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Insights Vol. 9 No. 1

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EDITORS' NOTE

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

- **Mexico: Recent Developments.** The Mexican government adopted its 2022 budget in late October 2021. Several provisions place special emphasis on plugging gaps in tax compliance. More power has been given to the Mexican tax administration when conducting tax examinations. Taxpayers under tax examinations face serious penalties where noncompliance is found to exist, including potential application of the domain extinction law, a forfeiture provision that applies ordinarily in serious criminal investigations. G.A.A.R. has been introduced, tax reporting obligations have been imposed on advisers reflecting policies behind D.A.C.6 in the E.U., and a new regime to disregard foreign entities and arrangements without legal personality have been adopted. Alil Álvarez Alcalá, the founding partner of Álvarez Alcalá, in Mexico City dives into these and other new regimes.

- **Israeli Start-Up Expansion to the U.S.: Who Should Be On Top?** Israeli high-tech companies have been quite successful in the past year in developing new technologies in Med Tech and Fin Tech spaces. Naturally, liquidity events followed. In their article, Anat Shavit and Yuval Peled, partners in the tax practice of FBC & Co., Tel Aviv, and Galia Antebi address the tax planning decision points that must be addressed in Israel and the U.S. Where should the I.P. be owned? What structures are demanded by angel investors? What tax issues are raised by the Israeli tax authorities? Can structures be revised? Is there a taxable presence in the U.S. for an Israeli company? What U.S. anti-deferral regimes could apply with a U.S. company as parent? When should planning take place for Q.S.B.S. tax benefits in the U.S.? Is there a cookie-cutter solution that fits all situations? These and other questions are addressed.

- **A C.T.A. of the C.T.A. – A Closer Targeted Analysis of the Corporate Transparency Act.** The C.T.A. was enacted on Jan. 1, 2021, ad to shed light on the beneficial owners of certain entities by requiring those entities to report information on their beneficial owners and other individuals known as company applicants. Many think of it as "Son of F.B.A.R.," but its application is much wider and is focused on small companies. FinCen published proposed regulations on December 27, 2021, which are intended to answer questions left open in the legislation. What companies must report? What companies are exempt? Who is a control person? What are the penalties for noncompliance? Andreas Apostolides, Nina Krauthamer, and Wooyoung Lee explain all. Those who ignore the obligations to report do so at their peril.

- **The More You Know, the More You Don't Know – U.S. Tax Issues on a Disposition of a Foreign Business.** When a U.S. person disposes of a business situated in a foreign country, the nature of the gain as capital or ordinary and the source of the gain may sound like simple issues that require simple tax advice. It may, however, turn out to be far more complex as one begins to review the relevant provisions of U.S. tax law in light of the facts and circumstances that exist. It is not uncommon for issues to pop up, one after the other and on a never-ending basis. In their article, Neha Rastogi and Stanley C. Ruchelman discuss the various U.S. Federal income tax issues that must be addressed by a U.S. seller in connection with a sale of a business as a going concern held indirectly through an entity that is treated as a disregarded entity for U.S. tax purposes. Mind-blowing complexity is not an overstatement.

- **Canada and the U.S. – Two Countries, One Border, Divergent Rules on Wealth Transfers.** Canadians and Americans share many things in common. Common language, one border, a love for teams in the National Hockey League, a slew of dual citizen individuals in Canada and Canadian residents in the U.S., and a common history up to the time of the American Revolution. But many differences exist, nonetheless. To illustrate, when wealth is transferred, the U.S. imposes gift and estate taxes based on value. Canada imposes capital gains tax. The U.S. imposes income taxes on global income based on citizenship as well as residence. Canada imposes income tax on global income based only on residence. Canada imposes departure taxes when any resident leaves the country to establish a residence elsewhere. The U.S. imposes departure tax only when citizenship is renounced, or when a long-term green card holder relinquishes his or her green card. These differences trigger several tax traps, many of which can be avoided by unique provisions in the Canada-U.S. Income Tax Treaty. But the treaty is not perfect. In his article, Andreas Apostolides explains the taxation rules for wealth transfers in both countries, the applicable provisions in the income tax treaty designed to be helpful, and most importantly, a solution that is followed by many Canadian tax advisers when the treaty fails to provide a solution for disparities in adjusted cost basis for certain assets received as a gift or a bequest.

- **Goodwill and Mister Donut – A Going Concern?** A sale of a business often involves an element of goodwill, a term that can have different meanings in different contexts, depending on whether the term relates to (i) purchase price allocations for financial statement purposes or income tax purposes or (ii) attempting to compute the source of income for foreign tax credit purposes. Compounding the definitional inconsistency, the meaning of the term has changed over time. In a 25-year old case, the overseas Mister Donut franchising business was sold to a foreign buyer in an asset-sale transaction. Although only intimated in the case, the taxpayer likely had significant amounts of deferred assets on its balance sheet arising from unused foreign tax credits. Because the seller was a U.S. company, gain from the sale of business generally results in the generation of domestic source income. Under the law in effect at the time, goodwill was sourced where business was carried on. Was that provision the key to access deferred foreign tax credits? The U.S. Tax Court said no. Sometimes, goodwill is not goodwill for foreign tax credit planning purposes. Michael Peggs and Wooyoung Lee look at the court's reasoning and comment on certain contemporary aspects of the decision in light of provisions in the Tax Cuts and Jobs Act and several I.R.S. pronouncements on goodwill.

- **Off to New Shores – Tax Extern at Ruchelman P.L.L.C.** Ruchelman P.L.L.C. actively participates in the extern arrangement for students in the LLM Program at New York Law School. We provide real life professional experience to the extern and the extern receives two credits towards his or her degree requirement. Our younger lawyers benefit by providing hands-on supervision of the extern, a needed step in professional development. Recently, we expanded our extern program to include European externs and trainee lawyers. Lioba Mueller spent two months with us as an extern, sponsored by the University of Bonn. She also qualified for a PROMOS scholarship, offered by the German Academic Exchange Service, under the German Ministry of Education and Research. In her article, Ms. Mueller tells of her experience in the U.S., both professionally with us and socially with others. Our experience with Ms. Mueller is that doing a good deed is, indeed, its own reward.

We hope you enjoy this issue.

- The Editors

MEXICO: RECENT DEVELOPMENTS

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Tags
Anti-Tax Haven
Domain Extinction Law
G.A.A.R.
Mexico
Reportable Transaction
Tax Transparency

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INTRODUCTION

This article focuses on certain provisions that have been added to Mexican tax law as part of the 2022 budget that was adopted in late October 2021. The provisions covered in this article place special emphasis on plugging gaps in tax compliance. In particular, more power has been given to the Mexican tax administration when conducting tax examinations, and for those taxpayers who are under examination, imposing more serious penalties where noncompliance is found to exist. Also covered are other changes based on the B.E.P.S. Actions of the O.E.C.D.

Tax authorities have informally let it be known that these changes were in the works for many years but could not be proposed earlier due to political reasons – prior administrations lacked control of both the House of Representatives and Senate, as was the case with A.M.L.O., during the first three years.

Criminal Tax Investigative Provisions

Some provisions adopted during A.M.L.O.'s term seek to aggressively attack noncompliance in tax matters by criminalizing certain acts of tax avoidance. If certain thresholds are met, another applies several investigation tools previously available only to authorities when fighting organized crime. In these cases, the authorities have broad investigative powers such as the power to intercept telephone calls and to apply the law of "domain extinction" to the assets of a targeted individual.

Mexico's domain extinction law is a forfeiture provision applicable when a person cannot prove that his or her assets can be tracked to a legitimate source of income. This law is applicable if criminal conduct is considered to be part of organized crime. Tax evasion, the acquisition of false invoices, and smuggling can be considered part of organized crime in certain cases. If the law of domain extinction applies, the assets are forfeited to the government without any compensation. This is a civil proceeding independent of the criminal procedure against the taxpayer.

As from 2020, tax crimes can also be considered as endangering National Security, the same as terrorism. Therefore, another provision calls for mandatory preconviction detention for some tax crimes if the amounts owed to the government are higher than, approximately 400 thousand dollars. That provision was ruled unconstitutional in 2021 by the Mexican Supreme Court.

Civil Tax Provisions

The most important changes or additions that might affect international clients are the following:

- Introduction of a general anti-avoidance clause (hereinafter, Mexican G.A.A.R.)
- New regime for foreign transparent entities or foreign legal arrangements without legal personality
- Inclusion of reporting obligations for tax advisors
- Lowering the threshold for applying anti-tax-haven tax rules under which a taxpayer is considered to control an investment in a tax haven and limiting the active-income exception when determining if the anti-tax-haven rules apply
- The introduction of a provision that allows nonresidents to pay Mexican income taxes on a net income basis with regard to certain property gains

Missing from the civil tax revisions is any attempt to impose an annual wealth tax on Mexican individuals. Regarding the taxation of wealth, Mexico currently imposes transfer taxes on gifts. However, those taxes are not imposed when the recipient has any of the following family relations to the donor:

- The recipient is a direct ascendant of the decedent or donor, such as a parent or grandparent.
- The recipient is a direct descendant of the decedent or donor, such as a child or grandchild.
- The recipient is the spouse of the donor.

There is no inheritance tax in Mexico.

No annual wealth taxes are imposed on the federal level or the local level, other than yearly real property taxes imposed on the value of real estate or personal property taxes imposed on the value of vehicles owned. The 2022 budget made no changes to the absence of a Federal wealth tax in Mexico. For many, this was surprising, notwithstanding prior statements of A.M.L.O.

MEXICAN G.A.A.R.

This new rule is included in Article 5-A of the Federal Fiscal Code. It gives Mexican tax authorities the right to recharacterize a transaction where the following two facts exist:

- The transaction lacks a business reason.
- The transaction generates a tax benefit.

Commentators have severely criticized the rule due to its broad nature and lack of clarity. The term "business reason" is not defined in Mexican Law. On the other hand, the term "tax benefit" is defined broadly by this article. It includes any deferral, elimination, or reduction of a tax payment through the application of a deduction, exemption, nonrecognition provision, adjustments to the tax basis, tax credits, recharacterization of a payment or activity, or change of tax regime.

Putting the two conditions together, if a Mexican resident engages in any particular transaction of any kind which, in the eyes of the tax authorities, is not taxed as it should be, the individual must articulate a good business reason for the transaction or face disallowance under G.A.A.R.

The effects of this recharacterization are both administrative – payment of taxes – and possibly criminal. A major problem with the G.A.A.R. rule is that taxpayers have the burden of proving the existence of a valid business purpose once the matter is raised by the tax authorities.

INTERNATIONAL TAX TRANSPARENCY REGIME

"Although the law treats these entities as transparent for tax purposes and any transfer of property to those entities or arrangement without legal personality is not considered to be a taxable sale, no tax provision exists that expressly makes that statement."

If a Mexican resident is either

- a member, shareholder, or owner of a foreign transparent entity; or
- a participant in a foreign legal arrangement without legal personality,

the entity or arrangement will be disregarded for tax purposes and the income will be taxed in Mexico as if received directly by the Mexican taxpayer. To encourage compliance and to penalize noncompliance, a Mexican tax resident must file a report of any participation in a transparent entity or legal arrangement even if the percentage of ownership is infinitesimally small. To illustrate, if a Mexican tax resident owns a 0.001 percent (one thousandth of one percent) ownership interest in a transparent investment fund, that investment is reportable for Mexican tax purposes and the Mexican resident's income is taxable in Mexico when and as realized by the fund. A special report must be filed in February following the close of the tax year. This report is the same as the one used to report investments in controlled entities based in tax havens.

Although the law treats these entities as transparent for tax purposes and any transfer of property to those entities or arrangement without legal personality is not considered to be a taxable sale, no tax provision exists that expressly makes that statement. Regrettably, a clarifying provision should have been included in the transparency provision when it was enacted.

These new rules can result beneficial for taxpayers in Mexico. Mexican tax residents that own assets through foreign transparent entities or legal arrangements can continue to qualify for the beneficial 10% tax regime for gains derived from trades effected on the Mexican stock exchange. Often, limited partnerships formed in certain Canadian provinces are used for this purpose. Also, if the Canadian limited partnership elects to be treated as a corporation for U.S. income tax purposes, U.S. situs assets may be held without exposure to U.S. estate tax.

The transparency regime gets more complicated when a Mexican tax resident pays Mexican source income to a foreign transparent entity or legal arrangement. The law establishes that, in this fact pattern, the entities or arrangements will be treated as foreign nontransparent entities. The rule is poorly drafted, and some degree of uncertainty exists as to its scope. Its purpose is to prevent the application of tax treaty benefits when payments are made to or through transparent entities or foreign legal arrangements owned by a person that is tax resident in a jurisdiction with which an income tax treaty is in effect with Mexico. The tax authorities have informally stated that an exception inherently exists to entity treatment if the foreign entity is transparent in its country of residence and an income tax treaty exists between Mexico and that treaty country requiring Mexico to grant tax treaty benefits to payments made through that entity.

These new rules also establish that when transparent entities or legal arrangements have their main place of administration (*sede de dirección efectiva*) in Mexico, they should be considered Mexican tax residents. Many commentators believe this rule is unnecessary because it contains a tax residency rule that already existed.

TAX ADVISORS REPORTING OBLIGATIONS

Mexican tax law establishes that if a person residing in Mexico regularly gives tax advice to clients, that person must file a report with the Mexican tax authorities describing all reportable transactions that generate a tax benefit in Mexico. The law contains a long list of transactions that are reportable. The list includes any structure that

- allows a taxpayer to avoid reporting obligations,
- eliminates the possibility of exchange of information between tax authorities,
- avoids the application of the transparency regime, or
- effects the transfer of tax loses.

Under an administrative rule issued by the Mexican tax authorities, a transaction that produces a tax benefit of less than MEX$100 million (approximately US$5 million) is not reportable. Under a second administrative rule, transactions that are not reportable trigger an obligation to report the reason reporting is not required. These new provisions include rules as to which a tax advisor should report if several firms or advisors are involved. They also establish when the obligation to report a transaction is shifted to the taxpayer because the advisor failed to file a report. As is readily apparent, this provision reflects concepts that appear in D.A.C.6 in the E.U.

TAX HAVENS

For many years, a tax haven entity was viewed to be controlled by a Mexican resident only where the Mexican resident controlled the timing of the payment of a dividend or income distribution. This rule has been changed significantly. Now, a Mexican tax resident is subject to the tax haven rules if the resident has effective control of the investment. In general, a tax haven entity is considered to be controlled by a Mexican tax resident if any of the following statements is applicable to the resident directly, indirectly or by any arrangement:

- The Mexican resident has the power to unilaterally define or veto management or administrative decisions of the tax haven corporation.
- The Mexican resident holds shares representing more than 50% voting rights.
- The Mexican resident holds shares giving it the right to more than 50% of the assets or 50% of the income of the tax haven corporation.

In the past, the tax haven rules did not apply if the tax haven company generated active business income. Now, the active income test is not applicable in either of the following circumstances:

- More than 20% of the income of the tax haven entity is considered to be passive. For this purpose, passive income includes (i) income from the performance of services rendered outside the tax haven country and (ii) income from the sale of goods that are located outside the tax haven country.

- More than 50% of the income of the tax haven entity arises from transactions that directly or indirectly give rise to a tax deduction in Mexico.

If a Mexican tax resident has an investment in a tax haven entity and no exception applies, the resident must file a report in February of the following year. The income of the tax haven is taxable in Mexico as if realized directly by the Mexican resident.

BROADER REQUIREMENTS FOR NET BASIS TAX FOR FOREIGN RESIDENTS

Mexican law allows a foreign resident to pay Mexican income taxes on a net basis when the tax is imposed on gain from sale of shares of a Mexican corporation or from real property located in Mexico. In order to benefit from this provision, the foreign resident must appoint a representative in Mexico that maintains all the accounting information related to the transaction.

Beginning this year, the representative is jointly responsible for the taxes owed to the Mexican government, albeit on net income rather than gross sales proceeds. The Mexican representative must demonstrate that it has sufficient liquid assets available to pay the tax imposed on the nonresident. The tax authorities may collect the taxes directly from the Mexican representative without the need to seek payment from the nonresident.

The new provision is included in Article 174 of the Income Tax Law. It is complex and may not be appropriate for certain foreign taxpayers.

ISRAELI START-UP EXPANSION TO THE U.S.: WHO SHOULD BE ON TOP?

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Tags
Exapanding to the U.S.
Israeli Start-Ups

INTRODUCTION

Congratulations. Your Israeli start-up is doing well enough for you to consider expanding operations to the U.S. market. Now what? The list of things to think of is endless, and tax should be at the top. Among other matters, you will need to consider

- the legal entity to use when expanding to the U.S.;
- whether the workforce should relocate Israeli employees to the U.S., hire locally in the U.S., or have employees work from Israel post-COVID19;
- investigation of appropriate transfer pricing policies for transactions between the U.S. entity and the Israeli entity, acceptable to tax authorities in each country, especially in regard to payments for the use of intellectual property; and
- identifying the group entity that should own the I.P.

This article considers these and other questions and presents views from both the U.S. and Israel. Like many other things in life, one answer may be preferable in certain circumstances but not others and balancing the conflicting forces is required.

EARLY-STAGE V. ADVANCED

Two early-stage considerations will impact planning latitude:

- Has intellectual property ("I.P.") been developed?
- Has money been raised from investors?

It becomes exceedingly more difficult to revise a structure as operations of the start-up becomes more advanced over time. If Israeli entrepreneurs don't think globally from the very beginning, moving ownership of the I.P. from the Israeli company to a U.S. subsidiary may be very expensive in terms of gain recognition in Israel. And while eventually it may be a necessity, the cost increases as time passes.

If the Israeli company will have very early-stage investors, their consent will be needed for any restructuring. Unless they are U.S. persons – which is not likely in this scenario because U.S. persons would have asked for a U.S. entity at the time of investment – they may resist.

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ESTATE TAX

One of the benefits for non-U.S. investors of a structure involving an Israeli parent and a U.S. subsidiary is the avoidance of exposure to U.S. estate tax at the conclusion of life of a non-U.S. shareholder. With planning, U.S. estate tax exposure for a non-U.S. investor can be addressed in several ways, including by the imposition of a personal holding company or obtaining term life insurance. Shares may also be gifted during life without the imposition of gift tax by a non-domiciled individual as they are considered to be items of intangible property. Consequently, limiting estate tax exposure for a non-U.S. investor by demanding an Israeli parent company should not be a driver in the decision-making process.

Removing the U.S. estate tax exposure from the equation, having a U.S. parent company at the top of the structure should be considered from the get-go. Of course, Israel is closer to Europe and there are other incentives to consider, which are discussed below. However, if the market and target investors are in North America, it may be prudent to consider starting out in the U.S. in a structure that will be favored by future investors and where corporate laws are developed and generally friendly. After all, the goal is to maximize the size of a liquidity event, not simply to limit potential U.S. estate tax exposure that results from an untimely death.

Having focused on pleasing potential U.S. investors, it is important to remember that, if I.P. developed in Israel is held by a U.S. parent, the Israeli Tax Authorities ("I.T.A.") may take the position that the economic ownership of the I.P. is in Israel if no sufficient substance exists in the U.S. parent because of an absence of substantial U.S. operations, employees, and facilities.

I.P.

Ownership of I.P. justifies special consideration as it is never easy to move I.P. out of corporate form without triggering gain recognition.

U.S. buyers are likely to want the I.P. to be owned in the U.S. in order to benefit from incentive legislation that can drive the tax rate down or to avoid immediate U.S. taxation of income generated by the I.P. under certain anti-deferral regimes. If I.P. is created in an Israeli entity and eventually the company is acquired by a U.S. buyer, the buyer is not likely to retain the I.P. in Israel and may factor the tax cost of moving the I.P. to a U.S. affiliate when structuring its best offer.

Unless the buyer structures the transaction as an asset deal, post-acquisition extraction of the I.P. would trigger significant amounts of Israeli tax, even if the acquired Israeli start up maintains its operations under the new business model led by the buyer. The tax treatment of a transfer of I.P. from a newly acquired Israeli subsidiary has been a hot topic in the last few years and the I.T.A. argues that such transactions constitute taxable business restructuring pursuant to applicable transfer pricing rules, contending that the company's acquisition price is the proper benchmark for the value of the I.P.

For all the foregoing reasons, I.P. ownership is a consideration to think of in the early stages. At that time, an Israeli start-up may structure its ownership to have a U.S. parent company and an Israeli subsidiary acting as an R&D contractor in developing I.P. for the U.S. parent.

However, locating the I.P. in the U.S. contains its own risks regarding Israeli tax:

- One is that young entrepreneurs may not have sufficient finances in the early stages to maintain real operations in the U.S.

- A second is that, if the U.S. parent is simply financing I.P. development in Israel, the I.T.A. may claim that the "economic" ownership of the I.P. is in Israel or that substantial income must be allocated to the Israeli subsidiary.

- A third is that the I.T.A. may argue that the Israeli subsidiary transferred I.P. having substantial value to the U.S. parent. If any of these assertions are raised, the Israeli company and its owners may find that they face a more complicated situation than would have existed if the I.P. were located in the Israeli subsidiary from day one.

Punting on the issue is always possible for an early-stage company. It certainly is of no harm if the I.P. fails. It is only when the I.P. appears to be attractive that the early shareholders will have remorse because the opportunity of moving the I.P. with little cost has been missed.

LEGAL ENTITY AND P.E.

If the Israeli start-up is simply testing the waters in the U.S., it may consider hiring an independent contractor to distribute a product or provide other services in the U.S. The issue here is to avoid having that person be considered a dependent agent whose presence in the U.S. could create a permanent establishment ("P.E.") in the U.S. A P.E. can expose a portion of the company's income to U.S. taxation.

While a detailed analysis of the possible existence of U.S. trade or business and a U.S. P.E. is beyond the scope of this article, one benefit that is derived when a treaty applies is that a higher threshold of activity must exist in the U.S. in order for the U.S. to impose income tax. If a treaty applies, the occasional conduct of activity in the U.S. by employees or agents of an Israeli start-up would likely not be enough to give rise to U.S. tax exposure on income generated in the U.S. Without a treaty, any activity conducted in the U.S. may be sufficient for the I.R.S. to characterize income that arises in the U.S. as effectively connected taxable income. Such income is subject to corporate income tax on the Federal and State levels and Federal branch profits tax.

In broad terms, a P.E. exists when the foreign company has a fixed place of business through which it is engaged in activity in the U.S. for an indefinite or substantial period. A company may have a P.E. directly by sending its employees to the U.S. and operating through a branch, or indirectly, through dependent agents that have the power to conclude binding contracts on behalf of an Israeli company. Note that a dependent agent empowered to negotiate the terms of a contract likely will be a P.E. even though the contract is not binding until approved by the head office in Israel. In comparison, the activities of independent agents generally don't give rise to a P.E., provided the agent is independent both economically and legally. An agent is not truly independent if it has only one customer and is integrated in the sales and marketing activity of that sole customer. Nor is an agent independent when its sole customer has control over what the agent does and how it is done, especially when the agent bears no economic risks. In those circumstances, the activities and place of business of the agent may be attributed to the company and could create a P.E.

Forming a U.S. limited liability company ("L.L.C.") that is wholly owned by the Israeli company and operating through it in the U.S. will result in the creation of a U.S. branch of the Israeli company, which results in the existence of a P.E. For U.S. tax purposes, a single member L.L.C. is not regarded to be separate from its sole owner unless an election is made for U.S. income tax purposes to treat the L.L.C. as a corporation. Where that election is made, the L.L.C. is treated as if it were separate from its owner, the Israeli company.

If a corporate subsidiary is formed in the U.S. by an Israeli corporation, the subsidiary does not itself create a P.E. for the Israeli company, provided it does not operate as the Israeli company's agent in the U.S.

Transactions between the Israeli company and its U.S. subsidiary are subject to arm's length transfer pricing rules in both Israel and the U.S., and the application of those rules in any given circumstance may provide different results in each country. In principle, only the income of the U.S. entity would be subject to U.S. taxation, and none of the Israeli company's income would be attributed to the U.S. subsidiary and be taxed in the U.S. However, the views of tax authorities in the U.S. and Israel may not be consistent when determining the scope of the U.S. company's U.S. source income.

COVID19 presented an interesting situation where many workers worked remotely. While, at first, no one thought remote working could be a long-term situation, now it is clearly acceptable, and many companies have adopted hybrid work rules. Full remote, or even hybrid U.S.-Israel remote work may not be easy to sustain in the long term. Nonetheless, those companies that have adopted such working arrangements must consider whether they create a P.E. when the arrangement has lasted for two or more years.

If the start-up intends to hire local employees or send Israeli employees to the U.S., it may be prudent to create a U.S. subsidiary sooner rather than later. putting aside the tax issues and P.E. issues, it is much easier for a U.S. company to maintain a payroll for employees and executives working in the U.S.

FOREIGN OWNERSHIP COMPLIANCE

U.S. ownership of foreign corporations may present significant reporting obligations, and under certain circumstances, may impose unfavorable tax rules. One such rule is the P.F.I.C. regime. Very broadly described, a passive foreign investment company (or 'P.F.I.C.") is a foreign corporation which meets one of two alternative tests:

- The first is an income test, under which 75% or more of the company's gross income is categorized as passive income.
- The second is an asset test, under which 50% or more of the company's assets are passive assets (including cash in excess of 90-day working capital and stock in underlying portfolio companies).

In years during which an Israeli company raises capital, and the cash is the most significant asset reported on a balance sheet, the company may be classified as a P.F.I.C. unless an off-balance sheet asset is identified, and a proper valuation is obtained to support a non-P.F.I.C. position. Even then, the cash must not be invested it short-term liquid assets producing passive income that is greater than the allowed threshold.

An Israeli company's P.F.I.C. analysis must be conducted annually and if an Israeli company is classified as a P.F.I.C. for any year, it retains its classification under a rule known as "once a P.F.I.C. always a P.F.I.C." P.F.I.C. status is problematic. Any ordinary dividend received from a P.F.I.C.by a U.S. individual is taxed as ordinary income that does not qualify for the lower, long-term capital gains rate which applies to dividend from a qualified foreign corporation. The tax treatment in the U.S. is worse if an "excess distribution" is made. An excess distribution is a distribution that exceeds 125% of the average distributions made by the foreign company in the three years immediately prior to the tested distribution. In computing the current year's tax on an excess distribution, the distribution is allocated to each day in the holding period of the shares. The tax on the deemed increase in income in each such prior year is computed at the highest rate for that year and is deemed paid late. The deemed late payment of tax is subject to an interest charge. Similar treatment is given to capital gains from the sale of P.F.I.C. shares.

A U.S. investor in a P.F.I.C. is subject to annual reporting on Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund.*

Other rules may apply and result in current taxation of the earnings of the foreign corporation irrespective of distributions if the Israeli company is considered to be a controlled foreign corporation ("C.F.C.") for U.S. income tax purposes. And even if the company is not a C.F.C., certain reporting on Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations,* is required. The failure to file Form 5471 or the filing of an incomplete form may trigger significant penalties over time. Note that the I.R.S. view of an incomplete form may not be the same as the view of the U.S. shareholder or its tax return preparer.

"A U.S. investor in a P.F.I.C. is subject to annual reporting on Form 8621 . . ."

Other heightened reporting also applies as a result of a need to report specified foreign assets (including shares in a foreign corporation) and possibly to file an F.B.A.R. form with FinCEN, a branch of the I.R.S. that enforces the Bank Secrecy Act. The F.B.A.R. reports ownership, financial interests, and signatory authority over foreign financial accounts owned by a U.S. company and its overseas subsidiaries.

Q.S.B.S.

Another consideration for having the parent company in the U.S. is the benefit provided in Code §1202. This Code section applies only to shares in a C corporation (*i.e.*, not an L.L.C. electing to be taxed as a corporation). When applicable and all requirements are met, U.S. taxpayers selling shares are eligible to exclude from their long-term capital gain the *higher* of $10,000,000 or 10 times the adjusted basis in the shares. This is a significant benefit that is attractive to investors and managers of U.S. investment funds. They are keenly interested in investing in U.S. corporations and not foreign corporations, and they may ask that the Israeli company invert with its subsidiary.

Acknowledging such situation, the I.T.A. developed a fast track for inverting using the exemptions available under the tax-free reorganization law.

ENCOUREGEMENT LAWS AND THE I.I.A.

One of the most attractive reasons to base the operation in Israel is the availability of benefits granted under the encouragement of capital law. Companies that qualify under the terms and conditions of such laws and that are based in central Israel will be eligible to pay a 16% corporate tax rate (compared to the standard corporate tax of 23%) and have dividend payments taxed at 20% (compared to 20%-30%). Eligible companies that are based outside of Israel's dense urban center are eligible for a corporate tax rate of only 7.5%, although the rate may be increased considering the forthcoming O.E.C.D 's Global Minimum Tax. Those reduced tax rates may be significant and should keep investors happy, except if those investors are U.S. citizens who then may be unhappy to discover that the Israeli rate does not qualify for the high-tax exception under anti-deferral rules applicable to U.S. persons owning 10% or more of the shares of a controlled foreign corporation.

Additionally, the Israel Innovation Authority ("I.I.A.") offers unique tools for entrepreneurs and start-ups to support the early development stages of technological initiatives. These tools assist in developing innovative technological concepts at the pre-seed or initial R&D stages, transform ideas into reality and reach significant fundable milestones. However, receiving grants from the I.I.A. comes with an obligation to pay royalties to the I.I.A. and penalties are imposed if the I.P. developed eventually is sold to a non-Israeli entity.

TRANSFER PRICING

Regardless of which company is the parent and which is the subsidiary, all transactions between a U.S. company and its Israeli affiliate (including charges for the use of I.P., interest accruing on loans, and inventory purchases) must be carried out in a manner that is consistent with arm's length principles. The taxable income of each entity must be clearly reflected and supported by a transfer pricing study that is based on methodologies allowed under U.S. Treasury Regulations and the Israeli transfer pricing regulations. If the transfer pricing is set at a price that is not deemed to be arm's length -- so that the U.S. company's profits are understated – the I.R.S. and the I.T.A. are authorized to adjust the price and impose penalties on the adjustment. Penalties may be avoided if a proper transfer pricing report is prepared on a timely basis. The report must explain the price determined and the methodology used and the reasons why the price was determined under the best method available under the regulations. In addition, the report must be prepared on a timely basis, which means prior to the date of the filing of the tax return for the year.

The arm's length transfer pricing rules in the U.S. may differ in technical ways from the O.E.C.D. Transfer Pricing Guidelines which the Israeli transfer pricing regulations draw upon. Separate reports must be prepared under both sets of rules, one for the U.S. and the other for Israel. In principle, the transfer pricing result should be the same under both. However, that is not always the case.

SUMMARY

The answer to the question "so what do you advise me to do" is never an easy answer. Young entrepreneurs are required to act as "fortune tellers" in the process of establishing their new business. The questions that should be asked at the outset include all of the following:

- What markets should we aim for?
- Will Israelis or Americans comprise the bigger share of our investor group?
- Will we need government support at the early stages?
- Will our exit strategy focus on the sale of assets, a private sale of shares, or an I.P.O?
- Where do we intend to live if the business succeeds?
- Who are the employees we want to hire and where do they live?

Those and many other questions may be very difficult to answer at the outset and are somewhat of a guess at the early stage; but they are important and may impact the taxation of their success. One bit of nontechnical advice that should be kept in mind – if difficulty is encountered in answering the foregoing questions, it may be time to purchase a new crystal ball.

A C.T.A. OF THE C.T.A. – A CLOSER TARGETED ANALYSIS OF THE CORPORATE TRANSPARENCY ACT

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On January 1, 2021, Congress passed the Corporate Transparency Act (C.T.A.) as part of the National Defense Authorization Act. The C.T.A. is designed to shed light on the beneficial owners of certain entities, defined as reporting companies, by requiring those entities to report information on their beneficial owners and other individuals known as company applicants. The information is to be compiled in a database, accessible to employees of the U.S. Treasury Department and law enforcement.

Insights previously discussed 11 important questions regarding the C.T.A., but the legislation left many others unanswered. Much discussion centered around definitions and obligations of reporting companies, beneficial owners, and company applicants. On December 7, 2021, FinCEN provided greater clarity on how the new reporting regime will work. This article identifies the business entities that must comply, the entities that are excepted, and provisions that should be addressed in subsequent regulations.

Until final regulations are issued, the reporting obligation is not yet operative, but because the final regulations could be issued as soon as mid-2022, it is advisable for both owners of businesses, and advisers who routinely interact with business owners, to commence preparing for compliance in the coming weeks or months.

REPORTING COMPANIES

Reporting companies are the entities that must report information about their beneficial owners. A reporting company is a corporation, L.L.C., or other similar entity that meets one of the following tests:

- **Domestic Entity**: It is a domestic entity that is created by filing a document with a secretary of state or a similar office under the law of a State of the Union or an Indian Tribe.

- **Foreign Entity**: It is an entity that is formed under the law of a foreign country and registered to do business in the U.S. by filing a document with a secretary of state or a similar office under the law of a State of the Union or Indian Tribe.

Prior to the proposed regulations, there was a great deal of discussion over what a "similar entity" meant. The statutory language mirrors the language for a legal entity customer under FinCEN's customer due diligence (C.D.D.) rules that spell out required background checks that banks and other financial institutions must carry out as part of their account opening procedures. Accordingly, many commentators predicted that the C.T.A. regulations would follow C.D.D. footsteps. Crucially, the C.D.D. definitions exclude sole proprietorships or unincorporated associations, despite the fact that they sometimes do have a filing requirement, but include general partnerships.

FinCEN's approach taken in the proposed rules reflects a literal interpretation: any entity that must file with any state office upon formation.[1] The agency anticipates that the following types of entities will also be included among reporting companies:

- Limited liability partnerships
- Limited liability limited partnerships
- Business or statutory trusts
- Most limited partnerships

The treatment of other entities – general partnerships, other trusts, and sole proprietorships – will depend on whether the specific state or Tribal law requires filing. FinCEN's interpretation is fairly literal.

The proposals include 23 specific exemptions from reporting. A significant exemption is for "large operating companies". A company is a large operating company if it

- has more than 20 full-time U.S. employees,
- filed Federal income tax returns in the previous year demonstrating over $5 million in gross receipts or sales, and
- has an operating presence at a physical office in the U.S.

Other specific exemptions are proposed for

- tax-exempt entities (churches, charities, nonprofits);
- entities that already have certain Federal reporting obligations, such as banks, insurance companies, and public companies; and
- a grandfathering provision for dormant entities (entities which, among other requirements, have been in existence for over a year before the C.T.A.'s enactment and are not engaged in an active business when the rules come into effect).

FinCEN is weighing whether companies will be required to apply for the exemption. Other suggestions under consideration include voluntary filing for exempt companies, or whether an exemption report would have to be obtained only if requested by a government body.

Legal practitioners will note that there is no exemption for small law firms and C.P.A. firms that fall within the definition of a reporting company. There are thousands of small law firms and accounting practices that operate in New York State, alone, where the vast majority of legal practitioners are solo practitioners or work in small firms with less than ten attorneys. Larger firms will be covered by the large operating company exemption.

The omission of law firms from the specific exemptions list is odd and most likely

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[1] See also Fact Sheet: Beneficial Ownership Information Reporting Notice of Proposed Rulemaking (NPRM), Dec. 7, 2021, summarizing the approach.

unintended. In trying to stop "wrongdoers from exploiting United States corporations for criminal gain," the C.T.A. surely was not targeting small law firms. The owners of small law firms are rarely the subject of controversy and generally have sufficiently compelling, independent reasons for not participating criminal conduct and money laundering. Nor are small law firms a particularly popular vehicle for money laundering. Lawyers are already regulated by state bar associations, and information on law firm ownership is readily available. As the C.T.A. already exempts certain other entities for whom reporting would be redundant, an exemption for small law firms would not be out of place.

There is certainly room for change. If appropriate, FinCEN could broaden the categories of excepted businesses to exclude a larger swathe of licensed or registered professions, such as medicine and health, actuarial science, architecture, training schools, inspectors, surveyors, technicians and lab workers, and insurance agents, in addition to lawyers and C.P.A.'s. As for active, non-licensed entities that fail the large operating company exception but merit relief nevertheless, engagement in an exception could be fashioned for entities hat have an active business carried on at a fixed location could be coupled with a gross assets or gross receipts threshold as demonstrated in Federal tax filings, if appropriate. The prime example would be mom-and-pop grocery stores or small dining establishments. The rationale for crafting these additional exceptions is intuitive. Requiring such businesses to report "neither serve[s] the public interest nor [would] be highly useful in national security, intelligence, law enforcement, or other similar efforts."

BENEFICIAL OWNERS

The opacity surrounding many beneficial owners is the motivation behind the C.T.A. The C.T.A. defines a "beneficial owner" as a natural person who

- exercises substantial control over a company,
- owns at least 25% of a company's ownership interests, or
- receives substantial economic benefits from a company's assets.

This is subject to some exclusions. Minors and people acting on behalf of others, like intermediaries or employees, cannot be beneficial owners for the purposes of the C.T.A. Creditors and prospective heirs are also excluded.

Prior to the issuance of the proposed rules, many commenters pointed out that "substantial control" was not defined. The new rules give three indicators of substantial control:

- Service as a senior officer
- Authority over the appointment or removal of a senior officer or dominant majority of the board of directors (or similar body)
- Direction, determination, or decision of, or substantial influence over, important matters of the company

These indicators seek to unveil people who "stand behind the reporting company and direct its actions." Substantial control is not limited to this list, thanks to a catch-all provision that covers additional forms of control. This makes the definition broad and undoubtedly will spark worries of ambiguity and overreach. But FinCEN rejected being boxed in by more easily administrable *per se* rules because it was persuaded that formal titles do not always reflect control.

The regulations also laid out the contours for other undefined "ownership interests" for which reporting is required. They include the following:

- Equity interests (of any class or type)
- Capital interests
- Profits interests (including partnership interests)
- Convertible instruments, warrants, rights
- Other options to acquire equity, capital, or other interests
- Debt instruments if they allow holder to exercise the same rights as other specified interests (*e.g.*, an instrument that can be converted to equity)

"Without additional exceptions, the unintended consequence may be that many 'innocent' smaller businesses will be ensnared even though their information is of no use to FinCEN."

The proposed rules do not take into account the likelihood that the rights will be exercised. Grafting a more-likely-than-not standard could reduce overbreadth.

FinCEN acknowledges that the highest burden will be on small entities with complex structures or multiple owners. The agency's justification for the present approach is threefold:

- Most companies do not have such complex structures.
- Those companies that have complex structures already have higher compliance costs and presumably are better able to accept more compliance requirements.
- Small entities are precisely those perceived to have the highest risk of criminal activity that the C.T.A. was designed to fight.

Without additional exceptions, the unintended consequence may be that many "innocent" smaller businesses will be ensnared even though their information is of no use to FinCEN. Small law firms are just one example of potential collateral damage.

For a foreign-owned U.S. business, if the foreign owner is a partnership or other type of business that is not required to register on formation, or that is not treated as having its own separate legal personality under that jurisdiction's law, it is not clear how many tiers of reporting are required, and whether it must be submitted on behalf of the individuals who are the ultimate beneficial owners (*i.e.*, the "warm body" at the top of the structure). As an example of the Proposed Regulations' approach, 31 C.F.R. §1010.380(b)(3)(iii) provides that if substantial ownership of certain foreign reporting companies is not clear because multiple individuals are involved, the information may be provided for the individual who has greatest authority. It is not clear what the equivalent rule would be for a foreign-owned domestic business owned through multiple tiers of foreign partnership. Based on the reported information and by analogy to C.D.D. rules, it is assumed that at least one 25% indirect owner who is a "warm body" must be reported even if multiple tiers up and multiple jurisdictions away.

REPORTS

Reporting companies must report the following information about both their beneficial owners and company applicants:

- Name
- Date of birth
- Address
- Unique identifying number from an acceptable identification document such as a driver's license registration number or a passport number accompanied by a copy of the identification document

Prior to the issuance of the proposed regulations, it was not clear whether a reporting company would have to report any information about the company itself. Nothing is explicitly required in the legislation, but it would have been odd if reporting companies could stay in the shadows. The proposed rules fill this gap; a reporting company must report its

- name;
- alternative names, if any, such as a d/b/a name;
- business address;
- jurisdiction of formation or registration; and
- unique identification number, which in most cases is likely to be a Tax Identification Number, or T.I.N. Alternatives are the Dun & Bradstreet DUNS Number and Legal Entity Identifier Code, or a 20-digit alphanumeric I.S.O. code available for companies which may be obtained here.

COMPANY APPLICANTS

In addition to information on beneficial owners, the C.T.A. requires reporting of "company applicants." Applicants are the individuals who file the document to form the entity in the case of domestic entities or register the entity in the U.S. in the case of foreign entities. It also includes those who direct or control the filing of the document.

The American Bar Association (A.B.A.) has expressed concern that applicants, which clearly includes attorneys, would acquire reporting obligations, which could conflict with the duty of confidentiality. The A.B.A. also highlighted privacy issues.

Regarding the nature of information provided, the regulations divide applicants into two categories. The first comprises those who provide a business service as a corporate or formation agent, such as lawyers. For this group, a reporting company should include the applicant's business address instead of a residential address. Although this might appear a response to privacy concerns, FinCEN believed that business addresses would provide greater value to law enforcement. All other applicants fall into the second category and must provide residential addresses.

The proposed rules confirm that applicants themselves do not have to file reports. This appears to address the A.B.A.'s confidentiality concerns.

TIMING

The date by which a reporting company must file reports depends on the date of formation relative to the C.T.A. Domestic companies formed after the C.T.A.'s effective date have 14 days from formation to file reports. Similarly, foreign reporting companies that have registered to engage in business in a particular State after the effective date have 14 days to file. By contrast, reporting companies formed before the effective date have a year to submit reports after the final regulations are effective. It is not yet clear precisely when the final regulations will be issued, but is anticipated that final regulations will not be issued before the middle of 2022.

The rationale for the discrepancy is that newly formed or registered companies are likely to have all necessary information on hand. However, FinCEN has already received comments that 14 days may not be enough. For example, a company that qualifies for exemption may need more time to obtain approvals that would establish its exempt status. Accordingly, FinCEN has invited further comment on whether the 14-day period will be too burdensome.

Additionally, reporting companies will not only have to file initial reports but provide updates and corrections as needed. Updates include a change in ownership and loss of exempt status. A company must provide updates to FinCEN within 30 days after the change and make corrections 14 days after the company becomes aware of any inaccuracies.

For the most part, these changes are more restrictive than the C.T.A. itself. Already existing companies would have had two years to file a report instead of one. Updates would have had to be disclosed within a year, rather than a month. But FinCEN does seem receptive to worries concerning newer companies – the 14-day deadline is more lenient than the C.T.A.'s would-be requirement that such reports be filed on formation.

PENALTIES

The C.T.A. makes it unlawful for any person to willfully provide, or attempt to provide, false or fraudulent beneficial ownership information or to willfully fail to report complete or updated beneficial ownership information to FinCEN. In general, a civil penalty of up to $500 may be imposed for each day a violation continues and a fine of up to $10,000 and imprisonment for up to two years may be imposed for a criminal violation.

CONCLUSION

These proposed regulations are not the end of the road – FinCEN is still accepting comments on the proposed regulations through February 7, 2022. Additionally, FinCEN intends to issue two more sets of proposed regulations. The first will deal with who gets access to the database that FinCEN will build using C.T.A. reports. As previously mentioned, access generally will be limited to the employees of certain government agencies. The second will revise C.D.D. rules as required by the C.T.A.

It is hoped that FinCEN will use the opportunity to also address some of the ambiguities identified in this article.

Those who believe that "what's past is prologue,"[2] will not be fooled if FinCEN takes several years to ramp up enforcement. As with enforcement of the Bank Secrecy Act, sooner or later FinCEN will initiate a campaign to seek out and penalize non-compliant reporting entities and their controlling persons. Those who ignore both history and the C.T.A. reporting obligation do so at their peril.

[2] See Act 2, Scene 1 of *The Tempest*, by W. Shakespeare.

THE MORE YOU KNOW, THE MORE YOU DON'T KNOW – U.S. TAX ISSUES ON A DISPOSITION OF A FOREIGN BUSINESS

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Passive Activity Loss
Sale of a Foreign Business
Separate Loss Limitation
Source of Income

INTRODUCTION

When a U.S. person disposes of a business situated in a foreign country, the nature of the gain as capital or ordinary and the source of the gain may sound like simple issues that require simple tax advice. It may, however, turn out to be far more complex as one begins to review the relevant provisions of U.S. tax law in light of the facts and circumstances that exist. However, as a deep dive is made into the facts and the law, it is not uncommon for issues to pop up, one after the other and on a never-ending basis.

This article discusses the various U.S. Federal income tax issues that must be addressed by a U.S. seller in connection with a sale of a business as a going concern held indirectly through an entity that is treated as a disregarded entity for U.S. tax purposes. It does so in the context of a hospitality business.

FACTS

1. Mr. A is a U.S. citizen who is a successful entrepreneur.
2. He runs multiple grocery stores in the U.S. and is actively involved in the day-to-day management of the business.
3. He also owns a luxury boutique hilltop resort in Valencia, Spain that offers accommodation, food, beverages, spa, and other luxury services to its clientele ("Resort V").
4. Mr. A owns Resort V through a Spanish company ("S Co"). S Co is treated as a disregarded entity for U.S. tax purposes under the U.S. entity classification rules.
5. Because of the disregarded status of S Co, Mr. A is deemed to directly own the individual assets of Resort V and the profits earned or losses incurred in the business of operating Resort V are regularly reported on Schedule C of Form 1040, *U.S. Individual Income Tax Return*, filed by Mr. A.
6. Resort V has not yet reached the breakeven point. Mr. A's Form 1040 for Year 2020 reported accumulated losses from the business of $2 Million.
7. Mr. A sells the shares of S Co to a foreign buyer in Year 2021 for $10 Million.
8. Because S Co is treated as a disregarded entity for U.S. tax purposes, the sale of the shares of S Co is treated for U.S. tax purposes as if it were a direct sale by Mr. A of all the assets of Resort V.

9. The business assets of Resort V include real property, tangible personal property, financial assets, and intangible property, whether or not reported on the balance sheet of the hotel business, such as self-generated goodwill.

POTENTIAL ISSUES

Mr. A would like to understand how gain from the sale of the shares of S Co should be treated for U.S. income tax purposes and how it will affect his U.S. income tax liability.

A careful analysis of the simple transaction entailing a sale of Resort V, effected by a sale of shares of a disregarded entity, will indicate an influx of several interesting tax issues that should be addressed to quantify Mr. A's U.S. income tax liability from the sale. The following issues that will be discussed in the article:

1. The manner in which the following tax items are determined:
   a. The character of the gain arising from the sale transaction, as either long-term capital gain or ordinary income,
   b. The manner of bifurcating the gain between those two categories,
   c. The tax rate applicable to each type of income category, and
   d. The source of the resulting long-term capital gain and ordinary income for purposes of applying the foreign tax credit provisions of U.S. tax law for income taxes paid to Spain in connection with the transaction.
2. The extent to which Mr. A may deduct the deferred losses from the Resort V business that have been reported on U.S. Federal income tax returns filed for each year in which Resort V was owned against the gain arising from the sale of the shares of S Co in view of the limitations imposed by the Passive Activity Loss rules under Code §469.
3. The extent to which Mr. A may deduct the deferred losses from the Resort V business that have been reported on U.S. Federal income tax returns filed for each year in which Resort V was owned against the gain arising from the sale of shares of S Co in view of the limitations imposed by the foreign tax credit rules under Code §904 and its regulations.
4. The extent to which U.S. Federal income tax may be reduced by the foreign tax credit for Spanish income taxes paid on the gain from the sale of shares of S Co.

DISCUSSION

For U.S. Federal income tax purposes, the sale of the shares of S Co will be viewed as a sale by Mr. A of each asset of the Resort V business

S Co is treated as a disregarded entity for U.S. Federal income tax purposes. A disregarded entity is an entity that is treated for U.S. income tax purposes as if it were not separate and distinct from its owner. In other words, the assets, liabilities, income, expense, profits, and loss of a disregarded entity are deemed to be owned, earned, and incurred by its sole member. Therefore, the sale of S Co will be treated as a direct sale by Mr. A of the business assets of Resort V, including real estate, tangible personal property, and goodwill, such as going-concern value of Resort V. Therefore, any gain or loss arising on the sale of business assets of Resort V, any income tax paid or withheld in Spain in connection with the sale of the shares of S Co will be reported by Mr. A on his personal U.S. Federal income tax return.

Allocation of sale consideration to specific business assets of Resort V in order to compute gain or loss on each asset

The gain from the sale of an asset is equal to excess of the sale consideration over the adjusted basis in the asset on the date of the transfer.[1] Because the form of the transaction is a share sale, but the U.S. tax treatment of the transaction is an asset sale, certain adjustments must be made to move from sale consideration to the amount realized. The most important adjustment to the consideration to the sale price is to increase the price to reflect debt on the balance sheet of S Co. This is balanced by the most important adjustment to the basis of asset, which is to look to the inside basis of the assets that are reflected on the balance sheet of the Form 8858, *Information Return of U.S. Persons With Respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs).* When the two adjustments are made, the analysis moves from looking at a sale of shares owned by Mr. A – the actual transaction – to looking at a sale of assets owned by Mr. A – the transaction that is realized for U.S. tax purposes. Consequently, in the balance of the discussion, the terms "sales price, "sales proceeds," and "consideration" each means the amount specified in the contract of sale plus the underlying debt of S Co. Similarly, the term "basis" means the basis in all the assets of S Co, not the shareholder capital that was contributed to S Co over the years by Mr A. For ease of illustration, we will refer to the amount of underlying debt of S Co as "$X."

"U.S. tax law provides that, in the case of a sale of a business as a going concern, the consideration received by the seller must be allocated sequentially among seven main classes of assets. . ."

Consequently, Mr. A will be required to undertake a purchase price allocation study allocating the sales proceeds to each class of assets that is part of the transaction. Under the study, the total consideration in the sale ($10 Million + $X) will be allocated to the assets of Resort V based on each particular asset's relative share of fair market value.

U.S. tax law provides that, in the case of a sale of a business as a going concern, the consideration received by the seller must be allocated sequentially among seven main classes of assets, in the following order:[2]

- Class I - cash and cash equivalents
- Class II: Actively traded personal property, certificates of deposit, and foreign currency
- Class III: Accounts receivables, mortgages, and credit card receivables
- Class IV: Inventory
- Class V: All assets not in classes I – IV, VI and VII (equipment, land, building)
- Class VI: Section 197 intangibles, except goodwill and going concern

[1] Code §1001(a).

[2] Code §1060.

- Class VII: Goodwill and going concern (residuary sale consideration)

The amount allocated to an asset, other than a Class VII asset, cannot exceed its fair market value on the purchase date. This clearly attempts to close the door to asset allocations that inappropriately allocate too much of the proceeds to assets that would result in favorable tax treatment for the seller, such as assets that give rise to capital gain tax treatment for an individual. The transferee and transferor may agree in writing as to the allocation of the consideration, or as to the fair market value of the assets. Such agreement is binding on both parties unless the allocation or fair market value is proven to be unreasonable or inappropriate.[3]

Consideration received ($10 million + $X) should be allocated as follows:

- This amount is first allocated to cash and cash equivalents that make up Class I assets transferred
- The balance of the consideration is allocated to Class II assets, then to Class III, IV, V, and VI assets in that order.
  - The order of allocation reflects a policy that purchase price should be allocated first to classes in which assets can be valued more reliably because they tend to reflect a market price, or a recent transaction, or some other objective factor.
  - Within each class, allocate the consideration to the class assets in proportion to their fair market values on the purchase date.
- Allocate the remaining consideration to Class VII assets.

If an asset in one of the classifications described above can be included in more than one class, choose the earlier class in the list (for example, if an asset could be included in Class III or IV, choose Class III).

Additionally, both the purchaser and seller must file Form 8594, *Asset Acquisition Statement Under Section 1060*, when there is a transfer of a group of assets that makes up a trade or business and the purchaser's basis in the acquired assets is determined wholly by the amount paid for the assets. This applies whether the group of assets constitutes a trade or business in the hands of the seller, the purchaser, or both. The purchaser and the seller must attach a Form 8594 to its income tax return for the year in which the transfer occurred. No requirement mandates the buyer and seller to agree on the same allocation, but if they agree in writing to an allocation in the transaction document, the agreed allocation must be used on the Form 8594 filed by each. If a party to the transaction is not a U.S. person and not a controlled foreign corporation ("C.F.C.") for U.S. tax purposes,[4] no obligation exists to file the form. If the party is a C.F.C., the form is filed by any person that is a U.S. Shareholder[5] of the C.F.C.

Class I (Cash) and Class III assets (Accounts Receivable) do not generate any gain. However, if the U.S. Dollar is not the functional currency of the Q.B.U. embodied in S Co (which will likely be the case), gain or loss could arise based in part on the

[3] Code §1060(a).

[4] Code §957(a).

[5] Code §951(b).

movement of currency values.

Once the sales proceeds denominated in Euros are allocated to Class I and Class III assets, the balance of the consideration will be allocated among Class V and Class VII assets (goodwill), if any.

Character of income and gain, tax rate, and source of income arising from the sale of the Resort V assets

The character of income determines the tax rate that will be imposed on Mr. A in the U.S. The source of income determines whether a taxpayer will obtain a benefit under the foreign tax credit of U.S. tax law. The foreign tax credit can be used as an offset to the U.S. Federal income tax imposed on the portion of the tax that is imposed on foreign source income.[6]

Gain from the sale of a capital asset is defined as the excess of the sale price allocated to the asset over its adjusted basis. As mentioned earlier, although the form of the transaction involving Mr. A and S Co is cast as a stock sale, because S Co is a disregarded entity, U.S. tax law treats the sale as an asset sale. Consequently, the gain from the sale of the land, buildings, improvements, P.P.E., intangible assets such as the Resort V trademark will be equal to the excess of the allocated sale price to each such asset over that asset's adjusted basis. The adjusted basis of a capital asset is equal to the amount of its original purchase price plus capital expenditures made to improve the asset and reduced by accumulated depreciation (amortization in case of an intangible asset) claimed under U.S. tax accounting concepts. The amount of the depreciation and amortization deductions and adjusted basis with respect to the assets as on December 31, 2020 can be approximated by reviewing the U.S. Federal income tax return of Mr. for 2020. Necessary downward adjustments should be made to the adjusted basis to provide for depreciation and amortization deductions for Year 2021 up to the date of sale.

Tax Treatment of the Gain from the Sale of Buildings and Land Improvements

Because depreciation deductions reduce basis, a portion of the gain is not attributable to market appreciation in the value of the asset measured from the date of original purchase. Rather, it is attributable to depreciation deductions that have reduced basis over time. To the extent the gain from the sale of the buildings is attributable to depreciation deductions, that portion of the gain is treated as ordinary income.[7] This is commonly referred to as depreciation recapture. This portion of the gain is taxed in the U.S. at the rate of 25% for an individual. Land typically is not depreciable. Consequently, no depreciation recapture exists for land. The gain in excess of depreciation recapture is treated as capital gain, and is taxed at 20% (plus the Net Investment Income tax (N.I.I.T.) at the rate of 3.8%).

A capital gain arising from the sale of a real property situated outside the US is a foreign source income.[8] Therefore, the capital gain from the sale of land on which Resort V is built is foreign source income. In addition, Mr. A will be eligible to offset his U.S. Federal income tax liability arising from the sale of the real property by a credit for the amount of the Spanish taxes paid. Benefit under the credit may be

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6 Code §901(a).

7 Code §1250(a).

8 Code §862(a)(5).

limited by the foreign tax credit limitation, which is discussed later.

Tax Treatment of the Gain from the Sale of P.P.E. (Personal Property)

Like building and land, the character and source of gain from the sale of P.P.E. also will depend on the extent to which the gain is attributable to accumulated depreciation deductions claimed through the day prior to the sale.

Depreciation Recapture on P.P.E.

The gain will be recaptured as ordinary income and taxed at the level of Mr. A as ordinary income at the rate of 37% to the extent of the accumulated depreciation claimed on P.P.E. over the years.[9] The balance of the P.P.E. gain will be treated as long term capital gain taxed at 20% plus the Net Investment Income Tax at 3.8%.

Source of the Gain from the Sale of P.P.E.

Generally, U.S. tax law provides that gain arising from the sale of a personal property (movable assets) is sourced in the country of residence of the seller.[10] However, an exception exists with respect to depreciable personal property, which will be explained below:[11]

- Gain is treated as U.S.-source income to the extent of the depreciation deductions that were allowable in computing U.S. source taxable income.[12] As with depreciable real property, the gain is converted to ordinary income that will be taxed at rates of up to 37%. The 25% tax rate for depreciation recapture applicable to real estate gains is not applicable for P.P.E. gains The foreign tax credit cannot be used to reduce the U.S. tax on this recapture.
- Gain is treated as foreign-source income to the extent of the depreciation deductions that were allowable in computing foreign source taxable income.[13] The gain will be treated as ordinary income and taxed at rates of up to 37%. The foreign tax credit can be used to reduce the U.S. Federal income tax on this recapture income.
- The foregoing rules are further modified for property used predominantly outside the U.S.[14] The entire depreciation recapture is allocated to foreign source income in these circumstances. If this occurs, the foreign tax credit is available to offset the U.S. tax imposed on this recapture income.
- Any gain in excess of the depreciation adjustments is sourced as if the property were inventory property.[15] This means that if title to the property passes to the purchaser outside the U.S., the gain is foreign source gain.

Mr. A confirmed that P.P.E. of the Resort V business was only used in the resort

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9 Code §1245.

10 Code §865(a).

11 Code §865(c).

12 Code §865(c)(1).

13 Code §865(c)(1).

14 Code §865(c)(3)(B)(ii).

15 Code §§865(c)(2) and 862(c)(6).

business located in Spain from the date of acquisition and have never been used in a U.S. trade or business. Therefore, the full amount of gain to the extent allocable to depreciation recapture should be treated as foreign source income. Similarly, the balance of the gain amount from the sale of P.P.E. should also be treated as foreign source income because title to the P.P.E. passes to the purchaser outside the U.S. As a result, the Spanish taxes on the gain and recapture should be available to offset the U.S. imposed on both those items, within the limitations of Code § 904.

Tax Treatment of the Gain from the Sale of Goodwill, if Any

The excess of the sale consideration over the fair market value of all assets under Class I, III, and V will be treated as goodwill. Goodwill is generally defined as the value of a trade or business attributable to the expectancy of continued customer patronage and that this expectancy may be due to the name or reputation of a trade or business or any other factor.[16] In Rev. Rul. 59-60, the I.R.S. describes goodwill in the following words:

> In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value.

The gain arising from the sale of goodwill will be treated as a capital gain subject to U.S. Federal income tax at the rate of 20% (plus Net Investment Income Tax at 3.8%). In addition, the source of goodwill is generally determined based on the location where the business activity is conducted which results in the generation of goodwill. Since the goodwill is associated with the Resort V business conducted outside U.S., goodwill from the sale of the business should be treated as foreign source income.[17] Therefore, Mr. A should be eligible to claim a credit of the Spanish taxes paid on the sale of goodwill against his U.S. Federal income tax liability arising from the same transaction.

Extent to which Mr. A can Offset the Unused Losses of $2 Million Against the Gain from the Sale of Individual Assets of Resort V Under the Passive Activity Loss Limitation Rules

Mr. A has been reporting the Resort V business as a passive activity under Code §469 on his income tax return for U.S. Federal income tax purposes.

An activity is a passive activity if the participation of a taxpayer in the activity of the business is not continuous and regular, and the individual does not materially and

[16] Treas. Reg. §1.197-2(b)(1).

[17] The considerations that caused the sale of a franchising business conducted outside the U.S. in *International Multifoods Corporation and Affiliated Companies v. Commr.,* 108 T.C. 25 (1997) are not present here. In *International Multifoods*, the taxpayer was in the business of licensing franchises. The value of the goodwill was inextricably tied to the trademarks and know-how that were sold. Gain from the sale those assets generated domestic source income. The case is discussed elsewhere in this edition of *Insights*.

actively participate in the day-to-day business operations.[18] An individual is treated as materially participating in an activity if:[19]

- Participation by the individual in the activity is for more than 500 hours during the year

- Participation by the individual in the activity is substantially all of the participation in the activity of *all* individuals (including non-owners) for the year. There is no indication of the meaning of "substantially all."

- Participation by the individual in the activity is for more than 100 hours provided it is not less than that of any other individual (including non-owners).

- The activity is a significant participation activity and participation in all such activities for the year exceeds 500 hours. A significant participation activity is a trade or business in which the individual participates for more than 100 hours per year, but does not materially participate under any of the other tests.

- Material participation occurred (under one of the other six tests) in the activity in any five (not necessarily consecutive) of the ten preceding years.

  The activity is a personal service activity and material participation occurred in any three preceding years (not necessarily consecutive). Unlike the test above, involving prior year participation, this test does not require that the prior year participation qualify under one of the other tests. A personal service activity consists of performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting or performing service in any other trade or business in which capital is not a material income-producing factor.

- Based on all of the facts and circumstances, the individual participates on a regular, continuous, and substantial basis during the year. For purposes of this test, services performed in the management of an activity are not taken into account unless

  - no other person receives compensation for performance of management services, and

  - no other person performs more management services than the taxpayer when measured in terms of hours.

  In addition, the individual must participate for more than 100 hours.

The classification of a business as a passive activity becomes relevant when the business generates operating losses. The losses arising from a passive activity are subject to the passive activity loss limitation rules of Code §469. The rules provide that a passive activity loss can be offset only against passive activity income.[20] In other words, even if a taxpayer realizes nonpassive activity income, such as salaries from employment or income from an actively managed business, a passive activity

"The classification of a business as a passive activity becomes relevant when the business generates operating losses."

[18] Code §469(c)(1).

[19] Treas. Reg. §1.469-5T(a).

[20] Code §469(a);(d).

loss cannot reduce the nonpassive taxable income. As a result, a taxpayer ends up paying U.S. Federal income tax on nonpassive activity income despite suffering losses in a passive activity in the same year. Note that any excess loss from a passive activity is not permanently lost. Rather, the loss is indefinitely suspended. The accumulated passive activity loss becomes available at the final disposition of the passive activity that generated the loss, provided that the gain from the disposition is fully taxable in the U.S. When that occurs, the suspended losses can be used to offset the gain arising from such disposition.[21]

Mr. A's 2020 U.S. Federal income tax return reported $2 Million of accumulated losses from the Resort V business. As discussed above, the sale of shares of S Co viewed as the sale of each asset will be fully taxable in the U.S. Accordingly, the final disposition of the assets of the Resort V business will free up the suspended passive losses of $2 Million. The freed-up losses will become available to offset the gain from the sale of the Resort V business.

Extent to which Mr. A can Utilize the Unused Losses of $2 Million (as Reported on Mr. A's 2020 U.S. Federal Income Tax Return) to Offset the Gain from the Sale of Shares of S Co Under the Foreign Tax Credit Rules

Until this point, the article addressed the source of gain and recapture income from the sale of each asset of Resort V and Mr. A's ability to utilize the unused loss of $2 Million under the Passive Activity Loss rules to reduce the taxable income that will be generated by the sale of S Co. We will now address how the foreign tax credit rules of U.S. tax law are applied to the contemplated gain and recapture income in order to eliminate double taxation.

Broadly speaking, the foreign tax credit rules impose three main limitations on a taxpayer's ability to claim a benefit from the credit for foreign taxes paid.

- The foreign tax credit benefit is limited so that it can be used to set off only the portion of U.S. Federal income tax that is imposed on net foreign source income determined under U.S. tax law.
- In order to prevent U.S. taxpayers from cross-crediting high foreign tax on business income against the U.S. tax on other items of income and gain from foreign sources, Code §904(d) categorizes income and foreign taxes into several baskets. The U.S. Federal income tax on income in a particular basket can be reduced only by foreign income taxes imposed on the income in that basket. As a result, foreign taxes in one basket cannot be used to offset U.S. Federal income tax on income in another basket. Where a taxpayer reports foreign income in more than one category, the foreign taxes must be allocated among the baskets.[22] After 2017, five foreign tax credit baskets exist: (i) general, (ii) passive, (iii) foreign branch, (iv) G.I.L.T.I., and (v) income resourced under a provision of an income tax treaty.
- If a taxpayer reports foreign source expenses in one basket in excess of the income in that basket, the net loss is called Separate Limitation Loss

[21] Code §469(g)(1).

[22] This is done by multiplying the foreign income tax related to more than one category by a fraction. The numerator of the fraction is the net income taxed by the foreign country in the relevant foreign tax credit basket. The denominator is the total net income taxed by the foreign country.

(“S.L.L.”).[23] An S.L.L. can be transferred to reduce the net income in one or more other baskets. Where an S.L.L. in one basket is transferred under this rule in a particular year, adjustments to the foreign tax credit baskets are required in subsequent years to reverse the effect of the transfer of losses. Income in subsequent years in the original loss basket is re-categorized as income in the basket to which the losses were transferred previously.[24] A re-characterization affects only the income in the basket, not the foreign taxes paid on the income in the basket.[25]

For example, if a passive category S.L.L. offsets income in the general category, then future passive category income will be re-characterized as general category income in subsequent years until the prior loss is fully recaptured.

In view of the last limitation discussed above, Mr. A will be eligible to reduce the gain from the sale of shares of S Co treated as a sale of business assets for U.S. purposes by the full amount of unused losses of $2 million if the gain and the loss fall under the same foreign tax credit category. If it is determined that the gain and the loss belong to different foreign tax credit categories, Mr. A can still offset the gain by the amount of full losses, however, it will result in the creation of an S.L.L. under the relevant foreign tax credit basket.

Prior to 2018, there were only two foreign tax credit categories for foreign tax credit purposes, general and passive. The 2017 Tax Cuts and Jobs Act introduced, *inter alia*, a new category, called the foreign branch category. Therefore, separate discussions are required to understand the category in which the losses in the Resort V business fall pre-2018 and post-2017.

Pre-2018: In the Absence of an Election Made by Mr. A, the Unused Passive Losses from the Resort V Business Incurred Through the End of 2017 are Attributable to General Category for Foreign Tax Credit Purposes

The 2017 U.S. Federal income tax return of Mr. A reported unused passive losses of $1.8 Million. The Resort V business is an active business for foreign tax credit purposes. Consequently, income, gains, losses, and foreign taxes should be reported in the general basket. It is of no consequence that for purposes of preventing Mr. A from deducting the losses from the Resort V business, the losses arise from a passive activity. In the absence of any election by Mr. A, the loss of $1.8 Million incurred through the end of 2017 can be used to offset any income earned in 2018 and subsequent years under the general category.

The gain from the sale of the shares of S Co treated as the sale of business assets will be reported in the general foreign tax credit basket.[26] Therefore, since the pre-2018 unused loss of $1.8 Million and the gain from the sale of the Resort V business fall under the same foreign tax credit basket, Mr. A will be eligible to reduce income and long-term capital gain in that foreign tax credit basket by the amount of unused losses. In other words, Mr. A will not be liable to pay any tax in the U.S. on the gain from the sale of the Resort V business to the extent of the unused losses as report-

[23] Treas. Reg. §1.904(f)-7(b)(3).

[24] Code §904(f)(5).

[25] Code §904(f)(5)(C); Treas. Reg. § 1.904(f)-8(b).

[26] Reg. §1.904-4(f)(2)(iv)(A).

ed on December 31, 2017.

If, for any reason, it is determined that the gain from the sale of the S Co should be reported in the foreign branch foreign tax credit basket, Mr. A may elect to treat the net operating loss carryforward ($1.8 Million) under the foreign branch foreign tax credit basket so that the losses reduce taxable gain in the foreign branch basket.[27]

Post-2017: The Loss Incurred from the Operations of Resort V in 2018 and Following Years up to the Date of Sale will be Reported in the Foreign Branch Foreign Tax Credit Basket

As mentioned above, the 2017 Tax Cuts and Jobs Act introduced a new foreign tax credit basket effective Jan 1, 2018, namely, foreign branch foreign tax credit basket. Therefore, a determination should be made as to whether the loss from the operations of the Resort V business in post-2017 years continues to fall under the general foreign tax credit basket or under the new foreign branch foreign tax credit basket.

In general, if income or loss qualifies as foreign branch income, the income or loss is reported in the foreign branch basket for foreign tax credit purposes. Foreign branch income includes income attributable to a foreign branch of a U.S. person held directly or indirectly through disregarded entities.[28] A foreign branch means a Q.B.U., or qualified business unit, that is a separate and clearly identified unit of a trade or business located in a foreign country for which the taxpayer maintains separate books and records.[29]

Resort V is indirectly owned by Mr. A through S Co which is a disregarded entity for U.S. tax purposes. Resort V is a separate and clearly identified unit that conducts a hospitality business in Spain. It also maintains separate books of accounts that record transactions and business income and losses on a regular basis. Therefore, it qualifies as a Q.B.U. Accordingly, any income or loss from the operations of Resort V will be treated as a foreign branch income for foreign tax credit purposes. Therefore, the losses in 2018 through the date of the sale will fall under the foreign branch category for foreign tax credit purposes.

The balance of the gain after setting off the unused net losses of $1.8 Million as on December 31, 2017, can be further reduced by the losses accumulated in 2018 and 2019 and incurred up until a day prior to the sale of shares of S Co in 2020. However, as discussed above, a cross basket offsetting of losses, results in the creation of an S.L.L. Since post-2017 losses fall under the new foreign branch foreign tax credit basket and the gain fall under the general category foreign tax credit basket, the offsetting of the loss will result in the creation of an S.L.L. account in the foreign branch basket with respect to general category basket.

For ease of understanding, let's assume that the accumulated losses incurred in the Resort V business for 2018 through a day prior to the sale of the shares of S Co is $500,000. In such case, a reduction of the gain by $500,000, will result in the creation of an S.L.L. account in foreign branch foreign tax credit basket with respect to general category foreign tax credit basket. As a result, any future income earned by Mr. A in the foreign branch category to the extent of $500,000 should be

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27 Treas. Reg. 1.904(f)-12(j)(4).

28 Treas. Reg. §1.904-4(f)(1)(i)(A).

29 Code §904(d)(2)(J); and Treas. Reg. § 1.989(a)-1(b)(2)(ii).

re-characterized as general category income for foreign tax credit purposes.

As mentioned above, only income is recharacterized. Foreign taxes on the income are not recharacterized.[30] Therefore, while any future income earned by Mr. A that qualifies as foreign branch basket income will be recharacterized as income under the general basket to the extent of $500,000, it will not recharacterize the foreign taxes paid on the foreign branch income into the general basket. Because foreign taxes in one basket cannot be used to offset U.S. tax on income in another basket, Mr. A will not be eligible to offset the U.S. tax on the recharacterized general category income by the foreign taxes that fall under the foreign branch basket that are paid on the recharacterized general category income.

When the rule is looked at one way, this will result in double taxation of the same income in the future. When the rule is looked at another way, this rule simply reverses the use of cross basket losses that reduced U.S. income and taxes for the year of the sale. If no foreign branch income is earned by Mr. A in the future, the S.L.L. account in the foreign branch category with respect to the general category will remain suspended until the full amount of loss is recaptured. On the other hand, if Mr. A derives highly taxed foreign source income in the general basket and low-tax income in the branch basket in future years, the transfer of income from the branch basket to the general basket may provide a benefit.

Eligibility of Mr. A to Claim a Credit for the Spanish Taxes Paid on the Gain from the Sale of Shares of S Co Against his U.S. Federal Income Tax Liability Arising from the Same Income

When computing the amount of tax that must be paid to the U.S. on an individual's worldwide income, a taxpayer is entitled to reduce the taxes owed to the U.S. by a credit for income taxes paid to a foreign government. However, the foreign tax credit can reduce only the portion of the U.S. income tax liability that is imposed on net foreign source income, as computed under U.S. Federal income tax concepts.

Let's assume Mr. A is subject to a Spanish income tax of 19% on the gain arising from the sale of shares of S Co. Mr. A will be able to reduce only the portion of his U.S. tax on the income and gain that is properly characterized as foreign source income. In principle, because most, if not all, of the gain and depreciation recapture will be treated as foreign source income (discussed above), most, if not all, of the U.S. income tax can be offset by Spanish income taxes paid. In practice, there will be some slippage. Also, to the extent the U.S. tax rate for long-term capital gains (20%) is higher than the Spanish tax rate (19%), a portion of the U.S. tax will exceed the Spanish tax, assuming income and gain are computed alike in Spain and the U.S. In addition, no foreign tax credit is allowed to reduce Net Investment Income Tax. Hence, the full 3.8% tax will be owed in the U.S.

In Case of the Gain from a Disposition of an Asset that would Otherwise be Treated as Foreign Source Gain or Income, a Taxpayer is Required to Re-Source the Foreign Source Gain to U.S. Source to the Extent of the Overall Foreign Loss Account

If a taxpayer consistently reports foreign source expenses in excess of foreign source income on an aggregate basis for all foreign tax credit baskets, the taxpayer

[30] Code §904(f)(5)(C); Treas. Reg. § 1.904(f)-8(b).

will report what is commonly called an overall foreign loss ("O.F.L."). An O.F.L. is the excess of deductions allocated and apportioned to gross income and gain from all foreign sources over the amount of that gross income.[31] If a taxpayer has taxable income from U.S. sources for a year for which he incurs an O.F.L., he is entitled to reduce his U.S. taxable income by the amount of O.F.L. As a result, the taxpayer receives a benefit from the O.F.L. in so far as he is not liable to pay U.S. tax on U.S. source income to the extent of the O.F.L.

In the absence of a provision to the contrary, if in a subsequent year, he reports net foreign source income and pays foreign tax on that income, the tax payable to the U.S. can be reduced by the foreign tax credit. This results in is a second tax benefit. The O.F.L. rule is designed to prevent the second benefit. It does so by resourcing all or a portion of the foreign source income in subsequent years into U.S. source income for foreign tax credit purposes.[32] As a result, the portion of the U.S. tax that can be offset by a credit for foreign income taxes is automatically reduced. When the second benefit is reduced, the reduction is generally referred to as a recapture.

The recapture generally works as follows. For each year after an O.F.L. has reduced U.S. source income, a taxpayer must recapture the O.F.L. by treating a portion of foreign source income as domestic source income. The amount recaptured is equal to the lesser of the following:[33]

- 50% of taxable income from foreign sources
- The O.F.L. not recaptured in prior years

In addition, if a taxpayer recognizes foreign source gain in a separate foreign tax credit basket on the disposition of an asset that was predominantly used in a foreign trade or business, and a balance exists in the O.F.L. account after a recapture according to the above formula with regard to that basket, a portion of such balance is further recaptured by treating the foreign source gain as domestic income. Again, the amount recaptured is the lesser of

- 100% of the foreign source taxable income recognized on the disposition that has not been previously characterized, and
- the remaining balance in the O.F.L.

With regard to the sale of shares of S Co, it is treated as a disposition of all assets of Resort V (owing to the disregarded nature of S Co) predominantly used in a trade or business in Spain. Therefore, if some portion of the losses from the Resort V business reduced Mr. A's U.S. source income in years prior to the year of sale, the O.F.L. provisions will apply, and he will be required to recapture some portion of the gain from the sale of shares of S Co as U.S. source income.

The losses in Spain arising from the Resort V business were properly treated as passive activity losses. Therefore, as discussed above, they could only be used in prior years to reduce passive activity income. To that extent, the Resort V losses, that were actually deducted to reduce U.S. passive activity income in prior years, will be recaptured as U.S. source income for purposes of computing the foreign tax

[31] Code §904(f)(2).

[32] Code § 904(f)(5)(A).

[33] Code §904(f)(1)(B).

credit limitation. To the extent the passive activity losses were deferred, they will simply reduce the foreign source income in the appropriate foreign tax credit basket for 2020.

CONCLUSION

The provisions relating to passive activity loss, separate limitation loss, and overall foreign loss typically become relevant in businesses that have a long gestation period resulting from a substantial initial capital investment. Because of the capital-intensive nature of the hospitality industry, a business more likely than not reports losses in initial years due to depreciation expense and lower profits. In such fact pattern, tax practitioners should not ignore the application of the separate limitation and overall foreign loss rules because it not only affects the taxation in the year of disposition but also future years until the income is fully recaptured.

The best place to start the tax analysis of a disposition of a business is to review the U.S. tax return of the seller that will indicate the characterization of the foreign entity that owns the business (Form 8858, *Information Return of U.S. Persons With Respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs),* in the present case) whether the business activity is characterized as a passive activity for Code section 469 purposes, whether the business is loss making and therefore has accumulated losses, etc. The more you come to know on a review, the more you will realize how little you know.

"The more you come to know on a review, the more you will realize how little you know."

CANADA AND THE U.S. – TWO COUNTRIES, ONE BORDER, DIVERGENT RULES ON WEALTH TRANSFERS

Author
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Tags
Canada
Canadian Inheritance Planning
Capital Gains at Death
Departure Tax
Pipeline
P.U.C.

INTRODUCTION[1]

> *"ἅπανθ᾽ ὁ μακρὸς κἀναρίθμητος χρόνος φύει τ᾽ ἄδηλα καὶ φανέντα κρύπτεται. . . κοὐκ ἔστ᾽ ἄελπτον οὐδέν[.]"*
>
> – Sophocles, *Aias*[2]
>
> *"[Darling,] it's a Mr. Death or something [at the door] – he's come about the. . . reaping? I'm not sure we need any of that…"*
>
> – Monty Python, *The Meaning of Life* (1983)

Like a handful of industrialized countries,[3] Canada has no estate or inheritance tax, but the adage about death and taxes being inevitable is just as true as true for Canada as for anywhere else since Canadian capital gains tax applies to all transfers, including a deemed disposition of all one's assets at death.

In a prior *Insights* article, we focused on the unpredictable U.S. tax consequences when foreign trusts acquire a U.S. beneficiary;[4] we now look at U.S. income and estate tax implications of a common Canadian wealth transfer planning technique referred to as a pipeline. This article is designed to introduce readers to the structure in simple terms, including the inside/outside basis disparity created for heirs who acquire corporate stock from a Canadian decedent, and how the pipeline strategy ensures that a post-death distribution to a shareholder does not attract further Canadian tax.

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1 The author thanks his colleagues, Henry Shew of Our Family Office Inc. in Toronto, as well as Nina Krauthamer and Stanley Ruchelman for their helpful comments and suggestions.

2 The quote by Ajax, the hero of the Trojan war in a play by Sophocles first performed in ca. 442 B.C., means that time brings all things out of darkness and buries them again, and so there is nothing that humans should not expect.

3 *E.g.*, Australia, New Zealand, Estonia, Mexico, Hong Kong/Macau, Singapore, Luxembourg, Norway, Portugal, Serbia, Slovakia, Sweden, Israel. All references to the "Code" and the sections thereof are to the U.S. Internal Revenue Code of 1986, as amended, and to Treasury Regulations, or "Treas. Reg. §" to applicable sections of the regulations enacted thereunder; unless specifically referenced as Canadian currency (C$), figures referred to by "$" herein refer to U.S. dollars.

4 See Nina Krauthamer, "Help – My Exclusively Foreign Trust Now Has a U.S. Beneficiary! What Are the Issues a Trustee Will Now Face in 2020?" *Insights* Vol. 7, No. 3. This is an updated version of the same article previously published by the American Bar Association in 2013.

We begin with a review of the U.S. and Canadian taxes applicable at death, in addition to the U.S.-Canada Income Tax Treaty (the "Treaty") which covers both income and estate taxes.[5]

BACKGROUND OF U.S. AND CANADIAN TAXATION OF DEATH — WHO OWES WHAT, WHEN?

Except as otherwise explicitly provided, the rules and rates discussed are applicable to individuals.

U.S. Income Tax

The U.S. currently taxes the income of its citizens and residents at progressive rates up to 37% on worldwide income, plus net investment income tax of 3.8% on select categories of passive income.[6]

State income tax is imposed on top of Federal tax on a flat rate or a graduated rate, typically not exceeding 10%.[7] In comparison to Canada's provinces and territories, which have a rule of convenience treating an individual as a full-year "factual resident" of the province where they reside on December 31 of a year,[8] an individual in the U.S. who moves from one state to another in the middle of the year is apt to be treated as a part-year resident in each of the states. Part-year tax returns will be filed in both states.

Nonresident, noncitizen ("N.R.N.C.") individuals are taxed only on U.S.-source fixed and determinable annual and periodic income[9] and effectively connected business income, which in certain circumstances may include foreign source income.[10]

As with individuals, U.S. estates must compute gross and net taxable income. For income tax purposes, an estate is domestic if it is not a foreign estate;[11] the Code provides that an estate is a foreign estate if its income is from sources outside the

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5 The Convention Between the United States of America and Canada With Respect to Taxes on Income and Capital. See art. XXIX B (Taxes Imposed by Reason of Death), added by art. 19 of Protocol III, dated March 17, 1995.

6 In 2022, for a single filer the 37% maximum rate applies only to taxable income over $539,900, and for a married couple filing a joint tax return, $647,850.

7 There are exceptions. California's income tax tops out at a rate of 12.3%. New Hampshire taxes dividends and interest, only. Approximately eight states have no income tax, while another eleven permit counties and cities to impose income taxes. For New York City residents, the combined Federal, State and City income tax burden can reach close to 60%. See Katherine Loughead, "State Individual Income Tax Rates and Brackets for 2021." Generally, double taxation is avoided where the same income is taxed by more than one state by claiming a tax credit in the state of residence. Where each of wo states claim that an individual is a resident of two states, there may be no remedy for double taxation of income derived from intangible property.

8 *"Your province or territory of residence . . ."*

9 Code §§861 and 871(a).

10 Code §§864(c)(4) and 871(b).

11 Code §7701(a)(30)(D).

United States not effectively connected with the conduct of a trade or business inside the United States.[12] The term "estate" is not statutorily defined.[13] Even if more than one will and multiple administrations are involved, the estate remains a unitary estate and must either be domestic or foreign, so cannot be both;[14] in addition, when the decedent is N.R.N.C. and the estate contains significant U.S. assets, determining whether it is domestic or a foreign may require careful analysis of the extent and duration of the U.S. administrator's duties.[15]

Three major aspects to consider relate to

- where the assets are located,
- the country in which the domiciliary administration is located, and
- the nationality and residency of the personal representative.[16]

In determining its net taxable income, a U.S. estate may claim a deduction for current distributions to beneficiaries,[17] who must pay tax on the income and gains embedded in the distribution as if received directly from the source, rather than through the trust.[18] If the estate is foreign and all income is from foreign sources, U.S. beneficiaries may owe no tax on distributions, depending on whether the distributions are out of what is referred to as "distributable net income," and the timing thereof.[19]

Typically, property distributions from an estate are free of income or inheritances taxes, although they must be reported if in excess of $100,000 from any single source that is not a U.S. person.[20] A special form is used, which is filed with the I.R.S. center in Ogden, Utah.[21] A U.S. recipient can face severe penalties if the inheritance is not timely reported or properly reported.[22]

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12 Code §7701(a)(31)(A).

13 In *Commr. v. Beebe,* the First Circuit Court of Appeals has defined it as "property of all kinds held, under the provisions of the will, by any legal representative appointed by the probate court, by whatever name he may be called, whose duty it is to keep safely such property, and finally to distribute it under the direction of the probate court[.]" 67 F.2d 662, 664 (1st Cir. 1933), aff'g 26 B.T.A. 190 (1932), nonacq., XI-2 C.B. 11.

14 See Rev. Rul. 64-307, 1964-2 C.B. 163 (involving two wills in two separate countries).

15 Rev. Rul. 62-154, 1962-2 C.B. 148, concluding that principles devised for "determining whether a trust is domestic or foreign, resident or nonresident, have equal application to questions concerning alienage and residence of estates[.]"

16 Nationality of the decedent and beneficiaries is not determinative. See Rev. Rul. 81-112, 1981-1 C.B. 598.

17 Code §661.

18 Code §662. Net investment income tax of 3.8% may also be applicable under Treas. Reg. §1.1411-3(e)(3)(ii).

19 Cf. Code §§643(a) & 662.

20 Code §6039F.

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

22 The penalty is imposed at the rate of 5% per month of the unreported amount and is capped at 25%.

Qualifying long-term capital gain arising with respect to stock of a foreign corporation owned for longer than one year may be eligible for a reduced Federal income rate of tax that does not exceed 20%. The reduced rate may also apply to qualified dividends paid out of the corporation's earnings and profits.[23]

U.S. Gift & Estate Tax

U.S. Federal gift and estate taxes are excise or transfer taxes imposed on the fair value of transferred property, starting at 18% and swiftly rising to 40%. For U.S. citizens and domiciled individuals, the gross estate is reduced for administration and funeral expenses, claims against the estate, and certain unpaid mortgages on property included in the estate.[24] Tentative tax is computed at highly graduated rates,[25] but a unified credit is allowed, which is designed to offset tax on a lifetime exemption amount.[26] It applies against both estate and gift taxes and is adjusted each year to reflect inflation. The credit currently applies to the tax on amounts up to $12.06 million. Because the benefit is in the form of a credit rather than a deduction, the maximum rate of 40% applies to all amounts given away during life and at death once the credit has been fully utilized. The average rate of tax payable by U.S. estates in recent years after the credit and all deductions are factored in may be close to 17%.[27] In recent years, just over one half of one percent of U.S. decedents' death results in a taxable estate tax return being filed, and the Federal government collects less than 1% of its gross tax receipts from Federal excise taxes.[28]

The estate of an N.R.N.C. decedent enjoys a credit against the estate tax, but it is limited to the estate tax on $60,000,[29] except as provided by treaty.[30] No credit is allowed to reduce gift tax. While the estate of an N.R.N.C. individual is entitled to reduce the estate tax base for the claims and expenses listed above, direct tracing is not allowed. Rather, all assets and all claims and expenses must be reported on a global basis in a U.S. estate tax return. Only a proportional amount of global claims and expenses are allowed, reflecting the U.S. portion of the value of global assets.[31] Moreover, the deduction is allowed only if the executor files a true and accurate U.S. estate tax return[32] that specifies global assets, global values, and

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23 Code §1(h)(11). The foreign corporation must be eligible for benefits under an income tax treaty with the U.S. including information-exchange program, or its shares must be readily tradable on an established securities market in the U.S.

24 Code §2053.

25 The first $1,000,000 of taxable value taxed at graduated rates totaling in $345,800. Additional taxable value is taxed at a flat 40% rate.

26 Code §2010.

27 According to the Americans for Tax Fairness, citing the Tax Policy Center of the Urban Institute & Brookings Institution.

28 See Joint Committee on Taxation, *History, Present Law, and Analysis of the Federal Wealth Transfer Tax System* (JCX-52-15), March 16, 2015, at pp. 25, 28, available at www.jct.gov. In 1940, the percentage of total receipts was 5.4%.

29 Code §2102.

30 See, for example, paragraph 2 of Article XXIXB (Taxes Imposed by Reason of Death) of the Treaty.

31 Code §2106(b).

32 Form 706-NA, *United States Estate (and Generation-Skipping Transfer) Tax Return.*

global expenses, thereby allowing the I.R.S. an opportunity to verify the percentage of global expenses claimed.

Interspousal gifts and bequests to a U.S. citizen spouse benefit from a 100% marital deduction, meaning they are exempt from Federal transfer tax, and the couple enjoys a combined credit of $24.12 million as of 2022.[33] The combined credit will increase with inflation. No gift tax marital deduction is allowed if the donee spouse is not a U.S. citizen. However, this is somewhat offset by the expanded annual exclusion, discussed below.

U.S. transfer taxes apply as follows:

- For donors who are N.R.N.C. individuals, U.S. gift tax applies only to transfers of U.S. situs real property and tangible personal property. Excluded are gifts of intangible property such as shares in U.S. corporations.
- For decedents who are N.R.N.C. individuals at death, U.S. estate tax applies to the extent it includes U.S. situs real property and tangible personal property, plus U.S. situs intangible property, which is not statutorily defined but includes shares in a U.S. corporation. Excluded are items of portfolio debt,[34] short-term original issue discount ("O.I.D.") obligations,[35] U.S. bank accounts not connected with a trade or business, life insurance policies owned by the N.R.N.C. individual,[36] U.S. Treasury securities, and U.S. government agency securities.[37]
- For U.S. donors and decedents, all gifts and bequests are subject to gift or estate tax, and benefit from the unified credit.

An exclusion from gift tax applies to all donors for the first $16,000 given to each separate recipient, each per year.[38] The amount is indexed for inflation. Spouses may elect to jointly split gifts even if made from the funds of just one of the spouses.[39]

In comparison to the objective residency test applicable for determining individuals' U.S. income tax liability,[40] or the multiple considerations discussed earlier which are factored into the decision as to whether an estate is domestic or foreign for Federal income tax purposes, the test of residency applicable for U.S. gift and estate tax is domicile – a squishy, court-made test that looks to one's permanent abode, where one intends to return when one is away.[41] While a N.R.N.C. decedent's estate

[33] Gifts to a N.R.N.C. spouse benefit from a much smaller exemption of just $164,000 (on top of the $16,000 exclusion applicable to gifts to all recipients). Amounts are indexed for inflation and applicable for 2022.

[34] Debt of a domestic obligor in which the N.R.N.C. creditor owns greater than 10% equity interests does not qualify as items of portfolio debt.

[35] Code §2105(b)(4).

[36] Code §2105(a).

[37] Code §2105(b).

[38] Indexed for inflation amount under Code §2503(b) applicable for 2022.

[39] Code §2513.

[40] For income tax purposes, a non-citizen individual is a resident if green card test or the substantial presence test is met. Both are objective tests. Code §7701(b).

[41] Code §2001(a); Treas. Reg. §20.0-1(b).

generally includes the same items as those of a U.S. domiciliary, only U.S. situs real and tangible property are included in the U.S. taxable estate.[42]

When property is transferred by gift, the U.S. tax basis of property in the hands of a donee is generally a carryover of the donor's basis.[43] When property is inherited, the U.S. tax basis generally equal to its fair market value on the date of decedent's death.[44]

Except for assets disposed of by the estate, which are valued using their disposition price, the Code permits the estate's representative to irrevocably elect to value the assets and compute tax based on their value six months after decedent's death.[45]

A special inheritance tax is imposed on a U.S. recipient of a gift or bequest from a covered expatriate meaning an individual who is no longer a U.S. citizen or a long-term permanent resident.[46]

The trio of tax regimes is completed by the generation-skipping transfer tax ("G.S.T."), beyond the scope of this article, applicable when a transferor seeks to avoid gift or estate tax by skipping generations.

"Canada does not have an estate or gift tax. However, gifts and bequests of certain appreciated capital property trigger a deemed disposition of the property for its fair market value, giving rise to capital gain to the donor in the case of a gift or the decedent if the property is held until the end of life."

Canada Income Tax

Canada does not have an estate or gift tax. However, gifts and bequests of certain appreciated capital property trigger a deemed disposition of the property for its fair market value, giving rise to capital gain to the donor in the case of a gift or the decedent if the property is held until the end of life. Canada taxes resident individuals on worldwide income at progressive rates that top out between 48% to 54%, depending on the province.[47] Nonresidents are subject to tax at identical rates on Canadian source income, which includes gain from the disposition of Canadian real property.

For Canadian income tax purposes, only one-half of net capital gain is included in taxable income. If the disposition results in a loss, the net capital loss can be carried back three years and forward indefinitely. Thus, for capital assets, the deemed disposition at death usually gives rise to taxable gain on one-half of the amount of gain recognized.

Rollover treatment is provided, however, for capital assets transferred to a spouse by gift or bequest. A special incentive applicable to "qualified property" also exempts up to C$913,630 of cumulative lifetime capital gains from taxable income.[48] Because a nonresident is taxed on disposition of Canadian-situs real property, and because rollover treatment is inapplicable unless both spouses are Canadian resident at the

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42 Code §2103. See Treas. Reg. §20.2104-1(a)(1) & (2).

43 Code §1015(a).

44 Code §1014(a)(1).

45 Code §2032(a).

46 Code §2801.

47 The highest Federal tax rate is 33% and applies to taxable income over C$216,511 (in 2022). Provincial income taxes also apply based progressive rate structures of their own.

48 Indexed-for-inflation figure applicable in 2022. An exemption from deemed disposition treatment also applies to the sale of a principal residence.

time of decedent's death, the deemed disposition of such real property will give rise to tax.[49] Where a deemed disposition triggers tax the asset is acquired with basis stepped up to its fair market value thereafter.

Residency for Canadian tax is established under either of two alternative tests:

- The first is based on a common-law concept of residence, which looks to primary ties, such as having a home available, close family members living in Canada, and spending significant time in Canada, and secondary ties, such as club memberships and hobbies. It also considers ties to other countries. This test can be thought of as a center-of-vital interest test.
- The second is an objective test known as "the sojourning rule," similar to the U.S. substantial presence test, which asks whether the individual spent 183 days in Canada during the calendar year.

Canadian-resident recipients of a bequest generally have no taxable income and owe no tax upon receipt of the assets from the estate; however, if the assets are shares of a corporation, Canadian tax law principles treat the distribution of assets from the corporation as a further taxable event.

While the disposition technically occurs the instant before the property leaves the estate's hands, the tax reduces the value of the assets received by the beneficiaries. Generally, capital assets, such as shares of a corporation, already have been taxed on the date of death and the basis has been stepped up. As a result, there likely is no further appreciation to be taxed. However, a subsequent distribution of the assets may crystallize additional appreciation, which will be taxed. Nonetheless, the additional gain does not apply on distributions to Canadian resident beneficiaries. Instead, the law provides rollover treatment,[50] and the appreciation is preserved for future tax in their hands. Favorable rollover treatment does not extend to a nonresident beneficiary.[51] As a result, the estate is required to compute and withhold tax on the portion of any appreciation belonging to a nonresident beneficiary.

While not dealt with at length in this article, it's good to keep in mind that Canada imposes a departure tax, also involving the deemed disposition of certain categories of assets, when individuals give up Canadian tax residence. Also, to be kept in mind, some provinces impose prohibitive probate taxes, computed on gross estate value.

TREATY

As with all U.S. treaties, the Saving Clause preserves the right of the U.S. to tax U.S. citizens and residents determined under the Treaty as if the Treaty were not in effect. The Saving Clause typically is subject to certain exceptions, and a common exception relates to the foreign tax credit.

In the case of a U.S. citizen who is resident in Canada, the Treaty permits the estate of the deceased individual to claim a credit against U.S. estate tax for Canadian

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49 See AGtax, (Feb. 12, 2014).

50 Subsection 107(2) of the Canadian Income Tax Act.

51 Subsection 107(2.1) of the Canadian Income Tax Act.

capital gains tax at death.[52] In each case, provincial death duties and probate taxes should be considered carefully.[53] Even where the U.S. or Canada might allow a credit under the Treaty for such taxes, states and provinces generally would not follow the national treatment.

For individuals whose domicile lies in Canada, the following provisions may be extremely valuable:

- A direct transfer to a surviving spouse is eligible for a full marital deduction in the U.S., even if the recipient is not a U.S. citizen, provided a spouse would have been eligible for the credit under U.S. domestic law[54]

- A Canadian decedent with a U.S. taxable estate, because, for example, he owned a condominium unit in Florida or New York, is permitted the benefit of a unified credit against the estate tax on his U.S. property. For this purpose, the amount of the unified credit is prorated based to match the portion of the value of the decedent's global assets that comprised of U.S. situs assets[55]

To illustrate, suppose a Canadian decedent owns a New York City apartment worth \$3 million and Canadian assets worth U.S.D.\$9 million after conversion of non-U.S. assets from Canadian dollars to U.S. dollars. Assuming no lifetime gifts have been made involving U.S. real property or U.S. situs tangible personal property, the *pro rata* U.S. unified credit is computed as:

$$\frac{\$3{,}000{,}000}{\$12{,}000{,}000} \times \begin{array}{c}\text{credit on}\\ \$12{,}060{,}000\end{array} = \begin{array}{c}\text{credit on}\\ \$3{,}015{,}000\end{array}$$

Here, there should be enough available unified credit to cover 100% of the U.S. estate tax imposed on the New York City apartment. Absent an extension, Federal Form 706-NA, *United States Estate (and Generation-Skipping Transfer) Tax Return Estate of Nonresident not a Citizen of the United States*[56] must also be filed within nine months of death where the value of U.S. situs assets exceeds \$60,000, a triggering amount that is unaffected by the Treaty.

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52 See Code §2014, which in determining the allowable credit for foreign death taxes contains a proration approach similar to that used here.

53 Treaty, art. XXIV(7) states that income taxes paid or accrued to a Contracting State includes taxes owing to political subdivision if imposed in a manner that is not inconsistent with the provisions of the Convention and substantially similar to the Federal taxes addressed by the Convention. This rule matches U.S. domestic law which allows a foreign tax credit for income taxes imposed by a foreign country and its subdivisions. Treas. Reg. §1.901-2(g)(2) prior to March 7, 2022, and §1.901-2(g)(1) beginning as of March 7, 2022.

54 Treaty, art. XXIX B(3) & (4). The election made by executor filing a U.S. Federal estate tax return and irrevocably waiving the benefit of the domestic marital deduction, provided in addition that (a) the property passes to the surviving spouse within the meaning of U.S. domestic law, and would have qualified for marital deduction if the surviving spouse was a U.S. citizen, (b) the decedent was a resident of either the U.S. or Canada, or a citizen of the U.S. at death, (c) the surviving spouse is a resident of either the U.S. or Canada at the time of decedent's death, and (d) if both were U.S. residents on the date of decedent's death, at least one was a citizen of Canada.

55 Treaty art. XXIX B(2)(a) & (b).

56 United States Estate (and Generation-Skipping Transfer) Tax Return Estate of Nonresident not a Citizen of the United States.

The benefit of the Treaty is limited to U.S. estate tax imposed on transfers at death. It does not apply to lifetime gifts made while a Canadian tax resident who is not a U.S. citizen is resident in Canada.

In the example above, estate taxes imposed by states must not be ignored. In the above example, estate tax exposure may exist in New York State. State estate tax applies at graduated rates of up to 16% to resident decedents. The tax also applies to nonresidents holding New York situs real property and tangible personal property. However, the estate tax base looks only to New York State situs property.

If the decedent holds property not in excess of a basic exclusion amount, currently set at $6.11 million,[57] no estate tax is due. However, if the basic exemption is exceeded by 5% or more, the exclusion is completely eliminated.

Other Income – Article XXII

When a Canadian estate distributes appreciated capital property to a U.S. heir, the distribution is a deemed disposition. Under paragraph 1 of Article XII (Other Income) of the Treaty, both Canada and the U.S. may tax the other income when the taxpayer is a resident on one country and the income arises in the other country. When the income takes the form of a distribution by a trust or estate in one country (Canada) that is made to a resident of the other country (the U.S.), the tax in the source country (Canada) is capped at 15% of the gross amount paid. Because the taxable portion of the capital gain is reduced by 50%, the Canadian effective tax rate is 7.5%.

Other Matters

Although the Treaty addresses double taxation of cross border income through the allowance of a foreign tax credit, an individual departing Canada likely will face departure tax on certain categories of property. At that point, double taxation will not be incurred because a tax event exists only in Canada. In future years, the same asset may be sold while the individual is a resident of another country. Unless the other country allows the individual a step-up in basis for the property, the very same gain may be taxed a second time. Worse, the Canadian tax will have been paid prior to the establishment of tax residence in the new country. Consequently, it would not be surprising for tax authorities in the new country to assert that the Canadian departure tax paid prior to arrival is not available to provide relief.

In the context of a U.S. citizen who is a Canadian resident who returns to the U.S., the Treaty allows the individual to elect to treat the departure from Canada as a disposition for U.S. tax purposes. This accelerates the taxable event in the U.S. to the tax period in Canada. As a result, the individual will compute gain, source the gain in Canada, compute U.S. tax, claim a foreign tax credit for the Canadian tax paid, and obtain a step-up in basis when the asset is actually sold in a later year.[58]

Although the Treaty does not apply to gift tax, if a Canadian donor makes a gift to a U.S. tax resident, the same election apparently can be made, to treat a Canadian

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57 Indexed for inflation amount applicable in 2022.

58 Treaty, art. XIII(7), added by Protocol IV, Sept. 21, 2007.

deemed disposition as a U.S. disposition (no U.S. tax due), so the donee can acquire the gift with basis stepped up to its fair market value.[59]

If payments or income items associated with a treaty claim exceed $100,000 and a U.S. Federal income tax return for the year in question is filed, then Form 8833, *Treaty-Based Return Position Disclosure* may be required to be attached.[60]

CANADIAN POST-MORTEM TAX PLANNING

Post-mortem Canadian tax planning relating to inheritance of shares in Canadian closely held corporations focuses on addressing an unintended glitch when a death triggers a deemed disposition of corporate shares (and step-up in basis at the level of the shareholder) in Canada but there is not a corresponding event inside the corporation permitting heirs to receive distributions free of Canadian income tax. The missing piece of the puzzle is referred to as paid-up capital ("P.U.C."). As a result, when subsequent distributions are received on the shares held by the heirs they will be fully taxed as a dividend (ordinary income) in their hands.

The pipeline addresses the P.U.C. deficiency through the issuance of a promissory note, which allows shareholders (or the estate) to receive the underlying asset without paying an additional level of tax. It is one of two techniques devised to address a problem that Canadian practitioners understand as an inside/outside basis disparity issue. The other technique, referred to as a subsection 164(6) loss carryback,[61] eliminates the decedent's share-level tax. It requires Can-Co to redeem high-basis shares, generating a loss which is carried back to the decedent's terminal tax return, erasing the capital gain that resulted in the increased basis to begin with. While Canada generally permits amended returns to be filed for a period of up to 10 years, a loss carryback must instead be claimed within one year.[62] Although either technique may be available with respect to the same entity, it generally would not make any sense to do both – each involves accepting tax at one level to avoid it at another; if within the one-year window to carryback, the adviser can assist in selecting the best approach to address the two-tier issue.

To understand how the pipeline addresses this inadvertent glitch, we review an example, involving a Canadian decedent, a U.S. heir ("A") and a Canadian heir ("B"), and the issuance of a promissory note to alleviate the P.U.C.-related problem.

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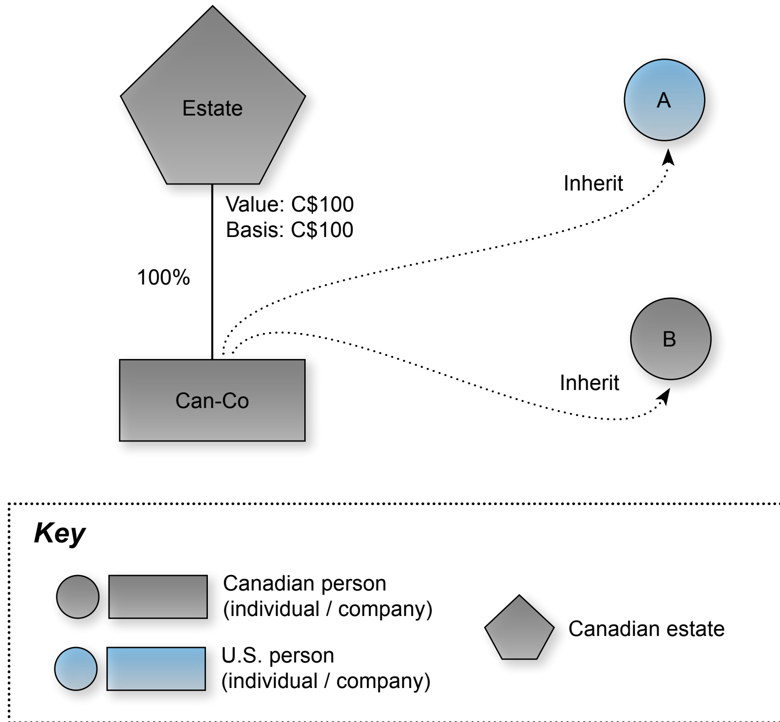
[59] See Department of the Treasury Technical Explanation of the Protocol, art. 8(3), dated July 10, 2008.

[60] Treas. Reg. §301.6114-1(a)(1) & (c)(2); in Canada there are a variety of forms which may be required, and which in each case should be checked with a Canadian practitioner.

[61] This refers to the Canadian Income Tax Act provision permitting the carryback. For a fuller description see Cadesky Tax, "Post Mortem Pipeline Transactions."

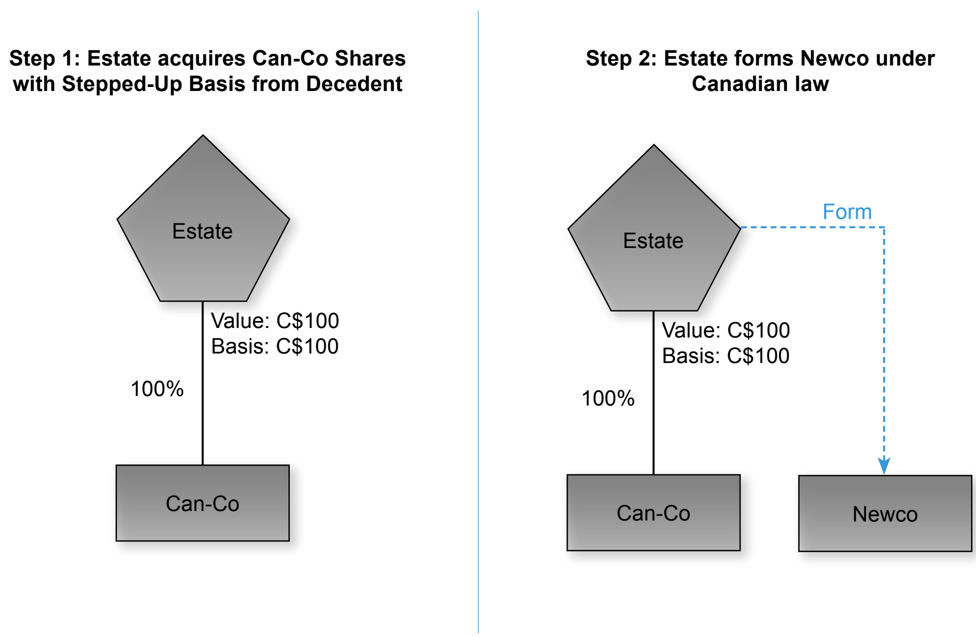
[62] This is not the same as the general three-year loss carryback rule. The condition to perform a subsection 164(6) transaction is that the estate (or the graduated rate estate) has to do the redemption within the first year of the estate's taxation year.

Figure 1 – No Planning

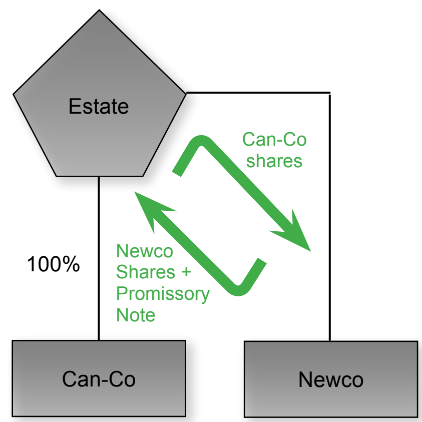


The pipeline is shown below.

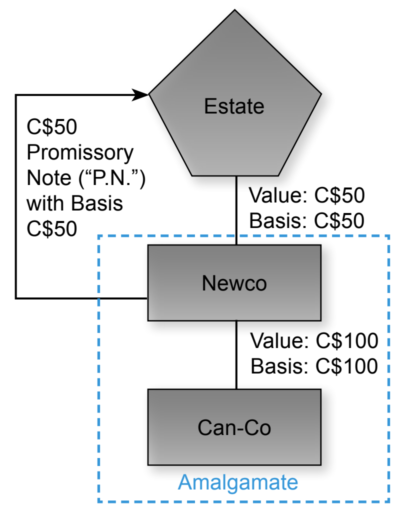
Figure 2 – How to Do a Pipeline in 6 Easy Steps…



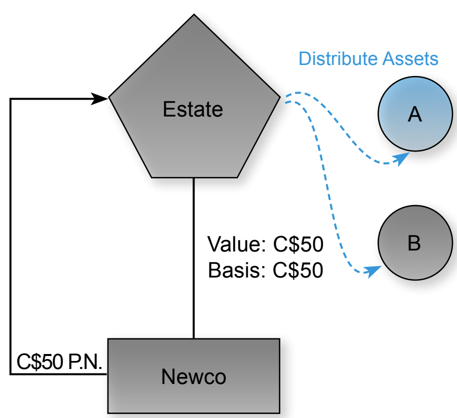
Step 3: Estate transfers Can-Co to Newco in Rollover Exchange for Consideration that is Part Stock and Part Promissory Note



Step 4: Can-Co and Newco are Amalgamated Under Canada Law

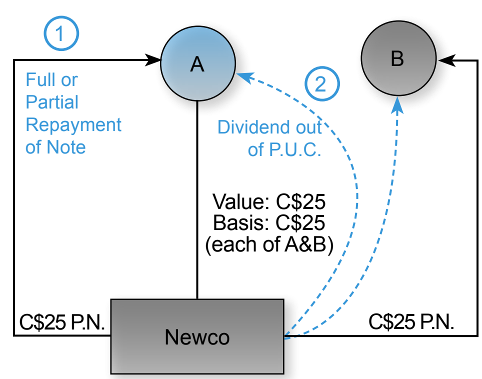


Step 5: Newco Distributes Assets to the Beneficiaries



** On or prior to the distribution, the promissory note can be reissued as two smaller notes*

Step 6: Ways for Beneficiaries to Receive Value from Newco (Mostly) Free of Further Canadian Tax: (1) Repayment of Note or (2) Distribution (if out of P.U.C.)



<u>The Fix Involves Doing the Following:</u>

1. The estate owns decedent's Can-Co's shares with basis equal to their fair market value.

2. The estate forms a new legal entity ("Newco") under Canadian law, which may be capitalized partly with debt and partly equity – here we assume 50/50.

3. Newco acquires all of Can-Co's outstanding shares from the estate in exchange for a promissory note with face value C$50 and its own common voting stock, which is treated as a partial tax-free rollover exchange.

4. Newco and Can-Co may be amalgamated under Canadian law; The basis of the amalgamated Newco remains at C$50 and Newco continues to owe the Estate a C$50 promissory note.[63]

5. The estate distributes both the note and shares to the heirs, A and B, without a taxable inclusion to the Canadians (B); no U.S. income or estate tax results to A. If as here, there are two beneficiaries, the C$50 promissory note must be issued as two smaller notes with a face value of C$25.

6. At the shareholders' option, Newco may repay its notes. The shares will continue to be in high basis, but with minimal P.U.C.[64]

TAX CONSEQUENCES FOR A U.S. HEIR

While the pipeline will help to address the Canadian two-tier tax problem, now that the heirs have received the stock, what other U.S. and Canadian tax rules should be kept in mind?

Receiving the bequest of Canadian corporate stock in the U.S. won't directly give rise to U.S. tax, however there are a number of considerations and caveats, some of which are listed below. And, apart from receiving the dividends paid by Newco, and considering the U.S. and Canadian tax rules applicable, there are U.S. anti-deferral tax regimes to consider – these may treat A, the U.S. heir, as owning a portion of Newco's stock from a date earlier than when the bequest is received, during the pendency of the Canadian estate. The anti-deferral regimes may not only require additional U.S. reporting by A to the I.R.S., but also give rise to actual income inclusions.

There are also U.S. reporting obligations at the time the stock is actually received by A, which can be prohibitive to get wrong.

A should keep in mind at a minimum the following rules.

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[63] An alternative variant of the pipeline transaction has Can-Co redeem stock generating distributable surplus, which ultimately may give rise to P.U.C.

[64] Canadian tax practitioners are generally aware of the potential risk that subsection 84(2) can apply to pipeline transactions. Essentially, subsection 84(2) may deem the tax-free nature of the repayment of the promissory note into deemed dividends. The Canada Revenue Agency has released administrative guidelines that allow pipeline transactions not to fall under subsection 84(2) as long as certain steps have taken place. These steps include running the operating business for at least one year, and only progressively repaying the promissory notes.

Canadian Tax

Estate Withholding on Subsequent Appreciation

While Canadian resident heirs are eligible for rollover treatment with respect to capital appreciation at the time the estate distributes the assets, A is not; thus, the estate is required to withhold from A's portion an amount sufficient to cover Canadian capital gain tax at a rate of 7.5%. Suppose Newco is initially worth C$50 on the date of death, and has appreciated by 20% by Step 5, then it is worth C$60, meaning C$10 of appreciation will be allocated 50/50 between A and B; A's 7.5% tax on C$5 will be C$0.375. Practically, it may be easiest for the U.S. beneficiary to provide a personal note to the estate and pay the C$0.375 once Newco makes any payment to A. Though, timing is of the essence because the withholding tax is due on the 15th of the following month of the distribution.

Income Tax Act, Subsection 212.1(6) Look-Thru Rule

Another lurking Canadian tax trap relates to a special provision of the Income Tax Act referred to as section 212.1, enacted to address certain cross-border "surplus stripping" transactions, whereby nonresident shareholders succeeded in extracting earnings from Canadian corporations in excess of P.U.C. without any Canadian tax. In its 2018 Budget, the Canadian government proposed a new look-through rule under subsection 212.1(6), which has the effect of attributing to any nonresident beneficiaries all activity of the estate during the administration period; through interaction with other provisions of the Income Tax Act, the result is that – in the facts above – if Newco's note (A's portion, worth C$25) exceeds A's P.U.C. (which would be essentially nil) such amount would be treated as an ordinary dividend out of Newco's earnings and profits to A, and A would be taxed; in this case, as A is American, the Treaty provides a beneficial 15% withholding rate rather than the maximum 40-49% domestic rate for non-eligible dividends.[65]

As it is understood that the Department of Finance is apprised of this unintended consequence and will not enforce the look-through rule for routine pipeline planning,[66] it is possible for A to avoid this problem, but it's strongly advisable to obtain a seasoned Canadian tax adviser's input before implementing the transaction to understand and confirm A's eligibility for the non-application relief.

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65 The rate varies depending on the province. Detailed explanation of this trap can be seen in Henry Shew, "Post Mortem Pipeline Fails For Non-Resident Beneficiaries," Canadian Tax Foundation (2019) 9:1 Canadian Tax Focus – Feb. 2019.

66 A number of letters have been written to the government to inform it that pipeline planning should be exempt from section 212.1(6)(1); while no Canadian tax rule has been promulgated in consequence of that correspondence, we understand that there is a general understanding among practitioners that the Canadian Revenue Agency ("C.R.A.") will not enforce the look-through rule for participants in a pipeline if the estate completes all distributions prior to three years after the decedent's death. See Brian Ernewein, "Cross-Border Surplus Stripping & Graduated Rate Estates" (stamped Dec. 2, 2019). See also description of Department of Finance's response in Henry Shew, "Finance Revives Post Mortem Pipeline For Non-Resident Beneficiaries," Canadian Tax Foundation (2020) 10:1 Canadian Tax Focus – Feb. 2020. A "graduated rate estate" refers to a Canadian estate that meets the three-year requirement aforementioned.

U.S. Tax

Anti-Deferral Regimes

Under the facts above, A ultimately acquired 50% of Newco; because the remaining 50% would be attributed to non-U.S. persons (B), Newco would not be a controlled foreign corporation ("C.F.C."), or one in which U.S. persons each owning at least 10% by vote or value, collectively own more than 50%. However, supposing A were fortunate enough to inherit a controlling stake from his generous Canadian uncle, A could walk into a very costly U.S. tax reporting problem. In such case, Newco would be a C.F.C. and would be subject to the anti-deferral regimes and reporting that is applicable to such entities known of as "Subpart F" and global intangible low-taxed income ("G.I.L.T.I.").

Here 50% ownership was not met, but if Newco earns at least 75% passive income or at least 50% of its assets are investments producing passive income, then it would be a passive foreign investment company ("P.F.I.C."), and A would be required to take certain inclusions into income.

The penalties for missing informational reporting can be prohibitive:

- Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, which each U.S. 10% owner in a C.F.C. is required to attach to their personal income tax return for every year in which there is at least a day of ownership, start at $10,000 per entity per year, accruing every 30 days up to a maximum of $60,000 per entity per year.[67]

- If Newco is characterized as a P.F.I.C. because A owns not more than 50%, Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund* would be required.[68]

- Form 8938, *Statement of Specified Foreign Financial Assets*, may be required unless the P.F.I.C. interests were reported on Form 8621.

More insidiously retroactive ownership to the date of death could apply for anti-deferral inclusion purposes and required U.S. tax reporting.[69] While applied routinely

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67 That's before considering missed anti-deferral income, for which penalties and interest could be applicable, including the penalty for substantial understatement, which applies if the taxpayer understates income by the greater of 10% of the amount required to be shown on the return, or $5,000.

68 There is no specific automatic monetary penalty for missing Form 8621, but penalties and income for a resulting understatement would remain applicable – and unless reasonable cause could be demonstrated A's failure to attach either Form 5471 or 8621 keeps the statute of limitations open on the entire tax return. Code §6501(c)(8).

69 See Code §§318(a)(2)(A) and 958(a)(2) ("stock owned, directly or indirectly, by or for a . . . foreign trust or foreign estate (within the meaning of section 7701(a)(31) shall be considered as being owned proportionately by its . . . beneficiaries."); Code §958(b)(2) provides that if the estate owns more than 50% of the combined voting power of all classes of stock entitled to vote, it shall be treated as owning 100%. See Treas. Reg. §1.958-1(d)(2), Ex. 3. In the case of foreign trusts, the I.R.S. may require stock to be attributed to U.S. beneficiaries using actuarial principles; the question is whether interests in a foreign estate can and should be submitted to a similar analysis.

to foreign trusts, the question is whether the I.R.S. would extend such rules to a foreign estate.

Acquisition Year Reporting

In any case, A must remember that in the first year in which she or he acquires at least 10% of Can-Co and/or Newco, A is required to report his or her interest in each of those entities on a Form 5471 as a "Category 3" filer.[70] In such case, assuming A's ownership is projected back to the date of death, A may also consider that no separate, indirect acquisition of C.F.C. occurred on the incorporation of Newco, as it may be viewed for U.S. income tax purposes as Can-Co's successor.[71]

U.S. Reporting of Foreign Bequest – Form 3520

In the year in which A actually receives Newco's stock, A is required to report the receipt of the bequest because it is valued more than $100,000. Congress has enacted a painful stick to urge compliance with this requirement under Code §6039F, which may be more costly than Canada's anti-surplus-stripping "look-through" rule – the penalty for failing to report foreign gifts or bequests on Form 3520 is 25% of the value of all property received. Such reporting is done using Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*, and must be mailed by the same date as A's regular income tax return for the year in which the bequest is received to the I.R.S. Ogden Service Center.[72]

Finally, once A has acquired Newco's stock, what happens next? Various considerations, including those relating to subsequent distributions by Newco, are addressed in the section below.

"On the Canadian side, while cross-border interest may be eligible for 0% withholding, dividends are withheld at rates of up to 15%; and under debt/equity and thin capitalization principles Newco's debt can be only safely increased up to a point."

WHAT HAPPENS AFTERWARD?

Ownership and Disposition of Newco

If Newco's income is subject to U.S. anti-deferral regimes, A may receive dividends out of "previously-taxed income" without further U.S. tax – keeping in mind that Canadian analysis of the same distributions is required. Interest will be taxed, but repayment of principal is not.

On the Canadian side, while cross-border interest may be eligible for 0% withholding, dividends are withheld at rates of up to 15%; and under debt/equity and thin capitalization principles Newco's debt can be only safely increased up to a point. Assuming A qualifies as a resident of the U.S. under the Treaty, A is entitled to be withheld at a rate of no more than 15% on dividends paid by Newco to the extent

70 For this purpose, special attribution rules must be considered, which compute one's ownership as including the interests of siblings; therefore, if B is A's non-resident brother or sister, each of A and B potentially could be treated as having first acquired 100% of Can-Co, and then later, of Newco.

71 Either under the court-made liquidation/reincorporation doctrine or by viewing the upstream non-insolvent amalgamation as a tax-free liquidation under Code §332 – *cf.* Treas. Reg. §1.332-2(d) and *Kansas Sand & Concrete, Inc. v. Commr.*, 462 F.2d 805 (10th Cir. 1972).

72 Both the promissory note and Newco stock are required to be reported, together with their respective fair market value on that date in Part IV (lines 54 and 56).

they represent distributions out of Newco's earnings; no withholding should apply if a distribution is made out of P.U.C. (which is understood to be minimal in this scenario), and if there is a sale of Newco's shares resulting in capital gain, as a U.S. resident under the Treaty A should not be subject to Canadian capital gains tax withholding.[73]

However, Canadian withholding rate on dividends falls to 5% under the Treaty if the recipient is a corporation in the other Contracting State owning 10% of the payor's voting stock.[74] Consequently, A may wish to consider setting up a wholly-owned U.S. corporation to acquire A's Newco interests ("Holdco"); Holdco would be eligible to make an S election and be treated as a flowthrough, avoiding a second layer of U.S. tax, and A will subsequently benefit from the 5% rate.[75] While A could simply accept the 15% rate and apply for a foreign tax credit for the full amount, a cashflow issue arises when A is withheld on by Canada but must wait till after year-end to apply for a U.S. foreign tax credit.[76] The S corporation significantly mitigates this problem.[77]

The S election is made by mailing or faxing Form 2553, *Election by a Small Business Corporation*, to the I.R.S. For a calendar year corporation if made by March 15 the S election may be effective retroactive to January 1.

In addition to attending to the State and local tax ramifications of the structure,[78] care should be taken with regard to Code §1374 built in gain upon acquisition of Newco's stock by Holdco, if there is appreciation after the date of death. Attention must also be paid to shareholder-level U.S. income tax costs arising on exit from the structure by A; if A bequeaths the property, in order for the heirs to acquire Newco with basis stepped up to its fair market value, prior action to liquidate Holdco is necessary.

Care should be taken if A sells or gifts the shares at a later date, if Newco's stock is

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73 Treaty art. XXII(4). This assumes that Newco is not a taxable Canadian property which would otherwise provide taxing rights to Canada. To obtain this benefit in Canada, A may have to provide Newco with a duly completed Form NR301 and Newco, as the payor, may be required to complete Form NR4.

74 If the distribution is neither a dividend or a tax-free return of capital out of P.U.C., *i.e.*, a capital gain for Canadian purposes, it should not be withheld on.

75 See Treaty, art. X(2)(a), as amended by arts. 2 & 5(1) of Protocol IV. In providing look-through rules at art. IV, paragraphs (6) and (7) for certain fiscally transparent entities including S corporations, the technical explanation indicates Canada will continue to allow benefits to S corporations under the Treaty in their own right. See also Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada, prepared by the Joint Committee on Taxation, July 10, 2008.

76 A applies for a foreign tax credit by attaching Form 1116, *Foreign Tax Credit (Individual, Estate, or Trust)* to her or his personal income tax return, generally for the year in which the dividend is received.

77 Generally, A would apply for a foreign tax credit for the 5% or 15% withholding tax by attaching Form 1116, *Foreign Tax Credit (Individual, Estate, or Trust)* to her or his personal income tax return. There is an irrevocable election to claim credits on the accrual basis by checking the "Accrued" box in Part II, which imparts on the taxpayer a duty to make certain adjustments later.

78 If A is resident in New York, for example, an S election may be made for New York State using Form CT-6, *Election by a Federal S Corporation to be Treated As a New York S Corporation*, but New York City does not recognize it.

taxable Canadian property.

Waiver of Inheritance

Suppose that after learning about all the above U.S. and Canadian tax consequences, A decides he has no interest in his Canadian uncle's generosity?

Canadian law permits a beneficiary to waive all rights to their inheritance. No filing is required, and the waiver is retroactive to the date of death provided the beneficiary has derived no benefits from the assets.[79] A witnessed written agreement signed by the beneficiary acknowledging the waiver may be advisable, though there is no prescribed form. A qualified disclaimer under U.S. tax law achieves a similar result – the beneficiary is treated as never having received property.

To qualify under the U.S. disclaimer provisions, A should scrupulously abide by the procedural steps outlined in the Code and Treasury Regulations.

The conditions for a qualified disclaimer are as follows:

- The refusal must be in writing.
- The written refusal must be received by the transferor of the interest, his legal representative, or the holder of the legal title to the property to which the interest relates not later than the date which is nine months after the later of
    - the day on which the transfer creating the interest in such person is made, and
    - the day on which such person attains age 21.
- The person that wishes to disclaim must not have accepted the interest or any of its benefits.
- As a result of such the refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either of the following persons:
    - The spouse of the decedent.
    - A person other than the person making the disclaimer.[80]

Once a witnessed Canadian letter or agreement has been executed in Canada, presumably after the uncle's death but before A has received a distribution,[81] a copy of the letter should be brought back to the U.S. and mailed to the Canadian executor

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79 See Hull & Hull LLP, "What Is A Disclaimer."

80 Code §2518(b); Treas. Reg. §25.2518-2(a).

81 There is some ambiguity as to whether the waiver may be made at any time before the terminal date or only within the nine-month window beginning on the date of death. Treatises sometimes refer to a "9-month window", but the law most likely should be applied literally. For a law school professor's very conservative opinion, see William Schwartz, "Effective Use of Disclaimers", B.C.L.. Rev. Vol. 19:3, Art. 7, discussing the changes introduced by the Tax Reform Act of 1976.

or administrator - creating an unambiguous document for both U.S. and Canadian purposes which shows that A has renounced all interests in the estate. The use of registered mail with proof of delivery is strongly recommended.[82]

In real life, the Canadian and cross-border implications of every case must be thoroughly evaluated with input from a seasoned practitioner because a pipeline's effectiveness is sensitive to the client's unique facts.

82 Caselaw indicates that the timely mailing rules of Code §7502 apply, meaning registered mail enables the sender to treat the postmark date as the delivery date, and hence also the date of the waiver. A scan of the mailed waiver, together with the certified mail slip, should be retained by A for future reference.

GOODWILL AND MISTER DONUT – A GOING CONCERN?

Authors
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Tags
Cost Sharing Agreement
Foreign Source Income
Franchising
Goodwill
Intangible Assets
Like-kind Exchange
Purchase Price Allocation
Section 367(d)
Section 865(d)
Section 1031
Section 1253
Transfer Pricing

INTRODUCTION

A sale of a business to a buyer often involves an element of goodwill, a term that can have different meanings in different contexts, depending on whether the term relates to (i) purchase price allocations for financial statement purposes or income tax purposes or (ii) attempting to compute the source of income for foreign tax credit purposes. Compounding the definitional inconsistency, the meaning of the term has changed over time.

The Merriam-Webster Dictionary defines goodwill in a non-business context as "a kind, helpful, or friendly feeling or attitude." In a business context, the term is given various definitions, including

- the amount of value that a company's good reputation adds to its overall value,
- the favor or advantage that a business has acquired especially through its brands and its good reputation,
- the value of projected earnings increases of a business especially as part of its purchase price, or
- the excess of the purchase price of a company over its book value which represents the value of goodwill as an intangible asset for accounting purposes.

This article examines the evolution of the international tax consequences of controlled and uncontrolled sales of goodwill by a U.S. corporation, and begins with a 1989 sale of a regional donut shop franchise business operated outside the U.S. to an uncontrolled Japanese buyer.

THE INTERNATIONAL MULTIFOODS CORPORATION CASE

Taxpayer's Franchising Business

International Multifoods Corporation v. Commr.[1] is a case that involves a U.S. corporation ("U.S. Co") that operated a donut store franchising business. It perfected a system that utilized franchisees to prepare and merchandise distinctive donuts, pastries, and other food products. The franchise agreements refer to this system as the "Mister Donut System," which entailed a unique and readily recognizable design, color scheme and layout for the premises wherein such business is conducted and for its furnishings, signs, emblems, trade names, trademarks, certification marks, and service marks.

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1 108 T.C. 25 (1997).

U.S. Co typically granted franchisees the right to open a fixed number of Mister Donut shops pursuant to established terms and conditions and at locations approved by U.S. Co. The franchise agreements provided that U.S. Co would not open or authorize others to open any Mister Donut shops in the franchisee's territory until the franchise agreement expired or was terminated, or unless the franchisee did not meet its development schedule by failing to open the requisite number of Mister Donut shops by the agreed-upon date. In the event the franchisee failed to open the agreed-upon number of shops, it lost its exclusive rights in the territory and could not open any additional Mister Donut shops.

Franchisees were entitled to use the building design, layout, signs, emblems, and color scheme relating to the Mister Donut System, along with petitioner's copyrights, trade names, trade secrets, know-how, and preparation and merchandising methods, as well as any other valuable and confidential information. However, U.S. Co retained exclusive ownership of its current and future trademarks, as well as any additional materials that constituted an element of the Mister Donut System. Use of these assets was prohibited after the termination of the franchise agreement.

Sale of Franchising Business

In early 1989, U.S. Co sold its Asian and Pacific Mister Donut franchising business to a Japanese purchaser for $2.05 million. Pursuant to the agreement, U.S. Co transferred its franchise agreements, trademarks, Mister Donut System, and goodwill for each of the Asian and Pacific countries in which U.S. Co had existing franchise agreements, as well as its trademarks and Mister Donut System for those Asian and Pacific countries in which it had registered trademarks but did not have franchise agreements. From the viewpoint of U.S. Co, the agreed price for the transaction took into account (i) the royalty income generated in the operating countries, (ii) the growth potential in the operating countries, (iii) the development potential in the nonoperating countries, and (iv) the value of the trademarks in the operating and nonoperating countries.

As a condition of the contract, U.S. Co agreed to a noncompete covenant for 20 years covering all countries in which franchising arrangements were in place or where trademarks were registered within the territory, but franchises did not exist. As a condition to full payment, U.S. Co needed to obtain consents of all franchisees.

Goodwill Reported as a Separate Asset from Trademarks and Systems

At the suggestion of U.S. Co's tax department, the asset purchase agreement did not allocate the purchase price to the assets sold. The ostensible reason given in a memorandum was concern that certain countries within the territory might consider imposing withholding taxes on the amounts allocated to local trademarks. Although not in the memorandum, the advice reflected divergent tax treatment for the source of gains when computing the foreign tax credit limitation of a U.S. taxpayer under the rules of U.S. tax law.

- Section 865(a)(1) of the Internal Revenue Code then in effect ("Code") provided that income from the sale of personal property by a U.S. resident is generally sourced in the U.S.

- Code §865(d)(1)(A) provided that in the case of any sale of an intangible, the general rule would apply only to the extent that the payments in consideration of such sale were not contingent on the productivity, use, or disposition of the intangible.

- Code §865(d)(2) defined "intangible" to mean any patent, copyright, secret process or formula, goodwill, trademark, trade brand, franchise, or other like property.

- Code §865(d)(3) carved out a special sourcing rule for goodwill. Payments received in consideration of the sale of goodwill are treated as received from sources in the country in which the goodwill was generated.

"According to the court, U.S. Co was mistaken when it attempted to separate goodwill from the assets in which the goodwill was embodied. Goodwill represents an expectancy that old customers will resort to the old place of business."

Consistent with the foregoing tax rules controlling the source of income, the tax department of U.S. Co ultimately advised that amounts allocated to goodwill and the noncompete provision would produce foreign source income for U.S. Co that in theory could release unused foreign tax credits from earlier years. The effect would be that no U.S. cash tax would be paid with regard to those items and previously unused foreign tax credits would be used, thereby producing a benefit.

Based on a purchase price allocation report prepared by a major accounting firm for use by U.S. Co, $1.93 million of the sale price was allocated to goodwill and a covenant not to compete. On its 1989 Federal income tax return, U.S. Co reported the income allocated to those assets as foreign source income for purposes of computing the foreign tax credit limitation under Code §904(a).

Challenge to Separate Asset Called Goodwill

The I.R.S. examined the tax returns for the years involved and disallowed the company's application of Code §865(d)(3). It contended that U.S. Co sold a global franchise to the purchaser and that all the value was in the trademarks and the Mister. Donut System, and treated the gain as being derived from U.S. sources. The unused foreign tax credits from prior years no longer produced a cash tax benefit.

The company filed a petition to the Tax Court challenging the deficiency asserted by the I.R.S. based on the fact that the goodwill in issue was attributable to the foreign trademarks used in the foreign markets in which the company conducted its franchising business. The court agreed with the I.R.S. According to the court, U.S. Co was mistaken when it attempted to separate goodwill from the assets in which the goodwill was embodied. Goodwill represents an expectancy that old customers will resort to the old place of business.[2] The essence of goodwill exists in a preexisting business relationship founded upon a continuous course of dealing that can be expected to continue indefinitely.[3] The value of every intangible asset is related, to a greater or lesser degree, to the expectation that customers will continue their patronage.[4] An asset does not constitute goodwill, however, simply because it contributes to this expectancy of continued patronage.

The court agreed with the I.R.S. that the purchaser acquired a franchise from U.S. Co to operate, relying on the definition found in Code §1253(a). Under that provision, a franchise includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area. That was the essence of U.S. Co's agreement with the purchaser. It then

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2 *Houston Chronicle Publishing Co. v. U.S.,* 481 F.2d 1240, 1247 (5th Cir. 1973); Canterbury v. Commr, 99 T.C. 223, 247 (1992).

3 *Canterbury v. Commr., supra*; *Computing & Software. Inc. v. Commr.*, 64 T.C. 223, 233 (1975).

4 *Newark Morning Ledger Co. v. U.S.,* 507 U.S. 546, 556. (1993).

concluded that the goodwill associated with the franchise business was part of, and inseverable from, the franchisor's rights and trademarks acquired by the purchaser.

> While there are no cases on point under section 865, case law interpreting other provisions of the Code supports respondent's position. In *Canterbury v. Commissioner*, 99 T.C. 223 (1992), we considered whether the excess of a franchisee's purchase price of an existing McDonald's franchise over the value of the franchise's tangible assets was allocable to the franchise or to goodwill for purposes of amortization pursuant to section 1253(d)(2)(A). We recognized that McDonald's franchises encompass attributes that have traditionally been viewed as goodwill. The issue, therefore, was whether these attributes were embodied in the McDonald's franchise, trademarks, and trade name, which would make their cost amortizable pursuant to section 1253(d)(2)(A), or whether the franchisee acquired intangible assets, such as goodwill, which were not encompassed by, or otherwise attributable to, the franchise and which were nonamortizable.
>
> We found that the expectancy of continued patronage which McDonald's enjoys "is created by and flows from the implementation of the McDonald's system and association with the McDonald's name and trademark." Id. at 248 (fn. ref. omitted).

Because no portion of U.S. Co's gain from the sale of its Mister Donut franchise business was attributable to a separate asset called "goodwill," the entire gain produced domestic source income for a U.S. corporate tax resident. Previously unused foreign tax credits were not available to offset U.S. tax on any portion of the U.S. Co's gain.

Legacy of Court's Decision

International Multifoods reinforced a long line of thought that goodwill is generally inseparable from trademarks and other marketing intangibles. It did not provide a promising path forward for other taxpayers that might want to allocate amounts toward goodwill, and thereby change the source of the income. The court defined goodwill as the "expectancy of continued patronage."[5] Less established companies naturally have less of a track record that might draw customers back in. Trademarks and other forms of branding may have a bigger role in attracting repeat customers. In other words, business goodwill might be more tied to other intangibles and less able to stand on its own.

Such reasoning seemed particularly relevant to Mister Donut. All its Asia-Pacific franchises were fairly new. In several countries for which Mister Donut sold franchise rights, Mister Donut owned registered trademarks in jurisdictions where operations were not yet carried on. Whatever goodwill it had in such countries could only be attributed to its franchise system. But dominance of franchise rights value is equally true for more established companies. The court relied on older cases involving franchises by more familiar names, such as McDonald's and Coca-Cola, that similarly held goodwill to be inseparable from the companies' franchises. The message of *International Multifoods* was that for most businesses, new and old, separating goodwill from other intangibles is a difficult task.

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5 Citing *Houston Chronicle Publishing Co.,* 481 F.2d 1240. (1973).

UNCONTROLLED SALES: DEVELOPMENTS AND RULEMAKING

The I.R.S. applied this logic in the context of like-kind exchanges. In Technical Advice Memorandum ("T.A.M.") 200602034, the I.R.S. held that trademarks are part of goodwill, going concern value, or both. As goodwill and going concern are unique to each business, trademarks were unique to each business, as well. Consequently, an exchange of trademarks could not qualify for nonrecognition as a like-kind exchange within the meaning of Code §1031.

Three years later, the I.R.S. explicitly rescinded T.A.M. 200602034 with Chief Counsel Advice ("C.C.A.") 200911006, which concluded that trademarks and similar assets can qualify for favorable like-kind exchange tax treatment. The conclusion reached in C.C.A. 200911006 provided support for the possibility of separating goodwill from marketing-based intangibles. The I.R.S. stated:

> Upon further consideration, the Office of Associate Chief Counsel (Income Tax & Accounting) has concluded that the analysis of Newark Morning Ledger Co. applies in determining whether intangibles constitute goodwill or going concern value within the meaning of §1.1031(a)-2(c)(2). Accordingly, intangibles such as trademarks, trade names, mastheads, and customer-based intangibles that can be separately described and valued apart from goodwill qualify as like-kind property under §1031. In our opinion, except in rare and unusual situations, intangibles such as trademarks, trade names, mastheads, and customer-based intangibles can be separately described and valued apart from goodwill.

The I.R.S.'s *volte-face* was driven by *Newark Morning Ledger*, a Supreme Court case that preceded *International Multifoods*.[6] In *Newark Morning Ledger*, a newspaper wanted to take deductions related to its amortization of its "paid subscribers." The I.R.S. argued that the asset was too connected to goodwill, which was not amortizable.[7] The Supreme Court focused on whether paid subscribers should be an amortizable asset, but in deciding in favor of the newspaper, it rejected the I.R.S.'s argument that goodwill could not be distinguished from paid subscribers.

Yet, *Newark Morning Ledger* covered fairly narrow grounds and focused on a specific type of intangible asset. Nothing in the case necessarily contradicted the long-standing idea that marketing-based intangibles like trademarks are inseparable from goodwill. *International Multifoods* mentioned the case but was not bound by it. And the Supreme Court even warned other taxpayers that the burden of splitting goodwill from other intangibles would still be "too great to bear" in most cases.

A conservative reading of C.C.A. 20091106 is that it applies only to like-kind exchanges. The case also lacked a franchise, which was an important factor in *International Multifoods*. There are ways to distinguish C.C.A. 20091106 from *International Multifoods*. For a franchisee, goodwill is embedded in the trademark, the brand advertising, the layout of the premises, and the sale of a standardized product.

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6 507 U.S. 546 (1993).

7 This is no longer an issue due to Code §197 allowing for amortization of goodwill.

Is one franchisee's Mister Donut donut different from another franchisee's Mister Donut donut? Yet, the comment that goodwill can usually be split from trademarks and other intangibles is generally stated. Whether by accident or by design, the I.R.S. has cast doubt on the relevance of *International Multifoods*, at least within the newspaper industry.

Status of the Statutes

Other changes have followed this trend. Valuation of goodwill was important in the context of Code §367, which requires gain recognition for transfers of certain property to foreign corporations, with Code §367(d) covering intangible property. Goodwill was originally not included in Code §367(d), because it was already located outside the U.S. This created an incentive to allocate sums to goodwill, since it could escape recognition treatment. The Tax Cuts and Job Acts of 2017 ("T.C.J.A.") added goodwill to Code §367(d), removing one need to value goodwill separately from other intangibles.[8] The preamble to the Code §367 regulations suggest that the I.R.S. wanted to reduce the number of difficult goodwill valuation fights.

But it would be hasty to conclude that *International Multifoods* is of no relevance. The impetus behind the case – the favorable sourcing rule for goodwill in Code §865(d)(3) that can be used to access unused foreign tax credits – still exists. C.C.A. 20091106 might have given fresh vigor to taxpayers hoping to take advantage of this rule.

International Multifoods may have drawn some helpful lines for taxpayers looking to fiddle with goodwill allocation. The court found that the existence of a franchise system subsumed all the goodwill in Mister Donut's franchising business. Mister Donut not only allowed the purchaser the use of its franchise system but dumped all its rights in Asia-Pacific into the agreement:

> Petitioner not only sold [the purchaser] petitioner's rights as franchisor in the existing franchise agreements in the operating countries, but also all its rights to exclusive use in the designated Asian and Pacific territories of its secret formulas, processes, trademarks, and supplier agreements; *i.e.*, its entire Mister Donut System.

This was backed up by the existence of noncompete covenants that prevented the parties from operating in each other's region. Taxpayers looking to benefit from a favorable goodwill allocation might be advised to move away from using franchises. Given opportunities for intangible allocation arbitrage still exist, these are still useful lessons.

CONTROLLED SALES OF GOODWILL

International Multifoods was a case about an uncontrolled sale of goodwill. Is the decision relevant for controlled sales of goodwill? At the time of *International Multifoods*, goodwill was not defined as an intangible asset under Code §367(d), but was defined under Code §936(h)(3)(B)(vi) as any similar item, which has substantial value independent of the services of any individual.

Following the *International Multifoods* decision in1997, goodwill became a definitional component of all other intangible property under Code §936(h)(3)(B)(i)-(v), namely:

See "Controlled Sales of Goodwill," below, for further discussion of this change. 8

(i) patent, invention, formula, process, design, pattern, or know-how,

(ii) copyright, literary, musical, or artistic composition,

(iii) trademark, trade name, or brand name,

(iv) franchise, license, or contract,

(v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data.

"Where the acquirer of goodwill planned to earn passive income, cost-sharing arrangements were adopted as replacements for actual transfers, especially as large tech companies began expansion outside the U.S. after the 1990's."

At that time, the definition of an intangible asset under Treas. Reg §1.482-4 referenced Code §367(d), which in turn referenced Code §936(h)(3)(B).[9] Controlled transactions that were nonrecognition transactions under Code §351 or §361 often relied on the active-trade-or-business exemption under Code §367(a)(3) to conclude a transfer of goodwill by the U.S. transferor without the recognition of any gain for the transferred goodwill asset. Other sale transactions involving a buyer that planned to use the transferred goodwill to earn income other than active business income relied on an accurate estimation or valuation of the arm's length consideration payable to the seller.

Valuation issues or issues with the application of a selected transfer pricing method dominated definitional issues in the context of a controlled transaction where the foreign acquirer's intent was the generation of passive income. Here, the cost approach to valuation likely would not have captured the dynamic effect of continued business patronage at the heart of goodwill value. The income approach that used a limited useful life or a steeply declining royalty rate over time may not have captured the momentum effect of goodwill in future sales or margins. Among the key assumptions that required robust support were (i) customer retention and (ii) an understanding of the way in which a retained customer base grows and contributes to sales and margins. Required forecasting assumptions may have influenced intangible asset value in transactions at that time.

Where the acquirer of goodwill planned to earn passive income, cost-sharing arrangements were adopted as replacements for actual transfers, especially as large tech companies began expansion outside the U.S. after the 1990's. One-time or lump-sum sales of goodwill therefore gave way to buy-in payments, known currently as platform contribution transaction payments, followed by cost-sharing payments between the participants over the term of a cost-sharing agreement.

Following the decision in International Multifoods, the citation trail is almost nonexistent in the context of controlled goodwill sales and its influence diminishes much the same way as uncontrolled goodwill sales.

2017 T.C.J.A.

Treasury clarified the valuation or quantification issue by codifying the requirement for aggregate valuation of intangible property transferred in foreign controlled transactions as part of the 2017 T.C.J.A.[10] At the same time, the definition of an intangible

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[9] As mentioned below in connection with the 2017 T.C.J.A., the list in Code §936(h)(3)(B) has been moved to Code §367(d)(4). In addition, two new categories of intangible property have been added.

[10] Dec. 22, 2017, 131 Stat. 2219, Pub. L. 115-141.

asset under Code §936 was replaced by an expanded definition under new Code §367(d)(4) that explicitly includes (i) goodwill, going concern value, or workforce in place (including its composition and terms and conditions (contractual or otherwise) of its employment) and (ii) any other item, the value or potential value of which is not attributable to tangible property or the services of any individual.

Goodwill and Chapter VI of the 2017 OECD Guidelines

In the 2017 edition of the O.E.C.D. Guidelines,[11] goodwill is handled not as a separate intangible asset but rather as a component of value of other intangible assets in the context of a controlled sale or other transfer. As such, it is consistent with the Tax Court's decision in *International Multifoods*. Going concern value is accorded the same treatment.[12] The I.R.S. view of goodwill as part of an aggregate intangible asset transfer is therefore currently consistent with the controlled transaction treatment of goodwill by other O.E.C.D. member state treaty partners.

CONCLUSION

Has the precedential value of *Mister Donut* gone stale?

The general approach of *International Multifoods* to foreign goodwill sales in the controlled transaction context remains very much in line with current law and is broadly consistent with multilateral guidance when Competent Authority is asked to address intangible property transactions with treaty partners.

In a unilateral context, the well-established theory behind *International Multifoods* is of uncertain status. The I.R.S.'s comments in C.C.A. 200911006 make it unclear whether the I.R.S. has fundamentally shifted its thinking or whether those remarks were intended to apply only in specific contexts. Either way, *International Multifoods* still matters. The taxpayer was unsuccessful, but it might only have provided an example of how not to play games with goodwill.

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11 O.E.C.D. (2017), O.E.C.D. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, O.E.C.D. Publishing, Paris.

12 *Id.* paragraph 6.28.

OFF TO NEW SHORES – TAX EXTERN AT RUCHELMAN P.L.L.C.

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Tags
Cross-border Transactions
German American Exchange
Internship
U.S. Tax Planning

"We all live under the same sky, but we don't all have the same horizon."

– First Chancellor of the Federal Republic of Germany, Konrad Adenauer

INTRODUCTION

In fact, not having the same horizon sometimes provides a special opportunity for learning and an enriching exchange for all involved. The curiosity of getting to know another "horizon" and approach to law induced me to travel 3,771 miles from Germany to New York City this past fall to participate in a Tax Externship at the New York law firm, Ruchelman P.L.L.C.

In this article, I share some of the thoughts, realizations, and learning opportunities that I was lucky enough to benefit from along the way.

WHO AM I?

My name is Lioba Mueller, and I come from Mönchengladbach, Germany. International law and global economic relations have fascinated me throughout my studies in Germany and the People's Republic of China.

In 2014, I enrolled in the bachelor's degree in Law and Economics at the University of Bonn, the former capital of Germany. The interdisciplinary approach of Law and Economics provided me with a methodology to assess which legal rules are economically efficient, and to understand their effects on human behavior. I also gained insights in areas such as micro- and macroeconomics, mathematics, and statistics. After graduating in 2018 with the LL.B., I continued to study German law. During my law studies I focused on International and European Law of Economic Relations with courses such as Foreign Investment Law and Antitrust Law. My studies were supported by the Konrad Adenauer Foundation's scholarship program for outstanding students. In 2021, I graduated from my German legal studies program with the First State Exam at the higher regional court.[1]

My first encounter with Anglo-American law was in 2015 during the two-year Foreign Law and Language Program at the University of Bonn covering areas like U.S. commercial law, U.S. civil litigation and international arbitration. My interest in international law also led me to participate in the 58th Philip C. Jessup International Law Moot Court Competition in 2016. In preparation for this competition, I drafted oral and written pleadings on issues such as obligations to endangered world cultural

1 Oberlandesgericht Duesseldorf.

sites, equitable use of shared natural resources, and repatriation of cultural property. Moreover, I took part in the 2017 summer program of the Xiamen Academy of International Law in China on international economic law and public international law featuring leading scholars, including Alain Pellet, Jean d'Aspremont and Eyal Benvenisti.

My fascination in cross-border matters and foreign trade law also led me to study a semester at the law faculty of Tongji University in Shanghai, China. In small classes, I participated in intense discussions on topics such as Chinese tax law, foreign trade law and intellectual property law. After returning to Germany, I have continued to deepen my knowledge about Asia in parallel with my law studies. In 2019, I received a B. A. in Asian Studies with Chinese Language at the University of Bonn. This allowed me opportunities to improve my fluency in Chinese language, and gain further understanding of Chinese and Asian history, society, and economy.

WHAT DID I EXPECT PRIOR TO THIS EXTERNSHIP?

My externship at Ruchelman P.L.L.C. brought me the opportunity to work at an established international firm with high expertise on cross-border matters.

Going into the externship, I was extremely excited to gain insights into U.S. tax planning and legal services and to become at least a tad more familiar with international provisions of the Internal Revenue Code as well as U.S. inbound and outbound commercial and financial transactions. What made Ruchelman P.L.L.C. further interesting is the team and its diverse client base. I was thrilled to work alongside a highly qualified and experienced set of attorneys with a background in three continents, and the chance to communicate with firm clients in various languages. The firm's diverse international client base was reflected in its broad-based and richly educated team. Clients include both non-U.S. individuals and foreign corporations operating or investing in the U.S., as well as individuals and firms based in the U.S. with operations or investments abroad.

As an extern, my hope was to contribute to the firm with my knowledge of German law, and, more broadly, my training in law and economics, my research skills, and my language skills. My research skills were honed through my six-year work as a student assistant for Prof. Dr Stefan Talmon,[2] Director of the Institute for International Public Law at the University of Bonn. My bachelor thesis was graded highest and term papers earned scores in the 98th percentile. Further, I hoped that my knowledge of English, German, Chinese, French, and Spanish might also be a useful asset.

By assisting the attorneys, I wished also to acquire specific technical knowledge and understanding of U.S. tax law. I anticipated bringing together many of the different skillsets that I have been building over the past few years by working on varied tax research projects and client matters, reviewing commentaries and treatises, assisting in the preparation of memorandums, and perhaps even drafting contracts and other documents required in connection with the firm's projects. In addition, I hoped to develop my tax research skills and to get acquainted with common databases.

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[2] LL.M., M.A.

Moreover, at a higher level I was extremely excited to gain insights into U.S., the working culture and "open-door" policy. Besides work, I looked forward to immersing myself in the American lifestyle and gaining a new perspective on things I may never have thought about. As it was my first time in the U.S., there certainly was a lot to discover everywhere, especially regarding U.S. culture, fan sports, society, and history. No matter where you come from, New York City offers an exceptional place to experience American vibrancy, creative spirit, and the so-called melting pot of cultures and traditions.

WHAT WAS MY EXPERIENCE LIKE?

There it was, my first day. I was filled with excitement and curiosity about the people I would work with. The firm's Office Manager showed me around the office, showed me my working space, and introduced me to the team. I had a first meeting with the Chairman of the firm, who took the time to meet with me, explain the firm's structure and practice, and ask me about my goals and expectations from this experience. Everything was set up including personalized accounts for research databases. The warm welcome and kindness of everyone made me immediately feel I was part of the team. This feeling is particularly memorable and one of the strongest and abiding takeaways – I am grateful to the Ruchelman P.L.L.C. team for including me in so many matters, from the get-go, and for inviting me to actively contribute to a number of them. This was an unforgettable experience!

"My research involved a high variety of topics, from the question of whether there was the need to notify the I.R.S. about repatriation payments to Holocaust survivors, the exit tax applicable after a renunciation of U.S. citizenship, and the voluntary disclosure of unreported foreign financial accounts by U.S. tax residents."

My first days focused mainly on understanding the general concepts of U.S. tax planning. The attorneys introduced me to the contours of their system, answered my questions, and provided me with comprehensive materials about the taxation of cross-border and foreign transactions in the U.S. I learned all about rules for determining residency, dual status for a tax year, the source of income, and more topics. Furthermore, I received the benefit of tutorials and research software for U.S. tax advice, namely Thomson Reuters Checkpoint and Bloomberg BNA. These two research tools are designed to provide answers to a variety of tax, accounting, trade, and finance questions. The introduction was extremely useful for later research, interpretation of rules and understanding cases.

Straight away, I received my first research assignment – in a matter concerning the foreign tax credit. A foreign company was being sold by its owner, after moving to the U.S. I learned about the effect of a bilateral tax treaty and its residence tiebreaker rule. It was fascinating to understand first the relation between the national and international rules, and second, the relation of norms of the treaty itself. It was also thrilling to conduct research for different attorneys and to discuss the results with them afterwards. My research involved a high variety of topics, from the question of whether there was the need to notify the I.R.S. about repatriation payments to Holocaust survivors, the exit tax applicable after a renunciation of U.S. citizenship, and the voluntary disclosure of unreported foreign financial accounts by U.S. tax residents. Through this work, I even learned about subjects, such as the I.P.O. process, and the evolution of cryptocurrency.

Another fascinating research assignment was one focused on the elements required for successful tax rescission. Have you ever wondered what happens for tax matters when attempting to "rescind" a transaction? The I.R.S. has set out two prerequisites in the Revenue Ruling 80-85. First, the parties must be returned to the *status quo* ante, the relative positions they would have occupied had no contract been made.

Second, the transaction must be restored to the *status quo ante* within the same tax year. Deeper insights are provided in a previous *Insights* article, "Rescission – Undoing a Transaction That Seemed Like a Good Idea at the Time."[3]

While the pandemic had negative impacts on various areas of life, it allowed me to take part in online webinars on tax planning matters. Particularly insightful was a seminar on Tax Planning Considerations When Marrying a Non-U.S. Citizen, part of the Continuing Legal Education ("C.L.E.") program at New York Law School. An introduction was given to different married couples' status for tax filing purposes (which in the U.S. includes filing jointly, separately or as what is referred to as head of household), the non-U.S. citizen spouse's income and pre-immigration planning considerations.

The tax externship allowed me as a German lawyer to gain deeper insights in a very different system of tax law and a common law regime. While working, similarities became apparent, especially in the area of company law. Discussions about inheritance law and gift law revealed some differences between common and civil law concepts, *e.g.*, the impact of disclaiming or renouncing one's inheritance for the benefit of other heirs.

During my daily work, I supported the team with preparation and categorizing of documents, and drafted conference notes. I received tasks from all the attorneys and was supremely grateful that they took the time to explain the background, reflect on the work done and give me timely feedback afterwards. Their legal input, guidance, and, most importantly, the freedom to think through problems in a principled, yet creative manner that they demonstrated to me, were unparalleled learning and growth opportunities for me. As previously mentioned, I was strongly impressed by the way the team welcomed and integrated me, on Day One, as an equal in their endeavors. It was great not only to work together with each of them, but to get to know everyone at work and at after-work events. It provided me with unexpected and enriching lunch discussions, celebration of passing my bar exams, the chance to catch an Israeli birthday song, practice my French and Chinese conversation skills, and even extended to sampling craft beers from Brooklyn and Belgium after work. I attended networking events with colleagues, such as a soirée organized by the British American Business Council ("B.A.B.C."), a transatlantic trade organization, and caught my first concert at the New York Philharmonic. Outside work, I celebrated my first real Thanksgiving with an American family in the Washington D.C. area, stood on the stairs of the Supreme Court while gazing at the resplendent Capitol, and even dug into the historical roots and meaning of America on the freedom trail in Boston. Filled with these rich experiences, it was finally time to say goodbye!

CONCLUDING REMARKS, SPECIAL THANKS AND… WHAT COMES NEXT?

I came to New York City full of curiosity and the simple wish to extend my horizons. My expectations were far and away exceeded. Working at Ruchelman P.L.L.C. gave me practical insights in the U.S. tax planning and the legal system that I could not obtain anywhere else. The externship allowed me to grow intellectually, professionally, and personally. With the team at Ruchelman P.L.L.C., I found wonderful

[3] See Ruchelman, Rastogi, "Rescission – Undoing a Transaction That Seemed Like a Good Idea at the Time," *Insights* 8 no 6 (2021): p. 40.

colleagues with whom I will delight to remain in touch. Special thanks go to Stanley C. Ruchelman and Galia Antebi, willing to accept me as a tax extern, as well as to the whole team – they included, from partners to staff (in alphabetical order), Andreas Apostolides, Nina Krauthamer, Wooyoung Lee, Claire Melchert, Simon Prisk, Zoë Ragoonanan, Neha Rastogi, and Julissa Rodriguez. I also wish to give my sincere thanks to the University of Bonn for supporting such an externship, through the PROMOS scholarship,[4] offered by the German Academic Exchange Service, under the German Ministry of Education and Research, and designed for the purpose of promoting students to go on short stays abroad.

Having returned to Germany just before the New Year, I am now ready to begin my legal training as a "*Rechtsreferendarin*," or Legal Trainee, at the Regional Court of Aachen, in the city which served as the Emperor Charlemagne's capital over 1,200 years ago. The experience of the legal externship at Ruchelman P.L.L.C., which I bring with me, is a highly precious one, which helps me not only in ultimately being a better and more well-rounded lawyer, but also by giving me tools of critical thinking and analysis that will help me in deciding the path that my career will take, and how to do that career better. In a globalized world, my sense is that it behooves us all to become more acquainted with different systems of law, and my immersion in U.S. tax and legal principles at this firm has incomparably extended my thinking, and my horizons!

[4] "PROMOS" stands for "*Programm zur Steigerung der Mobilität von deutschen Studierenden*," meaning "Program to Increase the Mobility of German Students."

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.

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