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INSIGHTS

ECONOMIC SUBSTANCE: VIEWS FROM THE U.S., EUROPE, AND THE B.V.I., CAYMAN, AND NEVIS

EFFECT OF RULING NO. 288/2023 – ITALIAN ANTI-HYBRID RULES ATTACK THE 2020 SWISS CORPORATE TAX REFORM

THE POUR-OVER CLAUSE IN A CROSS-BORDER CONTEXT

AND MORE

Insights Vol. 10 No. 3

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About Us

EDITORS' NOTE

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

- **Economic Substance: Views From the U.S., Europe, and the B.V.I., Cayman, and Nevis.** Like concepts of beauty, the presence or absence of economic substance in the tax context often is in the eye of the beholder. More importantly, economic substance means different things to tax authorities in different jurisdictions and the approaches in taxpayer obligations varies widely. This article looks at the concept of economic substance in three separate localities. Stanley C. Ruchelman and Wooyoung Lee look at the U.S., addressing case law establishing the requirement and the 2010 codification of the concept into the tax code. Werner Heyvaert, a partner in the Brussels Office of AKD Benelux Lawyers, and Vicky Sheik Mohammad, an associate in the Brussels Office of AKD Benelux Lawyers, look at the Danish Cases that establish an abuse of rights view for aggressive tax planning – the taxpayer abused rights granted to it by E.U. law – and the Unshell Directive designed to remove certain tax benefits from shell companies. David Payne, Global Head of Governance for Bolder Group, looks at the self-certification rules that have been adopted in the B.V.I., Cayman, and Nevis.

- **Effect of Ruling No. 288/2023 – Italian Anti-Hybrid Rules Attack the 2020 Swiss Corporate Tax Reform.** Sometimes, anti-abuse provisions are applied by tax authorities because of what happened in the past, not the present, much like a classic vendetta. This is what happened to an Italian subsidiary of a Swiss company that benefitted from the principal company regime in Switzerland. That regime presumed the existence of a deemed P.E. outside of Switzerland and the allocation of profit to the deemed P.E. The regime was repealed with effect as of January 1, 2020, and replaced by a relatively normal tax regime, with one specific transition rule. The Swiss parent was entitled to a tax-free step-up in the goodwill of the deemed P.E. which could be amortized over ten years, allowing a tax benefit for the Swiss company. In April of this year, the Italian tax authorities issued tax ruling no. 288/2023 to an Italian subsidiary of a Swiss company that previously benefitted from the principal company regime. It now was taxed under Swiss law in a straightforward way, but with the amortization benefit. In the ruling, the Italian tax authorities determined that the amortization deduction constituted a hybrid mismatch because the goodwill was not purchased. The result is that the Italian subsidiary cannot reduce sales by the related cost of inventory purchased from its Swiss parent. Federico Di Cesare, a Partner of Macchi di Cellere Gangemi, and Dimitra Michalopoulos, an Associate in the tax practice of Macchi di Cellere Gangemi explain the basis of the ruling and strongly suggest that it is not grounded on the existing provisions of the Italian anti-hybrid rules. Sounds like classical vendetta in the context of the A.T.A.D.

- **The Pour-Over Clause In A Cross-Border Context.** With all the career and job opportunities available, many Canadians and Americans choose to cross the border to pursue new goals. Providing trust and estate planning advice to Canadians living in the United States and Americans living in Canada is no longer a rare situation. Where an individual has spent part of his life in one country and part in the other, his will and power of attorney may have

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been executed in one country but not amended following the arrival in the other country. This can pose problems when an estate plan crafted to meet U.S. rules is applied to a U.S. citizen that relocated to Canada and remained in Canada for the balance of his life. Caroline Rheaume, a member of the Quebec Bar, focuses on pour-over provisions in trusts, frequently used by U.S. estate planners, but which encounter enforceability problems in several Canadian provinces. The takeaway is simple. When in Canada do as the Canadians do, or your legatees may find that you died intestate.

- **International Marriages – Special U.S. Tax Concepts.** Continuing with the theme of cross-border mobility and resulting tax consequences, U.S. tax law contains provisions that affect married couples coming to live in the U.S. from a country that has a community property regimes in force and effect. They may find that income tax consequences are not necessarily controlled by the marital laws of the former home country. The Internal Revenue Code contains provisions that apply to earned income that override community property regimes when one or both spouses are not U.S. residents or citizens. Nina Krauthamer and Galia Antebi address the circumstances controlled by Code §879. They also address rules for filing joint income tax returns when one spouse is not a U.S. citizen or resident, available elections under Code §6013(g) and (h) to allow for the filing of joint tax returns, elections for arriving persons to be treated as residents with an accelerated residency starting date, and tricky trust and estate rules that apply to a donor spouse when the donee spouse is not a citizen. A must read for arriving individuals.

- **New Tax Relief on Repatriation of Intangible Property.** Code §367(d) provides rules for intercompany transfers of intangible property to related parties abroad. Not only are they taxable when first made, but they may continue to give rise to taxable income for the transferor for extended periods of time, notwithstanding a fixed price that is arm's length at the time of the original transfer. Recently, U.S. companies have considered repatriating intangible property previously transferred abroad, in light of favorable provisions under the F.D.D.I. regime, the inability to defer tax under the C.F.C. rules, both Subpart F and G.I.L.T.I., and the prospect of Pillar 2's adoption. However, the rules that applied to repatriation of intangible property left issues unanswered. In early May, the I.R.S. published proposed regulations affecting transactions in which U.S. corporations bring intangible property back to the U.S. In their article, Stanley C. Ruchelman and Daniela Shani review the legislative background of the proposed regulations and address the key principles involved before the toll charges of Code §367(d) are turned off. If the repatriation transaction can be effected tax free under U.S. domestic law to the prior transferor or a qualified successor, no gain is recognized.

- **All Eyes on the I.C.-D.I.S.C. Part Two: I.R.S. Examinations.** The Interest Charge Domestic International Sales Corporation ("I.C.-D.I.S.C.") is an undervalued tax planning tool for exporters that can provide substantial tax advantages to U.S. export companies and their shareholders. In the March edition of Insights, Michael Bennet addressed the technical aspects, and tax benefits of the I.C.-D.I.S.C. In this month's edition, he addresses Part Two reviewing the I.R.S. examination procedure and key aspects taxpayers should keep in mind. Based on the I.C.-D.I.S.C. audit guide published by the I.R.S., the article explains the steps that should be followed to stand up to

the questions that will be asked by the examiner. Those who read Part One are strongly urged to read Part Two to understand the internal steps to be taken to ensure the I.C.-D.I.S.C. benefit is real after an I.R.S. examination is completed.

- ***Farhy v. Commr.* – The Penalty for Failing to Timely File Form 5471 May Not Be Assessed Administratively.** Sometimes, good things happen to the undeserving. In the play "Pygmalion," Alfred Doolittle – the undeserving father of Eliza Doolittle – receives a bequest from a faraway benefactor. In *Farhy v. Commr*., a scofflaw who refused to file Form 5471 for several Belize companies and received penalty notices regarding the seizure of his property convinced the Tax Court that the penalty was not self-enforcing. Rather, the Department of Justice would be required to initiate enforcement proceedings in District Court to collect the assessed penalties. Stanley C. Ruchelman and Wooyoung Lee explain the reasoning of the decision and then ask which other penalties have similar requirements. In answer, they survey client alerts published on the internet by various firms. Surprisingly, the answers are not consistent.

We hope you enjoy this issue.

- The Editors

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ECONOMIC SUBSTANCE: VIEWS FROM THE U.S., EUROPE, AND THE B.V.I., CAYMAN, AND NEVIS

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Tags
A.T.A.D. 3
Cayman Islands
Code §6662
Code §7701(o)
Business Purpose
B.V.I.
Economic Substance
I.R.D.
Nevis
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Sham Transaction

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Like concepts of beauty, the presence or absence of economic substance in the tax context often is in the eye of the beholder. As importantly, economic substance means different things to tax authorities in different jurisdictions. This article looks at the concept of economic substance in three separate localities – the U.S., the E.U., and certain Caribbean jurisdictions.

THE VIEW FROM THE U.S.

Background

U.S. tax law has a doctrine known as the economic substance doctrine. The main purpose is to prevent taxpayers from entering into artificial transactions for the principal reason of reducing tax exposure. Under the doctrine, a transaction that is purely or substantially tax motivated is disregarded.

The doctrine has been recognized in the caselaw for over 90 years. In 2020, it was codified in order to have the same standard applied in U.S. courts no matter where located. In comparison to rules in the E.U. and several Caribbean jurisdictions, it applies to transactions rather than the entities conducting transactions.

Along with the economic substance doctrine, caselaw has created other doctrines meant to achieve broadly the same effect. The various doctrines include the following:

- Economic substance doctrine
- Business purpose doctrine
- Sham transaction doctrine
- Substance over form doctrine
- Step transaction doctrine

However, the lines between these doctrines are not always clear. The result is that while these doctrines serve an important role in denying improperly earned tax benefits, it adds more uncertainty for taxpayers who may be caught by such doctrines. For example, the economic substance doctrine states that tax benefits can be denied if the transaction that gives rise to those benefits lacks economic substance independent of U.S. Federal income tax considerations, even if all facts occurred. Similarly, the business purpose doctrine states that tax benefits can be denied if the transaction was not intended to serve some useful non-tax purpose. Where both a useful non-tax purpose exists alongside overriding tax purposes, some courts have bifurcated the transaction in order to disallow the tax benefits of the overall transaction. Caselaw has not always helped in drawing clearer lines.

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Transactions Lacking Economic Substance

Commr. v. Court Holding Co.[1]

In this case, a corporation agreed to sell an apartment building with the intent of winding up once the transaction was completed. This would have resulted in two levels of tax: first, corporate income to the corporation effecting the sale, and second, income tax for shareholders as the sale proceeds were distributed. After agreement on price was reached, but before a written agreement was executed, the corporation visited a tax advisor who pointed out that a better tax result could be achieved if the apartment building were distributed to the shareholders as part of a liquidation of the corporation after which the building could be sold by the shareholders. Under the law in effect at the time, the corporation did not recognize gain when assets were distributed to shareholders as part of a liquidation. One level of tax could be eliminated. The form of the transaction was renegotiated. Following the advice of the tax advisor, the corporation approved a plan of liquidation and distributed the building to its shareholders. The shareholders effected the sale. The Supreme Court, reversing the Fifth Circuit, held that the corporation was still the true seller.

> The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress. [Citations omitted.]

Corliss v. Bowers[2]

The taxpayer transferred a portfolio of investments to a trust formed for the benefit of his wife and children. However, the taxpayer retained significant control over the trust, including powers to modify or revoke, in whole or in part, the trust deed. The taxpayer argued that he was not liable for tax on the trust income because he never received that income. The Supreme Court disagreed and pointed out that while the assets and money were sitting in a trust, the taxpayer had actual command over the property. By analogy, the court reasoned that a taxpayer would not escape tax liability merely because it was sitting in his bank account.

> [T]axation is not so much concerned with the refinements of title as it is with actual command over the property taxed – the actual benefit for which the tax is paid. If a man directed his bank to pay over income as received to a servant or friend, until further orders, no one would doubt that he could be taxed upon the amounts so paid. It is answered that in that case he would have a title, whereas here he did not. But from the point of view of taxation there would be no difference. * * * The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not.

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[1] 324 U.S. 331 (1945).

[2] 281 U.S. 376 (1930).

Commr. v. P.G. Lake, Inc.[3]

P.G. Lake was a company in the business of producing oil and gas. It owed a debt to its president. In consideration of the cancellation of its debt, Lake assigned him an oil payment right that consisted of a fixed amount and 3% of the unpaid balance that was payable out of 25% of the oil attributable to Lake's working interest. The president reported the oil payment right as long-term capital gain, taxed at favorable rates. The Supreme Court recognized that an oil payment typically produces long-term capital gain, the payment before the Court was an income payment, not a capital payment.

> The purpose of [long-term capital gains tax rates] was "to relieve the taxpayer from * * * excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions. * * * We do not see here any conversion of a capital investment. The lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income. The pay-out of these particular assigned oil payment rights could be ascertained with considerable accuracy. * * * These arrangements seem to us transparent devices. Their forms do not control. Their essence is determined not by subtleties of draftsmanship but by their total effect. [Citations omitted.]

Minnesota Tea Co. v. Helvering[4]

Minnesota Tea Co. was indebted to creditors at the time of its liquidation. As part of the liquidation, the company sold its assets at a gain. Under the law at the time, proceeds used by the corporation to pay off its debt would be taxed but not proceeds distributed to shareholders. In a strategy somewhat similar to the one used in *Court Holding Co.,* Minnesota Tea distributed all of the proceeds to its shareholders. The shareholders subsequently used one-quarter or so of the proceeds to pay off Minnesota Tea's debts. The Supreme Court recharacterized that portion as money used by the company itself to pay off debts

> Payment of indebtedness, and not distribution of dividends, was, from the beginning, the aim of the understanding with the stockholders and was the end accomplished by carrying that understanding into effect. A given result at the end of a straight path is not made a different result because reached by following a devious path. The preliminary distribution to the stockholders was a meaningless and unnecessary incident in the transmission of the fund to the creditors, all along intended to come to their hands, so transparently artificial that further discussion would be a needless waste of time. The relation of the stockholders to the matter was that of a mere conduit. * * *

Rice's Toyota World v. Commr.[5]

Rice was an automobile dealership that bought a used computer for $1.5 million from a promoter as part of a sale-and-leaseback transaction. Rice paid through a

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3 356 U.S. 260 (1958).

4 302 U.S. 609 (1938).

5 752 F.2d 89 (4th Cir. 1985).

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recourse note in the amount of $250,000 payable over three years and two nonrecourse notes payable over eight years. Rice leased the computer back to the promoter under an eight-year nonrecourse lease which allowed Rice to earn annual cash-on-cash income of $10,000. The Fourth Circuit found the transaction to be a sham under a two-prong test. First, under the subjective tax, Rice's only motive was obtaining tax benefits. Second, under the objective test, there was no reasonable possibility of generating a profit.

> The business purpose inquiry simply concerns the motives of the taxpayer in entering the transaction. The record in this case contains ample evidence to support the tax court's finding that Rice's sole motivation for purchasing and leasing back the computer under the financing arrangement used was to achieve the large tax deductions that the transaction provided in the early years of the lease.
>
> * * * [T]he record supports the court's subsidiary finding that Rice did not seriously evaluate whether the computer would have sufficient residual value at the end of the eight year lease to Finalco to enable Rice to earn a profit on its purchase and seller-financed leaseback. Under the purchase and lease agreements with Finalco, Rice was obligated to pay (and did pay) $280,000 to Finalco in the form of principal and interest on the recourse note. Finalco's rental payments provided Rice with a return on the investment of $10,000 annually after payment of Rice's principal and interest obligations under the nonrecourse notes. At the time of the lease, Rice could therefore be certain of receiving a $50,000 return since Finalco had subleased the computer for five years, but Rice could recover the additional $230,000 of its investment only if it could re-lease the computer after five years or realize a substantial amount by its sale. * * *
>
> Residual value of the computer (either in selling or re-leasing) should therefore have been the crucial point of inquiry for a person with a business purpose of making a profit on this transaction. However, Rice's principal officer knew virtually nothing about computers, and relied almost exclusively on the representations of a Finalco salesperson regarding expected residual value. * * *
>
> The second prong of the sham inquiry, the economic substance inquiry, requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits. * * * The record contains estimates of residual value made by several experts that range from a low of $18,000 to a high of $375,000. Although Rice's experts presented a range of predicted residual values with a high end sufficient to earn Rice a profit, the tax court found the Commissioner's experts to be more credible and to have used more reliable forecasting techniques.

The Merrill Lynch Transactions

Merrill Lynch developed a financial product to create capital losses that U.S. corporations could use to offset capital gains from other transactions. Under the financial product, the U.S. corporation would form a partnership with a foreign partner not subject to U.S. tax. The two partners would capitalize the partnership with cash

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contributions, primarily from the foreign partner, who would consequently become the majority partner. The partnership would purchase high-grade, floating-rate private placement notes ("P.P.N.'s") that included put options enabling the partnership to sell the P.P.N.'s back to the issuer at par.

In exchange for selling the P.P.N.'s, the partnership would receive consideration consisting of 80% cash and 20% indexed installment notes. The gain from the sales would be reported using the installment method under Code §453. Additionally, since the floating-rate notes were categorized as contingent consideration because the total amount to be received could not be determined at the time of sale, gain recognition would be accelerated but offset by deferred loss. This is because in installment sales with contingent consideration, basis is allocated equally to all years in which payment can be received.[6] A taxpayer recognizes gain if a payment in a particular year exceeds the allocated basis for the year. A payment that is less than the basis for that year is a recovery of basis. Losses are only allowed in the final year of payment.

"Since the foreign partner held the majority interest, it would be allocated the bulk of the gain in the first year."

In a simplified example from one court case involving these transactions,[7] a seller sells a property with basis and current value of $1 million in exchange for $500,000 cash and an indefinite five-year instrument. Because there are five years in which payment could be received, the $1 million in basis is allocated $200,000 to each year. In the first year, the seller receives $500,000 in cash, of which $200,000 is recovery of basis and $300,000 is gain. This leaves $800,000 in basis to be recovered. In the second year, the notes are sold for $500,000, producing a loss of $300,000 due to the remaining $800,000 of basis.

Since the foreign partner held the majority interest, it would be allocated the bulk of the gain in the first year. That gain would not be categorized as effectively connected income in the hands of the foreign partner. Consequently, no U.S. tax was imposed. The loss from the second-year sale of notes would be allocated to the U.S. partner, and was used to offset capital gains from an unrelated transaction.

In a series of lawsuits, courts struck down the transactions as a sham. There was no reason for the companies to get involved other than to produce a tax loss. Courts disregarded the existence of either the partnership[8] or the transaction.[9]

Andantech L.L.C. et al. v. Commr.

Like the Merrill Lynch transactions, this case[10] involved a manipulation of timing. Comdisco was a lessor, dealer, and remarketer of IBM computer equipment. It engaged in a sale-leaseback transaction with a partnership formed by two non-U.S. individuals. Comdisco then subleased the equipment to end users of the equipment. The partnership sold the right to receive rental payments, causing an acceleration of the rental income. Since the partners were both non-U.S. individuals, the income went untaxed. At that point, when the revenue stream was already disposed of, a

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[6] Temp. Treas. Reg. §15A.453-1(c)(3)(i).

[7] *ASA Investerings Partnership v. Commr.*, 201 F.3d 505.

[8] *Saba Partnership v. Commr.,* T.C. Memo. 2003-31; Boca Investerings Partnership v. U.S., 314 F.3d 625.

[9] *ACM Partnership v. Commr.*, 157 F.3d 231.

[10] 331 F.3d 972 (D.C. Cir. 2003).

U.S. corporation became a 98% partner and received its proportionate share of the depreciation deductions. There was no rental income to offset these deductions because the gain from the rental income had already been recognized.

The D.C. Circuit Court applied the sham-transaction doctrine and disregarded the partnership. The foreign partners' participation was disregarded under the step-transaction doctrine because they always intended to withdraw from the partnership. The sale-leaseback transactions were held to lack economic substance and a non-tax business purpose.

> [T]he intent of the [foreign partners] was not to run the business as a partnership or otherwise, but to assist with a transaction for which they * * * would be well compensated. Their contribution of cash was comparatively minimal and borrowed, and they withdrew almost all of it from the company after only three months, exactly as outlined in the June proposal. [The foreign partners] had only been made aware of the deal and offered their participation after an earlier pair of potential European partners backed out, and had a maximum of two weeks to consider the deal before the formation of the partnership. This, too, illustrates the lack of intent to actually enter into the partnership for a purpose other than to facilitate the proposed tax-beneficial transaction. The terms of the deal offered further evidence of the intent of the participants. For example, Andantech hired a Dutch business manager to run Andantech, but with a contract of only two and a half months, coinciding precisely with the timeline described in the proposal memo for the income-stripping transaction, and the time period in which the transaction, in fact, occurred.

Transactions Where the Taxpayer Prevailed

Frank Lyon Co. v. U.S.[11]

A state bank wanted to build a new headquarters building, but banking regulations prevented financing the new building with a conventional mortgage. Consequently, the bank entered into a sale-leaseback transaction. The bank sold the building to Frank Lyon, which financed its purchase with a mortgage and then leased the building back to the bank.

The I.R.S. argued that the sale-leaseback should be disregarded. In its view, the bank remained the true owner, and Frank Lyon should not have been allowed any depreciation deductions.

> * * * Although the rent agreed to be paid by the bank equaled the amounts due from the petitioner to its mortgagee, the sale-and-leaseback transaction is not a simple sham by which petitioner was but a conduit used to forward the mortgage payments made under the guise of rent paid by the bank to petitioner, on to the mortgagee, but the construction loan and mortgage note obligations on which petitioner paid interest are its obligations alone, and, accordingly, it is entitled to claim deductions therefor under §163(a) of the Internal Revenue Code of 1954. * * *

[11] 435 U.S. 561 (1978).

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> While it is clear that none of the parties to the sale-and-leaseback agreements is the owner of the building in any simple sense, it is equally clear that petitioner is the one whose capital was invested in the building and is therefore the party entitled to claim depreciation for the consumption of that capital under §167 of the Code. * * *
>
> Where, as here, there is a genuine multiple-party transaction with economic substance that is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features to which meaningless labels are attached, the Government should honor the allocations of rights and duties effectuated by the parties; so long as the lessee retains significant and genuine attributes of the traditional lesser status, the form of the transaction adopted by the parties governs for tax purposes. [Citations omitted.]

Twenty-First Securities Transactions

Two U.S. corporations were approached by Twenty-First Securities Corporation, a promoter, for a series of transactions. The promoter identified American Depositary Receipts ("A.D.R.'s") of public European companies that had announced dividend distributions. The promoter arranged for an intermediary to borrow A.D.R.'s owned by tax-exempt entities that were not able to claim a foreign tax credit on the 15% dividend withholding tax. The intermediary sold the A.D.R.'s short to the corporation-taxpayer for fair market value plus 85% of the expected dividends. The stock lender received cash equal to 102% of the fair market value.

This purchase carried a settlement date before the record date for the dividends, meaning the corporation received the dividends. The A.D.R.'s would then be sold immediately with a settlement date after the dividend-record date. The second sale price was lower because it did not include the dividends, creating a loss for the corporation. And unlike the stock lender, the corporation could claim a foreign tax credit for the dividend withholding tax.

The I.R.S. lost their attempts to recharacterize the transactions.[12] In *Compaq Computer Corp. v. Commr.*,[13] the Fifth Circuit held that the transaction was a genuine multi-party transaction, made at arm's length, that had business and regulatory motives behind it, rather than only tax avoidance.

The mere fact that a tax benefit existed did not make the transaction a sham. The transaction had a reasonable possibility or profit along with a real risk of loss. Notably, Compaq made profits on a pre-tax basis, as the gross dividend income before the foreign withholding taxes exceeded the capital loss. The I.R.S. argued that the economic benefit should have been measured on a cash basis, excluding foreign tax credits. The court rejected this argument. It was inconsistent with the I.R.S.'s acceptance that the issuing corporation's withholding and satisfaction of Compaq's foreign tax liability created additional income for Compaq. The argument was also internally inconsistent because the I.R.S. wanted to treat the withholding tax as a cost but not the foreign tax credit as a benefit.

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[12] *IES Industries Inc. v. U.S.,* 253 F.3d 350 (8th Cir. 2001).

[13] 277 F.3d 778 (5th Cir. 2001).

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The benefit stemming from the foreign tax credit in this transaction is no longer possible due to Code §901(k)(1)(A)(i), which disallows the foreign tax credit for withholding on dividends if the recipient of the dividend holds the stock for fewer than 16 days in the 31-day period beginning 15 days before the ex-dividend date.

Palmer v. Commr.

A chiropractic school found its ability to obtain grants limited because of its status as a profit-making corporation.[14] The school consequently decided to become a not-for-profit entity. To effect this conversion while maximizing the tax benefit, the corporation's shareholders formed a charitable foundation and contributed their shares to the foundation. This resulted in a deduction for charitable contributions. The foundation then caused the dissolution of the corporation. This allowed the school assets to be distributed in a liquidation distribution that was tax-free at the level of the corporation under the law at the time and not taxed at the level of the not for profit foundation. The I.R.S. unsuccessfully argued that the steps should be collapsed because the taxpayer in the lawsuit controlled the foundation and knew that the corporation was to be liquidated after its contribution to the foundation.

The case raised the question of whether a taxpayer must choose the form of transaction that yielded the highest tax liability. Problematically for the I.R.S., the vote in favor of the liquidation had not yet taken place. There was no requirement that the foundation go through with the plan.

The Tax Court ruled that an expectation of an event is not enough to rearrange the order of steps chosen by the taxpayer. The I.R.S. would eventually acquiesce in Revenue Ruling 78-197.

Code: §7701(o)

Reasons for the Enactment of §7701(o)

The report from the Joint Committee on Taxation reveals the reasons behind the creation of Code §7701(o).[15] The case law, as illustrated by the cases described above and others, indicated a lack of consistency in the approach to the economic substance doctrine. No uniformity existed regarding the type of non-tax economic benefit a taxpayer must establish in order to demonstrate that a transaction has economic substance. Some courts denied tax benefits on the grounds that a stated business benefit of a particular structure was not, in fact, obtained by that structure. Other courts denied tax benefits on the grounds that the subject transactions lacked profit potential. Still others applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but these factors were insignificant when compared to the tax benefits. Also, courts differed on whether financial accounting benefits arising from tax savings qualified as a non-tax business purpose.

Several cases involved transactions structured to allocate income for Federal tax purposes to a tax-indifferent party, with a corresponding deduction, or favorable basis result, to a taxable person. The income allocated to the tax-indifferent party for tax purposes was structured to exceed any actual economic income to be received by the tax-indifferent party to the transaction.

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[14] 62 T.C. 284 (1974).

[15] JCX-18-10.

Codification of the Economic Substance Doctrine

To help create a more unified doctrine, Congress enacted a statutory version of the economic substance doctrine. The codified rule provides that a two-prong test must be met in order for a transaction to have economic substance. The provision provides that, in the case of any transaction to which the economic substance doctrine is relevant, a transaction is treated as having economic substance only if

- the transaction changes in a meaningful way the taxpayer's economic position, apart from Federal income tax effects; and
- the taxpayer has a substantial purpose for entering into such a transaction apart from Federal income tax effects.

Under the second prong of the test, a taxpayer's non-Federal-income-tax purpose for entering into a transaction must be substantial. The provision does not mandate a minimum return. Rather, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

State or local income tax effect which is related to a Federal income tax effect will be treated in the same manner as a Federal income tax effect. Achieving a financial accounting benefit will not be treated as a purpose for entering into a transaction if the origin of the financial accounting benefit is a reduction of Federal income tax. Fees and other transactions are taken into account as expenses in determining pre-tax profit, and foreign taxes are to be treated as expenses per the Regulations.

"Under the second prong of the test, a taxpayer's non-Federal-income-tax purpose for entering into a transaction must be substantial."

The determination of whether the economic substance doctrine is relevant to a transaction is made in the same manner as if Code §7701(o) was not enacted.

Basic Business Transactions

The J.C.T. report states that the provision is not intended to alter the tax treatment of certain basic business transactions that are respected under longstanding judicial and administrative practice merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Illustrative examples of such transactions given by the J.C.T. report include the following:

- The choice between capitalizing a business enterprise with debt or equity.
- A U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment.
- The choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under Subchapter C of the Code.
- The choice to utilize a related-party entity in a transaction, provided that the arm's-length standard of §482 and other applicable concepts are satisfied.

As under present law, whether a particular transaction meets the requirements for specific treatment under any of these provisions is a question of facts and circumstances. Additionally, the fact that a transaction meets the requirements for specific treatment under any provision of the Code is not determinative of whether a transaction or series of transactions of which it is a part has economic substance.

Code §6662 Penalty

A 40% penalty applies under Code §6662(b)(6) where any portion of an underpayment is attributable to one or more undisclosed, non-economic substance transactions. The penalty calls for strict liability, and reasonable-cause arguments are not relevant. Reliance on the opinion of counsel is irrelevant, also. If the non-economic substance transaction is disclosed, the penalty is reduced to 20%. The disclosure is generally made on Form 8275 (Disclosure Statement). However, if a taxpayer takes a position that a Regulation itself is invalid, the appropriate form is Form 8275-R *(Regulation Disclosure Statement)*.

Notice 2010-62

The I.R.S. has issued Notice 2010-62, which advises taxpayers of the following:

- The law will be applied literally.
- Once it is determined that economic substance is relevant, both prongs of the legislative economic substance test must be met.
- Application of existing caselaw that applies only one leg of the two-pronged test will be challenged.
- The I.R.S. will not issue a Private Letter Ruling or determination letter regarding whether the economic substance doctrine is relevant to any transaction or whether any transaction complies with the requirements of §7701(o).
- The I.R.S. will continue to analyze when the economic substance doctrine will apply in the same fashion as under prior law.
- If authorities under prior law concluded that the economic substance doctrine was not relevant in determining whether certain tax benefits are allowable, the I.R.S. will continue to take that position.
- The I.R.S. anticipates that caselaw will continue to develop. This may be a euphemism that existing caselaw will be challenged.
- The I.R.S. does not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply.

Recent L.B.&I. Guidance

Previously, approval by the Director of Field Operations was required before the codified economic substance doctrine could be formally asserted. This reflected congressional concerns about overzealous I.R.S. examiners. But in 2022, the L.B.&I. (Large Business & International) Division issued a memorandum that removes the requirement to obtain executive approval before asserting the codified economic substance doctrine. Taxpayers are at greater risk of running afoul of the economic substance doctrine.

THE VIEW FROM THE EUROPEAN UNION

Background

Over the last decade, the international tax framework for holding companies operating in the European Union (the "E.U.") has grown increasingly complex. This complexity arises, *inter alia*, from the proliferation of anti-abuse rules designed to curb aggressive tax planning and ensure fair taxation. As a result, non-E.U. investors face a genuine challenge in navigating the fine line between legitimate tax planning, which may or may not be earmarked as aggressive, and abusive tax avoidance.

This section of the article aims to serve as a practical guideline to prevent E.U. holding structures from being classified as abusive leading to the potential denial of tax benefits.

We will first explore the advantages and restrictions associated with E.U. holding structures. Subsequently, we will delve into the primary abuse of rights within the E.U., drawing lessons from the so-called "Danish Cases" of the Court of Justice of the European Union (the "C.J.E.U."). Then, we will discuss the forthcoming substance requirements within the E.U. under the proposed Unshell Directive, also known as the third Anti-Tax Avoidance Directive ("A.T.A.D. 3"). Finally, we will review the similarities and differences between the Organization for Economic Co-operation and Development's ("O.E.C.D.") approach, specifically under the Principal Purpose Test (the "P.P.T."), and the E.U.'s approach under the general anti-abuse rules ("G.A.A.R.") found in the Parent-Subsidiary Directive (the "P.S.D.") and the A.T.A.D, as well as the general abuse principle recognized in the C.J.E.U.'s Danish Cases.

Tax Advantages and Restrictions for Holding Structures in the E.U.

Holding structures established or operating within the E.U. benefit from tax advantages under the applicable Double Tax Treaties ("D.T.T.") and national laws of E.U. Member States. In addition, they benefit from the following:

- Protection under E.U. primary law, namely the fundamental freedoms guaranteed by the Treaty on the Functioning of the European Union (the "T.F.E.U."), *i.e.*, the free movement of goods, services, persons, and capital.
- Potential advantages under E.U. secondary law, mainly the P.S.D. and the Interest and Royalties Directive (the "I.R.D."), which provide, *inter alia*, for no withholding tax ("W.H.T.") on dividend or interest payments made within the E.U. under specific circumstances.

Note, however, that the E.U. restricts or denies tax benefits for holding structures deemed abusive under the following:

- The general anti-abuse principle contained in E.U. primary law, as recognized in the C.J.E.U.'s "Danish Cases" that we will analyze below.
- Several anti-abuse provisions found in E.U. secondary law, including the following:
    - The Merger Directive (2009/133/CE) includes a Specific-Anti-Abuse Rule ("S.A.A.R.") under Article 15.
    - The P.S.D. (2011/96/E.U.) includes a S.A.A.R. under Article 1, §§ 2-4.

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- ○ The I.R.D. (2003/49/E.C.) includes a S.A.A.R. under Article 5.
- ○ The A.T.A.D. (2016/1164/E.U.) includes a G.A.A.R. under Article 6.

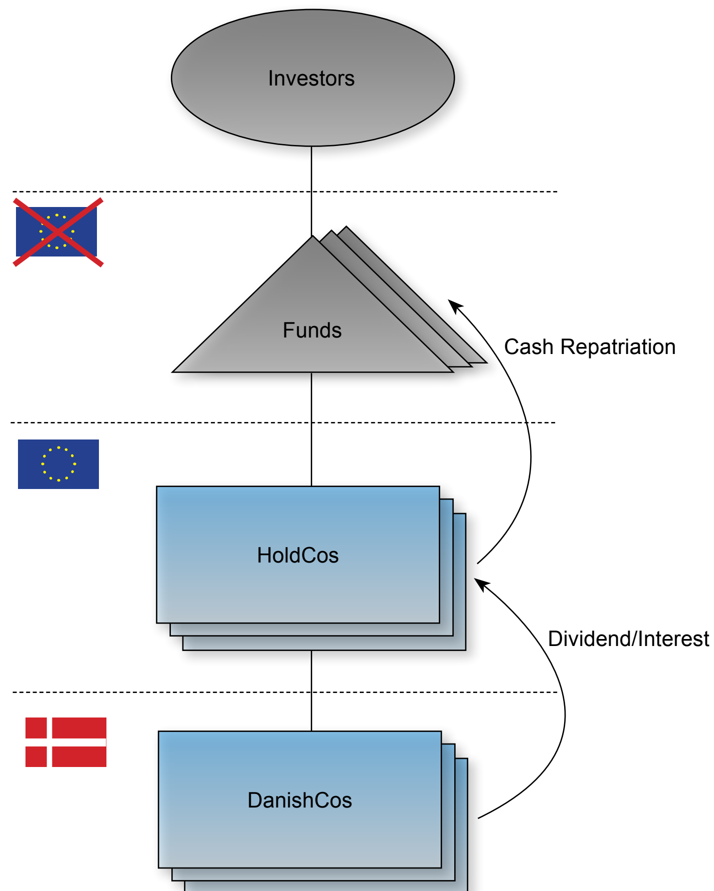
- Other relevant initiatives, such as the following:
  - ○ The Directive on Administrative Cooperation ("D.A.C.") (2011/16/E.U.), which promotes cooperation among E.U. tax authorities to combat tax evasion and avoidance.
  - ○ The E.U. Council's List of Noncooperative Tax Jurisdictions, which identifies jurisdictions that do not meet E.U. standards of tax transparency and cooperation.

Abuse of Rights in the E.U.: Lessons From the "Danish Cases"

In February 2019, the Grand Chamber of the C.J.E.U. delivered two landmark judgments, known as the "Danish Cases," addressing the issue of directive shopping under the P.S.D. and the I.R.D.

Since then, tax authorities in several Member States – including Belgium, France, Italy, the Netherlands, Spain, and Denmark – have relied on the Danish Cases to tackle cases of alleged directive shopping.

Background



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The main question in the Danish Cases was whether dividend and interest payments made by Danish operating companies to parent companies in other E.U. Member States such as Luxembourg, Cyprus, and Sweden were eligible for the W.H.T. exemption in Denmark when the income was fully or partially passed to non-E.U. ultimate parent companies and private equity funds located outside the E.U. in places such as Bermuda and the United States

The taxpayers applied the Danish W.H.T. exemption based on the P.S.D. and the I.R.D. However, the Danish tax authorities denied the W.H.T. exemption claiming that the E.U. parent companies were not the beneficial owners ("B.O.'s") of the payments but mere conduit companies. The case eventually ended up before the Danish High Court, which sought an answer from the C.J.E.U. regarding a preliminary question

General Anti-Abuse Principle

The Danish Cases raised the issue of how the prohibition of abuse of rights should be interpreted and applied under E.U. law. Specifically, the Danish courts asked the C.J.E.U. whether a Member State needed to implement a domestic anti-abuse provision to address abusive practices related to the P.S.D. and I.R.D.

This question was particularly relevant at the time because Denmark had not yet incorporated the P.S.D.'s anti-abuse provision into its national law. Therefore, the critical question was whether Denmark could deny tax benefits to a taxpayer under an anti-abuse provision that had not yet been implemented into national law.

Under the caselaw applicable at the time, a Member State could not apply a specific rule found in a directive if that Member State did not implement the directive into its national law. For example, in the *Kofoed* case (C-321/05), the C.J.E.U. considered that the anti-avoidance provision of the Merger Directive (20019/133/EC) reflected the general Community law principle that abuse of rights are prohibited, but required, that the transposition of an anti-avoidance rule be derived from the domestic general legal context to be in line with the principle of legal certainty. Therefore, and as expected, Advocate General Kokott followed the same conclusion in her opinion on the Danish Cases.

However, the C.J.E.U. disregarded the Advocate General's position and ruled that the E.U. principle regarding abuse of rights applies to prevent fraud or abuse even if domestic legislation has not been enacted. In other words, the C.J.E.U. ruled that Denmark had an obligation to counter abusive practices, even in the absence of a domestic G.A.A.R. in its national law or tax treaties. By doing so, the C.J.E.U. elevated the prohibition of abuse of rights to the rank of a general principle of E.U. primary law.

Note, however, that this principle applies only to rights derived from E.U. primary or secondary legislation, but not to rights based solely on domestic law or tax treaty laws of Member States.

Criteria to Assess Abuse

To determine the existence of an abuse, the C.J.E.U. reiterated the two-pronged tests provided in the *Emsland Stärke* Case (C-110/99), where it held the following:

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> [A] finding of an abuse requires, first, a combination of objective circumstances in which, despite formal observance of the conditions laid down by the [E.U.] rules, the purpose of those rules has not been achieved [and, second] a subjective element consisting in the intention to obtain an advantage from the [E.U.] rules by creating artificially the conditions laid down for obtaining it.

In other words, the E.U. G.A.A.R. incorporates an objective component (*i.e.*, causing the purpose of the applicable rule to be defeated) and a subjective one (*i.e.*, the intention to artificially obtain an advantage).

Even if the subjective and objective elements of the abuse concept can sometimes be difficult to distinguish in cases such as *Cadbury Schweppes* (C-196/04), which involved a wholly artificial arrangement, it is important to note that these two components remain separate.

In the Danish Cases, the Court held that the following elements are suggestive of abuse, even if they must be considered jointly with all of the other facts and circumstances:

- Dividends are passed on to companies that would not have benefited from the advantages granted by the P.S.D. or the I.R.D. without the interposition of the intermediary holding company.
- The intermediary holding company makes little or insignificant taxable profit in the Member State where it is established, as payments that are received are primarily forwarded to a non-E.U. companies.
- The sole activity of the intermediate holding company is to receive dividends and pay them to the B.O. or another entity. This activity, however, must be assessed based on all the relevant facts regarding management, financial statements, costs incurred, staff, premises, and equipment.

Beneficial Ownership

Since the I.R.D. limits the eligibility for the interest W.H.T. exemption to the B.O. of the income, the Danish court requested the C.J.E.U. to provide guidance on the meaning of the term "B.O." and on the relevance of the O.E.C.D.'s Model Tax Convention ("Model Treaty") and its commentaries for its interpretation.

The situation was different for the benefits granted under the P.S.D., as this directive does not include a B.O. test. Consequently, the issues surrounding the P.S.D. cases focused on the interpretation of the term "B.O." within the D.T.T.'s between Denmark and the jurisdictions of the E.U.-parent companies.

In both instances, the C.J.E.U. ruled that the concept of B.O. should focus on the actual recipient of the income, regardless of the person formally identified as such.

Practically speaking, a recipient will be deemed to be the B.O. where it receives the income for its own benefit. In contrast, a person is not a B.O. where it acts as an intermediary, such as an agent, trustee, or authorized signatory for someone else. In this respect, it is crucial for the recipient to be able to determine the use of the income freely.

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Advocate General Kokott proposed interpreting the B.O. concept autonomously under E.U. law, without regard to the commentaries on the O.E.C.D.'s Model Treaty She suggested that non-E.U. countries would otherwise have a say in the interpretation of the I.R.D. Nevertheless, the C.J.E.U. decided to adopt a more dynamic approach and stuck with the O.E.C.D.'s Model Treaty and its commentaries for interpreting the B.O. concept.

In a nutshell, the C.J.E.U. indicated that, in accordance with the O.E.C.D. commentaries on B.O., the fact that there is a legal or contractual obligation to pass on the dividend or, in fact, that dividends are passed on, should serve as an indication of abuse. Interestingly, the C.J.E.U. reproduced the O.E.C.D. commentary language, linking B.O. to a person that has the ability to use and enjoy those dividends.

Requirement of a Tax Advantage

The C.J.E.U. also reiterated the idea that a tax advantage is a *sine qua non* condition for abuse under E.U. law. In other words, there is no abuse if, in lieu of paying dividends directly to the B.O., a company decides to interpose an intermediate company without, however, benefiting from any tax advantage.

Burden of Proof

The C.J.E.U. diverged from Advocate General Kokott's opinion regarding the burden of proof in cases involving the B.O. receiving dividends and the denial of benefits under E.U. secondary law.

For the Court, national tax authorities are not required to automatically identify the B.O. but can request information from taxpayers to assess whether an abuse exists. If a taxpayer refuses to provide the requested information, benefits may be denied.

This does not mean, however, that there is a shift in the burden of proof from national tax authorities to taxpayers. The authorities still bear the responsibility of investigating potential abuse and must provide reasoning for the denial of benefits. However, this investigation can occur in certain cases, typically within the context of a tax audit, for which taxpayers are required to furnish the requested information.

Upcoming Substance Requirements – A.T.A.D. 3/Unshell Directive

On the legislative front, one of the tax developments in the E.U. is the Proposal for a Council Directive laying down rules to prevent misuse of shell entities for tax purposes. Introduced by the European Commission in December 2021, the Directive is commonly referred to as A.T.A.D. 3 or the Unshell Directive.

In the Explanatory Memorandum of the draft Proposal, the Commission explains the purpose of the directive:

> While important progress has been made in [the area of ensuring fair and effective taxation] in the last years, especially with the adoption of the Anti-Tax Avoidance Directive (A.T.A.D.) and the expansion of scope of the Directive on Administrative Cooperation (D.A.C.), legal entities with no minimal substance and economic activity continue to pose a risk of being used for improper tax purposes, such as tax evasion and avoidance, as confirmed by recent massive media revelations.

In fact, within the E.U., legal personality is granted by Member States based on purely formal requirements such as minimum capital or minimum number of shareholders and without any review or checks of the economic activity of the entity. Therefore, it is relatively easy for non-E.U. investors to interpose an E.U. entity to enjoy advantageous tax treatment under D.T.T.'s, E.U. primary law such as the fundamental freedoms or secondary law such as the P.S.D. and the I.R.D., and national laws of Member States.

To combat inappropriate use of shell companies, the draft Proposal proposes rules to identify shell entities in the E.U., allow for the exchange information among Member States about identified shell entities, and deny E.U. tax benefits to identified shell entities. Purportedly, the goal is not to make shell entities disappear, but to avoid their abusive use for tax purposes.

If adopted and implemented, undertakings deemed as lacking minimal substance would be denied treaty benefits and benefits under E.U. primary and secondary law, particularly under the P.S.D. and I.R.D.

First Step: Is the Entity in Scope?

All E.U. entities are in scope, except entities with listed securities such as publicly traded stocks or bonds and regulated entities. In the initial proposal by the Commission, entities with at least five full times employees are also out of scope. However, this exclusion was removed by the European Parliament.

Note that, in contrast with the O.E.C.D.'s Pillar 1 and 2 initiatives, the A.T.A.D. 3/Unshell Directive is not limited to large M.N.E.'s.

Second Step: Is the Entity at Risk?

The proposed Directive sets elements to identify undertakings that are at risk for lack of substance and potential misuse for tax purposes. It initially specifies the criteria that should lead to the obligation for taxpayers to report their substance on their tax returns. To be "at risk," an entity must meet three criteria:

- More than 65% of its income or assets are categorized as passive
- More than 55% of its activities or assets relate to cross-border transactions
- Administration and management are outsourced to a third-party

If an entity is at risk, it must report in its annual tax return whether

- premises are available for its exclusive use (shared use by entities of the same group also counts),
- at least one E.U. bank account is active, and
- at least one qualified director or the majority of the full-time employees live close to the undertaking and are involved in the decision-making process.

The current Proposal suggests that Member States impose a penalty of at least 2% of the entity's turnover for incorrect reporting or failing to report. In the event of a false declaration, an additional penalty of at least 4% of the entity's revenue would be imposed.

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National tax authorities must assess each year whether an entity or undertaking is a shell based on the information furnished by the company. A presumed shell entity can present proof to show it has genuine economic activity and sufficient nexus with the Member State of which it claims to be a tax resident. Even if an entity is not a shell under the A.T.A.D. 3/Unshell Directive, it may still be still be considered a shell under national law.

Third Step: What if the Entity is a Shell?

Shell entities are not eligible for tax benefits under the network of D.T.T.'s in force and effect of the Member State in which tax residence is claimed. Also, it is not considered to be resident of that State for purposes of claiming benefits of certain European Directives, such as the P.S.D. and the I.R.D.

Similarities in the O.E.C.D. and E.U. Approaches to Abusive Tax Structures

Comparing the indicia used by the O.E.C.D. and the E.U. to determine the existence of abuse, certain factors are similar under both sets of rules.

Legal (Non-Tax) Reasons and Political Advantages

In the *Centros* Case (C-212/97), the C.J.E.U. acknowledged that the choice of an individual to incorporate a company in a Member State cannot be the sole reason for a corporate structure to be deemed abusive so that tax benefits are denied under E.U. law. The court stated:

> Choosing to incorporate in a Member State] whose rules of company law seem to him the least restrictive * * * cannot, in itself, constitute an abuse of the right of establishment.

Along the same line, the O.E.C.D. Model Treaty commentary on Article 29(9)(Example F) identifies factors that are considered legitimate for establishing a company in a specific jurisdiction. Included are the following:

- Skilled labor force
- Reliable legal system
- Business-friendly environment
- Political stability
- Membership of regional grouping
- Sophisticated banking industry.

Mere Presence of an Intermediate Holding is Not Decisive

In the *Eqiom* Case (C-6/16), the *Deister Juhler* Case(C-504/16), and the Danish Cases (C-116/16), the C.J.E.U. acknowledged that the mere interposition of a holding company cannot be the sole determining factor for identifying an abusive situation. Likewise, having a single owner or ultimate owner in the holding structure is not automatically an indication of abuse. The O.E.C.D. Model Treaty commentary on Article 29(9) is in line with this approach.

Multiple Investments

The fact that a holding company has multiple investments is an indication of non-abuse. This appears to be relevant for both the O.E.C.D. and the C.J.E.U. as implied in the *Deister Juhler* Case (C-504/16) and in the Danish Cases (C-116/16).

Beneficial Ownership

This concept is relevant for both the O.E.C.D. Model Treaty and the C.J.E.U. even though the outcome might be different.

Nationality or Residency of Ultimate Owner

Even though the C.J.E.U. appeared not to find the nationality/residence of a taxpayer relevant in the *Eqiom* Case (C-6/16) and the *Deister Juhler* Case (C-504/16), the opposite approach was taken in the Danish Cases (C-116/16). In the Danish Cases, the fact that the ultimate beneficial owner was based in a third country and would not benefit from the same favorable tax treatment had it received the income directly was indicative of abuse. By doing so, the C.J.E.U. aligned itself with the O.E.C.D. criteria.

Limited Economic Activity

The C.J.E.U. indicated multiple times that limited economic activity can be analyzed with other facts and circumstances as an indication of abuse. Companies that merely receive and pass on dividends are targeted by this approach. This is also the O.E.C.D.'s approach.

It should also be noted that, even though not yet formally adopted and subject to modifications, the A.T.A.D. 3/Unshell Directive brings additional substance elements to the analysis that imply abuse.

Differences in the O.E.C.D. and E.U. Approaches for Assessing Abusive Tax Structures

Despite their similarities, the O.E.C.D. approach with the P.P.T. and the E.U. approach with G.A.A.R. contain three main differences. As a result, the same set of facts and circumstances may be deemed abusive under one test, but not on the other.

Scope of Application

While the P.P.T. applies only in situations involving benefits derived from a D.T.T., the E.U. G.A.A.R. has a more comprehensive reach. The A.T.A.D., for example, applies to all taxpayers subject to corporate tax in one or more E.U. Member States, including entities with permanent establishments ("P.E'.s") in E.U. territories. In both instances, the P.P.T. and the G.A.A.R. have a subsidiary character, meaning that they apply even when a S.A.A.R. is applicable.

Abuse Threshold

On the one hand, the E.U. G.A.A.R., influenced by caselaw from the C.J.E.U., focuses on artificiality in arrangements, categorizing them as non-genuine and lacking valid commercial reasons reflecting economic reality. On the other hand, the O.E.C.D.'s P.P.T. employs a reasonableness test, evaluating the primary purpose of a transaction or structure and its relationship to core commercial activities.

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Burden of Proof

In the E.U., the responsibility of demonstrating abuse lies primarily with tax authorities, who must collect and present evidence to support their claims. In contrast, under the O.E.C.D.'s P.P.T., tax authorities bear the burden of proof regarding the element of intent while the taxpayer bears the burden of proof that the transaction is within the object and purpose of the particular benefit that is claimed under the applicable D.T.T.

"The legislation adopted by the B.V.I. and Cayman are similar in nature and require that an entity which carries on a relevant activity as defined below is required to satisfy the appropriate economic substance test in relation to the activity."

VIEW FROM THE B.V.I., CAYMAN, AND NEVIS

Background

This portion of the article focuses on economic substance legislation in the British Virgin Islands, the Cayman Islands, and Nevis.

The British Virgin Islands ("B.V.I."), Cayman Islands ("Cayman"), along with fellow U.K. Crown Dependencies and Overseas Territories, introduced Economic Substance Legislation in response to concerns of the E.U.'s Code of Conduct regarding favorable tax regimes. The targets of the Code of Conduct are those jurisdictions and tax regimes in non-E.U. Member States that generate profits without proper economic activity, resulting in potentially harmful economic consequences to Member States of the E.U. For this purpose, harmful economic consequences generally refer to lost tax revenue in the E.U. Member State with no offsetting tax imposed abroad or to hidden income of a tax resident in an E.U. Member State.

The legislation adopted by the B.V.I. and Cayman are similar in nature and require that an entity which carries on a relevant activity as defined below is required to satisfy the appropriate economic substance test ("E.S. Test") in relation to the activity.

Nevis is part of the Federation of St. Christopher ("St. Kitts") and Nevis (the "Federation"). While it is not a U.K. Crown Dependency or Overseas Territory. Nevis adopted a regulatory initiative requiring companies to file simplified tax returns with the local tax authority. The Nevis legislation draws no distinction between entities carrying relevant activities and those that do not.

Additionally, all three jurisdictions adopted legislation as part of their commitment to comply with the Base Erosion and Profit Shifting ("B.E.P.S.") initiative of the O.E.C.D., with a focus on B.E.P.S. Action 5 covering intellectual property regimes.

B.V.I. and Cayman

If a relevant entity In the B.V.I. and Cayman carries on at least one relevant activity, it must submit a return to the local authority. In the B.V.I., the local authority is the International Tax Authority and in Cayman it is the Department of International Tax Co-operation (each of which is the "T.I.A.").

Self-Certification

The return is submitted on an annual basis, providing certain prescribed information and demonstrating how the relevant entity has satisfied the E.S. Tests set out in the relevant legislation. The T.I.A. reviews the return and determines whether the relevant entity satisfies the E.S. Test.

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The process of determining whether a relevant entity is in scope for economic substance purposes is one of self-certification by its directors or controlling persons. However, the local authority has made it clear that each relevant entity will need to demonstrate the process leading to the self-certification. The material will be held in the entity's permanent files and will be made available to the T.I.A. upon request. Where a relevant entity conducts more than one relevant activity, the E.S. Test must be met in respect of each relevant activity.

Relevant Entities

In general, a relevant entity includes the following:

- A company that is incorporated in the B.V.I. or Cayman and an LLC formed in Cayman.
- A limited partnership registered in the B.V.I. or Cayman. For this purpose, a limited partnership formed in the B.V.I. includes a partnership without legal personality.
- A company incorporated outside of the B.V.I. or Cayman and registered as a foreign entity under the relevant local companies act.

Relevant entities do not include the following ("Excluded Entities"):

- Investment funds. However, if the investment fund conducts one or more separate and distinct activities that fall within the definition of a relevant activity under the local regime, it will be a relevant entity as to those activities. As a result, Directors and controlling persons must be mindful of the Economic Substance Act. Prudence dictates that a determination should be undertaken each year as to the scope of activities carried on by the investment fund other than investment business.
- An entity that is tax resident outside the B.V.I. or Cayman. While these entities are Excluded Entities, a return is required demonstrating tax residence abroad.
- Ordinary domestic companies resident in Cayman
- Trusts
- Not for profit associations

Relevant Activity

All B.V.I. or Cayman entities must submit a notice to the T.I.A. confirming whether a relevant activity has been conducted during the reporting period. Relevant activities include each of the following:

- Banking business
- Distribution and service center business
- Financing and leasing business (without consideration are excluded)
- Fund management business (B.V.I. Approved Manager exemption)

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- Headquarters business
- Holding company business (pure equity holding entities have reducing economic substance return requirements)
- Insurance business
- Intellectual property business
- Shipping business

Requirements of the E.S. Test

A relevant entity conducting at least one relevant activity will satisfy the E.S. Test, if the relevant entity

- conducts core income generating activities ("CIGA") from within the B.V.I. or Cayman in relation to that relevant activity,
- is directed and managed appropriately from within the B.V.I. or Cayman, and
- having regard to the level of relevant income derived from the relevant activity carried out from within the B.V.I. or Cayman
    - has an adequate amount of operating expenditure incurred in the jurisdiction,
    - has an adequate physical presence, and
    - has an adequate number of full-time employees or other personnel with appropriate qualifications in the jurisdiction.

In applying the last bullet of the E.S. Test, the term "adequate" means as much or as good as necessary for the relevant requirement or purpose. The term "appropriate" means suitable or fitting for a particular purpose, person, or occasion.

Outsourcing

In both the B.V.I. and Cayman, a relevant entity can satisfy the E.S. Test in relation to a relevant activity by outsourcing relevant CIGA to another person in the B.V.I. or Cayman. Where that path is taken, the entity must monitor and control how the CIGA is carried on by the third party in the jurisdiction. If the CIGA is monitored and controlled by someone outside B.V.I. or Cayman, the E.S. Test will not be met.

While the relevant entity in the outsourcing arrangement files the tax return and self-certifies its compliance, the T.I.A. is in contact with the service provider who may need to verify information submitted to the T.I.A. by the relevant entity.

In no event may the outsourcing be employed to circumvent the E.S. Test.

Economic Substance Classification and Filing

For both jurisdictions, the Directors and controlling persons of the relevant entity are responsible for classifying and ensuring submission of the applicable Economic Substance return with the local authority.

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Penalties

Financial penalties can be imposed in the B.V.I. or Cayman for non-compliance or failing to meet the E.S. Test. Penalties are also imposed for the failure to file the Economic Substance Return and for the failure to file the return on time. If the compliance failure is criminal in nature, Cayman law calls for fines and imprisonment.

Nevis

The Federation operates a worldwide system of corporate income tax. Companies that are tax resident in the Federation are taxable on a worldwide basis. Companies that are not Federation tax residents are taxed only on income that is sourced in the Federation. This approach to tax differs significantly from the approach that adopted by the B.V.I. or Cayman.

Tax Residence

The Federation is a commonwealth jurisdiction. Federation law does not define the term "resident." Consequently, the term resident is interpreted by reference to common law.

In broad terms, a company is deemed to be tax resident in the jurisdiction where management and control occur. Tax residence in the Federation is determined by the central management and control test, as established under common law.

Central management and control is not daily operational management. Normally, central management and control is considered to be located in the jurisdiction where the board of directors convene and make management decisions on behalf of the company. This general rule is supplemented by ensuring that the board of directors is capable of making business decisions. Consequently, board members must consist of individuals suitably qualified and capable of managing the affairs of the company. Key strategic decisions of the company (especially relating to its business should be made at meetings of the board of directors. These decisions relate to capital structure, business strategy, investments, and dividend policy. All these requirements should be documented in minutes of meetings of the board of directors.

"In broad terms, a company is deemed to be tax resident in the jurisdiction where management and control occur."

If a company's management and control are located outside the Federation and no income is generated within the Federation, it will not be considered a tax resident of the Federation. Thus, it is important for the board of directors to serve a real function in the governance of a Nevis company. The delegation of corporate secretarial type functions to third parties in the Federation will not result in the company having its central management and control in the Federation.

Business Enterprise

Where a company is tax resident is determined separately from where it has its legal seat. A company's incorporation in the Federation does not mean it will be tax resident there. It is also possible for a company to be incorporated outside the Federation and a tax resident in the Federation.

Where a company is not tax resident in the Federation, it will be taxable in the Federation if activities carried on in the Federation amount to a Business Enterprise. A resident/non-resident company must take a factual approach of its business

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operations to assess if it meets the definition of having a Business Enterprise, and thus taxable in the Federation on its income connected with operations carried out in the Federation. This must be done on a case-by-case basis.

Where a company has a Business Enterprise in the Federation, it would be liable for tax. Alternatively, where a company is not tax resident in the Federation and does not have a Business Enterprise in the Federation, it would fall outside the scope of tax and would not be taxable in the Federation.

The establishment of a financial account in the Federation should not give rise to the nonresident having a Business Enterprise in the Federation. Similarly, the delegation of corporate secretarial, shareholder nominee services, or other administrative functions to corporate service providers in the Federation should not lead to the creation of a Business Enterprise in the Federation.

Tax Returns

Taxable entities in the Federation must file the required tax return on an annual basis. The tax return is due not later than three and one-half months after the fiscal year-end of the entity.

The official filing date depends on the delivery method. If the tax return is hand delivered, the return will be date stamped by the Inland Revenue Department (the "I.R.D.") on the day it is received by the department and that date will be considered the filing date. If the tax return is mailed or delivered by some other delivery method, the postmarked date will be considered the date of filing. In the event that a tax return is filed late, penalties and interest will be applied.

Entities classified as nonresidents will be required to file a Simplified Tax Return annually with the I.R.D. This requirement to file the Simplified Tax Return for nonresident entities applies to all entities that are registered under the Nevis Business Corporations Ordinance and the Limited Liability Companies Ordinance. Directors of Nevis corporations and managers of L.L.C.'s are required to sign a declaration and provide the I.R.D. with information about tax residence, activities, and income of entities.

The Simplified Tax Return will need to be filed by the local registered agent of the entity. However, all required information must be provided by the directors or managers of the entity.

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EFFECT OF RULING NO. 288/2023 – ITALIAN ANTI-HYBRID RULES ATTACK THE 2020 SWISS CORPORATE TAX REFORM

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Tags
Anti-Hybrid Rules
Circular Letter no. 2/2022
Legislative Decree No. 142/2018
Mismatch Arrangements
Principal Company Regime
Ruling No. 288/2023

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INTRODUCTION

Under the O.E.C.D./G-20 Base Erosion and Profit Shifting ("B.E.P.S.") initiative, hybrid mismatch arrangements have become a sensitive issue. This position culminated in the proposed anti-hybrid rules, *i.e.*, linking rules, to counter the double non-taxation resulting from double deductions or deductions without the inclusion of income by a counterparty.

Within the European Union ("E.U."), the Anti-Tax Avoidance Directive (E.U. Directive 2016/1164)[1] ("A.T.A.D. 1") introduced secondary legislation to ensure an effective and coordinated implementation of anti-avoidance tax measures. It establishes a minimum standard among Member States for countering tax practices that could affect the functioning of the internal market. An anti-hybrid rule is among the anti-tax avoidance measures contained in the A.T.A.D. 1. Among other things, it counters hybrid mismatches that arise in transactions touching corporate tax systems of two or more E.U. Member States.

Given the limited scope of A.T.A.D. 1, the Council decided that it was necessary to strengthen the level of protection against hybrid mismatches in the internal market. Consequently, the Council enacted Anti-Tax Avoidance Directive (E.U. Directive 2017/952)[2] ("A.T.A.D. 2"), which extends the scope of A.T.A.D. to third-country situations and counters new forms of asymmetric tax outcomes caused by permanent establishment ("P.E.") mismatches, imported mismatches, reverse hybrid mismatches, tax residence mismatches, and hybrid transfers.

THE ITALIAN ANTI-HYBRID RULES

Legislative Decree no. 142/2018[3] (the "Italian A.T.A.D. Decree") transposes A.T.A.D. 1 and A.T.A.D. 2 into the Italian tax system without significant deviation. It provides rules against the erosion of the tax base of E.U. Member States and the shifting of profits, including anti-hybrids rules.[4] The Italian anti-hybrid rules apply to fiscal years beginning on or after January 1, 2020, except for the provisions targeting the reverse hybrid mismatches, which will apply to fiscal years beginning on or after January 1, 2022.

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1 Council Directive (E.U.) 2016/1164 of July 12, 2016.

2 Council Directive (E.U.) 2017/952 of May 29, 2017.

3 Legislative Decree no. 142 of November 29, 2018.

4 Reference is made to Articles from 6 to 11 of the Italian ATAD Decree.

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Qualifying Taxpayers

The Italian anti-hybrid rules apply to all persons subject to Italian corporate income tax ("*Imposta sul reddito delle società – IRES*,"), generally imposed at the rate of 24%, including Italian P.E.'s of nonresident companies, partnerships treated as fiscally transparent under the Italian tax law, and individual entrepreneurs.

Scope

Mismatches involving taxpayers considered to be controlling or controlled enterprises located in different jurisdictions or arising in the context of a structured arrangement between two independent enterprises, wherever located, are covered by the Italian anti-hybrid rules. The notion of control[5] and structured arrangement[6] is in line with the definitions of under A.T.A.D. 1 and A.T.A.D. 2.

The Explanatory Note to the Italian A.T.A.D. Decree is aligned with point 28 of the Preamble to A.T.A.D. 2, and mirrors the explanations and examples included in the 2015[7] and 2017[8] O.E.C.D. B.E.P.S. Report on Action 2 – Hybrid Mismatch, which is a primary source of interpretation.

The purpose of the Italian anti-hybrid rules is to prevent double nontaxation by eliminating the tax advantages of mismatches and to put an end to (i) multiple deductions for a single expense, (ii) deductions in one country without corresponding taxation in another, and (iii) the generation of multiple foreign tax credits for the amount of a single foreign tax paid.

In particular, the Italian anti-hybrid rules target payments under a hybrid mismatch arrangement that give rise to one of the following three outcomes:

- **Deduction and non-inclusion mismatch ("D/N.I.").** This arises when a payment results in a deduction in one jurisdiction with no corresponding inclusion in the taxable base of the recipient located in the other jurisdiction. The D/N.I. must be derived from different tax treatment (irrespective of the legal label) in the two jurisdictions involved in an instrument, payment, entity, or branch.
- **Double deduction ("D/D").** This occurs when taxpayers are entitled to a deduction in two countries for the same payment.
- **Indirect D/N.I.** This relates to payments that are deductible by the payor under the rules of the its jurisdiction of residence but are not subject to tax in the jurisdiction of residence of the payee.

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5 Reference is made to Council Directive (E.U.) 2016/1164 of July 12, 2016, Article paragraph 1, no. 4.

6 Reference is made to Council Directive (E.U.) 2017/952 of May 29, 2017, Article 1, paragraph 1, no. 2, lett. c.

7 O.E.C.D. (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2, OECD/G20 Base Erosion and Profit Shifting Project*, OECD Publishing.

8 O.E.C.D. (2017), *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project*, OECD Publishing.

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Payments made under hybrid financial instruments and payments made by and to hybrid entities can give rise to D/N.I. Regarding D/N.I., the Italian anti-hybrid rules deny the deduction in the payer jurisdiction (the primary rule intervention). In the event the payer jurisdiction does not neutralize the mismatch, an additional defensive rule requires the payment to be included as ordinary income and taxed in the payee jurisdiction (the secondary rule intervention).

In line with point 11 of the Preamble to A.T.A.D. 1, the Explanatory Note to the Italian A.T.A.D. Decree clarifies that the Italian anti-hybrid rules are intended to address only cross-border mismatches and do not apply to mismatches arising between two taxpayers resident in Italy.

“In the event the payer jurisdiction does not neutralize the mismatch, an additional defensive rule requires the payment to be included as ordinary income and taxed in the payee jurisdiction. . .”

DEFINITION OF HYBRIDS AND MISMATCH ARRANGEMENTS

Hybrid mismatch arrangements may be divided into two broad categories, (i) hybrid instruments and (ii) hybrid entities.

Hybrid instruments may be further divided into hybrid transfers, in which persons in two or more jurisdictions claim ownership rights, and hybrid financial instruments, which are intended to allow the counterparties to take different positions as to the tax treatment of the same payment under an instrument.

In line with A.T.A.D. 2, the Italian A.T.A.D. Decree identifies different ways in which a D/N.I. (including an indirect D/N.I.) or a D/D mismatch can arise. They include the following:

- **Use of hybrid financial instruments.** A hybrid mismatch could arise where the D/N.I. is attributable to the differences in the tax treatment of the instrument or the payments made under the instrument. Examples include an instrument treated as a debt in the payer jurisdiction, but treated as equity subject to a participation exemption regime in the payee jurisdiction. Here, the payer will be entitled to a deduction for the interest payment, but the payee does not include the amounts received in taxable income.
- **Disregarded hybrid payments.** Here, a hybrid payment is deductible in the residence country of the payer, such as Italy, but is not recognized as a payment in the residence country of the payee, such as Switzerland.
- **Structures producing double deductions.** Here, a hybrid structure exists, allowing taxpayers in two countries, such as Italy and Switzerland, to claim a deduction for the same payment.
- **Reverse hybrid.** Here, there is a mismatch in identifying the taxpayer in a payment received by the entity, often a transparent partnership. In the country of residence of the entity (Italy), the payment is treated as income of its shareholder. At the same time, in the country of residence of the shareholder (Switzerland), the payment is treated as income of the entity.
- **Dual resident entities.** Here, an entity is treated as a tax resident in two different countries such as Italy and Switzerland, enabling it to obtain benefits of domestic laws or treaties of both countries.

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- **Imported mismatches.** Here, a country (Italy) is denied a deduction for a payment to a resident of a second country where all of the following conditions are met:
  - The recipient is resident in a country (Switzerland) that does not have hybrid mismatch rules.
  - The payment does not itself give rise to a hybrid mismatch for the payor.
  - The taxable income of the recipient is reduced by a payment that gives rise to a hybrid mismatch or a payment made to a third person that claims the benefit of a hybrid mismatch.
- **Deemed branch payments.** Here, there is a notional payment by a taxpayer that is not calculated by reference to an actual expenditure recognized in its accounts.
- **Branch payee mismatches.** Here, (i) a taxpayer in a country (Italy), (ii) maintains a branch outside of that country (Switzerland), (iii) claims a deduction for a payment to the branch, and (iv) taxable income is not recognized by the branch.

Important Caveat

Since cross-border mismatches may also arise in other contexts (*e.g.*, the payment (i) is deductible, (ii) is characterized as interest, and (iii) is paid to a tax-exempt entity), the only types of mismatches targeted by the Italian anti-hybrid rules are those that rely on a hybrid element to produce such outcomes.

CIRCULAR LETTER NO. 2/2022 – GUIDELINES FURNISHED BY THE ITALIAN TAX AUTHORITIES

On January 26, 2022, the Italian tax authorities published Circular Letter no. 2/2022 furnishing general instructions on Italian anti-hybrid rules.[9] The most important clarifications address the following items:

Taxes Covered by the Italian Anti-Hybrid Rules

The Italian tax authorities clarified that the Italian A.T.A.D. Decree does not apply to regional tax ("*Imposta regionale sulle attività produttive – I.R.A.P.*"), generally imposed at the rate of 3.9%. Where an income tax treaty covers local taxes such as regional and municipal taxes, the Italian anti-hybrid rules only consider taxes applied at the national level.

Definition of Negative Item of Income

The Italian tax authorities clarified that this notion should be interpreted in a broad way including any item of cost correlated with a financial flow. Examples listed by the Italian tax authorities include service fees, rental fees, interest expense, and royalty payments. Interestingly, it does not include cost of goods sold.

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[9] The Italian tax authorities published tax ruling no. 833/2021 on December 17, 2021, providing a preliminary set of limited clarifications on the Italian A.T.A.D. Decree on a cross-border royalty payment's scheme.

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Special Tax Regimes

The Italian tax authorities affirmed that no hybrid mismatch or transaction can be challenged when the non-inclusion is caused by a tax status of financial instruments or by a tax exemption regime applicable to the beneficiary for other D/N.I. transactions or as a consequence of a special tax regime.

Nature of Anti-Hybrid Rules

The Italian tax authorities stated that the Italian anti-hybrid rules qualify as tax system rules and not as anti-avoidance rules. This means that if a hybrid mismatch and a tax evasion are challenged as a consequence of a tax audit, possible criminal violations may arise in addition to the tax consequences.

Although the Circular Letter was composed of 115 pages and various examples, the Italian tax authorities do not address all open points previously raised by stakeholders.

RULING NO. 288/2023 –UPDATED GUIDANCE ON THE ITALIAN A.T.A.D. DECREE

On April 7, 2023, the Italian tax authorities issued tax ruling no. 288/2023 (the "Ruling"), furnishing additional administrative interpretations of the Italian A.T.A.D. Decree. The facts in the Ruling involved a Swiss parent company belonging to a multinational group. The ultimate parent company of the group was a U.S. resident entity. The Italian member of the group was owned by a Swiss intermediary parent company. The Italian company acted as a limited risk distributor. It's purchases of inventory from the Swiss parent ultimately were taken into account in determining cost of goods sold ("C.O.G.S.").

Through the close of tax year 2019, the Swiss parent company computed taxable income in Switzerland under the Principal company regime. For Swiss federal tax purposes, that regime provided for the unilateral recognition in Switzerland of the existence of a deemed foreign P.E. and the attribution to the P.E. of part of the Swiss company's profits. In a nutshell, this specific regime allowed the Swiss company to reduce the base upon which taxable income was computed.

From January 1, 2020, the Principal company regime was abolished pursuant to the Swiss Corporate Tax Reform.[10] This led to a repatriation by the Swiss company of its deemed P.E. and a step-up in the adjusted cost basis of the foreign-originated goodwill acquired in the deemed repatriation. The stepped-up cost basis could be amortized over a ten-year period.[11] The amortization could be applied to offset gross profit on sales to internal or external customers or distributors.

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[10] Reference is made to Federal Act on Tax Reform and AHV Financing (May 19, 2019 – Effective date January 1, 2020), and to Swiss Federal Tax Administration, Circular Letter no. 8 (November 15, 2018 – Effective date January 1, 2020), "International tax allocation for principal companies."

[11] Reference is made to Article 61a, par. 1 and 2 of Swiss federal act on Federal Direct Tax of December 14, 1990, allowing taxpayers to declare for Swiss income tax purposes any hidden reserves (including any goodwill) existing at the "beginning of taxation" in Switzerland, without this giving rise to any tax liability.

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In response to a question raised by an Italian company, the Italian tax authorities ruled that the amortization of the notional goodwill value in Switzerland triggered the application of the Italian anti-hybrid rules for D/N.I.[12] The Italian tax authorities explained that the step-up in adjusted cost basis for the foreign-originated goodwill and the of related amortization deductions led to a hybrid mismatch that falls within the scope of the Italian A.T.A.D. Decree.[13] The foreign-originated goodwill represented a negative item of income that triggered a deduction without a corresponding attribution of income in the country (*i.e.*, Italy) where the P.E. was deemed to exist.

Based on the above, C.O.G.S. incurred by the Italian company could not be claimed as an offset to sales when computing gross income to the extent of the amortization deduction claimed by the Swiss company for the accounting period in issue.

Effect on Other Companies

The interpretation provided with the Ruling is not binding on the applicant or other taxpayers. However, the answer given by the Italian tax authorities in tax rulings is strictly followed as guidance and scrutiny practice by tax auditors.

COMMENTS ON THE RULING

The Ruling reflects a hidden assumption that the Swiss tax regime in force from 2020 is a mere extension of the Principal company regime in force through the end of 2019. The Swiss company was unilaterally allowed to step up an amount of notional goodwill and to amortize that amount over a 10-year period. Nothing was paid by the Swiss company to acquire the goodwill. It was simply a consequence of the termination of the Principal company regime. Viewed in that light, it was analogized to old wine in new bottles.

"Whether the belief of the Italian tax authorities is correct is an open question."

Whether the belief of the Italian tax authorities is correct is an open question. The new regime in Switzerland calls for full taxation of profits from sales to the Italian subsidiary. The allowance of amortization deductions is not a special tax regime. Indeed, the Swiss treatment is aligned with rules in force in most European countries.

The rationale of the Italian A.T.A.D. Decree is clear. The Italian A.T.A.D. Decree does not (and cannot) interfere with the tax policy of a government. If Switzerland wishes to foster the Swiss companies engaging in international trades, without exploiting legislative loopholes, it is free to do so.

The Italian tax authorities seem to overrule that approach in the Ruling.

FINAL QUESTIONS

Several questions remain open by the Ruling, and depending on the answer, over-reaching may have occurred.

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12 Reference is made to Article 8, par. 3 of the Italian A.T.A.D. Decree.

13 Reference is made to Article 6, par. 1, letter no. 5 of the Italian A.T.A.D. Decree.

Is the distortion caused by a hybrid mismatch or by a mere introduction of new tax legislation in Switzerland?

In Circular Letter no. 2/2022, the Italian tax authorities clarified that no hybrid mismatch/transaction can be challenged whenever the non-inclusion is caused by (i) special tax status for a financial instrument, (ii) a tax exemption regime enjoyed by the taxpayer for other D/N.I. transactions, or (iii) as a consequence of a special tax regime. Here, the new legislation was enacted through a wide ranging Swiss tax reform. Should that be sufficient to lead to the conclusion that it is something different from a special tax regime?

Moreover, according to the principle of rule of law, the Italian A.T.A.D. Decree may only tackle mismatches deriving from the hybrid instruments and arrangements expressly listed in the Italian A.T.A.D. Decree.[14]

Which provision of Italian A.T.A.D. Decree expressly addresses the transaction in the Ruling?

The Ruling does not fall in any of the hybrid mismatches identified by the Italian A.T.A.D. Decree.

In the Ruling's fact pattern, no payment or cash flow associated caused the goodwill.[15] The Italian tax authorities in fact affirmed that the notional value was recognized by the Swiss company as a consequence of the termination of the Principal company regime. This means that there is no positive item of income correlated to the supposed negative item of income – the amortization deduction generated by the deemed repatriation of goodwill to Switzerland – and that the distortion is caused only by the enactment of new legislation in Switzerland.

Nonetheless, the Italian tax authorities took a highly formalistic approach in justifying its conclusion. It stated the following:

> [I]n other words, the goodwill amortization represents, from a substantial point of view, the method to recognize for tax purposes, even after the abolition of the Principal company regime, the 'internal dealing' between the Swiss parent company and the deemed permanent establishments. This mechanism will allow to transfer negative items of income otherwise not existent.

Where can we find an "internal dealing" if the structure is grounded on a Swiss domestic tax relief?

There is no internal dealing. The Italian tax authorities purport that the termination of the Principal company regime is a notional repatriation of the deemed permanent establishments, which should be a taxable event in Switzerland. However, the amortization deductions over the 10-year period eliminate tax.

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14 Reference is made to Articles 8, 9, and 10 of the Italian A.T.A.D. Decree.

15 The example of Circular Letter no. 2/2022 reported in the Ruling to support the Italian tax authorities' reconstruction of the events relates to a foreign company that purchases intangible assets to deduct the relevant annual amortization amounts. However, there is no purchase or payment in the facts involved in the Ruling.

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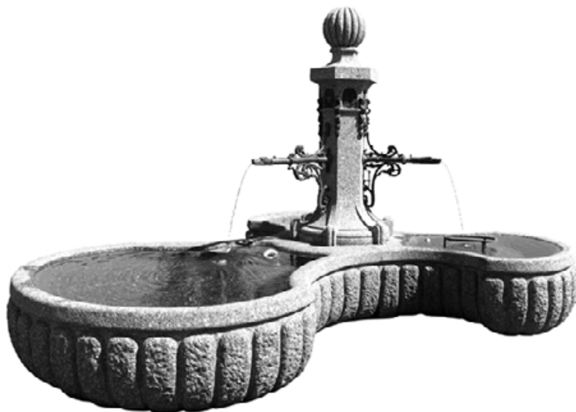
In other words, the goodwill's amortization for the Italian tax authorities represents internal dealing between the Swiss head office and the deemed permanent establishment that results in the creation of nontaxable income.

In our view, the conclusion of the story is best described as follows:

- The Italian tax authorities seem to be offended by the old Principal company regime.
- On this basis they claimed that the old regime pollutes the new regime (and its transitional measures) in force beginning fiscal year 2020.

This approach may appear appealing, but it is not convincing.

A more detailed analysis of the technical issues shows that the arguments developed by the Ruling seems to be weak and disputable in point of fact and in point of law. Rather than a replacement or continuation of the old regime, the new regime is a "totally" distinct regime.



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THE POUR-OVER CLAUSE IN A CROSS-BORDER CONTEXT

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Tags
Alter Ego Trust
Kellog Estate
MacCallum Estate
Pour-Over Trust
Quinn Estate
Revocable Trust
Self-Benefit Trust
Spousal Trust
Testamentary Trust
Vilenski v. Weinrib-Wolfman
Waslenchuk Estate

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INTRODUCTION

With all the career and job opportunities available, many Canadians and Americans choose to cross the border to pursue new goals. Providing trust and estate planning advice to Canadians living in the United States and Americans living in Canada is no longer a rare situation. Where an individual has spent part of his[1] life in one country and part in the other, his will and power of attorney may have been executed in one country but not amended following the arrival in the other country. In case of incapacity or death, this may cause serious headaches to family members. Even though *inter vivos* and testamentary trusts are used in both Canada and the United States, the estate planning strategies differ depending on the jurisdiction in which implemented. For example, U.S. revocable trusts, also called living trusts and grantor trusts, are frequently used in the United States. For assets transferred to the trust while the grantor is alive, the U.S. revocable trust avoids the probate process and acts as a will substitute. Those assets are transferred in accordance with the provisions of the trust, not the will.

A U.S. revocable trust may also be used to receive assets upon the grantor's death. One mechanism to achieve a transfer of assets from the grantor's estate to the revocable trust is the pour-over will that includes a pour-over clause. A pour-over will covers assets that were not transferred into the U.S. revocable trust while the grantor was alive. A pour-over clause is a provision directing that all or part of the grantor's estate be added to the corpus of an existing trust which is revocable and amendable. The validity of the pour-over clause is recognized in the United States. However, in Canada, courts have been hesitant to recognize the validity of a pour-over clause included in a Canadian will.

TYPES OF TRUSTS IN CANADA

For Canadian tax purposes, a testamentary trust is a trust that arose on and as a consequence of the death of an individual.[2] An "*inter vivos* trust" means a trust other than a testamentary trust. It is a trust set up during the settlor's lifetime or a testamentary trust that has lost its qualification as a testamentary trust. The person setting up an *inter vivos* trust is generally referred to as the "settlor" whereas the testator would be the person creating a testamentary trust.

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1 In this text, the masculine includes the feminine and is used only to ease the reading.

2 Subsection 108(1) of the *Income Tax Act*, R.S.C. 1985, c.1 (5th Supplement), as amended, hereinafter referred to as the "I.T.A."

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In Canada, *inter vivos* trusts are typically set up to hold private company shares to split income and capital gains among the beneficiaries and for asset protection.

As for testamentary trusts, a spousal testamentary trust may be recommended where the testator wishes to maintain some control over assets following the testator's death, while benefiting from the rollover that allows a transfer of assets at death on a tax-deferred basis.[3] Taxes are payable upon death of the surviving spouse,[4] and the remaining assets may be transferred outright to beneficiaries or to testamentary trusts.

Where assets are transferred to a testamentary trust that does not qualify as a spousal testamentary trust, the deceased individual is deemed to have disposed of his assets[5] immediately before death and income taxes are payable on the accrued gain.[6] Fifty percent of the gain is taxable.

Prior to 2016, the main difference between an *inter vivos* trust and a testamentary trust was that income earned by the testamentary trust was taxed at graduated rates, as is the case for individuals, while the income earned by an *inter vivos* trust was taxed at the highest marginal tax rate. Tax savings could be obtained by splitting income between the testamentary trust and the trust beneficiaries. For example, if the trust had two beneficiaries, it was possible to tax part of the trust income inside the trust at graduated rates, and to tax part of the trust income in the hands of the beneficiaries. Tax savings could be realized, especially where the beneficiaries had no other income. In addition, prior to 2016, the spousal testamentary trust was a popular tax strategy as income could be split between the trust and the spouse. Beginning in 2016, the spousal testamentary trust no longer provides tax benefits. For non-spousal testamentary trusts with several beneficiaries, tax savings can still be achieved by splitting income among the beneficiaries.

Therefore, prior to 2016, considering the tax savings that could be achieved with a testamentary trust, using an *inter vivos* trust to transfer assets at death was not a widespread strategy. But things changed in 2016, when the Canadian government decided to tax income from both *inter vivos* and testamentary trusts at the highest marginal tax rate.[7] The same applies at the provincial level. As such, a trust pays tax on its income at the highest marginal tax rate applicable in the province where the trust resides.

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3 Subsection 70(6) I.T.A.

4 Or if the trust sells assets.

5 Some exceptions apply.

6 Subsection 70(5) I.T.A.

7 Subject to two exceptions, one being an estate that qualifies as a graduated rate estate or G.R.E. for the 36-month period following the death of the testator and the other being a qualified disability trust set up for an individual who may claim the Canadian disability tax credit. These trusts may benefit from the graduated tax rates (but for a maximum of 36 months for the G.R.E.).

REVOCABLE TRUSTS IN CANADA

The Canadian Income Tax Act contains provisions allowing a taxpayer to set up an *alter ego* trust,[8] if aged 65 or over, or a self-benefit trust.[9] In both cases, assets can be transferred to the trust on a tax-deferred basis and the trust can generally be revoked during the settlor's lifetime. Taxes are payable when the trust sells assets and upon the settlor's death.

Whereas a self-benefit trust may not have contingent beneficiaries, an *alter ego* trust may. An individual aged 65 or over may transfer property to an *alter ego* trust on a rollover basis if the following conditions are met:[10]

- The trust was created after 1999.
- The trust and the individual are resident in Canada.
- The individual is entitled to receive all the trust income during his lifetime.
- No other person than the individual may, before his death, receive or otherwise obtain the use of any of the income or capital of the trust.

Even though only the settlor may receive or obtain the use of any of the income or capital of the trust during his lifetime, the trust may include contingent beneficiaries who may receive income and capital from the trust following the settlor's death. This strategy allows for assets to be transferred according to the provisions of the *inter vivos* trust, rather than under a will. For example, Mother could set up an *alter ego* trust to which she transfers her real estate and investment portfolio. This transfer will be made on a tax-deferred basis. The trust can provide that upon her death, her children will become beneficiaries of the trust. The assets within the trust are not subject to probate and the beneficiaries can access the assets without delay.

As such, the *alter ego* trust can be used in the estate planning context as a will substitute. However, as the trust document will not deal with all the steps required to liquidate the estate, and as some assets may be kept outside the trust, a simple will to govern the liquidation of the estate usually would be drafted.

When choosing which assets should be transferred to an *alter ego* trust, one must remember that pension plans such as Registered Retirement Savings Plans and Registered Retirement Income Funds, cannot be transferred to a trust without triggering tax. Property such as an investment portfolio, a principal residence, a cottage, rental property, shares of operating and holding companies, and cash can be transferred to the *alter ego* trust. The *alter ego* trust also serves as a tool for asset protection purposes.

The *alter ego* trust may be set up as an alternative to a power of attorney or enduring power of attorney (or protection mandate in the province of Quebec) for managing the assets of the settlor. This may be appropriate when the settlor has health problems that affect his mental capacity, such as Alzheimer's disease, or if there are doubts about the attorney's honesty and integrity. The settlor may be one of the

[8] A joint spousal or common-law partner trust may also be set up. In such a case, taxes are payable upon death of the surviving spouse. Subsection 248(1) I.T.A.

[9] Subsections 73(1), (1.01)(c)(ii), and (1.02)(ii) I.T.A.

[10] Subsections 73(1), (1.01)(c)(ii), and (1.02)(i), and 248(1) I.T.A.

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trustees and should he lose capacity, the trust will remain in place, with the remaining or replacement trustees.

Prior to 2016, using an *alter ego* trust for estate planning purposes could have triggered higher taxes. But since 2016, as explained above, income from both types of trusts is taxable at the highest marginal tax rate. As such, from a tax rate point of view, there is no difference between the two anymore.[11]

Considering the conditions that must be met for a trust to be an *alter ego* trust, a U.S. revocable trust would most likely not qualify as an *alter ego* trust.

Another point worth mentioning is that while a U.S. revocable trust is ignored for U.S. tax purposes, it is treated as a regular trust in Canada. This means that a transfer of assets to the U.S. revocable trust while the grantor/settlor is alive would trigger a deemed disposition for Canadian tax purposes and taxes would be payable on the accrued gains.[12]

THE POUR-OVER CLAUSE IN THE U.S.

A U.S. revocable trust (also called living trust or grantor trust) refers to a trust that is set up during the lifetime of the grantor, that can be amended and totally revoked while the grantor is alive.

The revocable trust is often used as an estate planning strategy. As mentioned above, assets can be transferred to the trust while the grantor is alive or upon the grantor's death. One advantage of the revocable trust is that it avoids the probate process upon the grantor's death on the assets that have been transferred to the trust while the grantor was alive. In case of incapacity or death, the trust may continue and is not automatically wound up. When used to transfer assets upon the grantor's death, a pour-over clause will often be used. As already mentioned, a pour-over clause is a provision directing that all or part of the grantor's estate be added to the corpus of an existing trust.

THE POUR-OVER CLAUSE IN CANADA

Situations where a pour-over clause may be used or considered in the Canadian context include the following:

- A U.S. citizen who set up a U.S. revocable trust while living in the United States moved to Canada on a permanent basis and wishes to transfer his Canadian assets to the U.S. revocable trust upon his death.

---

[11] But before using the *alter ego* trust as a will substitute, the type of assets held by the taxpayer must be reviewed, as well as the possibility of transferring assets on a tax-deferred basis to a surviving spouse or spousal testamentary trust. As taxes will be payable upon the settlor's death, assets held inside the trust cannot be transferred to a spouse or to a spousal testamentary trust on a rollover basis.

[12] A U.S. revocable trust may raise tax issues for an individual who is a Canadian resident for tax purposes, such as double tax and a mismatch of foreign tax credits. These issues are however beyond the scope of this article.

- A Canadian parent with a child living in the United States is looking for a strategy to reduce the child's exposure to U.S. estate tax and is then considering adding a pour-over clause in his Canadian will. A properly drafted U.S. revocable trust would be set up while the Canadian parent is alive for the benefit of the U.S. child and his children. This trust would generally be set up with a nominal amount. Following the Canadian parent's death, the U.S. revocable trust would receive assets from the parent's estate to reduce the child's exposure to U.S. estate tax.

"Regarding the revocable trust, one interesting point is that in addition to being amendable and revocable, the trust included a provision allowing the trustees to change the beneficiaries."

However, based on case law, is a pour-over clause a valid technique to transfer Canadian assets at death?

WHAT DO THE COURTS IN CANADA THINK ABOUT THE POUR-OVER CLAUSE?

<u>In British Columbia</u>

<u>Kellogg Estate</u>

In *Kellogg Estate (Re)*,[13] the court was asked to decide whether a real estate property located in British Columbia known as the "Musgrave Farm" could be transferred to a U.S. revocable trust under a pour-over clause found in a will made while the testator was living in Washington.

Robert Payne Kellogg and his wife made their wills in the U.S. in 1994 and a U.S. revocable trust was created at the same time (the "KF Trust").

Robert Payne Kellogg passed away on April 15, 1999, when he was living in Washington.

Regarding the revocable trust, one interesting point is that in addition to being amendable and revocable, the trust included a provision allowing the trustees to change the beneficiaries. The trust was amended after the will was executed to remove one of the beneficiaries of the trust.

The following provisions were found in the deceased's Will:

> Residue of Estate
>
> [a] I give, devise and bequeath all the rest, residue and remainder of my property of every kind and description (including lapsed legacies and devises), wherever situated and whether acquired before or after the execution of this Will, to the Trustee under that certain Trust executed by me, which is known as [the KF Trust]. * * *
>
> [b] If for any reason the said Trust shall not be in existence at the time of my death, or if for any reason a court of competent jurisdiction shall declare the foregoing testamentary disposition to the Trustee under said Trust as it exists at the time of my death to be invalid, then I give all of my estate including the residue and remainder thereof to that person who would have been the Trustee under

[13] 2013 BCSC 2292, 2015 BCCA 203.

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said Trust, as Trustee, and to their substitutes and successors under the Trust, as such trust is described hereinabove.

Justice Gray held that to recognize the validity of the pour-over clause would allow Robert Payne Kellogg to change his will without having to comply with the requirements of the *Wills Act* of British Columbia.[14] For the court, a gift cannot "pour over" on terms which did not exist at the time the will was executed. Consequently, a pour-over clause to a revocable, amendable, *inter vivos* trust is invalid. The fact that the trust could be amended in the future and that it was amended was determinative.

After concluding that the pour-over clause was invalid and mentioning that there is a strong presumption against intestacy, Justice Gray reviewed the provision of the will mentioned above under [b] called the Incorporation by Reference Clause applicable should the pour-over clause be declared invalid. After analyzing the requirements for incorporating a document in a will, Justice Gray indicated that the Incorporation by Reference Clause incorporates the terms of the KF Trust indenture, which governed the trustee on the date that Robert Payne Kellogg executed the will. Justice Gray came to the conclusion that the Musgrave Farm is to be held on a testamentary trust which is on the same terms as the KF Trust, without amendment, and with the result that the initial beneficiaries have an equal share in the Musgrave Farm. The beneficiary that was removed by the trustees was then added back.

Quinn Estate

The validity of a pour-over clause was also reviewed by the court in *Quinn Estate*.[15]

Pat Quinn, a former well-known head coach and general manager in the National Hockey League was a Canadian and American citizen. His wife, Sandra, had a green card and was a Canadian citizen. While living in the U.S., Pat Quinn set up a U.S. revocable trust for his wife and himself. The trust was settled on March 4, 1996. The trust deed provided that Pat Quinn and his spouse could withdraw property from the trust as well as amend it.

On April 1, 1996, Pat Quinn executed a will in respect of his Canadian assets. The Canadian will was prepared by his U.S. attorney and was executed in British Columbia. All the requirements for proper execution of a will were met.

In March 1997, Pat Quinn made some changes to the revocable trust so that it would qualify as a qualified domestic trust ("Q.D.O.T.").

Under the revocable trust, Pat and Sandra Quinn were the first beneficiaries. Upon death of the surviving spouse, assets held in Canada were to pour over in the U.S. revocable trust for the benefit of Pat Quinn's adult daughters Valerie and Kathleen. At the time of his death, on November 23, 2014, Pat Quinn was living in British Columbia.

Sandra Quinn, in her capacity as executor of the Canadian will of Pat Quinn, was seeking the court's determination as to whether a pour-over clause was invalid.

[14] Which was repealed by the Wills, Estates and Succession Act ("*WESA*"), SBC 2009, c. 13, s. 193, effective March 31, 2014.

[15] 2018 BCSC 365, 2019 BCCA 91.

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Under British Columbia law, to be valid, a will must meet all of the following requirements:

- It must be in writing.
- It must be signed at its end by the will-maker, or the signature at the end must be acknowledged by the will-maker as his or hers, in the presence of two or more witnesses present at the same time.
- It must be signed by two or more of the witnesses in the presence of the will-maker.

Although Pat Quinn's Canadian lawyer advised him, upon his return to Canada, to wind up the revocable trust and revise his estate plan, Pat Quinn unfortunately passed away before he could make the required changes.

In finding the pour-over clause to be invalid, the court stated:

> [49] The Legislature's purpose in requiring particular formalities for the proper execution of a will is to ensure certainty as to the deceased's final wishes and to avoid controversy (and possible litigation). The possible use of a revocable, amendable, *inter vivos* trust as the recipient of a testamentary gift, bequest or devise creates that uncertainty the Legislature sought to avoid. Put bluntly, a person could one day execute his or her will, fully observing the execution strictures of s. 37(1) of WESA, leaving the residue of his or her estate to a revocable, amendable, *inter vivos* trust, which he or she could then revoke or amend the following day without regard to any execution strictures.
>
> [50] Having two witnesses present at the time of a will-maker's execution of his or her will or codicil serves to protect against fraud or undue influence, or the perception of such, thereby helping to ensure certainty of the will-maker's final wishes. A well-founded perception that there is the protection against fraud or undue influence often serves to maintain, give, or secure family harmony, especially as the will-maker approaches his or her later part of life.

The court saw two problems with the revocable trust. The first problem was that since the trust was amendable and revocable and had in fact been amended after the execution of Pat Quinn's will, this amounted to an amendment not made in compliance with the formalities of the British Columbia's Wills, Estates and Succession Act.

The second problem is that since the trust can be amended, it cannot be known with certainty how the property will devolve upon Pat Quinn's death since the transfer of the property is governed by terms not found in the will itself.

Pat Quinn's daughter, Valerie, tried to convince the court to uphold the validity of the pour-over clause that transferred the Canadian assets to the U.S. revocable trust. Her lawyer urged the court to distinguish this situation from *Kellogg Estate* where the amendment involved a change in beneficiaries as opposed to a change of an administrative nature.

Unfortunately, the court concluded that the clause was invalid, and that the residue of the property should be vested according to the rules of intestacy.

The court of appeal for British Columbia refused to apply the doctrine of Incorporation by Reference to validate the pour-over clause because as of the date of Pat Quinn's will, the trust, being amendable and revocable, was not a presently existing document and a testator cannot, by his will, create for himself a power to dispose of his property by an instrument not duly executed as a will or codicil under British Columbia law.

Waslenchuk Estate

In *Waslenchuk Estate*,[16] the court applied the same reasoning as in *Quinn Estate*. In *Waslenchuk*, the testatrix set up a revocable trust and had her will prepared in November 2013 while she was living in Connecticut. Her will and the revocable and amendable *inter vivos* trust were executed in accordance with the formal requirements in force in that jurisdiction. Mrs. Walenchuk was looking for a vehicle to manage her assets in case of incapacity, provide for the ultimate distribution of her assets upon her death, and minimize the impact of probate.

However, she came back to British Columbia, where she was domiciled at the time of her death in 2016. Under her will, the residue of her estate was to be distributed to the revocable trust. The Supreme Court of British Columbia held that even though the revocable trust was never amended following the signing of the will, the pour-over clause was invalid.

The court referred to section 101 of the British Columbia Wills, Estates and Succession Act that indicates that regardless of where a will is made, the administration of an estate of a deceased person who was ordinarily resident or domiciled in British Columbia at the date of the person's death is governed by the statute:

> [54] A testamentary document such as a will is meant to reflect the testator's fixed and final intentions for the disposition of his or her estate upon death. A testator may change those intentions by revoking a will and executing a new one or by executing a codicil to the existing will, so long as the requirements in *WESA* are complied with.

In Nova Scotia

MacCallum Estate

There is one case decided by the Supreme Court of Nova Scotia, *MacCallum Estate*,[17] that approached the issue of the validity of a pour-over clause differently. It focused on whether there had in fact been an amendment or revocation of the trust after the will was executed.

Royal Trust Corporation of Canada ("Royal Trust") was the executor of the last will and testament of Helen F. MacCallum, and the trustee of the Helen MacCallum Alter Ego Trust. She passed away in 2020. The Royal Trust applied to the court for an interpretation of the legal effect of the will, specifically clause 3(d) that states:

[16] 2020 BCSC 1929.

[17] 2022 NSSC 34.

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> *Rest of my Estate*. Pay or transfer the rest of my estate to Royal Trust, as trustee of the Helen MacCallum Alter Ego Trust (the "Trust"), to be added to the capital of the Trust and administered and distributed in accordance with the terms of the Trust. The receipt of the trustee of the Trust shall be a sufficient discharge and release to all concerned without any need to inquire into or investigate the terms of the Trust. If the Trust does not exist at my death, distribute the rest of my estate on the same trusts, terms and conditions as the Trust as it existed as of the date of this will.
>
> Although I wish to note it here for the benefit of my trustees, I expressly do not incorporate the trust Helen MacCallum Alter Ego Trust establishing the Trust into my will be reference and it does not form part of my will. I want it to remain a private document.

The Supreme Court of Nova Scotia upheld the pour-over clause in *MacCallum*. Because (i) the trust was created before the signing of the will, (ii) it was funded, and (iii) its terms had not been changed since the signing of the will, the considerations raised in *Kellogg* and *Quinn Estate* were not applicable. For the court, recognizing the validity of the will is supported by the public presumption against intestacy and is in keeping with the clear intentions of the testatrix. The court added that the requirements provided under the Wills Act to make sure a will is valid were enacted to protect the testator against fraud and undue influence and to make sure the testator has testamentary capacity. But it remains important to respect the testator's wishes and where there is a will, there is a presumption that the transfer of assets upon death should not be made under the rules of intestacy.

"The Royal Trust was then authorized as executor of the will to pay and transfer the residue of the estate to the alter ego trust."

The Royal Trust was then authorized as executor of the will to pay and transfer the residue of the estate to the *alter ego* trust.

In Ontario

Vilenski v. Weinrib-Wolfman

However, this is not the end of the story as the *Vilenski v. Weinrib-Wolfman*[18] court case, rendered in Ontario after *MacCallum Estate*, applied the findings in *Kellogg* and *Quinn*. The pour-over provision found in a will made in 2017 that indicated that the residue of the estate had to be paid to an *alter ego* trust that was set up before the signing of the will was declared invalid even though there were no changes to the trust after the making of the 2017 will. The trust was set up in March 2016. For the court, the mere possibility that the trust be modified is an issue. The formalities required for a will to be valid are not respected.

Tal Vilenski who was the estate trustee of the estate of Lynda Weinrib and trustee of the Lynda Weinrib Alter Ego Trust was questioning the validity of the pour-over clause in Lynda Weinrib's will, considering that there was no decided case that he could find in Ontario that deals directly with the validity of a pour-over clause.

The pour-over clause in Lynda Weinrib's will reads as follows:

> 4. (d) Residue My Estate trustee shall pay or transfer the residue of my estate to the trustees of The Lynda Weinrib Alter Ego Trust (the

[18] 2022 ONSC 2116.

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> said trust having been established by me immediately prior to the signing of this my Will) who are holding such office at the time of my death or, if there is no person holding the said office at the time of my death, the trustees who are first appointed to such office after my death.

The fact that the adult children beneficiaries under the will were prepared to consent to a declaration that the pour-over clause was valid did not change anything.

The court compared the reasoning and approach taken by the courts in British Columbia and Nova Scotia and adopted the reasoning in the *Quinn Estate* case and determined that the pour-over clause in the 2017 will was not valid.

<u>In Quebec</u>

With respect to the province of Quebec, the courts have not been asked to consider the validity of a pour-over clause.

However, as is the case in other Canadian provinces, the formalities governing the various kinds of wills must be observed, on pain of nullity. In the province of Quebec, three forms of wills are recognized: the notarial will, the holograph will, and the will made in the presence of witnesses. However, if a will made in one form does not meet the requirements of that form of will, it is valid as a will made in another form if it meets the requirements for validity of the other form. As such, pending a court decision on this matter, upon death, it might be prudent to transfer assets to a testamentary trust as opposed to a revocable *inter vivos* trust.

CONCLUSION

In Canada, each province has specific legislation applicable to wills and estates and strict requirements must be met for a will to be valid.

Where the strict formality requirements for testamentary documents are not followed, assets are transferred on intestacy.

Given the state of the case law in Canada, if a pour-over clause is to be included in a will, estate planning practitioners should consider creating the trust directly in the Canadian will as opposed to having a separate document. The idea is to mirror the provisions of the revocable trust in the will.

Should a separate document be more appropriate, considering the facts and circumstances, another option may be to set up an irrevocable trust, instead of a revocable trust.

To be even more cautious, adding "backup" language in the will to avoid intestacy should be considered.

In any event, it will be interesting to see if courts from other provinces will follow *Quinn Estate* or will rather agree with the findings in *MacCallum Estate*.

There is no doubt that the combined expertise of Canadian and U.S. estate planning experts can be of great value when dealing with cross-border tax and legal issues and may prevent unpleasant surprises for individuals with ties to both Canada and the United States.

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INTERNATIONAL MARRIAGES – SPECIAL U.S. TAX CONCEPTS

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Tags
Civil Unions
Code §2056A
Code §6013(g)
Code §6013(h)
Code §7701(b)(4)
Code §879
Community Property
Domicile
Joint Returns
U.S. Residence

INTRODUCTION

It is not uncommon for a U.S. citizen or tax resident to marry a person who is not a citizen or resident of the United States. It is also not uncommon for non-U.S. spouses to come to the United States, and for one or both to eventually become U.S. tax residents. While some spouses may wish to obtain U.S. citizenship or residence, not all may wish to do so or can do so.

Tax residence is an important concept, as the U.S. taxes its citizens and residents on worldwide income. A nonresident alien as to the United States is taxed only on U.S. source income.[1]

Marriage customs vary in other countries. Some countries and certain U.S. States permit civil unions or civil partnerships. These arrangements would not be treated as a marriage for U.S. tax purposes. Treasury regulations provide that two individuals who enter into a relationship denominated as marriage under the laws of a foreign jurisdiction are recognized as married for Federal tax purposes if the relationship would be recognized as marriage under the laws of at least one State, possession, or territory of the United States, regardless of domicile.[2]

The concept of marriage is also important, as the U.S. permits certain married individuals to file a joint income tax return, with more favorable tax brackets.

SPECIAL RULE FOR COMMUNITY INCOME

Many jurisdictions outside the United States have some form of community property law determining the rights of each spouse to community income or marital income. The laws of the State or foreign country in which a couple is domiciled govern the determination of whether property is community property or separate property for Federal income tax purposes. Generally, community property is property

- that one spouse, or both, acquire during the marriage while both are domiciled in a community property State or foreign country,
- that both spouses agree to convert from separate property to community property, and
- that cannot be identified as separate property.

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1 For a discussion of tax residence, please see Stanley C. Ruchelman, "Pre-Immigration Income Tax Planning, Part I: U.S. Tax Residence," *Insights* Vol 2, No. 3 (March 2015)

2 Treas. Reg. §301.7701-18.

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Community income is generally income from

- salaries, wages, and other compensation received for the services performed by one spouse or both during marriage while domiciled in a community property State or foreign country; and
- real estate that is treated as community property under the laws of the State or foreign country where the property is located.

Separate property is generally

- property that one spouse owned separately before the marriage;
- money earned while domiciled in noncommunity property State or foreign country;
- property that one spouse received separately as a gift or inheritance during marriage;
- property that one spouse bought with separate funds, or acquired in exchange for separate property, during marriage;
- property that both spouses converted from community property to separate property through an agreement valid under local law; and
- the part of property purchased with separate funds if part were purchased with community property funds and part with separate funds.

Lastly, income from separate property generally is the separate income of the spouse who owns the property.

If a Code §6013(g) election has not been made to treat a nonresident alien spouse as a U.S. tax resident (discussed below), a special tax rule provides for allocation rules in the case of a married couple one or both of whom are nonresident alien individuals and who have community income for the taxable year. The definition of community property for this special tax provision may differ from the above general rules.[3]

- Earned income (generally income from the performance of personal services), other than trade or business income and a partner's distributive share of partnership income, is treated as the income of the spouse who rendered the personal services.
- Trade or business income, and a partner's distributive share of partnership trade or business ordinary income, is generally allocated to the spouse carrying on the business or the spouse who is the partner.
- Community income not described in in the prior two bulleted paragraphs which is derived from the separate property (as determined under the applicable community property law) of one spouse is treated as the income of such spouse.
- All other community income is treated as provided under the applicable community property law.

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[3] Code §879 and the regulations thereunder. All Code sections refer to the Internal Revenue Code of 1986, as amended.

Income derived from property acquired as consideration for personal services performed is explicitly excluded in the regulations from the earned income treatment in the first bulleted paragraph, above, and is therefore treated as income described in the third bulleted paragraph, above. Such treatment will therefore apply to the sale of stock acquired by the exercise of stock options and other equity-based compensation. Income derived from the exercise of a compensatory stock option will be the income of the person who was granted the stock option alone, but the gain from the sale of the stock will be the income of the grantee spouse alone only if the property is treated as separate property under local law. Otherwise, the gain will be treated as income of both spouses if the other spouse has a proprietary vested interest in that income under local law. As a result, if the grantee of the equity-based compensation is a nonresident and applicable foreign law treats the spouse as having a proprietary vested interest in the gain from the sale of the underlying stock, 50% of the gain may have to be reported in the U.S. even if it is not otherwise reportable by the nonresident spouse. But sometimes, this rule can be beneficial when the grantee is the U.S. citizen spouse, and the nonresident spouse has a vested right in the gain under local applicable law. This can also affect the classification of a foreign corporation as a controlled foreign corporation ("C.F.C."), requiring more than 50% U.S. ownership (as defined in Code §958.

It may be crucial to determine the property law that is applicable to the married couple. In certain circumstances, it may not be the law of the place where the couple currently lives, but rather the laws of the place where the couple was married. As stated above, these rules do not apply for any taxable year for which an election under subsection (g) or (h) of Code §6013 (relating to an election to treat a nonresident alien spouse as a resident of the U.S.) is in effect.

JOINT RETURNS

Ordinarily, the ability to file a joint return requires that both spouses be U.S. tax residents for the entire year. A joint return may be desirable if one spouse has little or no income, and the effective tax rate on joint income is less than it would be if separate returns had been filed. To illustrate, for 2023, the maximum ordinary income tax rate of 37% is reached at an income level of $693,750 for a married couple filing jointly. It is reached at $346,875 for spouses filing separately. A joint tax return may also be desirable as a means of combining capital gains and losses and of obtaining the benefits of foreign tax credits.

U.S. tax law provides some relief under those circumstances, permitting two types of elections.

Code §6013(g)

Code §6013(g) provides in effect that if one spouse is a nonresident alien at the end of the year but the other is a citizen or resident alien, the couple may elect to treat the nonresident alien spouse as a resident alien for the entire year. The effect of the election is to continue to classify the couple as tax residents for all subsequent years in which either of them is an actual resident alien for any part of the year, although the election may be terminated by the couple in a subsequent year.

Revocation or suspension is available under several circumstances. Once revoked, the election cannot be made a second time. Once the couple reach a year in which

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neither of them is an actual resident alien or citizen for any part of the year, however, the election will cease to have any effect and they will be classified as nonresident aliens for all of such year.

If the Code §6013(g) election is made for the first year in the United States and is not terminated with respect to their last year in the United States, the individuals will usually be classified as resident aliens up through the end of their last year in the United States (including all months during that last year after they have moved out of the United States).

"Once the couple reach a year in which neither of them is an actual resident alien or citizen for any part of the year, however, the election will cease to have any effect and they will be classified as nonresident aliens for all of such year."

Code §6013(h)

Code §6013(h) applies to the first year of potential tax residence. It provides that if both spouses are resident aliens (or one is a resident alien married to a citizen) at the end of the year but either or both of them was a nonresident alien at the beginning of the year, each spouse that was a nonresident alien at the beginning of the year may elect to be a resident alien for the entire year. In contrast with the Code §6013(g) election, however, this election has no effect on the couple's U.S. tax status in any subsequent year and may be made only once during a person's lifetime.

Code §7701(b)(4)

It is possible for a nonresident alien first arriving in the United States to fail to achieve residency status for the year if he or she arrived late in the year and has not been present in the United States for a sufficient number of days to meet the substantial presence test for residency. In such a case, it may be possible to achieve residency status by a special election.

Under Code §7701(b)(4) it is possible for a nonresident alien to elect resident alien status from the date of entry if a number of conditions are satisfied:

- The individual is not otherwise a resident alien for the calendar year (also referred to as the "election year").
- The individual was not a resident alien at any time in the calendar year immediately preceding the election year.
- The individual is a resident alien under the substantial presence test for the calendar year immediately following the election year (whether or not the individual is also a resident alien for that year under the green card test).
- During the arrival year the individual is present in the United States for 31 consecutive days and from the first day of that 31 consecutive day period to December 31 of that year, the individual is present in the United States for at least 75% of the time. For purposes of this day count, up to 5 days of absence can be disregarded and treated as days present in the United States.
- If by the due date for the individual's tax return for the election year (generally, April of the following year) he or she has not yet qualified as a resident alien for the following year, the individual pays tax for the election year as if he or she were a nonresident alien and files for an extension of time to file a return for the year. Once the individual becomes a tax resident under the substantial presence test in the following year, residence relates back to the year of arrival. The tax return for that year may be filed as if residence began in that year.

This election is helpful as it permits the spouses to file the Code §6031(g) election (if one spouse qualifies) or (h) election (if both spouses qualify). Recognizing that the Code §6031(g) election may be more flexible.

GIFT AND ESTATE TAX ISSUES

Gifts between U.S. citizen spouses do not attract gift tax. A gift to a noncitizen spouse does not qualify for the unlimited marital deduction and may be subject to Federal gift tax. However, a citizen spouse (or a resident spouse determined for gift tax purposes (domicile in the U.S.)) may gift up to $175,000 per year (for 2023) to a noncitizen spouse.

The creation of a joint interest may under certain circumstances be treated as a gift. However, a creation of a joint bank account or joint brokerage account may not be treated as a gift until the noncontributing joint owner draws on the account.[4] The creation of a joint tenancy in real property, any additions to the value of this tenancy in the form of improvements, reductions in indebtedness on the property, and similar arrangements are not deemed to be transfers of property for gift tax purposes.[5]

If a married couple, neither of whom is a U.S. citizen nor a U.S. resident, is contemplating a move to the U.S., it would be worthwhile to consider making transfers of foreign situs real property and U.S. situs intangible property prior to establishing U.S. residence. If achieved at that time, U.S. gift tax issues are not relevant, although foreign inheritance tax laws must be taken into account.

We have used the term "U.S. resident" throughout this article, for both income, gift, and estate tax purposes. However, the term is defined differently for income tax purposes than it is for gift and estate tax purposes. Residence for the latter purpose is generally referred to as domicile and looks to the place a person intends as a permanent home.

A person may be a U.S. tax resident for income tax purposes but a nondomiciliary for estate and gift tax purposes. Typically, this occurs where an individual is present in the United States for a temporary period and holds a visa other than a permanent resident visa, commonly known as a "Green Card." As a result, gifts made by such individual will be subject to the same rules applicable to other noncitizen nonresidents for gift and estate tax purposes, which generally impose estate tax on U.S. situs property only, and impose gift tax only on U.S. situs property that is tangible personal property such as jewelry, works of art, and automobiles situated in the U.S. or U.S. situs real property.

Under community property laws, since each spouse has a vested right in half of marital property, only half would be subject to U.S. estate tax, upon the death of one of the spouses. As a result, if the deceased spouse was domiciled in the U.S. or was a U.S. citizen, only 50% of the assets will be subject to U.S. estate tax. If the deceased spouse is not domiciled in the U.S. at the time of death but the surviving spouse is a U.S. citizen, no property will be subject to U.S. estate tax to the extent transferred to the surviving spouse.[6] This spousal estate tax deferral is available

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[4] Treas. Reg. Sec. 25.2511-1(h)(4). Rev. Rul. 69-148, 1969-1 C.B. 226.

[5] Treas. Reg. Sec.2523(i)(b)(1).

[6] Code §2056.

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only when the surviving spouse is domiciled in the U.S. In that fact pattern, a testamentary bequest to a qualified domestic trust ("Q.D.O.T.") established for the sole benefit of the surviving spouse may allow deferral until capital is distributed during the lifetime of the surviving spouse or the conclusion of her lifetime.[7]

If neither spouse is a U.S. citizen or a U.S. resident at the time of death, and the estate holds U.S. situs property, a presumption exists that the deceased spouse is the owner of the entire property owned by the couple, making the entire property subject to U.S. estate tax. This presumption may be rebutted by showing the surviving spouse participated in the acquisition with his or her own funds, or by using community property law rules if applicable to the marriage.

PLANNING CONSIDERATIONS SUMMARY

It is most important when advising a married couple to determine whether the couple will be treated as married for U.S. tax purposes. Once that status has been ascertained, it is important to understand whether one or both persons will be subject to U.S. taxation on a worldwide basis as a U.S. citizen or resident. If one, but not both, will be subject to U.S. tax, it would be important to ascertain whether the foreign community property laws would apply, and whether those laws operate to reduce or increase the income subject to tax by the U.S. Finally, it should be explored whether the couple would have a tax advantage if the couple were permitted to file a U.S. joint tax return and whether that should or could be an on-going or a one-year election.

[7] Code §2056A.

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NEW TAX RELIEF OF REPATRIATION OF INTANGIBLE PROPERTY

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Tags
Intangible Property
Repatriation
Section 367(d)
Subsequent Transfer
U.S. Transferor
Qualified Domestic Person

In early May, the I.R.S. published proposed regulations affecting transactions in which U.S. corporations bring intangible property back to the U.S.[1]

In this article, we review the legislative background of the proposed regulations and explain their importance. We will then address the key principle of the proposed regulations.

OUTBOUND TRANSFERS OF INTANGIBLE PROPERTY

Background

Certain transactions involving structural changes qualify for nonrecognition treatment under the Code.[2] Such transactions include contributions of property to 80%-owned corporations in exchange for capital[3] and transfers of property as part of corporate reorganizations.[4]

Code §367(a) limits, and in some cases shuts down, the nonrecognition provisions of Subchapter C of the Code where property is transferred by a U.S. person to a foreign corporation. Code §367(d) provides special rules when the outbound transfer involves intangible property.

Section 367(d)

The term "intangible property" is broadly defined for purposes of Code §367(d) and is applicable to a wide range of intangible properties.[5]

Under Code 367(d), the parties to a transfer of intangible property to a foreign corporation (respectively, the "U.S. Transferor" and the "Foreign Subsidiary") structured as a contribution described in Code §351 or a reorganization described in Code §361 are not eligible for nonrecognition treatment under Code §§351 and 361. Instead, the U.S. Transferor will be treated as having sold the intangible property for

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1 REG-124064-19, RIN 1545-BP55.

2 The Internal Revenue Code of 1986.

3 Code §351.

4 Code §361.

5 See Code 367(d)(4). The definition includes patents, invention, formula, process, design, pattern, know-how, copyright, artistic composition, trademark, tradename, brand name, franchise, license, contract, method, program, system, procedure, survey, study, campaign, forecast, customer list, technical data, goodwill, value of going concern, workforce or other item of value which is not attributable to tangible property or services of an individual.

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payments that are contingent on productivity, use or disposition of the property. Arms-length transfer pricing principles apply in determining whether the payments meet the requirements of Code §367(d).[6] Stated differently, a static amount set forth in the transaction documents likely will be adjusted to meet the deemed contingent consideration requirement.

In general, the payments are deemed received annually over the time of the useful life of the property and are treated as the equivalent of royalties for U.S. Federal tax purposes. In cases where the property is subsequently sold by the Foreign Subsidiary, income is deemed received by the U.S. Transferor at the time of disposition of the property. Similarly, the U.S. transferor is required to recognize gain if the stock of the foreign corporation is sold to an unrelated person.[7]

Any amount included in the taxable income of the U.S. Transferor, either annually or as a lump sum on a disposition, is reduced from the Foreign Subsidiary's earnings and profits.[8] In addition, to avoid double taxation, the royalties imputed by Code 367(d) generally can be paid by the foreign corporation to the U.S. Transferor without further U.S. tax consequences.[9]

SUBSEQUENT TRANSFERS OF I.P. TO RELATED PERSONS – CURRENT LAW

As mentioned above, the U.S. transferor is required to recognize gain on a disposition of the I.P. by the Foreign Subsidiary or on a disposition of the stock of the Foreign Subsidiary to an unrelated person. Immediately after such disposition, the application of Code §367(d) generally terminates.

However, where the I.P. or the stock of the Foreign Subsidiary is transferred to a related person, a different rule applies.[10] In general, Code §367(d) continues to apply following a transfer of the I.P. to a related person.

Three different scenarios of related-person transfers of I.P. are mentioned in the regulations that are currently in effect:

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[6] Code §367(d)(2)(D) and Treas. Reg. 1.367(d)-1T(c)(1).

[7] Code §367(d)(2)(A)(ii)(II); Reg. §1.367(d)-1T(d)(1), §1.367(d)-1T(f)(1).

[8] Code 367(d)(2)(B). Reducing the earnings and profits is expected to weigh heavily in determining the transferor's U.S. federal tax liability if the foreign corporation is a Controlled Foreign Corporation withing its meaning in Code §957.

[9] Treas. Reg. 1.367(d)-1T(g)(1)(i). If the imputed amounts are not paid within the taxable year in which they are imputed, the U.S. transferor may establish a non-interest bearing receivable for the amounts imputed but not paid. To the extent payment is not made on the receivable within the following two-year period, the receivable is deemed contributed to the capital of the foreign transferee corporation. The deemed contribution to capital increases the tax basis in the stock of the Foreign Subsidiary, but terminates the ability of the transferor to receive tax-free payments on the receivable account.

[10] "Related person" is defined in 1.367(d)-1T(h), and includes persons that are considered related under Code §267(b), (c) and (f) with certain modifications, as well as partners or partnerships described in Code §707(b)(1).

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“. . . the I.R.S. published proposed regulations in early May 2023 that terminate the application of Code §367(d) where the I.P. is repatriated to certain U.S. persons that are subject to U.S. taxation.”

- The first scenario involves the transfer of the I.P. by the foreign corporation to a related person. In this scenario, the U.S. transferor is required to continue including the annual payments as if the subsequent transfer never happened.[11] For purposes of this scenario, there is no *distinction* between a related foreign person and a related U.S. person.
- The second scenario involves the transfer of the stock of the Foreign Subsidiary by the U.S. Transferor to a related foreign person. Here, again, the U.S. transferor is required to continue including the annual payments as if the subsequent transfer never happened.[12]
- The third scenario involves the transfer of the stock of the Foreign Subsidiary by the U.S. Transferor to a related domestic person. Here, the related transferee succeeds to the U.S. transferor’s annual payments. Hence, it is referred to as the “U.S. Successor.“[13]

SUBSEQUENT INBOUND TRANSFERS OF I.P. TO RELATED U.S. PERSONS – NEW REGULATIONS

Terminating the Application of Code §367(d)

As explained above with respect to the first scenario, the existing rules provide that Code §367(d) continues to apply and the U.S. Transferor must continue to include the annual payments that are commensurate with the income attributable to the I.P. The existing rule applies even if the I.P. is transferred by the Foreign Subsidiary to a related U.S. transferee.

At the same time, income related to the I.P. is also expected to be included in the U.S. Transferee’s taxable income, since the U.S. Transferee is subject to tax on its worldwide income from all sources under the general U.S. Federal tax rules.

Since both the U.S. transferor and the U.S. Related Transferee are required to include in taxable income the payments related to the I.P., the existing rules may lead to excessive U.S. taxation on income related to the I.P.

To prevent this result, which could dissuade some companies from repatriating their intangible property, the I.R.S. published proposed regulations in early May 2023 that terminate the application of Code §367(d) where the I.P. is repatriated to certain U.S. persons that are subject to U.S. taxation with respect to the income derived from the I.P.[14]

Below are the key principles of the proposed regulations.[15]

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[11] Treas. Reg. §1.367(d)-1T(f)(3),

[12] Treas. Reg. §1.367(d)-1T(e)(3).

[13] Reg. §1.367(d)-1T(e)(1).

[14] REG-124064-19, RIN 1545-BP55.

[15] For a more detailed review, see, REG-124064-19, Explanation of Provisions of the proposed regulations.

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Requirements

Qualified Domestic Person

The proposed new regulations are subject to two conditions. The first condition is that the foreign transferee corporation transfers the I.P. to a Qualified Domestic Person.[16]

- A Qualified Domestic Person includes, first and foremost, the U.S. transferor that initially transferred the intangible property that is subject to section 367(d) which is being repatriated.
- A Qualified Domestic Person also includes any Successor U.S. Transferor to the I.P., provided that such U.S. Transferor is not exempt from U.S. Federal income tax under any of the Code provisions specified in the proposed regulations.[17]
- Finally, a Qualified Domestic Person includes any U.S. person that is related to the initial U.S. Transferor or the Successor U.S. Transferor, provided that if the related person is a U.S. corporation, it is not exempt from U.S. Federal income tax under any of the Code provisions specified in the proposed regulations as described in n. 17.

New Reporting Requirements

The second requirement for terminating the application of Code §367(d) under the proposed regulations is that certain reporting requirements must be satisfied.

While reporting requirements for subsequent transfers of I.P. that are subject to Code §367(d) are already in place under existing rules,[18] the proposed regulations make conforming changes to the reporting requirements, and add information reporting requirements for subsequent transfers to a Qualified Domestic Person.[19]

Tax Consequences

Gain Recognition as to the U.S. Transferor

The proposed regulations require the U.S. Transferor to recognize gain in some cases as a result of the repatriation transaction. Whether the U.S. transferor actually recognizes gain under the proposed regulations, and the amount of such gain, depends on the form of the repatriation transaction.[20]

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16 Defined under Prop. Reg. §1.367(d)-1(f)(4)(iii).

17 Under Prop. Reg. §1.367(d)-1(f)(4)(iii)(B), the following are considered to be persons exempt from tax: (i) a corporation exempt from tax under Code §501(a), (ii) a regulated investment company as defined in Code §851(a), (iii) a real estate investment trust as defined in Code §856(a), (iv) a domestic international sales corporation as defined in Code §992(a)(1)), and (v) an S-corporation as defined in Code §1361(a).

18 Treas. Reg. §1.6038B-1T(d)(2).

19 Prop. Reg. §1.6038-1(d)(2)(iv).

20 See, Prop. Reg. §1.367(d)-1(f)(4)(i) & (ii).

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At a high level, if the repatriation is structured as a nonrecognition transaction, such that the transferee (the Qualified Domestic Person) will have a transferred basis[21] in the transferred I.P.,[22] the U.S. transferor will generally not be required to recognize gain.[23]

If the repatriation is structured other than as described above, the U.S. Transferor will generally recognize gain on the disposition of the I.P., equal to the excess of the fair market value of the I.P. on the date of the transfer over the U.S. Transferor's former adjusted basis in the I.P.[24]

In addition, the proposed regulations require the U.S. Transferor to include in gross income a partial annual inclusion attributable to the part of its taxable year in which the Foreign Subsidiary held the I.P. (*i.e.*, prior to the transfer to the Qualified Domestic Person).[25]

Adjustments Related to the Annual Inclusions

To prevent the Foreign Subsidiary from recognizing gain that is also recognized by the U.S. Transferor by reason of the repatriation transaction, the proposed regulations allow the Foreign Subsidiary to reduce any income arising from the repatriation transaction, to take into account the gain recognized by the U.S. Transferor.[26] This amount can be paid to the U.S. Transferor without further U.S. tax consequences.[27]

Adjusted Basis in the Repatriated I.P.

The proposed regulations are meant to ensure that a Qualified Domestic Person does not receive a tax-free step-up in the adjusted basis in the repatriated I.P.[28]

To achieve that result, the proposed regulations provide for a special rule wherever the repatriation transaction is structured in a way that complies with a nonrecognition provision in the Code and the I.P. qualifies as Transferred Basis Property.

Under the proposed regulations, the Qualified Domestic Person's adjusted basis in the I.P. will be equal to the Foreign Subsidiary's adjusted basis in the I.P. immediately before the repatriations or the U.S. Transferor's former adjusted basis in the I.P., whichever is lower. The adjusted basis is then increased by the greater of the gain recognized by the U.S. Transferor upon the repatriation under the proposed

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[21] Within its meaning in Code §7701(a)(43). See reference in Prop. Reg. §1.367(d)-1(f)(4)(ii)(A).

[22] Determined without regards to Code §367(d). Prop. Reg. §1.367(d)-1(f)(4)(ii).

[23] However, gain might be recognized under certain circumstances. For example, a contribution of property to an 80%-owned corporation in exchange for stock is generally subject to nonrecognition treatment under Code §351(a). Nevertheless, gain must be recognized to the extent a taxpayer received money or other property in exchange for the contributed property under Code §351(b).

[24] Prop. Reg. §1.367(d)-1(f)(4)(ii)(B).

[25] Prop. Reg. §1.367(d)-1(f)(4)(i).

[26] Prop. Reg. §1.367(d)-1(f)(2)(i).

[27] Prop. Reg. §1.367(d)-1(f)(2)(ii). The tax-free transfer of gain is based on the account receivable mechanism provided in §1.367(d)-1T(g)(1).

[28] RIN 1545-BP55, Explanation to Provisions, I.B.2.

regulations, if any, or the amount of gain recognized by the Foreign Subsidiary, if any.[29]

Alternatively, if the intangible property does not qualify as Transferred Basis Property, a Qualified Domestic Person's adjusted basis in the I.P. will be equal to the fair market value of the I.P. as of the date of the repatriation transaction.[30]

Other Modifications

In addition to the key principles explained above, the proposed regulations provide for some other modifications and fix some longstanding errors.

Effective Dates

The new regulations are not yet final. They will apply to dispositions of I.P. occurring on or after the date of publication of the Treasury decision adopting the proposed rules as final regulations in the Federal Register.

CONCLUSIONS

For several years, the regulations issued under Code §367(d) have created excessive U.S. Federal tax liability on repatriation of intangible property. The newly proposed regulations will put an end to such excessive taxation.

The timing of the publication is not surprising. The proposed regulations are aligned with other measures taken by the Treasury Department in recent years to incentivize U.S. corporations to keep their intellectual property onshore.

[29] Prop. Reg. §1.367(d)-1(f)(4)(iv)(A).

[30] Prop. Reg. §1.367(d)-1(f)(4)(iv)(B).

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ALL EYES ON THE I.C.-D.I.S.C. PART TWO: I.R.S. EXAMINATIONS

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Tags
Expense Allocation
Exports
Combined Taxable Income
Grouping
I.C.-D.I.S.C.
I.R.S. Examinations

INTRODUCTION

The Interest Charge Domestic International Sales Corporation ("I.C.-D.I.S.C.") is an undervalued tax planning tool for exporters that can provide substantial tax advantages to U.S. export companies and their shareholders. The background, technical aspects, and tax benefits of the I.C.-D.I.S.C. are discussed in Part One, previously published in *Insights*.[1] Part Two of the I.C.-D.I.S.C. duology reviews the I.R.S. examination procedure and key aspects taxpayers should keep in mind, considering the growing number of I.C.-D.I.S.C. audits.

The number of I.C.-D.I.S.C. returns submitted was relatively low prior to the termination of the foreign sales company and extraterritorial income regimes and the reduction of individual tax rates on qualified dividends. Since 2004, the number of returns has steadily grown, catching the attention of the I.R.S. As a result, the I.R.S. released an I.C.-D.I.S.C. Audit Guide (the "Guidelines")[2] to assist I.R.S. examiners when reviewing tax returns of taxpayers claiming the benefit. Understanding what examiners will focus on also allows export companies to better structure I.C.-D.I.S.C. operations and tax calculations. This article explains important points in the Guidelines and their application to related suppliers that utilize an I.C.-D.I.S.C. to reduce taxes on export sales.

I.C.-D.I.S.C. REVIEW

In order for a corporation to qualify as an I.C.-D.I.S.C. (i) at least 95% of the gross receipts during the taxable year must qualify as export receipts and (ii) at least 95% of the total adjusted bases in assets at the close of the taxable year must consists of qualified export assets. An I.C.-D.I.S.C. can usually satisfy the first requirement through the receipt of a commission payment made by the export company. Because an I.C.-D.I.S.C. is typically established as a passive commission agent that receives fees and distributes dividends, typically the asset test is met.

The commission payment is computed by one of three methods: (i) the 4% of export gross receipts method – the easiest method to apply, (ii) the 50% of combined taxable income ("C.T.I.") method – more difficult to apply because export taxable income requires sophisticated computations, or (iii) the arm's length Code §482 method – which is rarely used as it requires the I.C.-D.I.S.C. to be fully staffed. The taxpayer can select the method that produces the highest commission, thereby generating the highest tax benefit. On the other hand, if a company operates without

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1. Bennet, Michael. "All Eyes on the I.C.-D.I.S.C. Part One: The Export Gift That Keeps On Giving," *Insights* Vol. 10 No. 2 (March 2023).
2. See here.

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a tax department and without a fully staffed I.C.-D.I.S.C., it may choose to use the method that is easiest to compute. The primary benefit of using an I.C.-D.I.S.C. today is converting ordinary income into a qualified dividend through the commission payment and its immediate dividend to individual shareholders, which is taxed at a preferential rate.

OVERVIEW OF THE GUIDELINES

The Guidelines place significant emphasis on the determination of (i) export property and qualified export receipts, (ii) apportionment of expenses, and (iii) the grouping of transactions.

The Guidelines advise examiners to determine whether the property sold is qualified export property. There are three requirements for a product to constitute qualified export property. First, the product must be manufactured in the U.S. by a person other than the I.C.-D.I.S.C. Second, the product must be held primarily for sale or disposition outside the U.S. Third, U.S. inputs must make up at least 50% of total inputs. Qualified export receipts consist primarily of revenue from the sale of export property.

The apportionment of expenses factors into how exporters maximize C.T.I., thereby leading to increased commissions and increased dividends taxed at 20% at the Federal level. One way C.T.I. can be increased is by apportioning a greater amount of expenses to domestic sales. However, that approach may be characterized as a fool's paradise as the I.R.S. is of the view that taxpayers often understate the allocation and apportionment of expenses to export sales. Consequently, the guidelines focus on this issue more than any other due to the complex nature of the calculations.

Generally, the determination of the I.C.-D.I.S.C.'s taxable income is performed on a transaction-by-transaction basis.[3] However, some or all of the computations may be made on the basis of grouping products or product lines.[4] An exporter can also use grouping for one product line and the transaction-by-transaction method for another product line.[5] Grouping allows exporters to increase commissions by separating sales of low-margin products from sales of high-margin products. Exporters generally have wide flexibility when grouping. The I.R.S. will accept an exporter's product grouping or product line grouping if it conforms to recognized trade or industry usage or the two-digit Standard Industry Classification ("S.I.C. codes").[6]

EXAMINATION PROCEDURE

The Necessary Forms

While it is essential for the taxpayer to properly execute and file the necessary forms, the examiner will also naturally pay special attention to the forms as the

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[3] Treas. Reg. §1.994-1(b).

[4] Treas. Reg. §1.994-1(c)(7).

[5] Treas. Reg. §1.994-1(c)(7)(iii).

[6] Treas. Reg. §1.994-1(c)(7)(ii).

foundation for analyzing operations and the tax position of the I.C.-D.I.S.C. and its related supplier.

A corporation must elect to be treated as an I.C.-D.I.S.C. by filing Form 4867-A. The election must be made within 90 days after the beginning of the first taxable year of a newly formed corporation or during the 90 days immediately preceding the beginning of the first taxable year to which the election applies. The I.C.-D.I.S.C. must use the same tax year as that of its largest shareholder, determined by reference to voting power.[7]

"Each transaction or group of transactions that generate qualified export receipts requires a separate Schedule P."

The I.C.-D.I.S.C. files its return on Form 1120-I.C.-D.I.S.C. The Schedule P of Form 1120-I.C.-D.I.S.C. is arguably the most important piece to the auditing puzzle as it is used to calculate the commission payment made by the related supplier to the I.C.-D.I.S.C. The examiner will review the related supplier's books and records in order to assess the accuracy of the Schedule P.

Each transaction or group of transactions that generate qualified export receipts requires a separate Schedule P. Together, the aggregate of all such schedules comprise the total C.T.I. from the sale of export property.[8] For commission I.C.-D.I.S.C.'s, C.T.I. equals the export company's gross receipts from sales of export property, reduced by the export company's expenses (excluding commissions paid to the I.C.-D.I.S.C.) and the I.C.-D.I.S.C.'s expenses related to the gross receipts.

The Schedule P provides the following:

- Name of the I.C.-D.I.S.C.
- Employer identification number
- Identity of the product or product line reported on the schedule
- Type of transaction: transaction-by-transaction or grouping of transactions

The related supplier may combine transactions or groups of transactions on a single Schedule P, provided it maintains supporting schedules for each transaction or group of transactions.

Learning the Taxpayer's Business

The initial step in the examination process is for the I.R.S. examiner to gain an understanding of the related supplier's business and I.C.-D.I.S.C.'s role, which typically is passive. The examiner will review the products that are being sold and the manufacturing process of such products. The examiner's goal is to understand how, when, and where the products are manufactured. Attention is also paid to the selling function and the purchasers of the products. The examiner is instructed to conduct research on the taxpayer's industry to gain a wholistic understanding of the business. Ordinarily, an examiner will attempt to gather information independently. However, nothing prevents a taxpayer from proactively supplying industry statistics to ensure that favorable information is taken into account during the course of the examination.

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[7] Code. §441(h).

[8] Treas. Reg. §1.994-1(c)(6).

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Requesting the Tax Workpapers

Like most audits, the examiner will request the tax workpapers related to the preparation of the tax return and the computation of C.T.I. Most of the expenses incurred to generate the qualified export receipts are on the books of the related supplier, while the expenses that relate to export promotion by the I.C.-D.I.S.C., if any, will be on the books of the I.C.-D.I.S.C.

The examiner will review the income statements of the related supplier to assess the methodology used to allocate and apportion expenses to qualified export receipts. The goal of the examiner is to evaluate whether all direct and indirect expenses have been taken into account.

The examiner will also request accounting records including (i) divisional profit & loss statements and balance sheets and (ii) product line profit & loss and balance sheets. These are more typical for larger companies and reflect the accounting department's view of how expenses should be allocated on a book basis.

Following the review of the above information, the examiner will generally assess the following criteria:

- Are the tax workpapers and Schedule Ps on a tax basis or book basis?
- Are expenses that are allocated to qualified export receipts computed on a reasonable basis for the taxpayer's business?
- Are the end results comparable to similar products sold in the U.S.? For example, if qualified export receipts show a profit of 30% of sales, but similar products sold domestically have a profit of 5%, the examiner will look to reconcile the difference.

Export Property and Qualified Export Receipts

At this point the examiner is instructed to begin analyzing specified export property and qualified export receipts. The examiner will gather and review all the relevant facts and determine whether the sales generate qualified export receipts.

When analyzing the facts relevant to export property, the examiner will review the following:

- The property sold
- The manufacturing process:
  - Who manufactured the property?
  - Where was the property manufactured?
  - Did the manufacturing process occur at more than one location?
  - What is the country of origin for the raw material used to manufacture the property?

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- ○ Did the manufacturing occur after the property was sold and before it was exported from the U.S.?
- ○ Is more than 50% of the value of inputs to export property imported into the U.S.?

- The movement of the property from the place of manufacture to the customer:
  - ○ Where was the property shipped from and which company was the carrier?
  - ○ What documents exist regarding shipment of the goods?
  - ○ Did the goods leave the U.S. within one year?
  - ○ Was the property subject to any further manufacturing, assembly, or other processing between the time of sale or lease and the delivery outside the U.S.?
- The customers
- Whether the property returned to the U.S. or if it can be expected to return to the U.S.
- Whether the property is disqualified from being export property, because it is proscribed in Code §993(c)(2).[9]

When analyzing the facts relevant to qualified export property, the examiner will also review

- whether the gross receipts are listed in Code §993(a)(1), and
- whether the gross receipts are excluded as qualified export receipts per Code §993(a)(2).[10]

Apportionment of Expenses and Computation of C.T.I.

Related suppliers can attempt to increase C.T.I. and D.I.S.C. commissions by allocating more expenses to domestic sales over foreign sales. To prevent abuse,

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[9] Excluded property includes: (i) property leased or rented by a DISC for use by any member of a controlled group (as defined in subsection (a)(3)) which includes the D.I.S.C., (ii) patents, inventions, models, designs, formulas, or processes, whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, for commercial or home use), good will, trademarks, trade brands, franchises, or other like property, (iii) products of a character with respect to which a deduction for depletion is allowable (including oil, gas, coal, or uranium products) under section 613 or 613A, (iv) products the export of which is prohibited or curtailed under section 7(a) of the Export Administration Act of 1979 to effectuate the policy set forth in paragraph (2)(C) of section 3 of such Act (relating to the protection of the domestic economy), and (v) any unprocessed timber which is a softwood.

[10] Excluded receipts are those receipts designated by the I.R.S. as: (i) arising from a transaction that is for ultimate use in the United States, (ii) accomplished by a subsidy granted by the U.S. or any instrumentality thereof, or (iii) for use by the United States or any instrumentality thereof where the use of such export property or services is required by law or regulation.

examiners are instructed to review the manner in which a taxpayer apportions expenses to domestic sales and export sales.

The examiner will use both judgement and actual data to assess whether the computation of C.T.I. is reasonable or requires further analysis. Particularly, the examiner will assess whether the end result complies with Treas. Reg. §1.861-8 (Computation Of Taxable Income From Sources Within The United States And From Other Sources And Activities).

The Guidelines provide examples where an extraordinary end result should be investigated further:

- The entire division had a profit of $10,000,000, but the sum of the profits on the C.T.I. statements, total $9,000,000, when the export sales are less than 50% of total sales.
- The widgets sold in the U.S. have a bottom-line profit of 5%, but when widgets are exported the bottom-line profit is 40%.

An extraordinary result does not automatically mean there should be an adjustment. Prices abroad may be higher than in the U.S. or the U.S. product is viewed to be a premium product in a particular foreign market. Nonetheless, higher profit margins for export suggest that the examiner may need to conduct further analysis. For the related supplier, the key is to adopt a reasonable methodology that is applied consistently and to maintain supporting documents that are part of the permanent tax work papers.

The examiner is encouraged to look at whether (i) certain categories of expenses were not allocated,(ii) other categories of expenses were allocated, but not on an unreasonable basis, and (iii) the product mix is different.

In addition to the above, the examiner will pay close attention to the following potential issues.

Is there a distortion of income that impacts the computation of C.T.I.?

In *General Dynamics Corp. v. Commr*.,[11] the taxpayer excluded certain period costs deducted prior to completion of the contract when computing C.T.I. A period cost is a non-inventoriable cost incurred and deducted in one year related to income recognized in a subsequent year. The taxpayer did not take into account the period costs deducted in a prior year when computing C.T.I. The court held that the taxpayer must account for period costs of both current and prior years in determining its C.T.I.

Example

A taxpayer incurs $100 of period costs on a three-year construction contract. The period costs are incurred $40 in year one, $30 in year two and $30 in year three. The taxpayer uses the completed contract method of accounting. The sale is booked in year three. Assume that 40% of the total sales contract generated qualified export receipts.

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[11] General Dynamics Corp. v. Commr., 108 T.C. 107 (1997).

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In the context of the facts above, the taxpayer argued that only the year three period costs should be allocated to C.T.I., so the taxpayer allocated (40% of $30) $12. The court held that the taxpayer's method resulted in a distortion and allocated (40% of $100) $40 to the C.T.I.

How were R&D expenses allocated by the related supplier?

In *Boeing Co. v. U.S.*,[12] the taxpayer divided its R&D into two broad categories: Blue-Sky and company sponsored product development which included product-specific research. Relying on Treas. Reg. §1.994-1(c)(6), the taxpayer treated all of the company sponsored product R&D as directly related to a single program, and as totally unrelated to any other program. For example, in the taxpayer's calculation of C.T.I., the cost of R&D directly related to the 767 model commercial airliner had no effect on the calculation of the C.T.I. produced by export sales of the other models.

The Supreme Court noted that Treas. Reg. §1.994-1(c)(6) allows the taxpayer to choose to group export receipts and the regulation establishes that there shall be an allocation and apportionment of all relevant costs deducted in the taxable year. However, the court held that Treas. Reg. §1.994-1(c)(6) does not speak to how costs should be allocated among different items or classes of gross income and apportioned between the I.C.-D.I.S.C. and export company once the taxpayer groups its gross receipts.

Example

The 727 was a new product line that did not generate any sales until year three. Sixt percent of the year three sales were exported. In years one to three, the program R&D expenses for the 727 were $100 per year. The $100 of Program 727 R&D expenses in years one and two should be allocated to all sales for all product lines not just sales of the 727 product line.

Are R&D expenses allocated to C.T.I. reduced by the portion of R&D subject to exclusive geographic apportionment?

R&D, like other deductions, is first allocated and then apportioned. The first step is to allocate R&D to product categories based upon the S.I.C. code. The second step is to apportion R&D between the statutory and residual grouping.

Once the R&D is allocated to a product category, it is apportioned under either the sales method or the gross income method. Each of those methods apportion a fixed percentage of the R&D to the geographic source where most of the R&D was performed. For most U.S. corporations, the portion of the R&D subject to the geographic source rule will be allocated to U.S. source income, since typically the R&D is performed in the U.S.

However, the C.T.I. calculation is not based upon whether the qualified export receipts generate U.S. source income or foreign source income. For purposes of computing C.T.I. related to export sales, the exclusive geographical apportionment rule is simply not applicable.[13]

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[12] *Boeing Co. v. U.S.,* 537 U.S. 437 (2003).

[13] Rev. Rul. 86-144.

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Example

The R&D assigned to a product category is $1,000. Sixty percent of the sales in that product category generate qualified export receipts. The taxpayer can use the sales method, and under the assumed facts, $500 is allocated to U.S. source income to the determine the foreign source income. However, the source of export income is not relevant to the computation of C.T.I. The R&D allocated to C.T.I. would be 60% of $1,000 or $600.

In apportioning interest income to export sales, does interest income reduce interest expense when computing C.T.I?

The issue here is whether, when allocating interest expenses to C.T.I., the related supplier must allocate gross interest expense or may it reduce interest expense by interest income and allocate only the net amount of interest expense.

In *Bowater v. Commr.*,[14] the Second Circuit reversed the Tax Court, and held that the plain language of Treas. Reg. §1.861-8(e)(2) controls. Under the regulation, interest expense must be allocated on a gross basis when computing C.T.I.

If export accounts receivable are factored by the related supplier, does this affect the computation of qualified export receipts and C.T.I.?

If an export company factors receivables from export property at a discount, then the discount reduces the qualified export receipts for purposes of computing I.C.-D.I.S.C. profits under the 4% and 50% commission pricing methods.

Did the related supplier recognize losses for the year?

The examiner will look to how a loss was allocated by the taxpayer, keeping in mind that neither the 4% gross receipts method nor the 50% C.T.I. method may be applied to cause a loss in any taxable year to the related supplier.[15]

How are currency gains and losses allocated to C.T.I. and were any variances allocated to qualified export receipts?

In Field Service Advice 199935008,[16] a U.S. subsidiary of a foreign parent manufactured export property in the U.S. and sold the export property to foreign purchasers through a commission F.S.C. The F.S.C. did not take title to the export property. Rather, the it was paid a commission for its services. Sales receipts for the exported property were denominated in foreign currency. Consequently, the U.S. subsidiary hedged the export receivables in order to minimize dollar denominated earnings volatility.

For purposes of determining C.T.I., the losses on the forward sale of foreign currency were required to be taken into account. Under Treas. Reg. §1.861-8(b)(2), a deduction is considered to be definitely related to a class of gross income and therefore allocable to that class if it is incurred as a result of, or incident to, an activity, or in connection with property, from which such class of gross income is derived. Where a deduction is incurred as a result of, or incident to, an activity or in

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14 *Bowater v. Commr.,* 108 F.3d. 12 (2d Cir. 1997).

15 Treas. Reg. §1.994-1(e)(1).

16 This F.S.A. relates to foreign sales corporations. However, the analysis is under Treas. Reg. §1.861-8, which also applies to I.C.-D.I.S.C.'s.

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connection with property which the activity or property generates, has generated, or could reasonably have been expected to generate gross income, the deduction is considered to be definitely related to that gross income as a class, whether or not (i) there is any item of gross income in that class received or accrued during the taxable year or (ii) the amount of deductions exceeds the amount of the gross income in that class. The taxpayer raised various arguments that the losses on the forward sale of foreign currency should have been allocated to potential gains of one kind or another, but not to the export sales income. However, the I.R.S. expressed the view that the foreign currency losses were factually more closely related to the export property receivables which the foreign currency contracts hedged.[17]

Grouping

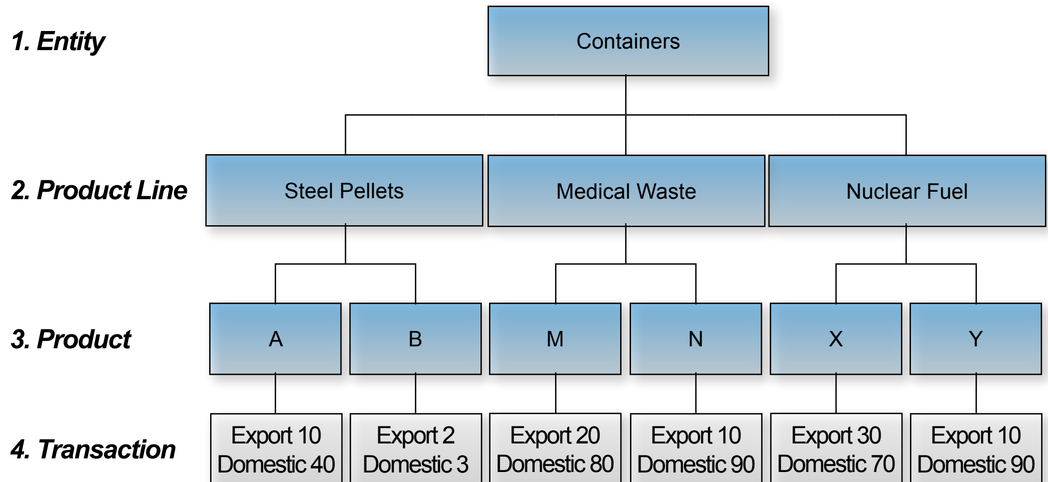
If a taxpayer groups products or product lines to prepare Schedule P of Form 1120-IC-DISC, the taxpayer must be prepared to answer two questions in the case of an examination:

- What is a product line?
- Can a C.T.I. statement be constructed from the taxpayer's books and records for the product or product line?

The first question is answered by applying the S.I.C. Codes or recognized trade or industry usage standard. The second question is answered by a review of the taxpayer's books and records.

The taxpayer can prepare income statements for each of the four levels (entity, product line, products, and transactions). All of the income statements can track the specific sales, direct material costs, direct labor costs, normal applied overhead, and inventory. The below-the-line expenses are allocated by the tax department.

The Guidelines provide several scenarios detailing what are acceptable and unacceptable grouping procedures using the below diagram and example.



[17] Under Code §6110(k)(3), an F.S.A. cannot be used or cited as precedent by any person other than the taxpayer involved. However, an F.S.A. tends to demonstrate the views of the National Office of the I.R.S. as of the date issued and can be cited by others for the limited purpose of avoiding certain penalties.

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In the example, the taxpayer's business is the design, manufacture, and sale of different kinds of containers. The containers store steel pellets, medical waste, and nuclear fuel. Each of these product lines contains two products. Some of the receipts qualify as qualified export receipts. Because the taxpayer has qualified export receipts, it must decide how to place them on Schedule P of the I.C.-D.I.S.C.

Using the example, the Guidelines indicate that the taxpayer has several grouping options, which would result in the following:

- **If performed on an entity basis:** One Schedule P. Total of all 82 export transactions.
- **If performed on a product line basis:** Three Schedule Ps: steel (total of 12 export sales), medical (total of 30 export sales) and nuclear (total 40 export sales).
- **If performed on a product basis:** Six Schedule Ps. For example, steel pellets would have two schedule Ps – product A (total of ten export sales) and product B (total of two export sales). The same idea would apply to medical and nuclear, each of which would have two products.
- **If performed on a transaction-by-transaction basis:** Eighty-two separate Schedule Ps for each export sale.

Taxpayers may also group by marginal costing in addition to the typical grouping rules. The grouping rules for marginal costing involve the computation of the Overall Profit Percentage Limitation ("O.P.P.L.").[18] For purposes of the marginal costing O.P.P.L., the grouping must be at least as broad as the one used to compute the full costing C.T.I.

Continuing with the example above, consider the ten export transactions for product A. Assume that the taxpayer places the first nine on separate Schedule Ps. The tenth transaction has a full costing profit of 1%. To compute the O.P.P.L. for the tenth transaction, the taxpayer can use either (i) all 50 transactions for product A, (ii) the sum of all of the transactions in product A (50 transactions) plus product B (five transactions), or all 455 transactions of the entire container division. The marginal costing rules are subject to a no-loss rule, and for that reason, the profit on the tenth sale cannot exceed the full costing C.T.I.

Lastly, the examiner will review whether any of the grouping are prevented by the regulations.[19]

- A sale transaction cannot be grouped with a lease transaction.
- Qualified export receipts from related and subsidiary services, which are booked in the same taxable year as the export property, can be grouped with the sale or lease to which they relate.

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[18] O.P.P.L. is computed by multiplying the qualified export receipts by the overall profit percentage. The overall profit percentage equals (full costing C.T.I. for I.C.-D.I.S.C. and export company both domestic and export of a product or product line)/(domestic and export sales of the product or product line).

[19] Treas. Reg. §1.994-1(d).

- Qualified export receipts from related and subsidiary services which are not booked in the same taxable year as the export property are subject to a different rule. These qualified export receipts can be grouped with the products or product lines to which the services relate, so long as the grouping of services chosen is consistent with the grouping of products or product lines for the taxable year in which the export property was sold.
- Qualified export receipts from engineering or architectural services are treated on a transaction-by-transaction basis.
- Qualified export receipts from an I.C.-D.I.S.C. rendering managerial services to an unrelated I.C.-D.I.S.C. is treated on a transaction-by-transaction basis.
- The following groupings are not allowable groupings under Code §994:
    - Customer groupings
    - Contract groupings
    - Product or product line groupings within customer or contract groupings
    - Country-by-country

CONCLUSION

While the Guidelines provide examiners with a road map to conduct audits of I.C.-D.I.S.C.'s, they are equally important for export companies utilizing I.C.-D.I.S.C.'s as they highlight the primary areas examiners will review. As part of the lead-up to a sale, prudent taxpayers should thoroughly analyze their determinations of export property and qualified export receipts, how they apportion expenses to domestic and foreign sales, and the manner in which they group transactions. Waiting to perform the analysis until after the year closes and tax returns are prepared can be suboptimal as what-if calculations may no longer be relevant as the facts already exist, and even if choices can be made, there may not be time for full analysis. These key areas comprise the central factors when commission payments and tax benefits are calculated. Having a full understanding of the rules, risks, and issues will assist the taxpayer in achieving the desired tax benefits provide comfort in the event an I.R.S. examination is initiated.

"Having a full understanding of the rules, risks, and issues will assist the taxpayer in achieving the desired tax benefits provide comfort in the event an I.R.S. examination is initiated."

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FARHY V. COMMR. – THE PENALTY FOR FAILING TO TIMELY FILE FORM 5471 MAY NOT BE ASSESSED ADMINISTRATIVELY

Authors
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Tags
Assessment
Code §603
Farhy
Form 5471
Levy
Penalty

INTRODUCTION

"Pygmalion" is a play by the great Irish playwright, George Bernard Shaw. It is named after the Greek mythological figure who carved a marble statue of a beautiful woman, fell in love with it, and finds that she has come alive. It is the basis for the Broadway play "My Fair Lady," and the Hollywood movie that followed.

In the play, Alfred Doolittle seeks £5 from Professor Higgins for allowing him to teach Eliza Doolittle proper manners and etiquette. Professor Higgins refuses, but offers £10, instead. Refusing anything more than £5, Alfred Dolittle goes into a long explanation of the conditions of the undeserving poor. Later in the play he returns a changed man, looking to take on responsibility.

Sometimes, good things happen to the undeserving. In the play, Alfred Doolittle receives a bequest from a faraway benefactor. Recently, a scofflaw who refused to file Forms 5471 and received penalty notices regarding the seizure of his property convinced the Tax Court that the penalty was not self-enforcing. Rather, the Department of Justice would be required to initiate enforcement proceedings in District Court to collect the assessed penalties.

The case is *Farhy v. Commr*.[1] This article explains the rationale for the court's decisions and provides excerpts from client alerts published by various law or accounting firms regarding the effect of the decision on other penalties that are imposed under the Internal Revenue Code.

FARHY V. COMMR.

During his 2003 through 2010 taxable years, Alon Farhy owned 100% of Katumba Capital, Inc., a foreign corporation incorporated in Belize. From 2005 or so through 2010, Mr. Farhy owned 100% of Morningstar Ventures, Inc., a foreign corporation also incorporated in Belize. During the years at issue, Mr. Farhy participated in an illegal scheme to reduce the amount of income tax that he owed, and on February 14, 2012, he signed an affidavit describing his role in that illegal scheme. He was granted immunity from prosecution by a nonprosecution agreement signed on September 20, 2012.

For the years in issue, Mr. Farhy had a reporting requirement under Code §6038(a) in regard to his ownership interests in both Katumba Capital and Morningstar Ventures. He was required to file Form 5471 (Information Return of U.S. Persons With Respect To Certain Foreign Corporations), but failed to do so. He continued to take no action after the I.R.S. brought the matter to his attention, leading the I.R.S. to assess penalties against him under Code §6038(b)(2).

[1] 160 T.C. __ No. 6 (April 3, 2023).

On February 9, 2016, the I.R.S. mailed Mr. Farhy a notice of his failure to file the required Forms 5471 for the years at issue. No forms were filed by Mr. Farhy and as a fact, the court found that failure to file was willful and not due to reasonable cause.

On November 5, 2018, the I.R.S. assessed an initial penalty under Code §6038(b)(1) of $10,000 for each year at issue, and on November 12, 2018, the IRS assessed continuation penalties under Code §6038(b)(2) totaling $50,000 for each Form 5471 for each foreign company for each year. The I.R.S. complied with the written supervisory approval requirements in Code §6751(b) in regard to the Code §6038 penalties.

On January 30, 2019, the I.R.S. issued Letter 1058, Final Notice of Intent to Levy and Notice of Your Right to a Hearing (the "Levy Notice"). In the Levy Notice, the I.R.S. sought to collect penalties under Code §6038 that were previously assessed in the matter.

Mr. Farhy timely requested a hearing pursuant to Code §6330. On February 19, 2019, Mr. Farhy's legal counsel submitted Form 12153, Request for a Collection Due Process or Equivalent Hearing. In the form, Mr. Farhy disputed whether the I.R.S. had legal authority to assess section 6038 penalties.

On June 4, 2021, the I.R.S. issued a Notice of Determination Concerning Collection Actions under IRC Sections 6320 or 6330 of the Internal Revenue Code (the "Notice of Determination"), regarding Mr. Farhy's liabilities for unpaid civil penalties imposed pursuant to section 6038. The Notice of Determination sustained the proposed collection action.

On June 9, 2021, Mr. Farhy timely filed a Petition with the Tax Court for a review of the determination. It was clear that, except for the assessment authority issue, the settlement officer conducting the Code §6330 hearing obtained verification from the I.R.S. that all requirements of applicable law and administrative procedure were met as required by Code §6330(c)(1).

The above recitation of facts strongly suggests that Mr. Farhy was undeserving. Yet, he won his case because he correctly parsed the words of the Internal Revenue Code regarding assessment of penalties.

Code §6038(b)(1) and (2) impose penalties. However, there is no statutory provision, in the Code or otherwise, specifically authorizing assessment of these penalties.

Code §6201(a) authorizes the Secretary of the Treasury to make assessments of all taxes (including interest, additional amounts, additions to tax, and assessable penalties) imposed by the Code. That grant of authority has been delegated to the Commissioner of Internal Revenue, and further delegated to other I.R.S. When a tax – including a deemed tax, such as an additional amount, addition to tax, assessable penalty, or interest – is assessed, the I.R.S. may take certain actions to collect the tax administratively. Examples follow:

- Under Code §6502(a), the I.R.S. is permitted to collect tax by levy. According to the I.R.S. website,[2] a levy is a legal seizure of a taxpayer's property to satisfy a tax debt. Levies are different from liens. A lien is a legal claim against property to secure payment of the tax debt, while a levy actually takes

[2] See here.

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the property to satisfy the tax debt. Code §6502(a) also provides a ten-year period of limitation for collection by a proceeding in court or by levy when a tax has been assessed.

- Code §6322 provides a lien arises when an assessment is made. The I.R.S. may immediately assess the tax determined by a taxpayer on his or her own return, as well as certain assessable penalties not otherwise subject to the Code's deficiency procedures. If deficiency procedures apply, a taxpayer has the right to seek a determination in Tax Court before an assessment of tax can be made. However, the term "assessable penalties" is left undefined. This raises the question regarding which penalties the I.R.S. may assess and ultimately collect through administrative means.

Agencies have only those powers given to them by Congress. On that basis, Mr. Farhy contended that the I.R.S. lacked authority to assess the penalty under Code §6038(b) because no law gives the I.R.S. authority to assess penalties under that provision. Assessment powers are not given to the I.R.S. under that section. Consequently, while the I.R.S. may be able to collect liabilities for these penalties through a civil action, the I.R.S. may not assess or administratively collect these penalties. The court accepted the argument and ruled in favor of Mr. Farhy.

Congress has explicitly authorized assessment with respect to myriad penalty provisions in the Code, but not for Code §6038(b) penalties. A non-tax provision of the U.S. Code, 28 U.S.C. § 2461 (Mode of Recovery), does so as well. Paragraph (a) of that section expressly provides as follows:

> Whenever a civil fine, penalty or pecuniary forfeiture is prescribed for the violation of an Act of Congress without specifying the mode of recovery or enforcement thereof, it may be recovered in a civil action."

In sum, the Code §6038(b) penalties at issue in the *Farhy* case are prescribed for the violation of the reporting obligations under Code §6038(a)(1) and (2). No mode of recovery or enforcement is specified for these penalties, unlike for myriad other penalties in the Code. Hence, the assessed penalties can be collected by a proceeding in District Court to obtain a judgment.

PATH FORWARD

In *Farhy v. Commr*., the court required the I.R.S. to collect penalties for a violation of U.S. tax law by commencing an action in U.S. District Court against the taxpayer. The immediate question is which other penalties imposed on taxpayers for the failure to timely file a required form may be collected only by a court hearing. To answer that question, a survey was made of pronouncements by various law or accounting firms. The survey was limited to an unscientific Google search of items published on the internet using the search term "Farhy tax court case." Only postings on the first page were used and only if the posting was in the form of a client alert. Here are excerpts of the published material.

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FGMK[3]

The IRS has relied on its "machines" to auto-generate and mail penalty notices for missed or late Form 5471 filings to taxpayers for many years. These "machines" were programmed to identify a missed or late filed Form 5471 (among other international centric forms) and auto-assess penalties under Section 6038. The Tax Court's ruling challenges the validity of the auto-assessments, not only to Form 5471, but other international tax forms as well (*e.g.*, Forms 5472, 8865, 8858).

Further, those who have paid these assessments may now seek recourse depending on the statute of limitations. It would not be surprising to see taxpayers facing such penalties argue, based on the reasoning in this ruling, that the Commissioner has no authority to collect the penalty without first filing a lawsuit. Thus, while the liability is not being absolved in the case, it would appear that the Tax Court is indicating that the IRS must take civil action and seek a resulting judgement to secure an amount a taxpayer owes.

* * *

How the IRS responds to the Tax Court's ruling is yet to be seen. The IRS may appeal or ask for reconsideration with the Tax Court. An appeal would be heard by the Circuit Court of Appeals for the District of Columbia. Alternatively, the IRS could file a Decision of Nonacquiescence concerning the ruling, indicating that it does not agree with the Tax Court's decision but will not pursue an appeal. The IRS could also let the ruling stand and seek a cure by way of Congressional intervention, something the IRS has had to do previously when a Tax Court case does not go its way. The legislative fix would likely have to include an amendment to Section 6038 or to some other statute that would expressly grant the IRS the authority to assess and collect the penalties in Section 6038(b) or in all of Subpart A. Any decisions made by the Commissioner will be in published guidance.

Skadden[4]

* * * This decision could affect a broad range of taxpayers and provide a basis for them to either challenge the automatic imposition of these and other penalties, including those under Sections 6038 and 6038A-D, or request refunds of such penalties previously imposed and paid.

* * *

Taxpayers should consider the impact of this decision on any penalties alleged by the I.R.S. under Sections 6038, 6038A, 6038B, 6038C or 6038D – including those that have been previously assessed and paid – and ensure that any resulting refund claims are filed within the appropriate statute of limitations.

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[3] See here.

[4] See here.

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Eisner Amper[5]

While not certain, the Farhy ruling may extend to the following other international information reporting penalties:

- Forms 5471 (for certain foreign corporations) under IRC 6038, 6038A and 6038C.
- Forms 5472 (for certain foreign-owned U.S. corporations) under IRC 6038A and 6038C.
- Forms 8865 (for transfers to certain foreign partnerships) under IRC S 6038 and 6038B.
- Forms 8858 (for certain foreign disregarded entities) under IRC 6038.
- Forms 926 (for certain transfers to foreign persons) under IRC 6038B.
- Forms 8938 (regarding foreign financial accounts) under IRC 6038D.
- Forms 8992 (US Shareholder GILTI calculation) under IRC 6038.
- Forms 3520 (for foreign gifts) under IRC 6039F.

In contrast, the Internal Revenue Code does provide statutory authority to assess penalties on the following international information returns and Farhy does not change the rule for these forms:

- Forms 3520 and 3520-A (for reportable events for foreign trusts) under IRC 6048, with penalties imposed under IRC Sec. 6677.
- Form 5471, Schedule O (for acquisitions and dispositions of an interest in a foreign corporation) under IRC 6046, with penalties imposed under IRC Sec. 6679.
- Form 8865 (for acquisitions or dispositions of an interest in a foreign partnership) under IRC 6046A, with penalties imposed under IRC Sec. 6679.

Procopio[6]

Based on the Tax Court's reasoning in Farhy, the IRS may also lack authority to assess civil penalties for failing to timely file other various international information returns (*e.g.*, Forms 3520, 5472, 8938, etc.). Each case, however, must be analyzed individually.

Time is of the essence (generally two years from when the penalty was paid) to request a refund of any penalties paid to the IRS.

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[5] See here.

[6] See here.

Please contact any member of Procopio's International Tax Group if you have further questions or need any assistance.

Olshan[7]

The Tax Court's holding in Farhy could be interpreted to mean that penalties under Section 6038(b), as well as similar penalties that the IRS is not specifically authorized to assess, are not subject to administrative collection actions, since the penalties should not have been assessed in the first place. Taxpayers who have paid penalties assessed pursuant to Section 6038(b) may consider the possibility of seeking a refund.

Greenberg Traurig[8]

It remains to be seen whether the IRS will appeal the Tax Court's decision in Farhy, but the decision likely will have widespread implications for thousands of taxpayers who are contesting or have paid I.R.C. § 6038 penalties. The decision may also have implications on other civil penalties where Congress has not prescribed the method of assessment, including penalties for failing to file Forms 8865, 5472, 8938 and 926. Farhy does not apply to penalties for failing to file Forms 3520 and 3520-A. It also remains to be seen whether this decision will apply to other civil penalties where Congress has not prescribed the method of assessment. Taxpayers who have paid I.R.C. § 6038 penalties may wish to consult with their tax advisor to determine whether they are eligible to file a claim for refund.

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7 See here.

8 See here.

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