sale of a service business conducted through a tax-transparent entity such as an L.L.C. Some alternatives may work; others may not.

We hope you enjoy this issue.

- The Editors

TAXATION IN INDIA AND THE U.S.: STAGES IN THE LIFE OF A U.S. OWNED INDIAN COMPANY

Authors
Indian Tax Law
Sanjay Sanghvi
Raghav Kumar Bajaj

U.S. Tax Law
Neha Rastogi
Stanley C. Ruchelman

Tags
C.F.C.
Distribution
G.I.L.T.I.
High Tax Exception
India
Investment in India
P.T.I.
Slump sale
Subpart F
United States

Sanjay Sanghvi is a Partner in the Mumbai office of Khaitan & Co. He advises clients on domestic and international tax matters related to M&A and transfer pricing.

Raghav Kumar Bajaj is a Principal Associate in the Mumbai office of Khaitan & Co.

With assistance from Mr. Avin Jain (Senior Associate in the Mumbai office of Khaitan & Co.)

INTRODUCTION

When a U.S. corporation expands its operations to India through formation of an Indian subsidiary, tax issues will need to be addressed at the various stages of the investment. This article discusses the Indian and U.S. tax consequences at each stage, beginning with formation and continuing through ultimate disposition.[1]

BACKGROUND

The basic facts are as follows:

- Mr. A is a U.S. citizen who runs a successful manufacturing business in the U.S. ("U.S.Co").
- He proposes expanding operations to India to take advantage of lower operating costs and a skilled workforce.
- U.S.Co forms a newly incorporated company in India ("IndiCo"). IndiCo is a private limited company which will be engaged in the business of manufacturing electric appliances in India.
- Under the U.S. default entity classification rules, IndiCo will be treated as an association taxed as a corporation for U.S. tax purposes.

STAGE 1: INVESTMENT INTO INDIA

Indian Tax Aspects When Making Investments Into India

While an investment of funds into India in return for the issuance of shares will likely not result in any income tax obligations in India, there are several factors that must be considered before entering the Indian market, such as the instrument issued to U.S.Co. in consideration for the investment and the value of investment.

Choice of Instrument

One of the key decisions for any investment is the type of instrument, or instruments, that will be issued by IndiCo, such as common shares, preference shares, convertible debt, and any other form of security. The decision is guided by various factors such as the long-term intention of the investor, the regulatory framework in India, and Indian tax rules.

[1] This article reflects rules in effect as of the date of publication. Major changes to U.S. tax law have been proposed by the Biden Administration. Those changes may have profound effect on much of the discussion contained herein.

One option available to IndiCo is the issuance of a debt instrument. From the point of view of the company receiving the investment, the deductible nature of interest payments may make the issuance of debts attractive for tax purposes. This presumes that no limitations exist on the ability of IndiCo to claim a deduction for the entire amount paid or that IndiCo would report profits, but for the interest expense claimed as a deduction. From the investor's viewpoint, interest income will be taxable and, where the investor is a U.S. taxpayer, interest income is recognized as it accrues, even if no payment is received or the payor reports a loss without taking the interest into account.

Normally, interest expense that is reported in IndiCo's books of accounts is deductible for Indian tax purposes, provided (i) appropriate taxes have been withheld and paid over in India, (ii) the issuance of debt does not run afoul of the thin capitalization rules under the Indian Income Tax Act, 1961 ("I.T. Act"), and (iii) the decision of issue debt does not run afoul of the General Anti-Avoidance Rule ("G.A.A.R."). Under Indian thin capitalization rules, interest deductions are capped at 30% of adjusted profits. Under G.A.A.R., the tax benefit of an arrangement may be denied if it arises from an impermissible avoidance arrangement.

In comparison to the issuance of a debt instrument, IndiCo may issue equity in the form of shares of common shares or preferred shares. Dividends can be freely repatriated under the current exchange control regulations. Under the Indian law, dividends can be declared only out of current and accumulated profits, subject to certain conditions. Under the current provisions, dividend payout is not deductible for the payor and is taxable in the hands of the shareholders. The statutory tax rate is 20%, and both a surcharge and cess[2] may be imposed on a nonresident investor. The tax rate may be reduced under the applicable income tax-treaty.

Choice of Acquisition – Direct or Indirect Subsidiary

Investment in India can be made either directly or via an intermediate holding company ("I.H.C."). Investment from an I.H.C. provides the following benefits:

- It protects the parent company from liability.
- If the I.H.C. is formed in an intermediary jurisdiction and subject to tax laws in the investor's country of residence, it may allow funds to be accumulated at the I.H.C. level free of tax in the country of residence of the investor and may be used to make future investments abroad.
- It provides an asset base at I.H.C. level to facilitate the raising of external funds for future investment.
- In the past, it eased an exit from the sale of IndiCo by means of a sale of sale of shares of an I.H.C.

---

[2] Surcharge is payable as a percentage of the income-tax payable. Currently, a foreign company with income in excess of INR 100 million is liable to pay surcharge at the rate of 5% on tax while foreign companies whose total income does not exceed INR 100 million (approximately $1.36 million as of September 10, 2021) but is greater than INR 10 million (approximately $136,000 as of September 10, 2021) are liable to pay surcharge at the rate of 2% on tax. Additionally, Health and Education Cess of 4% is levied on the aggregate of income-tax and surcharge.

While the investor may have its own preference as to the location of the I.H.C., Singapore, Mauritius, and the Netherlands have been preferred jurisdictions in the past, due to the combination of attractive tax frameworks for holding companies and favorable tax treaties with India. Indian tax authorities view such sales as abusive and the Government has adopted an indirect transfer provision in the I.T. Act. Popularly known as the Vodafone tax, it provides that shares of, or interests in, a foreign entity is deemed to be situated in India where such foreign entity derives substantial benefit from India – computed in a prescribed manner. More than 50% of value must be derived from India for the tax to be imposed.[3]

"Today, limitation on benefits provisions are in Indian tax treaties with the U.S., Mauritius, and Singapore."

Having strong commercial substance in the I.H.C.'s jurisdiction is essential in planning that is designed to reduce the exposure to the Vodaphone tax. Whether this is practical is an open question because, by definition, an I.H.C. may have been designed to be a special purpose vehicle to hold the investment in IndiCo. Building in functions for the I.H.C. may be a non-starter unless they are limited to managing only one investment, that being the investment in IndiCo.[4]

Today, limitation on benefits ("L.O.B.") provisions are in Indian tax treaties with the U.S., Mauritius, and Singapore. India has also approved the ratification of multilateral instrument ("M.L.I.") to implement tax treaty-related measures. Where approved by partner jurisdictions, India's existing tax treaties could require a showing that obtaining a tax benefit was not one of the primary purposes for channeling an investment through a particular country.

Fair Value Requirement

Any investment in India is required to be tested to determine whether the value of the asset acquired – such as face amount of debt bearing specific interest or the value of shares issued – meets a fair value requirement. The Indian income-tax law lays down a computation mechanism for such fair value requirement. An investor is required to obtain a valuation report from a Chartered Accountant or Category-I Merchant Banker at the time of investment. Any investment that has a value below the value of the instrument issued is treated as taxable income for the investor. Ordinary income tax rates apply. The rules for valuation of equity shares consider the fair value of underlying assets, such as shares and securities, stamp duty value in case of immovable property, and book value for the other assets.

---

[3] In 2012, the Indian government enacted legislation allowing the tax authorities to impose tax retroactively on gains derived from an indirect sale of an Indian company. (The law was enacted several years after the transactions, but was made effective several years prior to enactment in response to adverse decisions in Indian courts.) The provision was challenged by Vodafone and Cairn Energy in arbitration under a bilateral investment treaty. Both companies won and the matters are currently on appeal. Recently, the Indian government has withdrawn the retroactive applicability of this law providing a relief to foreign investors.

[4] An exception may exist for a Singapore corporation as the relevant income tax treaty deems a Singapore company to have substance ifs annual expenditure on operations in Singapore is at least S$200,000.

U.S. Tax Aspects When Investing Into India

Contribution of Appreciated Property May Result in Gain Recognition to the U.S. Shareholder

Generally, the U.S. does not recognize any gain or loss if property is exchanged solely for stock of a corporation which is controlled by the transferor immediately after the exchange.[5] A person is said to control a corporation if the person owns stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation. However, the above nonrecognition provision does not apply in case of a transfer of appreciated property by a U.S. person to a foreign corporation, even if all conditions of code §351 are otherwise satisfied. The foreign corporation is denied corporate status. Consequently, nonrecognition of gain is denied because the benefit of Code §351 applies only to transfers to a corporation in return for the issuance of shares.[6] Because the transferee foreign corporation is not considered to be a corporation, the U.S. transferor must recognize gain on the appreciation in the contributed property. Certain exceptions apply to the recognition rule. The provision does not extend to losses. Such losses are not recognized if the transferee is a foreign corporation and all the conditions of Code §351 are met.

Default Entity Classification Rules

U.S. tax law contains default entity classification rules according to which a foreign entity is treated as a corporation by default, if all members have limited liability.[7] If the entity has two or more members and at least one member has unlimited liability, the default status is that of a partnership. The entity will be disregarded if it has a single owner that does not have limited liability.[8]

If an entity is an eligible entity because it is not listed in I.R.S. regulations as a *per se* corporation, an election may be made by the entity to choose a classification different from the default classification. The election is commonly referred to as a "Check-the-Box" election. It is made by filing Form 8832, *Entity Classification Election*. It may be noted that the default classification rules and check the box election are relevant only for U.S. tax purposes and it will not affect the tax treatment in the foreign country in which it is organized.

All entities making an election, must have a U.S. tax identification number. This applies to foreign entities as well as U.S. entities. Form SS-4, *Application for Employer Identification Number*, is used to obtain a U.S. tax identification number.

In the facts above, the Indian entity will be incorporated as a private company limited by liability and therefore it will default to a corporate status since its only shareholder, U.S.Co, has limited liability with respect to its debts. No check the election is made by U.S.Co.

---

5 Code §351(a).

6 Code §367(a).

7 Limited liability means no liability for the debts of the entity.

8 Treas. Reg. §301.7701-3(b)(2).

STAGE 2: TAXATION OF PROFITS OF INDICO

Indian Income Tax Consequences on the Operations of IndiCo

Under Indian tax law, the business profits earned by a domestic company is taxed on a net basis, after deduction of permissible expenses. The corporate tax rate ranges from 15% to 30%, plus applicable surcharge and cess, depending on several factors including, (i) nature of the company's business, (ii) the date of incorporation, (iii) the volume of turnover, and (iv) specified incentives and deductions claimed by the company.

In certain scenarios, IndiCo may be subject to tax on its adjusted accounting profits ("Book Profit"), if tax computed under normal profits is less than 15% of Book Profit. The term used for tax in this set of circumstances is Minimum Alternate Tax. ("M.A.T."). Such excess tax paid under M.A.T. over and above normal tax liability is allowed as a credit against IndiCo's normal tax liability for later years up to a maximum of 15 years under current law.

Income of IndiCo subject to U.S. Tax Under Two Separate Tax Regimes

U.S. tax law provides for the potential application of two anti-tax deferral regime in the context of a controlled foreign corporation ("C.F.C."). One is commonly known as Subpart F, which addresses income of a C.F.C. from intercompany transactions that are viewed to be abusive under U.S. tax law or income that is merely a passive of funds by a C.F.C. The other is Global Intangible Low-Taxed Income ("G.I.L.T.I.") that governs the operating income of the C.F.C. not otherwise subject to U.S. tax.

A C.F.C. is a foreign corporation in which "U.S. Shareholders" directly or indirectly own shares representing (i) more than 50% of the total combined voting power of all classes of stock entitled to vote or (ii) more than 50% of the total value of all issued and outstanding shares of stock.[9] A U.S. Shareholder is a U.S. person[10] who directly or indirectly owns shares representing (a) 10% or more of the total combined voting power of all classes of stock entitled to vote or (b) 10% or more of the total value of all issued and outstanding shares of stock.[11]

IndiCo is a wholly owned subsidiary of U.S.Co. Consequently, U.S.Co is a U.S. Shareholder of IndiCo and IndiCo is a C.F.C.

Transactions Viewed to be Abusive

A U.S. Shareholder of a foreign corporation generally is not subject to tax on the income of the corporation until the shareholder receives a distribution from the corporation. However, under Subpart F, certain types of income earned by a C.F.C. are currently included in the income of its U.S. Shareholders even if the C.F.C. does not distribute the income to its shareholders in that year.

One such type of income is Foreign Base Company Sales Income ("F.B.C. Sales Income"). For an item of income to be characterized as F.B.C. Sales Income, it

9 Code §957(a).

10 A U.S. person includes, *inter alia*, a U.S. citizen, a lawful permanent resident of the U.S., an individual who meets the substantial presence test of determining residency, a U.S. corporation, and U.S. partnership.

11 Code §985(b).

must be derived by a C.F.C. from a purchase or sale of personal property involving a related party in which the goods are both manufactured and sold for use or consumption outside the C.F.C.'s country of organization. Such related party transactions are deemed to be tax motivated if the intermediary company is based in a low tax jurisdiction. If the intermediary company is subject to tax at an effective rate of 90% of the U.S. tax rate in effect for the year, the income arising from the purchase and sale of goods is not treated as F.B.C. Sales Income. Similarly, if the property is manufactured or sold for use or consumption in the C.F.C.'s country of organization, it cannot be F.B.C. Sales Income.

In determining whether an arrangement is abusive, U.S. law addresses transactions carried on through branches. The branch rule prevents a U.S. Shareholder from using a branch in lieu of a separate C.F.C. to shift sales income from a high-tax foreign country to a low-tax foreign country. Absent the branch rules, a C.F.C. and its branch would be treated as a single entity for U.S. tax purposes. However, when a C.F.C. carries on selling, purchasing or manufacturing activities by or through a branch outside its country of incorporation and the use of the branch has substantially the same tax effect as if the branch were a separate C.F.C., the branch and the remainder of the C.F.C. will be treated as separate corporations in determining whether the C.F.C. has F.B.C.S. Income from the sale of property. Generally, the branch and the remainder of the C.F.C. will be treated as separate corporations if the actual effective rate of tax of the branch is less than 90% of, and at least 5 percentage points below, the hypothetical effective rate of tax of the rest of the company.

A second type of income derived by a C.F.C. that results in immediate U.S. tax for a U.S. Shareholder is Foreign Base Company Services Income ("F.B.C. Services Income"). The rules for F.B.C. Services Income are intended to deny deferral when a U.S. Shareholder uses a C.F.C. to inappropriately shift services income from the U.S. to foreign jurisdictions or from a high-tax country to a low-tax country.

F.B.C. Services Income may take the form of compensation, commissions, fees, and other forms of payment for services. To be F.B.C. Services Income of a C.F.C., the income must be derived by a C.F.C. in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial or like services outside the C.F.C.'s country of organization for or on behalf of any related person.

Generally, services are considered to be performed where the persons doing the work are physically located when they perform the activities that generate the services income. The determination will depend on the facts and circumstances of each case. F.B.C. Services Income does not include income from services performed within the C.F.C.'s country of organization. However, in many cases, services are performed both within and outside the C.F.C.'s country of organization. In these circumstances, an apportionment is required to determine the amount of the income that is considered to be F.B.C. Services Income.

Typically, the total gross income of a C.F.C. that is derived in connection with services performed for or on behalf of a related person must be apportioned on the basis of time spent by employees of the C.F.C. performing the services within the C.F.C.'s country of organization and the time spent outside that country. In making the allocation, relative weight must be given to the value of the various functions performed by persons in fulfillment of the services contract or arrangement.

Passive Income Taxed as Subpart F Income

Items of passive income, such as interest, dividends, investment gains, royalties, and rents generated by a C.F.C. in a manner that is unrelated to the active conduct of a banking, licensing, or leasing company are considered to be items of Foreign Personal Holding Company Income. As with income from abusive transactions, Foreign Personal Holding Company Income of a C.F.C. will be subject to U.S. tax when and as generated by the C.F.C. Detailed rules have been adopted to distinguish when the above mentioned income and gains are derived in the active conduct of a trade of business by a C.F.C.

Taxation of a U.S. Shareholder

A corporate U.S. Shareholder is subject to a 21% tax on the Subpart F Income inclusion and is allowed an indirect credit for the foreign income taxes paid by the C.F.C. with regard to the income taxed under Subpart F.[12] An individual U.S. Shareholder, on the other hand, is subject to tax at ordinary rates of up to 37% and an indirect credit of the taxes paid by the C.F.C. on Subpart F Income in its country of incorporation is not allowed. However, the taxes paid by the C.F.C. reduce the earnings from the Subpart F Income and function as a deduction for the individual.

In the present fact pattern, IndiCo is an operating company and therefore predominantly earns income from its business operations. However, let's assume it earns interest income on the excess working capital invested in liquid investments in India. Per se, the interest income – which is not operating in nature – is Foreign Personal Holding Company Income, which is a type of Subpart F Income. Therefore the interest income will be taxed in the hands of U.S. Shareholders as Subpart F Income on current basis in the absence of an exception.

Two primary exceptions that are relevant to the present fact pattern are discussed below:

- *De minimis rule*[13] – If the aggregate of Subpart F Income is less than the lower of 5% of gross income or $1 million, none of the C.F.C.'s income is treated as Subpart F Income.[14]

- *High tax exception* – An item of income taxed at more than 90% of the highest U.S. corporate rate (*i.e.* 21% X 90% = 18.9%) in the country of incorporation is not Subpart F Income.[15]

IndiCo is incorporated in India which has a minimum corporate tax rate of 25% which is more than 18.9%. Assuming the computation of income and the timing or income recognition are materially the same for tax purposes in the U.S. and India, the interest income will not be treated as Subpart F Income under the High Tax Exception.[16] Alternatively, the interest income may also escape the Subpart F regime under the

---

12 Code §960(a).

13 Full inclusion rule, on the other hand, treats the entire gross income of a C.F.C. as Subpart F Income if more than 70% of the gross income constitutes Subpart F Income.

14 Code §954(b)(3)(A).

15 Code §954(b)(4).

16 However, see the discussion on G.I.L.T.I. Income excluded from Subpart F under the High Tax Exception is nonetheless treated as G.I.L.T.I. income.

De Minimis Rule if the interest income together with other Subpart F Income is less than the lower of 5% of gross income of IndiCo or $1 million.

Operating Income Taxed as Global Intangible Low-Taxed Income (G.I.L.T.I.)

The 2017 Tax Cuts and Jobs Act introduced a new tax regime called G.I.L.T.I. that is applicable to U.S. Shareholders of a C.F.C. Although, labeled as a tax on intangible income, the G.I.L.T.I. tax is, in effect, a tax imposed on U.S. Shareholders of a C.F.C. on their share of any income earned by the C.F.C. that is not otherwise subject to U.S. tax in one form or another.

The G.I.L.T.I. regime follows an elimination method to tax the income of a C.F.C. In broad terms, the computation begins with the gross income of the C.F.C. for the current year. Next, the gross income is reduced by current income that is already subject to U.S. tax under other provisions of the Code, such as (i) Subpart F Income, (ii) income that is effectively connected with a U.S. trade or business carried on by the C.F.C., (iii) income that is excluded from Subpart F under the high-tax exception, and (iv) dividend income received from related C.F.C.'s formed in the same country as the C.F.C. receiving the dividend. The residual income of the C.F.C. is subject to a series of adjustment and is taxed at an effective tax rate of 10.5%[17] when the shareholder is itself a corporation. A corporate shareholder is entitled to an indirect credit, but the credit is limited to 80% of the foreign income tax paid on the net G.I.L.T.I. taxable income of the C.F.C. An Individual shareholder is subject to ordinary tax rates of up to 37% without any benefit of indirect foreign taxes paid by the C.F.C.

"The residual income of the C.F.C. is subject to a series of adjustment and is taxed at an effective tax rate of 10.5% when the shareholder is itself a corporation."

Taxation of Subpart F Income and G.I.L.T.I. income have several similarities. Similar to the Subpart F provisions, the income subject to the G.I.L.T.I. provisions is taxed in the hands of U.S. Shareholders in the year earned even if the C.F.C. does not distribute the income to its shareholders on a current basis. In other words, unless an exception applies, the entire income of a C.F.C. is fully taxed in the U.S. on a current basis under the following categories:

- Subpart F Income
- G.I.L.T.I. Income
- Effectively connected income

Like Subpart F, the G.I.L.T.I. regime is also subject to a high tax exception (the "G.I.L.T.I. High Tax Exception"), which, if available and elected, excludes G.I.L.T.I. income from current tax rules. The G.I.L.T.I. High Tax Exception is available if the income is taxed in the country of incorporation at an effective rate that is 90% or more of the U.S. corporate tax rate (*i.e.* 21% X 90% = 18.9%). Income that is excluded from Subpart F under the Subpart F De Minimis Exception discussed above is subject to the G.I.L.T.I. tax regime.[18]

In the present fact pattern, IndiCo is an operating company engaged in the business of manufacturing electric appliances in India. Therefore, subject to the application of the G.I.L.T.I. High Tax Exception, the income of IndiCo that is not otherwise subject

---

17 The income tax rate on G.I.L.T.I. is set increase to 13.125% effective Jan 1, 2026.

18 Treas. Reg. §1.951A-2(c)(4)(iii).

to U.S. tax under other provisions of the Code will be subject to the G.I.L.T.I. Tax. As discussed above, India has a minimum corporate tax rate of 25% which is higher than 18.9%. Therefore, if the G.I.L.T.I. High Tax Exception is elected,[19] the G.I.L.T.I. income will not be subject to G.I.L.T.I. tax in the U.S., if the computation of income and the timing or income recognition are materially the same for tax purposes in the U.S. and India.

STAGE 3: REPATRIATION OF PROFITS BY INDICO

Indian Tax and Other Aspects When Repatriating Funds to the U.S.

At this stage, the investor looks to repatriate funds from the target entity to its home jurisdiction on an annual basis. However, repatriation of funds may trigger a tax in India. An investor must consider the following factors for repatriation of target profits from India.

Mode of Repatriation

Each mode of repatriation has its own pros and cons, and an investor must be mindful when selecting the method of repatriation. Typically, funds are repatriated to investors by way of dividends, interest, royalties, fees for technical services ("F.T.S."), or a return of capital ("Buy-Back").

While payments of interest, royalties, and F.T.S. may provide benefit in the form of tax deduction for the Indian target, they are subject to certain caps under the Indian transfer pricing law, must have commercial justification, and meet an arm's length test. In addition, interest payments are not deductible if the subsidiary making the payment is thinly capitalized. The deduction for interest paid to related parties cannot reduce net profit before interest income and expense by more than 30%.

Indian Withholding Tax Requirement

Under Indian tax law, any payment to a nonresident is subject to withholding tax. Under the I.T. Act, interest payments are subject to withholding tax imposed at rate ranging from 5% to 40% depending on factors such as currency of borrowing, nature of instrument, and type of investor. The tax is increased by the applicable surcharge and cess. In comparison, dividends are subject to flat withholding rate of 20% plus applicable surcharge and cess, and royalties, and payments of F.T.S. are subject to flat withholding rate of 10%, plus applicable surcharge and cess.

The above rates of withholding may be reduced under an applicable income tax treaty. Under the India-U.S. Income Tax Treaty, the rates of withholding taxes are reduced as follows:

---

[19] The G.I.L.T.I. High Tax Exception applies only if the U.S. Shareholder of a C.F.C. elects the application of the exception. The election is made by the majority shareholder and is made at a corporate level which implies that the election is applicable on minority shareholders, as well. The election is made by attaching a statement to the shareholder's U.S. Federal income tax return informing the I.R.S. of the election.

- For dividends, the rates are 15% where the shareholder is a U.S. corporation that holds shares representing at least 10% of the voting power in the target. In other cases, the tax rate is 25%.
- For interest payments, the rates are 10%, if the lender is a financial institution, and 15% in all other cases.
- For royalties and payments of F.T.S., the treaty rate is 15%, but the rate under domestic law is 10% plus applicable surcharge and cess.

To claim benefits under a tax treaty, an investor must be the beneficial owner of the income. This is determined under a fact-based exercise and requires detailed evaluation of various factors. It becomes more critical in case of I.H.C. structures.

Transfer Pricing Aspects

According to the Indian transfer pricing regulations, any income arising from an international transaction carried on between two or more associated enterprises ("A.E.'s") is computed under the principle of an arm's length price ("A.L.P."). Generally speaking, parties are treated as A.E.'s if one has the power to exert control over the other. In the context of a corporate structure, enterprises would be considered to be associated if any person or enterprise directly or indirectly holds shares carrying 26% or more of the voting power in each of the enterprises.[20] Thus, any transaction between an Indian target and its foreign sole shareholder must be carried out on an arm's length basis in order to be deductible. The I.T. Act prescribes specific methods for determining the A.L.P.

The Indian transfer pricing law also includes provisions relating to secondary adjustments, which provides that if the primary adjustment is not remitted to India within the prescribed time, the unremitted amount is deemed to be a form or loan or advance made to the foreign A.E. and deemed interest accrues on the deemed advance.

In addition, robust documentation in support of transfer prices must be maintained. The law provides for the filing of transfer pricing certification reports (Form 3CEB is an example). Any expenditure incurred in excess of an A.L.P. is not tax deductible. Similarly, where A.L.P. in a transaction with a foreign A.E. produces a loss for an Indian customer, the A.L.P. deemed to be zero.

Finally, like the I.R.S. in the U.S., the tax authorities in India have a robust mechanism in place for obtaining Advance Pricing Agreements to provide tax certainty in relation to transfer pricing matters.

U.S. Taxation of Distributions From a C.F.C.

As discussed above, Subpart F Income and G.I.L.T.I. are subject to U.S. tax in the hands of a U.S. Shareholder in the year in which a C.F.C. generates income. Absent the following rule, this previously taxed income ("P.T.I.") could be taxed again in the hands of the U.S. Shareholder at the time of an actual distribution. Code §959(a) prevents such double taxation by excluding the distributions of P.T.I. from gross income upon actual distribution.

[20] Section 92 of the I.T. Act.

Owing to multiple types of P.T.I. (*e.g.*, Subpart F, G.I.L.T.I., and Transition Tax), the Code provides for a specific order in which distributions are deemed to be made out of the earnings and profits ("E&P") of a C.F.C. Generally, the distributions are made under the Last-Inn First-Out method, which implies that the distributions are first made from E&P of the current year and then from the E&P of the immediately preceding year, and so forth until fully exhausted. Moreover, E&P of each year is further divided into the following categories and a distribution is sourced in the following order:

- Previously taxed earnings and profits ("P.T.E.P.") attributable to investments in U.S. property.[21]
- P.T.E.P. attributable to Subpart F Income, G.I.L.T.I. income, and Transition Tax.[22]
- General current and accumulated E&P ("non-P.T.E.P."). This category includes income not subject to tax in the U.S. on account of, *inter alia*, making a high tax exception election to the G.I.L.T.I. income or Subpart F Income, etc.

Distributions that are deemed to be made from the first two categories are not subject to U.S. tax because the income was subject to U.S. tax previously in the hands of a U.S. Shareholder in the year in which the C.F.C. earned the income. Nonetheless, a distribution of P.T.I. may be subject to withholding at source since distributions typically will be treated as dividend to the C.F.C.'s shareholder in the source country.

U.S. taxation of distributions deemed to be made from Category 3 (non-P.T.E.P.) depends on the corporate status of the shareholder. A corporate U.S. Shareholder of a C.F.C. is entitled to a 100% deduction of the foreign-source portion of any dividend received from that C.F.C. ("100% D.R.D.").[23] The foreign-source portion of a dividend generally is the portion of the dividend that is attributable to the non-P.T.E.P. (*i.e.*, distributions deemed to be made from Category 3) of the C.F.C. In other words, a distribution from a C.F.C. that is deemed to be made from non –P.T.E.P is fully exempt by reason of the 100% D.R.D. in the hands of a corporate U.S. Shareholder. Further, the corporate shareholder is not allowed a credit for any foreign taxes paid or accrued with respect to the dividend to which the 100% D.R.D. applies.[24]

A corporation must satisfy the following requirements to qualify for the 100% D.R.D.:

- The corporate shareholder must meet the definition of a U.S. Shareholder, as discussed above.
- The corporate shareholder must have held the stock with respect to which the dividend is made for more than 365 days during the 731-day period beginning 365 days before the date on which the stock is given ex-dividend status.[25]

---

21 Code §959(c)(1).- Investment in U.S. property is not the main focus of this article and therefore has not been discussed here.

22 Code §959(c)(2).

23 Code §245A(a).

24 Code §245A(d)(1).

25 Code §§246(c)(1)(A), 246(c)(5)(A).

- The foreign corporation must be a specified foreign corporation and the corporate shareholder must be a U.S. Shareholder with respect to that foreign corporation at all times during the period of 365 days.[26]

- The U.S. Shareholder has not diminished its risk of loss through various option arrangements.[27]

An individual shareholder receiving distributions from Category 3 E&P of a C.F.C. is treated as receiving taxable dividends that are subject to preferential tax rate of up to 20% when the dividend is a qualified dividend. For a C.F.C., the dividend would be qualified if the U.S. has an income tax treaty in place with the country of incorporation.[28] In the absence of a treaty, the distribution is taxed at ordinary rates of up to 37%. The individual recipient is allowed to claim a foreign tax credit for foreign taxes withheld from the dividend by the source country. The credit is subject to various limitations of U.S. tax law. Additionally, the Net Investment Income Tax ("N.I.I.T.") of 3.8% is imposed on individuals who receive the dividend directly or through tax transparent entities provided certain income thresholds are exceeded. The N.I.I.T. cannot be reduced by the foreign tax credit for withholding taxes imposed by a foreign country.

In the present fact pattern, U.S. taxation of distributions will depend on several factors, including

- whether IndiCo generates Subpart F Income;

- if so, whether De Minimis Rule or the Subpart F High Tax Exception is applicable; and

- whether the G.I.L.T.I. High Tax Exception is elected.

If the income of IndiCo is not taxed on a current basis (either under Subpart F or G.I.L.T.I. regime), the actual distributions that have not been taxed previously will be deemed to have been distributed from Category 3 E&P (non-P.T.E.P.). Those dividends will enjoy the 100% D.R.D., if applicable, as a result of which the profits of IndiCo will be fully exempt from tax. On the other hand, if the income of IndiCo is treated as Subpart F Income or G.I.L.T.I. Income, U.S.Co will be taxed in the U.S. on a current basis at the rate of 21% or 10.5%, respectively. A subsequent actual distribution to U.S.Co will not be subject to tax in the U.S. to the extent it is treated as a distribution of P.T.I. by virtue of Code §959.

---

26 Code §246(c)(5)(B).

27 Code §246(c)(4).

28 Code §1(h)(11)(C)(II).

STAGE 4: EXIT FROM INDIA

Indian Tax and Other Aspects on Exiting India

Mode of Exit

An exit can take the form of a simple share transfer, a slump sale,[29] or the liquidation of IndiCo. Under Indian tax law, capital gains earned by a nonresident investor from transfer of assets based in India, including shares of an Indian company, are taxed at a rate ranging from 10% to 40% (plus surcharge and cess), depending on the period for which such assets were held prior to transfer and the type of asset transferred. The tax treatment of the gain realized by a foreign investor may be modified under an applicable income tax treaty. However, tax treaties that have been entered with the U.S. and the U.K. do not provide any relief from Indian capital gains tax.

Valuation Requirement

In respect of certain assets, the Indian income tax law has specific valuation norms and prescribed valuation mechanisms under which the acquisition of assets for less than inadequate consideration could result in tax implications for the acquirer. Recently, such provisions have also been made applicable to slump sale transactions.

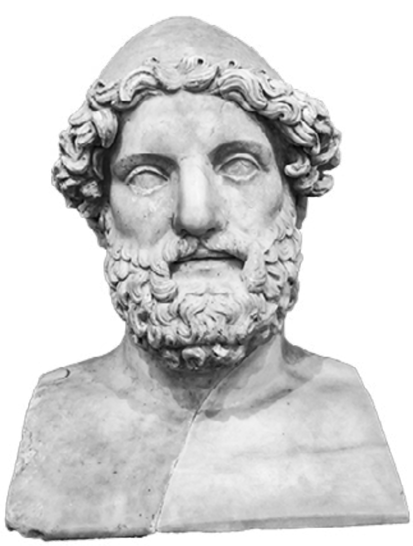
From the seller's perspective, the valuation aspect is critical as there are statutory provisions in India's domestic tax law (Section 50CA) that tax the seller on deemed consideration in certain cases.

Thus, sufficient care should be taken to ensure that the valuation aspect of a transaction is handled appropriately, so that there are no adverse income-tax implications for either of the parties.

Successor Liability Risk

Under the Indian income-tax law, there is a risk that upon acquisition of a business, the buyer, as a successor, would inherit the tax liabilities, if any, of the seller. This risk is triggered in cases where the transferor cannot be found or where any tax liability is not recoverable from the transferor, for example, on account of inadequacy of assets.

When the provision is triggered, the buyer may be held liable for the tax liabilities of the transferor for a specific period, typically the financial year in which the transfer of the business takes place and the immediately preceding financial year. Thus, a purchaser must confirm the seller's ability to meet its tax liability.



Clearance From Income-Tax Authorities

In the case of pending tax proceeding against the transferor, the Indian tax authorities have the power to declare a transfer of certain specified assets as void, where such transfer takes place without a prior approval of the jurisdictional tax officer. In this regard, the Indian income-tax law provides a mechanism for obtaining a tax clearance certificate for the transfer of business assets. In secondary transfers

29 In India, a slump sale is the transfer of an undertaking as a whole for a lumpsum consideration without considering values of individual assets or liabilities contained within the undertaking. That said, for the purpose of merely determining stamp duty or other similar taxes, individual values may be of relevance.

of business assets, this can become a point of negotiation between the parties because tax clearance certificates can be a time-consuming process. Hence, this aspect should be discussed early in deal negotiation to assess whether mere contractual covenants would suffice.

Tax Indemnities

Merger and acquisition transactions have been steadily growing in India and some of the most highly negotiated provisions are those relating to indemnities in case of breach of representations and warranties. In a secondary transfer, the purchaser takes over the target company together with all its related liabilities, including contingent liabilities. Hence, the purchaser normally requires more extensive indemnities than in the case of an asset acquisition. From a seller's perspective, globally there has been a rapid growth in the use of representations and warranties insurance ("R.W.I.") in relation to these transactions in order to avoid the out-of-pocket costs arising from an unforeseen liability. This has become a popular alternative to an indemnity under an S.P.A. or where indemnity is capped.

"When significant sums are involved, it is customary for the purchaser to initiate a due diligence exercise. Normally, this would incorporate a review of the target's tax affairs."

An alternative approach is for the seller's business to be transferred into a newly formed entity, so the purchaser can take on a clean business and leave its liabilities behind. Such a transfer may have tax implications. When significant sums are involved, it is customary for the purchaser to initiate a due diligence exercise. Normally, this would incorporate a review of the target's tax affairs.

U.S. Taxation of Disposition of Stock in IndiCo

Generally, any gain arising from a sale of stock of a corporation is treated as capital gain in the hands of the seller.[30] In the context of a C.F.C., Code §1248 requires the gain recognized by a U.S. Shareholder on the sale, exchange, redemption of stock, or liquidation of a foreign corporation to be treated as a dividend to the extent of the C.F.C.'s E&P that have not been taxed previously in the U.S.

Code §1248 provides parity of tax treatment for U.S. Shareholders who sell C.F.C. stock in the following two fact patterns:

- In the first, the C.F.C. is a corporation that distributes dividends regularly, providing its U.S. Shareholders with a stream of potentially taxable dividends as provided under U.S. tax law in effect at the time. When the stock of the C.F.C. is sold, the gain reflects solely the increase in value of the business of the C.F.C.
- In the second fact pattern, the C.F.C. is a corporation that accumulates its profits and pays no dividends. When the stock of the C.F.C. is sold, the gain reflects both the increase in the value of the C.F.C.'s business and the retained cash earnings.

In a system where long-term capital gains are taxed at a more favorable tax rate, as was the case in 1962 when Code §1248 was enacted, the second fact pattern resulted in more favorable tax treatment.

The gain is characterized into dividends if, at some time during the five-year period preceding the disposition, the corporation was a C.F.C. while the U.S. Shareholder

30 Code §1001.

owned (directly, indirectly, or constructively) shares of stock representing at least 10% of voting power of all shares of the corporation. Although the shareholder's 10% ownership must have coincided with the corporation's status as a C.F.C., Code §1248 applies even though one or both of these conditions is not satisfied when the gain is realized.

In determining the amount of E&P that will cause gain from the sale of shares to be treated as dividends under Code §1248, E&P that was previously included in the shareholder's gross income under Code §951 (*i.e.*, Subpart F and G.I.L.T.I.) and E&P from income that was effectively connected to the conduct of a U.S. trade or business carried on by the foreign corporation are excluded.

The gain treated as a dividend under Code §1248 enjoys the 100% D.R.D. under Code §245A. Hence, it is exempt from U.S. tax for a U.S. corporate seller.[31] Therefore, repatriation of the proceeds from the sale of a C.F.C. into the U.S. can be effected without any U.S. tax, although the gain may be subject to tax in India. The U.S. corporate seller will not be allowed a credit for the Indian taxes in the year of sale or future years.[32] In case of an individual U.S. Shareholder, the gain characterized as dividends are subject to U.S. tax at the rate of up to 20% or 37% (depending on whether the U.S. has signed an income tax treaty with the country of incorporation). The N.I.I.T. of 3.8% is also imposed on the gain in case of an individual shareholder.

CONCLUSION

Based on the above discussion, a parent-subsidiary structure to carry out business in India may result in a zero tax liability in the U.S. in the hands of the U.S. parent. If rules applicable to the computation of income and the timing of recognition of income and expenses are materially identical in both countries, the application of the Subpart F and G.I.L.T.I. H.T.E. could apply to U.S.Co as the Indian corporate tax rate is higher than 18.9%. Where all such factors coalesce, should not be subject to tax on Subpart F Income or G.I.L.T.I. Income in the U.S. on a current basis. As a consequence, any distribution from IndiCo will be treated as being distributed from non-P.T.I. earnings. This distribution will be exempt from U.S. tax if the 100% D.R.D. under code section 245A is available.

As a result, a U.S. investor can carry out business in India and repatriate business profits without incurring any addition U.S. tax. However, any dividend distribution by the U.S. parent to its shareholders will be subject to U.S. tax at the rate of up to 20% if the shareholder is a U.S. citizen or resident or 30% if the shareholder is not a U.S. person and is not entitled to treaty benefits.

U.S.Co will be required to annually file a Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*, to report its ownership interest in the Indian subsidiary and certain financial information of the Indian company to the I.R.S.

On the Indian side, the business profits of the Indian company will be subject to a minimum corporate tax of ~25% on net profits. Any distribution to the U.S. parent from its E&P will be treated as a dividend subject to a withholding tax of 15% (under the India-U.S. income tax treaty) in India.

---

[31] Code §245A(a)(1).

[32] Code §245A(d)(1).

SWISS UPDATE ON TRUST REGULATION AND TAXATION

Authors
Peter von Burg
Matthias Gartenmann

Tags
Administrative Assistance
Switzerland
Tax
Trust

INTRODUCTION

Trusts have been and still are of great importance to advisors all over the world. Even though trusts are mostly found in common law systems (*e.g.*, U.S.A.), several civil law jurisdictions have implemented the concept of trusts (*e.g.*, Liechtenstein). In practice, trusts are often used for international tax and/or estate planning as well as for asset protection.

Put simply, a trust is created by a settlor who transfers some or all of his or her assets to a trustee. The trustee holds title to the property in trust for the benefit of the beneficiaries. The trust is governed by a trust deed and other accompanying documents which stipulate the terms and conditions and the applicable law. Trust law may differ from jurisdiction to jurisdiction, with each jurisdiction assigning varying rights and duties to the trustee.

To date, there is no Swiss trust or Swiss trust law. However, Switzerland recognizes the concept of a trust since adopting the Hague Trust Convention, which entered into force in 2007. Following that, Switzerland has enacted rules on how to treat foreign trusts for tax purposes and for registration purposes in the land register. There have been several attempts to enact a Swiss trust law.

In addition, since January 1, 2020, trustees may fall under the new law regulating the business of Financial Institutions including trusts. The question of which trustees fall under the new law as well as what the regulation includes is dealt with below.

This article discusses the current status of an introduction of a Swiss trust law, provides an overview of taxation of trusts in Switzerland, and addresses administrative assistance in tax matters in connection with trusts and their beneficiaries.

Peter von Burg is a partner at Burckhardt Ltd. in Zürich. His practice focuses on national and international taxation issues. He is admitted to the bar of the Canton of Zürich and qualifies as a Swiss certified tax expert..

Matthias Gartenmann was educated at the University of Zürich, where he graduated in Law (lic. iur./MLaw). He is admitted to the bar of the Canton of Zürich. He holds a Swiss Tax Expert Diploma and a Diploma in Legal Studies of Kings' College London.

INTRODUCTION OF A SWISS TRUST

In Swiss politics, there have been several attempts to introduce a Swiss trust law. However, these have been rejected to date or have not yet been successfully finalized.

Supporters of a Swiss trust law argue that adoption of a domestic provision will strengthen Switzerland's status as a financial center. It will ensure a level playing field with foreign jurisdictions and eliminate competitive drawbacks. Opponents argue that it would be difficult to introduce a Swiss trust law because the differences between common law and civil law cannot be reconciled without major adjustments. It is also suggested that the admission of the family maintenance foundation would be a possible alternative. The need for legal adjustments would be smaller than in the case of the introduction of a Swiss trust.

As of today, several procedures are running in parallel, which could lead to a Swiss trust law:

- In 2016, a member of the Swiss Parliament proposed an elaborate procedure with the title "Incorporation of the Legal Institute of Trusts into Swiss Legislation." The responsible committee in parliament would like to follow this proposal, but enactment was postponed. It is expected that the National Council (First Council) will consider this proposal in the spring of 2022.
- In 2018, the Swiss Federal Council was instructed by a committee of the parliament to create the legal basis for a Swiss trust. A group of experts appointed by the Federal Office of Justice has been working on regulation proposals since June 2018. The tax treatment or adjustments of the existing taxation rules are being clarified by a working group of the Federal Tax Administration and other stakeholders. In addition, the Federal Council was authorized to prepare a report on the advantages and disadvantages of a possible introduction of the legal concept of trusts into Swiss private law.

There is still a long way to go before a Swiss trust could become a reality. We believe that a Swiss trust certainly has potential. Of course, implementing a concept that is not familiar to civil law is procedurally difficult. Nonetheless, with adoption of appropriate adjustments, implementation should be possible. We see the major advantage in the fact that succession planning can be reflected in one jurisdiction. In a globalized world, simplifying the number of jurisdictions involved in creating and managing a trust makes sense.

REGULATION OF TRUSTEES

Prior to 2020, trustees were generally not regulated in Switzerland. However, trustees are generally obligated to comply with the Swiss Anti-Money Laundering Act.

As of January 1, 2020, Switzerland enacted the Financial Institution Act ("FinIA") which regulates the supervision of financial institution, as defined by the law. The main goal of this regulation is the protection of customers.

Financial institutions include, in particular, asset managers, fund management companies as well as trustees. All must be approved by the Swiss Financial Market Supervisory Authority ("S.F.M.S.A."). Trustees domiciled or resident in Switzerland who operate in Switzerland or from Switzerland fall under the new law. Foreign trustees are subject to the FinIA if they have a branch in Switzerland, establish a permanent establishment here, or are factually managed in Switzerland. In summary, all trustees with a nexus to Switzerland need must determine whether if they fall under the FinIA.

In practice, existing trustees were required to notify S.F.M.S.A. of their presence in Switzerland within six months after entry into force of the, *i.e.*, end of June 2020. Further to that, they must comply with all requirements by end of 2023 and submit a license request to S.F.M.S.A.

The definition of a trust for purposes of Swiss law refers directly to the Hague Trust Convention. Accordingly, a trust means a legal arrangement created by a person, the settlor, applicable during life or as a result of death, in which assets have been placed under the supervision of a trustee for the benefit of a beneficiary or for a particular purpose. A trustee is a person who, on the basis of a trust deed within the meaning of the Hague Trust Convention, professionally manages or disposes specified assets for the benefit of the beneficiaries or for a specific purpose.

Trustees are deemed to act professionally in any of the following circumstances:

- They generate gross proceeds of more than CHF 50,000 per calendar year.
- They enter into business relations with more than 20 contracting parties per calendar year.
- They have unlimited control over third-party assets exceeding CHF 5 million at any time.

It is not entirely clear if the last alternative (assets exceeding CHF 5 million) is applicable to trustees at all, since one could argue that trusts hold their own assets rather than third-party assets. The law also stipulates some exceptions that apply. For example, for trustees who only manage assets of family members that are related to the trustee or, relatives, spouses or persons who live with the trustee in a long-term relationship are treated as family members.

Protectors may also be subject to FinIA depending on the powers granted to the protector. Generally speaking, where the powers of a protector are similar to a trustee, it is likely that the protector will fall under the new law. Since FinIA is directly linked to the definition of trust, there should be no room to also include board members of foundations under the new regulation.

In order to be licensed by S.F.M.S.A., a trustee must fulfill an extensive list of requirements including

- the adoption of written corporate governance rules,
- the implementation of risk management and internal control systems,
- the maintenance of a minimum capital of CHF 100,000,
- the maintenance of professional indemnity insurance,
- proof of professional qualification, and
- arranging for a yearly external audit.

A trustee that fulfills all requirements is entitled to a license.

By regulating trustees with nexus to Switzerland, the interests of settlors and beneficiaries are protected. At the same time, trustee activity in Switzerland becomes more complex and costly to provide. It is expected that certain trustees with domicile in Switzerland will no longer act as trustee based on the compliance costs involved.

TAXATION OF TRUSTS IN SWITZERLAND

In Swiss tax law, there is no legal basis to consider a foreign trust as being subject to Swiss tax on global income. Trusts are covered in Switzerland by the Hague Trust Convention and for tax purposes by Circular 30 of the Swiss Tax Conference of August 22, 2007. The trust assets are attributed to the settlor or the beneficiaries. It should be noted that, despite the existence of a circular, cantonal practice may vary considerably. The following information serves as an overview.

Trust With No Nexus to Switzerland

If the settlor as well as the beneficiaries are not resident in Switzerland and the trust assets do not include any Swiss real estates, there are generally no Swiss tax consequences.

Swiss Withholding Tax

Due to the lack of legal personality, a trust cannot reclaim Swiss withholding tax. At most, the Swiss resident settlor or the beneficiaries can reclaim the withholding tax, provided they are considered to be beneficial owners. In some Swiss double taxation treaties, the trust is mentioned, which is why a refund of the withholding tax based on the double taxation agreements may be possible under certain circumstances.

Where a trust structure holds Swiss assets – such as shares – a question arises as to how and to what extent Swiss withholding taxes may be refunded. The refund depends on the applicable double taxation agreement as well as on the type of the trust.

Transfer of Swiss Real Estate to a Trust

Where real estate is transferred to the trust structure, it should be checked if an entry in the land register will be accepted by the cantonal authority, and if it is, the possibility that real estate gain tax consequences will result from the transfer.

Income, Wealth, Gift and Inheritance Taxes

"If the settlor as well as the beneficiaries are not resident in Switzerland and the trust assets do not include any Swiss real estates, there are generally no Swiss tax consequences."

If the settlor or the beneficiaries are resident in Switzerland, a distinction must be made according to the type of trust. The decisive factor for the classification is not the designation in the trust deed, but the actual structuring of the settlor's control rights. The rights of the settlor should be analyzed not only on the basis of the documents, but also how they are actually practiced.

Swiss tax law simplifies the possibilities of structuring trusts and has defined three different types of trusts:

- Revocable trust
- Irrevocable fixed interest trust
- Irrevocable discretionary trust

For a revocable trust, there are no tax consequences on establishment, because the assets continue to be attributed to the settlor with domicile in Switzerland. Consequently, the settlor must continue to pay taxes on the income and assets of the trust. In addition, distributions to the beneficiaries may be subject to cantonal gift tax. Finally, the tax effect of the demise of the settlor should be analyzed prior to the creation of the revocable trust. Depending on the cantonal law and practice, a trust may become an irrevocable discretionary trust at the time of the settlor's death which may trigger the imposition of substantial inheritance taxes.

Upon the establishment of the irrevocable fixed interest trust, a gift is assumed and may be subject to gift tax as the assets are no longer attributable to the settlor. Beneficiaries must pay wealth tax on their share of the trust assets. Distributions to the beneficiaries constitute taxable income. Capital gains in private assets and the distribution of the contributed trust capital do not constitute taxable income. In practice this type of trust is rather seldom encountered. Detailed proof is required for a tax-free distribution of capital gains.

Where an irrevocable discretionary trust is established with the settlor domiciled in Switzerland, the assets and the capital gains are attributed to the settlor. Thus, like a revocable trust, there are in general no tax consequences. Where an irrevocable trust is discretionary and the trust is established by a settlor with foreign domicile, the beneficiaries have no enforceable property right and therefore no wealth tax to pay. However, all distributions are subject to income tax.

ASSISTANCE IN TAX MATTERS

The exchange of information in the area of administrative assistance in tax matters is divided into the spontaneous exchange of information, the automatic exchange of information and administrative assistance upon request.

With regard to trusts, there are two possible scenarios of administrative assistance on request. Thus, either a foreign tax authority may request Switzerland to provide information held by a Swiss bank where trust assets are deposited, or the foreign authority may request the Swiss tax authorities to provide information directly held by a trustee domiciled in Switzerland.

Switzerland participates in the exchange of information in tax matters and began adapting its double taxation agreements by accepting the standard O.E.C.D. Model provision. Thus, Switzerland's revised double taxation agreements provide that the competent authorities may exchange information that is foreseeably relevant not only for the application of the provisions of the treaty itself, but also for the enforcement of the domestic tax law of the requesting state. In addition, a Contracting State may not refuse to provide information solely because it is held by a bank, other financial institution, nominee, or person acting in an agency or a fiduciary capacity, or because it relates to ownership interests in a person.

In practice, many individual factors in the request for administrative assistance relating to trusts will affect whether information will be provided, including the type of trust and the wording of the request.

In a decision of the Federal Administrative Court concerning a request for administrative assistance from a foreign state and relating to bank deposits in Switzerland held by an underlying company and the latter held by a trustee, it was decided that the information would not be disclosed if the taxpayer concerned was only a discretionary beneficiary of a clearly irrevocable trust. The decision has been appealed and the matter is pending before the Federal Supreme Court.

CONCLUSION

In Switzerland, adjustments to the family foundation and the introduction of a Swiss trust are being discussed at various political and stake holder levels. Swiss law does not provide for trusts and concepts of splitting legal ownership from beneficial ownership. Hence, modifying Swiss law to address a family foundation, which is an alternative to a trust, may require fewer legislative adjustments.

As of January 1, 2020, Switzerland enacted the FinIA. As a consequence, all trustees with a nexus to Switzerland need to check if they may fall under the FinIA.

Swiss tax law simplifies the possibilities of structuring trusts. It has defined three different types of trusts: revocable trust, irrevocable fixed interest trust, irrevocable discretionary trust. In determining the classification of any particular trust, the decisive factor for the classification is not the designation in the trust deed, but the actual retention by the settlor of control rights.

The exchange of information in the area of administrative assistance in tax matters is divided into the spontaneous exchange of information, the automatic exchange of information, and administrative assistance upon request.

A foreign tax authority may request Switzerland to provide information held by a Swiss bank where trust assets are deposited, or the foreign authority may request the Swiss tax authorities to provide information directly held by a trustee domiciled in Switzerland. Whether the requested information will be exchanged depends on the facts of the arrangement. Hence, facts and circumstances will influence the administrative decision.

PLANNING FOR NONRESIDENT INVESTMENT IN FRENCH REAL ESTATE – THE CHOICE OF COMPANY MATTERS

Author
Sophie Borenstein

Tags
Capital Gain
France
Dividend Withholding
I.F.I.
Profit Making Activity
Real Estate
Société Civile Immobilière
Wealth Tax

Sophie Borenstein is a Partner in the Paris office of Klein Wenner, where she heads the firm's Tax Department. She advises clients on French and international tax matters, with a focus on wealth management and tax management.

INTRODUCTION

It is common for nonresidents to own a secondary residence in France through a company. One of the recurring questions posed to a French tax adviser relates to the type of company to choose. Should it be (i) French or foreign and (ii) subject to corporate tax, or not? This article focuses on the French tax consequences for a nonresident individual who owns French real estate through a French or foreign company that is subject or not subject to corporation tax.

OWNERSHIP THROUGH A FRENCH COMPANY

The *société civile immobilière* (an "S.C.I.") is a real estate holding company frequently used by nonresident individuals and foreign corporations. An S.C.I. is a pass-through entity used to hold French real estate.[1] It may carry out an ancillary commercial activity, provided that the income from that activity does not exceed 10% of the total income of the S.C.I.

An S.C.I. is not subject to French tax unless it opts to be liable to corporate income tax or unless it carries out a commercial activity in more than a *de minimis* amount. Although an S.C.I. is a pass-through company, the S.C.I. is not fully transparent for French tax purposes since taxable profit is computed at the entity level before being taxed in the hands of its shareholders. Each shareholder is taxable according to its own tax regime on its *pro rata* share of the profits derived by the S.C.I. This means that the portion of the S.C.I.'s profits that are attributable to corporate shareholders at December 31st of each year, is computed in accordance with the tax provisions applicable to corporate income tax.

The choice of tax regime for the S.C.I. should be made in advance of the purchase of the property. The alternatives are the pass-through tax regime that is common for an S.C.I. (which is recommended when the residence is used for private reasons by the S.C.I. partners) or by expressly opting for corporation tax ("C.I.T."). This choice will depend in part on the existence of a tax treaty and the tax treatment of rental income and capital gains from French sources. Rental income will generate lower taxes in France when the S.C.I. is subject to corporate income tax, due to a lower tax base reflecting the tax benefit of depreciation. However, that benefit will be offset by higher taxation of the capital gain on the sale of the property, assuming the relevant income tax treaty assigns the exclusive taxation right to France based on the location of the property.

---

1 This article addresses the tax character of an S.C.I. from a French viewpoint. A nonresident should seek advice from a home country tax adviser regarding taxation in his or her country of residence.

The choice will also depend on the use of the property. Generally it is not advisable to hold a secondary residence via a company subject to C.I.T., at least when the property is made available exclusively and free of charge to the partners of the S.C.I. The economic benefit from housing which the taxpayers reserve for themselves is normally exempt from taxation. However, this exemption is reserved for natural persons or partnerships with natural persons as partners. It does not extend to the taxable profits of companies that are subject to C.I.T. When these advantages are provided without the payment of consideration to the company, the company will be deemed to have taxable income for C.I.T. purposes and the partner will be deemed to have received a benefit.

OWNERSHIP THROUGH A FOREIGN COMPANY

Nonresident individuals often hold a secondary residence in France through foreign companies having a registered office outside France. These nonresident companies are often located in the individual's country. Typically, these companies take the form of a commercial company with limited liability for shareholders. In their state of residence, they are subject to tax on profits at rates equivalent to French corporation tax.

The corporate tax status of the foreign company holding French real property must be determined under French tax concepts, especially when the French property is made available to shareholders on a rent-free basis. Different tax results will be result based on the character of the company. In comparison to an S.C.I., a foreign company does not have a choice as to the tax treatment of profits

It is therefore necessary to compare the foreign entity with a French company to determine whether those characteristics allow the foreign entity to be considered translucent – and therefore its income will be passed through to its partners and taxed at that level – or opaque – and therefore it will be the taxpayer and its income will be subject to C.I.T. The principal factors that are taken into account are free transferability of shares and limited liability of shareholders. French case law relates mainly to U.S. L.L.C.'s. that provide limited liability to members while being tax transparent, and Delaware corporations that may have a civil purpose rather than a commercial purposes. In at least one case, the French administrative Supreme Court ruled that a multimember L.L.C. should be treated as a corporation because of its limited liability.

When a foreign entity's form does not cause it to be subject to French C.I.T., it may be subject to C.I.T., nonetheless, because it carries on a "profit-making activity." In making a determination, no bright line exists as a guide. In principle, the provision of free housing by a foreign entity to its principal owner and members of his family would not necessarily cause the entity to be viewed as carrying on a profit-making activity. However, an anstalt and a Liechtenstein *stiftung* were held to carry on a profit-making purpose when a building in France was left at the disposal of their beneficiaries or third parties.

INCOME TAXATION

Rental Revenues

Individuals not resident in France are taxed in France on their French-source rental income, whether the property is held directly or indirectly through a French S.C.I. or an equivalent foreign company, as determined under French law. The investor has the choice between two tax regimes with radically different consequences, income tax or C.I.T.

Case Where the Company is Not Subject to C.I.T.

When the S.C.I. does not opt to be subject to C.I.T., the income from the rental of bare dwellings is taxed directly at the partner level, regardless of tax residence. Here, care is required to avoid double taxation – one in France as rental income is realized – and a second time in the country of residence, either at the same time income is realized in France or in a later year when distributed as dividends.

These issues of double taxation are governed by income tax treaties concluded by France. Most of these tax treaties attribute the right to tax to the state where the real property is located. In some instances, the right to tax is attributed exclusively to that state. In other instances, the right to tax is concurrent. In these instances, the right to tax that is reserved by the state of residence is subject to provisions in the income tax treaty that are designed to eliminate double taxation.

When the property is located in France directly or through an S.C.I. by a nonresident individual, the nonresident's tax is computed under two methods. The one that produces the lower tax is the method that is used.

- Under the first method, a split rate is applied. Up to a certain amount of income, the rate is 20%. On income in excess of that amount, the rate is 30%. In 2020, the switchover occurred when net income amounted to €25,710.
- Under the second method, the nonresident computes the effective French tax rate on income from sources in France and outside of Franc based on graduated rates ranging up to 45%. The effective rate is applied to the French rental income.

In addition to the income tax, income from real estate is subject to social contributions. The rate is 17.2% for tax residents of a country outside the E.E.A. and Switzerland, and for tax residents of an E.E.A. country or Switzerland who are affiliated to a compulsory French social security system. For tax residents of an E.E.A. country or Switzerland who are not affiliated to a compulsory French social security scheme, property income is subject to a "solidarity levy" at a rate of 7.5%.

Case Where the Company is Subject to C.I.T.

If the company is subject to C.I.T., the tax base in France the net rental income. The company will also be liable, where applicable, for the rental income tax ("C.R.L.") at the rate of 2.5%. C.R.L. is imposed on income derived from the rental of buildings that have been completed for at least fifteen years as of January 1 of the tax year. If the rent is subject V.A.T., either by right or by option, it is not subject to the C.R.L.

In the event of a distribution by a French company subject to corporate income tax, a withholding tax will be due. The rate is 21% if the shareholder is resident in a Member State of the European Economic Area, 30% if the shareholder is resident outside the E.E.A., or 75% if he is resident in an noncooperative country or territory. The rate may be reduced by income tax treaty and can be eliminated if the Parent Subsidiary Directive is applicable under E.U. law. In practice, most tax treaties concluded by France reduce the rate of this withholding tax. In the event of an actual or deemed distribution of profits by a foreign company, the rates applicable to distributions from French permanent establishment will apply.

Capital Gain

French tax law allows France to tax capital gains on the sale of real estate located in France. The right to tax is subject restrictions, if any, under an applicable income tax treaty.

In the case of a sale of shares of the company, the capital gains tax regime for private individuals will apply in the case of a French company with a majority of real estate assets established in a Member State of the European Union or the European Economic Area. The tax is 19%, and is accompanied by social contributions of 17.2% or 7.5%. In other cases, the standard capital gains tax regime applies. The tax is 12.8% and is accompanied by social contributions of 17.2% or 7.5%.

France retains the right to tax the capital gains from the sale of shares only where the company is considered to be real estate company ("S.P.I.") as a result of its asset mix. In broad terms, a company is treated as an S.P.I. if more than 50% of the value of its gross assets at the close of the three financial years preceding the transfer consists of real estate, shares in other S.P.I.'s, or real estate rights not allocated to its own professional activity, whether such assets are located in France or other states.

In practice, most of the tax treaties concluded by France follow the model treaty proposed by the O.E.C.D. and do not remove France's right to tax these capital gains.

In the case of a sale of real property directly held by a company, two separate tax regimes apply. If the company is subject to C.I.T., C.I.T. will be due. The tax rate is 26.5% in 2021 and will be 25% in 2022. If the company is foreign the tax is collected by means of withholding, subject to adjustment in a final return. If, on the other hand, the company is a translucent company, whether French or foreign, it is the partner who is taxed on the capital gain, according to the tax regime of capital gains on real estate for individuals.

In addition to the levy, nonresidents subject to income tax (individuals or partnerships) are subject to a surtax on capital gains in excess of €50,000 and to the taxes on the sale of land that has become buildable.

Taxation of the Real Estate Assets

3% Tax

Subject to two exceptions, companies that own real estate in France must pay an annual tax of 3% of the market value of the property. It does not matter whether the company maintains its head office in France or outside France. Nor does it matter whether the real property is held directly or through intermediary companies.

The exceptions to the 3% tax are as follows:

- Companies are not subject to the tax if they file Declaration no. 2746-SD each year indicating (i) the location and designation of the buildings, (ii) the value of the real estate as of January 1st, (iii) and the identity of all partners holding more than 1% of the capital.
- Companies are not subject to the tax if, within two months of the acquisition of French real estate, they undertake to report (i) information concerning the real estate and (ii) the names of shareholders holding more than 1% of the share capital at the first request of the French tax administration.

An S.C.I. that is engaged in bare rental activities is required to file Declaration no. 2072 each year. Providing this declaration exempts the company from making the undertaking described in the second bullet above.

Real Estate Wealth Tax ("I.F.I.")

Nonresidents of France are subject to a real estate wealth tax ("I.F.I.") on real estate assets located in France. This includes shares in domestic or foreign companies that own directly or indirectly real estate in France. Regarding tax on shares of companies, the tax is levied only on the portion of the value of the company's shares attributable to the real estate assets. If the nonresident owns shares representing less than 10% of the voting rights and capital of the company, the wealth tax does not apply, unless he or she controls the foreign company. In determining whether control exists, the shares held by a spouse and by children are treated as if owned by the nonresident.

In the case of a chain of companies, the taxable value is assessed on the basis of the real estate owned by all member companies in the chain and by all structures in which chain members participate.

As with income tax, a nonresident of France potentially faces wealth tax in two jurisdiction – France and the person's country of residence. Double taxation may be eliminated by an applicable income tax treaty that covers wealth taxes. Most income tax treaties addressing wealth tax allow both states to impose wealth tax. Double taxation is avoided by a tax credit. Some income tax treaties assimilate the shares of real estate companies to real estate. The state in which the real estate is located has exclusive right to tax. Other income tax treaties do not distinguish between real estate companies and other companies. The right to impose wealth tax is allocated exclusively to the state of residence of the person owning the shares.

As a planning point for nonresidents, the tax base on which I.F.I. is imposed will be reduced when real estate in France is held by an S.C.I. that has financed the holding through the issuance of debt. The debt reduces the value of the shares.

Donation and Successions

Inheritance or gift tax is levied on the market value of shares received as a gift or as an inheritance. When computing the fair market value of the shares, the amount of the company's debt obligations will reduce the value of the shares. As with the I.F.I., holding the real estate assets through a company carrying a significant debt load will reduce the value of the shares given away during life or at its conclusion.

CONCLUSION

Foreign investors choosing to own real estate assets in France are well served to plan the structures by which French real estate is held in advance of the purchase and to monitor the structure after an acquisition has been completed. There is no miracle solution, but choosing the proper structure may minimize the taxes that are paid in France during the period of ownership and at the time of sale.

"Foreign investors choosing to own real estate assets in France are well served to plan the structures by which French real estate is held in advance of the purchase and to monitor the structure after an acquisition has been completed."

TAXATION OF FOREIGN PENSIONS IN IRELAND – WALKING THE TRICKY TIGHTROPE

Author
Lisa Cantillon

Tags
Ireland
Lump Sum Drawdown
Pensions
Precedent 28
Remittance Basis Taxation

Lisa Cantillon is a Director in the Dublin office of KTA. Her practice concentrates in the area of expatriate tax and international pension and social security issues for cross-border individuals.

INTRODUCTION

As more and more individuals come home to Ireland or relocate to Ireland, the taxation of assets brought with them takes on importance once Irish tax residence is established. What tends to be of most concern is the myriad of pension products that individuals accumulate while living and working outside of Ireland. The tax treatment of overseas pensions, and in particular, the taxation of lump sum payments from foreign pensions is an increasingly complex affair in the Emerald Isle.

This article will examine the tax treatment of overseas pension income and overseas pension lump sum payments, together with the current Irish Revenue position on such lump sum payments.

TAXATION OF FOREIGN PENSION INCOME

Irish Domestic Legislation

The good news is that the taxation of foreign pension income (*i.e.*, regular, ongoing payments) is relatively straightforward for Irish resident taxpayers. Foreign pension income is chargeable to Irish income tax under Schedule D Case III by virtue of Section 18(2) Taxes Consolidation Act ("T.C.A.") 1997. There are some rules particular to non-Irish domiciled taxpayers which are discussed later in this article.

Ireland has 3 charges on income - Income tax, Universal Social Charge ("U.S.C.") and Pay Related Social Insurance ("P.R.S.I."). The Irish income tax system has been labelled as progressive, in that the tax rates progressively increase as income increases.

Pension income is liable to income tax and U.S.C. However, P.R.S.I. is normally not levied on pension income. An Irish tax resident individual is entitled to a personal tax credit of €1,650 per tax year, and the first €35,300 of income is subject to income tax at 20%, the standard rate band. Taxpayers jointly assessed with a spouse can avail of a higher standard rate band, the precise amount of which is determined by the extent of the income of the spouse. Both the taxpayer and spouse must be tax resident in Ireland to avail of joint assessment.

The U.S.C. charge graduates from 0.5% to 8%. The 8% rate currently applies to pension income exceeding €70,044. Social welfare income, including both Irish and foreign social welfare pension income, is exempt from U.S.C. and this can be relevant in optimizing the tax position for a non-domiciled taxpayer remitting income to Ireland.

Individuals are also entitled to an age tax credit once the taxpayer reaches the age of 65 and a married couple may be entitled to a joint credit of €490. Certain foreign pension income may also qualify for a further tax credit of up to €1,650.

Once an individual becomes Irish tax resident and is in receipt of foreign pension income within the charge to tax in Ireland, the individual will need to

- register for income tax,
- include details of the pension income on a self-assessment tax return filed with the Irish Revenue on an annual basis, and
- pay tax to Irish Revenue.

The annual Irish tax return is due for filing by October 31 each year, and tax payments are due on the same date. The deadline is generally extended to mid-November where returns and payments are made electronically.

International Considerations

In general, most tax treaties with Ireland will allocate the taxing rights of foreign pension income by reference to where the recipient of the pension is resident at the time the pension payment is received. Therefore, typically, foreign pension income is only taxable in Ireland if the individual is Irish tax resident under both Irish domestic legislation and the tax treaty in question. There can however be anomalies in some treaties.

For example, the Ireland-U.S. Income Tax Treaty allows the U.S. to continue to tax pension income of U.S. citizens who are tax resident in Ireland as there is a specific provision applying to anyone that is Irish tax resident and a U.S. citizen. It is known as the "saving clause" because the U.S. saves the right to tax its citizens as if the treaty had not come into effect. Depending on the treaty, limited exceptions to the saving clause may exist. The U.S. effectively included a clause in the Ireland-U.S. Income Tax Treaty to ensure that the U.S. can continue to tax its citizens even if they become tax resident in Ireland. Therefore, for individuals that have retained US citizenship and are Irish tax resident, both Ireland and the U.S. have taxing rights on U.S. pension income. This should be read in conjunction with the Irish taxation of U.S. Social Security pensions which is dealt with later in this article.

The Ireland-U.S. Income Tax Treaty permits a credit for double taxation and this generally operates by allowing a credit in the U.S., allowing Irish tax paid on U.S. pension income to be set off against the U.S. tax liability on the same income. Typically, the Irish tax rate exceeds the U.S. tax rate, so there should be no additional tax on U.S. pension income when filing U.S. tax returns when the income is also chargeable to tax in Ireland in the same taxable period. While there may be no U.S. tax cost, from a compliance perspective, the requirement to file returns in both jurisdictions can be a burden.

EXEMPTIONS UNDER IRISH DOMESTIC LEGISLATION

As already noted, pension payments to Irish residents from a foreign pension source are taxable under Schedule D Case III, as *per se*ction 18 T.C.A. 1997. However, section 200 T.C.A. 1997 provides that certain foreign pensions are exempt from Irish tax. Several conditions must be satisfied before the exemption applies:

- It must be a pension, benefit or allowance which is

- ○ given in respect of past services in an office or employment; or
- ○ payable under the provisions of the law of a foreign country in which the pension arises which correspond to certain Irish legislation which governs Ireland's pensions, benefits and allowances for the purposes of our Social Welfare legislation.

- The country in which the pension, benefit or allowance arises has a tax which is chargeable and payable under the law of that country, and which corresponds to income tax in Ireland.
- If that pension, benefit or allowance were received by a person who is resident in the country in which it arises in and not resident elsewhere, it would not be regarded as income for income tax purposes in that country.

This can be a very useful exemption where Irish individuals who have been living abroad for several years return to Ireland to retire. It is key to determine if the foreign pension would have been exempt from income tax in the foreign jurisdiction had it been received by the person as a resident of that foreign country. In practice, this exemption has been seen to operate in Ireland on pension payments from Australia and Switzerland, where payments have been received by Irish residents.

For the purposes of section 200 T.C.A. 1997, the term "tax" in relation to any country means the tax that is chargeable and payable under the law of that country and which corresponds to income tax in Ireland. It is necessary for the country in which the benefit arises to have a tax meeting the foregoing criterion. Countries that do not have an income tax system like Ireland would not satisfy the conditions for the exemption to apply. The United Arab Emirates is an example.

Some Australian pension funds are structured so Australian residents are not subject to tax in Australia once the pension fund starts to pay out. This is because contributions are not relieved from tax with relief applied on payments from the pension instead. On this basis, some Australian pension income may be exempt from Irish tax under section 200 T.C.A. 1997 once an individual becomes Irish tax resident.

It is important to note that some foreign pension payments are not taxable in a foreign jurisdiction for individuals who are considered to be nonresident, however, the payments would be taxable if the individual were resident in that country at the time of receipt. The exemption would not apply in these circumstances as the person cannot be subject to income tax in the foreign jurisdiction were they resident there.

It is important to distinguish between the different types of pensions, benefits and allowances that can be paid by a social security regime in a relevant jurisdiction. For example, Irish residents in receipt of a U.S. Social Security pension will be subject to tax in Ireland as these payments are specifically excluded from the exemption. The reason for excluding U.S. Social Security pensions from the exemption is that the U.S. allows for an exemption from tax in the U.S., on the basis that the U.S. Social Security pension would be subject to tax in Ireland. In effect, the taxing rights have been transferred from the U.S. to Ireland in this regard.

Prior to April 6, 1998, U.S. Social Security pensions that were paid to nonresident aliens were subject to a 25.5% withholding tax in line with the U.S. rules. This gave rise to issues as withholding tax in many cases that resulted in a higher effective rate of tax than would normally have applied if the pensions were only taxable in

Ireland. Accordingly, from April 6, 1998, an Irish resident recipient of a U.S. Social Security pension is chargeable to tax on such pensions for income tax purposes, with no income tax charge in the U.S.

It is also important to distinguish between the different types of pensions that can be paid by a social security system. There may be other types of pensions paid to Irish residents which are not covered by article 18 of the Ireland-U.S. Income Tax Treaty. Those other types of pensions could potentially benefit from this exemption. Examples of such pensions could be items such as disability payments, war-related pensions, and other gratuity payments.

As you can see, understanding the type of payment that is received by an individual is important to determine the tax treatment. A payment from a private pension may be taxable in Ireland (and the U.S.) while a benefit, state pension or allowance may be exempt under Irish domestic legislation. Alternatively, the source country may retain taxing rights over the payment or relinquish such rights.

TAXATION OF FOREIGN PENSION INCOME AND THE INTERACTION WITH REMITTANCE BASIS TAXATION IN IRELAND

As noted, foreign pensions are a taxable source of income in Ireland. In general, the taxation of such pensions is determined by reference to the individual's tax residence position in Ireland. However, in Ireland an individual's domicile is relevant for determining the extent of that person's exposure to Irish taxation. In this context, individuals living in Ireland can be classified broadly into two categories for determining taxation status: non-Irish domiciled and Irish domiciled.

An individual who is resident in Ireland but who is not Irish domiciled is liable to Irish tax on all income and gains arising in Ireland. However, for most types of income and gains, there is no Irish tax on foreign income and gains provided that the income/gains are not remitted into Ireland. This is known as remittance basis taxation.

Foreign source pension income is subject to tax under Schedule D Case III. This can have either favorable or unfavorable consequences. The favorable consequence is that the pension income could benefit from the remittance basis of taxation. The unfavorable consequence is that treaty benefits in the source country may be lost if the income is not taxed in Ireland because it remains offshore. Some income tax treaties contain provisions that are designed to curb double nontaxation by permitting an override of benefits in one country or the other. The purpose of those provisions is to ensure that the pension income is either taxed in Ireland if remitted or the source country if the income is not remitted.

If an individual remits pension income to Ireland where a clause like this exists with the source country treaty, Ireland will tax this income in the year of remittance. One planning point that should be considered is to confirm the tax rate that applies in each country. If the rate of tax is lower in the source country it may be beneficial to leave this pension income to be taxed in the source country and not remit it to Ireland. Alternatively, if the Irish tax rate is lower, the pension should be remitted.

LUMP SUM DRAWDOWNS FROM A FOREIGN PENSION IN IRELAND

Background

To appreciate the taxation of lump sum drawdowns in Ireland it is important to understand the historical position regarding the Irish taxation of lump sum drawdowns.

Prior to December 7, 2005, Ireland did not have any domestic legislation which taxed lump sum drawdowns from pension funds. This meant that lump sums of 25% of the value of a pension fund could be taken tax-free regardless of the value of the pension fund. In Finance Act 2006 the Irish Revenue introduced section 790AA T.C.A. 1997 which put an end to this treatment. Section 790AA T.C.A. 1997 is the section which governs the taxation of lump sum payments in excess of a tax-free amount. This meant that the tax-free amount was capped at a value of €200,000 and any excess over and above €200,000 would be taxed at 20% up to a total drawdown of €500,000. Any balance over and above €500,000 would be taxed at marginal rates.

"For the purposes of lump sum drawdowns from foreign pension schemes, the only category that is relevant to consider is a qualifying overseas pension plan."

For the purposes of the legislation, "a lump sum" is a reference to a sum that is paid to an individual under the rules of a "relevant pension arrangement." A "relevant pension arrangement" means any one or more of the following:

- A retirement benefit scheme within the meaning of Irish legislation which has been approved by the Irish Revenue Commissioners
- An annuity contract or trust scheme or part of a trust scheme approved by the Irish Revenue Commissioners
- A P.R.S.A. contract, within the meaning of Irish legislation
- A qualifying overseas pension plan
- A public service pension scheme within the meaning of Irish legislation
- An Irish statutory scheme

For the purposes of lump sum drawdowns from foreign pension schemes, the only category that is relevant to consider is a qualifying overseas pension plan.

An "overseas pension plan" is defined in Irish legislation to mean a contract, an arrangement, a series of agreements, a trust deed, or other arrangements – but not a state social security scheme – which is established in, or entered into under the law of the United Kingdom or a Member State of the European Communities, other than Ireland itself.

For the purposes of the Irish legislation, a "qualifying overseas pension plan" means an overseas pension plan (i) which is established in good faith for the sole purpose of providing benefits of a kind similar to those referred to in Irish legislation, (ii) in respect of which tax relief is available under the law of the Member State of the European Communities in which the plan is established (or the United Kingdom) in respect of any contributions paid under the plan, and (iii) in relation to which the relevant migrant member of the plan complies with the requirement in Irish legislation in order for it to qualify as a qualifying overseas pension plan.

The above requirements mean the administrator of the pension plan must have the overseas pension plan "blessed" by the Irish Revenue Commissioners for it to fall within the definition set out in section 790AA T.C.A. 1997. As a result, most foreign pensions schemes are considered nonqualifying overseas pension plans because they haven't been blessed by the Irish Revenue Commissioners. Therefore, lump sums from such pension schemes are not taxable in Ireland as we have no domestic legislation to tax lump sums.

Current Irish Revenue Position

The foregoing historical background sets the scene in relation to the history of this topic. However, the Irish Revenue's position has changed over the years in relation to this matter.

The Revenue's current interpretation is that income from foreign securities and possessions is charged under Schedule D Case III, which is correct. However, they state that it includes the profits or gains arising from any kind of property the person possesses, including pension lump sum payments. The Revenue's current position is that the commutation of such lump sums is subject to income tax under Schedule D Case III as they are considered to be "foreign possessions." Accordingly, if a payment (even a lump sum) is paid from a foreign pension fund, the Revenue considers it to be income arising from possessions outside the State. As pension payments to Irish residents from a foreign source are normally taxable under Case III of Schedule D, the receipt of a lump sum from a foreign pension is a taxable source of income liable to Income Tax and U.S.C.

This stance is a fundamental change in Revenue practice. Of greater import, the Revenue have not formally notified practitioners of this change, nor have any of the appropriate manuals been updated to reflect this change. Irish practitioners are currently challenging the Revenue's position on the matter.

Current Irish Practitioner's View

Income tax in Ireland can be imposed only if there is a domestic charging provision. The Revenue are attempting to impose an income tax charge under Schedule D Case III. Income tax is chargeable on income and not capital. Schedule D applies to income only. As there is no income arising, a charge under section 18(2) T.C.A. 1997 cannot arise. Under section 18(2) T.C.A. 1997, the foreign possession is the foreign pension plan. Therefore, from a technical perspective, it is difficult to see how the Irish Revenue can legitimately view lump sum drawdowns as taxable income under Schedule D Case III. Lump sum payments are capital, not income. The ultimate conclusion is that a charge under Schedule D Case III cannot arise.

Looking at first principles, if a pension fund has been accumulated while an individual was neither Irish tax resident nor ordinary tax resident in Ireland, the taxation of any lump sum drawdowns from this pension fund is outside the scope of Irish taxation. This is because it is a well-accepted principle that capital accumulated before an individual becomes resident in Ireland is outside the scope of Irish tax.

The lump sum cannot be classed as employment related income because the employment related to the funding of this pension was carried out wholly outside of Ireland. Moreover, it was accumulated from contributions out of foreign income in respect of which no Irish tax relief was provided.

As discussed above, the foreign lump sum drawdown is not taxable under section 790AA T.C.A. 1997 because this section relates only to "relevant pension arrangements." As the pension arrangement is not within the definition of a qualifying overseas plan, the drawdown is not taxable under this section.

Another section which should be considered is section 781 T.C.A. 1997 which deals with the taxation position for individuals who decide to commute their entire pension in one lump sum. This section applies to an approved pension scheme and specifically does not apply where the employment was carried on outside Ireland.

Finally, there is an old Revenue Precedent, Precedent 28, dated July 30, 1987, which states that the tax-free lump sum in commutation of foreign pensions is not taxable in Ireland should an individual come to live in Ireland following retirement. Because this precedent is more than 5 years old, the Revenue are no longer willing to confirm the application of this precedent to lump sum drawdowns of foreign pensions by Irish residents. Nonetheless, precedent 28 is widely relied upon by practitioners.

CONCLUSION

As is evident from this article, the taxation of pensions in Ireland is complex. The trend we are seeing is that each foreign pension plan becomes more complex than the next. Individuals are returning from places such as the U.K. and the U.S. with pensions such as 401(k) plans, 529 plans, and 527 plans, all of which have a firm and certain purpose in relation to the source country in which they originated. Difficult tax issues arise when individuals move from one jurisdiction to the next, bringing along their entitlement to pension payments. On a global basis, it seems unfair to penalize an individual merely because of a change in the country of residence.

A wider implication of this stance by the Revenue is the principle that capital accumulated by an individual prior to becoming an Irish tax resident is within the scope of Irish taxation. Submissions have been made to the Irish Revenue requesting it to identify the domestic charging provisions that are applicable in Irish that authorize the imposition of an income tax charge in respect of overseas lump sum payments. At least one case has been appealed to the Tax Appeal Commission in Ireland.

We wait to see the outcome of the lobbying and the appeal to the Tax Appeal Commission on behalf of taxpayers to see how the taxation of foreign lump sums will evolve. It is likely that we will have a firm view on the position sooner rather than later.

DOMESTIC TRUST – DOES YOURS SATISFY THE COURT TEST?

Authors
Nina Krauthamer
Galia Antebi

Tags
Court Test
Domestic Trust

A trust is a relationship (generally a written agreement) created at the direction of an individual (the settlor), in which one or more persons (the trustees) hold the individual's property subject to certain duties to use and protect it for the benefit of others (the beneficiaries). In general, the term "trust" as used in the Internal Revenue Code ("Code") refers to an arrangement created either by a will or by an *inter vivos* declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts.

Trusts can be characterized as non-grantor trusts, grantor trusts, simple trusts or complex trusts. Generally, if a trust is categorized as a grantor trust, its assets are treated as owned by the grantor (the settlor) for income tax purposes, resulting in the income generated by the trust being included in the grantor's taxable income; in contrast, a non-grantor trust is treated as a separate person from the grantor for income tax purposes. A simple trust is generally a trust that distributes its income on an annual basis; compared with a complex trust, which accumulates all or some of its income. Trusts can be domestic trusts or foreign trusts. The U.S. tax laws have special definitions for these concepts and this article discusses one of the tests for making a trust a U.S. domestic trust.

A DOMESTIC TRUST

The status of a trust as foreign or domestic will affect the U.S. taxation and reporting requirements of the trust and its beneficiaries.

A trust is considered domestic if

- a U.S. court is able to exercise primary supervision over trust administration (the "court test"), and
- U.S. persons control all substantial trust decisions (the "control test").

All other trusts are considered Foreign Trusts.

The Court Test

The court test includes special definitions:

- The term **court** includes any federal, state, or local court.
- The **U.S.** is used in a geographical sense. Thus, for purposes of the court test, the U.S. includes only the 50 States and the District of Columbia. Accordingly, a court within a territory or possession of the U.S. or within a foreign country is not a court within the U.S. for purposes of the court test.

- The term **is able to exercise** means that a court has or would have the authority under applicable law to render orders or judgments resolving issues concerning administration of the trust.
- The term **primary supervision** means that a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust.[1]
- The term **trust administration** means all steps necessary to carry out the duties imposed by the terms of the trust and applicable law including maintaining the records of the trust, filing tax returns, managing and investing trust assets, defending the trust from suits by creditors, and determining the amount and timing of distribution.

If both a U.S. court and a foreign court are able to exercise primary supervision over the administration of the trust, the trust meets the court test.[2]

A Court Test Safe Harbor

A trust satisfies the court test under a safe harbor if[3]

- the trust instrument does not direct that the trust be administered outside of the U.S.;
- the trust in fact is administered exclusively in the U.S.; and
- the trust is not subject to an automatic migration provision.

The trust is subject to automatic migration provision (a so called "flee clause") if the trust document provides that a U.S. court's attempt to assert jurisdiction or otherwise supervise the trust directly or indirectly would cause the trust to migrate from the U.S.

Examples

Two examples in Treasury Regulations illustrate these concepts.[4]

In one example, a U.S. citizen, creates a trust for the equal benefit of A's two children, both of whom are U.S. citizens. The trust instrument provides that DC, a domestic corporation, is to act as trustee of the trust and that the trust is to be administered in Country X, a foreign country. DC maintains a branch office in Country X with personnel authorized to act as trustees in Country X. The trust instrument provides that the law of State Y, a state within the U.S., is to govern the interpretation of the trust. Under the law of Country X, a court within Country X is able to exercise primary supervision over the administration of the trust. Pursuant to the trust instrument, the Country X court applies the law of State Y to the trust. Under the terms of the trust instrument the trust is administered in Country X. The example concludes that no court within the U.S. is able to exercise primary supervision over the administration

---

1 A court may have primary supervision regarding the administration of the trust notwithstanding the fact that another court has jurisdiction over a trustee, a beneficiary, or trust property.

2 Treas. Reg.§301.7701-7(c)(4)(i)(D).

3 Treas. Reg. §301.7701-7(c)(1).

4 Treas. Reg. §301.7701-7(c)(5) Examples.

of the trust and therefore the trust fails to satisfy the court test and is a foreign trust. We can take from this that the choice of law as stated in the trust instrument, in this example State Y, will not be sufficient to make the trust a domestic trust where administration of the trust is to take place in Country X because it is assumed that a court within State Y is not able to exercise primary supervision over the administration of the trust as no administrative activities take place in State Y.

In another example, a U.S. citizen, creates a trust for A's own benefit and the benefit of A's spouse, B, also a U.S. citizen. The trust instrument provides that the trust is to be administered in State Y, a state within the U.S., by DC, a State Y corporation. The trust instrument also provides that in the event that a creditor sues the trustee in a U.S. court, the trust will automatically migrate from State Y to Country Z, a foreign country, so that no U.S. court will have jurisdiction over the trust. The example concludes that a court within the U.S. is not able to exercise primary supervision over the administration of the trust because the U.S. court's jurisdiction over the administration of the trust is automatically terminated in the event the court attempts to assert jurisdiction.[5] Therefore, the trust fails to satisfy the court test from the time of its creation and is a foreign trust.

"The fact that a trust agreement is governed by the laws of a State within the U.S. may not be sufficient to meet the court test. The determination weighs heavily on whether a U.S. court is able to render orders concerning the actions that govern the administration of the trust . . ."

SO, DOES YOURS SATISFY THE COURT TEST?

The fact that a trust agreement is governed by the laws of a State within the U.S. may not be sufficient to meet the court test. The determination weighs heavily on whether a U.S. court is able to render orders concerning the actions that govern the administration of the trust, *i.e.*, the maintaining of the records, the managing of the assets, the exercise of discretion with respect to distributions, etc. Clearly, when the safe harbor is met, the court test is satisfied. For that, all actions relating to the administration of the trust must be performed within the U.S. It is possible, however, for the court test to be met outside the safe harbor, although State law would have to be considered to assure primary (but not exclusive) supervision by a State court.

For those trusts where a U.S. third party institutional trustee or a U.S. individual trustee performs all administrative services in the U.S., there would be no question that a U.S. court would exercise primary supervision. It is possible in those cases that a non-U.S. court may also have jurisdiction, if, for example, there are trust assets situated outside the U.S., or the presence of a non-U.S. trustee outside the U.S.[6] Fortunately, U.S. court supervision, while primary, does not have to be exclusive.

But what of a privately held U.S. corporate trustee that performs all or some administrative functions abroad and therefore falls outside the safe harbor? And what of a U.S. citizen individual trustee residing outside the U.S. but who retains service providers in the U.S. to maintain the trust's books and records and to manage the trust's assets and investments?

---

5 Not only is the safe harbor not met, but the court test is not met even before the flee clause is triggered.

6 Which may, unrelatedly to the court test, affect the control test. A U.S. corporate trustee would be sufficient to satisfy the control test, even if its shareholders or directors are non-U.S. persons.

The Treasury Regulations' focus on administration reflects the most common definition of trust situs, as referred to in the Uniform Probate Code and Uniform Trust Code. The comment to UTC §108 (concerning designation of the principal place of administration) provides that

> [l]ocating a trust's principal place of administration will ordinarily determine which court has primary if not exclusive jurisdiction over the trust. It may also be important for other matters, such as payment of state income tax or determining the jurisdiction whose laws will govern the trust.

Further, the comment provides that

> Because of the difficult and variable situations sometimes involved, the Uniform Trust Code does not attempt to further define principal place of administration. A trust's principal place of administration ordinarily will be the place where the trustee is located. Determining the principal place of administration becomes more difficult, however, when co[-]trustees are located in different states or when a single institutional trustee has trust operations in more than one state. In such cases, other factors may become relevant, including the place where the trust records are kept or trust assets held, or in the case of an institutional trustee, the place where the trust officer responsible for supervising the account is located.

Clearly State law must be reviewed if significant administrative activities are to occur outside the U.S. This could be relevant where the officers of a privately held trust company live outside the U.S. and where an individual trustee resides (or subsequently moves) outside the U.S. In that case, it would be advisable to ensure that sufficient administrative services take place within the U.S. to ensure that a U.S. court would have primary supervision.

CONCLUSION

The characterization of a trust as a domestic or foreign trust is critical. While use of a U.S. trustee is necessary critical to achieve domestic status under the control test, it may not be enough if actual administration of the trust occurs outside the U.S. Practitioners representing foreign families should be mindful of this rule particularly if a private U.S. trust company or U.S. citizen individual trustee is part of the structure.

THE CAMECO AND GLENCORE TRANSFER PRICING CASES – COMMENTS ON THE COMMON COMPLICATIONS IN COMMODITIES COMMERCE CONTROVERSY

Author
Michael Peggs

Tags
O.E.C.D. Guidelines
Transfer Pricing
Transfer Pricing Controversy
Transfer Pricing Examination

INTRODUCTION

Two significant transfer pricing cases about pricing mined materials between controlled companies have now been finally concluded in Australia[1] and Canada.[2] Both decisions upheld the original transfer pricing policy of the respective taxpayer after lengthy disputes that challenged tax administration practices in the two countries and the 1995 edition of the O.E.C.D. Transfer Pricing Guidelines, since replaced by 2009, 2010 and 2017 editions.

This article begins by examining two transfer pricing questions that appear on the surface to be similar, but were approached in different ways by the tax authorities and evaluated in broadly similar ways by the courts. This article then addresses how each of these controversies might have differed under the 2017 O.E.C.D. published guidance.

COMMODITIES

Cameco[3] was a transfer pricing controversy about the price of uranium between a Canadian producer or buyer and a controlled Swiss trader or seller in 2003-2006. *Glencore*[4] was a copper concentrate pricing controversy between the Australian subsidiary of the Anglo-Swiss miner and the Australian Tax Office ("A.T.O.") over sales to a controlled Swiss trader during the 2007-2009 tax years. Both companies are among the largest suppliers of their product to world markets. Copper concentrate spot and forward prices are quoted on the London Metal Exchange. While uranium prices are not widely quoted on public markets, conditions are extensively reported in commonly referenced trade publications that (i) track pricing at various stages of production for various types of supplies, (ii) report on extraction and processing or refining cost, and (iii) publish periodic forecasts of regional and worldwide demand and supply.

In each case, the respective Canadian and Australian tax authorities conducted examinations of the controlled transactions entered into by commodity producers[5] at

1 *The Commissioner of Taxation of the Commonwealth of Australia v Glencore Investment Pty Ltd* [2021] HCA Trans 98.

2 *Her Majesty the Queen v. Cameco Corporation* Docket 39368/

3 *Cameco Corporation v. Her Majesty The Queen* (2018 TCC 195).

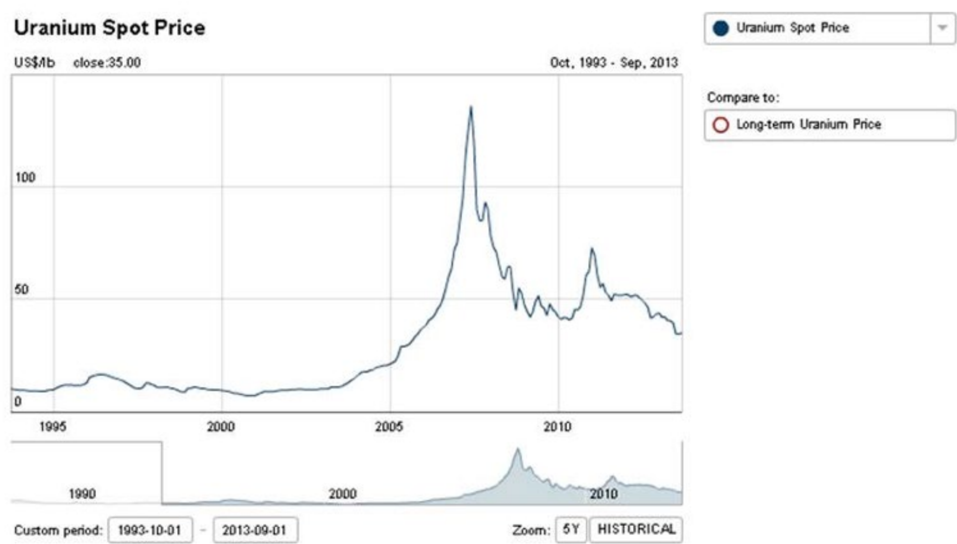
4 *Glencore Investment v Commissioner of Taxation of the Commonwealth of Australia* [2019] FCA 1432.

5 Cameco Corp. did not produce all the uranium in question. A significant share of the product was purchased by the Swiss trading company from Russian sources following decommissioning of nuclear weapons and sold to Cameco Corp.

a time when market conditions and pricing were volatile. Both cases showed that industry participants incorporated market volatility into their forward-looking decisions made during this period of uncertainty.

The *Cameco* controversy involved uranium transactions that were priced before a period of significant spot price increases that began in 2002, as shown in the first graph below. In *Glencore*, Glencore International AG revised the purchase pricing policy for minerals supplied by its Australian subsidiary mine from a spot market arrangement to a price-sharing arrangement in 2007, during a period of record-high world prices as shown in the second graph below.

For the years under examination in both cases, the relevant tax authority sought to adjust the transaction terms with the benefit of hindsight, in ways that would reflect higher future market prices and increase the taxable profit of the resident company. Both tax authorities took issue with the actual profitability of the nonresident counterparty.



Source: Cameco**, using data from Ux Consulting and Tradetech.**

Source: International Monetary Fund, Global price of Copper [PCOPPUSDA], retrieved from FRED, Federal Reserve Bank of St. Louis**; August 17, 2021.**

COMMON COMMERCIAL TERMS

Both taxpayers had written agreements in place with uncontrolled parties that governed the pricing of transactions with controlled parties. In *Glencore*, supply agreements existed between uncontrolled mines and trading companies. These were entered into evidence and served as critical support for the argument that the controlled transactions were comparable to independent transactions. Importantly, both taxpayers followed the terms set forth their agreements made with controlled parties. In *Cameco*, the Canada Revenue Agency ("C.R.A.") took issue with the alleged difference between the form of the controlled transactions and their economic substance. Ultimately, C.R.A. was unsuccessful in arguing the controlled transactions were a sham.

The two principal pricing terms that were in dispute in *Glencore* were the discount allowed by the miner for the refining of the ore being sold, and the reference price quotation period used to price the controlled transaction. C.R.A. did not dispute the price of uranium directly, but instead took issue with the apportionment of profit resulting from the controlled transaction.

In both cases, the arm's length nature of the transaction terms were challenged. The tax authorities questioned (i) the business and commercial practices used by the taxpayers to set price levels and receivable terms, (ii) the basis for forming management expectations concerning cost and the strategic responses of competitors, and (iii) the origin of certain critical assumptions made by management in determining the transfer prices and the preconditions for the transfer price. In response, the taxpayers presented testimony of past and present employees that was relied on by the courts in reaching their decisions.

The decision in *Cameco*, relevant excerpts of which were cited in *Glencore*, made use of key pieces of expert reports and testimony by two finance and business economics professors. All employees that were deposed or cross-examined at trial were found to be credible, and clearly indicated the extent of their expertise and knowledge. The credibility of several company witnesses in *Cameco* survived challenge despite testimony that occasionally shed a somewhat unflattering light on the accuracy of their prior work or the consistency of certain business practices critical to the management of transfer pricing policy. All were shown to be practical people managing real businesses under uncertain conditions.

Certain expert testimony in *Glencore*, however, was disregarded or given less weight due to the lack of experience or first-hand information of the expert with a particular topic. Hearsay or learned information was less helpful to the court on topics such as the operation of certain types of offtake contracts, and experience with certain contractual terms. A keen understanding of offtake contracts by the court was critical to the case.

COMMERCIAL RATIONALITY

The commercial terms of supply agreements mattered less however to the tax authorities. For different reasons, and owing largely to the construction of the respective country transfer pricing legislation, the Australian and Canadian tax authorities argued that two independent parties would not have adopted many of the transaction terms used in the controlled transactions. Neither country's legislation specifically incorporates the O.E.C.D. Guidelines, however the concept of "commercial rationality" crept into both cases as a necessary condition of an arm's length transaction.

The A.T.O. rejected all the independent offtake agreements put forward by the taxpayer to demonstrate comparable terms, contending they were unusable for the purpose of applying the taxpayer's transfer pricing method because they were not exact comparables. The A.T.O. argued that the taxpayer would have retained its pre-2007 controlled transaction terms based on spot market pricing and a different quotation reference period were it a participant in a transaction with an uncontrolled party. At trial, it introduced testimony of experts. Based on their experience, they proposed a different set of hypothetical commercial terms that they believed would have been more acceptable to independent parties.

Like the A.T.O., C.R.A. initially rejected the comparable uncontrolled price method used by Cameco. Instead, C.R.A. contended the trading company was a sham, and proposed adjusting the taxpayer's income based on an indeterminate transfer pricing method that set the transfer price to the Swiss trading company at an amount equal to that company's selling price to its customers. This had the effect of leaving the controlled Swiss trader with zero profit.

C.R.A. later changed its approach to recharacterize the transaction between the controlled parties from a form deemed to be a sham to an alternative form that assumed the controlled Swiss trader would be entirely excluded from the actual controlled transaction were it carried out between uncontrolled parties. This change in strategy forced C.R.A. to demonstrate the intent of Canadian Parliament in legislating transfer pricing rules was to restructure actual transactions to hypothetical transactions that eliminated the controlled intermediary for purposes of determining an arm's length price.

While the courts disagreed with the respective tax authorities over the recharacterization of the controlled transactions, they did so in different ways. The Canadian courts upheld a transaction recharacterization logic that first asks whether any two independent parties would have refrained from entering the controlled transaction under any transaction terms. It thereby challenged the logic of C.R.A.'s revised adjustment because it found that a price existed at which two independent parties would have entered the transaction. In comparison, the Australian courts employed a logical test that asked whether the actual controlled transaction was commercially rational.

All three Australian courts rejected the A.T.O. approach as counter to the intended objective of Australian transfer pricing legislation and referred to the *Chevron*[6] decision to distinguish between (i) a hypothetical transaction between two arm's length parties and (ii) an arm's length transaction between controlled parties with characteristics of the actual transaction undertaken by the taxpayer and an uncontrolled counterparty.

The two cases leave several clues concerning how commercial rationality can be demonstrated, but give no clear guidance. Choosing one transaction form over another is generally considered in most contemporary economic modelling. The analysis compares the present values of the streams of future benefits (appropriately defined and measured) arising from different identified alternatives. It is not unusual

[6] *Chevron Australia Pty Ltd v Commissioner of Taxation* (2017 FCAFC 62).

“. . . these two cases show that allocation of profit or income is mainly a policy outcome and not necessarily the instrument to compute an arm’s length transaction value.”

that a component of future benefit is expected profit. Both tax authorities argued in both qualitative and quantitative terms that the profit of the taxpayer during the tax years in dispute would have been higher under the selected hypothetical controlled transaction than under the actual controlled transaction. Both tax authorities pointed to the relatively low profit or the existence of a loss realized by the taxpayer and contrasted this with the relatively high profit of the foreign controlled taxpayer during the tax years in dispute. In contrast to the expected outcome from conventional present-value derived decision making, the courts rejected the use of hindsight by both tax authorities to substitute an *ex post* outcome for the consequence of *ex ante* controlled transaction terms.

In transfer pricing matters, we are often left to compare the profit of a controlled company to a sample of comparable companies, after having ruled out other pricing approaches that reference, among other things, forward-looking pricing of one kind or another. While it is clear that the intent of country transfer pricing rules is to allocate taxable income between tax jurisdictions in a fair and reasonable way and to prevent double taxation, these two cases show that allocation of profit or income is mainly a policy outcome and not necessarily the instrument to compute an arm’s length transaction value.

COMPARABILITY

In *Glencore*, the courts’ decisions showed that, despite some imprecision in the taxpayer’s comparability analysis, a thorough comparability analysis using independent agreements that evaluates the most economically relevant commercial terms can prevail in a transfer pricing controversy. Especially useful is support from company management to relate the terms of the controlled agreement to the relevant functions of the counterparties and the associated risks each incurs.

In *Cameco*, the court was left to evaluate the reliability of the taxpayer’s comparable uncontrolled price method application after having rejected C.R.A.’s recharacterization position. A thorough analysis of relevant transaction terms and a comprehensive use of transaction data supported by a secondary application of the resale price method prevailed at trial.

COMME IL FAUT?

With transfer pricing guidance changing frequently, the value of cases such as *Cameco* and *Glencore* must be carefully considered as precedent for current transfer pricing analysis and policy administration. How might the analysis in each case stack up against the 2017 standard set out in the O.E.C.D. Guidelines?

Both cases relied on the 1995 edition of the O.E.C.D. Guidelines, and to a lesser extent, the 2010 edition as authorities on transaction recharacterization. The substance-over-form condition for recharacterization set out in the 2010 O.E.C.D. Guidelines has been replaced by the more expansive requirement that a controlled transaction must be accurately delineated before applying the arm’s length standard. Leaving aside the meaning of “accurate delineation,” it seems that the courts addressed the relevant transfer pricing questions by transaction or transaction type and scrutinized the relevant transaction attributes before proceeding with their analyses.

The 2017 O.E.C.D. Guidelines introduce a new test criterion of "respective perspectives and the options realistically available to each of them at the time of entering into the transaction"[7] to supplement the specification of the main test for transaction recharacterization or disregard in paragraph 1.65 of the 2010 O.E.C.D. Guidelines. U.S. readers are familiar with the principle of "options realistically available" translated as "alternatives realistically available to the buyer and seller" as one of the factors to be considered under the broader subheading of economic conditions while conducting a comparability analysis. The *Glencore* analysis included consideration of counterfactual circumstances facing the controlled counterparties at the outset of the series of transactions governed by the revised intercompany terms.

Interestingly, though perhaps too specific to the mining industry, the long-term viability of the mine featured prominently in the courts' analyses of the question of whether one group of contractual terms would be preferred over another group. Mine viability figured into the more general determination of whether the controlled transaction met the "commercially rational" test. In this respect, the most recent guidance from the O.E.C.D. seems to have been taken into account by the Australian courts. The 2017 edition of the O.E.C.D. Guidelines offers no definition of "commercially rational" firm behavior other than to allude rather unhelpfully that single-year pretax profit might be a relevant hallmark of behavior that strays outside the painted lines of commercial rationality.

". . . some analysis of the 'options realistically available' may have served to support a different recharacterization decision."

The C.R.A. extreme position of a zero-profit counterfactual transaction does not lend itself well to the modern method of recharacterization. If C.R.A. were to have had better mining industry fact witnesses to evaluate the alternative transaction form potentially available in the circumstances of the controlled transaction, some analysis of the "options realistically available" may have served to support a different recharacterization decision. Interestingly, in the case of *Cameco*, there was general agreement that the controlled transactions were entered into for the principal purpose of saving tax, often thought of by practitioners as a high hurdle in controversy. Canadian controversy covering years that are controlled by current O.E.C.D. guidance may result in a different taxpayer outcome under a similar fact pattern.

If anything, these two cases demonstrate the volume of data, the effort, the time, and the expense that is required to settle a transfer pricing dispute for a large multinational company. Significant effort was expended to clearly define critical terms and to apply practical definitions to the facts of each case. Further effort will be needed from O.E.C.D. member country courts to continue the work of clarifying the meaning of a number of key terms in the 2017 edition of the O.E.C.D. Guidelines that will be central to the large and growing number of transfer pricing controversies.

More generally, both cases illustrate the transfer pricing effects of surprises, the importance of expectations, and documenting those expectations when evaluating the appropriateness of outcomes. In both cases, the surprise was a sudden change in market conditions. Some guidance can be taken from these decisions when contending with the transfer pricing effects of the sudden change in market conditions brought about by the COVID-19 pandemic.

---

7 Paragraph 1.122, OECD (2017), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, OECD Publishing, Paris.

THE IMPORTANCE OF EARNESTLY MODELING EARNOUTS: PITFALLS AND PLANNING RELATING TO THE PURCHASE OF A SERVICE BUSINESS

Author
Andreas A. Apostolides

Tags
Code §197
Code §453
Code §483
Code §1060
Treas. Reg. §1.1060-1
Temp. Treas. Reg. §15A.453-1T
Lane Processing Trust v. U.S.
Recovery Group, Inc. v. Commr.

INTRODUCTION

> It is a terrible thing for a man to find out suddenly that all his life he has been speaking nothing but the truth.
>
> – Oscar Wilde, *The Importance of Being Earnest*, Act III

This article addresses common pitfalls and planning opportunities relating to the sale of a service business.[1] It does so in the context of a business devoted to sourcing of news leads for major news conglomerates. The example looks at possible transactional models for reporting the sale and demonstrates the importance both of familiarity with structuring alternatives, and the necessity of modeling, as an aid both to decision-making and to communication with one's client.

While various references to rules are included, the series of examples are intended to demonstrate the obvious, yet important proposition that, before applying the technical definitions in the Code to a business transaction, it is necessary first to understand in simple terms what the parties are seeking to accomplish. The tax adviser's greatest contribution is often simply asking the right questions and then taking the time to think through the structure from different angles in a manner that helps the client reach a decision.

THE BASE CASE

In our example, the news business employs a small, dedicated staff of employees who rely on internet sleuthing, phone calls, occasional travel, and general savviness, to zero in on leading news stories at a speed that is faster than Google's algorithms. The business is carried on in the form of an L.L.C. treated as a disregarded entity because it is wholly owned by one person. One day, that person ("Seller") announces she would like to sell the L.L.C. to a key employee ("Buyer"). You have been retained by Buyer to advise on the tax consequences of the deal.

Your first observation is that the business involves minimal fixed asset investment — computers, office furniture, and coffee mugs — and the lion's share of the business value is attributable to intangibles, primarily the customer list of news conglomerates that purchase news stories and proprietary knowhow. The proposed transaction contemplates the sale of these business assets accompanied by standard non-compete and non-solicitation agreements.

---

[1] The author thanks his colleagues, Nina Krauthamer and Stanley C. Ruchelman, for their helpful comments and insights.

As the agreement between Buyer and Seller begins to take shape, Buyer provides you with the following expected purchase price allocation under Code §1060 which will be set forth in the contract.[2]

Table 1 — Purchase Price Allocation

Total Consideration	$100
Fixed Assets (computers, furniture, coffee machine, notebooks, pencils)	$15
Noncompete Agreement	$20
Customer List / Goodwill	$65

You counsel Buyer that his $85 of basis in intangible assets, including the noncompete,[3] will be amortized on a straight-line basis over 15 years, resulting in $5.67 of amortization per year.[4] Buyer may have preferred a greater allocation to assets eligible for first-year bonus depreciation, but would be advised to prepare a tax return consistent with the agreed allocation.

To explain what this means, you prepare a simple model for the first five years of operations. For simplicity, the following examples generally assume that Buyer and Seller live in States which do not impose an income tax.[5]

Table 2 — Results of Operations: Initial 5 Years

	Y1	Y2	Y3	Y4	Y5
Revenue	$60	$60	$60	$60	$60
Expense	($35)	($35)	($35)	($35)	($35)
§168(k) Bonus Depreciation	($15)	–	–	–	–
§197 15-year Amortization	($5.67)	($5.67)	($5.67)	($5.67)	($5.67)

---

2 In an asset deal, the buyer and the seller report the purchase price allocation on Form 8594, *Asset Acquisition Statement Under Section 1060*. As a practical matter, all allocations of the purchase price will be respected by the I.R.S., if agreed to by adverse parties in an arm's length transaction, see Question Five of Form 8594.

3 Because the noncompete agreement is in connection with the acquisition of a trade or business, the $5 is amortized over 15 years per Code §197(d)(1)(E). Also see *Recovery Group, Inc. v. Commr.,* 116 T.C. 289 (2001), *aff'd,* 329 F.3d 1131 (9th Cir. 2003), involving redemption of a shareholder plus a noncompete.

4 This is computed as $85/15; see Code §197(d), defining "section 197 intangibles."

5 It should be kept in mind that real-world buyers and sellers live in jurisdictions with an applicable State income tax and that various structures explored herein would have to be revisited to account for state income taxes.

	Y1	Y2	Y3	Y4	Y5
Taxable Profit	$4.33	$19.33	$19.33	$19.33	$19.33
Buyer's Tax @ 37%	($1.60)	($7.15)	($7.15)	($7.15)	($7.15)
After-Tax Profit	$2.73	$12.18	$12.18	$12.18	$12.18
Cash Flow[6]	$23.40	$17.85	$17.85	$17.85	$17.85

Based on the above numbers, Buyer will report all of the business income reported on the Taxable Profit line of the chart on his personal income tax return, at ordinary income rates topping out at 37%, without ability to accelerate the recovery of cost basis under Code §197. State and local income taxes will increase the tax cost that will be incurred from profits.

EARNOUT ARRANGEMENT

As you contemplate the deal, an alternative structure springs to mind — a deferred payment arrangement, which may at least defer Buyer's upfront cost of acquiring the news business.

"Before you do so," Buyer asks, "what effect will that have on my taxes and cashflow?"

You suggest that one or more payments to Seller could be made on a deferred basis. In the simplest case, the seller may agree to accept an interest-bearing note for the balance of the purchase price. In addition, or as an alternative, the Seller may be willing to accept future payments contingent on cash flow or future performance of the business. This is a negotiating point as Seller may demand a higher price (in addition to interest payments on a note) if payment is deferred. If structured properly, the deferred payment arrangement may enable Buyer to use cash flow from the business to pay for the acquisition. These arrangements must be carefully negotiated to ensure that the transaction is treated as an asset sale for tax purposes, and not some other arrangement, such as a joint venture or partnership, particularly if the seller has a continuing interest in the profitability of the business being sold. An earnout is typically negotiated where a seller does not believe that he or she is realizing the full value of the enter`prise at closing.

All aspects of the deferred payment terms will have to be hammered out between Buyer and Seller in the negotiations running up to the agreement of purchase and sale. Buyer looks at you warily. "I sense rising costs." Buyer says, with a hint of recrimination. You rush to assure Buyer that you will work efficiently to research this alternative approach, though you'd like to check with Seller's counsel first to see whether it can even work.

"Before you do so," Buyer asks, "what effect will that have on my taxes and cashflow?"

Table 3 illustrates a simple earnout arrangement designed to provide Seller with proceeds close in amount to the foregone upfront payment, over a period of five

6 Cash flow is computed adding back depreciation (a noneconomic expense) to after-tax profit.

years, plus some additional cash, which presumably serves to compensate Seller for the deferral. A down payment of $15 is assumed.[7]

Table 3 — 5-Year Earnout at 90% of Base[8]

	Y1	Y2	Y3	Y4	Y5	
Revenue	$60.00	$63.00	$66.15	$69.46	$72.93	
Expense	($35.00)	($36.75)	($38.59)	($40.52)	($42.54)	
§168(k) Bonus Depreciation	($15)	–	–	–	–	
§197 15-year Amortization	–	($1.50)	($3.08)	($4.73)	($6.47)	
Taxable Profit	$10.00	$24.75	$24.49	$24.21	$23.92	
Buyer's Tax @ 37%	($3.70)	($9.16)	($9.06)	($8.96)	($8.85)	
After-Tax Profit	$6.30	$15.59	$15.43	$15.25	$15.07	
Earnout Base (100%)	$25.00	$26.25	$27.56	$28.94	$30.39	
Seller's Earnout (90%)	($22.50)	($23.63)	($24.81)	($26.05)	($27.35)	= ($124.33)[9]
Cash Flow	($1.20)	($6.53)	($6.30)	($6.06)	($5.81)	= ($25.91)[10]

You note that if the annual installments are properly classified as deferred purchase price, Buyer's amortizable basis will have to be redetermined each year to take the most recent earnout payment into account.[11]

---

7 In Table 3, it is assumed that the Buyer makes an initial down payment of $15, based on which $34.36 will be the total additional cash to the Seller over the $100 purchase price initially discussed. The down payment also results in $15 of depreciable asset basis in Year 1. The following examples, in tabular form, refer to the earnout as a percentage of "base", or revenues less expenses (cash items), but ignores the depreciation, amortization and taxes imposed on the seller. In the real world, earnouts would typically be in addition to other consideration and would be applied at a lower percentage. However, the examples are simplified, and the numbers have been chosen simply to illustrate the cashflow problems that a real-world buyer may experience with even a realistic earnout percentage.

8 This example and the following example assume a purchase price that is determined based on a fixed percentage of pretax profits, payable out of cash flow.

9 The earnout does not reflect an assumed $15 down payment at the beginning of Year 1, which factors into the total $139.33 of cash ultimately to be received by Seller.

10 Similar to the earnout total, the net cashflow figure of ($25.91) does not reflect the assumed down payment of $15, meaning that it understates the Buyer's negative cash problem by the same amount — the total cash outlay required by the end of Year 5 is therefore ($40.91).

11 See also Treas. Reg. §1.1060-1(e)(1)(ii)(B), which requires each year's payment to be separately reported on Form 8594.

However, after reviewing Table 3, you remain transfixed by the final row, realizing that the negative cashflow implications of the arrangement could seriously hamper Buyer's attempts to take on the business successfully. The problem is accentuated by the fact that Seller notified Buyer that she intends to leave no cash behind and the long period over which the Buyer will recover his basis, made yet longer in consequence of the annual readjustments for earnout payments. Happily, however, toggling payment terms in the model, including the number of years over which the earnout will be paid, yields a possible solution as shown in Table 4.

Table 4 — 6-Year Earnout at 70% of Base

	Y1	Y2	Y3	Y4	Y5	Y6	
Revenue	$60.00	$63.00	$66.15	$69.46	$72.93	$76.58	
Expense	($35.00)	($36.75)	($38.59)	($40.52)	($42.54)	($44.67)	
§168(k) Bonus Depreciation	($15)	–	–	–	–	–	
§197 15-year Amortization	–	($1.17)	($2.39)	($3.68)	($5.03)	($6.45)	
Taxable Profit	$10.00	$25.08	$25.17	$25.26	$25.36	$25.46	
Buyer's Tax @ 37%	($3.70)	($9.28)	($9.31)	($9.35)	($9.38)	($9.42)	
After-Tax Profit	$6.30	$15.80	$15.86	$15.92	$15.98	$16.04	
Earnout Base (100%)	$25.00	$26.25	$27.56	$28.94	$30.39	$31.91	
Seller's Earnout (70%)	($17.50)	($18.38)	($19.29)	($20.26)	($21.27)	($22.33)	= ($119.03)[12]
Cash Flow	$3.80	($1.41)	($1.04)	($0.67)	($0.27)	$0.15	= $0.57

By adding an extra year and reducing the earnout percentage to 70%, Buyer's cashflow problem appears to be solved.[13]

"OK, now you can call Seller's counsel!"

---

12 The earnout does not reflect an assumed $15 down payment at the beginning of Year 1, which factors into the immediate bonus depreciation and results in a presumed total of $134.03 in cash ultimately received by Seller by the end of Year 5.

13 The problem of negative cashflow remains if the $15 down payment is taken into account, resulting in a total cash outlay of ($14.43) by the end of Year 5. In addition, real-world buyers likely live in a State with an income tax. Based on the earnout arrangement in Table 4, if a 50% cumulative income tax rate is used, a positive cashflow can be achieved by extending the earnout period by a year and decreasing the payout percentage to under 60%. Modeling involves constantly stress-testing the underlying assumptions and rerunning the model in this way.

BUT WAIT A MINUTE WHAT IS AN EARNOUT?

As Buyer's counsel, your first task is to help Buyer understand the U.S. Federal income tax consequences of the transaction, and any reasonable alternatives.

Before calling Seller to propose the new structure, you realize you have not yet clearly explained what a deferred payment in the form of an earnout is. While you mentioned that it generally refers to consideration paid in a subsequent year that is contingent on subsequent events, you neglected to mention that it does not have a set meaning for tax purposes. Earnout arrangements refer to a variety of contingent payment structures, each of which must further be analyzed to determine how they are classified for U.S. Federal income tax purposes.

For example, if the earnout is paid in the employee-shareholder context and is contingent on Seller remaining on the payroll of the business for a definite period after the sale, the payments must be analyzed to determine if they are considered to be compensation or contingent purchase price.[14]

In our transaction, the earnout is to be paid for a fixed period based on earnings of the news business, and clearly seems to be deferred consideration for Seller's proprietary interests. As such, no alternative analysis seems relevant,[15] and so "sale or exchange" treatment under Code §1001 would apply, entitling Seller basis offset. But does it? It is possible that the I.R.S. might nevertheless seek to characterize an earnout arrangement as a disguised partnership, denying a buyer the benefit of basis step-up in the acquired business assets. This risk increases as the portion of the fixed amount that is paid up front decreases and the number of years of the payout increases.

Understanding that Seller likely qualifies for long-term capital gain treatment on most of the assets from a fixed price sale, Seller's tolerance for alternative structures likely is low. Further, the transaction also falls in the definition of an "installment sale" under Code §453(b)(1), and absent an election to the contrary, it will be reported by Seller under the installment method.[16] And as previously discussed with the client, unless Seller elects out of installment sale treatment (unlikely, unless the Seller has an expiring net operating loss carryforward), Buyer's amortizable basis will probably also have to be redetermined each year based on the actual numbers, further reducing deductions relating to the purchased customer list/goodwill.

---

14 *Lane Processing Trust v. U.S.*, 25 F.3d 662 (8th Cir. 1994), addressed this in the context of an employee-shareholder whose interests were redeemed and who received annual earnout payments while remaining employed in the business.

15 For example, in *Central Life Assurance Soc'y v. Commr.*, 51 F.2d 939 (1931), the Eighth Circuit concluded that a 1919 acquisition of all the assets of one insurance company by another, followed by the transfer of its earnings to former owner individuals for a period of 22 years, was in fact not a sale but a retained interest.

16 Code §453(d); the transaction is also a contingent payment sale. Code §453(j)(2). Because there is deemed unstated interest with regard to the deferred earnout payments, interest may be required to be computed by the seller on each of those payments under Code §483. See Pub. 537, *Installment Sales*. Such interest would be reported by the buyer on Form 1099-INT. See the General Instructions to Form 6252, *Installment Sale Income* (Line 5). For the seller, Form 4797, *Sales of Business Property*, may also be relevant.

Finally, it occurs to you that properly understanding the benefits and the downsides of the earnout arrangement also requires familiarity with some additional alternative structures that Buyer and Seller might have considered in other circumstances. For example, Table 5 reflects the income tax and cashflow consequences of a profit-sharing agreement. (The down payment is assumed to be $0 in this case.)

Table 5 — The 75-25 Profit Split[17]

	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	
Revenue	$60.00	$63.00	$66.15	$69.46	$72.93	$76.58	$80.41	$84.43	
Expense	($35.00)	($36.75)	($38.59)	($40.52)	($42.54)	($44.67)	($46.90)	($49.25)	
Taxable Profit	$25.00	$26.25	$27.56	$28.94	$30.39	$31.91	$33.50	$35.18	
Seller's 75% Share	$18.75	$19.69	$20.67	$21.71	$22.79	$23.93	$25.13	$26.38	
Buyer's 25% Share	$6.26	$6.56	$6.89	$7.24	$7.60	$7.98	$8.38	$8.79	
Seller's Tax @ 37%	($6.94)	($7.28)	($7.65)	($8.03)	($8.43)	($8.85)	($9.30)	($9.76)	
Buyer's Tax @ 37%	($2.31)	($2.43)	($2.55)	($2.68)	($2.81)	($2.95)	($3.10)	($3.25)	
After-Tax Profit & Cash (Seller)	$11.81	$12.40	$13.02	$13.67	$14.36	$15.08	$15.83	$16.62	= $112.80
After-Tax Profit & Cash (Buyer)	$3.94	$4.13	$4.34	$4.56	$4.79	$5.03	$5.28	$5.54	= $37.60

While the profit-sharing deal provides nearly comparable aggregate cash to Seller and avoids cashflow problems to Buyer, Seller likely will consider it a non-starter, given the risk of an I.R.S. adjustment on auding, recharacterizing capital gain as simply a share of partnership profits. Your client is happy not to spend further time thinking about this approach.

Yet another transactional approach you consider briefly would be a consulting arrangement whereby the $100 could be paid to Seller over a number of years to retain him as an employee or consultant.[18] Assuming that services worth $100

---

17 Similar to "earnout," stating that something is a profit-sharing agreement does not answer the question of how the structure is to be treated for U.S. Federal income tax purposes. Presumably, it would be treated as a partnership, albeit of limited duration, and the parties would adopt consistent reporting.

18 Buyer and Seller could explicitly link payment of the earnout to Seller continuing as an employee (or consultant) for the initial three or four years after the disposition, to assist with the transition. See *Lane Processing Trust*, in *supra* note 10. Very little of the $100 of consideration would be allocated as purchase price, resulting in a significantly speedier recovery period than under Code §197.

are performed by Seller during each year of that period, little of that amount would be allocated as amortizable purchase price under Code §197, and most would be immediately deductible. Again, the amount of the salary or consulting fee cannot be determined “out of whole cloth.” A no-show job for Seller payable over a period of time would likely be treated as deferred sales price, leading to replacing compensation with 15-year amortization. When you tell this to Buyer, you notice his eyes have begun to glaze over. Before you have time to ask, the client suddenly says:

“I’ve had enough of talking and all this modeling. Let’s fix a price and pay her!”

About Us

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

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.

About Insights

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

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

Location

Architects and Designers Building | 150 East 58th Street, 22nd Floor | New York, New York 10155

Contacts

If you have any questions regarding this publication, please contact the authors or one of the following members.

Galia Antebi	antebi@ruchelaw.com	+1 212.755.3333 x 113
Andreas Apostolides	apostolides@ruchelaw.com	+1 212.755.3333 x 127
Nina Krauthamer	krauthamer@ruchelaw.com	+1 212.755.3333 x 118
Michael Peggs	peggs@ruchelaw.com	+1 212.755.3333 x 232
Simon H. Prisk	prisk@ruchelaw.com	+1 212.755.3333 x 114
Neha Rastogi	rastogi@ruchelaw.com	+1 212.755.3333 x 131
Stanley C. Ruchelman	ruchelman@ruchelaw.com	+1 212.755.3333 x 111

Editorial Staff

Stanley C. Ruchelman .... Editor in Chief

Claire Melchert .... Copyeditor

Francesca York .... Graphic Designer

WITH PHOTOS BY:

Galia Antebi, Jennifer Lapper, Simon Prisk, Stanley C. Ruchelman, and Francesca York.